

File No.

THE COMPETITION TRIBUNAL

IN THE MATTER OF an Application by the Commissioner of Competition for an Interim Order pursuant to section 100 of the *Competition Act*, R.S.C 1985, c. C-34, as amended;

AND IN THE MATTER OF an Inquiry pursuant to subsection 10(1)(b) of the *Competition Act*, R.S.C 1985, c. C-34, as amended, into the proposed acquisition by Labatt Brewing Company Limited of all of the outstanding units of Lakeport Brewing Income Fund.

BETWEEN:**THE COMMISSIONER OF COMPETITION**

Applicant

- and -

LABATT BREWING COMPANY LIMITED**LAKEPORT BREWING INCOME FUND****LAKEPORT BREWING LIMITED PARTNERSHIP****ROSETO INC.****TERESA CASCIOLI**

Respondents

AFFIDAVIT OF PHILIP B. NELSON

(sworn March 20, 2007)

I, **PHILIP B. NELSON**, of the City of Alexandria, in the Commonwealth of Virginia, in the United States of America, **MAKE OATH AND SAY:**

COMPÉTITION TRIBUNAL
TRIBUNAL DE LA CONCURRENCEFILED / PRODUIT
CT-2007-003
March 22, 2007Jos LaRose for / pour
REGISTRAR / REGISTRAIRE

OTTAWA, ONT

0004

1. I am an economist. My areas of specialization include microeconomics and industrial organization, with applications to antitrust and regulation. I received my Ph.D. in economics from Yale University in 1980. From 1978 to 1987, I worked as an economist for the Federal Trade Commission ("FTC") where I focused on antitrust matters, including mergers. Since 1987, I have been employed by Economists Incorporated ("EI"), an economic consulting firm in Washington, D.C. At EI, I have continued to work on antitrust matters, including numerous mergers and matters involving consumer products, including beverages. A copy of my curriculum vitae is attached as **Exhibit "1"**.

2. I have been retained by the Competition Bureau of Canada ("**Bureau**") to analyze the economic implications of allowing Labatt Brewing Company Limited ("**Labatt**") to acquire the units of Lakeport Brewing Income Fund ("**Lakeport**") before the Bureau completes its inquiry with respect to the proposed merger. As part of this analysis, I was asked to evaluate whether the acquisition, even in the presence of a hold separate arrangement, is likely to lead to actions that would have an irreparable effect on competition.

3. As background for my analysis, I have reviewed numerous documents obtained by the Bureau as part of its inquiry, the hold separate arrangement proposed by Labatt, and public materials related to the beer industry. The materials that I have reviewed are summarized in **Exhibit "2"**. My work is ongoing and I am continuing to review information that is being gathered as the case proceeds.

SUMMARY OF OPINION

4. Based on the analysis I have undertaken, I have concluded that allowing Labatt to proceed with the acquisition of Lakeport, even with the proposed hold separate arrangement or a modified arrangement that extends the hold separate period until the litigation is over, would allow Labatt and Lakeport to take actions that would have irreparable effects on competition.

5. This conclusion is based on the following:

- (1) Labatt's proposed acquisition of Lakeport raises significant competition law issues that deserve further investigation;
- (2) under the proposed hold separate arrangement, Labatt obtains substantial control over Lakeport;
- (3) allowing Labatt to buy the units of Lakeport would be likely to lead to actions that undermine ongoing competition, and thus have immediate, irremediable interim anti-competitive effects, even if the proposed hold separate is in place;
- (4) allowing Labatt to exercise control over Lakeport would be likely to lead to actions that will have long-term, irremediable anti-competitive structural effects, even under the proposed hold separate arrangement; and
- (5) the proposed hold separate has anti-competitive effects that do not depend on Labatt obtaining significant control over Lakeport's operations.

(1)

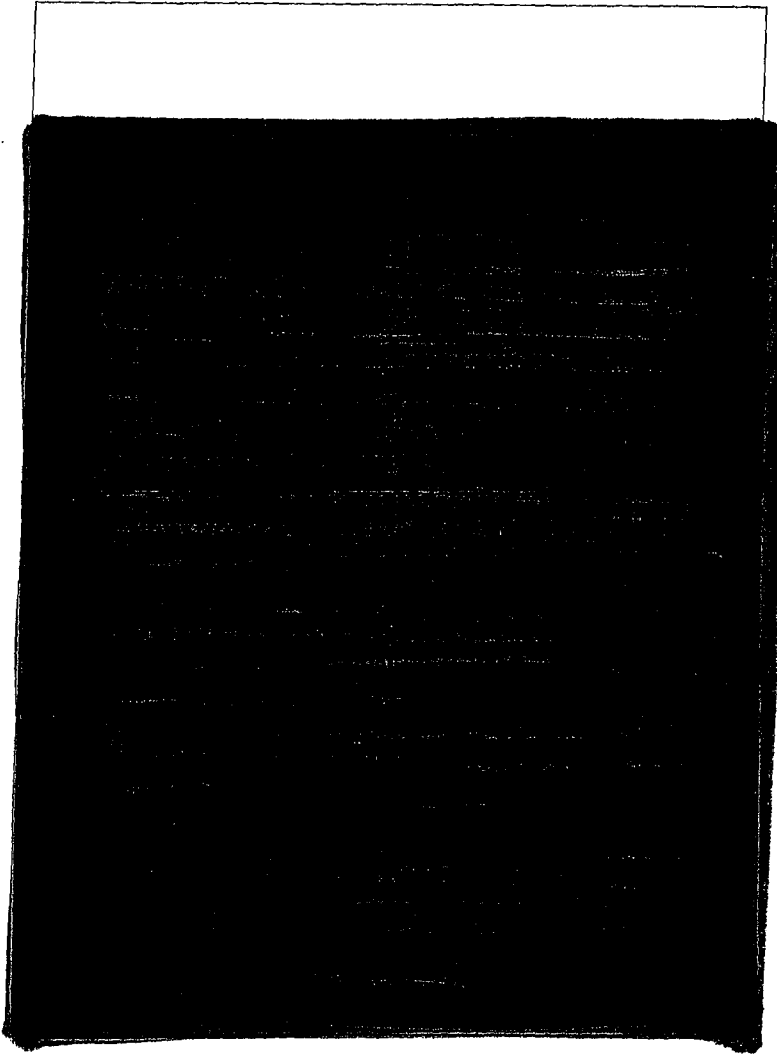
**LABATT'S PROPOSED ACQUISITION OF LAKEPORT RAISES SIGNIFICANT COMPETITION
LAW ISSUES THAT DESERVE FURTHER INVESTIGATION**

6. Assuming for the purposes of my analysis that the competition law market in issue is the sale of beer in Ontario, the acquisition of Lakeport by Labatt occurs in a highly concentrated market that is dominated by two firms: Labatt and Molson Coors Brewing Company ("Molson").¹ This is demonstrated by the following:

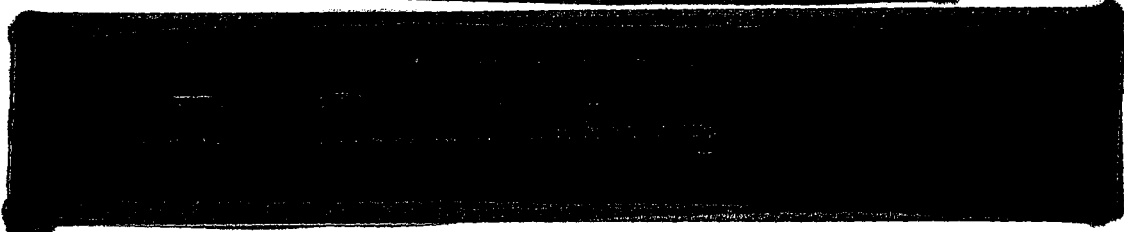
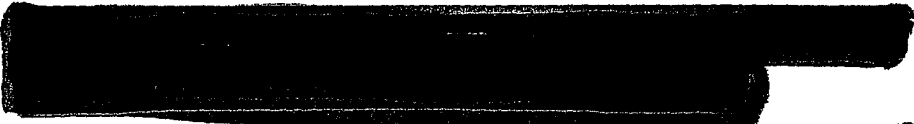
(a) 

¹ There may be narrower markets, sometimes called submarkets, such as the market for off-premises consumption that excludes beer sales through bars and other retail establishments that serve beer.

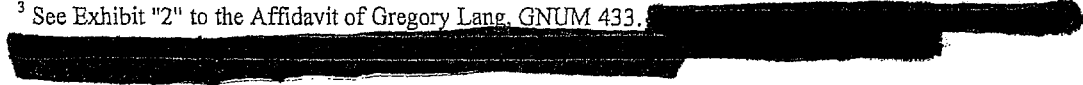
² See Exhibit "13" to the Affidavit of Gregory Lang, GNUM 4667.



(b)



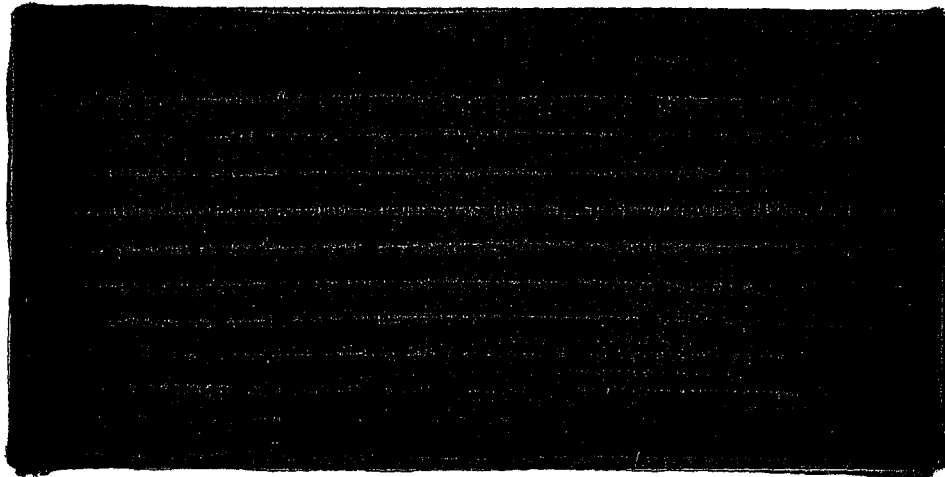
³ See Exhibit "2" to the Affidavit of Gregory Lang, GNUM 433.



- (c) Lakeport's 2006 Annual Report (published in March 2007), which reports shares based on The Beer Store sales, indicates that Lakeport's share was about 10% in 2005 and exceeded 11.5% in 2006. A true copy of the 2006 Annual Report is attached as **Exhibit "3"**.

7. As the preceding tables suggest, Lakeport has been increasing its share of the market and is now one of the largest competitors. This is supported by the following information found in documents provided to the Bureau by the merging parties:

(a)



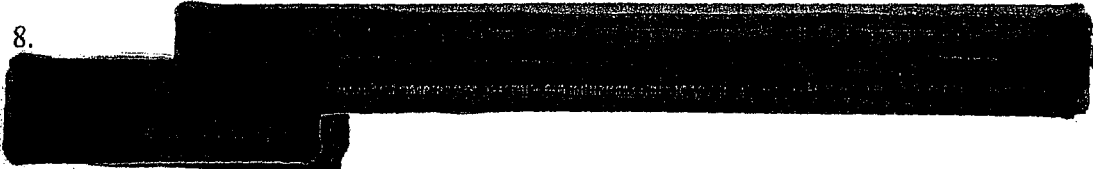
(b)

- (c) Lakeport is currently the only brewer other than Molson and Labatt with a brand listed among the top 10 selling brands at The Beer Store. Lakeport has in fact two brands in the top 10.⁶

(d)



8.



⁴ See Exhibit "26" to the Affidavit of Gregory Lang, GNUP 984.

⁵ See Exhibit "26" to the Affidavit of Gregory Lang, GNUP 974.

⁶ See Exhibit "22" to the Affidavit of Gregory Lang, GNUP 391.

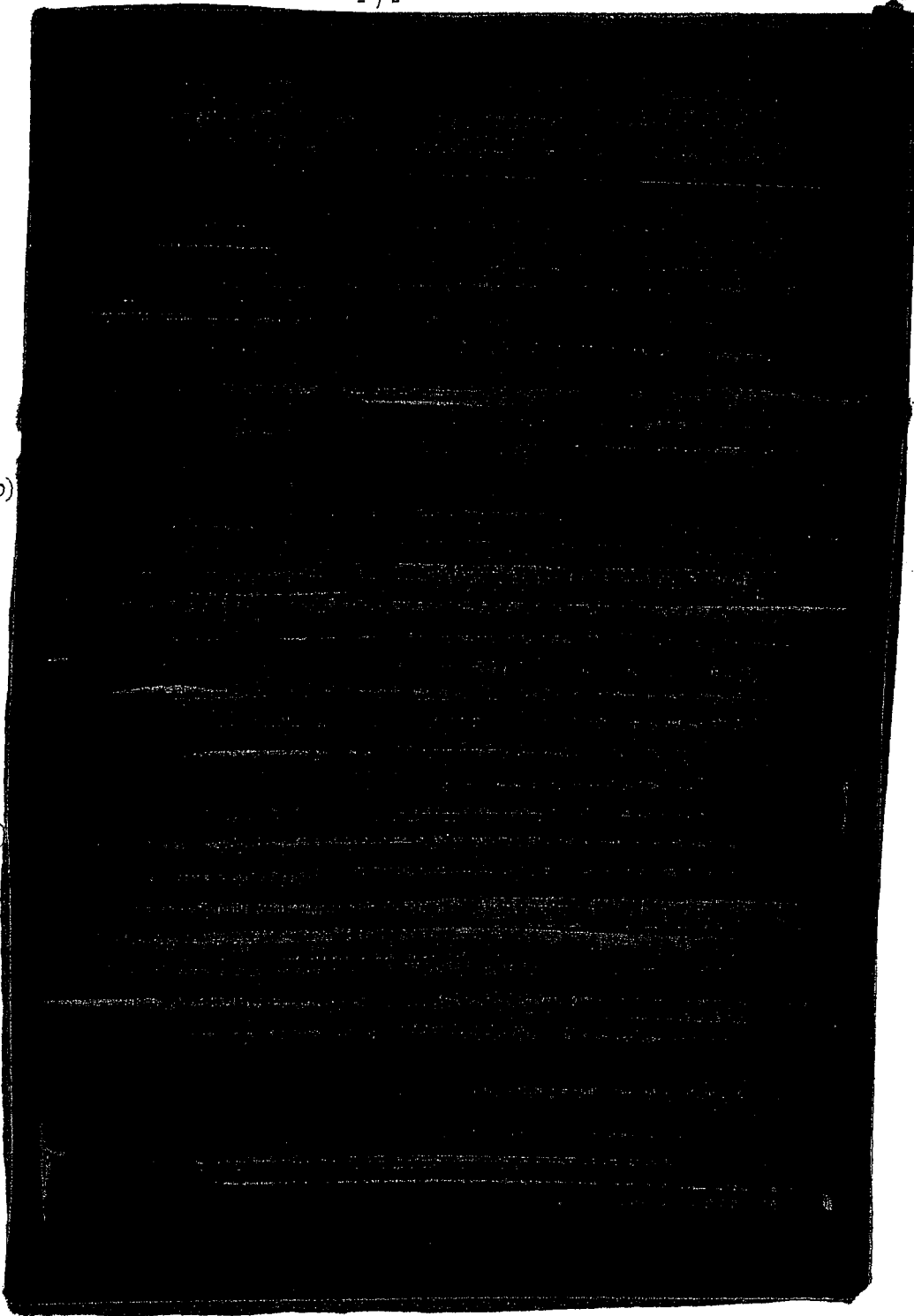
⁷ See Exhibit "6" to the Affidavit of Gregory Lang, GNUM 1638.

