

# THE REGULATION OF U.S.-CANADA AIR TRANSPORTATION:

PAST, PRESENT AND  
FUTURE

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On April 11, 1991, the Transport Minister of Canada and the U.S. Secretary of Transportation met in Ottawa to open a round of talks aimed at revising the bilateral agreements regulating transborder air transportation.<sup>1</sup> The discussions, expected to take over a year to complete, were directed at negotiating an "open skies" or deregulated air transport environment between the two countries. Similar talks had been undertaken previously to modernize existing agreements, but unlike past negotiations these "post-Free Trade Agreement" talks generated a large amount of media attention, especially in Canada.<sup>2</sup> The crux of the new talks was similar to the problem that negotiators failed to resolve in the 1980s: how to open the border to better air services for travellers and shippers in ways that would allow carriers on both sides of the border to compete fairly for air traffic. The stated Canadian position, although at this writing not communicated directly to the U.S. negotiators at the current talks, was that Canadian carriers would be able to compete fairly for

transborder traffic only if they were permitted to carry U.S. passengers on certain U.S. domestic routes. In return the Canadians were willing to allow U.S. carriers to transport Canadian passengers on some Canadian domestic routes. In other words, the Canadians proposed an exchange of limited, reciprocal cabotage rights.<sup>3</sup>

This essay examines the issues surrounding the current negotiations, the reasons why previous rounds of negotiations failed and the potential options for a future agreement. The first section describes the transborder air market, detailing the size of the market and its importance to the two countries. The second describes past United States-Canada air bilateral agreements and discusses the failed attempts at reaching a new agreement in the 1970s and the 1980s. The third section provides an overview of the different transborder air transport regulatory options open for negotiation. Section four analyzes the policy options available to the negotiators and the advantages and disadvantages each of the options affords to the two sides. Finally, the last portion assesses the likelihood of an agreement and discusses the form that it could take.

## THE TRANSBORDER AIR MARKET

Before discussing the issues in the current round of United States-Canada bilateral air transport negotiations, it may be helpful to take a closer look at the object of the negotiations; that is, the transborder air market.<sup>4</sup> The transborder air market is the largest international market for both Canada and the United States with over ten million passengers in 1989.<sup>5</sup> Scheduled services are provided on 83 city pairs, with Canadian carriers operating exclusively on 26 routes, U.S. carriers on 19 routes and carriers of both countries on the remaining routes.<sup>6</sup> Thirty-eight of the markets are served by small aircraft operators, many of these carriers operating under a 1984 commuter services agreement.<sup>7</sup>

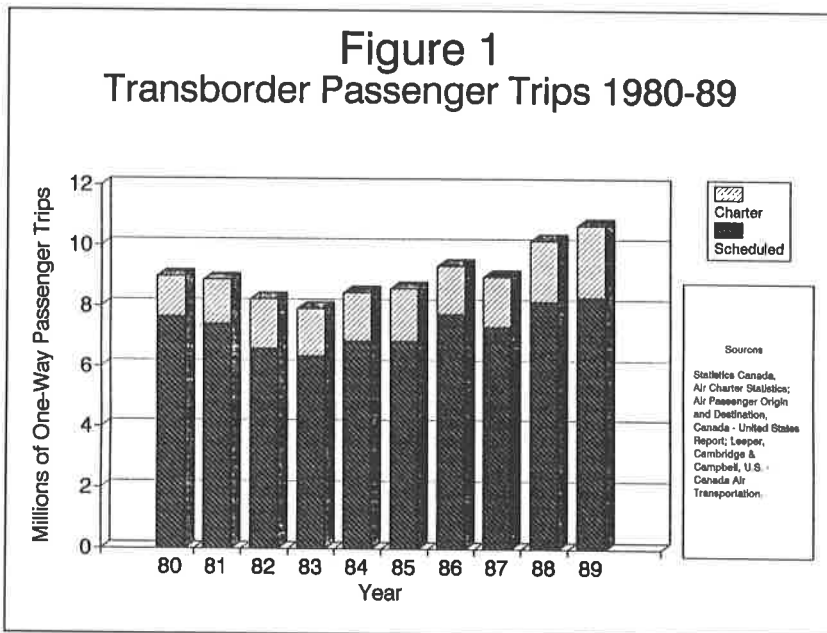
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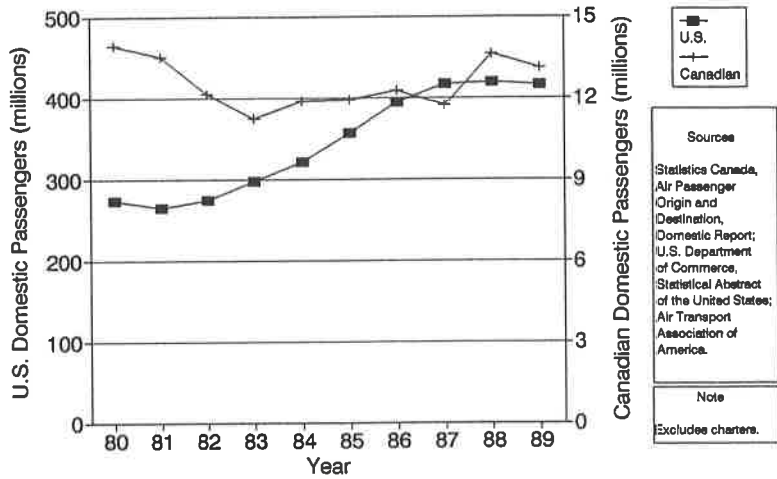
The total transborder market is estimated to generate two billion dollars (U.S.) in revenues annually with Canada claiming that the U.S. carriers earn about \$430 million more than their Canadian counterparts.<sup>8</sup> U.S. airlines carry a majority of the high yield scheduled passengers, while Canadian carriers dominate the lower yield charter market with a 96 percent share.<sup>9</sup> About two-thirds of transborder passengers (scheduled and charter combined) are residents of Canada.

Figure 1 shows the growth in the market during the 1980s. It can be seen from the figure that there were about 9 million total passengers in 1980. The total fell during the recession years to less than 8 million in 1983 before climbing to 10.7 million in 1989. During the period, the charter share of total traffic ranged between 15 and 22 percent, and the average annual growth rate in total traffic was 2.1 percent.

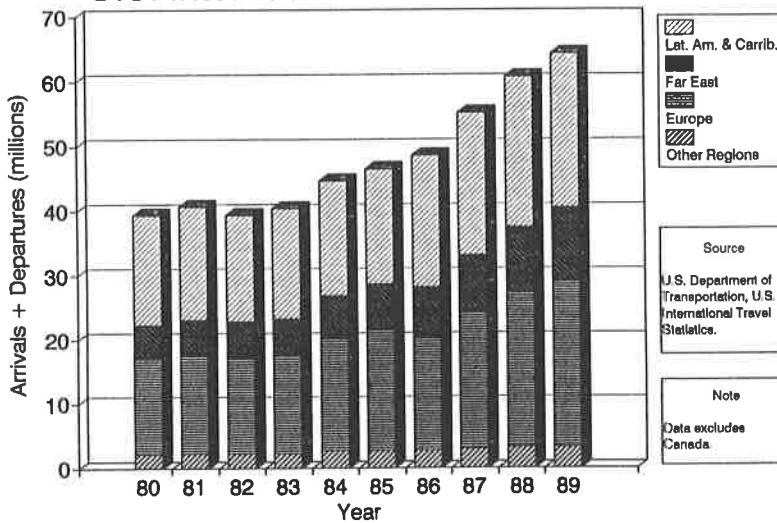


It is possible to compare the performance of the transborder market during the 1980s to the performance of the Canadian and United States domestic markets and to non-transborder Canadian and U.S. international traffic. Figure 2 illustrates the growth in the Canadian and United States domestic air transport markets during the 1980s. The huge U.S. domestic market increased from 273 million passengers in 1980 to

**Figure 2**  
Domestic Passenger Markets, 1980-89



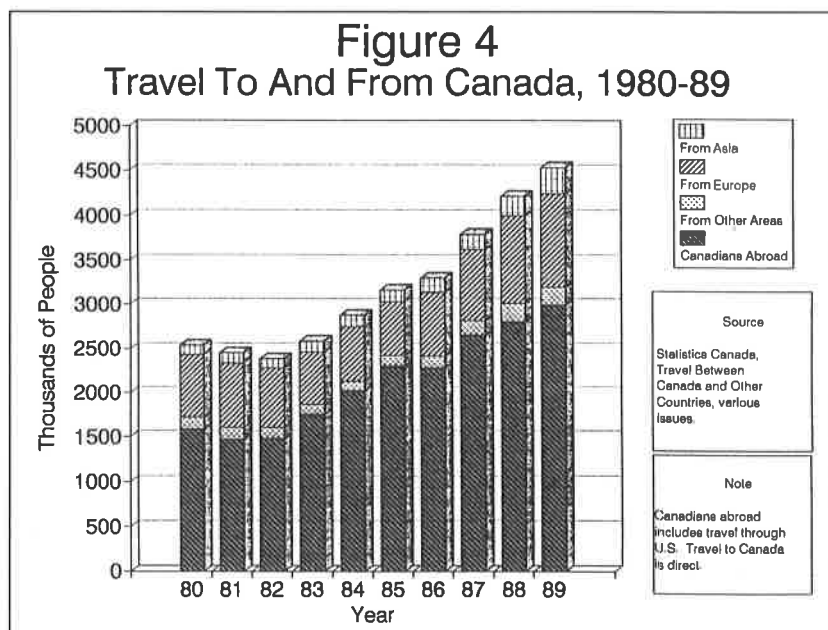
**Figure 3**  
U.S. International Air Traffic 1980-89



