R-I-37

Court File No.: CT-88-1

COMPETITION TRIBUNAL/TRIBUNAL DE LA CONCURRENCE

IN THE MATTER OF an application by the Director of Investigation and Research under subsection 64(1) of the *Competition Act*, R.S.C. 1970, c. C-23, as amended;

AND IN THE MATTER OF a Limited Partnership formed to combine the operations of the Reservec and Pegasus computer reservation systems;

AND IN THE MATTER OF The Gemini Group Automated Distribution Systems Inc;

AND IN THE MATTER OF an application by the Director of Investigation and Research under section 106 of the *Competition Act*, R.S.C. 1985, c. C-34, as amended, to vary the Consent Order of the Tribunal dated July 7, 1989

BETWEEN:

The Director of Investigation and Research

Applicant

- and -

Air Canada,
PWA Corporation,
Canadian Airlines International Ltd.,
The Gemini Group Limited Partnership,
The Gemini Group Automated Distribution Systems Inc.,
Covia Canada Corp.,
Covia Canada Partnership Corp.

Respondents

- and -

Consumers' Association of Canada,
American Airlines, Inc.,
Attorney General of Manitoba,
Alliance of Canadian Travel Associations,
Bios Computing Corporation,
IBM Canada Ltd.,
VIA Rail Canada Inc.,
Unisys Canada Inc.,
Council of Canadian Airlines Employees,
Attorney General of Alberta

Intervenors

AFFIDAVIT OF PROFESSOR RICHARD W. SCHWINDT

AFFIDAVIT

I, RICHARD W. SCHWINDT, of the Town of Mt. Lehman in the Province of British Columbia, MAKE OATH AND SAY AS FOLLOWS:

1. I am an Associate Professor of Economics and Business Administration with the Department of Economics and the Faculty of Business Administration at Simon Fraser University, British Columbia.

2. Now shown to me and marked as Exhibit "A" to this my Affidavit is a copy of my curriculum vitae.

3. I have been asked by Osler, Hoskin & Harcourt to provide my opinion on the remedies proposed by The Director of Investigation and Research in these proceedings.

4. The contents of the report attached as Exhibit "B" to this my Affidavit and the opinions expressed therein are true to the best of my knowledge, information and belief.

5. I do not have any interest as either an investor or a lender in Gemini or any of the partners or shareholders thereof, nor do I have any financial interest in the outcome of these proceedings.

6. I make this affidavit pursuant to Rule 42(1) of the *Competition Tribunal Rules*.

SWORN BEFORE ME at the District of, MATSQUI in the Province of British Columbia on the 4TH day of November, 1993.

Commissioner for Taking Affidavits, etc.

DAVID PATTERSON
Barrister & Solicitor
#201 - 2760 TRETHEWEY STREET
CLEARBROOK, B.C. V2T 3R1

Richard W. Schwindt

This is Exhibit " A " referred to in the affidavit
of Richard W. Schwindt
sworn before me herein, this 4th
day of Nov., *1993*

A Commissioner, etc.

DAVID PATTERSON
Barrister & Solicitor
#201 - 2760 TRETHEWEY STREET
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August, 1993

CURRICULUM VITAE

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Education: A.B. 1967 (Economics, with distinction)
University of California, Berkeley

Ph.D. 1973 (Economics) University of California, Berkeley--
Specializations: Industrial Organization, Antitrust Policy and International Trade--Thesis Supervisor: Joe S. Bain Jr.

