5 Views of third parties

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Introduction

5.1. This chapter summarizes the views of third parties. About one-half of those from whom we heard were critical of the merger, and suggested possible remedies. Others believed there were no adverse effects on the UK public interest, while the British Air Line Pilots Association invited us to consider the wider issues of international regulatory developments affecting the airline industry. None of the third parties suggested the merger should not be allowed, given the financial position of Canadian Airlines, but the main areas of concern, for which those critical of the merger proposed remedial measures, related to the availability of slots for competing services, interline and prorate arrangements for connecting traffic in Canada and the effects of FFPs and the structuring of commission payments to travel agents.

Canadian Government bodies

Canadian Government

5.2. The Canadian Government believed that the public interest issues raised by the creation of a dominant airline in Canada extended well beyond any mutual concern with competition on Canada–UK air routes. The Canadian Government had taken measures to address concerns about Air Canada's dominant market position, Air Canada now having a share of about 82 per cent of the Canadian market, while maintaining a balance of various competing interests. A number of these measures affected Canada–UK routes.

5.3. The Canadian Government would have preferred Air Canada and Canadian Airlines to remain in competition. However, there was no doubt that Canadian Airlines was a failing firm, although its

international services were profitable. In order to avoid major disruption across Canada, particularly to employees and in air services to many smaller communities, the Canadian Government negotiated a solution with Air Canada whereby the airline took on a number of broad obligations, including several relating to competition. Speaking before the merger was complete, the Canadian Government said that Canadian Airlines remained basically insolvent, a cash injection by Air Canada having allowed it to trade over the Christmas period. It was kept by Air Canada at arm's length while making arrangements with creditors, although Air Canada effectively controlled it: they were operating as one company within Canada, code-sharing on flights and setting schedules as one company.

5.4. In October 1999, the Canadian Government had issued a paper explaining its policy objectives. These included fostering competition in the airline industry in Canada, protecting Canadians from unduly high prices on monopoly routes, ensuring continuity of services, especially to small communities, and protecting the rights of affected employees, all while retaining existing requirements that the Canadian airline industry be Canadian owned and controlled.

5.5. Additionally, the Canadian Government had designed its policies and approaches to airline restructuring to ensure that Air Canada would remain a viable international air carrier, that the public would receive service in both of Canada's official languages where warranted by numbers, and that safety would not be compromised.

5.6. In December 1999, the Canadian Competition Commissioner negotiated a wide range of undertakings from Air Canada, including that CRAL (which operated regional feeder services, including flights into both Vancouver and Toronto) be offered for sale, some slots largely in peak hours at Lester B Pearson International Airport in Toronto be divested and that Air Canada delay any establishment of discount air carrier operations in Eastern Canada. Additionally Air Canada had to enter into interlining and joint fare arrangements with Canadian air carriers on commercially reasonable terms and it also had to surrender certain airport facilities. Air Canada had to offer access to its FFP to eligible Canadian air carriers. Restrictions had to be placed on the incentive override commissions that Air Canada could offer travel agents with respect to domestic air services. Air Canada's surplus aircraft were to be made available to Canadian air carriers and measures were to be imposed to limit Air Canada's ability to influence the decisions of smaller airports in Canada. A number of these measures would affect Canada–UK services.

5.7. Commitments from Air Canada were also negotiated, on behalf of the Minister of Transport, on service to communities and on the employment rights of affected employees.

5.8. In February 2000, the Canadian Government introduced Bill C-26, which addressed the many public interest issues raised by the development of a dominant carrier and which would provide for the undertakings negotiated by the Competition Commissioner to be legally enforceable. The draft legislation included additional notice requirements where a carrier proposed substantially to reduce domestic services between two points, authorizing the Canada Transportation Agency to review the reasonableness of all fares on monopoly domestic routes, and the creation of a new full-time Air Travel Complaints Commissioner. The list of anti-competitive acts specific to airlines would be defined by changes to the Canadian Competition Act to include anti-competitive acts or conduct of a person operating a domestic air service and would apply to Canadian carriers whether engaged in domestic or international services. The Competition Commissioner was authorized to make temporary orders requiring a person operating on domestic services to cease anti-competitive acts. In a subsequent amendment to the Bill, if a person operating on domestic services denied access to essential facilities and services for an air service, then that could be found to be in contravention of the Competition Act and action taken. Hence if interlining, for example, was judged to be an essential facility or service and if Air Canada were not to provide interlining or allow it under commercially reasonable terms, that would be a contravention of the Act. 'Essential facility or service' would be defined further in the regulation (which was still subject to formal consultation). If such measures proved inadequate, further transport legislation in the next year or year and a half would give an opportunity to correct it. The Bill came into force on 5 July.

5.9. The Canadian Government believed that the Canada–UK air market was open and competitive with substantial opportunities for increased competition. In particular, it believed concerns over traffic feed, slots and interline rates had been overstated. Intervention in the market place by the UK Government to impose remedies with respect to the Canada–UK air routes was not warranted. The more developments that occurred in the Canadian domestic market, the greater the likelihood that competition would grow on international routes.

5.10. Competition between BA and Canadian Airlines had been very limited before the merger, particularly given the sharing of revenue on the major London–Toronto route: it was difficult to regard the merger as having reduced the number of carriers from three to two. Since the merger, however, there were now five designated air carriers in the Canada–UK air market. The Canadian Government said that it was open for either the Canadian or UK Governments to designate additional airlines in this market. Any designated airline could serve any Canada–UK city-pair market with any frequency and effectively any price. Canada had an open designation policy with respect to the UK market and had earlier this year issued a new and very liberal international air passenger charter policy. The Canadian Government also liberalized some of its other larger international markets and intended further to review its overall international air policy in 2001 with the intention of further liberalization, having given the merged company an initial period of stability. Relaxation of foreign ownership restrictions could also be considered in such future negotiations, although the Canadian Government was not convinced that relaxation of ownership requirements would necessarily benefit competition. The existence of a financially fragile carrier had itself previously constrained further liberalization.

5.11. The Canadian Government believed that the international airports in both countries had sufficient infrastructure and space availability to accommodate new international carriers or expanded service offerings by existing carriers. Regarding slots at constrained airports, the Canadian carriers had amply demonstrated that there were many city pairs between Canada and the UK with sufficient demand to support viable air services and which did not require the use of a slot-constrained airport.

5.12. The former Canadian charter operators, now designated as scheduled carriers, had a substantial market share and brand recognition in the Canada–UK market, which would be to their advantage in expanding into the scheduled market. They were developing products that would be increasingly attractive to time-sensitive passengers, including two-class service, connections to their domestic networks in Canada, and display of their scheduled services on computer reservation systems. Sixth freedom carriers were also in a position to compete.

5.13. The Canadian Government pointed out that the two governments routinely approved requests for code-sharing between designated carriers and carriers from third countries. In return, Canadian authorities had promised reciprocity for similar requests from UK carriers.

Traffic feed

5.14. The Canadian Government said that even with Canadian Airlines as its partner, BA had traditionally attracted little connecting traffic in or beyond Canada, while depending heavily on traffic beyond Heathrow airport. Even if BA were unsuccessful in the short term in replacing the Canadian traffic feed (which accounted for less than 8 per cent of its passengers), it would have lost only a small part of its access to the Canadian market, particularly as it still benefited from the strong feed via Heathrow (61 per cent of its passengers). However, the former Canadian charter airlines were now operating scheduled services across Canada, and offered opportunities to carry feed traffic for BA and other international airlines, and a new entrant had recently announced domestic services between Vancouver, Calgary, Edmonton, Winnipeg, Toronto, Montreal, Ottawa and Halifax, focusing on the business market but also interested in connecting with international traffic.

5.15. Air Canada had a much higher reliance on Canadian connecting traffic, having limited access to traffic beyond London. Thus, both major carriers had very viable and continuing strategies for remaining strong and effective in the Canada–UK market.

5.16. The Canadian Government believed that BA could now pursue new strategies based on its membership of the Oneworld Alliance. It could bolster or expand its Canadian services with additional US traffic feed at Canadian gateway airports and carry additional Canadian traffic from behind the gateway points through northern US hubs that it shared with its partner American Airlines. The Canada–US ‘open border’ air agreement provided full flexibility for US carriers to serve any Canadian market and transborder route.

Slots

5.17. The Canadian Government told us that convenient slots at Lester B Pearson International Airport were available for new or expanded services to the UK, Air Canada and Canadian Airlines now

using substantially fewer slots than in previous years. Infrastructure development would also increase the availability of slots. Slots at Heathrow airport were problematic, but Air Canada and Canadian Airlines were making fewer flights in the Canada–UK market during the summer of 2000 than in previous years, freeing up 30 slots at Heathrow out of the 212 previously used. BA had a larger inventory of slots at Heathrow than any other carrier, and provided the best opportunity to free up slots for services to Canada if it judged the market was sufficiently attractive to do so. Slots at other UK airports were available, and services to these airports had been shown to be commercially viable.

Interline rates

5.18. The Canadian Government believed it was not surprising that Air Canada was offering domestic feed at Canadian gateway airports to BA at higher prorates than had previously been offered by Canadian Airlines, since Air Canada and BA were members of competing alliances.

5.19. The Canadian Government understood that Air Canada had offered prorates that were consistent with the IATA MPA, the industry standard for arm's length carriers, to which both carriers were signatories. It had been told that the prorates that BA offered Air Canada at Heathrow were consistent with the same agreement.

5.20. Given their mutual interest in better prorates from the other on traffic feed to their Canada–UK services, it would seem possible that commercial discussions between Air Canada and BA could generate a satisfactory solution to this issue.

Whether intervention is warranted

5.21. The Canadian Government believed that the Canadian air market place was therefore dynamic and evolving and could be expected to mitigate in its own time many of the concerns about competition. As well as the new entrant and the scheduled services now operated by the former charter airlines referred to in paragraph 5.12, two other operators had expanded their services. The Canadian Government believed competition from a number of such smaller-focused airlines was feasible, although it was unlikely that two carriers of the size of Air Canada and Canadian Airlines could be sustained. Even though for international passengers commencing or ending journeys behind the major centres there would initially be direct access only to international airlines of the Star Alliance, the conditions were there for other alliances to extend their reach. The more development that occurred in the Canadian market, the greater the likelihood that competition would grow on international routes and partners for BA and other international carriers would emerge. Intervention in the merger would be unfortunate and could affect Canada–UK bilateral air relations.

5.22. The Canadian Government further believed that many of BA's suggested remedies would actually reinforce Air Canada's dominant position on the Canadian market and would not enhance competition. At the very least, any intervention at this time would be premature, for example by contributing to the exposure of Air Canada's FFP. The market was evolving rapidly, the question of whether Air Canada would need all its slots at Heathrow airport was unresolved, and time was needed for normal commercial discussions and negotiations among interested airlines on matters such as interline prorates and traffic feed arrangements. Precipitate action by a government body at this time would pre-empt the ability of private sector parties to find commercial solutions, and worse, would undermine the interest of some parties in even trying. Some of the measures suggested, for example to require Air Canada to divest slots at Heathrow, would also set an unfortunate precedent in bilateral relations, while the competition authorities in Canada were best placed to decide whether it was necessary to intervene in other matters in future and had the power to do so.

Competition Bureau, Industry Canada

5.23. The Competition Bureau, Industry Canada, did not wish to make representations for or against the merger. It told us that it had been guided by two overriding considerations when negotiating the Undertakings with Air Canada. First, it had determined that Canadian Airlines was on the brink of financial insolvency. Secondly, in light of this urgent situation, the main issue was whether it would be competitively preferable to force Canadian Airlines into liquidation through bankruptcy proceedings, or

to allow the transaction accompanied by the Undertakings. The Bureau decided that the merger, with undertakings, would be more pro-competitive than liquidation through bankruptcy proceedings. It further believed that the concessions made by Air Canada in response to the Bureau's concerns provided a reasonable solution for Canadian consumers, given the circumstances.

5.24. The Bureau stressed that very significant competition concerns persisted in relation to the Canadian airline industry. Prior to a review of the transaction, conducted under the Competition Act of Canada, the Bureau submitted to the Government of Canada a list of recommendations designed to address competition concerns in the event of a dominant carrier arising from industry restructuring. Many of these recommendations involved legislative, regulatory and policy changes that were beyond the jurisdiction of the Competition Bureau to implement.

5.25. The Bureau did not want to see competition substantially lessened on international routes, including transatlantic routes, as a result of the merger. Further to BA's appearance before the Parliamentary Committee, examining the Government of Canada's Bill C-26 on airline restructuring, amendments had been made in order to address the concerns raised by BA and other carriers.

UK Government bodies

Civil Aviation Authority

Regulatory environment—ownership and fares

5.26. The CAA told us that air services between the UK and Canada were operated under the terms of the bilateral ASA between the two countries. The ASA placed no restrictions on the number of airlines each side designated, the city pairs they served and the frequency and capacity they mounted. However, it still contained nationality-based restrictions on the ownership and control of the airlines which each side designated. Such restrictions allowed either side the option of refusing to accept the designation by the other side of an airline where it was not satisfied that substantial ownership and effective control of that airline were vested in the designating country or its nationals. The effect of such restrictions was to limit the pool of potential new entrants to the market for UK/Canada air services to carriers who were substantially owned and effectively controlled by either UK or Canadian nationals, and thus act as a barrier to free market entry. The ASA also retained a number of restrictions on the ability of airlines to charge freely the fares they chose according to their commercial judgement. The ASA required the airlines of each country to file with the authorities of each side the fares they proposed to offer.

5.27. Each authority then had the ability to disapprove fares in accordance with complex procedures stipulated by the ASA. If either side disapproved a fare it would not come into effect, with a number of exceptions. The exceptions were essentially that:

(a) On 23 'agreed' UK–Canada routes, providing that a fare was either (i) above a bilaterally agreed minimum level or (ii) had tightly defined booking and travel conditions attached, the fare would take effect unless it was disapproved by its own authority on the grounds of being either excessive or predatory.

(b) Neither authority could disapprove fares proposed by airlines of the other country where they were matching or higher than those of its own airlines.

5.28. The CAA explained that there were three reasons why it might intervene to disapprove UK/Canada fares:

(a) if a proposed fare were excessively high due to market power. This might be the case where bilateral government-imposed constraints prevented free market entry. In these circumstances, the CAA's policy was to ensure that air travellers had access to a basic on-demand fare which was reasonably related to the cost of provision. In the UK/Canada market, the CAA monitored the lowest fully flexible economy fare type, the Y2 fare, and might be prepared to refuse proposed increases in this fare. The last occasion on which the CAA had done so was in 1996.

(b) if a proposed fare constituted anti-competitive behaviour. In practice, the CAA rarely intervened on these grounds, and had not had to do so in the UK/Canada market.

(c) in order to implement the sum of sectors policy (see Chapter 4) which the UK applied only to routes to and from Canada and the USA. This policy had been in place for many years and was originally justified on the grounds of protecting British airlines against unfair competition from carriers at the other end. However, the effect of the policy was higher air fares for passengers, and the CAA no longer believed the policy to be justified. It believed that more effective means of ensuring fair competition for British airlines were available.

5.29. The CAA believed that competition was generally much more effective than regulatory intervention in protecting air travellers from being overcharged. It reserved its powers of intervention for markets in which government-imposed constraints prevented free competition, and where its analysis of proposed fares increases established that they were clearly excessive relative to cost. The CAA did not apply this policy to foreign carriers because it had no means of accessing the relevant cost and revenue information. With very few exceptions indeed it was BA which was directly affected by the CAA's policy against excessive fares, since BA was the only UK carrier with systematic market power in markets to and from the UK.

