

Part II

Background and evidence

3 The merger situation and the companies involved

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Introduction

3.1. This chapter deals with the events surrounding the merger and describes the parties involved, including the financial performance of Air Canada and CAC (the parent company of Canadian Airlines). The chapter also examines measures taken by the Canadian Government to increase competition in the provision of air services in Canada following the merger.

Events surrounding the merger

3.2. The merger is between Canada's two major airlines, Air Canada and Canadian Airlines, which took place after Canadian Airlines had experienced severe financial difficulties. Canadian Airlines was formed in the 1980s by the merger of six domestic airlines, including in 1989 Wardair, which was itself in financial difficulties. The acquisition of Wardair brought Canadian Airlines more closely into competition with Air Canada, which had been privatized in 1988. Whereas Canadian Airlines, through its roots, was stronger in western Canada, Air Canada was better represented in more densely populated eastern Canada. The companies are described in greater detail in paragraphs 3.23 to 3.54.

3.3. Over the past decade Canadian Airlines and Air Canada have competed in domestic and international markets. However, Canadian Airlines always perceived itself as having a disadvantage compared with Air Canada, mainly for historical reasons, in terms of the availability of capital, the age of its planes, its customer base, the strength of its FFP and the routes that it served. Furthermore the nature of Canada, as a large but sparsely-populated country, means that whilst communities are heavily reliant upon air travel, nonetheless the volume of air travel may not have justified the existence of two airlines providing a similar service at similar cost on largely overlapping networks. For its part, Air Canada often thought itself to be at a disadvantage to Canadian Airlines, which it perceived as enjoying greater political support and having greater coverage of Far Eastern routes.

3.4. The weakness of Canadian Airlines' position was demonstrated by the fact that over the past ten years CAC has only once recorded a profit. Two major attempts were made to remedy this situation, via a strategic alliance with AMR (the ultimate holding company of American Airlines) in 1994 and via a restructuring plan initiated in 1996. The alliance with AMR involved that company taking an equity stake in Canadian Airlines, as well as entering a services agreement and code-sharing arrangements. However, by the beginning of 1999 it was clear to the management of Canadian Airlines that, in the absence of a major initiative, the company would sooner or later run out of money. Hence Canadian Airlines needed to find a partner or new owner who would be prepared to inject new capital. The only alternative to this would have been for Canadian Airlines eventually to go bankrupt resulting in the liquidation of CAC's and Canadian Airlines' assets, in order to try to recover some value for the group's creditors.

3.5. In January 1999, Canadian Airlines initiated discussions with Air Canada concerning the possible merger of the two airlines but, without any prospect of substantial concessions by AMR and Canadian Airlines' creditors, Air Canada concluded that the merger would not be viable on terms that enhanced value for its shareholders. Accordingly the discussions were terminated. Air Canada then approached Canadian Airlines in June 1999 with an offer whereby Air Canada would have acquired Canadian Airlines' international air routes for approximately C\$2 billion (the international routes offer) and entered into an extensive code-sharing arrangement with Canadian Airlines. However, Canadian Airlines doubted whether its remaining domestic business would have been viable without the international routes.

3.6. On 13 August 1999 the Canadian Government issued an order (the Section 47 Order), as it was empowered to do under the terms of the Canada Transportation Act, permitting the Cabinet to take any steps necessary to deal with extraordinary disruptions to Canada's transportation system. The Cabinet agreed that there was a real possibility of such a disruption and decided to suspend certain provisions of the Competition Act for a period of 90 days from 13 August 1999.

3.7. The Canadian Government told us that, if Canadian Airlines had failed, in the short term it would almost certainly have caused considerable disruption to air travel in Canada, isolating some communities, and could also have meant up to 16,000 redundancies. That was not an acceptable option. The Government had two other choices: one would have been to support Canadian Airlines financially, as indeed it had done in the past. Apart from the cost to the taxpayer of this course and the political undesirability of renewed state involvement in the airline industry, there was no likelihood that such a measure would have been other than a temporary solution. The other choice was to foster some kind of merger between Canadian Airlines and Air Canada. In issuing the Section 47 Order the Government decided to adopt the latter choice, by removing the regulatory barriers to the loss of competition that would ensue.

3.8. To deal with this loss of competition the Minister of Transport set up a process to develop a Policy Framework for the Canadian airline industry. The Minister of Transport also sought the views of the Competition Bureau and the Canadian Transportation Agency, which respectively deal with competition matters and the regulation of airlines in Canada.

3.9. The international routes offer from Air Canada was rejected by Canadian Airlines on 20 August 1999. On 24 August 1999 Onex, through its subsidiary Airline Industry Revitalisation Co Inc (Airco), supported by AMR launched a hostile takeover bid for Air Canada (the Airco offer). The intention of Onex, which is a diversified leveraged buyout company, was to acquire both Air Canada and CAC in order to create a single Canadian airline, which would have been part of the Oneworld Alliance. This would have meant that Air Canada would have left the Star Alliance, of which it was and still is a member.

3.10. American Airlines, which is owned by AMR, is a member of the Oneworld Alliance, as also were Canadian Airlines and BA. AMR was in a position of some influence, both through its services agreement with Canadian Airlines, termination of which would have involved a large financial penalty, and its effective control of around 35 per cent of the equity capital of Canadian Airlines (although in accordance with Canadian law it controlled only 25 per cent of Canadian Airlines' voting capital).

3.11. On 26 October 1999 the Canadian Government published its Policy Framework document outlining its requirements in relation to any dominant carrier that might emerge from the ongoing

discussions between Air Canada and Canadian Airlines and setting up a procedure for reviewing any proposals that were put forward towards creating one. Four days earlier the Commissioner of Competition had published a series of recommendations for enhancing competition in the Canadian airline industry, in the event of a single dominant carrier being created.

