

6 Views of main parties

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Introduction

6.1. This chapter summarizes the views of Air Canada and Canadian Airlines that were presented in written submissions and at hearings.

Air Canada

The merger

6.2. Air Canada said that on 4 January 2000, it had announced that 853350, a bidding vehicle controlled as to 10 per cent of its voting shares by Air Canada and financed by Air Canada, had acquired over 80 per cent of the voting shares of CAC following a public offer made on 11 November 1999. From that time it had material influence in a de facto sense with regard to Canadian Airlines, though not a legal controlling influence. The commercial decisions of the two parties during this period had been based on the premise that the acquisition would occur. The Canadian Bill C-26 deemed Air Canada and CAC to be affiliated as from 21 December 1999 for a number of legal purposes including the application of the Canadian Competition Act.

6.3. Air Canada said that 853350 had put to the courts a plan to restructure Canadian Airlines' debt. This had been found fair and reasonable and approved for implementation by an order made on 27 June 2000. The transactions contemplated in that plan were implemented on 5 July 2000 at which point Air Canada became the sole owner of 853350 and 853350 became the sole owner of Canadian Airlines. Air Canada said that although there was one outstanding appeal from a CAC bondholder, this would not affect the acquisition. The shareholders would be left with shareholdings in a company of no value.

6.4. Air Canada said that from January 2000 certain of its key personnel were reassigned to Canadian Airlines to assist its restructuring and full integration with Air Canada. After the legal and financial hurdles had been dealt with there remained integration hurdles in achieving a common information technology platform.

6.5. Air Canada described the current relationship between Canadian Airlines and American Airlines/AMR. AMR had owned about one-third of Canadian Airlines but this had been acquired by Air Canada after negotiation. Code-sharing rights between Canadian Airlines and American Airlines had been terminated by negotiation. Canadian Airlines' use of the AMR Sabre information technology platform would come to an end in autumn 2000 though the terms of the break fees still had to be agreed.

6.6. AMR had been a major partner in the Onex bid for Canadian Airlines. According to Air Canada, it had put up C\$0.5 billion of the C\$1.0 billion required for the takeover of Air Canada and Canadian Airlines. Despite AMR involvement, Air Canada made it clear that the offers for Canadian Airlines were not a battle between the Oneworld and Star Alliances. The imminent failure of Canadian Airlines had been an important domestic public policy issue, now resolved by the integration of Canadian Airlines with Air Canada. This integration of the two airlines would have occurred under either proposal. However, the present merger had the advantage of retaining competition between the Star and Oneworld Alliances, competition that would not have existed under the Onex proposals.

6.7. Air Canada said that in financing the merger it had purchased assets (a simulator, some aircraft spares), given bridging finance subject to Canadian Government consent to the change of the Toronto–Tokyo route code from CP to AC, and secured a credit facility from the Royal Bank of Canada of C\$70 million making a total of C\$145 million. If the merger had failed it would not have lost this money.

Plans for the new Air Canada

6.8. Air Canada said that it had taken a few limited steps on the path to creating a new Air Canada. Its strategy had been to:

- (a) reduce redundant flights and introduce new services;
- (b) negotiate new labour agreements where appropriate;
- (c) integrate support functions; and
- (d) lay the foundation for a unified global network.

6.9. Air Canada told us that it had begun to integrate schedules with Canadian Airlines on those routes where there was overcapacity. The Annual Report 1999 announced directional scheduling for domestic services which would improve aircraft utilization: ie eastbound or westbound aircraft arriving in Toronto and continuing on in the same direction, rather than flying back in the opposite direction. Additional services would be introduced on high-demand domestic routes. Internationally new or increased services would be introduced to seven US destinations plus Amsterdam and Munich. The frequency of flights between Canada and London would be reduced. At Toronto airport, Terminal 1 would be reorganized as an international gateway for both Air Canada and Canadian Airlines. Terminal 2 would serve all Air Canada and Canadian Airlines domestic and transborder flights. There would be major improvements to Terminal 1.

Domestic routes

6.10. Most of the reductions had been to domestic routes. However, because of increasing demand, Air Canada said that it had recently announced plans to introduce additional services in June 2000 over

various high-demand domestic routes, including Vancouver to Calgary, Winnipeg, Toronto and Ottawa, and from Toronto to Calgary, Regina, Ottawa, Montreal, Halifax and St John's. It had made a commitment to the Minister of Transport that Air Canada and Canadian Airlines would not eliminate service to remote areas for a period of three years from the date of take-up by 853350 of the shares in Canadian Airlines.

