Unclassified **DAF/COMP/WD(2014)34**

Organisation de Coopération et de Développement Économiques
Organisation for Economic Co-operation and Development

26-May-2014

English - Or. English

DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

DAF/COMP/WD(2014)34
Unclassified

AIRLINE COMPETITION

-- Note by Canada --

18-19 June 2014

This document reproduces a written contribution from Canada submitted for Item IX of the 121st meeting of OECD Competition Committee on 18-19 June 2014.

More documents related to this discussion can be found at:
www.oecd.org/daf/competition/airlinecompetition.htm

JT03357972

Complete document available on OLIS in its original format
This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

English - Or. English

1. Introduction

1. Canada's Competition Bureau (the "Bureau") is pleased to provide this submission to the OECD Competition Committee June 19 2014 roundtable on "Airline Competition". The Bureau, headed by the Commissioner of Competition (the "Commissioner"), is an independent law enforcement agency responsible for the administration and enforcement of the *Competition Act* (the "Act")[1] and certain other statutes. The Competition Tribunal (the "Tribunal") has jurisdiction to hear and dispose of all applications made by the Commissioner under certain sections of the Act. In carrying out its mandate, the Bureau strives to ensure that Canadian business and consumers have the opportunity to prosper in a competitive and innovative marketplace.

2. Canada has a rich history of aviation, with roots in the first powered heavier than air flight in Canada on February 23rd 1909, when John McCurdy took to the air in the *Silver Dart*, launched from Baddeck, Nova Scotia. The Bureau is committed to taking action where appropriate to safeguard competition in the airline industry, helping to uphold this heritage and ensure that the benefits of aviation continue to be accessible to Canadians.

3. While this submission is indicative of the approach the Bureau may take when examining the airline industry, it is not intended to be binding statement of how discretion will be exercised in a particular situation and should not be taken as such, nor is it intended to substitute for the advice of legal counsel or to restate the law.

1.1 The Importance of Airlines to the Canadian Economy[2]

4. The air transport sector plays a key role in the Canadian economy. Given the size and population distribution of Canada, air travel is in many cases the only practical and timely option for travel between different regions of the country.

5. In 2012, carriers reported 66.8 million passengers boarded planes ("enplaned") in Canada, a 6.2% increase over the previous year. 36.3 million passengers enplaned for domestic service, growing 5.3% over 2011. 30.5 million passengers boarded international flights, up 7.4%. More than one billion tonnes of air cargo was loaded and unloaded in Canada in 2012.[3]

6. The aviation industry employed 54,351 Canadians in 2012, who were paid $3.6 billion in wages. Carriers consumed 6.6 billion litres of fuel , worth $6 billion - this accounted for 31% of operating expenses, up from 30.2% in 2011.

7. Carriers reported $20.3 billion in operating revenues, over 95% of which were absorbed in operating expenses, totalling $19.2 billion. Overall, the aviation industry achieved a 3.4% profit margin in 2012.

---

1 R.S.C., 1985. c. C-34, as amended.

2 This section draws from the report: Statistics Canada, Catalogue No. 51-004-X, Vol. 46, No. 3, "Civil Aviation, Annual Operating and Financial Statistics, Canadian Air Carriers, Levels I to III", April 2014, available online at: http://www.statcan.gc.ca/pub/51-004-x/51-004-x2014003-eng.pdf. Unless otherwise noted, these statistics apply to 2012, are in Canadian dollars, and cover only those airlines that, in the previous year, realized at least $2 million in gross revenue for the provision of air services, transported at least 50, 000 tonnes of cargo or transported at least 100, 000 revenue passengers.

3 Statistics Canada. CANSIM *Table 401-0045, "Air cargo traffic and flights",* (accessed: 2014-05-06), available online at: http://www5.statcan.gc.ca/cansim/a26?lang=eng&retrLang=eng&id=4010045&paSer=&pattern=&stByVal=1&p1=1&p2=31&tabMode=dataTable&csid=

1.2 Brief History of the Airline Industry in Canada

8. Following measures to gradually introduce more market forces to the industry throughout the 1970s and 80s, the Government of Canada broadly deregulated[4] the airline industry with the passage of the *National Transportation Act, 1987.*[5] The Transportation Act also required the privatization of Air Canada, formerly the national carrier, which was completed in 1989. Among the restrictions that remained was the requirement that any carrier offering domestic service must be owned by Canadians. By the 1990s, the market had effectively developed into a duopoly, divided between Air Canada and Canadian Airlines International ("CAIL"). However, in 1996 a new discount carrier, WestJet, began offering regional jet service in western Canada.

9. In December of 1999, CAIL had become insolvent and was eventually acquired by Air Canada. After the acquisition, Air Canada became the dominant carrier, with more than 80% of domestic passenger traffic and close to 90% of domestic passenger revenues.

10. To gain regulatory approval for the merger, Air Canada made certain binding undertakings to the Minister of Transport and the Commissioner. A number of these undertakings were aimed at fostering entry. For example, Air Canada was required to relinquish takeoff and landing times at slot-congested airports and to refrain from operating a discount carrier in eastern Canada for a period of time.

