BEHIND the HEADLINES

VOLUME 60 NO. 3 SPRING 2003

A Vital Industry in Search of New Policies: Air Transport in Canada

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Published quarterly
$4.95 per single issue
$19.95 per year
(Canadian addresses add 7% GST)
GST Registration No. 10686 1610 RT

Date of issue – February 2004
ISSN 0005-7983
Publications Mail Registration No. 09880

Editor:

Robert Johnstone

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INTRODUCTION

Few businesses are as important as the airline industry for the smooth and efficient working of a modern society. Air transport has come to play an irreplaceable role in service to commerce and to the travel needs of the millions of people who fly every day. It is a global, technologically advanced and dynamic growth industry. In March, 2003 the International Civil Aviation Organization (ICAO) reported that the output of air transport had increased by a factor of 31 since 1960, while world GDP increased by a factor of 4. It is also an important industry in terms of the numbers it employs, directly and indirectly. These observations are as true in Canada as anywhere in the world. To take but one Canadian indication of the direct value of the industry, the Greater Toronto Airports Authority (GTAA) reported that the operations of Pearson International Airport in Toronto generated $14 billion in business revenues and 138,000 jobs in the Greater Toronto Region in the year 2000. [1] Air transport services (air carriers, air cargo, and general aviation) accounted for at least 85% of the total impact.

This industry is too important to the Canadian economy to be left to operate under outdated rules and subject to avoidable costs that impair its efficiency. Regrettably, that is the case.

Despite the economic importance of the air transport industry and its rapid rate of growth during the past 40 years, one of the two major carriers in Canada (Canadian Airlines International) was acquired at the end of 1999 just as it was on the verge of running out of money; the other (Air Canada) is going through a major restructuring after declaring bankruptcy under the *Companies'*

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Creditors Arrangements Act; and the International Air Transport Association (IATA), the international lobby group for the world's airlines, is at war with the GTAA, the management of Pearson International Airport—the largest airport in the country. So what has gone wrong with this industry in Canada?

No doubt errors of omission and commission by airline managements have contributed to the problems they have experienced, and the industry worldwide has gone through unprecedented turmoil since 1999. So the bankruptcy of Air Canada might have been inevitable. Thus far in this decade, everything that could go wrong has gone wrong for the air transport industry. The industry is highly cyclical, and so it was one of the first sectors of the economy to be negatively impacted by the collapse of the high tech sector at the end of the 1990s, and the subsequent recession and sluggish economic growth in 2000 and 2001. As the dot.com and technology bubbles burst in 2000, the effects spread to the financial services sector and led to a sharp fall-off in full-fare, business travel. The general slowdown in the economy that preceded September 11 increased the price sensitivity of business travel. This was followed quickly by a series of damaging after-shocks, including, oil price surges in 2001/2002, unusual summer and winter weather with the resulting weather-induced flight delays, and SARS.

But there is much more to the story in Canada than management failures and this series of disastrous shocks. Twenty years of ill-conceived domestic policies, and a restrictive international regulatory regime, have played a major role in creating the foundations for many of the problems currently engulfing the air transport industry in Canada, including the bankruptcy of Air Canada.

THE INTERNATIONAL POLICY FRAMEWORK

Bilateral treaties

Giovanni Bisignani, the Director General of IATA, has stressed that bold changes are needed to ensure the long-term financial sustainability of the air transport industry. According to Bisignani, the bilateral system, restrictive national ownership rules and the attitude of competition authorities are the three pillars of stagnation for the international air transport industry.

Airlines are still subject to regulation in the international marketplace, including limitations on foreign ownership and control. While trade barriers have dropped steadily since the first round of the GATT in 1947, the aviation industry has been caught in a time

warp of bilateral agreements that limit the degree of competition in international and domestic markets. These agreements specify such things as the cities each nation's airlines can serve, the number of flights they can operate, and how much regulatory authority the governments can exercise over fares.

The bilateral treaty arrangements regulating international air transport services had their genesis in the Chicago Convention, which entered into force on April 4, 1947. In November 1947, after a final attempt by the Commission on Multilateral Agreement on Commercial Rights in International Civil Air Transport to find a mathematical formula for the multilateral allocation of traffic acceptable to all sides, ICAO members turned towards bilateral solutions. The two major aviation powers of the time, the US and the UK, had reached an Agreement known as Bermuda 1 in 1946. Bermuda 1 served as a model for all subsequent bilateral agreements until the early 1980s. The classical bilateral agreement of the Bermuda 1 type is based on detailed negotiation of three "pillars" - routes (traffic rights in the strict sense), capacity (size of aircraft and frequency of service) and tariffs.

