4 The relevant markets

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Introduction

4.1. In this chapter, we describe how air services are regulated and the way in which airport capacity constrains services. Air services regulation is examined on a worldwide basis and in relation to Canada and the UK, bearing in mind the European dimension in the latter case. We then move on to describe the market for air services between Canada and the UK, and how this market can be segregated according to different types of travel and passenger. We look at competition in these different markets and how it has been and will be affected by the takeover of CAC by 853350 and the resulting merger of Canadian Airlines with Air Canada.

The regulation of air transport

International regulation

4.2. Air transport between countries is regulated by a framework of bilateral ASAs between governments. The ASAs often involve complicated government controls, within which scheduled airlines compete. They are based on the principle of a country's sovereignty over its airspace and, by extension, its right to decide who may operate air services to, from and within its territory. The framework within which air service operations are undertaken is that of the Chicago Convention, of December 1944, which establishes five 'freedoms of the air', specifying degrees to which carriers may be allowed to operate in a country's airspace. The UK, Canada and most other countries are parties to the Convention. The five freedoms are listed here, along with three further ones, which have been defined as the world air industry has developed since the Chicago Convention. Fuller details of all of them are given in Appendix 4.1.

First freedom:	The right to fly through a country's airspace without landing.
Second freedom:	The right for a foreign carrier to land in a country, but not for revenue-gaining reasons, ie without taking on or letting off passengers.
Third freedom:	The right for a foreign carrier to disembark passengers who have boarded in the carrier's home country.
Fourth freedom:	The right for a foreign carrier to take aboard passengers destined for its own country of origin.

Fifth freedom:	Under this freedom, a carrier can, on a service originating in its own country, pick up passengers in the grantor country, who are destined for a third country. Conversely, the carrier can pick up passengers in a third country, destined for the grantor country, on a service terminating in the carrier's own country.
Sixth freedom:	The right to fly into the territory of the grantor state and embark or disembark passengers for or from the carrier's own state, who are subsequently carried to (or who have originated from) a third state on a different service.
Seventh freedom:	The right of a carrier from one state to operate a service outside this country, between two other states.
Eighth freedom:	Also known as 'cabotage', this freedom confers the right for a carrier to operate domestic air services within the territory of another state.

Air services agreements

4.3. Outside the European Economic Area (EEA), that is the 15 EC countries plus Iceland, Norway and Liechtenstein, international air transport is regulated by ASAs, which usually require the airlines operating under these agreements to be owned and controlled by nationals of the countries involved. These agreements vary in their permissiveness, covering such matters as route rights and third-country traffic, numbers of carriers permitted on routes, service capacity and frequency, fares approvals, security and dispute resolution procedures. In the UK, the Department of the Environment, Transport and the Regions (DETR) is responsible for negotiating ASAs with states outside the EEA. Most of the provisions of bilateral ASAs between EEA states have been superseded by the creation of the single market in air services (see paragraph 4.15). Within the EEA, this single aviation market enjoys complete liberty of operation, including cabotage.

4.4. The ASA between the UK and Canada has no restrictions on the numbers of carriers, on the routes flown, or on the frequency of services on these routes, although the usual ownership conditions apply and cabotage operations are not permitted. In addition to the ASA between the two countries, there is also a Memorandum of Understanding relating to charter air services, another common practice in bilateral arrangements. This memorandum covers matters such as the latest dates for advance sales and minimum numbers of seats which can be chartered in such operations.

Fares in the UK–Canada air services agreement

4.5. The ASA deals with fare-setting in two ways. First, Article 13 requires airlines to file their fares with the authorities of both countries, generally 30 days in advance of their becoming operational, and the application of these fares must be approved by both sides (double approval). Secondly, the agreement specifies a collection of 'agreed' routes between the two countries, detailed in Table 4.1. On these routes, only single approval (by one government) is required for fares, providing that the levels set are 60 per cent or more of a predetermined reference fare for each route. If the fare concerned is less than 60 per cent of the reference fare, it must generally be subject to 'Apex' conditions such as advance booking, with a minimum stay and a return leg. Exceptions to these conditions are made for seasonal promotions, subject to another set of conditions.

TABLE 4.1 **'Agreed' routes between Canada and the UK, as specified in the UK–Canada ASA**

City	*Agreed routes*
Edmonton	London, Manchester
Hamilton	London
Halifax	London, Prestwick
Montreal	London
Ottawa	London
Gander	London
Toronto	London, Prestwick, Manchester, Birmingham, Cardiff, Newcastle, Leeds/Bradford
Vancouver	London, Prestwick, Manchester
Winnipeg	London
Calgary	London, Prestwick, Manchester
St John's	London

Source: CAA.

4.6. The CAA, the UK air services regulator, informed us that the UK is more liberal than Canada in applying the fare-setting terms of the UK–Canada ASA. For example, the minimum notice and agreed-route conditions are not applied, and fares on these routes are only refused if they are regarded as predatory or excessive. On non-'agreed' UK–Canada routes (ie those not in Table 4.1), the UK applies its own fares guidelines to all airlines, the most important of which deals with the 'sum of sectors' condition. This requires any fare on a route which is not directly served to be constructed as the sum of an approved fare on an 'agreed' route (in the UK–Canada case, this would be the transatlantic part) and the published fare on the domestic sector (the journey leg(s) within the UK or Canada).

4.7. The CAA believes that international aviation should be put on the same footing as other industries, as has been the case in the context of the single market in aviation within the EEA since 1993 (see paragraph 4.15). For the UK–Canada ASA, this would mean further liberalization in terms of lowering the existing barriers to entry, by removing ownership and control rules and allowing cabotage. Such measures would, of course, have to be the subject of agreement between the two Governments.

Canadian civil aviation regulation

4.8. Until the recent restructuring activity, Canada regulated its airline industry in a precise and protective fashion. The maximum number of Canadian carriers allowed to operate on individual international routes was two, one of which was permitted to operate only after the country market had reached a threshold of 300,000 passengers a year. The Canadian Government informed us that this approach was to a large extent taken because of the financial frailty of the second operator, Canadian Airlines, as the Government wished to maintain competition within the Canadian air services industry. With the financial difficulties of Canadian Airlines, and the ensuing restructuring of the industry in Canada, the Government is now trying to expand the number of designated Canadian carriers on its busiest international routes as soon as is feasible, and indeed has already done so for some European destinations with, for example, the designation of the former charter airlines, Canada 3000, Air Transat and Royal Airlines, as scheduled operators on Canada–UK routes. Apart from this measure attempting to strengthen air services in international markets, recent Canadian regulatory activity has been addressed to the domestic situation created by the failure of Canadian Airlines and the merger with Air Canada. The main focus of this regulatory change has been the new legislation,[1] recently passed by the Canadian Parliament (Act C-26—see paragraph 4.11).

4.9. Until the recent legislation, the laws governing the ownership of air carriers in Canada were similarly precise and protective. The Canada Transportation Act limited non-Canadians to owning a maximum total of 25 per cent of the voting shares of any Canadian air carrier, and also required that 'effective control' of the airline must rest with Canadians. In addition to this, following the privatization of Air Canada in 1988, the ACPPA decreed that no individual or single organization could control more

[1]Bill C-26, received Royal Consent on 29 June 2000 and its full 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.*

than 10 per cent of Air Canada's voting shares. Prior to the current takeover of Canadian Airlines, a bid to purchase the shares of both CAC and Air Canada fell foul of this law. There are, however, changes in, or provisions for altering, the two thresholds in the new Act C-26 (see paragraph 4.11).

4.10. In the Canadian domestic aviation market, the distinctions between scheduled and charter services have been largely removed by the Canadian Government, and the same type of operating licence is now used for both. This change was made in early 2000 in the hope of facilitating the development of larger, trans-regional domestic carriers, to operate in competition with Air Canada. In international markets, on the other hand, there remain both legal and economic distinctions between charter and scheduled air services, although, on Canada–UK routes, Canadian charter carriers can now operate either under the charter Memorandum of Understanding or, if so designated by the Government, as scheduled operators. The advantage for a charter airline in becoming scheduled is that this allows it to have its flights shown on computer reservation systems, greatly increasing their accessibility for sales to the public through travel agents alongside flights from other scheduled operators, such as BA and Air Canada.

New Canadian legislation

4.11. Act C-26 was passed by the Canadian Parliament with the purpose of addressing matters arising out of the takeover of Canadian Airlines by Air Canada. Brought into force on 5 July 2000, it amends a number of existing statutes, including the Canada Transportation Act, the Competition Act, and the Air Canada Public Participation Act. The provisions of the Act that are of relevance to this part of the inquiry refer to anti-competitive behaviour in the forms of a domestic carrier denying 'essential facilities or services' to another carrier 'on commercially reasonable terms', new 'cease and desist' orders available to the Canadian Competition Bureau to stop anti-competitive behaviour or to require steps to be taken to prevent injury to competition, and a partial relaxation of the rules on ownership for Canadian air carriers.

4.12. The first of the above changes is to define as anti-competitive any attempt by a Canadian domestic operator to deny access on 'reasonable commercial terms' to facilities or services that are essential to the operation of an air service. There are definitions of what facilities and services might be regarded as essential in the draft Regulations to be made under Act C-26 (see Appendix 3.6), but what might constitute 'commercially reasonable' terms is not defined.

4.13. Secondly, new 'cease and desist' powers are accorded to the Competition Commissioner, to be used (after consultation with the Canadian Transportation Agency) against anti-competitive behaviour in the air services market. These powers also entitle the Canadian Government to use sanctions against any anti-competitive action taken after a cease and desist order has been made against a carrier.

4.14. The amendment to the rules governing ownership of Canadian carriers is essentially twofold. First, the Air Canada Public Participation Act is changed to allow an increased maximum holding of 15 per cent (previously 10 per cent) for any one individual or organization. Secondly, the Canadian Governor in Council now has the authority to increase the foreign ownership limit for shares held in Air Canada, from 25 per cent, although the Act did not propose any specific changes to the limit.

European regulation

4.15. Prior to the initiation of regulatory change by the European Commission, air services in Europe were regulated through bilateral agreements between the member states. Now, within the EEA, there is effectively a single market in air services, with operators from any of the countries involved free to operate any domestic or international service within the EEA. This was established through a series of three 'packages' of regulations.

4.16. The first 'package', introduced in 1987, loosened some of the more restrictive features of this bilateral regime. First, either party to an existing ASA was given the right to designate as many national carriers as it wished on routes with over 250,000 passengers a year (with this limit falling to 180,000 after two years). Secondly, the maximum permitted share in a bilateral market by any one country's

carriers was increased to 55 per cent, rising to 60 per cent in 1989. Thirdly, airlines were allowed some freedom to compete on promotional fares and, finally, a block exemption to Article 81 (now Article 85) of the EC Treaty was granted[1] for revenue-pooling arrangements subject to certain precise conditions.

4.17. The second 'package', introduced in late 1990, dealt with further liberalization of promotional fares. It was, however, the third EC 'package', dating from January 1993, which had the most effect on the regulation of the European air services industry. This package had three components: a licensing regulation, introducing common criteria for licensing airlines in all EEA member states; an access regulation, deregulating all international intra-EEA routes with the implementation of full cabotage (ie freedom of operation on domestic EEA routes) by 1997; and a fares regulation, which left airlines free to set their own fares, provided that they are not predatory low prices or anti-competitive high prices.

4.18. The EC conferred an exemption[2] on EC carriers from general EC competition law, as contained in Article 81 of the EC Treaty, for certain practices concerning intra-EEA flights, namely consultations on passenger tariffs, coordination on slot allocation and airport scheduling, joint planning and scheduling of services, and the joint operation of services on low-density routes. The idea behind this exemption was to provide a framework of legal certainty, so that the European airline industry could develop towards full liberalization without airlines having to apply for exemptions on a regular basis for the practices mentioned above. The regulation giving these exemptions, due to expire in 1998, was extended to 2001 for tariffs and slot allocation, but not for schedules or for operations on low-density routes.

Impacts of the EC's liberalization packages

4.19. In a recent evaluation of the developing single market,[3] the CAA found that, while there was still room for improvement, this liberalization had had several positive effects. First, there had been significant levels of market entry, with second and third carriers acting as a competitive spur. This had resulted in the reduction of the dominance of national 'flag carriers' and in increased interlining, code-sharing and alliances between the newer, often smaller, firms and the incumbents, which benefited business passengers on many routes.

4.20. The second effect of the liberalization noted by the CAA was the establishment of price competition on some routes, mainly in leisure and economy fares. Although fully-flexible fares, established under IATA discussions, continued to rise throughout the period examined, the growth of charter and holiday flights, as well as the creation of new ticket types aimed at price-sensitive passengers and more frequent ticket offers and promotions, all tended to increase choice and reduce average prices for non-full-price fares.

UK civil aviation regulation

4.21. The two bodies responsible for the regulation of air services in the UK are the DETR and the CAA. The DETR is responsible for general aviation policy, as well as for negotiating the UK's ASAs with countries outside the EEA, and the CAA administers UK airline licences under the EC regime and licenses UK operators on routes not covered by the EC's third package. The views of the two organizations are summarized in Chapter 5.

4.22. The advent of a single market for aviation means that most of the policy competence for the regulation of air services within the EEA now lies with the European Commission. UK carriers have been able to compete with some success within this framework.

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[1]Council Regulation 3976/87.

[2]Commission Regulation 1617/93, amended by Commission Regulation 1083/99. One of the effects of the amendment was to extend the period of the exemption to June 2001.

[3]*The Single European Aviation Market: the first five years*. CAP 685, CAA London, 1998.

Traffic distribution rules

4.23. As well as being constrained in their operations through domestic licensing and international arrangements, carriers operating in the UK are also subject to further restrictions through government airport policy. These restrictions have been developed in the past mainly to deal with congestion at airports, principally Heathrow, and to encourage the development of other airports, such as Gatwick. The Secretary of State for the Environment, Transport and the Regions has powers to enforce traffic distribution rules (TDRs) at any two or more airports in the UK which serve the same geographical area.

4.24. In 1986, TDRs were introduced for airports serving the London area, formalizing existing arrangements set up to encourage traffic to move from Heathrow to Gatwick. These rules prohibited new international and domestic scheduled services and whole-aircraft charter flights from operating out of Heathrow, and placed restrictions on whole-aircraft cargo operations from both Heathrow and Gatwick. In 1991 this policy was abandoned and the restrictions dropped, leaving only restrictions on whole-aircraft cargo services, business aviation and general aviation at the two airports at periods of peak congestion as notified by the CAA on the advice of the airport operator (BAA plc) and the Scheduling Committee. This Committee is made up of airline representatives, and deals with rules to supplement the IATA and EC rules, such as those controlling night movements (IATA being the worldwide trade organization for the airline industry).

Capacity and access constraints on air services

4.25. As well as those limitations on the provision of air services resulting from governmental and EC regulation and international agreements, there exist physical constraints on the industry, imposed by the infrastructure and the availability of facilities.