Honors, Awards, Grants:

-Phi Beta Kappa (1967)
-Special Career Fellow, Berkeley (1967-1971)
-Graduate In-Trust Award, Berkeley (1971-1972)
-President's Research Grant, Simon Fraser University (1974 and 1978)
-Canada Council Research Grant (1978)
-Max Bell Foundation Research Grant (1983-1984)
-Research Fellow, University of Tromso and Norwegian School of Economics and Business Administration (1986)
-Excellence in Teaching Award, Simon Fraser University (1991)

Teaching Interests:

Industrial Organization
Public Policy towards Business
Business, Government and Society
Business Strategy

Employment:

-Instructor, then Assistant Professor, then Associate Professor, Department of Economics and Faculty of Business Administration, Simon Fraser University (1972-present)
-Visiting Associate Professor, Helsinki School of Economics and Business Administration (Spring Term 1986, 1987, 1988, 1989, 1990, 1991, 1992, 1993)
-Commissioner, Province of British Columbia, Resources Compensation Commission (1992)

Publications:

A. Books, Monographs, Technical Studies:

Report of the Commission of Inquiry into Compensation for the Taking of Resource Interests (Victoria, B.C.: Queen's Printer, 1992) R. Schwindt, sole Commissioner

Business Administration Reading Lists and Course Outlines, third edition, 14 volumes (Duke Station, NC: Eno River Press, 1991)

An Analysis of Vertical Integration and Diversification Strategies in the Canadian Forest Sector, Research Monograph (Vancouver: Forest Economics and Policy Analysis Project, University of British Columbia, 1985)

Business Administration Reading Lists and Course Outlines, (co-edited with James W. Dean) second edition, 12 volumes (Duke Station, NC: Eno River Press, 1985)

Industrial Organization of the Pacific Fisheries, Research Monograph (Vancouver: Commission on Pacific Fisheries Policy, 1981)

Business Administration Reading Lists and Course Outlines, (co edited with James W. Dean) first edition, 14 volumes (Duke Station, NC: Eno River Press, 1981)

The Existence and Exercise of Corporate Power - A Case Study of MacMillan Bloedel Limited, Study 15 (Ottawa: Royal Commission on Corporate Concentration, 1977)

The Real Cost of the British Columbia Milk Board (with H. Grubel) (Vancouver: Fraser Institute, 1977)

B. Chapters in Books:

"The Regulation of Salmon Aquaculture: an International Overview," (with T. Bjorndal) in K. Heen, R. Monahan and F. Utter, eds. *Salmon Aquaculture* (Oxford: Blackwell, 1993) pages 209-219

"Intellectual Property Rights: Anti-competitive Abuses and Competition Policy Antidotes," (with S. Globerman) in R.S. Khemani and W.T Stanbury editors, *Canadian Competition Law and Policy at the Centenary* (Halifax: Institute for Research on Public Policy, 1991) pages 463-496.

"Testing Hypotheses about Business-Government Relations: A Study of the British Columbia Forest Products Industry," (with S. Globerman), in Lee Preston ed. *Business and Politics: Research Issues and Empirical Studies* (Greenwich, CN.: JAI Press Inc., 1990) pages 289-322 (note: revision of a 1985 paper).

"The Structure of Salmon Markets: Implications for Forecasting," (with T. Bjorndal), in D. Devoretz, ed., *Salmon Price Forecasts for the 1990s* (Vancouver: Department of Fisheries and Oceans, 1990).

"The British Columbia Forest Sector," Chapter 6, and "The Pacific Salmon Fishery," Chapter 7, in T.Gunton and J.Richards eds., *Resource Rents and Public Policy in Western Canada* (Halifax: Institute for Research on Public Policy, 1987) pages 181-248

"The Dual: the Market and Planning, "Chapter 7 in J.Richards and D.Kerr eds., *Canada, What's Left* (Edmonton: NeWest Press, 1986) pages 113-127

"Business-Government Relations: Towards a Synthesis and Test of Hypothesis," (with S.Globerman) in V.V.Murray ed., *Theories of Business-Government Relations* (Toronto: Trans-Canada Press, 1985) pages 243-263

"Business and Society: a Review of the Work of the Royal Commission," in P.Gorecki and W. Stanbury eds., *Perspectives on the Royal Commission on Corporate Concentration* (Scarborough, Ont.: Butterworths, 1979) pages 271-301

"A Pessimistic View of Specialization Agreements," in N.Orvik ed., *Canada and the European Community* (Kingston, Ont.: Centre for International Relations, 1978) pages 64-75

C. Articles:

"An International Analysis of the Industrial Economics of Salmon Aquaculture," (with T. Bjorndal), *International Institute of Fisheries Economics and Trade: Proceedings of the IV Biennial Conference*, 1992, pages 1031-1046.