Regulatory environment—liberalization

5.30. The CAA believed that international aviation generally should be put on the same footing as other industries, as indeed it had been since 1993 within the EC's single aviation market. This required the removal of all government-imposed restrictions on designation, routes, frequency, capacity and pricing, and also of the special nationality-based restrictions on the ownership and control of airlines although within the EC market, airlines had to be EC-owned. The UK/Canada ASA fell short of this aim, and the CAA believed that further liberalization would be beneficial for users and the UK economy by opening the market more fully to the forces of competition. Such liberalization would reduce barriers to entry and would help to offset anti-competitive developments such as might be effected by the proposed acquisition. The CAA suggested that entry barriers in this market were therefore higher than would otherwise be the case.

5.31. In further explanation, the CAA said that it had advocated liberalization of the regulatory environment for some years. It made its views and analyses public through the CAA publications, speeches and appearances before select committees. It was present at all important bilateral negotiations. No progress had been made outside the EC on the question of ownership and control because everything was still within a bilateral relationship. Even the present degree of liberalization, as with Canada, was confined to UK or Canadian carriers, which limited the number of competitors in varying degrees.

5.32. The CAA tried to avoid the term 'open skies' as it meant different things to different people. What the CAA was proposing did not mean the same to the Americans. If all EC states agreed open skies US-style bilateral agreements (which the USA now had with ten other EC countries including Germany, the next biggest in aviation terms to the UK) then US carriers would be able to serve any route they wished both between the USA and the EC and within the EC (because the open skies template included so-called 'fifth freedoms'). European carriers would not have the same facility in the USA. They would only be able to fly in the bilateral corridor between their country and the USA, under the 'open skies' regime US-style. However, unlike within Europe, US carriers would not be able to buy into European carriers; nor would European carriers be able to buy in to US carriers.

5.33. 'Open skies' as described in paragraph 5.32 would deliver some of the consumer benefits, in that the powerful and generally low-cost US industry would be able to operate freely between the USA and the EC and within the EC. But it would not deliver all the potential benefits. In terms of the balance of opportunity for the two sides of the Atlantic, there would be a clear advantage in favour of the USA. Only through EC/US negotiations would it be feasible to achieve full liberalization including the full removal of restrictions on ownership and control. Then aviation would be on the same footing as other industries so that mergers and takeovers would be allowed subject to competition policy. Another challenge would be to achieve international arrangements which would allow an effective competition policy.

Competition analysis

5.34. Before the acquisition eight Canadian cities were served by scheduled services from London, all from Heathrow. There was direct competition between Air Canada, Canadian Airlines and BA on

routes to Toronto and Vancouver; between Air Canada and BA to Montreal; and between Air Canada and Canadian Airlines to Calgary and Ottawa. Air Canada held a monopoly on routes to Edmonton, Halifax and St John's. Additionally there were two routes to Toronto from Manchester and Glasgow, both operated by Air Canada.

5.35. The segment of demand most affected by any reduction in competition was that made up of time-sensitive passengers whose journey was between London and a Canadian city. Such passengers had a strong preference for Heathrow and for non-stop services. The most vulnerable passengers in this group were those who were also relatively price-sensitive.

5.36. All experience suggested that Heathrow had a very strong attraction relative to Gatwick and other London airports. Of business traffic travelling from Heathrow and Gatwick, about 80 per cent travelled from Heathrow. It was difficult to pin down the reasons for this, but the attraction of Heathrow was very clear from the way the airlines behaved. Heathrow might have a more effective catchment area for business traffic. It had built itself a network. Gatwick did not yet have the same image as Heathrow, at home or abroad. Its road links were more difficult, though rail links were good.

5.37. It was possible to shape a product at Gatwick and have lower costs and make the route profitable, but then be unsure whether what the airline was doing was actually affecting airlines at Heathrow. To some extent, certainly on short-haul routes, the tendency had been to find that although airlines at Heathrow could affect those at Gatwick, airlines at Gatwick did not affect those at Heathrow. Traffic with a high business mix tended to prefer Heathrow. Routes with a high proportion of leisure traffic were more likely to be sustainable away from Heathrow. Frequent flyers had probably decided to live in places which were convenient for Heathrow, so there was inertia in the system.

5.38. The new Canadian scheduled services which were previously charters would not easily become effective competitors for the time-sensitive market that used Heathrow. In the 1970s and 1980s the CAA, as part of applying its licensing policies within a highly restrictive bilateral system, had sought to develop effective competition at Gatwick. The Government had established British Caledonian Airways as the second force competitor to BA in the early 1970s although this policy had showed itself not to have worked by the 1980s. The CAA had encouraged a range of competitors at Gatwick and other airports through its multi-airline policy. The traffic distribution rules changed in 1991 so that carriers who had previously not operated international scheduled services from Heathrow could now do so. Subsequently airlines such as Virgin had moved as much as they could to Heathrow. The CAA's attempt to build Gatwick as an alternative competing hub to BA at Heathrow had not been an entirely effective approach in the end.

5.39. Two Canadian charter airlines were to begin scheduled flights to Gatwick. The CAA believed that charter airlines often found it difficult to establish a sufficiently big presence to be attractive to time-sensitive passengers and believed that a similar conclusion applied to fifth freedom services. It concluded that Air Transat and Canada 3000, who were to begin scheduled flights to Gatwick, in the short term were unlikely to bring a significant competitive stimulus to the relevant market of time-sensitive passengers.

5.40. Yield (revenue per passenger) had been higher at Heathrow primarily through the higher proportion of business traffic to leisure traffic, rather than higher fares for any one type of passenger. Published fares from Heathrow and Gatwick were often the same. At the bottom end although published fares may be the same, there were a whole range of promotional fares with different levels of availability. As to whether Heathrow took the higher end and Gatwick the lower end of the market for leisure passengers, the actual fare difference to move people from one airport to the other might not be as great as for business passengers.

5.41. Discussing the IATA Tariff Co-ordination System, the CAA said that it was a serious impediment to competition. While it could be argued that it helped interlining in the interests of consumers, it was a system which allowed airlines to collude on fares at a retail level. There had to be very good justification for maintaining a system which allowed airlines to coordinate fares under a block exemption from EC competition law. An alternative which might be worth exploring was one of posted wholesale prices where airlines undertook to sell their seats on a sector to any other airline to build into its product. The notion was quite complicated as the price would depend, inter alia, on the sort of fare it was.

5.42. Although the acquisition reduced the number of scheduled carriers serving routes between Canada and the UK from three to two, there had been a linkage between Canadian Airlines and BA

through the Oneworld Alliance and, more specifically, a code-sharing agreement on UK–Canada routes. One reason why this agreement came into being was the financial difficulty which Canadian Airlines was experiencing at the time. That financial difficulty continued and there were serious doubts whether Canadian Airlines could have survived as an independent carrier.

5.43. This raised the question as to whether the counterfactual to the acquisition should be the pre-merger situation, one in which Canadian Airlines was allowed to fail or one in which Canadian Airlines was bought in whole or in part by BA or a third party. As far as the CAA was aware, however, Canadian Airlines' financial problems stemmed from its domestic services, not its international operations, and it was not implausible that a buyer could have been found for the international operation.

5.44. Whichever best counterfactual was chosen, the acquisition would affect access to the feed traffic from Canadian Airline's back-points. Although the traffic between the UK and back-points in Canada was far less important to the viability of the gateway routes than it was on many routes to the USA, unlike the USA there were no gateway airports in Canada which were now not dominated by a single carrier (Air Canada). A foreign carrier would have little opportunity to find an independent Canadian airline domestic partner. The weakness of Air Canada's competitors in the back-point market could distort competition on the gateway routes. The loss of the link to Canadian Airlines' domestic network would clearly affect the position of BA but the volume of traffic which connected at the Canadian Airlines' gateways was much smaller than the volume connecting at Heathrow, BA's hub.

5.45. The CAA advised caution in relying on the development of new domestic services within Canada to provide competitive feed for transatlantic carriers. The history of the airline industry in Canada was one of consolidation. But it did not feel well placed to give a definitive view on whether the Canadian Government measures to encourage new domestic entrants would be successful. There were remedies which, without causing unreasonable problems for Air Canada, would overcome the feed problem without the development of new carriers, a development which could not at this point be relied on.

5.46. The CAA pointed out that prior to the acquisition the Canadian domestic market was dominated by Air Canada and Canadian Airlines with the latter allied to BA. So even then a new competitor to Air Canada and BA on UK–Canada routes would have had difficulty in gaining access to the Canadian domestic market.

5.47. In terms of gateway-to-gateway markets there were three overlap routes. Heathrow–Calgary would now be served by only Air Canada having previously been served on a broadly daily basis by both Air Canada and Canadian Airlines. The frequencies on Heathrow–Toronto had varied in the past but broadly there had been a rough parity between Air Canada on the one hand and BA/Canadian Airlines on the other. This summer BA would fly twice a day but Air Canada would have four services of its own and one operated by Canadian Airlines. On Heathrow–Vancouver the frequency balance swung from BA/Canadian Airlines having two services a day compared with Air Canada's one to a corresponding advantage to Air Canada. Based on 1999 scheduled passenger carryings the effect of the acquisition was to raise Air Canada's market share from 42 to 100 per cent on Calgary, from 39 to 69 per cent on Toronto and from 37 to 49 per cent on Vancouver. Air Canada's shares of the time-sensitive OD market on these three points would increase from 71 to 96 per cent on Calgary, from 40 to 66 per cent on Toronto and from 36 to 54 per cent on Vancouver.

5.48. The CAA was concerned about the potential loss of competition as a result of the merger, especially in respect of Heathrow to Calgary and Toronto. The merger increased measures of market concentration on these routes, whichever counterfactual was assumed. BA was perhaps the most likely new entrant on the Calgary route; however, it was far less dense than Toronto so that new entry might be deterred if Air Canada retained a double daily service. On Heathrow–Toronto, BA could use smaller aircraft and increase its frequency, but it would incur the cost of using more of its slot portfolio at Heathrow for its Canadian services. It was also unclear whether there would be difficulty for BA and new entrants in obtaining slots at Toronto.

5.49. The four London routes on which Air Canada had a monopoly were all relatively thin. Canadian Airlines had domestic services at all four points, either operated by itself or by a regional carrier under its code. BA would have been a potential entrant, particularly to Ottawa. Ottawa was quite a strong business route, stronger than its route size might suggest, and it might be attractive to an airline like BA to open a new service to Ottawa now that the feed had disappeared with the takeover. The Heathrow–Ottawa route had previously been code-shared with Canadian Airlines. It would not otherwise

have been identified with BA in passengers' minds. BA had the ability to market traffic through the strength of its network at Heathrow, but without the code-share it would be more difficult for BA to sell traffic through to Ottawa than it was before. The acquisition may, therefore, make it less easy for BA to enter.

The slot arguments

5.50. Discussing the availability of slots at Heathrow, the CAA pointed out that Virgin moved to Heathrow following the 1991 rule change which permitted new international carriers to go there. Slot constraints were not as tight then as they were now and since then the numbers of slots available had been increased through better air traffic management procedures (from around 70 an hour at busy times to over 80 now). Virgin had therefore been able to expand its services at Heathrow through this incremental growth in the numbers of slots. British Midland had also been able to build its portfolio of slots at Heathrow since it started developing international services in 1985, and it now had some 14 per cent of slots. However, the position at Heathrow now was very difficult. Very few new slots became available each year.

5.51. The CAA said that if Canadian Airlines had put its slots back in the pool they would be lost to it, but slots were sometimes loaned or leased out. An example of this was when United Airlines had dropped certain slots it was using to Chicago a few years ago and Lufthansa had started using them. The CAA said that the usual pattern for transatlantic operations was for arrival at London in the very early morning and departure in the early afternoon. Asked about the opportunity cost of a slot, the CAA mentioned that BA was understood to have paid KLM–UK £16 million for eight slots, which allowed it to make four round trips a day to Heathrow. So one pair of daily slots was reportedly worth £4 million in that case.

Slots under a liberalized regime

5.52. The CAA believed that the development of a proper slot market would be sensible. As a first step the CAA would like to see secondary trading. That would be a significant improvement making transactions overt and transparent. It would allow the authorities to see the terms on which slots were moving and the prices they were moving for. Major carriers with a large network would be prepared to pay more for a slot, everything else being equal, than a carrier not in that position. Also there might be gaming, where carriers bought or did not sell slots with a view to the effect on competitors rather than simply taking account of their own requirements. Competition policy would have to be used to regulate the secondary slot market, and perhaps not solely by complaint.

5.53. The CAA thought there were possibilities for going beyond that secondary market. One obvious example would be the auctioning of newly created pool slots. In that case there would be no confiscation of 'grandfather' rights (by which airlines held slots indefinitely provided they used them). The CAA thought there might also be merit in airports taking some of the value of new slots. This would need very careful consideration, but there might be an advantage in increasing their incentive to invest in new capacity. The CAA had also put forward to the Transport, Environment and the Regions Select Committee two years ago the idea that regional or local authorities, possibly with local business consortia, could purchase slots and lease them out to airlines. This would enable them to signal the value of the slots through purchase.

5.54. The CAA said that it was not attracted to a scheme such as that at Toronto where there was a priority allocation of slots for large aircraft and international routes. It would prefer to see a proper market, which would avoid the need to make administrative decisions that were unlikely to bring the most efficient result.

Competition between alliances

5.55. Air Canada's membership of the Star Alliance and BA's membership of the Oneworld Alliance raised the question of alliance competition. The move of Canadian Airlines to the Star Alliance would leave the Oneworld Alliance without a Canada-based carrier in its grouping. However, if it stayed in its present form, the Oneworld Alliance would still have access to the larger Canadian points through BA with its services to London and American with its services to its US hubs, most notably Chicago.

5.56. Alliances varied immensely. The traditional system of interlining was the IATA standard agreement between airlines. At the opposite extreme was the strategic alliance which BA and American Airlines had proposed involving, for example, profit sharing and the ultimate closing down of each other's sales force on each side of the Atlantic, though how far they would have gone towards full integration of their operations was a matter of speculation. The core members of Star, United Airlines, Lufthansa and SAS were working very closely together, as were KLM and Northwest in their alliance. In each case the aim was to have a common brand. The Chairman of KLM had recently spoken about the need for full mergers if airlines were going to get beyond the step of the revenue gains to the point of real cost savings.

5.57. Alliances sometimes found that their members could not participate in IATA tariff co-ordination discussions. The US Department of Transportation had imposed restrictions of this kind as a condition of granting alliances anti-trust immunity. Alliance partners had been required to withdraw from participation in any IATA tariff conference activities that discussed proposed through fares between the USA and the alliance partners' home countries. They had also been required to withdraw from participation in discussions about proposed fares between the USA and any other countries whose designated airlines participated in similar agreements with US airlines that had been or were subsequently granted anti-trust immunity. Tariff coordination was still commonplace in the industry, even in the liberalized EC, under the terms of a Commission block exemption from competition law (Commission Regulation (EC) No 1083/1999 of 26 May amending Regulation (EEC) No 1617/93).

New entrants

5.58. There were a limited number of scheduled entrants able to offer non-stop service from Heathrow. The most obvious were British Midland and Virgin. British Midland was a member of the Star Alliance and had about 13 per cent of the slots at Heathrow. Virgin had a licence to serve London–Toronto and had applied unsuccessfully for slots at Heathrow to serve Toronto in every season since summer 1998. Virgin had a relatively limited number of slots at Heathrow, virtually all of which were used on long-haul routes, and it faced a significantly higher opportunity cost for its slots than BA.

5.59. Asked about the Star Alliance impact on the Heathrow–Canada routes, the CAA did not see Virgin's relationship with Singapore Airlines (a 49 per cent shareholder and Star Alliance member) as preventing Virgin from competing on routes to Canada. Singapore Airlines did not hold a controlling interest in Virgin. Further, the CAA thought there might be some doubt as to whether British Midland as a Star Alliance member would operate in its own right and in genuine competition with Air Canada on the routes to Canada.

5.60. The CAA concluded that the acquisition would significantly reduce current competition on Heathrow–Calgary, that it would diminish the intensity of current competition on Heathrow–Toronto and on some Canadian backpoint markets, and, more speculatively, that there might be some reduction of potential competition on Heathrow–Ottawa.

