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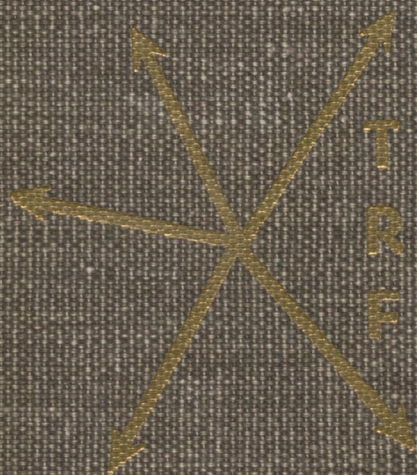
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TRANSPORTATION RESEARCH FORUM

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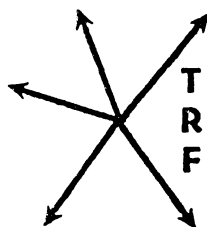
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TRANSPORTATION RESEARCH FORUM

Regulatory Moves in Canadian Air Transport — Pragmatists at Work

by J. J. Smith*

1. INTRODUCTION

(a) **T**HE LAST YEAR has seen the publication of a number of papers on the subject of the economic regulation of air transport. In particular:

Economic Regulation and Competition in the Domestic Air Carrier Industry: A discussion paper prepared by Transport Canada - Air, Canadian Transport Commission and the Department of Consumer and Corporate Affairs (February 1981).

The Administrative and Regulatory Environment of Air Carriers in Canada: Problems and Prospects: University of Calgary, Institute for Transportation Studies (December 1980).

Legal, Economic and Socio-political implications of Canadian Air Transport: McGill University, Centre for Research of Air and Space Law: sponsored by Transport Canada, Canadian Transport Commission and the Transportation Department Agency (Spring 1980).

Air Policy in the 80's: Guy Roberge, Q.C., Canadian Transport Commission: Notes for a panel discussion at the Air Transport Association of Canada Annual Meeting in Calgary (November 2, 1980).

Airline Deregulation: A Review after two years: Melvin A. Brenner Associates Inc. (January 1981).

(b) The nature of this paper—

The papers listed above provide a wealth of historical data. This paper tries to illumine that history with some personal flashes of recollection. This method is not always dependable, but it is quick and provides amusement, if not instruction.

This paper asserts the presence of a strong pragmatism in the economic regulation of air carriers in Canada. It sets out to demonstrate such a presence, and in general, approves of it.

2. 1937 TRANS-CANADA AIR LINES

It is clear from the record that the Mackenzie King government were convinced of the need for a single strong transcontinental air carrier. They re-

membered the duplications of the railway expansion and the Depression was a recent memory.

It is also apparent that extensive efforts were made to avoid outright government ownership if at all possible. The McGill paper¹ lists three proposals aimed at accommodating public and private interests in a consortium. In the end, the CPR withdrew from the last attempt, unwilling to accept a proposal of a nine-director Board in which it would have only three seats in the face of the CNR's three and the Minister of Transport's three.

Having CNR as sole owner was, in a real sense, the last choice. Given the United States development of an airway system, the Canadians were running out of time and they knew it. Even then, Mr. Howe appeared to leave the door open during the debate on the Trans-Canada Airlines Act saying that "the Canadian National Railways will underwrite, in the first instance, the stock of this company and distribute it among firms at present engaged in aviation in Canada which wish to participate."²

The use of the CNR as a channel for financing the infant airline avoided attracting too much Parliamentary attention. The passage of the Annual Financing and Guarantee Acts provided a traditional session of CNR-bashing which left little time for TCA-bashing. That came much later. The capital expenditures for the little airline were, in any case, insignificant compared with the sums being requested for the railway.

The use of the CNR channel had another effect. The Railway had enough financial troubles of its own without accepting the risk of airline losses as well. This problem was met by an arrangement by which capital advances passing through the CNR to the airline, whatever the form of obligation, were always rewarded as if a fixed interest obligation was in place. Eventually, the tradition arose of taking all capital advances in debt form. This was an awkward habit which the young airline was not able to kick until it was 40 years old, in 1977.³ The airline tried hard, but its parent was not easily persuaded.

There was another reason for the airline's low profile in Parliament in those early days. It was remarkably successful at breaking even after paying its inter-

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est charges. Mr. Howe's political umbrella allowed the management to get on with the job.