3.12. The Airco offer was initially rejected by Air Canada on the basis, among other things, that it was inadequate. The Airco offer was subsequently revised increasing the amount being offered for Air Canada and varying the terms slightly. However, following a court case brought by Air Canada and others, the Quebec Superior Court ruled on 5 November 1999 that the Airco offer violated the terms of the Air Canada Public Participation Act (ACPPA), which limited any one shareholder in Air Canada to holding no more than 10 per cent of the company's voting shares.

3.13. Onex had hoped to overcome this barrier by initiating a change in the law, if it had obtained the agreement of Air Canada's shareholders. However, Air Canada launched a successful defence, which included a share buy-back proposal and a proposal to launch a bid itself for CAC. Following the court decision the Airco offer was withdrawn on 5 November 1999. Shortly after, on 11 November 1999, an offer to acquire CAC was made by a newly incorporated bidding vehicle called 853350 Alberta Ltd (the 853350 offer).

3.14. The 853350 offer valued CAC at C\$92 million, which was equal to the amount offered by Airco for CAC. The shares in 853350 were held as to 10 per cent by Air Canada and 90 per cent by Mr Paul Farrar, a Toronto businessman, and the bid was financed by Air Canada, supported by funds provided by United Airlines and Lufthansa, fellow members of the Star Alliance, and by Canadian Imperial Bank of Commerce.

3.15. CAC initially advised its shareholders to take no action, pending further communication from their board. The management of CAC then met members of the Oneworld Alliance in order to discuss with them a significant equity contribution to and operational restructuring of Canadian Airlines. Members of the alliance had an interest in preventing their Canadian feed traffic from falling into the hands of the Star Alliance. Two Oneworld Alliance members expressed an interest in participating in such a plan, but CAC admitted to us that it was not itself convinced that it could put together a plan which had a realistic chance of making the airline profitable. BA had previously offered to pay Canadian Airlines C\$75 million in return for taking over Canadian Airlines' operations between Toronto and London, together with the associated Heathrow and Toronto slots. However, in the absence of contributions from other Oneworld Alliance members, the board of CAC did not feel that these developments represented an alternative as attractive to CAC's shareholders as the offer from 853350. Accordingly on 4 December 1999 CAC's board recommended acceptance of the 853350 offer.

3.16. By an exchange of letters on 21 December 1999 Air Canada gave various undertakings to the Commissioner of Competition and the Minister of Transport designed to satisfy the concerns that they had raised. In response the Minister of Transport confirmed to Air Canada (subject to various qualifications) that the Government of Canada was prepared to permit the acquisition of CAC by Air Canada.

3.17. By the end of December 1999 Canadian Airlines was about to run out of cash. It was only able to continue operating as a result of a deal with Air Canada comprising a sale and leaseback of several unencumbered aircraft and a flight simulator and the disposal of its Toronto-Tokyo route (technically this required the Canadian Government to agree to transfer the code on the route from one airline to the other). This resulted in a cash injection of C\$45 million. At the end of December Air Canada also agreed with AMR terms acceptable to both parties allowing Canadian Airlines to be released from the contractual requirements of the services agreement between the two companies and for 853350 to acquire AMR's minority interest in Canadian Airlines. The 853350 offer was declared unconditional and was completed on 4 January 2000, at which date 853350 held approximately 82 per cent of CAC's shares.

3.18. Following the take-up of the CAC shares by 853350, CAC and Canadian Airlines applied to the Alberta Court of Queen's Bench (the Court) in order to seek protection from their creditors and, in cooperation with Air Canada, put forward a plan to reduce and reorganize the group's long-term debt and certain other liabilities. The plan also involved transferring the ownership of Canadian Airlines from CAC to 853350 in return for nominal consideration, leaving CAC with no significant assets. The plan was approved by the requisite majority of creditors on 26 May 2000, but was subject to further review by the Court as to its fairness and reasonableness. This was confirmed by an order of the Court on 27 June

2000, although one participant in CAC's unsecured bond issue has indicated that it will seek leave to appeal the order on 3 August 2000. In the meantime the transactions envisaged in the plan were implemented on 5 July 2000.

3.19. Air Canada had an option to acquire all or any of the shares in 853350 that it did not already own at a price of C\$1,000 a share (a maximum of nine shares implying a cost of C\$9,000). This option was exercisable within a period of 180 days beginning from the earlier of the date on which the restructuring of CAC's debt has been satisfactorily completed and 1 May 2001. On 5 July 2000 Air Canada exercised its option and thereby became the sole owner of 853350, which became the sole owner of Canadian Airlines. Air Canada claims that this makes it the eleventh largest airline in the world.

3.20. Since 4 January 2000, the commercial activities of Air Canada and Canadian Airlines had been based on the premise that the merger would ultimately occur. It was a condition of the 853350 offer that satisfactory arrangements be made to secure the resignation and replacement of the directors of CAC. This occurred, effectively giving Air Canada management control over CAC. The board of CAC consisted of eight directors, only one of whom was a director of CAC before the 853350 offer. Three of the directors were also directors or officers of Air Canada, one was a former employee of Air Canada and a fifth was Mr Farrar, the controlling shareholder in 853350. Steps taken by Air Canada and Canadian Airlines prior to the assumption of full control included coordinating route planning, code sharing and the integration or partial integration of various support and other functions, including each airline's FFP. By letter dated 6 January 2000 the Oneworld Alliance terminated Canadian Airlines' membership of the alliance with effect from 7 July 2000 at the latest and potentially from 1 June 2000.