Possible safeguards

5.61. The CAA believed that there were a number of possible safeguards which might be considered to help mitigate the potential competition concerns it identified.

5.62. It had been suggested that Air Canada should be required to surrender slots at Heathrow to new or existing competition. In the CAA's view, slots at Heathrow did not present an insurmountable barrier to entry for BA which would be able to switch slots from other routes if it wished to expand its services on routes to Canada. This also applied to British Midland if it wished to enter the Heathrow/Canada market. Such airlines, however, would only reallocate slots to routes to Canada if their profitability were expected to cover the opportunity cost of the slots. The absence of a transparent market in slots at Heathrow presented difficulties for other potential new entrants. Any Canadian carriers wishing to commence services to Heathrow would qualify as new entrants under the EC slot regulation (Council Regulation (EEC) No 95/93), thus gaining priority for a proportion of the slots available for allocation from the pool. Virgin, however, would not qualify as a new entrant at Heathrow under the definition in the EC slot regulation.

5.63. The CAA had been informed by the Canadian authorities (Transport Canada) that it should be possible for BA or new entrant airlines to obtain the slots at Toronto (Pearson) airport they might need

for new or additional services between Toronto and London as a result of the priority given to new services and to services operated with large aircraft under the slot allocation procedures applied at Toronto. However, it would be important to establish in detail whether this would be so before concluding that slots at Toronto did not present a barrier to entry and thus that no safeguard was required in this respect.

5.64. A further consequence of the acquisition was that there would be no international gateway airports in Canada that were not dominated by Air Canada. Although higher proportions of the market made connections at Heathrow than at the Canadian gateways, Air Canada and other potential new entrants had a choice of interlining partners on most routes which provided feed traffic at Heathrow. That would not be the position in Canada after the acquisition. Airlines competing with Air Canada on UK/Canada routes would be vulnerable to Air Canada either refusing to interline with them at all or charging excessively high prorates for doing so, depending on the efficacy of Canadian competition law. To the extent that the ability to compete effectively in this market depended on access to feed traffic behind gateways in Canada, this could distort competition on the transatlantic routes in favour of Air Canada. A solution to this would be to impose an obligation upon Air Canada to interline on reasonable terms, including the levels of prorates for domestic sectors within Canada, with other airlines operating on UK/Canada routes.

Frequent Flyer Programmes

5.65. The CAA believed that the acquisition would increase the attractiveness of Air Canada's loyalty programmes to Canadian residents. Canadian residents would wish to use the airline offering the widest network from their origin of travel. BA had strong loyalty programmes in the UK and so concern about Air Canada's programmes would appear more relevant to potential competition, particularly from Canadian carriers.

5.66. The CAA was unsure whether the increased attractiveness of Air Canada's FFP to Canadian residents as a result of the merger would necessarily increase the difficulty of entry compared with the situation prior to the merger. Since the two main carriers operating in this market, BA and Air Canada, each had its own FFP, this would give each of them an advantage over the other in their respective home markets. It would be necessary to consider further whether the strengthening of Air Canada's position at the Canadian end of the route was sufficient reason to require it to open its FFP to new entrants without such a programme.

5.67. The CAA confirmed that it had noted the European Commission decision on FFPs in the cases of KLM/Alitalia and Lufthansa/SAS. In the Lufthansa/SAS case there had been no new entrants since the cooperation between Lufthansa and SAS started, so there was no evidence that the conditions had been successful. The KLM/Alitalia decision was relatively recent and in any event presumably falling away soon as KLM and Alitalia had recently announced they were terminating their relationship. The Lufthansa/SAS routes could be regarded as thin relative to London routes which were the biggest in Europe. The largest non-London international route in the EC was way down the European list at about one-quarter of the level of the most dense route, London–Dublin. The Germany–Scandinavia routes were not routes on which it was obvious that there were going to be new competitors springing up.

5.68. The CAA thought the circumstances with Air Canada/Canadian Airlines were different from the cases considered by the European Commission with respect to FFPs. There were not two carriers, one at each end of a route, tying up the FFPs. In the Air Canada case it was two carriers at one end with BA at this end remaining with a very strong FFP: unlike the cases which had come before the European Commission. The Canadian Government's view that FFP exchanges between Canadian Airlines and Air Canada would make it difficult for new entrants to get on the route was an issue to look at. New entrants did not have an effective FFP. But the CAA would not draw any strong conclusion generally on the Air Canada/Canadian Airlines FFP exchanges.

Code-sharing and interlining

5.69. The CAA believed that code-sharing between airlines could be pro-competitive in certain circumstances and anti-competitive in others. Code-sharing was usually associated with other forms of

cooperation between airlines, such as the coordination of schedules and the establishment of integrated passenger and baggage handling arrangements. These aspects may produce benefits for consumers, but may also have anti-competitive consequences in some circumstances. The CAA did not believe that it would be appropriate to impose conditions upon Air Canada which would result in a further reduction in competition on UK/Canada routes. For this reason, the CAA did not favour the imposition of any conditions relating to code-sharing.

Prorate fares

5.70. The feed traffic in Canada for BA was small compared with that in London for Canadian Airlines. BA had a strong position in London, despite the fact that there were a lot of other carriers, including British Midland and other international carriers, and Virgin on the long-haul routes. The scale of interlining in Canada was much smaller. BA was in effect now sealed off from it, to the extent that Air Canada was making it uneconomic for BA to use it. The issue was difficult but one starting point would be the normal industry approach of straight rate prorates, ie not allowing Air Canada to put provisos over and above the SRP. The CAA said that although BA had provisos at this end, and domestic carriers often did have provisos, there seemed to be a case for intervention in Canada, given the absolute dominance.

5.71. As an example, the CAA quoted a high fare (compared with fares actually being sold) which was there solely for prorate purposes. Air Canada's normal economy fare for Toronto–Edmonton was $1,400. Some fares in the system were as low as $400. The fare forming the basis for the proviso used for prorating was $4,000. Air Canada appeared to be playing around with the mechanism within the interlining system to make it difficult for other carriers to access the market.

Conclusion

5.72. The CAA believed that without safeguards there was a clear risk that the acquisition would result in a reduction in competition in certain markets between the UK and Canada. The principal concern with respect to existing competition was for time-sensitive passengers on the routes between, on the one hand, Toronto and Calgary and, on the other, Heathrow.

5.73. However, there would not seem to be particularly strong grounds for contemplating outright refusal of the acquisition since the main existing competitor, BA, did not face any insurmountable barriers to entry or expansion. The effect on BA did not give a case for rejecting the merger. It did not seem to the CAA that the merger caused a major barrier to entry or competition for BA. The CC in looking at it might not conclude that there was a practical and superior alternative to approving the merger. But there were particular things which ought to be looked at and possibly dealt with by remedies.

5.74. The CAA thought that making slots available for an operator on the Heathrow–Canada route was intricate legal territory. If it was part of an allocation for competition reasons, it would be possible, and had certainly been considered in the BA/American Airlines case which was analogous in this respect. A lot of careful legal analysis had been done on that case. The slot regulation made clear that EC competition law aspects could override the slot regulation but the CAA was unsure how far that went and what circumstances it covered.

5.75. The CAA noted the powers taken by the Canadian Government to require desisting from anti-competitive measures and to combat abuse of market strength and thought it might be difficult to make this sort of approach work. They felt it may not be realistic to encourage growth of competition in the Canadian airline industry by regulatory action. Complete liberalization was really a much better way of achieving growth.

5.76. In conclusion the general competitive climate would be improved by further liberalization of remaining government-imposed bilateral restrictions. There also seemed to be a case for securing both that Air Canada following the merger would interline, and do so on reasonable terms, with BA and other carriers serving UK–Canada routes and that, if necessary, it would make available sufficient and suitable slots at Toronto's Pearson airport to allow them to compete effectively on the London–Toronto route. Further consideration was also necessary of whether Air Canada should be required to relinquish suitable slots at Heathrow to the extent needed to facilitate new entrants to UK–Canada scheduled services.

Department of the Environment, Transport and the Regions

UK–Canada ASA

5.77. The DETR said that it was responsible for bilateral ASAs including the ASA with Canada dated 1988. Under Article 7(1) of the ASA, the UK and Canadian Governments agreed that there should be fair and equal opportunity for the airlines of both parties to operate the agreed air services. When negotiating these agreements the DETR said that it was looking to ensure that consumers were appropriately protected, and that there were mechanisms in place to deal with unfair or predatory behaviour. The DETR said that air services relations with Canada had been and continued to be very good. It would not contemplate terminating the ASA, an option open to the UK only if relations were to deteriorate very significantly.

5.78. The DETR explained that it had been represented to it by BA that the merger of Air Canada and Canadian Airlines had anti-competitive potential. It had looked at the matter and took the view that consumers would not be best served by the merger as it was currently proposed, without some remedies being put in place. Although the ASA contained an article about fair and equal opportunity to trade, this was not often used or enforced. It was not within the DETR's recent experience for this article to be discussed bilaterally. The best way to remedy the situation was for the CC to give a considered response.

5.79. The DETR said that the ASA with Canada had generally been kept under review. Now that aviation circumstances within Canada had changed, that might suggest that in a few months it would be appropriate for the two Governments to get together and consider whether the ASA was up to date. The UK was now putting forward in air services negotiations a new model ASA which was particularly liberal, allowing unrestricted frequencies and the like (already in place with Canada).

5.80. The DETR thought that a subject for review with Canada at the ASA negotiations would be the extent of foreign ownership and inward investment in air services. At present there was a limit of 25 per cent foreign investment in a Canadian carrier as opposed to 49 per cent which was the EC-norm position. The DETR suspected that Virgin would like to see the inward investment limit for Canada raised substantially. Among other matters in the ASA which might be revised were the articles on tariffs and customs dues. The DETR said that the ASA needed revision in the light of the changed circumstances since 1988, and the greatest change in circumstances was the growth of code-sharing and alliances.

Regulation of fares

5.81. The DETR said that the ASA contained an article covering tariffs and their regulation. A tariff was defined in Article 13 of the ASA as, broadly speaking, a passenger fare, a cargo rate or a fare or rate condition. Under the terms of the ASA the tariff had to be filed by the airline with the aeronautical authorities of the two countries and was deemed to be approved after 15 days had passed without either authority expressing dissatisfaction. The UK preference was to have a mechanism in place in the ASA which enabled either Government to intervene when certain tariff limits had been passed; either when an airline in a monopoly position had raised its prices without restraint, or when it had exhibited predatory behaviour by using its very strong position in the market to keep other entrants out. In between there was latitude for the carriers of each side to respond to the market as they saw fit.

5.82. Under the UK–Canada ASA the fares had to be filed and were then approved explicitly or implicitly. The authorities could intervene 'if the tariffs have not been established at reasonable levels having due regard to relevant factors' but invariably they would make no comment and allow the fare to pass into use.

5.83. The DETR said that the ASA Article 7(4) was about balancing capacity and demand. The agreed services of the airlines of the two countries had to 'bear a close relationship to the requirements of the public for transportation on the specified routes'. But this provision was not used by the UK Government. It was very much left to the carriers themselves to determine the capacity required on the UK–Canada routes. There were no restrictions on numbers of flights that could operate between points in either country.

Fifth freedoms

5.84. The DETR confirmed that it was open to the carriers of either side to operate fifth freedom services. There were quite liberal entitlements in the ASA from Canada into the USA, the Caribbean and elsewhere. There were also fifth freedoms for third parties, giving them the right to fly London–Canada. For example, Air India enjoyed such a freedom. Among the 200-odd UK ASAs there might be quite a few fifth freedoms for Canada granted over the years (see Table 4.7). To use them a carrier would, of course, have to obtain permission from the Canadians as well. Fifth freedom rights were traded during air service negotiations on a basis related to reciprocity. If the Indians sought a share of the UK–Canada market then the UK would look for fifth freedom rights from, say, Delhi to places in the Far East.

Regulation of code-sharing

5.85. The DETR explained that where two governments had agreed under the ASA that code-sharing would be allowed in any circumstances, it had no power to approve or disapprove a relevant proposed code-share arrangement. The DETR said that it would just register the existence of such a code-share. In the UK–Canada ASA there was no agreement to code-sharing. In that case the DETR said that it would probably allow a code-share to go ahead provided there was reciprocity, ie the Canadian carrier could code-share provided that the UK carrier had the same right. The BA/Canadian Airlines code-share arrangement was the result of a separate agreement between the two Governments.

Consumer protection legislation and charters

5.86. The DETR confirmed that no UK charter operator had complained to it about the consumer protection barriers placed in their way by the Canadian Government. (See evidence from Air 2000 in paragraph 5.99.) The issue of consumer protection barriers had only recently come to the Department's attention, but it had no details.

Alliances

5.87. The DETR said that it was probably inevitable that airlines would increasingly move towards consolidation. There were press reports that BA was discussing possible future combinations with KLM. United Airlines was discussing a takeover of US Airways Inc. If things proceeded in this way, within a very few years there would be either a few very large airlines or just a few alliances competing with each other. No single airline would be strong enough on its own to compete with these monolithic airlines or the alliances. There must be competitive implications in these moves or airlines would not enter into alliances. They did it because there could be economies of scale and efficiency, cooperating with each other, sharing facilities, joint marketing etc. Enormous monopolies would be anti-competitive; if there was just one alliance operating between two points the conceivable disbenefits were obvious. On the other hand, if one took the altruistic view, airlines getting together in alliances would make savings, and would be able to offer more competitive prices or better services to their customers.

5.88. In the DETR's view alliances were neither de facto a good thing, nor invariably a bad thing. There was the potential for them to be either and the DETR would always be alive to the anti-competitive possibilities. There could be competition. Continental Airlines (Continental) and Virgin had a cooperative agreement across the Atlantic between the USA and the UK, whereby Continental bought seats on Virgin's transatlantic services. Continental sold seats on Virgin flights cheaper than Virgin sold them, so there was competition on the same aircraft. Cooperation, collaboration, code-sharing and alliances did not necessarily mean a restriction of competition.

5.89. The DETR felt that it might be misleading to see the takeover of Canadian Airlines as a battle between the Oneworld and Star Alliances. The UK Government was formally disinterested in the merger. Neither Ministers nor BA had any wish to see the merger not take place. If the merger saved Canadian Airlines and that was a satisfactory outcome for Canada, all well and good. The UK Government was most concerned about the lack of a realistic partner airline in Canada for UK carriers to work with. The Canadian Government was renewing its civil aviation policies and it was too early to say what the outcome might be.

5.90. The DETR thought that the rationale for code-sharing before and after the merger was very much a matter for the airlines concerned. There had been a change in code-share arrangements as a result of the merger in that passengers no longer had a choice of service to a Canadian back-point. Whereas previously they could fly by Air Canada or by BA/Canadian Airlines for the full journey, they were now restricted beyond the gateway to an Air Canada flight. BA had to code-share with Air Canada for this domestic journey and the fare had been raised by Air Canada to the point where BA could not compete. The change in fares after the merger altered the competitive balance on the route as a whole.

New entrant carriers

5.91. Considering which carriers might open new services to Canada, the DETR said that the carrier with the largest slot portfolio had more flexibility to make slots available for a transatlantic service. BA and British Midland had the largest portfolios with Virgin some way behind. It might also be pertinent to look at slots in alliance terms, how many for Oneworld Alliance, how many for Star Alliance. But it did not necessarily follow that British Midland would fail to compete with its Star partners on the transatlantic route. An alliance neither guaranteed nor prevented competition. It could do either. The DETR thought that the charter services becoming new scheduled carriers were an unknown quantity. They did not at present give the assurance of long-term competition between the UK and Canada. For historic reasons, Heathrow was seen abroad and in London as the principal UK airport so services to Gatwick were at a marketing disadvantage for the start-up carriers. A further barrier to these new entrants was the Air Canada nationwide network for feed traffic, which encouraged passengers to use Air Canada international services by offering special deals on domestic services.

