Canada's Competition Bureau is studying whether competition in the domestic airline industry is working as desired. Any assessment of competition in the airline industry is complicated be of its concentrated nature. A useful framework considering the scope of airline competition is the Structure–Conduct–Performance (SCP) paradigm.

Structure refers to the number of players, the similarity of the product, and the costs of entry and exit. Domestic competition in Canada is limited to four scheduled passenger airlines – excluding the Arctic and remote communities. Air Canada and WestJet, which are "full service" airlines, account for over 80% of the market. They operate airport hubs to serve domestic, transborder and international passenger services, as well as air cargo services. The two small airlines, Flair and Porter, operate point-to-point services with niche strategies. Flair positions itself as a discount carrier, while Porter offers non-price benefits and caters more to a business clientele.

For many consumers, air travel has become a commodity. All companies use the same airplanes, with minimal differences in the non-price attributes of the service. The geography of the market also matters. The narrow, linear shape of the Canadian market means that all competitors fly the same parallel routes across the country, leaving scant room for differentiation.

Industry entry and exit depends on the ratio of fixed to variable costs. A high proportion of fixed costs favours industry concentration. However, some costs can be made semi-variable, such as by leasing aircraft and by subcontracting labour, e.g., baggage handling. The largest variable cost is fuel. Entry costs involve setting up a reservation system, labour contracts, renting airport space and maintenance operations. Industry exit is easier, but these become sunk costs.

Large airlines experience economies of scale and size. The more origin-destination pairs in their network, the bigger their customer base. Size also enables airlines to form hub and spoke networks. Larger aircraft, which are more profitable, can be deployed from hub locations. Economies of size also apply to operations such as, hangars, maintenance, and overhead expenses.

Conduct of firms is generally opaque. Regulations exist to curb anti-competitive activities, like price-fixing, misrepresentation, and abuse of a

dominant position. In an oligopolistic market however, tacit collusion is possible. The major players can react to each other's moves with an eye to sharing the market and maximizing their joint profits.

Until the mid-1980s, airline conduct was subject to strict price and route regulation with the goals of stability and consumer protection. The airlines were stable, but the ticket prices were sky high. Opening the airlines to competition brought air travel within reach of the masses.

Deregulation of the airlines was based on the theory of contestable markets. Essentially, this theory holds that the participants in a market with few rivals could conduct themselves in a competitive manner, providing the threat of new entrants was sufficient to cause them to focus on sales rather than profits.

The history of the Canadian airlines since deregulation has supported the reliance on contestable market theory. The number of new airlines entering and exiting has kept the market competitive. For example, the big airlines set up "discount subsidiaries" to meet the challenge posed by new entrants by matching their fares and routes.

Performance of the airlines is measured by their profitability and efficiency. Profitability is easier to assess for publicly traded companies, than efficiency. In general, investors have viewed the profitability of the scheduled air carriers as less attractive than most publicly traded companies.

Whether air service in Canada is as efficient as it could be is clouded by protectionism. Domestic competition is constrained by cabotage restrictions. Foreign airlines are prohibited from competing for passengers within the Canadian market. Protectionism also applies to the percentage of foreign ownership. Removing restrictions on the access to international investment capital could enable smaller carriers to reach more efficient scale and to be more resilient.

Since deregulation, airline competition in Canada has resulted in two large scheduled carriers and the entry/exit of a series of smaller carriers. The recent loss of a very small airline (Lynx) does not mean that further contraction is inevitable, but instability is the price of efficiency. Applying the Structure-Conduct-Performance lens to airline competition in Canada suggests that the

status quo is providing reasonable outcomes for most consumers, notwithstanding service cuts in some smaller centres.

The ability of new entrants to challenge the dominant carriers is the basis for the relaxed level of economic regulation in Canada. The presence of smaller carriers forces the larger players to act in a more competitive manner. Whether these small carriers can remain economically viable is an open question, but it is important that government policy continues to make it possible for challengers to contest the market. The Competition Bureau should examine the removal of foreign investment restrictions and possibilities to negotiate cabotage with the U.S.

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