11. In addition, the Act was amended to include a number of airline-specific anti-competitive acts for the purposes of the abuse of dominance provisions. These amendments came into force on August 23, 2000.[6] The new provisions dealt broadly with predation in the airline industry, the pre-emption of facilities, and other exclusionary conduct. The amendments also empowered the Commissioner to issue temporary orders to prohibit domestic airline services from engaging in conduct that could constitute an anti-competitive act.[7]

12. At the time of the merger, CAIL was the largest private sector employer west of Ontario and the Government of the day strongly preferred an orderly restructuring of the industry by way of an acquisition by Air Canada rather than the dissolution of CAIL through bankruptcy. A likely "failing firm" defence posed an obstacle to the Commissioner challenging the merger before the Tribunal. Taking all of this into account, the merger, conditioned by various undertakings extracted from Air Canada and strengthened oversight under the Act, was seen as the preferred response to the emergence of a dominant carrier in the domestic Canadian airline market.

---

4 Deregulated in the sense of freedom to set prices and networks. While market forces govern entry, pricing and capacity in domestic and transborder air markets, services on international routes continue to be governed by international air agreements which may include varying elements of economic regulation. To the extent to which they regulate various elements of competition, international air agreements are a factor which the Bureau considers in assessing enforcement matters.

5 R.S.C, c. 28 (3rd Supp.), consolidated and revised in the *Canada Transportation Act*, S.C. 1996, c. 10, (the "Transportation Act"), available online at: http://laws-lois.justice.gc.ca/eng/acts/C-10.4/page-1.html.

6 See, for example, the version of the Act that prevailed between December 31, 2002and March 31, 2003, available online at: http://laws-lois.justice.gc.ca/eng/acts/C-34/20021231/P1TT3xt3.html.

7 In 2003, the Quebec Court of Appeal declared this provision of the Act to be inoperative, finding that it contravened the *Canadian Bill of Rights*; *Air Canada v. Canada (Attorney General)* (2003), 23 C.P.R. (4th) 129. This provision of the Act was formally repealed in 2009.

13. In April of 2003, Air Canada filed for bankruptcy protection, which the firm emerged from 18 months later in September of 2004. By that time, its market share in the passenger air travel market had decreased and a number of rival carriers had begun serving key routes. While a number of discount carriers had entered the domestic market post-merger, a number of them (CanJet, Royal, JetsGo and Canada 3000) failed over a relatively short period of time. However, WestJet continued its growth and expanded significantly to become a viable national carrier. In 2009, the airline specific provisions of the Act were repealed on the grounds that they were no longer necessary.[8]

14. Following its restructuring under bankruptcy protection, Air Canada continued to focus on reducing its cost structure while WestJet continued its expansion. In 2014, Air Canada has 55% of the domestic market based on available seat miles, WestJet 36% and others 9%. Broadly speaking, the industry has returned to a duopoly structure somewhat similar to that which existed prior to the Air Canada / CAIL merger. However, there are also a number of smaller but significant regional carriers, including Porter Airlines which established service from the Toronto Island Airport in 2006 serving routes in Eastern Canada and the United States.

1.3 Bureau Actions in the Airline Industry

15. The Bureau has applied many of the key provisions in the Act to safeguard competition in the airline industry. The Bureau has brought applications to the Tribunal under the Act's abuse of dominance provisions regarding unilateral conduct (sections 78 & 79), merger provisions (section 92), and competitor collaboration provisions (section 90.1). In addition, the Bureau has investigated and prosecuted criminal price-fixing conspiracies under section 45 of the Act. The Bureau's actions include:

- Action against Air Canada for predatory conduct under section 79 of the Act[9] (the "Air Canada Matter");
- Action against a proposed joint venture and other agreements between Air Canada and United Continental Holdings under sections 90.1 and 92 of the Act[10] (the "Air Canada/United Continental Holdings Matter"); and
- An investigation into a conspiracy regarding international air cargo under section 45 of the Act (the "air cargo investigation").

16. A more detailed explanation of these cases is included in Appendix A.

---

8 It should be noted that the airline specific anti-competitive acts formed part of a non-exhaustive list, and that conduct previously covered by these provisions may still be considered as anti-competitive acts.

9 *Commissioner of Competition v. Air Canada*, 2003 Comp. Trib. 13 ("*Air Canada*"), available online at: http://www.ct-tc.gc.ca/CMFiles/CT-2001-002_0145a_40QXN-4132004-736.pdf.

10 *The Commissioner of Competition v. Air Canada, United Continental Holdings Inc., United Airlines Inc., and Continental Airlines Inc.* (CT-2011-004) ("*Air Canada/United Continental"*), Notice of Application, available online at: http://www.ct-tc.gc.ca/CMFiles/CT-2011-004_Notice%20of%20Application_1_45_6-27-2011_7637.pdf.

2. Unilateral Conduct

17. Unilateral anti-competitive conduct in the airline industry includes three significant categories: predatory conduct, exclusionary conduct (including the pre-emption of necessary facilities or resources), and potentially anti-competitive use of loyalty programs.

18. As part of assessing the competitive effects of unilateral conduct or mergers in the airline industry, the Bureau will generally define the relevant market(s) and examine barriers to entry. By doing so, the Bureau considers the ability of existing or potential competitors to discipline the exercise of market power, or to enter the market in response to the dominant firm exercising market power. The Bureau's approach and past findings are discussed below.