5.92. The DETR said that slot allocations were governed by EC regulations. The sale of a slot was illegal under EC law. However, slots had been exchanged for less suitable slots with some extra consideration.

Back-points and domestic services

5.93. Discussing BA's prospects for services to Toronto, Montreal, Vancouver and Calgary, the DETR said that these were very much questions for the airline to answer from a commercial viewpoint. However, it was clear that the time-sensitive traveller required a non-stop flight and a frequent service. It might not be profitable for the UK airline to operate such a flight to Canadian back-points such as Edmonton or Calgary. Even if the UK airline did think of serving Calgary or Edmonton from UK direct, it would require slots at Heathrow to do so. It would also require slots at Toronto Pearson which the DETR believed to be slot constrained, despite the assurances the CC had been given to the contrary.

5.94. The DETR said that the back-point traffic for BA, although small, was significant in that even one passenger could tip the balance between a scheduled flight being loss-making or profitable. The DETR did not think that the new Canada domestic carriers would be of a suitable standard for BA or Virgin to interline with in their early days. They would take time to reach a good level of service. And passengers would prefer Air Canada for its FFP. The DETR thought that UK carriers would have to have access to the Air Canada frequent flyer points scheme to be competitive in Canada.

5.95. The DETR did not think a British airline (such as Virgin) would be interested in investing in CRAL. It would be difficult for it to maintain its reputation, and the level of investment was limited to 25 per cent. However, Virgin was starting an airline in Australia, so at a higher level of investment (49 per cent) it or BA might be interested in investing. But it was not for the DETR to make commercial judgements on behalf of carriers.

Remedies

5.96. The DETR had written to the Office of Fair Trading (OFT) in April 2000 to suggest that domestic services in Canada be separated from international services, thus creating an airline in Canada with which trunk carriers could cooperate. That theoretical possibility was now unlikely. To achieve access to the Canadian interior on fair and reasonable terms so that consumers would benefit and UK airlines would not be wrongly discriminated against, it would be necessary to get fair and reasonable access to the FFP, reasonable commercial prorates, interlining facilities and measures to ensure that the new dominant Canadian carrier did not abuse its position by denying access to essential facilities.

5.97. It would not be possible to introduce such UK desiderata by using the ASA. The ASA was not heavily regulatory. The DETR did not wish to replace the present ASA with a heavily regulated system. On frequent flyer points the DETR took the view that if all competing airlines had Air Canada frequent flyer points, the outcome was not support for Air Canada. In fact it neutralized Air Canada, reducing the incentive to use Air Canada just for its points. This was not an anti-competitive effect. Nor would it benefit the UK carriers to join the small Canadian airlines in FFPs. The small carriers would never be in a position where they could compete.

5.98. The DETR could understand that the Canadian Government might regard any suggestion of taking slots from Air Canada as expropriation. But it would also recognize that the UK had its consumers to protect. Giving up slots was not an unprecedented remedy. It had been imposed on airlines as a precondition for alliances.

Airlines

Air 2000

5.99. Air 2000 believed that air services between the UK and Canada had in the past been generally competitive. The only exception was the operation of charter flights, where, to be economic, it was essential to carry both UK originating passengers and Canadian originating passengers. Canadian bureaucracy in the application procedures, and in particular consumer protection requirements, had placed significant additional cost burdens on UK charter carriers, with the result that the market was served mainly by Canadian operators. The Canadian Government had recently introduced revised procedures, reducing the bureaucratic cost burden, but had only indicated that it would look at consumer protection issues. These remained disproportionately high for UK carriers against Canadian carriers. Air 2000 believed UK carriers would be unlikely to compete effectively with their Canadian counterparts in the foreseeable future.

Air Transat AT Inc

5.100. Air Transat, Canada's second largest independent airline, told us that it was a wholly-owned subsidiary of Transat AT Inc of Montreal, Canada's largest holiday travel company. It operated a fleet of 23 large jet aircraft and provided scheduled and charter passenger services between Canada and 29 countries worldwide, including the UK. It currently operated scheduled air services from Toronto, Montreal, Vancouver, Calgary and Halifax to 12 destinations in the UK.

5.101. Air Transat was neither for nor against the merger but believed it should be for the market place to decide whether or not it would succeed, whilst having the Government ensure that certain safeguards and oversight or review mechanisms remained in place to ensure fair and effective competition.

5.102. Air Transat believed it was important that conditions existed which allowed it to compete with the major carriers. It felt that the Canada–UK air transport agreement, signed in 1988, provided the possibility of operating direct services between any and all points in Canada and the UK. However, the continued requirement to file fares and related conditions, as well as maintenance of a single disapproval regime for fares in a number of city-pair markets, penalized smaller competitor carriers, since it limited Air Transat's ability flexibly to price and sell services in an often volatile market, and ensured continued fare regulation and bureaucratic vetoes in smaller secondary city-pair markets. Competition would be enhanced if the current pricing regime were replaced by double disapproval rules on all routes and the elimination of the tariff filing requirement.

5.103. Air Transat operated daily flights to and from Gatwick airport. The ability to access desirable slot times at Gatwick was critical to the success of Air Transat's competitive service. However, with congestion increasing at Gatwick airport, Air Transat believed it would be necessary to ensure that a policy was in place which would continue to provide fair and effective access for smaller competitors.

5.104. Air Transat was also concerned about predatory behaviour by larger carriers in the market. It had thus successfully convinced the Canadian Government to introduce legislation which strengthened the powers of the Competition Bureau to intervene in matters of airline predation. Similar powers to

intervene quickly and suppress anti-competitive behaviour in the UK's important bilateral international markets might be appropriate.

British Airways Plc

5.105. BA believed the merger had given the combined entity a position in the market which would enable it to deny consumers competitive choice, both in the Canadian domestic market and for travel to and from Canada.

5.106. BA said that the air transport markets in Canada were unique. Air transport played a particularly important role as there was little competition between air transport and other modes of transport for time-sensitive travellers. In the 1980s there were seven separate domestic carriers serving the Canadian market. By 1989 there was a duopoly within the domestic airline industry consisting of Air Canada and Canadian Airlines. BA said that Air Canada eliminated Canadian Airlines as a competitor and now held a near-monopoly over domestic airlines in Canada as a result of the merger.

5.107. BA thought it was unlikely that any new entrant would significantly challenge Air Canada's near-monopoly status, a number of competitors in the market having previously failed. In addition, there were regulatory barriers implemented by the Canadian Government that precluded competition from foreign carriers, for example restrictions upon ownership by foreign entities and prohibitions against foreign carriers servicing domestic markets presented significant barriers to entry.

5.108. BA told us that the Canadian Commissioner of Competition had undertaken an extensive review of the competitive effects of the merger. The Commissioner concluded that very significant competition concerns would develop in the event of the merger, and that the most vulnerable consumers were likely to be time-sensitive or business travellers in various markets: the merged entity would account for close to 90 per cent of domestic revenues and in excess of 80 per cent of domestic passengers carried. The Commissioner also noted that barriers to entry were high. Notwithstanding these concerns the Commissioner confirmed his approval of the merger subject to certain undertakings on the basis that Canadian Airlines was facing imminent insolvency, necessitating the need for urgent action.

5.109. BA recognized the validity of the public policy objections that the Commissioner had considered in approving the merger, and had accepted that these public policy concerns were clearly in favour of permitting the merger. In BA's view, steps should be taken to ensure that such competition as remained was protected from abuse by Air Canada of its position.

5.110. BA had cooperated with the Canadian authorities in their efforts to implement legislation that would address the significant competition concerns that had resulted from the merger. The legislation (which received Royal Assent on 29 June 2000) incorporated a number of undertakings provided by Air Canada to the Canadian Commissioner of Competition but these undertakings were limited to the domestic markets and not international routes. BA welcomed amendments subsequently made to the proposed legislation and was continuing to work with the Canadian Competition Bureau and Ministry of Transport to address certain issues concerning the regulations that would fall out of the statutory provision, but the process that followed such legislation was likely to be cumbersome (including the need to establish that certain facilities were, as allowed for in the legislation, essential). The legislation was not therefore an immediately effective remedy per se to BA's concerns, since the necessary litigation would take some time.

5.111. In considering the effects of the merger, BA believed that it was appropriate to regard Gatwick as a reasonable alternative to Heathrow, but noted that the Competition Bureau in Canada regarded scheduled and charter carriers as serving different markets, charter operators not providing the frequency necessary to compete for time-sensitive passengers. Even when charter operators were redesignated as scheduled carriers, they tended to operate in the manner of charter carriers and a number of charter operators had failed to establish successful scheduled services.

5.112. Prior to the merger, BA and Canadian Airlines were strong competitors to Air Canada, accounting for 30 and 24 per cent respectively of scheduled passengers between the UK and Canada compared with Air Canada's 46 per cent, although BA acknowledged that it did not truly compete with Canadian Airlines with the airlines cooperating on all routes, and with a revenue-sharing agreement on the Toronto route. Following the merger, BA was the only direct competitor to Air Canada for scheduled

services between Canada and the UK and the merger had significantly increased Air Canada's share of the market. It was estimated by the Canadian Commissioner of Competition that immediately subsequent to the merger, the merged entity held approximately 72 per cent of the market, with 25 per cent held by BA. However, competition to serve destinations beyond the main gateways had been lost, and BA's ability to compete would decline further unless there was action to address its concerns.

5.113. BA acknowledged that without the merger Canadian Airlines would have failed, and the market structure within Canada would have been much as it now was, although it was possible that other carriers such as BA on the London routes would have taken on some of the international services. BA had itself made an earlier offer to Canadian Airlines for its Heathrow–Toronto operation including slots, although the Heathrow slots would not necessarily all have been deployed on services to Canada.

5.114. BA's submissions in Canada had focused on four main areas of concern:

(a) the absence of competitive interline and code-share arrangements with the merged entity;

(b) the need for access to the FFP of Air Canada and Canadian Airlines;

(c) the distribution of airport slots; and

(d) the potential for anti-competitive behaviour by the merged entity.

In its submission to us, BA expanded on these points.

Interline agreements and prorate

5.115. Prior to the merger, BA had competitive interline agreements and code-share agreements with Canadian Airlines for over 1,000 flights a week, including flights from London to the 12 major cities in Canada. The revenue generated from those agreements was significant enough to make the difference between certain routes being profitable and unprofitable. These arrangements had not continued after the merger and as a result Air Canada had an effective monopoly on the routes that were previously competitively served by BA and Canadian Airlines. The undertakings provided by Air Canada to the Commissioner of Competition regarding interlining agreements were restricted to domestic carriers. BA had recommended that Air Canada should be required to provide access to its domestic network through competitive interline and prorate arrangements with international carriers on reasonable commercial terms. Although BA would welcome the development of competition and of other carriers with which to reach interline agreements, many other Canadian carriers were not alternatives for BA, for example they were purely point-to-point carriers not interested in interlining and operated out of secondary airports.

5.116. Feed traffic was important in providing service over a network of scheduled flights. In markets where international carriers had alternatives for feed traffic there was no difficulty entering into interline agreements at competitive prorates. BA said that Air Canada had a choice of airlines with which to interline to all significant points in Europe behind the gateways, including its alliance partners, but there was no alternative for feed traffic in Canada, and Air Canada would have no incentive to enter into interline agreements at competitive prorates.

5.117. BA said that the prorate requirements for connecting traffic, particularly business traffic, that Air Canada had imposed were such that at present it was not economically sustainable for BA to sell business traffic beyond its Canadian gateways. It was presently continuing to sell business traffic beyond its Canadian gateways into behind destinations such as Ottawa, Winnipeg and Calgary, but at a loss in the hope that the situation would be remedied. It did not wish to drop out of the market and then return. BA believed that if there was no change in Air Canada's behaviour regarding prorates, its ability to compete, particularly in the area of business traffic, would be impeded. Further specific comments on Air Canada's prorate charges are at Appendix 5.1. In response to points put to us by British Midland and Air Canada that BA itself charged prorate fares higher than the normal fares on certain services out of Heathrow, BA acknowledged that this was to some extent true, but said that this occurred only as a result of the application of the straight rate prorate principle, and it did not file any provisos which would have this effect. BA also acknowledged that other US carriers charged prorate fares higher than normal fares, and in response to a request from us provided us with details of such policies as applied to a sample of North American fares. BA believed, however, as confirmed by that analysis, that the differential between

special prorate fares and normal fares currently applied by Air Canada was considerably greater than that applied by other North American carriers; it also told us that there was sufficient competition among other North American carriers to enable BA to negotiate reasonable terms despite the high level of many published prorate fares.

5.118. BA did not expect its previous agreement with Canadian Airlines to be continued, since Air Canada would have no incentive to do so, but it considered that it should be able to interline with Air Canada on reasonable terms. It should not be expected to have to pay Air Canada more than the standard (straight rate) prorate or, if Air Canada chose to apply one, a proviso giving Air Canada no more than the published fares which local consumers would use.

Frequent Flyer Programme

5.119. BA said that in many mergers and commercial agreements considered by European authorities, the airlines concerned had been required to give access to their FFPs to airlines which sought to compete on routes where competition would be reduced or lost, when that airline did not participate in a comparable scheme. BA did not view this as a remedy which was important in properly competitive markets. It believed FFPs were used by airlines as competitive tools to distinguish one from another. In Canada the situation was unusual in that the market would not be properly competitive as there was no FFP scheme, other than that of Air Canada, in which a competitor could participate, and which was as attractive to Canadian consumers.

5.120. Although prior to the merger BA had only 50,000 Canadian members in its FFP, it had reciprocal arrangements with Canadian Airlines in respect of FFPs and this had made its scheme fully competitive with Air Canada's FFP. It enabled BA to offer its Canadian consumers points which were combinable with the points they could earn on the Canadian Airlines domestic services and which could be redeemed on those same services.

5.121. The Undertakings provided access to Air Canada's FFP to air carriers operating domestic services within Canada. They did not provide access in connection with international services. To ensure that international competitors were not disadvantaged by the lack of an alternative FFP in Canada, BA therefore suggested that Air Canada should be required to allow the FFPs of other international carriers to be used on Air Canada's domestic flights on commercial terms.

Slots

5.122. Air Canada had control of 80 per cent of the slots at Toronto's Lester B Pearson airport, which BA said was a congested airport at which it was difficult to obtain slots at commercial times. Air Canada had provided undertakings to the Commissioner of Competition which addressed allocation of slots at that airport but limited to the assignment of slots to domestic carriers.

5.123. BA said that even at Heathrow it was difficult to get slots at the timings it wanted. However, once BA had gained a slot it could go to other carriers, juggle with their slots and gradually move its own slot to a more suitable time. This worked well where there were many carriers. (At Heathrow, BA was also in a position to stop using a slot for one route and use it for services to Toronto.) It was more difficult if, as in Toronto, the main competitor held the majority of the slots as there were not enough carriers to exchange slot timings with.

5.124. BA would have liked to have acquired the slots of Canadian Airlines so that it could increase the number of flights to Toronto. This did not happen, and BA could see considerable difficulties in getting the additional slots to operate additional frequencies at the right times.

Leveraging the domestic monopoly

5.125. BA said that Air Canada's near-monopoly on domestic routes afforded it an opportunity to leverage that position to reduce competition in international air travel markets through the use of incentive programmes with agents. Although BA believed that, as a generality, it was entirely proper for an airline to offer incentives to travel agents in the form of commission linked to the amount of travel booked on that airline, it did not believe that this generality extended to a situation where an incentive

was offered to an agent on a route or bundle of routes on which the airline was in an unprecedentedly dominant position and where the incentive was conditional upon the agent making travel bookings in another, competitive, market. Air Canada had instituted programmes which offered discounts on domestic travel within Canada in exchange for a higher share of international business. As a result, Air Canada's near monopoly in the domestic Canadian market was being leveraged against international competitors to permit Air Canada to secure a further share of the international market.

