Competition Tribunal Tribunal de la Concurrence

Reference: *Commissioner of Competition* v. *Air Canada*, 2003 Comp. Trib. 13
File no.: CT2001002
Registry document no.: 145a

IN THE MATTER of an application by the Commissioner of Competition under section 79 of the *Competition Act*, R.S.C. 1985, c. C-34;

AND IN THE MATTER of the *Regulations Respecting Anti-Competitive Acts of Persons Operating a Domestic Service*, SOR/2000-324 made pursuant to subsection 78(2) of the *Competition Act*;

AND IN THE MATTER of certain practices of anti-competitive acts by Air Canada.

B E T W E E N:

The Commissioner of Competition
(applicant)

and

Air Canada
(respondent)

and

WestJet Airlines Ltd.
(intervenor)

Dates of hearing: 20021127-28, 20021202-06, 20021209-13, 20021216-19, 20030114, 20030120, 20030123-24, 20030127-31, 20030203-07, 20030210-14, 20030217-19, 20030224 and 20030303-05
Members: Blais J. (presiding), L.R. Bolton, L.P. Schwartz
Date of reasons and findings: 20030722
Reasons and findings signed by: Blais J., L.R. Bolton, L.P. Schwartz

REASONS AND FINDINGS

TABLE OF CONTENTS

GLOSSARY OF KEY TERMS

Available Seat Miles (ASMs): This is a measure of airline passenger capacity. It consists of the number of seats on an aircraft multiplied by the miles flown by that aircraft.

Break Even Load Factor (BELF): This is a measure of the load factor required for a flight to break even. BELF depends on yield. The higher the yield, the lower the BELF and vice versa. The calculation of BELF requires assumptions on the average revenue per passenger.

Passenger Load Factor (PLF): This measure compares the number of revenue passengers to the capacity offered. It is expressed as a percentage. PLF is equal to RPM divided by ASM; or, for a single flight, the number of revenue passengers divided by the number of seats on the aircraft.

Phase I Period: The allegation period between April 1, 2000 to March 5, 2001 on the sample routes at issue.

Revenue Passenger Miles (RPMs): "Revenue passengers" are passengers who have paid to fly. RPM is a measure of the traffic carried by the airline. It consists of the number of revenue passengers on an aircraft multiplied by the miles flown by that aircraft.

Yield: This is a measure of the average revenue per passenger, expressed as cents per RPM. Yield equals revenue divided by RPM. Yield is determined by the mix of fares sold to passengers on a flight.

I. INTRODUCTION

[1] On March 5, 2001, the Commissioner of Competition (the "Commissioner") filed a notice of application (the "application") pursuant to section 79 of the *Competition Act*, R.S.C. 1985, c. C-34 (the "Act") and the *Regulations Respecting Anti-Competitive Acts of Persons Operating a Domestic Service*, SOR/2000-324 (the "Airline Regulations"), alleging abuse of dominant position by Air Canada. The application states, *inter alia*, that, between the period of April 1, 2000 and March 5, 2001, Air Canada responded to the entry of WestJet Airlines Ltd. ("WestJet") and CanJet Airlines ("CanJet") on seven central and Atlantic Canada routes by increasing its capacity and/or decreasing its fares, in a manner that did not cover the avoidable cost of operating the flights on such affected routes, in violation of paragraphs 1(*a*) and 1(*b*) of the Airline Regulations.

[2] In the application beginning at paragraph 1, the Commissioner seeks:

1. An Order prohibiting the Respondent, including its affiliates, officers or agents (collectively, "Air Canada") from:

a) Operating capacity at fares that do not cover the avoidable cost of providing the service on the following routes (the "Air Canada Affected Routes"):

i) St John's, Nfld (YYT) – Halifax (YHZ)
ii) Montreal (YUL) – Halifax (YHZ)
iii) Ottawa (YOW) – Halifax (YHZ)
iv) Toronto (YYZ) – Moncton (YQM)
v) Toronto (YYZ) – Fredericton (YFC)
vi) Toronto (YYZ) – Saint John, NB (YSJ)
vii) Toronto (YYZ) – Charlottetown (YYG)

b) Increasing capacity on the Air Canada Affected Routes at fares that do not cover the avoidable cost of providing the service;

c) Engaging in a policy of "matching" fares offered by low cost carriers on the Affected Routes (as that term is defined in the Statement of Grounds and Material Facts) and operating capacity at those fares:

i) Without regard for the effect of such fares on Air Canada's profitability;
ii) Without regard to the additional benefits associated with the service offered by Air Canada; and
iii) With the foreseeable effect of significantly diluting revenues of low cost carriers, rendering their operations unprofitable.

2. If necessary, an Order under section 104 prohibiting Air Canada from offering fares or operating capacity on the Affected Routes on such terms as may be requested by the Commissioner.

3. Such further or other Order as the Tribunal considers appropriate.

[3] On May 15, 2001, at the request of both the Commissioner and Air Canada, the Competition Tribunal (the "Tribunal") ordered that the application be heard in two phases: Phase I, to deal with the application of the avoidable cost test to two sample routes, from the period of April 1, 2000 to March 5, 2001; and Phase II, to deal with the balance of the application. Furthermore, the Tribunal stated that during the Phase I Period, it would consider two issues and four questions. This order, entitled Order Regarding Issues to be Determined at the Hearing, 2001 Comp. Trib. 011 (the "Phase I Order"), states at paragraph 4:

> The following issues shall be heard and determined before proceeding with the balance of the application:
>
> (a) Between the period from April 1, 2000, to the date of the application, has Air Canada operated or increased capacity at fares that do not cover the avoidable costs of providing the service, within the meaning of paragraphs 1(a) and 1(b) of the *Regulations Respecting Anti-Competitive Acts of Persons Operating a Domestic Service* (the "Airline Regulations"), SOR/2000-324, on the Toronto-Moncton/Moncton-Toronto route?
>
> (b) Between the period from July 1, 2000, to the date of the application, has Air Canada operated or increased capacity at fares that do not cover the avoidable costs of providing the service, within the meaning of paragraphs 1(a) and 1(b) of the Airline Regulations, on the Halifax-Montreal/Montreal-Halifax route?

And further at paragraph 5:

> THE TRIBUNAL FURTHER DECLARES THAT in determining these issues, it will consider and answer at least the following questions:
>
> (a) What is the appropriate unit or units of capacity to examine?
>
> (b) What categories of costs are avoidable and when do they become avoidable?
>
> (c) What is the appropriate time period or periods to examine?
>
> (d) What, if any, recognition should be given to "beyond contribution"?

[4] The Tribunal notes that a failure of the avoidable cost test, even if it constitutes an anti-competitive act as per the Airline Regulations, does not lead to a conclusion that the party engaged in an abuse of dominant position under section 79 of the Act. Indeed, a *practice* of anti-competitive acts, among other elements, must be demonstrated under that provision. The element of "practice" and other elements will have to be determined in Phase II of the hearing.

[5] In Phase I, the Tribunal must elaborate an avoidable cost test for the purpose of paragraphs 1(*a*) and 1(*b*) of the Airline Regulations. The test will apply to any dominant air carrier in Canada who engages in the conduct stated at paragraphs 1(*a*) and 1(*b*) of the Airline Regulations. The Tribunal will then respond to the aforementioned issues set out in paragraph 4 of the Phase I Order. Furthermore, the Tribunal will at least answer the questions stated at paragraph 5 of the Phase I Order in order to interpret and implement the avoidable cost test set out in the Airline Regulations, as well as define the scope of the analysis and both the revenue and cost sides of the equation.

[6] It should be noted that Phase I will not determine whether Air Canada engaged in an abuse of dominant position that violated section 79 of the Act. Air Canada cautioned the Tribunal that under the guise of "background" or "context", the Commissioner called evidence that is not relevant to the creation of an avoidable cost test. While Air Canada agrees that background and context are to be considered by the Tribunal during Phase I, it cautions that any attempt to have Phase II issues "colour the record" or influence the Tribunal as to the avoidable cost test – the only issue in Phase I – is entirely inappropriate.

[7] The balance of the application shall be heard at a later date. These matters will include (i) the question of whether Air Canada engaged in anti-competitive acts on the other five routes as stated in the Commissioner's application, by increasing its capacity and/or decreasing its fares in a manner that did not cover the avoidable cost of operating the flights on the "affected routes", contrary to paragraphs 1(*a*) and 1(*b*) of the Airline Regulations, (ii) whether Air Canada controlled the market as defined pursuant to paragraph 79(1)(*a*) of the Act, and (iii) whether the practice of anti-competitive acts is likely to result in a substantial prevention or lessening of competition as per paragraph 79(1)(*c*).

II. THE PROCEEDINGS

[8] On August 29, 2001, Phase I of the hearing began. The hearing has been adjourned twice since September 2001, first on September 11, 2001, due to terrorist attacks in the United States, and second on October 15, 2001, by motion on behalf of Air Canada, which was of the opinion that the events of September 11, 2001 had changed matters relevant to the issue of avoidable cost and that additional time was required to assess the effects of such changes. Therefore, the hearing of this matter began again on November 27, 2002. These reasons and findings only take into account the evidence filed for, and presented at, the hearing which started in November 2002.

[9] The Phase I hearing lasted 40 days. A total of 499 exhibits were introduced by the parties. The Commissioner called five witnesses. The first two consisted of representatives from WestJet and CanJet. Mr. Clive Beddoe, Chairman, President and a founding shareholder of

WestJet, and Mr. Kenneth Rowe, Chairman and Chief Executive Officer of I.M.P. Group International, which group operated “CanJet I” (and now operates “CanJet II”). They both provided evidence as to the business realities and the nature of competition of the airline industry, including Air Canada’s responses to the entry of WestJet and CanJet on the relevant sample routes. The Commissioner also presented expert evidence of Mr. Frank M. Vettese, who was qualified by the Tribunal as an accounting expert; Dr. Michael W. Tretheway, who was qualified as an expert in airline economics; and Dr. Douglas S. West, who was qualified as an expert in economics.

[10] For its part, Air Canada called some employees as witnesses: Mr. Montie Brewer, Executive Vice-President, Commercial; Mr. Marcel Forget, Senior Director, Network Planning and Management for Domestic Routes, responsible for Canadian planning and marketing; Mr. Paul Brotto, Executive Vice-President, Planning and Cost Management, who has 30 years experience with Air Canada, seeking the reduction of its costs; Mr. Luc Piché, Director of Financial Services, Marketing, who assists the marketing department with financial evaluations for decision-making purposes and who, for the purposes of the Competition Bureau’s (the “Bureau”) inquiries, examined all of Air Canada’s costs and available tools and reports; Mr. Craig Landry, Manager, Network Management of Transcontinental Markets, who works in Mr. Forget’s group, who was involved in formulating and implementing Air Canada’s competitive response to both WestJet and CanJet and who provided evidence regarding the automated revenue management systems used by airlines and also regarding some of the practical pricing issues to be addressed in a competitive environment; Mr. Percy Cooley, Director of Labour Relations, CAW and International, who has 30 years experience with Air Canada, who explained the realities of labour relations issues at Air Canada; Ms. Chantal Baril, Senior Director of Airport Operations, who explained staffing at airports and the constraints thereon; Mr. Andrew Torriani, Director of Labour Relations for In-flight Services and Flight Operations, who described the rules for pilots and flight attendants; and Mr. Jon Turner, General Manager of Aircraft Programs, who explained both maintenance and aircraft ownership issues. Air Canada also presented expert evidence of Dr. William J. Baumol, who was qualified as an expert in antitrust economics; Dr. Peter P. Belobaba and Dr. Gary J. Dorman, both of whom were qualified as experts in airline economics.

[11] For Phase I purposes, the Commissioner relied on the information provided by Air Canada. Therefore, the accuracy and exhaustiveness of the analysis conducted by the Commissioner and his experts are dependent on the information provided by Air Canada.

[12] In this regard, the Tribunal draws attention to subsections 69(1) and (2) of the Act, which enunciate:

> 69 (1) In this section,
>
> “agent of a participant” means a person who by a record admitted in evidence under this section appears to be or is otherwise proven to be an officer, agent, servant, employee or representative of a participant;
>
> “participant” means any person against whom proceedings have been instituted under this Act and in the case of a prosecution means any accused and any

person who, although not accused, is alleged in the charge or indictment to have been a co-conspirator or otherwise party or privy to the offence charged.

(2) In any proceedings before the Tribunal or in any prosecution or proceedings before a court under or pursuant to this Act,

(*a*) anything done, said or agreed on by an agent of a participant *shall*, in the absence of evidence to the contrary, be deemed to have been done, said or agreed on, as the case may be, with the authority of that participant;
(*b*) a record written or received by an agent of a participant *shall, in the absence of evidence to the contrary, be deemed to have been written or received, as the case may be, with the authority of that participant*; and
(*c)* a record proved to have been in the possession of a participant or on premises used or occupied by a participant or in the possession of an agent of a participant *shall be admitted in evidence without further proof thereof and is prima facie proof*
(i) that the participant had knowledge of the record and its contents,
(ii) that anything recorded in or by the record as having been done, said or agreed on by any participant or by an agent of a participant was done, said or agreed on as recorded and, where anything is recorded in or by the record as having been done, said or agreed on by an agent of a participant, that it was done, said or agreed on with the authority of that participant, and
(iii) that the record, where it appears to have been written by any participant or by an agent of a participant, was so written and, where it appears to have been written by an agent of a participant, that it was written with the authority of that participant. [emphasis added]

[13] The Tribunal notes that certain evidence provided by Air Canada was either incomplete or inaccessible. There is doubt about the information that Air Canada provided to the Commissioner concerning labour turnover (confidential exhibit A-106). It appears that the information was prepared by an employee of Air Canada who had left the company by the time the hearing started. Witnesses for Air Canada, Mr. Cooley and Ms. Baril, were not aware of the document (transcript at 30:5147 (10 February 2003)). They were unable to understand the terminology used in the document and disputed some of its contents (transcript at 32:5438 (12 February 2003)). The respondent submitted another document prepared by Ms. Baril.

[14] By order of September 27, 2002, Air Canada provided to the Commissioner four tapes containing its General Ledger for 2000 and 2001 (confidential exhibits A-447, A-448, A-449 and A-450). However, the Commissioner could not access the information on these tapes and, as a result, one of the Commissioner's expert, Dr. West was unable to distinguish common costs from avoidable costs in certain cost categories.

III. <u>THE CANADIAN AIRLINE INDUSTRY</u>

[15] Until December 1999, Canada had two full service network carriers that offered domestic and international services: Air Canada and Canadian Airlines Corporation ("Canadian Airlines"). In 1999, these two carriers accounted for over 80 percent of passengers in the top 200 city-pair markets in Canada. Such city-pairs represented approximately 90 percent of total domestic passengers.

[16] Air Canada acquired Canadian Airlines and Canadian Airlines International Ltd. (which operated Canadian Airlines), including their regional airline subsidiary, Canadian Regional Airlines (1998) Ltd. ("CRAL"), in late 1999, early 2000. In order to obtain regulatory approval for the acquisition, Air Canada gave a series of undertakings to both the Department of Transport (exhibit R-113) and the Commissioner (exhibit R-492) to address some of the anti-competitive effects of the merger. Three undertakings are particularly significant in that Air Canada agreed: (1) that until March 2002, no employee would be laid off or involuntarily transferred as a result of the merger; (2) to continue to serve all small communities that had previously been served by either Air Canada or Canadian Airlines until January 2003; and (3) that any aircraft which it wished to sell would have to be offered to Canadian air carriers first.

[17] In July 2000, Air Canada completed its acquisition of Canadian Airlines and, in January 2001, the two corporations were amalgamated under the corporate name "Air Canada". According to the Commissioner, at the time of the application, Air Canada had a 90 percent share of Canadian travel agency sales for domestic markets and at least a 75 percent share based on seat capacity. It operated 375 aircraft and carried over 30 million passengers a year (Statement of Grounds and Material Facts, in the application at paragraph 30).

[18] Due to regulatory restrictions, foreign airline carriers can neither offer domestic services in Canada nor other services between two Canadian points (*Canada Transportation Act*, R.S.C. 1996, c. 10 (the "CTA"), subsection 55(1) and sections 57, 61, 62). Hence, Air Canada's competition in the domestic market comes from domestic low cost carriers. At this time, the Canadian domestic passenger airline industry is characterized by the presence of a dominant full service network airline, Air Canada, operating multiple brands; one established low cost carrier, WestJet; two new low cost entrants, CanJet II and Jetsgo; and the recent disappearance of four low cost carriers, CanJet I, Royal Airlines, Canada 3000, and Roots Air.

[19] The following table, provided at paragraph 67 of the Commissioner's Final Argument, confidential exhibit A-494 [Commissioner's Final Argument], highlights some of the key features of full service network airlines and low cost carriers:

	Full service network airlines	*Low cost carriers*
Goal	• "fly to wherever they want to go, whenever they want to go" (Mr. Brewer)	• Offer inexpensive transport to leisure passengers and price sensitive business passengers
Network structure	• Hub and spoke • Use connecting banks to allow efficient connections for passengers	• Point to point, or simpler networks • Avoid banks due to inefficiencies in airline operations
Fleet	• Various aircraft types in order to serve many different markets • Increases maintenance and pilot costs	• One aircraft type keeps maintenance and pilot training costs down
Aircraft utilization	• Hub and spoke system reduces utilization	• High utilization
	Full service network airlines	***Low cost carriers***
Service levels	• Redundant frequencies for business traffic • Business class cabin and lounges • Free meals and entertainment • Frequent flyer points	• Generally (but not always) fewer frequencies • One class of service – all economy • No meals or entertainment • No frequent flyer plan
Employees	• Unionized • Restrictive work rules • High wages	• Non-unionized • Flexible work rules • Lower wages, but profit sharing
Fare structure	• Many fares • Fences protect high yield traffic • High spread between "Y" fare and leisure fares	• Fewer fare classes • Mainly rely on advance purchase conditions • Less spread between "Y" and leisure fares
Costs	• High	• Low

IV. LEGISLATIVE AND REGULATORY BACKGROUND - SECTIONS 78 AND 79 OF THE ACT AND THE AIRLINE REGULATIONS

[20] The Commissioner filed the application pursuant to section 79 of the Act, alleging an abuse of dominant position by Air Canada. The provisions of the Act relating to the abuse of dominant position provide the Tribunal with broad remedy powers. Indeed, where the Tribunal finds that the elements of section 79 are met, it may make an order prohibiting a respondent firm or firms from engaging in the practice of anti-competitive acts. In addition or alternatively, if the Tribunal concludes that such an order may not be adequate to prevent the practice, it may make any other order directing any such actions, including the divestiture of assets or shares, as are reasonable and necessary to do so. Section 79 sets out the following three essential elements, all of which the Tribunal must find to exist for it to grant an order:

> **Prohibition where abuse of dominant position**
>
> **79**(1) Where, on application by the Commissioner, the Tribunal finds that
>
> (*a*) one or more persons substantially or completely control, throughout Canada or any area thereof, a class or species of business,
> (*b*) *that person or those persons have engaged in or are engaging in a practice of anti-competitive acts*, and
>
> (*c*) the practice has had, is having or is likely to have the effect of preventing or lessening competition substantially in a market,
>
> the Tribunal may make an order prohibiting all or any of those persons from engaging in that practice.
>
> **Additional or alternative order**
>
> (2) Where, on an application under subsection (1), the Tribunal finds that a practice of anti-competitive acts has had or is having the effect of preventing or lessening competition substantially in a market and that an order under subsection (1) is not likely to restore competition in that market, the Tribunal may, in addition to or in lieu of making an order under subsection (1), make an order directing any or all the persons against whom an order is sought to take such actions, including the divestiture of assets or shares, as are reasonable and as are necessary to overcome the effects of the practice in that market.
>
> **Limitation**
>
> (3) In making an order under subsection (2), the Tribunal shall make the order in such terms as will in its opinion interfere with the rights of any person to whom the order is directed or any other person affected by it only to the extent necessary to achieve the purpose of the order.
>
> . . .

Superior competitive performance

(4) In determining, for the purposes of subsection (1), whether a practice has had, is having or is likely to have the effect of preventing or lessening competition substantially in a market, the Tribunal shall consider whether the practice is a result of superior competitive performance.