3.21. On 17 February 2000 a bill, known as Bill C-26, was introduced in the Canadian Parliament in order to establish the domestic legal framework within which the new Air Canada would operate and to give the undertakings given by Air Canada to the Commissioner of Competition the force of law. Bill C-26 was brought into force on 5 July 2000 and its full and proper title is 'An Act to amend the Canada Transportation Act, the Competition Act, the Competition Tribunal Act and the Air Canada Public Participation Act and to amend another Act in consequence'. The undertakings secured from Air Canada by the Canadian Government and the Commissioner of Competition are described further in paragraphs 3.55 to 3.61.

3.22. The merger affects various routes between the UK and Canada operated or marketed by Canadian Airlines and Air Canada. Canadian Airlines also had code-sharing arrangements and prorating agreements with BA, which ceased on 25 March and 1 June 2000 respectively. The details of the UK routes primarily affected by the merger, all of which are also operated by Air Canada, are as follows:

- (a) *Heathrow-Toronto*. Canadian Airlines and BA both operated this route pursuant to a code-sharing agreement and a revenue-sharing agreement.
- (b) *Heathrow-Vancouver*. Canadian Airlines operated a summer-only service on this route, which supplemented BA's year-round service. Both airlines marketed each other's flights and code-shared on this route.
- (c) *Heathrow-Calgary*. BA and Canadian Airlines code-shared on this route which was operated by Canadian Airlines.
- (d) *Heathrow-Ottawa*. BA and Canadian Airlines code-shared on this route which was operated by Canadian Airlines.
- (e) *Heathrow-Montreal*. BA and Canadian Airlines code-shared on this route which was operated by BA.

The companies

3.23. Air Canada is a public company with its headquarters at Montreal, Quebec. Its shares are listed on the Toronto Stock Exchange and the NASDAQ stock market. As at 19 June 2000 its market capitalization was C\$2.3 billion (£1 billion). CAC is also a Canadian public company, based in Calgary,

Alberta, and its shares were listed on the Toronto, Vancouver and Alberta Stock Exchanges. Trading in CAC shares was suspended on 5 July 2000 and in due course the shares will be delisted.

3.24. The Canada Transportation Act imposes nationality-based restrictions on ownership of shares in airlines providing domestic and international services, which apply to both Air Canada and CAC. Non-Canadian shareholders in aggregate are restricted to owning not more than 25 per cent of the shares of an airline operating under such licences and, in the case of Air Canada, under the ACPA no one shareholder is allowed to own more than 10 per cent of the company's voting shares. A similar limit restricting a single shareholder in CAC from holding more than 10 per cent of the company's voting shares was removed at the request of its shareholders, prior to the involvement of AMR in 1994, by the Government amending the relevant legislation. The rules for CAC also apply to Canadian Airlines.

3.25. In the following paragraphs we consider the history, development and financial performance of Air Canada and CAC in turn.

Air Canada

3.26. Air Canada was established as Trans-Canada Airlines by an Act of the Canadian Parliament on 10 April 1937. Initially it was owned by Canadian National Railway Company, which was itself owned by the Canadian Government. The creation of the airline was intended to ensure the existence of a trans-continental and mainline air carrier in Canada. The airline was renamed Air Canada in 1965 and in 1977 legislation was enacted which transferred its ownership directly to the Government.

3.27. In October 1988, following further legislation and restructuring, the Government sold 43 per cent of its shares in Air Canada in a public offer for sale. The remaining 57 per cent of shares were sold to the public in July 1989. As noted in paragraph 3.24, there are restrictions on who can hold Air Canada's shares. As at 25 May 2000, 86.1 per cent of Air Canada's shares were held by Canadians. Approximately 80 per cent of its shares are held by institutions and the remainder are held mainly by private individuals and employees.

3.28. Air Canada operates air services under its own name and under the names of its regional airline subsidiaries, Air Ontario, Air Nova and Air BC (referred to collectively as Regional Airlines). Regional Airlines operate regional jet and turboprop aircraft on local routes. Air Canada has a combined fleet of some 240 aircraft operating around 1,200 daily flights. In 1999 it carried approximately 19.4 million passengers. Air Canada's main hub is at Toronto, Pearson airport. Three-quarters of total operating revenue is from passenger transportation. Other sources of revenue are from cargo services, maintenance, ground handling and other contract services, vacation tour packages and other miscellaneous products and services, such as Air Canada's FFP—Aeroplan.

3.29. Air Canada told us that in recent years it has pursued a strategy of selective growth. This has focused on providing added-value customer service, strengthening its global network through code-sharing relationships and opening up new international routes, investing in technology to improve service and efficiency and improving productivity. Air Canada's main aircraft fleet (excluding Regional Airlines) is relatively modern, with an average age of just over nine years. Air Canada told us that its acquisition of Canadian Airlines is not an objective it would have pursued in the absence of the circumstances surrounding the collapse of CAC.

Financial performance of Air Canada

3.30. Profit and loss accounts and balance sheets for Air Canada for the five years ended 31 December 1999 are set out in Appendices 3.1 and 3.2 respectively. Some of the more significant figures derived from the accounts, together with various measures of performance, are analysed in Table 3.1 and considered in the following paragraphs.