- (a) [REDACTED]
- (b) [REDACTED]
- (c) [REDACTED]
- (d) [REDACTED]
- (e) [REDACTED]

9. Lakeport's sales growth has been supported by aggressive pricing, increasing marketing expenditures and the introduction of new beer brands:

- (a) [REDACTED]

⁸ See Exhibit "19" to the Affidavit of Gregory Lang, GNUM10731.
⁹ See Exhibit "11" to the Affidavit of Gregory Lang, GNUM 3460.
¹⁰ See Exhibit "13" to the Affidavit of Gregory Lang, GNUM 4679.
¹¹ See Exhibit "19" to the Affidavit of Gregory Lang, GNUM10730.
¹² See Exhibit "19" to the Affidavit of Gregory Lang, GNUM10727.



(b)

(c)

¹³ See Exhibit "6" to the Affidavit of Gregory Lang, GNUM 1641.

¹⁴ See Exhibit "6" to the Affidavit of Gregory Lang, GNUM 1640.

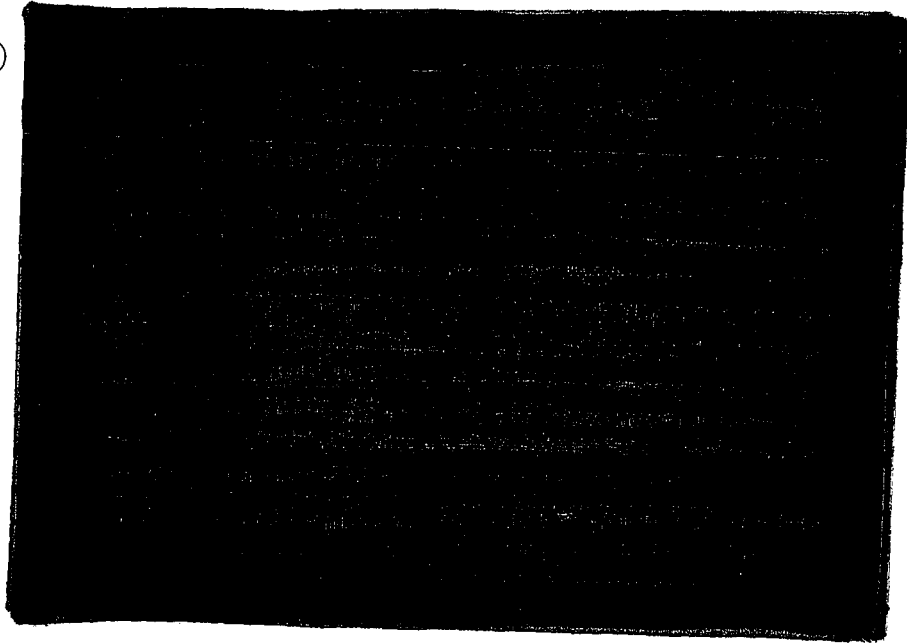
¹⁵ See Exhibit "17" to the Affidavit of Gregory Lang, GNUM 5988.

¹⁶ See Exhibit "6" to the Affidavit of Gregory Lang, GNUM 1640.

¹⁷ See Exhibit "29" to the Affidavit of Gregory Lang, GNUP 1331.

¹⁸ See Exhibit "23" to the Affidavit of Gregory Lang, GNUP 731.

(iii)

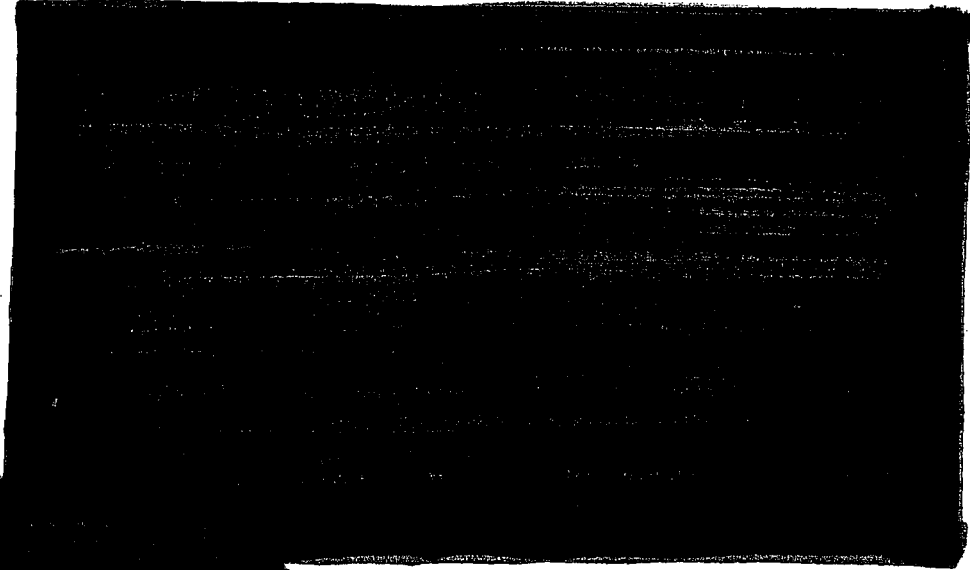


10. Lakeport is an aggressive competitor that responds quickly and aggressively to rivals' competitive strategies, [REDACTED]



(a)

(b)



¹⁹ See Exhibit "25" to the Affidavit of Gregory Lang, GNUP 950.

²⁰ See Exhibit "23" to the Affidavit of Gregory Lang, GNUP 731.

²¹ See Exhibit "26" to the Affidavit of Gregory Lang, GNUP 972.

²² See Exhibit "4" to the Affidavit of Gregory Lang, GNUM 507.

²³ See Exhibit "4" to the Affidavit of Gregory Lang, GNUM 507.

(a)

(b)

(c)

(d)

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(f)

12

²⁴ See Exhibit "11" to the Affidavit of Gregory Lang, GNUM 3466.

²⁵ See Exhibit "5" to the Affidavit of Gregory Lang, GNUM 900.

²⁶ See Exhibit "8" to the Affidavit of Gregory Lang, GNUM 2494.

²⁷ See Exhibit "6" to the Affidavit of Gregory Lang, GNUM 1638.

²⁸ See Exhibit "14" to the Affidavit of Gregory Lang, GNUM 4727.

²⁹ See Exhibit "16" to the Affidavit of Gregory Lang, GNUM 5687, 5698.

(a)

(b)

(c)

(d)

(e)

(f)

(g)

³⁰ See Exhibit "12" to the Affidavit of Gregory Lang, GNUM 4573.

³¹ See Exhibit "26" to the Affidavit of Gregory Lang, GNUP 984.

³² See Exhibit "10" to the Affidavit of Gregory Lang, GNUM 3048.

³³ See Exhibit "6" to the Affidavit of Gregory Lang, GNUM 1641.

³⁴ See Exhibit "6" to the Affidavit of Gregory Lang, GNUM 1645.

³⁵ See Exhibit "6" to the Affidavit of Gregory Lang, GNUM 1646. See also Exhibit "15" to the Affidavit of Gregory Lang, GNUM 4850, 4853-54.

³⁶ See Exhibit "6" to the Affidavit of Gregory Lang, GNUM 1651.

³⁷ See Exhibit "6" to the Affidavit of Gregory Lang, GNUM 1704. See also Exhibit "15" to the Affidavit of Gregory Lang, GNUM 4850, 4853-54.

13.

[REDACTED]

(a)

(b)

(c)

14.

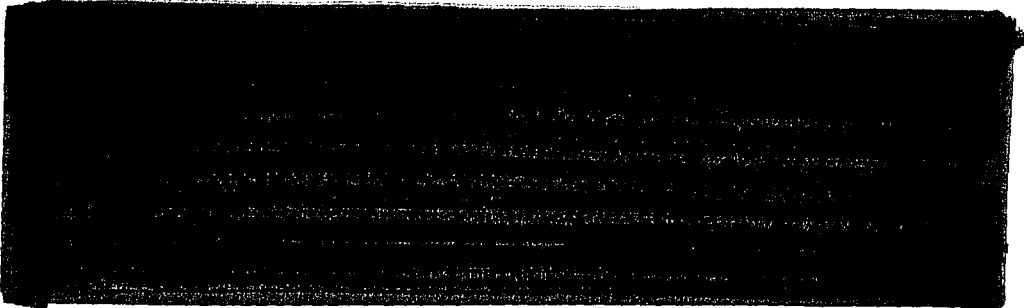
[REDACTED]

³⁸ See Exhibit "5" to the Affidavit of Gregory Lang, GNUM 919.


³⁹ See Exhibit "7" to the Affidavit of Gregory Lang, GNUM 1743.

⁴⁰ See Exhibit "19" to the Affidavit of Gregory Lang, GNUM 10727.

⁴¹ See Exhibit "24" to the Affidavit of Gregory Lang, GNUM 977.



15. In light of the foregoing, and given the significant ongoing competition between Labatt and Lakeport and the highly concentrated structure of Ontario beer sales, Labatt's proposed acquisition of Lakeport raises significant competition law issues that deserve further investigation.



(2)

**UNDER THE PROPOSED HOLD SEPARATE ARRANGEMENT, LABATT OBTAINS
SUBSTANTIAL CONTROL OVER LAKEPORT**

(a)

**The Proposed Hold Separate Does Not Eliminate
Direct Corporate Control of Lakeport by Labatt**

16. Corporate control refers to the ability of a firm to directly control or otherwise influence a firm's competitive decision-making, including pricing, product selection, advertising and promotion, and investment. In this case, one issue is the extent to which Labatt obtains control over Lakeport.

17. In accordance with the Support Agreement entered into by Labatt and Lakeport⁴³, Labatt has provided to the Bureau documentation regarding the implementation of a hold separate arrangement.⁴⁴ According to this documentation, the

⁴² See Exhibit "30" to the Affidavit of Gregory Lang, GNUP 3282.

⁴³ See Exhibit "1" to the Affidavit of Gregory Lang, GNUM 102.

⁴⁴ See Exhibit "32" to the Affidavit of Gregory Lang.

proposed hold separate would only keep Lakeport as a separate business for an "interim period" which is defined to mean "the period of time commencing on the date of this consent interim agreement, and ending on April 25, 2007 (30 days after March 26, 2007, being the day upon which the long form waiting period expires in respect of this matter) or such earlier date as may be agreed upon between the Commissioner and Labatt or ordered by the Tribunal" (see paragraphs 1(j) and 6 of the proposed hold separate).

18. Given the definition of "interim period" and the ability of Labatt to take complete control of Lakeport after the interim period, the proposed hold separate does not provide significant protection since it would give Labatt complete control over Lakeport after April 25, 2007.

19. However, even if the April 25, 2007 date were changed to be the date on which there is a final decision on the merger (including any potential appeals), the proposed hold separate does not prevent Labatt from obtaining significant control over Lakeport and does not eliminate the problems associated with the change in Labatt's financial incentives that will occur when it owns a major competitor. Despite the inclusion of certain language in the hold separate that puts some limits on Labatt's control over Lakeport, it is nonetheless clear that Labatt obtains substantial control over Lakeport under the proposed hold separate. The ways in which Labatt will be able to exercise control over Lakeport under the hold separate are described below.

(b)

**The Interim Period Managers Appointed by Labatt
Have Significant Managerial Control**

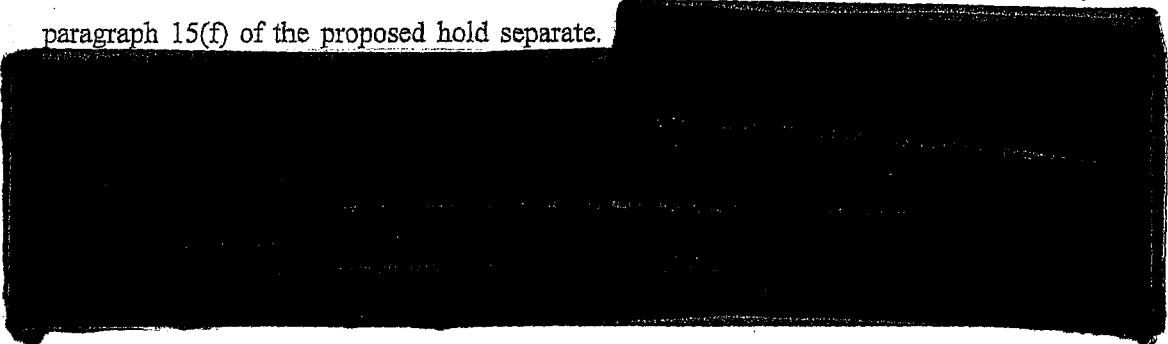
20. Under the proposed hold separate, Labatt has the right to "appoint one or more managers (the "interim managers") to assume complete managerial responsibility over the operations of Lakeport during the interim period" (see paragraph 9 of the proposed hold separate). This is consistent with paragraph 5.2(g) of the Support Agreement which indicates that Labatt has reserved the right to require the hold separate

agreement to "permit the Offeror [Labatt] to designate the CEO of the Fund and the Fund Subsidiaries".