Safeguards

5.126. As noted above, BA had been active in seeking action by the authorities in Canada to address the concerns discussed above, in particular the concern that the undertakings given by Air Canada did not address the impact of the merger on international routes. Following its second reading before the Canadian House of Commons, Bill C-26 was referred for review by the Transport Standing Committee of the House. BA, Cathay Pacific and Air France jointly testified before the Standing Committee and proposed certain amendments to the Bill. Among those amendments was the inclusion of an 'essential facilities' provision that was intended to prevent Air Canada from lessening or eliminating competition by refusing to grant access, or only granting access on discriminatory terms, to essential facilities or services which other competitors require to compete. Certain of the amendments proposed by BA and other airlines, including the essential facilities doctrine, were incorporated into Bill C-26.

5.127. Bill C-26 had now been enacted, including the amendments proposed by BA. However, the bill required that certain regulations be passed to define conduct that would be prohibited as anti-competitive and to describe those facilities to which Air Canada would be required to grant access under the essential facilities provision. (The draft listed a number of services and facilities which might be included, but to which that provision would not be limited.) These legislative provisions were not a complete substitute for the giving of satisfactory undertakings. Rather, the legislative provisions provided authority to the Canadian Commissioner of Competition to institute proceedings before the Competition Tribunal. That process could require extensive litigation and delay and would not provide the direct and immediate effect that undertakings could accomplish.

5.128. BA therefore believed the merger had brought about a situation in which Air Canada could behave in a way which would deprive consumers of effective choice. It had already behaved in a way that had damaged competition through actions connected with prorates and commission payable to travel agents. BA said that although the potential behaviour at issue was essentially in respect of Canadian domestic services, it would have an impact on competition for UK consumers. In consequence, BA believed there was a case for seeking undertakings from Air Canada to address these concerns. BA wanted to see conditions imposed on Air Canada which ensured that Air Canada:

(a) did not leverage its domestic monopoly in its incentive and discount arrangements for international travel, and be prevented from linking the commission on domestic sectors to the achievement of targets on international ticket sales;

(b) provided interline facilities on its domestic flights to international competitors on reasonable terms; and

(c) entered into reasonable agreements with international airlines which were interested to allow those airlines' passengers access to Air Canada's FFP.

Even these undertakings would not of themselves restore the competitive balance in respect of direct services between the UK and Canada, where airport congestion made it difficult for competitors to increase their frequencies.

British Midland Airways Limited

5.129. British Midland told us that in February 1998 it announced its intention to re-enter the transatlantic market to operate long-haul services between London Heathrow and the USA. The severe restrictions of the bilateral ASA with the USA, known as Bermuda II, prevented this so British Midland made an application to the CAA in February 2000 to operate scheduled services between London and Toronto, Montreal and Vancouver.

5.130. In November 1999, British Midland had also announced its intention to join the Star Alliance (from 1 July 2000). Membership of the Star Alliance would enable it to compete more effectively in the UK against the Oneworld Alliance, established in September 1998 by BA and American Airlines. The Oneworld Alliance collectively controlled 50 per cent of the slots at London Heathrow airport in comparison with 24 per cent held by the Star Alliance. British Midland had had a limited code-share with Air Canada, a founder member of Star Alliance, since July 1994 (see paragraph 5.168).

Canadian Airlines

5.131. British Midland said that Canadian Airlines, and its predecessor Wardair, had operated to the UK as a scheduled airline since 1985, originally as a competitor to both BA and Air Canada. In 1994 the AMR Corporation, the parent company of American Airlines, purchased one-third of Canadian Airlines. The AMR Corporation had in this way secured the inclusion of Canadian Airlines in the Oneworld Alliance when it was established by BA and American Airlines. British Midland said that prior to 1996 BA had operated services to Toronto, Montreal and Vancouver without any particular feeder services in Canada or special marketing arrangements with Air Canada or Canadian Airlines. Even after the alliance with Canadian Airlines BA had not increased its frequency of services between the UK and Canada. British Midland would have expected BA to have provided additional transatlantic services if additional passengers had been generated from its connecting services in Canada with Canadian Airlines.

Onex Corporation

5.132. British Midland said that on 16 September 1999 the Onex Corporation notified the EC of its proposed acquisition of Canadian Airlines and takeover of Air Canada. The financing of these transactions was to be principally by AMR Corporation. The merger between Air Canada and Canadian Airlines in January 2000 was a direct consequence of the impending financial collapse of Canadian Airlines and the failed bid by the Onex Corporation to acquire Air Canada via a hostile takeover. Had this transaction succeeded, it would have concentrated all scheduled services between the UK and Canada into the single Oneworld Alliance. British Midland had been against that transaction. It said that the transaction of January 2000 now under review by the CC had ensured that competition between Air Canada and BA was maintained and that the major alliances, Oneworld and Star, were competing in the London–Canada market by proactive and aggressive competition. The consumer travelling between the UK and Canada would therefore not be disadvantaged.

UK–Canada air services arrangements

5.133. British Midland said that the bilateral ASA between the UK and Canada was liberal and unrestricted. Any UK airline was free to operate any service between the UK and Canada and British Midland had acquired the necessary licences. Also the Government of Canada had recently licensed three more Canadian airlines to operate scheduled services to France and to any city in the UK. As British Midland was prohibited from operating from Heathrow to the USA by the ASA between the UK and the USA, it was certainly a potential new entrant on UK–Canada routes.

Alliances

5.134. British Midland described what it saw as the two significant alliances. Star was slightly more structured. It was a larger alliance comprising a bigger cultural mix of airlines—Varig, All Nippon Airways, United Airlines, Lufthansa, SAS, Austrian, Singapore Airlines and British Midland—which required a more singular template to cope with the very different languages, culture and operation in the different countries. There was slightly more dominance of the English-speaking world in the Oneworld Alliance. It appeared to be less formal.

5.135. British Midland said that the global airline industry was becoming more liberalized and deregulated. The industry had attracted, greatly to the benefit of the consumer, a wide range of new airlines. The last 20 years had seen the growth of the charter airlines, with their package holidays. This different level of airline service also competed for the scheduled service business. British Midland further identified a third category of service in the last few years, the low-cost airline. These airlines

operated from peripheral airports and/or to destinations not of prime location. Thus the consumer now had a choice of three different levels of service: scheduled, charter and low cost.

5.136. As a result of these changes the industry had become hugely diversified. British Midland saw signs of significant overcapacity in the industry and thought that a good deal of consolidation probably needed to take place at each level. The scheduled service industry comprised approximately 182 airlines, the members of IATA. There had been mergers in the non-scheduled airline business, between charters. And British Midland saw that some low-cost airlines were not making any money, but were nevertheless increasing their market share by 'confusing movement with action'. The industry was going through one of its periodic cycles of unprofitability and there was a need to make the product in the full service scheduled airline business more attractive to the consumer, by offering much greater choice in networks and facilities. That was how the alliances had evolved. British Midland believed in making sure that the full service airline product became better value and that the network and facilities across its alliance were considerably greater than was possible for individual airlines operating independently.

5.137. As the second largest carrier at Heathrow, British Midland saw its mission as building Heathrow into a two-alliance hub similar to Chicago, which had the major carriers American Airlines and United Airways. At Chicago approximately 83 per cent of the slots were held almost equally between the two major airlines. British Midland likened this to 'a Pepsi Cola versus Coca Cola' situation, where there was no doubt in the mind of the consumer that the two brands were vigorously competing with each other. Heathrow was the only hub airport in Europe where the two alliances could compete like this. The Oneworld Alliance might come to a situation where it had over 50 per cent of the total slots and as Star Alliance developed it might acquire 30 per cent of the total slots. These proportions formed the critical mass for the two alliances to compete. British Midland saw this development of a two-alliance hub at Heathrow as the context in which the Air Canada/Canadian Airlines inquiry was being held.

5.138. British Midland noted that regulatory issues had to be taken into account when airlines considered any kind of joint venture. As appropriate, British Midland would go to the European Commission or the OFT with a proposal. It had a case before the European Commission at present concerning its ability to compete within the huge volume of new seats on the market between the UK and Europe. British Midland had proposed, in relation to certain routes between Heathrow or Manchester and countries within the EEA, that three Star Alliance carriers (British Midland, SAS and Lufthansa) would operate a joint venture to compete with the Oneworld Alliance and other European alliance groupings. With that larger critical mass the three airlines could deliver effective competition. But the joint venture it proposed would be formally outside the Star Alliance, which did not itself contemplate profit sharing or joint venture activities. The Alliance arrangements focused on the consumer benefits of network competition (such as the quality of lounges).

5.139. British Midland said that BA's decision in 1998 to establish the Oneworld Alliance had encouraged it to join the Star Alliance. Some airlines British Midland had been working with, American Airlines, Cathay Pacific and Iberia, had deserted it in favour of BA. By working with the Star Alliance, British Midland was offering UK consumers the opportunity to choose between the two alliances. The UK–Canada market was also best served in this competitive way.

5.140. British Midland explained that a key benefit of alliance membership was the computer system infrastructure; this was expensive for one airline to develop on its own. Electronic ticketing was part of this technology. However, British Midland was not bound by exclusive arrangements. It had strong code-share arrangements with non-Star Alliance members, for example Virgin, and Virgin competed with United Airlines (a Star Alliance member). British Midland thought that exclusivity clauses in the alliance templates would now be permitted by the US Department of Transportation in certain circumstances. British Midland might have lost out through the application of exclusivity clauses for others. When American Airlines, Cathay Pacific and Iberia had switched to BA, British Midland had lost revenue. If British Midland started services to Canada, it would have to compete with Air Canada unless it applied for competition law exemption which would be considered on its relative merits.

5.141. British Midland told us that there would therefore be effective competition between itself and Air Canada on Canadian routes. Virgin was able to do this with Continental Airlines selling seats against each other on the same aircraft. Without anti-trust immunity or competition exemption this was the only choice. If British Midland felt it was not possible it would apply to the authorities for exemption. British Midland said that its relationship with Air Canada was not one of huge integration. They code-shared on

eight European destinations and took advantage of the alliance relationship, but on matters outside that, such as pricing, they were in competition.

Relevant markets

5.142. British Midland said that the affected market in this case was the provision of passenger and freight services between the UK and Canada. It competed with BA World Cargo and would expand this service when operating more long-haul routes, though freight did not have the same importance, and was a smaller part of the market than the passenger side. It was for the CC to decide whether it was necessary to consider freight in this inquiry. On the passenger side, British Midland said that extensive charter services provided genuine alternatives to scheduled services, offering seat-only prices with schedules operating on a frequent basis and good-quality products for both leisure and business travellers, and that the attractiveness of these services would be increased now that these carriers had been given scheduled status.

5.143. British Midland also suggested that in considering the impact on services between London and Canada, operations from Heathrow should not be considered in isolation from the other airports serving London. Heathrow was no longer unique and separate. Passengers had begun to regard the airports as interchangeable. All London airports had good rail links to the centre and there were a variety of air services and surface links available from each airport. British Midland said that in designing and pricing its product it had to react to what competitors were doing at the other London airports. This was demonstrated by the impact on prices charged by airlines at both Heathrow and Gatwick of competitors such as Easyjet, Ryanair, KLM (UK) and Go at Stansted and Luton. The three main airports shared a similar catchment area that included central London, its suburbs and the Home Counties. They all attracted both leisure and business passengers.

5.144. British Midland said that the proportion of premium traffic on Canadian routes was lower than on many of the routes to the USA and a great deal of traffic went with the former non-scheduled airlines through Gatwick and Stansted. These very active Canadian charter airlines formed part of the London–Canada market. The charter companies starting operations as scheduled services would have an easier task now that their flights appeared on the travel agents' computerized reservation systems. They would be able to issue proper tickets. Canada 3000 already used British Midland tickets.

5.145. The interchangability of services in the London area had been further demonstrated through the willingness of BA to transfer services on both short-haul and long-haul routes between Heathrow and Gatwick, presumably on the basis that passengers would accept either airport. British Midland said that scheduled passengers could easily interline at Heathrow and to a lesser extent Gatwick. Gatwick was a BA feeder hub using the former CityFlyer services (now part of BA). However, BA appeared to give low priority to the economy and super economy passenger. It concentrated its Canada service exclusively at London, ignoring the Air Canada services to Manchester and Glasgow where there were no feed opportunities for Air Canada. British Midland said that BA had chosen not to compete with the charter product.

5.146. British Midland accepted that Heathrow was something of a self-fulfilling prophesy with its catchment area of international business travellers. British Midland's own domestic services from Heathrow had remained at the same load factor or better, despite the advent of better road links and high-speed trains from Heathrow and the other London airports. A new expanding economy, especially computer businesses, had positioned itself in the Thames Valley and out to Swindon and the West. Heathrow, despite its reputation for difficult transit, was in reality extraordinarily efficient. Its design with the building in the centre and the runways outside was a great asset. The 15-minute express to Paddington had significantly enhanced accessibility to the city centre, certainly in comparison with major hub airports in Europe. Heathrow would always be the premium London airport, though the airlines were trying to make the three airports interchangeable. BA had moved Luxembourg–London services to Gatwick. British Midland had started to use Stansted. Virgin used both Gatwick and Heathrow. But it was clear to British Midland that Heathrow for the Canadian leisure passenger was less important, and the Canadian market was leisure dominated.

5.147. British Midland explained that Heathrow and Gatwick were both important for North America. BA now operated to more US destinations from Gatwick than from Heathrow. US carriers prohibited by treaty from using Heathrow (US Airways, TWA, Northwest, Delta, Continental) would

probably opt to divide their services if they had the opportunity in the future to use Heathrow. There were different markets requiring different utilizations. Virgin's operations were already split between the two airports.

5.148. There was also competition with other hubs, with the passengers overflying London. British Midland explained that though passengers preferred non-stop flights, there were not enough UK to long-haul destinations as all communities would like. Carriers like KLM (UK) had set up a regional service feed from the UK to Amsterdam to connect with KLM's long-haul fights. This had come about, in part, because Heathrow was seen as a difficult connecting point. Arguably therefore KLM was competing in the Manchester–Toronto market as vigorously as BA was. Airlines at Heathrow competed both against other London airports and against other European hubs.

Slot constraints at Heathrow

5.149. British Midland said that, at Heathrow in common with the majority of the world's major airports, the supply of slots did not meet demand. But there were sufficient slot opportunities for a British carrier to open new services to Canada if it wished. It was clear from the CC's report on BA/CityFlyer that Virgin had voluntarily given up slots previously held at Gatwick, which could have been used to fly to Canada. At Heathrow, Virgin had chosen to fly to more profitable, restricted markets rather than use its slots for Canada. BA had similarly made slots available by transferring some primarily domestic routes to other London airports. Since BA had held a monopoly on some domestic routes from Heathrow, British Midland expected that if the CC required Air Canada to surrender slots to allow entry of additional competitors on Canadian routes, similar provision would be made for British Midland, or other airlines, to provide services on such routes as Heathrow to Inverness.

5.150. British Midland noted that the terminal capacity that would have been necessary to undertake further operations to Canada had been created by BA at Terminal Four to accommodate not only the flights of Canadian Airlines but also another alliance partner, Qantas.

5.151. British Midland therefore considered that Virgin had had opportunities to operate additional transatlantic services from Gatwick and new services from Heathrow, such as to Chicago, while BA controlled the single largest portion of slots at both Heathrow and Gatwick. Thus it was unrealistic to suggest that either BA or Virgin were prevented from commencing services to Canada due to slot restrictions at UK airports. Indeed both BA and Virgin had objected to the proposed liberalization of UK–US routes, presumably on the basis that new US entrants could (after any renegotiation of Bermuda II) obtain viable slots at Heathrow without assistance.

Slot transfer

5.152. British Midland said that it was frustrating for airlines that there was no updated code of practice for the formal trading of slots. The grey market was unsatisfactory (see paragraph 5.157). The existing slot coordinating system at Heathrow was excellently run within the rules. Any carrier could operate new or expanded services within the rules if they felt the commercial circumstances were favourable. It was the commercial choice of any airline, for example Virgin, to open a service to Canada in preference to, say, Chicago, Miami or Los Angeles if they wished. Airlines might try to obtain slots through regulatory fora like the CC; that was also a commercial opportunity.