6.11. Air Canada said that it expected to face significant competition on domestic routes. It expected that a number of Canadian air carriers would introduce services to cover some of the routes on which Air Canada and Canadian Airlines were reducing their service. It cited a report that Canada 3000 was seeking market capital through a public offer to acquire four new aircraft and to increase its seat capacity from 26,000 to 40,000 a year in order to serve Canadian domestic routes; and a report that a new airline, Roots Air, was to be launched as a development of the existing Sky Service, with the aim of providing competition in the business market and interlining opportunities for international carriers. It quoted the Minister of Transport as saying that if domestic carriers did not increase their services to compete with Air Canada, the Government might permit foreign carriers to enter the market. It expected therefore to continue to face significant domestic competition.

International routes

6.12. In terms of international services, Air Canada explained that it and Canadian Airlines had sought to introduce new services, and to improve capacity over existing routes, where demand existed. In particular it intended to launch new or increased services to Amsterdam; Munich; Austin, Texas; Denver, Colorado; Ontario, California; Philadelphia; Pennsylvania; and Washington DC.

6.13. Air Canada said that both it and Canadian Airlines had reduced the number of flights between Canada and London. The two airlines combined had released 34 weekly slots at Heathrow for the summer season, representing just over 15 per cent (ie 34 slots out of 216 slots held) of Air Canada's and Canadian Airlines' total slot holdings (and 41 per cent of the slots acquired as a result of the transaction). Air Canada presented a table (see Table 6.1) to show the number of slots per week held by Air Canada and Canadian Airlines at Heathrow. It explained that services from Canada to Glasgow and Manchester remained unaffected by the preliminary steps taken.

TABLE 6.1 **Slots at Heathrow**

	<i>Summer 1999</i>	<i>Summer 2000</i>	<i>Change</i>
Air Canada	134	126	-8
Canadian Airlines	82	56	-26
Total	216	182	-34

Source: Air Canada.

Failure of Canadian Airlines

6.14. Air Canada said that Canadian Airlines had told it that while Canadian Airlines' unit cost performance was comparable with North American counterparts, the unit revenue performance was poor and could not support the debt. Canadian Airlines' poor unit revenue in comparison with Air Canada was because of flying longer sectors and carrying a smaller share of business travellers; a third of the passengers flew to Asia. The economic crisis in Asia over a period of three to four years lowered unit revenue. Canadian Airlines' long-haul markets were generally profitable. The economic downturn in Asia lowered that to just better than break even. The profound difficulties for the airline were in short-haul flying in Canada for which the Boeing 737 fleet was unsuitable. Europe was also unprofitable. In 1996 Canadian Airlines had removed the routes Canada to Germany and France from its schedules and concentrated on Canada-UK where it had started a code-share with BA. This had taken the route from small losses to moderate profitability. It had been advantageous for Canadian Airlines to join BA's hub network in UK. Previously it had been in third place behind Air Canada and BA facing competition from the hub carriers Lufthansa in Frankfurt and Air France in Paris. In third place Canadian Airlines carried only the lowest yielding passengers.

6.15. From 1996 onwards Air Canada said that Canadian Airlines had tried to restructure its network and make more use of CRAL as a low-cost subsidiary for feed traffic. It redeployed aeroplanes to the US transborder market. This had all helped, but it was not enough to make Canadian Airlines profitable. There had been no public subsidy for domestic air services at least since the air industry was deregulated in the 1980s.

6.16. Air Canada said that Canadian Airlines' profitability had declined particularly towards the end of 1999 when the public became increasingly aware of its poor record. There was a crisis of confidence among quality travellers, the corporations and those with large banks of frequent flyer points. Air Canada said that the Bureau of Competition in Canada had established the financial facts and said that Canadian Airlines faced imminent insolvency and there was no more preferable alternative for Canadian Airlines than the one proposed by Air Canada, the present merger. The Government of Canada had endorsed the Competition Bureau's conclusion that Canadian Airlines was a failing firm (an important defence in a merger situation). In the political context, it was made clear to Air Canada that in deciding what was to happen to Canadian Airlines it had to have regard to the real concerns within the country, particularly the employment situation and stability within the industry. The alternative of allowing Canadian Airlines to fail would have been an easier strategy for Air Canada to adopt, but it was not an alternative desired by Air Canada nor an option it considered feasible in a real sense.

Plans for Canadian Airlines

6.17. Air Canada said that it was its intention to drop the Canadian Airlines code CP when the combined information technology platform for the merged airlines was introduced in autumn 2000. There may be some future usage of the Canadian Airlines brand name for marketing purposes but in general the aim would be to move towards the Air Canada brand in the future. The savings generated by the merger of C\$650 million to C\$800 million would be used to grow the airline and protect the jobs of the employees during the period of integration. Savings would be generated from redesign of the network, capacity rationalization, better aircraft utilization and cutting out duplication in procedures, advertising, purchasing and maintenance.