TABLE 3.1 Air Canada: profitability, 1995 to 1999

| | <i>C\$ million</i> | | | | |
|--|--------------------------------|--------|--------|--------|-----------------|
| | <i>Years ended 31 December</i> | | | | |
| | 1995 | 1996 | 1997 | 1998 | 1999 |
| Operating revenues | 4,507 | 4,880 | 5,572 | 5,932 | 6,509 |
| Operating income | 275 | 215 | 368 | 144 | 503 |
| Net income/(loss) before tax | 72 | 153 | 466 | (29) | 387 |
| Average capital employed | 2,467 | 2,547 | 2,544 | 2,593 | 2,672 |
| | | | | | <i>per cent</i> |
| Return on sales* | 6.1 | 4.4 | 6.6 | 2.4 | 7.7 |
| Return on average capital employed* | 11.1 | 8.4 | 14.5 | 5.6 | 18.8 |
| <i>Operating statistics†</i> | | | | | |
| Revenue passenger miles (m) | 16,747 | 20,596 | 22,788 | 23,211 | 24,242 |
| Available seat miles (m) | 26,578 | 29,431 | 32,061 | 32,719 | 33,970 |
| Passenger load factor (%) | 63.0 | 70.0 | 71.1 | 70.9 | 71.4 |
| Yield per revenue passenger mile (cents) | 18.0 | 16.4 | 17.5 | 18.8 | 19.8 |
| Yield per available seat mile (cents) | 11.4 | 11.5 | 12.5 | 13.3 | 14.1 |
| Operating cost per available seat mile (cents) | 10.5 | 10.8 | 11.4 | 13.0 | 12.8 |

Source: Air Canada published accounts.

*Based on operating income.

†Air Canada (excluding Regional Airlines).

3.31. Between 1995 and 1999 operating revenue increased by 44 per cent from C\$4.5 billion to C\$6.5 billion (around £2.9 billion at current exchange rates). By comparison available seat miles grew by 28 per cent over the period and revenue passenger miles by 45 per cent, reflecting a higher load factor. Yield per revenue passenger mile fell from 18.0 cents in 1995 to 16.4 cents in 1996, but rose each year thereafter to reach 19.8 cents in 1999.

3.32. Operating income fluctuated each year reaching a low of C\$144 million in 1998 and a high of C\$503 million in 1999 (around £220 million at current exchange rates). Air Canada's results in 1998 were adversely affected by a 13-day pilots' strike. Even so, operating income in 1999 at C\$503 million was Air Canada's highest ever and C\$109 million higher than 1998 figures adjusted for the effects of the strike. Profitability and yields generally increased all round in 1999 although the contribution from US transborder traffic increased significantly.

3.33. Return on sales and return on average capital employed also fluctuated each year in line with operating income. Return on sales reached a low of 2.4 per cent in 1998 and a high of 7.7 per cent in 1999, against a medium-term goal of 10 per cent. Return on average capital employed reached a low of 5.6 per cent in 1998 and a high of 18.8 per cent in 1999.

3.34. Table 3.2 shows Air Canada's operating revenue from passenger transportation analysed between different destinations, namely: domestic, Canada-US transborder and other international routes.

TABLE 3.2 Air Canada: analysis of passenger operating revenue by destination

| | <i>Year ended 31 December 1999</i> | |
|-----------------------|--|-------------|
| | <i>C\$m</i> | <i>%</i> |
| Domestic | 2,510 | 45.5 |
| Canada-US transborder | 1,671 | 30.3 |
| Other international | <u>1,339</u> | <u>24.2</u> |
| | 5,520 | 100.0 |

Source: Air Canada published accounts.

3.35. Approximately one-quarter of Air Canada's passenger transportation revenue in 1999 was earned from international routes. This compares with roughly three-quarters of all its cargo transportation revenue.

3.36. Table 3.3 shows Air Canada's revenue and contribution to profits for routes between Canada and the UK by major route grouping (MRG). The figures are leg based and include revenue and profit attributed to the sector between Canada and the UK only. Contribution to profits is arrived at after deducting variable costs but before any aircraft ownership and overhead costs. Three MRGs are shown:

- (a) Atlantic Canada–UK comprises routes from Halifax and St John's, Newfoundland to Heathrow.
- (b) East Canada–UK comprises routes from Montreal, Toronto and Ottawa to Heathrow and (in the case of Toronto) to Manchester and Glasgow.
- (c) West Canada–UK comprises routes from Vancouver and Calgary to Heathrow.

TABLE 3.3 Air Canada: analysis of revenue and contribution to profits on Canada–UK routes by MRG

| | Year ended 31 December 1999 | | |
|--------------------|---|----------------------|-------------|
| | Revenue C\$m | Contribution C\$m | Margin % |
| Atlantic Canada–UK | <div style="display: flex; align-items: center; justify-content: center;"> <div style="font-size: 4em; margin-right: 10px;">[</div> <div style="text-align: center;"> <p><i>Figures omitted.</i></p> <p><i>See note on page iv.</i></p> </div> <div style="font-size: 4em; margin-left: 10px;">]</div> </div> | | |
| East Canada–UK | | | |
| West Canada–UK | | | |

Source: Air Canada internal accounts.

3.37. It is clear from Table 3.3 that the vast majority of revenue in 1999 was earned on routes from East Canada to the UK. This is because of the overwhelming importance of Toronto as an origin/destination for passengers flying between Canada and the UK and because Toronto is Air Canada's principal hub. The average contribution margin for Air Canada in 1999 (excluding Regional Airlines) was [38] per cent, compared with [28] per cent for all Canada–UK routes. Similarly the yield per passenger revenue mile for all Canada–UK flights in 1999 was [38] cents per mile, compared with the average for the whole of Air Canada (excluding Regional Airlines) of [28] cents per mile. In general yields on domestic and transborder routes were higher than on international routes, because the pricing structure reflected higher variable costs per mile flown on such routes and because the traffic mix had a higher component of business travellers.

CAC

3.38. CAC was incorporated in 1956 as PWA Corporation (PWAC) and it operated a small regional airline in western Canada called Pacific Western Airlines (PWA). In the 1980s considerable consolidation occurred in the Canadian airline industry. Canadian Airlines was formed out of a series of mergers involving PWA, Canadian Pacific Air Lines, Nordair, Eastern Provincial Airways and Transair. The merged airline was launched under the new name of Canadian Airlines International Limited in 1987, although it retained the CP flight code of Canadian Pacific Air Lines. Subsequently in 1989 Canadian Airlines acquired control of Wardair.

