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Transportation: Emerging Realities



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An Analysis of Canadian Air Transport Policy

I - Executive Summary - This paper analyzes the Canadian federal government's policy with respect to economic regulation of the airline industry. The paper opens with a short introduction which details why airline policy is important to Canadians. A concise history of Canadian airline regulatory policy is then presented to give the reader an appreciation for how present airline policy has evolved. Present airline policy is then reviewed and critiqued in detail and a set of specific recommendations for change is offered. Each of these later sections are organized by the three major regulatory classifications of domestic market, international market and trans-border market.

The paper argues that the economic structure of the Canadian airline industry has characteristics which lead to industry consolidation and provide the potential for abuse of dominant market position. Accordingly, a review of Canadian competition policy and its impact on airline markets is provided. This competition policy section concludes that Canadian competition policy is ineffective in preventing or mitigating the effects of competitive market failures in the airline industry.

Having established the present regulatory context from both an aviation policy perspective and the more general perspective of basic competition policy, the paper delivers a critique of the existing airline policy package. It is argued that the present pro-competitive package, which favours deregulation in all markets, fails to define a sustainable role for Canada's major carriers. The policy package strongly favours the short term interests of consumers of transportation over the interests of providers of the service. It is argued that a short term focus on stimulating competition in all market areas weakens the domestic airline industry, hurts the long term interests of Canadian consumers and limits the ability of Canadian carriers to carve out a strong role in the global market for aviation services. It is also argued that certain political and national interests are advanced by maintaining a viable domestic airline industry and that such interests would not be serviced by foreign carriers.

The paper concludes with a set of normative policy recommendations which attempts to establish a more equitable balance between the long term interests of consumers and the long term interests of carriers. A pro-competitive stance is advocated for the domestic and trans-border

markets while elimination of competition between Canadian carriers on international routes is recommended. It is also proposed that a more proactive role for airline regulators be established in order to prevent abuse of dominant market position. In summary, the revisions which I propose recognize that the transportation system exists to service the needs of consumers, but they also recognize that a healthy air travel industry is consistent with the long term interests of consumers.

II - Introduction - Government policy with respect to transportation is of vital importance in a country such as Canada. Canada is one of the largest countries in the world in terms of area, yet we have a relatively small population base which is scattered along the U.S. border from the Atlantic to the Pacific. Our unique geography has always been a major obstacle to the formation of a cohesive economic union. From a purely economic point of view, Canada is an unnatural economic unit and our history is full of examples of government intervention in transportation markets in attempts to offset the effects of geography. The most notable example of government intervention was in the construction of the Canadian Pacific Railway. As Michael Bliss points out, this initiative was not justified on the basis of developing the economic potential of the western region, but it was successful, at least to date, in cementing the nation as a political unit (Bliss, 5).

In more recent times, there has been a shift in Canadian trade patterns from east/west flows to north/south flows. As Courchene points out, this shift has diminished the role of the railway as an economic policy factor binding the country together (1992, 763). The railway's role was further diminished by the emergence of aviation as the dominant transportation mode for the movement of people between regions. Today, aviation links play a crucial role in shrinking the size of Canada and facilitating the continued operation of our federal system of government.

Canada is also a nation which relies heavily on international trade and tourism for its economic well being. The airline industry plays an important role in facilitating trade and developing tourism. In a country the size of Canada, there are no practical alternatives to air travel in such applications. Air transport policy is, therefore, a matter of vital importance to the nation and it should be a high priority issue for all levels of government.

Stakeholders - The Stakeholder groups affected by air transport policy are effectively identified in Transport Canada's international air transport policy document (1994, 2).

Canadian's look at air transport from variety of perspectives: as a means to travel abroad...for business and leisure purposes; as a means to attract commercial activity to our communities; as a means to import and export high value and perishable commodities; as a means of employment; as a generator of foreign currency and wealth; as a driver of technological change; and as a source of civic and national pride.

The policy document goes on to classify this "Community of interests" into four interest groups - the business sector, travel and tourism, airlines and consumers. It also goes on to identify the formulation of "clear and coherent objectives, strategies, and policies that best meets the overall national interest" as being the appropriate role for government. It is difficult to find issue with the government's assessment of the stakeholder interests or the government's self defined role.

III - Brief History of Canadian Aviation Regulation and Policy

In order to assess current policy, it is useful to have an appreciation for how the industry has evolved to its present status. A useful review of the development of regulatory policy is provided by Christopher in a paper which was issued during the development period in advance of the National Transportation Act of 1986 (1982, 1-17). Supplementary information from other sources has been added to Christopher's review to produce the following summary:

A. The Early Days 1936 - 1942 - Government involvement in aviation in Canada began in 1936 with the formation of Civil Aviation Branch of the Department of Transport. The potential role for aviation in national transportation was recognized by C.D. Howe, the Minister for Transport and he established Trans-Canada Airlines (TCA) as a government airline with a monopoly in all areas of service. By 1942, TCA had established transcontinental service linking all major cities in Canada. The monopoly protection given TCA was instrumental in allowing airline service to expand throughout the infant national market (Christopher, 1982, p 3).