19. In Canada, anti-competitive unilateral conduct is often examined under sections 78 and 79 of the Act, which deal with abuse of a dominant position.[11] The abuse of dominance provisions may apply when a dominant firm (or group of firms) in a market engages in a practice of anti-competitive acts, with the result that competition has been or is likely to be prevented or lessened substantially.[12]

2.1 Market Definition

20. When assessing unilateral conduct or mergers in most cases the Bureau defines one or more relevant markets to examine whether there are existing competitors (or likely potential competitors) that may constrain the ability of the firm or firms in question to profitably raise prices, maintain high prices, or otherwise restrict competition. Identifying all competitors faced by an airline requires identifying both the geographic areas over which firms are competing (geographic markets), as well as the types of competing services (product markets).

21. The Bureau applies the hypothetical monopolist test to define relevant markets.[13] Conceptually, a relevant market is defined as the smallest group of products, including at least one product of the merging parties, and the smallest geographic area, in which a sole profit-maximizing seller (a "hypothetical monopolist") would impose and sustain a small but significant and non-transitory increase in price ("SSNIP") above levels that would likely exist in the absence of the conduct. In most cases, the Bureau considers a five percent price increase to be significant and a one-year period to be non-transitory.

22. The following discussion on market definition is specific to passenger air travel.

---

[11] In addition to abuse of dominance, the Act includes provisions regarding refusal to deal, price maintenance, exclusive dealing, tied selling, and market restriction. These types of conduct may also be examined under the abuse of dominance provisions, although the Act specifically bars an application from being made against the same person under both the abuse of dominance and price maintenance provisions regarding substantially similar facts.

[12] For a more thorough treatment of the Bureau's general approach to dealing with alleged abuses of dominance, see: Competition Bureau, *Enforcement Guidelines: The Abuse of Dominance Provisions (Sections 78 and 79 of the Competition Act),* 20 September 2012, available online at http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03497.html

[13] For information, see: Competition Bureau, *Enforcement Guidelines: Merger Enforcement Guidelines*, 6 October 2011 ("Merger Enforcement Guidelines"), available online at http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03420.html.

2.1.1 Product Market

23. As a general rule, the Bureau considers passenger air travel to be in a separate market from other kinds of transportation. Exceptions may exist where the distance travelled is very short. The Bureau may also consider business travel to be distinct from leisure travel as the two customer segments often exhibit different demand characteristics.

24. Nonstop service between two cities may be in a different market from one-stop or multiple-stop service, depending on passenger time sensitivity and fare differential. Highly time-sensitive passengers are unlikely to see a route with three stop overs as a good substitute for a direct flight, for example.

25. In addition, levels of service may play a role in defining the relevant product market. Loyalty programs, in-flight and in-airport amenities, frequency of flights, and availability of connections are among the factors that passengers may consider when choosing their flight, and therefore may affect the substitutability of one carrier for another.

2.1.2 Geographic Market

26. The Canadian airline industry is segmented between domestic (within Canada), trans-border (to and from the United States) and international or offshore routes. The regulatory regimes governing these segments vary and there are different sets of competitors offering services. However, Canadian jurisprudence has held that an origin-destination city-pair will generally constitute a geographic market for the purposes of analyzing competition in the airline industry.[14]

27. Frequently, an origin or destination will consist of a single airport, but this need not always be the case. It is possible that two or more reasonably proximate airports may be considered sufficiently substitutable by travellers that they are part of the same geographic market.

28. The extent to which two airports in the same general area are substitute origins or destinations depends on a number of factors, including the geographic distribution of passengers in the area, the ease and duration of travel to each airport, the airlines serving each airport, the flight schedules at each airport, the availability of connecting flights, and differentials in fares. The nature of the flight may also affect the substitutability of airports – for example, passengers may be more willing to travel to a more distant airport if they are making a longer journey.

2.2 Barriers to Entry

29. When analyzing the exercise of market power, the Bureau considers barriers to entry, and conditions of entry. When entry is likely, timely and sufficient in scale and scope, an attempt to increase prices or otherwise exercise market power is not likely to be sustainable as buyers of the product in question are able to turn to the new entrant as an alternative source of supply.

30. The Bureau considers that the airline industry is characterized by high costs and barriers to entry, which may limit the ability of new entrants to discipline the exercise of market power. These include:

---

[14] See *Director of Investigation and Research v. Air Canada*,CT-1988-001), Reasons and Order, 22 April 1993 at page 60, available online at: http://www.ct-tc.gc.ca/CMFiles/CT-1988-001_0800a_45PBT-4282004-6665.pdf. (Prior to 1999, the Commissioner of Competition was known as the Director of Investigation and Research.)

a. Requirements in the Transportation Act that domestic carriers, including new entrants, must be Canadian owned and "controlled in fact". This imposes restrictions on the financing and contractual relationships that Canadian carriers can have with foreign carriers;

b. Lack of feed traffic at both ends of their routes;

c. Lack of an effective frequent flyer program;

d. Lack of business class airport lounges;

e. Lack of an established brand with a reputation for reliability and safety;

f. Costs of leasing or purchasing aircraft;

g. Costs of hiring flight crew (pilots) and cabin crew;

h. Obtaining access to certain airport facilities, including gates, loading bridges, ticket counters, and baggage systems;

i. Costs of committing to a schedule in order to establish a reputation for reliability;

j. Advertising, travel agent familiarization costs, online booking system costs, and other marketing costs;

k. Regulatory requirements, such as insurance and financial requirements that may be mandated under the Transportation Act;[15] and

l. Scarcity of attractive time slots at key airports.