3.39. However, Canadian Airlines faced a number of problems. The cost of its acquisitions, some of which like Wardair were loss-making, meant that the company was under-capitalized. It faced strong competition in most of its markets from Air Canada, which had been privatized in 1988. It needed to compete with Air Canada on internal domestic routes in order to provide the feed traffic for its international routes, yet these routes were often unprofitable. Air Canada on the other hand had a healthier balance sheet, a more sustainable debt structure and a newer fleet of aircraft. It was strong in

the more populous eastern part of Canada and attracted a greater proportion of business and first class passengers than did Canadian Airlines. By 1992 Canadian Airlines was in severe financial difficulties.

3.40. Canadian Airlines was rescued by AMR, which is the parent company of American Airlines. In 1994 AMR made a C\$246 million equity investment in Canadian Airlines, in the form of convertible redeemable preferred shares. If converted at 31 December 1999 these shares would have given AMR a 35 per cent equity interest in Canadian Airlines (but control over only 25 per cent of the voting capital, in accordance with Canadian law). In return Canadian Airlines agreed to exit from Gemini, which was Canadian Airlines and Air Canada's joint reservation system, and switch to using American Airlines' reservations system called Sabre instead. Canadian Airlines also adopted other American Airlines operations technology. In addition Canadian Airlines and American Airlines entered into joint code-sharing, marketing and promotional arrangements, including participation in each other's FFP, and American Airlines was entitled to appoint two directors to Canadian Airlines' board.

3.41. In 1995 PWAC changed its name to Canadian Airlines Corporation. However, despite AMR's investment, by 1996 Canadian Airlines and CAC were once more in severe financial difficulties. CAC was not even making an operating profit. Accordingly the board of CAC identified that the group's problem was greater than just a high burden of debt. Their initial response was to make some changes to Canadian Airlines' network, having identified perennially poor-performing routes. This included ceasing to fly to Paris and Frankfurt, entering code-sharing and revenue-sharing agreements with BA, so as to improve services to the UK market and make use of Heathrow as a gateway for European traffic, and making greater use of American Airlines' hubs.

3.42. In addition on 1 November 1996 Canadian Airlines unveiled an Operational Restructuring Plan. This was intended to address the longer-term question of profitability by achieving C\$180 million of cost savings every year for four years. Of this amount, C\$70 million was attributable to reductions in employee costs and from fuel tax rebates, C\$70 million was from reduced overheads, including a reduction of C\$48 million in the annual fee paid to AMR, and C\$60 million was to be derived from network improvements. This was offset by an anticipated annual increase in fuel costs of C\$20 million. In order to create a cash 'bridge' while the plan took effect, Canadian Airlines unilaterally instituted a moratorium on debt repayments and entered into negotiations with individual creditors.

3.43. Although CAC made a small profit in 1997 Canadian Airlines was badly affected by the Asian economic crisis in 1998 and early 1999. This hit the airline hard, since Canada-Asia routes accounted for approximately 30 per cent of its total capacity, and so by the beginning of 1999 Canadian Airlines and CAC were once more in financial trouble.

3.44. CAC had two main operating subsidiaries, Canadian Airlines and CRAL. Through these subsidiary companies and related service and support companies it operated scheduled and chartered air passenger and cargo services from and within Canada. In addition to its core services Canadian Airlines also provided a number of other services to third parties related to its airline operations, such as aircraft overhaul and maintenance services, passenger and cargo handling services, training programmes and the sale of points on its FFP—Canadian Plus. In 1999 Canadian Airlines and CRAL combined had approximately 137 aircraft and carried 11.2 million passengers. The average age of Canadian Airlines' fleet of 82 aircraft is 15.6 years.

3.45. Canadian Airlines' main hub is at Vancouver and it has historically held a large share of the Canada-Asia market (around 40 per cent in 1999). According to CAC's Annual Information Form dated 18 May 2000 (ie some four months after Air Canada took effective control of CAC), Canadian Airlines directly served 39 destinations in 12 countries, including around 10 domestic destinations and 17 transborder destinations in the USA. Its main international destinations comprised London Heathrow, Beijing, Hong Kong, Honolulu, Nagoya, Taipei, Tokyo, Mexico City, Milan and Sao Paulo. Canadian Airlines' network is extended through code-share alliances, including alliances with Air Canada (since 4 January 2000) and American Airlines, to approximately 245 destinations worldwide. Canadian Airlines also operated ad hoc charter services. As at 31 December 1999 CRAL served 37 destinations in Canada and two in the USA (using small jet and turboprop aircraft), as well as providing a small number of charter services.

Financial performance of CAC

3.46. Profit and loss accounts and balance sheets for CAC for the five years ended 31 December 1999 are set out in Appendices 3.3 and 3.4 respectively. Some of the more significant figures derived from the accounts, together with various measures of performance, are analysed in Table 3.4 and considered in the following paragraphs.

