Submission on

Draft Enforcement Guidelines on the Abuse of Dominance in the Airline Industry

NATIONAL COMPETITION LAW SECTION
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PREFACE

The Canadian Bar Association is a national association representing over 37,000 jurists, including lawyers, notaries, law teachers and students across Canada. The Association's primary objectives include improvement in the law and in the administration of justice.

This submission was prepared by the National Competition Law Section of the Canadian Bar Association, with assistance from the Legislation and Law Reform Directorate at the National Office. The submission has been reviewed by the Legislation and Law Reform Committee and approved by the Executive Officers as a public statement by the National Competition Law Section of the Canadian Bar Association.

Submission on
Draft Enforcement Guidelines on the Abuse of Dominance in the Airline Industry

I. INTRODUCTION

The National Competition Law Section (the Section) of the Canadian Bar Association welcomes this opportunity to comment on the Draft Enforcement Guidelines. In preparing these submissions, the Section has consulted with its members who are familiar with the airline transportation sector. The Section looks forward to participating in any follow-up discussions concerning the Draft Guidelines.

At the outset, we commend the Commissioner for undertaking this initiative. Given the economic importance of this industry, all market participants should understand the approach of the Competition Bureau (the Bureau) to allegations of abuse of dominance in the airline sector. Issuing draft guidelines for public comment enhances the Bureau's goals of confidentiality, fairness, predictability, timeliness and transparency.

Enforcement guidelines must strike an appropriate balance between transparency and predictability on the one hand, and enforcement flexibility and discretion on the other. When guidelines state enforcement principles too starkly, they may create unrealistic public expectations of the Bureau's enforcement action in any particular situation. On the other hand, when guidelines simply indicate that the Commissioner will exercise discretion, without setting out the factors to be used in exercising that discretion, they are of little use. While the Bureau has attempted to chart a course between these two extremes, this enforcement dilemma is nonetheless evident in the Draft Guidelines.

II. GENERAL COMMENTS

A. Airline Regulatory Regime

The Draft Guidelines are so detailed that they essentially constitute an airline regulatory regime. This deviates significantly from the overall approach of the *Act,* which is to provide a general framework for the regulation of competition rather than to regulate specific industries.

The Canadian airline sector is currently dominated by a single carrier. Air Canada, current competitors, potential future competitors, users of airline services and the Canadian public at large need to clearly understand what type of behaviour is acceptable and what can legitimately be expected of enforcement initiatives by the Commissioner's office. The Section recognizes that the Government chose not to adopt the Commissioner's previous suggestions to enhance competition in this sector. We also recognize that in issuing the Draft Guidelines, the Commissioner is attempting to address, in competition policy terms, a less-than-optimal market situation.

The Section is concerned that the enforcement approach in the Draft Guidelines, and particularly the application of the avoidable-cost test, will require the Bureau to dedicate significant resources to monitoring one particular industry, and indeed one particular industry participant. These resources could otherwise be used to deal with issues in non-airline sectors. The need for such specialized resources to effectively monitor the activities of one industry participant is perhaps indicative of a need for a special regulatory regime outside of the *Act* for the airline industry.

Attributing airline costs and revenues on a flight basis involves complex and inter-related decisions. The airline industry employs thousands of people to consider the calculations, projections and strategies involved in making seat and fare allocation decisions. The Draft Guidelines attempt to reduce what is in essence an airline cost-of-service regime to a statement of principles. While this is laudable, the Section has three concerns. First, the principles may be overly simplistic and may not therefore provide a significant degree of certainty, transparency or predictability. Second, the practical application of these principles may be overly complicated. Third, the principles are set out in a deceptively clear fashion, which may inadvertently raise unreasonable expectations on the part of those seeking enforcement action from the Commissioner.

B. Transparency and Public Participation

Implementation of the Draft Guidelines will result in a significant amount of interaction between the Commissioner and the dominant carrier with little process transparency or opportunity for public participation.