Low-cost airline

6.18. Air Canada said that the new low-cost airline mentioned in its plans would operate in Canada with maybe some transborder services. It would be directed at the price-sensitive market but would not fly to the UK. Its objective would be to entice people to travel by air who otherwise might not. In the USA, Southwest had been very successful. EasyJet and Go in the UK were similar. The service would probably start in western Canada using 737 aircraft, suitable for short- and medium-range journeys. It would suit leisure traffic.

Canadian Regional Airlines (1998) Limited

6.19. Air Canada said that the sale of CRAL had been a more prolonged process than expected. Air Canada and the Canadian Competition Bureau disagreed as to the level of the fair market value to be taken as the reserve price. While the Competition Bureau would favour a liquidation value, Air Canada had favoured a price based on the operating cash flow. The matter went to arbitration and a fair market value was settled. CRAL has been offered for sale until 28 August 2000. Air Canada said that its commitment was to put the company up for sale on a best efforts basis, and retain it in the Canadian Airlines/Air Canada family if a purchaser could not be found. CRAL if purchased would serve smaller communities linked to the main Canadian gateways. CRAL's regional network had great linkage and viability.

6.20. Air Canada said that it had not included all the slots for CRAL at Toronto Pearson in the sale, because a prospective purchaser would be free and able to acquire slots itself. Air Canada said it had been agreed that it should retain the CRAL slots for certain peak morning and late afternoon periods to assist the ongoing development of the Air Canada/Canadian Airlines network and its regional make-up. Historically many of CRAL's slots at Toronto Pearson had been used by Canadian Airlines before 1996/97.

Relevant markets

6.21. Air Canada said that it did not consider Heathrow a distinct market. It was just as convenient for passengers to travel to or from Gatwick as Heathrow. Gatwick had been voted best UK airport in an industry survey. However, Air Canada was unlikely to open up there as it had a large investment in facilities at Heathrow and it would involve duplicate costs to open at Gatwick. Canadian Airlines had moved to Heathrow from Gatwick in 1995 in order to work more closely with BA and to handle more connecting traffic. Although Heathrow remained important for connecting traffic, its advantage was diminishing with the increase in connecting services at Gatwick. It was also important to note that passengers from Canada for points beyond Heathrow had a choice of hubs to change at. They could go to Paris, Frankfurt or Amsterdam and change there for points in Europe or destinations such as Moscow or Delhi. And from within the UK, Gatwick, from where all three former charter airlines operated, provided a viable alternative to Heathrow for travel to Canada.

Freight

6.22. Air Canada said that it did not consider itself a major player in the air freight business. Its only concern was to fill the cargo space in passenger aircraft. There were good alternatives for freight movement out of Canada to the UK, whether via the US hubs using companies such as Federal Express or UPS, or trucking to Chicago or New York for onward delivery by air from there. A non-stop service was not crucial for cargo. Some European carriers were also competitive through the hubs at Amsterdam and Frankfurt. Freight was but a small component of the overall Air Canada business.

Charter services

6.23. Air Canada explained that the service operated by charter airlines from Gatwick and Stansted had evolved over the last few years, attracting more business travellers in addition to their price-sensitive leisure passengers. They were not viewed in Canada as just a 'cheap and cheerful' service and already carried 38 per cent of the UK-Canada traffic while restricted to their charter status. With the new Canadian Government licence to operate scheduled services, which could be booked on travel agents' computer screens, they would make an increasingly competitive offering. Passengers who in the past had looked for convenient daily schedules, choice of flights, quality of service and FFPs were becoming more price-conscious and looking now for good value for money. There was a lot of enthusiasm for this ex-charter market, encouraged by the Canadian Government removing its limit of only two airlines for designated international carriers. They could be expected to operate scheduled services between Canada and the USA, France, Germany and Japan; indeed wherever the markets opened up. They had operated scheduled services to the USA for several years.

6.24. Air Canada explained that in relation to charters minimal restrictions still applied following the recent further liberalization of the rules. In purchasing a seat passengers had to deal through an intermediary and the charter had to be a whole-plane service. The integrity of the ASA had been maintained in this way. Some countries already complained about Canadian charterers coming close to scheduled services. The restrictions were very limited and Air Canada did not think they provided significant barriers to marketing the product. In any event, the three operators of charter services from Canada to the UK were adopting scheduled designation to which no such restrictions applied.

6.25. Air Canada emphasized that the Canadian ex-charter airlines were substantial operators. They were not minnows. Between them, Royal Airlines, Air Transat and Canada 3000 had 1½ times as many long-haul aircraft as Virgin, an acknowledged strong participant in the worldwide aviation market.

