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COMPETITION POLICY AND CANADIAN PASSENGER TRANSPORTATION

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I. INTRODUCTION

This report examines the effectiveness of the *Competition Act* as an instrument to protect the interests of consumers of commercial air, rail and bus passenger transportation services relative to:

(1) existing direct regulatory controls established by the *National Transportation Act, 1987* (NTA), the *Railway Act* (RA) and the *Motor Vehicle Transport Act, 1987* (MVTA); and

(2) generally, the more interventionist approaches of public utility regulation of prices, profits and products where prior approvals of a government body for some or all of these business activities are required by legislation. State ownership of privately owned commercial passenger transportation services is not examined directly as an alternative regulatory mechanism.

This is a study of the choice of governing instrument where the focus is government intervention to restrict private business choice in situations where unconstrained business choice would not be in the public interest.

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Given that the public interest is multi-faceted and mercurial in a pluralistic democracy, this evaluation must look both at statements of purpose in enabling legislation and the ongoing application of the legislation's standards.

Accordingly this report examines the interrelationship between:

(1) the substantive commercial conduct standards and remedies of the *Competition Act* and other more direct regulatory mechanisms with respect to the passenger transportation sector; and

(2) the institutional and administrative structures for applying these substantive standards and remedies.

The particular aspect of the public interest selected as the focus for evaluation in this study is the "consumer interest." There is, unfortunately, no single pervasively accepted set of standards defining what business conduct is in the consumer interest and what business conduct is not. "Consumer interest" has become a political term to a large extent. The definition of consumer interest selected for this study must therefore be somewhat arbitrary and it certainly will not please everyone.

This study assumes that the consumer interest comprehends maximizing product choice and innovation and minimizing opportunities for businesses to be less than fully efficient in the supply of their products.

In this context, achieving fair prices through internal cross subsidization is regarded only as a means to achieve maximum consumer choice and business efficiency and not as an end in itself.

Inclusion of social goals or income distribution, policy-pricing objectives as a necessary and important aspect of the consumer interest would, therefore, result in considerably different analysis and results. As discussed below, in parts II, III and IV, fair or politically motivated pricing is not an objective of the *Competition Act*. However, existing passenger service regulation creates both the incentive and the opportunity to establish prices based predominantly on fairness and social policy either directly or through controlling exit and entry.

It should, however, be noted that unregulated markets are rife with prices that are established not just to cover marginal costs. There are other pricing considerations related to sales maximization, stimulating demand for a firm's complementary or related products, administrative convenience, and maintenance of good customer relations. From the economist's strict marginal cost pricing perspective, all these can contribute to unregulated supplier price structures which display stability and geographical uniformity and which entail an element of internal cross subsidization.

Private markets regulated only by the *Competition Act* can and do deliver price structures that are fair, stable and, to some degree, geographically uniform in consumers' eyes. Such markets do not, however, deliver price structures that involve substantial redistributions of wealth geographically between particular income groups.

To summarize, this report examines alternative regulatory instruments in relation to their capacity to facilitate maximum consumer choice and business efficiency in the supply of commercial passenger transportation services. It does not look at their capacity to function as taxation and subsidization instruments.

II. COMPETITION ACT

A. OVERVIEW

The *Competition Act* is general legislation of general application founded principally upon the federal trade and commerce power. Criminal prohibitions in the Act against agreements to lessen competition (the original focus of Canadian competition law) have also been supported by the federal criminal law power.

The legislation is enforced by the Director of Investigation and Research (DIR), a Governor in Council appointee responsible to the Minister of Consumer and Corporate Affairs. In practice, the DIR's office, known as the Bureau of Competition Policy (Bureau), operates with a measure of independence from political control similar to a combination of a provincial police force and Crown Attorney's office. The DIR is responsible for the conduct of all formal inquiries into possible criminal offences and practices reviewable

by the Competition Tribunal and for making applications for remedial orders to the Competition Tribunal. Criminal matters are generally referred to the Attorney General for Canada for the laying of charges and prosecution, but the Attorney General's Agent generally consults closely with the DIR on these matters. The DIR reports annually to Parliament through the Minister.

The legislation has been broadened, refined and clarified a number of times over its 100-year history, with the most recent and comprehensive revision in 1986. The 1986 revisions:

(1) clarified the conspiracy prohibitions in relation to the case law and expanded opportunities for lawful export agreements;

(2) established the Competition Tribunal (to replace the Restrictive Trade Practices Commission (RTPC)) as an expert quasi-judicial body comprising Federal Court judges and business and economics experts to adjudicate reviewable practices. (The Competition Tribunal is purely an adjudicative body and, unlike the RTPC, does not have the capacity to support DIR inquiries or conduct fact-finding inquiries into monopolistic practices);

(3) revised the Act's investigative powers to comply with the *Canadian Charter of Rights and Freedoms*;

(4) substituted new reviewable practices respecting mergers and abuse of dominant position for ineffective criminal law prohibitions against mergers and monopolies;

(5) introduced new reviewable practices respecting systematic delivered pricing and specialization agreements;

(6) established a new purposes section to guide administration of the Act by both the DIR and the Competition Tribunal; and

(7) established a new requirement to notify the DIR of mergers above a certain threshold to assist in enforcement of the merger provisions.

As noted, the substantive standards of the *Competition Act* comprise both criminal law prohibitions administered by the provincial superior courts, and reviewable practices over which the Competition Tribunal has sole jurisdiction to issue remedial Orders.

The principal criminal prohibitions, that is, offences in relation to competition, relate to:

- agreements to lessen competition unduly in a market;
- bid-rigging;
- resale price maintenance;
- price discrimination among competing purchasers;
- predatory pricing; and
- misleading advertising.

Matters reviewable by the Competition Tribunal include:

- non-price vertical restraints (refusal to deal, consignment selling, tied selling, market restriction and exclusive dealing) engaged in by major participants;
- abuse of dominant position which substantially lessens competition in a market;
- systematic delivered pricing;
- specialization agreements; and
- mergers which substantially lessen competition in a market.

These categories are not entirely self-contained. It is possible to maintain an abuse of dominant position application using evidence of predatory pricing or non-price vertical restraints, and it is possible to support a merger application based upon increased prospects for post-merger cartelization or abuse of dominance.

The foundations of Canadian competition law, in my view, are the prevention of:

(1) inefficient monopolization or increased market concentration whether through acquisition or horizontal agreement; and

(2) exercising of market power to exclude competition in primary markets, in secondary markets or in new markets, whether through pricing or contractual practices.

These are also the basic objectives of competition law throughout the world.

Maximizing competition is viewed as a necessary and a generally sufficient condition to maximizing consumer welfare in the classical economics literature.

Notwithstanding the classical economics underpinnings of the *Competition Act*, the 1986 revisions established a more human and accessible face to the law through a new purposes provision (section 1.1):

> The purpose of this Act is to maintain and encourage competition in Canada in order to promote the efficiency and adaptability of the Canadian economy, in order to expand opportunities for Canadian participation in world markets while at the same time recognizing the role of foreign competition in Canada, in order to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the Canadian economy and in order to provide consumers with competitive prices and product choices.

Under the regulatory intervention model of competition law, markets are presumed to be functioning properly unless certain standards are breached. In such cases, the State is considered to be entitled to intervene to remedy a defined problem. The remedy can be justified in lasting only long enough to eliminate the problem and to restore adequate competition in the market. The remedy is imposed by the courts or an adjudicative body; it is not legislated.

As a result, the application of competition law remedies occurs in a strongly contested adjudicative environment where the person(s) against whom the remedy is sought have extensive rights to challenge the government position. In the event a remedy is authorized, they may return at their own instance to the adjudicative environment to seek modification or elimination of the remedy if it can be shown to be no longer effective or even counter-productive.

Debate on the relative merits of competition law and more interventionist direct regulatory instruments, therefore, turns not so much on the structural coverage and efficiency of competing instruments to remove consumer harms once the State acts, but on competing political or even ideological visions on the appropriate relationship of the State and private business.

Competition law, with its built-in presumptions that the onus is on the State to prove that focussed intervention is justified in the eyes of an impartial adjudicator on a case-by-case basis, strikes a political or ideological chord with those who contend that government intervention in business decision-making is inherently counter-productive and that social goals should be achieved through taxation, subsidization and the State supply of pure public goods, that is, products which society demands but which private markets fail to supply. Competition law also finds favour with those who believe that general legal standards can and will be followed by business without direct and specific State instruction, and that there is a tangible general deterrent effect of obtaining litigated remedies against participants in the economy.

Direct regulation, on the other hand, is supported by those who consider that private enterprise, because of pervasive market imperfections including imperfect information, imperfect price signals and a myriad of supply rigidities, can and should generally benefit from State guidance or even control of business management. Direct intervention is also favoured by those who consider that it is not feasible to construct general economic conduct laws that provide useful standards for action by particular businesses.

This political or ideological cleavage becomes particularly pronounced in an examination of the role of the State in relation to the supply of products which are important to all consumers: food, housing, transportation, communications and energy. The ideological gap is even more evident when the inputs required to produce these products include a high proportion of priced or unpriced products supplied by the State, that is, public goods.

This report, however, does not attempt to address or reconcile these political or ideological differences in examining the relative effectiveness of the *Competition Act*. Rather, the analysis flows from the author's perspective that competing governing instruments should be evaluated solely upon their *a priori*, or demonstrated, capacity to achieve certain objective performance standards.

B. SCOPE OF COVERAGE

The *Competition Act* is a general law of general application. The key terms of the Act (product, business, supply, trade, industry profession) are defined with maximum breadth and flexibility. However, its application to economic conduct in Canada is not universal. Statutory and common law rules limit its application.

With respect to passenger transportation services, the key limitations relate to both government and regulated private sector conduct.

1. Statutory Exemptions

Given the constitutional underpinnings of the *Competition Act*, it is generally accepted that only validly enacted federal legislation may expressly exempt an activity from the operation of the *Competition Act*. The instances in which Parliament has elected to limit the scope of the *Competition Act* are few and far between.

Agreements among shipping conference members are exempted from the conspiracy prohibition of the *Competition Act* if certain conditions are met by operation of the *Shipping Conferences Exemption Act, 1987*. The *Competition Act* itself contains certain limited exemptions relating to activities that need not be considered for the purpose of this report. The *Farm Product Marketing Agencies Act* also contains an express exemption with respect to the conspiracy prohibition.

2. Common Law Exemptions

(a) Crown Agency

It is a general rule of statutory interpretation applied by the courts that an enactment is not binding on the Crown or its agents unless the enactment expressly says that it is. Crown agency status may be expressly granted by valid legislation of the federal government or a province, or it may be a constructive agency arising from the facts — the actual relationship between a person and the Crown.

This principle has been applied by the courts to the *Combines Investigation Act* (the predecessor legislation to the *Competition Act*) with respect to

prosecutions under the Act's criminal conspiracy provisions (*R. v. Eldorado Nuclear Ltd.*, [1983] 2 S.C.R. 551, 4 D.L.R. (4th) 193). It is also established that this principle applies equally to federal legislation of a non-criminal and regulatory nature founded upon the federal trade and commerce or interprovincial undertakings power, for example, *Alberta Government Telephone v. CRTC* (1989), 61 D.L.R. (4th) 193 (SCC).

The *Competition Act* expressly applies to Crown Agents that are corporations *but only* to the limited extent set out in section 2.1 of the Act:

> This Act is binding on and applies to an agent of Her Majesty in right of Canada or a province that is a corporation, in respect of commercial activities engaged in by the corporation in competition, whether actual or potential, with other persons to the extent that it would apply if the agent were not an agent of Her Majesty.

Therefore the *Competition Act* does not apply to, and would not be a substitute for, valid regulatory legislation affecting:

(i) the federal and provincial Crowns themselves acting other than through a corporation; and

(ii) federal or provincial Crown corporations which are either not engaged in commercial activities or are not engaged in activities which are in actual or potential competition with other persons in Canada.

Stated another way, without new federal legislation expressly making the *Competition Act* applicable, the *Competition Act* currently does not apply to:

(i) commercial activities conducted by federal or provincial government departments;

(ii) activities of Crown corporations that are not regarded by the courts or the Competition Tribunal (depending upon the activity in question) as being "commercial activities." (There is no definition of commercial activity in the *Competition Act*, and the Bureau of Competition Policy has provided no administrative guidance to date with respect to its interpretation of this term); and

(iii) commercial activities of a Crown corporation which are not engaged in competition with others. (Again, there is no statutory or judicial

amplification of what constitutes a non-competitive commercial activity, but presumably this might include the monopoly supply of products in a given market. From the wording of section 2.1, it is possible to argue that only actual and not potential competition is relevant.)

These restrictions clearly have implications for the effectiveness of the *Competition Act* where governments consider the privatization, devolution, contracting out or pricing of elements of the transportation system which have heretofore been supplied by government departments as pure or priced public goods. Such elements include airport landing slot or runway access, road access or use, provision of navigational services and the provision of regulatory inspection services. Accordingly, we will examine the concept of Crown agency more fully in Part V of this report.

(b) Regulated Conduct

It is a well-established principle that business conduct that is required or authorized by validly enacted federal or provincial legislation is not subject to the *Competition Act* (unless the legislation also expressly makes the *Competition Act* applicable). There is some debate as to whether this doctrine is, in effect, a constitutional doctrine based upon paramountcy considerations rendering application of the *Competition Act* invalid in principle; or whether it amounts instead to a regulated conduct defence whereby no sanction or remedy will be issued if the accused (or the respondent as the case may be) demonstrates as a matter of fact that an element the federal government must prove cannot in the circumstances be proven because the accused relied upon prior government requirements or approvals.

This is by no means a purely academic legal distinction. If the regulated conduct doctrine is quasi-constitutional, then both the inquiry and remedial powers of the *Competition Act* do not apply to a particular industry or activity, and efforts to amend the Act to expand its scope, and thereby to trench upon provincial or federal activities from the trade and commerce power base of the legislation, would be ineffective. Equally the provinces could essentially enact *any* regulatory legislation that would otherwise be valid under provincial heads of power to ensure that the *Competition Act* could not apply to the subject activity. Probably such provincial action could extend only to intra-provincial activities. The leading case in support of this constitutional perspective is *A.-G. Canada v. LSBC*, [1982] 2 S.C.R. 307, 137 D.L.R. (3d) 1.

If there is only a regulated conduct defence, then the inquiry powers of the Act would still be valid and the courts or the Competition Tribunal, as the case may be, would have greater scope, first, to ascertain whether the regulatory scheme was effective in requiring the impugned behaviour, and, secondly, where the behaviour was merely authorized, to weigh the relative merits of allowing or not allowing the defence in relation to the goals of the competing legislation. The leading case favouring this approach is *R. v. Canadian Breweries Ltd.* (1960), 126 C.C.C. 133, [1960] O.R. 601, 33 C.R. 1 (H.C.J).

In this context both the LSBC and the Canadian Breweries cases determined the applicability of criminal prohibitions of the former *Combines Investigation Act*. There have been no successful constitutional challenges to date regarding the reviewable practices provisions of the *Competition Act* which are exclusively founded upon the federal trade and commerce power. As well, recently, the Supreme Court has been more open-minded in determining the scope of the trade and commerce power. In *A.-G. Canada v. C.N. Transportation Ltd.*, [1983] 2 S.C.R. 206, 3 D.L.R. (4th) 16, the Court upheld the validity of the non-price vertical restriction practices of the Act and ruled that they were not an excessive invasion of the provincial property and civil rights domain.

Nevertheless, the regulated conduct doctrine is the basis for defining the applicability of the *Competition Act* in relation to the regulation of commercial passenger service entry, exit, merger and price. In my view, the current state of the law in relation to this boundary is as follows:

(i) It is now uncertain whether licensing requirements for *entry or exit or ownership* based on economic (that is, public interest, or public convenience and necessity) considerations as opposed to commercial fitness criteria (that is, fit, willing and able) could by themselves make the merger or abuse of dominant position provisions of the Act inapplicable to the subject industry. However, licensing and merger approval involving detailed conditions or performance requirements which clearly constrain business behaviour would very likely make the merger and abuse of dominance provisions inapplicable at least with respect to a case based upon a lessening of competition in the activities caught by the conditions or performance requirements.

(ii) *Price approval requirements or a power of price disallowance* coupled with statutory pricing standards in regulatory legislation would make the predatory pricing and price discrimination provisions of the *Competition Act* inapplicable to unilateral pricing activities of regulated companies. However, low pricing, even if sanctioned by a regulator, could still constitute anti-competitive practice for the purpose of establishing abuse of dominant position.

(iii) The *conspiracy prohibitions* of the Act may be inapplicable only where the impugned agreement or arrangement is specifically required or authorized as part of an otherwise valid regulatory scheme, or the agreement or arrangement is necessary to the achievement of valid regulatory purposes.

(iv) For substantive provisions of the Act apart from conspiracy, abuse of dominant position, predatory pricing and merger, there is no regulated conduct defence or exemption for regulated industries.

C. ENFORCEMENT POWERS AND PRACTICES

Inquiries by the DIR may be either informal or formal, with the boundary line being somewhat unclear.

An informal inquiry technically becomes a formal inquiry where:

(1) the DIR has received a six-resident complaint in proper form as required by section 9 of the Act;

(2) the DIR has reason to believe that grounds for a remedial order exist or an offence under the Act has been or is about to be committed; or

(3) a formal inquiry is directed by the Minister.

The Act requires all formal inquiries to be private and, in practice, all informal inquiries are conducted also in private.

Most inquiries (with the possible exception of merger inquiries) are based upon complaints from competitors, suppliers or purchasers. Because of the Act's privacy requirement, complainants are not kept abreast of the inquiry they have initiated and may not be involved (except with the consent of the subject of the inquiry) in negotiations directed at an out-of-court settlement.

The Act provides special, superior court-supervised information-gathering powers to support formal inquiries which are subject to judicial supervision. These include powers to search and seize and to require oral examination, production and written returns.

The inquiry process is generally time consuming. There are no statutory deadlines that must be observed. Some major conspiracy inquiries have taken several years before charges were laid. The inquiry stages of the three predatory pricing cases that have gone to trial under the criminal provisions of the Act took many months, nor was interim prohibition sought to stop the alleged predatory conduct, as is provided for in the Act. Recently, reviewable practices inquiries have taken several months to a year before applications were filed with the Competition Tribunal.

Merger inquiries are, however, fast-tracked to ensure that the parties know whether the DIR intends to challenge the merger before its implementation.

The adjudicative process has also proven to be fairly time consuming. The determination of criminal charges (apart from those arising from misleading advertising and resale price maintenance) has often taken from one to several years. This is the case in part because of the criminal law requirement for a preliminary inquiry and a high incidence of procedural and Charter challenges raised by those accused. Recent Competition Tribunal proceedings have ranged from 12 to 18 months from application to decision.

Because of the costs and uncertainties of the inquiry and adjudicative process, the DIR in particular, but also the parties to the inquiry, have strong incentives to reach out-of-court settlements. Settled court-approved prohibition orders with respect to criminal conspiracy inquiries and informal merger undertakings have been increasingly prevalent in the last five years. Less frequently, the DIR has sought Competition Tribunal approval of a merger agreement (*DIR v. Palm Dairies Ltd.* (1986), 12 C.P.R. (3d) 540 (Comp. Trib.) and *DIR v. Imperial Oil Ltd.* (unreported Comp. Trib. decision, February 6, 1990), CT-89/3). One disputed merger, *DIR v. Air Canada* (1989), 27 C.P.R. (3d) 476 (Comp. Trib), resulted in a consent agreement following the application to the Tribunal but before trial.

Complainants have limited opportunity to participate in trials under the Act. In criminal matters complainants may only participate as witnesses, usually for the Crown. In reviewable matters, the Competition Tribunal has the

discretion to allow third-party interventions (*American Airlines v. Canada (Comp. Trib.)*, [1989] 2 F.C. 88, 23 C.P.R. (3d) 178, 54 D.L.R. (4th) 741 (C.A.), affd [1989] 1 S.C.R. 236) but has been fairly tough in attaching conditions to intervener participation. These conditions include having to ask the DIR to call certain evidence before being allowed to do so, and avoidance of repetitive cross-examination. On the other hand, intervener participation in hearings to approve the Imperial/Texaco merger conditions and the Reservec merger case was thorough and extensive. These competitor interventions had considerable impact on the outcome.

The most severe criticisms of the *Competition Act* are directed, not surprisingly, at the inquiry and adjudicative processes of the regime, and not at the Act's substantive standards. They relate to the secretiveness of the inquiry process, the very long time from complaint to result, the low incidence of complaint-induced results, and the lack of complainant opportunity to participate in inquiries or in adjudication.

In short, justice is not seen to be done, and justice delayed is justice denied (especially when the acts in question have affected the market before the DIR appears to do anything). Criticism is also focussed on the inadequacy of the government-led anti-trust machinery because, unlike the U.S., there is no tradition (and little apparent opportunity or incentive) for private anti-trust enforcement. In the U.S., private anti-trust suits by far outweigh government suits — a reflection to some degree of the availability of treble damages and contingency fees.

However, within a broad range, it is possible to reform the inquiry and adjudicative process without undermining or affecting the substance of the law. It might also be possible to restructure a large part of the criminal law substance of the Act as civilly reviewable practices given the clear overall current foundation of the law on the trade and commerce power.

III. *Competition Act* — Principal Jurisprudence

A. INTRODUCTION

In light of the inquiry and adjudicative process, it should not be surprising that there is a very low volume of case law relating to the key provisions

concerning monopolistic and cartel behaviour. There is also a dearth of case law relating specifically to the transportation sector.

This section examines the core provisions of the Act that interface with direct regulatory schemes. They are:

- predatory pricing;
- conspiracy;
- merger; and
- abuse of dominant position.

The analysis covers recent judicial and Competition Tribunal decisions. In the case of merger and predatory pricing, recently published proposed, DIR enforcement guidelines are discussed in detail. With respect to conspiracy, the focus is more on the substance of recent prohibition orders agreed to in lieu of trial. Two important recent prohibition orders relate to the used household goods transportation industry, and the for-hire general trucking industry in Western Canada.

The published DIR analysis of the clearance of the CAIL/Wardair merger sheds some light on merger review. It should be noted that the National Transportation Agency and the Competition Tribunal have concurrent jurisdiction over airline mergers.

In addition, the Reservec/Gemini merger proceeding addresses, through a transportation service, the application of competition law to the consequences of mergers establishing control over the supply of essential or "bottleneck" inputs consumed by them and their competitors.

On the other hand, there are no reported Canadian competition law decisions or settled cases relating specifically to the passenger transportation sector where the DIR has actually challenged industry conduct using the enforcement machinery of the Act. The DIR has, of course, been a strong proponent of economic deregulation of this sector (with some particular success in air transport policy) and has also advocated privatization and pricing of quasi-public goods as necessary steps to establish self-sustaining and efficient markets in the supply of these services.

B. PREDATORY PRICING AND PRICE DISCRIMINATION (PARAGRAPH 50(1)(C) OF THE *COMPETITION ACT*)

1. Introduction

Section 50 of the *Competition Act* establishes three separate but related criminal offences addressing unilateral pricing behaviour.

The Act's *predatory pricing* standard provides:

> Everyone engaged in a business who . . .
>
> (c) engages in a policy of selling products at prices unreasonably low, having the effect or tendency of substantially lessening competition or eliminating a competitor, or designed to have that effect,
>
> is guilty of an indictable offence and liable to imprisonment for a term not exceeding two years.

Section 50 also contains prohibitions against *price discrimination* in sales of "articles" to competing purchasers, and against *geographic price discrimination* which substantially lessens competition.

Although the price discrimination offence is restricted to sales or articles, article is defined in the Act to include tickets or like evidence of a right to transportation. The price discrimination offence therefore, in my view, applies to sales of transportation services. However, as noted, the discriminatory sales must be to competing purchasers. This requirement has been interpreted consistently by the Bureau of Competition Policy to mean purchasers which compete with each other in the product they produce, or purchasers which are major purchasers of an article in limited supply.

Neither test for competing purchasers would appear to apply realistically to the sale of passenger transportation services with the exception of sales or services to brokers, wholesalers or retail resellers (for example, tour operators, travel agents) who compete in the same product or geographic market.

Accordingly, this report does not focus on the price discrimination prohibition except to note that it has limited applicability to the passenger service intermediary sector. It should not, in its present form, be regarded as a

means of preventing price discrimination at the retail level of the direct sale of commercial passenger services.

In addition, section 50 as presently drafted does not apply to price discrimination in sales of transportation services to discrete geographic monopolies.

Nor, and this is the principal limitation of the section, does this prohibition apply to the sale of services which are inputs to, or products of, commercial passenger transportation service suppliers. For example, the price discrimination prohibition would not apply to the pricing of computerized reservation services or travel services such as car rentals or hotels packaged with commercial passenger transportation services.

The geographic price discrimination offence has not been applied on a stand-alone basis. Complaints of geographical price discrimination are examined by the DIR in the context of either predatory pricing or abuse of dominant position.

It is too early to tell whether the predatory pricing offence will stay separate for enforcement purposes, as it is possible to structure a predatory pricing case involving a dominant firm (the only kind of firm that economic theory suggests would have the incentive and ability to predate successfully) as an abuse of dominance case. This would mean that the criminal standard of proof would be avoided, and the hearing would be before an expert tribunal.

The history of predatory pricing charges (three trials, two not guilty findings, one conviction where the price was zero,[1] and an apparent incapacity of the courts to focus individually on the elements of the offence, thus providing no useful guidance to the Bureau or to producers) would suggest that the Bureau may well prefer to pursue predatory pricing issues before the Competition Tribunal in the future.

The history of predatory pricing charges and inquiries over the last 20 years also suggests that Canadian competition law authorities have been affected by the strong criticism levelled by senior U.S. economists against the presumption of the offence that firms (even dominant ones) have an incentive and an ability to increase long-term profits through predatory pricing, regardless of what production cost-based price floor for the determination

of "unreasonably low prices" may exist. As this critique goes, predatory pricing might result in a long-term loss of consumer welfare only where the industry is subject to significant long-term barriers to entry.

This uncertainty has, in my view, been reflected in the draft Predatory Pricing Bulletin discussed below.

The following discussion of the Bureau's proposed predatory pricing enforcement policy can also be applied to Bureau enforcement of the abuse of dominant position provision where the focus is the unilateral pricing behaviour of the dominant firm.

In addition, and perhaps more important, those same criteria that are presented in the draft Predatory Pricing Bulletin to determine whether structural market conditions exist to exercise short-run market power could be used by the Bureau to assess the related issues of market dominance and substantial lessening of competition under the abuse of dominant position provisions.

2. Draft Predatory Pricing Bulletin

In April 1990, the Bureau circulated for public comment a draft Bulletin laying out its enforcement policy with respect to the predatory pricing offence of the *Competition Act*.[2]

The Bulletin notes at the outset that there is very limited jurisprudence on the interpretation of this provision and that, in the past, the Bureau has provided little public guidance on its enforcement policy regarding predatory pricing.

The Bulletin restyles the predatory pricing offence somewhat by defining it as the sale of products at prices so low as to cause injury to competition through the elimination of a competitor or the deterrence of entry or expansion of a competitor. Injury to competition is defined as a situation where the alleged predator is regarded as having a reasonable expectation of recouping any of the profits foregone by its low pricing conduct. Accordingly, the Bulletin notes that instances of true predatory pricing are usually rare and would be limited to markets with specific structural characteristics that allow the alleged predator to increase prices without fear of encouraging effective competitive entry in response.

The Bulletin proposes a *two-stage screening exercise* to determine whether these requisite structural characteristics are present. Because of the emphasis on market structure, elimination of a competitor or evidence of intent to do so generally would not be sufficient on their own to cause the DIR to exercise enforcement.

The *first stage* of the screening process is an *assessment of the degree of short-run market power possessed by the alleged predator.* This includes an examination of whether the entry and exit conditions in the relevant market might permit that firm to recoup losses caused by predatory pricing. The Bulletin makes it clear that, if such market conditions do not exist (that is, the alleged predatory firm is presumably only harming itself and not the alleged victim of predation in the market), the matter will not be pursued.

The second stage of the screening process examines *the pricing policy of the alleged predator in relation to cost information* and would come into play only if the Stage I market conditions have been satisfied.

The first task in Stage I is to define, through objective measures, the market power of the alleged predator. As a preliminary step, the relevant product market would be defined by examining both current and potential substitutes for the product whose prices are being examined. The geographic market would be established by an examination of consumer options for relocating their purchases in the event of significant price increase. For a predatory pricing inquiry to proceed, the alleged predator must have sufficient short-run market power to restrict output and raise prices through unilateral conduct.

The principal measures proposed by the Bureau for examining market power are the market share of the alleged predator; the measures of concentration in the relevant industry; the overall number and distribution of firms serving the relevant market; and the volatility of market shares of these firms. As a rule of thumb, the Bureau has proposed that the alleged predator must have at least a 35 percent share of the relevant market and be at least twice as large as its next largest competitor.

The Bureau has indicated that it would be unlikely to pursue any action against unilateral pricing conduct of a firm falling below these two thresholds. On the other hand, if a firm meets these criteria, the Bureau would still consider

other factors before determining whether to pursue the matter. As indicated by the Bulletin, such factors include the history and practices of the alleged predator, its overall size and financial strength, and any special advantages resulting from government intervention in the marketplace. Consideration would be given to whether the alleged predator is an incumbent firm or a new entrant.

In the Bureau's view, incumbent firms are more likely to engage in predatory pricing as they are more likely to have the incentive and ability to predate than do smaller entrants and may be in a better position to identify strategies to disadvantage their rivals.

This emphasis on relative market power as the initial screening device is consistent with the traditional notion that true anti-competitive low pricing will be practiced only by a significant incumbent firm to keep out vigorous new firms into its established market. In this initial stage, much will turn, therefore, on the definition of the relevant market. If the geographic and product markets are relatively narrowly defined in practice, this initial screening measure may persuade the Bureau to ignore low pricing behaviour by dominant or multi-product firms entering new markets with the objective of dominating those markets.

The second aspect of the first stage is an examination of conditions of entry and exit in the relevant market. The Bulletin notes that, for low pricing not to be a concern, the market must display the prospect of "effective entry," that is, not simply theoretical entry but whether "timely, sufficient" entry is likely. When both effective entry and exit are easy, the Bulletin contends, the initial low price behaviour of a firm's short-run market power will not be viewed as a threat to the competitive process. The following factors would be examined by the Bureau to determine whether the conditions for effective entry are present in that particular market.

(1) Speed of entry: This is regarded as the essential element for effective entry and the major focus of the Bureau's analysis. Speed of entry is defined to be the time required between identifying a business opportunity and selling in the relevant market. The Bulletin proposes that, as a general rule, a market is not exposed to effective entry if the minimum time required to enter exceeds 18 months. Accordingly, entry that would take several years

to accomplish would not deter or prevent "supra-competitive pricing" by a firm possessing market power once its low pricing policy achieved its short-term results of reducing competition.

(2) Sunk costs: These are investments the value of which could not be recovered in the event of business failure because they are either highly specialized or are not liquid. High sunk costs increase the financial risk of entry and reduce the expected short-run profitability upon entry.

(3) Economies of scale and scope: Economies of scale refer to the reduction of unit costs from increased volume of a firm's output. Economies of scope refer to reduction of unit costs through the production of products jointly rather than individually. The two concepts are, in practice, inseverable for large multi-product firms. The presence of these elements is considered essentially a supplementary factor shading the analysis in the favour of conclusion that barriers to entry exist if there is evidence of low speed of entry and/or high sunk costs.

However, it is hard to see why the Bureau would consider the presence of economies of scale and scope as evidence of predatory pricing behaviour. Predatory pricing laws have been criticized for discouraging pricing innovations which would make a firm more efficient through economies of scale and scope. Predatory pricing laws are not supposed to penalize efficient firms for undercutting the prices of inefficient firms, particularly where excess capacity exists or where efficiency increases with a firm's level of output.

In a technical sense, economies of scale and scope create a barrier to new entry. To become an efficient competitor, the new entrant must be capable of achieving the production volumes of the largest and hence the most efficient firm in the market. But, *if* in achieving its market foothold, the new entrant incurs higher unit costs than the established competitor, and the established competitor's output decreases while its unit costs increase, and *if* the Bureau's approach to predatory pricing inhibits incumbent pricing that may force out the less efficient new entrants, it is possible that industry efficiency and consumer welfare will end up in second place to the objective of increasing the number of visible competitors in the market.