5.153. British Midland said that it had never contemplated selling a slot and was not familiar with the slot market. It thought the value of a slot might be judged from the recent High Court action in which the price mentioned was £2 million per slot. Slots were the basis of the business, the means of earning revenue. For British Midland's business to grow it would be necessary to buy slots rather than sell them.

5.154. British Midland said that it had not used slots from its domestic services to open an international service since 1992, after the M40 opened and it no longer made sense to fly Birmingham–London. Those slots were used for developing European routes. BA had changed some domestic services from Heathrow to Gatwick and used the Heathrow slots for European and other long-distance services. Virgin had no Heathrow slots in 1992 but moved some services from Gatwick to Heathrow after a Government directive redistributing traffic was relaxed, and had then built up a significant portfolio over the years. Fifty-six new airlines had come into Heathrow since 1992, though none operated in the less

profitable domestic market. Virgin, unlike British Midland, was permitted to operate to the USA, South Africa, India and Tokyo. Hong Kong was open to British Midland, but not by flying over Russia, so the route was too long. A new entrant Canadian carrier wanting to fly to Heathrow would have priority under the slot regulations over British Midland, BA or Virgin. However, Canada was not seen as such an attractive market as the restricted USA. Canada was unrestricted for UK and Canadian airlines, but rather seasonal. British Midland felt strongly that the access to Heathrow was too generous for new entrants; they were allowed 50 per cent of all new slots. This had brought in a lot of peripheral airlines, serving, for example, almost every former Soviet republic. This had fractionated the market and brought choice, but had not helped competition. The EC policy had spread the slots over a large number of carriers with one or two flights per day, or per week.

5.155. The impact of slots for the short-haul carrier was more significant than for the long-haul carrier. When British Midland started its service to Manchester it needed at least 16 slots a day to compete with BA. By contrast, all of BA's services to Canada required only half that number of slots a day. The same would apply to Virgin or British Midland starting a long-haul service. British Midland said that the slot requirement for successful long-haul services was much smaller than for a domestic service.

5.156. British Midland took the view that slot auctions in the UK would be unworkable. They would lead to a hybrid system to the disadvantage of UK operators. There would never be a free system with auctions in the home countries of foreign carriers. British Midland cited Rome, Frankfurt and Amsterdam as examples of airports where auctions would not be permitted. In running an air service there had to be slots at both ends of the route. A slot auction in the UK alone would give an automatic advantage to the non-UK operators who would not have that system in their own countries.

5.157. British Midland said that the grey market for slots would benefit from transparency. A lot of movement might then take place. Some airlines would consider whether they might be better not to operate from Heathrow and take a one-off dividend from the years they had spent building up that route through the sale of the slot. British Midland thought it would ease the market considerably to introduce transparency. Movement in just 2 or 3 per cent of the 430,000 to 460,000 slots per year at Heathrow would bring more flexibility which would be welcome.

5.158. British Midland said that when it changed its routes it swapped the slots from one route to another. There was a small element of slot swapping between carriers, less than 2 per cent. Where there was limited infrastructure British Midland looked for efficiencies. Historically it had had insufficient slots to serve Spain or Italy with the appropriate frequency. By swapping slots with its alliance partners, it was able to put together a portfolio of timings which enabled it to offer the consumer a new competitive choice. Heathrow–Spain had been exclusively Oneworld Alliance; UK–Finland remained exclusively Oneworld Alliance. British Midland had been able to enter the Spanish market by juggling slots to bring significant benefit. It had been denied entry to Helsinki by an offer of inadequate slot timings at Helsinki.

5.159. Turning to Canadian Airlines slots, British Midland said that the airline had been unprofitable for a long time, beyond redemption. If it had failed and gone into receivership its slots might have been bought by another carrier. The administrator, had he continued to operate the airline, would probably have had a grey market offer for the slots, and not necessarily for use in the Canadian market.

5.160. British Midland said that the slots which Air Canada/Canadian Airlines had already given up at Heathrow might have improved competition by reducing capacity on the Canadian routes. It took the view that the slots would not have been given by Air Canada to another airline. That would be illegal. Unused slots had to be given back to the coordinator for redistribution in accordance with the EC directive, unless a competition authority such as the CC instructed Air Canada otherwise. When Air Canada reduced frequencies to Heathrow this had been a green light to others, a green light which had been ignored. As British Midland had already explained, both BA and Virgin had the opportunity to make a commercial decision to operate more services to Canada. British Midland thought it possible that BA and Virgin were hoping to get some free slots from the CC which they could add to their portfolio and use elsewhere.

5.161. British Midland said that despite the facts that Air Canada's share of the market had gone up dramatically on some routes, for example Heathrow–Calgary, and that Air Canada had acquired extra slots at Heathrow by taking over Canadian Airlines, competing airlines could not be forced to operate routes that were not commercially viable. For example, the potential UK entrants would not be persuaded

by an offer of slots to operate services to Calgary because the market was so small that none of them would want to lose money to take part in the market. More British carriers would operate to Canada when there was profit in it. British Midland made clear that in its view it was not the role of the competition authorities to introduce competition where there was no viability. In the three markets which were potentially viable, Toronto, Montreal and Vancouver, all three UK operators could already make the commercial choice to enter if they wished.

5.162. British Midland took the view that Virgin had no greater need of slots to build up a viable operation than British Midland had. British Midland operating to short-haul destinations was in fact more constrained than Virgin. Virgin had made the strategic move to target the high-yield, high-profitability, low-frequency routes. New York was the only destination Virgin served three times a day. Most of its other services were once a day, so it could make significantly greater profits than British Midland with significantly lower slot utilization at Heathrow. Virgin had cherry-picked the most profitable routes in the world in markets where there was restricted competition. The USA, South Africa, Japan and China were constrained whereas all of British Midland's markets with the exception of Budapest were fully liberalized and in most of them it operated high-frequency services. In picking Chicago before Toronto, Virgin had made a questionable decision. Chicago was the hub for American Airlines and United Airlines, and BA's hub was at the other end of the route. Commercial logic suggested that Virgin made the Chicago decision in preference to competing against BA and Air Canada to what Virgin must have seen as the less profitable destinations of Toronto, Montreal or Vancouver despite the fact that there were no restrictions on any of these destinations.

5.163. British Midland said that it did not foresee difficulty obtaining slots at Toronto Pearson if it chose to open a service there requiring a small number of slots.

Barriers to entry

5.164. British Midland told us that BA had suggested to the Canadian Parliament and the Canadian press that the transaction between Canadian Airlines and Air Canada would prevent BA accessing interior cities within Canada and that as a result BA may have to suspend operations in Canada. BA had also cited Air Canada's code-share arrangements with British Midland as giving Air Canada unfair access to the BA 'home' market.

5.165. British Midland said that it did not understand BA's rationale for these statements. It was clear that BA had operated to Canada for many years as a direct competitor to Air Canada, Canadian Airlines and its predecessor, Wardair. Prior to the creation of the Oneworld Alliance BA did not benefit from any particular or favourable arrangements with either Air Canada or Canadian Airlines. In addition other smaller European airlines which were neither members of the Oneworld or Star Alliances, such as Air France, Swissair, KLM and Sabena, had continued to operate to Canada from countries with smaller passenger markets than the UK and without any code-share or FFP arrangements with either Canadian airline. In British Midland's view this demonstrated that the present code-share, FFP, interline and prorate arrangements did not constitute barriers to entry.

Code-share

5.166. British Midland said that whilst BA had previously offered code-share connections to a limited number of interior cities within Canada, these cities represented only a small percentage of the total number of passengers travelling between the two countries. The major centres of population in Canada (Toronto, Montreal and Vancouver) were all served directly by BA.

5.167. British Midland said that the customer invariably preferred a non-stop flight, or failing that a code-share or intraline service. Code-sharing was a marketing concept. The passenger perceived baggage as being safer on a code-share service, but in truth all the baggage at Heathrow went through the same process be it interline, code-share or straight transfer. And for British Midland interlining remained more important than the alliance systems in revenue terms. British Midland had 120-odd interline partners as against six or seven alliance partners. Nevertheless the alliance concept was to provide as seamless a service as possible to the customer, bearing in mind the complexities of the airline business and the physical difficulties of some airports.

5.168. British Midland said that it had, since July 1994, provided Air Canada with code-share services between Heathrow and Manchester, Glasgow, Edinburgh, Belfast, Leeds/Bradford, Teesside, Amsterdam and Brussels. Unlike Air Canada, however, the BA hub at Heathrow provided connecting opportunities from the principal Canadian cities to around 50 cities in Europe, and major cities in Africa and the Middle East together with the substantial markets of the Indian sub-continent. The connecting services operated by British Midland provided Air Canada with only limited third market opportunities beyond London.

5.169. British Midland found it ironic that BA had suggested to the Canadian Parliament that as Canadian Airlines decided to leave the Oneworld Alliance, Air Canada should be compelled to offer 'favourable' code-share and interline arrangements to BA. British Midland pointed out that as a consequence of the formation of Oneworld Alliance, long-standing partner airlines, such as American Airlines, Iberia and Cathay Pacific, on joining the Oneworld Alliance, had cancelled their code-share arrangements with British Midland. Should BA successfully make representations on code-sharing and interlining to the CC, British Midland would expect 'favourable' code-share and interline arrangements from BA and from those airlines which were previously British Midland partners and which had chosen to join a competing alliance.

5.170. British Midland contrasted its situation vis-à-vis Air Canada with BA/Finnair. BA/Finnair had 100 per cent of all services to Finland, they code-shared on all flights and were in the same FFPs. Finnair was the most dominant airline in Europe in terms of the percentage of slots it held at its home airport. BA had assured the European Commission that it and Finnair were vigorous competitors. It had not sought exemption from competition law in a situation where it completely overlapped with the supposed competitor. The alliance activities did not overlap in this way. If they did British Midland would seek exemption as it was doing in its arrangements with SAS and Lufthansa in Europe.

Interlining and prorates

5.171. Discussing the importance of interline prorate feed traffic, British Midland said that its market position was recognized only in the UK, not in North America. This had to be taken into account when considering opening a service to Canada. One of the most difficult aspects for airlines was selling their product at the other end of the route. British Midland's core business was domestic. It had 60 per cent of the Heathrow–Belfast market, 38 per cent of the London airports–Belfast market and coming up to 35 per cent of the Heathrow–Glasgow/Edinburgh market. It had been very effective against BA to the major UK trunk destinations. There was a necessary balance between this strong home market and building up its long-haul and European services. It had no interest in cutting off its feed to Europe and to long-haul services.

5.172. A dilemma for British Midland with short-haul domestic services was to keep them viable and sustainable throughout the day. The routes were busy in the morning and evening but in the middle of the day the point-to-point business traffic had to be replaced with passengers for other parts of the world. British Midland therefore had traditionally worked with a large number of other carriers. It basically worked with anyone who competed with BA, because it would not get feed from BA. As BA set up its competing alliances and took British Midland's historic partners, it became evident that British Midland would have to feed itself to retain the level of frequency that the UK and European customer wanted. This was now the strategy for British Midland's European, domestic UK and long-haul routes. The feed was vital for long-haul services. Virgin as an example would lose an important slice of its business if British Midland gave its feed from Europe to someone other than Virgin.

5.173. British Midland said that in this case the importance of the feed was unique to the Heathrow end of the transatlantic routes. It explained that BA's strength built up over the years 1947 to 1998 was in serving the three major cities in Canada where the Canadian population predominantly lived. Both BA's relationship with Canadian Airlines, and the importance to BA of Canadian Airlines' feed, were recent phenomena. Previously it had operated without feed arrangements other than the IATA standard. British Midland therefore was surprised that BA should threaten to withdraw from Canada now because it had lost the advantage of Canadian Airlines feed. By contrast Heathrow was an important connecting centre to the whole world for transatlantic routes. 40 per cent of the entire US–EEA market passed through the UK, more than through Germany, France, Italy and the Netherlands combined. BA uniquely, unlike British Midland, Virgin or Air Canada, could connect passengers to UK domestic and to 2½ times as many places in Europe as British Midland could fly, as well as Africa, the Middle East and the Indian

subcontinent. To be able to take 80 per cent of Canadian air travellers and connect them with cities around the world was a very sizeable competitive position to enjoy. BA's connecting opportunities outstripped those of British Midland, with its limited code-sharing arrangements with Air Canada (only six UK domestic destinations plus Amsterdam and Brussels), by a considerable margin.

5.174. British Midland said that while it could interline in Canada or elsewhere with anyone it chose, including new domestic carriers in Canada, it would be fair to assume that it would interline in Canada with Air Canada because that airline could offer other consumer benefits, such as lounges. British Midland reminded us that KLM, Air France and Sabena had been flying to Canada successfully during the whole period that the market had been primarily served by Star Alliance and Oneworld Alliance.

5.175. British Midland expressed the view that the issue of prorates was something of a red herring. BA itself, on routes within the UK, charged Air Canada more than the local domestic fare. Examples were:

Sector	*Domestic fare*	*BA's charge to Air Canada*
London–Aberdeen	£147	£311
London–Newcastle	£134	£209
London–Jersey	£124	£193

5.176. British Midland said that the industry system allowed this to happen because the mileage-based division of the fare produced these figures. The full business class Aberdeen–Toronto fare was £1,656. The mileage split meant that BA received £311 compared with the full local domestic fare of £147. This mileage split system produced a very small figure on the shorter leg when the fare was low. British Midland said that there were fares in the market that, when split, gave it as little as US$18 for a London–Glasgow leg. That amount did not cover the direct passenger costs. Airlines generally took the rough with the smooth and hoped that the average income over time equated to an equitable yield.

5.177. British Midland said that although this practice of BA's had been going on for a long time and was not a consequence of the merger, the more favourable arrangements BA had with Canadian Airlines had only been in existence since 1998. Previously and since, BA had used the industry prorates. The relationship between carriers was about feeding into each other's networks. British Midland added that some airlines had terminated relationships with British Midland (Cathay Pacific, Iberia, American Airlines) but British Midland had not run to the European Commission asking for an order forcing them to provide British Midland with special prorates. The industry system worldwide was based on the division of the fare by mileage. Very few countries had competitive local airlines for a trunk carrier to choose between when interlining. The industry prorate system was the most equitable way, so far, devised and all the airlines had signed up to it. Through fares were an asset to consumers enabling them to travel worldwide on one ticket. British Midland's understanding was that BA was having to pay the correct prorates set under the international agreement it had signed. This was quite proper.

5.178. Thus British Midland believed that Air Canada was offering interline arrangements to BA at the industry standard. Through the CC, BA was seeking something better, a favourable arrangement. If the CC were to impose favourable interlining arrangements as a condition for the Air Canada merger, then British Midland would seek similar arrangements with BA at this end on the same grounds of dominance. These arrangements would enable British Midland when it entered the Canadian market to go into favourable feed arrangements at this end with BA where the latter had monopolies, such as Heathrow to Aberdeen and Newcastle. Interlining, and for that matter FFPs, were not essential service issues. EC case law had, British Midland believed, dismissed that argument as not applicable. BA was a global brand, the largest international airline in the world, operating to a country that had very strong ties with Great Britain. If a competitor of that structure and natural advantage was affected by Air Canada's FFP and standard IATA interlining arrangements, the identical arrangements at Heathrow could be presumed to have a far greater effect on BA's interlining partner British Midland. A CC judgement involving FFPs or favourable interlining arrangements had to be cognizant of the situation at both ends of the route.