416 million passengers in 1989 with an average annual growth rate of 4.9 percent. During the same time period, the Canadian market remained flat with essentially no growth in air traffic between 1980 and 1989.<sup>10</sup>

The United States international market (excluding U.S.-Canada travel) is illustrated in Figure 3. Total passengers in this market increased from 39.5 million in 1980 to 64.4 million in 1989, an average annual rate of 5.7 percent. The annual increases for Latin America/Caribbean, Europe and the Far East were 3.9 percent, 6.3 percent and 10.0 percent, respectively. The U.S. carrier share of the international market (excluding Canada) was 50 percent in 1989, compared to the estimated 60 percent share U.S. carriers have of the transborder scheduled passenger market.<sup>11</sup>

Figure 4 provides an indication of the growth in the Canadian international (except transborder) air transport market during the 1980s.



The figure shows the number of foreign residents who entered Canada directly from different regions of the world, and the number of Canadian residents who travelled abroad.<sup>12</sup> It can be seen that the number of

foreign residents entering Canada directly from abroad increased from 957 thousand in 1980 to 1.5 million in 1989, for an average annual increase of 6 percent. The figures for Europe and Asia were 3.8 percent and 12.3 percent, respectively. The number of Canadian residents travelling abroad increased from 1.6 million in 1980 to 3 million in 1989, for an average annual increase of 7.6 percent.

In summary, the transborder routes form an important market for Canadian carriers, nearly the size of the Canadian domestic industry and larger, in terms of passengers, than Canada's other international markets combined. The transborder market is an important international area for U.S. carriers, but is tiny in comparison to the U.S. domestic market. Passenger growth during the 1980s on transborder routes was sluggish, lagging behind passenger growth in other United States and Canadian international markets and behind the growth of the U.S. domestic industry. Only the Canadian domestic industry experienced slower growth.

## THE REGULATORY FRAMEWORK

### Historical Perspective

As most aviation scholars and laymen alike are aware, heavier-than-air flights had their start with the Wright brothers in 1903. Less well-known is the fact that interest in commercial aviation grew very slowly in the years following the Wright brothers' first flight.<sup>13</sup> It was only following the First World War, after sufficient experience had been gained in the manufacture and flying of aircraft, that commercial aviation developed.

It was also following World War I that the major underlying principle regulating international air transport, national sovereignty over air space, was accepted. Before the war this principle had been debated by representatives of 19 states in Paris. At that time the delegates had recognized that national sovereignty rights were superseded by the principle of freedom of passage for foreign aircraft.<sup>14</sup> But in an era characterized by a post-war mentality of distrust for other nations, the principle of full national sovereignty over air space was affirmed at the Paris Convention following World War I.<sup>15</sup>

National sovereignty over air space implied that there must be bilateral or multilateral agreements (implicit or explicit) in order to permit international flights to take place. The first agreement between Canada and the United States was signed in 1929.<sup>16</sup> It stated that if a carrier was licensed to operate in Canada, then it could operate transborder air services but could not operate on domestic U.S. routes. Likewise, a

carrier licensed in the United States could operate transborder services but could not operate on domestic Canadian routes.<sup>17</sup>

The 1929 arrangement was replaced by a second agreement in 1938.<sup>18</sup> The new one required U.S. carriers to have the consent of the Canadian government to operate transborder routes, and for Canadian carriers to have U.S. government consent to operate these routes. In other words, governmental restrictions on the operation of transborder air services were placed on what had been a *de facto* free air transport market.

Two new bilateral agreements were concluded soon after the end of World War II. For the first time these accords included specific route schedules.<sup>19</sup> The 1945 agreement gave Canadian carriers the right to operate on 8 routes and U.S. carriers operating rights on 10 routes. Each of the routes was single-tracked, meaning that no route was assigned to both U.S. and Canadian carriers with the exception of Fairbanks-Whitehorse. A new accord in 1949 replaced the 1945 agreement and added for the first time "fifth freedom routes" for both countries.<sup>20</sup> This proviso gave Canadian carriers the right to transport passengers between Honolulu and Australasia and between Tampa and points in the Caribbean. U.S. carriers could transport passengers between Gander, Newfoundland and Europe.<sup>21</sup> The 1949 agreement was amended in 1959 when a number of new routes were added, especially in western North America.

### **The 1966 and 1974 Agreements**

Dissatisfaction with the 1949 agreement, as amended, surfaced in both Canada and the United States in the 1960s.<sup>22</sup> Canadian carriers lacked many "deep penetration" routes stretching from Canadian cities to southern U.S. points such as Dallas and Los Angeles.<sup>23</sup> U.S. carriers were unhappy with provisions requiring them to make two stops on certain flights between Toronto and Florida.<sup>24</sup> Despite the dissatisfaction on both sides, it took four years of negotiations, the intervention of the Canadian prime minister and the U.S. president, and a report by John Kenneth Galbraith, the Canadian-born, Harvard-based economist, to conclude a new agreement.<sup>25</sup> The 1966 route schedule, still in force (as amended) today, is shown in Table 1. It can be seen that U.S. carriers won permission to operate on 15 major routes and 6 smaller routes (grouped together as "route 16"); Canadian carriers were authorized to operate on 11 major routes and 3 smaller ones. Canadian carriers obtained deep penetration routes to Los Angeles and Miami (which could be served as a co-terminal with Tampa), and restrictions were removed for U.S. airlines carrying Canadian traffic to Florida.

**TABLE 1**  
**1966 ROUTE SCHEDULE**

Routes Permitted to U.S. Carriers	Routes Permitted to Canadian Carriers
1. Seattle-Vancouver	1. Victoria-Seattle
2. Los Angeles/San Francisco-Vancouver	2. Vancouver-San Francisco
3. Denver/Great Falls-Calgary	3. Halifax-Boston/New York
4. Chicago-Toronto	4. Montreal/Toronto-Chicago
5. Detroit-Toronto	5. Toronto-Cleveland
6. Tampa/Miami-Toronto	6. Toronto-Los Angeles
7. Tampa/Miami-Montreal	7. Toronto-Tampa/Miami
8. Los Angeles-Toronto	8. Montreal-Tampa/Miami
9. New York-Montreal/Ottawa	9. Montreal-New York
10. New York-Toronto	10. Toronto-New York
11. Boston-Montreal	11. Canada-Honolulu-Australasia and beyond
12. Washington-Ottawa/Montreal	12. a. Prince Rupert-Ketchikan
13. Buffalo-Toronto	b. Whitehorse-Fairbanks
14. Minneapolis-Winnipeg	c. Whitehorse-Juneau
15. U.S.-Gander-Europe and beyond	
16. a. Spokane-Calgary	
b. Duluth/Superior-Fort William/Port Arthur	
c. Ketchikan-Prince Rupert	
d. Fairbanks-Whitehorse	
e. Juneau-Whitehorse	
f. Erie-Toronto	

**Source:**

Canada Treaty Series, 1966, No. 2, Schedules 1 and 2.

Within four years of the signing of the 1966 agreement, negotiations to establish additional routes for carriers of each country had started. Canada was still dissatisfied with the number of deep penetration routes available to its carriers, while the United States had a limited interest in some additional transborder routes. As well, the United States



had recently adopted a policy of seeking to sign bilateral accords to regulate charter flights and thought that a charter agreement would provide U.S. carriers with a greater opportunity to compete for the large Canadian "sun market" to the southern United States.<sup>26</sup> The negotiations were conducted over a number of years with the final sticking point being the Canadian demand for a Toronto-Dallas/Fort Worth/Houston route and the United States refusal to grant it. As former U.S. air bilateral negotiations advisor Joseph R. Chesen noted,

The Canadian negotiator then took a personal gamble by threatening to cut off all U.S. customs and immigration pre-clearance of passengers in Canada unless Canada got that route. The [U.S. Civil Aeronautics Board] correctly perceived the threat as a probable bluff (because Canadian residents would be the largest losers) and held firm against granting the Texas route. Nevertheless, the Department of State invoked foreign policy considerations and conceded the route, but obtained a previously unsought U.S. mirror image route.<sup>27</sup>

The result of the negotiations was 3 separate accords regulating routes, charters, and pre-clearance procedures.<sup>28</sup> The schedule from the 1974 route agreement is outlined in Table 2. It shows that the number of routes allocated to both U.S. and Canadian carriers was increased substantially over the 1966 agreement. U.S. carriers gained 23 new routes and new points on 5 existing routes. Canadian carriers gained 14 new routes and new points on 3 existing routes.