Two examples are provided to explain why economies of scale and scope might count against an alleged predator. First, the Bulletin suggests that large-scale projects may require time-consuming plant construction that goes well beyond the period required by the predator to recoup any losses incurred from its predatory behaviour. However, if the new plant is more efficient than the predator's plant at a given level of output using average prices over the predation and post-predation time periods, the manner in which construction or start-up costs are accounted for should not matter. The more efficient plant should be built if it can produce at costs below that average price. If up-front accounting costs do matter, this arguably reflects more on imperfections in financial markets and accounting techniques than on possible market failure through predatory pricing.

The Bulletin also suggests that the entry may not be effective because of difficulties in overcoming brand loyalty. Arguably, brand loyalties have nothing to do with economies of scale and scope; rather, they represent imperfections of consumer information or simple consumer unpredictability or irrationality on the demand side of the market as opposed to the supply side (which side is more germane to determination of predatory pricing).

It is possible that the Bureau may reconsider the weight attached to economies of scale and scope in its Stage I analysis.

Finally, several other factors are mentioned as possible impediments to effective entry including institutional (patent, tariff or regulatory) barriers, established contractual arrangements of incumbent firms, and control over inputs by incumbent firms. The Bulletin also mentions that a firm with market power might signal to potential competitors that the market is unprofitable by pricing conduct, thus discouraging interest in the market.

In the event that this Stage I analysis reveals "a potential danger of effective predation," the Bureau would proceed to the second stage which involves an examination of price-cost relationships. The Bulletin emphasizes that no single price-cost test or criterion would be employed. In a restatement of the jurisprudence with respect to unreasonably low prices, the Bulletin suggests that whether certain prices are predatory depends on factors such as the duration of the period in which the low prices are maintained, whether they are adopted unilaterally or as a response to pricing policies of competing firms, and the underlying intent of the alleged predator.

Three general rules (again derived from the jurisprudence) are presented. First, a price at or above the average total cost incurred by the alleged predator is unlikely to be regarded as predatory. Secondly, a price below the average variable costs of the alleged predator is likely to be treated as predatory, unless there is clear justification. And thirdly, a price below the alleged predator's average total cost but not lower than its average variable cost (the "grey range") may or may not be treated as predatory depending on the circumstances.

These circumstances could include the intent of the pricing policy, the costs and financial weakness or strength of the target firm(s), the feasibility of re-entry of the market indicated by the Stage I analysis, the existence of excess capacity, and general demand conditions prevailing in the market.

In adopting this modified form of a variable cost threshold for anti-competitive prices, the Bureau has unfortunately provided only thin guidance to industry on how to determine variable costs. How the Bureau would determine these costs has also been left unclear since it would appear that the only way the Bureau could obtain useful evidence of the alleged predator's variable cost would be through the exercise of formal investigatory powers following the initiation of a formal predatory pricing inquiry under the *Competition Act* rather than in the course of a pre-inquiry screening analysis.

The Bulletin notes that variable costs include costs that may be varied with levels of output, including labour, material energy, promotional allowances and use-related plant depreciation.

With multi-product firms, of course, the exercise of identifying direct and indirect variable costs with particular product lines and output changes has proven to be a very difficult and often arbitrary exercise. No specific guidance is provided on the appropriate principles of common or joint cost allocation. The Bulletin offers no guidance with respect to the period of time over which the variability of particular input costs with levels are to be determined. Over a sufficiently longer period of time, of course, all costs are variable. Needless to say, no conventional cost-accounting framework provides a guarantee that all costs can readily be causally related to variation in a particular product line's output, even though all budgeted costs vary to a degree with the budgeted revenues of a firm.

The Bulletin does indirectly suggest that fixed costs include costs associated with investment in plant and machinery and fixed assets. On the other hand, the Bulletin suggests that "use-related plant depreciation " is a variable cost. It is hard to determine the Bureau's boundary line between fixed and variable costs. In practice this distinction can vary considerably according to the parameters of the cost analysis employed.

Moreover, many firms' physical facilities and machinery can be incremented easily within the 18-month period established by the Bulletin for assessing likely effectiveness of entry. Such plant investment may be traced to specific product lines or addition of volumes produced in existing product lines. Are these costs fixed or variable?

To cloud the picture further, the Bulletin suggests that its cost analysis would also be based on "reasonably anticipated rather than actual variable costs." The question arises then as to whether the Bureau, for whatever time frame it selects to analyze the predatory behaviour, might unilaterally impose adjustments to the existing or recorded cost structure of the alleged predator. These adjustments might be based on, for example, inflation and increased excess capacity caused by a loss of market share from successful entry by the alleged victim of the predator's pricing conduct or, alternatively, the Bureau might cost assets at their current replacement cost as opposed to their recorded historical and depreciated cost.

Finally, the Bureau suggests that its price-cost analysis need not be restricted to a static analysis. It may take into account the possible future cost structure of incumbent firms if additional plant capacity is built in response to entry by the alleged victim of predatory pricing. Consequently, the Bulletin suggests that the timing of plant increments in relation to new entry would be a relevant consideration. The application of hypothetical costs from yet to be built or newly on-stream capacity increments, particularly where production technology is changing, may further complicate the price-cost analysis. This, in turn, will further reduce the ability of business planners to anticipate the reaction of the Bureau to low pricing conduct should a matter reach Stage II of the Bureau's preliminary analysis.

The Bureau has also indicated that, in any event, it does not intend to be bound to the results of whatever cost test it applies. Where prices are below the average total cost but above the average variable cost (the most likely

outcome), the Bureau would take into account the surrounding circumstances. These could include the intent of the pricing policy, the costs and financial weaknesses or strengths of the target firm(s), the feasibility of re-entry to the market as revealed in the Stage I analysis and the existence of excess capacity and general demand conditions prevailing in the market.

To ensure that the potential for certainty is clouded, the Bulletin then concludes that the inferences drawn will depend directly upon the apparent purpose of the low pricing and its reasonableness in light of the facts. (p. 12)

Thus, having apparently rejected the subjective, or intention-driven, aspect of the offence in favour of an objective, structural- and cost-driven analysis at the outset of the Bulletin, the Bulletin reintroduces intention as a critical swing variable in determining whether to pursue cases in the grey range of the Stage II analysis.

C. CONSPIRACY

1. Introduction

The core of the *Competition Act* is the criminal prohibition against agreements or arrangements to lessen competition unduly. The Act states:

> 45.(1) Every one who conspires, combines, agrees or arranges with another person
>
> (a) to limit unduly the facilities for transporting, producing, manufacturing, supplying, storing or dealing in any product,
>
> (b) to prevent, limit or lessen, unduly, the manufacture or production of a product or to enhance unreasonably the price thereof,
>
> (c) to prevent or lessen, unduly, competition in the production, manufacture, purchase, barter, sale, storage, rental, transportation or supply of a product, or in the price of insurance on persons or property, or
>
> (d) to otherwise restrain or injure competition unduly,
>
> is guilty of an indictable offence and liable to imprisonment for a term not exceeding five years or to a fine not exceeding ten million dollars or to both.

Section 45(2) is intended to clarify the concept of undueness by not requiring that complete elimination of competition in the relevant market was the result of the agreement or the object of the parties:

> (2) For greater certainty, in establishing that a conspiracy, combination, agreement or arrangement is in contravention of subsection (1), it shall not be necessary to prove that the conspiracy, combination, agreement or arrangement, if carried into effect, would or would be likely to eliminate, completely or virtually, competition in the market to which it relates or that it was the object of any or all of the parties thereto to eliminate, completely or virtually, competition in that market.

Introduced with the 1986 revision, sections 45(2.1) and 45(2.2) are intended to prevent judicial interpretation of the offence as requiring proof of communication among the parties to prove the existence of an agreement, and requiring proof that the parties specifically intended that the agreement would lessen competition unduly:

> (2.1) In a prosecution under subsection (1), the court may infer the existence of a conspiracy, combination, agreement or arrangement from circumstantial evidence, with or without direct evidence of communication between or among the alleged parties thereto, but, for greater certainty, the conspiracy, combination, agreement or arrangement must be proved beyond a reasonable doubt.
>
> (2.2) For greater certainty, in establishing that a conspiracy, combination, agreement or arrangement is in contravention of subsection (1), it is necessary to prove that the parties thereto intended to and did enter into the conspiracy, combination, agreement or arrangement, but it is not necessary to prove that the parties intended that the conspiracy, combination, agreement or arrangement have an effect set out in subsection (1).

The offence does not apply to arrangements that relate only to the following, unless there is proof that the agreements actually lessen competition in respect to prices, quantity or quality of production, markets or customers, or channel or methods of distribution:

(a) the exchange of statistics;

(b) the defining of product standards;

(c) the exchange of credit information;

(d) the definition of terminology used in a trade, industry or profession;

(e) cooperation in research and development;

(f) the restriction of advertising or promotion, other than a discriminatory restriction directed against a member of the mass media;

(g) the sizes or shapes of the containers in which an article is packaged;

(h) the adoption of the metric system of weights and measures; or

(i) measures to protect the environment.

Export agreements are also exempted unless they result in a reduction in the real value of exports of a product; restricted entry or expansion in an export business; or undue restriction of competition in the supply of services facilitating Canadian exports.

In my view, the conspiracy prohibition applies now to regulated passenger transportation services to the same extent that it would apply if the applicable regulatory structures were removed. Note, however, that the application of the conspiracy provisions is limited in relation to the Crown and its agenda to the same extent as are all other provisions of the Act.

The conspiracy jurisprudence is extensive. Over the last decade, convictions or pre-conviction prohibition Orders (a substitute to a plea bargain specifically provided for by the Act) have generally been obtained when charges have been laid. The circumstances giving rise to charges generally have involved an actual or constructive agreement among all major suppliers in a market not to compete with respect to an important aspect of competition (price, product quality, product choice); or some disciplinary mechanism applied by wayward incumbents to innovative new entrants (for example, withdrawal or refusal of a group service needed to function as an effective competitor).

2. Prohibition Agreements

Important prohibition agreements with respect to the used household goods moving industry and the Western Canada for-hire trucking industry have effectively eliminated the use of tariff bureaux as a cartelizing mechanism

and have introduced price competition for the first time in these sectors. These prohibition agreements have been influential in re-orienting the Bureau's conspiracy law enforcement policy. Instead of seeking convictions and large fines, the Bureau is leaning towards obtaining assurances that affirmative steps would be taken more quickly by the accused to open up the market and, to a degree, offset some of the negative affects of the agreements.

The used household goods prohibition Order, entered into in December 1983, requires the winding up of the Canadian Household Goods Carriers' Tariff Bureau and prohibits several restrictive practices by van lines including:

- rate fixing;
- adoption of fighting brands (that is, lower priced products targeted on a competitor's customers);
- using cost studies to coordinate rates;
- standardizing or limiting products;
- coordinating van utilization or requiring that products be supplied to discipline competition;
- generally using a van line's market power as franchisor to discipline the competitive conduct of van line members or to coordinate competition among van line members.

Periodic compliance reports were required to be filed with the Bureau and the court.

The Western trucking prohibition Order was entered into in April 1988. The inquiry on which charges were based commenced in the 1960s. The accused trucking companies (18 in all) and the Western Transportation Association (WTA) were prohibited from agreeing with any other motor carrier to:

(a) fix or coordinate single line rates in the market;

(b) enforce adherence to single line rates in the market as published by the WTA or any other motor carrier tariff bureau or motor carrier industry association;

(c) develop, adopt or use any policy, plan or program to respond to any motor carrier operating in the market;

(d) attempt, directly or indirectly, by threat, promise or any like means, to influence upward or to discourage the reduction of, the price at which any other motor carrier supplies or offers to supply single line services in the market; or

(e) restrict or impede in any manner the entry of any motor carrier competitor or potential motor carrier competitor in the market.

The trucking companies were also prohibited from using the Western Transportation Association or any other industry association, to signal adoption of single line rates unless notice was given to the public by other means.

The WTA and its officers and employees were prohibited from:

(a) initiating tariff rate proposals, docketing their own tariff rate proposals or making any recommendations whether to adopt, reject or otherwise dispose of tariff rate proposals before the WTA applicable to the market;

(b) initiating or developing any collective response among the members of the WTA to rates proposed or changed by any motor carrier operating in the market.

However, the Order does not extend to agreements on interline rates.

Taken together, the prohibition Orders set out with some certainty the types of tariff-bureaux conduct and rate arrangements in the transportation sector that the Bureau will likely challenge.

3. Constitutionality

The effectiveness of the conspiracy prohibition has recently been seriously called into question by a September 1990 decision of the Nova Scotia Supreme Court which found the prohibition, as drafted, in violation of the *Canadian Charter of Rights and Freedoms* and of no force as a consequence.

The case arose from charges brought in Nova Scotia against 12 pharmaceutical firms. The charges alleged that the firms had illegally conspired between January 1974 and June 1986 to lessen competition in the sale

and provision of prescription drugs and dispensing services. The accused brought a motion to have section 45 ruled invalid as being contrary to sections 7, 11(a) and 11(d) of the *Canadian Charter of Rights and Freedoms.*

The first argument of the accused was that the *mens rea* (subjective intent) required to obtain a conviction violated section 7 (the right to life, liberty and security of the person deniable only in accordance with the principles of fundamental justice) and section 11(d) (presumption of innocence of an accused until proven guilty at a fair public hearing).

The Court found that the *actus reus* of the offence contained two elements:

(a) an agreement to which an accused was party; and

(b) the agreement, if implemented, would have the effect of limiting competition unduly.

The Court concluded that, in restricting proof of *mens rea* only to the first element, the provision violated sections 7 and 11(d) of the Charter.

The accused also contended that the undueness element of the offence was so vague as to deny their section 11(a) and (d) rights to a full answer and defence, and a fair trial. The Court agreed, stating:

> As indicated in Reference Re s.193, supra, the test, for determining whether or not a law is vague, as stated by Chief Justice Dickson and quoted earlier, is whether a person is capable of knowing, in advance, with a high degree of certainty, what conduct is prohibited and what is not. In my opinion, the virtual monopoly definition, of Mr. Justice Cartwright, provided some degree of certainty, but Parliament has eliminated that definition. The Crown says it is a question of degree, and that evidence of lessening competition was so extensive that it would be shown to be undue, but this does not answer the "knowing in advance" portion of the Reference Re s.193 test.

Having so found, it was easy for the Court to conclude that it would not be possible for the Crown to provide sufficient information in an indictment to ensure a fair and full trial.

The Court also addressed whether section 1 of the Charter could sustain these provisions, notwithstanding the violations of guaranteed rights. Section 1 states:

> The *Canadian Charter of Rights and Freedoms* guarantees the rights and freedoms set out in it subject only to such reasonable limits prescribed by law as can be demonstrably justified in a free and democratic society.

In reviewing the cases considering section 1, the Nova Scotia Court quoted, in particular, from a decision of Mr. Justice Graham of the Ontario Court of Appeal in *R. v. Seaboyer* (1987), 20 O.A.C. 345 (O.A.C.) where he stated:

> I think it would be a most unusual result that a law which offends s. 7 in that it deprives an accused person of making full answer and defence could ever be found "to be demonstrably justified in a free and democratic society."

In conclusion, the Court stated: "This is not one of the rare or exceptional cases such as a war or an epidemic where a s. 7 violation can be justified under section 1. Nor is the vagueness and uncertainty, contained in this section, a limitation prescribed by law."

Having come to these conclusions, the Nova Scotia Court then struck down the present sections 45(1)(c) and 46 as being contrary to the Charter. The Court also quashed the indictment in its entirety even though it dealt with events which took place before the passage of the Charter in 1982.

The Crown is appealing the decision. The Bureau has taken the position, as it normally does in such constitutional disputes, that the conspiracy law will continue to be applied in all other provinces until this case is determined. However, the Bureau's position may have to change if the Nova Scotia Court of Appeal upholds the decision or if a federal court in a different case reaches the same conclusion.

This decision again highlights the difficult constitutional underpinnings of federal competition law under the current constitutional structure and will certainly cause a reconsideration of structuring key elements of the law as criminal offences. It is worth noting that federal government proposals

for competition law reform dating from the mid-1970s favoured the shift of all criminal matters, including conspiracy, to a civil law context to be adjudicated by an expert tribunal.

The case will undoubtedly be resolved by the Supreme Court of Canada. This will probably take at least two years.

This decision was a shock to what was thought to be the firmest foundation of Canadian competition law and will likely test the commitment of the federal government to a federal competition law.

D. MERGERS

1. Brief History

The 1986 revisions to the *Competition Act* included a dramatic change to the general merger law, replacing a clearly ineffective criminal prohibition with a complex standard for merger review by the Competition Tribunal.

However, since the new merger regime took effect four years ago, only one contested merger (that of Reservec/Gemini) has reached the trial stage and two others have been the subject of yet-to-be adjudicated applications (Quebec meat renderers and British Columbia south mainland newspapers). A much larger number of mergers challenged by the Bureau have resulted in agreement between the merging parties and the DIR to restructure the merger to remove the aspect of the transaction that would have caused a substantial lessening of competition in the relevant markets. In consideration of this, the DIR did not make application to the Tribunal.

Typically, these agreements have involved the divestiture of certain assets or product lines to third parties to increase overall competition in the industry and to reduce market power in the most concentrated submarkets supplied by the merging parties.

To date, only horizontal mergers have been challenged. A general rule has developed over the first three years of enforcement. A merger would be challenged if it involved two of the three largest suppliers in a market and resulted in the merged company having a market share above 50 percent with no comparable competitive market share.

More frequently, the DIR has submitted a consent arrangement for Tribunal approval. In two cases, *DIR v. Palm Dairies Ltd.* (1986), 12 C.P.R. (3d) 540 (Comp. Trib) and *DIR v. Imperial Oil Ltd.* (unreported Comp. Trib. decision, February 6, 1990, CT-89-3), the Tribunal exercised its independence and rejected the original proposals on the basis that they did not sufficiently correct the lessening of competition caused by the merger.

Since the new merger law had generated very limited true jurisprudence, particularly with respect to what constitutes a substantial lessening of competition, in November 1990, the Bureau published proposed merger guidelines to increase the predictability of the law. These guidelines were finalized in March 1991. They are discussed briefly below. Rather than providing a general survey of all merger resolutions, the following section reviews the Director's approach to the PWA/Wardair merger and the resolution of the Reservec/Gemini CRS merger case.

2. Merger Law

The Act defines a merger broadly as the acquisition or establishment, direct or indirect, by one or more persons, whether by purchase or lease of shares or assets, by amalgamation or by combination or otherwise, of control over or of significant interest in the whole or part of a business of a competitor, supplier, customer or other person (section 91).

The Bureau considers a "significant interest" to be less than a controlling position but entailing the actual or potential ability to influence materially the firm's economic behaviour.

A reviewable merger is an actual or proposed merger which prevents or lessens, or is likely to prevent or lessen competition substantially in a market (section 92(1)).

The Tribunal may not make a finding of substantial lessening of competition solely on the basis of evidence of concentration or market share (section 92(2)).

The Act provides a non-exhaustive discretionary list of factors for assessing the impact on competition:

(a) the extent to which foreign products or foreign competitors provide or are likely to provide effective competition to the businesses of the parties to the merger or proposed merger;

(b) whether the business, or a part of the business, of a party to the merger or proposed merger has failed or is likely to fail;

(c) the extent to which acceptable substitutes for products supplied by the parties to the merger or proposed merger are or are likely to be available;

(d) any barriers to entry into a market, including:

(i) tariff and non-tariff barriers to international trade,

(ii) interprovincial barriers to trade, and

(iii) regulatory control over entry,

and any effect of the merger or proposed merger on such barriers;

(e) the extent to which effective competition remains or would remain in a market that is or would be affected by the merger or proposed merger;

(f) any likelihood that the merger or proposed merger will or would result in the removal of a vigorous and effective competitor;

(g) the nature and extent of change and innovation in a relevant market; and

(h) any other factor that is relevant to competition in a market that is or would be affected by the merger or proposed merger.

The Tribunal may not issue a remedial Order if it finds that the merger is likely to bring about efficiency gains that will be greater than, and offset, the effect of any lessening of competition and these efficiency gains would not likely be attained if the remedial Order were made (section 96).

Finally, certain joint ventures of limited duration that meet conditions set out in the Act are also exempted (section 95).

The merger guidelines emphasize that the primary focus in determining an effect on competition is the ability to exercise a greater degree of market power, with the price dimension of competition being the dominant concern. Relevant price increases may either be unilateral or the result of "interdependent behaviour." That is, the possibility that the merger might result in

collusion or even conscious parallelism would be taken into account. This concern over an enhanced ability to collude has been supported in both the Reservec/Gemini and Imperial Oil/Texaco cases.

The guidelines provide that a substantial effect on prices would be one that is materially greater over a substantial part of the effective market and that new or increased competition would not likely be eradicated within two years.

3. Market Definition

Definition of the relevant market is critical in merger assessment. The draft guidelines provide, after an extensive discussion, the following conceptual definition: . . . a relevant market is defined as the smallest group of products in the smallest geographic area in relation to which sellers could impose and maintain a significant and non-transitory price increase above the level that would likely exist in the absence of the merger. In most cases the Bureau considers a 5 percent increase to be significant, and a one year period to be non-transitory.[3]

This hypothesis will certainly be hard to apply. Consequently, the merger guidelines present a lengthy list of more subjective market definition criteria:

(a) the views and behaviour of buyers of the product;

(b) the views of other competitors in the same business;

(c) the functional substitutability of products in the market;

(d) the physical and technical characteristics of the product;

(e) the costs a buyer would incur in switching to a different product;

(f) price relationships or relative price levels between two products;

(g) cost of adapting or constructing facilities to sell the product; and

(h) whether there exists a second-hand, reconditioned or leased product market.

With respect to geographic market definition, the evaluation criteria set out in the guidelines are:

(a) the views of buyers in the marketplace;

(b) the switching costs of moving from one producer's product to another;

(c) transportation costs as an impediment to sourcing product outside a defined area;

(d) any local setup costs for a new entrant;

(e) inherent characteristics of the product which could be relevant, such as perishability;

(f) review of price movements in different geographic areas and any evidence of correlation;

(g) the shipment patterns of the product in the past; and

(h) foreign competition.

4. Statutory Evaluation Criteria

The guidelines also address each of the statutory factors listed above. The objective is to suggest thresholds below which it is unlikely a merger would ever be challenged. For example, with respect to the critical concepts of market share and concentration, it is proposed that the merger would not be challenged where the post-merger market share was less than 35 percent, or where the post-merger market share of the four largest firms in the market was less that 65 percent and the market share of the merged firm was less than 10 percent.

Of the remaining factors, barriers to entry, effective competition remaining and failing firm are the most important.

If entry were to take place on a sufficient scale to ensure that a price increase could not be sustained for more than two years, the merger would not be challenged.

Where the pre-merger level of effective competition would remain, the merger would not be challenged.

The guidelines present a detailed discussion of what constitutes a failing-firm situation. To accept this as a ground for not challenging the merger, the Bureau would require identification of the time within which the firm

might become insolvent, a reasonable search for a purchaser prepared to pay more than the firm's breakup value, and provision of detailed supporting financial information. The guidelines state that the Bureau needs about 60 days to determine whether a firm is indeed failing and may require a third party to find a buyer.

The guidelines also raise two new factors: market transparency and transaction value and frequency. With respect to market transparency, the guidelines state:

> . . . where a merger raises concerns that it may be likely to facilitate interdependent behaviour, the extent of transparency in the relevant market will ordinarily be assessed. Transparency in this context connotes information that is readily available in the market about competitors: prices; levels of service; innovation initiatives; product quality; product variety; level of advertising; etc.. In general, as the level of transparency in a market decreases, coordinated behaviour becomes increasingly difficult, because firms find it harder to detect and retaliate against secret discounts and other deviations from interdependent situations. (p. 42)

The guidelines also talk about schemes which increase transparency such as delivered pricing systems, product standardization, exchanges of information through trade associations, etc., public disclosure of information by buyers or government sources, and "meeting competition" contractual terms.

The second new factor — transaction value and frequency — is also related to mergers where independent behaviour may be a concern. It states:

> Interdependent behaviour often becomes increasingly difficult as the frequency and regularity of sales of the relevant product decrease, and as the value of each sale increases. (p. 43)

Although the guidelines do not state how important these two criteria are, they both relate to the interdependent behaviour or tacit collusion on which the DIR might challenge a merger.

5. Procedure

The guidelines indicate that the DIR should be able to make a preliminary determination within three weeks as to whether there is a serious question. If there is, the guidelines state:

> . . . a determination can be made of whether a merger prevents or lessens competition substantially within eight weeks after the parties have provided all requested information. This period of time is required in order to review this information, and to gather and review information provided by customer, suppliers, competitors, experts, others in the industry and government departments that have information pertaining to the market(s) in question. Where information is not provided upon request by merging parties or others, the Director may seek to exercise the formal powers provided under section 11, 15 or 16 of the Act. (p. 60)

The guidelines also indicate that where there is still a significant issue after this period, which presumably means that the DIR has concerns about the merger, the DIR can take up to a further four months to decide whether to refer the matter to the Tribunal.

6. PWA/Wardair Merger

The first merger clearance accompanied by a fairly detailed set of reasons related to the 1989 merger of PWA and Wardair.

After an investigation, the DIR announced on April 14, 1989 that he believed Wardair to be a failing firm and that, in those circumstances, the merger would be challenged only if a viable third party came forward and was willing to acquire Wardair. In the week that followed the Director's announcement, there were other expressions of interest in Wardair, including a possible joint offer between American Airlines, the large U.S. based carrier, and certain Canadian partners. Finally, however, no offer was forthcoming by any third party.

It is apparent from the background information provided by the DIR, that the acquisition raised serious concerns. The DIR viewed Wardair as a vigorous and effective competitor. The background information document states:

> Overall, in markets where it participated, Wardair was often the price leader, offering effective competition to the two established national carriers in all classes of service.[4]

The DIR also was concerned that the acquisition would threaten effective competition in the domestic airline service industry. The background document stated that most scheduled airline service in Canada would be provided by Air Canada and Canadian Airlines International Ltd. and that consumers would have little countervailing power to deal with such a "duopoly."

The DIR indicated there were other reasons to expect that the merger would lessen competition. In particular, he noted that the stock market reaction, which had led to higher stock prices for both Air Canada and PWA, was a sign that investors expected increased profits for the rivals of Wardair. Also, he cited statements by officials of Wardair and PWA that the merger would reduce capacity in the industry and restrict the availability of discounted seats.

The DIR was also concerned with barriers to entry to the domestic airline industry in the short to medium term. He indicated that:

> Recent economic analysis of the industry indicates that the industry reflects the presence of economies of scope which give scheduled carriers offering a range of fare types cost advantages over scheduled carriers offering one-fare, one-class service, and over chartered carriers that can offer only restricted fares with travel conditions on return dates and itinerary changes.[5]

The DIR referred to the preference of business travellers for an airline with an extensive network and frequent flights, the loyalty generated by frequent flyer programs, and the preference for good commuter connections made easier by the two largest carriers.

The DIR also cited the limited ability of Transport Canada to provide landing rights to new carriers at Pearson International Airport in Toronto. The DIR stated that:

> At Pearson International Airport, the most critical public resource at the moment is the take-off and landing times at peak hours. These are

> currently limited to 70 per hour. Accommodating new entrants at this juncture will be difficult. Nevertheless, Transport Canada has recently reaffirmed to the Bureau that every effort will be made to do so.[6]

As a final barrier to entry, the DIR mentioned the restrictions on foreign ownership which allow non-Canadians to hold a maximum 25 percent voting interest in a Canadian scheduled carrier. He also noted that cabotage rules prohibit foreign carriers from offering point-to-point scheduled service within Canada. The Canadian cabotage rule is similar to that in the United States.

Nevertheless, the question of the failing-firm factor under the merger law remained. The DIR noted that there were two significant issues to be assessed in considering the failing-firm issue: first was the extent to which the failure is, in fact, likely to occur and, secondly, whether there are alternatives to the merger that would be less restrictive of competition.

With respect to the first factor, the DIR stated:

> A firm that is facing certain and imminent financial failure will cease to exercise any competitive influence in the market after its failure. Therefore, the loss of this influence in the marketplace cannot be attributed to the merger.[7]

The accounting firm of Peat Marwick, retained by the DIR to review the financial evidence provided by Wardair, reviewed the options which might have prevented the failure of Wardair. These included deferring principal payments, loans on existing fixed assets, the sale of a minority interest and reversion to a chartered carrier status. The Director's background statement indicates that none of these are attainable or workable in the circumstances of Wardair.

With respect to alternatives, the DIR considered third-party buyers and also liquidation of the failing firm. The DIR concluded that the most likely result would be the withdrawal of Wardair's assets from the Canadian market. The background statement indicates:

> There now exists considerable excess capacity in the market and Wardair's A310 aircraft are not compatible with the fleets of other airlines in Canada.[8]

Having weighed all of these factors, the DIR concluded that the significance of the failing-firm factor outweighed the negative assessment of the other competition-based factors in the Act.

It is evident that the Director's decision was a difficult one. The effect on competition of the withdrawal of Wardair was immediate and palpable. Fares went up; fare choices declined.

The failure of Wardair raises serious questions more about the viability and effectiveness of airline deregulation in Canada in the context of remaining regulatory entry barriers effectively controlled by Transport Canada and less with respect to the effectiveness of the merger law.

These government-controlled entry barriers are principally:

(1) *the statutory foreign investment ceiling* of 25 percent which reduces the access of new and existing carriers to the capital market and severely reduces the effective market for control of larger existing carriers. In particular, this investment limit creates a significant disincentive to the transfer of technology and managerial skills from non-Canadian air carriers to Canadian air carriers;

(2) *landing and takeoff slot allocation practices* of airport management which "grandfather" incumbent allocations, effectively control new entry to airports through incumbent-dominated advisory committees, and do not ration supply on the basis of the marginal value of slots; and

(3) *limitation of foreign, and particularly U.S., air carrier access* to the Canadian market through treaty arrangements.

The Director's background statement identifies three reasons why deregulation may not have been as successful as expected when it was introduced in the early part of this decade. The first is the possibility that economies of scope are a significant barrier to entry into the scheduled airline business. When the United States and Canada deregulated airlines, the common view was that economies of scale were small in the industry and that economies of scope were not significant. Since then, it has become clear that economies of scope are much more important than previously thought. Secondly, restrictions on foreign ownership and foreign operations in Canada give the federal government the means to

inject competition in the domestic market if it wishes to do so. Whether Transport Canada will relax these requirements, however, remains to be seen. Finally, the analysis points to a third factor, access to hub airports. Since this is controlled by committees made up of incumbent carriers and Transport Canada officials, it is also seen as a serious barrier to entry.

The National Transportation Agency found that the Wardair acquisition by PWA was not against the public interest. Its decision was based largely on the financial health of Wardair, as was the Director's decision. Indicating that it was in no way interfering with the DIR's review, the NTA stated that the purpose of its review was different from that being conducted by the DIR under the *Competition Act*. This is apparently the first time the NTA has explicitly recognized the separate jurisdiction of the DIR to review the same merger transaction.

7. Reservec/Gemini Merger

On March 3, 1988, the DIR applied to the Competition Tribunal for an Order ordering Air Canada (AC) and Canadian Airlines International Limited (CAIL) to dissolve their limited partnership instituted to combine the operations of the Reservec and Pegasus Computer Reservations Systems into a single system known as Gemini.

Computer Reservations Systems (CRSs) are an increasingly important element in the distribution and sale of airline passenger seats to travel agents and to the travelling public. The systems distribute information on schedules, fares, rules and seat availability to subscribers (usually travel agents) for the airlines which are hosted on, or participate in, the system. This information is distributed electronically through a Computer Reservation Terminal (CRT) which is sold or leased to the subscriber and is located on the subscriber's premises.

The Director's application stated that before the merger, Air Canada's Reservec distributed information to approximately 2,900 travel agencies on behalf of 50 airlines, railways and car rental agencies, 3,000 hotels and 16 tour wholesalers. The application indicated that Reservec was the dominant CRS in Canada, holding about 72 percent of the CRS market as measured by travel agent locations.

Pegasus was developed by Canadian Pacific Airlines before its 1987 merger with PWA. Pegasus entered the Canadian market in 1984 and, according to the Director's application, "introduced some innovative features, providing competition for Reservec." The application claimed that between 1984 and 1987, Pegasus established its system in approximately 720 travel agencies providing information on and to 60 airlines, 14 car rental agencies, 3,000 hotels and tour wholesalers. The application stated that Pegasus was the second largest CRS in Canada, holding approximately 18 percent of the CRS market as measured by travel agent locations.