Exception

(5) For the purpose of this section, an act engaged in pursuant only to the exercise of any right or enjoyment of any interest derived under the *Copyright Act, Industrial Design Act, Integrated Circuit Topography Act, Patent Act, Trade-marks Act* or any other Act of Parliament pertaining to intellectual or industrial property is not an anti-competitive act.

Limitation period

(6) No application may be made under this section in respect of a practice of anti-competitive acts more than three years after the practice has ceased.

. . . [emphasis added]

[21] On June 29, 2000, Royal Assent was given to Bill C-26, *An Act to amend the Canada Transportation Act, the Competition Act, the Competition Tribunal Act and the Air Canada Public Participation Act and to amend another Act in consequence,* (2d Sess., 36th Parl. 2000), and it came into force on July 5, 2000. On August 23, 2000, the Airline Regulations came into force. The said regulations establish a list of anti-competitive acts for the purpose of paragraph 78(1)(*j*) of the Act. The Airline Regulations were adopted by Parliament pursuant to Air Canada's acquisition of Canadian Airlines to address alleged abuse of dominant position in the Canadian airline industry. Prior to the introduction of the Airline Regulations, the term "avoidable cost" had never been used in the Act.

[22] In addition, the Act was further amended to provide the Commissioner with the power to issue temporary orders in the airline industry under certain specified circumstances. Section 104.1 of the Act enables the Commissioner to intervene in order to prevent the following: (i) injury to competition; (ii) the elimination of a competitor, or (iii) significant loss of market share or revenue of a competitor, between the time that an inquiry under the Act has commenced and an application pursuant to section 79 of the Act can be filed.

[23] In *Air Canada c. Canada (Procureure générale du)* (16 January 2003), QCCA 500-09-011298-015 (500-05-060623-004), the Québec Court of Appeal repealed the Commissioner's power to issue temporary orders, on the grounds that section 104.1 of the Act was in violation of paragraph 2(*e*) of the *Canadian Bill of Rights*, R.S.C. 1960, c. 44, which prohibits depriving a person of the right to a fair hearing in accordance with the principles of fundamental justice.

[24] Section 78 of the Act sets out a non-exhaustive list of acts which could constitute an "anti-competitive act" for purposes of section 79:

78. (1) For the purposes of section 79, “anti-competitive act”, without restricting the generality of the term, includes any of the following acts:

(*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;
(*i*) selling articles at a price lower than the acquisition cost for the purpose of disciplining or eliminating a competitor;
(*j*) acts or conduct of a person operating a domestic service, as defined in subsection 55(1) of the *Canada Transportation Act*, that are specified under paragraph (2)(*a*); and
(*k*) the denial by a person operating a domestic service, as defined in subsection 55(1) of the *Canada Transportation Act*, of access on reasonable commercial terms to facilities or services that are essential to the operation in a market of an air service, as defined in that subsection, or refusal by such a person to supply such facilities or services on such terms.

(2) The Governor in Council may, on the recommendation of the Minister and the Minister of Transport, make regulations

(a) specifying acts or conduct for the purpose of paragraph (1)(j); and
(*b*) specifying facilities or services that are essential to the operation of an air service for the purpose of paragraph (1)(*k*). [emphasis added]

[25] Prior to the enactment of the Airline Regulations, the Commissioner invited interested parties to make their views known to the Bureau. The Airline Regulations specify that, *inter alia*, the following acts or conduct by a dominant domestic air carrier, constitute anti-competitive acts for the purpose of section 78 of the Act. Paragraphs 1(*a*) and 1(*b*) of the Airline Regulations read as follows:

> (*a*) operating capacity on a route or routes at fares that do not cover the avoidable cost of providing the service;
> (*b*) increasing capacity on a route or routes at fares that do not cover the avoidable cost of providing the service;

[26] The Regulatory Impact Analysis Statement accompanying the Airline Regulations, published in the *Canada Gazette* Part II (134:18 (23 August 2000)), states:

> . . . The Regulations respond to concerns that Air Canada may act in an anti-competitive manner to preserve its dominant market position by attempting to eliminate competitors or to deter entry by new competitors in the airline industry.
>
> . . .
>
> These Regulations supplement the general provisions of the *Competition Act* relating to abuse of a dominant market position by defining what would constitute anti-competitive conduct on the part of a dominant air carrier . . . .
>
> The specified anti-competitive acts capture predatory conduct, including predatory or below cost selling to eliminate competitors or to deter competitors from entering into a market, or adding capacity or using a low cost so-called fighting brand carrier to achieve the same anti-competitive effect . . . .
>
> In light of Air Canada's overwhelmingly dominant position in the industry (accounting for 90% of domestic passenger revenues) and the ease with which a dominant airline can deploy its fleet of aircraft to target competitors with predatory prices or engage in other anti-competitive practices, the existing provisions of the *Competition Act* would not be fully adequate to address potential concerns . . . .

[27] At the time of the Phase I hearing of this application, the Bureau had not yet released the *Enforcement Guidelines on: The Abuse of Dominance in the Airline Industry*. However, draft guidelines were issued in February 2001.

[28] The Tribunal is of the view that the avoidable cost test, although elaborated in the context of an application filed by the Commissioner against Air Canada, should not be crafted specifically for Air Canada.

[29] On that point, counsel for Air Canada submitted, during cross-examination of Dr. Tretheway, at transcript at 8:1239 (9 December 2002), that:

> . . . this test that the Tribunal needs to formulate is going to apply across the country to any airline that is dominant in any market.
>
> . . . The reason that we are striving to adopt a generally applicable avoidable cost test is because we are trying to come up with what the Commissioner has called a code of conduct.
>
> . . . The reason for the code of conduct is because we want to provide clarity to industry participants . . . .

[30] Counsel for Air Canada further submitted that the four questions of the Phase I Order need to be answered in such way that will permit the avoidable cost test to be used as an industry standard for any dominant airline. Indeed, the avoidable cost test must allow the flexibility to consider the particular circumstances of each dominant airline to which it may apply. According to Air Canada, this can readily be accomplished by formulating "industry standard" answers to the said questions, relating to the unit of capacity, the time period, the recognition that should be given to "beyond contribution", and general guidance as to the cost categories themselves. As each case arises, such general guidance could be applied on an airline-specific basis; in the case at bar, the Tribunal will achieve the exercise by answering the two issues stated in the Phase I Order in reference to the Toronto-Moncton and Halifax-Montreal routes.

[31] In closing arguments, counsel for WestJet focussed on the appropriate interpretative framework within which these issues and questions should be addressed. The term avoidable cost must be interpreted in a manner that is consistent with Parliamentary intent and that recognizes that the concept exists as part of a legislative regime that has been designed by Parliament to achieve a specific and defined purpose. It is therefore critical to establish a purposive interpretive framework for the determination of the issues before the Tribunal. Counsel for WestJet refers to section 12 of the *Interpretation Act*, R.S.C. 1985, c. I-21, which provides decision-makers with a basic, yet powerful principle for the interpretation of statutes: " Every enactment is deemed remedial, and shall be given such fair, large and liberal construction and interpretation *as best ensures the attainment of its objects.*" [emphasis added]

[32] The basic principle for the Tribunal is then to ensure that its interpretation of avoidable cost ensures the attainment of the purpose of the Act. The purpose of the Act is set out in section 1.1 of the Act as follows:

> **1.1 Purpose of Act**
> 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 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.* [emphasis added]

[33] According to counsel for WestJet, three key aspects of this purpose must be considered by the Tribunal in its interpretation of avoidable cost and its determination of an avoidable cost test. Specifically, the test must be designed to:

(a) maintain and encourage competition;

(b) promote efficiency; and

(c) provide consumers with competitive prices and product choices.

V. <u>THE PARTICIPANTS AND THEIR POSITION</u>

A. APPLICANT

[34] The Commissioner is the officer appointed by the Governor in Council under section 7 of the Act to administer and enforce the Act. He is the only person authorized to bring this application.

[35] Further to the Phase I Order, the Commissioner's position is outlined at paragraph 22 of the Commissioner's Final Argument as follows:

> **(a) What is the appropriate unit or units of capacity to examine?**
> The appropriate unit of capacity is the schedule flight.
>
> **(b) What categories of costs are avoidable and when do they become avoidable?**
> Substantially all of Air Canada's costs, with the exception of those properly characterized as overhead, are avoidable within a period of approximately three months.
>
> **(c) What is the appropriate time period or periods to examine?**
> (i) The test should be applied in monthly increments;
> (ii) Air Canada has the ability to know if it is operating below avoidable costs and to avoid these costs within a period of approximately three months;
> (iii) Three months is the appropriate time period to apply in assessing whether Air Canada has engaged in an anti-competitive act.
>
> **(d) What, if any, recognition should be given to "beyond contribution"?**
> So called "beyond contribution" should not be included in the calculation to determine whether Air Canada has operated flights on a route below avoidable costs. In the appropriate case, network benefits could constitute a legitimate business justification for operating a flight below avoidable costs.

[36] The Commissioner disagrees with Air Canada on various elements, including:

(a) the unit of capacity: applying the cost test at a higher level of aggregation than that of the schedule flight creates the risk of masking predatory conduct on a flight level and thus of defeating the purpose of the Airline Regulations. The Commissioner uses the following considerations to support his position: (i) the plain meaning of the Airline Regulations is that the unit of capacity is something less than a route; (ii) the nature of capacity in the airline industry: the smallest unit is a flight; (iii) economic theory, which indicates that predation can occur on a schedule flight; (iv) Air Canada's practice: in particular, Air Canada's Flight Profitability System; and (v) practical considerations;

(b) Air Canada claims that it cannot avoid many costs because of inflexible contracts and other constraints. The Commissioner submits that it can be no defence for the incumbent to claim that its avoidable costs are higher as a result of contracts and constraints that are of its own creation;

(c) the Commissioner and Air Canada disagree about the evidence required to show that costs are avoidable through redeployment of resources. Air Canada's position appears to be that the Commissioner must demonstrate by an after-the-fact analysis, that redeployment to a specific opportunity would have been profitable. Yet this is virtually impossible to show, according to Air Canada's airline expert Dr. Dorman (transcript at 18:3242-48 (23 January 2003)). The Commissioner submits that the existence of potential redeployment opportunities is evidence of avoidability;

(d) counsel for Air Canada contends that the time period to examine should be one year. The Commissioner contends that this position is inappropriate for at least two reasons. First, a new entrant or a small competitor could be seriously damaged or driven from the market in less than a year. Second, a time period of a year could mask predation. As Dr. Baumol states "A program of predation has to be a quick and dirty act . . ." (transcript at 36:6178-79 (18 Febraury 2003)). A dominant carrier can inflict irreparable harm on a new entrant in a short period of time. Examining this over a year not only risks masking predation, but also declares "open season" on new entrants (transcript at 7:1196-99 (6 December 2002)) and expert affidavit of M.W. Tretheway (12 November 2002) confidential exhibit A-80 at 71 [Tretheway Affidavit]); and

(e) the Commissioner contends that the inclusion of beyond contribution in Air Canada's formulaic approach is based on the assumption that Air Canada would lose the business of all the passengers travelling beyond the flight segment in question if it did not offer that flight segment. The Commissioner's position is that Air Canada will retain its beyond revenues even if it cancels a flight, for three reasons: (i) it has alternative means of getting the passenger to the final destination; (ii) it has strong passenger loyalty, and (iii) there are little or no competing services available to passengers (Tretheway Affidavit at 36).

B. RESPONDENT

[37] Air Canada is Canada's dominant airline and principal network carrier. It is subject to the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, and the *Air Canada Public Participation Act*, R.S.C. 1985, c. 35 (4th Supp.). Air Canada operates domestic services and international services, as those terms are defined in the CTA. Air Canada operates passenger airline services itself and through a number of subsidiaries under a number of different brands. During the period at issue, Air Canada's two mainline brands were Air Canada and Canadian Airlines. Air Canada operated four regional airline brands through a subsidiary, Air Canada Regional Inc., namely, Air Ontario Inc., Air Nova Inc., Air BC Limited, and CRAL.

[38] Air Canada's position as to the Phase I questions is the following:

> **(a) What is the appropriate unit or units of capacity to examine?**
> The appropriate unit of capacity is a route and it is only when problems or issues arise on the route level that specific flights may be examined (Air Canada's Phase I Closing Argument, confidential exhibit R-495 [Respondent's Final Argument] at paragraphs 92 and 103).
>
> **(b) What categories of costs are avoidable and when do they become avoidable?**
> Air Canada's position would exclude certain variable costs and would treat aircraft costs as entirely unavoidable.
>
> **(c) What is the appropriate time period or periods to examine?**
> Air Canada would have the test apply for the period of alleged predation, with adjustment for seasonality (Respondent's Final Argument at paragraph 134).
>
> **(d) What, if any, recognition should be given to "beyond contribution"?**
> Air Canada would include "beyond contribution" by adding it to the route revenue in the avoidable cost calculation (Respondent's Final Argument at paragraph 249).

[39] Counsel for Air Canada disagrees with the Commissioner's position that virtually all of its costs (other than those characterized as "overhead") are avoidable within three months (Commissioner's Final Argument at paragraph 287). Air Canada is of the opinion that this approach is fatally flawed for a number of reasons, including the following, as outlined in paragraph 13 of the Respondent's Final Argument:

> (a) the Commissioner ignores the evidence of all of the economist experts (and Mr. David McAllister's admission on Examination for Discovery) to the effect that joint or common costs cannot be considered avoidable. If a cost is incurred in order to provide multiple products (i.e., multiple flights), it is not an avoidable cost for any one of them. Yet the Commissioner includes joint, common system and station labour (and other) costs as avoidable at the level of each flight;

(b) the Commissioner ignores the unit of capacity in his avoidability analysis. That is, he poses the question of what costs would be avoidable upon cancellation of a schedule flight yet - by the admission of the Commissioner's own experts - includes as avoidable, costs that require the cancellation of several schedule flights before they could possibly become avoidable;

(c) the Commissioner assumes that the ability to avoid some aspect of a cost in certain circumstances necessarily means that the entire cost category is avoidable in all circumstances. Furthermore, the Commissioner treats, from day one, as 100 percent avoidable, costs which would never be avoided in so short a time period;

(d) the Commissioner acknowledges the constraints upon airlines generally, and Air Canada specifically, in their ability to avoid costs, yet ignores those constraints for the purposes of the avoidable cost test. Thus, while aircraft cannot be sold in one month, nor do profitable redeployment opportunities exist, the Commissioner nonetheless calls aircraft costs avoidable. While many Air Canada employees have job security protection precluding termination of employment, the Commissioner nonetheless calls labour costs avoidable for Air Canada;

(e) the Commissioner ignores the numerous and significant transaction costs and severance costs associated with cost avoidance in calculating Air Canada's avoidable costs. The Commissioner's own experts have admitted the existence of those costs and have acknowledged that such costs need to be taken into account. Yet, Dr. West's calculations of Air Canada's financial performance on the two sample routes completely fail to do so;

(f) it is physically impossible to cancel a single schedule flight without creating a ripple effect in the schedule; a schedule flight is smaller than the marginal unit of capacity that is deployable. It is therefore incorrect to consider the revenues and costs of a schedule flight for the purpose of determining whether an operation is economically rational;

(g) the Commissioner's theory that aircraft and labour costs are avoidable due to redeployment entirely ignores the practicality of true redeployment and assumes without any foundation whatsoever that profitable redeployment opportunities are constantly available. The uncontradicted evidence of Air Canada is that it is constantly seeking more profitable redeployment opportunities and that its worst performing route or flight is better, taking into account operational and business constraints, than the next best available opportunity to Air Canada; and

(h) the Commissioner's use of "recapture" to justify the exclusion of beyond contribution from the analysis is hypothetical, unsupported by the evidence, and is entirely inconsistent with his theory of redeployment. The recapture theory assumes that Air Canada would lose no revenue if it cancelled a schedule flight, which stands in direct contrast to the assumption that Air Canada can always generate incremental revenues by redeploying assets to routes with existing service. How can one simultaneously assume incremental revenues for increased service, but no revenue decline for service reduction?

[40] According to counsel for Air Canada, applying the test advocated by the Commissioner will lead to a clearly incorrect conclusion that Air Canada is engaged in anti-competitive conduct, when it is simply conducting normal and usual business operations. Further counsel submits that a proper avoidable cost test simply should not lead to routine "findings" of anti-competitive conduct throughout the Air Canada system. Yet, counsel for Air Canada argues that this is the precise result of the Commissioner's test.

C. INTERVENOR

[41] A request for leave to intervene filed by WestJet was granted by the Tribunal on April 20, 2001, in Reasons and Order Granting Request for Leave to Intervene (2001 Comp. Trib. 4). In the Phase I hearing, the intervenor chose to examine and cross-examine some of the witnesses and made representations on the issue of avoidable costs, both in general and as it relates to Air Canada's avoidable costs.

[42] WestJet is a low cost carrier. It operates a domestic service within the meaning of the CTA. It commenced operations in western Canada in February 1996.

[43] WestJet follows the low cost, low-fare model pioneered in the United States by Southwest Airlines. This model relies on several strategies to keep costs, and thus fares, down: short-haul routes (initially); no-frills service (no meals, no headsets, no advance seat selection, no frequent flyer points); and operation of only one aircraft type (Boeing 737).

[44] At the time of the hearing, WestJet served 16 Canadian cities with 23 Boeing 737-200 aircraft. WestJet is a publicly traded company listed on the Toronto Stock Exchange.

[45] WestJet's position as to the Phase I questions is outlined in WestJet's Memorandum of Argument, confidential exhibit I-493, [WestJet's Final Argument] at paragraphs 3 to 5:

> **(a) What is the appropriate unit or units of capacity to examine?**
> The appropriate unit of capacity to examine is a schedule flight.
>
> **(b) What categories of costs are avoidable and when do they become avoidable?**
> WestJet agrees with the Commissioner that Air Canada's variable costs and flight specific fixed costs are avoidable costs that could be avoided if Air Canada did not operate the flights in question. Air Canada could have avoided these costs by not incurring them or by redeploying the resources to another use. In WestJet's view, if Air Canada adds capacity, all costs of that capacity are avoidable at the outset. If it does not add capacity, then some time is required to avoid some costs. The Commissioner claims, and WestJet agrees, that all of Air Canada's costs are avoidable, except those properly classified as overhead.

(c) What is the appropriate time period or periods to examine?
WestJet agrees with the Commissioner that:
(i) the test should be applied in monthly increments;
(ii) Air Canada has the ability to know if it is operating below avoidable costs and to avoid these costs within a period of approximately three months;
(iii) three months is the appropriate time period to apply in assessing whether Air Canada has engaged in an anti-competitive act.
(d) What, if any, recognition should be given to "beyond contribution"?
WestJet submits that in performing the avoidable cost calculation, no recognition should be given to beyond contribution.

VI. COMING INTO EFFECT OF THE AIRLINE REGULATIONS

[46] In the application, the Commissioner alleges that, beginning in April 2000, Air Canada engaged in the practice of anti-competitive acts pursuant to section 78 of the Act and paragraphs 1(*a*) and 1(*b*) of the Airline Regulations. As stated above at paragraph 24, section 78 of the Act contains a non-exhaustive list of anti-competitive acts and the Airline Regulations specify those acts or conduct for the purpose of paragraph 78(1)(*j*) of the Act.

[47] The parties asked the Tribunal to develop an avoidable cost test and to apply it to two sample routes over the period of April 1, 2000 to March 5, 2001. Therefore, the Tribunal has been asked to apply the Airline Regulations to a period of time (almost five months) prior to their enactment.

[48] The Commissioner's position is that the Airline Regulations simply clarify that certain conduct by a dominant carrier may be an anti-competitive act. He argues that for the period prior to the enactment of the Airline Regulations, it is open to the Tribunal to find that this conduct was an anti-competitive act under section 78 of the Act. In that regard, the Commissioner cites the following decisions: *Canada (Director of Investigation and Research) v. Laidlaw Waste Systems Ltd.* (1992), 40 C.P.R. (3d) 289 [1992] C.C.T.D. No. 1 (QL) (Comp. Trib.) [Laidlaw] and *Canada (Director of Investigation and Research) v. NutraSweet Co.* (1990), 32 C.P.R. (3d) 1 [1990] C.C.T.D. No. 17 (QL) (Comp. Trib.) [NutraSweet]. Both the Commissioner and Air Canada have introduced expert economic evidence that the avoidable cost test is an appropriate way to identify anti-competitive conduct in the airline industry. Hence, even in the absence of the Airline Regulations, operating capacity below avoidable cost could be found to constitute an anti-competitive act.