"Have a Heart: Increasing the Supply of Transplant Organs for Infants and Children," (with A.Vining), *Journal of Policy Analysis and Management*, Vol.7, No.4, Fall 1988, pages 706-710

"Proposal for a Future Delivery Market for Transplant Organs," (with A.Vining), *Journal of Health Politics, Policy and Law*, No. 3, Fall, 1986, pages 483-500

"The Organization of Vertically Related Transactions in the Canadian Forest Products Industries," (with S.Globerman), *Journal of Economic Behavior and Organization*, Vol. 7, 1986, pages 199-212

"Testing Hypotheses about Business-Government Relations: A Study of the British Columbia Forest Products Industry," (with S.Globerman), *Research in Corporate Social Performance and Policy--A Research Journal*, Vol. 7, 1985, pages 103-136

"Harvesting Canadian Fish and Rents: A Partial Review of the Report of the Commission on Canadian Fisheries Policy," (with D.Devoretz), *Marine Resource Economics*, No. 4, Spring, 1985, pages 347-367

"Structural Change in the Canadian Pacific Salmon Fishery," *The Canadian Journal of Regional Science*, No. 2, Autumn, 1984, pages 195-210

"Structure of the British Columbia, Washington and Oregon Hotel Industries–A Comparative Analysis," (with T.Var) *Journal of Travel Research*, No. 1, Summer, 1980, pages 2-8

"Advertising, Direct Foreign Investment and Canadian Identity," (with B.Schoner), *Canadian Review of Studies in Nationalism*, No. 1, Spring, 1980, pages 127-150

"The Pearse Commission and Industrial Organization of the British Columbia Forest Industry," *B.C. Studies*, No. 41, Spring, 1979, pages 3-35

"Industrial Structure of the British Columbia Traveller Accommodation Sector: An Application of the Industrial Organization Model to Service Industries," (with T.Var) *Journal of Travel Research*, No. 4, Spring, 1978, pages 21-29

"Bank Act Revision in Canada: Past and Potential Effects on Market Structure and Competition," (with James W. Dean) *Banca Nazionale del Lavoro--Quarterly Review*, No. 116, March 1976, pages 19-49

"Competition in Canadian Financial Markets," (with James W. Dean) *Proceedings of a Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago, 1974, pages 196-200

D. Book Reviews and Abstracts:

"A Taxonomy of International Banking," (with James W. Dean), abstracted in *Atlantic Economic Journal*, No. 3, September 1985, page 82

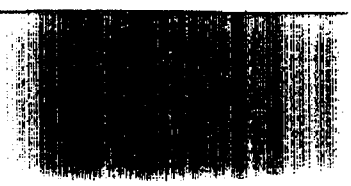
Review of David W. Green, *The Canadian Financial System Since 1965*, in *Canadian Journal of Economics*, No.3, August 1977,(with James W. Dean) pages 518-519

Consultancy: Anti-trust litigation support for the Bureau of Competition Policy in cases involving:

merger in the pulp and paper industry
lumber milling and plywood manufacture
petroleum refining
merger in dairy processing
refusal to deal in automobile parts
tied selling in computer maintenance services
merger in food services supply
merger in flour milling

Private sector anti-trust litigation support in cases involving:

heavy construction equipment distribution
motion picture distribution
building materials buying group practices
metalurgical coal
retail grocery distribution
automobile insurance



This is Exhibit " B " referred to in the affidavit
of Richard W. Schwindt
sworn before me herein, this 4th
day of NOV. , 1993

A Commissioner, etc.