B. Regulatory Protection 1942 - 1959 - Canadian Pacific Airlines (CP) was formed in 1942 from several small bush pilot operations which had been allowed to develop around the periphery of the TCA monopoly. CP pressed for rights to compete with TCA but met with little success. The only rights available to CP were routes not wanted by TCA. For example, in 1948, CP applied to Howe for rights to service Sydney, Hong Kong, and Tokyo. As TCA was the designated international carrier, Howe approached TCA to see if they were interested. TCA's president, Gordon McGregor, is reported to have stated, "Who would want to lose money on those routes? Let him (Grant McConachie, CP's President) lose it all and get out of our hair." (Goldenberg, 1994, 14). Thus was born Canada's "policy" of dividing the world between TCA and CP based on Pacific (CP) and Atlantic routes (TCA). Constant efforts to secure competitive domestic rights finally resulted in CP being granted rights to provide one daily flight in each direction between Vancouver and Montreal (Christopher, 1982, 4).

C. Growth of Competition 1960 - 1980 During this period, CP gradually became a more serious contender to TCA in the domestic market and several regional carriers developed. In 1966, Canadian policy was adjusted to recognize 5 regional markets served by 5 different carriers - Pacific Western Airlines, Transair, Nordair, Quebecair, and Eastern Provincial Airways. Policy was also adjusted to allow international charter operations by companies such as Wardair, but care was taken to ensure that such operations, as well as the operations of the regionals, were kept separate from the national carriers' routes (Goldenberg, 1994, 150). In 1967, the government allowed CP to increase its share of trans-continental service to 25%. By 1980, CP air was allowed to compete head to head with Air Canada¹ in the domestic market.

¹ TCA was renamed Air Canada in 1964

IV - Present Regulatory Policy

A. Domestic Policy - Development of the present regulatory environment can be linked to the introduction of airline deregulation in the United States in 1978. According to Tretheway, the gradual introduction of deregulation in the U.S. between 1978 and the end of 1984 led to the following developments:

1. An increase in the number of airlines.
2. A decrease in passenger concentration.
3. A decrease in the general level of fares.
4. A decrease in average operating expenses.
5. Neutral impact on surviving carrier profits and employment
6. Fewer labour disturbances and a general increase in employee productivity (1986, 299).

These changes were, of course, closely observed in Canada. The new Canadian air policy that emerged in May of 1984, provided for substantial deregulation, including the elimination of the distinct roles of national, regional and local carriers. The policy proposed that any carrier be allowed to operate any service within a defined "liberalized zone" and it proposed the elimination of fare controls. It is interesting to note that the policy of deregulation was opposed not only by the major Canadian carriers, but also by the aviation bureaucracy in the Canadian Transport Commission (Goldenberg, 1994, 50). The transport minister of the day, Lloyd Axworthy, felt that the regulatory body had become too closely aligned with the interests of the industry which it was trying to regulate.²

The air policy of 1984 was not enacted due to the fall of the liberal government. The conservative government which followed recognized the popularity of the deregulation issue. As a result, the "Freedom to Move" policy, which was issued in 1985, also promoted deregulation of the domestic industry. The move towards deregulation was put into law

² Axworthy's comments are consistent with the Capture Theory of Economic Regulation. This theory states that regulation is initially provided to meet public interest objectives but that over time regulatory agencies come to be dominated by the industries they regulate. This theory, as well as a variety of other theories of economic regulation, is effectively detailed and analyzed by Richard Posner (1974, 335-357).

with the passage of the National Transportation Act of 1987. The act contains only 3 basic requirements for entry into domestic markets. The agency shall issue a license if:

- (1) the applicant is a Canadian³; and
- (2) the applicant holds a Canadian aviation document; and
- (3) the applicant has the prescribed liability insurance.

In March of 1996, Bill C-14 received first reading. It proposes to revise the NTA of 1987, but the only substantive changes to domestic policy are the addition of a fourth test which would ensure that an applicant meets "prescribed financial requirements" and extension of the zone of de-regulation to include the northern region.

The NTA was built around the principle that the transportation system should exist to serve the needs of shippers and travelers. Accordingly, present domestic airline policy is heavily weighted in favour of consumers of air travel. This was a large departure from previous systems which were designed to promote and advance the development of designated national carriers.

B. International Policy - Present international policy recognizes the fact that international route rights can only be gained through government to government negotiations. Canada secures aviation rights which it then allocates as it sees fit to designated carriers. Historically, TCA/Air Canada was the designated carrier. Subsequently, the government adopted a policy of splitting the world between carriers according to defined regions. In 1994, however, Canada adopted a new policy with respect to international air transport - the "use it or lose it" policy. Substantive changes associated with the new approach were:

1. Elimination of the allocated territories policy.
2. Designation of 37 countries for assignment to new carriers.
3. Designation of secondary carriers on high volume routes.
4. Provision for foreign carriers to serve routes without concurrent Canadian carrier service.
5. Establishment of financial hurdles for new charter entrants.
6. Creation of regulations to eliminate computer reservation

³ Canadian is defined in the NTA as being a minimum of 75% Canadian ownership.

system bias in favour of the host airline.

The new policy extends the trend towards deregulation into the international sphere. The policy document clearly states, "...the time has come to focus on the interests of travelers and shippers and airport communities." Accordingly, competition is promoted between Canadian carriers in the international market. The policy swing in favour of users as opposed to carriers is made apparent throughout the document. In fact, the international air policy is stated to be subservient to the government's earlier policy with respect to transfer of airports to community based organizations (Transport Canada, 1994, 2).

C. Trans-border Canada's international policy does not apply to the U.S. market. This area was covered by a series of bilateral agreements which provided for a total of 83 specific point to point routes. Canadian carriers had sole rights on 26 city pairs, U.S. carriers had sole rights on 38 city pairs, and Canadian and U.S. carriers competed on the remaining 18 city pairs. Under this agreement, Canadian carriers carried 38% of the traffic while U.S. airlines carried 62% of the traffic. Due to the fact that Canada has its population concentrated in a few major cities, U.S. carriers had access to 90% of Canada's population base while Canadian carriers could only access 30% of the U.S. market (Lewis, 1995, 5).