Competition issues

6.26. Air Canada said that competition between airlines in the UK-Canada market had been enhanced by the designation of charter airlines as scheduled carriers. The merger had not changed the basic situation, which was that the two carriers Air Canada and BA competed against each other. When BA and Canadian Airlines had been in the same alliance with code-share and revenue-sharing agreements they represented really only one carrier, given the close coordination of their activities. After the

merger between Air Canada and BA there were still two major scheduled carriers in competition on UK–Canada routes as well as the three newly designated scheduled operators.

6.27. Air Canada said that it continued to espouse the Canadian Government’s policy of liberalization of air services. It explained that it had taken some while for it and the Government to reach that position. In 1987 it had taken 20 months of negotiation to achieve the liberal terms of the UK–Canada ASA. The liberalization with the USA had been a leap of faith, but it had led to Air Canada having 2,048 flights a week into the USA and being able to reach 58 cities, compared with 14 before the agreement. Experience had proved the value of liberalization.

6.28. From a competitive point of view, Air Canada saw the new services of the former charter airlines as the third force in the UK–Canada market, rather than another new entrant scheduled carrier. The entry of a further carrier might or might not stimulate the market. Canadian Airlines’ experience had been that in filling a third aeroplane it was generally attracting a lower-yielding passenger and needed a lower cost structure to provide a sustainable service. Worldwide most markets were served by two carriers and many by just one. Air Canada’s plans to counter the new scheduled competition provided by the ex-charter carriers were based on offering at a premium price a premium product backed by its long-standing reputation.

6.29. Air Canada said that it continued to generate a higher unit revenue than Canadian Airlines due to its success on its Canada/US routes, relying on the US Open Skies Agreement, the North American Free Trade Agreement, and its good blend of domestic services, transborder services and international services across the Atlantic and the Pacific. Air Canada said that the prospects in the domestic market for new competitors were reasonable. Westjet in western Canada had increased its fleet in the last five years from 3 to 15 aircraft, using low cost as a weapon and seeking out niche markets. Canjet in eastern Canada and Roots Air in Toronto intended to launch new 737 short-haul jet operations. Roots Air was building on the Sky Services airline which had already been in operation for some years. Also the charter business in Canada was dynamic.

6.30. As for new entrants on UK–Canada routes, Air Canada thought that the London–Calgary and London–Ottawa routes were too thin to support a further carrier. The number of London–Calgary passengers (95,000 a year) was possibly too small to support two carriers. However, there were no barriers to prevent another carrier opening a service. Two of the ex-charter operators provided an alternative to Air Canada, and it was possible to fly indirectly via US or European hubs. BA had never flown the route. It had simply had a code-share arrangement with Canadian Airlines. Air Canada anticipated that a new carrier would focus more on Toronto or potentially Montreal, where it would be competing with BA and the three newly designated scheduled airlines in addition to Air Canada itself. So there would be a move from two to six carriers on the routes. The ex-charter carriers had 38 per cent of the market already. They were well established and in fierce competition with BA and Air Canada. It might be difficult for the route to be viable for a new carrier.

The undertakings

6.31. Discussing the work of the Canadian Bureau of Competition, Air Canada said that the Bureau was primarily concerned with creating a competitive domestic environment. In the international sphere its intention was to provide for a viable major Canadian carrier that could compete adequately with the major carriers of the world. It did not feel that it had to build in further protection with respect to the perceived dominance of Air Canada in the international arena. Air Canada said that the Bureau did not see a competitive threat there that needed to be held in check. Air Canada said that it had 80 per cent of the domestic market (including charter operators) compared with 38 per cent of the UK/Canada market. The undertakings negotiated in December 1999 had both civil and criminal sanctions attached.

6.32. Air Canada explained that in respect of the undertakings about the sharing of airport development and operating costs, it had taken the view that the arrangements of the major airports should be different from the others to reflect the strong presence of Air Canada after the merger. It had therefore agreed with the Bureau that retention of the Majority in Interest rights system for development in major airports (Toronto, Vancouver, Montreal and Calgary) would better reflect the appropriate cost structure of contributions and the interest of the major carriers in these developments. It was an accepted North American system. In the case of the Chicago formula for airport use, the Bureau had accepted a division of costs for these and other major airports based on 20 per cent of cost divided equally between carriers

and 80 per cent based on use reflecting again the weight and financial obligations on Air Canada. At other airports cost would be divided 100 per cent based on usage. This was also the US hub practice.

6.33. In the Parliamentary Bill C-26 there was a revised section dealing with abuse of a dominant position in the provision of essential facilities. Air Canada said that it was currently in the process of providing comments to the Minister of Transport and the Competition Bureau on regulations dealing with essential services, regulations which had yet to be enacted. It was therefore difficult at this stage to provide a definitive view interpreting the law. While provisions relating to essential facilities were unlikely to be confined to domestic carriers, the likelihood from a practical perspective of a foreign carrier having a legitimate essential facilities issue might be thought to be small.