The charter agreement was the first between Canada and the United States covering non-scheduled air services. The total number of transborder charter passengers at the time was about 400,000 per year with the vast majority (over 90 percent) carried by Canadian air carriers.<sup>29</sup> The agreement formalized the regulatory arrangement for charter flights by providing each country with the right to designate one or more carriers to operate non-scheduled air services.

The third of the 1974 agreements covered existing pre-clearance of flights destined for the United States through U.S. customs and immigration in Canada as well as the possibility of Canadian pre-clearance in United States territory. This agreement was of primary benefit to the American carriers which had used this service for a number of years without a formal agreement. Pre-clearance allowed the United States to continue or establish customs and immigration facilities in up to 11 Canadian cities, and for Canada to establish pre-clearance facilities in up to 13 U.S. cities. Since most passengers flying to Canada terminate

**TABLE 2**  
**1974 ROUTE SCHEDULE**

Routes Permitted to U.S. Carriers	Routes Permitted to Canadian Carriers
<i>A. Atlantic-State Routes</i>	<i>A. Atlantic Provinces Routes</i>
1. Boston-Montreal	1. Sydney-Boston
2. Boston-Toronto	2. Halifax-Boston/ New York
3. New York-Montreal/Ottawa	3. Halifax-Bangor/ Portland-Montreal
4. New York-Toronto	
5. Albany/Burlington- Montreal	
6. Philadelphia-Montreal	
7. Philadelphia-Toronto	
8. Pittsburgh-Toronto	
9. Washington-Ottawa/ Montreal	
10. Tampa/Miami-Montreal	
11. Tampa/Miami-Toronto	
<i>B. Great Lakes-East Routes</i>	<i>B. Quebec Routes</i>
1. Buffalo/Rochester- Montreal	1. Quebec-New York
2. Buffalo-Toronto	2. Montreal-Boston
3. Erie-Toronto	3. Montreal-New York
4. Cleveland-Montreal	4. Montreal-Tampa/Miami
5. Cleveland-Toronto	5. Montreal-Cleveland
6. Detroit-Montreal	6. Montreal/Toronto- Chicago
7. Milwaukee/Detroit- Toronto	
8. Chicago-Montreal	
9. Chicago-Toronto	
10. Duluth/Superior- Thunder Bay	
<i>C. Great Lakes-West Routes</i>	<i>C. Ontario Routes</i>
1. Rochester-Toronto	1. Toronto-Boston
2. Chicago/Minneapolis/St. Paul-Winnipeg/Edmonton- Anchorage	2. Toronto-New York
3. Milwaukee/Duluth/ Superior-Winnipeg	3. Toronto-Tampa/Miami
4. Chicago-Vancouver	4. Toronto/Hamilton- Pittsburgh
	5. Toronto-Cleveland
	6. Toronto-Dallas/ Ft. Worth/Houston

**Table 2 Continued ...**

Routes Permitted to U.S. Carriers	Routes Permitted to Canadian Carriers
<i>D. Great Plains Routes</i>	<i>D. Prairie Province Routes</i>
1. Houston/Dallas/Ft.Worth- Calgary/Edmonton- Anchorage/Fairbanks	1. Regina/Winnipeg- Chicago
2. Houston/Dallas/Ft.Worth- Toronto/Montreal	2. Calgary/Winnipeg- New York
3. Bismarck/Minot-Winnipeg	3. Calgary-Chicago
	4. Edmonton/Calgary- San Francisco
	5. Edmonton-Calgary- Los Angeles
<i>E. Transcontinental Routes</i>	<i>E. Transcontinental Routes</i>
1. Los Angeles-Toronto/ Montreal	1. Montreal/Toronto- San Francisco
2. San Francisco-Toronto/ Montreal	2. Montreal-Toronto- Los Angeles
<i>F. Pacific-State Routes</i>	<i>F. British Columbia/Yukon Routes</i>
1. Los Angeles/San Francisco- Vancouver	1. Vancouver/Victoria- Seattle
2. Los Angeles-Calgary/ Edmonton	2. Vancouver-San Francisco/Los Angeles
3. San Francisco-Calgary/ Edmonton	3. Prince Rupert- Ketchikan
4. Las Vegas-Calgary/Edmonton	4. Whitehorse-Fairbanks
5. Spokane-Calgary/Edmonton	5. Whitehorse-Juneau
6. Spokane-Vancouver	
7. Seattle-Vancouver	
8. Ketchikan-Prince Rupert	
9. Juneau-Whitehorse	
10. Fairbanks-Whitehorse	
11. Fairbanks-Inuvik	
12. Honolulu-Vancouver	
<i>G. Intercontinental Routes</i>	<i>G. Intercontinental Routes</i>
1. U.S.-Gander- Europe and beyond	1. Canada-Honolulu- Australasia and beyond

**Source:**

Canada Treaty Series, 1974, No. 18, Schedules 1 and 2.

their flight at the first Canadian stop, Canadian pre-clearance in the United States was of little value to Canadian carriers. On the other hand, a large percentage of Canadian-originating passengers do not disembark at their first U.S. stop. Having the right to pre-clear these passengers in Canada allows the U.S. carriers to transport the passengers to their final destination without having to wait for customs clearance at the first U.S. stop.

### **Liberalization Initiatives**

It was only a few years after the signing of the three 1974 agreements when the U.S. government initiated a major change in the way U.S. air transport was governed. The passing of the Airline Deregulation Act<sup>30</sup> in 1978 set the stage for dramatic changes in the U.S. air transport industry. Concurrent with the institution of a domestic deregulation policy, the United States undertook to liberalize its international air transport policy. The most important feature of the new American international air transport policy was the liberal bilateral.<sup>31</sup> This was different from previous bilateral air agreements in a number of important ways:<sup>32</sup> first, it contained a new type of pricing clause. Whereas earlier agreements typically allowed either government to reject prices proposed by carriers on routes (known as double approval), liberal agreements allowed only the country where a flight originated to reject a fare (country of origin clause), or in some cases required action by both countries to reject fares (double disapproval). As well, liberal agreements generally expanded the number of routes available to carriers between the two countries, removed restrictions on existing routes (such as mandatory intermediate stops) and allowed governments to designate as many carriers as they would like to fly routes (known as multiple designation). Beginning with a new United States-Netherlands agreement in 1978, the United States signed over twenty liberal or partially liberal agreements.<sup>33</sup> But it was unsuccessful in negotiating a comprehensive liberal or open skies agreement with Canada.

Some years after the U.S. initiative Canada, too, deregulated most of its domestic air transport system. A major step towards deregulation was taken in 1984 under Liberal Transport Minister Lloyd Axworthy, in a "new Canadian air policy."<sup>34</sup> Among other initiatives Axworthy discontinued that portion of Canada's air transport policy which had kept regional airlines out of the transcontinental market, and he reduced governmental control over air fares except for northern regions of the country. The deregulation of Canada's south was completed with the passage of the National Transportation Act in 1987<sup>35</sup> and

with the complete privatization of Air Canada in 1989. Unlike the United States, however, Canada did not aggressively pursue a liberal international policy in conjunction with its domestic deregulation. Most of the bilateral agreements Canada signed in the first few years following the Axworthy initiative in 1984 were restrictive, instructing carriers to collude on prices and often on capacity levels.<sup>36</sup>

### **Negotiations During the 1980s**

Negotiations over a new transborder bilateral air agreement began again in 1979. However, as Chesen outlined, the problems were much different in this set of negotiations than in previous rounds.<sup>37</sup> After the deregulation of the U.S. domestic air transportation system, the American carriers radically changed their route structures from a system of mainly linear paths to hub-and-spoke networks. Each carrier established one or more hubs and developed routes into and out of these hubs. A major U.S. demand in the new negotiations was, therefore, to include new transborder routes into the hubs in a revised route schedule. As well, in keeping with its liberal bilateral initiative the United States wanted a new liberal pricing policy to be included in the agreement. Canadian carriers wanted far fewer routes than U.S. carriers and were therefore unwilling to agree to a major expansion of routes for their U.S. counterparts.