On March 10th, 1995 the government announced the completion of the "Open Skies" agreement with the U.S. The main points covered under this agreement are as follows:

1. Canada gains immediate access to all U.S. points.
2. U.S. carriers gain immediate access to all Canadian points except Toronto, Montreal and Vancouver. Increased U.S. service to these destinations to be phased in over a 3 years.
3. Restrictions on cabotage⁴ remain in both countries.
4. 24 new landing slots are provided to Canada at Chicago and New York to improve Canadian carrier access.⁵

⁴ Cabotage refers to the carriage of passengers by a foreign airline between two points in another country's domestic market.

⁵ Landing slots at U.S. airports are governed by the municipal level of government. Local airports sell gate rights to carriers. U.S. federal negotiators had previously taken the position that provision of landing

The new air services agreement governing trans-border routes completes the government's deregulation package. It opens up options for additional routes into the U.S., increases competition from U.S. carriers and it encourages competition between Canadian carriers. Both Canadian and Air Canada will, for example, be competing for passengers on routes into Chicago and New York.

V - Canada's Competition Policy - Its Impact on Airline Markets

As clearly established under section IV, Canada has pursued a policy of deregulation within its airline industry. Removal of airline regulation entrusted the marketplace to competitive discipline and the generic rules of Canada's competition policy. A review of competition policy and the economic characteristics of the airline industry is, therefore, in order.

The economic structure of the airline industry in Canada is not conducive to perfect competition. While economies of scale are reported to be negligible, there are substantial economies to be achieved with respect to route density (Tretheway, 1991, 8). This economic characteristic leads to the formation of hub and spoke route networks as the most efficient structure for the industry. Under such a structure, regional routes consolidate traffic into a central hub and the consolidation of density leads to cost efficiencies in travel between hubs. As a result, marginal increases in traffic generated by the feeder system generate large amounts of profit on the main line route (Madore & Shaw, 1993, 5).

Economies of traffic density create the need for an airline to establish strong feeder networks which have schedules closely coordinated with those of the trunk lines. Additionally, there are strong consumer preferences to fly with a large carrier and to avoid interlining where possible. Such consumer preferences are strengthened through airline loyalty programs such as frequent flier miles. These characteristics combine to produce a strong incentive to achieving network economies through mergers and acquisitions.

In the U.S., several competing hub and spoke structures have developed as different carriers developed hubs in different cities. Additionally, the

slots was outside of their jurisdiction and could, therefore not be part of the "open skies" agreement.

density of traffic in certain areas of the U.S. permits viable competition between carriers at common hubs (Windle & Dressner, 1993, 29). In Canada, however, the long thin geographic structure and the concentration of our relatively small population in only a few cities, limits the choices for hub locations; consequently, Canadian carriers compete head to head at the same locations. Given the small size of the Canadian market, economic arguments can be made that the natural consequence of complete deregulation of the airline industry in this context will be the formation of a domestic market monopoly.

As indicated above, the economic characteristics of the airline industry produce strong tendencies towards industry consolidation. These same forces can be assumed to create strong incentives for anti-competitive practices. Airline policy, however, is designed to minimize regulation of the industry. In this situation, competition policy is relied on to keep the industry competing fairly. The evidence would suggest that Canadian competition policy has not been a substantial barrier to industry consolidation to date. The entire history of Canadian Airlines is one of growth through acquisition and merger. Air Canada has also pursued growth in its feeder system through this strategy. Under section 96 of the Competition act of 1986, gains in efficiency are recognized as a legitimate reason to allow a merger if the competition tribunal finds that efficiency gains will offset or be greater than the effects of the lessening of competition. Section 93 (b) also indicates that one of the factors to be considered is whether the party being acquired is likely to fail without the merger. These sections provide a great deal of flexibility within the competition act to allow concentration within the industry.

In the area of anti-competitive practices, the issue of predatory pricing is of particular relevance to the airline industry. Given the large economic rewards to be derived from eliminating the competition and achieving associated increases in route density, there is a strong incentive for a carrier to engage in predatory pricing as a strategy to drive out a weaker competitor. Competition law allows for such practices to be addressed in two ways. Under the civil law section covering abuse of dominant position, the use of fighting brands to discipline or eliminate a competitor is prohibited. Predatory pricing is also dealt with under section 50 of the act which deals with criminal offenses (Brander, 1995, 310).

For practical purposes it is extremely difficult to successfully prosecute a case dealing with predatory pricing in the airline industry. The difficulties associated with proving a case are as follows:

1. Predatory pricing has been defined by the Director of Investigation and Research of the Bureau of Competition Policy as, "a price which is below the average variable costs of the firm" (Odette & Shaw, 1993, 8). In the airline industry, average variable cost (AVC) is not easy to define. If it is defined as direct operating costs exclusive of charges for aircraft ownership or use, there is tremendous scope for pricing flexibility. Additionally, employment of marginal cost pricing strategies can be justified as a legitimate pricing practice in certain airline applications.
2. The issue is further complicated by the industry's adoption of sophisticated yield management systems. As a result, the number of fare classifications has proliferated and there are many different fare classes offered on any given flight. The question of whether a given fare is predatory is sufficiently complicated to lead one industry expert to comment, "...it is impossible to prove ... unless the competitor or anti-trust authority has a written proof (e.g. internal memo) which shows the intention to predate..." (Oum, 1996).
3. The requirement to prove guilt beyond a reasonable doubt eliminates practical use of the criminal provisions of the competition act. As stated above, even the civil law provisions are difficult to prove on a balance of probabilities basis. These two factors combine with the relatively minor costs of conviction to make anti-competitive behavior an attractive business strategy.⁶ Even under the new act, fines have rarely exceeded the costs of restitution. The situation is best described as a retroactive license to engage in anti-competitive behavior. Under such an environment there is little incentive to avoid anti-competitive practices such as predatory pricing.