Airport congestion

4.26. Airport congestion is caused by an excess of demand over supply of runway, terminal or stand capacity. Terminal capacity is expressed in terms of a maximum hourly throughput of arriving and departing passengers. Runway capacity is defined as the number of air traffic movements (ATMs, ie landings or take-offs of aircraft) which can take place during a given period. These ATMs are allocated specific scheduled times of arrival or departure, or ‘slots’, at airports, on specific dates. In Canada, the only airport at which it has been suggested that there is any runway or terminal congestion is Lester B Pearson International at Toronto. According to the Greater Toronto Airports Authority and the Coordinator at Pearson airport, however, there is no real congestion problem, especially not for trans-atlantic services. In the UK, although there is congestion at many major airports during peak periods, Heathrow and Gatwick have the largest congestion problems.

4.27. In the UK, the limits on runway and terminal capacity are decided upon at the beginning of each season by an airport’s operating company (usually BAA or, as in the case of Heathrow and Gatwick, a BAA subsidiary). The runway capacity decided upon is based on an average delay criterion of 10 minutes. Where delays are less than this value, the effect of adding new slots is looked at by computer simulation. If the results of this simulation are acceptable, then the new slots are made available for allocation. This process has permitted marginal year-on-year improvements in the declared capacity. Once these limits have been decided upon, the responsibility for allocating runway and terminal resources rests with the slot allocator ACL (see paragraph 4.32).

4.28. Slots are, however, not the only determining factor in an airport’s capacity. Table 4.2 shows the hourly passenger flow capacities at the four Heathrow terminals, for the summer 2000 season. The capacities of the four terminals act as a significant constraint at Heathrow at certain times of the day, particularly Terminals 3 and 4.

TABLE 4.2 **Heathrow terminal capacities, summer 2000**

Terminal	*Arrivals/ departures*	*Passengers per hour*
T1 Domestic	A	1,600
T1 CTA*	A	850
T1 International	A	2,400
T1 Domestic	D	1,750
T1 CTA*	D	750
T1 International	D	2,600
Terminal 2	A	1,800
Terminal 2	D	1,800
Terminal 3	A	3,500
Terminal 3	D	3,000
Terminal 4	A	3,000
Terminal 4	D	2,500
T1+T2+T3	A+D	14,000

Source: ACL.

*Common Travel Area: the Channel Islands and the Republic of Ireland.

Note: Capacity for T1+T2+T3 reflects the capacity of the road tunnel to the three terminals and in practice is never a binding constraint on the airport's activities.

4.29. In addition to terminal capacity, stand and parking facilities for aircraft serving the terminals can be a limiting factor in overall capacity. ACL informed us that there was a shortage of stands on the south apron which restricted the allocation of slots at Terminal 4 at peak times. Thus, even if additional slot capacity were to be made available at this time, the resulting flights might have to be allocated to the central area (Terminals 1, 2 and 3). The passenger throughput capacity at Terminal 3 was also a constraint for a one-hour period at this time.

Airport slot assignment

4.30. Through IATA, there has developed over time a system for managing the excess demand for runway capacity at airports, involving a process of schedule coordination and slot allocation. The IATA World Scheduling Guidelines are a framework within which airport coordinators undertake this task in a neutral, non-discriminatory and transparent manner. The three priorities of the IATA guidelines are, in order of precedence: historic slots, new entrants, and the introduction of year-round services. Further criteria, used in deciding between similar cases, include the length of time for which a service will be operated during a season, market size and requirements of competition and the travelling public. Within the EEA, this process is, however, superseded by the EC's slot regulation.

The EC slot regulation

4.31. Council Regulation (EEC) No 95/93 of 18 January 1993 (the EC slot regulation) was introduced in an attempt to increase the opportunities for new entrants into European aviation in the process of unifying the market for air services within the EEA. The provisions of the IATA guidelines are, therefore, taken into account only when they are compatible with the EC slot regulation. The regulation was also expected to optimize the use of existing airport capacity and to provide a fair and transparent way for managing the airport scheduling process. It requires the member state responsible for a 'fully-coordinated' airport (a status denoting a certain level of congestion, with accompanying requirements for slot management) to oversee the appointment of a Coordinator, in consultation with the airlines using the airport and the airport authorities.

4.32. In the UK, full coordination is carried out at four airports, including Heathrow, Gatwick and Stansted, by ACL, a former subsidiary of BA, which since 1992 has been jointly owned by BA and ten other airlines. ACL administers the allocation of airport slots principally according to UK and European legislation, and secondarily in line with IATA guidelines, and is advised on technical matters by a

Coordination Committee (made up of representatives of the airport operator, air traffic control and airlines) and also by the Scheduling Committee.

4.33. Airport runway slots are allocated twice a year, for winter and summer seasons. The EC slot regulation deals with the allocation of slots in two ways. First, those slots which were allocated to a particular carrier in the previous equivalent season, and which were used to a sufficient extent (see paragraph 4.34), revert to the same carrier. This is known as a system of 'grandfather rights', and usually accounts for the great majority of slots, particularly at peak times. Also receiving priority under these rights are requests for previously held slots to be moved to different times of the day. The remaining slots, whether newly introduced through allocation improvements, returned by previous users or lost through lack of use, are then pooled and allocated. (This pool usually accounts for only around 4 per cent of the total capacity at Heathrow.) New entrants are given priority in the allocation of 50 per cent of these pool slots. For the purposes of the regulation, new entrants are defined as:

(a) carriers holding or allocated fewer than four slots at that airport on the day in question; or

(b) carriers requesting slots for a non-stop service on a route between two EEA airports, where at most two other carriers operate a direct service on the day in question, and where the applicant holds or has been allocated fewer than four slots for that day and service.

Overriding this, no carrier in possession of more than 3 per cent of all the slots at a particular airport (or more than 2 per cent of the slots at an airport system) can be considered as a new entrant. Any remaining capacity after these requests have been dealt with is allotted to requests for new and increased services by incumbent airlines.

The use-it-or-lose-it rule

4.34. To ensure the efficient use of a scarce resource, and to avoid the hoarding of allocated slots by incumbent operators, the EC slot regulation (Article 10(3)) dictates that slot holders must utilize an allotted slot 80 per cent of the time (70 per cent in the case of charter operators) to avoid losing it back into the pool for the next equivalent season's allocation. Although slots lost under this rule cannot be re-allocated until the end of the season for which they apply (even if the 20 per cent or 30 per cent idle thresholds are reached before then), those returned voluntarily to the pool can be reassigned immediately and often on a temporary basis, until the next allocation of pool capacity.

Slot exchange and trading

4.35. Under Article 8.4 of the EC slot regulation, slots can be freely exchanged between carriers, between routes and between types of service, either by agreement or through mergers or takeovers, providing that such exchanges are made publicly and that the Slot Coordinator regards them as feasible. Although the European Commission claims that slots can neither be sold nor traded with some sort of accompanying payment, there is some uncertainty in this area and it is certainly true that some airlines have been involved in what has been termed 'grey market' activity concerning the trading, or 'artificial exchange', of slots. The uncertainty remains, notwithstanding a recent decision of the High Court in England,[1] which ruled that an 'artificial exchange' of slots between KLM-UK and BA, believed to have involved an accompanying payment by the latter of £16 million for four daily pairs of slots, was an exchange within the meaning of Article 8.4 of the EC slot regulation.

4.36. ACL's position on 'artificial exchange' is that it is a useful mechanism for carriers to improve their slot allocations. They have also advised airlines on methods of leasing or lending their slot capacity, a not uncommon practice among alliance partners. These methods also involve an 'artificial exchange', with some accompanying contract between the carriers involved. In reality then, slot trading is not an uncommon practice and, furthermore, such trades can involve considerable sums (£4 million for a daily

[1] *R v ACL ex parte the Guernsey Transport Board*, March 1999.

pair of slots in the case mentioned above). ACL even reported that there had been some brokerage activity, mainly undertaken by banks, in attempting to arrange 'artificial exchange' deals between airlines, although so far without success. Such activity has, however, a fairly binding constraint, since slots can only ever be allocated to operating airlines and never third parties, and in any case they are believed to remain the property of the airport authorities: only the right to use the slot is ever held or exchanged. Usually, airlines themselves broker slot trades, an arrangement made easier through alliances and other cooperative airline arrangements.

4.37. In recognition of 'artificial exchange' as both an unavoidable fact and as a way of introducing more movement into an allocation process severely constrained by the use of grandfather rights, several organizations have proposed the formal recognition and opening up of secondary slot trading. Acknowledging the probable need for regulation of this by competition policy, the CAA suggests that secondary transactions be allowed, in a transparent and overt way, and that, furthermore, newly-created pool slots be auctioned rather than allocated administratively. Other interested parties have gone further than this, suggesting as a solution to the entry barriers posed by the current slot situation the abolition of grandfather rights in favour of a system of slot franchises of limited duration, for example 10 or 20 years, or at least the discontinuation of grandfather rights on new or pooled slots. Another idea has been to allow local government the ownership of some slots, in order to preserve important services on some routes, or even to profit from their sale (in the event of such processes becoming permissible). There are some signs that the European Commission is looking at some of these possible changes to the slot regulation, and the extent to which it is willing to adopt them will become apparent once its current considerations are put out for consultation.

Slots at Heathrow

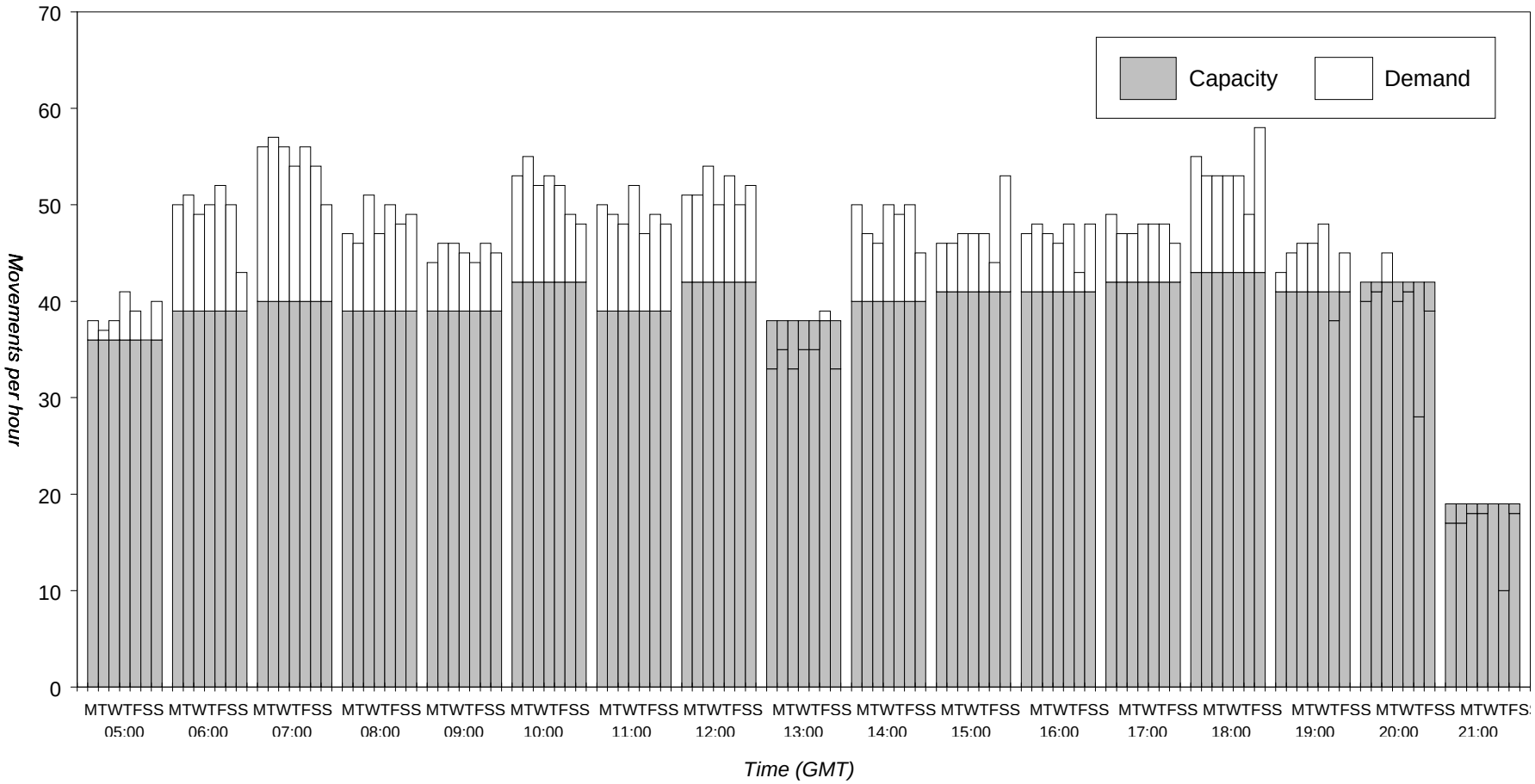
4.38. Among the airports involved in UK–Canada operations, Heathrow is the one at which slot allocation and availability are of most relevance when competition issues arise from potential market entry problems. Figures 4.1, 4.2, 4.3 and 4.4 show the hourly demand, capacity and allocation of slots at Heathrow for the summer season in 2000: 99 per cent of such slots are utilized, but all are used at peak periods.

4.39. As can be seen from Figures 4.1, 4.2, 4.3 and 4.4, there is very little excess capacity at most hours of the day at Heathrow, with demand greatly outstripping it. The declared capacity in the middle of the day is intentionally lower in order to allow for a recovery of delays built up during the morning peak period. ACL told us that even this 'fire break' is being eroded year on year, to create new slots. In addition, the capacity is non-uniform throughout the day, due to the aircraft mix that results from the combination of carrier schedules at different times. Aircraft generate a wake vortex in the air that can disrupt the flight of following aircraft. The necessary separation distances required between aircraft types, and hence the runway throughput rate, is a function of the size and mix of aircraft. Greater separation is required behind a heavy aircraft, with the worst case being a light aircraft following a heavy aircraft. For example, the lower than average capacity during the 0500 GMT hour on arrivals at Heathrow is the result of a mix of predominantly heavy aircraft (ie jumbo jets) operating long-haul routes. This results in a lower achievable arrival rate than at other times of the day.

4.40. According to ACL, most of the physical options for increasing runway capacity at Heathrow have been explored, and those remaining raise political or environmental sensitivities. For example, more capacity could be achieved through a redesignation of the two runways. The current arrangement is to have one solely for landing traffic and the other for outbound, with a switch in mode at 3 pm. ACL informed us that this was done to mitigate the environmental disruption to the surrounding residential and greenbelt areas. Around 10 per cent more capacity could be accommodated were the runways to be designated for mixed inbound and outbound use, but this decision is out of the hands of ACL, since the ending of runway alternation would almost certainly require a decision by the Government. Currently, mixed-mode operation can be used only as a temporary measure in extreme cases of delay build-up (to an average of over 25 minutes). ACL told us that other technological improvements which could be implemented include microwave landing systems at airports, which would reduce the distance for which incoming aircraft would need to align, and vortex-reduction systems on aircraft themselves, which would permit closer formation of traffic in the air, especially between small and large aircraft. Both of these are, however, still in development stages and will not become operational for some time to come.