21. While paragraph 15 of the proposed hold separate imposes some limits on the powers of Labatt-appointed managers, these limits are not well-defined and thus are not particularly restrictive. For example, while the Labatt-appointed managers are supposed to "carry on [Lakeport's] business in the ordinary course of business in accordance with generally prevailing industry standards" and "use best efforts to preserve and enhance the goodwill of Lakeport", it will be difficult to assess whether these managers are behaving appropriately. There is simply no concrete standard against which such "best efforts" or performance "in accordance with generally prevailing industry standards" can be measured.

22. The interim managers will have substantial discretion over key competitive decisions, such as pricing and marketing decisions. In a market where prices vary from month to month, there is no clear standard for assessing whether a particular price response (or lack of response) is the industry norm. Similarly, when a firm has been increasing advertising over time and when there is reason to adjust advertising levels in response to rivals' advertising, there is no clear standard for assessing whether a particular advertising level is appropriate.

23. Further, it would be particularly difficult to measure whether Labatt managers are "us[ing] best efforts to take any other actions which are consistent with improving the value and competitiveness of the business of Lakeport", as provided by paragraph 15(f) of the proposed hold separate.



⁴⁵ See Exhibit "22" to the Affidavit of Gregory Lang, GNUP 392.

[REDACTED]

With Labatt interim managers in place, it is unlikely that such plans will be pursued, and there is no way to measure Labatt's performance in this forward-looking dimension.

24. Paragraph 9 of the proposed hold separate states that the "interim managers may be members of Labatt or its affiliates' senior management teams".⁴⁷ While these managers are to "sever all employment ties with Labatt and its affiliates" and shall not be given "a legally enforceable guarantee [...] of reemployment by Labatt or any of its affiliates upon expiration of the interim period" (paragraph 9 of the proposed hold separate), the proposed hold separate does not rule out that these managers will be rehired by Labatt. Given the relatively short period covered by the "interim period", it is logical to expect that most of the interim managers would expect to be rehired by Labatt. There is no reason to believe that these managers do not anticipate being rehired by Labatt or being dependent on Labatt for referrals to obtain another job, with the rehiring or referral being dependent on Labatt's perception of whether they performed to Labatt's satisfaction when they managed Lakeport.

25. Given the incentives of Labatt to limit the growth of Lakeport during the interim period, one would expect Labatt-selected managers to use the vagueness of the standards in the proposed hold separate to promote Labatt's interests.

26. While the proposed hold separate indicates in paragraph 19 that a "monitor" will be appointed and that "[t]he monitor shall be responsible for monitoring the business of Lakeport as is necessary to ensure compliance with this consent interim agreement", the monitor is likely to be a "Labatt employee"⁴⁸, and there are no clear

⁴⁶ See Exhibit "22" to the Affidavit of Gregory Lang, GNUM 391-392.

⁴⁷ The Support Agreement indicates that Labatt will prepare a list of "Proposed Persons" to be the CEO of the Fund and the Fund Subsidiaries and submit this list to the Commissioner of Competition for approval. A second list, of which a majority will be persons not employed or affiliated with Labatt, will be proposed if no one on the first list is satisfactory to the Commissioner of Competition. There is no provision for someone besides Labatt to name the CEO if no one on either of the two lists that are submitted by Labatt are acceptable to the Commissioner of Competition (see paragraph 5.2(h) of the Support Agreement).

⁴⁸ While the Commissioner may object to the monitor proposed by Labatt, the Commissioner will have to pay the salary of the monitor if the monitor is not "an employee or appointee of Labatt or any of its affiliates" (paragraph 22 of the proposed hold separate).

standards for this monitor to use in determining if there is compliance with the hold separate order.

(c)

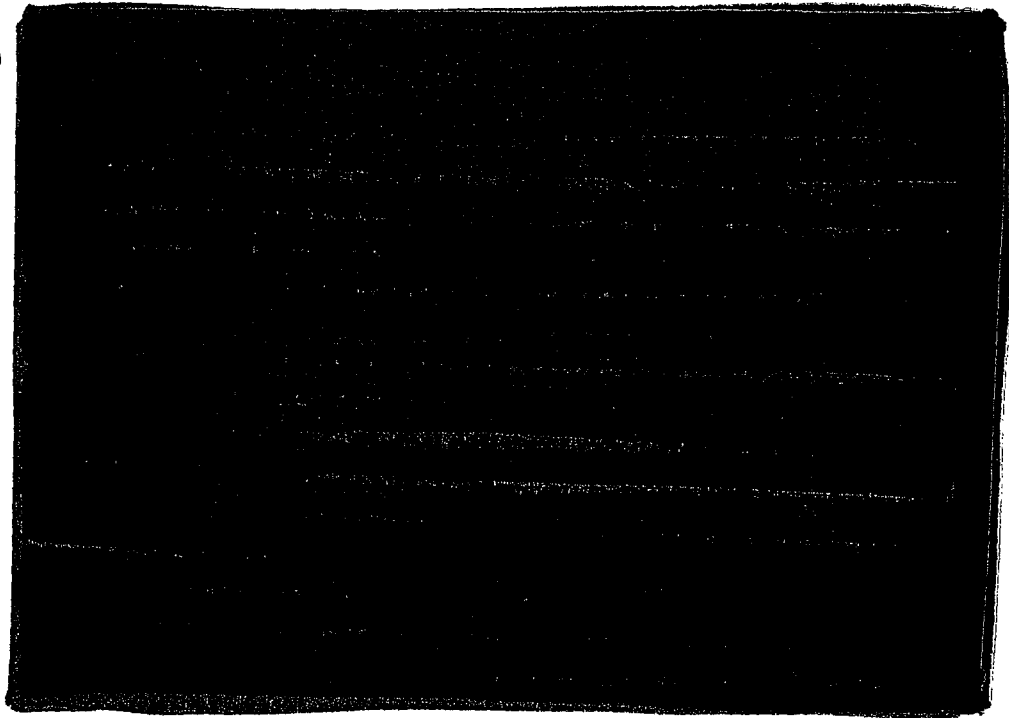
Labatt Appoints Lakeport's Boards of Trustees and Directors

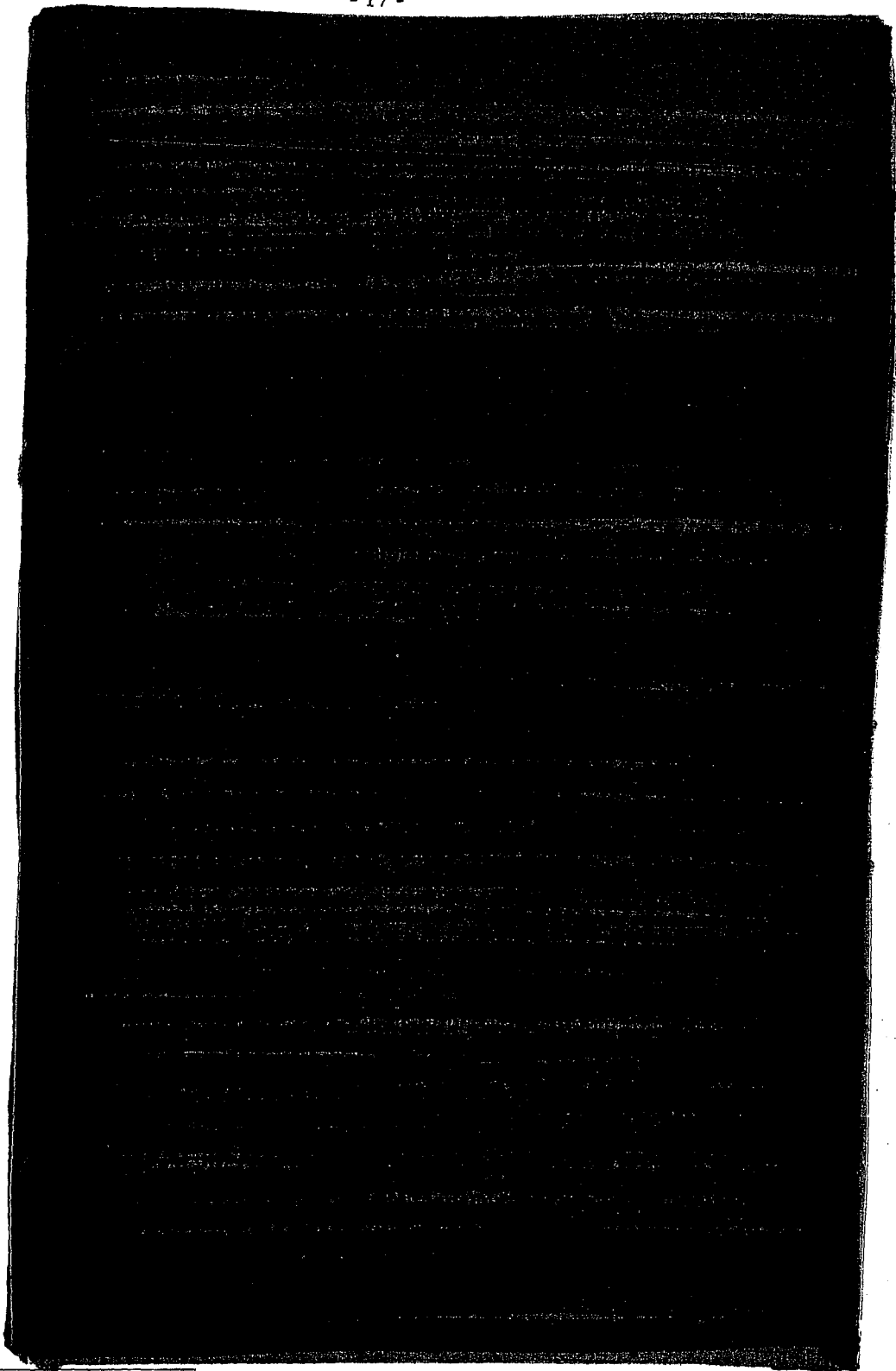
27. The proposed hold separate provides in paragraph 17 that "[o]n closing of the acquisition, Labatt shall reconstitute the boards of trustees and directors of Lakeport." It is anticipated that at least some of the members of the boards of trustees and directors will be individuals that previously did not serve on these boards and that are selected by Labatt, as is evidenced by the references to "new" trustees and directors in paragraph 17.

28. Labatt's appointment of Lakeport's board members is unusual since an independent competitor typically does not appoint the members of its competitor's board of directors. Moreover, the reappointment of these board members and directors will be determined by Labatt, which gives Labatt additional control.

29. The Labatt-appointed Lakeport Boards of Trustees and Directors will control important decisions that affect competitive conduct by Lakeport. For example:

(a)





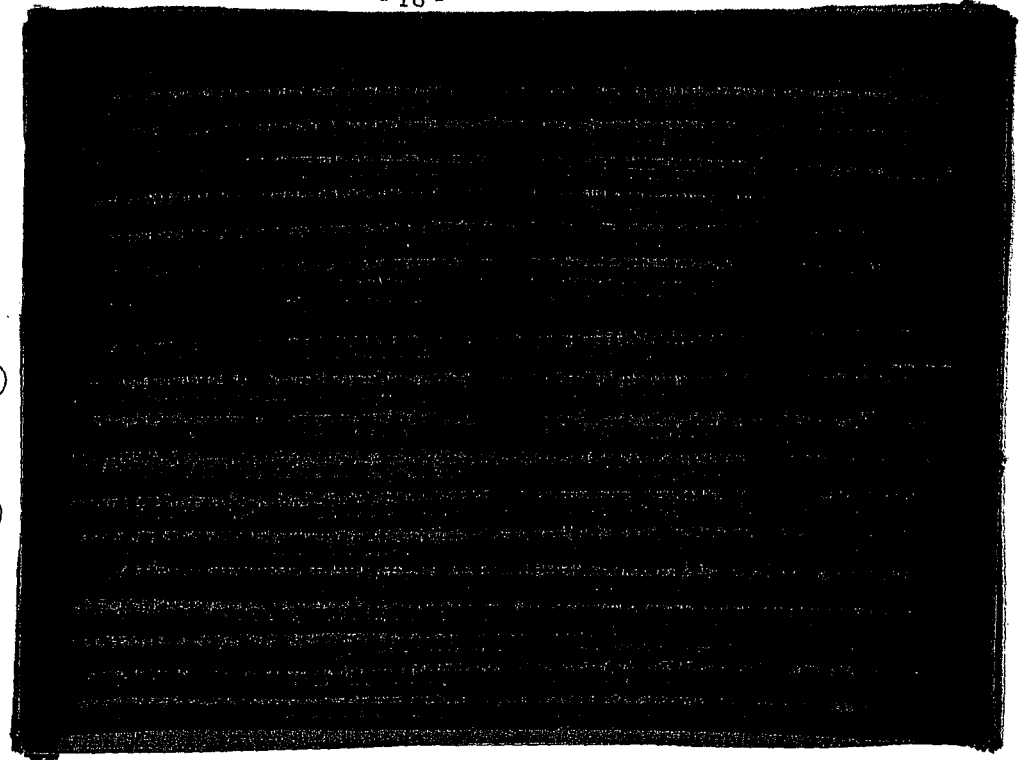
⁴⁹ See Exhibit "6" to the Affidavit of Gregory Lang, GNUM 1704.

⁵⁰ See Exhibit "6" to the Affidavit of Gregory Lang, GNUM 1705.

⁵¹ See Exhibit "30" to the Affidavit of Gregory Lang, GNUP 3282, 3286.