On June 1, 1987, AC and CAIL (the airline resulting from the CP/PWA merger) took steps to merge the Reservec and Pegasus systems through a limited partnership in which each of the parties received partnership units and other consideration reflecting the proportion of assets contributed to the partnership.

The DIR submitted that there are no effective substitutes to a CRS and that prior to the merger there were three other competitors to Reservec and Pegasus, including Sabre, a subsidiary of AMR Corporation which also owns American Airlines. Sabre had entered the Canadian market in 1983 and, by June 1987, had approximately 10% of the market as measured by travel agent locations. The other two competitors noted are Apollo, a CRS operated by Covia Corporation which is owned by United Airlines, and Soda/System One, owned by Texas Air Corporation. The application claimed that the latter two CRSs have an extremely small presence in the market with a combined market of less than 1%. To establish the importance of CRSs in the supply of airline tickets, the application noted that travel agencies are now the primary means for airlines to distribute their product to the travelling public. Approximately 70% of the tickets sold by Canadian airlines are sold through travel agents and approximately 90% of all Canadian travel agencies use CRSs to make airline reservations and to print tickets. The other 30% of the tickets are sold by the airlines directly to the travelling public. In almost all cases, the application claimed, the airlines use CRSs to assist with sales.

Critical to the Director's theory of the case was the distinction between the CRS services available to a "hosted carrier," and the lesser grade of CRS services available to a "participating carrier." If a carrier is hosted, the CRS stores the carriers complete inventory information. In this case, the CRS provides the carrier with both an internal reservation and management

system to manage its inventory and an external reservation system to distribute its product to travel agents and consumers. Air Canada and Canadian Airlines International are now hosted with the Gemini system.

If an airline is a participating carrier, the CRS does not supply an internal reservation and management system but instead only lists the information on fares, schedules and seat availability which the participating carrier supplies. A participating carrier may choose not to supply all of its inventory so that certain classes of seats may not be displayed on the CRS in which the airline is participating.

The application alleged that a hosted carrier has a significant competitive advantage over participating carriers because of the completeness, accuracy and timeliness of information on seat availability from the CRS with respect to hosted carriers.

The application also stated that, for practical purposes, an airline can store its entire inventory in only one place, which means that it can participate in a number of CRS systems but can be hosted by only one. Many of the advantages of hosted carrier status, however, can be obtained by means of a direct access data link between the CRS and the data base of the participating airline. The application noted that there are several CRS vendors in the United States, all of which have a direct access link with carriers who are hosted in another CRS:

> These links mean that these CRS vendors compete on the basis of what their systems can do and the price at which they do it rather than on the basis of exclusive control of airline inventory. In Canada, prior to October 31, 1987 there were no direct access links between the three largest CRS vendors in Canada namely Reservec, Pegasus and Sabre. On or about October 31, 1987 an electronic direct access link was established between Reservec and Pegasus, giving users of either Reservec or Pegasus last seat availability on Air Canada and Canadian Airlines International.

Last Seat Availability refers to the capacity of the CRS to call up for reservation seats held back by the airline from CRS booking of the airline. It is regarded by travel agents as an important competitive feature.

The principal grounds presented by the DIR in his application were:

- *Increased concentration:* Gemini's post-merger market share is calculated at 90 percent (of travel agent locations versus 10 percent for Sabre) and "has reduced the number of significant CRS competitors in Canada from three to two and in many non-urban areas has eliminated competition completely."
- *Increased barriers to entry:* The application contended that the superior service delivered by Gemini for AC and CAIL and their affiliated and aligned carriers, coupled with the current dominant position of these two carriers in the Canadian market, provides Gemini and its owners with the ability to block or frustrate the entry of competing CRSs by reducing the access of competing systems to timely and reliable information on the operations of AC and CAIL. The application also claimed the possibility of new entry into the CRS by a non-airline vendor is remote because of the substantial software and hardware development costs and the fact that airline vendors enjoy significant economies of scope because they must have a reservation system in any event.
- *Lack of availability of substitutes:* The application claimed that other sources of information such as manual reference to the *Official Airline Guide* and the use of the telephone to make airline reservations are too time consuming to be a practical alternative for most travel agents.
- *Effective competition remaining and removal of a competitor:* The application stated that the merger would reduce the effectiveness of Sabre as a competitor because Sabre, in the absence of a direct access link with Air Canada, CAIL and Gemini, would not be able to provide its travel agent subscribers with Last Seat Availability and other enhancements on AC and CAIL flights available through Gemini. The application also alleged that Sabre could be quickly neutralized by AC and CAIL if they exercised the market power they hold by reason of their dominant position in the airline market. For example, the application suggested that withdrawal of their participation in Sabre "would likely force Sabre to withdraw from the Canadian market because Sabre would then be providing a service without any booking fee revenues."
- *Impact on airline industry competition:* The application also alleged that the merger would likely entrench the dominant position of AC and CAIL in the airline industry at the expense of Wardair and potential new entrants in both the jet carrier and turbo-prop markets in Canada; it would also be

a detriment to U.S. and international carriers who compete in transport or international markets with AC and CAIL. In this regard, the application suggested that competing carriers which host or participate with Gemini may be subject to bias and other disadvantages which could severely inhibit their ability to compete. The suggested disadvantages include denial of access to the CRS, inaccurate loading of information, biased flight display ordering, and discriminatory booking fees. However, it should be noted that the application did not allege that any such practices have in fact taken place in Canada. The application essentially suggests that such activities would be more likely were the merger to take place.

The application therefore presented a number of important issues:

- To what extent should concentration in one market in transport be used in assessing the impacts of a merger in the production of a complementary product (CRS), and conversely what weight should the Tribunal attach to the possible lessening of competition in air transport that may result from the CRS merger?
- Is dissolution of the merger the only appropriate remedy? Could the possible anti-competitive impacts of the merger be sufficiently reduced if Air Canada's and CAIL's competitors were provided with direct access data links with those carriers' reservation systems as is done in the U.S.? To what extent is the viability of this option affected by the more concentrated nature of the Canadian air transport industry compared to the U.S. industry?
- What weight, if any, should be given to any increased potential for the abuse of dominant position in the market of the merger or related markets in determining whether the merger substantially lessens competition?
- Does the merger entail efficiency gains which are not likely to arise if the merger were dissolved and which, therefore, may exempt it from a remedial Order notwithstanding that it may lessen competition?

(a) Air Canada and CAIL Responses

The written responses of Air Canada and CAIL followed similar lines and disputed the Director's application in the following principal areas:

- market definition;

- efficiency gains and competitiveness in the CRS business; and
- impact on competition in the air transport business.

With respect to market definition, the respondents contended that in certain respects the appropriate market for CRS and airline services should include the domestic, transborder and international markets. In such a market, Gemini remains a minor player relative to Sabre, the dominant CRS in North America, and the principal remaining CRS competitor in Canada. The respondents also contended that measurement of market share according to travel agencies served (as was done in the Director's application) is not appropriate and leads to an overstatement of Gemini's share. Booked flight segments was proposed as the appropriate proxy for CRS revenues.

Several efficiency-related arguments were presented:

- The merger resulted in cost savings of $15 million a year flowing from economies of scale (reduced facilities and operational duplication).
- The world market could sustain only a few CRS firms due to the requirement for large-scale technology and the inherent cost advantages of an airline-sponsored CRS. A minimum efficient firm size or "critical mass" for the North American and Canadian markets is at least that of Gemini, if not larger, and only CRSs sponsored by major airlines are likely to survive over the long term. Air Canada and CAIL, therefore, contended that the merger increased the competitiveness of Gemini against rivals such as Sabre which had already reached an efficient size and could enter the Canadian market. Thus the market could support only one indigenous CRS. Dissolution of the merger would therefore result in two inefficient Canadian CRS suppliers.
- Pegasus was a non-starter. It could not achieve an efficient scale on its own and, due to poor product design and Reservec's previously established position in the Canadian market, Pegasus could capture only low-volume, non-urban travel agencies.
- The economies of scale realized from the merger would allow the Canadian CRS system to invest in new technology and to provide high-quality service to smaller Canadian centres.
- Air Canada's and CAIL's desire to increase market share against North American rivals would keep Gemini CRS booking fees low for travel agents.

With respect to the impact on competition in the airline business the respondents stated that:

- the merger increased the ability of Air Canada and CAIL to negotiate improved reciprocal access to the North American CRSs, thus enhancing their overall access to the North American and international market; and
- CAIL benefitted from obtaining some of the "halo effect" Reservec formerly provided exclusively to Air Canada.

On the related issue of the merger facilitating future abuse of dominant position in both CRS and air travel, the respondents argued that:

- Reservec used to have 100 percent of the Canadian market but no anti-competitive conduct was detected by a federal task force, unlike the findings of the 1984 Civil Aeronautics Board with respect to the airline display practices of some U.S. systems;
- both Air Canada and CAIL were formally committed in writing to the Minister of Transport to allow fair access to Canadian CRSs;
- Gemini was operated autonomously from the airlines; and
- the DIR could make an abuse of dominance application at any time when the facts support it.

The Director's application considered at some length Gemini's provision of Last Seat Availability (LSA) only to Air Canada and CAIL and argued that this practice would lessen competition among Canadian airlines by creating an incentive to agents to rely on Air Canada's and CAIL's service exclusively. The respondents, however, contended that LSA had been overrated as an impediment to fair competition since travel agents could obtain the last seats directly from the airline in any event. They also contended that LSA provides an important commercial advantage in competing for travel agency clients with the "functionally superior" U.S. based Sabre system.

(b) Director's Reply

The Director's reply presented the following principal arguments:

(i) Market definition: Canada is the appropriate geographic market. CRS operations are geared to the principal business incentives of their airline

parents. U.S. CRSs, therefore, lack the same incentives as Gemini to provide service in Canada since their airlines cannot serve the entire Canadian market.

(ii) Critical mass/economies of scale: The respondents had presented no empirical evidence on the minimum efficient size for a CRS firm and no evidence that the Canadian market could support only one indigenous firm. Reservec was profitable before the merger with 2,900 travel agency subscribers.

(iii) Pegasus as a Failing Firm: Pegasus should be expected to lose money in its start-up years but by the time of the merger Pegasus had achieved 72 percent of the 1,000 travel agency subscribers originally forecast as required for break-even.

(iv) Remaining effective competition: Sabre's competitiveness in the Canadian market was entirely dependent on Gemini not exercising its market power by Gemini's refusal to provide direct access to airlines competing with Air Canada and CAIL.

(v) Abuse of dominance: Political assurances of fairness were insufficient protection to competitors. Wardair and other domestic competitors had no domestic CRS alternative as the result of the merger. Gemini had a near monopoly in some local CRS markets.

(c) Further developments

During the pre-hearing stages of the case it was announced (September 28, 1988) that the Gemini Group and the PARS reservation system based in the U.S. would become partners in a new CRS. This partnership would be the largest multi-hosted CRS in the world comprising the 3,500 Gemini and 6,300 PARS travel agency locations. The owner of PARS are Northwest Airlines and TransWorld Airlines.

On December 7, 1988, the DIR filed an amended application requesting the Competition Tribunal to order Air Canada and Canadian Airlines International Limited (CAIL) not to proceed with the PARS merger or, if that merger was complete, to order its dissolution.

The Director's application contended that the PARS merger, in addition to the Gemini merger, enabled Gemini and its airline owners to sell a share of their near monopoly in CRS in Canada to another company in exchange for the PARS CRS technology without diluting the market power that flows from the Gemini merger. The DIR contended that the PARS merger would not reduce either the incentive or the ability of Gemini to exercise that market power to prevent or lessen competition in Canada. Further, the DIR alleged that the PARS merger made it even more likely that Gemini would maintain or increase its "overwhelming market dominance" as follows:

> As long as Air Canada and CAIL refuse to allow direct access links to other CRS systems from their completed inventorial schedule, fare rules, seat classes and seat availability, the enhanced functionality of PARS over Gemini makes it even more unlikely that any other CRS will be able to effectively compete in Canada. . . .
>
> The PARS merger will also eliminate additional possibilities for enhanced CRS competition and entry in Canada. PARS could have sold its CRS software to either Reservec or Pegasus; become an independent entrant in Canada; or more likely become a joint venture partner with one of the Gemini airline owners with the other free to operate independently or join with one of the other major U.S. or European CRS's as a second major CRS competitor in Canada.

The DIR also alleged that the PARS merger supported his position that the Gemini merger was not necessary to obtain state-of-the-art CRS technology for Canada. Such technology would appear to be readily available in the U.S. and elsewhere, and Air Canada or CAIL individually could acquire such technology by a joint venture or by hardware or software purchases from a number of CRS vendors. Consequently, the DIR stated that Gemini did not need a "near monopoly" in Canada in order to build a "made in Canada" CRS and that indeed with the PARS merger it had chosen not to do so.

With respect to the impact of the PARS merger on competition in the airline industry, the DIR contended that Air Canada and CAIL would continue to have the incentive and ability to prevent or lessen competition in airline markets and that the PARS merger did not alter this at all. In addition, the DIR contended that the remaining partners in PARS, TWA and Northwest Airlines, would have no incentive to stop this lessening of competition within Canada because they did not serve domestic Canadian city pairs and would

not be adversely affected by any reduction in domestic airline competition. The DIR also noted that the U.S. Civil Aeronautics Board rules, requiring non-discriminatory CRS access, were not applied to the operation of PARS in Canada. As a result, PARS would be able to engage in CRS abuses in Canada without being subject to any CRS rules or regulations.

Finally, the Director's application contended that the current PARS data display was ordered in such a way that interlined connections were penalized and given a lower priority in the display as compared to on-line connections. No interline "penalty" would be imposed on connections between Air Canada/CAIL and their respective affiliates. The DIR contended that the inability of interlined carriers, such as Wardair, to have their flights and fares displayed without the substantial "penalty" imposed through the PARS merger prevented such carriers from competing with the two dominant Canadian carriers, Air Canada and CAIL. The application contended that the PARS "penalty" against interlined connections heightens the barrier to entry into Canadian city-pair markets by increasing the control of Air Canada and CAIL over feed traffic.

(d) Resolution

The Tribunal's hearing on the Director's expanded application was to have commenced on April 3, 1989. The Tribunal was critical of this long delay to trial and largely placed the blame on the tactics of legal counsel on both sides. On that date, the DIR advised the Tribunal that agreement had been reached with the respondents and that he would be seeking the Tribunal's approval of the consent.

The proposal in essence allowed the Gemini merger to remain intact but required Gemini to provide data links to competing CRSs. Following a hearing on the proposed Order, at which a competitor/intervener, American Airlines, provided both expert and factual evidence, the Tribunal, at a post-hearing conference indicated changes it would require to approve the Order.

The principal elements of the Order approved by the Tribunal on July 7, 1989 were:

(1) Air Canada and CAIL must provide any other CRS operating in Canada with the same advance seat selection and boarding pass capability which they have provided to Gemini, if that other CRS offers reciprocity;

(2) Gemini must make available to travel agents any and all enhancements made available to Gemini by participating carriers;

(3) Gemini must provide direct access links to provide Last Seat Availability on Air Canada and CAIL, providing both "look but not book" and "look and book" features, subject to specified terms, implementation dates, and prices for certain existing competing CRS;

(4) Booking fees must be non-discriminatory; and

(5) The respondents would prepare a set of CRS rules affecting information display, contracts with participating carriers and subscribers (to prevent discrimination, tying or other exclusionary practices), access to airline information service enhancements, marketing information, ticketing and enforcement.

The reasons for its approval of the Order amplify the Tribunal's approach to exercising its discretion to approve such orders. The key elements are:

(1) The role of the Tribunal is not to ask whether the consent Order is the optimum solution to the anti-competitive effects which are assumed to arise from a merger;

(2) The Tribunal's role is to determine whether the consent Order meets a minimum test. The test is whether a merger, as conditioned by the terms of the consent Order, results in a situation where the substantial lessening of competition, which it is presumed will arise from the merger, has, in all likelihood, been eliminated; and

(3) If the terms of an Order are vague and therefore cannot be enforced by way of contempt proceedings, or if the terms imposed are virtually impossible to monitor, then the Order cannot meet the test of effectiveness necessary to eliminate the substantial lessening of competition which is required of it.

In this context it would be worth setting out the concluding remarks of the Tribunal:

> The determination of whether or not a given situation will result in a substantial lessening of competition is a speculative decision. An order such as that which the Tribunal is asked to issue is a web of

interrelated provisions. Counsel for the Director referred to it as a delicate balance of trade-offs. There is no doubt that there is more than one combination of terms and conditions which could achieve the result which it is hoped the terms and conditions which are now before the Tribunal will achieve.

There have been significant modifications made to the consent order in response to concerns raised during the course of the hearing of this application and in response to suggestions made by the Tribunal. A comparison of the consent order filed on April 13, 1989 and that filed on June 2, 1989 demonstrates this.

As noted above, the Tribunal has expressed concerns that have not been met. It may very well be that had the Tribunal crafted the order itself a set of conditions would have resulted different from those which the Director and the respondents have agreed upon. There is no doubt that if some of the provisions proposed by American Airlines had been adopted into the consent order a more rigorous instrument for creating a post-merger competitive environment would have been created. But, as has already been said, the Tribunal does not consider that it has been given a mandate to craft the best possible terms and conditions for protecting competition. Its role is limited to vetting the order before it to ensure that the proposed terms and conditions are likely to be effective in eliminating any adverse effects of the merger.

It is of considerable significance that almost all of the intervenors support the consent order, including American Airlines. It is of significance that there has been little evidence adduced that the merger as conditioned by the consent order will lead or will likely lead to a substantial lessening of competition. In addition, the Tribunal notes that the general trend is toward the formation of large, jointly-owned CRSs. It is clear that the implementation of some of the terms of the consent order will require the diligent and continual surveillance of the Director. It is clear that changed conditions or effective enforcement of the order may require a return to the Tribunal for either changes to or interpretations of the order. Taking all these considerations into account, the Tribunal concluded, on the basis of the evidence before it, that the consent order meets the test required by the legislation.[9]

E. ABUSE OF DOMINANT POSITION

1. Introduction

The 1986 revision established a new reviewable practice, abuse of dominant position, to replace the ineffective and unused criminal prohibition against creation or operation of a monopoly against the public interest.

Abuse of dominant position is broadly drafted, and could become potentially sweeping in scope, depending upon the priorities and creativity of the DIR and the initial jurisprudence of the Tribunal.

As discussed above, it is at least likely that abuse of dominant position will take the place of the predatory pricing offence as the means of reviewing and controlling unilateral anti-competitive pricing behaviour.

Unfortunately, it is not easy at this point to anticipate the likely scope or effectiveness of this reviewable practice. In the one decided case (NutraSweet discussed below) the Tribunal also granted substantially all the relief sought by the DIR through finding the existence of "lesser" reviewable practices (tied selling and exclusive dealing). There have been no enforcement guidelines published.

Abuse of dominant position is, however, modelled upon article 86 of the *Treaty of Rome* which established the general competition policy for intra-Community trade, and there is a considerable and growing body of European Community jurisprudence on the practice. In fact, the NutraSweet monopoly over aspartame was challenged under the *Treaty of Rome* prior to the DIR applying for a similar remedy in Canada.

For example, the market control concept of the *Treaty of Rome* relates to a position of economic strength which allows an undertaking to prevent effective competition being maintained in the relevant market. Such a position enables the company to behave to an appreciable extent independently of its competitors and customers, and the ultimate consumer. At first, this approach appears to be broader than the concept of market control advanced in North American anti-trust literature which (see the proposed merger guidelines) concentrates on the capacity to sustain price increases for a non-transitory period. In Europe, dominance has been found where the

supplier's overall market share was less than 50 percent but it had a much higher specific share by virtue of its brand recognition in certain product lines.

2. Statutory Provisions

Section 79 of the *Competition Act* authorizes the Tribunal to issue an Order prohibiting all or any respondents in a DIR's application from engaging in a practice of anti-competitive acts where:

(1) the respondent(s) substantially or completely control a class or species of business throughout Canada or in any area of the country;

(2) the respondent(s) have engaged in or are engaging in a practice of anti-competitive acts; and

(3) the practice is having, has had, or is likely to have the effect of preventing or lessening competition substantially in a market.

If a remedial prohibition Order is insufficient to restore competition, the Tribunal has the jurisdiction to order divestitures of asset or shares sufficient to overcome the practice's effects.

In making its impact assessment, the Tribunal must address whether the practice is a result of superior competitive performance.

Section 78 of the Act is a non-exhaustive list of anti-competitive acts. These are:

(a) squeezing, by a vertically integrated supplier, of the margin available to an unintegrated customer who competes with the supplier, for the purpose of impeding or preventing the customer's entry into, or expansion in, a market;

(b) acquisition by a supplier of a customer who would otherwise be available to a competitor of the supplier, or acquisition by a customer of a supplier who would otherwise be available to a competitor of the customer, for the purpose of impeding or preventing the competitor's entry into, or eliminating the competitor from, a market;

(c) freight equalization on the plant of a competitor for the purpose of impeding or preventing the competitor's entry into, or eliminating the competitor from, a market;

(d) use of fighting brands introduced selectively on a temporary basis to discipline or eliminate a competitor;

(e) pre-emption of scarce facilities or resources required by a competitor for the operation of a business, with the object of withholding the facilities or resources from a market;

(f) buying up of products to prevent the erosion of existing price levels;

(g) adoption of product specifications that are incompatible with products produced by any other person and are designed to prevent his entry into, or to eliminate him from, a market;

(h) requiring or inducing a supplier to sell only or primarily to certain customers, or to refrain from selling to a competitor, with the object of preventing a competitor's entry into, or expansion in, a market; and

(i) selling articles at a price lower than the acquisition cost for the purpose of disciplining or eliminating a competitor.

The common feature of these anti-competitive acts is an exclusionary purpose or effect. Thus, the presence or prospect of competitive entry or expansion into the relevant market (which need not be the market in which the respondent is dominant) would appear to be essential to achieve a remedy from the Tribunal.

Conversely, the practice would not appear to be directed to remedying monopoly practices by a firm in its dominant market where there was no real competition or no reasonable prospect of competition: in the extreme, a market supplied by a "natural" monopoly.

Apart from this qualification, the Act invites an "I know it when I see it" approach to identifying a practice of anti-competitive acts. In practical terms, these are defined by the nature of the way they lessen competition, the extent of market control of the dominant firm, and the extent of existing and prospective competition. Thus it is quite difficult to make specific or discrete advice on each element of the practice.

The Tribunal's remedial power, while broad, is cast as a prohibition aimed at removing the undesirable effect on competition. It therefore does not imply direct government regulation of the manifestation of dominance (for example, prices). And the Tribunal's discussion of enforceable merger consent Orders makes it clear that a properly fashioned dominance prohibition would have to permit the Tribunal to stand back and watch rather than participate with the dominant firm's management in restoring competition.

3. NutraSweet Case

(a) DIR Application

On June 1, 1990 the DIR filed a Notice of Application with the Competition Tribunal requesting Orders against the NutraSweet Company under the abuse of dominant position, exclusive dealing and tied selling provisions of the *Competition Act*.

NutraSweet is the principal supplier in Canada of aspartame, an intense sweetener used as a substitute for sugar in a variety of food products. The application noted that NutraSweet controls about 95 percent of the market for aspartame in Canada and that its principal competitor, Tosoh Canada Ltd., a subsidiary of Holland Sweetener Company of the Netherlands, supplied approximately three percent of the market.

The application contended that aspartame constitutes a distinct product market from sugar and other artificial sweeteners for a variety of reasons: it provides an alternative to sugar for diabetics and weight-conscious consumers; it is not harmful to the teeth; it is non-caloric unlike other bulk sweeteners; and it is distinctive from other intense sweeteners such as saccharin and cyclamates because of the much greater range of food products and applications for which it has been authorized under the Food and Drug Regulations.

The alleged anti-competitive acts, exclusive dealing and tied selling requirements, flow from the same set of alleged contractual provisions which, as a whole, the DIR contend had prevented the creation of a separate Canadian market for the sale of aspartame. The DIR's application alleged that these acts constituted predation and sophisticated price discrimination practices.

The acts alleged by the DIR included:

(1) Use of NutraSweet's U.S. position to foreclose competition in other countries through entering into worldwide exclusive supply contracts of several years' duration with the parent companies of the largest purchasers of aspartame in Canada (principally soft drink manufacturers).

(2) Inducing exclusivity through the structure of its supply contracts. The relevant provisions include customer obligations to purchase their entire supply of aspartame from NutraSweet; customer obligations to use aspartame as the sole sweetener in their products; and a variety of fidelity rebates which the DIR alleged are designed to induce customers to purchase all of their aspartame requirements from NutraSweet. These fidelity rebates were alleged to include volume discounts, incentives for encouraging others to purchase aspartame from NutraSweet, and allowances for the display of NutraSweet's trademark or brand name on a customer's packages. The DIR contended that, in order to remain competitive, a NutraSweet customer must take advantage of all the rebates offered by NutraSweet under its supply contracts. As a result, the customer was effectively forced to purchase its entire supply of aspartame from NutraSweet and to affix NutraSweet's trademark to its packaging.

(3) Extending patent rights through exclusive contracts. The DIR contended that, immediately before the expiration of its Canadian patent, NutraSweet negotiated a number of long-term, exclusive supply contracts for aspartame which, the DIR alleged, ensured the maintenance of NutraSweet's dominant position in the Canadian market regardless of whether its patent had expired.

(4) Creation of market transparency to control competition. The DIR alleged that, through contractual terms with its customers (which were ostensibly aimed at maintaining the customers' competitiveness), NutraSweet was able to obtain knowledge of its competitors' activities and to meet the competition in a fashion that substantially lessened competition. The DIR contended that these agreements take several forms: "Meet or release" clauses (also known as "English clauses") which allow customers to obtain competitive offers for aspartame but also permit NutraSweet to meet the competitor's price if it were lower or to release the customer from the supply contract if NutraSweet elected not to meet the offer; an "extended release" clause which permits one customer to go to

another for aspartame in the event that another third-party customer of NutraSweet aspartame is released from its supply contract; a "most favoured nation" clause which requires NutraSweet to ensure that the customer is not charged a price for aspartame which places it at a competitive disadvantage in its own industry.

(5) The combination of most favoured nation and fidelity clauses. The DIR alleged that the combination of these terms induce customers to purchase their entire supply of aspartame from NutraSweet because customers can become free riders on the lower prices obtained by other aspartame customers and therefore have no incentive to seek lower prices on their own.

(6) Abuse of trademark. The DIR contended that NutraSweet's practice of providing allowances to those customers which place NutraSweet's trademarks on their products creates barriers to entry since the competitor's price must both justify the cost of removing the trademark and cover the foregone trademark display allowance.

(7) Selling below acquisition cost or long-run average cost. The DIR also alleged that the net prices charged to certain Canadian customers after all of the above discounts, allowances and rebates are less than NutraSweet's average acquisition cost or long-run average cost in production of aspartame.

Accordingly, the DIR contended that these alleged anti-competitive acts have foreclosed the aspartame market in Canada to potential alternative suppliers; the Canadian market is not open to competition at all due to the worldwide contracts negotiated outside Canada which require exclusive use of NutraSweet's aspartame in Canada; and there is no incentive for customers to seek alternative sources of supply because of the price preferences and other measures noted above.

The DIR also relied on the contractual provisions which he alleged constitute anti-competitive acts as the basis for asserting that NutraSweet has practiced both exclusive dealing and tied selling.

To establish exclusive dealing, the Director's application referred to the alleged presence of exclusive worldwide supply contracts; exclusive supply provisions in individual contracts; the affixing of the NutraSweet trademark on customers' product labels; exclusive dealing inducements through the

presence of English clauses; most favoured nation clauses; trademark display allowance provisions; cooperative marketing rebate schemes; fidelity rebates; and free product clauses in NutraSweet's arrangement with its customers.

The DIR alleged that tied selling had occurred because NutraSweet, as conditions for the supply of NutraSweet's aspartame required customers to affix the NutraSweet trademark to their products and to refrain from using another brand of aspartame in conjunction with NutraSweet's brand. The DIR also alleged that the provision of substantial allowances for trademark display in a number of NutraSweet's supply contracts together with other fidelity clauses constituted inducements to meet these conditions.

The Orders requested by the DIR relating to abuse of dominant position, exclusive dealing and tied selling were similar. They prohibited world-wide contracts with multinational customers governing the supply of aspartame to Canadian affiliates; they prohibited the requiring of customers to purchase their entire supply of aspartame from NutraSweet; they prohibited the selling of aspartame to Canadian customers at below acquisition cost, and the granting of customer price concessions and other allowances not available to competitors of the customer for the same agreed volume of aspartame.

As well, the DIR applied for a declaration that the contractual provisions noted above were of no force or effect and could not be judicially enforced by NutraSweet. The DIR also requested the Competition Tribunal to order NutraSweet to include a most-favoured-nation clause in all supply contracts of customers which compete with each other in selling products containing aspartame if such a clause was included in a contract with any of them.

Finally, the DIR sought a declaration that any contracts entered into by NutraSweet or its affiliates pursuant to worldwide contracts were of no force or effect insofar as they affected the supply of aspartame in Canada and that NutraSweet could not require minimum exclusive annual volume commitment in any supply contract which was greater than 50 percent of a customer's total annual volume requirements of aspartame.

(b) NutraSweet's Reply

The NutraSweet response, filed on July 25, 1989, contended that the firm's success in the market was purely the result of innovation, risk-taking and superior competitive performance. The respondent contended that its superior competitive performance was the result of continuous research and development, testing of aspartame to obtain approvals in various countries, intensive promotion, and a superior product and supply network, none of which had been undertaken by its competitors.

NutraSweet also contended that it had no market power in the supply of aspartame for a number of reasons including the following:

(1) extensive in-house research and development of artificial sweetener is now being conducted by manufacturers of food products;

(2) large food and beverage manufacturers can readily manufacture aspartame once it comes off patent;

(3) competition and supply of aspartame will intensify towards the end of NutraSweet's U.S. patent in 1992;

(4) no barriers to entry exist in Canada for manufacturers that currently supply aspartame.

NutraSweet also noted that its principal customers were large and sophisticated and could readily choose among competing suppliers; that prices for aspartame have been declining rather than increasing; and that contracts for the supply of aspartame were freely negotiated and had short time commitments that facilitated frequent competitive overtures from other suppliers.

NutraSweet denied that aspartame might be regarded as a distinct product market. The firm suggested that aspartame, as well as many other natural and artificial sweeteners, competed for the same ultimate customers and that aspartame fulfilled the same purpose as all other sweeteners. NutraSweet also noted extensive research and development activity by drug and food companies to improve and invent artificial sweeteners.

With respect to the geographic market, NutraSweet contended that Canada was not the appropriate geographic market, but that, rather, given the

very low cost of shipping artificial sweeteners and the number of plants in existence in a variety of countries, the geographic market was global.

NutraSweet contended that the contractual practices which the DIR regarded as evidence of policy to maintain market pre-eminence were, in fact, all provisions sought by NutraSweet's customers to secure benefits for themselves or were normal commercial practices.

NutraSweet claimed that exclusive use and worldwide contracts were negotiated by customers to obtain secure supplies and consistent high-product performance. Volume discounts and cooperative marketing are regarded as normal commercial practices by NutraSweet. Trademark display allowances provide a benefit to customers through cost reductions of aspartame and, in turn, facilitate NutraSweet in protecting the goodwill of its trademark. "Meet or release" and "price protection" clauses, NutraSweet contended were actually sought by its customers to permit them to maintain their own competitiveness, particularly in the soft drink market.

(c) Tribunal Decision

The Tribunal's decision was published on October 4, 1990. The Tribunal concluded that the practices of abuse of dominance, tied selling and exclusive dealing were present and issued a remedial Order.

At the time of writing, NutraSweet had appealed the decision to the Federal Court, and the DIR had cross-appealed seeking different remedies than those imposed by the Tribunal.

With respect to the issue of market definition, the Tribunal examined the market for all sweeteners and assessed the cross-elasticity of demand between high-intensity and high-calorie sweeteners and regulatory barriers facing suppliers of high-intensity sweeteners. The Tribunal found that there was no direct evidence of competition between aspartame and caloric sweeteners, and only weak evidence of indirect competition between high-intensity sweeteners. However, the Tribunal felt that no other high-intensity sweetener was a good substitute for aspartame across large market segments. The Tribunal therefore decided to define the product market as aspartame since it mattered little whether the definition was "aspartame" or "high-intensity sweeteners" because of the very limited degree to which non-aspartame, high-intensity sweeteners were present in the Canadian market.