Any application of the avoidable-cost standard will be highly technical and fact-specific. Because the necessary detailed information on Air Canada's costs and revenues is confidential and competitively sensitive, the Bureau's investigation would take place behind closed doors. This affords little or no opportunity for input from a complainant or other interested parties as the Commissioner's analysis evolves. If the Commissioner decides not to bring an application to the Tribunal, neither the complainant nor the general public will have any way to evaluate whether the decision was appropriate. If the Commissioner does bring an application and the Tribunal conducts a full hearing, the Tribunal's decision will be based largely on confidential information that will remain unavailable to the public.

We raise this issue not to suggest that Air Canada's confidential information be disclosed to its competitors or the public. Rather, we simply wish to point out that this lack of public information about the Bureau's investigation and, in particular, the application of the avoidable-cost test means potential complainants will remain unable to predict the merits of making a complaint to the Commissioner.

Further, the Bureau and the dominant airline will need to have regular contact to discuss cost structures and minimum allowable fares. This raises issues of perceived (or actual) regulatory capture. In other words, there is a risk that this regulatory scheme may continue in force after the need for such regulation has passed, or may change over time to serve the interests of the dominant carrier or the airline industry above the interests of consumers, even though the scheme originated to address the potential for market failure caused by predatory activities of the dominant carrier.

C. Accountability in Exercise of Enforcement Powers

The Draft Guidelines do not include mechanisms which will promote increased accountability in the Bureau's exercise or non-exercise of enforcement powers. The Draft Guidelines should establish what parties can expect from the Bureau, whether they are prospective market entrants or existing competitors considering expansion to compete against Air Canada. It is unclear that the Draft Guidelines achieve this objective.

The federal government has enacted special legislation conferring special powers on the Bureau in respect of the airline industry. As a result, industry stakeholders might reasonably expect special attention from the Bureau and rapid enforcement action on allegations concerning abuse of dominance. The Draft Guidelines should clarify what competitors and potential competitors can expect in two areas: first, enforcement of complaints of abuse of dominance; and, second, enforcement of undertakings given by Air Canada. Among other things, the Bureau should indicate a time frame within which it would strive to assess a complaint and, if appropriate, seek a remedy. The Draft Guidelines should also include more practical examples reflecting issues that the Bureau has actually investigated.

D. Cease and Desist Orders

The Draft Guidelines should elaborate on the factors that the Commissioner will use in exercising the discretion to issue cease and desist orders. This is a significant new power, which has been in force for less than a year.[1] The Commissioner can issue cease and desist orders on an *ex parte* basis, without judicial oversight and is subject to limited judicial review on appeal.

This change of role of the Commissioner from investigator to adjudicator is being closely watched by industry participants, their advisors, and consumers. In its submissions on Bill C-26,[2] which introduced this power, the Section expressed specific concerns about how the power would be exercised, as well as a more general concern that the provision was setting a bad precedent. We reiterate those concerns.

The Draft Guidelines must articulate the circumstances under which the Commissioner intends to use the cease-and-desist authority. Its mere existence may have a chilling effect on legitimate market behaviour. Conversely, the failure to use it may discourage potential entry or expansion. In addition, as articulated in the Conformity Continuum Information Bulletin, the Commissioner has several enforcement alternatives available to resolve a particular case. Accordingly, it is important that interested stakeholders understand the factors that will influence the Commissioner's decision to issue a cease-and-desist order as opposed to pursuing alternative enforcement approaches.

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1 Since July 5, 2000.

2 National Competition Law Section, Submission on Bill C-26, *Canada Transportation Act and Competition Act* amendments (Airline Restructuring) (Ottawa: Canadian Bar Association, April 2000).

The Draft Guidelines should establish:

- the situations in which a temporary order would be made;
- the factors the Bureau would consider in determining which acts would be prohibited;
- the required steps to obtain an order;
- the duration of such an order;
- the information which would be contained in or which would accompany a temporary order; and
- the test which the Commissioner must satisfy to have the order confirmed by the Tribunal.