It should be pointed out that the costs of predation can be significant. Game theory in an oligopolistic setting (Dixit & Nallebuff, 1991, 95) predicts that such action would only be profitable for the predator if there

⁶ Fines have rarely exceeded \$1 million for competition policy offenses. Such fines are minor in relation to the \$7 billion combined revenue of Air Canada and Canadian Airlines.

is a substantial difference in the economic strength of the competitors. Where competitors are evenly matched predatory pricing would result in mutual destruction. Unfortunately, actions taken by the federal government in the privatization of Air Canada set the stage for predation. In order to make the sale attractive, Air Canada was privatized with a low debt position and a market imbalance was created.

The Gemini case provides an interesting sidelight to the area of competition law and the airline industry (Brander, 1995, 333). As pointed out by Brander, the ruling by the competition tribunal to allow Canadian to exit the Gemini reservations partnership came down to a matter of airline policy. Did Canada want to maintain two domestic carriers or only one? The tribunal ruled in favour of preserving Canadian Airlines but this was a rather backhanded approach to determining government policy on a fundamental issue. The inescapable conclusion is that competition policy is, at best, only able to address such issues on a reactive basis and only when the situation is already in crisis.

VI - Critique of Government Policy

A. Domestic Policy - A critique of Canadian airline policy must begin with the fundamental values underlying the National Transportation Act. In assessing this legislation it is important to recognize that the value which underpins all Canadian transportation policy is that the transportation system exists to service the needs of shippers and travelers. Canada has made the choice to favour consumers of transportation service over the interests of Canadian providers of such services. Given that transportation is largely a derived demand and that Canada is highly dependent on efficient transportation service, this fundamental value makes sense. Canada's industries must have access to efficient and cost effective transportation systems in order to remain viable.

Recognizing the fundamental value, we must now determine to what extent the maintenance of a viable Canadian air transport industry is tied to the interests of Canadian shippers and travelers. Are consumers of travel better off with a strong domestic industry which is focused on servicing the Canadian market, or would we be better served by lower cost foreign based carriers? If Canada were to drop its Canadian content rules tomorrow, it is unlikely that there would be any great rush by foreign carriers to provide service domestically across Canada. Our

market is simply too small to be of much interest. Instead, we would probably see the major Canadian cities incorporated as spokes into major US hubs. Travel between Canadian points and from Canadian points to international destinations would, in many cases, be routed through U.S. hubs.⁷ While the cost of service would likely fall, the services provided would not be targeted to the needs of Canadians. Additionally, there would likely be serious political issues to contend with if our air system was totally integrated into the U.S. system. As stated earlier, the transportation system plays a role in binding the country together. If travel between Canadian regions becomes dependent on U.S. airline hubs, it does not bode well for Canadian unity.

If we accept the premise that a strong Canadian airline industry is still in the national interest, the next question becomes, "Is it in our national interest to have more than one domestic trans-continental carrier?" Here there is a trade-off to be made between the efficiencies to be gained from traffic density and the efficiencies to be gained from carrier competition. A monopoly structure would likely be more efficient from a carrier perspective, but it would be difficult to sell to the Canadian public. The prospect of a "Mapleflot"⁸ holds little interest for Canadians due to the potential for such a carrier to abuse its dominant position. Reverting back to the fundamental value, such a trade off decision should be made in the interests of travelers. Thus it appears that the preferred approach is to maintain competition between two *balanced*⁹ domestic carriers. The conclusion that Canada should maintain two major domestic carriers appears to be unstated government policy. Unfortunately, the requirement for balance does not seem to be recognized.

The growth of Canadian Airlines to become a legitimate competitor to Air Canada, was achieved through acquisitions (Barone et al, 1986, 421). The expansion was required in order to achieve needed network efficiencies, but it left Canadian in a weakened financial position. In

⁷ This type of structure is referred to as "Hub Cabotage"

⁸ The term Mapleflot was coined by Canadian Airlines employees who were opposed to the proposed merger of Canadian and Air Canada. It is intended as a derogatory term comparing the merged Canadian airline to Aeroflot the former Soviet Union's national carrier.

⁹ As demonstrated in Section V balance is required for the competitive system to be sustainable as imbalance creates incentives for predation.

1991 the effects of the Gulf War, the bombing of a Pan Am flight over Lockerby, Scotland, and a worldwide recession all contributed to poor performance within the airline industry. Because of its highly leveraged position, Canadian was particularly hard hit. Losses of \$162 million in 1991, \$543 million in 1992 and \$292 million in 1993 drove the carrier to the brink of bankruptcy. Air Canada fared little better recording losses of \$318 million in 1991 and \$197 million in 1992 before breaking even in 1993. Collectively the two Canadian carriers lost more than \$1.5 billion in just three years.