Routes between two countries have been negotiated by reference to pairs of cities, which could be served by designated domestic carriers in each country, either directly or indirectly through intermediate stops. If intermediate stops took place on the territory of a third county, they required the agreement of this country, expressed in another bilateral agreement. The Chicago Convention and Bermuda 1 also imposed domestic control requirements. Most bilateral agreements contain clauses allowing states to refuse designation of air carriers which are not substantially owned and effectively controlled by nationals of the other party to the agreement.

Open Skies Agreements, which have flourished since 1993 because of the active support of the US, have liberalized some of the most restrictive features of the Convention and Bermuda 1, but generally have maintained restrictions on domestic control and cabotage—the right of a foreign carrier to compete in the domestic market of another country.[2]

(For definitions of cabotage and other traffic rights referred to in this article, see the Appendix FREEDOMS OF THE AIR)

Canada-US Bilateral Agreements

In 1966 Canada and the US signed an Air Service Accord (ASA) which governed transborder air transport services between the two countries. Under this ASA, commercial airline services were authorized for

only 83 city-pairs. Only 19 of these were allowed to receive service from both a US and a Canadian carrier. The remaining city-pairs received monopoly service: 26 routes were reserved for Canadian carriers; the remaining 38 were to be served exclusively by US carriers. While capacity was left to the determination of the designated carriers, either government was allowed to reject proposed transborder fares.

Gordon Baldwin and Michael Pustay have pointed out that the 1966 ASA threatened to limit the potential gains for Canada from the increasing integration of the Canadian and US economies:

"Post-1966 shifts in North American economic activity left many booming cities with inadequate or nonexistent transborder service. Accordingly, many transportation, economic development and government officials expressed concern that the inability of the two countries to renegotiate a transborder ASA would slow the growth of commercial ties between the two neighbors, misdirect transborder trade and locational decisions, and fail to meet the evolving needs of the increasingly integrated North American economy."[3]

The 1966 ASA was amended in 1984. Commuter carriers operating aircraft with 60 seats or less were allowed to enter transborder city-pairs as long as the cities met certain size and distance criteria. Eligible US cities had to have a population of less than one million and Canadian cities a population of less than 500,000. The stage length of the intended service had to be less than 600 miles, except in Ontario and Quebec, where the stage lengths were limited to less than 400 miles. In addition, greater freedom of entry was granted on transborder routes serving Montreal's Mirabel Airport or the airport at San Jose, California, although potential service between Mirabel and seven important US gateway cities was excluded from the 1984 amendments.

Despite these amendments, Baldwin and Putsay found that the availability of transborder air service was far from matching the needs, as indicated by the absence of convenient service for many cities engaged in substantial transborder business.

Following several years of negotiations, a much more liberalized air service accord was signed in 1995—the Canada-US Open Skies Agreement. After a two-year phase-in period to 1997 that granted Canadian carriers a head start in transborder markets serving Toronto, Montreal and Vancouver, the new Open Skies Agreement permitted unfettered freedom of entry and exit to Canadian and US carriers in the entire transborder market. Carriers were also given pricing freedom: only if both governments found them unwarrant-

ed could new prices be disallowed.[4] But this new Agreement did not allow for modified sixth freedom rights (eg the right of a Canadian carrier to provide and market service between two US cities with a stop in Canada) or cabotage. Nor did it change the foreign ownership limits that remained at 25% in both countries.[5]

Nevertheless the Open Skies Agreement did lead to a great expansion in the number of city-pairs served in the transborder market, bringing the availability of service more into line with economic needs.

US and Open Skies

The Canada-US Open Skies Agreement was part of a concerted US effort in the 1990s to liberalize its international aviation markets, in view of strong airline traffic growth, more liberal trade policies by many partners, the increasing importance of global airline alliances, and the financial strength of the major US airlines. [6] The US has now concluded in excess of 50 "Open Skies" Agreements. These generally follow the same formula and allow for an exchange of traffic rights, without any limitation on routes, the number of carriers serving these routes or the capacity offered by the airlines on each of these routes. The Agreements also provide liberal regimes for pricing, charters, cooperative marketing agreements and other commercial opportunities.

US Open Skies Agreements with other countries have opened entry on all routes; allow unrestricted capacity and frequency and complete flexibility in fare setting by the airlines with limited government oversight; and permit code-sharing between US carriers and their foreign airline alliance partners. However, these agreements continue to maintain foreign ownership and control restrictions and have not allowed for cabotage rights.