In assuring market control, the Tribunal focussed on entry barriers. The Tribunal concluded there were significant entry barriers comprising patent portfolios, economies of scale and sunk costs.

The DIR had argued that market control meant control over supply as defined by the normal dictionary meaning. NutraSweet argued that it meant "market power." Market power would mean an ability to set prices above competitive levels for a considerable period.

The Tribunal accepted the respondent's position, stating however:

> This finding is of little practical import because, ultimately, all relevant indicators of market power must be considered in determining whether there is likely to be a prevention or lessening of competition substantially.

Having accepted the respondent's definition of control, the Tribunal proceeded to assess whether large buyers, such as Coca-Cola and Pepsi, were able to protect their interests through their own strong bargaining position. The Tribunal concluded that, although Coca-Cola and Pepsi have considerable resources to protect their interests, this did not in and of itself eliminate NutraSweet's market power. The Tribunal concluded:

> The evidence that NSC possesses appreciable market power given its market share (over 95% of sales in Canada), entry conditions and the constraints operating on its largest customers is sufficiently compelling so that the boundaries of substantial control need not be explored. Its "control" is clearly substantial.

With respect to "class or species of business" the DIR argued that these words should be interpreted in the commercial sense rather than in an economic sense, and that, accordingly, the business of NutraSweet was the manufacture and supply of aspartame. The Tribunal took the view of the respondent, however, that "class or species of business" is the same as the relevant product market.

The Tribunal's interpretation of "class or species of business" is an important decision, particularly since it contradicts the Eddy Match decision of the

Quebec court, under the old monopoly section. The Tribunal justified this distinction in the following manner:

> Based on the facts in Eddy Match Co. and the different legislative schemes of the *Combines Investigation Act* and the *Competition Act*, the Tribunal does not believe that this case provides a sound basis for identifying "class or species of business" without referring to possible substitutes. The court in that case was seized with charges under a criminal statute, a case in which the accused had engaged in highly aggressive conduct towards other producers of wooden matches; Eddy certainly acted as though wooden matches were sufficiently distinct so that it was worthwhile for it to concentrate its efforts on that industry. In the present statute, however, s.79 provides other remedies and the deciding body is a specialized tribunal. It would run contrary to the spirit of this legislation for the Tribunal to eschew other relevant factors (that is, possible substitutes) on some presumed technical ground.

The decision by the Tribunal that it will not necessarily follow previous jurisprudence under the *Combines Investigation Act* in criminal matters is an important indication of the Tribunal's view of the purpose of the 1986 revisions.

The Tribunal then considered the requirements of a "practice of anti-competitive acts" as contained in section 79. In this area also, the Tribunal's decision is an important precedent. It stated:

> This list of anti-competitive acts is clearly not meant to be exhaustive and the respondent admits that other conduct not specifically mentioned in s.78 can constitute an anti-competitive act. A number of the acts share common features but, as recognized by the Director and the respondent, only one feature is common to all: an anti-competitive act must be performed for a purpose, and evidence of this purpose is a necessary ingredient. The purpose common to all acts, save that found in paragraph 78(f), has an intended negative effect on a competitor that is predatory, exclusionary or disciplinary.

This finding indicates the Tribunal believes there must some element of intent or purpose to constitute an anti-competitive act.

The Tribunal interpreted "practice" as follows:

> If there is a good reason to avoid a limiting interpretation of "practice" under criminal law, it is all the more important to do so under s.79. The anti-competitive acts covered in s.78 run a wide gamut. Some almost certainly entail a course of conduct over a period of time, such as freight equalization in paragraph 78(c), whereas others consist of discrete acts, such as the setting of product specifications in paragraph 78(g). The interpretation of "practice" must be sufficiently broad so as to allow for a wide variety of anti-competitive acts. Accordingly, the Tribunal is of the view that a practice may exist where there is more than an "isolated act or acts." For the same reasons, the Tribunal is also of the view that different individual anti-competitive acts taken together may constitute a practice. It is important to stress, however, that this does not in any way relieve the Director of the burden of establishing an anti-competitive purpose for each of the acts.

The Tribunal then considered how one would establish an anti-competitive purpose. The DIR submitted that this test could be met through evidence of subjective intent, such as verbal or written statements of personnel of the respondent, or through a consideration of the nature of the act itself, the latter being based on the premise that a corporation intends the necessary and foreseeable consequences of its acts. The Tribunal accepted the Director's position. It also indicated that, in most instances, the purpose of a particular act will have to be inferred from the surrounding circumstances.

With respect to meet or release clauses, the Tribunal found that large customers, such as Coca-Cola or Pepsi, used them as a way of mitigating the effect of being locked into an exclusive contract. The Tribunal stated:

> If exclusive supply is objectionable in the instant case, so is a meet or release clause: by making exclusivity more acceptable to customers it serves as an inducement for customers to enter into exclusive arrangements.

With respect to the most favoured nation clause whereby NutraSweet contractually agreed to offer its best price in its contracts, the DIR had argued that this was an inducement to exclusive dealing. The Tribunal found that:

> The Director submits, correctly in the Tribunal's view, that only a firm with a very large market share can be expected by its customers to provide a most-favoured-nation clause because only it will almost certainly be selling to the customers' competitors.

However, the Tribunal appeared not to find all of these practices as anti-competitive acts. The Tribunal stated:

> The Tribunal sees little purpose in the context of the present case in determining whether each clause constitutes an anti-competitive act. It is doubtful whether the meet or release and most-favoured-nation clauses would exist in the absence of an explicit or implicit exclusive supply agreement. In the Tribunal's view, the issue is whether the agreements requiring exclusive supply and all the contract terms related to it, have an exclusionary purpose. The Tribunal is persuaded that this is the case.

The DIR had alleged that NutraSweet had engaged in the anti-competitive act set out in paragraph 78(i) of "selling articles at a price lower than the acquisition cost for the purpose of disciplining or eliminating a competitor." The Tribunal accepted the respondent's argument that acquisition cost is not easily applied in a manufacturing situation. The Tribunal also found that the language of the paragraph suggested that Parliament intended it to be applied mainly to distribution situations where the articles would be resold.

While limiting the application of paragraph 78(i), the Tribunal considered the broader issue of whether there could be an anti-competitive act or some form of predatory pricing not specified in section 78 but nevertheless, caught by the dominance provisions. The Tribunal, in an important conclusion, stated that it was satisfied that the section was broad enough to cover other forms of predatory pricing. The Tribunal then considered the appropriate test for predatory pricing and basically concluded that the Areeda-Turner test is the appropriate standard (that is, prices are presumed not to be predatory if they exceed average variable costs). This is similar in principle to the Stage II test under the Bureau's proposed Predatory Pricing Bulletin.

The DIR had alleged that NutraSweet was using its patent in the United States to gain a competitive advantage in Canada. This U.S. market power was alleged to have been used with Coca-Cola and Pepsi in particular. The

Tribunal accepted the Director's position that the use of a monopoly position in one country to obtain a competitive advantage by a dominant firm in another market constitutes an anti-competitive act.

With respect to proof of substantial lessening of competition, the Tribunal stated:

> The factors to be considered in deciding whether competition has been or is likely to be substantially lessened are similar to those that were discussed in concluding that NSC has market power. In essence, the question to be decided is whether the anti-competitive acts engaged in by NSC preserve or add to NSC's market power.

In summary, the particular acts the Tribunal found to be anti-competitive were exclusive supply and use clauses, logo display allowances, cooperative marketing allowances, meet or release clauses, and most-favoured-nation clauses. The Tribunal also included the use of U.S. patents to foreclose competition by a system of rebates on exports from the United States to induce Canadian importers to have only NutraSweet aspartame in their products. The Tribunal, therefore, concluded that those practices were having the effect of preventing or lessening competition substantially.

IV. *Competition Act* Compared with *National Transportation Act, 1987* and Related Legislation

A. INTRODUCTION — HISTORICAL PERSPECTIVE

The *National Transportation Act, 1987* (NTA, 1987) represents the most recent legislative milestone in a process of staged reduction in direct federal regulation of intercity transportation services that has continued since the 1960s.

However, federal regulatory policy for the transportation industry was not static between the 1968 and 1987 revisions to this industry-specific legislation. For example, during this period, largely due to competitive pressures from expansions in trucking as a substitute to rail freight and from passenger air deregulation in other jurisdictions, regulatory and policy changes increased the operating flexibility of rail service and air carrier managers.

To some extent, particularly in relation to air carrier regulation, the 1987 revision mirrored rather than advanced prevailing regulatory policy of the Canadian Transport Commission.

However, the NTA, 1987 did not significantly alter the principal institutional and administrative elements established in the NTA of 1967, for the delivery of the federal government regulatory product for this sector.

By way of contrast, as discussed in Parts II and III, the 1986 revision of the *Competition Act* included both major substantive changes geared to increase effectiveness and predictability as well as major institutional changes involving the establishment of the Competition Tribunal and "decriminalization" of Canada's merger and monopoly laws of general application. These changes have facilitated a more hands-on and proactive approach to competition law enforcement.

In fact, the substitution of civil for criminal process and substantive standards can be regarded as an overall trend in the evolution of Canadian competition law that is not confined to the 1986 revision. Prior to the 1976 revision of the *Combines Act*, the law was entirely based upon criminal law prohibitions. The 1976 revisions introduced a range of reviewable practices relating to non-price vertical restraints to competition which were regarded as manifestations of inefficient monopolization — as well as new criminal prohibitions respecting unfair and inefficient marketing practices. These prohibitions are now being reviewed by the Bureau as possible candidates for decriminalization. Charter requirements may ultimately force decriminalization of the conspiracy prohibitions. And, in light of the structure of the abuse of dominant position practice, it is now probable that this provision, together with the Bureau's draft predatory pricing policies, and not the criminal predatory pricing prohibitions, will be the general future context for Bureau action respecting anti-competitive unilateral pricing practices.

This comparison of the *National Transportation Act, 1987* and the *Competition Act* looks at both the institutional arrangements for law enforcement and the substantive law established by each Act.

The comparison is based on a point-in-time snapshot of two streams of economic regulation. It is probable, in my view, that enforcement and substantive provisions of both Acts will be significantly amended within the decade.

B. *NATIONAL TRANSPORTATION ACT, 1987* AND RELATED LEGISLATION

As noted in Part II, the *Competition Act* does not apply, by operation of common law, to commercial activities that are otherwise authorized or regulated by valid legislation. Nor does it apply to agents of the Crown. The 1986 revisions have, however, made the *Competition Act* applicable to certain Crown corporation activities. And, as noted below, this exemption of regulated conduct can be, and has been, overridden by legislation.

1. Substantive Provisions

The *National Transportation Act, 1987* and related legislation establishes discretionary regulatory authority to control the following intercity commercial behaviour of intercity passenger transportation service suppliers:

- *Intercity rail transport:*

  (a) entry is dependent upon a public convenience and necessity finding;

  (b) tariffs are subject to review and variance if found not to be in the public interest. (By contrast, rail freight rates are required to be "compensatory" using a standard based on a statutory average variable cost coverage that has been elaborated by extensive regulatory cost accounting rules.)

- *Intercity domestic air transport:*

  (a) Southern and Northern Canada ("designated area"):

  Domestic service basic fare increases may be rolled back or disallowed, upon complaint, if unreasonable and if there is no alternative, effective, adequate and competitive transportation service.

  (b) Northern Canada (only):

  Limited entry and exit restraint based upon locality and assessment of impact on competitors.

  Service level and points served subject to licence restrictions.

- *Intercity bus transport:*

  Jurisdiction delegated to individual provinces which employ a range of discretionary entry, exit and price controls of varying intensity and effectiveness. No material substantive changes have been made in the *Motor*

Vehicle Transport Act (MVTA), *1987* compared to the MVTA of 1954 with respect to extra-provincial bus transportation. Provincial regulatory policies all involve an element of protection of incumbent firms from competitive entry to help sustain a higher level of service (and lower prices) in less dense markets. In some cases, overall limits to firm profitability have been applied through the tariff approval process. Corporate profitability constraint appears to have been of diminishing importance over the last decade.

The NTA, 1987 also retains certain *non-discretionary regulatory controls*:

(a) Acquisitions of Canadian Transportation Undertakings (all intercity passenger rail, bus and air suppliers) having in excess of $10 million in assets or annual sales are subject to prior public notice and approval (which approval may be deemed after a certain period of time by operation of the statute). Disallowance requires a finding that the acquisition is against the public interest.

(b) Entry by non-resident air carriers is subject to compliance with state-to-state agreements which comprehend carrier designation, points served, freedom of the air and capacity offered.

(c) Non-resident voting share investment in domestic air carriers is limited to 25 percent.

The NTA, 1987 expressly provides that its regulatory regimes affecting base air fares and acquisitions do not affect the operation of other Acts of Parliament. Accordingly, the *Competition Act*'s merger and abuse of dominance jurisdiction (to the extent that high pricing may be construed as an anti-competitive act) continues to operate and to run in parallel to these NTA regimes.

2. Institutional Features

The *principal institutional features* of the 1987 NTA revision are:

- Implementation and enforcement of discretionary and non-discretionary regulatory controls by an independent expert tribunal, the National Transportation Agency (the Agency), supported by its own staff and having an option to exercise its substantive powers following public hearings, and possessing disclosure powers to support its enquiries. The

structure of this regulatory agency is essentially the same as its predecessor the Canadian Transport Commission (CTC). The Agency and CTC are therefore not distinguished in our analysis of the behaviour of regulatory agencies (section D below). *The absence of a dynamic restructuring of the regulatory agency at the same time that federal regulatory discretion over the transport sector was being reduced, in my view, has created a potentially unhealthy tension between the new regulatory law and the institutional values and methods of the Agency that applies it.*

- Expanded opportunities for Cabinet intervention in Agency decision-making through binding policy directions to complement the pre-existing power to vary or rescind any Agency decision. (This power has, to date, proven to be academic).

- Reformulation of an elaborate "Parliamentary statement of national transportation policy" which the Agency is expected to implement through the exercise of its regulatory discretion. This policy seeks a safe, economic, efficient and adequate network of viable and effective transportation services making the best use of all available modes of transportation at the lowest total cost. As implementation guidance, the policy identifies:

  (i) competition and market forces as the prime agents;

  (ii) economic regulation only where necessary to serve the transportation needs of shippers and travellers but with no "unfair" limit on competition;

  (iii) balancing commercial viability with regional economic development objectives;

  (iv) that carriers bear a "fair share" of the costs they cause;

  (v) that carriers receive "fair" compensation for public obligations; and

  (vi) that fares be non-discriminatory and not create an undue obstacle to trade.

This policy statement arguably places more emphasis on the role of competition and market forces than did its predecessor in the NTA of 1967.

However, the potential impact of this shift, or any one of the enumerated policy goals for that matter, is left uncertain by the sheer variety of policy statements and their contradictory implications. Parliament, in my view,

has through unclear legislative policy (particularly when compared to the *Competition Act*) still left the Agency with ample room to act as an arbitrator of competing political and economic interests and to perpetuate institutionalized economic performance values carried over from the CTC era.

C. JURISDICTIONAL RELATIONSHIPS

1. Retail Level

(a) Exclusive Transportation Regulation Jurisdiction

Based on the considerations presented in Part II, at present, federal transportation legislation, and not the *Competition Act*, would apply only to the following dimensions of intercity bus and rail service:

- unilateral high or low pricing behaviour or discriminatory tariff terms of intercity rail service suppliers;
- discriminatory or exclusionary conduct arising from the geographical scope and level of VIA rail services; and
- in provincial jurisdictions where intercity bus tariffs require regulatory approval, both unilateral high and unilateral low pricing behaviour by such suppliers, as well as the terms and conditions of service provision.

The *Competition Act*'s prohibitions against predatory pricing and abuse of dominant position (where the grounds are price gouging) would not apply in these circumstances.

Clearly, the remaining direct regulatory measures at the retail level which are applicable to intercity passenger transportation services have become quite limited. It would also be fair to say that the rate of erosion of direct economic regulation of retail pricing and terms of service has varied among modes.

Common carrier regulation for intercity bus service by blanket delegation of federal jurisdiction remains in the hands of provincial governments. In terms of process and substantive decision rules, this form of regulation remains largely the same as it has been for 20 years.

Passenger rail regulation jurisdiction is largely unchanged although there is increased scope to regulate service access for persons with disabilities and greater Cabinet and corporate discretion over the geographical scope and level of service.

Retail pricing regulation in intercity air transport is now restricted to a discretionary power to roll back basic service price increases. To date this power has not been exercised. Low pricing, and scheduled service terms and conditions and service levels (outside the designated area, that is, Northern Canada) are now not subject to direct regulation.

(b) Parallel Jurisdiction

Two areas of parallel jurisdiction confirmed by statute have already been noted: (1) high unilateral pricing by air carriers within Canada; and (2) mergers/acquisitions among transportation service suppliers.

However, there are major differences in the manner in which these jurisdictions may be exercised under federal regulatory and competition law.

These differences are examined below with respect to procedural administrative matters.

There is also, in my view, parallel regulatory and *Competition Act* jurisdiction in relation to certain structures or conduct of intercity passenger service.

First, the conspiracy provisions of the *Competition Act* may be employed to challenge high or low pricing behaviour of the intercity bus industry, even where this conduct is approved individually for each firm under a prior provincial tariff approval requirement, where such behaviour flows from an agreement among suppliers. This position is based upon a more restrictive interpretation of the Law Society of British Columbia case (see Part II, section B) than advanced by some commentators. Specifically, it is my view that more recent jurisprudence has confirmed that the conspiracy prohibition would be ousted in relation to the conduct of regulated firms or professions *only* where the agreement is authorized either expressly or by necessary implication by valid enabling legislation.

It should be kept in mind that the governing structure of the legal profession considered in the Law Society of British Columbia case is a statutorily

required collective agreement regime. However, provincial bus regulation is generally premised upon individual tariff applications being made by individual licensees rather than upon collective rate approval. Conceivably, there could be an exception from the conspiracy provisions where the provincial bus regulation regime expressly provides for the filing of joint tariffs by suppliers in the same geographic market (as opposed to joint tariffs respecting the provision of a particular service such as transportation between A and B using more than one licensee).

On the same basis, the conspiracy provisions of the *Competition Act* would have parallel application with the NTA, 1987 with respect to air carrier entry, exit and terms of service matters (to the extent the latter is not prescribed by regulation but is rather determined by the Agency on a case-by-case basis) which remain subject to some direct Agency regulation in the designated area.

Further, it is arguable that the definition of abuse of dominant position is sufficiently broad and flexible to apply to some conduct of an intercity bus or air carrier (in the designated area) where:

- the carrier's market dominance is the result of restrictive regulatory entry policies; and
- the regulator either lacks the jurisdiction or the practical opportunity to order cessation of the anti-competitive acts or to eliminate the opportunity to conduct them through either franchise elimination (delicencing) or allowing greater competition by licensing alternative suppliers.

As a practical matter, however, the Bureau of Competition Policy would probably not assert jurisdiction at this time in such a situation due to (1) the lack of jurisdictional certainty, (2) the likelihood that the markets involved are intra-provincial as opposed to national, and (3) the minor impact on economic efficiency and consumer welfare that the anti-competitive acts would entail.

(c) Exclusive Competition Act *Jurisdiction*

At the retail level, therefore, in my view, the *Competition Act* is the exclusive trade practices regulation instrument with respect to:

- predatory pricing and abuse of dominant position by air carriers (that is, pricing and other acts aimed at eliminating competition);

- resale price maintenance by air, rail and bus services; and
- non-price vertical restraints such as refusal to deal or tied selling practices by all modes of intercity passenger services where the transportation service is the tying product.

Because of the mode-specific nature of existing transportation regulation, it appears to be fairly clear that the *Competition Act* would apply exclusively to agreements to lessen competition (for example, price fixing and market sharing), including bid-rigging, involving more than one mode and non-price vertical restraints (for example, fixed selling and market restriction) between modes.

(d) Remaining Uncertainties

As discussed in Part III, section B, "article" under the *Competition Act* includes evidence of the right to transportation. The prohibition of price discrimination in this Act applies to discriminatory sales among competitors and also to discriminatory promotional allowances. Where the retail price of an intercity transportation service requires regulatory approval, it is arguable that the price discrimination prohibition does not apply at common law, since any discrimination has been lawfully authorized. However, where no express price approval is required, but there is a complaint-based appeal mechanism, it is arguable that there is room for application of the price discrimination prohibition given its highly specific nature. In either case, it would appear that the prohibition against discriminatory promotional rebates would apply to the passenger service supplier since the focus of the *Competition Act* is on a collateral service rather than on the regulated transportation service itself.

2. Input Market

(a) Introduction

Apart from being mode-specific, perhaps the principal jurisdictional difference between transportation regulation laws and the *Competition Act* is that the former are focussed upon the retail level of trade while the *Competition Act* applies to both the input and retail levels of an industry.

Transportation regulation laws are to a large extent responses to perceptions either that the retailer of passenger services would have excessive

market power without regulation, or alternatively, that market power should be generated by regulatory protection and directed to facilitate the pursuit of social policy objectives. *Such laws therefore do not (apart from the limited area of railroad access) provide a comprehensive instrument for eliminating market failures and inefficiencies that increase ultimate consumer costs or reduce ultimate consumer choice. Stated another way, transportation regulation laws do not remedy a market failure or excessive market power relating to inputs to the regulated service.* At the same time, they represent a legislative assumption that the most serious market failure or market power problems exist at the retail level.

Such an assumption may be initially valid but it is difficult to maintain as market conditions evolve. A comparative virtue of the *Competition Act* is that the legislation itself makes no assumptions about where in the production process the most serious forms of market failure or excess market power are likely to be found. Thus, subject to the reservations discussed in (c) below respecting markets subject to very high entry barriers, competition law is arguably better positioned to attack the root causes of consumer welfare loss (the disease) as opposed to the end result of these causes (the symptoms).

By way of example, the Bureau of Competition Policy, and not the Agency or federal Transport Department, was the source of a remedy to preclude exclusionary practices from developing in the dominant Canadian computer reservation system (CRS) firm. There is no longer any industry, travel agent or consumer support to legislate common carriage requirements based on snapshot observations of what may or may not be a "natural monopoly." Since the Competition Tribunal's resolution of the Gemini/Reservec case (see Part III, section D), there do not appear to have been substantial complaints of preferential display or access from air carrier competitors, travel agency consumers, or suppliers of collateral services (for example, ground transportation and accommodation).

(b) Competition Act *Jurisdiction*

The starting proposition therefore is that the *Competition Act* has exclusive jurisdiction in relation to passenger transportation service inputs. However, this jurisdiction is subject to two very basic limitations. First, for conduct to be actionable there must be a business relationship and also generally priced transactions. The evidentiary requirements of the Act's criminal

prohibitions and reviewable practices cannot for all practical purposes be met where the supply of goods or services is not being rationed by private sector markets using a price system. This effectively removes the Act from the supply of public goods or government services whether as inputs or as end products.

The supply of government services (whether they are priced as otherwise supplied under a contract, or not) is also effectively exempted by the common law exemption relating to Crown Agents. As noted, the exemption was cut back in the 1986 revisions to the Act only with respect to the commercial activities of Crown corporations.

Thus, to the extent that market failure or excessive market power in government-supplied inputs to passenger transportation services have a negative impact on consumer welfare, such problems remain out of reach of the *Competition Act* and are subject to correction, if at all, only through Ministerial accountability. It is arguable that this accountability structure is least susceptible to the introduction of the market-creation measures implicitly favoured by competition laws to remedy problems of inefficient resource allocation.

(c) Comparison of Substantive Tests

Regulation legislation for federal and provincial passenger service has largely adapted "public interest" and "reasonableness" tests to the determination of whether regulatory intervention is required in price, merger and supply decisions. Certain provincial statutes for the regulation of intercity bus service market entry and the *Railway Act*, with respect to railway market entry, contain a "public convenience and necessity" test.

All three tests are in practice equally broad. In fact, as legislative articulations of government decision-making discretion go, they are probably the broadest legislative grants of discretion that can be made. In the case of NTA, 1987 powers, it is possible to argue that the Act's statement of transportation policy limits regulatory discretion. However, in reality the policy statement is so extensively qualified and rife with contradictory objectives that can only be balanced on a case-by-case basis, that no real limitation to regulatory discretion has been created.

Thus, these federal and provincial regulatory laws effectively permit the decision maker to apply any set of economic or social criteria to define appropriate regulated firm conduct. Stated another way, there is no externally imposed reference for what is, or is not, in the consumer interest. Identification of that becomes a self-referential exercise based on references to and analysis of the regulatory jurisprudence under each regime together with the balance of interests represented in the overall decision-making process.

Accordingly, there is nothing in the substantive tests of existing transportation regulation laws that would prevent the decision-makers from adopting the standards of anti-competitive behaviour of the *Competition Act* as, at the very least, difficult-to-rebut presumptions of behaviour that is not in the consumer interest even though administrative law rules require the decision making to retain some discretion and objectivity to support case-by-case adjudication.

On the other hand, the decision-making tests of the *Competition Act*, reviewed in Part III, are much more highly articulated and clearly focussed upon economic concepts and standards. This Act itself provides considerable guidance in such areas as the definition of anti-competitive acts of a dominant firm, the characteristics of anti-competitive non-price vertical restraints to trade, and the criteria for merger impact assessment.

Additional detailed guidance has been provided by the Bureau itself on key matters such as market definition of what is unreasonably low pricing, and what constitutes a substantial lessening of competition. The level of detail in this guidance may appear daunting but it is designed to permit private interests from anticipating Bureau action with the greatest possible precision. The Bureau is in a better position to provide such guidance and to bind itself to it as its role is administrative and does not involve adjudication. The Bureau is therefore not constrained by administrative law rules that require regulatory agencies to retain impartiality and decision-making discretion.

In my view, the criteria of the *Competition Act*, as supplemented by the DIR guidelines on price discrimination, predatory pricing and mergers discussed in Part III, are to a high degree consistent with prevailing microeconomics theory in the situations where individual firm behaviour is likely to result in a net reduction of consumer welfare within the economy as a whole.

That is not to say that firm behaviour which is not actionable under the *Competition Act* would never disadvantage particular consumers or groups of consumers for a certain period of time. Such a guarantee of course cannot be made in a competitive market system where government trade regulation is designed to be applied on an exceptions basis. Rather, the *Competition Act* addresses the overall impact on consumer welfare in the product and geographic markets served by particular firms. Through the use of economy-wide conduct standards, the Act attempts to ensure that all such markets are subject to the same restraints and therefore that all markets operate under the same incentives and opportunities to maximize outputs and profits.

The basic assumptions of competition law are that:

(1) markets are subject to competition; and

(2) markets (including both buyers and sellers) optimally respond to prevailing price signals.

The first assumption, however, cannot be readily satisfied if the industry is most efficiently supplied by a single firm, or barriers to entry preclude competitive responses to high pricing or exclusionary conduct.

An efficient monopoly exists in a particular market where the marginal unit costs of supplying the relevant product in the relevant geographic market are least if there is one supplier, over the longer term, without any artificial barriers to entry or exit in the market. This requires constantly increasing economies of scale and/or scope for the industry as a whole in the market for the entire level of demand in the long term even as technology changes.

These conditions are very difficult to satisfy. Very high, fixed, start-up costs (high economic entry barriers) coupled with a capital-intensive business structure and assets which have little or no alternative use or secondary market value (high economic exit barriers) are often considered as necessary conditions for a natural monopoly. Plant- or firm-level economies of scale or scope are, however, generally not regarded as sufficient for a natural monopoly in a particular market. As well, the more rapid the pace of technological change (and hence the greater the capacity to innovate) and the more physically mobile or generic the principal assets of firms in a market are, the less likely an industry is to meet the economic conditions for a natural monopoly.

High entry barriers can also be created by government regulation, trade policy, government procurement preferences and capital market imperfections.

In other words, the current *Competition Act* and, in my view, probably any form of competition law which aims at preventing consumer welfare losses from private sector restraints to trade on an exceptions basis, is not likely to prevent monopolistic conduct in industries characterized by high concentration and/or high entry barriers. Specifically, the current abuse-of-dominant-position practice is clearly directed at forestalling monopolizing behaviour (behaviour that is directed at reducing competition) in intrinsically competitive markets. It seems almost axiomatic that an efficient monopoly or a firm that becomes more efficient as competition is eliminated could not practice anti-competitive acts in its own market since the elimination of all its competitors would result in production at the lowest possible costs.

Classical economic theory suggests that a firm that profit-maximizes in an industry with very high entry barriers would undersupply the market relative to a situation of competitive supply. The firm would price-discriminate according to consumers' ability to pay in order to appropriate to itself as much consumer welfare as it could.

However, these reservations do not apply to the extension of monopoly or market power from that base market to other intrinsically competitive markets. The *Competition Act* has several reviewable practices specifically tailored to preventing such anti-competitive monopolization.

The second assumption behind competition law cannot readily be met where consumption and production decisions are so fraught with non-price externality effects that prices cannot be used as a benchmark of resource value trade-offs. Equally, markets fail if prices cannot be created or collected. These latter conditions define a pure unpriced public good.

The former externality conditions define situations where market failure may be addressed to a limited extent by what economists call "second-best" solutions through subsidized or mandatory consumption (where prices exceed marginal social value resulting in insufficient consumption) or by the imposition of social cost taxes, mandatory consumption restrictions and/or mandatory product design rules to minimize social costs not reflected in the price (where prices are less than marginal social value).

Safety regulations are an example of this first situation; applied in a market on an evenhanded basis, safety regulation imposes general costs akin to taxes. Such regulation therefore would not distort input prices to a degree that would make competition law impossible to apply because, in practice, adequate evidence could not be developed to support a remedial Order or criminal conviction. Safety regulation and competition law can therefore comfortably co-exist.

Pure public goods may readily be identified based upon the physical inability to exclude non-payers from the benefits of consumption by payers or conversely the physical inability to get users to pay for any socially useful level of production. They include policing and defence and possibly little else. They do not necessarily include goods originally provided by the state to accelerate or increase their production from what the private sector was then offering, but which now can be produced abundantly by private markets or which can now be effectively charged for (that is, potential free riders can now be excluded).

Whether the production or consumption of a non-pure public good is so enmeshed in externalities that prices are meaningless is largely a matter of political judgement.

However, to a significant extent such externalities can be minimized through consumption or product standards or explicit targeted subsidies in order to maximize the ability of individuals to exercise price-based choices. As a general proposition, consumer welfare as a whole would appear to be better served through a system of explicit and targeted subsidies and/or consumption standards for which there is clear political accountability than through a price system involving hidden internal and untargeted subsidies or hidden consumption standards.

D. INSTITUTIONAL/ADMINISTRATIVE DIFFERENCES

1. Introduction

This section examines the institutional and administrative differences that exist between the government bodies that apply the substantive business conduct and industry structure standards of the *Competition Act* and the *National Transportation Act, 1987* and related federal and provincial passenger transport regimes.

As previously noted, there is no statutory or common law requirement that the National Transportation Agency or provincial intercity bus regulators adopt substantive decision-making criteria that *differ* from those of the *Competition Act* in those areas where their jurisdiction either parallels or excludes the operation of that Act. Such bodies apply sufficiently broad discretionary tests that fitting *Competition Act* criteria into them would be lawful even if the regulator had previously applied different criteria. The only requirement in doing so would be adherence to the administrative law rules of fairness or natural justice.

Any difference between the regulators' criteria and the prevailing standards of the *Competition Act* must therefore be regarded not as a legal requirement but as a result of the balancing of competing principles and interests established as legitimate through the individual regulator's institutional structure and/or through the decision making rules imposed upon the regulator by the courts, particularly due process requirements. It is also conceivable that the regulatory agency may employ due process standards which go beyond the minimum level required by the courts. It would do so to satisfy general political expectations respecting direct public involvement in decision making, or to increase the legitimacy of its actions by co-option of affected interests.

2. Regulatory Agencies — A Behavioural Profile

Procedurally, one thing can lead to another. Once having embarked upon a decision-making process that involves identification and ranking of legitimate or affected political or economic interests (a polling process), a regulatory agency will find it very difficult to order its priorities or to structure its decisions in a fashion which does not fall within a "range of reason" established by the positions of the interests involved in its decision-making process. Over time, a regulatory agency may also base its priorities upon the more dominant or persistent economic or political interests appearing before it (these can be producer, consumer or even governmental interests).

Under these circumstances it becomes very difficult for the regulatory agency in practice to implement priorities based upon objectives, such as maximization of competition which, over the long term, are relatively abstract and do not appeal to the direct economic interests that are involved in its decision making.

For example, *future* competitors are, by definition, never directly present in a decision-making process.