(b)

(c)



(d)

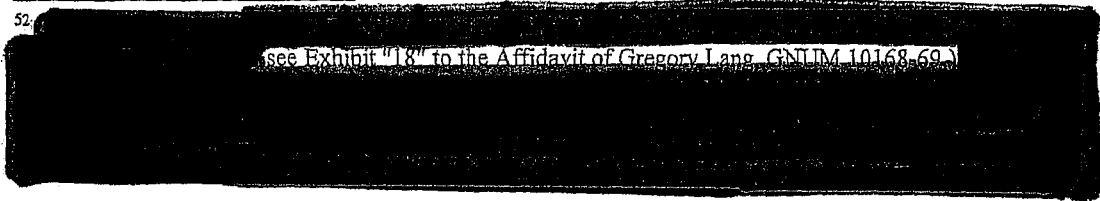
Labatt's President Can Have Input Into Lakeport's Operations

30. Under the proposed hold separate, "in the event that the President [of Labatt], acting reasonably, becomes concerned about the financial and/or operational well-being of Lakeport, as a result of his review of the periodic performance reports or otherwise, nothing shall prohibit the President from communicating and discussing his concerns, and making recommendations as he considers appropriate, to the management, trustees and/or limited partners of Lakeport" (see paragraph 13 of the proposed hold separate).

31. Paragraph 18 of the proposed hold separate also contemplates that Labatt's President could become a member of the Lakeport boards (i.e. the Fund board of trustees, the Lakeport Trust board of trustees and the Lakeport GP Inc. board of directors) "[i]n the event that the President, acting reasonably, is of the view that there is a material

52.

see Exhibit "18" to the Affidavit of Gregory Lang, GNJM 10168-69.



deterioration, or a reasonable prospect of a material deterioration, of the business of Lakeport."

(e)

Labatt Obtains Direct Control Over Many Decisions

32. The proposed hold separate states in paragraph 8 that "the Labatt board of directors shall be entitled to make decisions regarding material financing and credit arrangements, material capital investments, material disbursements, material asset sales, the repayment of any material loans other than pursuant to their terms, and matters relating to material litigation with respect to Lakeport which are not in the ordinary course of business."

33. Paragraph 8 of the hold separate defines the word "material" to cover two situations: (1) situations where there is "consideration in excess of \$250,000 in respect of any a single transaction"; and (2) situations where there is consideration in excess of "\$500,000 in aggregate in respect of any series of such transactions".

34. The \$250,000 and \$500,000 thresholds are low enough that they may capture important competitive decisions that occur on a regular basis. For example, the \$250,000 threshold is likely to capture any significant capital expenditures. The \$500,000 threshold, because it captures "any series" of payments, is likely to capture significant promotional efforts, such as a series of advertising campaigns.

35. 

⁵³ See Exhibits "21" and "26" to the Affidavit of Gregory Lang, GNUP 251, GNUP 995.

(b)

(c)

(d)

36. While the proposed hold separate requires that Labatt's board of directors exercise its power with respect to these decisions in a way that "does not adversely affect the ability of Lakeport to operate as an effective competitive business", there is substantial ambiguity in what it meant to be an "effective, competitive business".

(3)

**LABATT'S INCREASED CONTROL OVER LAKEPORT WILL HAVE IMMEDIATE,
IRREMEDIALE INTERIM ANTI-COMPETITIVE EFFECTS**

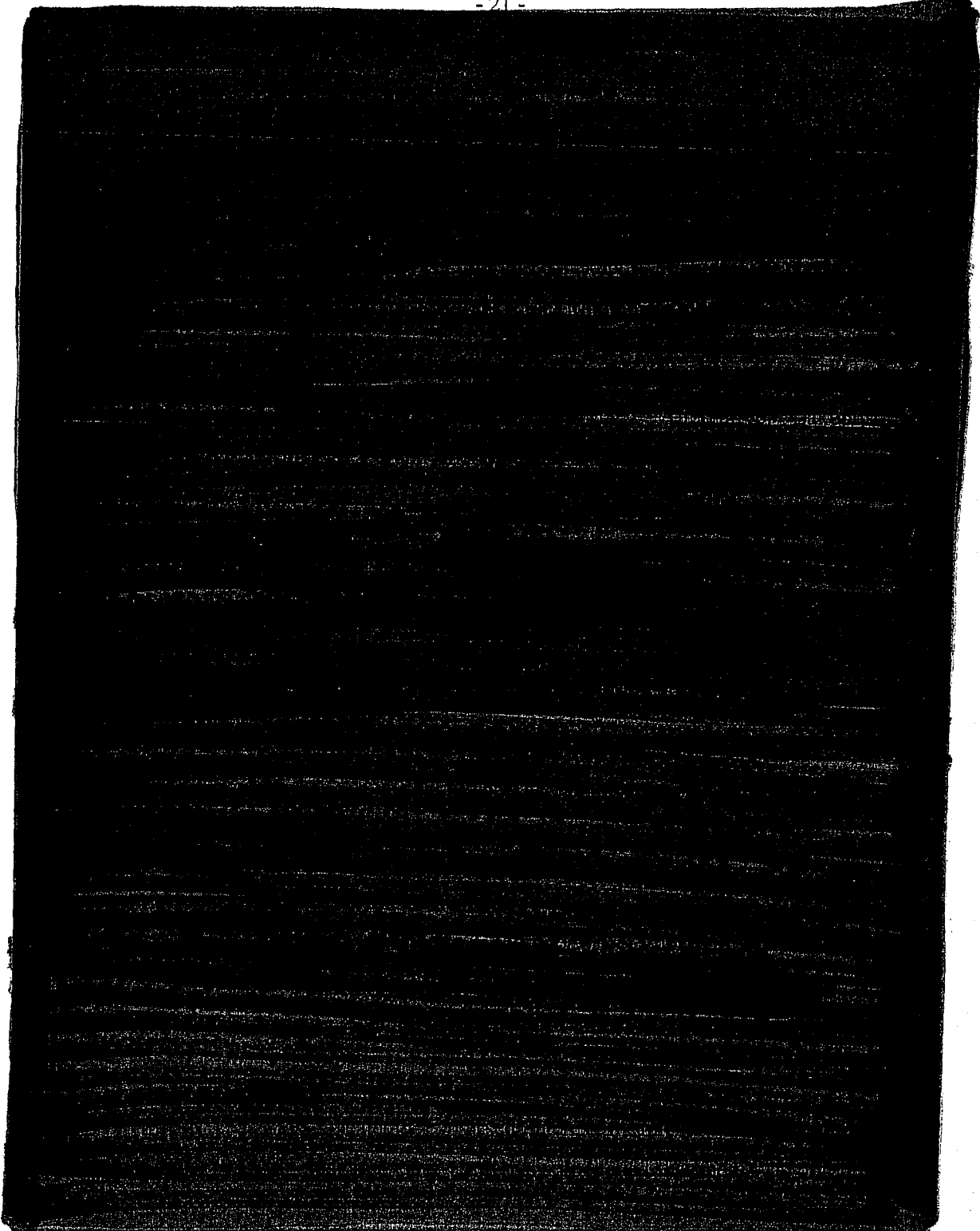
37. As is indicated in the first section of this affidavit, there is preliminary evidence that supports the view that Lakeport is a maverick competitor that plays a significant pro-competitive role in the Ontario beer market.

38. 

⁵⁴ See Exhibit "19" to the Affidavit of Gregory Lang, GNUM 10734.

⁵⁵ See Exhibit "28" to the Affidavit of Gregory Lang, GNUP 1164.

⁵⁶ See Exhibit "27" to the Affidavit of Gregory Lang, GNUP 1100.

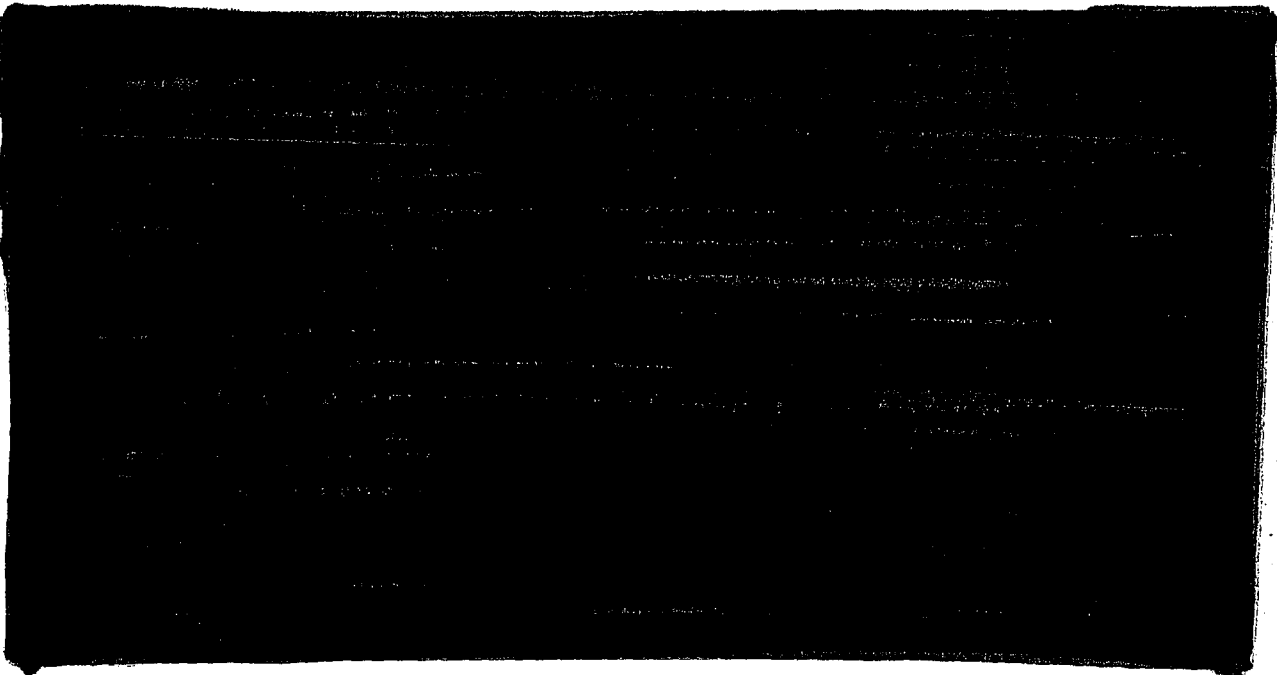


⁵⁷ See Exhibit "4" to the Affidavit of Gregory Lang, GNUM 508.


⁵⁸ See Exhibit "20" to the Affidavit of Gregory Lang, GNUM 10755_00000045.

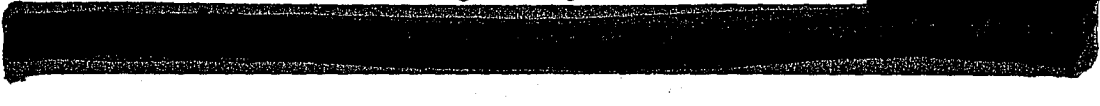
⁵⁹ See Exhibit "18" to the Affidavit of Gregory Lang, GNUM 10168-69.

⁶⁰ See Exhibit "12" to the Affidavit of Gregory Lang, GNUM 4583.




42. Industry analysts who have commented on the proposed acquisition of Lakeport by Labatt have predicted that Labatt will use its control over Lakeport to raise prices. For example, one article reported that David Hartley, a beverage analyst at Blackmont Capital, stated that "[t]he idea [of the merger] is to bring the pricing for the industry up as a whole, and this deal might do that over time."⁶⁴ Further, according to Anthony Bucal, a Bear Stearns & Company analyst, the transaction "would reintroduce order to the marketplace."⁶⁵

43. Labatt also has an incentive to divert customers from Lakeport brands to Labatt brands when Labatt earns a higher margin on its Labatt brands. 



⁶¹ See Exhibit "18" to the Affidavit of Gregory Lang, GNUM10166.

⁶² See Exhibit "12" to the Affidavit of Gregory Lang, GNUM 4583.



⁶⁴ D. Friend, "Labatt's \$201.4M takeover of Lakeport could inspire further discount beer buyouts", available at http://ca.news.yahoo.com/s/capress/070201/business/labatt_7, accessed 3/14/07. A true copy of this article is attached as Exhibit "4".

⁶⁵ M. Bhatia and K. Bell, "InBey Agrees to Purchase Lakeport to Expand in Canada", February 1, 2007, available at <http://www.bloomberg.com/apps/news?pid=20601082&sid=asmU>. A true copy of this article is attached as Exhibit "5".

44. In sum, during the period when this matter is being investigated by the Bureau and considered by the Competition Tribunal ("Tribunal"), the proposed hold separate would give Labatt substantial control over a close competitor, which raises the serious threat of reduced competition during this time period. The price increases that would result from reduced competition will not be addressed by a structural remedy such as a divestiture. In particular, the Tribunal will not be able to devise a remedy that compensates consumers that paid a supra-competitive price for beer during the period of time when the hold separate is in place and the investigation and litigation are ongoing.

(4)

**LABATT'S INCREASED CONTROL OVER LAKEPORT WILL HAVE LONG-TERM,
IRREMIABLE ANTI-COMPETITIVE EFFECTS**

(a)

**Experience from Prior Divestitures Reveals that Purchasers Often Alter Acquired
Assets in Ways that Undermine the Effectiveness of the Relief of Divestiture**

45. In his seminal work on merger policy, Elzinga found that in only about ten percent (4/39) of merger cases was there "successful" or "sufficient" relief.⁶⁷ He wrote that relief was especially difficult to achieve after a merger had been completed:

One of the greatest problems in [merger] relief is restoring the assets of a firm after they have been consumed by a merger. Whenever one firm absorbs another, even if their locations are geographically separate, the personnel remain separate and unchanged, and the assets involved continue in their general premerger usage, separating the two firms will present problems. [...]

But the problems mentioned above are minor compared to those so often encountered in trying to restore a once viable firm.⁶⁸

⁶⁶ See Exhibit "9" to the Affidavit of Gregory Lang, GNUM 2903.

⁶⁷ K.G. Elzinga, "The Antimerger Law: Pyrrhic Victories?" (April 1969) XII(1) *The Journal of Law and Economics* 43 at 51 [hereinafter "Elzinga"]. A true copy of this article is attached as Exhibit "6".