DAVID PATTERSON
Barrister & Solicitor
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I have been asked by Osler Hoskin and Harcourt to provide my opinion, as an economist, on the consequences of the proposed remedies in the matter of the *Director of Investigation and Research v. Air Canada et al.*

At the outset it should be recognized that the proposed remedies have been developed within the context of very definite findings. My opinion is conditioned by a number of givens which are set out below.

A. Givens

1. *The survival of Canadian Airlines International (CAI) would have positive effects on the level of competition in the domestic Canadian airline industry.*

This implies that the failure of CAI and the subsequent dispersal of assets would not facilitate the entry of other air carriers. It also assumes that current restrictions on foreign ownership of Canadian air carriers and cabotage rights remain unchanged.

2. *The original Consent Order properly addressed the competition issues raised by the erger which resulted in the creation of Gemini. Specifically, the operation of Gemini, as conditioned by the Consent Order, did not and is not likely to result in a substantial lessening of competition in either the Canadian airline or computer reservation system (CRS) markets in Canada.*

I have reviewed the original U.S. Civil Aeronautic Board's (CAB) rules dealing with CRS operations, the terms of the original Consent Order and the findings of the Competition Tribunal as set out in its Order of April 22, 1993. I am satisfied that with the benefit of hindsight it is possible to conclude that the Gemini merger, as conditioned by the Consent Order, "passed the test" in terms of the *Merger Enforcement Guidelines* of the Director of Investigation and Research (DIR).

> In general, a merger will be found to be likely to prevent or lessen competition substantially when the parties to the merger would more likely be in a position to exercise a materially greater degree of market power in a substantial part of a market for two years or more, than if the merger did not proceed in whole or in part.[1]

Certainly if Gemini had resulted directly in a substantial lessening of competition, say, through facilitation of collusion by the airline partners the situation would be very different. In such a case, reconsideration of the merger and

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1 *Guidelines*, p. i.

contemplation of extreme remedies (e.g., unwinding) clearly would be in order.

3. *The survival of CAI is contingent upon an alliance with AMR, and such an alliance is contingent upon CAI's extrication from Gemini.*

This assumption is based upon the evidence of the Director of Investigation and Research (DIR) which was accepted by the Competition Tribunal. I am not in a position to test the proposition that the proposed alliance is the only, or best means to preserve CAI, or that the alliance is truly contingent upon an unwinding of Gemini.

4. *The costs to the remaining Gemini partners of the withdrawal of CAI exceed the direct costs associated with the transfer of assets as set out in the DIR's proposed remedies.*

Under the terms of the proposed remedies the direct costs of transferring the "Canadian Data Base" and "such other assets" to CAI will be borne by PWA and CAI. There are, however, additional opportunity costs (e.g., foregone revenues) borne by the remaining partners for which there will be no compensation under the terms of the proposed remedies.

B. Merits of the Proposed Remedies

To evaluate the merits of the proposed remedies, some criteria must be imposed. Conventionally, economists attempt to appraise public policy in terms of efficiency and equity (i.e., fairness).

1. The Context

Economists generally assume that under normal conditions private contracting results in the allocation of resources to their highest value use. In the case at hand normal conditions do not prevail, in part, because of government participation in the contracting process.

CAI is in financial difficulty and has "shopped" for a partner or purchaser. Its best offer has come from AMR Corporation, the parent of American Airlines. AMR has offered CAI an equity investment of $246 million for a 25 percent voting interest in the company. The terms of the offer require that CAI be free of any liability to Gemini. Presumably the value of the participation to AMR would be lower (and the offer would be lower) if CAI remains liable to Gemini. In the result, CAI's shareholders have an incentive to minimize (at the extreme, nullify) this obligation. Symmetrically, the remaining Gemini partners have an incentive to maximize the obligation and to insure that it is discharged. At issue is who will bear the cost of CAI's liability to Gemini?