FIGURE 4.1

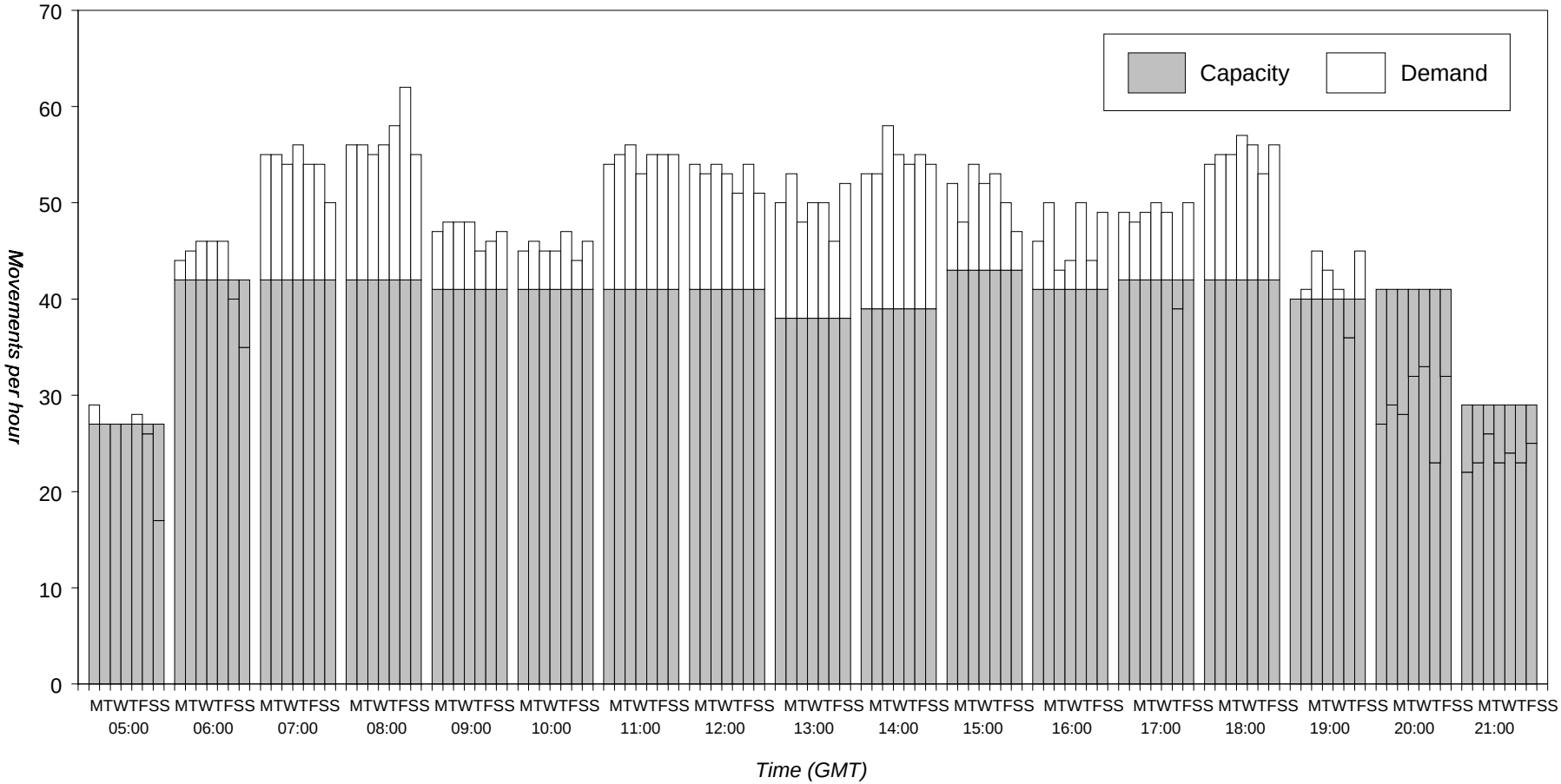
Heathrow arrivals demand, summer 2000



Source: ACL.

FIGURE 4.2

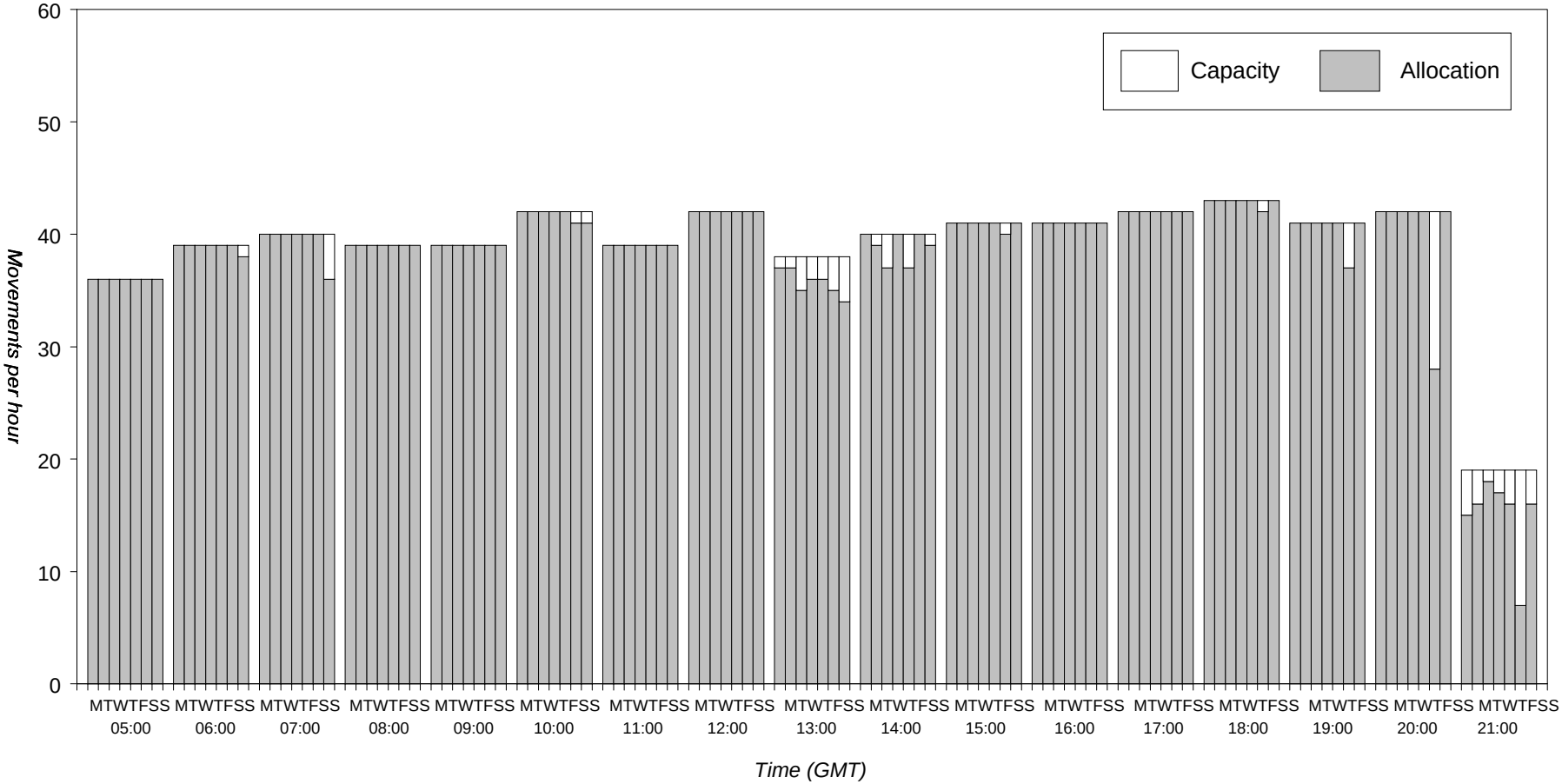
Heathrow departures demand, summer 2000



Source: ACL.

FIGURE 4.3

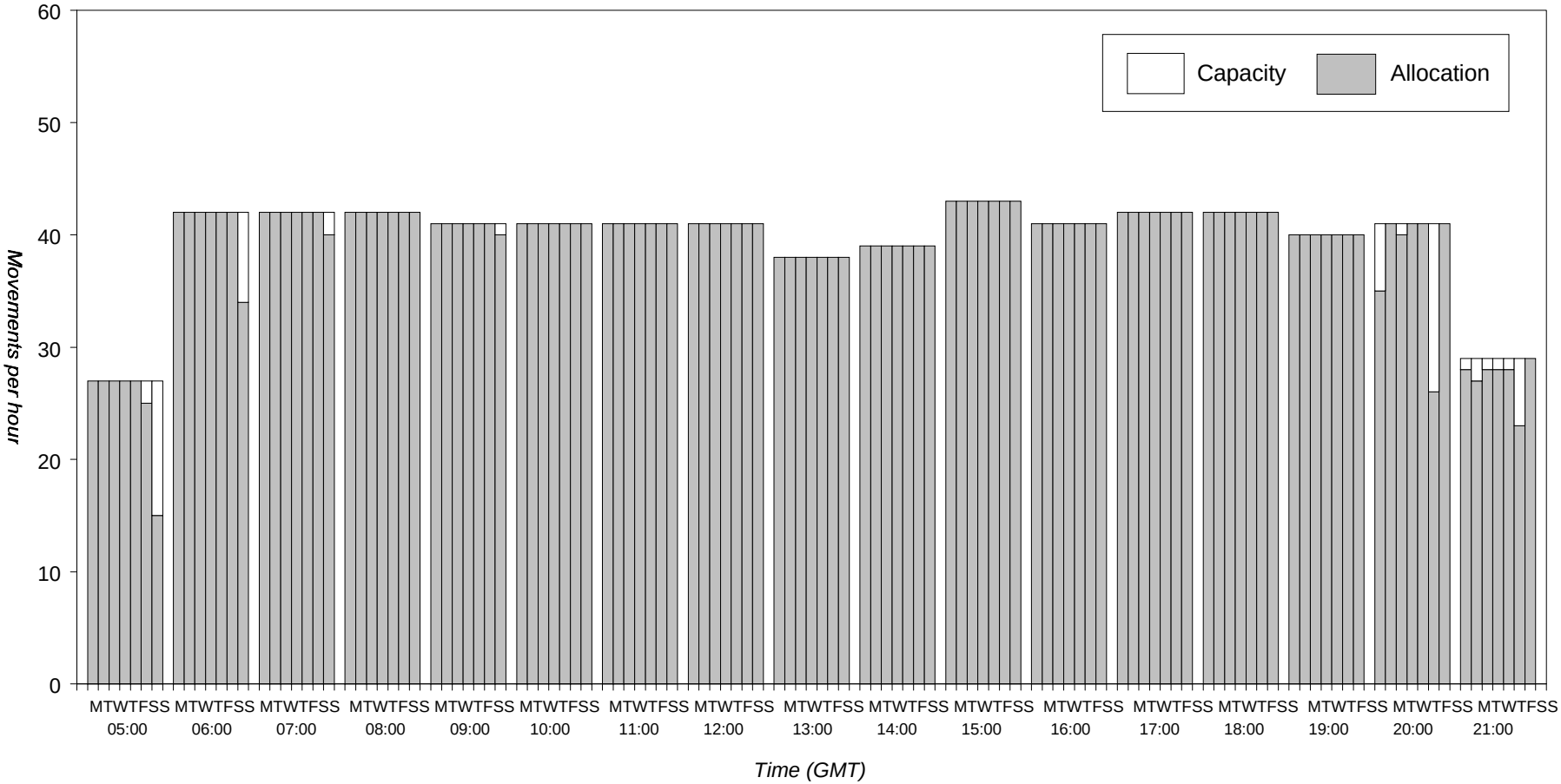
Heathrow arrivals allocation, summer 2000



Source: ACL.

FIGURE 4.4

Heathrow departures allocation, summer 2000



Source: ACL.

4.41. The slot allocations at Heathrow for Air Canada, Canadian Airlines, BA, British Midland and Virgin over the past four summer seasons are shown in Table 4.3.

TABLE 4.3 **Airline slot holdings at Heathrow, summer 1997 to 2000**

Carrier	*Summer 1997*	*Summer 1998*	*Summer 1999*	*Summer 2000*
Air Canada	3,942	3,581	3,804	3,813
Canadian Airlines	1,606	1,907	2,061	1,606
Canadian subtotal	5,548	5,487	5,865	5,419
British Airways	100,236	103,880	104,867	106,690
British Midland	34,759	36,791	38,703	38,756
Virgin Atlantic	5,098	5,312	5,708	6,096
UK subtotal	140,094	145,983	149,278	151,812
US airlines	11,231	12,658	13,712	13,881
Other airlines	113,419	112,011	110,725	113,564
Total	270,292	276,140	279,580	284,676

Source: ACL.

Note: The BA figures include all flights operated under a BA flight code, including franchise partners British Mediterranean and GB Airways.

It can be seen that, prior to the merger, Canadian Airlines was still in the process of building its slot portfolio at Heathrow after moving its operations from Gatwick. The summer 2000 schedule shows a considerable divestiture of slots by Canadian Airlines (around 20 per cent at Heathrow), as a result of restructuring within the new combined Air Canada. According to ACL, Air Canada exchanged some of these slots with its Star Alliance partners before handing them back to the Heathrow pool: six arrival slots were exchanged with Air New Zealand, and seven arrival slots (ie one daily) and one departure slot were exchanged with British Midland. The exchange with Air New Zealand solved a long-standing problem and, according to ACL, had the slots been returned to the pool directly, they would probably have been allocated to Air New Zealand in any case.

4.42. Air Canada told us that, following the takeover of CAC by 853350, there was a process of consolidation and rationalization of the services flown by the two airlines, which resulted in the release of 33 slots at Heathrow for the summer schedule in 2000. A further 20 slots for the next winter period were released more recently. It added that some of these slots were first offered to its Star Alliance partners, and to other airlines, for trading and that, as a result, some of the original slots released were not put back into the pool.

Slot assignment in Canada

4.43. At Canadian airports, as in the UK, slots are allocated within the context of the IATA World Scheduling Procedures. The only Canadian airport which has reportedly experienced any real congestion is Lester B Pearson International at Toronto, which is fully coordinated and therefore requires a slot coordinator. On the whole, the slot allocation process at Toronto is similar to that of the EC slot regulation (as indeed is the new IATA guideline, effective from 26 March 2000), with grandfather rights taking precedence, surplus slots being returned to a pool where new entrants have priority on allocation, and a use-it-or-lose-it rule.

4.44. Although slots at Pearson have in the past been said to be scarce, the Canadian department of transport, Transport Canada, has expressed the view that there would in practice be no difficulty for a transatlantic carrier to obtain further slots at Toronto. This is partly because of two of the prioritizing rules for the allocation of pool slots at Pearson, which give preference to international carriers and to airlines operating large aircraft.