[49] On the basis of these submissions, the parties have asked the Tribunal to apply the same standard (i.e. the avoidable cost test) to Air Canada's conduct, both before and after the enactment of the Airline Regulations.

[50] The Commissioner submits that "Failing the avoidable cost test leads to the inference that the dominant carrier has committed an anti-competitive act." (Commissioner's Final Argument at paragraph 124). He recognizes that the Airline Regulations do not expressly require a showing of anti-competitive purpose, but emphasizes that the Tribunal has previously observed that the common feature included in section 78 of the Act is that the anti-competitive acts are all performed for a "purpose", namely, ". . . an intended negative effect on a competitor that is predatory, exclusionary or disciplinary" (see NutraSweet at 34, cited above at paragraph 48). Hence, the Commissioner argues that, under the Airline Regulations, anti-competitive purpose is inferred from a dominant carrier operating below avoidable cost, subject only to the possibility of legitimate business justification for the conduct. He relies on the decision of *R. v. Consumers Glass Co. Ltd.* (1981), 57 C.P.R. (2d) 1 (Ont. H.C.J.).

[51] Further, the Commissioner argues that when a dominant carrier alleges a legitimate business justification, its existence must be assessed objectively. Companies are presumed to intend the consequences of their actions. Business justifications can be based on efficiency or actions that favour competition. The mere proof of some legitimate business justification may not be sufficient to support a finding that no anti-competitive act occurred. Any justification must be weighed in light of any anti-competitive effects in order to establish the overriding "purpose" of the acts alleged to be anti-competitive, which in this case is operating below avoidable cost. The Commissioner cites *Canada (Director of Investigation and Research) v. D & B Companies of Canada Ltd.* (1995), 64 C.P.R. (3d) 216, [1995] C.C.T.D. No. 20 (QL) (Comp. Trib.) and Laidlaw, cited above at paragraph 48). According to the Commissioner, a legitimate business justification could include, for example, a situation where it is necessary to operate a flight at the end of the day to position the aircraft for its next mission (a so-called "balancing" or "positioning" flight).

[52] Counsel for the Commissioner submits, however, that in this case, Air Canada has not offered a legitimate business justification for operating below avoidable cost on the two sample routes.

[53] Counsel for Air Canada argues that the economic and legal concepts of "abuse of dominant position" and "predatory pricing" have been addressed by the Tribunal and by the courts. Air Canada submits that such consideration is instructive in considering the object of the relevant provisions of the Act and thus of the appropriate scope of the Airline Regulations. Air Canada further submits that the interpretation of "avoidable cost" adopted by the Tribunal must be consistent with the principles established in reference to the concepts of abuse of dominant position, predatory pricing, as well as with the objectives of their related legislative provisions (Respondent's Final Arguments at paragraph 24).

[54] The Tribunal cannot accept the position advanced by the Commissioner that a dominant carrier failing the avoidable cost test merely leads to the inference that such party has committed an anti-competitive act. Indeed, the anti-competitive acts stated in section 78 of the Act (with the exception of paragraph 78(1)(*f*) and the definition of domestic service as defined in subsection 55(1) of the CTA namely paragraphs 78(1)(*j*) and 78(1)(*k*)) require an "object", "design" or "intent" to engage in an exclusionary conduct that is having the effect of augmenting, entrenching or extending market power. The presence of such wording made relevant the concept of legitimate business justification in past Tribunal jurisprudence. However, the Tribunal observes that no such intention has been expressly stated in paragraph 78(1)(*j*) of the Act. In the Tribunal's view, the wording of paragraph 78(1)(*j*) is clear: once a party fails the avoidable cost test, its conduct constitutes an anti-competitive act.

[55] In the Tribunal's view, evidence of a legitimate business justification accepted in past Tribunal jurisprudence could be considered in this case for the period of April 1, 2000 to August 23, 2000, prior to the coming into effect of the Airline Regulations. However, with the enactment of paragraphs 78(1)(*j*) and 78(1)(*k*) of the Act on July 5, 2000, the Tribunal is of the view that no consideration of legitimate business justification can be given when determining whether anti-competitive acts as defined therein have occurred. The Tribunal may, however, consider legitimate business justification, among other elements, when determining whether a "practice" of anti-competitive acts has occurred pursuant to section 79 of the Act.

VII. THE AVOIDABLE COST TEST

[56] Experts for both sides agree that paragraphs 1(*a*) and 1(*b*) of the Airline Regulations prescribe an objective "avoidable cost test" for assessing whether a dominant carrier's response to a new or existing smaller competitor is an anti-competitive act. They also agree that the avoidable cost test proposed by Air Canada's economic expert, Dr. Baumol (William J. Baumol, "Predation and the Logic of the Average Variable Cost Test", (1996) XXXIX(1) J.L. & Econ. 49 [Baumol Article]), exhibit A-488, is the test they wish to apply in this case.

A. FIXED AND VARIABLE COSTS

[57] Costs may be classified as to whether they vary with output and whether they are recoverable in the event of exit. As a general matter, the variable costs of producing a given level of output of a good or service are those costs (such as the costs of labour and material inputs) that vary with changes in the amount of that output. Fixed costs (i.e. overhead costs such as executive salaries and rent) do not change with the level of output except over a longer period of time and may therefore become variable in the long run.

[58] Economic experts for both sides in this case agree that for the multiproduct firm, the concept of average total cost is not well-defined and its application in discussions of predation is misplaced. The respondent's economic expert, Dr. Baumol, at page 59 of the Baumol Article, writes:

> Since the concept of "average total cost" (ATC) intrudes so often in discussions of predation, it is worth noting briefly that in the case of a multiproduct firm it violates all economic logic. Outside a textbook, there probably exists no such thing as a single-product firm, and all multiproduct firms have fixed costs incurred in common on behalf of two or more of their products. There is, however, no economically defensible way of dividing such costs up among the firm's various products. As is well known, all methods for the allocation of common fixed costs are arbitrary.

[59] In the expert affidavit of D.S. West (12 November 2002) confidential exhibit A-103 [the West Affidavit] at 11, the Commissioner's economic expert, Dr. West, similarly notes:

> . . . There is another cost concept, average total cost, that is frequently used in textbook discussions of a firm's costs. It is usually defined to be the sum of average variable and average fixed costs. This cost concept, which can be used if the firm under consideration is a single-product firm, is not well defined for a multiproduct firm. Multiproduct firms incur some costs that are common costs for two or more products. Any allocation of such common costs to separate products would be arbitrary. [footnote omitted]

[60] Mr. Beddoe states that WestJet evaluates flight and route profitability on a fully-allocated basis. Accordingly, WestJet's fixed costs (including amounts distributed pursuant to profit-sharing arrangements) are allocated to specific flights and routes according to rules and procedures that WestJet established several years ago.

[61] Having regard to the evidence of the economic experts noted above, the Tribunal accepts that while such allocation rules may be reasonable in the circumstances, there will usually be several reasonable rules that could be adopted and applied consistently, and yet the resulting allocation of fixed costs to a flight or route will vary, possibly quite significantly, depending on the particular rule adopted. Flight or route profitability will vary accordingly when such fixed costs are allocated to flights or routes.

[62] As WestJet's financial analyses of performance of its Hamilton-Moncton route indicate, its "profit margin" on that route over a given time period can be negative when measured on a fully-allocated basis, even though the variable contribution for that route is positive (confidential exhibit I-75). Mr. Beddoe states that WestJet makes decisions on flight and route cancellation on the basis of the profit margin after fully-allocated costs (transcript at 3:368-71 and 396-98 (2 December 2002) and Mr. Vettese (transcript at 15:2610-14 (18 December 2002).

[63] In the multiproduct enterprise, a variable cost may be associated with more than one product. In the context of an airline that earns revenue by carrying both passengers and cargo, the cost of fuel that is consumed by an aircraft carrying both passengers and cargo on the same flight is a variable cost of the flight which cannot be attributed to either of the two lines of business except by arbitrary allocation rules. The fuel cost is common to both activities and is avoided only if the flight does not take place.

[64] A fixed cost may serve only one product rather than several products in a multiproduct enterprise. In the instant case, the Commissioner asserts that "aircraft ownership costs" are costs that are fixed and specific to the use of aircraft, and refers to them as product-specific fixed costs.

B. SUNK COSTS

[65] Costs may also be classified by the extent to which they are recoverable in the event of termination of production (i.e. exit). Advertising already completed or product-specific development costs are not recoverable when production of the good or service is terminated and are therefore referred to as sunk costs.

[66] In the expert affidavit of F. M. Vettese (14 November 2002) confidential exhibit A-115 [Vettese Affidavit] at 21, the Commissioner's accounting expert defines a sunk cost as follows: "[a] sunk cost is a cost that has already been incurred and that cannot be changed by any decision made now or in the future." [footnote omitted]

[67] Citing the discussion of costs in an intermediate microeconomics text, the Commissioner's economic expert, in the West Affidavit at 12, accepts that a firm's specialized machinery could wear out with use and hence its costs are variable. If that machinery is so specific to the firm that there is no secondary market in which it could be sold following exit, its costs are sunk. However, if a secondary market exists, the costs of the machinery, or some portion thereof, are not sunk.

[68] In the Baumol Article at 57, footnote 13, the definition of sunk costs includes a time dimension:

> . . . A *sunk cost*, however, is a cost that cannot be avoided for some limited period of time, but after that period it becomes *avoidable* or *escapable*. A cost that is fixed may or may not be sunk, and a cost that is sunk may not be fixed . . . . [emphasis in original]

Accordingly, Dr. Baumol appears to differ with the Commissioner's experts on the extent to which a time period is an important consideration as to whether a cost is a sunk cost. In Dr. Baumol's analysis, a cost that is a sunk cost need not be sunk forever.

C. AVOIDABLE COSTS

[69] The parties agree that an avoidable cost for the purpose of the Airline Regulations is a cost that is incurred in the production of a specified good or service and which would not be incurred if the enterprise ceased production of that good or service.

[70] The Commissioner's economic expert, in the West Affidavit at 10, defines avoidable costs as follows:

> Avoidable costs refer to all costs that can be avoided by not producing the good or service in question. In general, the avoidable cost of offering a service will consist of the variable costs and the product-specific fixed costs of offering the service. Where a particular input is used in the production of multiple products or services, the product-specific cost of the input will be a component of the avoidable cost for that product . . . . [footnote omitted]

[71] The respondent's economic expert, Dr. Baumol, states in direct evidence (transcript at 36:6172-73 (18 February 2003)), that only avoidable costs are relevant in determining predation and that a cost is not avoided solely by attribution elsewhere:

> . . . That logic says it is the avoidable costs that are the relevant costs. By avoidable, we mean costs that you really and truly escape, not costs that you shift from one pocket to another.

Under questioning he goes further to state that a cost would be avoidable if it was covered by a revenue source somewhere else in the organization, that is, redeployment could make a cost avoidable (transcript at 37:6450 (19 February 2003) and Baumol Article at 57, footnote 13).

[72] At page 20 of the expert affidavit of G.J. Dorman (18 November 2002) confidential exhibit R-263 [the Dorman Affidavit], the author defines avoidable costs as ". . . expenses that would be avoided if operations on a route were scaled down or eliminated . . . Any expenses that would still be borne by Air Canada but would merely be reallocated to another route or flight are not truly avoidable."

[73] In the expert affidavit of W.J. Baumol (18 November 2002) confidential exhibit R-485 [Baumol Affidavit] at 11 and 12, Dr. Baumol emphasizes the pertinent time period:

> Avoidable cost is defined as any outlay that a firm may be able to escape if it ceases some pertinent activity. Some costs simply cannot be avoided by a firm if it is to continue in business, no matter how much of its activity it contracts. More important, the amount of a firm's expenditures that it can escape depends upon the length of time it has available to arrange for the cost reduction . . . Failure to choose a defensible period is an invitation to the parties appearing before a tribunal to create avoidable cost numbers that suit their purposes.

[74] The Tribunal notes that in the Baumol Article at 56, the author also includes fixed costs that are not sunk in his definition of variable cost. When he defines avoidable costs at pages 58 and 59, he specifically includes product-specific fixed costs that are not sunk in the relevant time period:

> The AAC [Average Avoidable Cost] figure must, however, include all pertinent portions of the product-specific fixed but avoidable costs, that is, all portions of such costs that can be escaped in the pertinent time period.

In his testimony, Dr. Baumol makes the same point.

[75] Hence, the economic experts' definitions of avoidable cost are similar in that both include variable costs and product-specific fixed costs that are not sunk. However, they differ with respect to the relevance of a time period for avoidable costs generally and for non-sunk, product-specific fixed costs in particular. Dr. West's definition does not refer to any time period in defining an avoidable cost, whereas for Dr. Baumol it appears that the pertinent time period is critical. Dr. Dorman is the only expert who disagrees that redeployment results in cost avoidability.

[76] Having regard to the agreement of the experts, it is the Tribunal's view that the definition of avoidable costs to be used for the purpose of the avoidable cost test for determining predation is the following: All costs that can be avoided by not producing the good or service in question. In general, the avoidable cost of offering a service will consist of the variable costs and the product-specific fixed costs that are not sunk.

D. COMMON COSTS

[77] A common cost is a cost that is indivisibly associated with one or more outputs or activities, for example, the cost of heating a factory that produces two products and that must maintain a normal working temperature even if production of one of the products is terminated. A common cost may be a fixed cost such as overhead or a variable cost such as labour associated with operations; the key issue is indivisibility.

[78] In his testimony (transcript at 36:6209-10 (18 February 2003)), Dr. Baumol emphasizes this indivisibility:

> If you take something that is done on behalf of several products and it is no more done on behalf of the one product than the other, how can you say 12.62 per cent of that cost belongs to product A and the remainder to product B?
>
> The answer is it is indivisibly dedicated to the two products.
>
> If the cost does actually increase the more product A that you sell and you put in the number that represents that rate of increase, that is not an allocation any more . . . .

[79] The salary of a pilot flying an aircraft that carries both passengers and cargo is an example of a variable cost of operations that is also a common cost. However that pilot is paid (i.e. annual salary or per flight), that pilot is serving both lines of business simultaneously and indivisibly.

E. THE TEST

[80] The avoidable cost test for predation determines whether a firm's revenue (price) is above or below its (average) avoidable cost. As discussed by Dr. Baumol, the multiproduct enterprise will rationally continue to produce a given product as long as the revenue from the sale of that product exceeds the product's avoidable costs. If the cost-savings achieved by exit exceed the revenue foregone, then the firm will terminate production of that product. Since no enterprise will rationally set the price per unit of any of its products below their respective (average) avoidable costs in the pursuit of maximum short-term profits, deviations from this rational pricing behaviour may be predatory.

[81] As proposed by Dr. Baumol, the avoidable cost test for predation determines whether the price charged by an alleged predator constitutes a threat to equally efficient competitors. As long as the unit price of the alleged predator exceeds its (average) avoidable cost, then that price must also be above the avoidable cost of an efficient rival and that competitor will not exit.

[82] Throughout the hearing, comments were made about the relative costs of the respondent and competitors, including WestJet, that may have adopted a different business model ("The Fallacy of the 'Efficiency' Argument of the Commissioner", exhibit R-499). The Tribunal notes for greater certainty that the avoidable cost test does not require a comparison of an incumbent's costs with those of an entrant or potential entrant nor does it require, in the context of litigation, an assumption that the specific entrant or potential entrant is at least as efficient as the named incumbent. The avoidable cost test compares the incumbent's revenue (price) with its (average) avoidable cost. As long as the former exceeds the latter, an equally-efficient entrant will be able to enter the market at a price above its avoidable cost. When the incumbent's revenue (price) is below its (average) avoidable cost, then, subject to other concerns, it may be inferred that the incumbent is predating on the entrant.

[83] As described by the economic experts, a particular cost (or part thereof) is avoidable if the firm could escape it following a hypothetical cancellation of a unit of relevant activity. Accordingly, in the Tribunal's view, avoidability is a factual matter that can only be established through a conceptual experiment. It follows that evidence of cost avoidance following actual cancellation may be useful in establishing avoidability for the purpose of the avoidable cost test. However, it may be that following an actual cancellation, the airline in question decided not to take action to avoid a particular cost even though that cost was avoidable. Accordingly, evidence that a particular cost was avoided following an actual cancellation is not required by the test.

[84] It is not entirely clear whether the parties agree in this regard. In final argument, counsel for the Commissioner argued that the identification of cost avoidability does not involve a time element, although the period of time in which avoidable costs can be avoided is relevant in conducting the avoidable cost test (transcript at 38:6587-88 (3 March 2003)):

> It didn't strike me appropriate to say a cost is not avoidable, is not avoidable, is not avoidable and then all of a sudden it is. I think the better way to look at it, in my submission, is to say: *It's an avoidable cost or it is not.* If it is, then the question is: What is the period of time it would take Air Canada or a carrier to avoid the cost? . . . [emphasis added]

[85] At paragraph 12 of the Respondent's Final Argument, counsel for the respondent characterizes the avoidable cost test as requiring that evidence be adduced that a particular cost would be avoided:

> As such, the avoidable cost test must be applied carefully so as to balance the unit of capacity, the time period, the particular circumstances of the dominant airline in issue, and the appropriate measure of revenues. *The test cannot simply identify a list of costs which a dominant airline might possibly be able to avoid at some level and over some time period and label all such costs as avoidable in testing*

> *for predation. Such an approach would be contrary to business sense, to common sense and to competition law and policy. The law requires identification of the costs the dominant airline actually would avoid if it took an action (such as cancelling a schedule flight) so as to determine whether continuing that action is rational or irrational from an economic point of view.* It is when a dominant airline persists in performing irrational operations that have no legitimate business purpose other than their ability to discipline or drive out a competitor that the law says that an act is anti-competitive. [emphasis added]

In the Tribunal's understanding, the respondent's position is that a cost is avoidable for the purpose of the avoidable cost test if it *would* be avoided following cancellation.

[86] The Tribunal is of the view that neither party has stated the avoidable cost test in a way that is free of ambiguity. The Commissioner's view of time periods is confusing in that a cost that was not avoidable throughout an alleged predatory period would nonetheless be included in the avoidable cost test for that period. The respondent's approach is also confusing. The issue is what costs (or parts thereof) could, rather than would, be avoided following a hypothetical cancellation. Since the cancellation is only hypothetical, it is not possible to identify what actions the dominant airline would take and which costs would be avoided.

[87] Witnesses for the respondent stated that flight cancellation is itself problematic since it may be costly in light of scheduling problems, with the implication that Air Canada has only limited ability to cancel flights. However, since the avoidable cost test is premised on a hypothetical cancellation of the relevant activity, no inquiry can be made as to whether Air Canada could or would cancel a particular activity; the cancellation is taken as a given for the purpose of the test. The implications for the avoidable cost test of Air Canada's ability to know when its revenues are below avoidable cost and to make the required changes are discussed below at paragraph 180.

F. WAYS TO AVOID COSTS

[88] Counsel for the Commissioner submits that a particular cost is to be considered avoidable if at least one of the three following conditions hold:

(a) the cost would not be incurred if the schedule flight were not operated (i.e. outright shedding of costs following cancellation);

(b) the resource associated with the cost can be redeployed to another use (including indirect redeployment by passenger recapture); and/or

(c) the resource associated with the cost can be disposed of.

Counsel for the Commissioner asserts that a very high percentage of Air Canada's costs can be avoided in these ways because the costs are variable or "step-variable" costs or non-sunk product-specific fixed costs.

[89] Counsel for the respondent submits that the opportunities for Air Canada to shed costs outright are limited, that "step-variable" costs are in effect common costs that are not escapable following cancellation, that the opportunities for redeployment must be profitable and are few in any case, and that disposal of resources, aircraft in particular, is for all intents and purposes not possible. The respondent also argues that the Commissioner overstates the magnitude of avoidable costs by failing to take transaction costs into account, that the Commissioner regards a cost as wholly avoidable when only a portion thereof is avoidable, and that Air Canada does not have the relevant information in sufficient time to effect cost reductions within the pertinent period of time.