TABLE 3.4 CAC: profitability, 1995 to 1999

| | C\$ million | | | | |
|--|-------------------------|---------|---------|---------|-----------------|
| | Years ended 31 December | | | | |
| | 1995 | 1996 | 1997 | 1998 | 1999 |
| Operating revenues | 3,140.6 | 3,096.4 | 3,075.5 | 3,171.3 | 3,263.0 |
| Trading income/(loss) | (26.7) | (94.1) | 97.1 | (21.8) | (141.9) |
| Operating income/(loss) | (74.8) | (100.5) | 97.1 | (21.8) | (141.9) |
| Net income/(loss) before tax | (193.3) | (185.4) | 7.2 | (135.3) | (220.7) |
| Average capital employed | 1,214.1 | 913.1 | 768.3 | 651.8 | 445.0 |
| | | | | | <i>per cent</i> |
| Return on sales* | (0.9) | (3.0) | 3.2 | (0.7) | (4.3) |
| Return on average capital employed* | (2.2) | (10.3) | 12.6 | (3.3) | (31.9) |
| <i>Operating statistics†</i> | | | | | |
| Revenue passenger miles (m) | 15,439 | 16,145 | 16,022 | 16,695 | 16,595 |
| Available seat miles (m) | 22,340 | 22,726 | 22,051 | 23,217 | 23,326 |
| Passenger load factor (%) | 69.1 | 71.0 | 72.7 | 71.9 | 71.1 |
| Yield per revenue passenger mile (cents) | 14.8 | 14.0 | 13.9 | 13.5 | 14.0 |
| Yield per available seat mile (cents) | 10.2 | 10.0 | 10.1 | 9.7 | 9.9 |
| Operating cost per available seat mile (cents) | 12.0 | 11.9 | 11.4 | 11.3 | 12.2 |

Source: CAC published accounts and Annual Information Form.

*Based on trading income/(loss).

†Canadian Airlines only (excluding CRAL).

3.47. Between 1995 and 1997 operating revenue declined slightly from around C\$3.1 billion, before increasing by around 6 per cent from 1997 to 1999 to C\$3.3 billion (around £1.5 billion at current exchange rates). By comparison available seat miles grew by 5.8 per cent over the three-year period from 1997 to 1999 and revenue passenger miles grew by 3.6 per cent, resulting in a slightly lower load factor. Yield per revenue passenger mile fell each year from 1995 to 1998 from 14.8 cents to 13.5 cents, before increasing to 14.0 cents in 1999.

3.48. Trading income/(loss) represents operating income/(loss) before deducting restructuring charges. In the five-year period under review CAC only made a trading profit once and that was in 1997. Trading losses varied from C\$21.8 million in 1998 to C\$141.9 million (around £64 million at current exchange rates) in 1999, which led to the demise of CAC as an independent company. As noted in paragraph 3.47, yield per passenger revenue mile declined between 1995 and 1998, although it rose slightly in 1999 to 14.0 cents, but this was still well below Air Canada's level of 19.8 cents.

3.49. The persistent incidence of losses (excepting a small overall profit in 1997), without any injection of new funds, meant that average capital employed fell dramatically from C\$1.2 billion in 1995 to just C\$0.4 billion in 1999, a fall of 63 per cent. In addition to almost C\$1.1 billion long-term debt and preferred shares shown in CAC's balance sheet, CAC had contracted with AMR to acquire certain support and information services from it for 20 years from 1994. The outstanding commitment under this contract at 31 December 1999 was around C\$2.4 billion.

3.50. With the exception of 1997, returns on sales and returns on average capital employed between 1995 and 1999 were negative. In 1999 they fell to negative figures of 4.3 per cent and 31.9 per cent respectively, thereby eliminating almost a third of CAC's capital base.

3.51. Table 3.5 shows Canadian Airlines and CRAL's operating revenue from passenger transportation analysed between different destinations, namely: domestic, Canada-US, transborder and other international routes.

TABLE 3.5 CAC: analysis of passenger operating revenue by destination

| Year ended 31 December 1999 | | | | |
|-----------------------------|---------------------------------------|----------------------|-----------------------|--------------------|
| | <i>Canadian Airlines C\$m</i> | <i>CRAL C\$m</i> | <i>Total C\$m</i> | <i>Total %</i> |
| Domestic | 897.4 | 458.4 | 1,355.8 | 48.1 |
| Canada-US transborder | 334.1 | 42.1 | 376.2 | 13.3 |
| Other international | 1,030.5 | - | 1,030.5 | 36.5 |
| Charter | 55.4 | 2.9 | 58.3 | 2.1 |
| Inter-company transfer | <u>(44.0)</u> | <u>44.0</u> | <u>-</u> | <u>-</u> |
| | 2,273.4 | 547.4 | 2,820.8 | 100.0 |

Source: CAC published accounts.

3.52. Approximately one-third of CAC's passenger transportation revenues in 1999 were earned from international routes (excluding transborder routes) and almost half were derived from domestic routes (similar to Air Canada). Of the trading loss of C\$141.9 million in 1999, C\$165.6 million was attributable to Canadian Airlines, whereas CRAL made a trading profit of C\$23.7 million.

3.53. Table 3.6 shows CAC's revenues and profits on its operations between Canada and the UK between 1997 and 1999.

TABLE 3.6 CAC: analysis of revenue and profits on Canada-UK routes

| | <i>C\$ million</i> | | |
|----------------------------|--|------|------|
| | <i>Years ended 31 December</i> | | |
| | 1997 | 1998 | 1999 |
| Passenger revenue | <div style="font-size: 4em; display: inline-block; vertical-align: middle;">(</div> <i>Figures omitted. See note on page iv.</i> <div style="font-size: 4em; display: inline-block; vertical-align: middle;">)</div> | | |
| Cargo revenue | | | |
| Other revenue | | | |
| Variable expenses | <div style="font-size: 4em; display: inline-block; vertical-align: middle;">(</div> <i>Figures omitted. See note on page iv.</i> <div style="font-size: 4em; display: inline-block; vertical-align: middle;">)</div> | | |
| Contribution | | | |
| Aircraft ownership expense | | | |
| Fixed expenses allocated | | | |
| Fully allocated earnings | <div style="font-size: 4em; display: inline-block; vertical-align: middle;">)</div> | | |
| | | | |
| | <i>per cent</i> | | |
| Contribution margin | [| ⌘ |] |

Source: Canadian Airlines internal accounts.