While airline losses were incurred worldwide during this period, losses by Canada's carriers represented 10% of the total industry loss. Given that travel to, from and within Canada on both domestic and international carriers only represents 2% of the world market (Madore & Shaw, 1993, 3) the Canadian share of the loss is disproportionately high. By 1993, Air Canada's shareholders had lost 47% of their investment's net worth and Canadian's shareholders had lost 95% (Madore & Shaw, 1993, 13-15). An investment analyst likened the battle between Canadian and Air Canada to, "...two people jumping from an office tower - PWA¹⁰ from the 15th floor and Air Canada from the thirtieth, thumbing its nose because PWA would hit the ground first." (Goldenberg, 1994, 81).

There is strong circumstantial evidence that Air Canada attempted to drive Canadian Airlines out of existence during this period (Madore & Shaw, 1993, 9). Having failed twice in 1991 in its effort to merge with Canadian or acquire its international routes, Air Canada began an aggressive campaign of discounting fares and adding capacity. It also arranged to increase its credit by the sum of \$400 million which was, coincidentally, equivalent to Canadian's cash and accounts receivable. Internal correspondence from Air Canada refers to a "scorched earth" policy with respect to the Gemini negotiations and it is clear that Air Canada continued to express interest in a merger, "...because as long as we profess interest, it helps prevent an AMR¹¹/PWA deal." (Goldenberg, 1994, 127).

¹⁰ PWA Corp was the holding company which owned Canadian Airlines International Ltd. In 1994 the name of the company was officially changed to Canadian Airlines as part of the corporate restructuring.

¹¹ AMR Corp is the parent company to American Airlines.

It has been argued that PWA/Canadian's management was negligent in allowing their liquidity position to deteriorate to the point where they became vulnerable to such tactics (Madore & Shaw, 1993, 24). While there is some merit to the claim that PWA's management was negligent, the argument indicates that companies should be responsible for their own protection when it comes to anti-competitive behavior. It also fails to recognize the fact that PWA had to extend itself in order to form a network which was capable of supporting competition with Air Canada and it ignores the government's role in contributing to the imbalance through the favourable terms associated with the privatization of Air Canada.

If one accepts Madore's position that PWA was the author of its own misfortune, PWA's shareholders paid a large price for their management's mistakes. Additionally, the sale of a 30% equity interest in the airline to AMR Corp. was made on very unfavourable terms. While AMR Corp. did not gain full control of the airline it did gain an equal voice with respect to such matters as capital expenditures, sale of assets and acquisitions (Smith, 1993, 4). The shape of the domestic industry was changed dramatically, but it was done out of a private company's desperation rather than through conscious strategic policy on the part of industry or government.

Throughout much of the course of these events the government chose to sit on the sidelines. When they did get involved their position was often inconsistent. For example, in July of 1992 the government stated that it would purchase 3 Airbus 310 aircraft from PWA for \$150 million if PWA agreed to break off talks with AMR and resume merger talks with Air Canada (Goldenberg, 1994, 103). At other times the government appeared to favour the AMR alliance, as was demonstrated by the competition tribunal's Gemini decision and the provision of a \$50 million interim loan.¹² The result of the lack of decisive action in this crisis was the financial decimation of the domestic industry. It is hard to see how the government's lack of action was in the interests of Canadian travelers. Short term benefits may have been provided in terms of

¹² Part of the inconsistency was related to the change in governing party from Conservative to Liberal in 1993. The liberals took a more proactive role in attempting to settle the dispute but neither government acted in a consistent decisive manner.

reduced airfares, but the cost to the industry reduced its ability to provide future service. When you are focused on keeping enough cash in the bank to keep creditors at bay, innovation and market development take a back seat.

The government's reluctance to act decisively was very costly, however, it is somewhat understandable given the structure of decision making in Canadian government. Aviation policy is a tough issue which presents no easy solutions. Policy decisions are further complicated by the division of the industry along regional lines with Air Canada being based in Quebec and Canadian being based in the west. Bakvis and MacDonald argue that Canada's system of cabinet decision making limits the government's ability to deal with broad issues of national scope. They argue that the decision structure constrains government to a select set of issues deemed to be strategic for the government's agenda (Bakvis and MacDonald, 1993, 75). As aviation policy was not a clearly defined strategic issue for either the liberal or conservative governments at the time of the crisis, each government had difficulty in dealing with the situation.

B. International - The competition tribunal's decision to allow PWA to withdraw from Gemini only removed part of the obstacles to PWA's recovery. PWA was still faced with several Air Canada lawsuits which totaled billions of dollars. Mysteriously, Air Canada withdrew its opposition to the AMR/PWA deal on January 26th, 1994. On January 27th the Canadian government rewarded Air Canada for its new stance with new international route rights to Osaka, Japan. This was subsequently followed up with second carrier rights to Hong Kong. Rather than being censured for anti-competitive behavior, Air Canada was rewarded with additional international rights. The course of events clearly indicates that the government finally took action to resolve the impasse by buying off Air Canada with additional route rights. The fact that the government choose to use a carrot instead of a stick is indicative of Air Canada's lobbying strength and strong government ties. One must question, however, the power balance in the regulatory system when a carrier can dictate terms to the government.

The award of rights to Air Canada in the heart of Canadian's international marketplace is inconsistent with the government decision to preserve two competitors in the domestic marketplace. The bulk of Canadian's profits are generated on its north pacific international routes. It simply makes no

sense to open up a weak carrier's most profitable routes to additional competition if you wish to allow the carrier to recover some semblance of fiscal strength. The market timing of the decision was also in question. The addition of Air Canada's service to Japan and the concurrent addition of a second Japanese carrier, took place at a time when traffic to and from Japan had fallen by 25%. It is noteworthy that Canadian has still not been able to return to profitable operation.