46. Elzinga also found that the passage of time after a merger was consummated made it even more difficult to achieve an adequate divestiture. The one factor which works against asset restoration in all anti-merger cases is the time factor. As a general rule, one could safely say that the "unscrambling" problem is a function of the time span from the time of the acquisition to the time of the relief order. The longer this span, the less likely are the chances for unscrambling.⁶⁹

47. Similarly, Rogowsky's research found that delays in divestiture undermine their effectiveness, and that nearly 75 percent of the divestiture orders in the sample that he studied were either deficient or unsuccessful.⁷⁰

48. Robert Pitofsky, Chairman of the FTC from 1995 to 2001, commented that he preferred for merging parties to identify an up-front purchaser of any assets to be divested, rather than undo a merger after-the-fact, because "[o]ur merger and compliance division managers [at the FTC] had observed that some divestitures took too long, and some divestiture packages may not have included sufficient assets to be readily saleable or to present a sufficient likelihood of success."⁷¹

49. The 1999 FTC report *A Study of the Commission's Divestiture Process* provides some insights into how to improve the odds of success for divestiture orders. The study evaluated FTC divestiture orders issued from 1990 through 1994. Among other things, the Commission found that divestiture orders were more likely to be successful if they "required persons acquiring assets to submit an acceptable business

⁶⁸ Elzinga at 53 (Exhibit "6").

⁶⁹ Elzinga, at 54 (Exhibit "6").

⁷⁰ R.A. Rogowsky, "The Economic Effectiveness of Section 7 Relief" (Spring 1986) XXXI(1) *The Antitrust Bulletin* 187 at 202, 209. A true copy of this article is attached as Exhibit "7".

⁷¹ "More than Law Enforcement: The FTC's Many Tools - A Conversation with Tim Muris and Bob Pitofsky" (2005) 72(3) *Antitrust Law Journal* 773 at 829. A true copy of this article is attached as Exhibit "8".

plan for those assets."⁷² This recommendation reflects a concern that the acquirer might not be prepared to use the assets well and to prevent them from deteriorating.

50. Another study of 86 merger cases brought by the Antitrust Division of the U.S. Department of Justice during 1990-2003 also found that post-merger divestitures were generally inadequate. Specifically, this study found that settlements involving structural remedies "frequently result in 'compromise' or less-than-full removal of the competitive overlap argued to be the source of harm to future competition."⁷³

51. The FTC has been concerned about the effectiveness of its divestiture orders since at least the mid-1990s. At that time a review of nine post-merger divestitures "confirmed the need for changes to the way [the FTC] approached merger remedies."⁷⁴ Because of this concern, the FTC began "a program of following-up on divestitures on a case-by-case basis."⁷⁵

52. One of the concerns the FTC has about divestitures is that the assets to be divested will deteriorate when they are under the control of the acquiring party. The Commission's policy has evolved to encourage "up-front buyers" because "[u]p-front buyers significantly reduce the risk that assets will deteriorate by speeding up the process and by creating a third party with a vested interest in ensuring that the assets are preserved."⁷⁶ The FTC uses up-front buyers when possible, minimizing the need for hold-separates.⁷⁷

⁷² *A Study of the Commission's Divestiture Process*, prepared by the Staff of the Bureau of Competition of the Federal Trade Commission, William J. Baer, Director, 1999, p. iv. A true copy of this study is attached as Exhibit "9".

⁷³ M.S. Kouliavtsev, "Measuring the Extent of Structural Remedy in Section 7 Settlements: Was the US DOJ Successful in the 1990s?", *Review of Industrial Organization*, forthcoming, at 21. A true copy of this article is attached as Exhibit "10".

⁷⁴ *Merger Remedies*, prepared remarks of George S. Cary, Senior Deputy Director, Bureau of Competition, Federal Trade Commission, before the American Bar Association, Antitrust Spring Meeting, April 10, 1997, p. 1 [hereafter *Merger Remedies*]. A true copy of these remarks is attached as Exhibit "11".

⁷⁵ *Merger Remedies* at p. 2 (Exhibit "11").

⁷⁶ *Merger Remedies* at pp. 3-4 (Exhibit "11").

⁷⁷ *Merger Remedies* at p. 5 (Exhibit "11"); and *Reflections on 20 Years of Merger Enforcement Under the Hart-Scott-Rodino Act*, Prepared Remarks of William J. Baer, Director, Bureau of Competition, Federal Trade Commission before The Conference Board (October 29, 1996) and The 35th Annual Corporate Counsel Institute, Northwestern University School of Law, October 31, 1996, p. 17. A true copy of these remarks is attached as Exhibit "12".

53. Several public cases illustrate some of the types of problems that can arise when control passes to the acquiring party before there is an effective divestiture:

- (a) When Schnuck Markets Inc. acquired National Food Markets in 1995, the FTC required divestitures, but ran into problems. The FTC cleared the merger on the condition that, after the acquisition, the company would divest 24 supermarkets in the St. Louis area. As soon as the acquisition was completed, it became clear that Schnuck had no intention of honoring the asset maintenance agreement attached to the FTC's order – it started closing departments of the divested stores, unlisting telephone numbers and referring customers to other Schnuck branches that were not being divested. During the year it had to sell the stores, the sales for those stores declined by approximately 35%.⁷⁸
- (b) The FTC also had an unsatisfactory experience with the divestiture required in the CVS/Revco case. Before being allowed to merge, these two large drugstore chains were required to divest a total of 120 former Revco retail stores. Just before CVS sold the stores to another drugstore chain, Eckerd, it "removed its automated computer prescription system, resulting in substantial difficulty in accessing customers' prior prescription records."⁷⁹
- (c) When the largest drugstore chain in the United States, Rite-Aid, acquired LaVerdiere Enterprises, Inc. in 1994, it was ordered to divest three drug stores in Maine and New Hampshire. The divestiture was eventually completed under a Commission-appointed trustee, "but the evidence

⁷⁸ R. Brambilla, "US Merger Review: Changing at the Edges" (March 2001) *Global Counsel* 16 at 21-22. A true copy of this article is attached as Exhibit "13". See also W.J. Baer & R.C. Redcay, "Solving Competition Problems in Merger Control: The Requirements for an Effective Divestiture Remedy" 69 *The George Washington Law Review* 1701 at 1704. A true copy of this article is attached as Exhibit "14".

⁷⁹ *Report from the Bureau of Competition*, Prepared Remarks of William J. Baer, Director, Bureau of Competition, Federal Trade Commission, before the American Bar Association Antitrust Section, Spring Meeting 1998, April 2, 1998, p. 11 [hereinafter *Report from the Bureau of Competition*]. A true copy of these remarks is attached as Exhibit "15".

- 27 -

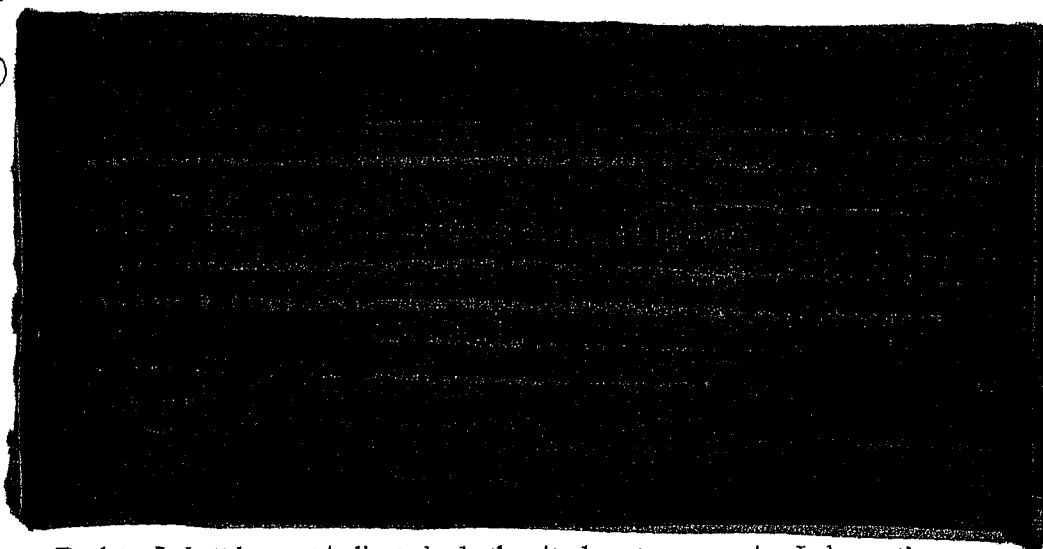
indicated that Rite Aid had made essentially no effort to carry out its obligation to divest."⁸⁰

(b)

There is a Serious Threat that Labatt Would Make Structural Changes in Lakeport's Operations Which Would Undermine the Ability to Remedy the Anti-Competitive Effects of the Merger

54. While Labatt has not articulated a clear post-acquisition plan, the rationalization of Lakeport's operations in a way that "scrambles the eggs" is a possibility:

(a)



(b) To date, Labatt has not indicated whether it plans to reorganize Lakeport's operations. This means that one cannot rule out the possibility that Lakeport's operations will be dismantled. Labatt has indicated that it plans to delist the units from the Toronto Stock Exchange (TSX), if permitted by the hold separate agreement.⁸²

55. Similarly, Labatt has not articulated a clear pricing strategy after the acquisition. One possibility is that Labatt will use its control over Lakeport to raise the

⁸⁰ Report from the Bureau of Competition at p. 11 (Exhibit "15").

⁸¹ See Exhibit "18" to the Affidavit of Gregory Lang, GNUM 10169.

⁸² See page 32 of Labatt's Offer to Purchase for Cash, which is attached as an exhibit to the Affidavit of Stephen Peters.

price of Lakeport's discount brands or undertake other actions (such as changes in marketing efforts) to divert sales from Lakeport brands to higher-priced Labatt brands.

56.



57. Industry analysts have suggested that implementation of a "diversion strategy" may follow the merger. For example, one article reported that David Hartley, a beverage analyst at Blackmont Capital, stated that "[t]here's an opportunity here for Labatt to trade drinkers up to higher-priced brands."⁸⁴

(c)

Even if Labatt Cannot Immediately Consolidate the Labatt and Lakeport Businesses, Labatt Is Likely to Slow or Refocus Lakeport's Growth in Ways that Will Make Lakeport a Less Effective Competitor at the Time of the Divestiture than It Otherwise Would Have Been

58.



⁸³ See Exhibit "31" to the Affidavit of Gregory Lang, GKPK 460.

⁸⁴ D. Friend, "Labatt's \$201.4M takeover of Lakeport could inspire further discount beer buyouts", available at http://ca.news.yahoo.com/s/capress/070201/business/labatt_7, accessed 3/14/07 (Exhibit "4").

(a)

(b)

59. Slowing Lakeport's growth can result in an immediate payback to Labatt, while at the same time preserving the value of Lakeport's current assets.

60. However, slowing Lakeport's growth will make Lakeport a less effective competitor after the divestiture. Lakeport has an efficient and flexible manufacturing process, which it characterizes as giving it the ability to deal with a variety of packaging sizes and a wide variety of can and bottle formats.⁸⁷

While Lakeport obtains some economies of scope by packaging non-beer beverages at its facility, there are likely to be economies of scale that may be lost if Labatt is successful in limiting Lakeport's growth during the interim period. As a result, there is the possibility that Lakeport would lose a portion of the manufacturing economies that it would enjoy "but for" the change in control.

61. Further, Lakeport has been able to achieve cost savings in advertising by focusing on a multiple-brand or family approach. This approach spreads costs over a number of successful brands and thereby results in significant cost savings.⁸⁹ If Labatt is successful in limiting Lakeport's growth during the interim, it could impede Lakeport's ability to achieve additional economies of scale and scope in advertising, raising its cost structure at the time of the divestiture relative to what it otherwise would be.

⁸⁵ See Exhibit "20" to the Affidavit of Gregory Lang, GNUM 10755_00000045.

⁸⁶ See Exhibit "20" to the Affidavit of Gregory Lang, GNUM 10755_00000045.

⁸⁷ Lakeport Annual Report, 2006 at p. 4 (Exhibit "3").

⁸⁸ See Exhibit "22" to the Affidavit of Gregory Lang, GNUP 391.

⁸⁹ Lakeport Annual Report, 2006 at p. 4 (Exhibit "3").

62. Finally, slowing Lakeport's growth may reduce the number of Lakeport products that are in the Top Ten beers sold by The Beer Store, also making Lakeport a less effective competitor after the divestiture. This is because The Beer Store often gives special treatment to the Top Ten Brands. These brands are displayed in a more favorable position than other brands. In particular, these beers are placed in a cooler in front of the counter, while all other beers are kept behind the counter. The Top Ten Brands are also featured on The Beer Store's website. As of October 2006, two Lakeport beers, Honey Lager and Pilsener, were among the ten top selling beers in Ontario.⁹⁰

(d)

**Labatt's Control Over Lakeport Is Likely Not Only to Slow Lakeport's Growth,
But to Lead to an Absolute Decline in Lakeport's Ability to Compete**

63. As is pointed out above, there is a basis for assuming that Lakeport is a "maverick" that has created a more competitive market, leading to lower beer prices in Ontario. As is also explained above, Labatt can have a short-term incentive to use its control over Lakeport to force a cessation of Lakeport's "maverick" behavior since this will lead to higher beer prices in Ontario.

64. Similarly, Labatt has an incentive to restructure Lakeport so that it is not as effective a competitor in the long run. In particular, Labatt has an incentive to use its control over Lakeport to undermine Lakeport's long-term ability to compete after a divestiture order, such that, among other things: (a) post-divestiture prices are higher than they would have been absent Labatt's control over Lakeport during the interim period; and (b) customers from Lakeport brands are diverted to Labatt brands.

65. By raising Lakeport's prices, changing Lakeport's marketing, and undertaking other actions that undermine Lakeport's competitive position, Labatt can make Lakeport a less effective competitor in the future and strengthen Labatt brands by diverting customers from Lakeport to Labatt.

⁹⁰ Lakeport Press Release, October 18, 2006, available at <http://media.integratir.com/t.tfi.un/PressReleases/pilsener8.pdf>. A true copy of this press release is attached as Exhibit "16".