Frequent flyer programme

5.179. British Midland said that BA had also suggested to the Canadians that its lack of access to an FFP in Canada would restrict its ability to compete and to attract business passengers. As a result BA

should be allowed to purchase points in Air Canada's programme at a reasonable rate. British Midland explained that it suffered from significant disadvantages arising from BA's market power in the UK. If BA perceived that non-participation in the Air Canada FFP was a barrier to its operating in the Canadian market, which was relatively full of competition for all comers, how much more of a barrier would non-participation be to a carrier with a small FFP of its own such as British Midland, entering the London–Helsinki market? British Midland would, if the CC were to accept BA's argument, seek membership on a similar basis of the BA Executive Club and Airmiles programmes, in addition to the FFPs of other Oneworld Alliance members, Finnair, Iberia and American Airlines.

5.180. Commenting more generally on the decision of the Canadian Competition Bureau to impose obligations on Air Canada which were designed to facilitate competitive growth in the domestic market, British Midland said that if these undertakings were extended to the international carriers because of Air Canada's dominance, there were grounds to examine the situation elsewhere. BA had been found by the European Commission in a travel agency commission case to be dominant in the UK. BA should therefore be obliged to make its FFP available to competing British and Canadian carriers. FFPs were difficult for small carriers to compete against. BA should not be permitted to gain access to Air Canada's programme without granting reciprocity. Air Canada and British Midland would have to be given access to BA's much larger and impressive programme, and the American Airlines programme which was the largest in the world. British Midland was denied access to these programmes. If the CC were making access available to FFPs then British Midland would seek a wider application of the principle.

Conclusion

5.181. British Midland did not believe that the overwhelming majority of passengers travelling between the UK and Canada would be disadvantaged as a result of the merger. It was clear to British Midland that Canadian Airlines would not have survived in its previous form. British Midland thought that we should pay less regard to the loss of specific competition on individual routes and look at the wider UK Canada market. The Onex deal would have given an effective monopoly in this wider market to BA, American Airlines, Canadian Airlines and Air Canada. The current arrangement preserved competition between the alliances for the 80 per cent of consumers going to the principal Canadian cities. The current merger would ensure that passengers would be able to continue to benefit from two competing alliance groupings between the UK and Canada and additional competition from new entrants. There were no regulatory, substantial infrastructure or other constraints that would prevent British Midland, BA or Virgin offering additional services between London and Canada. In British Midland's view the Air Canada/Canadian Airlines merger had not unduly distorted the international market; the major consequences were for domestic Canadian services. The Canadian authorities had scrutinized that situation and put in place a number of provisions. One new airline had already taken advantage of the regulatory changes in Canada. Internationally the situation was quite different. The major travelling population was centred round three cities. As a consequence of the merger these three cities continued to be served vigorously from the UK by both Oneworld Alliance carriers, through BA directly, and indirectly through the USA by American Airlines, and by the Star Alliance carrier, Air Canada. The consumer had a choice of the two global alliance groupings competing head-to-head on the routes to the three cities. In addition there were a number of new entrant carriers offering a specific product for those passengers looking for cheap deals, in a market in which BA chose not to compete.

5.182. British Midland said that its concerns over FFPs and interlining were related to the effect of these systems globally. It was inappropriate to regard them simply as UK–Canada issues; they affected the UK airline market as a whole. Other airlines, such as the low-cost airlines, would voice concerns about them as barriers to entry given the opportunity.

5.183. On the specific market the CC was examining British Midland saw it as unnecessary to distort the existing situation. Carriers could be left to make commercial decisions. Following the merger Air Canada had increased its presence significantly only in markets like London–Ottawa and London–Calgary which were unattractive to UK competitors. The equivalent in US terms would be opening a service from London to Minneapolis, a Northwest Airlines hub. The market was small and these were not viable routes for a British carrier. British Midland and Virgin had both applied for the same three Canadian cities, which could be viable routes.

5.184. British Midland said that it had been before the MMC on three previous occasions to discuss questions of far greater market dominance. It cited the British Caledonian takeover by BA, the DanAir

takeover by BA and the CityFlyer takeover by BA. The MMC had not released any BA slots to the UK market in these far worse cases and British Midland would find it very difficult to see justification for a release of slots if that were to happen in this case.

Canada 3000 Airlines Limited

5.185. Canada 3000 told us that it had as a result of the merger been awarded scheduled service licences by the Canadian Government. It believed that the market between the UK and Canada, including that between Heathrow airport and Canada, was and would be adequately served and that the public had a choice of carrier at both airports in the London area and from the provincial airports in the UK and Canada. It saw no reason why this competitive situation would change or be reduced in the future. Both the Star Alliance and the Oneworld Alliance continued to be represented on these routes, although as a result of the merger there had been some change in their membership.

Virgin Atlantic Airways Limited

5.186. Virgin said that the merger had created a dominant position on UK–Canada scheduled air passenger services, and specifically on certain markets including Heathrow to Toronto. This dominant position was likely to lead to increased prices or reduced services for UK consumers, or have other significant adverse effects on competition in the UK, including increasing barriers to entry for airlines seeking to operate additional international services to Canada. It could therefore be expected to operate against the public interest.

5.187. Virgin said that aviation had grown up in a very regulated environment with very detailed government intervention. The result of this had been the dominant position that the so-called flag carriers had achieved in their home markets, which had the effect of creating severe barriers to entry for other carriers wishing to enter the market. Canada was a good example of this.

5.188. Virgin said that following the merger Air Canada and Canadian Airlines had begun to consolidate their operations. Air Canada had eliminated duplication between the two airlines on domestic routes within Canada and had taken up some route rights between Canada and points in Asia which were formerly dominated by Canadian Airlines. At the same time, Air Canada had maintained most of the two airlines' frequencies on routes between Canada and the UK.

5.189. The main effect of the merger on the UK market had been to create a massively dominant airline on UK–Canada scheduled air passenger services, as well as in certain 'overlap routes' or airport-pair markets previously served by Air Canada and Canadian Airlines. The Heathrow–Toronto route was particularly important as it accounted for around 42 per cent of total UK–Canada scheduled air traffic. As a result of the merger, Air Canada was now dominant on the route with a market share of 71.4 per cent of passengers in 1999. Virgin believed Air Canada's dominance of the UK–Canada scheduled air passenger services, and the Heathrow–Toronto market in particular, was anti-competitive particularly in circumstances in which new entry to the route was effectively precluded.

5.190. BA and Canadian Airlines had cooperated very closely prior to the merger and had a significantly dominant position in the market place. Virgin was unable to take any action against that because of the competition legislation in the UK prior to the recent Competition Act.

5.191. Air services between London and Toronto were an important opportunity for airlines. Toronto was the third busiest long-haul destination from London; the Toronto route was the sixth busiest route from Heathrow. The Heathrow–Toronto route was one to which commercial customers in particular constantly referred. Virgin was looking for a Heathrow–Toronto route that was competitive with other operators on that route. It could not enter the market at substantial disadvantage. Once it was on the route it would be able to build the frequency.

5.192. Virgin had previously taken the commercial decision to start operations to Chicago rather than Toronto, but Toronto was now high in its priorities. Virgin had looked at every possible way of serving the route, but had come to the conclusion that starting from Gatwick was too great a risk. Starting from Heathrow and then possibly adding a second daily frequency from Gatwick would be a more acceptable approach, and an approach Virgin had used on other routes.

5.193. Virgin had been prevented from entering the London–Toronto market by the shortage of slots at London airports, particularly Heathrow; it had become increasingly difficult to obtain slots since Virgin (or subsequently Canadian Airlines) had switched its operations to Heathrow. Recent new entrants at Heathrow tended to be low-frequency services at off-peak times, many to Eastern Europe. Available slots for transatlantic services had effectively disappeared: but to establish a new service profitably, it had to operate at peak times. Although slots could be exchanged, in combination with payment, no one was prepared to sell slots at the peak times for transatlantic flights. Larger operators with a larger number of slots were at a distinct competitive advantage compared with Virgin in being able to play around with their slots to produce a sensible programme. Virgin said, however, that if it had the slots and entered the market, it would have encountered other barriers to entry which other carriers (BA) had highlighted to the Canadian competition authorities.

5.194. Virgin had wanted to reform the slot allocation rules in Europe and had launched a lobbying campaign with the European Commission on that. Primarily its focus was on two issues: first, the grandfather rights and second, the sale of slots. Virgin believed that slots should be treated as a franchise and awarded only for a limited period (10 or 15 years), then handed back to the pool for reallocation with the original occupier having the ability to bid along with other competitors. This would substantially liberalize and open up the markets and create far more competition in Europe. Allied to that, Virgin believed that the slot franchises thus introduced should be tradable.

Relevant markets

5.195. Virgin said that the market for time-sensitive passenger travel had been found by a number of authorities (including the OFT and the European Commission) to represent a distinct market. The market for scheduled air passenger services on a route could also be regarded as distinct from the market for all air passenger services, since they were characterized distinctly from charter passenger services by a number of features:

(a) Scheduled services generally ran according to similar schedules throughout the year—many charter services did not operate in the winter, or operated on severely reduced frequencies or at different departure and arrival times from those in the summer season.

(b) On many scheduled passenger routes, including those between Heathrow and Toronto, Heathrow and Vancouver, Heathrow and Ottawa and Heathrow and Calgary, scheduled airlines offered daily or more than daily flights—many charter operations were not daily operations. The availability of at least daily flights was a key differentiating factor for time-sensitive passengers.

(c) Scheduled carriers offered services generally unavailable on charter flights, such as flexible tickets with no penalties for charges or cancellations, airport lounges, premium cabins with more space and comfort on board aircraft, higher-quality meals and on-board service and private ground transfers to and from airports.

(d) These features were particularly important to time-sensitive travellers, particularly those travelling on business. Charter services could not therefore be a substitute for scheduled passenger services for these travellers, who represented a sizeable body of passengers (according to the CAA survey data, 20.8 per cent of passengers on the Heathrow–Toronto route in 1999 were travelling for business).

5.196. Even if charter passenger services were taken as substitutable for scheduled services, the impact of the merger on competition was virtually the same as if scheduled-only services are considered. No charter operator offered any Heathrow–Toronto services. One charter operator offered daily Gatwick–Toronto flights (although Gatwick was not, in Virgin's view and for reasons explained below, substitutable for Heathrow). Other operators offered less frequent charter services from Gatwick but, for the reasons set out above, Virgin did not consider that a less than daily service was substitutable from the point of view of time-sensitive passengers. However, if charter services between Gatwick and Toronto were considered as part of a London–Toronto market for all air passenger services, the combined share of Air Canada and Canadian in a market defined in that way would be 56.8 per cent.

5.197. Routes from Gatwick also tended to constitute separate markets to those from Heathrow. According to the CAA's report on Airline Competition in the single European market, survey data showed that flights from Heathrow attracted far more business passengers than those at the other London

airports. Historical price movements indicated that lower on-demand fares at the other airports were not matched at Heathrow while a price change at Heathrow clearly affected pricing elsewhere in the London area.

5.198. In addition, Heathrow attracted considerably more business passengers than Gatwick because it served a different catchment area (in particular extending from the west and north-west of London, thus including areas of particularly high business activity); because business passengers considered Heathrow to be London's premier airport and preferred to fly from it; and because there was both greater frequency of connecting flights from Heathrow than from Gatwick and a greater number of destinations served, thus attracting more connecting passengers. Hence, although published fares from Heathrow and Gatwick were often the same, discounts were greater at Gatwick, passenger mix was different and the yield was significantly lower.

5.199. The difference in passenger numbers in business class on the routes from Heathrow and Gatwick to Newark also revealed strong passenger preference for flights from Heathrow. In the 12 months to April 2000, Virgin carried 138 per cent more business class passengers and 12 per cent more economy class passengers between Heathrow and Newark than between Gatwick and Newark. Time-sensitive business passengers, which constituted the vast majority of Virgin's upper class passengers, thus showed a marked preference for Heathrow, and did not regard Gatwick as a substitute.

5.200. It was notable that there had been no scheduled passenger services between Gatwick and Canada. BA had an extensive hub at Gatwick serving a large number of long-haul destinations including 12 in the USA, two of which BA also served from Heathrow; yet BA did not offer any services from Gatwick to Canada. This suggested that either scheduled services from Gatwick to Canada would not be competitively and commercially viable; or Gatwick was not substitutable for Heathrow.

5.201. In any event, there were only ten return scheduled passenger services a week between points in Canada and UK regional points (Glasgow and Manchester), compared with over 120 return scheduled services a week between Heathrow and Canada. UK–Canada scheduled passenger traffic was therefore concentrated almost entirely on services from Heathrow. In the absence of any scheduled services at all between Gatwick and Canada, potential scheduled services between Gatwick and Canada could not be regarded as substitutable for services between Heathrow and Canada.

5.202. Nor were flights to Canada from regional UK airports substitutable for flights from Heathrow, particularly for time-sensitive passengers, because the length of travel time from London to Manchester or Glasgow placed them in entirely different catchment areas to that of Heathrow, because passengers (particularly time-sensitive passengers) would not accept an indirect flight via one of the regional airports and because the regional airports offered much lower frequencies (also a determining feature for time-sensitive passengers) than Heathrow. Relevant markets for scheduled passenger services from London could therefore be defined as airport-pair markets, and specifically as the markets for services from Heathrow.

5.203. Virgin also argued that indirect scheduled services between Heathrow and Canada—that is, services on which passengers travelled via an intermediate point where they changed planes—were not a substitute for direct scheduled passenger services on these routes. Time-sensitive passengers in particular did not want to incur the extra time involved in taking an indirect flight even though airlines frequently offered lower fares for indirect flights (for example, via points in the USA). In 1999, only 3.3 per cent of passengers from Heathrow to Toronto, for example, travelled on indirect services (according to CAA survey data).

Adverse impact of the proposed merger on competition

5.204. Virgin argued that the merger of Air Canada and Canadian Airlines had resulted in a major change in competition on UK–Canada routes and in the Heathrow–Toronto market. Before the merger, Air Canada and Canadian Airlines competed with each other on the Heathrow–Ottawa route; they also competed with each other on routes from Heathrow to Calgary, Toronto and Vancouver on which a third carrier also operated. The third carrier, BA, cooperated with Canadian Airlines under a code-share

agreement (which would finish in June 2000). Nonetheless, even on routes where BA and Canadian Airlines were cooperating, the largest market share held by either Air Canada or BA/Canadian Airlines combined on any airport-pair route in 1999 was 61.9 per cent. This was BA/Canadian Airlines' share on the Heathrow–Vancouver route (on the Heathrow–Toronto route, the combined share of BA and Canadian Airlines was 60.6 per cent). Combining the shares of Air Canada and Canadian Airlines, in 1999 the two carriers accounted for 71.4 per cent of passengers on the route. On UK–Canada scheduled routes as a whole, Air Canada/Canadian Airlines' share of passengers was 71.2 per cent.

5.205. For time-sensitive business travellers, frequency of service was a particularly important feature affecting their choice of carrier. The combined frequency share of Air Canada and Canadian Airlines was at levels which gave them dominance of frequencies. For example, on the Heathrow–Toronto market, the merged entity accounted for 71.6 per cent of frequencies (June 2000 schedule).

5.206. Virgin said that, even if the pre-merger market shares of BA and Canadian Airlines were aggregated to reflect the reduced competition between them as a result of their code-sharing agreement, the increase in market share post-merger was significant: an increase in the HHI of 691.2 points.

5.207. The increase in market shares was reinforced by the fact that the merger was also combining parties' domestic services feeding into Toronto: some 85 per cent of domestic capacity was not duplicated, providing a much higher number of online connecting services than before the merger to the transatlantic services of both BA/Canadian Airlines and, separately, Air Canada. This was likely to leverage the parties' combined share of the Toronto–Heathrow market still further. Although BA, for example, enjoyed corresponding online effects at Heathrow, these effects were stable rather than likely to increase as a result of the merger.

5.208. Virgin said that the anti-competitive situation was worsened by constraints which precluded new entry. In particular, slot congestion at Heathrow made it difficult for a new entrant to enter Heathrow–Canada routes with a competitive new service. Incumbent airlines predominantly operated overnight from Canada to Heathrow. These services required morning arrival slots and late morning departure slots at Heathrow. Entering the Heathrow–Toronto route at off-peak timings would place a new entrant at a substantial disadvantage which would prevent successful entry. Virgin had applied for slots at Heathrow to operate a new service to Toronto starting in the 1998/99 winter season, and for each subsequent season. No slots had been available for such a service. Virgin believed there might also be slot constraints at Toronto. The Heathrow–Toronto route was the most likely to be viable for a new entrant as it was the busiest Heathrow–Canada route.