It now appears that the US is prepared to experiment with even more liberal versions of its current Open Skies Agreements. For example, the US and six other nations (all part of the Asia Pacific Economic Cooperation (APEC) forum) have recently entered into the "Kona Accord", a multilateral agreement that provides each party's airlines with the opportunity to operate freely between each other's territories. This agreement eliminates the traditional ownership provisions found in most bilaterals. There is also an optional Protocol that allows parties to exchange seventh freedom passenger rights and cabotage rights, providing a "club within a club" option for willing partners to extend liberalization to new areas. Brunei, New Zealand and Singapore have already signed on to this Protocol. Although the

agreement had its origins in APEC, its membership is not restricted to APEC economies.

Liberalization in the European Union

The European Union (EU) took substantial steps towards liberalizing the internal European air transport market in July 1992 when it implemented the so-called "third package" relating to several key aspects of the industry's operation including access for community air carriers to intra-community air routes, licensing and fares. The previous packages (the first in 1987 and the second in 1989) represented more modest moves towards liberalization and came in the wake of European Court of Justice rulings applying Articles 85 and 86 of the *Treaty of Rome* (relating to antitrust type restrictions) to air transport. The third package applied initially to the 12 member states. Norway and Sweden joined in mid 1993; Austria, Finland and Iceland in 1995 and Switzerland in 1997.

This third package set the stage for the creation of a single aviation market within the European Economic Area (EEA) by April 1997 when cabotage was allowed throughout the EEA. This ended the use of traditional bilateral negotiations to organize air services inside the EEA, opening up market access within a common regulatory framework and transferring the right to set fares from governments to the airlines.

A recent decision by the European Court of Justice, involving "Open Skies" Agreements between individual EU Member States and the US, will reverberate throughout the international air transport industry.[7] The Court concluded that the nationality clauses inserted in bilateral agreements on air services constituted discrimination on the grounds of nationality contrary to Article 43 of the EC Treaty, and thus infringed the Community principle of freedom of establishment. For example, the France-US Open Skies Agreement restricts service between cities in France and cities in the US to French and US carriers and excludes carriers from other EU countries. According to the Court, this infringes on the rights of carriers headquartered in other Member States to offer competing services out of the European Union.

This ruling offers a unique opportunity to allow EU carriers to fully compete with each other on an EU-wide basis for third country traffic. In practice, every EU carrier will have to be given the opportunity to operate between any city in the EU and any city in other countries that are covered by existing bilateral agreements between each respective member of the EU and non-EU countries, even if at the present time, traffic rights specified in a bilateral agreement

restrict authority to the carrier(s) of the EU member that is the sole EU party to the agreement.

The elimination of the nationality clauses will also take away a major impediment to the restructuring and consolidation of the EU airline industry. However, each EU Member State will now have to re-open its Open Skies Agreements, not only with the US but also with other countries, in order to permit all EU carriers to operate between the EU and other countries. The other parties to these Agreements will demand some concessions in return, and herein lies an opportunity to further liberalize the air transport industry.

General Agreement on Trade in Services (GATS)

The GATS is a government-to-government agreement among the 134 members of the World Trade Organization (WTO) which sets out a framework of legally-binding rules governing the conduct of trade in services. The GATS was agreed as part of the Uruguay Trade Round of negotiations and came into force on January 1, 1995.

The Agreement has three basic principles: first it covers all services except those provided in the exercise of governmental authority; second, discrimination in favour of national providers is prohibited-the national treatment principle; and third, there should be no discrimination among GATS Members—the most favoured nation (MFN) principle. However, the GATS does provide for exceptions. Governments can choose the services for which they make market access and national treatment commitments; and they can limit the degree of market access and national treatment they provide.

There is only limited coverage of air transport services in the GATS. During the Uruguay Round, it was felt that air transport was characterized by special features which would prevent the application of the GATS disciplines. This Agreement does not apply to measures affecting traffic rights, however granted, or services directly related to the exercise of traffic rights, with the exception of three specific ancillary services: aircraft repair and maintenance services; the selling and marketing of air transport services; and computer reservation systems.

THE ROAD MAP AHEAD

The US and the European Union

Commenting on the system of bilateral treaties, Jeffrey Shane, the Under Secretary for Policy at the US Department of Transport (DOT), stated at an IATA General Meeting in March, 2003.