66. This erosion in Lakeport's competitive position and strengthening of Labatt's competitive position offers the longer term advantage of reducing the competitive pressure that Lakeport can put on Labatt's higher priced brands, which can benefit Labatt whether or not it is forced to divest Lakeport:

- (a) If Labatt believes that it will be allowed to keep Lakeport, then Labatt has an incentive to operate the Lakeport assets in the interim as it would if Lakeport were being incorporated into or absorbed by Labatt. To the extent that Labatt's longer run goal is to close down Lakeport or slow its growth, then Labatt has no incentive during the pendency of the hold separate to invest further in Lakeport's tangible or intangible assets in the way that an independent Lakeport would. This incentive to let Lakeport weaken would be accentuated during the interim period to the extent that lost sales by Lakeport would be diverted to Labatt, raising Labatt's profits. Even if Labatt intended in the longer run to employ Lakeport's manufacturing facility as one of its own plants and thereby has an interest to maintain Lakeport's physical capital, Labatt would have no need to maintain the intangible assets that have allowed Lakeport's brands to grow and compete with Labatt. As such, one would expect significant deterioration of at least Lakeport's intangible assets during the interim period.
- (b) If Labatt believes that there is a non-trivial chance that it will ultimately be required to divest Lakeport, the extent to which Labatt will benefit from a deterioration in Lakeport's business will depend on a variety of factors. These factors include: (a) the amount of Lakeport's business that is diverted to Labatt during the interim; (b) the profitability of this incremental diverted business; (c) the profitability that results from higher industry prices in the long run due to a weakened Lakeport post-divestiture; and (d) the capital loss that Labatt will take when it resells Lakeport's business for a lower price than if it fully maintained the assets.

67. As suggested above, Labatt will benefit in the long term from larger sales of Labatt brands if it can use its control over Lakeport to build up Labatt's brands relative to Lakeport's brands. Labatt already offers a number of brands that are close substitutes for Lakeport's brands and that are likely to pick up diverted customers.

(a)

(b)

(c)

(d)

68. Lakeport's competitive position depends largely on "intangible assets" that can depreciate quickly under Labatt's control:

- (a) Beer is a consumer product for which brand name reputation is quite important.
- (b) A brand's reputation is an "intangible asset." This means that the value of a firm's brands is reflected in the value of the firm's goodwill (the market

⁹¹ D. Friend, "Labatt's \$201.4M takeover of Lakeport could inspire further discount beer buyouts", available at http://ca.news.yahoo.com/s/capress/070201/business/labatt_7, accessed 3/14/07 (Exhibit "4").

⁹² See Exhibit "19" to the Affidavit of Gregory Lang, GNUM 10727.

⁹³ See Exhibit "8" to the Affidavit of Gregory Lang, GNUM 2494.

⁹⁴ See Exhibit "6" to the Affidavit of Gregory Lang, GNUM 1704.

value of the firm above the net value of the tangible assets that are recorded on the firm's balance sheet).

(c)



(d) Lakeport recognizes that it has significant intangible assets in its 2006 Annual Report:

- (i) "The Fund's intangible assets consist of brands, listing fees and customer relationships. Brands and listing fees have an indefinite life and are not amortized, but instead are tested for impairment annually, or when indicated by events or changes in circumstances, by comparing the fair value of the assets to their carrying value. Customer relationships are amortized straight line over their estimated useful life."⁹⁹
- (ii) "Goodwill represents the cost of the acquired business in excess of the fair value of net identifiable assets acquired. Goodwill is tested for impairment annually, or when indicated by events or changes

⁹⁵ See Exhibit "23" to the Affidavit of Gregory Lang, GNUP 715.

⁹⁶ See Exhibit "23" to the Affidavit of Gregory Lang, GNUP 725.

⁹⁷ See Exhibit "23" to the Affidavit of Gregory Lang, GNUP 725.

⁹⁸ See Exhibit "23" to the Affidavit of Gregory Lang, GNUP 728.

⁹⁹ Lakeport 2006 Annual Report, p. 22 (Exhibit "3").

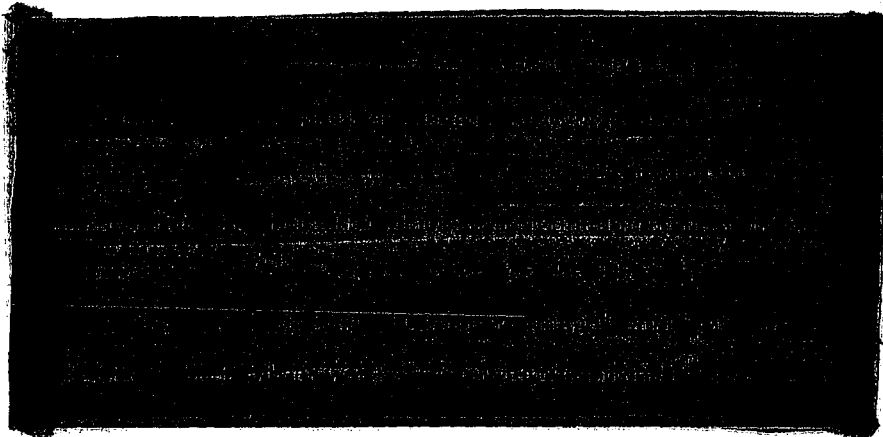
in circumstances, by comparing the fair value of the acquired business to its carrying value."¹⁰⁰

- (iii) Lakeport's 2006 Annual Report lists intangible assets and goodwill as follows:

Intangible Assets:	2006:	\$24,727,000
	2005:	\$24,923,000
Goodwill:	2006:	\$32,955,000
	2005:	\$32,955,000 ¹⁰¹

- (e) Intangible assets can depreciate quickly:

(i)



- (ii) If Lakeport's advertising and other marketing expenditures are reduced relative to the levels that would have occurred "but for" the merger, or if the message contained in the ads is altered, Lakeport's reputation may erode.¹⁰⁴

¹⁰⁰ Lakeport 2006 Annual Report, p. 22 (Exhibit "3").

¹⁰¹ Lakeport 2006 Annual Report, p. 25 (Exhibit "3").

¹⁰² See Exhibit "12" to the Affidavit of Gregory Lang, GNUM 4601.

¹⁰³ See Exhibit "12" to the Affidavit of Gregory Lang, GNUM 4601.

¹⁰⁴ A survey of the econometric literature on this subject confirms that "90% of the cumulative effect of advertising on sales of mature, frequently purchased, low-priced products occurs within 3 to 9 months of the advertisement. The conclusion that advertising's effects on sales lasts for months rather than years is strongly supported." See D.G. Clarke, "Econometric Measurement of the Duration of Advertising Effect on Sales" (November 1976) *XIII Journal of Marketing* 345 at 355. A true copy of this article is attached as Exhibit "17". Recent improvements in econometric techniques indicate that the empirical techniques used in these older studies impart an upward bias to the results, and their "estimates of the duration of the cumulative advertising effect might be too high." (G.J. Tellis & P.H. Franses, "Optimal Data Interval for

- (iii) If Lakeport's prices drift up relative to other discount brand's prices, Lakeport's reputation as a "good value" will erode.
- (iv) If Lakeport's inventory policies are changed, Lakeport's reputation as a brand that can be found with little consumer search will be compromised.
- (v) If Lakeport's quality control effort is compromised and inferior quality product is sold, Lakeport's reputation for providing a quality discount beer will be undermined.

69. Lakeport's historical success has come from the well-timed introduction and successful promotion of new brands. [REDACTED]

[REDACTED] Because the hold separate takes control over both the introduction of new brands and the support of new and existing brands out of the hands of Lakeport's existing management, it could allow Labatt to undermine Lakeport's existing brands and Lakeport's ability to grow through the introduction of new brands. It is unlikely that an interim manager will be able to grow the brand as well as the existing Lakeport management, particularly given the divided loyalties of that interim manager. Illustrative historical strategic decisions that have supported Lakeport's growth are listed below. Decisions of this type are likely to arise in the future, particularly if the hold separate is in place for an extended period:

- (a) While the Steeler brand was a preexisting brand (launched in 1986), the current management launched a large number of new brands: Lakeport Pilsener in 1994; Brava in 1997; Lakeport Light in 1997; Lakeport Strong in 1997; Lakeport Ice in 1998; Mongoose Malt Liquor in 1998; Lakeport Honey Lager in 2002; and Wee Willy in 2003.¹⁰⁶ The timing of the

Estimating Advertising Response" (May-June 2006) 25(3) *Marketing Science* 217 at 227. A true copy of this article is attached as Exhibit "18".

¹⁰⁵ See Exhibit "23" to the Affidavit of Gregory Lang, GNUP 729.

¹⁰⁶ 2006 Lakeport Annual Report, p. 6 (Exhibit "3").

introduction of new brands can be very important, since it typically is better to be first on the market with a new product in a particular market niche because of "first mover" advantages.¹⁰⁷

(i)

(ii)

- (b) After launching its brands, Lakeport's management monitored them and modified their packing formats and designs. For example, in 2006 alone, Lakeport made the following packaging modifications:

¹⁰⁷ R. Schmalensee, "Product Differentiation Advantages of Pioneering Brands" (June 1982) 72 *American Economic Review* 349 at 349-365 (a true copy of this article is attached as Exhibit "19"); and C.A. Conrad, "The Advantage of Being First and Competition Between Firms" (December 1983) 1 *International Journal of Industrial Organization* 353 at 353-364 (a true copy of this article is attached as Exhibit "20").

¹⁰⁸ See Exhibit "24" to the Affidavit of Gregory Lang, GNUP 909 - 910.

- (i) "[N]ewly designed packaging was launched for all of the Lakeport brands."¹⁰⁹
- (ii) "Lakeport became the first brewer to offer a 24-can pack in the value category, making Lakeport Honey Lager, Lakeport Pilsener, and Lakeport Light brands available in this format."¹¹⁰
- (iii) "Lakeport made available all of its leading brands in 355 ml cans in a 6-pack format."¹¹¹
- (iv) "Lakeport's top-selling brands were launched in 473 ml. can formats exclusive at the LCBO."¹¹²
- (v) "Lakeport Ice became available in 24-pack bottles and can formats"¹¹³

70. Lakeport's ability to compete in the future will decline if it loses key personnel due to the shift in control over Lakeport's operations. Lakeport's current management team has performed unusually well and will be difficult to replace effectively during the interim period:

- (a) Lakeport's President and CEO, Teresa Cascioli, has won awards and received recognition nationwide for the exceptional job she has done while heading Lakeport. The brewery was in bankruptcy when she was brought in to head the company in 1999. In 2000, Lakeport was primarily a contract brewer.¹¹⁴ Under Ms. Cascioli's guidance, Lakeport has expanded sales of its proprietary brands to its current share of 11 percent of the Ontario beer market. Two of its beers, Lakeport Honey Lager and

¹⁰⁹ 2006 Lakeport Annual Report, p. 4 (Exhibit "3"); and Press Release, <http://media.integratir.com/t.tfr.un/PressReleases/Lakeport%20Strong.pdf>, accessed 3/17/07. A true copy of this press release is attached as Exhibit "21".

¹¹⁰ 2006 Lakeport Annual Report, p. 4 (Exhibit "3").

¹¹¹ 2006 Lakeport Annual Report, p. 4 (Exhibit "3").

¹¹² 2006 Lakeport Annual Report, p. 4 (Exhibit "3").

¹¹³ 2006 Lakeport Annual Report, p. 4 (Exhibit "3").

¹¹⁴ Lakeport Brewing press release, <http://www.integratir.com/overview.asp?ticker=t.tfr.un&title=null>, accessed 3/13/07. A true copy of this press release is attached as Exhibit "22".

Lakeport Pilsener, are among the top ten beer brands in Ontario. Lakeport Light is the fastest growing light beer in Ontario.¹¹⁵

- (b) In acknowledgement of her success at Lakeport, Ms. Cascioli has recently received various honors, including Canada's Most Powerful Woman in 2006, the number three position in the Eighth Annual Profit W100 Rankings of Canada's Top Women Entrepreneurs for 2006, and Finalist for the 13th Annual Ernst & Young 2006 Entrepreneur of the Year Award, Entrepreneur of the Year by Canada's Venture Capital & Private Equity Association.¹¹⁶ In 2004, Ms. Cascioli was the recipient of the Entrepreneur of the Year Award in the Turnaround Category.¹¹⁷
- (c) Under Ms. Cascioli's leadership, Lakeport set new achievement records during 2006:

"With the support of Ontario's consumers and the continuing razor-focus of our management team and employees, Lakeport set new achievement records for the quarter and for the year in every key area of performance," Cascioli told investors in a conference call.

"The growth in our sales and market share for the year confirmed that marketing strategies, promotion and advertising efforts in 2006 were highly successful."¹¹⁸

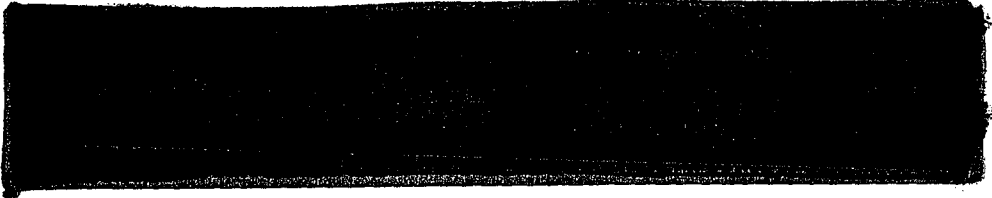
(d) 

¹¹⁵ Lakeport 2006 Annual Report, p. 3 (Exhibit "3").

¹¹⁶ Lakeport Brewing press releases, <http://media.integratir.com/t.tfr.un/PressReleases/wxnaward1.pdf> (a true copy of this press release is attached as Exhibit "23"); <http://media.integratir.com/t.tfr.un/PressReleases/2006profit100.pdf> (a true copy of this press release is attached as Exhibit "24") and <http://www.integratir.com/newsrelease.asp?news=2130955482&ticker=T.TFR.UN&lang=EN>, accessed on 3/13/07 (a true copy of this press release is attached as Exhibit "25"), all accessed on 3/13/07.