3. 1944 THE AIR TRANSPORT BOARD

The creation of the Air Transport Board in 1944 provided Canadians with the form, if not the substance, of economic regulation by a quasi-autonomous tribunal. However, the Board had two major constraints: its obligation to approve route licence applications, filed by TCA under the terms of the Trans-Canada Contract, and the overriding powers of the Minister of Transport.

4. 1948 CROSS SUBSIDY IS BORN

In reading recent literature, one can get the impression that cross-subsidy was some kind of inspired policy practised by benign government planners. The truth is otherwise.

In 1947 a new aircraft arrived, the Canadair North Star. By 1948 it was serving much of the trans-continental traffic. Fares within Canada in those days were constructed on a constant rate per mile basis, about six cents per mile. Any departure from such a scheme would have been considered sharp practice. The North Star's direct flying costs were about two cents per seat mile; the DC-3's were three cents per seat mile. North Stars were deployed on the longer haul routes where the incidence of ground handling costs is also lower. It followed that with a constant six cents per mile long haul routes with North Stars could make profits, and short haul routes with DC-3's generally made losses.

Cross-subsidy arrived with a new aircraft and not with a policy. The age of innocence ended in 1948. The support of "small-town" Canada by Transcontinental and Atlantic passengers was substantial in those days. Its extent was known to the regulators and sensed with pleasure by many in public life. The great days of cross-subsidy lasted from 1948 to 1961. You may ask if 1961 saw a change in regulatory policy. No. 1960 was the year that the late Gordon McGregor got hooked on St. Thomas Aquinas and Just Price. He was hooked indirectly. It all started with Stephen Wheatcroft who asserted in 1958 that cross-subsidy was bad social accounting. Mr. McGregor dismissed this idea, presumably since "social accounting" was not language consonant with his own habits of thought and speech.

Some time in 1960, Mr. McGregor addressed a man named Norman Taylor in words roughly as follows: "You know

these curves of operating cost versus stage length that Clayton Glenn draws? Go and construct a set of fares which will follow the cost curve." The fares came into effect on January 1, 1961.

The Interdepartmental study⁴ gives an excellent account of the ensuing development (since 1970) of cost formula fares derived from a fixed Terminal Charge and a Line Haul charge per mile.

The study is careful to point out that such a method does not eliminate cross-subsidy. The Terminal and Line Haul charges are derived from Domestic System data, and therefore do not fit perfectly the circumstances of individual routes and stations. It is possible to represent flying costs for selected stage lengths reasonably well so long as the mix of aircraft types does not change too much. However, it is unlikely that the Terminal Charge would correctly reflect the ground handling costs at both Toronto and Charlottetown. The utilization of personnel and equipment at Charlottetown is constrained by the lower traffic density and schedule frequency.

So there is a kind of residual cross-subsidy, evolved by airline and not by government. A pale shadow. Not like the old days. In spite of the talk of market forces, the cost of production ideas of St. Thomas Aquinas have come a long way in domestic fare setting since 1958. Not bad for him, considering his age.

A final footnote on pragmatic cross-subsidy in the early days. It decided which Canadian carrier would serve the Pacific in 1949. My recollection is that Mr. Howe asked Mr. McGregor first to do it, and that Mr. McGregor declined on the ground that it would drive TCA into the red during the developmental years.

5. 1958 WAS THE YEAR OF THE FIRST ATTACK ON THE TCA TRANS-CONTINENTAL MONOPOLY

The Board was unimpressed by any notion that competition for competition's sake was a desirable policy.^{5,6} The Board found that additional transcontinental air services could not be introduced at that time without major detrimental effects to existing operations (meaning TCA). They also found, however, that the position of CPA as an international carrier needed strengthening, and that they should be licenced to operate a daily transcontinental service to connect CPA's existing international operations at Vancouver and Montreal. The monopoly was cracked. The slogan "regulated competition" was used to cover a system of administered market shares.

6. 1958 HEES AND EARLY DEREGULATION

The then Minister of Transport, George Hees, gave notice in a policy speech that the government of the day intended to reduce licensing requirements for charter services through a form of deregulation. What happened was that persons seeking a charter licence and proposing the utilization of small aircraft (i.e., up to 4,000 lbs. take-off weight) need not show that the service intended was required in the public interest—in other words licences applied for would be granted freely by the Air Transport Board provided the financial and other capabilities of the applicant were satisfactory and an operating certificate obtainable.