"While bilateral agreements between nations opened markets in the 20th century, it is time… to develop new models for how we govern aviation services. The second century of flight will need a broader multilateral framework, replacing the current patchwork of bilateral agreements with a more comprehensive structure for expanding aviation markets... In the immediate term we will continue to rely on the current crop of bilateral agreements, but their inherent limitations will render them increasingly inadequate in accommodating the needs of international air transport in the 21st century. Geographically limited bilateral agreements simply don't have the scope to facilitate the global efficiencies the industry requires in the long run, nor can they accommodate the kind of seamless system that today's customers and a globalized economy demand."

It thus appears that the US may be prepared to begin the next round of liberalization of the air transport industry. So too may the European Union.

The European Commission has proposed a Transatlantic Common Aviation Area with the United States that would allow airlines to benefit from liberalization, while regulators would keep the necessary tools to ensure competition in the market. Key elements include:

- No geographical limit in principle, but initially the EU and the US would lead the development of what could become a new worldwide multilateral regime;
- No artificial barriers on market access and entry: airlines of the contracting parties would have full freedom to provide services between and within the territories covered by the agreement; and
- No barriers to cross border investment: airlines would be free to invest in airlines established in the territory of the other party, or to establish such airlines themselves.
- Strict enforcement of the respective competition laws but also close co-operation between the competition authorities of the parties.

The EU and the US commenced negotiations on this proposal in October 2003. However, it is unlikely that these negotiations will produce any major breakthroughs in 2004 since it is an election year in the United States. The US Department of Transport believes the negotiations have very ambitious goals that will present many political difficulties for the United States. According to the DOT, the political and economic climates are not conducive to drastic changes at this time.[8] This is particularly true with respect to the right of establishment, foreign ownership and cabotage.[9] The DOT believes it

is more likely that there will be a series of agreements over the next few years, eventually producing a truly open market between the EU and the US later this decade.

The industry

The airlines are also strongly in favour of further liberalization of the industry. The 59th Annual General Meeting of the International Air Transport Association in June 2003 concluded with the CEOs of IATA member airlines calling upon governments to help ensure a sustainable future for international air transport by:

- Completing the liberalization process so that air carriers would be better able to shape their commercial policies and business structures and to access global capital markets through liberalization of ownership restrictions;
- Regulating airport and air traffic service providers to ensure that these natural monopolies do not abuse their position and that their services are cost-efficient;
- Improving harmonization of the industry's regulatory framework by increasing co-operation among national competition authorities; and
- Ensuring that taxes and fees imposed by governments do not discriminate against the aviation industry relative to other industries or modes of transport.

In effect, the members of IATA want full liberalization of ownership and control rules, the right of establishment and freedom to consolidate across national boundaries. The airlines want the same economic freedoms as most other industries have.

Options for Canada

Where does all of this leave Canada?

The federal government has gone as far as it can in deregulating the domestic market. The passage of the *National Transportation Act, 1987* (NTA) led to the deregulation of the civil aviation industry in southern Canada. In 1996, air transport in northern Canada was also deregulated. Thus, starting in 1988, all licensed domestic carriers were free to operate wherever and whenever they chose within southern Canada and this right was extended throughout all of Canada in 1996. Canadian airlines were also given full freedom in setting fares, subject only to the provisions in the *Competition Act* regarding predatory pricing.

Before 1984, when the stage was being prepared for the eventual deregulation of the industry, so-called regional airlines (Pacific

Western Airlines, Nordair, Quebecair and Eastern Provincial Airways) were restricted to providing service in their respective designated regions of the country, with only CP Air and Air Canada permitted to provide services across the country. Further, the government, through the Canadian Transportation Commission, had to approve changes in fares.

The industry began to consolidate very rapidly in 1984, and by the time the industry was deregulated in 1988, only one of the original regional airlines (Pacific Western Airlines, renamed Canadian Airlines after it acquired CP Air) and one of the national airlines (Air Canada) had survived as independent companies. During this period, the privatization of Air Canada began.

Since 1988, there have been a number of entrants into the domestic market, and almost an equal number of failures. Among the entrants who failed were Wardair, Intair, Vistajet, Greyhound Air, Canjet 1, Royal Air and Roots Air. Canada 3000, a charter carrier that transformed itself into a hybrid charter-scheduled service carrier in 2000, also failed.[10]

On the other hand, Westjet, which entered into the Canadian market in 1996, has grown rapidly since that time and now is the second largest carrier in the domestic market. Canjet 2 and Jetsgo (the re-incarnation of Royal Air) re-entered the domestic market in the fourth quarter of 2002. Both are still operating.