G. FLIGHT PROFITABILITY DATA

[90] Air Canada's systems provide a great deal of information on a flight basis. Air Canada can generate advance booking and load factor information on a flight basis and its Flight Profitability System contains, and can provide, profitability information for individual flights (i.e. specific dated departures). This information can be aggregated up to other levels, such as the schedule flight and the route.

[91] The Flight Profitability System was specifically designed to deliver information on a *flight* basis. Mr. Brotto from Air Canada, testified (transcript at 26:4387 (4 February 2003)) that:

> . . . I recall when I was Vice-President of Marketing in the early 1990s one of my frustrations was the inability to see what the profitability was of a *flight* as opposed to a route, to have accurate information, to be able to analyze profitability by day of week. Is a Monday flight more profitable than a Tuesday flight and so on? . . . [emphasis added]

[92] The parties appear to agree that the cost categories under review in this proceeding are those identified by Air Canada in its 328 Report as set out below.

Total Revenues
- Passenger Revenues (Premium, Economy, Charter)
- Cargo Revenues (Freight, Mail, Charter)

Passenger Expenses
- Passenger Commissions
- Passenger Acquisition
- Food & Supplies
- Passenger Insurance
- Aeroplan Charges (including Aeroplan Liability)
- Other Passenger Expenses (including Inflight Magazines, Maple Leaf Lounges, Passenger Communications)

Traffic Expenses
- Airport Passenger Servicing Labour
- Reservation Direct Labour
- Cargo Commissions
- Cargo Acquisition
- City Ticketing Direct Labour
- Other Traffic Expenses (including Airport Security, Flight Delays, Inflight Entertainment, Revenue Accounting, Cargo Accounting, Cargo Communication, Cargo Loss & Damages)

Capacity Flying
- Flight Crew Labour
- Flight Crew Cycle
- Cabin Crew Labour
- Cabin Crew Cycle
- Fuel & Oil
- Fuel Handling
- Maintenance Labour
- Maintenance Material
- Navigation Fees

Capacity Ground
- Passenger Aircraft Servicing Labour
- Cargo Aircraft Servicing Labour
- Passenger Purchased Terminal Handling
- Cargo Purchased Terminal Handling
- Commissary Handling
- General Terminal Assessments
- Landing Fees
- Maintenance Labour
- Maintenance Material
- Other Cargo Expenses (including Cargo Sales Labour, Cargo Trucking, Cargo Pick-up & Delivery)

Total Variable Expenses
- **Variable Contribution**
- Market Value/Aircraft Insurance
- Overhead

Net Contribution

This report, produced from Air Canada's Flight Profitability System, categorizes all costs as variable, except aircraft ownership, insurance and overhead (Air Canada 328 Reports, August-November 2000, YHZ YOW, confidential exhibit A-20) (the "328 Report")).

[93] The 328 Report is a route-level report, with direct feed of certain dated flight leg information. The other costs are prorated or allocated according to "drivers" to get flight level information.

[94] The parties agree that 17 cost items in the 328 Report (i.e. "Food and Supplies" and "Fuel and Oil") are avoidable due to their variable-cost characteristics and that costs identified therein as overhead are unavoidable.

[95] Counsel for the respondent states that the cost categorization in the 328 Report is sometimes arbitrary, and that certain costs shown as variable are in fact unavoidable. The respondent groups the 26 disputed costs in the 328 Report into five broad categories: (1) system labour costs, (2) station labour costs, (3) aircraft labour costs, (4) non-labour system and sunk costs, and (5) aircraft ownership and insurance costs (Respondent's Final Argument at paragraphs 137 and 140).

H. STEP-VARIABLE COSTS

[96] The parties agree that costs that are variable with the level of activity are properly considered avoidable. However, counsel for the respondent argues that certain variable costs asserted by the Commissioner to be avoidable would not be reduced in the event of cancellation of activity on a single schedule flight or route; rather, these costs would only be reduced after cancellation of a significant number of such activities.

[97] Counsel for the Commissioner submits that certain costs as defined by the expert on cost accounting, Mr. Vettese, should be treated as avoidable even though they cannot necessarily be avoided following cancellation of one schedule flight. Several labour costs are held to be step-variable, such as remuneration for employees in "front-line" positions in Aeroplan staffing (Aeroplan Center Charges), check-in and gate agents (Airport Passenger Service Direct Labour), reservation call centre agents (Reservation Direct Labour), city ticketing office agents (City Ticketing Direct Labour), flight attendants (Cabin Crew Labour), and ground handlers (Passenger Aircraft Service Direct Labour), *inter alia*.

[98] Mr. Vettese distinguishes between a "direct variable cost" and a "step-variable cost". The former varies in total in direct proportion with changes in the level of activity but is generally constant on a per unit basis (Vettese Affidavit at 12). The latter has both a fixed and a variable component. It is a cost that remains constant for a range of activity levels, then, on a further increase (decrease) in activity, the cost jumps to a new level and remains constant over a certain range until the next jump occurs. When such jump occurs, however, the cost increase (decrease) would be greater (smaller) than had the cost been directly variable with the level of activity (Vettese Affidavit at 14).

[99] The fixed component may arise from the need for some minimum number of staff that may be required to conduct certain activities and regulatory requirements, among others. For example, certain customer service areas must be staffed by more than one agent.

[100] Mr. Vettese also considers "smoothing" as an indication that step-variable costs behave like direct variable costs. When a change is made to the flight schedule, some costs will change but others will not. At the next change, these other costs may be affected. On balance, he contends, step-variable costs are subject to "smoothing" that results in cost behaviour similar to direct variable costs.

[101] As a general matter, Mr. Vettese treats step-variable costs or portions thereof as avoidable even though an assessment of factual circumstances needed to determine avoidability may not be practical (Vettese Affidavit at 16). After examining the particular step-variable costs, he concludes that they are inherently related to activity levels or become avoidable through redeployment. In certain cases, the costs are overtime labour that is more easily escaped than remuneration of full-time workers. Another factor tending to suggest avoidability is the generation of incidental revenue from other airlines. Labour costs incurred in this regard can be avoided more easily than the costs of serving Air Canada's own operations.

[102] The Commissioner's economic expert, Dr. West, notes that certain costs that are step-variable serve several flights and routes (i.e. Reservation Direct Labour). Had a schedule flight been cancelled, the passengers who would have travelled on that flight may continue to travel on the remaining flights and routes offered by the same carrier to get to the desired destination and hence are recaptured by that carrier. Accordingly, Dr. West treats the relevant step-variable costs of the cancelled flight as avoidable because they are incurred in respect of the remaining flights after cancellation (transcript at 11:1837-39 (12 December 2002)). (The issue of "passenger recapture" is discussed below, beginning at paragraph 110.)

[103] Counsel for the respondent argues that a cost that can only be avoided upon cancellation of several flights is not avoidable upon the cancellation of one. Further, since step-variable costs are common costs incurred in respect of multiple flights (i.e. check-in counters and baggage handling), they are not avoidable with respect to the single schedule flight, and generally, if a cost would have to be incurred in any event to serve other products, then it is not avoidable for any one product (Respondent's Final Argument at paragraphs 151-155).

[104] In the Tribunal's understanding, the allocation of a cost and its avoidability are separate matters. The key issue is whether a step-variable cost can be avoided and, as suggested by the Commissioner, there are various ways in which avoidability might be established. In the Tribunal's view, the respondent is emphasizing that step-variable costs cannot be shed outright; however, there are other ways in which a step-variable cost can be avoided.

[105] Air Canada's expert on airline economics, Dr. Dorman, testified that costs incurred in respect of multiple flights are not avoidable simply because cancellation of a schedule flight leads Air Canada to attribute costs to remaining flights. At transcript 18:3264 (23 January 2003) he says the following:

> You are certainly not avoiding any costs. You are reallocating -- for some categories of these costs, the ticket counter agents at the front of the airport, they just check in people. They are there pretty much during a certain window and check in whoever comes up to the counter. So the fact that you now have people flying on A to C rather than A to B just means that because of the allocation scheme their costs would be reallocated from A to B to the A to C flight.

It appears to the Tribunal that Dr. Dorman regards the remuneration costs of ticket counter agents as common costs, hence unavoidable when a schedule flight is cancelled.

[106] It is important to distinguish between common and avoidable costs within the same cost category as defined by Air Canada's chart of accounts. In connection with Aeroplan Center costs, at page 58 of the West Affidavit, Dr. West distinguishes common costs from those that are avoidable:

> Some of the Aeroplan Center costs, such as rent for the Aeroplan Center and costs associated with supervisory staff, instructors and marketing people, are in the nature of common costs that are incurred to service multiple flights in different markets. These costs are not avoidable in the event of a flight cancellation. However, these costs are not included in the list of cost accounts that Air Canada provided to the Bureau, called the General Ledger Reconciliation (GL), as separate line items. They could be included in one or more of the overhead accounts. Other Aeroplan Center costs, such as the costs associated with personnel answering the calls, would be avoidable in the event of a flight cancellation. Either fewer personnel or less overtime would be required.

In Dr. West's view, some costs in a cost category are common costs while others are avoidable. In his view, the labour costs of ticket counter agents would not be common costs.

[107] The Tribunal disagrees with the respondent's characterization of all step-variable costs as entirely common costs. It is true that the salaries of baggage handlers and reservation call centre agents remunerate them for their labour with respect to various flights and routes, however, their activities are sequential, not simultaneous. Unlike the pilot that serves passenger and cargo businesses on the same flight simultaneously, the operational labour components of baggage handling and reservation call centres are divisible; those workers move from flight to flight as the outgoing flights depart and the incoming flights or telephone calls arrive. A labour cost in a given pay period is not a common cost simply because the worker performs several different tasks at different times in that pay period.

[108] The "commonality" seems to arise from the fact that the worker is paid a wage or salary for all work done, rather than paid by the flight or route serviced. Baggage handlers could be paid by the amount of baggage handled and call centre staff could be paid flight-specific commissions for booking passengers on particular flights or routes. In such arrangements, it would be clear that the labour cost is not a common cost of the several flights or routes handled but rather of the individual flights or routes served. However, as in the case of baggage handlers, this arrangement could be costly to administer and verify. In the case of reservation call centre agents, commission-based remuneration may establish the wrong incentives. Accordingly, if there is any common cost element in the labour component of step-variable costs, it is purely administrative.

[109] If, as a result of a flight cancellation, the workers were paid the same amount for doing less work, then the salary paid in respect of that flight would be an unavoidable cost. However, if they perform the same work elsewhere through passenger recapture or redeployment as discussed below, then the labour cost is avoidable with respect to the cancelled flight.

I. PASSENGER RECAPTURE

[110] In his expert affidavit and oral testimony, Dr. West states that one consequence of the cancellation of a schedule flight by Air Canada is that customers who would have taken that flight may travel on other schedule flights offered by Air Canada on the same route. Those customers may be passengers previously booked on the cancelled flight, as well as new passengers for whom the schedule flight is no longer available. Accordingly, the costs of the cancelled flight will be incurred on the other flights to the extent of this passenger recapture.

[111] Dr. West states that the costs no longer incurred due to cancellation of the schedule flight are avoidable costs of that flight for the purpose of the avoidable cost test, and become costs of the other Air Canada flights on which the recaptured passengers travel. In the West Affidavit at 51, he identifies a number of cost categories, such as incentive passenger commissions, as avoidable on this basis (as well as for other reasons).

[112] Regarding in-flight food costs, Dr. West quotes the statement of Mr. Piché from Air Canada (Examination for Discovery, 6 June 2001 at 111-13) who states that food costs are not avoidable in respect of protected passengers (West Affidavit at 55); in the event of individual or schedule flight cancellation, protected passengers (whom Air Canada commits to boarding on other flights) cause the same food costs as if cancellation had not occurred.

[113] According to Dr. West, when passenger recapture occurs following cancellation of the schedule flight in question, the avoidable costs on the remaining flights will increase. In the Tribunal's view, this conclusion assumes that the passengers taking the remaining flights do not simply displace the passengers that would have flown thereon regardless of the cancellation of the schedule flight in question; the conclusion assumes that there is excess seating capacity on these other flights.

[114] In effect, due to the recapture of passengers to the remaining schedule flights on the route, the resource (i.e. in-flight food) has been redeployed to those flights. Accordingly, the food costs on the remaining flights will increase yet, when all of the passengers are recaptured, Air Canada's total in-flight food cost will be the same as before the cancellation. Counsel for the respondent argues that passenger recapture therefore results in limited or no cost avoidance, but simply causes a reallocation of the food costs to the remaining flights that would have been incurred prior to cancellation.

[115] At paragraph 40 of the Dorman Affidavit, the respondent's expert on airline economics states that any expenses that would still be borne by Air Canada, but would merely be reallocated to another route or flight, are not truly avoidable.

[116] It is true that when Air Canada cancels a schedule flight, the fixed costs it had previously allocated to that flight are now distributed among the remaining flights. The result is that the fixed costs attributed to each remaining flight rise because the same amount of fixed costs are now spread over a smaller number of flights. However, the total fixed costs actually incurred have neither increased nor decreased because, by definition, they do not vary with changes in activity; they are unavoidable costs.

[117] The same cannot be said with respect to the food costs on the remaining flights; food consumption on those flights, and hence food costs thereon, have increased to the extent of passenger recapture and the resulting higher load factors, assuming excess capacity had existed on those flights. In the Tribunal's understanding, it cannot be said that the food costs on the cancelled flight have merely been reallocated to the remaining flights.

[118] The principal issue is whether excess capacity permits passenger recapture on the remaining flights on the relevant route. Relevant evidence could include the number of flights, historical load factors, the number of passengers, and importantly, the number of flights offered by competing air carriers.

J. REDEPLOYMENT AND DISPOSAL

[119] The parties disagree on whether a cost can be avoided through redeployment and disposal, and the type of evidence needed. The Tribunal discusses separately the issue of disposal relating to aircraft.

[120] Counsel for the Commissioner submits that redeployment of resources following cancellation of a schedule flight renders the associated cost (in whole or in part) on that flight avoidable. Redeployment might be achieved by shifting the resources of the cancelled flight, such as the aircraft, pilots, and cabin crew, among others, to other flights (including newly scheduled flights) or to third-party contracts. Generally, redeployment results in cost avoidability when Air Canada earns revenue in a new use that covers the cost of that resource, or avoids an expenditure that otherwise would have been incurred. Passenger recapture, as discussed above, is a form of redeployment.

[121] The Commissioner also submits that the ability to dispose of a resource makes the cost thereof avoidable with respect to the schedule flight in issue.

[122] The Commissioner further submits that evidence of the existence of profitable potential redeployment opportunities suffices to establish cost avoidability. Evidence of specific alternative uses to which Air Canada might have redeployed the resources of a particular cancelled flight should not be required.

[123] The evidence led by the Commissioner of Air Canada’s general ability to redeploy resources includes various public statements by senior management that such opportunities exist and are profitable, and evidence that Air Canada had many such opportunities arising from new services and routes, additional flights, elimination of redundant capacity, ordering and taking delivery of new equipment.

[124] Counsel for the respondent asserts that Air Canada lacks these extensive opportunities for redeployment, in part due to practical considerations including the location of employees and aircraft, timing and scheduling constraints, and in part because Air Canada is a mature network airline. In addition, evidence of specific opportunities must be shown, absent which the general presumption must be that Air Canada cannot avoid costs through redeployment (Respondent’s Final Argument at paragraph 165). The respondent further asserts that the opportunities must be profitable and that there is no evidence that Air Canada had more profitable opportunities to redeploy than those which it acted upon during the period under review.

[125] Dr. Dorman completely excludes redeployment as a consideration in assessing avoidability. It has been argued that some costs would be avoidable through the redeployment of inputs to alternative uses. In other words, certain costs would still be incurred by Air Canada, but would be treated as “avoidable” under the assumption that the resources would be redeployed elsewhere. In the expert rebuttal affidavit of G.J. Dorman (24 November 2002) confidential exhibit R-264 [the Dorman Rebuttal Affidavit] at 13-14, no costs are deemed avoidable through redeployment for the following reasons:

> There are several basic problems with defining “avoidability” to include an assumption of redeployment. First, it requires a specific analysis of the real-world opportunities for the redeployment of resources in order to justify adopting that assumption . . . Second, and closely related, is that it requires a substantial amount of “second-guessing” on the part of the analyst when attempting to determine how resources might be redeployed. This is particularly difficult in the airline industry because of the wide variety of geographically-dispersed resources (personnel, facilities and equipment) that are used to provide service. Third, the purpose of this proceeding is to establish a generalized methodology that can be applied across carriers, routes and time periods, with the goal of providing consistent guidance to airline managements and enforcement authorities. Any methodology that requires frequent, detailed, route- or flight- or station-specific studies to be conducted would be an unsatisfactory basis for public policy.

[126] In his rebuttal affidavit and in his oral evidence, Dr. Dorman observes that moving employees such as baggage handlers to other flights would not save costs because of scheduling problems. He states that Dr. West did not identify opportunities for profitable redeployment and that such opportunities did not exist in the period under review. He states that because air carriers generally staff for peak operations, cancelling a particular flight would not permit any staff reductions, especially at hub airports where staffing is needed to handle multiple banks of incoming flights (Dorman Rebuttal Affidavit at 15).

[127] Dr. Dorman states that many costs classified by Dr. West as avoidable through redeployment are common costs associated with airline operations at the station level, and hence are not affected by cancellation. He further states that flight cancellation will not affect call volume at Aeroplan or reservation centres, that it is impractical for Air Canada to adjust staffing levels from month to month as new flights are added or dropped, that staff hiring and terminations require time for training, notice and severance, and that Dr. West's assumption that these events can take place within one to three months is an assumption without basis in fact. Finally, Dr. Dorman asserts that Dr. West's assumption that costs fall "proportionately" with reduction in Air Canada's "scale of operation" is invalid (Dorman Rebuttal Affidavit at 16).

[128] Dr. Dorman notes that according to Dr. West's calculations, 42 percent of all of Air Canada's domestic flights operate below avoidable cost in the average month. Thus, in Dr. Dorman's opinion, Dr. West has effectively proved that there were no opportunities for profitable redeployment (Dorman Rebuttal Affidavit at 17-18).

[129] In the Tribunal's understanding, Dr. West allocated common costs of the Aeroplan Center to flights only because he did not have access to the data in the General Ledger that would have enabled him to distinguish between common and non-common costs. He identifies the labour costs of front-line workers in that and certain other areas as variable but not common costs.

[130] Dr. West does not state that Air Canada adjusts staffing in these areas on a month-to-month basis as new flights are added or dropped. Observing Air Canada's behaviour can provide evidence that is relevant to the proper conduct of the avoidable cost test but, as noted above, the conceptual nature of the test means that evidence of actual avoidance cannot be required. Dr. West makes findings as to what labour costs could be avoided after a hypothetical cancellation and he concludes that the amount of time needed to avoid costs generally is one to three months.

[131] With respect to labour costs, Dr. Dorman may have in mind the restrictions on hiring and termination in the applicable collective agreements. As noted, termination is only one way in which a cost may be avoided. At the hearing, there was considerable discussion about (i) Air Canada's use of part-time workers to cover peak periods; (ii) its ability to redeploy ramp workers and sales and gate agents; (iii) the surplus of CAW Union workers and the absence thereof in IAM Union workers due to layoffs; and (iv) the changes Air Canada makes to the flight schedule, without "rebidding the entire schedule", throughout the year (transcript at 31:5381-422 (11 February 2003)). Accordingly, the Tribunal regards Dr. Dorman's critique of Dr. West's opinion as incomplete. As discussed below at paragraph 201, the payment of overtime also indicates the avoidability of some labour costs. Moreover, Dr. Dorman did not indicate what time period is appropriate for staff termination.

[132] Finally, it is not clear what Dr. Dorman means when he states that Dr. West assumed proportionate cost reduction. Possibly Dr. Dorman is referring to the fact that common costs in certain categories would not be avoided upon cancellation of a single schedule flight, in which case he is agreeing with Dr. West. Except for aircraft costs as discussed below at paragraph 260, Dr. Dorman produced no evidence to counter Dr. West's findings.