The Draft Guidelines should also indicate the kind of evidence a complainant should submit to the Bureau and a usual time frame within which the Bureau would attempt to assess a complaint.

As indicated in its submission on Bill C-26, the Section is concerned that section 104.1 of the *Act* authorizes the Commissioner to issue temporary orders in circumstances where the Tribunal would not have jurisdiction to make an order under section 79. Section 104.1 should not be used as an alternative to bringing an application to the Tribunal, for instance, in a situation where the Bureau believed it would not be successful under section 79. The temporary order power should only be used when the Commissioner needs more time to complete an inquiry and believes there is a reasonable likelihood that there will be sufficient evidence to bring an application to the Tribunal. The Draft Guidelines should indicate that the Commissioner will not make a temporary order unless, at the time the order is made, there is reason to believe that grounds to make an order under section 79 exist.

The Section also remains concerned that section 104.1 of the *Act* authorizes the Commissioner to issue a temporary order without providing any notice to the affected person. The Draft Guidelines should indicate that, except in cases of real urgency, the Commissioner will notify the affected person that an investigation or inquiry has begun and give that person a reasonable opportunity to make representations as to why a temporary order should not be made.

III. DETAILED COMMENTS

A. Predatory Pricing

Paragraph 32 of the Draft Guidelines states that matching the dollar price of a competitor may not be the same as charging the same real price for the same quality and quantity of a product, if the "matching" firm offers a superior service, schedule or frequent flyer program. In such a case, if the "matched" price is below the "matching" firm's costs, the Draft Guidelines state that a party cannot justify charging a price which would otherwise be considered predatory by using the fact that the price is a response to a competitor's price.

The Section submits that real price matching should never be considered predatory pricing. This is consistent with the Bureau's Predatory Pricing Enforcement Guidelines and case law developed in the criminal context. If the Bureau's position is that different considerations apply in a civil context and that real price matching in the airline industry could be considered anti-competitive, this should be clearly stated in the Draft Guidelines. This position would represent a significant departure from the present law in this area and would be an extremely difficult principle to apply in practice.

B. Elements of the Avoidable-Cost Test

i) Cost categories

Paragraph 42 refers to "aircraft costs." Does this refer to the cost of purchasing or leasing the aircraft? Unless they are included in "aircraft costs," maintenance costs other than labour (for example, parts) should also be listed. We note parenthetically that they would be avoidable to the extent that the life of equipment depends on flight time rather than age. Other costs that could be listed in the "outright avoidable" category are: segment booking charges through computer reservation systems (CRS); agency incentive commissions; security, customs and immigration charges; meals and hotel expenses of the crew; frequent flyer points; and insurance.

Paragraph 43 indicates that prorated revenues from connecting passengers and revenues from miscellaneous services (such as cargo and bar service) are included in flight revenue. The guidelines should also indicate that the related costs of such miscellaneous services are taken into account. Moreover, if the Bureau intends to allocate revenues between feeder routes and the route under investigation, the Guidelines should adopt a standard formula for prorationing rather than using the dominant carrier's methodology. With so few competitors in the market, it would be inappropriate to rely on the dominant carrier's revenue allocation methodology as an indicator of "general industry practice."

ii) Cross-subsidization

Paragraph 45 indicates that if a low-cost carrier's costs are subsidized by shifting them to an affiliated mainline carrier, then this might assist the low-cost carrier to pass an avoidable-cost test. Obviously, this would only be the case if avoidable costs are shifted. The Draft Guidelines should clarify that, under an avoidable-cost test, fixed costs which are subsidized by an affiliate would nevertheless have to be fully covered by revenues generated from the use of the assets to which the subsidized costs relate.