The market for air services

The structure of the air services industry

4.45. There are two principal types of passenger air service, scheduled and chartered, and a distinction is made between two types of passenger, time-sensitive and price-sensitive, generally taken to correspond to business and leisure travellers respectively. A further distinction could also be made between leisure traffic for holidays and those leisure passengers 'visiting friends and relatives' (VFR), because the VFR market is more limited in its choice of destination. Scheduled air services are advertised in published schedules by airlines and sold directly to travellers or through agents. Charter services are sold only through intermediaries, who buy blocks of seats, or even whole flights, and sell them on either as part of holiday packages or as flights only. Such chartering of services is more seasonal and, obviously, much more linked to the leisure market than are scheduled services.

4.46. The main differences between the two types of service relate to frequency of flights, flexibility of tickets and classes of travel. Scheduled flights are usually more frequent (for example, several times a day to a particular location, as opposed to a few times a week) and have differing classes of travel (first class, business, economy). Some economy and business class tickets are sold on less flexible terms (although changeable tickets can usually be bought for all classes), whereas charter tickets tend to be fixed once booked. In addition, although there is sometimes a business class on UK–Canada former-charter flights, this is not yet of a comparable standard to that on the scheduled carriers, and there is no first class cabin, or any equivalent, on these or on charter flights. Another difference, relating to ticketing, is that only scheduled operators can sell through-tickets for journeys to destinations served by other scheduled operators. This practice, known as interlining, is widespread in the scheduled air services industry and is facilitated by agreements between airlines or through IATA. Charter carriers do not usually have interlining agreements with scheduled operators, since the latter type of operator tends to be less willing, given the non-comparability of the different services provided by the two.

4.47. Another important difference between the two types of operation lies in the methods of ticket sale. Scheduled operators use computer reservation systems (CRSs), usually in conjunction with other allied airlines, on which connected travel agents can observe seat availability, make bookings and access centralized information on connecting flights and alternative services. Charter operators do not appear on CRSs with scheduled operators.

Air passenger services between Canada and the UK

4.48. As was mentioned in paragraph 4.4, the UK–Canada ASA is regarded as fairly liberal by both the UK and Canadian Governments, in that it places no limits on the numbers of designated carriers from either country, nor does it put limits on capacities or frequencies flown. There are currently two principal designated scheduled Canadian carriers, Air Canada and Canadian Airlines. For the purposes of this chapter, we will treat differently, for certain markets, the former charter operators recently given scheduled designation by the Canadian Government. This is because, as explained below, we do not believe that these operators can as yet be considered as providing services which will attract time-sensitive business travellers to any great extent. However, for other travellers, such as holidaymakers, we believe that the former charter operators should be included in the market definition.

4.49. Before January 2000, when CAC was taken over by 853350, competition on UK–Canada scheduled routes was, to a greater or lesser extent, provided by three airlines: BA, Air Canada and Canadian Airlines. Eight of the agreed routes to Canadian cities listed in the ASA were served by scheduled services from London, all from Heathrow. These were:

— *Edmonton* (summer only), *Halifax* and *St John's*, served only by Air Canada;

— *Ottawa*, where Air Canada competed with Canadian Airlines;

— *Calgary*, where Air Canada competed with Canadian Airlines;

— *Montreal*, where Air Canada and BA competed and from which Canadian withdrew in 1998; and

— *Toronto* and *Vancouver*, served by all three airlines.

In addition, two routes to Toronto, from Glasgow and Manchester, were also served by scheduled flights from Air Canada. The airline statistics for total market for air services between the UK and Canada is detailed in Table 4.4. The figures represent passengers travelling in either direction. They do not capture indirect passengers flying between the cities mentioned (for example, the London–Vancouver figures do not include London–Toronto–Vancouver passengers) and they do include passengers flying from other origins and destinations (for example, the London–Vancouver figures will include passengers who actually fly Paris–London–Vancouver).

TABLE 4.4 **UK–Canada passengers, 1999**

UK airport	*Canadian airport*	*Scheduled traffic*	*Charter traffic*	*Total traffic*
Gatwick	Calgary	-	16,665	16,665
	Toronto	-	243,833	243,833
	Vancouver	-	120,823	120,823
Heathrow	Calgary	247,245	-	247,245
	Edmonton	31,027	-	31,027
	Halifax	87,969	-	87,969
	Montreal	295,656	-	295,656
	Ottawa	145,440	-	145,440
	St John's*	-	-	-
	Toronto	1,023,292	1,275	1,024,567
	Vancouver	472,972	-	472,972
Stansted	Toronto	-	16,843	16,843
Belfast	Toronto	-	34,220	34,220
Birmingham	Toronto	-	35,191	35,191
Cardiff	Toronto	-	8,641	8,641
Edinburgh	Toronto	-	12,651	12,651
Exeter	Toronto	-	6,562	6,562
Glasgow	Toronto	71,562	81,427	152,989
	Vancouver	-	27,993	27,993
Manchester	Calgary	-	18,290	18,290
	Toronto	75,215	99,534	174,749
	Vancouver	-	48,538	48,538
Newcastle	Toronto	-	10,702	10,702
Other routes		-	15,194	15,194
Total		2,450,378	798,382	3,248,760

Source: CAA statistics.

*The figure for St John's passengers is included in that for Halifax, since they share a one-stop flight.

4.50. The figures we quote in this chapter are based primarily on estimates by the CAA, some of which are based in part on survey details; market share figures provided to us by Air Canada on the basis of ticket sales data, which it believed may understate numbers of passengers on scheduled flights, suggested that the share of airlines other than Air Canada, Canadian Airlines and BA could be somewhat higher than estimated by the CAA; but these differences do not affect our analysis below.

4.51. Prior to the merger, Canadian Airlines competed with Air Canada on four direct UK–Canada routes, between Heathrow and Toronto, Vancouver, Calgary and Ottawa, and with BA to Toronto and Vancouver. Competition has been directly affected on these routes. On the first two of these, ignoring for the moment those charter carriers which have entered the market as redesignated scheduled carriers since the merger, the number of scheduled direct carriers has been reduced from three to two, Air Canada and BA; on the Calgary route there is now only a single direct scheduled carrier, Air Canada; and on the London–Ottawa direct route there is similarly only one scheduled carrier, Air Canada, Canadian Airlines having ceased operations on this route on the commencement of the takeover activity.

4.52. It is important at this stage, however, to note that competition among the three scheduled airlines took place within the context of their memberships of different alliances, Air Canada being a member of the Star Alliance, and both BA and Canadian Airlines belonging to the Oneworld Alliance. BA and Canadian Airlines competed significantly less with each other on their overlapping routes than

they did with Air Canada. Not only did BA receive preferential treatment for ongoing traffic (interlining prorates), but the two carriers code-shared on their overlapping routes between 1996 and 1999, and even had a revenue-sharing agreement on their London–Toronto services. (See the section on interlining arrangements in paragraph 4.91ff for details on interlining and code-sharing agreements.) It has been suggested by some parties that, prior to CAC's takeover by 853350, BA and Canadian Airlines should in fact be seen as one entity for competition purposes and that there were only two competing forces on the overlapping routes since BA and Canadian Airlines became part of the same alliance. From this viewpoint, Canadian Airlines has simply switched from one side to the other, as it did from Oneworld Alliance to Star Alliance. This point is relevant to a consideration of the change in competition in direct services on the overlapping routes following the merger. The table below shows the market shares for the direct services of the three scheduled carriers on their four overlapping routes for 1999.

TABLE 4.5 **Market shares (passengers) in 1999, as quoted by the CAA**

per cent

		Scheduled overlap routes, 1999			
		Air Canada	*BA*	*BA/CP*	*Canadian Airlines*
Heathrow–Toronto	*(a)* BA separate from CP	39	31		30
	(b) With BA/CP together	39		61	
	(c) With merger	69	31		-
Heathrow–Vancouver	*(a)* BA separate from CP	37	51		12
	(b) With BA/CP together	37		63	
	(c) With merger	49	51		-
Heathrow–Calgary	*(a)* Pre-merger	42	-		58
	(c) With merger	100	-		-
Heathrow–Ottawa	*(a)* Pre-merger	56	-		44
	(c) With merger	100			-

Source: CAA Airport Statistics.

Note: CP = Canadian Airlines.

4.53. Looking at the routes, the change in market shares following the merger can be quite different, depending on the importance put on the prior arrangements between BA and Canadian Airlines. If we assume they were separate competitors, competition has suffered on all four routes. On the other hand, assuming that BA and Canadian Airlines were acting as a single entity, in the case of the route to Vancouver, for example, a pre-merger BA/Canadian Airlines combination of 63 per cent market share, compared with 37 per cent for Air Canada, is reduced to 51 per cent for BA, balanced by an almost identical 49 per cent for the new combined Air Canada. With either approach, however, it should be noted that, looking only at the three scheduled carriers in existence at the time of the merger, the routes to Calgary and Ottawa would have experienced a total loss of competition. In addition, whatever the interpretation of the pre-merger situation, Air Canada could now be regarded as the dominant UK–Canada scheduled carrier: Air Canada itself claims this on its Annual Information Form (16 May 2000), describing itself as 'the dominant carrier between Canada and the UK'.

Redesignated charter services

4.54. As apparent from Table 4.4, charter operators accounted in 1999 for about 25 per cent of direct passengers between UK and Canada, of which the bulk are carried by Canadian charter airlines (see Table 4.6). The Canadian Government was of the opinion that the relatively greater success of Canadian charter carriers (compared with UK ones) on UK–Canada routes has been because of both their longer history of operations (given the earlier beginnings of Canadians travelling to Europe for tourism) and the fact that Canadian operators could reschedule their flights to serve the large demand for transport from Canada to the Caribbean during the winter months, a demand which was perhaps absent from the UK charter market.

4.55. The Canadian Government recently changed its policy of having only two scheduled Canadian operators on UK–Canada routes by allowing the redesignation of charter airlines as scheduled carriers. There have also been changes to relax some of the conditions imposed on its charter carriers (see paragraph 4.10). The second of these measures involved the elimination of advance booking and minimum stay requirements, and permitted the sale of one-way tickets for these airlines. (Two restrictions on charter operations remain; tickets will still have to be sold through agents and chartered and scheduled passengers cannot be carried on the same aircraft.) As well as these relaxations, the Canadian Government also allowed the redesignation of existing charter operators as scheduled carriers. Three charter carriers took advantage of this situation to take on a redesignated, scheduled status on some Canada–UK routes early in 2000. These carriers were Canada 3000, serving Calgary, Toronto, Montreal, Halifax, Ottawa and Edmonton; Air Transat, serving Calgary, Toronto, Montreal and Halifax; and a third charter airline, Royal Airlines, serving Toronto, Montreal, Winnipeg and Edmonton.

4.56. All three of these airlines operate from Gatwick airport and, to a lesser extent, Stansted airport, rather than Heathrow, and provide less frequent UK–Canada services than the other scheduled airlines. In addition to London services, these new scheduled carriers also operate limited charter services to other UK destinations, such as Manchester, Birmingham, Glasgow, Edinburgh, Cardiff, Aberdeen and Newcastle.

4.57. The effect of considering these redesignated charter services on the direct London–Canada routes is shown in Table 4.6. Also shown are UK charter carriers, Britannia and Monarch, and their passenger percentages on the routes, the only significant one of which is Britannia's 5 per cent on London–Calgary.

TABLE 4.6 **Overlap routes: London–Canada traffic statistics, 1999**

Canadian gateway	*London airport*	*Airline*	*Flights*	*Seats*	*Passengers*	*Share %*	*AC+CP %*	*BA+CP %*
Toronto	Heathrow	Air Canada	2,187	475,929	394,702	31		
	Heathrow	Canadian	1,777	399,095	306,604	24		
	Heathrow	BA	971	368,256	309,275	24		
	Gatwick	Canada 3000	413	132,982	124,559	10		
	Gatwick	Air Transat	307	101,228	90,442	7		
	Gatwick	Royal Airlines	144	33,794	28,832	2		
	Stansted	Royal Airlines	77	19,665	9,086	1		
	Stansted	Air Transat	71	16,479	7,969	1		
		Total	5,947	1,547,428	1,271,469	100	55	48
Vancouver	Heathrow	Air Canada	913	212,641	176,466	29		
	Heathrow	Canadian	260	67,342	58,250	10		
	Heathrow	BA	725	283,513	241,338	40		
	Gatwick	Canada 3000	236	75,488	68,985	11		
	Gatwick	Air Transat	122	42,680	40,280	7		
	Gatwick	Royal Airlines	24	6,360	5,206	1		
	Gatwick	Britannia	29	8,462	6,352	1		
	Stansted	Royal Airlines	26	6,890	5,088	1		
		Total	2,335	703,376	601,965	100	39	50
Calgary	Heathrow	Air Canada	720	163,990	118,058	40		
	Heathrow	Canadian	797	198,785	160,268	54		
	Gatwick	Britannia	57	17,748	15,481	5		
	Gatwick	Monarch	6	2,244	1,184	0		
		Total	1,580	382,767	294,991	100	94	54
Ottawa	Heathrow	Canadian	351	71,955	53,079	44		
	Heathrow	Air Canada	538	96,686	66,526	56		
		Total	889	168,641	119,605	100	100	44

Source: CAA airport statistics.

4.58. London–Canada scheduled services are in general operated on a single sector basis so the sector traffic shown in the table should give an accurate indication of the passenger flows between

London and the Canadian points. However, charter flights are often multi-sector and the traffic data are reported by the CAA on an aircraft origin-destination basis. For example, a service going from London to Calgary and on to Vancouver will be recorded as a London–Vancouver flight. As Vancouver and Toronto are generally end points on charter routings, the passenger numbers to these two destinations will be overstated, whereas the opposite will be true for Calgary and Ottawa. In making our own estimates of the share of passengers on direct routes and on origin and destination traffic in Tables 4.15 and 4.16, we have made an adjustment for this fact, taking into account Air Canada's estimates of charter traffic on these routes, and we are satisfied that any remaining uncertainty does not affect our analysis or the conclusions drawn.

4.59. The London–Ottawa figures relate only to non-stop flights. In addition to these, Air Canada operated one-stop flights over Montreal during the winter months in 1999. CAA Airport Statistics indicate that Air Canada carried 106,836 passengers between London and Ottawa on its combined non-stop and one-stop services. In addition, Canada 3000 operates a number of Gatwick–Ottawa–Toronto flights and some passengers on these services are likely to have disembarked at Ottawa. In 1999, there were 49 Gatwick–Ottawa–Toronto flights by Canada 3000, with 16,660 seats, carrying 15,799 passengers.

4.60. The inclusion of these carriers has a significant effect on the post-merger market shares of the new Air Canada/Canadian Airlines combination: from 69 to 55 per cent on the Toronto route and 49 to 39 per cent on the Vancouver route. (On the basis of the CAA statistics, market shares on the Calgary and Ottawa routes change little, however, with the inclusion of the other airlines, which partly reflects the basis of the statistics discussed in paragraph 4.58.) Such differences are only of any meaning if it is appropriate to include the current and former charter services in the market for time-sensitive passengers. For those wishing to connect with interlining services, particularly at London, the current services run by former charter operators are unlikely to be regarded as reasonable alternatives to the other scheduled services to and from London. While looking at the general market, therefore, it is important to keep in mind not only market shares but the different separate market segments which exist within the overall framework of UK–Canada air passenger services. This is discussed in the section on relevant markets in paragraph 4.71ff. Before going on to consider this, however, it is important to look at the other services between the UK and Canada which might come into consideration.