5.209. The anti-competitive effects were compounded by other features which prevented successful new entry to Heathrow–Canada routes. Virgin believed Air Canada had the largest numbers of members of an FFP in Canada. By merging with Canadian Airlines, the merged entity had access to an even stronger base of FFP members. Air Canada and Canadian Airlines also dominated relationships with travel agencies in Canada. Air Canada's ability to foreclose Canadian domestic feed traffic by charging high prorate fares to interlining carriers could be used anti-competitively to discourage new entry on Heathrow–Canada routes.

5.210. New entry to Heathrow–Canada routes by UK airlines other than Virgin was highly unlikely. The only credible contender was British Midland. However, British Midland was a partner of Air Canada in the Star Alliance. It had withdrawn from the Heathrow–Frankfurt route where it formerly competed with Lufthansa, also a Star Alliance partner. This suggested that British Midland was most unlikely to enter any Heathrow–Canada routes in competition with Air Canada. Virgin had been highly critical of the global alliances and believed they were anti-competitive. Singapore Airlines, another member of the Star Alliance, did have a 49 per cent shareholding in Virgin, but none of their routes overlapped so there was no competition issue. Virgin had stated that it had no intention of joining the Star Alliance at present.

5.211. Virgin believed the FFP was an extremely powerful marketing tool in the hands of a dominant carrier, and it wanted to be able to participate in Air Canada's programme on the same terms on which other partners of Air Canada participated. Participation alone was meaningless. It was the price of the participation that was crucial, as was the ability to have access to interline fares at the same level with which other carriers were provided, and the control of the extent to which Air Canada could lever its dominant position with travel agencies and corporate customers.

Prorates

5.212. Virgin understood that BA and Canadian Airlines had had an arrangement for special prorates, with more favourable bilaterally-negotiated rates, which did not follow the standard IATA approach. Air Canada had withdrawn those rates and imposed higher ones. However, Air Canada was able to offer very low rates to itself, therefore BA could not compete viably against Air Canada. A solution to this was that, if Air Canada was in a dominant position in the market place, it should not be able to pick and choose who it made special arrangements with. If it was commercially sensible for Air Canada to offer a prorate to Lufthansa for x Canadian dollars, then that offer should be available to everyone else in the market, otherwise competition would be distorted.

Remedies

5.213. Virgin believed there was significant evidence that the addition of a third airline on a route had a disproportionate effect on competition, and the work that the CAA had undertaken on European routes pointed very strongly in that direction. However, the CAA had looked at 'traditional' airlines, and Virgin liked to think it was a less traditional airline and would compete more effectively and strongly than a traditional airline no matter how many other carriers were on a route. However, generally, two carriers was a duopoly and three carriers tended to be more competitive. When Virgin entered a market, it believed fares tended to come down in consequence, and new traffic was generated.

5.214. The Canadian authorities had focused solely on domestic issues. Although the former charter operators to the UK had been redesignated as scheduled carriers, this was merely a rebranding of their services, which provided competition for a large part of the leisure market, but not for business passengers.

5.215. Virgin believed that the CC should find against the proposed merger. In order to promote pro-competitive new entry to UK–Canada scheduled air passenger routes, the CC should call for remedies including, but not limited to:

(a) Divestment of daily pairs of slots by Air Canada/Canadian Airlines at Heathrow and Toronto to enable a carrier not currently serving the Heathrow–Toronto route to provide a new service operating daily at times of day which enabled a commercially-viable service, and in particular allowing for early morning arrivals each day at Heathrow. Virgin believed it was particularly important that any slots required to be divested at Heathrow and Toronto should be available to a third carrier on the Heathrow–Toronto route to add competition. In this context, Virgin noted that nine out of the ten busiest long-haul routes from Heathrow supported three or more carriers operating independently of each other; two of these routes supported four independent carriers; two supported five independent carriers.

(b) Opening to any new entrant carrier on UK–Canada scheduled passenger routes the ability to join Air Canada's FFP on terms no less favourable than those offered to Air Canada's existing FFP partners.

(c) Preventing Air Canada from offering travel agency and corporate commission discounts which bind loyalty (as found illegal, in the case of travel agency commissions, by the European Commission in its case against BA, case no IV/34.780).

(d) Ensuring that Air Canada made available to any new entrant carrier on UK–Canada scheduled service routes interline fares for connecting traffic to Canadian domestic points at prorates no less favourable than those it offered to its existing airline partners.

Others

Air Transport Users Council

5.216. The Air Transport Users Council believed that the effect of the merger was to put 80 per cent of the Canadian domestic market into the hands of one carrier, with very serious implications for

competition in that market and a potentially adverse impact on Canadian consumers. It was concerned that UK consumers would be affected when their destinations were not at a gateway airport or when they entered at one gateway and returned from another. Although affecting only a small proportion of passengers, this traffic could be crucial to the viability of a service and, if denied to BA as a consequence of the merger, could result in the withdrawal of one or more transatlantic service.

5.217. Consequently the Air Transport Users Council saw merit in the merger being made conditional on Air Canada providing interlining services to other international carriers on a normal commercial basis.

The British Air Line Pilots Association

5.218. The British Air Line Pilots Association (BALPA) believed that as long as Air Canada enjoyed a dominant position in the market there should exist structural checks and balances to prevent it or any other carrier from exploiting its position.

5.219. BALPA said that the wider issue of industry consolidation also required a fair and equitable industry framework, guaranteeing access to all markets by carriers who wished to serve them. It did not think this problem could be remedied by the 'open skies' solution. Canada demonstrated par excellence the dangers of allowing market forces alone to determine the future shape and structure of the industry. The fact that few competitors were prepared to offer the range of service options which Air Canada offered demonstrated two things: first, it showed the importance of strong domestically-owned and -controlled carriers to the future well-being of a country's air transport industry; secondly, the pressing need for sensible and measured regulatory intervention on both a national and global basis. BALPA believed that only the intervention of the respective governments and the International Civil Aviation Organisation could solve such regulatory problems. This required a strengthening of the apparatus of global economic regulation to supplement the competition authorities in ruling on complex and multi-faceted competition issues such as the Air Canada case.

5.220. BALPA believed that although the CC must address the specific commercial and economic dimensions of the merger case, it also needed to address wider issues as the industry reached a regulatory turning point.

Consumers' Association

5.221. The Consumers' Association said that the proposed merger of Air Canada and Canadian Airlines was likely to have a significant effect on the ability of UK consumers, be they business or leisure, to access a choice of flights to Canada. The degree of concentration that the merger would bring about was clearly worrying from a competition standpoint.

5.222. The current market was fairly evenly divided between Air Canada, BA and Canadian Airlines. On a route by route basis, the pattern of competition was rather muted. Only Air Canada served seven cities in Canada, of which BA served three (Montreal, Vancouver and Toronto) and Canadian Airlines four (Ottawa, Vancouver, Calgary and Toronto). At present traffic levels it could be argued that a number of the routes flown solely by Air Canada were not sufficiently attractive to generate more competition. However, the history of market entry by second carriers suggested that such entry tends to generate traffic growth, sometimes in excess of the traffic substitution.

The increase in concentration on specific routes

5.223. On routes from Heathrow to Ottawa, Vancouver, Calgary and Toronto, the level of concentration had increased quite markedly. This was particularly the case for Ottawa and Calgary where a duopoly had been turned into a monopoly. The position on the London–Toronto market was also worrying, given the fact that the market would be divided between a single player with 71 per cent of the market and one with 29 per cent.

The raising of entry barriers

5.224. The increase in concentration and likely decrease in competition on specific routes was compounded by the overall dulling of competition between London and Canada and the overall increase in strength of the merged entity. The proposed merger would not simply mean that the number of effective competitors was reduced by the one firm being removed from the market, but the actual effect would be greater, the number of effective competitors (derived as the inverse of the Herfindahl index)[1] being reduced from 2.85 to 1.74. Even the current situation was far from competitive, three carriers providing less competition than would be indicated from an equal division of the market. The post-merger situation would be even worse, effectively leaving less than two competitors on London–Canadian routes.

TABLE 5.1 **Effective competition on London–Canada routes**

			Effective competitors (HI number equivalent)	
	HI pre-merger total	*HI post-merger total*	*Pre-merger*	*Post-merger*
Edmonton	1.00	1.00	1.00	1.00
Halifax	1.00	1.00	1.00	1.00
Ottawa	0.61	1.00	1.64	1.00
Montreal	0.54	0.54	1.85	1.85
Vancouver	0.40	0.50	2.49	2.00
Calgary	0.54	1.00	1.84	1.00
Toronto	0.34	0.59	2.95	1.69
Total	0.35	0.57	2.85	1.74

Source: Consumers' Association.

Indirect traffic

5.225. In a merger situation one also had to address the possibility that consumers would divert their consumption away from the merged entity. However, in the airline market this had proved to be an illusory solution; the amount of indirect traffic from Heathrow to Toronto was very small, only some 3.3 per cent of the total. Even this very small amount of traffic tended to be mainly funnelled through European hubs, rather than North American hubs, indicating that the extremely price-sensitive, or alliance-dependent, share of traffic was very low.

Conclusions

5.226. The proposed merger of Canadian Airlines and Air Canada clearly indicated a large increase in market power on the part of the merged entity. The effect on time-sensitive business travellers, who were unlikely to seek indirect routes as alternatives to the merged airlines' dominance, was likely to be particularly large. Any increase in business class fares that such a merger might trigger would be an additional cost to UK and Canadian businesses: a significant issue for the economic well-being of UK businesses. The increase in concentration, and relative weakness of the sole remaining competitor, were also likely to have an effect on the number of promotional fares available to economy class and the balance between full fare and promotional fare was also likely to be affected. The post-merger Canadian airline market showed that the merger had already affected both fares to consumers and service levels. The perceived need to appoint an ombudsman to regulate relations between the merged airline and its customers was a sorry indication of how the airline market had been affected. The position of the remaining UK carrier, BA, would be weakened significantly as a result of the merged airline.

5.227. However, the Consumers' Association recognized that the Canadian authorities had already sanctioned this merger (with apparently negative consequences for Canadian consumers) and a unilateral

[1]The Herfindahl index is a similar measure of concentration to the HHI used in some other parts of the report, but whereas the HHI is based on the square of the percentage market share with a maximum value of 1,000, the Herfindahl index is based on the square of the proportion of market share, with a maximum value of 1.

blocking move in the UK would be unlikely to have the desired effect. The Consumers' Association believed there were only two realistic solutions to increase market power:

(a) *Slot divestiture:* Given the fact that the airline merger had been allowed, the merged airline should be forced to divest itself of those slots used by the smaller partner on any route on which they previously competed and now cooperated. The merged airline should thus give up slots (equivalent to the Canadian Airlines share) on the London to Ottawa, Vancouver, Calgary and Toronto routes. Where possible, such slots should be provided to a third carrier to replace the exiting airline. Ideally, the nationality of such a carrier should be an irrelevance, but the reality of bilateral aviation treaties meant that a designated UK carrier would probably have to be targeted for the reallocation. The Consumers' Association recognized the difficulty of targeting slot reallocations, given the current regulatory framework, but thought this was the most effective means of ensuring that competition was both preserved and encouraged on UK–Canadian routes.

(b) *Liberalization talks:* The long-run position of the UK–Canada market should be dealt with by the promotion of a more liberal trading environment between the two countries that does not limit, in law or in practice, the number of competitors on any one route.

Policy report on airline competition

5.228. The Consumers' Association also drew our attention to its policy report[1] on airline competition. The report concluded that the overall results of deregulation had been positive for US consumers. While the results for US airline workers and airlines themselves had been less clearly positive, the gains from deregulation, namely lower fares and greater choice, had been the clearest benefits for consumers. The clearest negatives, increased concentration on some routes and the creation of fortress hubs had less to do with deregulation than with allied efforts to apply a market solution to a regulatory problem. The failure of the buy/sell rule to free up competition on slots in crowded airports attested to this. The European Commission needed to learn from the US experience, and open up the airline market so that the consumer interest was put to the fore. A number of key problems needed to be tackled.

Slot allocation

5.229. First, the current system of slot allocation in the EC provided incumbents with considerable advantages and limited the ability of new entrants to gain a meaningful foothold in the most important markets. However, the slot-trading system developed in the USA appeared to have made the problem even worse. The most important US airports had become fortresses for the most powerful carriers, consigning smaller airlines to the margins of competition. If the slot-trading system in the USA had failed US consumers there was no reason to believe that slot trading would benefit European consumers. Not only would unconstrained secondary slot trading have a negative effect on the distribution of slots, it would not provide for an efficient usage of those slots. For such a combination of efficiency and fairness to develop, there must be a radical curtailment of grandfather rights for existing slots. If incumbent airlines were prepared to give up their grandfather rights on slots then a secondary system might work. However, as they were unlikely to want to do this such a system must be rejected. That left slot regulators with the dilemma of how to deal with the allocation of slots in a more equitable and efficient manner. The solution to this problem lay not so much in the right mechanism as the right target. Slot regulators needed to target themselves on enhancing consumer welfare and competition.

5.230. The overall effect on consumers of the increase in hubbing following deregulation in the USA had been mixed. The dominance of fortress hubs by big carriers has certainly increased fares by, in some cases, very significant amounts. However, this had to be offset by shorter connection times at hub airports and the greater number, and frequency, of connections occurring within an airline, rather than between airlines. As consumer valuations of time for flights would vary depending on the nature of the trip, the effect on consumers of higher fares at hubs, offset by improved service, would differ. For time-sensitive and low-income consumers, the effect was likely to be marginally negative, for business travellers marginally positive. In either case the costs or benefits of increased hubbing had not been

[1]*Airline Competition—a long haul for the consumer*, Consumers' Association Policy Report, 1997.

particularly significant. The likelihood that EC consumers would experience the same problems with hub airports as their US counterparts was, however, relatively small. While some national hubs were, and would be, less important than others, the complete elimination of the less important ones was unlikely.

5.231. The old maxim that information is power held as much for aviation as it did for any other industry. The main problem with the power of Computerised Reservation Systems (CRSs) to direct people's decisions was that consumers did not seem to be aware that their choices were in any way being directed. The CRS problem was a clear example of an information-based market failure: the CRS operator had the information, the consumer did not. In the view of the Consumers' Association the first step to a potential solution to the problem lay in educating consumers about the problems they might face in making an informed choice about their preferred travel option; the second step must be even tighter regulation to ensure that CRSs were not abused.

5.232. Consumers who were members of FFPs gained a benefit from flying regularly with a specific airline or its partners. In return the airline gained the ability to skew the decisions of consumers and to bombard them with other marketing information. FFPs distorted competition, disadvantaged smaller players and new entrants and helped incumbent airlines strengthen their positions; but frequent flyers liked them and gained benefits from them. FFPs existed as a quasi-tradable good. They could sometimes be traded under special circumstances and they could be used to gain benefits in kind or upgrades and better seats. The Consumers' Association thought that it would be of benefit to everyone to enable FFPs to exist as properly tradable goods, with an electronic barter system to allow frequent flyers to trade miles on each others' programmes.

5.233. The effect of alliances on consumers was unclear and each case must be dealt with on an individual basis. However, the method for analysing the effect of these alliances on consumers must be consistent and transparent. Only through closely analysing the myriad of alliances and agreements could a consistent picture of their effect on consumers be produced.

5.234. Airline safety was a vitally important issue for consumers. However, air transport was both considerably safer than other forms of transport and generally getting safer. The fear that deregulation would lead to a weakening of air safety standards had not been borne out. Nevertheless liability limits for accidents involving passenger injury or death needed to be phased out quickly.