2.3 Predation in the Airline Industry

31. Under the airline-specific abuse of dominance provisions of the Act which applied between 2000 and 2009, the Bureau made one application to the Tribunal regarding predatory conduct in the Air Canada Matter.[16] The litigation involved allegations of predatory pricing against Air Canada on seven city-pair routes in eastern Canada being served by new entrant discount carriers WestJet and CanJet.

32. The application was to be considered in two phases, the first dealing with specific questions related to the application of the avoidable cost test, including the unit of analysis, the appropriate timeframe and what costs are properly considered avoidable. The second phase was to consider issues of dominance and competitive effects. Following phase one, the Tribunal made a finding that Air Canada had operated flights below avoidable cost, but in view of Air Canada's filing for protection from bankruptcy and changed market circumstances, the Commissioner discontinued the application prior to phase two of the hearing. Further discussion of this matter appears in Appendix A.

33. Predation continues to be covered by the abuse of dominance provisions of the Act, in the airline industry and elsewhere.

---

15 See, for example, Section 61 of the Transportation Act, which mandates that a domestic carrier has "the prescribed liability insurance in respect to the service to be provided" and "meets prescribed financial requirements".

16 See description of *the Air Canada Matter* in Appendix A.

2.3.1 The Avoidable Cost Test

34. The Bureau is of the view that operating flights on a route that do not cover avoidable costs, or expanding capacity on a route such that the airline will not recoup the cost of doing so, may constitute predatory conduct. In the Air Canada Matter, the Tribunal accepted that for the purpose of applying the avoidable cost test for determining predation, all costs that can be avoided by not producing the good or service in question must be included. In general, the avoidable cost of offering a service will consist of the variable costs and the product-specific fixed costs that are not sunk.

35. Avoidable costs are those that could have been avoided by the dominant airline had it chosen not to offer the service in question over the relevant time period. The avoidable cost test compares these costs to the revenues derived from offering a service over the relevant time period to determine if the pricing strategy is predatory in nature. If the revenues are lower than the avoidable cost, the Bureau may conclude the carrier is engaged in predatory conduct.

36. When applying the avoidable cost test, the Bureau considers and the Tribunal has accepted that the appropriate unit to analyze is the schedule flight.[17] Carriers adjust capacity by adding or subtracting flights, or by changing the size of the aircraft used to provide service. Carriers can and do cancel badly performing flights, or may deliberately maintain flights that do not cover avoidable costs for the purpose of predation. This view has been confirmed by jurisprudence.[18]

37. The relevant time period is the duration of the conduct, in accordance with the Bureau's general approach to analyzing predation. In the past, the Tribunal has ruled that relevant time period is one month. The Tribunal has also ruled that "the obligation on the dominant carrier to keep avoidable costs below revenues is continuous".[19]

38. As a general rule, the Bureau considers it appropriate to compare all revenue derived from offering a given flight against all avoidable costs instead of focusing on a specific fare class. Revenue may include that from passenger fares, including a prorated portion of fares paid by passengers connecting to other flights, air cargo services, or in-flight purchases. However, as the Tribunal accepted, the revenue calculation does not include "beyond contribution", which is revenue earned on other flights carrying connecting passengers (beyond, and in addition to, the pro-rated portion of those fares).

2.3.2 Categories of Avoidable Cost

39. To apply the avoidable cost test, it is necessary to determine which costs are avoidable over the relevant timeframe were the airline to choose to not offer that flight. In general, the longer the timeframe,

---

17 Defined as departures on a city-pair route which occur at identical or similar times.

18 See *Air Canada*, *supra* note 9 at para. 337. In this decision, among other things, the Tribunal answered four questions related to the avoidable cost test. Summarized in paragraph 337, these holdings included:

- The unit of capacity is the schedule flight (paragraph 165);
- The determination of various categories of avoidable cost (see paragraph 197 onward, and section 2.3.2, below);
- One month is an appropriate period of time to examine (paragraph 194); and
- No recognition should be given to "beyond contribution," related to passenger connections (See paragraph 286).

19 *Ibid*. at para. 196.

the more costs become avoidable. The Tribunal has considered specific avoidable costs in considerable detail in the Air Canada Matter.[20]

40. Avoidable costs that vary with the number of passengers served would include costs such as passenger commissions, some portion of fuel and oil expense, food, and supplies. Flight-specific fixed costs are also avoidable unless they would still be incurred or could not be reallocated in the event the flight is cancelled. These would include base fuel, flight and cabin crew costs, aircraft costs, navigation fees, landing fees, maintenance labour and aircraft service costs.