Canadian Airlines was acquired by Air Canada at year-end 1999. And Air Canada, the other national airline in 1988, entered into court protection under the bankruptcy law *(Companies' Creditors Arrangements Act)* in April 2003.

Overall, there appears to be room for two significant domestic carriers in the Canadian market and possibly a number of much smaller niche carriers.

If the two major Canadian carriers—Air Canada and Westjet—are to have new opportunities for growth, and if new competition is to materialize in the domestic market in Canada, then Canada will have to negotiate new Open Skies Agreements that truly permit free trade in air transport services.

But where should Canadian negotiators focus their efforts?

The EU-US negotiations are a non-starter for Canada. The EU does not want Canada either as an observer to the negotiations or as a participant. The EU is willing to allow Canada to become a signatory to the final agreement negotiated between the EU and the US, but is not willing to give Canadian negotiators any role in shaping the final agreement or any intermediary agreements.

The multilateral route through either ICAO or the WTO (GATS) is another non-starter. The US is adamantly opposed to multilateral negotiations. The DOT believes that the multilateral route would lead to the lowest common denominator in negotiations because of the inclusion of so many countries. The DOT is probably right that the multilateral approach would produce little after many years of negotiations. Instead, the US and the EU believe that their new agreement could serve as a template for a multilateral framework for the industry, and as a result, they might be able to play much more important roles in shaping the future regulatory environment for the industry.

This leaves bilateral negotiations with the US as the sole option for Canada at this time. Air Canada has been quite out-spoken in advocating a new round of negotiations, which could lead to a true free market in air transport services between Canada and the United States with cabotage rights and the elimination of foreign ownership and control restrictions. It appears that the US is ready to entertain an offer from Canada to re-negotiate the 1995 Open Skies Agreement. In January 2004, Paul Celucci, the US Ambassador to Canada, stated that Washington would be interested in negotiating with Canada a free trade regime for air transport services that would include cabotage. Unlike his predecessor David Collenette, Canada's new Transport Minister, Tony Valeri, has not ruled out this possibility. However, he indicated that he wanted to get input from all of the stakeholders in Canada before he decides whether or not to approach the US to open up the 1995 Agreement.

Canada should jump at the opportunity, for a new Agreement would not be finalized over-night. The prospects for a true free trade arrangement for this industry should improve following the November elections in the US, and if Canada and the US could develop a concerted program to deal with security issues. The ultimate goal of a new round of negotiations should be to emulate the EU model and create a Canada-US Common Aviation Area:

- Canadian and US carriers should be able to operate freely throughout both countries—this would require the granting of cabotage rights and the right of establishment (as in the European Commission third package);
- Canadian and US carriers should be able serve all international markets covered by the respective bilaterals of Canada and the US—for example, Air Canada should be allowed to operate direct services between US and foreign cities, and American Airlines should have a similar right to operate directly between Vancouver and Asian destinations (the ulti-

mate consequence of the November 2002 European Court of Justice decision).

With the EU Member States under pressure to change their individual Open Skies Agreements so as to remove the nationality clauses, Canada and the US have a window of opportunity to open up the markets between the EU and North America (ex Mexico).

Financial burdens on the industry in Canada

In order to enable Canadian carriers to maximize the opportunities created by a Canada-US Common Aviation Area, Ottawa will have to re-work its airports and other policies.

The airports

As a result of the introduction of the National Airports Policy (NAP) in 1994, eight airports (Vancouver, Calgary, Edmonton, Montreal, Toronto, Ottawa, Winnipeg and Halifax)) are now operated as Canadian Airport Authorities (CAAs). These are purportedly not-for-profit organizations. They are not accountable to their principal stakeholders— airlines and airline customers — nor are the charges they levy on these stakeholders regulated or reviewable by any agency of government. In effect the National Airport Policy created unregulated and largely uncontrollable monopolies. By way of contrast, in the US and the EU most airports are owned and operated by governments: their fees must be approved by government.

On January 27, 2004, the former Transport Minister responsible for developing and implementing the NAP, Doug Young, speaking at an airline conference said that he"deeply regrets handing control of Canada's airports over to the regional agencies that run them as non-profit organizations because these authorities are gouging trevellers and building palatial terminals without due regard for costs." [11]

In the process of establishing the CAAs the federal government changed its role from airport owner and operator to that of owner and landlord. The government retains ownership of the eight CAAs and collects rent from them. It also owns all 26 airports identified as part of the National Airports system.