[133] Moreover, it appears to the Tribunal that Dr. Dorman does not accept passenger recapture as a basis for avoidability through redeployment. He offers no analysis of conditions under which passenger recapture could be reasonably assumed. Furthermore, he insists that unless there are redeployment opportunities at the precise time of flight cancellation (which, in his view, scheduling difficulties prevent in any case), then certain costs (i.e. some of the affected baggage handlers) cannot be avoided. Regarding call centre volume, the Tribunal has noted above at paragraphs 106 and 107 that calls are associated with specific flights and routes and that Air Canada attempts to measure labour costs of the front-line staff in those centres and assigns those costs to flights and routes. The avoidability of costs that are not common costs cannot be ruled out *a priori*, and the Tribunal regards Dr. Dorman's total rejection of cost avoidability through redeployment in these areas as unfounded.

[134] As the Tribunal has stated above, the avoidable cost test proceeds based on an hypothesized flight cancellation. Accordingly, it is inconceivable that knowledge of specific redeployment opportunities could be anything more than speculative, more especially since the avoidable cost test will usually be conducted in an investigation long after the beginning of the alleged anti-competitive conduct. As such, the Tribunal cannot burden the Commissioner with the requirement to identify the specific redeployment opportunities at that point in history. However, the Commissioner must show that such opportunities were generally and realistically available at the time of the alleged predation.

[135] From the various announcements and actions of Air Canada, the Commissioner identifies 52 new routes on which Air Canada decided, announced or commenced service during the Phase I Period and 37 additional routes on which Air Canada increased or announced increases in service (Commissioner's Final Argument at Appendix 1). Evidence from internal correspondence suggests that Air Canada had difficulty finding aircraft to provide capacity in the Maritimes in 2000 (Maritime Capacity Correspondence, 7 May 2000, confidential exhibit A-145).

[136] The Tribunal notes that Dr. Dorman is the only witness to reject cost avoidability through redeployment. In his expert report and oral evidence, Dr. Baumol insists that redeployment be profitable, that opportunities be available, and that only the truly avoidable portion of a cost be included in the test. For example, the Baumol Article at 57-58, footnote 13, addresses aircraft redeployment:

> . . . For example, one cannot operate an airline between, say, New York and Milwaukee without investing in at least one airplane, an outlay whose amount does not vary with number of passengers until capacity is reached. Thus, this cost is fixed, and does not become variable even in the long run, because one cannot run an airline on the route with zero airplanes. In contrast, this cost is not sunk because, if traffic between New York and Milwaukee declines drastically, the plane can be shifted to serve another route . . . .

[137] The evidence of Messrs. Brewer and Forget of Air Canada (transcript at 23:3931-32 (30 January 2003)) is that Air Canada is always looking for opportunities to profitably redeploy assets and people:

> MS KAY: And can you explain from your perspective what redeployment is all about?

> MR. BREWER: Redeployment is really just taking these aircraft, scheduling them a different way to a different set of markets and seeing if you get a better system profit out of it.
>
> It's kind of pulling capacity out of here and moving it over there. Basically you are trying to see if you can find -- with a set of aircraft and expenses, how can I get the greatest amount of revenue to offset that flying.
>
> MR. FORGET: Which is a function of our job on an ongoing basis.
>
> MS KAY: And is the process, the redeployment process, if I can call it that, is it different in the good times or the bad times?
>
> MR. FORGET: Definitely. I mean in the good times you don't have enough resources to go after all the opportunities that are out there. You go back, you know, to summer 2000, I mean we were short of capacity, short of resources.
>
> When there is a slowdown that we have experienced, opportunities are much fewer to do such a reallocation of resources because the return on those additional opportunities are not positive.
>
> MR. BREWER: So the process is the same. During good times you never have enough aircraft and during bad times you don't have -- you have too many opportunities in bad times, you have poor opportunities, but you are constantly evaluating during the good and the bad times.

[138] Given that Air Canada is always looking for profitable opportunities to redeploy resources, Mr. Brewer states that at any given point in time, it has already identified and acted upon those opportunities (transcript at 23:3980-82 (30 January 2003)); accordingly, there are no such opportunities remaining.

[139] The Tribunal does not take issue with Mr. Brewer. However, in the context of the hypothetical cancellation that guides the avoidable cost test, new opportunities arise from the availability of resources that the cancellation creates. The assumption that Air Canada would allow such resources to sit idle is not supported by the evidence in this case; indeed, the evidence suggests the direct opposite.

[140] The Tribunal agrees with counsel for the respondent that opportunities for redeployment must enhance profitability. The Commissioner does not claim otherwise. In the Tribunal's view, the evidence of new routes, additional flights, redeployed assets, among others, demonstrates that Air Canada generally has many such opportunities and has used these opportunities to increase profits or minimize losses. A "profitable" redeployment opportunity is one that is profitable in the circumstances in which the decision is made and, accordingly, it must be assumed that Air Canada's decisions in redeploying resources are taken in order to increase profitability.

[141] In this regard, the evidence of the impact of the events of September 11, 2001, and the following economic downturn may suggest that opportunities were fewer in number. Yet, while these conditions may have reduced the desire of Air Canada management to expand activities and services, it cannot be said that the pressure to improve profitability was any less. Following September 11, 2001, Air Canada continued to redeploy resources and to determine opportunities for cost-savings, according to the remarks of Mr. Robert Milton, President and Chief Executive Officer of Air Canada in exhibit A-13, an Air Canada News Release, “Air Canada Releases Preliminary Third Quarter 2001 Results” (2 November 2001):

> . . . “After September 11, we swiftly took action to further cut costs including the necessary but difficult decision to eliminate 9,000 jobs, including the 4,000 previously announced. Our overall network capacity, including that of our regional airlines, is being reduced by up to 20 per cent and we are progressively removing 84 aircraft from the fleet, with 20 to be transferred to the low fare carrier in due course and up to four to our sports charter unit. We have introduced a strict cash conservation policy, we are reviewing contracts with our suppliers, we have restricted capital spending to mission critical requirements and we have implemented initiatives designed to stimulate traffic, such as Tango by Air Canada, which was launched yesterday . . .”

[142] Counsel for the respondent submits that the Commissioner’s approach to redeployment is entirely theoretical, in part because the time period needed to effect redeployment has not been addressed by the Commissioner in deciding whether a cost is avoidable through redeployment (Respondent’s Final Argument at paragraph 165). The Tribunal discusses this matter below, beginning at paragraph 166 in its treatment of the appropriate time periods.

[143] On the basis of the above, the Tribunal is of the view that the Commissioner has shown that redeployment of resources is a means by which costs can be avoided. In addition, Air Canada did have profitable opportunities to redeploy resources during the periods at issue in the application.

K. OVERVIEW OF THE TEST

[144] For illustrative purposes only, to summarize the avoidable cost test, the following table illustrates the calculation using the information from Air Canada’s 328 Report, as noted above at paragraph 92.

Avoidable Cost Test

plus	Passenger Revenues Cargo Revenues	
less	Passenger Expenses Traffic Expenses Capacity Flying Capacity Ground	*Variable expenses (avoidable)*
less	Market Value (aircraft ownership) Aircraft Insurance	*Product-specific fixed costs (avoidable)*
equals	Above or below avoidable costs	

For the sake of illustration, all costs are assumed to exclude fixed and common costs.

VIII. <u>THE QUESTIONS TO BE DETERMINED BY THE TRIBUNAL</u>

A. FARES

[145] Airfares vary widely in price, availability, conditions (or "fences") that are associated with the fare, whether the fare is for one-way or return travel, and class of service (i.e., business and economy class). Fares with fewer restrictions are generally higher than fares with more restrictions. The restrictions imposed by network carriers may include the following:

(a) advance booking and purchase requirements;

(b) minimum and maximum stay requirements;

(c) limits on refundability;

(d) limits on changes and change fees; and

(e) time of day, day of week, and flight specific restrictions.

[146] The Airline Regulations refer to ". . . fares that do not cover the avoidable cost of providing the service . . ." This wording suggests that more than one fare could be relevant in conducting the avoidable cost test.

[147] In the instant matter, the parties agree that the avoidable cost test should be based on the relevant revenue drawn from all fares charged rather than the individual fares that Air Canada announces.

[148] It appears to the Tribunal that this approach has been adopted because of the difficulties in identifying the avoidable cost associated with operating or increasing capacity at each of the multiple fares that Air Canada announces for schedule flights and routes. The related issue, also not contested in the instant case, is whether the Airline Regulations refer only to passenger fares or include the prices that Air Canada charges for cargo when the same aircraft on a schedule flight or route carries both passengers and cargo.

[149] The evidence shows that air carriers, including Air Canada, have established multiple fare classes for schedule flights and that fares offered to passengers vary both between and within fare classes. The evidence also shows that Air Canada has adopted a sophisticated "yield management" system which determines on a daily basis, if not more frequently, the number of seats available on an aircraft in a given fare class up to the departure of the individual flight on a given date. As a result, passengers may find that seats in their preferred fare class are not available because the yield management system has allocated them to different fare classes by the time bookings are made.

[150] The Airline Regulations do not specify a time period for the anti-competitive act. Accordingly, a dominant air carrier commits what is deemed to be an anti-competitive act if, at any time, it operates or increases capacity at fares that do not cover the avoidable cost of providing the service. This suggests that when capacity is operated or increased, each announced fare might be compared with the expected avoidable cost of serving a passenger in that fare class. This avoidable cost test would be applied at the level of the individual seat on an aircraft and would require separate tests for services on the same individual flight offered at different fares.

[151] Alternately, the expected revenue at announced fares could be compared with the total expected costs of providing the services to all passengers on the aircraft. Such an approach would be problematic as it would entail an assumption about the number of seats sold in each fare class, an assumption that would likely be incorrect given the practice of yield management.

[152] In the current matter, the avoidable cost test is applied *ex post*: both parties submit that total revenue actually received from (or attributable to) a schedule flight or route in a given historical time period should be compared with the corresponding actual total avoidable cost. This test is concerned with actual, rather than announced, fares in comparison with actual, rather than expected, avoidable costs.

[153] A method that involves total revenue and total avoidable costs over several different services will, in effect, be analyzing "product combinations" as discussed in the Baumol Article at 57-59. Accordingly, it will include all of the costs that are common to all of the services provided on the flight, hence avoiding the need to allocate such costs among services on the flight. For example, it avoids an allocation of the pilot's salary to the passenger and cargo business because the same salary expense would be incurred if either of the two businesses were cancelled.

[154] The Tribunal accepts that total actual revenue, rather than announced individual and cargo fares, is the proper basis for conducting the avoidable cost test in the instant case. In the Tribunal's view, it is consistent with the Airline Regulations that the avoidable cost test be conducted on the basis of aggregate revenue and aggregate avoidable cost over the appropriate unit of capacity.

B. THE APPROPRIATE UNIT OF CAPACITY TO EXAMINE UNDER THE AIRLINE REGULATIONS

[155] In the Phase I Order, Mr. Justice William McKeown provides, at paragraph 5, that the Tribunal shall address the following question: "What is the appropriate unit or units of capacity to examine?"

[156] The Commissioner's position is that in conducting the avoidable cost test the uni-directional schedule flight is the proper unit. The respondent asserts that the appropriate unit of capacity is the city-pair route.

[157] A "schedule flight" is a numbered departure scheduled at approximately the same time of day on some regular periodic basis, i.e. the daily 8:00 a.m. flight from Toronto to Ottawa. A "route" is the collection of all schedule flights operating between two airports. In the Commissioner's view, the avoidable cost test can legitimately be applied to one schedule flight, although there are special cases in which other units of analysis may be appropriate. Accordingly, the Commissioner examines the revenues and relevant costs of each schedule flight on the two routes at issue. The respondent conducts the test by aggregating and comparing the revenues and costs of all schedule flights on the same route.

[158] Both sides argue that the wording of the Airline Regulations supports their approach to the avoidable cost test. The Airline Regulations make it clear that a dominant air carrier commits what is deemed to be an anti-competitive act when it operates or increases capacity on a route or routes at fares that do not cover the avoidable cost of providing the service.

[159] Counsel for the respondent argues that the wording "route or routes" itself rules out the schedule flight as the unit of analysis. The Tribunal disagrees with the respondent on this aspect of wording. Whether it operates a single schedule flight on a route or multiple flights thereon, a dominant air carrier is operating capacity on a route or routes. Nevertheless, it can be argued that the language of the Airline Regulations supports various interpretations for the unit of capacity, so that the language cannot be the sole basis for a decision of the Tribunal.

[160] Counsel for the Commissioner submits that the avoidable cost test should be applied at the level of the schedule flight. He submits that applying the cost test at a higher level of aggregation would create the risk of masking predatory conduct on a flight level and thus defeating the purpose of the Airline Regulations. In support of this position, the Commissioner relies on the following elements: (i) the plain meaning of the Airline Regulations is that the unit of capacity is something less than a route; (ii) the nature of capacity in the airline industry: the smallest unit is a flight; (iii) economic theory, which indicates that predation can occur on a schedule flight; (iv) Air Canada's practice: in particular, Air Canada's Flight Profitability

System; and (v) practical considerations (Commissioner's Final Argument at paragraphs 232-33).

[161] Air Canada's position is that since the Airline Regulations specifically refer to "operating capacity on a route or routes at fares that do not cover the avoidable cost of providing the service" and do not mention the word flight, the ordinary language of the Airline Regulations requires the analysis to be performed on a route basis.

[162] The experts discussed the question of the appropriate unit of capacity at length. The Commissioner relies on the evidence of Drs. Tretheway and West who opine that predation can occur at the level of the schedule flight. Counsel for the respondent cites the evidence of Drs. Baumol and Dorman that below cost operation by a dominant carrier on a schedule flight indicates that there must be profitable opportunities on the same route for competitors; accordingly, predation at the level of the schedule flight does not threaten an equally efficient competitor on that route.

[163] In his testimony (transcript at 36:6219-22 (18 February 2003)), Dr. Baumol states that predation could be found at the level of the schedule flight. Accordingly, the avoidable cost test could be conducted at that level when the incumbent engages in successive predatory actions as the competitor moves from one departure time to another on the same route. In the Baumol Affidavit at 19, the author states that an incumbent may well operate a schedule flight below its avoidable cost but he suggests that there may be legitimate business reasons for doing so.

[164] Air Canada's expert, Dr. Belobaba, criticizes both the schedule flight and the route as proper units of analysis. In his view, the proper unit is the full aircraft rotation. However, he does not deny that predation could occur at the level of the schedule flight (expert affidavit of P.P. Belobaba (14 November 2002) confidential exhibit R-470 [the Belobaba Affidavit] at 13).

[165] It appears to the Tribunal that the expert evidence supports the possibility of predatory conduct at the level of the schedule flight. Accordingly, the Tribunal is of the view that operating a schedule flight below avoidable cost is an anti-competitive act pursuant to the Airline Regulations. Applying the avoidable cost test at the route level risks obscuring such conduct where it may be occurring. As the Tribunal has discussed above, the existence of a legitimate business justification for operating a schedule flight below its avoidable cost is not a consideration under the Airline Regulations.

C. THE APPROPRIATE TIME PERIOD(S) TO EXAMINE UNDER THE AIRLINE REGULATIONS

[166] The Phase I Order provides, at paragraph 5, that the Tribunal shall deal with two questions involving time periods:

(b) What categories of costs are avoidable and when do they become avoidable?

(c) What is the appropriate time period or periods to examine?

[167] As counsel for the respondent points out, it is important not to confuse these two questions. The first relates to the timing of avoidability of costs. The second concerns the period of time over which the operating results of the dominant airline will be considered for the purposes of the avoidable cost test (Respondent's Final Argument at paragraph 121).

[168] Counsel for the Commissioner submits that substantially all of Air Canada's costs, except overhead, are avoidable within three months. With respect to the second question, the Commissioner submits that, within the allegation period for each of the routes in issue, a three-month period is the appropriate one in which to conduct the avoidable cost test (Commissioner's Final Argument at paragraphs 22 and 23). Counsel for the Commissioner submits that revenues below avoidable costs in each of three successive months constitutes an anti-competitive act, but argues for a "forward-looking" approach.

[169] Counsel for the respondent submits no particular time period for the avoidability of costs, suggesting rather that the Tribunal set the parameters or factors that should be taken into account in determining what costs are avoidable (Respondent's Final Argument at paragraph 136). The avoidable cost test should be conducted over a twelve-month period, or the entire period of alleged predation (approximately one year for each route in issue in the instant case) having regard to seasonal effects. Counsel further submits that the conduct of the test should also take into account the time required by Air Canada to collect the relevant information and implement operational changes.

(1) The Commissioner's Approach

[170] Counsel for the Commissioner submits that with the exception of overhead, substantially all of Air Canada's costs are avoidable within a period of approximately three months from the time of a decision to remove an established flight from the schedule (Commissioner's Final Argument at paragraph 438).

[171] In a case where capacity is added to a route in response to entry or to a competitor, counsel for the Commissioner further submits that all of the costs associated with that increment of capacity should be considered avoidable immediately. Accordingly, if an airline leaves capacity in place at a time when it would normally have reduced capacity (i.e. in low season), this decision constitutes an increase in capacity, the costs of which are avoidable immediately (Commissioner's Final Argument at paragraph 439).

[172] Counsel for the Commissioner also submits that Air Canada has the ability to adjust scheduled service quickly, and relies on the opinions of Drs. West and Tretheway that the period required for Air Canada to know it is below costs, and to avoid costs, is three months in total, and in the opinion of Mr. Vettese, the relevant period could be as long as four months (Commissioner's Final Argument at paragraphs 444-46). Counsel for the Commissioner submits that Air Canada's reporting systems produce relevant information on flight profitability in short time periods and that it has moved rapidly to implement schedule changes in the past.

[173] In oral argument, counsel for the Commissioner states that the three-month period over which the avoidable cost test is conducted must be viewed as including the time Air Canada needs to collect and analyze flight profitability data and implement changes to ensure that revenues are above avoidable costs (transcript at 38:6612-26 (3 March 2003)).

[174] In the Tribunal's understanding, the Commissioner conducts the avoidable cost test on the basis of all costs that are avoidable as a consequence of cancellation, regardless of when avoidability commences. This is illustrated in the oral evidence. In the transcript at 38:6587-88 (3 March 2003), counsel for the Commissioner states:

> It didn't strike me appropriate to say a cost is not avoidable, is not avoidable, is not avoidable and then all of a sudden it is. I think the better way to look at it, in my submission, is to say: *It's an avoidable cost or it is not.* If it is, then the question is: What is the period of time it would take Air Canada or a carrier to avoid the cost? . . . [emphasis added]

In the transcript at 39:6805 (4 March 2003), he also states:

> The approach was to look at how long does it take to avoid these costs and to recognize that in developing a test, that is a relevant consideration: how long does it reasonably take to avoid these costs -- as is the flip side: how long should Air Canada be allowed to operate below, given the purpose of the test?
>
> On the issue of how long does Air Canada have to be below to be offside the test, it is driven largely by those two things.
>
> *We are not saying that you start with what is avoidable within three months and what is not, and whatever you decide on that those avoidable within three months are then the only avoidable costs.* [emphasis added]

This exchange takes place in the transcript at 39:6830 (4 March 2003):

> MEMBER SCHWARTZ: . . . So if a cost could not be avoided over one to three months, I take it the Commissioner's position is that cost does not get included.
>
> MR. HOUSTON: No. The Commissioner's position would be in that situation then you would continue to treat that cost as avoidable but recognize, if that is your conclusion, that it would take four months to avoid it and not three.
>
> So you don't exclude it from the mix. You just recognize, if that is the view that you take, that it takes another month to avoid.

And further at page 6833:

> MR. HOUSTON: All I am saying it is a different way. Instead of saying pick some time period and then look at what is avoidable within that time period and what is avoidable outside that time period, we have looked at it in the other direction in effect and said: *Try to come up with an assessment of how long does it take to avoid these costs and to apply the test over that period*, also recognizing that you don't want to get to the point where you have a test that takes so long to apply that it becomes a meaningless test. [emphasis added]

[175] Dr. West compares revenues with avoidable costs in monthly increments; it appears that he would include an avoidable cost for the entire month even if it could be avoided for only part of a particular month.

[176] With regard to determining the appropriate time period(s) to examine, the Commissioner compares revenues with avoidable costs in one-month increments: total monthly revenue is compared with total avoidable costs attributable to the month. This procedure is adopted in part due to the fact that Air Canada's reporting system produces relevant reports on a monthly basis. Counsel for the Commissioner further submits that a shorter period can produce misleading results due to temporary or random events that affect bookings, whereas a longer period may mask predatory pricing or capacity increases (Commissioner's Final Argument at paragraph 424).