41. Jurisprudence has confirmed that redeployment of resources following the cancellation of a schedule flight – for example, shifting aircraft, pilots, or cabin crew to other flights – is a means by which costs can be avoided.[21] Generally, redeployment results in cost avoidability when the dominant carrier earns revenue in a new use that covers the cost of that resource, or avoids an expenditure that otherwise would have occurred.

42. If a cost is common to many flights and/or invariant to whether or not the flight in question is offered over the relevant period, then it should not be considered an avoidable cost. These types of costs may include fixed overhead costs, such as maintenance facilities, corporate offices, and executive salaries that are required to offer any service from a particular city. However, as the relevant time period increases, some of these costs may become avoidable.

2.4 Exclusionary conduct and Pre-emption

43. As offering effective airline service requires potentially scarce inputs – such as facilities and landing slots – the Bureau considers the potential for an incumbent to attempt to exclude a rival by pre-empting inputs that are necessary for sustained entry. In general, the Bureau is not concerned with conduct that forces competitors to be more effective, but conduct that makes it more difficult for competitors to be effective at disciplining the exercise of a firm's market power; to prevent them from entering the market or to eliminate them from the market entirely.

44. Pre-emption usually carries with it the idea that an investment is being made before it can yield a positive return on a flow basis. Hoarding of inputs essential for the production of a good or service, in order to keep them from being used by a potential rival, would be a pre-emptive act if the inputs were not immediately contributing towards higher returns for the firm. By pre-empting the market and keeping new firms from entering, the dominant carrier will be able to charge higher fares and earn higher profits than it would have if new entry did occur.

45. The Bureau considers that it is not necessary for facilities or resources to go unused to be subject to pre-emption. For instance, a dominant carrier may employ the facilities or resources for service if they are subject to "use it or lose it" rules, or to reduce suspicion that the inputs have been acquired to exclude a rival. Where appropriate, the Bureau employs the avoidable cost test to determine if such service is justified on its merits.

---

20 *Ibid.* at para. 144.

21 *Ibid.* at para. 143.

46. Facilities or resources that may be subject to pre-emption include:

- Landing slots during peak travel periods, or at airports that are slot-constrained;
- Baggage handling services and facilities;
- Maintenance services;
- Ticket counters;
- Gates; and
- Loading bridges;

47. Distinct from pre-emption, altering schedules, networks or infrastructure may be considered an anti-competitive act. Concern may arise when an anti-competitive purpose and effect have been identified for an alteration and for which no valid business reason has been articulated. As an example, consider the case where a new entrant has negotiated an interline agreement with the dominant carrier, and subsequently scheduled and marketed a flight based on reasonable assumptions about feed traffic that would accrue to the entrant based on the dominant carrier's announced schedule. If the dominant carrier altered its schedule subsequent to the interline arrangement in a way that made the entrant's service unprofitable, and if the change in schedule was not motivated by some valid business reason, then it may be considered an anti-competitive act.

2.5 Loyalty Programs

48. Loyalty programs, such as frequent flyer programs, may have anti-competitive implications. These include "loyalty inducing" effects, as well as providing a method through which to effect predation.

49. Frequent flyer programs provide an incentive for passengers to concentrate their travel on a single carrier. As part of these programs, passengers are awarded points that can be redeemed for travel on other routes. Because the number of points the customer has with a specific airline depends on the amount of business the customer has given to that airline, the customer has an incentive to fly as much as possible with the same carrier. In addition, such frequent flyer programs will induce customers to choose to fly on airlines with larger networks that provide a larger number of routes on which the frequent flyer points can be accumulated and redeemed. All of these features contribute to the ability of a frequent flyer program to induce loyalty from customers.

50. Loyalty programs also provide a method that may be used to effect predation. For example, suppose that in response to entry on a particular route a dominant carrier increases frequent flyer rewards on that route beyond what it would normally offer in similar circumstances. This increase would have the same effect as lowering fares on the route; a package of greater value is being offered for the same price. If this increase is justified only because it eliminates or disciplines the new entrant, then it would be considered anti-competitive.

51. The Bureau anticipates that the manipulation of frequent flyer rewards would most likely be anti-competitive when their manipulation is part of an overall anti-competitive strategy. Therefore, the Bureau considers whether loyalty programs are being employed in order to contribute to, or enhance, the effects of other anti-competitive strategies. However, the Bureau does not rule out the possibility that such manipulation alone may be sufficient to constitute a practice of anti-competitive acts.

3. Co-ordinated Conduct: Mergers, Conspiracy and Competitor Collaboration

52. In addition to unilateral conduct, the Bureau has reviewed potentially anti-competitive mergers, criminal conspiracies, and agreements or arrangements between competitors that may reduce competition substantially.

3.1 Mergers

53. When reviewing mergers in the airline industry the Bureau assesses whether a transaction is likely to substantially lessen or prevent competition.[22] In making this determination the Bureau has generally focussed on unilateral theories of harm; namely, the elimination of actual or future rivalry between the parties on both direct and indirect routes where they overlap (or would likely have overlapped but for the transaction). The Bureau has also evaluated the extent to which transactions between airlines are likely to lessen or prevent competition on routes where one of the merging parties competes with an alliance partner of the other merging party (even though this party may not itself be present on those routes). The reason for this is that pre-existing alliance agreements, depending on their nature, structure, and financial incentives, may dampen the intensity of competition post-transaction between the merged entity and the alliance partner (i.e. post-transaction both will be members of the same alliance). Market definition and the analysis of barriers to entry for the purposes of merger review are broadly consistent with the discussion in sections 2.1 and 2.2 of this submission when considering passenger air travel.