This difficulty increases with the vagueness or generality of the statutory decision-making criteria. This considerable vagueness is inevitable, in my view, once a regulatory agency model is adopted where investigation and adjudication are merged in a single institution. The absence of statutory or executive policy guidance and the resulting dominance of jurisprudence and consensus-oriented process also significantly reduce the ability of this form of regulatory agency to adopt dramatically different behavioural or structural standards for an industry to reflect changes in the industry's economic fundamentals.

Because a consensus-oriented, decision-making process involves a degree (often very significant over time) of interest-group brokering, there is often compelling pressure upon the regulatory agency to make decisions that are "fair" to the interests involved. The tendency is bound to increase to the extent that the regulator's enabling legislation does not provide detailed and internally consistent decision-making standards.

Finally, because regulatory decisions, particularly where public hearings are involved, take on some jurisprudential value, and because a closely knit group of producers with strong expectations for consistency of regulatory policy/jurisprudence (the regulated sector) are involved in its decision making, it becomes extremely difficult politically for a regulatory agency to amend significantly its objectives or priorities. Typically the initiative to change objectives or priorities comes from an exogenous "shock to the system," such as dramatically different market conditions affecting the regulated sector, government policy, or (most rarely in Canada) judicial intervention.

Put simply, as the result of a combination of factors, regulatory agency decision making tends over time increasingly to broker competing economic interests through decisions that are politically legitimate (that is, fair). There is generally no internal correction or arresting mechanism in the agency's structure or in its instructions from the legislation to keep the agency from continuing along this slippery slope.

This correction must generally be imposed externally through legislative change (including deregulation). For reasons discussed below, other external options such as judicial intervention, legislative review of appointees or agency performance, executive policy guidance, and staff and decision-maker overhaul (such as is applied in the U.S. revolving-door approach) are not significant in the Canadian context.

It would be useful, therefore, to summarize the convergence of institutional and structural factors which support decisions that gravitate to political fairness and modest change rather than maximum competition and rapid change. These factors are in relation to Canadian regulatory agencies, such as the National Transportation Agency, that combine investigative and adjudicative functions and employ open public hearings in their decision-making process.

(a) Absence of Clear Statutory or Executive Policy Guidance

Tests such as "just and reasonable," "public convenience and necessity," "no undue discrimination," and especially "in the public interest" are no more than large receptacles for the case-by-case exercise of unconstrained administrative discretion. They have no substantive or operational meaning in and of themselves.

Regulatory statutes are seldom revisited by the legislature in a fashion which would cause a reassessment of priorities. Opportunities for executive policy guidance are few and largely unused.

(b) Little or No Policy Accountability of Regulatory Appointments

Appointments are often political rewards and almost never designed to ensure application of a particular economic policy. Appointees are often not selected because of their expertise and where expertise is a criterion, the expertise often is developed through involvement with incumbent producer interests. Reappointments or new appointments occur gradually over time; thus the complexion of regulatory agencies, much like the Supreme Court of Canada, is hard to identify and political balances are slow to change.

Appointees who do not perform effectively are almost never removed for cause before the appointments period ends. Rather they are not re-appointed. Few proposed appointees are even interviewed publicly by the legislature

before the appointment is made, to identify either expertise or priorities. The legislature seldom reviews the substance of the agencies' decisions other than during brief examinations of financial requirements.

Notwithstanding the virtually unfettered review and override powers of Cabinet, and thus the opportunity for Cabinet to articulate in advance the circumstances under which overrides may occur, extremely few Canadian regulatory agency decisions are changed by the executive branch of government.

(c) Longevity of Staff Advisors

In contrast to the fairly even and rapid turnover of agency appointees, Canadian regulatory agency staff tend to be employees of long duration with senior staff often recruited from the regulated sector itself or other branches of government that regard the particular regulated sector as a client from an economic development perspective. This difference tends to increase the influence of staff in the decision making and provides an important opportunity for the regulated sector to exercise decision-making influence outside formal or public elements of the process.

As well, the agency staff, rather than agency appointees, tend to be the source of industry expertise.

(d) Absence of Judicial Intervention

Typically, judicial review of agency decisions is restricted to errors of law or jurisdiction, which can include insufficient procedural fairness, misinterpretation of statutory decision-making criteria, bias and acting for an improper purpose.

However, given the inherent vagueness of regulatory decision-making criteria and statements of legislative policy in Canadian regulatory statutes and the absence of constitutional economic rights, there are virtually no opportunities for judicial intervention into the merits of a decision.

As well, Canadian due process law respecting regulatory agencies is relatively new and costly and time-consuming to activate. It has to date not provided as effective a tool as American due process law in ensuring a balance

between competing economic interests (for example, producers versus consumers) in access to regulatory information or access to decision-making activities (including off-the-record influence).

(e) Role of Public Hearings

Public hearings can be a device for levelling the impact of resource disparities among competing economic interests. They also can be a double-edged sword. Public hearings open up at least some part of the overall decision-making process to a structured competition between the articulated merits of competing economic interests. On the other hand, public hearings are costly and, if there is no tradition of open access, public hearings can reinforce the impact of resource disparities between producers and consumers and favour advancement of the views of the traditional dominant player, usually the regulated sector as a whole or major incumbent firms.

The value of public hearings as a levelling device also decreases where their actual use or relative importance in the decision-making process cannot be predicted with accuracy. For example, regulatory agencies often have considerable discretion over whether or not to conduct a hearing in order to decide, and, if a hearing is conducted, considerable discretion over its role remains. In practice, if an agency's decision does not expressly state that the record of a hearing was ignored in making the decision, judicial intervention into the agency's reasons is highly improbable. The agency is thus free, in relation to the risk of judicial intervention, to ignore what might reasonably be supposed to be a key, if not determining, decision-making event.

3. Transportation Regulatory Agencies

Several considerations affect an assessment of the comparative capacities of direct regulatory intervention and competition law to protect consumer interests that relate to specific design features of economic regulators for Canadian passenger transportation services.

First, all such agencies have their genesis in a legislative presumption that the sector requiring regulation was subject to chronic and significant market failure. There are no deregulation provisions in the enabling legislation to permit the regulator to bail out of counter-productive intervention in the event that the circumstances causing market failure disappear. This neatly avoids any need by the regulator to review the underpinnings of its continued

existence or, in the extreme, to consider self-destruction. Rather, in practice, it provides an opportunity for the regulator to fortify its continued existence by consciously promoting the continued validity of the presumptions that led to its existence in the first place.

The market failure prompting regulatory legislation appears to have differed among modes. For rail, it was a fear of natural monopoly power. For air and trucking, it was a fear that unconstrained competition was inherently destructive and would result in inadequate levels of service, rapid swings between over- and under-capacity and few incentives to invest. It is now recognized that, to a large extent, market failure rationales played a secondary role to the sheer political power of producer interests and were largely developed as after-the-fact ways of legitimizing interests wishing to maintain a regulated industry structure.

The concern over inadequate service levels also, before and after the fact of agency creation, provided a strong opportunity to generate a regulated sector price structure that was riddled with hidden but politically attractive internal subsidies. These subsidies reduced or eliminated the need for explicit government subsidies covering the start-up phase of the sector, or individual firms, avoided the uncertainty and political risks of their possible removal, and permitted the regulator to appear fair to competing consumer interests.

Finally, because transportation technologies developed at different times and the political balance of the federal and provincial levels of government has shifted over time, transportation regulation legislation has been historically confined to single modes (that is, technologies). Jurisdiction has been split between the federal and provincial levels based upon political rather than economic considerations. Rail and air services are federally regulated while road-based services are effectively provincially regulated. Public road passenger jurisdiction is also split at the provincial level between the province itself (buses) and its municipalities (taxis).

This historical accident has created an inherent bias within individual transportation regulation bodies to regard each mode as a discrete industry having a discrete market rather than functioning as a substitute for other forms of public or private transportation.

However, mode-specific analysis tends to avoid the real questions to be answered in identifying continuing market failure such as: given all available substitutes in providing transportation services within a particular geographic area to a discrete set of consumers (for example, passenger service consumers), is it possible for any one supplier or group of suppliers (without an agreement not to compete) to earn monopoly profits or to stay in business while providing an unacceptable level of service?

Mode-specific analysis also tends to discourage an examination of the impact of enforcing traditional hidden subsidies, through regulated prices in a particular mode, on the long-term survival prospects of that mode where technological change offers new effective substitutes.

4. Competition Law Contrasted

(a) Substance

There are major differences in the substantive conduct standards of competition law and the direct regulation model and in the manner in which these standards are applied. These differences are critical to an assessment of the relative merits of each approach for the future protection of intercity passenger service consumer interests. They may be summarized as follows:

(i) Statutory industry performance standards are more explicit under competition law.

(ii) Competition law remedies are designed to be transitory. Firms or industries subject to competition law intervention and restraint have this restraint lifted by the courts or the Competition Tribunal once the statutory prerequisites for restraint disappear or circumstances change.

(iii) Markets, and hence the presence of market failure, are defined in a consistent manner for all aspects of the economy free of institutional presumptions or any market analysis of the presence of functional substitutes and the prospective impact of competitive entry regardless of the technology employed to produce the final product. This, in my opinion, makes competition law, as a general law of general application, a more effective instrument for assessing the effects on a particular sector or industry of evolving market or technological conditions. Competition law also encourages an analysis of the consumer impact of firm or

industry behaviour which emphasizes the likely response of competitors or investors to that behaviour over the current performance or structure of an industry;

(iv) Competition law precludes intervention to generate hidden consumer subsidies through price structures and therefore places the subsidy responsibility directly on the appropriate legislature. The objectives of economic efficiency, industry development and wealth distribution are thus not commingled in a murky jurisprudential soup that militates against public accountability over the adoption of often non-complementary policies;

(v) Finally, in my view, the overall set of actionable behaviour under Canadian competition law is largely congruent with the behaviour described by established microeconomic theory as most likely to reduce consumer welfare through higher prices, reduce choice or reduce innovation. In contrast, the open-ended nature of transportation industry regulatory intervention standards creates an opportunity to make actionable behaviour which could enhance consumer welfare. A possible exception to this observation is, as noted previously, a situation of natural monopoly.

(b) Process/Administration

There are also very basic differences between competition law and transportation regulation administration. Competition law is enforced equally against all elements of the economy with the investigative or fact-finding process occurring in private without there being any enforceable involvement by affected economic interests. Competition laws are adjudicated in a strict judicial environment even where the Competition Tribunal is the adjudicator. The adjudicator is exposed only to a series of "one-off" issues relating to specific behaviour of a specific firm.

On the other hand, transportation regulation is enforced only with respect to specific industry components with fact finding involving some enforceable input rights for affected interests. Issues are adjudicated in a less judicial and more political environment. The ultimate decision maker is exposed to what amounts to a continuum of issues relating to the business policies of that particular industry component.

These differences, in my view, have resulted in compelling incentives for transportation regulators to go beyond the level of intervention necessary to maximize consumer welfare. They should become a "second layer of

management" which attempts to strike a delicate balance, within a non-managerial environment, between competing suppliers, consumers and industry development goals. They should use a statutory framework that encourages decisions to be made on the grounds of fairness. The decision-making structure of transportation regulation, as with other industry-specific regulatory regimes which constrain competitive industries, contains a variety of elements which collectively create a bias in favour of protecting incumbent supplier interests. This ultimately leads to a less than fully efficient development path for the industry as a whole.

(c) Conclusion

The substantive and administrative structure of competition law appears to provide reasonable assurance that consumer welfare will be maximized in the supply of transportation services, as with other services, with the exception of those transportation services that are demonstrably natural monopolies. There is a built-in tendency of transportation regulation to import and balance, largely in a hidden unaccountable fashion, policy considerations which are different from, or in conflict with, consumer welfare maximization. Competition law in my view is a superior instrument to transportation regulation to maximize consumer welfare, and therefore to protect consumer interests.

An exception to this general proposition could be made where regulatory protection was determined to be an appropriate transitory policy during the infancy period of a new industry (to be "sunsetted" once a sustainable and competitive industry structure was achieved). However, on balance, regulatory protection would appear to be an excessively risky instrument to distribute wealth among consumers. There are too many serious industry inefficiencies caused by the prices and entry barriers necessary to sustain cross subsidies.

V. Transportation Industry Developments: Appropriate Trade Practices Framework

A. INTRODUCTION

This part examines the suitability of competition law regulation of trade practices, and the likely approach of the Bureau of Competition Policy towards complaints, in relation to the following industry developments:

(1) increased cross-modal ownership (for example, bus and air feeder services);

(2) infrastructure access arrangements and pricing;

(3) airport defederalization;

(4) road privatization;

(5) intercity bus service deregulation;

(6) air carrier entry and price deregulation in Northern Canada;

(7) increased competition from non-Canadian suppliers (for example, fifth freedom or cabotage rights provided to U.S. carriers; increased airport access under bilateral arrangements); and

(8) passenger ferry privatization.

B. INDUSTRY DEVELOPMENTS

1. Cross-Modal Ownership

A competition law analysis of industry structure and concentration of ownership changes is conducted in relation to the relevant product and geographic market rather than changes in the relative financial or bargaining power among firms engaged in a particular transportation mode. Such an analysis would consider the nature of economic and regulatory entry barriers in each mode and whether it was likely that increased cross-modal ownership would, on a case-by-case basis, foreclose single-mode competitors from important sources of customers and interconnecting traffic.

There would only be a potential competition law concern if the respective modes supplied the same markets or if one mode was an essential input to another market. No concern would arise if there were no apparent economic or regulatory barriers to entry into the relevant market. Economic barriers to entry would be examined in relation to the extent of fixed and start-up costs, and the capacity of customers to switch suppliers.

Given the low economic entry costs in most transportation services, the mobility of transportation assets (excluding roadbed which is generally separately owned), and the maturity of development of the passenger transportation sector, there is little reason to conclude that the basic set of

trade practices controls of competition law would not satisfactorily prevent industry behaviour that did not result in maximization of consumer welfare.

Without regulatory entry barriers, there is little chance of an actionable competition law issue arising. This further supports the relative desirability of the less interventionist administrative structure of competition law.

2. Infrastructure Access Arrangements and Pricing

This next section examines the usefulness of the *Competition Act* in constraining anti-competitive behaviour with respect to controlling access to essential "bottleneck" inputs to the production of passenger transportation services. These inputs include access to airport terminal facilities, railway, roadbeds and highways.

Before proceeding with this discussion, it should again be emphasized that the *Competition Act* itself does not permit the application of social, environmental or industrial development policy goals on economic decision making. It takes the prevailing price system or conditions of supply as given. To the extent that these prices or conditions of supply reflect such policies, the *Competition Act* becomes an increasingly less effective instrument in encouraging economic efficiency and consumer welfare.

This inverse relationship should, of course, not be surprising since it essentially reflects the overall balancing being made by society through its laws. Economic efficiency as measured purely by private transactions and their prices is balanced against overall social welfare, the measurements of which become permeated with subjective and political judgements because of the presence of important perceived, but not easily measured, consumption and production externalities.

For example, assume that roadway usage charges for large, energy inefficient passenger cars were set by a supplier well above the long-run marginal costs imposed on the roadway by such cars in order to discourage their consumption and thereby to reduce pollution. It would be far more difficult for the Bureau of Competition Policy to examine a complaint from a manufacturer or rental car supplier that the pricing practice had anti-competitive effects (for example, in relation to competition with public transit including intercity buses, or smaller car suppliers) than if the roadway usage prices had been set using the principles of marginal cost pricing.

The following discussion will therefore assume away pressure favouring substantial "social policy" pricing in the commercial supply of transportation infrastructure access.

Two situations are considered: (1) the supplier of infrastructure access is also a supplier of passenger transportation services which require the infrastructure or which compete with services that require that infrastructure (a vertically integrated supplier); and (2) the supplier of the infrastructure is *not* vertically integrated with a supplier of passenger transportation services.

In both instances, assume that the infrastructure supplier is the sole supplier in a geographic market but that there is no regulatory licensing barrier to prevent or control new infrastructure suppliers in that market.

(a) Vertically Integrated Supplier

This situation could arise, for example, if

(i) roadway access was supplied by a commercial Crown corporation or an investor-owned firm which also controlled or had a significant investment in suppliers of public transit, intercity buses or taxi-type passenger transportation services;

(ii) rail access was supplied by a commercial Crown corporation or an investor-owned firm which also controlled or had a significant investment in a passenger rail service or intercity bus service supplier; or

(iii) airport access was supplied where the airport owner was a commercial Crown corporation or an investor-owned firm which also controlled or had a significant investment in an airline.

The *Competition Act* contains several quite clear provisions directed at preventing vertically integrated suppliers with strong market power in one market from extending that power through exclusionary or discriminatory pricing practices into a second, more competitive market made up of unintegrated suppliers or customers.

In situations where the vertically integrated infrastructure supplier was attempting to control access through discriminatory pricing against third-party customers, discriminatory access conditions, or outright refusals to supply access, the following provisions would apply:

(i) *refusal to deal:* Assuming infrastructure access is supplied on a commercial basis, then the Competition Tribunal could order the infrastructure owner to supply access to parties on usual trade terms if there is a refusal to supply but access is in ample supply, and the third-party passenger service supplier is substantially affected or precluded from carrying on business due to an inability to obtain adequate supplies. This inability must result from insufficient competition, and the third party must be ready, willing and able to meet the infrastructure supplier's usual trade terms;

(ii) *abuse of dominance:* The illustrative anti-competitive acts set out in the *Competition Act* include "squeezing, by a vertically integrated supplier, of the margin available to an unintegrated customer who competes with the supplier for the purpose of impeding or preventing the customer's entry into, or expansion in, a market" (this is aimed at dominant supplier price discrimination), and "pre-emption of scarce facilities or resources required by a competitor for the operation of a business, with the object of withholding the facilities or resources from a market" (this is aimed at discriminatory supply conditions by either a vertically integrated or unintegrated supplier either to inhibit competition or to obtain monopolistic profits).

As previously noted, dominant position and the effect of a substantial lessening of competition from the practice of anti-competitive acts must also be proven using a civil law standard of proof.

There is, as has been discussed, a considerable jurisprudence under the *Competition Act* dealing with exclusionary practices and pricing by vertically integrated suppliers. In some cases, such as the supply of replacement Chrysler auto parts or aspartame sweetener, the supplier, subject to a Competition Tribunal review application was, in effect, a monopoly.

Clear applicability and orientation of the *Competition Act* are not in doubt. The question is whether the Act and its administrative apparatus provide a sufficiently practical and timely way of remedying this form of anti-competitive behaviour.

It would be inappropriate to focus only upon the average turnaround time of litigated cases before the Competition Tribunal that ultimately result in a Tribunal remedial Order. The bulk of complaints arising under the reviewable trade practices provisions of the Act are settled informally, after Bureau

intervention outside the formal inquiry process, to the apparent satisfaction of complainant and supplier. This suggests that timely remedies on an informal basis are the norm. As well, suppliers are increasingly relying upon opinions of the Bureau, provided under its Program of Compliance to structure their businesses.

One interesting option may therefore be, at the time at which infrastructure access is to be put on a commercial basis, to require, as a condition of business transfer to the new supplier, that the new supplier obtain and adhere to a Program of Compliance opinion on how to avoid *Competition Act* violations.

With respect to the practicality of the remedy that may be provided under the *Competition Act*, the refusal to deal and abuse of dominance provisions should be distinguished. The refusal to deal remedy is resumption of supply on normal order terms — it does not allow for an offset for advantages obtained from past anti-competitive behaviour. However, abuse of dominance provides a more sweeping power to the Tribunal if a cease and desist order is not likely to restore competition: to order whatever is reasonable and necessary to overcome the effects of the anti-competitive practice in the market, *including* divestiture of the firm against which the Order is directed.

(b) Non-Vertically Integrated Supplier

As previously discussed, the abuse of dominance position provisions of the *Competition Act* are, in my view, not well suited to preventing market failure in markets where a single supplier is most efficient or where there are extremely high economic or indirect regulatory entry barriers. Although the abuse of dominance provisions do include a divestiture power, this power is, from a practical standpoint and in relation to the overall remedial structure of the Act, a power which would be seriously considered only in exceptional circumstances. Moreover, divestiture of a supplier which is, in effect, a geographical natural monopoly may not be a complete answer if the only result is the creation of a number of smaller geographic natural monopolies.

As well, the overall orientation of the *Competition Act* is towards the remedy of transitory problems in inherently competitive markets.

Consequently, the situation of the unintegrated monopoly supplier should be examined both in terms of its home market and in terms of its impact as a supplier of inputs to competitive retail level passenger transportation services.

The same analysis as applied to vertically integrated infrastructure suppliers would apply to the unintegrated supplier with respect to price or supply discrimination among customers in relation to commercially available products. The motive and consequences of anti-competitive behaviour would, however, become substantially more difficult, although certainly not impossible to establish if the infrastructure supplier did not have a direct economic interest in a transportation service competitor. However, the case could still be based upon the comparative impacts of discriminatory prices that do not reflect marginal costs or discriminatory supply restrictions on competitive firms.

Both the evidentiary problems and conceptual orientation of the abuse of dominance provisions become significantly greater when inter-competitor discrimination is not an issue, but instead, the complaint arises from perceived inefficiency, excessive prices and profits, or absence of innovation on the part of the unintegrated sole supplier. In short, this is the traditional problem of monopolistic profits, goldplating, and dulled performance that has supported both government ownership and public utility regulation.

Previously noted was the illustrative anti-competitive act of "pre-emption of scarce resources" which conceivably could be extended to monopoly under-supply of a market (which classical economics theory suggests will occur with a profit-maximizing monopoly). However, in my view, this is stretching the scheme of abuse of dominance as presently written.

As well, it appears uncertain whether there is an effective remedy available to the Competition Tribunal in these circumstances. The Tribunal has no authority to control prices or profits or to require the provision of yet-to-be supplied products. As noted, the divestiture power is not likely to be any help in these circumstances.

Thus, in my opinion, either amendments to the *Competition Act* or a separate regulatory regime would be necessary to control the monopoly power of an infrastructure supplier that was not manifested in discriminatory pricing or supply conditions among its customers.

On the other hand, it does not necessarily follow that the only real options are government ownership (the effectiveness of which is not examined in this report) or direct (public utility-type) regulation of services, profits and products.

For example, the infrastructure supplier's pricing behaviour could be made subject to the *Competition Act*, but its overall corporate performance could be subject to non-regulatory incentives such as a periodically renewed franchise tied not to the continued operation of the business but to management of the business. A remedial trusteeship of specified duration could be imposed by government to supplant incumbent management if profits, costs or the level of overall innovation appeared unreasonable upon a periodic corporate performance review. Another option, which arises at privatization, is the retention of a "golden share" in the hands of government which, coupled with a shareholder's agreement, requires government or third-party review of overall corporate performance, but not specific pricing and supply decisions.

Such options would, in my view, not cast a cloud over the applicability of the *Competition Act* to pricing and supply decisions. To assess their effectiveness, they should be compared to direct regulation of access prices and conditions by an independent agency.

The principal benefit of direct intervention is that government control of industry behaviour would be regarded as fairer and less-hidden since decision making would occur in a more public and consensus-oriented forum. Access prices and conditions certainly, or stability, if they are considered to be important outcomes, do not require direct regulation to be realized since price transparency and minimum-price duration requirements could readily be made through franchise renewal or divestiture conditions.

On the other hand, assuming that monopoly profits can be precluded through franchise renewal or divestiture conditions, the regulatory agency option, as it has developed in practice in Canada, runs the risk of establishing prices that are no more conducive of efficient economic behaviour than is current rationing of capacity on non-price basis. A regulatory agency is also a costly administrative apparatus that adds considerably to the complexity of supplier decision-making.

To some degree, this problem of natural monopoly performance could also be mitigated if, in the course of infrastructure privatization, the infrastructure was broken up into a substantial number of distinct geographical monopoly suppliers. To operate, these suppliers would have to enter into traffic exchange or joint operating arrangements with each other in order to be efficient.

Two conditions would prevail: (1) these suppliers would have strong financial incentives to maximize traffic and obtain access to other infrastructure suppliers at minimum cost, or (2) there would be consumer transparency among infrastructure suppliers.

Condition (1) could arise, for example, in a privatized road system where users were billed by one "home-base" system for all travel, but could shop around for the most economic home-base supplier. Condition (2) could arise where all road services were billed on a usage basis, and the prices of all road service suppliers were separately identified on each bill.

Such a market structure could impede monopoly practices through the balancing of bilateral local monopoly bargaining power. It might also produce sufficient price comparisons of firms with similar cost structures and comparable (but not identical) terms of supply to permit an analysis of whether any one firm might be subject to a remedy under abuse of dominant position.

Here, however, an effective anti-conspiracy control (again possibly taking the form of a binding Bureau Compliance Opinion) would be essential to ensuring the establishment of useful "shadow market" information, and to prevent industry-wide coordination practices.

3. Airport Defederalization

The discussion in (b) applies to the supply of airport facility access. Airport access is presumably supplied on a quasi-commercial basis. The constraint to current application of the *Competition Act* is ownership: airport access is provided by a federal department, the supply activities of which remain exempt from the Act by operation of the common law on Crown Agent coverage.

If airports were sold to private investors or a Crown corporation of either the federal or provincial governments, there is no doubt that the *Competition Act* would then apply. If airports were sold to municipal governments, the Act would also apply since such governments are statutory creatures. However, municipalities have the capacity to become Crown Agents if expressly made Crown Agents by legislation.

Notwithstanding that airports are presently subject to exclusive federal regulatory jurisdiction, it still appears possible for the provincial Crown to

make airports Crown Agents thus exempting them to the extent possible from the *Competition Act* until that Act is amended to cover all Crown Agents.

4. Road Privatization

In addition to vertical integration and natural monopoly issues discussed in subsection 2 above, road privatization also raises the issue of the capacity to price, bill and collect on bills — an issue that in effect defines whether roads should continue to be regarded as potentially private goods, as opposed to the current view that roads are a pure public good.

Without an actual pricing system for roads, even with privatization to a firm subject to the *Competition Act*, the capacity of this legislation to prevent behaviour that reduces consumer welfare would be low. However, it could apply to contractual access terms which could constitute abuse of dominance, for example, measures directed at frustrating competitive entry.

5. Intercity Bus Service Deregulation

The only serious barrier to intercity bus service deregulation is the presence of a significant degree of geographic cross-subsidization which is considered to be necessary to maintain the current geographic coverage of bus service. This requires an assessment of barriers to entry and probably pricing of new entrants services in "thin markets."

This industry segment is not a natural monopoly. Buses, like freight transport trucks, are low-cost, highly mobile and self-sufficient factories. On this basis it would appear that the *Competition Act* provides a sufficient trade practices regime for this industry.

6. Air Carrier Entry and Price Discrimination in Northern Canada

Again the effectiveness of competition law as a consumer protection instrument should be examined in light of the structure of the air services sector under this regime, particularly entry barriers, and the availability of modal substitutes.

Clearly the availability of modal substitutes to passenger air services is less in Northern Canada than in Southern Canada. However, the capital cost associated within Northern route entry appears to be quite modest in

relation to thick interurban route entry in Southern Canada since many Northern markets can be well served with small propeller-driven passenger aircraft. As well, passenger service in Northern Canadian routes would appear to be virtually a joint product with the supply of cargo services, since a relatively high proportion of goods consumed in Northern communities (and particularly high-value goods) is shipped in via air. Thus there would appear to be quite low barriers to entry into supplying air passenger services to the region as a whole and to particular origin-destination pairs in that region.

On the other hand, given the overall importance of air transportation to such communities, and the vulnerability that comes with remoteness, security of supply becomes a more important element of the overall consumer interest than with respect to other passenger service modes. Even a service disruption of as short a period as a week can be of major concern to Northern communities. This is the basis for the entry and exit restrictions established in the *National Transportation Act, 1987.*

Under Canadian competition law, competitiveness in terms of rate of new entry has traditionally been measured in longer time frames than are likely to be tolerated by Northern Canadian consumers of passenger or cargo air services. However, if a solution were to continue to be provided with respect to security of supply, it would appear that, given the overall inherent competitiveness of this air transport industry segment, competition law could be satisfactorily substituted for the other direct regulatory constraints of the *National Transportation Act, 1987.* A mandatory exit waiting period as a condition of an operating licence granted under a "fit, willing and able" test could be sufficient. A supplementary measure, if warranted, might include a security deposit or bond to permit community chartering of replacement service in the event of a breach of this waiting period condition.

Finally, as a general proposition based in part on airline deregulation in the U.S., particularly Alaska, a program of direct thin-route subsidies may be a low-cost and easily administered option for maintenance of supply security.

7. Increased Competition from Non-Canadian Suppliers

This issue may be considered in relation to both air and bus passenger services. However, the geographic coverage of U.S. or overseas air service

suppliers is clearly greater. And the most immediate prospect of competitive entry is from U.S. carriers having a significant existing transborder business.

The principal issue for consumer protection is whether foreign-based suppliers would have an incentive and an ability to enter the Canadian market at low prices, force Canadian incumbents out of the market, and then raise prices to levels that would otherwise not be possible.

More succinctly, the issue is the likelihood of successful foreign supplier predatory pricing, or effective service "dumping," to use the international law equivalent.

First, it should be noted that the predatory pricing, price discrimination and abuse of dominance provisions of the *Competition Act* apply to all prices charged in Canada by persons engaged in a business in Canada. Thus, it would be incorrect to assume that, because the *Special Import Measures Act*, which contains Canada's anti-dumping regime, does not apply to the importation of services, there is no Canadian law applicable to predatory pricing of service imports. The *Competition Act* applies to the supply of such imports in Canada.

Any uncertainty as to whether a foreign-based passenger services supplier was engaged in a business in Canada could adequately be overcome by:

(i) requiring an identifiable presence in Canada as a condition of supplying Canadian origins or destinations;

(ii) requiring that business presence to provide adequate security by way of a performance bond or other security deposit; and

(iii) making compliance with Canadian pricing laws a condition of entry and continued Canadian business rights.

It is in this context, that consumer protection measures beyond the *Competition Act* should be examined.

Prerequisites for effective predatory pricing are:

(i) capacity in other markets to raise prices above competitive levels to fund entry through predatory prices; and

(ii) a capacity to withstand further entry in the market where predatory pricing has been practiced to reduce or eliminate incumbent competition.

This requires an analysis of the level of competition and barriers to entry in both the established and the new market. With respect to the U.S. air transport sector, there is a very high degree of excess plant capacity (unused operating aircraft). This strongly suggests that there is little or no incentive or capacity on the part of U.S. air carriers to use revenues in the U.S. market to fund sustained below-incremental cost entry into Canada since both the "home base" and the Canadian markets are intrinsically highly competitive and have low economic entry barriers. Equally, the low entry and exit barriers in air transport would strongly suggest that any post-predation attempt to raise prices above competitive levels would be quickly met by price competition.

The only possible basis for effective U.S. based, air service predation into the Canadian market would be an agreement among all U.S. suppliers authorized to enter the Canadian market not to compete among themselves domestically and in Canada in a fashion that would permit post-predation joint monopolization of the Canadian market. The agreement not to compete in the U.S. to facilitate this export cartel strategy would of course be subject to U.S. anti-trust laws which are much more severe than the *Competition Act*. The agreement would also be subject to the conspiracy prohibition of the *Competition Act*. These exposures would have to be weighed against the prospective permanent benefits of a U.S.-supplier, market-sharing arrangement governing the Canadian market.

This joint monopolization scenario appears very remote. Not only is an effective joint monopoly unlikely, but, in my view, U.S.-based suppliers are unlikely to risk U.S. anti-trust sanctions and the prospect of being shut out of the Canadian market under a treaty arrangement as part of a Canadian government response.

Accordingly, the remote likelihood of successful predation as part of further U.S. air service entry supports reliance on competition law as the

appropriate trade practices regulation instrument with respect to U.S. air services competition.

Basically the same analysis applies to support reliance on competition law with respect to U.S. bus service entry.

This analysis, however, may not apply with equal force to further entry by non-U.S. based air services since these services are by-and-large national monopolies or obligations, and entry into these foreign national markets is often very strictly controlled. Thus, there may be a domestic market structure that might support successful predation. However, for such services the question must be asked whether any such national carrier would have a real business incentive to practice predatory pricing in the Canadian market, especially since such pricing behaviour would be very easy to detect quickly. In all likelihood, there would not be a greater incentive or capacity to predate successfully by such suppliers.

The *Competition Act*, therefore, would probably provide the appropriate regulatory framework for non-U.S. air service entry as well.

8. Passenger Ferry Privatization

The same considerations respecting natural monopoly power as were discussed in subsection 2 in relation to infrastructure access arise also in relation to marine ferry privatization.