Prorates

6.34. Air Canada said that it did not consider itself a dominant carrier and saw no obligation to offer behavioural undertakings in the UK–Canada market similar to those it agreed with the Competition Bureau for new entrants in the domestic market. Airlines serving the UK–Canada market through key gateways such as Toronto or Montreal had only 6 per cent beyond Canadian gateway traffic. The importance of interlining, code-sharing, prorating and frequent flyer points was therefore minimal. Air Canada said that it had special prorate agreements with 80 carriers round the world and was open to negotiate such agreements provided they were mutually beneficial to both parties.

6.35. On prorate fares Air Canada said that it had recently adopted the North American practice of issuing special fares for prorate purposes which were greater than the published fares for domestic travel (Canadian Airlines had also adopted this practice before the merger). It was the North American practice to make up a prorate fare which bore no close relation to what the customer would pay for the journey. The rates had been devised in response to what the North American airlines saw as high European prorates. These in turn were high due to what North American carriers saw as the inefficiency of European carriers and the higher cost structure of airport operations generally. Air Canada said that it had entered into special prorate agreements with around 80 carriers (including Qantas, Cathay Pacific, Finnair and Iberia from the Oneworld Alliance) and was also in discussion with BA. The special Prorate Agreements superseded the IATA standard Prorate Agreement. The largest segment of traffic from Canada travelled beyond London and there was a mutually beneficial balance for Air Canada to strike in discussion with BA. North American carriers had devised this method of charging higher rates locally to match the higher rates in Europe. Air Canada emphasized that the higher prorate issue had nothing to do with the merger. It was a system generally applicable to all its services and partners. For example, it was important for Air Canada to have a special prorate agreement with Air France. It was of mutual advantage to both carriers. Air Canada needed to transfer passengers to provincial French points and there were no alternative carriers with which to negotiate in France. Air Canada said that it had also been trying to work out something with the French railways, relating to the use of the TGV.

6.36. For passengers to Canada there were lots of alternative routings via the USA. Roots Air and Westjet in Canada itself would be looking for international feed opportunities. There was no need for BA to have interim arrangements with Air Canada while the internal competition developed improved standards. BA had flown on UK–Canada point to point routes for decades maintaining sustainable business before latterly code-sharing with Canadian Airlines. Historically BA had worked without a partner in Canada. From 1992 to 1996 Canadian Airlines was partnered with Lufthansa. From 1993 to 1996 Air Canada was in partnership with Air France. KLM continued to operate without a partner in Canada.

6.37. Air Canada said that special prorate agreements were based not so much on any alliance relationship but rather on the traffic which could be exchanged between the participating carriers. With a major carrier it would expect a sizeable volume of business but the terms would be different for a small operation. Air Canada did not feel it was necessary for it to be required to offer prorates on reasonable terms to UK transatlantic carriers for a period while competition in the domestic services Canada was established. It was satisfied that the IATA standard prorate agreement worked well and negotiation on other rates was best left to the market. Negotiations with BA were in progress. These would include points beyond London and other points in Europe that would bring similar value to the access that BA required in Canada. Air Canada said that its approach to prorating was not unique to Air Canada or to North America. There was no question of it seeking to impose unreasonable terms from a position of strength.

Frequent Flyer Programme

6.38. Air Canada confirmed that it was fulfilling its undertaking to the Competition Bureau to provide domestic competitors with access to its FFPs. It was in negotiation with Royal Airlines, one of the former charter airlines. The programme might be in place by the autumn, if Royal Airlines could get the support systems in place for its customers. Westjet had not sought to have a programme. An FFP probably did not suit Westjet's 'no-frills' approach. Air Canada was working to harmonize the benefits of its programme and Canadian Airlines' programme and to simplify the programme to make it less confusing for customers. Canadian Airlines and Air Canada customers could accumulate points whether they flew on Air Canada or Canadian Airlines.

6.39. Air Canada did not see a case for extending the frequent flyer point undertakings required within Canada to international traffic on the UK–Canada route. BA and Air France had their own programmes with a base of customers in Canada. Admittedly these points could not be used on internal Canadian routes, but there were ways to access other points in Canada from within the country using Oneworld Alliance points. A passenger could fly Toronto/Chicago/Winnipeg, for example.