[177] Counsel for the Commissioner submits that operating capacity below avoidable costs for three months should give rise to an inference of an anti-competitive act (Commissioner's Final Argument at paragraph 448). The Commissioner argues that a one-year period would be inappropriate because such period is long enough to drive a small competitor from the market and could mask predation.

[178] Having regard to the evidence of Dr. West, it is clear that the Commissioner is referring to three consecutive months, i.e. operating capacity when monthly revenue falls below monthly avoidable costs for three successive months. In oral argument (transcript at 38:6592-93 (3 March 2003)), however, counsel for the Commissioner recognizes that the requirement of three successive months could be problematic, and submits that the test should be "forward-looking":

> MR. HOUSTON: . . . The situation I was dealing with was a situation where you have a period of significantly below cost operations. Let's say starting in October the carrier is operating below costs in October and November, and then let's say in December, with Christmas, whatever, it is perhaps borderline or perhaps just above.

> The question is: Would we say that in that situation that means that there would have to be another three months of below cost operation in January, February and March and no anti-competitive act until the end of March?
>
> My answer to that would be no; that you would have an anti-competitive act in that situation based on the operation below October and November, and based on the fact that even if they get a little bit above in December, it would be foreseeable, likely, known that they are going to continue to operate below January, February and March.
>
> So in my submission, that would be an anti-competitive act.

[179] In response to seasonality concerns and the possibility that below cost operations in low season could mistakenly be deemed predatory, counsel for the Commissioner submits that seasonality is predictable and that Air Canada takes steps to reduce its impact. These steps include, among others, reducing capacity in winter, scheduling heavy maintenance in winter and redeploying capacity to “sun-destinations”.

(2) The Respondent’s Approach

[180] Counsel for the respondent emphasizes that the appropriate time period must take into account the time it takes for Air Canada to collect, synthesize and assess its financial information relating to route performance as well as the time necessary to make and implement operational changes once it has discovered that revenues are below avoidable costs. As Air Canada does not have the information or time needed to implement changes within the three-month period adopted by the Commissioner, the respondent argues that its conduct will be judged irrational inappropriately. Counsel for the respondent emphasizes this point (transcript at 40:7070-71 (5 March 2003)):

> . . . The reason that it matters, the reason that the time it takes to get the information matters is again because we are testing for irrational conduct. If we start creating a time period that is so short that it effectively doesn’t allow Air Canada any time to review the information, form an opinion and make adjustments, then we are labelling as anti-competitive conduct that is perfectly rational . . . .

[181] Counsel for the respondent submits that redeployment opportunities are few, that Air Canada’s reporting systems do not provide the information on performance until three to six weeks after the month being assessed, and that load-factor and booking-class information available prior to departure does not allow Air Canada to estimate profitability in advance.

[182] Counsel for the respondent also criticizes the Commissioner’s approach to cost avoidability and the conduct of the avoidable cost test because it does not take account of seasonality. As a result, operations below avoidable cost in low season may be mistaken as predatory when, in fact, the reason is low travel demand.

[183] Dr. Belobaba states that the relevant time period for the evaluation of operations is twelve months (Belobaba Affidavit at 12). Accordingly, all costs that are avoidable within twelve months would be considered in the avoidable cost test. Dr. Dorman suggests a one-year period if predation is alleged to be taking place during the off-peak period (Dorman Affidavit at 16). However, when predation is alleged in the peak season, he states that a shorter period of four to six months would be appropriate (transcript at 18:3165-66 (23 January 2003)). On this basis, only those costs that are avoidable within the four- to six-month period would be included in the test.

[184] Having regard, *inter alia*, to seasonality issues, Dr. Baumol regards the twelve-month period proposed by Air Canada as conservative. Generally, he states that the appropriate time period is the period of time that the alleged predatory act continued (Baumol Article at 14-15). However, as noted above at paragraph 73, he emphasizes that a cost should be deemed avoidable only for the time that the cost could be escaped within the pertinent time period.

[185] Counsel for the respondent criticizes the Commissioner's approach to time periods, on the basis that Dr. West's methodology leads to the inclusion of costs that are not avoidable within the pertinent time period. The appropriate period should include an avoidable cost only to the extent that it could be escaped within that period.

(3) The Tribunal's Analysis

[186] The language of the Airline Regulations makes it clear that a dominant air carrier commits what is deemed to be an anti-competitive act when it operates capacity on a route or routes at fares that do not cover the avoidable cost of providing the service. These regulations were developed and put into the Act with knowledge of industry conditions and practices and they do not specify a time period for defining what constitutes an anti-competitive act. Accordingly, whenever the dominant carrier operates capacity at fares below the avoidable cost of providing the service, it commits an anti-competitive act.

[187] It is, of course, the Commissioner's role to enforce the Airline Regulations and, accordingly, it is the Commissioner's obligation to indicate when fares were below avoidable costs when he alleges that an anti-competitive act or acts occurred during some period in the past. Whether it is three months, one month, one day or one flight departure on a given day, that time period will be the relevant one under the Airline Regulations.

[188] Indeed, it may seem surprising that the Commissioner has adopted so short a period. It was stated by witnesses for both sides that the longer the time period considered, the greater the share of costs that can be avoided. Correspondingly, it may seem surprising that the respondent favours a twelve-month period. At page 14 of the Baumol Affidavit, the author writes that he found this situation contrary to usual positions in predatory pricing litigation:

> Here it is significant to note that in predatory pricing litigation it is normal for the complainant to advocate a rather lengthy time period as the basis of the calculation, while the respondent or defendant normally advocates a much briefer time period, because, as just explained, the longer the time period selected the

> larger the magnitudes of the avoidable cost figures that will emerge from the calculations, and the hurdle that the prices at issue must surmount in order to pass the test becomes correspondingly more difficult. *Here, apparently, the normal pattern has been reversed, with the Competition Bureau advocating a one-month test period, and Air Canada proposing a period of at least one year.* [emphasis added]

[189] While Dr. Baumol refers here to the one-month increment adopted by Dr. West, his point applies equally to the three-month period in which Air Canada can allegedly avoid substantially all of its costs, except overhead. Indeed, Dr. Baumol finds it "astonishing" that this could be true, but he admits that his expert affidavit involves only principles and he has not done any empirical work in this case (transcript at 36:6229, 6258-59 (18 February 2003)).

[190] In light of Dr. Baumol's view that the pertinent time period for the avoidable cost test could be the period of time in which the alleged predatory conduct continued and since, in the Tribunal's view, the Airline Regulations permit the Commissioner to conduct the avoidable cost test over a three-month period, the Tribunal accepts that the three-month period suggested by the Commissioner might be appropriate. However, there is no reason for the Tribunal to make a ruling on this question as the Airline Regulations do not specify any time period. This question will be dealt with in Phase II of this hearing when determining if the anti-competitive act or acts constitute a practice pursuant to section 79 of the Act.

[191] The respondent's principal reason for favouring the longer time period is seasonality. Air Canada submits that using the longer period allows the revenues in high season to offset lower revenues in low season. The Tribunal does not accept this rationale. First, although several witnesses stated that airlines "lose money" in low season, the only evidence adduced was financial information presented according to regulatory or generally accepted accounting principles. In the Tribunal's view, these presentations are affected by arbitrary accounting policies (i.e. historical costs, depreciation) and they include fixed costs that do not affect the firm's operations. Dr. Dorman states in the confidential transcript at 18:749 (27 January 2003)):

> . . . All I am showing at the bottom is that on a net basis, after allocating all the system-wide costs and the overheads, carriers typically don't make money in the winter.
>
> That is partly a function of the allocation system, and it is partly a function of the fact that many of those costs are simply not avoidable.You don't run a major network carrier only six months of the year and shut it down the rest, which is what would be required to be done in order to not lose as much in the winter months.

In the Tribunal's view, such financial information does not establish that carriers "lose money" in low season.

[192] The Tribunal accepts the Commissioner's submissions that seasonality is predictable and that Air Canada take measures to improve performance in low season in the normal course of operations.

[193] The Airline Regulations provide no exclusion for operations at fares below avoidable costs in low season. Accordingly, it is an anti-competitive act to operate below avoidable costs in low season. However, the Commissioner has the discretion not to file an application when he determines that the only reason for fares below avoidable costs is seasonality.

[194] The Commissioner has adopted the results of Dr. West who conducted the avoidable cost test using a one-month increment. It appears to the Tribunal that the adoption of such period was influenced by the practical consideration that Air Canada's systems currently produce reports and analyses on a monthly basis. While the Tribunal accepts the one-month increment, it rejects the Commissioner's suggestion that a shorter period would be inappropriate due to temporary or random events that affect bookings. Again, the Airline Regulations provide no exemption for operating below avoidable costs because of random factors; however, it is within the Commissioner's discretion whether or not to proceed with an increment shorter than one month.

[195] Dr. West opines that a very large proportion of Air Canada's costs are avoidable within three months. This conclusion suggests that some of the avoidable costs that he included in his monthly calculations are not avoidable or fully avoidable from the outset.

[196] Both parties say that Air Canada requires time to collect, assess, and act upon the information. The Commissioner's submission that the three-month period for the avoidable cost test period contains sufficient time for Air Canada to comply is confusing because it tends to suggest that some of those costs are not avoidable for the full three-month period. While the respondent insists that the three-month period is too short to allow it to comply, it is clear that the same issue will arise with any period less than three months, and perhaps with certain longer periods as well. However, the Airline Regulations clearly specify that a dominant carrier commits an anti-competitive act whenever it operates capacity at fares below avoidable costs. Thus, in the Tribunal's view, the obligation on the dominant carrier to keep avoidable costs below revenue is continuous; there is no provision for a "grace period" during which the carrier may operate below avoidable cost while it is collecting and assessing information and implementing changes.

D. CATEGORIES OF AVOIDABLE COSTS

[197] The Commissioner submits that substantially all of Air Canada's costs, except overhead, are avoidable within three months.

[198] The parties agree that 17 cost items in the 328 Report are avoidable due to their variable-cost characteristics and that costs identified therein as overhead are unavoidable. The following list is compiled from the Commissioner's Final Argument at paragraph 294 and the Respondent's Final Argument at paragraph 139:

Food and Supplies	Passenger Insurance	Aeroplan Liability
Cargo Acquisition	Flight Delays	Cargo Loss and Damages
Flight Crew Cycle	Cabin Crew Cycle	Inflight Entertainment
Fuel and Oil	Fuel Handling	Navigation Fees
General Terminal Assessment	Landing Fees	Passenger Purchased Terminal Handling
Cargo Purchased Terminal Handling	Commissary Handling	

[199] Counsel for the respondent states that the cost categorization in the 328 Report is sometimes arbitrary and that certain costs shown as variable are in fact unavoidable. The respondent disputes the Commissioner's treatment of 26 costs in the 328 Report, and groups them into five broad categories: (1) system labour costs, (2) station labour costs, (3) aircraft labour costs, (4) non-labour system and sunk costs, and (5) aircraft ownership and insurance costs (Respondent's Final Argument at paragraph 140).

(1) System Labour Costs

[200] Six labour categories considered variable in Air Canada's 328 Report contain labour cost estimates attributed to individual flights. These labour costs are for employees that do not work on aircraft or at airports.

(a) Aeroplan Center Labour: Customer service agents who work in the Aeroplan Center
Reservation Direct Labour: Customer service agents who work at Air Canada Reservation Centres
City Ticketing Direct Labour: Customer service agents who work at Air Canada ticketing offices

[201] Relying on the evidence of Dr. West and Mr. Vettese, counsel for the Commissioner submits that these labour costs are step-variable and avoidable through redeployment. Overtime payments initiated to handle increased flight activity can be avoided when a flight is cancelled.

[202] Counsel for the respondent states that the activity is related to incoming-call volume, not changes in the flight schedule; the labour costs are common costs and hence no reduction in labour cost would occur following cancellation. In addition, the employees are members of the CAW Union and have job security until March 27, 2004 (Respondent's Final Argument at paragraph 178).

[203] Dr. West distinguishes these labour costs from the common costs in these categories. In the Tribunal's view, these labour costs associated with the cancelled flight will become associated with the other Air Canada flights on which Aeroplan members and other passengers would travel. The Tribunal regards these labour costs as avoidable, principally on the basis of redeployment through passenger recapture. Also, these costs are not common costs.

(b) Passenger Revenue Accounting Labour: Finance agents who work in Winnipeg
Cargo Accounting Labour: Finance agents who work in Winnipeg

[204] These employees are represented by the IAM Union (Respondent's Final Argument at paragraph 198). Accordingly, they have the same job protections as "below the wing" workers at Air Canada. The Commissioner notes, however, that Air Canada was able to reduce the number of finance and clerical personnel by 29.4 percent in 2001 through layoffs, voluntary leaves of absence programs, and attrition (Commissioner's Final Argument at paragraph 342).

[205] Neither Dr. West nor Mr. Vettese took account of severance, similar costs of layoffs and leave programs that Air Canada had established to promote labour flexibility. In argument, counsel for the Commissioner submits that these transaction costs are one-time costs, whereas the savings in labour costs endure, and concludes that transaction costs do not make an avoidable cost unavoidable (Commissioner's Final Argument at paragraph 218).

[206] Dr. Baumol emphasizes that when actions are taken to avoid costs, any costs incurred by the action should be deducted from gross avoidable costs. In the Tribunal's view, transaction costs must be considered to the extent that they are unavoidable; accordingly, the Tribunal agrees with the respondent that failure to do so results in overstatement of the quantum of avoidable costs. The Tribunal notes, however, that where avoidability is achieved through redeployment, severance payments will not be involved.

[207] The timing issue raised by the Commissioner is significant, as avoidability does not have a time dimension in the Commissioner's approach. It appears to the Tribunal that the correct approach would be to deduct appropriate transaction costs from avoidable costs in the relevant period to the extent that they would be incurred in that period. However, Air Canada did not provide any evidence as to how this matter should be handled.

[208] Apart from these issues, the parties' submissions regarding the labour costs in these two areas are identical to those previously discussed. But for the issue of transaction costs, the Tribunal views these labour costs as avoidable mainly through redeployment through passenger recapture.

(c) Heavy Maintenance Labour: Maintenance personnel

[209] The parties agree that heavy maintenance on an aircraft is performed on a regular calendar basis and requires a highly skilled and specialized workforce. Air Canada's Flight Profitability System includes, for each schedule flight, an annual budgeted amount of maintenance costs for the aircraft equipment type used on that flight.

[210] The respondent regards these labour rates as unavoidable due to the calendar-driven nature of these costs; they will not change if the schedule flight is cancelled and workers will not be terminated thereupon.

[211] Counsel for the Commissioner submits that the amount of such maintenance required is driven by the aircraft takeoff/landing frequencies and by wear and tear due to flying time. Accordingly, maintenance labour is a variable cost and could be reduced if cancellation led to reduced aircraft utilization with fewer aircraft being scheduled for maintenance.

[212] Counsel for the Commissioner points out that maintenance employees do not have job security protection under the IAM collective agreement. Further flexibility in maintenance labour costs is achieved through attrition. Counsel also notes that Air Canada did lay off not quite 20 percent of its maintenance workers after the events of September 11, 2001 (Commissioner's Final Argument at paragraph 381).

[213] Although not recorded in the Flight Profitability System, Air Canada incurs significant overtime costs for maintenance labour, approximately $25 million in 2000, equal to 13 percent of base maintenance salaries. Accordingly, the Commissioner submits, flight cancellation would reduce overtime labour costs (Commissioner's Final Argument at paragraph 382).

[214] The Commissioner also notes that flight cancellation, to the extent that it reduces demand for maintenance inside Air Canada, would increase its ability to obtain maintenance contracts from third parties. In effect, the redeployed maintenance labour would be earning revenue outside Air Canada and its cost would be attributed to the contract. Air Canada has earned significant revenues from such contracts with other airlines and has publicly stated its intention to sell a 49 percent interest in its maintenance division and increase such activity under separate management (Commissioner's Final Argument at paragraph 388).

[215] Finally, the Commissioner states that if the aircraft is redeployed to other flight(s) following cancellation of a schedule flight, its maintenance labour will be a cost of the new flight(s) and hence avoidable through redeployment.

[216] Accordingly, the Tribunal accepts the Commissioner's submission that heavy maintenance labour costs can be avoided in several ways and hence are properly treated as avoidable in the event of cancellation.

(2) Station Labour Costs

[217] Five labour costs considered variable in Air Canada's 328 Report contain labour cost estimates attributed to schedule flights. These labour costs are for employees that work in or at airports but not on aircraft.

(a) Airport Passenger Service Direct Labour: Check-in, gate and ticket agents
Maple Leaf Lounge Labour: Customer service agents who work in the Maple Leaf Lounges
Maintenance Labour: Line maintenance personnel
Passenger Aircraft Service Direct Labour: Customer service agents responsible for ground functions
Cargo Aircraft Service Direct and Sales Labour: Customer service agents responsible for cargo

[218] As a general matter, the respondent views all of these labour costs as common costs as these employees serve a number of flights or the airport as a whole. Moreover, these positions are "static" in that they must be staffed whenever the airport or the Lounge is open regardless of flight activity. Accordingly, the labour costs of these positions are unavoidable following cancellation of a single schedule flight.

[219] The scheduling of check-in, gate and ticket agents (Airport Passenger Service Direct Labour) and of ramp and baggage handlers (Passenger Aircraft Service Direct Labour) is governed by a sophisticated "bidding" process and is structured to meet the demands of peak periods in the day. Counsel for the respondent submits that the cancellation of a single schedule flight will almost never change these labour requirements, especially the cancellation of a flight in a peak period, and that workers whose shift is cancelled will receive another shift according to seniority. Accordingly, the respondent argues that a sophisticated and expensive pattern of rebidding would be required and hence Air Canada would not undertake such rebidding if a single schedule flight were cancelled (Respondent's Final Argument at paragraph 207).

[220] The check-in, gate and ticket agents and Maple Leaf Lounge agents are CAW Union members and have job security until March 27, 2004 (Respondent's Final Argument at paragraph 208). There is currently a surplus of CAW Union workers, so that Air Canada would not initiate the aforementioned bidding process simply to move one employee to the surplus pool.

[221] The Commissioner submits that Air Canada's airport staffing is driven directly by the flight schedule and hence the number of flights operated out of a station. The Commissioner views each of these costs as step-variable, inherently avoidable and avoidable through disposal, redeployment and passenger recapture.

[222] Counsel for the Commissioner submits that, despite the apparent scheduling complexities and costs, Air Canada has the ability to, and does in fact, make staffing changes on a regular basis and in a relatively short period of time. The evidence of Ms. Baril from Air Canada is that revisions to the schedule are communicated weekly to the stations and ground level staffing is adjusted correspondingly (transcript at 31:5341-42 (11 February 2003)).

[223] As evidence of avoidability through redeployment and disposal, the Commissioner points to the significant incidental revenue earned by Air Canada as a result of redeploying the employees in these categories to service flights of other airlines, to Air Canada's recently-announced intention to create a separate business for its technical and ground services and to sell a stake in that business to a third party.

[224] As evidence of outright avoidability, the Commissioner cites the significant amount of overtime paid to workers in these groups, the use of part-time workers and temporary employees for peak-season periods. The cancellation of a schedule flight can therefore avoid labour costs without necessarily terminating a full-time worker protected by a collective agreement.

[225] Finally, the Commissioner points to substantial reductions in workers in the CAW Union and IAM Union workforces in 2001, despite contractual rigidities and no-layoff provisions. For example, ramp workers, baggage and cargo handlers were reduced by 28.5 percent in that year (Commissioner's Final Argument at paragraph 323).

[226] In the Tribunal's view, having regard to redeployment by passenger recapture, the Commissioner has established that these costs are properly treated as avoidable.

(3) Aircraft Labour Costs

(a) Flight Crew Labour: Pilots
Cabin Crew Labour: Flight attendants

[227] These costs include pilot and flight attendant wages, benefits, pensions and payroll taxes. The costs are collected in the Flight Profitability System and assigned to particular schedule flights by direct feed through Air Canada's payroll system.

[228] The respondent notes that work schedules for these employees are set through a sophisticated bidding process that occurs monthly. Each monthly work schedules are bid on for flights in the following month.