4.61. Airlines of certain other countries have the right to carry passengers between the UK and Canada. The UK and Canada permit fifth freedom operators as described in paragraph 4.2. Only one fifth freedom service is currently operating, the Pakistan International Airlines' service from Karachi via Manchester to Toronto. Air India used to operate a fifth freedom service from Delhi to Toronto via London. We are not aware of any plans to start or increase use of fifth freedom rights between London and Canada. The DETR informed us of the current list of countries which have fifth freedom rights for operating air passenger services between the UK and Canada, which are shown in Table 4.7.

TABLE 4.7 **Fifth freedom entitlements between Canada and the UK**

Country	*Route entitlement (with ability to omit points on the route)*	*5th freedom services operated*
Belgium	From points in Belgium via Manchester, Shannon, Canada and on to the USA	None
Switzerland	From points in Switzerland via Manchester or Prestwick, Shannon, Iceland, Greenland, Gander, New York or points in Canada	None
China	Up to 6 services per week (SPW) from London to a point beyond	None
India	Up to 16 SPW from London, Birmingham and/or Manchester	None
Pakistan	Up to 6 SPW from regional points	2 SPW between Manchester and Toronto
Russia	Up to 7 SPW from London to 4 points in North America	None
Turkmenistan	Up to 2 SPW to Canada from a specified regional point	None at present, but intend to operate 2 SPW from Birmingham, probably from winter 2000/01

Source: DETR.

UK–Canada indirect services

4.62. The range of carriers offering indirect travel between the UK and Canada is wider than that of direct services. Under the UK–USA bilateral agreement, American Airlines and United Airlines are both permitted to operate from Heathrow to the USA, and connections to Canada can be made through their domestic hubs. In addition, Continental, Delta, Northwest, TWA and US Airways all fly to the USA from Gatwick, and can offer similar onwards flights into Canada, under the US–Canada 'Open Skies' agreement. Virgin flies from Heathrow to seven cities in the USA, and from Gatwick to four, from which connections can be made on other carriers into Canada and, of course, indirect services via the USA are also available on BA (interlining for the second leg from the USA to Canada). Other European operators flying direct to Canada include Air France, Lufthansa and KLM, all of which have connecting flights from UK airports and offer sixth freedom indirect services under the European single market regulations and their states' bilateral agreements with Canada. A small but significant sixth freedom operator is Icelandair, which flies from London to Halifax via Reykjavik.

4.63. A summary of indirect London–Canada OD traffic is given in Table 4.8. OD traffic between two points is composed of airline passengers who begin and end their journey at those points, and includes passengers who travel indirectly between them. Appendix 4.2 gives an explanation of the difference between OD and direct traffic. More indirect traffic flies via Continental Europe than via the USA, although US–London routes have many more flights and therefore more flexibility. It has been suggested that the reason for this may be that UK–Canada passengers changing planes in the USA have to go through US Customs and Immigration controls, while UK–Canada passengers changing planes in, say, Amsterdam do not have to clear such controls there. In 1998, the total indirect traffic to the Canadian airports listed in Table 4.8, including transfers through other Canadian destinations, came to around 22 per cent of all OD traffic on London–Canada routes. On three of the four overlap routes, however, this indirect traffic was much less important, at 8 per cent for Toronto and Calgary, and 15 per cent for Vancouver, although it was as high as 29 per cent for Ottawa. Excluding transfers through Canadian airports, indirect London–Canada passengers in 1998 came to 9 per cent. On the four overlap routes, OD passengers not transferring through Canada were 7 per cent for London–Toronto, 9 per cent for London–Vancouver, and less than 1 per cent for Calgary and Ottawa.

Services to beyond Canadian gateway airports

4.64. As well as the change in market shares on UK–Canada direct and indirect routes to major Canadian destinations (international 'gateway' airports), competition on services between the UK and Canadian destinations beyond these larger centres may have been reduced following the merger. It has been emphasized by several parties during our inquiry that Canada is highly dependent on its air services for the movement of people and goods between its major conurbations. Road travel is not a feasible option on many routes due to the sheer size of the country and Canada's train services are said not to be a reasonable alternative to air, either in service and reliability or in capacity, even over distances where rail travel would be competitive with air travel in Europe. Although the change in competition on the Canadian domestic air services market is not of primary concern here, it is relevant to the extent that it affects UK–Canada travellers in their journeys to places beyond the Canadian gateways.

4.65. With respect to access for foreign international operators to the market for domestic services, Air Canada is now, according to the Canadian Competition Bureau, in a dominant position.[1] Looking at Table 4.9, which details the terminating and onward traffic on London–Canada services, it can be seen that, prior to Canadian Airlines' merger with Air Canada, there was competition on indirect routes to non-gateway Canadian destinations through five of the eight gateways: Toronto, Vancouver, Montreal, Calgary and Ottawa. Through the sale of through-tickets, two or three of the three principal scheduled carriers competed on these routes. The traffic connecting through these gateways to other Canadian destinations accounted for 97 per cent of the total of such traffic connecting through all gateways in Canada.

[1]Air Canada's post-merger domestic market position is described as dominant by the Canadian Competition Bureau in its description of the new Regulations Respecting Anti-Competitive Acts of Persons Operating a Domestic Service, in the *Canada Gazette* Part I, of 8 July 2000. In addition, the Bureau describes Air Canada as 'the current dominant carrier', with an 'overwhelmingly dominant market position in the industry (accounting for 90 per cent of domestic passenger revenues)', in its Regulatory Impact Analysis statement accompanying the draft Regulations Respecting Anti-Competitive Acts of Persons Operating a Domestic Service (see paragraph 3.65).

TABLE 4.8 **London–Canada indirect OD passengers by intermediate airport, 1998**

Intermediate airport	*Destination airport*										
	Vancouver	*Toronto*	*Montreal*	*Edmonton*	*Ottawa*	*Winnipeg*	*Victoria*	*Halifax*	*Calgary*	*Other*	*Total*
Over Canada	13,850	2,611	8,440	18,231	22,269	21,689	17,489	528	7,317	44,837	157,261
Toronto	7,839	-	8,440	8,210	18,687	15,361	660	528	6,067	16,278	82,070
Calgary	4,952	-	-	10,021	-	826	2,242	-	-	10,647	28,688
Vancouver	-	-	-	-	-	-	14,588	-	1,250	8,930	24,768
Montreal	1,059	-	-	-	3,273	5,502	-	-	-	6,323	16,157
Other	-	2,611	-	-	310	-	-	-	-	2,658	5,579
Over Europe	10,795	18,399	16,002	0	0	0	0	13,606	0	0	58,801
Amsterdam	8,539	2,255	10,789	-	-	-	-	-	-	-	21,583
Paris CDG	-	10,613	3,343	-	-	-	-	-	-	-	13,956
Reykjavik	-	-	-	-	-	-	-	13,606	-	-	13,606
Other	2,256	5,531	1,869	-	-	-	-	-	-	-	9,656
Over USA	10,142	11,942	2,786	4,894	413	0	0	0	730	8,235	39,142
Over other	0	0	0	0	0	0	0	0	0	4,784	4,784
Total indirect	34,786	32,952	27,227	23,125	22,682	21,689	17,489	14,134	8,047	57,856	259,998

Source: CAA survey 1998.

Note: Excludes passengers connecting at London and those flying from Stansted.

TABLE 4.9 **Passengers connecting at Canadian gateways on direct London–Canada services, 1998**

				Connecting to:		
Airline	*Gateway*	*Total*	*Terminating*	*Other Canada*	*USA*	*Other*
Air Canada	Toronto	414,565	306,063	62,245	41,739	4,518
	Vancouver	163,755	115,400	26,143	21,707	505
	Montreal	125,959	107,335	12,063	6,561	0
	Calgary	102,723	73,994	25,809	2,921	0
	Ottawa	67,653	67,653	0	0	0
	Halifax	61,196	55,929	5,267	0	0
	Edmonton	32,601	32,601	0	0	0
	St John's	24,982	22,711	2,271	0	0
	Total	993,435	781,686	133,798	72,928	5,023
BA	Toronto	282,597	256,534	24,442	884	736
	Vancouver	236,484	202,371	22,614	10,188	1,311
	Montreal	190,381	184,154	4,796	1,431	0
	Total	709,461	643,059	51,852	12,503	2,047
Canadian	Toronto	304,670	230,664	57,784	5,937	10,285
	Calgary	136,576	107,951	28,440	0	185
	Vancouver	68,841	66,063	2,200	0	577
	Ottawa	31,690	28,111	3,579	0	0
	Total	541,776	432,789	92,003	5,937	11,047
Grand total		2,244,672	1,857,534	277,653	91,368	18,117

Source: CAA survey 1998.

4.66. A further point to note from Table 4.9 is the very small amount of London–Canada traffic which connects onwards to US destinations, 4 per cent in 1998. The CAA informed us that the practice of UK–Canada flights continuing into the USA after stopping at Canadian gateways has to a large extent been discontinued, as there were not the numbers of passengers wishing to continue on to US cities to make such services economically viable. This is perhaps explained by the small demand for onward flights through Canada, as indicated in the table.

The Canadian domestic market

4.67. As noted in paragraph 4.65, the Canadian domestic market is now regarded as being characterized by a dominant carrier, Air Canada, which provides the bulk of Canada's nationwide interior flights, with some interior long-range services provided by former charter airlines, and a number of small regional airlines serving particular areas, sometimes overlapping into the USA. This lack of strong domestic competition has been of concern to the Canadian Government, which has already taken measures to try and mitigate the anti-competitive effects, as described above (paragraph 4.11). In addition, measures relating to the restructuring of the Canadian domestic market in the undertakings negotiated between the Canadian Competition Bureau and Air Canada, under which the merger was allowed to go ahead, are detailed in paragraph 4.125. The implications raised for UK–Canada air service markets by Air Canada's position in the domestic market are examined more closely in paragraph 4.91.

Services beyond the UK

4.68. Paragraph 4.64 looks at the market for services into Canada beyond the international gateways. Whereas in Canada there is now considered to be a dominant carrier for onward flights into domestic non-gateway destinations from international connections, the situation at the Heathrow end of the routes in question (and indeed for other airports at the London end of UK–Canada operations) is different. Both the fact that BA has a strong competitor in the UK market in British Midland and the context of the European single market in air services in which BA operates at Heathrow go to make the situation at the UK end of the UK–Canada routes very different from the market position enjoyed by Air Canada in the Canadian domestic routes. In addition, British Midland has recently become a member of the Star

Alliance, and so after the merger Air Canada will benefit from interlining arrangements with an alliance partner.

4.69. Table 4.10 shows a high rate of connecting traffic at the London end of flights between Canada and the UK: 49 per cent from the Toronto route (ie the 42 per cent of passengers who changed at London only, plus the 7 per cent who changed at both ends), 49 per cent for Vancouver, 54 per cent for Calgary and 40 per cent for Ottawa. According to the CAA, the majority of connecting UK–Canada traffic at Heathrow connects to or from destinations outside the UK. This shows the importance to traffic from Canada of the network of onward flights from Heathrow, and emphasizes the distinctive position of Heathrow in the UK (see paragraph 4.81).

TABLE 4.10 **Connecting traffic on the overlap routes in 1999**

			Connect at:			
		End to end	*London*	*Canadian end*	*Both*	*Total*
Toronto	Air Canada	168,324	93,540	99,096	31,759	392,719
		43%	24%	25%	8%	100%
	BA	106,601	166,627	11,271	19,643	304,141
		35%	55%	4%	6%	100%
	Canadian	95,561	161,302	26,980	21,212	305,055
		31%	53%	9%	7%	100%
	Total	370,486	421,468	137,347	72,614	1,001,916
		37%	42%	14%	7%	100%
Vancouver	Air Canada	80,774	37,085	39,465	15,629	172,952
		47%	21%	23%	9%	100%
	BA	84,489	144,746	16,114	18,085	263,434
		32%	55%	6%	7%	100%
	Canadian	24,562	29,252	5,649	2,282	61,746
		40%	47%	9%	4%	100%
	Total	189,825	211,083	61,229	35,996	498,132
		38%	42%	12%	7%	100%
Calgary	Air Canada	51,060	27,207	14,061	14,287	106,615
		48%	26%	13%	13%	100%
	Canadian	42,385	79,619	14,791	19,341	156,137
		27%	51%	9%	12%	100%
	Total	93,445	106,826	28,852	33,628	262,751
		36%	41%	11%	13%	100%
Ottawa	Air Canada	51,781	33,698	7,034	3,426	95,939
		54%	35%	7%	4%	100%
	Canadian	30,728	22,307	-	931	53,967
		57%	41%	0%	2%	100%
	Total	82,510	56,006	7,034	4,357	149,907
		55%	37%	5%	3%	100%

Source: CAA origin/destination passenger survey.

Air freight services

4.70. The market for freight services is generally regarded as non-time-sensitive and, partially because of this, there is a large choice of routes and carriers which can be taken for any UK–Canada freight movement. Because of the possibility of moving freight by road haulage, airports are also generally considered to be less localized in their 'catchment areas' for freight than they would be for passenger air travel. In addition, we have not received any complaint about the market for air freight services between the UK and Canada in the course of our inquiry into the merger, and so for all of these reasons we will not be examining the market for air freight services any further in the context of this inquiry.

Relevant markets

4.71. Competition in the airline industry takes place on a number of levels and the relevant market in an examination of airline competition can vary from one case to the next. The simplest case is often taken as a direct route between two airports, with airlines competing against each other to serve this

route, in the context of a market which includes the flows of traffic by all modes, from the area around one airport to that around the other. Passengers travelling by air are usually categorized according to their OD cities. These cities tend to be determined by the purpose for which the passenger is travelling: a traveller for business purposes, for example, will have a specific, fixed OD city pair in mind, as will, to a similar extent, someone travelling to visit friends or relatives, whereas a holiday traveller may have made a choice only of a type of destination, being more flexible in their final decision.

4.72. Another distinction which helps to define different markets is whether a traveller is time-sensitive or price-sensitive (airline ticket prices and conditions usually mean a trade-off between flight flexibility and cost). Business travellers are usually categorized as time-sensitive (and are often taken as a proxy for the time-sensitive category when looking at passenger flows) since they tend to place more importance on availability of non-stop or direct flights, frequency of service and ticket flexibility, whereas leisure travellers are more often willing to compromise on flight timing and fixed tickets for the sake of price and are categorized accordingly. In this context, charter flights are usually viewed as relevant only to the leisure market, since they do not normally offer the service frequency, ticket flexibility or indeed higher levels of service associated with business travel, and have a particular disadvantage in not offering the facility to interline with other carriers. Virgin told us that it regarded charter services as non-substitutes for scheduled services, particularly for time-sensitive and business travellers, for reasons which would still apply to scheduled-status ex-charter airlines, such as standard of service and lounge facilities. Thus, although the ex-charter operators now have scheduled status, they cannot be said to offer a competing business service whilst they do not provide the advantages customary for business travel. For example, they have low-frequency services and they fly from Gatwick in the UK.