It should also be noted that a dominant airline need not create a separate low-cost carrier in order to cross-subsidize operations. A dominant airline could alter the cost-revenue analysis on a route which is subject to low-cost competition by operating feeder routes at a loss where those routes do not face such competition. This could have the effect of increasing traffic on the route under investigation without reducing revenue per seat on that route. The same questions should be asked in this context as are suggested in paragraph 45 with respect to low-cost second brand carriers.

iii) Frequent flyer points

Paragraph 74 indicates that the awarding of frequent flyer points by a dominant carrier could be anti-competitive because it increases the attractiveness of the dominant carrier's fare relative to its rivals' fares. The Draft Guidelines should clarify that awarding frequent flyer points would normally be considered abuse of dominance only if it results in revenues falling below avoidable costs.

Its December 1999 undertakings require Air Canada to sell its frequent flyer points to eligible Canadian air carriers (as defined in the undertakings) on commercially reasonable terms. However, nothing in the undertakings would prevent Air Canada from increasing the attractiveness of its flights on routes where it faces low-cost competition by offering "bonus" frequent flyer points for travelling on such routes or by reducing the number of frequent flyer points which must be redeemed to travel on such routes. The Draft Guidelines should indicate that costs (or lost revenues) associated with frequent flyer programs will be considered in determining whether a dominant carrier's revenues are below avoidable costs.

C. Application of the Avoidable-Cost Test

The Draft Guidelines should distinguish between avoidable cost and variable and marginal costs, as discussed, for example, in the Predatory Pricing Enforcement Guidelines. The objective of the avoidable-cost test should be the same as the usual predatory pricing analysis — that is, to determine whether the capacity/fare decision of the dominant carrier would only be economically rational if it resulted in a competitor exiting the market or curtailing operations.

The Draft Guidelines indicate that the Bureau will apply the cost-revenue analysis under the avoidable-cost test to flights, rather than seats. This analysis is too limited. A carrier can substitute a smaller plane with fewer seats on a given route, especially where it is a dominant carrier with a large network. Therefore the carrier can “avoid” the cost of some of the seats on a flight without cancelling the flight. Conversely, a dominant carrier can respond to new entry by substituting a larger plane for a smaller one. Applying the cost-revenue analysis to flights does not recognize situations where the additional revenue derived by a dominant carrier through the use of larger aircraft does not offset the additional costs of using that larger aircraft.

Applying the cost-revenue analysis on a flight basis may also be unsatisfactory because air carriers are able to price discriminate among classes of passengers. Air carriers discriminate on the basis of factors such as dates and times of travel, duration of stay, and time between booking and departure to differentiate among passengers based on their willingness to pay for air travel (usually between business and leisure travellers). A dominant carrier facing competition from a low-cost carrier for leisure travellers on a particular route could reduce its discount fares to match or beat the low-cost carrier’s fares, but maintain revenues above avoidable cost for each flight by increasing fares to business travellers. Accordingly, there is a risk that applying the cost-revenue analysis on a flight basis rather than a fare-class basis or a seat-by-seat basis will fail to identify certain anti-competitive behaviour.

However, applying the cost-revenue analysis on a fare-class or seat-by-seat basis is problematic, because only a small proportion of flight costs can be avoided by taking one less passenger. One way to address this is to allocate some costs which are avoidable at a flight level to each passenger. However, it is not clear how this could be done without distorting the theoretical underpinnings of the avoidable-cost test. Even if a reasonable allocation could be made, it would likely require a detailed understanding of air carriers' yield management strategies, propensities of various types of passengers to use miscellaneous services such as bar and cargo services, and so on. Even if effective, this kind of detailed analysis is clearly beyond the expertise of the Bureau and should be done by a sector-specific regulator.

Another possible solution is to apply the avoidable-cost test at the flight level, but introduce a measure of opportunity costs into the analysis. An opportunity-cost analysis would identify situations where a dominant carrier is operating on a route at a capacity greater than its profit maximizing capacity (in other words, where the carrier would be better off operating a smaller plane on that route and flying the larger plane on an alternate route, unless the strategy of operating excess capacity eliminates or disciplines a competitor).