[229] Flight and cabin crews are paid according to either (i) the time they are scheduled to fly, or (ii) the actual amount of flying time, whichever is greater, subject to monthly minimum-hour guarantees. These labour costs are unavoidable if a flight is cancelled after the schedules have been bid upon and assigned. When a flight is cancelled prior to the completion of the bidding process, the flight and cabin crew costs are not incurred. Accordingly, when a schedule flight is cancelled, the labour costs associated with the previously-scheduled departures are unavoidable, but no labour costs continue thereafter as no further scheduling of that flight will be made.

[230] Counsel for the respondent points out that Air Canada cannot lay off its flight attendants, or pilots under the Air Canada Pilots Association Agreement (Respondent's Final Argument at paragraph 220). However, counsel for the Commissioner observes that Air Canada has recently negotiated work-sharing and leave-of-absence programs to reduce these labour costs, that Air Canada's attrition rate for pilots is approximately 100 per year, and that the active flight and cabin crews fell by 122 and 1,285 respectively in 2001 (Commissioner's Final Argument at paragraph 309).

[231] The Commissioner further notes that labour costs pursuant to the monthly minimum-hour provisions are rarely incurred. This indicates to the Tribunal that profitable opportunities to redeploy pilots and flight attendants arise frequently.

[232] Subject to the short-term unavoidable costs of scheduled activity, the Tribunal accepts the Commissioner's submission that these costs are avoidable outright and through redeployment.

(4) Non-Labour System and Sunk Costs

[233] The respondent refers to these costs as non-labour system costs or costs that are sunk by the time a flight is cancelled.

(a) Passenger Commissions: Commissions paid to travel agents
Cargo Commissions: Commissions paid to cargo agents

[234] Air Canada pays regular and incentive commissions to travel agents. Counsel for the Commissioner submits that these commissions are avoidable in the event of cancellation of a schedule flight because there will be no further bookings thereon. However, counsel for the respondent submits that commissions paid for bookings prior to cancellation of the flight are not avoidable following cancellation; in essence, commissions already paid to travel agents are not refundable.

[235] The Commissioner does not dispute this aspect of these commission costs. If these commissions are non-recoverable, they are sunk and should be treated as an unavoidable cost.

(b) Passenger Acquisitions: Discounts paid to large corporate customers

[236] Counsel for the respondent submits that these payments are common costs that do not reduce upon cancellation of a schedule flight. Dr. West notes that if corporate passengers on the cancelled flight take other Air Canada flights, the payments become costs of these other flights. If corporate passengers do not fly on Air Canada, then Air Canada saves the discount (West Affidavit at 53).

[237] Accordingly, these costs are not common costs, and they are avoidable outright or through passenger recapture.

(c) Aeroplan Center Charges: Costs of operating the Aeroplan Center (excluding labour)
Maple Leaf Lounge: Costs of operating the Maple Leaf Lounges (excluding labour)

[238] The Commissioner does not dispute that the non-labour costs that are truly common costs of operating the Aeroplan Center and Maple Leaf Lounges are unavoidable. Dr. West identifies these costs as including rent and costs associated with the supervisory staff, instructors and marketing people (West Affidavit at 58, 61-62).

[239] Accordingly, these common costs should be treated as unavoidable.

(d) In-flight Magazines: Cost of on-board magazines and newspapers

[240] Although Air Canada’s 328 Report classifies this cost as variable, counsel for the respondent claims it is an unavoidable cost.

[241] It appears from Dr. West's evidence that none of the relevant contracts have minimum order requirements and that the lead time to cancel subscriptions is from a few days to two months. Dr. West also refers to Mr. Piché's Examination for Discovery (5 June 2001) that magazines would be redeployed from a cancelled flight to other flights (West Affidavit at 60-61).

[242] In the Tribunal's view, this cost is properly treated as avoidable.

(e) Passenger Communications: Computer reservation charges ("CRS") and telephone charges

[243] The respondent submits that reservation fees already paid for passengers booked on the cancelled schedule flight and telephone expenses are unavoidable costs.

[244] In the West Affidavit at 63-64 and footnote 52 therein, the Commissioner's expert states that certain costs in this category are common costs but that he can not isolate them in the General Ledger. Dr. West accepts, however, that CRS charges in respect of passengers already booked are not avoidable in the event of flight cancellation. He assumes that The Official Airline Guide subscription dues and the CRS fixed charges are included in overhead.

[245] The Commissioner acknowledges that when a flight is cancelled, the CRS fees incurred in respect of passengers already booked is unavoidable (Commissioner's Final Argument at paragraph 337).

[246] On this basis, the Tribunal agrees with the respondent that these costs are unavoidable.

(f) Airport Security: Costs paid to third parties for airport security

[247] The 328 Report shows an allocation of security costs to each flight based on passengers boarded. Counsel for the respondent submits that this is a common cost and is in the nature of overhead and, as such, would not be avoided in the event of flight cancellation.

[248] The Commissioner asserts that prior to April 2002, the largest airline at an airport was responsible for contracting for airport security. The cost was then shared among all airlines at the airport on a per passenger basis.

[249] Accordingly, if one flight were cancelled and the passengers did not fly on other Air Canada flights, the cost paid by Air Canada would decline. If the passengers were recaptured on other Air Canada flights, the security cost would be incurred on those flights.

[250] Thus, the security cost was an avoidable cost through April 2002.

(g) Passenger Revenue Accounting: Costs associated with passenger accounting (excluding labour)
Cargo Accounting: Costs associated with cargo accounting (excluding labour)

[251] **Counsel for the** respondent submits that these non-labour costs are common costs associated with operating the accounting function office in Winnipeg.

[252] According to the West Affidavit at 74-75, Air Canada regards the passenger revenue accounting costs as "mostly comprised of labour". Dr. West concludes that 89.6 percent of Passenger Revenue Accounting costs are avoidable on this basis.

[253] Dr. West found that Cargo Accounting costs were included in "Other Traffic" in the General Ledger and he assumed that this was true of the Other Traffic cost in the 328 Report. He found that 12.4 percent of Other Traffic expenses are unavoidable (West Affidavit at 76).

[254] Accordingly, the Tribunal agrees with the respondent that the non-labour costs in these areas are unavoidable.

(h) Maintenance Material: Costs of maintenance parts and materials

[255] Counsel for the respondent submits that because maintenance on an aircraft is a scheduled activity, the cost of maintenance materials declines only marginally with the cancellation of a schedule flight.

[256] It appears, however, that Air Canada does not separate the materials costs of scheduled maintenance from those of line maintenance (Commissioner's Final Argument at paragraph 368).

[257] Materials costs arising from line (unscheduled) maintenance should be expected to vary with flying activity. If flight cancellation results in reduced aircraft utilization, then line maintenance and the associated materials costs should decline.

[258] Counsel for the Commissioner submits that if the aircraft is redeployed to other flights following flight cancellation, there will be no reduction in maintenance costs of either type and materials costs would be attributed to the new flights.

[259] In the Tribunal's view, if aircraft utilization declines, maintenance materials costs are avoidable in proportion to the decline. If aircraft redeployment to other flights is possible, then all maintenance materials costs are avoidable through redeployment.

(5) Aircraft Ownership and Insurance Costs

(a) Background

[260] Aircraft ownership costs appear in the 328 Report as combined “market value and aircraft insurance”. The concept of aircraft ownership costs could be confusing as the label does not indicate what Air Canada measures or its objective therein.

[261] It appears that, prior to 1993, Air Canada followed the industry practice of defining aircraft ownership costs to include certain costs incidental to the use of the aircraft in its control, such as aircraft leasing costs, engine leasing costs and depreciation, *inter alia*. The measurement and presentation of these costs were based on certain accounting conventions, for example, historical cost of leases and depreciation; interest cost and equity cost were excluded. It appears that these ownership costs continue to be included in the Overhead category in the Flight Profitability System, and are consequently treated as unavoidable costs.

[262] In his testimony (transcript at 26:4397-98 (4 February 2003)), Mr. Brotto identifies the reasons why Air Canada adopted a market value approach to aircraft ownership costs:

> . . . The allocation of aircraft ownership was based on whatever the depreciation policy was. The depreciation policy changed over time.
>
> When I joined, we used to depreciate aircraft over 12 years; the next generation aircraft was 20 years; the next generation aircraft was 25 years. So you could have this arbitrariness in depreciation policy impact aircraft ownership.
>
> The fact that you didn’t count interest -- we borrowed money to finance these aircraft and yet we never recorded the interest component in the aircraft ownership.
>
> It depended on not only depreciation policy, but whether you owned versus leased, and it reflected a historical perspective.
>
> What we wanted to do is we wanted to reflect a more current perspective, because we wanted the marketing people to understand that we don’t want you to keep asking for an aircraft type because (a) it is fully depreciated or cheap, or whatever. It is based on an historical decision. It is simple; we are going to have to replace that fleet.
>
> You should really be reflecting what is the current market value to acquire an asset like that.
>
> The other choices to the company could have been we could either sublease that aircraft or sell it for its current fair market value, which may be a superior decision than you continuing to deploy it on a particular route because of an historical anomaly.

[263] Air Canada derives a market-value lease rate from the annual valuation of its fleet by AVITAS, Inc., an independent airline valuation firm (AVITAS document, confidential exhibit A-129). It has adjusted the first such estimated figure for lease income for a given type of aircraft annually according to the estimated change in market value of that aircraft type. Then it allocates the lease income to each aircraft of that type in the fleet per flying hour. That amount now appears in the 328 Report and allows Air Canada to compare the variable contribution of a schedule flight with the income it could earn by leasing the aircraft to a third party. In the 328 Report, aircraft ownership costs are shown immediately below variable contribution and above overhead.

[264] This measure of foregone income can be viewed as a cost of the particular aircraft in its current use in the sense that, as with other costs, if it is not covered by revenue then the flight is insufficiently profitable. In the 328 Report, aircraft ownership costs are comparable in magnitude to the largest variable expenses shown, except fuel.

(b) Positions of the Parties

[265] Counsel for the Commissioner submits that aircraft ownership costs are avoidable through redeployment: if a schedule flight is cancelled, the aircraft can be moved to another flight or route to which the aircraft ownership costs will then be attributed. In final argument, the Commissioner submits that aircraft ownership costs are product-specific fixed costs (transcript at 38: 6584-85 (3 March 2003)).

[266] The Commissioner also states that aircraft ownership costs are avoidable outright through disposal of the aircraft via resale, sublease, returning the aircraft to the lessor, not ordering new aircraft or deferring delivery of aircraft ordered, and through not operating ("parking") the aircraft.

[267] The respondent views aircraft ownership costs as overhead and submits that Air Canada's market value lease rate approach overstates the actual ownership cost of the aircraft in its fleet. The fact that Air Canada did not reduce the market value lease rate in the 328 Report in 2002 or 2003, despite a decline in aircraft market values, indicates that the amount shown thereon does not reflect a true economic cost that could be saved upon flight cancellation. Moreover, because Air Canada allocates an annual figure on the basis of flying hours, aircraft ownership costs will be higher in periods such as low season when flying hours are lower.

[268] Counsel for the respondent further states that aircraft serve the system as a whole, hence the ownership costs are common costs. In addition, the cancellation of a single schedule flight would not give rise to disposal of an entire aircraft. The markets for sale and sublease are thin and have not existed at all since 2001, as indicated by the number of parked aircraft. Further, the respondent submits that the Commissioner has ignored the transaction costs associated with disposal, subleasing and parking, and those costs associated with lease terminations. In the respondent's view, aircraft ownership costs are avoidable only through redeployment to new and more profitable opportunities immediately upon flight cancellation; however, such opportunities did not exist in respect of the sample routes under review.

(c) Tribunal's Analysis

[269] As to the argument that a market-value based approach is wrong in principle, the Tribunal notes that even Dr. Baumol in his testimony (transcript at 37:6365 (19 February 2003)), regards it as correct, although he was not familiar with Air Canada's specific approach:

> MR. HOUSTON: So you can say, Professor, that the fair market value, the price at which you could dispose of the aircraft or the price at which you could lease out the aircraft, because it is the fair market value that is an avoidable cost.
>
> DR. BAUMOL: Yes. I have said that all along.
>
> The point is that it may be a tiny portion of what the firm still owes on account of the airplane. It may represent a tiny portion of what it had hoped to get out of the aircraft. It may represent a tiny portion of its original payment after full depreciation has taken place. All those other numbers are irrelevant.
>
> What is avoidable -- and I have always said some portion of an aircraft ownership cost is avoidable in general, unless the market has [no] buyers. At least the scrap value is avoidable. That scrap value in a terrible market is the fair market value.

[270] The Commissioner's accounting expert, Mr. Vettese, in his testimony (confidential transcript at 15:578 (19 December 2002)), states that a market-value based approach is appropriate:

> I think with respect to the approach to aircraft costs the use of a market value as opposed to, as you have indicated, trying to determine costs perhaps in an incomplete way, in a different way such as trying to build up costs and then worry about how it is financed, et cetera. I believe very strongly that the fair market value approach is the right approach to use for aircraft costs, clearly.

[271] Taken in conjunction with Dr. Baumol's view that the fair market value of aircraft is an avoidable cost and with the reasons given by Air Canada's managers for moving to that approach, the evidence clearly supports the use of a market-value based approach to aircraft ownership costs in the avoidable cost test.

[272] In particular, the Tribunal rejects the view at page 27 of the Dorman Affidavit that the market-value lease rate is hypothetical as it is not based on actual transactions of Air Canada. Dr. Dorman does not criticize the accuracy of the valuations provided by AVITAS, Inc., and he offers no other way to assess aircraft ownership costs. His position is that aircraft ownership costs are unavoidable.

[273] The respondent correctly observes that Air Canada did not reduce the fair market-value lease rate in 2002 or 2003, as conditions apparently warranted. This suggests, and perhaps led to, mistakes in the assessment of flight profitability at Air Canada in those years, but does not challenge the validity of the approach when properly and consistently applied. The correct figure for an avoidable cost test is the current market-value lease rate, even if Air Canada has declined to use it for certain months in flight profitability analysis. In any case, these years are outside the period which the instant case concerns.

[274] The respondent suggests that aircraft ownership costs, as determined by Air Canada's calculation procedure, are too high in low season months when flying hours decrease. However, the respondent does not argue that the lower aircraft ownership costs in high season months must also be inaccurate. In the Tribunal's view, the problem may be resolved if Air Canada updates its market value estimate more frequently; that Air Canada has not done so indicates that it does not find it worthwhile. Accordingly, the Tribunal accepts Air Canada's monthly calculations of the market-value lease rate.

[275] Referring to the Attempted Reconciliation of Aircraft Costs (Market Value to GL), confidential exhibit A-124, produced by the Commissioner's accounting expert, Mr. Vettese, counsel for the respondent argues that the estimated market-value lease rate is well in excess of Air Canada's actual ownership costs. However, it is not clear what "actual ownership costs" the respondent has in mind. The ownership costs based on historical cost accounting procedures cannot be said to be accurate; Air Canada rejected those costs as inaccurate. On the evidence, it appears to the Tribunal that the market-value based approach is superior to the accounting-based approach that Air Canada had itself rejected for flight profitability purposes. Accordingly, the Tribunal rejects the respondent's assertion that Air Canada's fair market value is greater than Air Canada's actual ownership costs (Respondent's Final Argument at paragraph 223).

[276] For reasons given above, the Tribunal does not consider aircraft ownership costs as common costs; like call centre agents and baggage handlers, the aircraft serves one individual flight after another. When an aircraft is taken out of active service and "parked" indefinitely, the ownership costs become common costs in the sense that they burden the entire operation, not individual flights and routes.

[277] The view that the cancellation of a single schedule flight would not give rise to disposal of the aircraft on that flight misstates the proper test, which is whether Air Canada could avoid the relevant costs. In any case, disposal is only one way in which aircraft ownership costs could be avoided.

[278] The respondent's main criticism is that profitable redeployment opportunities do not generally exist, either for lack of markets or for reasons of restrictions in the leasing agreements. The evidence in Tables 6 and 7 of the Dorman Affidavit is that Air Canada's fleet of narrowbody aircraft was largely stable in the 1990-1999 period and in the sixteen months from January 2000 to April 2001.

[279] The Commissioner contends that in fact there were many changes to the composition of the fleet and demonstrates, on Dr. Dorman's numbers, that 106 changes to fleet composition occurred in 1990-1999. During this period, the older DC9s and B727s were retired and replaced with Airbus equipment, a trend that continued until all of the DC9s were retired by March 2002 (Commissioner's Final Argument at paragraph 400).

[280] In addition to new routes and service expansions in the Phase I Period as noted above, Air Canada placed orders for 32 aircraft in 2000 and took delivery of 11 (Air Canada 2000 Annual Report, exhibit A-4 at 5 and 40). Air Canada's 2001 Annual Report, exhibit A-130 at 34, describes the ways in which it adjusted its fleet:

> During 2001, Air Canada took delivery of 16 aircraft: four Airbus A330-300, four Boeing 767-300, five Airbus A321 and three Airbus A319 aircraft. In addition, by year end 2001, 30 aircraft had been removed from service at the Mainline carrier: one leased Boeing 747-400 scheduled to return to service in 2002, three Boeing 767-300 aircraft subleased to Qantas Airlines, returning to Air Canada in January 2002, four Boeing 767-200 aircraft parked and available for sale or return to the lessor, 13 DC-9 aircraft available for sale, nine Boeing 737-200 aircraft of which four were subleased and five were parked pending either return to lessors or potential sale.

[281] Accordingly, aircraft ownership costs were avoided by disposal, sublease, and return to lessor, indicating to the Tribunal that such costs can be avoided in several ways. Accordingly, these costs are not sunk costs to the extent that the claimed amounts thereof represent realizable market value.

[282] At paragraph 409 of the Commissioner's Final Argument, counsel submits:

> "Parking" an aircraft can mean simply not flying it for a few hours in the day, in which case the aircraft will remain at the airport. It also refers to parking the aircraft in the desert for an extended period of time.

[283] Counsel for the Commissioner also submits that to the extent that an in-service aircraft is not flown, its ownership cost is reduced through "power by the hour" lease payments that affect a few aircraft. The Commissioner's expert on airline economics states, at page 66 of the Tretheway Affidavit, that regular maintenance offsets an aircraft's deterioration allowing it to continue to perform at the same rate until the end of its economic life. Accordingly, the value of an aircraft is equivalent to its remaining life. Hence, not flying the aircraft reduces normal maintenance costs.

[284] The Tribunal disagrees with the Commissioner that "parking" an aircraft in the desert avoids the ownership costs. It appears to the Tribunal that the aircraft that Air Canada has removed from service but has not disposed of have no ready market; the market value may be close to scrap value. Air Canada does not allocate the ownership costs thereof to "market value and aircraft insurance" in the 328 Report; they may however be included in overhead in that report.

[285] The Tribunal disagrees with the respondent's submission that profitable opportunities for redeployment on the routes in issue must be shown. As stated above, the Tribunal will be satisfied if the Commissioner shows that opportunities for redeployment were generally and reasonably available. Taken together with other statements by Air Canada senior management on the record, the Tribunal regards as convincing the evidence that Air Canada had the ability to avoid aircraft ownership costs shown in the 328 Report during the Phase I Period in various ways.

E. BEYOND CONTRIBUTION

[286] Beyond contribution is an attempt to measure the importance to the initial flight leg of carrying connecting or through passengers from a city to other destinations within the network. Air Canada calculates this by taking the amount of a continuing passenger's fare that is prorated to the connecting leg (the beyond revenue) and subtracting a measure of cost for carrying the passenger on the connecting leg (the beyond cost).

[287] Air Canada has used different approaches to measuring beyond contribution. Currently, beyond costs are calculated in two different ways depending on the load factors on the beyond flight. In the first calculation where the number of continuing passengers from a given flight is below the break-even load factor of the beyond flight, the cost deduction is composed principally of marginal costs which are passenger commissions, passenger acquisition, food and supplies, passenger insurance, Aeroplan charges, and other passenger expenses. This generally amounts to 20 percent of Air Canada's costs. In the second calculation, where the number of continuing passengers from a given flight is greater than the break-even load factor on the beyond flight, then Air Canada deducts all costs shown in the 328 Report, except overhead, for those passengers. This represents about 90 percent of Air Canada's costs.