Although the series of negotiations which began in 1979 failed to produce a comprehensive new agreement, two smaller accords were concluded in 1984.<sup>38</sup> The first covered air routes that were considered to be regional, local or commuter services.<sup>39</sup> It provided for the automatic approval of new transborder routes which met the following criteria:

- The capacity of the aircraft to be used on the route was no more than sixty passengers and the payload capacity no more than 18,000 pounds;
- The city pair was not included in the 1974 route schedule;
- The Canadian city had a metropolitan population less than 500,000 or the U.S. city had a metropolitan population under 1 million;
- The stage length of the route did not exceed 400 miles to or from cities in central Canada and 600 miles to and from cities in the rest of Canada; and,
- The proposed service was not already authorized to an airline of the same country.

The second agreement, known as the experimental transborder air services program, was designed to "foster new transborder air services" and to "gain experience with innovative pricing and service mechanisms."<sup>40</sup> Under the program both Canada and the United States could designate carriers to operate routes to two airports, one in Canada and the other in the United States. Routes were to be automatically accepted by both governments and prices were to be approved unless rejected by both governments (double disapproval).<sup>41</sup> Canada designated Montreal's Mirabel as its airport in 1984 and the United States designated San José as its airport in 1986.<sup>42</sup>

Although the two agreements in 1984 represented steps towards liberalization, the vast majority of air travel between Canada and the United States remained covered by the non-liberal 1966 agreement and the 1974 amendments. Recognizing that the air transport arrangements in place did not meet the needs of the travelling public, Prime Minister Brian Mulroney and President Ronald Reagan decided to renew air transport negotiations as parallel talks to the discussions leading to a comprehensive free trade agreement. Consequently, in June of 1985 Canada and the United States exchanged "concept papers" outlining how each government proposed to liberalize transborder air services.

The United States concept paper<sup>43</sup> envisaged a free transborder market, allowing carriers of either country to serve whichever transborder routes they wished. An advantage to this approach, according to the Americans, was that the negotiators would not have to try to balance benefits between the carriers of the two countries by "trading" routes. All transborder routes would be, *de facto*, open to the carriers of both countries. In addition the U.S. paper called for a liberal, double disapproval pricing clause.

The Canadian concept paper was even more revolutionary than its U.S. counterpart.<sup>44</sup> It called for an integrated North American air transportation market. This proposal would allow Canadian carriers to serve U.S. domestic markets on routes beginning or ending in Canada and U.S. carriers to serve Canadian domestic markets on routes beginning or ending in the United States. In other words, the Canadian proposal called for a grant of limited reciprocal cabotage rights. As for pricing arrangements, the Canadian proposal was not as specific as the U.S. paper, although it did call for a more flexible and competitive pricing system than the one currently in place. The Canadian proposal also stated that there should be safeguards preventing Canadian carriers from being the price leaders on U.S. domestic routes and U.S. carriers from being the price leaders on Canadian domestic routes.

The sticking point in the negotiations quickly became the issue of cabotage. The Canadians felt that unless the agreement included cabotage rights for its carriers, Canadian airlines would not be able to achieve a "satisfactory level" of traffic in an open transborder system."<sup>45</sup> As the former chief air negotiator for Canada, Geoffrey Elliot, stated:

The essential reality is that USA airlines have better access to the [transborder air] market. Even though at least half the transborder traffic originates in Canada, the domestic hub and spoke system in the United States permits [U.S.] airlines to do a much better job of accumulating transborder traffic at hubs and connecting these hubs to the relatively small number of Canadian population centers... We are under no illusion that access to limited cabotage rights would resolve the competitive disadvantage of Canadian airlines in the market. Cabotage on extensions of transborder services would, however, provide important added service flexibility which might make the difference between whether or not a Canadian airline could provide a viable service on particular transborder city pairs in competition with USA airlines.<sup>46</sup>

The Canadian cabotage proposal was rejected by the United States in February, 1986. In a letter to the Canadians, Samuel C. Keiter, then chief of the aviation negotiations division of the U.S. Department of State, declared that the United States was convinced that proceeding with bilateral discussions on the basis of an exchange of cabotage rights was "not a viable option."<sup>47</sup> Although Keiter did not mention the reasons for the U.S. rejection of the cabotage proposal, they likely stemmed from U.S. carrier opposition to cabotage and perceived problems in getting Congress to pass legislation permitting a cabotage agreement.<sup>48</sup> Although the Canadians tried, for a period, to convince the U.S. government to reverse its opinion, the American rejection and the Canadian insistence on cabotage effectively left the talks stalemated.<sup>49</sup>

## OVERVIEW OF THE POSSIBLE ALTERNATIVE AGREEMENTS

Before the current issues under negotiations are presented in detail, it would be helpful to review the different regulatory alternatives for transborder air transport in broad terms. The first possibility would be for Canada and the United States to enter into an agreement that includes the reciprocal exchange of cabotage rights. The exchange of reciprocal cabotage rights would allow Canadian carriers to operate domestic routes in the United States and American carriers to operate domestic routes in Canada. Limitations to the reciprocal cabotage rights would likely restrict Canadian carrier operations between U.S. points to routes which originated or terminated in Canada (e.g., Toronto-Chicago-Phoenix rather than just Chicago-Phoenix) and U.S. rights in Canada to routes which originated or terminated in the United States. The exchange of cabotage rights would be combined with greater (or unlimited) freedom for carriers to operate on transborder routes (i.e., "open skies"), so that there would be sufficient opportunities for carriers to establish cabotage routes as extensions of transborder routes.

An alternative to reciprocal cabotage would be to allow carriers on both sides of the border unlimited transborder routes but without cabotage opportunities ("open skies without cabotage"). As there is some feeling on the Canadian side that this arrangement favors U.S. carriers over Canadian carriers due to the U.S. carriers' ability to accumulate traffic at their hubs, there would probably have to be a period of adjustment before an agreement was fully in place. During this transition U.S. carriers would be restricted in some ways. They may, for example, be prohibited from adding routes from certain U.S. points (namely major hubs such as Chicago) to key Canadian cities (namely Toronto, Vancouver and Montreal). Canadian carriers could use this period of grace to develop affiliate arrangements with U.S. carriers. The Canadian and affiliate U.S. carriers could then combine resources to serve a large number of cities on both sides of the border for the benefit of the carrier partners.

Should Canadian and U.S. negotiators fail to come to an agreement on either a cabotage or on an open skies agreement without cabotage, there appears to be only two other alternatives. One is to sign no agreement at all and continue with the present arrangement. The second is to sign an agreement with a limited number of new routes specified in a route schedule. Neither of these alternatives would be attractive from a consumer's viewpoint, since neither would serve to significantly increase service levels on transborder routes or to reduce prices. A regulatory arrangement, similar to the current structure, may



also not be in the best long-term interest of transborder carriers. As outlined earlier in this essay, in recent years transborder passenger growth rates have been below levels experienced on other Canadian and U.S. international air routes. The restrictive transborder agreements currently in force likely have contributed to the slow growth rate.

In summary, the possibilities for the regulation of U.S.-Canada air transportation include free skies with cabotage, free skies without cabotage, an improved version of the current arrangement and the current arrangement with no changes. In the next section these arrangements, along with the other important issues under negotiations, are discussed in more detail with the advantages and disadvantages outlined for airlines and consumers on both sides of the border.

## CURRENT NEGOTIATIONS

The issues currently under negotiation have been divided into three broad areas: traffic rights; pricing; and, competitive concerns.

### Traffic Rights

The most contentious issue in the current round of negotiations, as it was in the last round, is the Canadian-proposed inclusion of cabotage in the scheduled service agreement. Since 1985 the Canadians have stated publicly that they are in favor of a cabotage agreement, although they have not agreed to present formally a cabotage proposal to U.S. negotiators during current talks.<sup>50</sup> The Americans have indicated a willingness to discuss a cabotage arrangement, but they are not seeking access to Canadian cabotage and thus have not tabled any proposal.<sup>51</sup>

What would be the major advantages and disadvantages of the exchange of reciprocal cabotage rights to Canadian and U.S. carriers? The major advantage to the Canadian carriers would be the right to compete for passengers in the huge U.S. domestic market, an opportunity that they are currently denied. Canadian carriers would gain the ability to serve U.S. cities which may not be feasible to serve without cabotage. For example, the market between Toronto and Phoenix probably would not support sufficient traffic for a Canadian carrier to offer even one flight per day. However, if the Canadian carrier could fly Toronto-Chicago-Phoenix and exercise cabotage rights on the Chicago-Phoenix leg of the route, then the route might be viable.