The airports collect fees from the airlines and from their other customers. As shown in Table 1 covering the operations of the eight CAAs, the landing and terminal Aeronautical Fees paid by airlines amounted in 2002 to $566 million while the Airport Improvement Fees (AIFs) levied on passengers totaled $295 million.[12] These charges are high compared to passenger facility charges set by airports in the United States. To the extent that they are higher than they need be

they are a disincentive to the efficient operation of the Canadian airline system, particularly in short-haul markets.

For two reasons the charges by the CAAs are in fact higher than they need be.

Table 1: Selected financials, eight major CAAs, 2000-2002
($ millions or %)

	2000	2001	2002
AIFs	$164	$226	$295
Aeronautical fees	515	541	566
Profits	168	136	117
Ground rents	241	249	253
Profits/revenues	14%	11%	9%
Profits/AIFs + air fees	25%	18%	14%
Rents/AIFs + air fees	35%	32%	29%

Sources: Annual Reports of the Eight CAAs (Vancouver, Calgary, Edmonton, Montreal, Toronto, Ottawa, Winnipeg, Halifax)

Firstly, the federal government, as owner of the airports, charges the CAAs with rent. These rental payments have cost the airports more than $1 billion since airport transfers began in 1992. As the table shows Ottawa received over $250 million in 2002. It is estimated by the CAAs that by the end of the decade the rent payments could increase to some $450 million annually.

This revenue grab by the federal government is a major burden on the Airport Authorities and therefore on their users. Had there been no rent payments in 2002 and the amount applied to reduce the fees charged by the CAAs to airlines—landing fees and terminal charges—these fees could have been 45% lower, or the total payments by airlines and passengers (AIFs) could have been reduced by 29%.

Secondly is the matter of the profits of these supposedly not-for-profit organizations. In 2002 profits of the eight major CAAs were $117 million. Since 1992 their cumulative profits have amounted to $1.2 billion.. Had they not set their fees at levels that generate these

profits, a further substantial reduction in their charges would have been possible—a 14% reduction in 2002 in the total fees paid by the airlines and passengers.

Canada has created an inappropriate matrix of private companies, not-for-profits, and government agencies with different goals/objectives/mandates, resulting in their working at cross-purposes most of the time. If there is any reason to propose increased regulation in the air transport industry, the strongest case could be made to constrain the market power of the airport authorities by granting a new regulatory agency the mandate to review and approve the pricing of all of the major airport authorities before any new prices, including the Airport Improvement Fees, could go into effect. In the EU and the UK, several airports are subject to economic regulation by government agencies.

Security

In the wake of the attacks in New York on September 11, 2001 the December 2001 Canadian federal budget introduced a major and costly set of programs to overhaul and enhance national security. The air transport sector was the only one required to fully pay the costs. This further tilted the competitive playing field against this industry, disproportionately impacted low fares in general, and fares in short-haul markets in particular. As a result, there has been a shift of resources towards longer-haul markets and away from short-haul markets.

The Budget announced the creation of the Canadian Air Transport Security Authority (CATSA) that would be responsible for the provision of aviation security services in Canada and would be fully funded by the Air Travellers' Security Charge ($12 inclusive of GST per one-way trip in North America) imposed on passengers. The tax went into effect on April 1, 2002. It was reduced to $14 (inclusive of GST) per round trip in Canada effective March 1, 2003. But even at this reduced level, it is among the highest security taxes in the world.

IATA believes that governments have direct responsibility for aviation security and its funding. Since the security threat against airlines is a manifestation of a threat against the State, the provision and cost of aviation security should be borne by the State from general revenues and not from taxes and user fees. Therefore, the federal government should immediately cancel the Air Security Tax charged to air travelers and pick up all of the operating and capital costs for CATSA.

Additional burdens on Air Canada

Air Canada has been placed at an increasing competitive disadvantage by the federal government. In February 2000 the government introduced legislation to protect the public interest during the period of airline restructuring. This Bill re-imposed a form of regulation on the airline industry, particularly Air Canada. It was seen as a temporary measure, created to ensure "an ordered restructuring of Canada's airline industry, with the least possible disruption to communities, the traveling public and to airline employees". The provisions of this Bill and the Air Canada undertakings are best seen as a government-created, regulatory substitute for a competitive market.

The *Air Canada Public Participation Act* also imposes various operational restrictions on Air Canada, and Air Canada alone. For example:

- S. 6.(1)(d): Air Canada must maintain operational and overhaul centres in Mississauga, Montreal and Winnipeg.
- S. 6.(1)(e): Air Canada must keep its head office in Montreal.
- S. 10.(1) and (2): *Official Languages Act* applies to Air Canada and its subsidiaries.