Air services between city pairs

4.73. As well as directly-linked airports, markets to be considered can also exist between city pairs which are not directly connected. Services between such pairs can often have more than one possible route, through hub or gateway airports. In this context, the possibilities for airlines to combine or to use each other's services (interlining) are of importance, since air passengers prefer travelling with the same airline throughout journeys of more than one flight (intralining) and the ability of foreign airlines to compete on such through routes can be affected by access to domestic networks. In indirect markets such as these, as well as in direct markets, airline loyalty programmes and the interchangeability between these, as well as the growing phenomenon of airline alliances in general, have become important forces in shaping the competition on routes.

4.74. Table 4.11 details the city-pair OD markets and airline shares for services between London and the major Canadian cities, together with population statistics. These OD figures include passengers on indirect routings and exclude those connecting at either end of the city pairs.

TABLE 4.11 **London–Canada scheduled OD markets in 1999**

	Population '000	*Air Canada*	*BA*	*Canadian*	*Other*	*Total*
Toronto	4,680	170,399	107,689	95,561	42,392	416,042
Vancouver	2,017	83,817	85,889	28,920	15,557	214,182
Montreal	3,439	72,269	69,176	627	3,556	145,630
Calgary	934	53,570	2,825	43,623	3,842	103,860
Ottawa	1,065	55,226	3,441	37,615	2,244	98,526
Halifax	353	38,137	797	1,319	9,906	50,159
Edmonton	929	18,393	1,429	6,984	11,958	38,764
Victoria	316	17,098	9,657	3,247	681	30,684
Winnipeg	678	14,087	707	2,944	-	17,738
St John's	175	10,220	1,430	-	-	11,650
London	419	5,115	-	2,486	-	7,601
Other points		29,455	7,770	6,970	1,451	45,646
Total		567,786	290,810	230,297	91,588	1,180,481

Source: CAA Origin/Destination Passenger Survey. Population statistics from Statistics Canada.

Note: Figures exclude Stansted airport, which was not surveyed.

4.75. From Table 4.11 it can be seen that the number of markets of any major size is limited; only routes from London to Toronto, Vancouver, Montreal and Calgary carry more than 100,000 OD passengers a year, and of the rest only routes to Ottawa and Halifax carry more than half this amount. This apparent thinness of many of the routes is of particular relevance when considering the effect of the merger on the London–Calgary and London–Ottawa routes, where Air Canada and Canadian Airlines used to compete, and it is open to conjecture as to whether the demand was in fact sufficient to support two carriers. On the other hand, it should be noted that, since the withdrawal of Canadian Airlines' service on the Calgary route, Air Canada has introduced an extra daily service to replace it, which could imply that there are profits to be made on two flights a day.

Time-sensitive markets

4.76. In 1999, travellers on business purposes accounted for around 24 per cent of the total London–Canada OD scheduled market, a relatively low extent compared with services to the USA (see paragraph 4.79). According to CAA figures—as can be seen in Table 4.12—in all the city-pair markets with above 10,000 passengers a year, the share of the business market held by the combined three scheduled carriers under consideration (ie Air Canada, Canadian Airlines and BA) is 95 per cent and above (except for Halifax). Furthermore, according to the CAA's submission, only 2 per cent of the substantial share of the OD market, taken by now redesignated charter services, was made up of business travellers in 1998. If we look at the routes concerned in the merger between Air Canada and Canadian Airlines, it can readily be seen that the relevant market most likely to be adversely affected is that of time-sensitive passengers (accepting business travel as a fair proxy) in three OD markets between the UK and Canada: London to Toronto, Ottawa and Calgary.

TABLE 4.12 **London–Canada scheduled OD business markets in 1999**

	Air Canada	*BA*	*Canadian*	*Other*	*Total*
Toronto	45,730	26,182	30,988	4,773	107,674
Montreal	23,002	18,535	-	736	42,273
Ottawa	22,895	1,486	13,739	-	38,119
Vancouver	5,607	13,776	3,612	512	23,507
Halifax	18,351	-	1,319	3,766	23,437
Calgary	6,461	-	5,841	-	12,302
Victoria	2,131	4,593	404	-	7,129
Winnipeg	3,162	679	334	-	4,174
Medicine Hat	706	-	2,376	-	3,082
Thunder Bay	2,684	-	-	-	2,684
St John's	902	1,430	-	-	2,332
Other	6,686	2,991	1,174	226	11,078
Total	138,318	69,671	59,787	10,014	277,790

Source: CAA Origin/Destination Passenger Survey.

Price-sensitive markets

4.77. The market for price-sensitive travel between Canada and the UK has been affected to a different extent by the merger. Price-sensitive travellers are customarily willing to accept less flexibility and more indirect routings in return for lower-priced travel. The relevant market for these travellers could be seen as all services between London and Canada on the overlapping routes. The market shares on these services are shown in Table 4.13.

TABLE 4.13 **Market shares (passengers) as quoted by the CAA, London–Canada overlap routes, total direct traffic 1999**

per cent

		Air Canada	*BA*	*BA/CP*	*Canadian*	*Other*
London–Toronto	*(a)* BA separate from CP	31	24		24	21
	(b) With BA/CP together	31		48		21
	(c) With merger	55	24		-	21
London–Vancouver	*(a)* BA separate from CP	29	40		10	21
	(b) With BA/CP together	29		50		21
	(c) With merger	39	40		-	21
London–Calgary	*(a)* Pre-merger	40	-		54	5
	(c) With merger	94	-		-	5
London–Ottawa	*(a)* Pre-merger	56	-		44	-
	(c) With merger	100	-		-	-

Source: CAA.

Note: These figures understate the share of other airlines to Calgary and Ottawa: see paragraph 4.58.

4.78. The inclusion of the redesignated charter airlines in this definition of the supply of air services in the price-sensitive market makes a significant difference to the market shares of the scheduled airlines on the London to Toronto and Vancouver routes. Thus, the figures include new scheduled flights from Gatwick, run by redesignated former charter carriers. Air Canada's shares with the merger in these markets, using 1999 figures, are 55 per cent and 39 per cent respectively, compared with 69 per cent and 49 per cent (see Table 4.5).

4.79. The traffic on UK–Canada direct services is characterized by relatively high proportions of leisure passengers. Compared with that on other transatlantic routes, for example those to the USA, business traffic between the UK and Canada is a significantly lower proportion of the total. The latest available figures for business and leisure passengers analysed by nationality are shown in Table 4.14. The CAA advised us that the foreign passengers on UK–Canada routes are almost all Canadian.

TABLE 4.14 **Business/leisure content on selected UK–Canada and UK–US routes in 1996: OD passengers on direct services**

	Foreign business	*Foreign leisure*	*UK business*	*UK leisure*	*Total*	*Total business*
Toronto	49,389	254,179	35,163	210,961	549,692	84,552
	9%	46%	6%	38%	100%	15%
Vancouver	10,822	99,995	8,384	130,722	249,922	19,206
	4%	40%	3%	52%	100%	8%
Boston	67,674	180,679	74,870	187,580	510,803	142,545
	13%	35%	15%	37%	100%	28%
JFK (New York)	235,676	366,054	238,938	437,961	1,278,629	474,614
	18%	29%	19%	34%	100%	37%
Los Angeles	46,831	183,010	55,400	237,019	522,260	102,231
	9%	35%	11%	45%	100%	20%

Source: CAA Origin/Destination Passenger Survey.

4.80. The proportions of leisure passengers are higher on UK–Canada routes than on UK–US ones. The different business/leisure balance in the UK–Canada market, compared with the UK–US market, has its origins in the large VFR segment of the leisure UK–Canada market.

Competition between London airports

4.81. Although we have looked thus far mainly at flights from Heathrow to Canada because it is on Heathrow–Canada routes that the competitive situation has changed most directly, it is important to consider the possibility of other UK airports as substitutes for Heathrow. Most previous examinations of this nature have concluded that Gatwick constitutes a separate market from Heathrow. BA did inform us that there were no differences in its published fare structures for identical transatlantic flights at Heathrow and Gatwick, but noted that not only did demand for these fares differ greatly, in that Heathrow had far more business passengers, but also that more seats on Gatwick flights were sold at a discount than on Heathrow flights, making the average revenue per passenger lower on UK–Canada flights from Gatwick.

4.82. The chief reason why Heathrow is generally held to be preferred over other London airports is the range and frequency of onward flights available from it. In this respect, it is probably first among European airports, and is certainly unrivalled in the UK. Table 4.10 showed that nearly half (49 per cent) of the passengers on the overlap routes (direct flights from Heathrow to Toronto, Vancouver, Calgary and Ottawa) in 1999 connected at Heathrow. The airlines clearly believe that operating from Heathrow is more profitable than operating from Gatwick. Notwithstanding this, BA has, over recent years, developed a considerable operation out of Gatwick, to Europe, North and South America, and Africa, which it consolidated through its takeover of CityFlyer in 1999. In addition, Virgin and several US operators fly from Gatwick to the USA, although this is perhaps more due to the UK–US ASA's restrictions on carriers flying from Heathrow. Nonetheless, despite its large slot holding at Heathrow, BA has continued to run Gatwick–US operations. On the other hand, both potential UK entrants to the UK–Canada market, British Midland and Virgin, have declined to set up these services from Gatwick, preferring to wait until the right slots become available at Heathrow.

4.83. A second reason sometimes given for travellers' preference for Heathrow is its easier access from London, compared with that of Gatwick. This has probably been enhanced by the recent opening of the Heathrow Express rail service from Paddington station in central London. Outside London, both Heathrow and Gatwick have large suburban residential areas within their catchment areas, although this perhaps has more relevance to airport access for leisure travel than for business. In addition to residential areas, however, there has been substantial recent growth in new industries, such as information technology, along the Thames Valley and the surrounding area, most of which will probably favour Heathrow for business travel. Indeed, many of these businesses chose their location in the M4 corridor so as to have easy access to Heathrow.

4.84. While the margin of Heathrow's superiority in terms of its network is perhaps declining, due to Gatwick's expanding role as a second London hub, its overall pre-eminence is still maintained, not least as evidenced by the preference of airlines to operate from Heathrow (see also paragraphs 5.198 to 5.200).

The competitive situation following the merger

Market concentration

4.85. Judging the change in the competitive situation on the overlap routes is dependent on the construction put on the cooperation between BA and Canadian Airlines prior to this (see paragraph 4.52). Tables 4.15 and 4.16 show market shares and HHI for alternative assumptions in the overlap direct, OD and OD business London–Canada markets before and after the merger, based on passenger figures for 1999. HHIs are an indication of the concentration in a market and are calculated from the sum of the squares of the percentage market shares of the competing firms, and so a lower index indicates less concentration within a market.

TABLE 4.15 **Estimated market shares, before the merger, 1999**

	Air Canada %	*Canadian Airlines* %	*BA* %	*BA plus Canadian Airlines* %	*HHI (assuming BA+CP)*
*Passengers on direct services**					
UK–Canada	35	18	23	41	3,120
London–Canada	37	21	27	48	3,750
London–Toronto	31	24	24	48	3,440
London–Vancouver	31	10	42	52	3,770
London–Calgary	36	49	-	49	3,760
London–Ottawa	63	31	-	31	4,950
*OD passengers**					
UK–Canada	30	12	15	27	2,100
London–Canada	36	15	18	33	2,590
London–Toronto	26	14	16	30	2,160
London–Vancouver	27	9	28	37	2,520
London–Calgary	35	29	2	31	2,490
London–Ottawa	51	35	3	38	4,110
Scheduled business OD passengers					
London–Canada	50	22	25	47	4,720
London–Toronto	42	29	24	53	4,590
London–Vancouver	24	15	59	74	6,060
London–Calgary	53	47	-	47	5,020
London–Ottawa	60	36	4	40	5,200

Source: CAA.

*CAA figures for charter passengers (which are also assumed to be primarily OD passengers) have been adjusted as noted in paragraph 4.58.

TABLE 4.16 **Estimated market shares, with the merger, using 1999 passenger figures**

	Air Canada plus Canadian Airlines %	*BA* %	*HHI (assuming BA+CP)*	*Change in HHI*
*Passengers on direct services**				
UK–Canada	53	23	3,550	430
London–Canada	58	27	4,170	420
London–Toronto	55	24	3,770	330
London–Vancouver	41	42	3,500	–220
London–Calgary	85	-	7,280	3,520
London–Ottawa	94	-	8,860	3,910
*OD passengers**				
UK–Canada	42	15	2,460	360
London–Canada	51	18	3,090	500
London–Toronto	40	16	2,440	280
London–Vancouver	36	28	2,500	–20
London–Calgary	64	2	4,410	1,920
London–Ottawa	86	3	7,470	3,360
Scheduled business OD passengers				
London–Canada	72	25	5,820	1,100
London–Toronto	71	24	5,630	1,040
London–Vancouver	39	59	5,010	–1,050
London–Calgary	100	-	10,000	4,980
London–Ottawa	96	4	9,230	4,030

Source: CAA.

*CAA figures for charter passengers (which are also assumed to be primarily OD passengers) have been adjusted as noted in paragraph 4.58.

4.86. Using 1999 figures, following the merger market concentration has increased on the London–Toronto, London–Calgary and London–Ottawa routes, for direct, OD and scheduled business OD passengers. On the London–Vancouver route, market concentration has reduced, especially for scheduled business OD passengers.

Slot concentration

4.87. Air Canada's slot holdings at Pearson Airport in Toronto increased significantly following the takeover of CAC by 853350 and the passing of control over Canadian Airlines' slots to Air Canada. Before the takeover, Air Canada held rights to 4,060 slots per week at Pearson, which grew to 5,862 (ie up by 44 per cent) on the addition of Canadian's slot holdings. This has since been reduced slightly to 5,552 (a 27 per cent increase on the pre-takeover level) on the disposal of some of Canadian's slots (see paragraph 4.113). The proposed sale of the Canadian Airlines subsidiary CRAL (see paragraph 4.126), if it goes ahead, will lessen this holding further, although the slots released in this case will not be at prime times, since Air Canada intends to keep these.

Frequency of services

4.88. Table 4.17 shows the weekly frequencies for the London–Canada flights of the three scheduled operators for a number of recent seasons. The overall capacity serving the Canadian gateway airports has decreased significantly. Taking all three carriers, capacity has fallen by 16 per cent (138 flights per week to 116) on the previous equivalent season (between summer 1999 and summer 2000). Looking solely at Air Canada/Canadian Airlines' share, however, reveals that there has been a 22 per cent fall in the number of these flights over the same period.

4.89. On the four overlap routes, total direct scheduled flights have fallen from 56 flights per week to 49 (12.5 per cent) on London–Toronto, from 26 to 21 (19 per cent) on London–Vancouver, 16 to 14 (12.5 per cent) on London–Calgary, and from 11 to 7 per cent on the London–Ottawa route. The combined Air Canada/Canadian frequencies have fallen from 45 to 35 (22 per cent) on London–Toronto, and from 19 to 14 (26 per cent) on London–Vancouver (with these two airlines being the only operators on the London–Calgary and London–Ottawa routes). BA has actually increased its capacity on the London–Toronto route, from 11 flights per week to 14 (27 per cent), since losing its revenue-sharing arrangement with Canadian Airlines.