6.40. Air Canada did not think that BA would wish to enter into an arrangement with it that allowed holders of BA points to cash them in on internal Air Canada and Canadian flights. That would mean BA paying Air Canada for seats. Also from a reciprocal point of view BA would be required to sell seats out of London to Air Canada. To take it one step further, BA should be required to sell seats beyond London to the former charter carriers which did not have access to other airlines FFPs as did Air Canada. Air Canada thought that the Canadian market problem had been addressed by their Competition Bureau. The problem seen from outside Canada was international, not purely British. In regulating any of the international issues there was the question of what had to be done for the other competitors in the market. Neither did Air Canada think that it would be practical to give UK carriers access to Air Canada frequent flyer points. BA was in the Oneworld Alliance. It would be highly confusing for the market place to have a cross-alliance agreement on frequent flyer points. It would also be a complex operation to arrange, based on the experience it was having integrating the Canadian Airlines programme. The proposal to extend its FFP to BA was not attractive. It would be far better for BA to go into a frequent flyer points agreement with one of the new Canadian ex-charter carriers, or the new entrants such as Canjet or Roots Air.

Slots

6.41. Air Canada accepted that there might have been some buyers interested in Canadian Airlines' international routes, but these could not be sold as the route rights belonged to the Canadian Government. BA had made an offer of C\$50 million for the UK routes but it was not proceeded with. BA's offer had emphasized that it would not intend to use all the slots at Heathrow for Canadian services. The Air Canada offer of C\$400 million for Canadian Airlines' routes had been more an offer to Canadian Airlines to exit the international scene and become a domestic carrier. Air Canada was not able to value the Heathrow slots. Canadian Airlines had worked hard over the years from 1994 when it moved from Gatwick to Heathrow to build up a portfolio of slots. The schedule changes following the merger had led to a surplus of slots and these had been properly released to the Heathrow pool. The slots were for arrivals 06.50 to 19.50 and departures 10.45 to 20.05, suitable times for North America. Before returning slots to the pool Air Canada had had exchanges and discussions with its alliance partners and other carriers and a few slots were exchanged before they were returned. All those returned were, it thought, suitable for UK–Canada services.

6.42. Air Canada pointed out that slots surrendered to the pool at the beginning of this year were disposed of before it became evident that the UK competition authorities were going to look at its case. It said that the slot protocol demanded that slots falling vacant were returned to the pool under the 'use it or lose it' principle. Air Canada's invariable practice in this situation was to surrender surplus slots before they were taken away. The slots had not been returned to the pool to prevent the entry of new competition.

6.43. Air Canada said that there were slots available at Toronto for a new entrant with arrivals at noon to 14.00 and departures 20.00 to 23.00. The company presented a letter from the Greater Toronto Transport Authority confirming this. Air Canada had subsequently notified the CC that the Greater Toronto Transport Authority had allocated new slots to BA and Virgin for the winter season 2000.

6.44. Air Canada said that it had released to the pool the slots that it thought were not going to be used, and saw no necessity to divest slots beyond that. The slot holding at Heathrow was already at a level in line with the services Air Canada intended to provide. It did not accept that in the absence of the availability of slots there would be no airline able to start new services to Canada. In fact it had checked with ACL that there were slots available, and those British carriers capable of using them at present (BA, Virgin and British Midland) had not commenced any service.

Code-sharing

6.45. Air Canada said that it would consider code-sharing London–Canada routes with the Star partner British Midland and it would be prepared to discuss code-sharing with any other new entrant. However, many international carriers operated to Canada without a code-share arrangement. That was an indication that code-sharing was not essential for a profitable operation. Air Canada drew attention to the three ex-charter airlines which might be interested in providing code-share opportunities for UK carriers. And there were code-share options via the USA. A lot of traffic for Canada came via Minneapolis, Detroit or Chicago. The customs clearance issue in the USA was not a problem. Air Canada was now hoping to arrange pre-clearance for transit passengers. The USA and Canada had to be seen as one market from an aviation point of view. US hubs were very close to Canada.

Interlining

6.46. Air Canada said that there was a more general expectation under multilateral agreements that airlines would interline with each other; it was not a matter of choice. Provided there was an equitable balance of business between the parties, Air Canada said that it would also enter into a special prorate agreement with any other airline. The mutual interests of BA and Air Canada were broadly balanced and might therefore provide opportunities for agreement on a special prorate.

Travel agents' commissions

6.47. Air Canada said that it had set up a commission system for travel agents which conformed to the wishes of the Competition Bureau. There was a straight-line commission on domestic sales, and a trigger mechanism based on international sales which could increase that straight line commission in steps up to a maximum of 4 per cent. The programme was very similar to that used by other international carriers and applied to qualifying Canadian-based IATA travel agents. It would be monitored by the Competition Bureau for five years. The commission rate on domestic sales increased if international sales compared favourably with peers.

Conclusions

6.48. Air Canada held strongly the view that competition on airline services between the UK and Canada had not been adversely affected by the merger. Canadian Airlines would in any event have ceased to be a competitor because of its imminent financial collapse and the absence of any alternative means of restoring the airline on a sound financial basis. The proposal by the Onex group to acquire both Air Canada and Canadian Airlines and join them to the Oneworld Alliance alongside BA would have eliminated all competition between the main UK–Canada carriers. The proposal failed when it was declared illegal under laws limiting the extent of ownership of Air Canada's common shares and the foreign ownership of Canadian airlines. Canadian Airlines had not ceased to be an independent business as a consequence of the merger, but rather of its financial collapse.

