CT-2000 / 004

THE COMPETITION TRIBUNAL

IN THE MATTER OF the *Competition Act*, R.S.C. 1985, c. C-34, as amended

AND IN THE MATTER OF an Application by Air Canada pursuant to subsection 104.1(7) of the *Competition Act*

AIR CANADA

Applicant

- and -

COMMISSIONER OF COMPETITION

Respondent

AFFIDAVIT OF WILLIAM J. BAUMOL
(sworn November 1, 2000)

I, **WILLIAM J. BAUMOL**, of Monmouth Beach, New Jersey, in the United States of America, MAKE OATH AND SAY:

Qualifications

1. My name is William J. Baumol. I reside at 45 Ocean Avenue, Monmouth Beach, New Jersey, 07750, USA. I am professor of economics and Director of the C.V. Starr Center for Applied Economics at New York University. This statement is based on nearly forty years of experience in working on transport regulation in the United States, both in university studies and in the actual regulatory arena.

2. I received my bachelor's degree in economics from the College of the City of New York in 1942 and my Ph.D. from the University of London in 1949. After my military service in Europe during World War II, I taught at the London School of Economics from 1947 through 1949. I then served as a member of the faculty of Princeton University for 42 years, where I recently became professor *emeritus*, and where I still hold an appointment as Senior Research Economist. I have written more than 30 professional books and 500 articles. I have served as president of four leading professional organizations of economists including the American Economic Association, the world's largest organization of economists from business, government, colleges and universities. I hold nine honorary degrees and other honors in the United States and abroad, and am a member of three of the nation's leading honorific societies, including the National Academy of Science.

3. I have taught university courses on the economics of antitrust, regulation and industrial organization, and have been invited to lecture on these subjects in forums throughout the world, most recently in Australia, France, Israel, Italy, England and Venezuela. I have also written a number of articles and books related to these subjects and have testified extensively on antitrust and regulatory issues before courts and regulatory agencies in the United States and abroad. Over my almost fifty years of activity as an economist, I have analyzed a number of issues related to antitrust matters in a wide variety of industries. Attachment A to this affidavit provides a fuller description of my qualifications.

Nature of this Affidavit

4. I have been retained by Air Canada regarding this matter and have been asked, in connection with Air Canada's challenge to the issue by the Commissioner of Competition (the "Commissioner") of an Order dated October 12, 2000 (the "Temporary Order") prohibiting Air Canada from charging certain fares on five city pair routes (the

"Restrained Routes"), to provide my preliminary opinion regarding the issue of the Temporary Order.

5. Air Canada has provided me with certain facts relating to the circumstances at issue in this case which I have relied upon in forming my preliminary opinion. Those facts on which I base my initial opinion are set out at paragraphs 6 to 15 below.

Facts Relied On

6. Air Canada is a full service network airline providing domestic, trans-border and international air service.

7. CanJet, a start-up discount airline, announced on July 31, 2000 and August 10, 2000 that it would commence flying certain routes in eastern and central Canada in September 2000. CanJet's business plan appears to be modelled on that of SouthWest Airlines in the United States in that it is a low cost carrier, utilizing a common aircraft fleet and providing a "no frills" service.

8. CanJet's network plan as at August 10, 2000 involved providing service to at least fourteen city pairs. Some of these fourteen city pairs were to be served only by one-stop or two-stop service. On all of these city pair routes, CanJet's one way ticket prices were lower than any of Air Canada's lowest one way ticket prices. However, CanJet's prices on a round trip basis were approximately equal to or higher than Air Canada's lowest year-round ticket prices on six of the routes. On the remaining eight of CanJet's routes, CanJet's original prices on a round trip basis were lower than Air Canada's lowest year-round ticket prices.

9. On August 24, 2000, another domestic discount carrier, Royal Airlines ("Royal"), announced that it was expanding its regularly scheduled domestic service. Royal served seven of the routes also served by CanJet, but overall did not serve as many city pairs as CanJet. Royal undercut CanJet's prices on certain routes.

10. On August 28, 2000, CanJet responded to Royal by substantially reducing the ticket prices on most if not all, of its routes (calling the new prices "Smart Fares" or "Special Fares"), even those on which it was not competing with Royal.

11. On August 31, 2000, Air Canada established new fares on the eight CanJet routes on which CanJet's original prices on a round trip basis were lower than those of Air Canada. In most cases, Air Canada's new lowest ticket price matched CanJet's original ticket prices (pre-Smart Fares) on a one-way basis. Air Canada did not match CanJet's Smart Fares or Special Fares on any routes, and consequently *never actually matched CanJet's lowest prices at any time.*

12. CanJet's fares are all based on one way travel and they do not have a minimum stay or advance purchase requirement. Air Canada's new lowest fares on these routes are called either L14EASTS fares or LL7NITE Fares, depending on the route. L14EASTS fares are for one way travel but require a 14 day advance booking. LL7NITE fares are return fares which require a Saturday night stay and a 7 day advance booking. Both the L14EASTS and the LL7NITE tickets are non-refundable and have a $100 fee for changes.

13. Air Canada did not increase capacity in response to CanJet on any of the CanJet routes.

14. On October 12, 2000, the Commissioner issued the Temporary Order under section 104.1 of the *Competition Act* stating, among other things. that:

a. The Commissioner considers it likely that in the absence of a temporary order, CanJet is likely to be eliminated as a competitor on specific routes and suffer other harm;

b. In the Commissioner's opinion Air Canada has engaged in conduct which could constitute anti-competitive acts in that Air Canada reduced fares to target CanJet on five city-pair routes. These routes are Halifax-Ottawa,

Halifax-Montreal, Halifax-St. John's, Toronto-Windsor, and Ottawa-Windsor (collectively, the "Restrained Routes"); and

c. Air Canada is prohibited from offering or selling, directly or indirectly, L14EASTS or similar fares on the Restrained Routes.