The *Competition Act* as presently structured would not readily provide an adequate restraint to the exercise of market power unless competition were introduced through privatization. This could be through the sale of ferries serving a route to more than one supplier, coupled with a fairly strict anti-conspiracy control (possibly implemented by the Bureau of Competition Policy under its existing program of negotiating informal compliance undertakings).

In the event that all ferries serving a market were sold to one firm, there may be a need for some form of public-utility type of price and service regulation. This would be particularly true if the sale included the docking facilities or a franchise in the market.

VI. Concluding Remarks

Part IV examined the substantive, structural and administrative differences between the *Competition Act* and the general characteristics of transportation regulation legislation and regulatory agencies.

The analysis has largely focussed upon the general institutional characteristics of economic regulation as applied in Canada through independent regulatory agencies and the legal and institutional characteristics of Canadian anti-trust or competition law enforcement.

It is not possible, in my view, to conduct an empirical comparative analysis of the economic results of the decisions of the Bureau of Competition Policy and the National Transportation Agency (the Agency). There is a dearth of jurisprudence under the *Competition Act*. But this is even more so with respect to the *National Transportation Act, 1987* since there have been only very few litigated cases producing reasons with respect to pricing, entry, exit and merger of passenger transportation firms — or all transportation firms under the Agency's jurisdiction for that matter. There are no "smoking guns" of a good or bad application of economic principles under either jurisdiction to date.

In any event, for policy-making purposes, a more appropriate focus, is upon the long-term consequences of applying certain combinations of legal standards and institutional delivery mechanisms.

Transportation regulation regimes, due to a combination of factors, are less likely to encourage industry behaviour which is consistent with maximizing consumer welfare over the longer term when compared to competition law. Exemptions to this finding can be made, however:

(1) where an industry or a particular component of it is in its early stages of development and requires some protection from competition to overcome capital market inadequacies or to maximize the locating of a particular industry in Canada;

(2) where there are no transactions or transaction prices in the supply of a product; and

(3) where in the market under consideration there is a single supplier, high entry barriers, and the concern is excessive prices or profits.

Competition law applies a clearer and more rigorous set of rules in the prevention of trade practices which reduce consumer welfare. These principles are consistent with prevailing economic analysis of practices that are most likely to reduce consumer welfare.

But, as noted, competition law in general, and the *Competition Act* in particular, is not well suited to providing an effective remedy to the market failure known as "natural monopoly" or where pure public goods are supplied.

The *Competition Act* does not presently cover commercial activities of the Crown (as opposed to Crown corporations).

The *Competition Act* also remains in an evolutionary state due to uncertainty over the constitutional underpinnings of the key conspiracy and merger provisions and continuing dispute over the appropriateness and economic rationale for criminal prohibitions against price discrimination.

The *Competition Act* and its administrators presently suffer a "legitimacy" disadvantage in a democratic society where enduring regulatory legitimacy depends upon some degree of openness of administration and even public involvement in decision making. Presently all inquiries under the Act must take place in private, and public involvement in adjudication is strictly limited by judicial and Competition Tribunal criteria in granting standing to intervene. This impediment to establishing ongoing legitimacy is made all the more apparent when competition law administration is compared to the regulatory environment which involves more open fact-finding and adjudicative processes.

Nevertheless, the Bureau of Competition Policy has slowly but consistently tested the limits on its fact-finding activities and has become more forthcoming in the presentation of its analysis of informally settled matters. It would be possible to relax the legislated privacy requirement without undermining the objective of maintaining confidentiality. For example, the Bureau could be required to present more details on the results of its inquiries in its Parliamentary Report without naming the subjects of each inquiry.

In addition, there is increasing business reliance on, and respect for, the provision of detailed compliance opinions as part of the Bureau's Program of Compliance. Such proactive measures will become increasingly available and useful as the shift from a criminal law to a civil law environment for enforcing Canadian competition law is implemented in practice.

CHARTS

The following charts provide a snapshot of the current jurisdictional coverage of the *Competition Act* and the *National Transportation Act* and underlying provincial bus regulation discussed in Part IV and the relative merits of competition law and direct economic regulatory law in addressing the future developments review in Part V.

Chart 1:
COMPARATIVE JURISDICTIONS: COMPETITION ACT VERSUS PASSENGER TRANSPORTATION AND PROVINCE, PART IV

	Competition Act	**NTA, Provincial Bus Regulation**
Mergers	x	x
Predatory pricing price discrimination	x	x (busing, rail passenger only)
Agreements to lessen competition	x	
Vertical restraints (refusal to supply tied selling, market restriction, exclusive dealing)	x	
Industry structure level of competition (entry, exit, terms of service)		x
Abuse of dominance (monopolizing conduct)	x	
Excessive prices (monopoly profits)		x

Chart 2
Assessment, Part V

	Competition Act	Direct Regulation	Possible Other Measures
1. Increased Cross-Modal Ownership	current provisions adequate	parallel jurisdiction not necessary	
2. Infrastructure Access and Pricing	for (a) to (c) Act requires amendment to cover all Crown Agents	generally a second-best solution	linking Bureau compliance opinion with dissolution or privatization
(a) Customer Discrimination	abuse of dominance and non-price vertical restraint provisions adequate	not desirable — high risk of introducing non-economic "fairness" criteria	
(b) Supply Restriction	no means of requiring new products or increased overall supply	no means of requiring new products or increased overall supply	• periodic franchise review • golden share • break up territorial monopolies into smaller units • increase infrastructure supplier interdependence subject to strict anti-collusion control
(c) Excessive Prices/Profits	no effective remedy if market supports only one firm	public utility regulation of prices and profits feasible but carries significant risks of dulling innovation and technological change	see 2(b)
3. Airport Defederalization*	amendments to cover all Crown Agents desirable	not necessary (see 2)	creation of a private gate-and-landing-time market subject to *Competition Act* compliance opinion and undertakings
4. Road Privatization	See 2	See 2	See 2
5. Intercity Bus Deregulation	provisions adequate — industry has low entry barriers	not necessary if very large geographic cross-subsidies are not required	

Chart 2 (cont'd)
ASSESSMENT, PART V

	Competition Act	Direct Regulation	Possible Other Measures
6. Air Carrier Deregulation (Northern Canada)	provisions adequate		• retention of exit notice period • direct thin-route subsidy
7. Non-Canadian Competition	provisions adequate	retain only if domestic industry protection is more important than efficiency or consumer welfare	• remove 25% foreign ownership limit • liberalized entry under bilaterals
8. Passenger Ferry Privatization		second-best solution	periodic franchise
(a) monopoly profits	not adequate	compared to periodic franchise review	review with price cap condition
(b) price discrimination	not adequate		
(c) service quality	not adequate	review and price limit	

* **This section relates only to transfer of airport ownership and operating responsibility from the federal government to other governments or to the private sector. Controls for monopoly power abuse are examined in 2 and are relevant regardless of the ownership or operating structure for airports.**

ENDNOTES

1. *R. v. Carnation Co.* (1969), 4 D.L.R. (3d) 133
   - no practice where prices are a temporary expedient to meet competition.

   R. v. Consumers Glass Co. (1981), 124 D.L.R. (3d) (Ont. H.C.J.)
   - prices are not unreasonably low if accused is minimizing losses where there is excess industry capacity.

   R. v. Hoffmann-La Roche Ltd. (No. 1 and 2) (1981), 125 D.L.R. (3d) 607 (Ont. H.C.J.)
   - what is unreasonably low is a question of fact depending on all the circumstances.

2. In September 1991, the Bureau published revised draft guidelines. These guidelines do not differ substantially from the April 1990 draft examined in this report, with the exception that the more recent draft does not so explicitly propose a two-stage screening process.

3. This definition is taken from 1990 Draft Merger Enforcement Guidelines, which have been superseded by the Merger Enforcement Guidelines, Information Bulletin No. 5, March 1991 which adopt essentially the same features.

4. Consumer and Corporate Affairs Canada, *Information Document on the Proposed Acquisition of Wardair Inc. by PWA Corporation*, CCAC No. 189 10234E, (Ottawa, April 1989), p. 3.

5. Ibid., p. 4.

6. Ibid., pp. 4–5.

7. Ibid., p. 6.

8. Ibid., p. 6.

9. *Reasons for Consent Order Dated July 7, 1989*, Competition Tribunal, CT-88-1, *DIR v Air Canada*, et al., pp. 69–70.

8

CONTROLLING MARKET POWER IN WEAKLY CONTESTABLE CANADIAN AIRLINE MARKETS

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1. INTRODUCTION

In recent years, the structure of the Canadian airline industry has undergone important changes. Air Canada (AC) has been transformed from a government-owned airline with special responsibilities and privileges to a private company competing on an even footing with Canadian Airlines International Limited (CAIL). Like AC, CAIL is a product of corporate metamorphosis and privatization. Pacific Western Airlines, formerly an Alberta Crown corporation, bought CP Air and Wardair to form CAIL. AC and CAIL link the larger Canadian centres and provide international service.

While these structural changes were taking place, regulatory change was also occurring. Elements of former policy were abandoned including the regional airline policy, introduced in 1966. In its stead, new and distinct regulatory regimes govern the North and the South. Although there is more regulatory flexibility everywhere in the system than previously, control over fares and route adjustment is tighter in the North than in the South. The regions and small communities are now served by feeder airlines, aligned by contract and equity positions with AC or CAIL, and a diminishing cast of independents. The feeders and independents provide commuter service

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between smaller communities and link travellers to the networks of the major Canadian and foreign carriers. Some of the larger independents have offered service between large cities in competition with the majors.

The policy of restricting carriers to particular routes and of regulating fares,[1] frequency of flights and type of aircraft flown has either been abandoned or substantially relaxed. In the current regime, greater reliance is being placed on commercial incentives to determine flight characteristics and patterns. Federal regulatory attention has shifted to certifying ability to provide service; setting, monitoring and enforcing safety standards; providing certain airport facilities and establishing the terms of access to them.

Position papers, regulatory initiatives and legislation provide benchmarks in what was, and continues to be, an ongoing process of policy evolution. The important events, statements of intent and codifications of change in legislation include the pricing experiments initiated and monitored by the Air Traffic Committee of the Canadian Transport Commission in the late 1970s; the endorsement by the House of Commons Standing Committee on Transport of further regulatory liberalization in 1982; the announcement in 1984 of *The New Canadian Air Policy*, in which the Minister of Transport in the Liberal Government, Lloyd Axworthy, promised legislation to relax controls over routes and fares; the creation of the Canadian Aviation Safety Board in 1984; the release by the new Conservative Government in mid-1985 of the position paper, *Freedom to Move — a Framework for Transportation Reform*, and its review by the House of Commons Standing Committee on Transport;[2] and the passing of the *National Transportation Act, 1987*.

Experience under the new regime has confirmed some expectations and identified some areas of concern. As Soberman recently noted:

> The euphoria that followed deregulation of the Canadian airline industry (influenced to a great extent by the U.S. Airline Deregulation Act of 1978) has now given rise to serious concerns about increasing fares, reduced competition, safety, and poorer quality of service, as a result of consolidation of all airline service into two national networks and the disappearance of Wardair.[3]

There is concern that the consolidation of the system into two dominant commercial networks has increased private economic power at the same time that reforms have weakened the ability of the government to respond

to that power. A number of questions are currently being posed. Will the forces leading to concentration leave Canada with only one major carrier? Is the mix of existing industry regulation and competition policy adequate to cope with the dominant duopoly or monopoly? Can domestic industry performance be made more effective by the development of an integrated North American or international regime for air travel? What are the implications of greater reliance on commercial incentives for the safety of the system? Can airport pricing and construction plans be developed to relieve congestion at airports? Can the system supply appropriate service to small communities?

This paper addresses an issue that cuts across a number of these questions — whether reinstating old or devising new regulatory measures to curb the exercise of market power is desirable.

2. The Problem

There are two aspects of single-carrier service that merit attention in the current policy environment. The first is whether the service is economically provided. Does the current commercial/regulatory system efficiently respond to the private demands of Canadian travellers? More specifically does it:

- encourage an appropriate choice of quality of service;
- minimize costs of providing that service;
- adequately discipline the pricing of the carrier; and
- realize timely introduction of new techniques and organizational reforms?

The second concern is whether collective demands, regional development, environmental goals and congestion alleviation are being economically served. In this study, we focus on the cost, quality and pricing aspects, and discuss dynamic aspects and collective responsiveness only to the extent that they interact with the former set of issues.

3. The Approach

We begin by describing current regulatory controls over airline pricing and quality. We then report on Canadian price and quality experience from 1978 to date and selectively refer to American events. In the next section we

discuss economic models, explaining pricing and quality decisions where more than one, but not a large number, of carriers serve the market. We then to consider the ability of potential competition to discipline the industry, as incumbents realize that entry will occur if market power is exercised. *A fortiori*, the contestability of the market is important when routes are supplied by only one carrier. The flip side of market contestability is the degree to which barriers to entry naturally exist or are created by incumbents.

After considering the influence of market forces, we shift to private and public institutional defences. We investigate the ability of private organizational responses and contracting to deal with inefficiencies arising from the pricing and quality decisions of a single or small number of suppliers. Government affects the efficacy of these private responses through contract law (which delimits the promises that are enforceable and defines private and public enforcement roles) and through competition policy (which further restricts the arrangements a business can effect). Governments also intervene directly into different transportation activities — bus, rail and trucking. Sector-specific regulation is tailored to the idiosyncrasies of the technology and the transacting environment of the industry.

Finally, we explore how sector-specific regulation of prices and quality has performed for other transportation modes available to travellers and assess the applicability of these techniques to the airline industry.

4. Current Access, Rate and Fare Controls

The *National Transportation Act, 1987* establishes two zones with different regulatory regimes, southern Canada and northern Canada.[4] Any flight beginning or terminating in the northern sector is governed by northern rules.

SOUTHERN CANADA

Section 72(1) of the Act states that the National Transportation Agency "shall issue" a licence to any applicant who:

- is at least 75% Canadian owned;[5]
- holds a Transport Canada operating certificate; and

- has the prescribed liability insurance coverage.

Potential entrants are not required to demonstrate that their proposed service is required by "public convenience and necessity" as was the case before 1987.

Section 76 also states that a licensee must give the National Transportation Agency 120 days' notice before discontinuing or reducing to less than one flight per week any service the licensee has offered once a week or more for a period of six months or more. Agency permission to discontinue a service is not required.

With respect to fares, section 80(1) of the Act states that if, on receipt of a complaint in writing, the National Transportation Agency finds that there is no other alternative effective, adequate and competitive transportation service and that the carrier (licensee) has imposed an unreasonable basic fare increase, the Agency may either disallow the basic fare increase or reduce the increase in the basic fare by such amounts and for such periods as the Agency deems reasonable. Where practicable, the Agency may direct the licensee to make refunds to persons deemed by the Agency to have been overcharged as a result of the fare increase.

Section 80 does not apply to confidential contracts which carriers may enter into with various customers.

NORTHERN CANADA

Section 72(2) of the *National Transportation Act, 1987* states that the Agency "shall issue" a licence to any applicant satisfying the three conditions required of entrants on southern routes (Canadian ownership, an operating certificate and liability insurance) *and* if the Agency is satisfied that the issuance of a licence would not lead to a significant decrease or instability in the level of service. The onus is on those objecting to new entry to demonstrate that it would jeopardize the quality of existing services (reverse onus test).

A licensee may discontinue or reduce the frequency of a northern service to less than once a week provided it gives 120 days' notice. As is the case with southern services, this applies to any service that has operated with a frequency of at least once a week for a period of six months or more.

Section 80(2) states that if, on receipt of a complaint in writing, the Agency finds that a carrier (licensee) has either an unreasonable basic fare *level* or has imposed an unreasonable basic fare increase it may disallow the basic fare *increase* or direct the licensee to reduce the level of, or increase in, the basic fare by such amounts and for such periods as the Agency deems reasonable. Where practicable, the Agency may direct the licensee to make refunds to persons deemed by the Agency to have been overcharged as a result of the basic fare level or increase.

APPLICATION OF PROVISIONS

The annual reports of the National Transportation Agency refer to several investigations of air fares on northern routes. There have been no investigations regarding the reasonableness of fares on monopoly southern routes to date, that is, no section 80(1) investigations. There have been several investigations of fares on northern routes, that is, section 80(2) investigations. There have been two decisions under section 80(2), both relating to the reasonableness of fares between Winnipeg and Lynn Lake, Manitoba. Decision number 187-A-1990 stated that the fare complained of was a discount fare rather than an economy fare (a "basic fare") and was thus beyond the jurisdiction of the Agency. The other decision (number 133-A-1990) addressed the reasonableness of the increases in the basic fare between Winnipeg and Lynn Lake. It found the increase, which amounted to 100 percent over two years, to be "not unreasonable." The Agency gave the following reasons:

- The carrier (Calm Air) was in a loss position overall.
- The Winnipeg–Lynn Lake service also operated at a loss, and the losses had been increasing.

These increases were apparently the result of decreasing load factors due to the decline of the local economy and to improved road access.

The National Transportation Agency has conducted investigations of fares on other northern routes under both section 80(2) and section 59. Under section 59 the Agency can investigate whether or not rates charged for the carriage of goods by air, water, rail or pipeline are prejudicial to the public interest. Routes which have been investigated include Winnipeg–Gillam,

Manitoba, Winnipeg–Oxford House, Manitoba, Yellowknife–Holman Island, Northwest Territories and Yellowknife–Coppermine, Northwest Territories.

The investigation of the Yellowknife routes provides some indication of the criteria the Agency is likely to employ in assessing the reasonableness of fares or the fairness of freight rates under sections 80 and 59 respectively. The criteria used in that investigation included:

- the overall profitability and rate of return on investment (long-term debt plus equity) of the carrier;
- the profitability of a "service" or related set of routes and the rates of return earned on them. (Profitability is revenue less direct cost less allocated indirect cost. Rate of return is profit divided by allocated investment);
- the profitability of individual routes (estimated as the basic fare times the average number of passengers plus estimated freight revenue per flight less direct and indirect operating costs per flight);
- comparison of fares over equivalent distances with equivalent equipment, load factors, service frequency and regularity; and
- accounting for the effect of infrastructure on costs. An example would be the restrictions imposed by short runways.

It appears that the Agency regards unreasonable air fares under section 80 and unfair freight rates under section 59 in much the same manner. A fare or rate on a route that is earning a normal rate of return is unlikely to be deemed prejudicial to the public interest.

While Agency decisions on and investigations of northern routes provide some guidance as to how the Agency might deal with monopoly southern routes, the latter are likely to be more complex. Both joint costs and revenues are likely to be more difficult to allocate to a particular route. Moreover, if there is a contestability problem, southern monopoly routes are going to be characterized by excess profits. Consequently, the concept of a normal rate of return will have to be more tightly defined for southern routes than on northern routes where rates of return appear to have been quite low. (An exception is Winnipeg–Gillam, Manitoba which, in the Agency's view, was yielding "a reasonable return on investment.")

5. Pricing and Quality Experience

This section provides background for assessing the adequacy of current rate and entry regulations and outlines what has transpired in Canada as commercial forces have been given more play.

In 1978, the Canadian Transport Commission sanctioned low-price experiments which were maintained until 1982. In this same period, all capacity constraints were removed from CP Air, advanced booking charters were allowed, and the major carriers began to develop feeder airlines. As a result, passengers on discount fares rose from 14.5 percent of traffic in 1978 to 37 percent in 1982. A sequence of new discriminatory pricing strategies was introduced by the scheduled carriers.[6]

DISCOUNTING

Discriminatory fares can result in a more economical use of resources when there are economies of scale and/or fluctuations in demand. For this to be achieved, the differences between the rights acquired at different prices (called "fences" in the industry) have to separate the travelling population into two groups which together generate sufficiently high load factors and average revenues to make the flight remunerative. The intent of the different rates would obviously be frustrated if all travellers chose the low-price option. The target is to discriminate, provide service to the marginal traveller at the incremental cost, and cover average costs by "taxing" inframarginal purchases. Discrimination can occur along a number of dimensions: different rates by time of day, by amenities on the same flight, by time of booking, by length of stay, by characteristics of the passenger and by frequency or volume of purchases.

Airlines add to their fleets depending on the prospective return. Price discrimination affects the return realized on each plane and therefore influences investment decisions. For many routes, adding an additional plane represents a discrete and sizable change in capacity. Ignoring the often small marginal costs of adding another passenger to a flight, the situation is one in which public goods, from which a customer can be excluded unless a specified price is paid, are being provided competitively. There is controversy in the economic literature on whether such competition results in over provision or the correct provision.[7]

In reviewing the evidence generated by the pricing experiments, the Canadian Transport Commission concluded that discount fares with appropriate fences raised load factors and encouraged new business. Price differentials succeeded in generating more nighttime traffic, but were less effective in smoothing out demand cycles between seasons of the year. The experience during this period also revealed that amenity-related fences — baggage, meals, placing on aircraft — were less effective separating devices than trip-related fences — advance notice, length of stay, time of travel, number of stopovers.[8]

Charter traffic also responded to new opportunities and increased fivefold. In 1982, 9 percent of all domestic low-priced air traffic flew on charters. This niche was dominated by Wardair, which carried 76 percent of charter passengers in that year.

The experiments of this period were controlled and closely monitored initiatives. Subsequently, the carriers enjoyed even greater freedom to manage their load factors through discriminatory pricing initiatives. Alfred Kahn, an architect of airline deregulation in the United States, had predicted that "much of the [price] discrimination will tend to disappear"[9] with the relaxation of regulatory controls. In 1988, he reported his surprise at "[t]he persistence — indeed, intensification — of price discrimination."[10] Like their American counterparts, Canadian carriers took full advantage of the scope for discriminatory pricing.

Price structures have accordingly become more complex. Bailey and Williams provided the following American example:

> For example, in 1978 the tariff department at Delta had twenty-seven employees tracking competitors' fares and adjusting Delta's prices. By 1984 Delta's staff had grown to 147 employees monitoring 70,000 fares offered by Delta and its competitors, with the goal of optimizing some 5,000 price changes a day.[11]

Management has become more sophisticated at choosing the number of discounted fares to be offered per flight, their depth and the appropriate fences to maximize the revenue generated per flight. Alice Peung, the manager of AC's revenue enhancement programs claims that load management can raise a carrier's revenue by 4 percent.[12] Because of these practices, load factors have remained higher, *ceteris paribus*, than they were under more rigid pricing.

During the 1980s, the proportion of travellers flying on discount fares rose in Canada until it stabilized at a level of about two of every three travellers. Charter flights became less important on domestic routes as discount fares became more widely available.[13] Scheduled economy and business fares rose more rapidly than the consumer price index in the 1980s.

Although business class fares have risen relative to other fares, business travellers benefit from denser schedules and from frequent flyer programs. Of increasing importance is the ability of large businesses to negotiate confidential contracts with airlines for special fares. For obvious reasons, information about the extent of such contracts and their terms is fragmentary. There are occasional disclosures such as this 1985 account from an American business magazine:

> Last year, Delta Air Lines entered into a special deal with General Electric in which it guaranteed specific fare discounts in exchange for an up-front cash prepayment of $1 million as well as a guaranteed minimum volume of business. Some regional or business travel-oriented airlines have programs in place that give companies free tickets or credit toward future ticket purchases based on total sales volume.[14]

The availability of discounts and their average depth also varied by length of flight and by the regulatory regime governing air travel. For short-haul flights, high load factors are important in maintaining viability, as the following account of the challenges facing a small commuter airline attests:

> Financial success for a small independent regional airline like Skycraft, which flies 4,000 passengers a month, requires keeping the business loads up between 75 and 95 per cent and breaking into new markets where there is a lot of head-office-to-head-office travel.
>
> In Skycraft's case, that means moving General Motors of Canada Ltd. employees from Oshawa to Windsor and Detroit.[15]

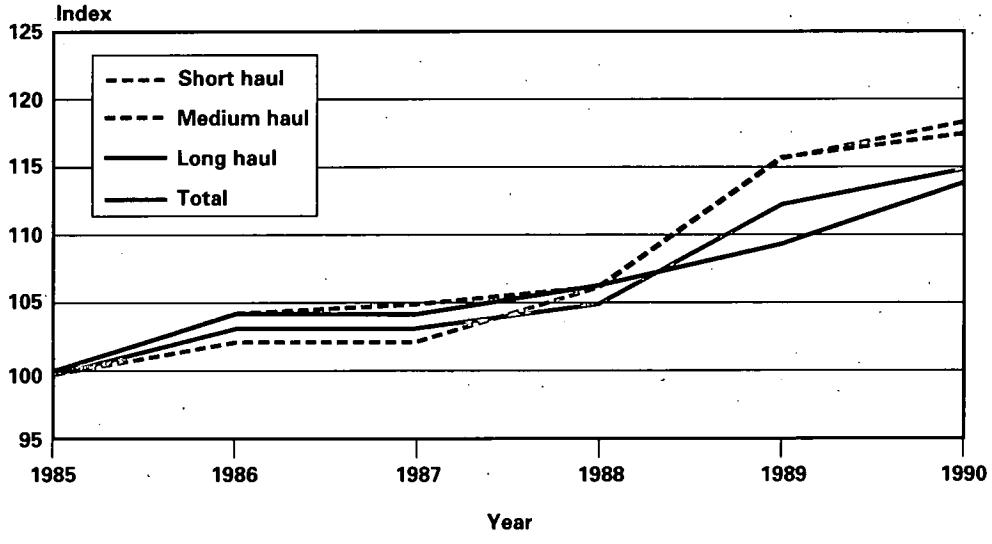
The scope for load management also depends on the stochastic flow and mix of customers with different reservation prices. Before deregulation, short-haul and less-travelled markets had lower load factors than average.

Despite the impact of low load factors on profit of short-haul routes, the relative number of seats available at discount are generally not as great on the short-haul flights offered by affiliates and independents.[16]

This reduced reliance on discounting indicates that discounting is a less effective instrument in generating higher loads for these routes. The difference in the pricing patterns by length of flight is reflected in the indices reported in Chart 1 for economy fares and in Chart 2 for discount fares.

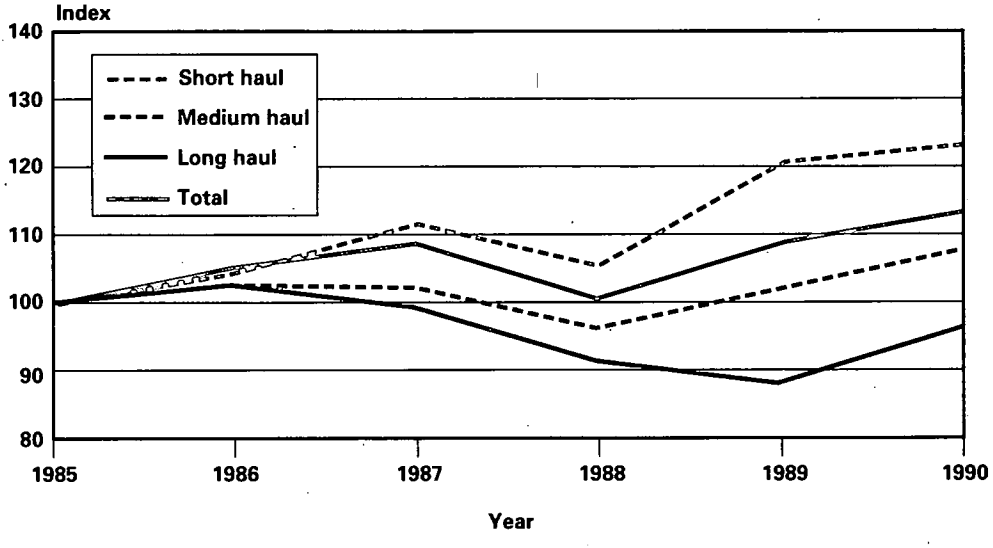
Statistics Canada reports that economy fares and discount fares grew less quickly in the more tightly controlled North than in the South from the fourth quarter of 1986 through to the fourth quarter of 1989.[17] On the other hand, the level of discounts and their availability are lower in the North. The differences in economy and discount fare indices between the South and the North for the first quarter of the period 1985 to 1990 are graphed in Chart 3.

Chart 1
First Quarter Air Fare Indices
Economy Fares by Length of Haul



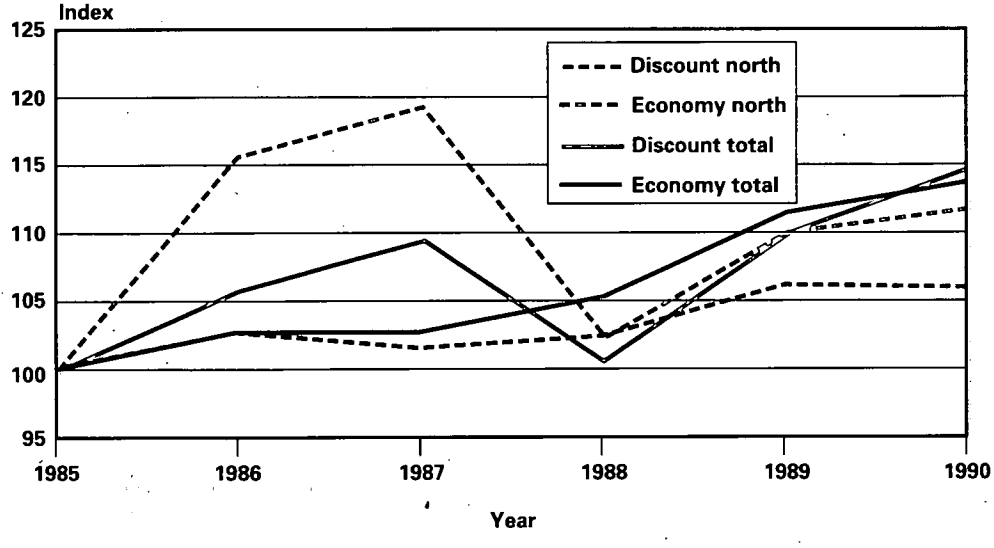
Source: Transport Canada, *Aviation Industry Review*, 1990, p. 35.

Chart 2
First Quarter Air Fare Indices
Discount Fares by Length of Haul



Source: Transport Canada, *Aviation Industry Review*, 1990, p. 35.

Chart 3
First Quarter Air Fare Indices
Economy and Discount Fares, North/Total



Source: Transport Canada, *Aviation Industry Review*, 1990, p. 36.

FREQUENT FLYER PROGRAMS

American Airlines introduced frequent flyer programs in 1981, and this volume discount scheme has become standard industry practice. According to one recent American survey, 72 percent of business travellers and 23 percent of leisure travellers now participate in at least one such program.[18]

The plans were introduced into Canada in 1984. Most of the members of the Canadian Commercial Flyers Association belong to two frequent flyer programs.[19] A special appeal of affiliation with AC or CAIL is the right to participate in a program which can offer better and more varied rewards. Frequent flyer programs have been singled out by some analysts as a potentially potent barrier to entry.

TRAVEL AGENTS AND PRICES

A traveller commits a substantial amount of money and time to a plane trip. For the infrequent traveller much uncertainty and ignorance exist concerning the qualities and prices of service available. Travel agents represent an important instrument for overcoming the informational problems facing air travellers. Under the current price regime, the number of agencies and the percent of bookings done by agents have grown rapidly. As drug manufacturers often address their marketing efforts primarily to doctors, airlines focus on travel agents. In the United States, 81 percent of tickets on scheduled carriers were sold through travel agents in 1988. This compares to 56 percent before deregulation. At the same time, the number of agency locations rose from 14,800 in 1978 to 29,600 in 1987.[20] Customers' anticipation that information of benefit to them but not to the travel agent will be withheld grows as the fare structure becomes more complex and more tickets are sold through agencies. This problem has many dimensions and exists because of the commercial incentives for agents. Recent criticism has focussed on contracts between agents and airlines that provide for override commissions, premiums paid based on the volume of business transacted by the agent for the airline. Evidence is unavailable in Canada, but in the United States the importance of override commissions has increased dramatically. In 1986 over half of the travel agents surveyed received such commissions. Since it is estimated that travel agents are influential in dictating the choice of carrier in over one half of the non-business ticket and one quarter of the business

ticket sales, there is concern that agents will not direct the purchaser to the cheapest source but to the source from which they will receive the highest remuneration.