The potential advantages for U.S. carriers of exercising cabotage rights in Canada are not particularly large because of the small size of the Canadian traffic relative to the U.S. domestic market. It may be possible

for U.S. carriers to enter a few high density Canadian routes such as Toronto-Montreal and Toronto-Ottawa by operating a hub in Toronto. Flights from U.S. cities could stop in Toronto and enplane domestic Canadian passengers before continuing on to Ottawa or Montreal. As well, U.S. carriers could conceivably gain a percentage of Canadian long distance traffic by funneling passengers through existing U.S. hubs. For example, United Airlines could fly Toronto-Vancouver or Toronto-Calgary passengers through its hub in Chicago, although this service would be inferior to the non-stop service offered by Canadian carriers on these routes.<sup>52</sup>

Just as the potential for gain appears to be larger for the Canadian carriers than for the U.S. carriers, the downside also would be greater for the Canadian carriers. The two major Canadian carriers, with their commuter affiliates, currently control almost 100 percent of the Canadian domestic market. Allowing the U.S. carriers to compete on Canadian domestic routes, even if they chose only to operate on a few high density routes, could substantially erode Canadian airlines' market share to the point where the Canadian carriers were no longer financially viable. On the other hand, the Canadian firms would have to double or even triple in size to make a substantial impact in the U.S. domestic market.

Passengers on both sides of the border could benefit from a reciprocal cabotage arrangement if it were successfully implemented, although the main beneficiaries would likely be Canadian-based travellers. Canadian residents constitute about two-thirds of the transborder travel market. Canadian transborder travellers could take advantage of the increased same-plane service that could be made available due to a cabotage agreement (e.g., as stated above, Toronto-Chicago-Phoenix, offered by a Canadian carrier). Canadian domestic travellers would also have greater carrier choices, especially on the high density routes which would be the most likely Canadian entry choices for U.S. carriers. On the other hand, Canadian carrier penetration in the U.S. would not likely be high and might only benefit a small proportion of U.S. domestic passengers.

What are the prospects for a cabotage arrangement? There appears to be at least two major problems with concluding it. The first problem is that there is not a political consensus on either side of the border in favor of it. In the United States the administration appears in favor of cabotage, but Congress, which must enact legislative changes to approve such an arrangement, is not clearly in favor of it.<sup>53</sup> There is some concern in the United States that a cabotage agreement could serve as a precedent, opening the U.S. domestic market to foreign carrier compe-

tition from Europe and Asia. Some U.S. carriers such as American Airlines still favor a cabotage agreement, but other carriers and airline labor unions do not.<sup>54</sup> In Canada there is also no consensus on cabotage among governmental, carrier and interest groups.<sup>55</sup> Their concern is that a cabotage arrangement could threaten the viability of the two major Canadian carriers and cost Canadian jobs.

The second problem, related to the first, is that the issue has become politicized. Unlike the last round of transborder air bilateral negotiations, these talks have drawn considerable press coverage, especially in Canada. In light of perceived problems or imbalances with the Free Trade Agreement, and perceived problems with the deregulated transborder trucking industry, it may be difficult for the Canadian government to sign a cabotage agreement thought by some parties to favor U.S. carriers.<sup>56</sup>

Due to the problems of obtaining an agreement on cabotage, it appears unlikely that a new agreement will include an exchange of cabotage rights except perhaps on a limited number of routes. A more likely prospect is for an agreement which allows unlimited transborder services but no cabotage and would be achieved only after a lengthy "phase-in" period. During the phase-in carriers might be limited as to the new routes they could serve (especially if other carriers already served these routes), capacities they could offer, or prices they could charge. Carriers might be asked to reduce frequencies or capacity levels if their market share reached a certain point on a route (e.g., 70 percent). The phase-in would be sought by the Canadians as a period of adjustment for their carriers in order to place them in a better position to compete with their American competitors.

During the phase-in there are a number of strategies that the Canadian carriers could use in order to improve their competitive position. Chesen suggested that the Canadian carriers could establish hubs at various U.S. points (much as U.S. carriers have done at points such as Frankfurt, Paris and Tokyo) and enter into joint marketing and code-sharing agreements with U.S. carriers at these hubs.<sup>57</sup> This could allow, for example, a Canadian carrier to operate spoke routes from Toronto, Montreal, Ottawa (and perhaps other Canadian points) to Orlando, where a "bank" of transborder flights could connect with onward flights by a U.S. affiliate from Orlando to points such as Sarasota, Ft. Meyers, Ft. Lauderdale and Key West, possibly even with the livery of the Canadian carrier. The U.S. carrier could also carry U.S. domestic traffic. Other suggestions by Chesen include Canadian and U.S. carriers leasing blocked space on the other country's carriers (e.g., ten seats a day between a pair of cities) particularly on "thin" transborder routes; dry

leasing (i.e., without crew) Canadian aircraft on U.S. domestic sectors so that U.S. domestic traffic could be carried; and changing existing Canadian carrier service patterns to feed U.S.-based hubs. Canadian carriers could also purchase minority interests in U.S. carriers (and *vice versa*) to help cement working relationships.<sup>58</sup>

Who would benefit from an agreement allowing unlimited transborder routes? U.S. carriers could use the new transborder routes to connect Canadian cities to their northern hubs. These new routes would allow the U.S. carriers to transport Canadian passengers to a larger number of U.S. destinations, through their hubs, with on-line service. The superior service available by both Canadian and U.S. carriers might also expand the market. New traffic could be generated because of better transborder routings. The Canadian carriers might benefit from the increased traffic (especially if they used the phase-in period wisely to undertake agreements with U.S. carriers) and find themselves with an increased passenger load.<sup>59</sup>

Undoubtedly the biggest beneficiaries from a new route agreement with unlimited transborder carrier access would be present or potential transborder air travellers and cities on both sides of the border. Passengers would benefit from improved routings and, perhaps, from a larger selection of discount fares due to increased competition. In decrying the current transborder route structure, frequent transborder passenger Chesen stated in 1989:

Today, people in Atlanta can fly nonstop across the Atlantic to Amsterdam, Brussels, Frankfurt, London, Munich, Paris, Shannon, and Zurich, as well as to Bermuda, Mexico City and other destinations in the Western Hemisphere. But they cannot fly nonstop to any Canadian city.

Orlando, Florida, a world renowned recreation area, has nonstop flights to and from Amsterdam, Frankfurt, London, Manchester and even Reykjavik, Iceland, as well as Manaus and Rio de Janeiro. But nonstop scheduled air services from Orlando to Montreal, Toronto, or any Canadian city are out of the question for both Canadian and U.S. airlines.

Air travel is still quite possible, to be sure. It is just more laborious and more time consuming. It is often less convenient and even less competitive than the services consumers in both countries receive in domestic markets.<sup>60</sup>

A second alternative to the cabotage agreement may be an enhanced version of the current route agreement. An enhanced route agreement would require the addition of a limited number of routes for both U.S. and Canadian carriers. U.S. and Canadian negotiators could "trade-off" routes based on their estimated values. The major problem with this approach is obtaining any degree of consensus on the value of new routes. The valuation is not only subjective but complicated because new routes inevitably draw traffic away from existing ones so that impacts must be estimated in order to find a valuation. It was the difficulty of determining a fair exchange of routes, coupled with a more complex negotiating process, that caused talks on a new bilateral agreement to fail in the early 1980s.<sup>61</sup> The major disadvantage of this type of agreement is that it will probably not result in a significant increase in consumer benefits in the form of lower prices and increased carrier service levels.

### Pricing

Next to the determination of route schedules and possible related safeguards, the matter of how prices should be set may be the most important issue to settle for the Canadian and American bilateral negotiators. In the transborder market, prices are currently established by the carriers, individually, subject to the approval of both governments.<sup>62</sup> Since the mid-1980s government approval has been relatively automatic, allowing carriers to determine prices in a reasonably free manner.<sup>63</sup> However, the lack of government interference with transborder prices may be due in large part to a scarcity of price competition on transborder routes. If a new bilateral agreement allows for increased competition on transborder routes (and if one is signed, it almost surely will do so), then the issue of government control (real or potential) over prices becomes increasingly important.

The question of whether governments should or should not be allowed to veto prices takes on increased importance when other "de-regulated" international markets are examined. In the Chile-U.S. market, both American Airlines and Pan Am used the liberal provisions of the 1989 U.S.-Chile bilateral agreement to slash prices, triple frequencies and offer incentives such as triple mileage for frequent fliers on flights to Chile.<sup>64</sup> The result was a precipitous decline in load factors for the two Chilean carriers operating U.S. international routes.<sup>65</sup>

The United States has indicated that it would like to incorporate a liberal double *disapproval* pricing clause into a new bilateral agreement making it difficult for governments to veto prices.<sup>66</sup> Canada has not been

as specific in its pricing proposals but would appear to prefer a more conservative approach to pricing, perhaps with pricing zones within which carriers would receive automatic approval. Outside of the zones, prices would be set subject to a more stringent assessment, such as approval by both governments.<sup>67</sup> The Canadian and American positions do not appear to be irreconcilable. However, to obtain Canadian airline acceptance of a compromise pricing proposal, the Canadian government may have to address Canadian carrier concern over Canadian-U.S. carrier cost differences.