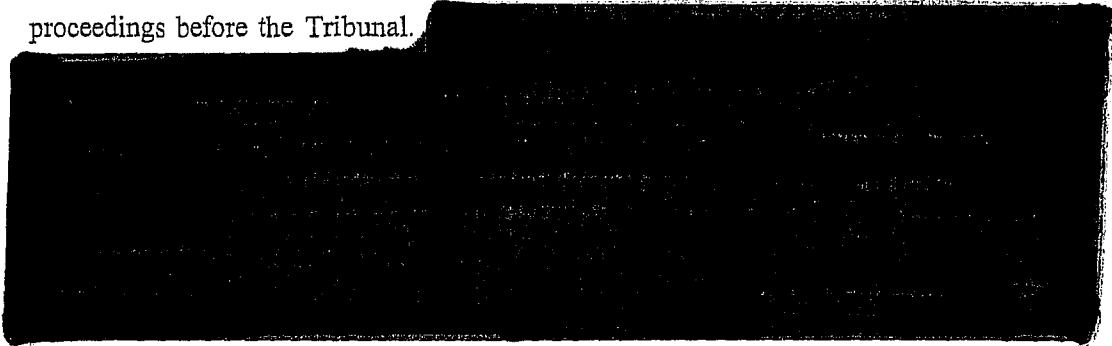
¹¹⁷ Lakeport Brewing press release, <http://www.integratir.com/newsrelease.asp?news=2130955914&ticker=T.TFR.UN&lang=EN> (a true copy of this press release is attached as Exhibit "26")

¹¹⁸ D. Friend, "Lakeport Brewing Set Records in Every Key Performance Area, CEO Says" *Canadian National Post*, 3/6/07, <http://www.canada.com/nationalpost/financialpost/story.html?id=685773b2-fb8f-496c-8b7b-cfdc623243a6&k=93733>, accessed 3/14/07. A true copy of this article is attached as Exhibit "27").



(e) Ms. Cascioli says she doesn't know whether she will have a role with Labatt/InBev.¹²⁰ She holds about 20% of Lakeport shares and stands to make about \$40 million from the deal.¹²¹

71. Finally, Lakeport also has physical assets that may be compromised if Labatt chooses to "milk" the Lakeport operation during the investigation and potential proceedings before the Tribunal.



(5)

**THE PROPOSED HOLD SEPARATE HAS ANTI-COMPETITIVE EFFECTS
THAT DO NOT DEPEND ON LABATT OBTAINING SIGNIFICANT CONTROL
OVER LAKEPORT'S OPERATIONS**

(a)

**The Proposed Hold Separate Provides Labatt with Increased Information
About Lakeport's Operations Which Will Facilitate Anti-Competitive
Coordination Between Competitors**

72. While the proposed hold separate has language that limits the flow of information between Lakeport and Labatt, the hold separate nonetheless allows

¹¹⁹ See Exhibit "26" to the Affidavit of Gregory Lang, GNUP 972.

¹²⁰ M. Bhatia and K. Bell, "InBev Agrees to Purchase Lakeport to Expand in Canada", February 1, 2007, available at <http://www.bloomberg.com/apps/news?pid=20601082&sid=asmU> (Exhibit "5").

¹²¹ D. Friend, "Labatt's \$201.4M takeover of Lakeport could inspire further discount beer buyouts", available at http://ca.news.yahoo.com/s/capress/070201/business/labatt_7, accessed 3/14/07 (Exhibit "4").

¹²² See, e.g., Exhibit "23" to the Affidavit of Gregory Lang, GNUP 743, 746, 748-749, 751.

significant amounts of competitively sensitive information to flow between Lakeport and Labatt:

- (a) Under the proposed hold separate, Lakeport will provide Labatt with "monthly financial and operating reports ('periodic performance reports') to the President and to the AmBev and InBev Board of Directors and Executive Committee." (paragraph 12)
- (b) The proposed hold separate also provides in paragraph 13 that "in the event that the President [of Labatt], acting reasonably, becomes concerned about the financial and/or operational well-being of Lakeport, as a result of his review of the periodic performance reports or otherwise, nothing shall prohibit the President from communicating and discussing his concerns, and making recommendations as he considers appropriate, to the management, trustees and/or limited partners of Lakeport."
- (c) Paragraph 14 of the proposed hold separate states that "Lakeport will further provide such information, confidential and otherwise, necessary for the Labatt board of directors to make the assessments and decisions provided in paragraph [8] herein". Paragraph 8 calls for the Labatt board to control decisions on one-time transactions exceeding \$250,000 and a series of transactions exceeding \$500,000.
- (d) The "monitor" who will examine Lakeport's activities is likely to be a Labatt employee who will not only monitor Lakeport, but also "perform his or her regular employment duties" (see paragraphs 29-23 of the proposed hold separate). Pursuant to paragraph 24 of the hold separate, this monitor will have access to Lakeport's premises, information relating to its operations, assets and business, management meetings, and minutes of its boards of directors', trustees' and limited partners' meetings. Thus, the monitor will be making business decisions for Labatt at the same time he or she has access to competitively sensitive Lakeport information.

73. The information accessible to Labatt pursuant to the proposed hold separate will make it easier for Labatt to coordinate its competitive activities with Lakeport. [REDACTED]

74. It is well understood that access to information about rivals, as well as information about how rivals see the market place, aids in coordination. The U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines¹²⁴, for example, cite "the extent of information available to firms in the market" as a key indicia of whether market conditions are conducive to reaching terms of coordination.¹²⁵ They state that "[k]ey information about rival firms and the market may also facilitate reaching terms of coordination."¹²⁶ The U.S. Department of Justice and Federal Trade Commission Antitrust Guidelines for Collaborations Among Competitors¹²⁷ similarly state that the "sharing of information related to a market in which the collaboration operates or in which the participants are actual or potential competitors may increase the likelihood of collusion on matters such as price, output, or competitively sensitive variables. [...] Other things being equal, the sharing of information relating to price, output, costs, or strategic planning is more likely to raise competitive concern than the sharing of information relating to less competitively sensitive variables."¹²⁸

75. It is in Labatt's interest to operate Lakeport so as to maximize the joint profits of both Labatt and Lakeport together. Information gained through the proposed hold separate [REDACTED] in conjunction with other factors discussed above that allow Labatt to control decisions and spending at Lakeport, could well aid Labatt in achieving this anticompetitive goal.¹²⁹

¹²³ See Exhibit "20" to the Affidavit of Gregory Lang, GNUM 10755_00000045.

¹²⁴ A true copy of these Guidelines is attached as Exhibit "28" (hereinafter "U.S. Merger Guidelines").

¹²⁵ U.S. Merger Guidelines at §2.1 (Exhibit "28").

¹²⁶ U.S. Merger Guidelines at §2.11 (Exhibit "28").

¹²⁷ A true copy of these Guidelines is attached as Exhibit "29" (hereinafter "U.S. Collaboration Guidelines").

¹²⁸ U.S. Collaboration Guidelines at §3.31(b) (Exhibit "29").

¹²⁹ It is also possible that through information flows during the hold separate Labatt will learn Lakeport's trade secrets that will stay with Labatt after any divestiture. This would make it harder for Lakeport to compete as successfully as it currently does with Labatt post-divestiture.

(b)

**The Proposed Hold Separate Contains Language That Restricts
Labatt's Ability to Compete Aggressively with Lakeport**

76. Because Labatt has a duty to "maintain the independent viability of Lakeport", Labatt is under a duty not to undertake any action that will "adversely affect" the "financial status of Lakeport" (see paragraph 15(e) of the proposed hold separate). This duty restricts Labatt's ability to compete aggressively with Lakeport.

77. This effect on competition is accentuated by Labatt's financial interest in Lakeport under the hold separate. As discussed in the next section, Labatt has an incentive to market its brands less aggressively to the extent that resulting lost sales are diverted to Lakeport, in whose profits Labatt shares.

(c)

**The Common Ownership of Lakeport and Labatt Will Change
the Firm's Profit Maximizing Calculus, Giving the Merged Firm
an Incentive to Charge Higher Prices**

78. I have shown above that under a hold separate, Labatt can still maintain elements of direct control over the operations of Lakeport, despite some restrictions on Labatt's control contained in the proposed hold separate arrangement. The hold separate's failure to prevent Labatt from exercising significant direct corporate control over Lakeport is only one aspect of the problem. Another compelling problem is that Labatt's financial interest in Lakeport under a hold separate also changes the incentives of both Labatt and Lakeport so that they will operate less competitively than before the hold separate. In particular, the financial linkage between the firms reduces the incentive for the firms to compete aggressively against each other.

79. Financial interest refers to the acquiring firm's entitlement to a share of the profits of the acquired firm. In this case, Labatt would obtain 100% of the profits of Lakeport after it buys 100% of the units. Even if the hold separate were to successfully

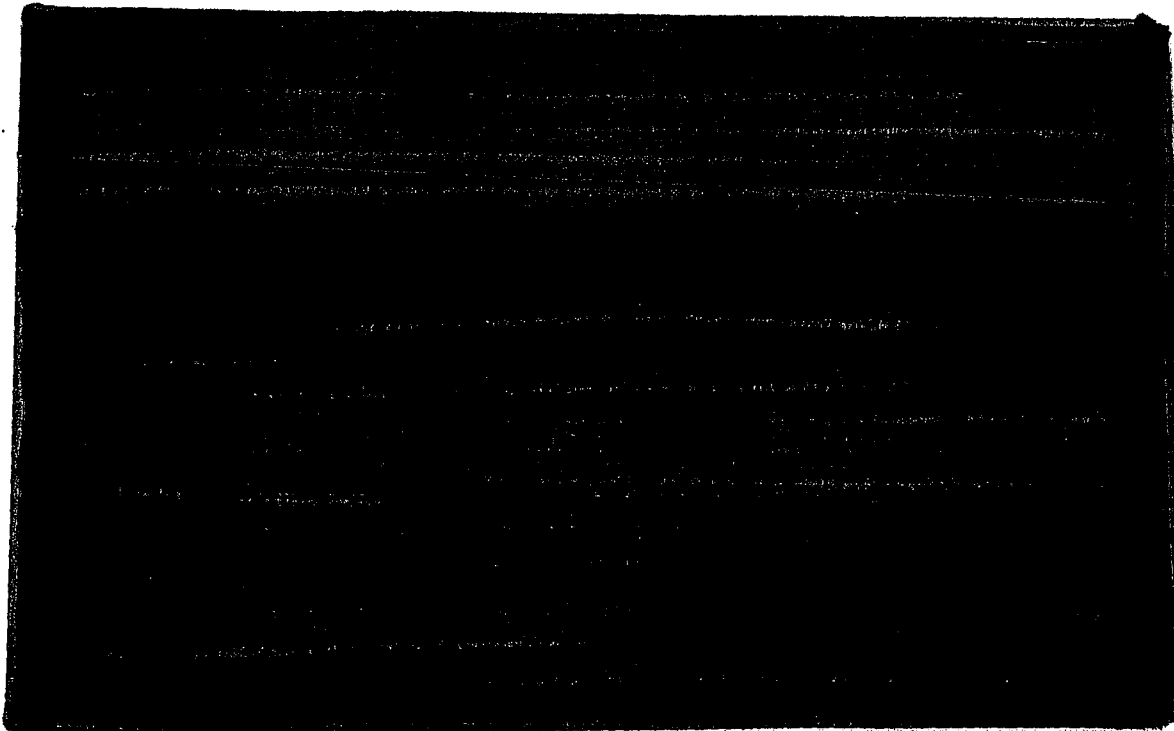
limit direct influence or control by Labatt in the production and pricing decisions of Lakeport, Labatt's ownership of Lakeport under the hold separate is likely to create financial incentives for: (a) Labatt to raise prices; and (b) Lakeport's managers (some of whom are otherwise Labatt employees) to run Lakeport less aggressively. The potential anticompetitive effects of these types of financial interest effects are well documented in the economics literature.¹³⁰

80. In this case, Labatt's financial interest under the hold separate is likely to result in a different, less competitive, outcome than if Labatt and Lakeport continued to compete independently, with no shared financial interest. This type of incentive problem may generally limit the effectiveness of hold separates as a means of preventing anti-competitive harm. In addition, the particular facts in the present case make this incentive problem from financial interest particularly problematic.

81. Labatt is likely to compete less aggressively due to its financial interest in Lakeport under the hold separate (which allows Labatt to acquire all of Lakeport's units). When a firm like Labatt acquires a financial interest in a rival such as Lakeport, Labatt's incentive to compete is reduced at the margin. That is because some of the customers Labatt would lose when it increases price are diverted to Lakeport, whose profits go to Labatt after it acquires all of the units. The greater this diversion from the acquiring to the acquired firm, all else equal, the more significant is the financial interest effect. Thus, the financial interest of Labatt allows it to recapture some of the profits that would be lost from the price increase if there were no financial interest in Lakeport. When Labatt takes this recapture into account, it has a greater incentive at the margin to increase prices. This increased incentive of the acquiring firm to raise prices does not depend on any assumption that the acquiring firm controls the acquired firm; the increased incentive to raise prices comes directly from the acquiring firm's financial interest.¹³¹

¹³⁰ See, for example, D.P. O'Brien & S.C. Salop, "Competitive Effects of Partial Ownership: Financial Interest and Corporate Control" (2000) 67 *Antitrust Law Journal* 559 at 559-614 (hereinafter "O'Brien-Salop"). A true copy of this article is attached as Exhibit "30".

¹³¹ O'Brien-Salop at 571-574 (Exhibit "30").



83. Correspondingly, Lakeport is likely to compete less aggressively due to Labatt's financial interest under the hold separate. To the extent that Labatt has some degree of control or influence on Lakeport's pricing, the financial interest of Labatt is likely to affect Lakeport's incentives to compete as well. In a manner analogous to the effect on the incentives of Labatt, if Lakeport were to raise its prices, some portion of the customers lost would be diverted to Labatt, increasing its profits. That will affect Lakeport's pricing incentives, as carried out through Labatt's influence. Again, the greater the diversion, the larger the financial interest effect on the acquired firm. As a result, as long as Labatt has a degree of control over Lakeport's pricing, its managers will take into account this diversion of sales and profits to Labatt when setting Lakeport's prices.¹³⁴



84.