54. In testing these theories of harm, the Bureau has relied on a range of documentary and empirical evidence from both parties and third parties, including strategic and tactical documents. In recent reviews, the Bureau has placed an increased emphasis on the econometric analysis of ticketing and route performance data, including cross sectional analysis and route entry/exit analysis, in order to more precisely understand the degree of rivalry between parties and the likely effects of a transaction. When appropriate and when sufficient data are available, the Bureau will also carry out demand estimations to facilitate the use of merger simulation techniques.

55. The Bureau has applied the theories and analyses above to a range of airline mergers. The merger provisions of the Act are sufficiently broad to allow the Bureau to review and challenge not only "traditional" airline mergers but also certain "non-traditional" airline mergers such as joint ventures that involve close cooperation between competitors. The Bureau's experience in the Air Canada/United Continental Holdings Matter (explained in Appendix A) is an example not only of enforcement actions taken in respect of a "non-traditional" airline merger and certain pre-existing alliance agreements, but also of the types of remedies that the Bureau may rely on in respect of such mergers and alliance agreements.

56. Transactions involving a "transportation undertaking" that are subject to notification under the Act must also be notified to Transport Canada for review. The Minister of Transport may subject the transaction to a public interest inquiry with input from the Commissioner, and receive undertakings to address any concerns.

---

22 For information on the Bureau's general approach, see the Merger Enforcement Guidelines, *supra* note 13.

3.2 Conspiracy

57. The Act contains several provisions that prohibit cartel activity in its various forms. Section 45 is the cornerstone cartel provision of the Act. It makes it a criminal offence when two or more competitors or potential competitors conspire, agree or arrange to fix prices, allocate customers or markets, or restrict output of a product. In March 2010, amendments to the Act came into force increasing the penalties for violation of the conspiracy provisions of the Act. Conduct contrary to section 45 that occurred following the amendments is punishable by a fine of up to $25 million, or imprisonment for a term of up to 14 years, or both. For conduct that occurred prior to March 2010, penalties include a fine of up to $10 million, imprisonment for a term of up to five years, or both.

58. Appendix A summarizes the Bureau's ongoing investigation into a criminal conspiracy with respect to air cargo services, which provides one example of the Bureau's approach.

3.3 Agreements or Arrangements that Prevent or Lessen Competition Substantially

59. In addition to "hard-core cartels" that fix prices or restrict output, the Bureau is of the view that other types of collaboration between competitors in the airline industry – like any industry – have the potential to restrict competition.[23] While agreements between competitors have the potential to bring efficiencies, certain types of arrangements between competitors may materially reduce incentives to compete and discipline the exercise of market power on the part of rivals. The Bureau's application to the Tribunal in the Air Canada/ United Continental Holdings Matter included pleadings under section 90.1, regarding co-ordination and alliance agreements, among other things.

60. In accordance with its general approach to competitor collaborations,[24] when analyzing an agreement or arrangement between competitors the Bureau will consider various factors including:

- Market shares of the parties;
- Ease, timeliness, and likelihood of entry or expansion by firms not party to the arrangements;
- If the collaboration will reduce incentives to compete, or otherwise enhance the ability to exercise market power; and
- Credible efficiencies resulting from the collaboration.

61. In the past, the Bureau has taken action against the following types of arrangements in the airline industry under the civil competitor collaboration provisions of the Act:[25]

---

23 The Act has two provisions that deal with arrangements between competitors. Section 45 is a criminal *per se* prohibition against conspiracies to fix prices or restrict output. Section 90.1, a civil provision, deals with other types of arrangements between competitors that prevent or lessen, or are likely to prevent or lessen, competition substantially in a market. Section 90.1 includes an efficiencies exception if the efficiencies resulting from the agreement or arrangement are greater than and will offset the prevention or lessening of competition. For more information, see Appendix B.

24 For more information, see: Competition Bureau, *Enforcement Guidelines: Competitor Collaboration Guidelines*, 23 December 2009, available online at http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03177.html.

25 See discussion of the Air Canada / United Continental Holdings Matter in Appendix A.

- Coordination on price, inventory, and yield management, route planning, sales, marketing, and scheduling;
- Sharing of net revenues and/or costs on certain routes; and
- Integration of business, such as reciprocal access to frequent flyer programs.

4. Conclusion

62. The Bureau considers the airline industry to be of key importance to the Canadian economy. The Bureau will continue to investigate alleged anti-competitive conduct in the airline industry and take enforcement action where appropriate.

APPENDIX A: SELECT CASES

1. The Air Canada/ United Continental Holdings Matter (2011)

63. In October 2010, Air Canada and United Continental Holdings announced their intention to enter into a joint venture that would have resulted in a merger of their operations on trans-border routes between Canada and the United States. Specifically, the parties' proposed joint venture would have involved cooperation on pricing, capacity setting (route planning), frequent-flyer programs and sales, as well as revenue and cost-sharing. In addition to reviewing the joint venture, the Bureau also reviewed three pre-existing "coordination agreements" between Air Canada and United Continental that allowed the parties to coordinate key aspects of competition including, but not limited to, joint pricing and scheduling, as well as revenue sharing.