The requirement to maintain three specific maintenance bases complicates the process for restructuring and reorganizing the company. The *Official Languages Act* requirement constrains the company's ability to utilize its staff because of seniority. As Air Canada becomes more international in focus, multilingual employees become more important, but there need not be any specific requirements imposed on the company.

The federal government's tax and subsidy initiatives in the transportation sector have further exacerbated the competitive environment for Air Canada and all other domestic air carriers. The federal government has been extracting almost $270 million per year from the air transport industry since fiscal 1999. By comparison, VIA Rail has been the beneficiary of annual subsidies averaging $250 million during this same period. Thus, a key competitor to the airlines, especially in the Toronto-Montreal corridor, continues to be heavily subsidized.

Government and the industry in the US

While this is not the place to analyze in any detail the position of the airline industry in the United States, a number of striking contrasts with Canada that are worth noting.

The impact of September 11, 2001 on airlines in both countries was severe but the response of federal governments was very different.

Without going into all the details, the Canadian government paid out $90 million to compensate the Canadian industry for the damages suffered during the week following the attack on the World Trade Center. The US government has paid out US $ 4.l6 billion. Each of the seven major airlines in the US received more than did Air Canada and six received more than the total budget in Canada. Air Canada's Star Alliance partner, United Airlines, received almost 10 times the amount that Air Canada received. With the exception of Southwest, Air Canada competes with all of the other major US carriers on some transborder routes and with several of the other regional airlines as well.

In addition the US government provided loan guarantees and substantial amounts for security and safety in light of the increased threat of terrorist actions.

It is true that US Government has introduced or permitted a vast array of taxes and fees to be imposed on the airline industry. However, in the US, all revenues generated by the industry through taxes and aeronautical fees are re-invested into the industry. In Canada, on the other hand, the net revenues generated by the GST and the federal excise tax on aviation fuel and most of the ground lease payments received from the airports are not plowed back into the industry. It appears as a result, that the US better appreciates the importance of this industry and the externalities it generates for the entire economy than does Canada.

CONCLUSIONS

The government must develop an air transportation policy that will provide a framework in which domestic carriers can thrive. This could ensure that Canadians are connected directly, conveniently and efficiently into global networks, thus enhancing their mobility, for both business and leisure, and their ability to transport goods to and receive goods from all parts of the world. This environment could also make Canadian airports more viable by generating more traffic for them.

Otherwise, if the government continues to pursue the path of the past 20 years – one of confusion and lack of direction – there is a risk that there will be no international Canadian airline. Canadians would still be connected to global networks—via Chicago, Dallas, Los Angeles, Miami, London, Frankfurt, Paris, Hong Kong or Dubai. But it will take longer, be less convenient and more expensive. The airports at Toronto and Vancouver also could stagnate and all airports across Canada would find it difficult to cover their expenses.

It is important to have realistic expectations regarding the competitive consequences in the Canadian market of a Canada-US Common Aviation Area. We should not expect a free-for-all of entry. The Canadian market, with the exception of a very small number of city-pairs, is very small. But some entry should occur. More importantly, Canadian carriers would have new opportunities, and as a result, if the government corrects its airports policies and reigns in the GTAA, both Pearson International Airport, as a result of both Air Canada and Westjet capitalizing on new market opportunities in the US and between the US and international destinations, and Vancouver International Airport, as a result of Canadian and US carriers using a Canada-US Common Aviation Area to restructure their trans-Pacific routes in order to take advantage of the shorter flying distances through Vancouver, should become much more important international gateways.

Ottawa must act quickly to introduce a new policy framework for this industry, one that will facilitate the development of strong, financially healthy and globally competitive Canadian airlines that in turn will contribute to economic growth and maximize economic and social benefits, locally, regionally and nationally.

The cornerstone of the new policy framework should be the negotiations of a Canada-US Common Aviation Area that removes all constraints on the operations and ownership of airlines in both countries. In addition, Ottawa will have to rectify its policy blunders in its National Airports Policy; remove the remaining legislative shackles on Air Canada; assume fiscal responsibility for security in the air transport industry; and stop using this industry as a cash cow for fiscal purposes.

APPENDIX: THE FREEDOMS OF THE AIR

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A *traffic right* is the right granted by both countries that are parties to a bilateral agreement to a designated airline to transport passengers over an authorized route or routes between two or more countries. A traffic right is associated with one or more of the nine freedoms of the air:

First Freedom is a right granted by one country to an airline or airlines of another country to fly across its territory without landing. For example, Russia has given Air Canada *first freedom* rights to fly over its territory for its service between London's Heathrow Airport and New Delhi in India.