3.54. Canadian Airlines told us that prior to the code-sharing arrangement with BA in 1996 its UK routes were not profitable. However, between 1997 and 1999 revenues grew by [⌘] per cent from C\$[⌘] million to C\$[⌘] million. Over the same period the contribution to profits increased by [⌘] per cent from C\$[⌘] million to C\$[⌘] million. The contribution margin fell from [⌘] per cent in 1997 to [⌘] per cent in 1999. This compares with a margin of [⌘] per cent for Air Canada's UK routes in 1999, although the inclusion of slightly different revenues and costs in the calculation for each company means that the two ratios are not entirely comparable.

Measures taken by the Canadian Government

3.55. As described in paragraphs 3.6 to 3.8, 3.11 and 3.16, the Canadian Government and the Commissioner of Competition had been closely monitoring the events surrounding the proposed merger of Air Canada and CAC. As a result of this Air Canada gave certain undertakings to the Commissioner of Competition and the Minister of Transport in letters dated 21 December 1999. During our inquiry the Canadian Government was in the process of passing an Act of Parliament, Bill C-26, which (among other things) was intended to make these undertakings legally enforceable. However, notwithstanding that, Air Canada irrevocably consented to accept the enforceability of its undertakings to the Commissioner of Competition, if necessary through the means of an order of the Competition Tribunal.

Undertakings to the Canadian Commissioner of Competition

3.56. The undertakings to the Commissioner of Competition were given jointly by Air Canada and 853350, although in practice it is primarily Air Canada that is responsible for implementing them, in view of the degree of control which it has exercised over 853350 and CAC since 4 January 2000. The undertakings are generally intended to apply for a period of seven years from the date that 853350 acquired CAC (ie from 4 January 2000). However, certain undertakings are intended to apply for a shorter timescale. The undertakings are reproduced in full in Appendix 3.5. The following is a summary of the principal features and purpose of the undertakings:

- (a) Air Canada gave undertakings related to majority-in-interest rights over the collection of airport improvement fees at Canadian airports excluding Toronto (Pearson), Vancouver, Montreal (Dorval), Montreal (Mirabel) and Calgary. These rights allow carriers with over two-thirds of the volume of passengers at some airports to delay expansion plans, including plans for new gates and terminals. The undertaking increased the required proportion to 80 per cent, thereby making it slightly harder for Air Canada to hinder the construction of new facilities for potential competitors.
- (b) Air Canada agreed to use its best efforts at certain Canadian airports to convert the cost allocation formula for airport services from the 'Chicago Formula' to a formula based entirely on passenger volumes. The 'Chicago Formula' allocates the first 20 per cent of costs equally among all airlines at an airport and the remaining 80 per cent on the basis of passenger volumes. The undertaking would therefore remove a cost advantage enjoyed by Air Canada over smaller competitors at these airports, which, however, do not include Toronto, Vancouver, Montreal (Dorval), Montreal (Mirabel), Calgary, Edmonton, Ottawa, Halifax and Winnipeg.
- (c) Air Canada undertook (for a period of three years) to make available for sale at fair value to other Canadian air carriers any aircraft that were surplus to its and CAC's requirements and to give such carriers the option to match any offer made by a non-Canadian carrier to acquire one of its planes. This should benefit domestic carriers wishing to compete with Air Canada by giving them immediate access to relevant aircraft at market prices.
- (d) Air Canada agreed (for a period of five years from 1 June 2000) to vary the terms of its override commissions. These are in effect bonus commissions on top of base commissions, which are used as incentives to Canadian-based IATA travel agents that qualify for such overrides. Air Canada gave two undertakings:
 - (i) not to impose eligibility requirements for the payment of override commissions based on the revenue performance for domestic business, but based solely on transborder and international route revenues; and
 - (ii) to pay override commissions to agents in respect of domestic services based on a straight-line percentage applied to domestic revenue volumes and not based on domestic market share targets.

The regime that Air Canada has introduced provides for override commissions on domestic revenue volumes at straight-line percentage rates between 0 and 4 per cent, depending on eligibility criteria based on market share and revenue growth of international and transborder business, as permitted in the undertaking. This undertaking is designed to reduce the incentive

for travel agents to sell an Air Canada ticket on a domestic route. However, the override commission structure introduced may well increase the incentive for travel agents to sell an Air Canada ticket on an international or transborder route.