Although there is no such reference in the Draft Guidelines, the Commissioner's pending application to the Tribunal for an order against Air Canada indicates that "in determining whether an airline is offering capacity below avoidable costs, it is appropriate to take into account an acceptable rate of return on capital" (Statement of Grounds and Material Facts, paragraph 85). In our view, this would be inappropriate. While target rates of return are useful in making planning decisions, the only rate of return relevant to the avoidable-cost analysis is the rate the capital would actually have earned in its next best use (in other words, the opportunity cost).

While an opportunity-cost analysis would be an appropriate component of the avoidable-cost test, its use would also raise some extremely difficult issues in its practical application. For example, the opportunity-cost analysis should be based on the information available to the dominant carrier at the time the capacity allocation decision was made. If the dominant carrier could not have known at the time that a particular use would have been more profitable, it should not be held to an after-the-fact analysis. The opportunity-cost analysis should also take into consideration the risks and uncertainties faced by carriers in allocating capacity, and provide an appropriate margin for error.

An opportunity-cost analysis is a significant departure from the traditional antitrust law predatory pricing analysis. Its use means a carrier could be found to be abusing its dominant position even if it is meeting all its variable and fixed costs. If the Bureau wishes to make such a significant policy shift, it should issue revised Draft Guidelines and provide a further opportunity for comment.

Carriers commonly cancel badly performing flights. Paragraph 34 thus indicates that if a carrier's revenue falls below its avoidable costs on a flight (a particular route at a particular time), this could be considered anti-competitive. However, passengers often value service which is stable, predictable, regular and frequent. Therefore, maintaining service on a flight in order to avoid schedule disruptions might contribute to the carrier's overall revenues and have no anti-competitive purpose.

Paragraph 35 states that the Bureau will consider whether the revenue covers the avoidable cost "on a daily basis for a period of at least one month." It is arguable that many costs are fixed in such a short period, which would not be regarded as fixed in a longer time frame. A six-month time frame might be more appropriate, as we understand that this is the standard scheduling period used by air carriers.

A six- month period is also more consistent with the U.S. approach, which employs a "short to medium term" time frame for analysis.

D. Anti-Competitive Exclusionary Practices

Paragraph 48 deals with pre-empting airport facilities — in other words, acquiring facilities such as gate space before it can yield a positive return on a flow basis. The paragraph states that this could be considered anti-competitive if intended to keep airport facilities from being used by a potential rival. In paragraph 59, the Draft Guidelines contemplate a dominant firm making facilities surplus to its needs available to rivals "on reasonable commercial terms." If acquired facilities only yield a positive return because the dominant airline obtains lease payments from rivals in respect of those excess facilities, acquiring the facilities should be considered anti-competitive. The Bureau should also consider whether acquiring surplus facilities and making them available to rivals on reasonable commercial terms could be anti-competitive. There could be two reasons for this. First, the terms, although "reasonable," could be higher than what the rival could have negotiated with the airport authority if the dominant firm had not acquired the facilities. Acquiring the facilities would therefore raise a rival's costs. Second, as overall demand increases, the dominant firm could exclude rivals on the basis that its own needs for the facilities have increased.

Paragraph 49 indicates that pre-empting a take-off or landing slot that a dominant carrier "had no immediate use for" is anti-competitive. The paragraph correctly points out that in determining whether a carrier has an immediate use for a slot, it is insufficient to consider whether the carrier is actually using the slot. This is because many airports have a "use it or lose it" slot allocation policy and the carrier may be maintaining a minimum use in order to retain the slot. However, this point could be made more clearly.

Paragraph 50 indicates that in the presence of a “use it or lose it” slot allocation policy, the Bureau would determine whether a slot has been pre-empted based on whether the carrier is covering the avoidable cost of offering the service in that slot. Two points should be made in this regard. First, this test should apply whether or not there is a “use it or lose it” policy. Second, if this is the test, then section 1(e) of the regulations would be redundant, unless the remedy would be different than for an anti-competitive act described in section 1(a). If a carrier is not covering the avoidable cost for a slot, then it will not be covering the avoidable cost for a flight.