15. The ticket prices on the Restrained Routes for Air Canada's L14EASTS fares and the comparable CanJet original fares, CanJet Smart Fares, Royal lowest fares, and Air Canada's previous lowest fares, are as follows:

Route	**CanJet Original Fare (July 31 & August 10)**	**CanJet Smart Fare (August 28)**	**CanJet Special Fare (August 28)**	**Royal Fare (August 24)**	**Previous Air Canada Low Fare**	**L14 EASTS Fare**
Halifax – St. John's	$109.00 one way	$89.00 one way	$69 one way	N / A	$254.00 return	$109.00 one way
Halifax – Ottawa	$109.00 one way	$99.00 one way	$87 one way	$106.00 one way	$390.00 return	$109.00 one way
Halifax – Montreal	$99.00 one way	$89.00 one way	$67 one way	$99.00 one way	$390.00 return	$99.00 one way
Ottawa – Windsor	$139.00 one way	$119.00 one way	$99 one way	N / A	$500.00 return	$139.00 one way
Toronto – Windsor	$89.00 one way	$69.00 one way	$59 one way	N / A	$211.00 return	$89.00 one way

This table does not take into account the number of seats actually available at the lowest prices for any of the air carriers, nor does it take into account the fact that on each of the routes all three carriers have passengers flying at a range of higher fares.

My Preliminary Opinion

16. The definition of "anti-competitive act" in the regulations to the *Competition Act* which appears to be pertinent in this case is "operating capacity on a route or routes at fares that do not cover the avoidable cost of providing the service". Evaluation of the allegedly anti-competitive character of the act at issue must consider whether there could be an abuse of dominant position which, by definition, requires there to be a "substantial lessening of competition". The same "substantial lessening" analysis (together with other factors) is required in any consideration of predatory pricing.

17. In my opinion, from the facts described above, Air Canada's actions cannot be said to be anti-competitive or to have resulted in a substantial lessening of competition. Air Canada never matched CanJet's lowest ticket prices. Even if price matching had taken place, this cannot result in a substantial lessening of competition. Simply put, *all* competitors must be allowed to compete. Matching of a competitor's price is a fundamental feature of competition. The reduction of prices to match competition is an indicator of the effectiveness of competition, and cannot be said to be a lessening (let alone a "substantial lessening") of competition. Moreover, where the impugned action entails reduction of prices to a point above that which would constitute matching, the case is even stronger. The act in question simply cannot entail anti-competitive conduct or lessening of competition.

18. A price that is not below a floor constituted by average avoidable cost (avoidable cost per unit of output) cannot be deemed predatory. This is so because, as standard economic analysis recognizes, such prices will never lead to the exit of a profit-seeking competitor that is at least equally efficient, that is, whose costs, including avoidable costs, are at least as low as those of the firm under scrutiny. An efficient rival, when facing such prices, will always find it more profitable to remain in the market than to exit. This is certainly true at least unless the prices at issue are retained for a period of time sufficiently long for all sunk outlays to become variable (in which case, however,

they will automatically enter into avoidable cost). The logic of this assertion is clear. If the rival in question were to exit it would, by definition, save itself only the avoidable costs that it would incur by remaining in the market. But along with that limited saving, it must forego the revenues it would obtain by staying in that business. If price were indeed above the average avoidable cost, it follows that by exiting the firm would give up revenues greater than the costs it escapes. Evidently, an act that reduces revenues more than it cuts costs must inescapably reduce profits. Consequently, no price cutter can expect to drive out a rival by means of its low prices so long as those prices remain above the corresponding average avoidable costs.

19. In the short run, a price that matches that of a competitor cannot be deemed anti-competitive. For the reasons just mentioned, this is particularly so if the prices exceeds average avoidable cost. But, in any event, in the sequence of events in question, it is the entrant that initially selected the prices at issue and, by choosing them voluntarily indicated that it deemed them viable, at least in the short run. By matching these prices the incumbent is consequently not forcing any entrant to adopt prices any lower than those it itself introduced.

20. Evidently, competition in a market is enhanced further after entry if both the entrants and the previous incumbents survive and continue their rivalry than if ill-advised intervention forces the exit of the incumbents. But that is patently a likely consequence if matching of an entrant's low introductory fares by an incumbent is prohibited on the unsustainable ground that it is anti-competitive. Such a rule clearly takes over control of the industry from the market, and threatens the survival of the incumbents who probably will be unable to induce their former customers to remain with them, rather than migrating to the lower priced entrants.

21. Since in the circumstances here at issue the Air Canada fares were all actually higher than those of the entrant, and more restrictive as well, I am forced to conclude that the notion that they constituted anti-competitive behaviour is totally indefensible.

The regulatory action, though undertaken presumably with the intention of protecting competition, manifestly does the opposite. Regulation has itself been known to produce anti-competitive consequences. A regulatory action that clearly prevents either of a pair of rivals from competing fully and fairly is a manifest example, in which the appearance of competition is preserved at the expense of its substance.

SWORN BEFORE ME at the City of New York, in the State of New York, in the United States of America this 1st day of November, 2000.

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WILLIAM J. BAUMOL

AIR CANADA Applicant	And	COMMISSIONER OF COMPETITION Respondent	CT-2000/004

THE COMPETITION TRIBUNAL

AFFIDAVIT OF WILLIAM J. BAUMOL
(sworn November 1, 2000)

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