Market entry

4.90. Another possible effect of the Air Canada/Canadian Airlines merger is on the barriers for new or other carriers to enter the markets described in the sections above. The ability of any airline to do this will depend to some extent on the ease with which it can become integrated into the existing network of domestic and international operators. Barriers to entry in this respect can range from the existing interlining and code-sharing arrangements, to more indirect barriers such as passenger loyalty schemes.

Interlining arrangements

4.91. Flying between two destinations often involves using the services of more than one airline. In order to simplify and smooth such travel, airlines are usually party to agreements, either bilateral or multilateral, with other airlines, which formalize the conditions under which the transfer of passengers between carriers, or interlining, is undertaken. Through these arrangements, an airline can sell a ticket to a traveller wishing to use its service, flying to an eventual destination which is not served by the carrier. Interlining agreements come in a wide variety of forms, with differing degrees of integration between carriers, from standard industry interlining and prorating arrangements to code-sharing, when carriers agree to allow their flights to carry the flight designation code of their partner airlines, and even as far as the coordination of timetables and the sharing of revenues on a particular route (as Canadian Airlines and BA had on the London–Toronto service prior to the former's merger).

TABLE 4.17 **London–Canada weekly frequencies**

		Summer 1998			*Winter 1998/99*			*Summer 1999*			*Winter 1999/2000*			*Summer 2000*		
		AC	*CP*	*BA*	*AC*	*CP*	*BA*	*AC*	*CP*	*BA*	*AC*	*CP*	*BA*	*AC*	*CP*	*BA*
Toronto	Non-stop	27	18	10	16	17	7	28	17	11	20	17	7	28	7	14
	One-stop	2				3						3				
Vancouver	Non-stop	10	7	7	7		7	12	7	7	7		7	7	7	7
	One-stop	2							1							
Montreal	Non-stop	7		7	7		7	7		7	7		7	7		7
Calgary	Non-stop	8	7		7	7		7	9		7	9		7	7	
	One-stop															
Halifax	Non-stop	2						3						3		
	One-stop	5			5			4			5			4		
Ottawa	Non-stop	7	3		3	3		7	4		5	3		7		
	One-stop				4						2					
Edmonton	Non-stop	3														
	One-stop	3						3								
St John's	Non-stop	5			5			4			5			4		
Total	Non-stop	69	35	24	45	27	21	68	37	25	51	29	21	63	21	28
	One-stop	12	0	0	9	3	0	7	1	0	7	3	0	4	0	0

Source: OAG flight guide.

Prorating arrangements

4.92. When a traveller's journey involves interlining between two or more carriers, the fare charged for the whole journey is normally less than that which would be levied for the component flights on the sections involved, with the possibility of travel over different hubs and with different carriers. This means that participating airlines must agree on how this 'through' fare should be apportioned between them. Many airlines have agreements with others on routes or combinations of routes, either bilaterally or through alliances. For example, Air Canada has around 80 interlining agreements with other airlines. Where there is no such agreement, the basic industry convention under which revenue is divided is the multilateral prorate agreement (MPA), and the principal method used in this is known as straight-rate prorating (SRP). This approach apportions the through fare in proportion to prorate mileages established for each sector. The prorate mileage for a sector is based on the actual distance, with a prorate factor weighting to reflect the unit costs typical of a flight of that length, in that geographical region.

4.93. With the through fare apportioned in this way, airlines are allowed to file a 'proviso' on their sector (where the distance of that sector is less than 3,000 prorate miles), referring to a minimum which they are willing to receive for their sector (usually expressed as a proportion of their retail price for the stand-alone journey). The proviso may vary according to the type of fare being prorated and the origin/ destination of the journey involved. Should, however, any proviso leave another participating airline with less than a certain amount for their share of the journey (calculated using an industry rate of 8.8 US cents per mile, applied to the air distance), then all provisos are ignored in the calculation and the fare is apportioned according to the SRP. The prorate factors used in the SRP process are collated and published, along with individual airlines' provisos, by IATA's Prorate Agency.

4.94. The SRP minimum rates explained above are low enough to allow an airline with high proviso rates to appropriate a disproportionate share (that is, compared to the actual distance travelled) of the fare on more expensive tickets. For example, consider a two-leg journey, with one leg of 5,000 miles (the maximum leg distance on which a prorate proviso can be set is 3,000 miles) and the other leg of 500 miles. Assume that the longer-leg airline sells a through ticket for the two-leg journey for C$3,000 and is obliged to pay the other airline for the passenger's travel on the other leg (the prorate). Straight-rate prorating would divide the fare into C$2,727 for the longer leg and C$273 for the shorter one, with some further adjustment, in favour of the smaller fare, for fixed costs. The short-leg airline can implement a reserve price for its share of the voyage, up to an amount which leaves the long-leg airline with no less than the equivalent of 8.8 cents per mile for its journey (the current IATA minimum for the sector), or C$440. Thus, the short-leg airline could, by setting the appropriate prorate proviso level, bring its share of the through fare up to C$2,560, or 85 per cent of the ticket price, even though it only takes the passenger for less than 10 per cent of the voyage distance. As long as it was left with an amount above the IATA minimum, the long-leg airline would have to accept this amount if it wished to offer the through ticket.

Code-sharing between carriers

4.95. Often airlines will agree to cooperate on certain routes to a greater extent than simply agreeing on prorates. In some cases, airlines agree to use their own flight numbers on each other's flights when selling tickets, a practice known as 'code-sharing'. This can take the form of cooperation by airlines flying the same route, through which tickets sold by one airline could be used for services provided by another, under the selling airline's flight code. It can also take the form of an airline using its flight number on a through-ticketed service with a further leg on another airline. In this way, service frequency on a route can seem higher, or an indirect flight can appear more seamless, as if the journey involves intralining rather than interlining, both effects seen as important when flights are being chosen through, for example, a travel agent's computer system. In addition to this, code-sharing means that an airline's flights will appear more often on travel agents' CRS screens. Thus, for example, BA used its own flight number on Canadian Airlines flights between Heathrow and Toronto, as well as on connecting flights run by Canadian Airlines for onward services into Canada from gateway airports (and the reverse was true for passengers travelling such routes in the opposite direction and buying their tickets from Canadian Airlines). Code-sharing, then, is an indicator that an enhanced form of interlining is being offered. In itself, it may be little more than a cosmetic action, but the carriers involved see it as a valuable marketing device.

4.96. The importance of both favourable prorating terms and code-sharing agreements, negotiated between interlining carriers, is reflected to an extent in the recent growth in airline alliances (discussed

further in paragraph 4.105). On a highly competitive international route, an airline can derive great benefit from having a sizeable interlining partner for code-sharing on that route, for example in competing against another carrier on the same route that does not have similar favourable terms for through tickets. Airlines therefore see the lack of availability of interlining and code-sharing partners as important potential barriers to entry into air services markets.

Interlining, code-sharing and competition

4.97. One of the most significant consequences of Air Canada's acquisition of Canadian Airlines is that there will be no international gateway airport in Canada that is not dominated by Air Canada. Although it is often pointed out that more passengers make connections at the Heathrow end of UK–Canada journeys, the choice of interlining partners available at that end is considerably greater. This would not be the case at the Canadian end with the merger completed, since Air Canada offers the only all-class and geographically-comprehensive option for interlining and, consequently, any airline competing with Air Canada on UK–Canada routes would be dependent on the prorates which Air Canada chooses to provide (see also BA's views in Chapter 5).

Changes in prorates since the takeover of CAC by 853350

4.98. After CAC had been taken over by 853350, Canadian Airlines' membership of the Oneworld Alliance ended and its preferential interlining agreement with BA was cancelled. Following this, the setting of fares by Canadian Airlines used for establishing interlining proviso prorates under the MPA was undertaken in accordance with the new alignment between the two carriers. Both Air Canada and Canadian Airlines declared proviso prorates on many of their domestic routes which were almost three times their previous levels. These fares are detailed in Table 4.18.

TABLE 4.18 **Air Canada and Canadian Airlines fares, as filed first quarter 2000**

From	*To*	*Fare C$*	*Basis*	*New fare C$*	*New basis*	*% Increase*
Calgary	Edmonton	226	Y1	662	Y	193
		264	J1	774	J	193
Calgary	Kelowna	340	Y1	996	Y	193
		398	J1	1,166	J	193
Toronto	Halifax	678	Y1	1,987	Y	193
		793	J1	2,323	J	193
Toronto	Sault Ste Marie	417	Y1	1,222	Y	193
		488	J1	1,430	J	193
Toronto	London, Ontario	129	Y1	378	Y	193
		378	Y	-	-	-
Toronto	Ottawa	333	Y1	976	Y	193
		389	J1	1,143	J	193
Victoria	Vancouver	175	Y1	513	Y	193
		205	J1	601	J	193
Thunder Bay	Toronto	584	Y1	1,711	Y	193
		683	J1	2,001	J	193
Quebec City	Montreal	261	Y1	765	Y	193
Quebec City	Toronto	578	Y1	1,694	Y	193
		676	J1	1,981	J	193
Montreal	Ottawa	299	Y1	876	Y	193
		350	J1	1,026	J	193
Winnipeg	Toronto	770	Y1	2,256	Y	193
		901	J1	2,640	J	193
Kelowna	Vancouver	259	Y1	759	Y	193
		303	J1	888	J	193
Prince George	Vancouver	300	Y1	879	Y	193
		350	J1	1,026	J	193
Calgary	Toronto	1,214	Y1	3,557	Y	193
		1,420	J1	4,161	J	193
Vancouver	Toronto	1,450	Y1	4,249	Y	193
		1,696	J1	4,972	J	193
Windsor	Toronto	357	Y1	1,046	Y	193

Source: CC study from industry sources.

4.99. On the routes detailed above, either Air Canada or Canadian Airlines is the carrier, and a code-sharing arrangement exists between the two. In the first quarter of this year, Air Canada and Canadian redesignated their highest existing fully flexible fares in economy and business class, Y and J, to Y1 and J1, and increased the Y and J fares by the percentages detailed in Table 4.18. The conditions covering the old and new types of ticket were practically the same. This was done for the period of around three weeks during which the Prorate Agency (an IATA body responsible for collecting fare and proviso data for the MPA) collected data for its quarterly publication. Thus, the higher fares were registered by the Prorate Agency for Air Canada/Canadian Airlines' prorate provisos, while tickets continued to be available for sale at the Y1 and J1 fares.

4.100. Looking at the effect of these price changes on, for example, flights from London to Ottawa via Toronto, another transatlantic carrier, wishing to interline with Air Canada or Canadian Airlines on the Toronto–Ottawa leg, would have to pay C$1,143 for a business class single fare, as opposed to C$389 before the fare change. Air Canada's own fare for the London–Ottawa journey is C$2,250 so, if another carrier were to compete with it on the route, it would have to charge a similar fare while still paying the higher prorate proviso fare. This would leave the transatlantic carrier with C$1,107 for the London–Toronto leg, compared with C$1,143 for Air Canada for the Toronto–Ottawa leg. Since the minimum amount the transatlantic carrier could receive for its leg, according to the MPA, would be C$560,[1] the default SRP would not be triggered.

4.101. It should be noted, however, that the use of high prorate proviso fares is not unique to Air Canada and Canadian Airlines. The setting of proviso fares by a carrier which are well above its own local fare for the same journey is also undertaken by many US carriers throughout the USA. As mentioned in paragraphs 4.96 and 4.105, the importance of airline alliances is well illustrated by this situation. In reality, however, agreed rates are often negotiated by airlines on a reciprocal basis, either through alliance membership or as a consequence of competitive pressures.

Frequent Flyer Point schemes

4.102. FFP schemes are an important feature in attracting passengers to an airline. They are particularly important to business travellers, since many more points are given on business class flights than on economy tickets, and since business travellers travel far more than those who use economy tickets (notwithstanding any small overlap between the two). FFP schemes are usually designed to produce customer loyalty to a particular airline or, as is increasingly the case, to a particular airline alliance. They also enable the airline to acquire demographic and other data about their best customers.

4.103. In Canada, Air Canada had by far the largest FFP scheme membership of the two main scheduled carriers, with around 5 million members, as opposed to 2.9 million in Canadian Airline's scheme. At the time of the start of merger activity between Air Canada and Canadian Airlines, it was a matter of concern to the Canadian Competition Bureau that the new merged entity would be in a strong position to attract Canadian passengers, particularly those travelling on business, to their FFPs and to 'lock-in' their future travel by their dominance in the domestic market, combined with their high market share in Canadian international routes and their membership of the Star Alliance. This was seen as a potentially strong barrier to entry for new or redesignated Canadian carriers, and the matter was addressed in the Canadian Competition Bureau's set of recommendations made to the Canadian Ministry of Transport and became subject of one of Air Canada's undertakings in December 1999 (see paragraph 4.118).

4.104. A second result of a future merger of Canadian Airlines' FFP scheme with that of Air Canada would be the lack of any domestic or international Canadian carrier which is a member of another FFP scheme with the consequence that non-Canadian international carriers such as BA would have problems in attracting Canadian travellers through their FFP schemes if their points could not be redeemed either within Canada or on many international flights out of Canada. However, BA has alliance partners who fly into Canada from other international destinations, such as American Airlines, on whose flights BA FFPs could be used. In addition, at the other end of UK–Canada air routes, BA is fairly strongly

[1]The prorate distance between Toronto and London is 4,299 miles. At 8.8 US cents per mile, this comes to US$378.31, roughly equivalent to C$560.

positioned, both within the UK and with its alliance partners in Europe, to attract passengers to its own FFP scheme.

The Star and Oneworld Alliances

4.105. A major development in the airline industry in recent years has been the growth in cooperation between airlines. This cooperation can vary widely, from bilateral interlining agreements and code-sharing arrangements, to revenue-sharing and franchise arrangements. Although there are obviously significant economies of scale to be exploited in the airline industry, another main reason behind such cooperative arrangements is that of access to regional and other national markets. The protectionist nature of the world air services industry means that many economies of scale cannot be exploited directly by mergers, due to the nationality restrictions on ownership. In addition, most ASAs contain restrictions on the access of foreign carriers to destinations within countries and airline cooperation can provide a way around such restrictions.

4.106. Airline alliances are of increasing importance in the aviation industry, as it moves towards an environment of global networks. Indeed, with the emergence of larger and more extensive global groups, competition in the air services industry is moving towards competition between rival alliances. The exit of Canadian Airlines from the Oneworld Alliance will mean that there will be no access for this alliance to passengers at non-gateway points in Canada on UK–Canada routes. Nonetheless, access will be retained to passengers in the major Canadian cities, both through BA's routes to gateways and American Airlines' flights via the USA, which two sets of routes account for most of the scheduled passengers travelling from the UK to Canada.