[288] Air Canada states that it makes regular use of beyond contribution in its ongoing assessment of route performance, and the beyond contribution numbers appear on all the flight profitability "All Statistics" reports used by the Air Canada planning and marketing department (confidential exhibit R-428).

[289] The result of this formula is that the variable and ownership costs per passenger will only be used for continuing passengers when the number of continuing passengers from each flight exceeds the break-even load factor on the beyond flight. The Commissioner points out that due to this feature of the calculation, very few of Air Canada's flights will incur the full variable cost of carrying continuing passengers. In the Commissioner's submission, the measure of beyond cost will understate the true cost of carrying continuing passengers and hence beyond contribution will be overstated.

[290] Counsel for the Commissioner further argues that including beyond contribution in the avoidable cost test assumes that the entire amount of beyond revenue attributed to the schedule flight being analyzed would be lost upon cancellation thereof. To the extent that some or all of the continuing passengers would continue to take Air Canada flights on the subsequent legs, Air Canada recaptures their business and cancellation does not lead to loss of beyond revenue. The Commissioner further submits that Air Canada will not lose continuing passengers on either domestic or international routes. Regarding the two routes at issue in this case, Air Canada itself offered other flights thereon and competitors on the two routes offered only a limited number of flights on subsequent legs.

[291] In oral evidence (transcript at 37:6388-89 (19 February 2003)), Dr. Baumol indicates that the extent of recapture is an important consideration in determining the appropriate treatment of beyond contribution. He regards Air Canada's assumption of total loss of continuing passengers as no more justified than the Commissioner's assumption of full recapture.

[292] In the Belobaba Affidavit at 24, Air Canada's expert on airline management clearly states that, for a continuing passenger, the correct revenue figure for evaluation of a flight segment is the continuing passenger's network revenue contribution, i.e. the total passenger fare. Dr. Belobaba states that when an originating flight leg is cancelled, the airline loses not only the revenue of local passengers on that leg, but also all of the revenue from continuing passengers because all connecting traffic is lost, and he doubts that all revenue from continuing passengers could be recaptured on other flights.

[293] At page 26 of the Belobaba Affidavit the author points out that the use of network revenue contribution is valid only when the continuing passenger does not displace local passengers on the continuing leg. If the continuing passenger displaces such a passenger, then the fare of that displaced passenger should be deducted from network revenue contribution. He also discusses the "Spill Model" for approximating such displacement costs. Dr. Baumol also states that incremental number of passengers on the continuing leg should be calculated net of the passengers displaced (transcript at 37:6442-43 (19 February 2003)).

[294] Mr. Piché from Air Canada states that an approach previously used for beyond cost considered displacement. He states that the approach currently used does not. He also states that the current approach is not a good indicator thereof (confidential transcript at 25:1207-09 (6 February 2003)).

[295] Counsel for the Commissioner further submits that by double-counting revenues and not deducting the appropriate costs, including beyond contribution would allow a dominant carrier to subsidize predatory behaviour with revenues that are not properly attributed to the operation of capacity on a route.

[296] Air Canada claims that the word "fare" when paid by a connecting passenger is for that passenger's origin to destination journey; there is no "fare" for each separate leg. However in Air Canada's Flight Profitability System, the fare actually paid by a continuing passenger is prorated to the different legs of the passenger's journey.

[297] Air Canada also claims that the phrase "route or routes" referred to in paragraph 1(*a*) of the Airline Regulations supports the inclusion of beyond contribution in the analysis, in that the use of the plural "routes" in the Airline Regulations identifies for analysis a unit greater than the single local route under consideration.

[298] Air Canada further claims that beyond contribution does not result in "double-counting" because it is not aggregated over the entire system. Rather, it is considered in the context of analyzing individual routes and includes the actual fares paid by the passengers travelling on those routes and that failure to include beyond contribution would amount to undercounting or discounting of revenue on the route being considered because of the prorate system.

[299] The Tribunal accepts that Air Canada is a network carrier, whose "raison d'être" is to serve passengers travelling across the network. In light of the network attributes emphasized by Dr. Belobaba, the Tribunal is of the view that the revenue of continuing passengers that Air Canada attributes to subsequent legs and flights should be included in beyond revenue when the issues of recapture and displacement have been addressed in some reasonable way. The burden is on Air Canada to provide reasonable estimates of recapture and revenue displacement consequent to the hypothetical cancellation and it has not done so in respect of the two routes at issue.

[300] Correspondingly, the relevant costs for inclusion in beyond cost are those incremental costs imposed on the network by the reasonably-expected continuing passengers. This matter received less attention; it follows however, that if net incremental revenue for those continuing passengers is used, the corresponding incremental costs should be used.

[301] Accordingly, the Tribunal finds that there is no proper basis for including beyond contribution as submitted by the respondent. Further, the Tribunal accepts the Commissioner's submission that, when properly estimated, beyond contribution could be considered as a legitimate business reason for operating a schedule flight below avoidable cost, but is not to be included in the calculations for that test.

IX. <u>THE ISSUES TO BE DETERMINED BY THE TRIBUNAL</u>

[302] Pursuant to the Phase I Order, the Tribunal must decide whether Air Canada operated or increased capacity at fares that did not cover the avoidable costs of providing the service (a) on the Toronto-Moncton route between April 1, 2000 and March 5, 2001; and (b) on the Halifax-Montreal route between July 1, 2000 and March 5, 2001.

A. AIR CANADA'S RESPONSE TO WESTJET (TORONTO-MONCTON)

[303] The Commissioner alleges that in 1999, the Toronto-Moncton route was one of Air Canada's worst performing, qualifying as one of the "Bottom 20" performing routes. Consequently, for the year 2000 and before WestJet's entry, Air Canada had planned to reduce capacity by 9.3 percent. This reduction entailed going from two DC-9s (182 seats) to three F28s (165 seats) (Commissioner's Final Argument at paragraph 84).

[304] On January 20, 2000, WestJet announced that, commencing in mid-April 2000, it would enter the eastern Canadian market, offering service out of Hamilton, Ontario.

[305] On February 29, 2000, WestJet further announced that, commencing on April 19, 2000, it would offer service on the Hamilton-Moncton route with one way fares, ranging from $129 to $339 (Commissioner's Final Argument at paragraph 89).

[306] On March 10, 2000, Air Canada's proposed strategy included:

(a) increasing capacity from three F28s to two F28s and one 737;
(b) converting existing lowest regular return fare into a one-way fare in order to match WestJet's $129 offering; and
(c) increasing the allocation of lower fare seats "on competing flights".

For the year 2000, the strategy's projected impact on the Toronto-Moncton route was a negative contribution of approximately $1.93 million, or -12.5 percent (Commissioner's Final Argument at paragraph 90).

[307] A few days after announcing service, Air Canada prepared another revenue impact analysis based on a higher projected yield assumption. Three projections were presented based on different levels of capacity:

(a) Stop Gap - three F28s;
(b) Middle - two F28s and one 737; and
(c) Aggressive - three 737s.
All three continued to project negative variable contributions for the year 2000.

[308] Between March 13 and April 1, 2000, Air Canada (Commissioner's Final Argument at paragraph 92) decided to:

> (a) increase capacity on the Toronto-Moncton route from 3 F28s to 2 DC9s and 1 CRJ for the month of May 2000, and to 2 737s and 1 F28 from June forward. This represented an increase in capacity of 55% over what was planned prior to WestJet's announced entry;
>
> (b) match WestJet's lowest one way fare of $129 with a 10 day advance purchase one way fare, offer a 5 day advance one way fare of $179, and a one way walk-up fare of $249. The $249 fare undercut WestJet's walk-up fare of $339.

[309] In his testimony, WestJet's Chairman, Mr. Beddoe, explains that by adding capacity in response to entry, Air Canada can offer enough seats at discounted fares to "suck up" all of the demand. This can prevent the entrant, in the case at bar WestJet, from selling seats at higher fares and achieving a profitable yield. Mr. Beddoe states (transcript at 3:475-76 (2 December 2002)):

> . . . Enlarging the number of seats sold at that lower fare class will mean that neither of us will ever get to our higher fare class. But if you don't care how much money you lose on the route, it doesn't matter to them. But it matters to us.

[310] In the past Air Canada did not meet competition with an unrestricted walk-up fare. The undercutting of WestJet's walk-up fare was an exceptional response and resulted in a disproportionate impact on its revenues. It is Mr. Beddoe's evidence that walk-up passengers represent five to seven percent of passengers but generate 20 to 25 percent of revenue (transcript at 3:474-75 (2 December 2002)).

[311] Air Canada's final revenue projection, taking its capacity additions and lower fares into account, showed modestly positive contribution margins in the peak season May to August 2000. These peak-season estimates were much lower than the actual margins for the same period in 1999. Moreover, no estimate of the full-year profit margin was made.

[312] Demand in the summer 2000 peak-season was exceptionally strong. Air Canada operated all of its flights on the Toronto-Moncton route above avoidable cost in July and August.

[313] In the fall of 2000, Air Canada reduced capacity on many of its domestic routes. It also considered pulling back capacity on its Toronto-Moncton route from two 737s and one F28 to one 737 and two F28s, but maintained its summer capacity in accordance with its "WestJet strategy". This capacity remained in place until May 2001.

[314] During the Phase I Period, WestJet incurred losses on its Hamilton-Moncton route. Its performance improved subsequently.

B. AIR CANADA'S RESPONSE TO CANJET I (HALIFAX-MONTREAL)

[315] The Commissioner submits that CanJet I was modelled on Southwest Airlines' low cost, low-fare model. It operated a "no-frills service", using six planes of one aircraft type, a non-unionized labour force, and electronic ticketing.

[316] In April 2000, CanJet I announced its intention to offer passenger airline service from Halifax to a number of eastern Canadian cities. On July 31, 2000, it announced that it would commence service between Halifax and Montreal, which it did on September 25, 2000.

[317] CanJet I's announced lowest fare was $99 one-way. In response, Air Canada matched this fare with its 14-day advance purchase "L14EAST" fares, but only on flights with similar departure times to those of CanJet I. On August 28, 2000, CanJet I announced a special fare of $89 one-way. Air Canada did not match this fare at that time. Prior to CanJet I's entry, Air Canada's lowest fare on the Halifax-Montreal route was $390 return in low season and $473 return in the high season (confidential exhibit A-9, Air Canada new fares document).

[318] In October 2000, Air Canada ceased offering the "L14EAST" fares, in accordance with a temporary order issued by the Commissioner pursuant to section 104.1 of the Act.

[319] In November 2000, Air Canada decreased capacity on the Halifax-Montreal route from seven to six flights in accordance with previous plans. On November 6, 2000, Air Canada offered a new return "L14SPCL" fare of $228.

[320] In early 2001, Air Canada decreased capacity again from six to five flights as part of a system-wide review called "Q1 Network Optimization". In February 2001, it offered two additional fares: "NECONO2" fare of $178 return, and a short-lived "LAC" fare of $89 one-way.

[321] CanJet I's costs were in line with its initial projections, but its revenues were much lower. CanJet I's Chairman, Mr. Rowe, attributed this to Air Canada's response.

[322] In April 2001, after suffering heavy losses, CanJet I was acquired by Canada 3000 which, in November 2001, declared bankruptcy.

C. THE TRIBUNAL'S FINDINGS

[323] The Tribunal must take into account the timing of the coming into effect of the Airline Regulations when assessing the results. Therefore, the Tribunal applies the standard that existed prior to the enactment of the Airline Regulations for the period prior to August 23, 2000. In particular, it means that any evidence of anti-competitive conduct might be offset by a legitimate business justification. Such justification was recognized and applied in the Tribunal's past jurisprudence. While the Tribunal could have accepted a legitimate business justification in this case for the period of allegation prior to August 23, 2000, the respondent did not expressly present evidence thereto. As a result, the Tribunal assessed the evidence before it in order to make such determination.

[324] Given its concerns with Air Canada's formula for calculating beyond contribution, the Tribunal will not consider any amounts in respect thereof in determining whether Air Canada committed anti-competitive acts, whether before or after August 23, 2000. As indicated, the Tribunal could consider beyond contribution as a legitimate business reason for operating below avoidable cost in Phase II, but only if Air Canada's formula addressed the problems of passenger recapture and displacement satisfactorily.

[325] Regarding schedule flights on the Toronto-Moncton route, Dr. West examined each schedule flight by month from January 2000 to February 2001 inclusive (although the period at issue in the application is from April 1, 2000 to March 5, 2001). For example, in January 2001, flight QK8613, one of three schedule flights operated by Air Canada or affiliates from Moncton to Toronto in that month, had revenues of 18.9 cents/ASM and avoidable costs of 23.1 cents/ASM (West Affidavit at Table 5).

[326] Within each month and for each schedule flight, Dr. West determined the number of individual flights (i.e. departures) that were above and below avoidable costs. For flight QK8613, six individual flights flew above avoidable costs in January 2001 while 22 were below (West Affidavit at Table 5).

[327] In determining the number of schedule flights in a month, Dr. West counted all schedule flights departing at the same time as one schedule flight. However, he assessed each schedule flight separately when determining whether it operated above or below avoidable cost and accordingly his approach creates inconsistencies in a few instances. In the Tribunal's review of Table 5 of the West Affidavit, 73 monthly schedule flights on the Toronto-Moncton route operated in the eleven-month period from April 2000 to February 2001, inclusive. Forty-three schedule flights thereof had monthly revenue below monthly avoidable costs. Of those 43 schedule flights, 216 individual flights operated above avoidable cost and 762 were below.

[328] Using the same methodology for analyzing schedule flights on the Halifax-Montreal route, and acknowledging that Dr. West identified some data difficulties, Table 6 of the West Affidavit identifies 111 monthly schedule flights from August 2000 to February 2001 (although the period at issue in the application is July 1, 2000 to March 5, 2001). Of these, 72 monthly schedule flights had revenues that did not cover avoidable costs. Of those schedule flights, 279 individual flights operated above avoidable cost and 1,187 were below.

[329] It appears to the Tribunal that the costs that Dr. West treated as avoidable in his monthly calculations were fully avoidable throughout each month, either through outright shedding, redeployment or disposal. Having regard to the Tribunal's findings on avoidable costs, there is no indication of contractual or other restrictions that prevented Air Canada from escaping those costs from the point of hypothetical cancellation. Thus, while the Tribunal rejects the Commissioner's broader view of cost avoidability, it finds that Dr. West followed the approach advocated by Dr. Baumol.

[330] It is possible that certain costs that Dr. West treated as avoidable are overstated because, lacking access to the General Ledger, he was not able to fully exclude common costs. In his affidavit, Dr. West identified the cost categories where this problem arose and he adjusted his calculations to reduce the possibility of error.

[331] It appears to the Tribunal that Dr. West relied heavily on redeployment through passenger recapture. As the Tribunal noted above, the plausibility of passenger recapture is determined by excess capacity on other Air Canada flights on the route and, *inter alia*, the availability of flights on that route offered by competing carriers. Along with the calculations in Table 5 and Table 6 of the West Affidavit, Dr. West provided monthly load factors for each schedule flight. Many of these load factors are below the 70-75 percent range that, according to the evidence of Messrs. Brewer and Forget, give rise to "spill situations" (transcript at 22:3806-07 (29 January 2003)). This evidence tends to support Dr. West's assumption of full passenger recapture.

[332] However, certain monthly load factors cited by Dr. West are in the range that would suggest spillage and the absence of excess capacity, and this evidence tends to suggest that full passenger recapture was not possible in those months. In the hearing, there was some discussion of the interpretation of load factor evidence, and it may be that monthly estimates are too highly aggregated to give a realistic picture of excess capacity on particularly flights. For example, if the monthly load factor is 75 percent, there would be days and weeks within the month where the load factor could be much lower (transcript at 22:3806-07 (29 January 2003)). In the Tribunal's view, the evidence of monthly load factors is not dispositive.

[333] The tables in the West Affidavit also indicate that WestJet and CanJet I were the only alternate carriers with schedule flights on the two routes, and that they offered very few flights. This evidence tends to support the assumption that Air Canada would recapture a very significant portion of the passengers from a cancelled flight on its other flights. Together with the available load factor evidence, the Tribunal accepts Dr. West's assumption of passenger recapture and cost avoidance thereby.

D. SPECIAL CONSIDERATIONS FOR THE RELEASE OF THESE REASONS AND FINDINGS

[334] By way of letters from counsel for Air Canada and for the Commissioner, received respectively on April 8, 2003 and on April 11, 2003, the Tribunal was informed of the Initial Order in *Air Canada (Trustee of) (Re)* (ONSC 03-CL-4932) made under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, by Farley J. of the Ontario Superior Court of Justice dated April 1, 2003 (the "Farley Order"). At paragraph 70 of the Farley Order, Farley J. requests "the aid and recognition" of the Tribunal, among others, "to act in aid of and to be complementary to this Court [Ontario Superior Court of Justice] in carrying out the terms of this order."

[335] Following a telephone conference with the parties on April 15, 2003, the Tribunal issued the Order Regarding the Issuance of the Final Reasons and Order dated April 16, 2003 (2003 Comp. Trib. 6), where it confirmed that although it agreed with the spirit of the Farley Order, the said order was not binding on the Tribunal. Regarding the issuance of its reasons, the Tribunal concluded at paragraph 10 of its April 16, 2003 order that:

> In the spirit of Farley J.'s Order, when the reasons and order are ready, the Tribunal will consider whether it is appropriate to release them.

[336] Pursuant to the Tribunal's order of April 16, 2003, the Tribunal is of the view that it is now appropriate to release these final reasons and findings and to provide a copy to Farley J. of the Ontario Superior Court of Justice. However, to comply with paragraph 70 of the Farley Order and to respond to the request of "aid and recognition" of the said Order, the Tribunal hereby orders a stay of execution of the present reasons and findings until the stay ordered on April 1, 2003, by Justice Farley is lifted. Indeed, while the Tribunal recognizes that these reasons and findings contain important information for the parties, the divulging of which should not be further delayed, the Tribunal wants to ensure that the appeal period does not start until the aforementioned stay ordered by Farley J. is lifted.

X. CONCLUSION

[337] In response to the Phase I Order, the Tribunal finds that for the purpose of conducting the avoidable cost test pursuant to the Airline Regulations:

(a) **What is the appropriate unit or units of capacity to examine?**
The unit of capacity is the schedule flight.

(b) **What categories of costs are avoidable and when do they become avoidable?**
The categories of costs that are avoidable are those discussed above beginning at paragraph 197; the avoidable costs so found are avoidable from the outset by virtue of shedding, redeployment or disposal.

(c) **What is the appropriate time period or periods to examine?**
One month is an appropriate period of time to examine.

(d) **What, if any, recognition should be given to "beyond contribution"?**
No recognition should be given to "beyond contribution".

[338] Based on these answers to the questions posed in the Phase I Order, the Tribunal finds that in the period from April 1, 2000 to March 5, 2001 (the date of the application), Air Canada operated or increased capacity at fares that did not cover the avoidable costs of providing the service on the Toronto-Moncton/Moncton-Toronto route.

[339] The Tribunal also finds that in the period from July 1, 2000 to March 5, 2001 (the date of the application), Air Canada operated or increased capacity at fares that did not cover the avoidable costs of providing the service on the Halifax-Montreal/Montreal-Halifax route.

[340] At this stage, it is important to note again that, even if the Tribunal concluded that Air Canada failed the avoidable cost test, it does not lead to a conclusion that Air Canada has engaged in an abuse of dominant position under section 79 of the Act. Indeed, a *practice* of anti-competitive acts, among other elements, must be demonstrated under that provision. The element of "practice" and other elements set out in section 79 will have to be determined in Phase II of the hearing.

[341] The evidence filed as confidential with the Tribunal shall remain designated as confidential. However, to ensure the intelligibility of these reasons and findings, references to confidential evidence herein are now deemed public information.

DATED at Ottawa, this 22nd day of July, 2003.

SIGNED on behalf of the Tribunal by the panel members.

(s) Pierre Blais

(s) Lorne R. Bolton

(s) Lawrence P. Schwartz

APPEARANCES:

For the applicant:

The Commissioner of Competition

Donald B. Houston
W. Michael G. Osborne
Jeanne L. Pratt
Jim Marshall

For the respondent:

Air Canada

Katherine L. Kay
Eliot N. Kolers
Danielle K. Royal

For the intervenor:

WestJet Airlines Ltd.

Daniel J. McDonald, Q.C.
Alicia K. Quesnel