Large customers may generate sufficient business to warrant hiring services that audit their travel decisions and determine whether they have received good service or not.[21] However, this defence is uneconomical for individual consumers who must rely on experience and the agent's reputation for probity. Competition among agents to create such a reputation may result in some agents voluntarily publicizing the general nature of their relations with airlines. Although a disclosure requirement might be helpful, the costs of consumer monitoring could be lowered by having travel schedule information more readily available. Ideally the information could be distributed over cable or telephone services such as the experimental "Alex" offering of Bell Canada. Terminals at libraries could extend the reach of the information. The *National Transportation Act, 1987*, section 83(1), requires that airlines make fare schedules available at their business offices, and a copy has to be made available to a customer on request at cost. The availability of discounts and their amounts and conditions change very quickly. A printed schedule distributed to a customer carries both irrelevant and outdated information.

COMPUTER RESERVATION SYSTEMS

Agents depend increasingly on computer reservation systems (CRS) to provide marketing information and travel services to their clientele. The potential ability of a CRS provider to bias this information for anti-competitive purposes has been a source of public concern. Court decisions and complaints to regulators[22] prompted the promulgation of rules to govern the provision of CRSs in the United States. Display bias, pricing, contract length, terms and conditions of contracts and non-discriminatory access to enhancements such as direct access links are governed by the rules. In Canada the Competition Tribunal recently imposed a set of similar rules and constraints as a condition for its approval of the merger between the computer reservation systems of AC and CAIL.

OVERALL CANADIAN PRICE PERFORMANCE

The existence and importance of discount fares and the shift by the major carriers toward providing long-haul flights were contributing factors in making the revenue per passenger-kilometre for major Canadian airlines

grow at a much lower rate than the general price level. In the previous price structure, above-cost rates on long-haul flights cross subsidized rates on short-haul flights. As networks realigned in response to greater freedom of entry, exit and pricing, commercial pressures resulted in the fall of long-haul relative to short-haul rates. A further factor that reduced fares was the squeezing of economic rents earned by workers in the industry under the previous regulatory regime.

This process is well documented for the United States. Before deregulation, American labour relations in the airline industry were governed by the *Railway Labor Act,* which encouraged organization according to craft or class. Consequently, a fragmented bargaining environment had evolved. Thirty-four different unions had members in the American airline industry, many of which could halt activity at an airline. In 1958, the carriers responded by organizing the Mutual Aid Pact which provided for compensation of member carriers by other members for losses resulting from a strike.

Despite employer organization, wage rates in the industry were substantially higher than those for comparable jobs in other sectors, and many restrictive labour practices were adopted. For example, United's labour contract required it to fly its Boeing 737s with three flight crew members while Piedmont and Southwest flew with two. Thornicroft reported that: "By 1980, many pilots were flying only 44.3 hours per month, despite guaranteed payment for 75 hours per month and FAA regulations that permitted pilots to fly 100 hours per month."[23]

The differences between the union wages under regulation and the market wages for similar skill levels were substantial. Moore noted that: "Nonunion pilots earn as little as $32,500 per year for flying a Boeing 737, compared to the $102,000 salary that United Airlines pays one individual to pilot a similar craft."[24]

Labour represents the industry's largest operating expense. Between 1978 and 1986, 14 of the new entrants in the United States were non-unionized. Generally, these companies had fewer senior personnel, operated under less restrictive work rules and hired more part-time workers to meet peak demands. Labour costs were consequently much lower for the new entrants.

> For example, in 1984 USAir's average pay and benefit package per employee was $47,896, while that of People Express was $17,139, providing People Express with a significant cost advantage. Similarly, when Continental underwent bankruptcy and was able to replace its unionized labor force with nonunion workers, its pay and benefit package was reduced from $36,875 (per employee) in the first quarter of 1984 to $23,433 by the fourth quarter of that year.[25]

Many of the unionized airlines threatened to create non-unionized affiliated carriers, and some did. For example, Texas Air and Frontier Airlines formed New York Air and Frontier Horizons. Litigation and strike activity increased. In 1979, 4,075 person-years were lost, and 24,968 employees were involved in strikes in the United States.[26] The intensity of labour confrontation abated in the early 1980s. Two-tier labour contracts and beneficial changes in work rules were introduced. Under the two-tier contracts, new employees were paid considerably less than existing ones. For example, at American new pilots started at 50 percent of the old pay scale. Most of the two-tier contracts called for the merging of the two tiers within a prescribed period of time. By 1990, the labour cost differences of the immediate post-deregulation period had narrowed considerably.

Similar but less dramatic effects occurred in Canada with a time lag. Both major carriers have pared their workforces. In December of 1989, CAIL announced the elimination of 1,900 jobs of which 1,017 were former Wardair jobs.[27] In October of the following year, Air Canada cut 2,900 jobs[28] and CAIL announced further layoffs and schedule retrenchments.[29]

Overall price performance is difficult to assess because the number of different types of flights and the multitude of rates on any one flight result in particularly wicked index number problems. Nevertheless, analysts familiar with the industry make general statements about price performance. For the most part, they agree that there was a substantial fall in average prices during the transition period to the new regime. The following statement by Bence is representative:

> In 1985, 64 per cent of passengers travelled in Canada at reduced rates, the average reduction in relation to the base rate being over 50 per cent. Since each level of reduction is subject to a varying

number of restrictions (advance bookings, length of stay), this means that a much wider choice of rate/service combinations were available to passengers.[30]

Price performance has not been as impressive recently, and there is concern that without the stimulus of new entry, with less scope to squeeze factor rents and a higher degree of concentration, future performance will not match that of the past.

AMERICAN PRICING EXPERIENCE

The United States has experienced similar but not identical price patterns. Prices and the proportion of travellers enjoying discount rates appear to be more volatile in the United States than in Canada. In some years, the proportion of Americans travelling on discount fares has been considerably higher than in Canada. For example, Kahn notes that "90 percent of all passengers in 1986 travelled on discount tickets, at an average 61 percent below coach fare."[31] The percent in Southern Canada was just below 60 percent.[32] In the United States, price competition was vigorous in 1986, and financial performance was dismal.

Meyer and Oster provided the following overall summary of American experience:

> Deregulation's effect on fares has varied with the type of ticket and the size of the market. First-class fares are relatively higher in most markets, although increases generally have been small (on the order of 2 percent). Unrestricted coach fares have decreased slightly in the largest and most dense markets, while average coach fares in medium and small markets have risen about 3 and 6 percent, respectively. More important, since deregulation discount fares have become available in over 80 percent of all markets, and well over 60 percent of all passengers were flying on discount fares by 1984, with these discounts ranging upward to 50 percent or more. Prior to 1976 discount fares were rarely available outside the largest markets and were seldom deeper than a 20 percent reduction. Discounting also has increased pressures to reduce standard coach fares in the largest markets.[33]

As in Canada, recent price performance has not been as impressive as in the transition period.

PRICES AND NUMBER OF CARRIERS

Statistical exploration of the American evidence of the connection between the number of suppliers and the exercise of market power in pricing, indicates that fewer suppliers mean higher prices. The studies differ in quantifying the effect of actual competition and in assessing the impact of each additional competitor. For example, Moore reported:

> The evidence is impressive: those markets served by only one or two carriers experienced price jumps of over 40 percent in real terms, while those markets served by five or more carriers enjoyed fare increases of less than 3 percent. The ratio of fares does decline slightly from one to four, but the big drop is with the five-or-more-carrier market.[34]

Morrison and Winston, working with a different period and specifications, concluded that if suppliers fell from two carriers to one, an "average round-trip fare on the route would increase about 9 cents a mile, or $89 when evaluated at the mean sample distance of 983 miles."[35] In contrast to Moore, they found that moving from three to two competitors had much less effect and the bulk of the benefits derived from having multiple suppliers is realized by a duopoly.

NETWORK RECONFIGURATIONS, AFFILIATES AND INDEPENDENTS

As well as changes in fare levels and structures, there were important changes in the many dimensions of service — frequency of flights, reliability of scheduled information, air time, ground time, baggage service, ticketing, registration, waiting room comfort and convenience, and flight amenities — which affect the quality of air travel. Under the more permissive environment, mergers and alliances have resulted in larger organizations coordinating equipment, standards and flights. The resulting networks provide a different quality of service than formerly.

A characteristic of the new network is the hub-and-spoke configuration. Flights are scheduled to reach and leave a hub airport during a common

period of the day so passengers originating at different centres can be pooled to proceed to other destinations.[36] However, some passengers may be worse off if an indirect flight through a hub replaces a direct connection. In the United States, the large airlines have a number of main hubs and regional hubs. Delta, for example, has four anchors (Atlanta, Cincinnati, Dallas and Salt Lake City) and four corner posts or supplemental hubs (Boston, Los Angeles, Orlando and Portland).[37] In Canada, which has a belt rather than a grid as a geographic market, the economies realized from a hub-and-spoke configuration are less than in the United States. Nevertheless substantial realignments have occurred. Toronto has become a major hub,[38] and Montreal and Vancouver are regional ones. Unlike the United States, there are few connections in Canada which would be competitively served by more than one hub-and-spoke system, that is, two systems connecting destinations through a different hub.

As flight patterns were being realigned, AC and CAIL concentrated on the longer flights on dense routes and established feeder affiliates either directly or through acquisition or contract. Affiliation agreements typically coordinate timetables and integrate the local airline into the baggage, reservation and frequent flyer systems of the major carrier. The structure of the affiliate groupings frequently changes. The components of the AC and CAIL families in 1989 are presented in tables 1 and 2. The general strategy of AC is to control its affiliates while CAIL typically owns less than 50 percent of its partner companies.

Table 1
AIR CANADA CONNECTORS

Carrier	Linkage	Fleet
Air Nova	AC owns 49%	4 jets, 9 non-jets
Air Alliance	AC owns 75%	9 non-jets
Air Ontario	AC owns 75%	17 non-jets
Air Toronto	Code sharing, AC agreement to purchase	10 non-jets
Air BC	AC owns 85%	5 jets, 26 non-jets
NWT Air	AC owns 90%	2 jets, 6 non-jets

Table 2
CAIL Connectors (Canadian Partners)

Carrier	Linkage	Fleet
Canadian North	Division of CAIL	8 jets
Air Atlantic	CAIL owns 45%	15 non-jets
Ontario Express	CAIL owns 49%	19 non-jets
Frontier Air	Ontario Express owns 100%	11 non-jets
Calm Air	CAIL owns 45%	15 non-jets
Time Air	CAIL owns 46%	3 jets, 28 non-jets

The affiliates fly smaller aircraft and serve commuter traffic as well as providing connector flights.

In addition to the affiliates, independents and small commuter airlines provide scheduled service. In 1987 there were 103 such carriers. Another 634 offered commuter charter service.[39] Many of the new independent entrants have not survived, despite success in their early years. In 1985 the President of City Express stated:

> City Express either would not exist or would have taken years to reach the point we are at today had it not been for this new Canadian Air Policy. It gave us the chance to (achieve) flexibility in pricing and the ability to have a simple fare structure with no confining conditions of sale. The skies are opening up at last.[40]

By July 1990, the company was in financial difficulty with four of its Dash 8 aircraft seized by Mutual Life of Canada. Formal bankruptcy followed. Wardair, another early enthusiast for and beneficiary of deregulation, ran into financial difficulties and was taken over by CAIL in early 1989. With Wardair's departure, Intair, a former partner in the CAIL system, became the largest independent. Intair challenged AC and CAIL on the dense Montreal–Toronto–Ottawa axis. By March of 1991, Intair was in financial difficulties and was reported to be negotiating to return to the CAIL fold.

SCALE AND NETWORK ECONOMIES

The misplaced enthusiasm of the executives of Wardair and City Express over the opportunities created by deregulation was reflected by academic opinion which generally underestimated the significance of scale and

network economies in air travel. For example, Gillen, Oum and Tretheway claimed:

> A small network carrier should not have a *cost* disadvantage, provided it achieves traffic densities within its small network similar to those of Air Canada and CAI. Two independent carriers for whom data was not available, Wardair and City Express, appear to be attempting to build such small, but high density, networks in scheduled markets.[41]

By the date of publication of their article, Wardair had disappeared, and City Express was a few months away from bankruptcy.

Caves, Christensen and Tretheway introduced a distinction between economies of density and scale.[42] Earlier empirical work had shown substantial unexploited system scale economies for the U.S. local airlines. This seemed to be confirmed by the higher unit costs experienced by the local carriers. Caves et al. were persuaded to make the distinction by the paradox that despite these cost differences the local airlines were competing effectively with the trunk carriers and gaining market share from them. Their study covers American airlines between 1970 and 1981. The Gillen, Oum and Tretheway study adopted similar categories and distinctions in analyzing the Canadian data from 1964 to 1981.

Caves et al. distinguished between the size of the networks and the transportation services provided within them. Output was captured by four variables: volume of services provided, load factors, average stage length and a network variable. Economies of scale occur if the increase in total costs is less than proportional when an increase in the size of the network and services provided takes place (keeping load factor and average stage length constant). Density economies occur if unit costs fall with an increase in services within a network of a given size (keeping load and stage length the same). The size of a network is measured by the number of points served. For example, a network linking Toronto, Hamilton and St. Catharines would be the same size as one linking London, Toronto and Los Angeles. Average stage length catches the effects of distance between points in the network. Gillen et al. used a hedonic measure of output and a similar separate measure for the network effect.

Caves et al. identified the scale elasticity as 1.07. As a result, they did not reject the notion that the "true" value is 1.00 and then concluded that there are no economies of scale. In this context, there is no reason to maintain constant returns-to-scale as a null hypothesis. It would be more instructive to report a confidence interval for the scale measure. In any case, the most likely value of returns-to-scale is 1.07. Larger American airlines would then be expected to have lower costs. In comparison, for Canada, Gillen et al. found that the best estimate of returns-to-scale for 1980 was 0.881 for Air Canada and 0.96 for CP Air. Based on their variable cost function estimate, an overall returns-to-scale of 0.992 was reported, indicating that larger-scale airlines face a cost disadvantage in Canada.

William Jordan came to the same conclusion with respect to the importance of scale and density. In an article contrasting American and Canadian events during the period 1978 and 1984, when American regulation was more relaxed than Canadian, he noted:

> This clear contrast between the Canadian and U.S. experience provides unambiguous evidence that one effect of deregulation has been to increase both the number of jet airlines entering the industry and the number in existence at any point in time.[43]

The gap between the econometrically measured scale effects in Canada and the commercial lack of success of small carriers may be due to the difficulties of uncovering the details of an industry's cost relations from the data available with even the most sophisticated of econometric analyses. Gillen, Oum and Tretheway used the number of points served by an airline as a proxy for its degree of networking. However, the data for their analysis cover the period from 1964 to 1981 when routes, frequency of flight and type of aircraft flown were regulated in Canada. The authors faced the difficult task of inferring the degree of network economies from a crude proxy and data generated by a situation in which the companies were constrained in choosing route structures. The subsequent restructuring in Canada and the American experience suggest that the regulatory constraint was binding. Graham and Kaplan noted that in the United States the Civil Aviation Board "often retarded the development of a highly integrated route network."[44]

Based on the Canadian evidence from this earlier period, one might conclude that any airline could add service between a particular city-pair at a similar or lower cost, regardless of the exact configuration of its existing network

and where it was located in relation to the city-pair under consideration. Indeed the smaller the airline the more effective service it would be able to offer.

This inference is doubtful. Sometimes demand characteristics, which outweigh the identified cost conditions, are posited as the reason for the advantages of size. This claim can be confusing.[45] If passengers are willing to pay more to deal with a large established airline, presumably it is because they anticipate more or better outputs such as baggage handling, availability of alternatives, care and information with respect to delays and security of service. These services are part of an airline's output. Their exclusion in output measures in the econometric studies represents a specification error.

The paradox of successful competition from the local airlines with the trunks, mentioned by Caves et al., and the crowded field of contesting carriers, observed by Jordan, was a temporary phenomenon. The present situation could not be described as one in which local airlines were competing effectively with the trunk carriers and gaining market share. Bankruptcy and merger have been more frequent experiences than expanding market shares.[46] Given the ubiquitous consolidation trend we suspect that cost economies are playing some role in the process, despite the econometric evidence to the contrary. Canadian analysts were not alone in underestimating the importance of scale in providing network airline service. In his candid admissions of what he had not anticipated about American deregulation, Alfred Kahn confessed in 1988 that:

> We advocates of deregulation were misled by the apparent lack of evidence of economies of scale — the principal explanation of the differences in cost among the carriers appeared to be differences in their route structures, which we hoped to eliminate by permitting totally free entry and exit — and by the physical mobility of aircraft, which caused us to underestimate the other obstacles to entry.[47]

CONGESTION AND ACCESS TO AIRPORTS

The schedules which take advantage of hub-and-spoke configurations have accentuated the traditional concentration of flights at peak travel times and shifted patterns of travel. As a result, congestion has occurred at some airports. In the United States, events associated with the 1981 air traffic

controllers strike made this problem more acute by reducing the number of flights that could be handled at airports.[48] A number of American airports adopted rationing systems during the early 1980s; today four major American airports[49] still have a slot control system in place.

Toronto and Vancouver airports have also experienced congestion. Toronto's Pearson airport experienced extensive delays and cancellations at the end of 1988.[50] The director of airport terminals at Pearson, Jim Mattick, stated: "I have pictures from Christmas [of 1988] showing 37 aircraft lined up for take-off. There were ground delays of 180 to 200 minutes."[51]

As a result, Pearson introduced a slot allocation system administered by committees of airport, airline and federal representatives. These committees consider international flight commitments, gate assignments, customs and immigration requirements and security arrangements in making their decisions.

In the United States, the carrier committees were originally granted antitrust immunity with respect to their allocation of slots. As a result of concern within the Federal Aviation Administration (FAA) that the committees were biased against new entrants, a more market-oriented system was introduced in 1985. A block of slots at the four constrained airports were assigned to incumbents, who could then buy or sell them.[52] The FAA can take a slot away from a carrier, and there is a "use it or lose it"[53] provision. Within those slots allocated to carriers, a subset are designated for international use. Transfer of these international slots is further restricted.

A new entrant can purchase or lease a slot from a current holder or acquire one through the lottery used to allocate new slots and those returned under the "use it or lose it" rule. Estimates of the value of a slot vary from US$800,000 to US$2,000,000.[54] The slot market is not characterized by the law of one price. In 1990, Secretary of Transportation Skinner's task force reported: "The slot holder must be concerned about the uses to which another operator will put the slots, regardless of whether the potential buyer is a new entrant to the specific slot market or an existing carrier in that market."[55]

America West has complained that carriers selling slots have not notified all potential buyers of the availability of the slot. It cites a sale by Alaska Airlines of a slot at O'Hare to United as a case in point.[56]

The Americans have favoured entrants or small incumbents in allocating new and returned slots. In 1980 the Secretary of Transportation ordered that 28 slots at Washington National be given to five new carriers. More recently, 25 percent of new and returned slots allocated by lottery have been reserved for new carriers. Windfall gains have accrued to new carriers which in many cases have not used the slots in their own operations, but have sold them. Of the 145 slots made available to new entrants or to limited incumbents (those with less than eight slots) only 15 were in use by the carriers that first received them. Some slots were returned to the FAA without use, but the majority of them were sold or transferred in a merger.[57] In Canada, there are no special provisions for new entrants. Recently, Intair had what the National Transportation Agency of Canada termed a "well-publicized skirmish with Canadian Airlines over landing-slots at Pearson International."[58]

As well as access to the runway, an airline requires rights to gates, waiting room space, ticket counters, airplane service facilities and luggage pickup areas. In the past, American airport ownership patterns and financing arrangements have been more varied than in Canada where major airports have been largely owned, financed and operated by the federal government. Recently, Canadian policy has encouraged more private participation in financing airport expansion and the transfer of ownership of existing facilities to local interests. Reaching agreement with local interests affected by the expansion of airports and the development of new runways and air traffic control techniques has been difficult in both Canada and the United States. Sometimes incumbent airlines have been covert partners with affected residents in delaying measures to address airport congestion.

Prices for slots, terminal space and other airport facilities provide information about scarcity and aid in making informed investment decisions. Private ownership of the rights encourages the evolution of pricing schemes that reflect the time-of-day patterns of scarcity. Rental prices charged by a private owner for use at prescribed times would reflect the value realized by the user. More crudely, airlines could adjust their positions by swapping access rights under their control. With public ownership, the authority could charge time-of-day user-costs to carriers. The gains from obtaining better information and coordination are substantial. Morrison and Winston estimated that optimal airport pricing and investment would generate benefits of $11.0 billion in the United States.[59]

Adoption of such measures has been slowed by the political opposition of those adversely affected. As it has with privatization schemes, distributing the private rights judiciously among those affected may broaden the base of support, as the recipients gain a valuable resource. As well as encouraging privatization of airports, Transport Canada has announced a target of having users finance the airport services it provides. Charges for landing, terminal use, aircraft parking and fuel have been raised, and plans to introduce general terminal fees at airports have been announced. Understandably, the industry does not welcome paying for scarce resources it was previously receiving on concessionary terms. The Air Transport Association of Canada's chief executive officer claimed that a full recovery of costs by Transport Canada on regional service will mean an additional $300 million charge.[60]

FLIGHT QUALITY

When flights are switched from a major carrier to one of its affiliates or an independent, jet service is frequently replaced by propeller-driven service and smaller aircraft. Comfort generally decreases while scheduled frequency and duration of flight increase. Some additional direct flights are introduced, and some existing ones are replaced by connections through a hub. In other cases, indirect routing through a hub provides a competitive alternative to the direct flight. For example, Air Toronto provides city-to-city service on 152 flights per week from Toronto to eight eastern US destinations. This Air Canada affiliate does not fly into major American airports. A traveller could fly directly between Toronto and Indianapolis on a propeller-driven plane or fly there by jet, transferring in Chicago.

How all these changes affect the quality of air travel on shorter flights depends on the traveller and the travel itinerary. The National Transportation Agency, the industry overseer, views the net effect on quality as positive:

> When the major airlines withdraw from a market, the community usually receives improved air service in the form of increased direct flights and available seats from the regional affiliates. In some cases, competing air service is provided by independent carriers. Also, while the replacement services are usually provided with non-jet aircraft, some markets continue to receive jet service.[61]

On longer domestic flights, Wardair provided a different class of cabin and ancillary service than that offered by the traditional companies. Similarly, in the United States, a broad range of service qualities was offered during the early years following deregulation. At the low end of the market, People Express unbundled the pricing of different cabin services and provided many innovations in vying to become the McDonald's of the industry, as the following tribute from Moore described:

> Started in April 1981 with three used Boeing 737s flying from its Newark hub to Buffalo, Columbus and Norfolk, People Express has grown in three years to serve twenty-two cities with forty-six planes and to employ over 2,300 people. Originally, it served only smaller cities in the East Coast area; recently, its network has expanded to include Houston, West Palm Beach, London, Los Angeles, Chicago, Minneapolis, and Oakland, where it offers the lowest-cost service available. Its success is based on offering low-cost air travel while requiring passengers to pay for all additional service. Thus if a passenger checks luggage, it costs $3.00 per bag. Coffee and soft drinks are sold for fifty cents. Passengers pay for their flights after boarding the aircraft. No hot food is served on any flights, including the ones to London; even the premium-class passengers must pay for their meals. However, People's fares are the lowest to be found.[62]

By the time Moore's article was published in 1986, People Express had gone bankrupt. The cabin and ancillary service options offered on long-haul flights today look remarkably like those that were in existence before deregulation and do not appear to be markedly more varied. The innovations of the deregulation period that pass the survivor test are hub-and-spoke networking and load management.

CHARTERS IN THE NEW SYSTEM

In Canada, a number of jet charter carriers have also entered the industry offering an alternative service to scheduled international flights. Recently, however, the exit of charter carriers has been more frequent than the entry. Of the 11 jet charter companies offering flights at the end of 1988, seven have disappeared. In 1989, Holidair and Minerve ceased operation and, in 1990, the exodus accelerated with the financial grounding of Vacationair,

Points of Call, Crownair, Odyssey International and Worldways. Consumers have suffered inconvenience and sometimes financial losses from these failures. As Oum et al. noted:

> The recent bankruptcies of several Canadian charter airlines has resulted in substantial losses to consumers as their prepaid tickets were not protected in trust funds. To some extent this is a failure of enforcement rather than policy, although the existing law leaves it to provinces to set policies and many of them have not.[63]

Ontario is one province with consumer protection legislation. However, the Ontario travel industry compensation fund does not become operative unless a tour operator has gone bankrupt, and therefore does not offer relief in situations like the Worldways collapse which affected over 8,000 passengers. Many received assistance through tour operators such as Carousel Holidays, Fiesta Holidays and Conquest Holidays, which contracted with the remaining charter companies to supply replacement seats.[64]

SCHEDULED FLIGHT FREQUENCY

Travellers have more flexibility in planning and adjusting to unforeseen events when there are more flight offerings. Under the new regulatory regime, the frequency of flights in North America increased significantly. In Canada the number of cities linked by flights rose by almost 60 percent between 1983 and 1989.[65] In addition, capacity on major city-pairs has risen markedly.[66] Although we are prepared to attribute this rise to the greater pricing, exit and entry freedom, the relation may not be strictly monotonic. While both the South and the North of Canada operate under more flexible regimes than before, there are more controls in the North. Between 1984 and 1989 departure frequency almost doubled in the South but grew even faster in the North.[67] In the United States, traffic increased since deregulation by 50 percent (passengers) and 27 percent (departures) according to the Federal Trade Commission.[68]

CARRIER COMPETITION

The National Transportation Agency publishes and interprets much useful data in its annual reviews. With respect to the degree of actual competition on Canadian routes, it noted that for 1989:

> Among the top 146 domestic city-pairs, which account for almost 90 per cent of passenger traffic in Canada, the proportion served by two or more competing carriers rose from 44 per cent to 77 per cent between 1983 and 1989 . . . [and] . . . Among the top 42 communities in the network, where about 95 per cent of domestic passengers originate or terminate their travel, all had at least two scheduled carriers in 1989 while one-half of them were served by five or more airlines.[69]

The accompanying exhibits indicate that among the top 146 city-pairs the proportion served by one or no carrier has fallen from over 50 to about 20 percent. The Agency has maintained in both its annual reports that there is no lack of competition in Canadian air service. In 1988 it stated:

> Any appearance of diminishing competition in this situation is misleading. There is extensive duplication of route coverage between the Air Canada and Canadian networks, and regional affiliates face an increasing number of small commuter carriers as well as each other in the scramble for local or feeder traffic.[70]

In its 1989 review the Agency commented:

> Canada's airline industry has always been concentrated, but when examined closely, be it in terms of passengers carried, passenger-kilometres, arriving/departing flights, seats offered etc., it is less dominated by one airline now than it was before the relaxing of regulatory controls in 1984.[71]

Judging the effectiveness of competition is not an exact science. Although aspects of what is occurring support the Agency's conclusion, there are reasons for concern. First, after an initial period of entry the trend has been to consolidation. Some analysts feel that trend has not run its course, and in the future there will be one airline aligned by strategic alliances with foreign megacarriers. Bence provides a clear outline of this script:

> First of all, the privatization of Air Canada lifts the political obstacles to a merger with Canadian International. In addition, the two carriers recently stepped up their cooperation in the area of computerized reservation systems through the joint creation of the Gemini system. . . . The second remark relates to the liberalization of trade with

> the United States. Despite much reluctance and resistance, it is very probable that the total or partial creation of a North American air transport market is only a matter of time. . . . For some months, there has been a multiplication of commercial agreements between companies of different countries. Canada has not remained inactive in this area and Air Canada, for example, has concluded agreements with Air India and Singapore Airlines International. A new step toward the internationalization of the industry seems to have taken place recently with the exchange of assets between companies. In this regard, information has been circulating in the industry concerning a possible agreement between Canadian and Cathay Pacific Airways. The last phase of this evolution would be the creation of large multinational groups active on several continents.[72]

Second, American evidence indicates that the demand price of a traveller is higher for a ticket with a carrier which offers more frequent flights on a route. The carrier with more frequent service experiences higher loads and can charge a higher price.[73] A small number of flights offered by other carriers may not exert substantive pressure on the pricing of the carrier offering concentrated service on the route. In documenting the existence of the relationship, Borenstein illustrated its strategic importance by quoting from a 1985 internal memo from an executive Vice-President to the President of USAir:

> There is still much to do before we can be confident that we have established a northeast stronghold that is as impervious as possible. Ideally we should control a major portion of the traffic at each of the cities in the north east. The beauty of the niche strategy is not just the marketing identity and control that it gives us. In addition, it enables us to keep control of prices within our niche territory, thus insulating a significant portion of our traffic from the devastating effects of unbridled price competition.[74]

Third, the amount of effective competition generated when a small number of carriers serves a route is moot. Will the competitors collude implicitly or explicitly, or will competition be intense? In the United States there has been concern with the rising concentration even though there is more overlap between different systems, and geography increases the number of alternative means of getting from one destination to another. Alfred Kahn,

for example, is not only concerned about the current level of concentration in the United States, but blames lax antitrust enforcement for the situation.

> The concentration process reflected also what many of the advocates of deregulation would characterize as a lamentable failure of the administration to enforce the policies of the antitrust laws — to disallow a single merger or to press for divestiture of the computerized reservation systems or attack a single case of predation.[75]

PROFITS

If concentration is a problem it should manifest itself either in increased profitability or in a costly dissipation of potential profits. The evidence fails to indicate that providing air service has become more profitable under the new regime either in the United States or in Canada. Nor is it evident that potential monopoly profits exist and are being masked or dissipated through slackness or some other avenue.

For the United States, Cunningham et al. summarized the evidence:

> There have been a variety of studies of the profitability of the airline industry during its transition from regulation to deregulation. It is clear from these studies that most measures of profitability of the airline industry that are based on historical accounting returns have not improved since deregulation.[76]

At first, the performance of the stock of new and old airlines in the United States reflected the optimism of many of the new entrants in the industry.[77] Since then the stock values of the established carriers has been mixed while that of the many entrants have either been bought out or have become worthless through bankruptcy. In 1989, four American airlines made profits of US$1.6 billion while the five other major companies made a loss of US$1.59 billion. The successful companies were American, Delta, United and Northwest. The only new entrant to survive, Midway, was then reported to be "low on cash and rumoured to be a merger candidate."[78] Since 1989, Midway has declared bankruptcy.

One concern of opponents of deregulation was that competition would be destructive, and carriers would not generate the profits that had been

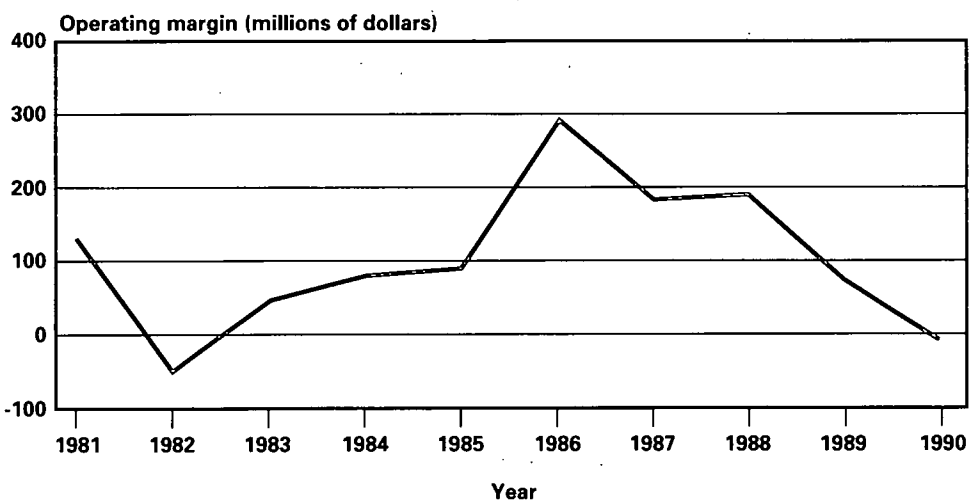
experienced with regulation and which were necessary for financing capital acquisitions.[79] Van Scyoc addressed that issue and concluded that:

> It was not deregulation of airlines which adversely affected profits but, rather, the sluggish economy and rapidly rising fuel cost along with higher real interest rates. Deregulation has allowed the airlines to increase their average load factor (ALF), keeping their profits from falling even lower than they have.[80]

The operating margin[81] in Canada for Level I airlines[82] is shown in Chart 4. The margin was negative in 1982 and 1990. Indices of the margin and two output measures are shown in Chart 5. As the index of passenger traffic and freight carried rises, the margin shows great volatility and no upward trend.