4.107. The possibility of entrants into the UK–Canada air services market should also be considered in terms of their alliance membership. For example, British Midland has recently become a member of the Star Alliance, of which Air Canada is also a member. Should British Midland enter the UK–Canada market, this would almost certainly have an effect on the arrangements between it and Air Canada for matters such as prorating, possibly even code-sharing. The extent to which such market entry would increase active competition in the market could then be considered in the same light as BA's previous links with Canadian Airlines through the Oneworld Alliance. Another potential entrant into the UK–Canada scheduled market could be Virgin. Although Singapore Airlines has a 49 per cent shareholding in Virgin, the latter stated that it had no links whatsoever to the Star Alliance, of which Singapore Airlines was a member.

4.108. The evolution of the industry towards global alliances may mean future competition between fewer carriers on individual routes, but of increasing intensity. The loss of its Canadian-based carrier could motivate the Oneworld Alliance into increasing its presence in the UK–Canada market, perhaps by serving more gateways, or by gaining access to some of the larger Canadian backpoints via American Airlines' US hubs. On the other hand, it is possible that the increase in multi-market contact which would occur between a few global alliances may act to dampen, rather than to invigorate, competition.

The acquisition of Canadian Airlines by Air Canada

4.109. The Canadian Government recognized that Canadian Airlines could not continue to operate as a firm on its own. It told us that it had originally believed the company would fail in the first quarter of 2000, but that in the event it was in imminent danger of financial failure before that, in December 1999.

The referral to the Canadian Competition Bureau

4.110. In August 1999, in recognition of the increasing likelihood of Canadian Airlines' failure, the Canadian Minister for Transport requested the views of the Canadian Competition Bureau on the competition aspects of a potential restructuring of the Canadian airline industry. In the ensuing analysis by the Competition Bureau, presented to the Minister in October, it was assumed (as requested by the Minister) that a dominant carrier would emerge from the process, that Canada's rules disallowing more than 25 per cent foreign ownership of a Canadian airline would be respected, and that the possibility of cabotage in Canada by a foreign operator would not exist.

Conclusions on a Canadian airline merger

4.111. The Competition Bureau concluded that the emergence of a single dominant national carrier, through either the failure of Canadian Airlines or its merger with Air Canada, would create a situation of market dominance and high entry barriers in both the domestic and international markets, and that such a situation would be open to anti-competitive abuses by such a dominant carrier. The Bureau felt that such an eventuality could be detrimental to the interests of business passengers in international, trans-continental, regional and local markets, and to those of leisure travellers in local and regional markets. In order that the possible adverse effects of such a restructuring might be mitigated, the Bureau drew up a set of recommendations for the terms on which it might be undertaken.

Restructuring recommendations

4.112. The recommendations made by the Bureau related to both the domestic and international markets for air services in and from Canada.

Domestic airports

4.113. First, the Bureau recommended that an emergent dominant carrier give up, on demand from other Canadian carriers, a sufficient number of the airport slots acquired through the restructuring process at Pearson airport in Toronto (as well as at any other Canadian airport where congestion became an issue), in order that other carriers might be able to compete on levels of service, and that Canadian carriers might offer effective competing domestic services.

4.114. Secondly, a dominant carrier should agree to make airport facilities such as gates, baggage systems and ticket counters available to airport authorities under reasonable terms, in order to guarantee the availability of these for other carriers.

4.115. Thirdly, it recommended that a dominant carrier be requested to waive any majority-in-interest clauses they might have at particular airports. Under such clauses, carriers with two-thirds of the passenger volume have the right to delay proposed capital expansion plans at airports. The exercise of such rights could prevent adequate new facilities being constructed for other carriers, particularly at airports where there might be only the dominant operator after a restructuring.

4.116. Finally, the Bureau felt that it would be important for smaller or entrant carriers not to be disadvantaged in sharing the costs of airport services. In many airports, the cost of services, such as security and runway and aircraft de-icing, are shared by operators according to the Chicago Formula. This involves the first 20 per cent of such costs being allocated equally among all carriers, irrespective of size, with the remaining 80 per cent being paid for according to passenger volume. In changing this rule at Canadian airports to allocate all service costs according to passengers, the Bureau hoped to avoid putting small or entrant carriers at a financial disadvantage, compared with a dominant carrier.

Slots at international airports

4.117. The Bureau recommended that a dominant Canadian carrier be required to surrender ‘a sufficient number’ of slots at airports outside Canada (again unspecified) of which the only suggested UK one was Heathrow. It was hoped that these could then be made available to new Canadian carriers. Such an arrangement, however, would be difficult to achieve under the EC slot regulation (which stipulates that any returned slots should be put back into the pool and cannot be earmarked for any route or carrier).

Frequent Flyer Programmes

4.118. The Bureau recognized the importance of FFPs within the Canadian domestic air service market, and the corresponding potential barrier to entry that they pose. Accordingly, it recommended that

entrants into the Canadian domestic market be able to purchase points in a dominant carrier's scheme at that carrier's internal transfer cost or the cost to an affiliate, if lower. It went further in recommending that the points be purchasable by Canadian carriers on international routes, should analysis prove that competition on international routes was inadequate.

Commission overrides

4.119. According to the Canadian Competition Bureau, travel agents account for more than 75 per cent of ticket sales by Canadian scheduled airlines. Travel agents in Canada are usually remunerated through a dual system, involving base commissions on a fixed percentage of the ticket price, and additional commission payments, called override commissions, paid when agents meet specific sales targets, which can include market share or revenue growth. These overrides provide strong incentives for agents to encourage the purchase of tickets on particular carriers, and in the case of the emergence of a dominant carrier in Canada, the Bureau was concerned that overrides might become a barrier to entry for new airlines. As such, these schemes can constitute an abuse of the airline's dominant position in the market. Accordingly, the Bureau recommended that, in the Canadian domestic market, travel agent remuneration systems should be linked to sales volume alone, on a straight-line basis, and not tied directly or indirectly to travel agent loyalty. The Bureau recognized the experience of the European Commission in developing remedies to deal with travel agent loyalty schemes imposed by large carriers.

Surplus aircraft

4.120. While recognizing that there might be a considerable divestment of aircraft under the consolidation of Air Canada and Canadian Airlines, the Competition Bureau was concerned that these aircraft should not be sold on outside the country, thus limiting the chance of an entrant operator to purchase enough capacity with the appropriate certifications at a reasonable price to begin operations. Its reason for this concern was that Canada's high safety standards and resulting restrictions and delays on the importation of foreign aircraft for use within Canada could have an adverse effect on the development of competing domestic carriers. The Bureau was also concerned that a dominant carrier might consider parking rather than selling any surplus aircraft. It therefore recommended that an emerging dominant carrier offer for sale within Canada all surplus aircraft resulting from a restructuring process, on reasonable terms, before either selling them abroad or mothballing them.

Interlining and code-sharing

4.121. Recognizing that any entrant into the Canadian domestic market would probably be based in one particular region, at least to begin with, and would therefore need to interline with a dominant domestic carrier to be able to offer service to and from outside such a region, the Bureau made recommendations regarding the availability and pricing of code-share operations between any entrant and the dominant firm. These suggested that the dominant carrier be required to negotiate interline agreements on 'commercially reasonable terms' with all entrants into the domestic market who desired to do so. They also recommended that entrants be able to code-share with the dominant carrier on such services as these interlining agreements referred to. This second recommendation does not specify whether entrants should be able to insist on code-sharing arrangements.

Regional carrier divestiture

4.122. Finally, the Bureau, looking at the implications for overall domestic competition resulting from the emergence of a dominant carrier in the Canadian air services industry, found that the divestiture of regional affiliates by a dominant carrier would be necessary to introduce some competitive activity into the domestic market. Furthermore, it recognized that the success of any independent regional or sub-national new or divested domestic carrier would depend on the nature of its interaction with the dominant national carrier and therefore made the following recommendations.

4.123. The Bureau suggested that, on divestiture, the regional carrier retain the holdings of slots and other airport facilities which had been effectively allocated to it under the previous arrangement as part of the dominant carrier's organization. It also recommended that the dominant carrier be required to enter into interlining and code-sharing agreements with the divested carrier and that the dominant carrier be required to maintain the same operational and financial services which it had provided previously to the regional carrier, on reasonable commercial terms.

4.124. It was hoped that all these recommendations would safeguard against an emerging dominant firm abusing its position within the Canadian domestic market.

Air Canada's 'Undertakings'

4.125. Prior to the completion of the offer made by 853350 for CAC, a process of negotiation was undertaken by the Canadian Competition Bureau and the Canadian Government with Air Canada, in order to reach an agreement over the way in which the restructuring recommendations, made by the Bureau to the Ministry of Transport and detailed above, could be implemented. The result was a set of Undertakings, agreed upon by the two parties, in which Air Canada agreed to accept certain conditions 'in order to promote and maintain airline competition in Canada'. These undertakings are described more fully in Chapter 3 of this report, and are set out in Appendix 3.5. Two matters should be taken into consideration when looking at these Undertakings in the light of the Canadian Bureau of Competition's previous recommendations. First, the recommendations were made at the time of the previous bid for both Air Canada and Canadian Airlines by Onex and therefore do not refer directly to Air Canada's take-over of Canadian Airlines, but only to the emergence of a dominant operator in the Canadian market. Secondly, at the time of these negotiations, Air Canada was about to agree to several conditions including continuing services to remote areas, taking on Canadian Airlines' workforce without large compulsory redundancies, and taking on a substantial amount of (albeit discounted) debt from Canadian Airlines, none of which was assumed or allowed for in the Canadian Competition Bureau's recommendations.

Canadian Regional Airlines divestiture

4.126. The Undertakings included an agreement by Air Canada to offer for sale the Canadian Airlines regional operator inherited in the merger process, CRAL. This regional operator has been described as based mainly in western Canada, but as being 'substantial' nonetheless. The offer was to be made on terms agreed between Air Canada and the Bureau and would be made for 60 days, after which, if still unsold, CRAL would revert to Air Canada, which would no longer be under any obligation to sell it.

4.127. A condition accompanies the sale, referring to CRAL's existing slot holding at Toronto. A clause in the Undertakings states that the slots currently held by CRAL at Pearson during the two peak times of the day would not be sold along with the regional company, but would revert to Air Canada's holding. Air Canada told us that this was to allow them to compete more effectively with US carriers for transborder traffic. A newly-independent carrier might find it more difficult to operate without the slots needed to offer an attractive peak-time service.

Slots

4.128. In addition to the retention of CRAL's peak-time slots at Pearson, Air Canada negotiated the conditions governing the number of slots it would have to divest in the event of the sale of CRAL either going ahead or not. These conditions require Air Canada to surrender slots during the period around the two peak times of the day at Pearson (and to give back more slots if CRAL remains unsold) but, combined with the retaining of CRAL's peak slots, could allow Air Canada to choose the slots it retains from the best available in the two companies' pools.

Domestic airports

4.129. Air Canada undertook, for the period of one year, to offer for sale or otherwise make available some airport facilities for common use, such as ticketing and check-in facilities, gates and loading facilities. In terms of sharing airport costs on a basis less prejudicial to new domestic carriers, Air Canada agreed to use its best efforts to change the use of the Chicago Formula at Canadian airports, in favour of a system allocating 100 per cent of costs on a passenger volume basis, but made the important exception of the nine gateway airports. The waiving of majority-in-interest rights was agreed to but with the exception of the six largest airports in the country. Such moves make it more difficult for any new domestic carriers to operate other than on a regional basis outside the gateway airports.

Interlining and joint fare agreements

4.130. Also included in the Undertakings is an agreement by Air Canada to enter into negotiations for interlining and joint fare agreements with any domestic carrier, on 'commercially reasonable terms'. No similar undertaking is made, however, in relation to international non-Canadian carriers. We note that Act C-26 introduces as an anti-competitive act the denial by a person operating on domestic services of access on reasonably commercial terms to essential facilities or services. It is proposed that regulations specify facilities or services which are essential and in the current draft of the regulations (set out in Appendix 3.6), interline arrangements are provided as an example of a service or facility which may be designated as being essential. These provisions apply in respect of refusals to both domestic and international air carriers.

The sale of FFP points (access to Aeroplan)

4.131. The undertakings regarding the sale of FFPs refer only to other Canadian air carriers, although they can be acquired or redeemed on the international services of these carriers. Thus, for example, points can be awarded on the international services of former charter airlines such as Air Transat and Canada 3000, and redeemed on the international flights of any carrier which has an Aeroplan agreement with Air Canada.

Travel agent commission overrides

4.132. Travel agent commission overrides are described in paragraph 4.119. Prior to the recent consolidation activity, Air Canada rewarded travel agents who sold tickets on its domestic services through a system which calculated commission overrides on the basis of domestic market share and growth. In recognition of its increased market power in the event of its merging with Canadian Airlines, Air Canada agreed in the Undertakings that rewards for sales of domestic tickets would depend only on domestic revenue volumes. This was done since it was felt by the Canadian Competition Bureau that Air Canada could potentially use its increased market power to tie in the custom of travel agents, by making a substantial part of their income depend on their loyalty to Air Canada services, through market share and revenue growth.

4.133. In May 2000, a new commission system was announced by Air Canada to Canadian travel agents with effect from 1 June 2000, which based incentive override commissions for both Air Canada and Canadian Airlines domestic flights on domestic revenue volumes. The actual percentage rates applied to these volumes, however, depend on the travel agent's performance, in terms of market share and revenue growth, in transborder (ie to the USA) markets and other international flights. The new rates are shown in Table 4.19.

TABLE 4.19 **Payment grids for Air Canada's new travel agent commission programme, 'Horizon 2000'**

	World share				*World revenue growth*			
Relative position	*Atlantic and Pacific rate %*	*USA and sun rate %*	*Canada reward %*		*Relative position*	*Atlantic and Pacific rate %*	*USA and sun rate %*	*Canada reward %*
Less than 0	*Figures omitted. See note on page iv.*				Less than 0	*Figures omitted. See note on page iv.*		
0 – 9.99					0 – 4.99			
10 – 19.99					5 – 9.99			
20 – 29.99					10 – 14.99			
30 – 34.99					15 – 19.99			
35 – 39.99					20 – 24.99			
40 – 44.99					25 – 29.99			
45 – 49.99					30 – 34.99			
50 – 54.99					35 – 39.99			
55 – 59.99					40 – 44.99			
60 +					45 +			

Source: Letter from Air Canada to incentive commission programme travel agents, 18 May 2000.

4.134. Thus, for example, if an agent's World Share Relative Position were 45.50 per cent, and its World Revenue Growth Relative Position were 21.50 per cent, it would receive [✂] per cent ([✂] per cent plus [✂] per cent) on its Atlantic and Pacific revenues, [✂] per cent ([✂] per cent plus [✂] per cent) on its USA and 'Sun' (ie Caribbean) revenues and [✂] per cent ([✂] per cent plus [✂] per cent) on its domestic Canadian revenues.

4.135. Such a secondary link is not contrary to the Undertakings, since these dealt only with disallowing the linking of commission on domestic sales to domestic market share. Since the Undertakings focused only on the Canadian domestic situation, Air Canada has been able to reward travel agents' loyalty through the international market.