The rush for licences was such that it produced a chaotic excess of capacity for that segment of the charter industry.

It rapidly became apparent to the Air Transport Board that the public interest was not being served and the government was quickly persuaded to re-instate the requirement to prove need. Mr. Diefenbaker's government had made an experiment, presuming some benefits of competition among small charter operators. The pragmatists picked up the pieces and carried on.

7. THE PICKERSGILL YEARS

The events of 1958 leave the observer with the impression that the government and its Air Transport Board were content to tinker. No serious investment could be made in the industry by private sector entrepreneurs until the government would declare the rules of the game and undertake to stick with them for ten years or so. Mr. Pickersgill set out to make everything clear, starting in 1964.⁷

In a nutshell, he tried to state the route licence rules:

- (a) which carriers would be serving which international routes
- (b) no domestic licence would be granted to anyone which could put Air Canada in the red
- (c) what the regionals would be allowed to do.

On international routes a variety of swops, partnerships and even mergers were discussed. Mr. Pickersgill asked the mainline presidents, accompanied by their railway mentors, to talk. So they talked, but settled on the status quo. The message was that "the geographical areas now served by each should be defined and extended . . ." Africa was to be "left aside until some practical ques-

tion arises." No decision on U.S. routes was to be made pending a new bilateral treaty. The mainline carriers were to help each other and stop quarreling.

On the domestic mainline scene, he undertook to study what further competitive initiatives might be taken without driving Air Canada into the red. This led to the 25% market share to CP Air concept, which lasted fourteen years. Good or bad, the rules were known. Aircraft orders and schedules tacitly conformed to the rules. On his summary on June 1, 1965,⁸ Mr. Pickersgill lets us glimpse the truth. "In the domestic field a degree of competition will remain to provide the public with the advantages that can result from a competitive atmosphere; while at the same time this policy will avoid the excesses of competition which were ruinous to all but one of the main railways of Canada . . ." Mr. Pickersgill knew the folk mind very well.

Mr. Pickersgill's quest for order for the second level carriers expressed itself as a set of geographical regions. While emphasis was on North/South traffic, some competition with the mainline carriers was contemplated. However, big boys must not use their size and strength to drive smaller boys from such competitive routes. If this happens, "the Air Transport Board will, if necessary, exercise appropriate control to provide a chance for a fair competitive relationship." Administered market shares: competitive atmosphere again. Regionals might try some domestic charter work and this would be encouraged. They might try some international charters, and that this would be encouraged too was implicit in the October 20, 1966⁹ statement.

8. AFTER THE REGIONAL POLICY

The Regionals saw the green light and jumped at it. All obtained large jet equipment and proceeded to try their hands at the charter/inclusive tour business. None succeeded. All regional carriers have now withdrawn from the use of dedicated long range equipment in the charter business. The experiment was fatal for Transair, in spite of the granting of a scheduled life-line into Toronto. Alberta bought control of PWA, and PWA took Transair in distress. The Alberta transcontinental had its inaugural flight June 1, ten days ago. We may sigh for the best-laid plans of mice and men.

The surviving Regionals learned their lesson. They concentrated their 737 equipment on their scheduled, business oriented markets and then sought to de-

ploy the surplus night hour and weekend capacity in the U.S. and Caribbean vacation markets.

In the dedicated long range charter market, Ontario World Air tried and failed. Wardair lives on alone and with high repute.

Wardair has met the conditions of survival in long haul markets—wide-bodied fuel efficient aircraft and the marketing ability to keep them flying and reasonably full. The market risks are substantial. Wardair sought and obtained the rights to operate domestic charters, and to top up one-third of the seats with individual passengers in the seven days prior to departure. If the mainline and regional carriers can choose where and when to behave as scheduled, charter or part charter carriers, Wardair argues that all they want is the right to compete “on equal terms,” meaning to have the choice of where and when to be a charter, part charter, or scheduled carrier. Ian Gray of CP Air said, on one of our ATAC platforms, “Why don’t you apply for a licence, Max?”

9. 1975 ON — CHANGING MARKET ENVIRONMENT

The search for the discretionary spender, and for the prices and conditions that he would accept, began in Europe in the 1950's and has continued with growing intensity around the world.