E. Other Anti-Competitive Acts

The example in paragraph 53 helps to clarify what to expect from the Bureau when dealing with a concrete problem, namely schedule alterations which disrupt interline arrangements. However, it is insufficient for the dominant carrier to respond by showing “some valid business reason” for the conduct. What if there is a valid business reason but the predominant purpose is anti-competitive? If the dominant carrier articulates a business reason for the conduct, on what basis would the Bureau be prepared to second guess its validity? There is a similar problem in paragraph 74, which refers to an increase in frequent flyer points justified “only because” it eliminates or disciplines a new entrant. The Draft Guidelines should indicate that the Bureau will make inferences about intent based on all available evidence of the surrounding circumstances.

Another potentially anti-competitive act which should be addressed by the Draft Guidelines is increasing capacity or reducing fares on a route between the time that a prospective competitor publicly announces its intention to enter the market and the actual time of entry. This pre-entry period is a critical time for a potential entrant, which typically needs to obtain funding to support its launch. A dominant carrier can alter the prospective entrant’s financial projections and its ability to obtain financing, by altering conditions on the routes the prospective entrant is targeting.

The Bureau should consider adding a statement to the Draft Guidelines that any violation by Air Canada of the December 1999 undertakings, while not anti-competitive *per se*, could constitute conduct reviewable under section 79.

F. Enforcement Action against Third Parties

Paragraph 69 indicates that an exclusive contract between a dominant carrier and an airport authority could be anti-competitive. While the Tribunal could make an order prohibiting the dominant carrier from enforcing the exclusivity provision, the airport authority would not be bound by such an order. The Draft Guidelines should clarify how the Bureau would take effective enforcement action to put an end to arrangements in such circumstances.

G. Substantial Prevention or Lessening of Competition

The last sentence of paragraph 82 suggests that any preservation, entrenchment or enhancement of market power by eliminating or disciplining a competitor or deterring entry into the market would be a "substantial" lessening of competition. The Draft Guidelines should recognize and explain the concept of "substantially" or it should refer to the forthcoming Enforcement Guidelines on Abuse of Dominant Position, which apply more generally.

The Draft Guidelines should state that the Bureau's approach will be to look at the ultimate impact of alleged anti-competitive acts over a particular time frame (for example, two years) on prices, choice and service to consumers. In other words, the Bureau will consider taking remedial action that results in a short term detriment to consumers (for instance, prohibiting a discount by the dominant firm) in the interests of maintaining a more competitive environment and better prices over the long term.

H. Other Comments

In the introduction, the Bureau should consider adding a more prominent cross-reference to the discussion on the elements of section 79 from the forthcoming Enforcement Guidelines on Abuse of Dominant Position (set out in paragraph 17 of the Draft Guidelines). These apply equally in the context of the airline industry. However, consideration should be given to including a paramountcy provision clarifying that in the event of a conflict or inconsistency between the two sets of guidelines, the airline-specific guidelines should prevail.

The Draft Guidelines should identify other agencies or government departments with jurisdiction over aspects of airline regulation in Canada that are more appropriate for certain types of complaints – for example, pricing on monopoly routes or lost baggage.

In paragraph 48, "excess to" should be changed to "excess of." In paragraph 49, "is similar to anti-competitive act" should be changed to "is similar to the anti-competitive act."

IV. CONCLUSION

The Section commends the Commissioner for publishing the Draft Guidelines. They help clarify the Commissioner's interpretation of the term "avoidable costs" and other concepts which were only recently introduced in the *Act* and Regulations and with which the competition bar and the airline industry are therefore relatively unfamiliar.

The Section hopes that the comments we have provided will assist the Bureau to develop an improved final version of the guidelines. Section members are interested in participating in any follow-up discussions that may be held to deal with the Draft Guidelines.