Second freedom is a right granted by one country to an airline or

airlines of another country to land in its territory for non-traffic purposes; for example, to refuel aircraft, to make unexpected repairs or to respond to an emergency.

Third freedom is a right granted by one country to an airline or airlines of another country to carry passengers originating in the home country of the airline(s) between the two countries.

Fourth freedom is a right granted by one country to an airline or airlines of another country to carry passengers originating in this country and destined for the home country of the airline(s). (Third- and fourth-freedom rights generally go together in bilateral agreements.)

Fifth freedom is a right granted by one country to an airline or airlines of another country to carry passengers between this country and a third country.

Sixth freedom is not technically a separate right and not currently negotiated between states. It results from the ability of an airline to combine third- and fourth-freedom rights under different bilateral air transport agreements, such that an airline, can offer a service between third countries by way of a connection in its home country. For example, Air Canada could potentially fly a traveler in Los Angeles to Paris via Toronto by combining rights under the Canada-United States and Canada-France agreements.

Seventh freedom is a right granted by one country to an airline or airlines of another country to put down and to take on passengers, coming from or destined to a third country, in the territory of the country granting the right, independent of the airline providing services (under third- and fourth-freedom rights) between the country and the home market of the airline(s).

Eighth freedom is a right granted by one country to an airline or airlines of another country to put down and to take on passengers coming from one city in that country and destined to another city in this country as an extension of its third- and fourth-freedom rights. Under this right, also known as consecutive cabotage, Air France, for example, could be allowed to pick up passengers in Montreal (Toronto) destined for Toronto (Montreal) on its route Paris-Montreal-Toronto-Montreal-Paris under a Canada-France agreement.

Ninth freedom is the right granted by one country to an airline or airlines of another country to carry domestic passengers in the country, without the need for any connection to the international network of the airline. This freedom, also known as stand-alone cabotage, would permit Continental Airlines, for example, to carry pas-

sengers between Vancouver and Calgary without operating any services between either of these Canadian cities and any one of the US cities in its domestic network.

ENDNOTES

1. GTAA, Briefing Paper #3, "Economic impact summary" (September 2001).
2. For example, if cabotage were permitted in the Canada-US bilateral agreement, Air Canada could operate on an equal footing with US carriers between any two US cities. That is, Air Canada would be able to fly US originating passengers between city-pairs in the US market.
3. Gordon Baldwin and Michael Pustay, "Trade and transportation: The impact of the 1995 transborder Air Services Accord", Statistics Canada cat. 51F0007-XIE, p. 5.
4. The grounds for governmental disapproval were limited to protecting carriers from predatory competition or from having to compete against low fares resulting from government subsidies or to prevent unreasonable price discrimination or exploitation of a dominant position.
5. At the present time, the *Canada Transportation Act* requires that holders of air carrier licenses be Canadian, controlled in fact by Canadians, and that at least 75 percent of their voting interests be owned and controlled by Canadians. Economic equity held by non-Canadians can exceed 25 percent to a maximum of 33 percent. The US rules restrict foreign ownership to a maximum of 25 percent of the voting interests and a maximum of 49 percent of the economic interest. In special circumstances, the Department of Transportation may permit non-US citizens to hold up to 49 percent of the voting equity.
6. Code-sharing enables alliance partners to jointly market and sell flights operated by either partner. For example, United and Air Canada are members of the Star Alliance and both offer service between Toronto and Chicago. United can market the flights operated by Air Canada on this route as their own flights, and similarly, Air Canada can market the United flights on this route.
7. Opinion released by the Advocate General on January 31, 2002 and confirmed in his final judgement on November 5, 2002.

8. These concerns include national security and the financial and competitive fragility of the major US carriers—United, US Airways, Delta, American, Continental and Northwest.
9. Right of establishment would permit, for example, a European airline to set up in the US and operate throughout the domestic US market in direct competition with US carriers.
10. Canjet 1 and Royal Air were acquired by Canada 3000 in the first half of 2001 and Canada 3000 failed in November 2001.
11. Steven Chase, *Ottawa Citizen*, January 28, 2004.
12. The Airport Authorities were given de facto "taxation" powers. That is, they are allowed to charge user fees—Airport Improvement Fees—to passengers. There are no controls over these fees. The revenues collected from thee fees should be used to finance capital investments made by the CAAs. But there is no provision in the Act that established the CAAs that mandates that the AIF revenues be used for any particular purpose.

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Publications Mail Registration No. 40062474
Postage paid at Scarborough