¹³² See Exhibit "31" to the Affidavit of Gregory Lang, GKPK 433, 448.

¹³³ See Exhibit "31" to the Affidavit of Gregory Lang, GKPK 434; 437.

¹³⁴ O'Brien-Salop at 571 (Exhibit "30").

85. As noted, a key variable in determining the magnitude of the financial interest effect is the degree of diversion between the products of the acquiring and acquired firm. All else equal, the greater the diversion between these firms (i.e., the closer these firms' products compete with one another), the greater the financial interest effect. Economists often summarize this relationship by calculating a diversion ratio. The diversion ratio measures the amount of a firm's sales that are diverted to a firm's prospective merger partner in response to a price increase, relative to the total substitution away from the price-increasing firm.¹³⁶ For example, if the total substitution away from a firm due to a price increase is 100 units, but 30 units are lost to the firm's prospective merger partner, then the diversion ratio is 30%.

86. There are a number of ways to try to estimate diversion ratios between firms. If one knows or can estimate the elasticity of demand for the brands of the acquiring firm as well as the cross-elasticity of demand between the brands of the acquired and acquiring firm, one can calculate the diversion ratio.¹³⁷ However, it is sometimes difficult to obtain or estimate these measures. Alternatively, if the merging brands are similar in characteristics (i.e., particularly close substitutes), or if the merging brands have large shares within a broader product category, the diversion ratio is likely to be relatively high. Also, for brands with similar characteristics, the diversion ratio is likely to be high for a smaller brand that is merging with a dominant brand, since customers switching away from the smaller brand are more likely to divert to the similar dominant brand.¹³⁸

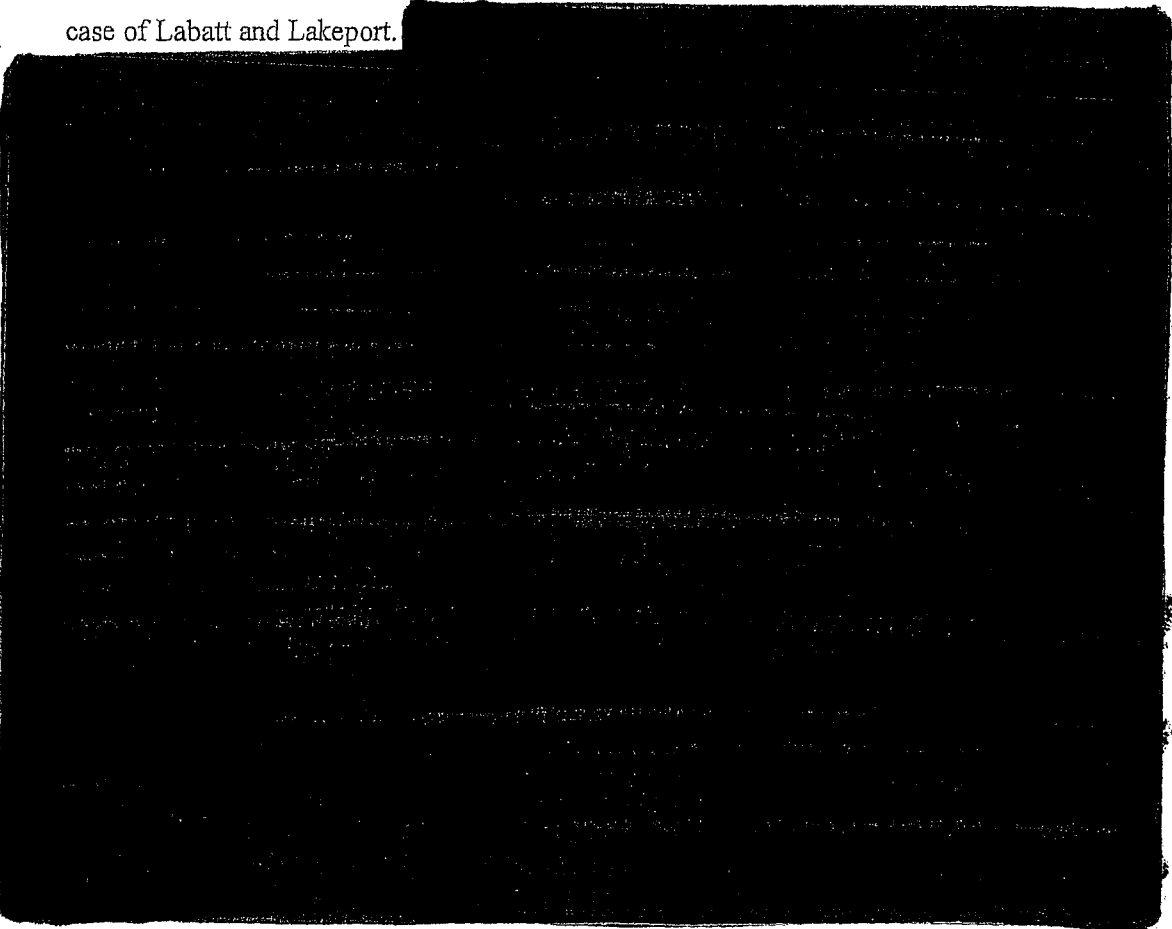
¹³⁵ See Exhibit "20" to the Affidavit of Gregory Lang, GNUM 10755_00000045.

¹³⁶ C. Shapiro, "Mergers with Differentiated Products" (Spring 1996) Antitrust 23 at 23 (hereinafter "Shapiro"). A true copy of this article is attached as Exhibit "31".

¹³⁷ As a technical economic matter, the diversion ratio is the ratio of the cross-elasticity of demand between the brands of the merging parties to the own elasticity of demand of each brand, multiplied by the ratio of the quantity of the acquiring firm to that of its prospective merger partner (O'Brien and Salop at 563, Exhibit "30"). If one assumes that the unit sales of the merging brands are equal prior to the merger, then the diversion ratio is just the ratio of the cross-elasticity of demand between the brands to the own elasticity of demand of each brand (Shapiro at 24-25, Exhibit "31").

¹³⁸ Shapiro at 25-26 (Exhibit "31").


87. There is evidence that the diversion ratio is likely to be quite high in the case of Labatt and Lakeport.



¹³⁹ See Exhibit "33" to the Affidavit of Gregory Lang, GKPK 398.

¹⁴⁰ The elasticity of demand for a brand is defined as the percentage change in the quantity demanded of the brand, divided by the percentage change in the price charged. Thus, if a 1% price rise resulted in a sales drop of more than 1%, it would be said that the demand for that brand was "elastic"; if sales fell by less than 1%, its demand would be termed "inelastic".

¹⁴¹ The cross-elasticity of demand for a brand is the percentage change in the quantity of that brand demanded divided by the percentage change in the price of a competitive brand. The larger the cross-elasticity of demand between two brands, the closer the substitutability between them.

¹⁴² 
¹⁴³ See Exhibit "33" to the Affidavit of Gregory Lang, GKPK 420.

¹⁴⁴ 

88.



89. Another factor influencing the importance of the financial interest effect is the margin of the acquiring and acquired firms on the relevant brands. The larger is the acquired firm's (Lakeport's) margin relative to the marginal cost of the acquiring firm (Labatt), the greater is the profit recaptured by the acquiring firm on sales diverted to the acquired firm, and hence, the greater the marginal incentive for the acquiring firm to raise prices.¹⁴⁷ Thus, other things equal, the incentive for a firm to raise prices due to financial interest is larger the higher the diversion ratio from the acquiring to the acquired firm, and the higher the acquired firm's margins. The incentives of the acquired firm to raise prices are analyzed in a similar way, and depend on the size of the acquiring firm's (Labatt's) margin relative to the marginal cost of the acquired firm (Lakeport). The larger is Labatt's margin relative to the marginal cost of Lakeport, the greater the gain to Labatt from diversion from Lakeport, and the greater the marginal incentive to increase Lakeport's prices.

90. The problem of financial interest, combined with elements of control still remaining in the hold separate, has been identified as a significant issue in economic assessments of past hold separates in the U.S. For example, a 1997 study by Schumann, Reitzes, and Rogers¹⁴⁸ analyzes the hold separate that was imposed by the U.S. District

¹⁴⁵ See Exhibit "11" to the Affidavit of Gregory Lang, GNUM 3492; Exhibit "5" to the Affidavit of Gregory Lang, GNUM 900; Exhibit "8" to the Affidavit of Gregory Lang, GNUM 2494; Exhibit "7" to the Affidavit of Gregory Lang, GNUM 1743; Exhibit "12" to the Affidavit of Gregory Lang, GNUM 4492, 4552, 4557, 4583; Exhibit "19" to the Affidavit of Gregory Lang, GNUM 10730-31.

¹⁴⁶ See Exhibit "31" to the Affidavit of Gregory Lang, GKPK 455.

¹⁴⁷ O'Brien-Salop at 599 (Exhibit "30").

¹⁴⁸ L. Schumann, J.D. Reitzes & R.P. Rogers, "In the Matter of Weyerhaeuser Company: The Use of a Hold-Separate Order in a Merger with Horizontal and Vertical Effects" (1997) 11 Journal of Regulatory

Court in response to the FTC's attempt to enjoin the acquisition by Weyerhaeuser of Menasha's corrugating medium assets in Oregon. The Court allowed the acquisition to proceed subject to a hold separate agreement with respect to the Oregon mill. The study examined the issue of "whether managers' incentives are affected by transfers of ownership even if regulatory measures (i.e., hold-separate orders) are instituted to prevent changes in corporate control." The study hypothesized that "Weyerhaeuser's ownership of the mill [under the hold separate] may have created incentives for the mill's managers to unilaterally set price and output levels that they perceived to be in the best interest of Weyerhaeuser." These incentives were hypothesized to occur because "the mill's managers were employees of Weyerhaeuser and that Weyerhaeuser received the mill's profits. If the managers of the North Bend mill perceived a positive probability that Weyerhaeuser would win the pending antitrust case and gain direct control of the mill, then they may have believed that their best interest required setting prices or production in a manner that was consistent with Weyerhaeuser's best interest. Thus, even though Weyerhaeuser could not directly control the North Bend mill, its ownership of the mill under the hold-separate order may have created incentives for those who did control the North Bend mill to act to maximize Weyerhaeuser's profits." The study tested these hypotheses empirically with historical industry data and concluded that the results "strongly suggest that allowing Weyerhaeuser to purchase Menasha's North Bend corrugating medium plant under the hold-separate order resulted in an increase in corrugating prices." These results were held to be "consistent with the view that the hold-separate order allowed any anticompetitive effects of the acquisition to be realized".¹⁴⁹

(6)

CONCLUSION

91. If the closing of the transaction proceeds, even with the proposed hold separate, it is likely that there will be a reduction in competition during the investigation and any subsequent litigation that will be irremediable, assuming, as is consistent with

Economics 271-289. All three authors are former Federal Trade Commission staff economists (hereinafter "Schumann-Reitzes-Rogers"). A true copy of this article is attached as Exhibit "32".

¹⁴⁹ Schumann-Reitzes-Rogers at 273, 276, and 284 (Exhibit "32").

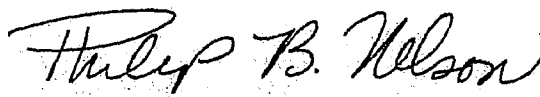
the market information described in Section (1) above, that Lakeport and Labatt are close competitors in a concentrated market where the merger is likely to have anti-competitive effects. Similarly, allowing Labatt to purchase Lakeport before the investigation and any subsequent litigation is resolved is likely to lead to actions that will impair Lakeport's ability to compete in the future if the Tribunal determines that Lakeport should be divested by Labatt:

- (a) Under the hold separate, Labatt obtains significant control over Lakeport's operations and information about its competitive strategies. Labatt can use this control and information to chill competition between Lakeport and Labatt.
- (b) Even if Labatt does not obtain control over Lakeport, acquisition of a financial interest in Lakeport through the acquisition of the Lakeport units will alter Labatt's and Lakeport's profit maximizing calculus. This will color the competitive decisions of the affiliated companies, chilling competition while the firms are financially linked.
- (c) Under the proposed hold separate, Labatt will have control over many of Lakeport's key competitive decisions. Because Lakeport has been growing, supporting this growth with increased advertising and aggressive competitive responses to price cuts, Labatt can make it hard to restore Lakeport to its "but for the acquisition" stature by limiting expenditures and price discounts that are designed to support this growth trajectory.
- (d) Because the proposed hold separate anticipates a change in managerial make-up and source of control, the management that is in place at Lakeport when litigation is complete and the Tribunal may determine that divestiture is appropriate is likely to be different than the "but for the acquisition" management. This difference in management will make it difficult for the Tribunal to remedy the effect of the proposed transaction since it may not be able to recreate the successful management team that has supported Lakeport's impressive growth.

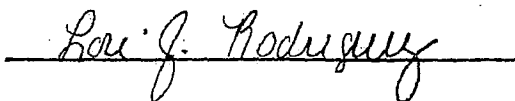
(e) More generally, because the core Lakeport assets are intangible assets, such as brand reputation, that can decay quickly, turning over the operation of Lakeport to a management team that is chosen by Labatt runs a serious risk that the Lakeport assets that are available to be divested, should this matter be litigated and the Tribunal decide that divestiture is the appropriate remedy, will not be adequate to remedy the effect of the proposed merger on competition.

92. I make this affidavit in support of an application by the Competition Bureau under section 100 of the *Competition Act*, and for no other or improper purpose.

SWORN before me at the City of)
Washington, in the District of Columbia,)
in the United States of America,)
this 20th day of March, 2007)


PHILIP B. NELSON

A Commissioner for Taking Affidavits



LORI J. RODRIGUEZ
A NOTARY PUBLIC OF DISTRICT OF COLUMBIA
MY COMMISSION EXPIRES JUNE 30, 2008

THE COMPETITION TRIBUNAL

Proceeding commenced at Ottawa

AFFIDAVIT OF PHILIP B. NELSON
(sworn March 20, 2007)

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