There has also been no decrease in the volatility of the margin over the different months of the year as shown in Chart 6. This volatility is consistent with greater stability in the load factor over the year. The industry is capital intensive, and interest costs can squeeze margins. The percentage of interest expenses to operating expenses is presented in Chart 7. There is

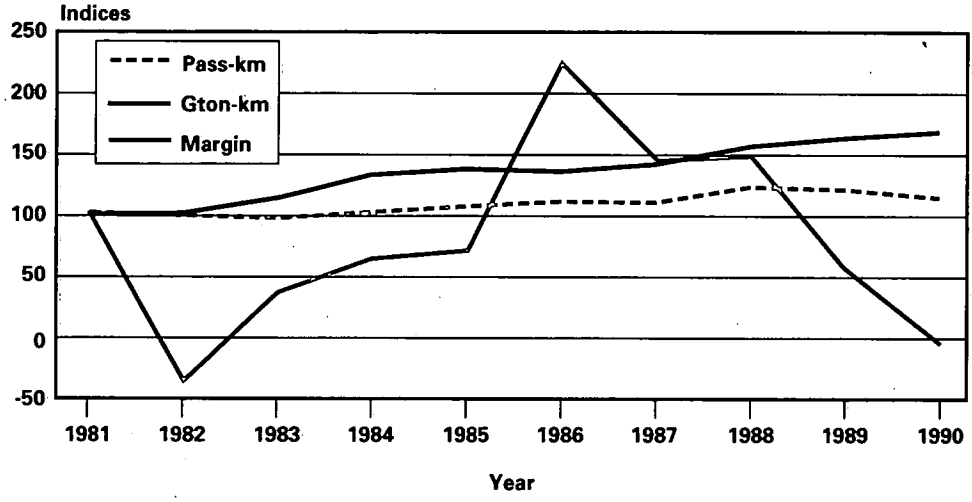
Chart 4
Annual Operating Margins
Level I Carriers



Source: Statistics Canada, CANSIM.

Notes: Margin is operating revenue (CANSIM D462215) less operating expense (D462216). 1990 margin estimated based on 9 months data.

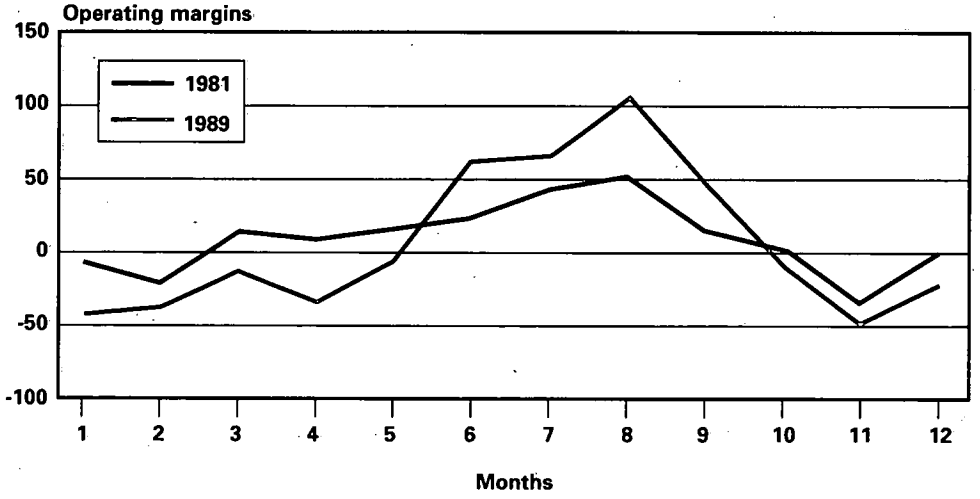
Chart 5
AIRLINE LEVEL I, 1981-1990
OUTPUTS AND MARGIN



Source: Statistics Canada, CANSIM.

Notes: Raw data from CANSIM D462210, D462212, D462215 and D462216.
Margin for 1990 estimated based on 9 months of data.

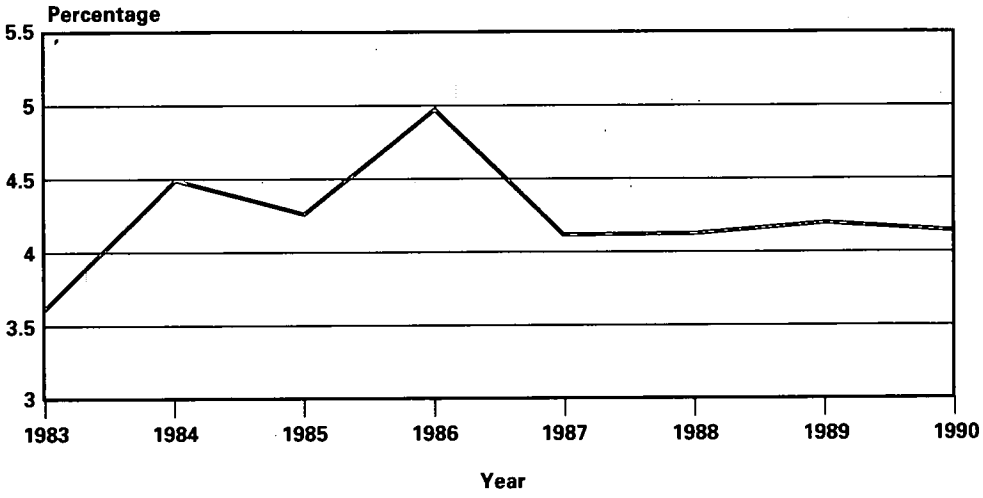
Chart 6
MONTHLY PATTERN OF OPERATING MARGINS
LEVEL I CARRIERS — 1981 AND 1989



Source: Statistics Canada, CANSIM.

Note: Margin is operating revenue (CANSIM D462215) less operating expense (D462216).

Chart 7
INTEREST TO OPERATING EXPENSE PERCENTAGE
LEVEL I CARRIERS — ANNUALLY



Source: Statistics Canada, CANSIM.

Notes: Interest (CANSIM D462217) to operating expense (D462216). 1990 based on 9 months.

no indication that this ratio has been extremely volatile, and it reached its peak in the same year, 1986, that the operating margin peaked.

Profit rates are hard to measure because of the difficulty of assessing economic depreciation in the industry, and reasonable observers disagree about their level. Despite this ambiguity, there does not appear to be any convincing evidence of excess profits, and no analyst claims the contrary. However, since the current regulatory regime has been in place for only a short time, the profit position of the airlines needs to be monitored closely. Considerable information is needed to identify trends in this industry, as profit margins are extremely sensitive to the general level of prosperity.

Another possible concern is that the lack of overall excess profits is masking monopoly profits on non-competitive routes. With no overall excess profits being made, compensating losses must exist on the other routes flown. If there are no scale effects, the airlines would presumably drop the losers, and excess profits on their total operations would surface. If instead, costs on different routes in a network are interrelated with each other and with

the details of the network configuration, profit margins on individual routes that ignore these interdependencies are misleading measures for guiding public policy.

6. The Number of Carriers and the Exercise of Market Power

As noted above, the city-pairs accounting for the bulk of Canadian air traffic are served by two or more competing carriers. There remains some uncertainty regarding the number of carriers required on a route to ensure that passengers have the benefit of competitive pricing. Fares may be competitive with one carrier if a route is contestable. The question of contestability is addressed in the next section.

The relationship between pricing and the number of carriers presently serving a route depends on the nature of the interaction among them. If the flights offered by each carrier are indistinguishable, and each carrier sets its fares on the assumption that the other(s) will maintain theirs at existing levels, then fare levels will be driven to marginal cost when there are two or more carriers on a route. This is what is known in price theory as undifferentiated Bertrand competition. When competition takes this form, fare revenue is not sufficient to cover fixed costs. For this reason undifferentiated Bertrand competition is sometimes called destructive competition, and it cannot prevail over the long run.

If the flights offered by each carrier are indistinguishable, and each carrier assumes that rivals will maintain their capacity on the route and adjust fares to maintain load factors, then fares will exceed marginal cost — approaching it asymptotically as the number of carriers on the route becomes very large. This is known as undifferentiated Cournot competition. Taken together with free entry, this form of competition results in fares that approach average cost.

Incumbent carriers may also agree tacitly to share the traffic on a route in roughly fixed proportions. In this case fares will remain at the monopoly level regardless of the number of carriers on a route. It may become increasingly difficult, however, to maintain a market-sharing arrangement as the number of carriers on a route increases.[83]

The assumption that the respective flights of individual carriers on a route are indistinguishable does not seem very realistic. Individual flights may be

differentiated with respect to departure times and connections as well as the number of stops, the airport (Pearson or Toronto Island, for example), the type of equipment and cabin service. In this case it is more difficult to talk about "the price" because the offering differs. If the differentiation is assumed to be simple, involving only departure times, for example, it can be shown that the fare charged by each carrier declines as the number of carriers on a route increases.[84] Fares would tend to marginal cost only if allowed departure times were virtually adjacent, and the fixed costs of offering a flight were very low.

The empirical evidence on the relationship between the fares and the number of carriers on a route in the United States has been cited above. Some evidence suggests that two carriers are sufficient to generate competitive fares. This is consistent with the undifferentiated Bertrand model. Other evidence implies that it may take up to five carriers on a route before competitive results are achieved. This is consistent with a variety of models including the Cournot, market-sharing and differentiated product models.

The unprofitability of most airlines in recent years is consistent with either undifferentiated Bertrand (destructive) competition or with free entry. The continuing presence of price discrimination is not consistent with undifferentiated Bertrand competition. Moreover, the evidence cited in the next section implies that barriers to entry do exist. Thus it is difficult to characterize the nature of the oligopolistic rivalry among airlines with any precision on the basis of the evidence presently available.

The relationship between fares and the number of competitors on Canadian routes does not appear to have been subject to the same type of analysis. The National Transportation Agency has noted the salutary effect of competition on fare levels in several of its northern fare investigations.[85]

7. Contestability

Contestability draws attention to the disciplining power of potential competition — of the deterring effect of credible threats to enter. The concept has venerable roots, although it has recently been rediscovered, refined and given a patina of mathematical respectability. The central idea was clearly and subtly articulated by Schumpeter:

> It is hardly necessary to point out that competition of the kind we now have in mind acts not only when in being but also when it is merely an ever-present threat. It disciplines before it attacks. The businessman feels himself to be in a competitive situation even if he is alone in his field or if, though not alone, he holds a position such that investigating government experts fail to see any effective competition between him and any other firms in the same or a neighbouring field and in consequence conclude that his talk, under examination, about his competitive sorrows is all make-believe. In many cases, though not in all, this will in the long run enforce behavior very similar to the perfectly competitive pattern.[86]

For the purposes of this study, it is useful to distinguish between contestability with a single homogeneous service and with a number of differentiated services. Consider first a situation in which each flight is sold at the same price, and the market is supplied by a single carrier. Perfect contestability describes a polar case in which the threat of competition has a maximum effect. It requires that the potential entrant have the same costs of providing service as the incumbent, and some mechanism should exist for the potential entrant to contract with customers without cost. The entrant can offer better terms to passengers currently flying with the incumbent, and they can switch their business without cost. To keep its existing customers, the incumbent has to price services with no excess profit. If that did not occur, the entrant could decrease the price slightly and still be viable.[87]

If travellers can be separated into different groups by differentiating service, perfect contestability ensures that no subscribers to a service class can do better by contracting with a potential entrant alone, or in conjunction with some of the other groups, or in a grand alliance with every group being currently served.[88] When price discrimination is possible, there may be a number of price packages for each service class that defend the incumbent against the challenger. Each choice within this set of sustainable break-even pricing options involves different contributions from each of the service segments.

The more contestable a market is the less the need for oversight and intrusive regulation. The degree of contestability depends on the costs of potential entrants and the barriers to entry. For a particular route, other active airlines obviously have expertise in providing service. However the network configuration of the potential challenger can raise its cost of providing service to the particular city-pair. There may be none or only a few carriers

which can integrate the route as effectively into their current network as the incumbent. Foreign airlines with effective cost configurations would widen North American air service if they were permitted to enter the market. In Canada, American airlines with adjacent networks would be particularly effective.

Barriers to entry are costs imposed on an entrant but not the incumbent. In considering contestability and air service, many analysts focus on the fact that the airplane is not considered sunk capital and is suitable for "hit-and-run" entry into a market. In classroom discussions the airlines become the archetypal example of a perfectly contestable industry. The real world has failed to confirm that hypothesis. There are many other valuable informational and structural assets involved in providing airline service which are sunk. Barriers to entry alleged to exist in airline service include control over airport slots, gates and ancillary facilities; frequent flyer programs; feeder line control and hub or route concentration effects; computer reservation systems and graduated travel agent commission schedules; and predatory pricing.

The airport congestion problem in Canada is an issue at Toronto and Vancouver. It and various externality problems can be alleviated by appropriate pricing of airport facilities. Halting steps are being taken in this direction. Unfortunately, as noted by Soberman, the media have focussed attention on less-pressing issues than price rationalization and the provision of, and access to, airport facilities:

> The capacity of Toronto's Pearson International Airport, for example, is a real issue. It affects costs, aviation safety, and congestion for much of the remaining domestic airline network. By contrast, recent VIA Rail cuts were perceived by numerous elected officials and newspaper editorialists to create real problems of urban traffic congestion. In fact, in a place like Toronto, all VIA services accounted for about 200 commuters per day in comparison with the 1.7 million passengers per day carried by all other public transportation agencies.[89]

With appropriate pricing, an incumbent would face the same cost of using airport facilities as would an entrant, and no barrier to entry would exist. The gains appear to be so considerable from proper pricing of airport facilities that it is difficult to understand the political hesitation in implementing appropriate systems. Political opposition, however, is ubiquitous. For the United States in 1989, Hahn and Krozner reported that a small private

plane could land for a US$6 charge while a commercial jetliner paid between US$90 and US$200, although both caused the same congestion effects. They also noted that Congress limits the revenue-raising abilities of airports which receive federal financial aid and has imposed restrictions prohibiting the levying of "passenger facility charges."[90] Perhaps the key to reducing this opposition is to stress the externality control features of pricing as well as the more obvious alleviation of financing difficulties.

Gaining access to congested airports can be avoided by entrants flying into and out of other airports that serve the same or contiguous areas as the major airport. The lack of such alternatives for major Canadian routes prompted Lazar to comment in 1984:

> There are only two sets of markets that have the traffic potential to support multi-frequency, end-to-end, turnaround routes such as those flown by People Express and Southwest. These markets are the Vancouver–Calgary–Edmonton and the Toronto–Ottawa–Montreal–Quebec City groupings. In none of these cities however, is there a close-in and/or relatively uncongested second airport that can accommodate jet aircraft.[91]

Alternative airports exist for commuter traffic on shorter routes, and since 1984 the capabilities at a number of these have been enhanced. Partly in response to congestion at Pearson International, traffic has risen at Oshawa, Hamilton (jet capacity), Buttonville and Toronto Island airports. The development of even more sophisticated facilities at these alternative sites may enhance competition even further, although the area air traffic control problem may be exacerbated.

Another aspect of the airport access problem is the domination of an airport by one or two carrier systems. Feeder traffic is critical to the operation of a hub-and-spoke system. Density on many feeder routes can often support only one supplier. Contractual links or ownership of these feeders has been cited as another barrier to entry:

> Air Canada and CAIL have been successful in purchasing all of the feeder carriers of any importance in Canada. By preventing their feeder subsidiaries from signing interlining agreements with other carriers, or from putting in joint fares with other carriers, they are excluding new entrants from the trunk airline routes from important

> segments of trunkline markets. Just prior to Wardair's demise, it announced that it was going to pay feeder airline fares, at great expense, in order to get access to an important segment of the scheduled airline market.[92]

Exclusive contracts and refusal to supply are addressed by competition policy. This study did not uncover any idiosyncrasies which would dictate a special governance arrangement for competition practice in air service.

Tretheway referred to frequent flyer programs "as a powerful entry barrier."[93] For the United States, Winston and Morrison estimated that a frequent flyer program is valued at US$32.01 per round trip of an average length over their sample.[94] A fledgling or local airline offering service between points A and B only cannot launch an effective self-contained plan. The frequency of use by a typical business passenger may not generate enough credits and for the passenger who does qualify for a prize, winning yet another trip to B may generate minimal excitement. This is true regardless of whether the airline has just begun business or has been offering service for a long period of time. The barrier is not one of entry but of size. The constraint is that the "in kind" volume bonus has to be attractive. A non-airline company which could offer attractive prizes from its existing services could take over a single route and immediately implement a competitive marketing plan. Prizes for volume purchasing could take a number of forms including waiving credit card fees, "free" vacations at some resort or free options on the purchase of an automobile, depending on the price cost margins in the portfolio of products and services sold by the parent company. "In kind" bonuses are ubiquitous in Canada, ranging from Canadian Tire script to obtaining three for the price of two. Presumably, airlines offer prizes in the form of flights rather than other "in kind" prizes, because it aids their load management.

An affiliate of one of the two major carriers may enter into a single-carrier route, or if the existing carrier is part of one system, an affiliate of a rival system may enter. In either case, the entrant would already be linked into a viable frequent flyer program, and no competitive problem would arise from this source. A small airline, which is not an affiliate, can negotiate inclusion in the plan of AC, CAIL or a foreign line. For example, when Intair departed the CAIL family to fly as an independent, it offered a frequent flyer program in conjunction with American Airlines and KLM.

Organizational innovation is an important competitive element in a small-numbers service industry. Pricing innovations have diffused quickly in this industry. Since a frequent flyer program represents a pricing initiative which is attractive to customers, it is not advantageous to prohibit such plans[95] or tax them.[96] For a low enough level of tax that would still give entrants an incentive to develop their own plan, entry would not be encouraged. For a level of tax at which an entrant without a plan could compete with an incumbent who maintained a taxed plan, entry would be subsidized. A large enough tax that would prevent anyone offering a plan would be the same as a prohibition.

Remedies which enhance competition by other means than proscribing or implicitly taxing those dimensions of service which one class of firms (in this case large firms) does better are preferred. The frequent flyer plans may be improved by disclosure requirements or even access requirements. However, the most effective pro-competitive step available is to broaden access to alternative sources of frequent flyer schemes through a North American, or preferably more widely based, air pact.

Morrison and Winston estimated the competitive advantage conferred by a hub to be US$25.66 on their representative American round trip.[97] The new hub-and- spoke network architecture reduces costs and increases the options available to passengers. Canadian independent airlines can make feeder arrangements with American airlines but opportunities are restricted. Before its demise, City Express was negotiating a feeder agreement with Continental Airlines. Reducing the barriers to competition between configurations can be encouraged by removing artificial barriers to international competition. In this instance, a North American pact would be sufficient to harvest the benefits.

What is essentially a regulatory remedy has been adopted in Europe, the United States and Canada with respect to computer reservations systems.[98] In 1989 after submitting the proposed merger between Reservec and Pegasus to the Competition Tribunal, the Director of Investigation and Research amended his application to permit the merger if a proposed set of rules governing the operation of the enlarged computer reservation system (CRS) and access to it was adopted. The Tribunal approved the merger and a modified set of rules in mid-1989. After the decision, the Minister of Transport directed Transport Canada and the National Transportation Agency to develop appropriate regulations for reservation systems.

Even with a regulatory code in place, a barrier to entry may persist. Algorithm bias, halo effects such as commission payments based on CRS use and the market intelligence conveyed provide the CRS carrier with an alleged advantage. In evidence given before the Canadian Competition Tribunal, Michael Levine, a dean at Yale and a former executive at New York Air, argued for divestiture of CRSs from the carriers because regulation of them had failed:

> Detailed regulation in the United States has succeeded in reducing incremental revenue effects from 50% or more to "only" 13–20% (estimate of the U.S. Department of Transportation), but that compares with typical airline profit margins of 5% or less, suggesting that even a heavily regulated CRS sufficiently distorts competition to make the difference between success and failure in the marketplace.[99]

Although the same remedy was not recommended, the same concern was expressed by the American Secretary of Transportation's Task Force:

> In certain areas, the rules have not worked as well as the CAB originally intended. In particular, the issue of allegedly restrictive subscriber contract provisions and practices remains one of the most controversial CRS policy issues. In addition, the prohibition on display bias did not eliminate incremental revenues. Finally, the CAB's expectation that booking fees could be controlled by the bargaining power of major non-vendor airlines proved unrealistic.[100]

Bailey and Williams argued that the CRS and hub domination reinforce each other as barriers to small entrants:

> One use of these (CRS) systems has been to enhance high-volume control at large hubs. Since deregulation, American's system has come to process 88 percent of ticket sales in the Dallas–Ft. Worth market, United's to process 72 percent of the Denver market, and United's and American's together to process 83 percent of the Chicago market. Thus, American's Sabre System and United's Apollo dominate the travel agencies in the hubs where these carriers operate, enhancing local monopoly rents from these geographic regions as well as scale-based rents over competing carriers. Both sources of rent are thereby enhanced for these especially powerful carriers.[101]

In Canada, entrants that have challenged AC and CAIL have subscribed to other CRSs. Intair aligned itself with Sabre, the CRS of American Airlines. Before its takeover by CAIL, Wardair subscribed to System One, the CRS of Texas Air.

In the United States major airlines which do not have their own CRS often buy into the CRS of another carrier. For example, the Apollo system is 50 percent owned by United, with Alitalia, British Airways, KLM, Swissair and USAir owning 49.9 percent. Air Canada recently purchased a 1 percent interest in this system. These private responses are similar to those observed with bottleneck facilities like pipelines. They provide some insulation to existing airlines from exploitation. They may make entry easier by setting a precedent on the terms and conditions for ownership participation in a CRS, but on the dark side they may facilitate the coordination of incumbents to fight entrants.

CRSs require common conventions as to format and structure. For this reason, as well as the barrier to entry concern, regulation may be warranted. However, regulation may affect system innovation. In the personal computer field there has been a spectacular increase in power, an explosion in sophisticated applications and a marked reduction in real price generated in the absence of regulated operating systems and architecture.

To what extent would the adoption of such systems have stifled this remarkably innovative sequence? Any stifling effect has to be balanced against an acknowledged reduction in a barrier to entry. The Bureau of Competition Policy and the Tribunal are not the best-suited institutions for ensuring a flexible evolution of the code which neither penalizes nor subsidizes entry.

Graduated travel commissions are another source of concern for small entrants. Although traditionally based on total ticket sales, more recently airlines have been targeting particular routes. The rate of override also increases as the share of the agency's business directed to the carrier increases. Large organizations can protect themselves by private contracting and these arrangements reduce the barrier to entry. An example is provided by the American Department of Transportation's Task Force:

> Consequently, some agencies and corporate clients have shifted to a fee system, where the client, not the air carrier, compensates the agency by paying it a fee. The agency then turns its airline commissions

> over to the client. The fee system would help ensure that the agency's incentives are consistent with the client's expectation that the agency's goal is to provide it with the best possible service and would reduce the uncertainty facing an agency over the adequacy of its compensation.[102]

With respect to predatory pricing, it is alleged that carriers have selectively responded to incursions by low-price entrants or by other incumbents breaking an established pattern of pricing. As of the end of June 1990, the U.S. Justice Department was proceeding with four cases involving alleged collusion, predation or attempts to block entry against airlines.[103] In one of these cases carriers are accused of using the monitoring service of the Airline Tariff Publishing Co. to signal that new fares were in retaliation for the pricing aggressiveness of others.

People in the industry say the crucial signals between carriers translate as follows: "Let me determine the price at my hub airport and I'll let you do the same at yours." The most common — and perhaps most questionable — "discussion" between airlines is played out like this: Carrier A, often a smaller operator such as Midway Airlines or America West, attempts to boost its business by lowering ticket prices. It enters lower fares in the industry's computer system. In response, Carrier B, the dominant carrier at the affected airport, not only matches the new fares, but lowers them in other markets that are served by Carrier A.[104]

Alfred Kahn did not include predation in his discussion of the events that surprised him about airline deregulation:

> I take perverse satisfaction in having predicted the demise of price-cutting competitors like World and Capital Airways if we did nothing to limit the predictable geographically discriminatory response of the incumbent carriers to their entry, and in having rejected the conventional wisdom that predation would not pay because any attempt to raise fares after the departure of the price-cutting newcomers would elicit instantaneous competitive reentry.[105]

Although competition policy can be mobilized if the threat of predation is a significant barrier to entry, there are particular difficulties in identifying predation in the airline industry. Prices are frequently regarded as predatory, if they are below incremental cost. Incremental cost is an ambiguous

concept in this industry. It depends on the time horizon adopted. It also may have an opportunity cost component that will not be evident in accounting data. Prices are sometimes regarded as predatory if they are discriminatory. In this market discrimination is likely to be a feature of an efficient equilibrium. It may be difficult to determine when a change in the degree of discrimination is a predatory rather than a competitive response.

8. Institutional Defences against Market Power

City-pair airline markets may not be perfectly contestable, and the lower density routes may be characterized by small-numbers competition. This raises concerns about the possible exercise of market power on these routes. Contestability may be limited by any or all of incumbent control over airport slots, gates and ancillary facilities; frequent flyer programs; feeder line control and hub or route concentration effects; computer reservation systems and graduated travel agent commission schedules; and predatory pricing.

Defences against the excercise of market power may take any of three forms:

- further deregulation;
- residual rate and fare regulation and/or the imposition of access requirements; or
- decentralized public and private responses.

FURTHER DEREGULATION

While it does constitute a considerable liberalization of the regulations governing air and other forms of transportation, the *National Transportation Act, 1987* retains some provisions which may reduce the contestability of city-pair airline markets. The first of these is the requirement under section 76 that an incumbent carrier give 120 days' notice before dropping a service or reducing its frequency to less than once a week. This requirement effectively commits the incumbent to the market for four months regardless of the attractiveness of a new entrant's offering. The legislation requires the incumbent to "stand and fight" and undermines the contestability of the market as a consequence.

A second restrictive feature of the Act is the requirement under section 72 that all carriers be 75 percent Canadian owned. This restriction could be relaxed by Order in Council. This would increase the number of potential entrants and may also increase the discipline imposed on incumbents by the threat of entry. U.S. carriers may be well-placed to enter some domestic Canadian routes or to link various Canadian cities via their U.S. hubs or regional hubs. In addition, U.S. carriers are already realizing frequent flyer, CRS and other network economies. They would have less, if any, need for regulatory intervention to ensure their credibility as entrants.

RESIDUAL RATE OR FARE REGULATION

The National Transportation Agency has the power to control economy fares on southern routes where there is an absence of effective competition. Thus the option of imposing fare ceilings on monopoly routes still exists. The appropriate definitions of a monopoly route and of what constitutes a competitive fare are dealt with below. In this regard the U.S. experience with defining monopoly rail routes and with setting rates on them in the post-*Staggers Act* period is instructive as is the Canadian experience with competitive line rates on railways and with fare regulation on monopoly bus routes.

The *Staggers Rail Act*

The *Staggers Rail Act* left the Interstate Commerce Commission (ICC) with limited jurisdiction over railway freight rates. The ICC can order that a rate be raised to average variable cost which is the minimum "reasonable" rate under the Act. The ICC also has the power to set maximum rates under a restricted set of circumstances. Specifically, the ICC may investigate the reasonableness of a rate if it exceeds 180 percent of variable cost and the carrier has market dominance. If the rate is found to be unreasonable the ICC may order it to be reduced. Any rate below 180 percent of variable cost or which is set by a railway which is not in a position of market dominance is presumed reasonable.

The existence of any one of four forms of competition is sufficient to disprove market dominance. These are:

- intra-modal competition: competition from another railway;
- intermodal competition: competition from road or water transport;

- geographic competition: the ability of a receiver to obtain the product to which the rate in question applies from another source or of the shipper to ship it to another destination; and
- product competition: the ability of the receiver to use a substitute for the product to which the rate in question applies or the ability of the shipper to make and ship a substitute.

Railways deemed to be "revenue inadequate" may further increase their rates by 4 percent annually even if these rates exceed 180 percent of variable cost, and market dominance exists. This is called the "zone of rate flexibility." At present all U.S. railways are deemed by the ICC to be revenue inadequate, that is, earning less than their cost of capital.

In its assessment of the reasonableness of rates which exceed the 180 percent of variable cost, for which there is market dominance and which are not in the zone of flexibility, the ICC uses a "constrained market pricing" approach. Constrained market pricing is based on two principles. These principles are "differential pricing" and "stand-alone cost." The principle of differential pricing is that a greater proportion of common costs should be recovered from the customers with the less elastic demands. Differential pricing is thus a simplified version of Ramsey pricing. Because prices exceed marginal cost by the largest amount in the market segments in which this has the smallest effect on demand, Ramsey pricing minimizes the distortion in output associated with the recovery of a given level of fixed costs.

The stand-alone cost principle is that no shipper should pay a rate higher than the lowest stand-alone average cost of serving that shipper or any group of shippers. This is what any shipper would pay if the market for freight services were contestable. That is, given contestability, a railway that charged shippers more than the stand-alone average cost of serving them would lose the market to a new entrant.

The application of these two principles was illustrated by Willig and Baumol.[106] Suppose that a railway serves markets S and T. Variable costs are $80 in each market, and there are common costs of $40. Suppose further that as a result of intermodal competition customers in the S market can only be charged $80. Then customers in the T market pay $120 which is the variable cost of service plus the fixed costs. This $120 is also the cost a new entrant would incur in serving the T market alone.

Roberts pointed out that the practical application of the stand-alone average cost ceiling to captive railway shippers presents a number of difficulties. First, it may be difficult to determine what the costs of a specific component of an integrated rail network are. Second, it may also be difficult to determine the group of shippers a hypothetical new entrant might serve.[107]

There has been considerable dissatisfaction among captive U.S. shippers with the ICC's constrained market pricing approach. Mid-western coal shippers have been the most vocal. Dunbar and Mehring found, however, that at least during the early years of the *Staggers Act*, real, distance-corrected coal rail rates fell on average.[108]

Roberts has proposed an alternative to the stand-alone cost approach to determining rate ceilings.[109] He suggests that all shippers paying rates above the system average price–marginal cost ratio be treated as a class. The rates paid by this group would all have the same ratio to marginal cost. This ratio would be sufficient to cover all fixed system costs. In the terms of Willig and Baumol, the hypothetical entrant is the same as the railway's existing network and the hypothetical group of customers is all customers currently discriminated against (in the sense of paying above-average price-cost margins).

Competitive Line Rates on Canadian Railways

Sections 134–143 of the *National Transportation Act, 1987* provide for the establishment by the National Transportation Agency of competitive line rates. A competitive line rate may be established between either the point of origin or the point of destination of a shipment and a connecting rail carrier. A competitive line rate cannot be applied over more than 50 percent of the distance between the points of origin and destination or 750 miles whichever is greater. The formula to be applied in determining the competitive line rate is given in section 137. The competitive line rate is the interswitching rate plus the revenue per mile of the connecting carrier multiplied by the number of miles over which the competitive line rate is to apply less the distance over which the interswitching rate applies.

The first competitive line rate case decided by the National Transportation Agency under the 1987 Act is described by Lande.[110] The case involved shipments of methanol by tank car from Medicine Hat to Shelby, Montana.

The shipper, Alberta Gas & Chemicals Ltd. was captive to CP Rail at the point of origin but could interswitch with Burlington Northern. Alberta Gas had a rate from Burlington Northern but could not agree with CP on a rate on its portion of the route. The Agency set the CP rate at the Burlington Northern rate per ton-mile in Canadian dollars times the CP mileage in excess of the interswitching distance plus the interswitching charge. This rate has been renewed twice by the Agency.

Extra-provincial Bus Transport

Section 195(2) of the *National Transportation Act, 1987* states that the National Transportation Agency "may, by order, disallow any tariff of rates or any portion thereof if, in its opinion,

(a) the tariff or portion thereof is not compensatory and is not justified by the public interest; or

(b) there is no effective alternative and competitive transportation service by a common carrier . . . and the tariff of rates unduly takes advantage of a monopoly situation."

A 1986 Canadian Transport Commission decision under section 40 of the 1967 Act illustrates the factors likely to be considered in determining whether a bus fare is unduly monopolistic. In *Re TerraTransport* (Decision number MV-40-224), the Motor Vehicle Transport Committee of the Commission found no justification for disallowing a 5 percent increase in fares on the Roadcruiser bus service in Newfoundland.[111] Its reasons were that TerraTransport was not and had not been profitable, there was no evidence of excessive or misapportioned costs or of an overall deterioration in service, and there was no indication that past fare increases had themselves discouraged traffic appreciably. The Committee also implied that it would continue to look favourably on fare increases at TerraTransport until the latter was earning "a reasonable rate of return which would generate enough capital to reinvest in the operation in order to maintain and, if there is sufficient demand, to expand the service."[112]