6.49. The number of independent competitors on the UK–Canada routes was unchanged. (Indeed the redesignation of the former charter airlines would enhance competition.) Before the merger Canadian Airlines and BA operated as a team, code-sharing in all routes and revenue sharing to Toronto. Since the merger Canadian Airlines operated in full cooperation and management with Air Canada.

6.50. At most the merger had led to some redistribution of London/Canada market share. 1999 figures suggested that of the 62 per cent of the passenger market held by the three airlines Air Canada

(33 per cent), BA (18 per cent) and Canadian Airlines (11 per cent), Air Canada with Canadian Airlines now had 44 per cent, and BA 18 per cent. The balance (38 per cent) was carried by other scheduled, charter and indirect flights (most of it by the three former charter airlines). Two small routes representing 10 per cent of the total traffic, London–Calgary (95,000 passengers a year) and London–Ottawa (71,000 passengers a year), now had no daily competition since only Air Canada and Canadian Airlines previously flew those routes daily. Two of the former charter carriers flew several times weekly. The level of traffic would possibly not support a further scheduled carrier.

6.51. The market share redistribution would have occurred in any case in the absence of the transactions, given the imminent exit of Canadian Airlines.

6.52. Competition in the market was very much alive with BA holding sufficient slots in London to augment its service if it wished, benefiting as it did from valuable feed traffic from Canada to Europe, Africa and the East. It had recently acquired further slots at Toronto.

6.53. To encourage competition the Canadian Government had designated three Canadian charter airlines to fly scheduled services. Any British carrier could commence new flights to Canada. Virgin and British Midland both had sufficient Heathrow slots to open services if they wished and Virgin had recently acquired slots at Toronto. However, it was clear that in many respects other London airports served broadly the same market and UK passengers could also travel to Canada from regional cities direct or via European and US hubs.

6.54. The appropriate market against which to consider the public interest aspect of the merger was all passenger traffic between London and Canada's international gateway cities. Competition in that market had not been gravely affected. Indeed it had been enhanced by the designation as scheduled carriers of the three other carriers from Canada.

Canadian Airlines

6.55. Canadian Airlines told us that the company had spent ten years lurching from crisis to crisis. There had been a financial restructuring in the early 1990s when in a compromise with creditors it had raised capital from AMR. There was a debt restructuring with Canadian Government assistance in 1992. Information technology had been outsourced from AMR. What was not addressed in retrospect was operational restructuring to deal with the core problem of low unit revenue. From 1996 the attempt to address operational inadequacies covered route reorganization and a new relationship with AMR under the US open skies aviation policy. However, the company had taken a risk in 1996 by not raising more capital. It was thus too weak to face the downturn in Asia, the emergence of new competitors such as Westjet in Western Canada, and the elimination of code-sharing with AMR for eight months in 1998. Operating margins at that time had been below reasonable expectations.

6.56. Canadian Airlines said that its international long-haul business was profitable now. The UK routes had benefited from the code-share with BA, so much so that on Heathrow–Toronto, Canadian Airlines had agreed to revenue sharing, because it was benefiting more than BA from the code-sharing agreement. By borrowing BA's brand and its passengers, the route became profitable for Canadian Airlines. Canadian Airlines said that the long-haul transcontinental routes were just profitable; 30 to 40 per cent was feed business. But the domestic routes served by Boeing 737 aircraft were loss-making, due to the fact that Canadian Airlines' network was needlessly duplicative with Air Canada's domestic network.

6.57. Canadian Airlines said that its relationship with BA had been very good. The two airlines had worked as a team starting with one code-share in 1996 and then code-sharing everything as time went on. They cooperated with advertising and this was enhanced as the Oneworld Alliance branding developed from 1997 onwards. Canadian Airlines said that without the bilateral arrangements permitting code-share and BA membership of the Oneworld Alliance, it could not have made a success of UK–Canada routes. The company's financial involvement with AMR, and BA's own interest in working with AMR, were contributory factors. Canadian Airlines said that it had made efforts to continue a team operation with BA by supporting the unsuccessful Onex/AMR initiative. Where there had been two teams in Canada, Air Canada in the Star Alliance and Canadian Airlines and BA in the Oneworld Alliance, there were still two teams, with Canadian Airlines having changed sides in the merger.