The Canadian mainline carriers have adapted. If surplus seats could be successfully predicted and sold in controlled volumes, lower fares could compete with charters, with the limited numbers of such seats constraining the erosion of yield. Domestic schedule service load factors on Air Canada and CP Air together rose from 61% in 1976 to 68% in 1980.

The marketing initiatives taken by the Canadian scheduled airlines in this adaptive process, surplus seat sales, Charter class fares, and the whole aircraft methods of Night Hawk, Skybus, etc., have been well described by the CTC Research Branch in “A Review of low priced air fares 1979.”

These initiatives were taken at home in Canada. Traffic between Canada and Europe moves at fares which cannot be inconsistent with those available in the much larger U.S.A.-Europe market. This is also true to the Orient. To this difficulty we must add the trends in European and Japanese general price levels, relative to our own, the serious depreciation of the Canadian dollar in foreign exchange, and the knowledge that 1981 will be the fourth successive year in which real disposable income per work-

er will show a decline. Foreign originations now outnumber Canadians on Atlantic services.

The words of Guy Roberge of the CTC come to mind.¹⁰ “The absence of easy solutions does not imply the absence of solutions. The success of this search will depend, as always, on the imagination and common sense of the entrepreneurs.” “It has been my experience that progress relies on entrepreneurial skill rather than on the confines of policy or regulations.”

10. The mainline and regional carriers have been feeling their way toward meeting both the business markets (Connaisseur, Empress Class, Business Jet) and discretionary markets (surplus seats, charter class, Skybus) while keeping in their own hands the options leading to higher market share, higher load factors and higher aircraft utilization.

By their prices and fences they have sought to add to net income, increase efficiency and contain their risks. The thrust on route applications, however, and on aircraft orders, has not been towards containment, but towards expansion.

A situation unique in our history now presents itself. While the world, and we, debate the U.S. experiment in deregulation, it is now possible to travel on regular services between Toronto and Vancouver on Air Canada, CP Air, PWA and Wardair. It is now possible to travel between Montreal and Toronto on Air Canada, CP Air, Nordair, Quebecair and Eastern Provincial.

This is quite unlike the administered market share situation. The special status of Air Canada before the ATC had been swept away with the 1977 revisions to the Air Canada Act. The winds which have blown across the border since 1978 have brought “competitive atmosphere” with a vengeance, and this time it is real, at least in the dense markets. This is competition where pricing initiatives are there in plenty, and the capacity offered is limited largely by what the air carrier wishes to venture, and on the record, entry regulation can hardly be called restrictive on these dense traffic routes. That deregulation debate, which many of us have so enjoyed, has been overtaken by events. The carriers have pursued their market opportunities, and the Canadian regulators, while retaining their powers, have not stood in the way.

11. The aircraft orders tell their story. Taking Air Canada, CP Air, PWA and Wardair the firms orders are:

Boeing 727	8
Boeing 737	15
Boeing 767	20
L1011-500	6
DC-10-30	3
A 310	6

The cost of these firm orders with spares and ground equipment is:

	U.S.\$ millions
Air Canada	955
CP Air	549
PWA	254
Wardair	500
	<hr/>
	2,218
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When the declared option orders are counted in the total comes to about \$4 billion. These are not the actions of a set of carriers shivering in some policy vacuum. The orders rather suggest that the carriers, at least, know what they want to do and are betting on being able to do it. Canadian Aviation magazine, speaking of the Wardair A 310 order, says "The fact that he (Mr. Ward) has no assurance from Ottawa that he will be able to operate the A 310 on a scheduled air service licence does not seem to worry him in the least."

12. IN SUMMARY

Certain events have cast very long time shadows: the choice of the CNR to own Trans-Canada Air Lines, the constraints of the Trans-Canada Contract upon the regulators, the memories of railway failures and the depression, the unpredicted effects of cross subsidy.

Some more recent events have changed the habits of forty years: the removal of any regulatory privilege for Air Canada and the U.S. experiment.

In dense markets there has been extensive pricing initiative, remarkable freedom of entry, bold aircraft ordering and a low rate of corporate failure.

Guy Roberge made a graceful admission last November¹¹ of the pragmatic role of the economic regulators of air transport. The charm of the paper lay in the way he rendered his graceful admission also as a spirited defence.

It has been my privilege to suggest, through the view of history which recollection allows, that much of the spirited defence was justified.

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