Under normal conditions liability for damages would be borne by CAI and the extent of damages would be determined either through negotiations or the courts. In this instance negotiations have been complicated by the existence of public policy concerns resulting in government intervention. The DIR has concluded that the failure of CAI will have anti-competitive effects on the domestic airline market and consequently would generate significant social welfare costs. In effect, stalled negotiations might frustrate the participation of AMR and lead to the failure of CAI. CAI perceives that in pursuit of social welfare goals, government will facilitate the AMR transaction by minimizing or nullifying its obligations to Gemini. On the other hand, the other Gemini partners perceive no advantage in facilitating CAI's low cost or no cost exit from the partnership.

The DIR's proposed remedies, if implemented, would minimize CAI's financial liability to Gemini. In effect, the remaining partners would be forced to bear the costs (other than the immediate costs of switching the hosting of CAI from Gemini to Sabre) of CAI's exit from the partnership. This raises both efficiency and equity concerns.

2. Direct Efficiency Consequences of the Proposed Remedies

From an efficiency perspective there is no clear rationale for imposing the costs of CAI's exit from Gemini on the remaining partners. Given Air Canada's financial difficulties, admittedly not as severe as CAI's, this additional burden could have manifold, but difficult to identify, impacts. The loss of revenues and/or increased costs of operating Gemini without CAI would have to be made up in some manner and this would impact on the operations of the partners. Bearing these costs would increase the fragility of Air Canada's financial position. Similarly, it is difficult to identify the impacts on CAI if it were required to fulfill its financial obligations to Gemini. However, it is arguable that CAI shareholders would accept a lower price from AMR given the alternative. Since CAI is technically bankrupt the options are a lower payment from AMR or accepting the break-up value of the airline. Presumably the former is preferable to the latter.

In any event, there is no clear efficiency rationale for imposing the exit costs on the remaining Gemini partners. There are, however, equity and ancillary efficiency considerations which argue against imposing the costs in this way.

3. Equity Considerations

The primary equity issue raised by the proposed remedies involves a redistribution of wealth. Dissolution of the merger (or any of the alternative remedies proposed by the DIR) effectively imposes costs upon a direct competitor,

Air Canada, the other partners, and potentially other hosted services and suppliers. In normal circumstances competition policy commonly results in reallocations of wealth. Specifically, effective policy curbs the exercise of market power which in turn reduces monopoly returns. From an equity perspective this is generally viewed as acceptable because in competitive markets enterprises are not expected to, and have no right to receive such super-normal returns. In the case at hand, however, the remedies impose substantial costs upon parties to the merger who have not reaped monopoly returns as a result of the merger. In this sense, the proposed remedies raise serious equity concerns because they entail an arbitrary imposition of costs.

From a fairness perspective there is no reason to assume that Air Canada shareholders, and the other stakeholders in Gemini, are less worthy than the owners of CAI. Indeed, it might be argued that investors in CAI voluntarily assumed the risk and therefore should bear the costs of poor economic performance.

4. Ancillary Efficiency Considerations

The proposed remedies run the risk of introducing inefficiencies beyond this transaction. Broadly, the implementation of these remedies will introduce uncertainty about the stability of understandings reached with the Director of Investigation and Research, either in the form of consent orders or other undertakings. This in turn could have wider ranging adverse effects if it discourages mergers that are otherwise efficiency enhancing.

The Consent Order in this case appears to have done what it was intended to do. The Order was recognized as behavioural, it constrained the manner in which the partnership and the partners were to operate. The parties, including Air Canada, fulfilled the expectations of the Order. Moreover, there is no evidence that changed circumstances have allowed the partnership or the partners to behave in a manner which evades the letter or the spirit of the Order. Now, as a result of changed structural circumstances (the impending failure of CAI) and the behaviour of a competitor not party to the Order (the alliance condition imposed by AMR) the merger is viewed as anti-competitive by the DIR. Clearly, externally influenced structural changes and the behaviour of third parties could not be foreseen, and cannot be controlled, by the partnership or the partners.