Prorate agreement

6.58. Canadian Airlines said that it had had a special prorated agreement with BA. It was common airline practice to discuss with interline partners the mutual benefits of passing business one to the other and setting rates for this. The reason for the practice was that the standard IATA system often made little sense. If Air Canada's interline arrangements now were out of line with the market, this would be a disadvantage to it in the long run. The market would find a way round an uncompetitive practice, perhaps from another country. The most likely outcome was that the parties would negotiate a commercially reasonable agreement. Two huge hub carriers like BA and Air Canada talking to each other was the best kind of policing the market could have.

6.59. Commenting on its likely failure in late 1999, Canadian Airlines said that the profitability of disposing of the international business had been considered. It had decided that Air Canada's offer for the routes was subeconomic; it neither amounted to enough for the routes, nor enough for Canadian Airlines to transform itself. And the remainder of the airline would not have been a profitable venture. It was virtually a liquidation offer which Canadian Airlines' creditors would not have allowed it to accept. The creditors could block a substantial sale of assets. The final merger with Air Canada with prior arrangements for debt restructuring had been acceptable to the main creditors. Had Canadian Airlines failed, the aircraft lessors would have found it difficult to lease their Canadian-registered aircraft elsewhere. They would have tried to move them to Air Canada in any case. They had quickly signed up to material changes in either lease rates or amounts owing, once the Air Canada arrangements for debt restructuring had been understood.

6.60. Canadian Airlines explained that while Air Canada had funded the bidding vehicle 853350, it owned only 10 per cent of the shares. Air Canada did not have to consolidate the bidding vehicle into its accounts. In discussion meanwhile with creditors it was able to say that if the right terms were not available, it would not be able to complete the deal. This had been a valuable lever in negotiating with third parties.

6.61. Canadian Airlines said that if it had gone into liquidation, Air Canada would probably have got the lion's share of what it wanted. The Canadian Government would probably have favoured the creation of one great Canadian carrier. The British, French and Japanese all had such a carrier. This would have influenced the disposal of the route authorities, which were the only real asset. Canadian Airlines had a few aircraft, but over time it had moved to leasing aircraft rather than buying them.

6.62. Asked about control, Canadian Airlines said that Air Canada had de facto control of the airline. The Canadian Airlines board had three Air Canada members including the Chief Executive Officer, plus a number of outsiders. The overlap of board members ensured Air Canada's control.

Canadian Regional Airlines (1998) Limited

6.63. Canadian Airlines said that it would be difficult for Air Canada to sell CRAL as directed by the Competition Bureau. The sale would be dependent on the arbitrated sale price. The matter would not have gone to arbitration if there had been more care taken to define the basis of the price at the time of the undertakings. Essentially Air Canada was thinking of a price based on what it was worth to them in terms of operating cash flow, whereas the Competition Bureau was seeking a liquidation price of about C\$10 million. There was a huge gap between the two figures. Depending who acquired CRAL, it might or might not compete with Air Canada. CRAL had in the past fed the Canadian Airlines network. With Air Canada CRAL could feed its network very effectively. Outside that relationship with Air Canada, it might be more difficult for CRAL to be successful. Local point-to-point traffic into, say, Vancouver would not be enough to sustain it.

6.64. Canadian Airlines expressed surprise at the rapid licensing and development of the Canadian charter carriers. One of these, Canada 3000, was reported to be raising public capital to buy aircraft. The Canadian Government had been quick to act over route licensing and the attitude of the financial markets seemed to be favourable. The charterers had a profound weapon in their low-cost structure and their concentration on point-to-point service. The presence of an ailing Canadian Airlines in the market up to this point had affected business attitudes and possibly constrained the growth of competition.

6.65. Canadian Airlines said that the market would remedy any imperfections following the merger. Intervention was not needed. Hub carriers round the world went through periods when they lost money

because traffic was finding another way round. From a network point of view the market would not allow abuse. Practice would change. Air Canada had been through its own periods of difficulty in the past, in competition not with Canadian Airlines, but (as far as the stockholders were concerned) with AMR and US Air. Air Canada's financial results were compared with those companies in stock market terms. The transborder services had been remarkably successful; Air Canada had turned Toronto into a US-style hub, whereas it would never have been characterized as a hub six or seven years ago.

Frequent Flyer Programme

6.66. Canadian Airlines said that FFPs created loyalty to a network and persuaded people to make journeys they would not otherwise make. But the points had been commoditized now that they were given out in supermarkets and for credit card purchases. Many people collected points and never travelled. By joining up with BA and AMR, Canadian Airlines had been able to offer points holders a route network far greater than their own. The Oneworld and Star Alliance systems had rather eclipsed the Canadian points schemes with global branding. Prior to global branding, the large airline was always wary of the small airline in negotiation since points earned on the larger were most likely to be spent on the smaller. It had been necessary to renegotiate agreements every year or two to balance out the costs and benefits.

D JENKINS (*Chairman*)

N GARTHWAITE

J HANRATTY

G STACY

P A BOYS (*Secretary*)

2 August 2000