### **Competitive Concerns**

In addition to pricing and routes, there are a number of other issues which could affect the "level playing field" between U.S. and Canadian carriers. Most prominent among these is the issue of airport access. The problem, from a Canadian carrier perspective, is how Canadian airlines can effectively compete with their U.S. counterparts when major U.S. airports are currently used to capacity during peak periods. In other words, an open skies agreement might provide Canadian carriers with the right to fly to the U.S. airports of their choice, but if gates and slots (permission to depart or arrive at a given time) are not available then the Canadian carriers could not provide the transborder service.<sup>68</sup> U.S. carriers, on the other hand, with gates and slots at key American airports, would be able to provide increased transborder flights under an open skies agreement.<sup>69</sup>

In order to address the access issue, a new bilateral agreement will likely contain arrangements enabling carriers to obtain slots and gates at key airports in the other country. Although these arrangements could prove difficult to negotiate since U.S. airports (except National and Dulles in Washington) are operated by local authorities rather than by the federal government, they may be included in an agreement in order to guarantee carriers of both countries a fair and equal opportunity to compete for business. The guarantee would provide Canadian carriers with the right to obtain gates and slots at U.S. airports (and *vice versa*) even when slots and gates are not available to U.S. domestic carriers. As Cheslen, the former U.S. bilateral negotiations advisor, has stated, given the right to a fair and equal opportunity to compete for traffic, Canadian carriers could have some bargaining leverage for access to gates and other space at U.S. airports because in most cases they could deal with a competing U.S. airline that needed access to the Canadian airport at the other end of the route. The access could be denied unless the Canadian carrier had equal opportunity to compete on the route.<sup>70</sup>

A second competitive concern is how the Canadian carriers will be able to compete with the much larger U.S. airlines. As argued in the press, not only are costs thought to be lower in the United States, but the sheer size of the U.S. carriers allegedly provides them with a competitive edge over their Canadian counterparts.<sup>71</sup> However, it is not necessarily the case that the largest carrier is the most efficient, most profitable and strongest airline. A well-managed small carrier may be able to out-compete much larger airlines. A study conducted by Dresner and Windle found that U.S. carriers were not able to significantly increase their market shares on international routes following the signing of liberal agreements, despite the fact they were much larger than their foreign counterparts.<sup>72</sup> Although Canadian carriers may not be able to outperform their U.S. competitors, the key criterion for success or lack of it is not likely to be carrier size.

A third issue relates to costs. Canadian carriers have contended that they face higher operating costs than their U.S. counterparts and would be at a competitive disadvantage for this reason.<sup>73</sup> An example cited has been the transborder trucking market. Canadian truckers have stated that higher operating costs and taxes in Canada have made their operations uncompetitive with U.S. truckers in a deregulated, price-competitive marketplace, resulting in declining market share, losses and bankruptcies.<sup>74</sup>

In a study on the cost competitiveness of Canadian carriers, Tretheway found that in some cost categories Canadian carriers have an advantage while in others U.S. carriers have the advantage.<sup>75</sup> For example, wage rates in the airline industry were lower in Canada while the cost of raising capital was higher. For the cases of landing fees and fuel prices, even though costs were higher in Canada than in the United States, there would be no advantage for U.S. carriers serving transborder routes since both U.S. and Canadian competitors would have to land and buy fuel in Canada. Overall, Tretheway concluded that the two major Canadian carriers were not as efficient as the average U.S. carrier but were within the performance range of the 6 largest American carriers.<sup>76</sup>

In summary, there are a number of issues related to traffic rights, pricing and competitive concerns which must be resolved in the current round of negotiations before a new agreement is reached. The complexity of these issues is likely to result in protracted negotiations.

## CONCLUSIONS

Since September, 1979, Canada and the United States have been attempting on and off to renegotiate their bilateral air transport agreements and, more recently, to reach an "open skies" arrangement. This would replace an existing, outdated bilateral signed in 1966 (as amended). It is hoped that a new agreement would spur growth in a transborder market, which during the 1980s expanded at a pace much slower than other U.S. and Canadian international markets.

The negotiators have not been able to conclude a new comprehensive agreement despite repeated rounds of talks. The major problem facing the negotiators is how to create a situation that would allow carriers of both countries to compete equally for available traffic. The problem is difficult to solve because U.S. carriers, with their strategically located northern hubs, have a perceived structural advantage in a competitive market. In the past the Canadians have proposed to address the imbalance through reciprocal cabotage rights which would allow Canadian carriers to compete in the U.S. domestic market and U.S. carriers in the Canadian domestic market. Reciprocal cabotage has not been formally discussed during the current negotiations since the proposal faces considerable political opposition in both Canada and the United States. A more likely prospect is an agreement which would allow unlimited transborder access to carriers of both countries, with built-in safeguards for Canadian carriers. At least for a period, the safeguards could restrict carriers from starting new routes or limit capacity levels on new routes.

Aside from routes, a number of other issues must be decided by the bilateral negotiators. With respect to prices, the two sides appear to be reasonably close and should conclude an agreement that allows carriers increased latitude in determining prices without governmental interference. The important issue of airport access can also be addressed in a new agreement allowing carriers admittance to the airports of the other country in order to ensure a fair and equal opportunity to compete for traffic.

In short, Canadian and American negotiators appear closer than they have since 1979 to concluding a new market-oriented, comprehensive air transport bilateral. Should agreement be reached, it will almost certainly benefit transborder passengers, shippers and business interests on both sides of the border.



## NOTES

<sup>1</sup>I would like to thank Joseph Chesen, Bob Hedges, Lee Preston, Carl Scheraga, Michael Tretheway and the anonymous referees for their helpful comments. Invaluable research assistance was provided by Erwin Dresner, Allan Goldstein and Marge Westerlund.

<sup>2</sup>Brenda Dalglish, "Soaring to Open Skies: Ottawa Promotes a Free Trade Deal for Airlines," *Maclean's*, October 15, 1990, 56-57; Zuhair Kashmeri, "Open Skies Means Open War: Pilots," *Globe and Mail*, December 8, 1990, B3; Wayne Lilley and James Bagnall, "The Trouble With Freedom," *Financial Times of Canada*, January 7, 1991, 10-12; Philip DeMont, "Airlines In Holding Pattern Over New Open-Skies Deal," *Toronto Star*, January 9, 1991, F1, F7; David Vienneau, "Restrict U.S. Access, MPs Say," *Toronto Star*, January 9, 1991, F1; Zuhair Kashmeri, "Lewis Supports Open-Skies Treaty," *Globe and Mail*, February 13, 1991, B6; Editorial, "As Canada Prepares to Bargain for Open Skies," *Globe and Mail*, February 22, 1991, A14; Martha M. Hamilton, "U.S., Canada Seek to Forge 'Open Skies' Pact," *Washington Post*, March 8, 1991, F1, F4; Andrew Tausz, "Open Skies Frightens Air Cargo Companies in Canada," *Globe and Mail*, March 26, 1991, B21-B22; Geoffrey Rowan, "Big Airlines Star at Open Skies," *Globe and Mail*, April 8, 1991, B1-B2; Alan Toulin, "U.S. Sees 'Open Skies' Bonanza," *Financial Post*, April 9, 1991, 1; Terrence Corcoran, "Nationalist Baggage Weighs Down Air Talks," *Globe and Mail*, April 10, 1991, B2; Laura Fowlie, "Lewis Sends a Warning on Eve of Bilateral Talks," *Financial Post*, April 10, 1991, 7; Geoffrey Rowan, "'Effective Access' Key to Open Skies Treaty," *Globe and Mail*, April 10, 1991, B1, B4; Drew Fagan, "Open Sky Fears Grounded With Cabotage Issue Dead," *Globe and Mail*, April 12, 1991, B1, B2; and, Geoffrey Rowan, "What Price Open Skies?" *Globe and Mail*, April 13, 1991, B1, B4.

<sup>3</sup>This position was presented by Canada as early as 1985 when it issued a "concept paper" explaining the Canadian proposals for a revamped transborder air transport agreement. In a November, 1985, speech to the International Aviation Club in Washington, D.C., the then Canadian transport minister, Don Mazankowski, stated that Canada requires "limited reciprocal cabotage rights as an essential element of any open transborder aviation system." In a February, 1991, speech to the Aero Club of Washington, D.C., Doug Lewis, another former Canadian transport minister, reiterated the Canadian stance when he stated: "The Canadian government position for these negotiations consistently has

been to pursue a liberal agreement, with cabotage, along with phase-ins and safeguards for Canadian air carriers." See Canada, Department of External Affairs, "A Framework For Canada-USA Air Negotiations" (1985); Canada, Transport Canada, "Notes for an Address by the Minister of Transport the Honourable Don Mazankowski to the International Aviation Club, Washington, D.C." (November 15, 1985); and, Canada, Public Affairs, Ottawa, "Canada-U.S. Air Negotiations," Speech by the Honourable Doug Lewis, Minister of Transport, Government of Canada, to the Aero Club of Washington, D.C. Tuesday, February 12, 1991.