Implementation of the proposed remedies will have several adverse effects on the consent order process. First, parties to such orders will have to consider the likelihood that exogenous structural changes will render their merger anti-competitive and subject to a forced unwinding. This uncertainty, which will complicate negotiations with the DIR, will increase as the period of exposure to review increases. Put differently, if structural changes in the distant future can

trigger a review, this generates greater uncertainty over the durability of a merger or a consent order conditioning a merger.[2]

Second, because the remedies accommodate conditions imposed by a third party, this would provide an incentive to third parties to attach such conditions in the hopes that government will enforce them. This too will complicate the framing of consent orders because parties will have to consider not only future structural change, but also the strategic behaviour of competitors and other private interests.

Finally, the use of the blunt instrument of dissolution will further complicate the consent order process. At present there are very limited options open to the DIR and the Competition Tribunal in the event of a finding of "changed circumstances" as set out in section 106 of the *Competition Act*. Either the parties agree to a revised order or the merger is dissolved. Because it can be far costlier to unwind a merger than to enter into one, parties may be forced to agree to terms which they would not have agreed to in pre-merger consent order negotiations. In the result, parties to a consent order will have to consider possible hold-up strategies should the merger be reviewed under the changed circumstances provisions of the *Act*.

In summary, if the integrity of consent orders is not to be undermined, it would seem that they should not be terminated by government fiat unless the parties have failed to live up to the terms of the order, or changed circumstances have allowed them to evade the spirit of the order. Otherwise, the implication is that potential parties to future consent orders must factor in the risk that their commitments may be undercut by government policies motivated by considerations beyond those that motivated the consent order. This added risk, on the margin, will discourage parties to enter into consent orders.

The cost of this discouragement factor is difficult to assess. To the extent that consent orders are a valuable tool in the competition policy arsenal, the long-run costs can be quite substantial. Specifically, mergers and other combinations that might otherwise improve efficiency may be abandoned because of the unwillingness of parties to assume the risks associated with agreement to consent orders.

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2 It is not difficult to imagine situations where structural change renders a merger anti-competitive. Consider an industry with three firms, A, B and C. A and B merge on the basis of projected efficiency gains. The gains are realized but subsequently firm C fails. The precedent which would be set if the proposed remedies were implemented would call for an unwinding of the merger because, in the changed circumstances, it likely would not have been allowed.

C. A Role for Regulatory Intervention

It must be stressed that the rationale that CAI must leave Gemini in order to remain viable is fundamentally an issue of redistribution, not efficiency. If, from the perspective of private markets, CAI is worth more dead than alive, it is efficient to let it die and let its assets be used by viable airlines. If it is worth more alive than dead, AMR (or someone else) should be willing to pay fair market value for all or part of CAI's assets. It should not be necessary for regulators to arrange for an appropriation of wealth from someone else (e.g., the remaining partners) to make the alliance worthwhile.

If there is a role for regulatory intervention, it is to facilitate private bargaining which has stalled or otherwise not resulted in an efficient restructuring of an agreement. But in this case, the intervention should try to emulate what private markets would accomplish, the payment of fair value when assets are exchanged. It is my understanding that in general when parties to a merger are required to sell off specific assets to mitigate competition policy concerns (i.e., when pre-closure or post-closure restructuring is required) the terms of sale are not constrained.

Alternatively, if CAI is worth more alive than dead only when social benefits (the efficiency benefits of competition in the airline industry) are factored in, public policy must determine who shall pay to insure these social benefits are reaped. In the current situation, there is neither an efficiency nor equity justification for making the remaining Gemini partners pay.

D. Conclusion

The proposed remedies score poorly on both equity and efficiency grounds. The imposition of costs on the remaining Gemini partners has no efficiency rationale and is clearly inequitable. Moreover, the proposed remedies may well impair the consent order process with concomitant adverse affects on structural change.