A lack of competition between Canadian carriers on international routes does not mean that the route is not competitive. International carriers provide aggressive competition on all major international routes. Additionally, Canadian carriers are often at a competitive disadvantage due to high taxes, conservative depreciation rules, and high Canadian interest rates. Dispersion of Canadian route rights only produces an additional competitive disadvantage for Canadian carriers. Again the situation is one where additional competition between Canadian carriers will produce short term savings for consumers, but the end result could be the failure of Canadian carriers and a loss of competition in both the domestic and international markets. Even if this event does not occur, if Canadian carriers continue to fight each other they will have little left with which to take on foreign competition.

C. Trans-border The demand for trans-border air transportation has increased greatly since 1966. The 1966 agreement was outdated and no longer serviced the needs of either country. The new agreement has been welcomed by users of the transportation system as it will make travel to and from the U.S. much easier. From a carrier perspective the agreement is predicted to provide more benefit to U.S. carriers than to Canadian carriers (Lewis, 1995, 10). U.S. carriers already enjoy 62% of the market and they have a significant advantage with respect to operating costs. Additionally, U.S. carriers often have the benefit of carrying Canadian traffic beyond the initial leg of the trip to a secondary destination. This is rarely the case for traffic to Canada.

Canada has tried to correct the imbalance by securing a phase in period for additional American service to Canada's three major markets. Canada's negotiators were relatively unsuccessful in this task as the protected period is only 2-3 years. Canada was somewhat more successful in obtaining landing slots and gate rights at major U.S. airports.

Overall, the open skies policy recognizes the economic realities of airline travel to the U.S. Canadian carrier interests have been made subservient to improved services for travelers and economic development for airport communities. Given the network and cost advantages of U.S. carriers and the economic importance of efficient transportation links to Canada's largest trading partner, this policy appears to be rational. It is interesting to note, however, that the direction taken under the Open Skies agreement is contrary to the recommendations of the Ministerial Task Force on International Air Policy which recommended that carrier interests should take precedence (Lewis, 1995, 10). The Canadian negotiating position with respect to the bilateral agreement reflected the perceived need to use the agreement to ensure the viability of the domestic industry. This approach delayed the agreement and is yet another example of inconsistency within Canadian air policy.

D. Conclusions Regarding Present Policy - The present package of Canadian airline policy is a collection of individual policies which have been patched together over a period of approximately 12 years. The policies are generally clear in their stated objectives to put the needs of travelers ahead of the needs of carriers, but there is no vision expressed for the role that Canadian carriers should play in the system. Additionally, there is little recognition of the interdependencies between domestic markets and international markets. This is a crucial failure as approximately 40% of the revenue generated by Canada's airlines is generated on international routes and growth in air travel markets is concentrated in the international and trans-border markets.

It can also be argued that the present policy does not reflect the economic structure of the Canadian industry. Canada's approach to airline deregulation was borrowed from the U.S. without adequate recognition of the differences in structure between the two countries' airline industries.

Finally, the timing of recent changes to Canadian air policy has been poor. Additional competition is being created at a time when the domestic industry is weak and vulnerable. Carriers are being encouraged to extend themselves into new international markets when their balance sheets are extremely weak. As the industry is highly subject to business cycles, the results could be disastrous if the industry meets with another recession before Canadian carriers can improve their financial position.

VII - Where to from Here?

A. International Market - There is conflicting evidence as to whether strategic national industrial policies work. Those who oppose creation of such strategies claim that "...governments are not particularly successful in picking winners, but losers are incredibly adept at picking governments." (Sylvia Ostry as quoted in Courchene, 1992, 777). Because of the uncertain track record, some have suggested that governments should not attempt to set industrial strategies. The fact remains, however, that international aviation routes have to be negotiated between states. This means that the government cannot avoid involvement in establishing strategy for Canadian air carriers.

I have argued that a coherent air policy incorporating all market areas is essential for Canada's economic development. The air transport system is a vital part of the infrastructure required to connect our businesses and travel destinations to global markets. I have also argued that a strong domestic airline industry is desired, not necessarily as a economic objective for the nation,¹³ but as a means to deliver transport services tailored to the specific needs of Canadians and to continue the role of domestic carriers in providing political linkages across Canada.

Our airline policy must reflect the relative strengths and weaknesses of our domestic carriers within the global environment. Michael Bliss in commenting of Martin Frobisher's adventures in Canada remarked that, "No amount of faith, subsidy or aid, can produce gold where it does not exist." This comment should also be recognized with respect to Canada's airlines. The role carved out for domestic carriers within our air policy must be consistent with their capabilities. It is unfortunate that these capabilities have recently been greatly reduced by destructive

¹³ While the economic contribution of the domestic airline industry to Canada is argued to be subordinate to the economic interests of the industries which it serves, the contribution is still very substantial. The industry employs in excess of 50,000 people in relatively high skill and wage positions. Given the present liberal government's strategic issue of job creation, strong policy arguments could be advanced to support a level of protection for the domestic industry on the basis of job security. I have, however, chosen to focus on other aspects of the policy debate.

competition, but this is now the economic reality. We must define a sustainable role within this environment.

Tae Oum has defined a vision for the role which Canada might play in the world aviation market. He argues that globalization of the airline industry is inevitable and that it is only a matter of time before the industry forms global networks. Each network is expected to be created from the alliance of "anchor" carriers from each of three major continental regions - North America, Europe and Asia. Oum has also indicated that the world airline market will only be able to support 5-6 networks and that Canadian air policy should be designed to prepare and strengthen our industry to assume an anchor carrier role within one of the global networks. In short Oum has advocated the consolidation of Canada's carriers into one stronger international player (1993, 14-28).