- (e) Air Canada agreed to sell points from its FFP (Aeroplan) at a reasonable price to other Canadian air carriers (subject to certain conditions) for a period of five years from 1 October 2000 at the latest. This should reduce an arguable barrier to entry by allowing small carriers to offer Aeroplan points to their customers. Points are more attractive to customers the greater scope there is for earning and redeeming them. Hence small operators offering their own plan points have a disadvantage compared with large operators.
- (f) Air Canada undertook to make available (by entering into arrangements with airport operators), for a period of one year, a quarter of CAC's ticket and check-in counters at Canadian airports (excluding Toronto, Pearson) where Air Canada and CAC held more than 60 per cent of such facilities. These would then become available for use by other airline operators. In addition, Air Canada agreed to relinquish a number of gates at selected Canadian airports, for the same purpose. This should benefit small Canadian air carriers wishing to expand their operations.
- (g) Air Canada committed itself to enter into interlining agreements with other Canadian air carriers in accordance with IATA standards and to negotiate Joint Fare arrangements (ie prorates) with them on commercially reasonable terms. This should make it easier for a small operator in the Canadian domestic market to offer a comprehensive network service beyond its own niche market.
- (h) Air Canada agreed to delay until September 2000 the introduction of its proposed low-cost domestic airline in eastern Canada pending the possible commencement of such a service by any other Canadian air carrier (other than WestJet). If such a competing airline did commence operations the prohibition on Air Canada would be extended by a year. Air Canada is not, however, prohibited from establishing a low-cost airline operating western Canada, transborder or international services. This undertaking is designed to encourage competition to Air Canada in the Canadian domestic market.
- (i) Air Canada undertook to give up a number of slots at Toronto, Pearson airport, to any Canadian air carrier wanting such slots. The number of slots to be given up varied depending on whether CRAL was sold (see (j)). If CRAL were sold, the number of slots to be given up would be 8 between 7.00 and 9.00 am and 20 between 3.00 and 8.00 pm (with a minimum of two slots per hour). If on the other hand CRAL were not sold, the number of slots to be given up would be 12 between 7.00 and 9.00 am and 30 between 3.00 and 8.00 pm (with a minimum of three slots per hour). The mechanism for the slots to be given up would mean that they would be returned to the slot coordinator by Air Canada in the event that another Canadian air carrier requested them. This undertaking is designed to increase the availability of slots at Toronto, Pearson, which are restricted at certain times of day, in order to benefit Canadian air carriers wishing to compete with Air Canada. The Commissioner of Competition agreed to the retention of more slots by Air Canada in the event that CRAL is sold in order to strengthen Air Canada's ability to compete with US carriers for transborder traffic and also to minimize disruption to Air Canada resulting from the loss of CRAL's feed traffic.
- (j) Air Canada agreed to offer CRAL (CAC's regional airline subsidiary) for sale at or above its fair market value for a period of 60 days. In the event that no bids are received at or above the fair market value, then Air Canada is entitled to retain CRAL. The sale does not include CRAL's slots during peak hours (7.00 to 9.00 am and 3.00 to 8.00 pm) at Toronto, Pearson, which are dealt with by a separate undertaking. This is a further measure designed to increase competition in the domestic Canadian market for air travel.

Undertakings to the Minister of Transport and his response

3.57. In its letter dated 21 December 1999 to the Canadian Minister of Transport, Air Canada also gave commitments in respect of redundancies and services to small communities. These were as follows:

- (a) Air Canada undertook that, for a period of two years, there would be no involuntary redundancies or relocation of unionized employees of Air Canada or Canadian Airlines or their wholly-owned subsidiaries as a result of the merger.
- (b) Air Canada also undertook that, for a period of three years, the domestic service to any Canadian community currently receiving domestic service from Canadian Airlines, Air Canada or any of their wholly-owned subsidiaries would continue to be provided by any them.

3.58. In his reply, also dated 21 December 1999, the Canadian Minister of Transport confirmed that the Government was prepared to allow the merger to proceed and that legislation would be introduced to approve it retrospectively. This legislation would also incorporate Air Canada's transportation commitments and competition commitments in the law so as to make them enforceable.

3.59. The Minister of Transport stated in the same letter that, with immediate effect, large international country markets (ie those exceeding the 300,000 annual scheduled passenger threshold, which includes the UK) would become open for designation to any Canadian airline wishing to operate a scheduled service. Prior to that it had been Canadian Government policy to allow no more than two Canadian scheduled carriers to operate in any international country market (and below the 300,000 passenger threshold no more than one). One consequence of the review of policy regarding scheduled services has been that three Canadian former charter carriers operating to Gatwick (and certain other UK destinations), namely Air Transat AT Inc (Air Transat), Canada 3000 Airlines Limited (Canada 3000) and Royal Airlines, have been granted permission to operate scheduled services between Canada and the UK.

3.60. The Minister of Transport also proposed to review and liberalize Canada's air charter policy (this was done in April 2000) and, after a period of one year, Canada's international air policy governing scheduled air services.

3.61. In addition the Minister of Transport said that the Government intended in its legislation to deal with a number of elements highlighted in its Policy Framework document, including a merger review process for air transportation undertakings, pricing and predatory behaviour and notice of exit provisions, to complement Air Canada's commitments on service to small communities.

Bill C-26

3.62. As well as making enforceable the undertakings given by Air Canada to the Commissioner of Competition, the provisions of Bill C-26 (draft dated 15 May 2000) deal with a number of matters including the rules governing ownership of Air Canada, anti-competitive acts by a person operating a domestic airline, the denial by such a person of access or refusal to supply on commercially reasonable terms facilities or services essential to the operation of an air service by another carrier, and cease and desist orders relating to anti-competitive acts.

3.63. The Canadian Government has amended, via Clause 17 of Bill C-26, the rules governing the ownership of Air Canada. The changes allow an increased maximum holding of 15 per cent (formerly 10 per cent) for any one individual or organization and allow the Canadian Government to make an order increasing the foreign ownership limit above 25 per cent if it so wishes.

3.64. Clause 13 of Bill C-26 amends the Competition Act by adding two new acts specifically relating to domestic airlines to the non-exhaustive list of anti-competitive acts or conduct applicable to the provisions regarding abuse of dominant positions. The additions are in two sub-clauses:

- (a) The first empowers the Governor in Council to specify in respect of a domestic airline any new anti-competitive acts or conduct.
- (b) The second adds 'the denial by a person operating a domestic airline ... of access on reasonable commercial terms to facilities or services that are essential to the operation in a market of an air service ... or refusal by such a person to supply such facilities or services on such terms'.

3.65. The 8 July 2000 draft regulations to Bill C-26, which are set out in Appendix 3.6, define a number of anti-competitive acts and also define 'essential facilities'. The definition of essential facilities specifically mentions interline arrangements.

3.66. Clause 15 of Bill C-26 empowers the Commissioner of Competition to make a temporary order requiring a person operating a domestic air service to cease anti-competitive acts or to take steps necessary to prevent injury to competition.