<sup>4</sup>The discussion will concentrate on the transborder passenger market rather than the freight market. While the carriage of transborder freight, especially small packages, may prove to be an important issue in the new bilateral negotiations, freight currently accounts for only a small percentage of transborder carrier revenues. From the U.S. perspective, Canada represents 3 percent of international freight tons compared to 15 percent of U.S. international passenger traffic. Of the \$175 billion in merchandise trade between Canada and the U.S. in 1990, it was estimated that only 5 percent of the total moved by air. See U.S. Department of State, "Service Sector Summary Papers," presented by the U.S. delegation to the U.S.-Canada bilateral negotiations to the Canadian delegation, June 5, 1991.

<sup>5</sup>Statistics Canada, *Air Passenger Origin and Destination, Canada-United States Report*, 1990. The Canadian House of Commons Special Committee on Canada-United States Air Transport Services, Report of the Special Committee on Canada-United States Air Transport Services, *Open Skies: Meeting the Challenge*, 1991 at p. 7, reports a higher "current" figure of more than 13 million passenger trips. Statistics Canada may understate the total market due to non-reporting by smaller carriers.

<sup>6</sup>Canada, House of Commons, Report of the Special Committee on Canada-United States Air Transport Services, 7.

<sup>7</sup>U.S., Department of State, "Service Sector Summary Papers." The commuter agreement is discussed in the next section of the paper.

<sup>8</sup>Canada, House of Commons, Report of the Special Committee on Canada-United States Air Transport Services, 7.

<sup>9</sup>Statistics Canada, *Air Charter Statistics*, 1989. Joseph R. Chesen correctly noted in comments on an earlier draft of this paper that higher yield passengers are higher cost as well.

<sup>10</sup>The Statistics Canada figures exclude passenger totals from smaller Canadian carriers and may hide growth in the commuter sector of the air transport industry. The accounting methods for passengers used in the Canadian and U.S. calculations may not be strictly comparable so that a comparison of the *level* of passengers in the two countries may not be accurate.

<sup>11</sup>U.S., Department of Transportation, *International Travel Statistics*, 1989; Canada, House of Commons, Report of the Special Committee on Canada-United States Air Transport, 7.

<sup>12</sup>The latter figure includes travel through the United States.

<sup>13</sup>See: Richard Y. Chuang, *The International Air Transport Association* (Leiden, The Netherlands: A. W. Sijthoff, 1972), 16.

<sup>14</sup>See: D. Goedhuis, "The Air Sovereignty Concept and the United States Influence On Its Future Development," *Journal of Air Law and Commerce* 22 (1955): 211.

<sup>15</sup>This principle was reaffirmed at the Havana Convention of 1928 and the Chicago Conference of 1944.

<sup>16</sup>For a history of early air transport agreements between Canada and the United States, see: McGill University, Centre for Research of Air and Space Law, "Legal, Economic and Socio-Political Implications of Canadian Air Transport" (1980), 560-563.

<sup>17</sup>*Ibid.*, 560.

<sup>18</sup>*Ibid.*, 560-561.

<sup>19</sup>*Ibid.*, 561-563.

<sup>20</sup>A fifth freedom route for a carrier of Country A gives that airline the right to fly passengers originating in Country B to Country C (and *vice versa*) on routes beginning or ending in A.

<sup>21</sup>In 1949, Gander was an important refuelling point on North Atlantic flights.

<sup>22</sup>McGill University, "Legal, Economic and Socio-Political Implications of Canadian Air Transport," 563.

<sup>23</sup>The United States was reluctant to allow Canadian carriers to operate on these routes since they would then be able to compete with U.S. carriers already able to provide this service. U.S. carriers could provide service to southern U.S. cities after first stopping in a northern U.S. city that was in the 1949 or 1959 route schedule. See Joseph R. Chesen, *Canadian-American Air Service Negotiations: Ending the Gridlock* (Washington, D.C.: J.R. Chesen Associates, 3518 Northampton St. NW, Washington, D.C. 20015, 1989), 7.

<sup>24</sup>The stop requirement was contained in an exchange of notes that qualified the 1959 route schedule amendment. U.S. carriers wishing to fly a same-plane service between Toronto and Florida through Buffalo had to make an additional stop on the way. The exchange of notes was designed to protect the market of a Canadian carrier authorized to fly non-stop from Toronto to Tampa. See McGill University, "Legal, Economic and Socio-Political Implications of Canadian Air Transport," 563.

<sup>25</sup>Chesen, *Canadian-American Air Service Negotiations: Ending the Gridlock*, 7.

<sup>26</sup>*Ibid.*, 8.

<sup>27</sup>*Ibid.*, 10. Chesen continued, "Ironically, in 1987 Air Canada ceased all operations on the Toronto-Dallas/Ft. Worth/Houston route that had been the bone of contention, and in 1989 the incumbent U.S. airline on the mirror image route is operating six round-trip flights daily."

<sup>28</sup>*Canada Treaty Series*, 1974, no. 17.

<sup>29</sup>Martin Dresner, Carolyn Hadrovic and Michael W. Tretheway, "The Canada-U.S. Air Transport Bilateral: Will It Be Freed?" *Transportation Practitioners Journal* 56, no. 4 (Summer 1989): 395-396.

<sup>30</sup>United States Congress, *Airline Deregulation Act* (Pub. L. 95-504, October 24, 1978, 92 Stat. 1705).

<sup>31</sup>Other features of the new American policy included the following: the threatening of anti-trust action against the International Air Transport Association, an association which operates price-setting conferences for international air carriers; and, the passing of the International Air Transportation Competition Act of 1979 (Pub. L. 96-192, February 15, 1980, 94 Stat. 34) which promoted a more competitive approach to

international air transport. For discussions of the threatened anti-trust action (the IATA "show-cause" order) and the 1979 act, see P.P.C. Haanappel, *Pricing and Capacity Determination in International Air Transport* (Deventer, The Netherlands: Kluwer, 1984).

<sup>32</sup> See for example Stanley B. Rosenfield, "International Aviation: A United States-Government Industry Partnership," *The International Lawyer* 16, no. 3 (Summer, 1982): 478-479.

<sup>33</sup> Haanappel, *Pricing and Capacity Determination in International Air Transport*, Appendix 3.

<sup>34</sup> Government of Canada, "New Canadian Air Policy," May 10, 1984.

<sup>35</sup> *National Transportation Act, 1987* (Statutes of Canada, 1987, volume 1, chapter 34), 881-1065.

<sup>36</sup> For details on these agreements, see Martin Dresner and Michael W. Tretheway, "Policy Choices for Canada in International Air Transport," *International Business*, proceedings of the Administrative Sciences Association of Canada, 1987, 83-94. The Canadian agreement with the United Kingdom, signed in 1988, comes close to being liberal (*Canada Treaty Series*, 1988, no. 28). The agreement allows multiple carriers from either country to fly any route between the two countries. The agreement, however, does contain a double approval pricing clause allowing either government to reject proposed fares. An annex to the agreement places limits on the use of governmental vetoes but still allows either government to disapprove most deep discount fare offerings.

<sup>37</sup> Chesen, *Canadian-American Air Service Negotiations: Ending the Gridlock*, 11-15.

<sup>38</sup> In addition to these agreements the negotiations also produced two minor changes to the 1974 route schedule. In 1981, a separate New York-Ottawa route was added for U.S. carriers, supplementing the route U.S. carriers could serve from New York to Ottawa co-terminal with Montreal. As well, a Canadian carrier was authorized to serve the route if U.S. carriers did not meet minimum frequency levels. In 1984, Canada and the United States agreed to allow one carrier from each country to fly between San Juan and Toronto/Montreal. See *Canada Treaty Series*, 1981, no. 34; and "Exchange of Notes Between the Government of Canada and the Government of the United States of America Amending the Air

Transport Agreement Between the Two Countries of January 17, 1966, As Subsequently Amended," Ottawa, May 24, 1984.

<sup>39</sup> *Canada Treaty Series*, 1984, no. 24. For descriptions of both of the two agreements, see Dresner, Hadrovic and Tretheway, "The Canada-U.S. Air Transport Bilateral: Will It Be Freed?" 401-402.

<sup>40</sup> "Exchange of Notes Between the Government of Canada and the Government of the United States of America Concerning an Experimental Transborder Air Services Program," August 21, 1984 and March 13, 1986.

<sup>41</sup> There were a limited number of routes which were excluded from the agreement. These included routes to the designated Canadian airport from seven U.S. gateways-Boston, Chicago (O'Hare), Los Angeles, Miami, New York (JFK), San Francisco and Seattle.