" This article advocates that the governments should set policies in such a way as to maximize the long run combined consumer and producer surpluses plus external economic benefits. Severe economic penalties are associated with not being a major partner in the global network formation process. The adoption of a pro-competitive policy especially when it is motivated by short run consumer surplus maximization, may significantly reduce the future ability for a nation's carriers to earn surpluses or for that nation to enjoy the increased economic activities and employment arising from senior partner status....The strategic industrial policy usually involves trading off short run benefits for much larger gains in the long run....With respect to the Canadian situation, unless some action is taken it is likely that global airline networks will bypass Canada altogether" (Oum, 1993, p27)

Oum is clearly an advocate for "forcing the pace" of international development of Canada's airline industry, but are his views realistic?¹⁴ While there is a strong trend towards globalization within the international industry we are a long way from the global structure which is presented.

¹⁴ It should be noted that Oum's views on consolidation of the Canadian airline industry may reflect his position as a consultant to the industry. Positions he expresses in his recent papers are in conflict with positions expressed in prior work authored jointly with M. Tretheway.

The world aviation market is highly complex and still heavily regulated. It is my view that we will continue to move towards the structure presented by Oum but that consolidation will be slow and that there will be many regional niches that do not conform to the general industry structure.

Even if one accepts Oum's view, is it realistic to believe that a Canadian carrier could be attractive as an "anchor" alliance partner? Even if the two Canadian carriers were combined, the combined carrier would still be small in comparison to the major U.S. carriers, ranking only 7th in revenue-tonne-kilometers. In terms of revenue, Canadian's international business ranked 23rd amongst the world's airlines while Air Canada's ranked 24th. On the domestic revenue side Air Canada ranks 15th while Canadian ranks 18th (IATA, 1994).

More important than relative size is the fact that neither Canadian carrier has direct access to the major part of the continental market. U.S. traffic to Asia is 11 times greater than Canadian traffic (Oum, 1993, 21). Similarly, U.S. traffic to Europe is 6 times greater than Canadian traffic. These facts dictate that the anchor carrier will be based in the U.S. Air Canada's initiative to acquire a 25% interest in Continental Airlines recognized this reality.¹⁵ Such approaches may allow Canadian carriers to gain a greater share of the benefits from emerging global alliances and therefore should be encouraged, however, it must be recognized that the benefits of this approach are limited because U.S. policy limits foreign ownership of U.S. airlines to 25%. The analysis leads to the logical conclusion that Canada can not hope to create an anchor carrier in a global network. The best that we can hope to become is a minority interest partner. To restructure Canada's airlines to achieve anchor carrier status is beyond the power of government. As Kroeger remarks in reference to King Canute, "There are some things that governments just can't do." (Kroeger, 1).

Having rejected the anchor carrier role for our carriers we are still left with the dilemma of finding a sustainable role for Canadian carriers to play which also serves the interests of Canadian travelers. Both Canadian

¹⁵ Air Canada's recent decision to divest itself of this share is, in my view, a financial decision related to their weakened position and their need to refinance a major portion of their debt in the coming year.

and Air Canada have now established alliances with U.S. carriers. Our policy should recognize and support these alliances. It would seem that a rational approach would be to focus on making the two carriers as attractive as possible as complementary second tier carriers.

One of the advantages that Canada can contribute to an alliance is an extra set of bilateral license agreements. Division of route rights amongst Canadian carriers should be made in recognition and support of the alliance strategy chosen by that carrier. This means that route awards should be concentrated in certain regions of the world and that care should be taken to minimize direct competition between Canadian carriers on international routes. Instead of trying to serve all areas of the world, Canadian carriers should be encouraged to focus their efforts on specific regions. Given the decimated financial position of the industry, focus is desperately needed.

One of Canadian Airlines major attractions is its strength on north-pacific routes. This is an area of weakness for Air Canada and it is one of the factors which attracted AMR to form an alliance. On the negative side, Canadian's alliance with AMR ultimately cost it other alliance positions with European carriers Lufthansa and Air France. Air Canada on the other hand is much stronger than Canadian in Europe and this strength complements Continental Airlines' relative weakness. While both Continental and Air Canada are weak in the North Pacific, it makes more sense for Continental and Air Canada to fill this hole through an Asian partner such as Cathay Pacific. If international route designations were tailored to support each Canadian carrier's alliance strategy, the restriction of direct competition between Canadian carriers on international routes would strengthen each domestic carriers position.¹⁶ At the same time competition on the route would still be provided for the benefit of Canadian travelers.

The recommended approach is not simply a return to the division of the world policy. It contemplates that carriers would bid for licenses and that the awards would be based on who could present the best strategic

¹⁶ While Oum proposes the adoption of multiple carrier designations on international routes, he recognizes that, "...awarding rights to a second Canadian carrier may prevent either carrier from developing a profitable service." (1995, 22)

argument on how they could exploit the route. Transport Canada would assume the role of determining which carrier could make best economic use out of the license. Periodic reviews and adjustment would be made to allow the system to adjust to changing traffic patterns.

B. Domestic Market - Returning again to the domestic market, the international route award policy which I have suggested might also be used to deal with extreme abuse of dominant position in the domestic market. If a carrier engaged in what the regulatory agency regarded as anti-competitive behavior, they could be punished by the revocation of international route rights. This ability exists today, but the regulatory agency has been reluctant to use it. In my view, such a proactive approach by the agency could be an effective way to police the industry. The agency would, of course, have to walk a fine line between encouraging true competition and preventing abuse. Additionally, some mechanism would need to be found to protect the system from special interest group pressure. A better solution would be to ensure that imbalances in the financial strength of the carriers are not created. As pointed out earlier, predation is only profitable when there is a large difference in the relative strength of the competitors.