64. As a result of its review, the Bureau concluded that the joint venture would lead to a monopoly on ten trans-border routes, and substantially reduce competition on nine others, leading to increased prices and reduced consumer choice. On this basis, the Bureau filed an application with the Tribunal in June 2011 in which it not only challenged the proposed joint venture under the merger provisions of the Act, but also sought to unwind the three aforementioned coordination agreements under section 90.1 of the Act, which allows the Commissioner to challenge anti-competitive agreements – whether existing or proposed – between competitors.

65. In October 2012, a Consent Agreement [26] was reached, pursuant to which the parties are prohibited from implementing their joint venture agreement with respect to 14 high-demand trans-border routes. In addition, the parties are prohibited from coordinating via their existing coordination agreements on these routes. The Consent Agreement will remain in force for as long as these existing agreements or the joint venture remains in force. In the event there is a substantial change to competition on any of the 14 routes, the Consent Agreement provides that specific prohibitions can be suspended or reinstated as appropriate. An independent monitor was appointed to ensure that the parties comply with the terms of the Consent Agreement.

2. The Air Canada Matter (2001)

66. In March 2001, the Commissioner brought an application to the Tribunal against Air Canada, alleging that Air Canada had engaged in predatory conduct on a number of passenger airline service routes between certain areas in the maritime provinces of Canada and cities in Ontario and Quebec. The Commissioner alleged that, in respect of those routes, Air Canada had:

- Operated capacity at fares that did not cover the avoidable cost of providing the service;
- Increased capacity at fares that did not cover the avoidable cost of providing the service; and
- Engaged in a policy of "matching" fares offered by low cost carriers without regard for the effect of such fares on Air Canada's profitability, and without regard to the additional benefits associated with the service offered by Air Canada with the foreseeable effect of rendering the operations of the low cost carriers unprofitable.

[26] *Air Canada/United Continental*, *supra* note 10, , Consent Agreement, available online at http://www.ct-tc.gc.ca/CMFiles/CT-2012-001_Consent%20Agreement_2_45_10-24-2012_7871.pdf.

67. The Commissioner argued that Air Canada substantially controlled each of the relevant markets (defined as airline passenger service between the relevant areas), that there were high barriers to entry, and that Air Canada's conduct was likely to cause a substantial lessening and/or prevention of competition by forcing competitors to exit the affected routes and/or impede their expansion.

68. The application was to be considered in two phases, and the reasons and order for the first stage were released on July 22nd, 2003.[27] Among other things, the reasons and order considered the avoidable cost test, including the unit of analysis,[28] the appropriate timeframe, and what costs are properly considered avoidable. The results of this decision are reflected in the discussion in section 0.

69. Subsequent to Air Canada filing for bankruptcy protection in April of 2003, the application was discontinued on October 29th, 2004.

70. Following the Tribunal's decision in July, 2003, in October 2004 the Bureau released a statement clarifying its approach to future cases involving airline predation. The key points were as follows:

- Reviews of alleged abuses of dominance in the airline industry will be triggered only by significant responses by a dominant carrier to existing competition or to new entry, not by a carrier's usual seasonal or operational practices;

- The Bureau recognizes that there can be legitimate business reasons for an airline to operate a flight below its avoidable costs. As such, operating capacity below avoidable costs will not necessarily give rise to enforcement action in all circumstances; and

- As a general principle, the Bureau will not take enforcement action where a dominant carrier responds to competition by reducing its fares to match, but not undercut, the fares of a competitor. This signals a qualified tolerance of fare matching, which is a softening of the Bureau's previous position on this key issue. However, the Commissioner's letter also states that if such fare reductions are accompanied by a significant increase in capacity, or an increase in the number of seats available at the lowest price, the Bureau will consider whether enforcement action is appropriate.

3. Air Cargo Investigation (2006, Ongoing)

71. In 2006, the Bureau began an investigation into a conspiracy among international air cargo carriers in relation to international air cargo transportation on routes to and from Canada and elsewhere. The matter came to the Bureau's attention through the Immunity Program. The Immunity Program is one of the Bureau's most effective tools for detecting and investigating criminal anti-competitive activities prohibited by the *Act*. Under the Immunity Program, the first party to disclose to the Competition Bureau an offence not yet detected or to provide evidence leading to the filing of charges may receive immunity from prosecution from the Director of Public Prosecutions of Canada (DPP) as long as the party co-operates with the Bureau.

72. The Bureau's investigation into this matter also benefitted from cooperation of certain parties. Under the Bureau's Leniency Program, the Bureau may recommend to the DPP that cooperating parties who have breached the cartel provisions under the *Act*, who are not eligible for a grant of immunity, nevertheless be considered for lenient treatment in sentencing.

---

27 *Air Canada, supra* note 9.

28 *E.g.,* a flight vs. a rout.