<sup>42</sup> The reasons why Canada assented to the experimental transborder air services agreement may have had more to do with internal politics than with its desire to establish experiments in liberal transborder air services. The decision to designate Mirabel as Canada's experimental airport may have been largely due to the fact the airport has been under-utilized since it was completed. The treaty did not prove to be successful in attracting sustained business to Mirabel and is no longer in force.

<sup>43</sup> United States, Department of State, "U.S.-Canada Bilateral Aviation Negotiations Concept Paper," June 13, 1985.

<sup>44</sup> Canada, Department of External Affairs, "A Framework for Canada-USA Air Negotiations," June 13, 1985. A revised paper was issued on September 9, 1985, called "A Proposed Framework for Canada-USA Air Negotiations: Canadian Paper No. 2."

<sup>45</sup> The Honorable Don Mazankowski, Minister of Transport for the Government of Canada, address to the International Aviation Club, Washington D.C., November 15, 1985.

<sup>46</sup> Geoffrey Elliot, "International Air Services Liberalization (A Canadian Perspective)," speech to the 39th Annual Conference of the Airport Operators Council International, Denver, Colorado, September 24, 1986.

<sup>47</sup> Letter, Samuel C. Keiter to Geoffrey Elliot, February 11, 1986.

<sup>48</sup> See, for example, James K. Gordon, "Canadian-U.S. Bilateral Talks Hinge on Cabotage Agreement," *Aviation Week and Space Technology* 123, no. 22, December 2, 1985.

<sup>49</sup> The Canadians went so far as to draft a model bilateral agreement including cabotage provisions. See, Canada, Department of External Affairs, "Draft Agreement Between the Government of Canada and the Government of the United States of America on Air Transport," June 12, 1986.

<sup>50</sup> See, for example, a speech delivered to the Aero Club of Washington D.C., February 12, 1991, by then Canadian Transport Minister Doug Lewis. He stated: "I believe that a liberal agreement, with cabotage, is essential for Canadian carriers to access the U.S. market fully and to redress the structural [route] imbalance [favoring U.S. carriers]."

<sup>51</sup> In testimony before a Congressional subcommittee, Jeffrey Shane, Assistant Secretary for Policy and International Affairs, U.S. Department of Transportation, stated that the United States was willing to consider a cabotage arrangement if that were the basis on which Canada wanted to negotiate a new bilateral agreement. See the testimony of Jeffrey Shane, Hearing before the Subcommittee on Aviation, of the Committee on Public Works and Transportation, House of Representatives, "Review of International Aviation Policy and Bilateral Agreements," October 11, 1990, 41.

<sup>52</sup> Canadian-based passengers will also have to clear both U.S. and Canadian customs unless arrangements to by-pass customs clearance can be resolved.

<sup>53</sup> See the discussion in Joan M. Feldman, "The Foreign Ownership Dilemma," *Air Transport World* (January 1991): 23.

<sup>54</sup> *Ibid.* and Hamilton, "U.S., Canada Seek to Forge 'Open Skies' Pact," F4.

<sup>55</sup> See, for example: Kashmeri, "Open Skies Means Open Wars," and Fowlie, "Lewis Sends a Warning on Eve of Bilateral Talks."

<sup>56</sup> The thought that a cabotage arrangement favors U.S. carriers may prove to be correct. A simulation study on the potential effects of various transborder bilateral agreements found that under a reciprocal cabotage arrangement, U.S. carriers would be expected to gain 40 percent of the Canadian domestic market while Canadian carriers would obtain less

than 1 percent of the U.S. domestic market. See David W. Gillen, Mark Hansen, and Robson Ramos, "Assessing the Alternatives to Liberalize the Canada-U.S. Air Transport Bilateral," *Journal of the Transportation Research Forum* 31, no. 2 (1991): 326-335.

<sup>57</sup>Chesen, *Canadian-American Air Service Negotiations: Ending the Gridlock*, 38-40.

<sup>58</sup>Neither U.S. nor Canadian laws and regulations currently permit foreign majority control of their air carriers.

<sup>59</sup>In addition, Canadian carriers may be able to use Canadian hubs to transport a larger amount of United States international traffic across the North Pacific and the North Atlantic. Canadian cities are strategically situated on the "great circle routes" from United States interior cities to Europe and East Asia. With better transborder connections, Canadian carriers may be able to use their international routes to transport increasing numbers of passengers between interior U.S. points that lack good international connections (e.g., Cleveland) and European and Asian destinations. U.S. carriers could take advantage of better access to Canadian markets to increase their other international traffic as well. U.S. carriers, for example, could obtain an increasing amount of Canada-Caribbean traffic.

<sup>60</sup>Chesen, *Canadian-American Air Service Negotiations: Ending the Gridlock*, 1-2.

<sup>61</sup>*Ibid.*, 12-15. Chesen stated that much larger negotiating teams, the use of lawyers by the negotiating parties and a multiplication of interested parties concerned with the talks, led to a more complex negotiation process.

<sup>62</sup>The international airlines' price-fixing organization, the International Air Transport Association (IATA), has never been actively involved in the setting of transborder prices.

<sup>63</sup>Government fare approval was not always easily obtained. For example, in the early 1980s the Canadian government became concerned about competition from Continental Airlines in the Canada-Australia (through Hawaii) market and refused to allow Continental to match certain discount fares offered by the Canadian carrier, Canadian Pacific. The U.S. government retaliated by refusing to approve an Air Canada discount program to U.S. cities. After negotiations, both programs were approved.



<sup>64</sup> See: Edvaldo Pereira Lima, "Chile At Center Stage—Again," *Air Transport World* (August 1991): 31-34.

<sup>65</sup> The U.S.-Chile market is, of course, only a fraction the size of the Canada-U.S. market and likely much easier for the U.S. carriers to dominate.

<sup>66</sup> With a double disapproval pricing clause, tariffs would take effect unless both governments disapproved them. The United States has incorporated the double disapproval pricing clause into a number of its liberal agreements and proposed it for a new United States-Canada Agreement. See, U.S., Department of State, "U.S.-Canada Bilateral Aviation Negotiations Concept Paper."

<sup>67</sup> This type of pricing scheme was suggested by the Canadian House of Commons Special Committee on Canada-United States Air Transport Services. See the committee's report, *Open Skies: Meeting the Challenge*, 17.

<sup>68</sup> Four U.S. airports are "slot-controlled": O'Hare in Chicago; LaGuardia and Kennedy in New York; and National in Washington.

<sup>69</sup> Note that the U.S. carriers could have problems providing the increased service to Toronto or Vancouver where slots are also difficult to obtain. See, Fowlie, "Lewis Sends A Warning On Eve of Bilateral Talks."

<sup>70</sup> Chesen, *Canadian-American Air Service Negotiations: Ending the Gridlock*, 37.

<sup>71</sup> The comparison cited in the press has often been that USAir, the seventh largest U.S. carrier, has revenues greater than the combined revenues of Air Canada and Canadian Airlines International. See, for example, Lilley and Bagnall, "The Trouble with Freedom," 11.

<sup>72</sup> Martin Dresner and Robert Windle, "The Liberalization of U.S. International Air Policy: Impact on U.S. Markets and Carriers," *Journal of the Transportation Research Forum* (forthcoming). Two examples are the U.S. international routes to Singapore and to the Netherlands. The U.S. signed liberal agreements with both of these countries in 1978. In the three years prior to the signing of these agreements, Dresner and Windle reported U.S. carriers held an average of 99 percent of the U.S.-Singapore market and 10 percent of the U.S.-Netherlands market. In the 11 years

following the signing of the liberal agreements, U.S. carrier market share shrank to an average of 21 percent on U.S.-Singapore routes and remained at 10 percent on U.S.-Netherlands routes. The U.S. carriers were unable to gain market share on the Netherlands routes and lost most of the Singapore market, despite being much larger than their foreign competitors. Singapore Airlines and KLM, the Netherlands carrier, are comparable in size to Air Canada and Canadian Airlines International.

<sup>73</sup> See, for example, Rowan, "‘Effective Access’ Key to Open Skies Treaty," B4.

<sup>74</sup> See, for example, Glen Allen, "Hitting the Road," *Maclean's* (May 27, 1991): 18.

<sup>75</sup> Michael W. Tretheway, "The Cost Competitiveness of Canadian Carriers," University of British Columbia Working Paper Number 91-TRA-004, June 1991.

<sup>76</sup> Both major Canadian carriers have already embarked on cost reduction programs. See, for example, Geoffrey Rowan, "Air Canada Cuts Executive Ranks," *Globe and Mail*, April 19, 1991, B1; and Geoffrey Rowan, "‘Fine Tuning’ Could Bring More Layoffs for PWA," *Globe and Mail*, August 17, 1991, B1, B4.

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