New challenges for policy makers continue to arise in the domestic market. In 1996 WestJet introduced regional service throughout western Canada and Greyhound announced its intention to enter the market as a low cost national carrier. Given the industry's history of poor financial performance, one must question the wisdom of these ventures. It would appear that the romance of the industry has clouded sound business judgment and it will be interesting to see if these ventures will succeed. From a policy perspective, it would appear that WestJet's service is consistent with domestic objectives. WestJet is a regional carrier which is focusing on expanding the market by offering low cost fares. As their target market is people who now choose to drive rather than fly, their operations should not bleed substantial revenues from the national carriers. In short, regional competition will provide substantial benefits to consumers without significantly weakening the major carriers.

The Greyhound situation is more complicated. While Greyhound is also trying to offer low cost service they are targeting their efforts at the national market. Of equal importance is the fact that Greyhound is trying to skirt the existing regulations with respect to the 75% Canadian

ownership requirement for domestic airlines.¹⁷ The National Transportation Agency has dealt firmly with Greyhound's actions by threatening to shut down the carrier if it should begin service. These actions are consistent with existing policy and, as detailed in other sections of this paper, they are also consistent with the long term interests of consumers of air transportation in Canada.

Greyhound has proposed to restructure its ownership to meet the Canadian content requirement. If they are successful in this initiative, present policy requires that they be granted a license. Introduction of additional domestic market competition on national routes will lead to fare wars which, given its already weakened position, may result in the failure of Canadian Airlines. In recognition of this possibility the government should implement a temporary moratorium on new licenses for trans-continental service. Once balance is restored to the industry the moratorium should be lifted as it is important to maintain contestable trans-continental markets in order to ensure that the trans-continental carriers continue to provide competitive fares.

In equilibrium then, the domestic market would rely on competition between equally matched major carriers. The costs associated with predatory pricing would make the practice unattractive and open access to markets would help to ensure that the majors do not collude to charge monopoly fares. In the event that further intervention becomes required, the government would have access to its discretionary power with respect to international route awards to police the system.

C. Trans-Border - The proposed international policy is consistent with the domestic policy of maintaining competition between the major carriers on trans-continental routes but it must also be consistent with policy in the trans-border sector. The Open Skies agreement opened up the ability to connect any point in the U.S. with any point in Canada. This is consistent with my recommendations for international policy as it allows the formation of multiple links between Canadian carriers and their U.S. alliance partners. In addition, it allows Canadian carriers to take advantage of certain niche markets. For example, Air Canada is well

¹⁷ Greyhound is 67% owned by the Dial Corporation of Phoenix, AZ. Their business plan involves the contract use of aircraft provided and flown by Kelowna Flight Craft which is Canadian owned.

positioned to take advantage of passenger's distaste for overcrowded hubs by use of an "overfly" strategy on selected markets. As a side benefit to Canada, Air Canada would utilize Canadian built Canadair jets on such services.

On the other hand, the Open Skies agreement continues to restrict cabotage and both countries have preserved their 25% limit on foreign ownership of their airlines. These restrictions are consistent with the domestic policy of maintaining Canadian carriers. If Canada were to drop these restrictions Canadian air travel would be integrated into a continental hub and spoke system. It is argued that such a system is politically unacceptable.¹⁸

Finally, I believe that further consideration needs to be given to removing the disadvantages Canadian carriers face with respect to fuel costs and the tax structure. Canadian carriers face a difficult business environment in the global market for air travel. The government should endeavor to provide them with a cost base which is equivalent to their international competitors.

In summary, my recommendations for an integrated air transport policy are:

1. Canada should explicitly recognize that a balanced system of domestic competition between two major carriers is in the national interest.
2. Open access to domestic markets should be maintained as contestable markets will help to ensure that domestic markets remain competitive. However, a temporary moratorium on new licenses for the trans-continental market should be implemented until the industry's financial position improves.
3. Canadian international policy should discourage competition between Canadian carriers on international routes and it should support competition with international carriers.

¹⁸ Restrictions on foreign ownership of domestic airlines have traditionally been based on national security reasons. In the event of war or natural disaster governments wish to have access to a fleet of aircraft. Such arguments appear to be weak in the Canadian context.

4. Canada should encourage its domestic carriers to form alliances with complementary international carriers.
5. International route awards should be competed for on the basis of which national carrier can make better use of the rights within its alliance structure.
6. The government should assume a more proactive role in the health of its aviation industry. International route awards should be used to police the domestic industry in cases of extreme abuse.
7. The competitive approach established in the open skies agreement should be maintained as is.
8. Existing restrictions on foreign ownership of Canadian carriers should be preserved.
9. Action should be taken to ensure that Canadian carriers fuel cost and tax structure is competitive with major foreign carriers.

These policy recommendations are designed to establish a more equitable balance between the long term interests of consumers and the long term interests of carriers. A largely pro-competitive stance is maintained in the domestic and trans-border markets while competition between Canadian carriers on international routes is eliminated. In summary, the revisions which I propose recognize that the transportation system exists to service the needs of consumers, but they also recognize that a healthy air travel industry is consistent with the long term interests of consumers. If these recommendations were to be implemented, a stronger domestic industry would emerge - one that would be better able to service the needs of Canadian travelers into the next century.

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