73. The investigation revealed that various international air cargo carriers conspired, combined, agreed or arranged with other air carriers to lessen competition unduly in Canada in the sale and supply of international air cargo transportation services originating in Canada. To date, the Bureau's air cargo investigation has resulted in nine criminal convictions and fines of over $25 million. The carriers, which include Air France, KLM, Martinair, British Airways, Cargolux, Korean Air, Cathay Pacific, LATAM and Qantas, pleaded guilty in Canada to a violation of subsection 45(1)(c) of the Act. The convictions related to agreements between or among air carriers to fix the price of one or more surcharges, such as fuel or navigation surcharges, on international air cargo transportation on certain routes from Canada between at least April 2002 and February 2006. The Bureau's investigation into alleged price-fixing in the air cargo industry is ongoing.

APPENDIX B: RELEVANT PROVISIONS OF THE ACT

1. Mergers

74. On application by the Commissioner, section 92 of the Act allows the Tribunal to issue a remedial order in respect of a merger or proposed merger which prevents or lessens, or is likely to prevent or lessen, competition substantially. The Tribunal may not make this finding solely based on concentration or market share; instead it may consider a range of factors laid out in section 93 of the Act including acceptable product substitutes, barriers to entry, effective remaining competition, or any other factor which is relevant to competition in a market. If the Tribunal chooses to issue an order, the remedy may include dissolution of the merger, disposition of certain assets or shares, or an order that the merger, or part of it, not proceed. Section 105 of the Act allows the Commissioner and respondent(s) to come to a consent agreement, which will be registered with the Tribunal and be enforced in the same way as an order.

75. Section 96 of the Act provides an efficiency exception to the merger provisions. When a merger creates, maintains or enhances market power, subsection 96(1) creates a trade-off framework in which efficiency gains that are likely to be brought about by a merger are evaluated against the anti-competitive effects that are likely to result. The categories of efficiencies that are relevant to the trade-off analysis include allocative efficiencies, technical efficiencies and dynamic efficiencies. For the purposes of the trade-off analysis in litigated proceedings before the Tribunal, the Bureau must show the anti-competitive effects of a merger while the parties' burden includes proving that the gains in efficiency are likely to occur, are brought about by the merger or proposed merger, are greater than and offset the anti-competitive effects, and would not likely be attained if an order under section 92 were made.[29]

2. Abuse of Dominance

76. On application by the Commissioner, section 79 of the Act permits the Tribunal to issue a remedial order in respect of an abuse of a dominant market position. Under the Act, abuse of dominance occurs when: (i) a dominant firm or a dominant group of firms in a market; (ii) engages in a practice of anti-competitive acts; (iii) with the result that competition has been, is being, or is likely to be prevented or lessened substantially. Where the Bureau establishes each of these three elements, the Tribunal may issue an order: (i) prohibiting the practice of anti-competitive acts; (ii) directing the respondent(s) to take actions that are reasonable and necessary to overcome the anti-competitive effects of the practice, including the divestiture of assets or shares; and/or (iii) requiring the respondent(s) to pay an administrative monetary penalty of up to \$10 million on a first order, and up to \$15 million for each subsequent order.

77. Subsection 78(1) of the Act sets out a non-exhaustive list of nine types of conduct that are deemed to be "anti-competitive acts" for purposes of section 79, including predatory pricing. Because the list is non-exhaustive, other practices aimed at excluding or disciplining competitors, such as the pre-emption of essential facilities, could be examined under section 79.

---

[29] Further information on the Bureau's approach to the evaluation of efficiencies can be found in Part 12 of the Merger Enforcement Guidelines, *supra* note 13.

3. Competitor Collaborations

78. Section 90.1 of the Act allows the Tribunal, upon application by the Commissioner, to issue an order regarding agreements or arrangements between competitors that prevent or lessen, or are likely to prevent or lessen, competition substantially. The Tribunal may prohibit any person from doing anything under the agreement or arrangement, or require any person with their consent and the consent of the Commissioner to take any other action.

79. Section 90.1(4) provides an efficiency exception, which bars the Tribunal from making an order if it finds that the agreement or arrangement has brought about, or is likely to bring about, gains in efficiency that are greater than and offset the substantial lessening or prevention of competition. These gains must also be subject to the order not being made.

4. Conspiracy

80. Section 45 is the cornerstone cartel provision of the Act. It makes it a criminal offence when two or more competitors or potential competitors conspire, agree or arrange to fix prices, allocate customers or markets, or restrict output of a product. This offence is punishable by a fine of up to $25 million, or imprisonment for a term of up to 14 years, or both.

81. The Bureau recognizes that some desirable business transactions require explicit restraints on competition to make them efficient or even possible. As a result, the Act provides an "ancillary restraints defence" to ensure that strategic alliances or other types of legitimate collaborations between competitors are not treated as criminal offences.

82. To qualify for this defence:

- the agreement must be "ancillary" to a broader or separate agreement that includes the same parties;
- the agreement must be directly related to and reasonably necessary for giving effect to the objective of the broader or separate agreement; and
- the broader agreement must itself be legal.

83. When the ancillary restraints defence applies, the Commissioner can still challenge the agreement before the Tribunal as a civil matter, if there are substantial anti-competitive concerns.