

REBUTTAL TESTIMONY OF DR. GARY J. DORMAN**I. INTRODUCTION**

1. My name is Gary J. Dorman. I am an economist and a Senior Vice President of National Economic Research Associates, Inc. (NERA). My qualifications to present expert testimony in this proceeding have been described in a prior document entitled "Testimony of Dr. Gary J. Dorman," submitted on January 18, 1993. This rebuttal testimony constitutes a response to the document entitled "Report of Professor Jerry A. Hausman," dated January 25, 1993. In this rebuttal, I will not attempt to respond to every argument raised by Professor Hausman in his 35 page report, but will instead focus on a few key issues.

II. RESPONSE TO THE REPORT OF PROFESSOR J. HAUSMAN

2. As stated in my prior testimony, the primary issue in this proceeding is (and ought to be) the possible consequences of the Director's proposed remedies with respect to preserving airline competition in Canada. Professor Hausman, however, spends the first 26 pages of his report discussing computer reservation system (CRS) competition in Canada. The reason for his focus is clear: Professor Hausman has already abandoned hope of preserving meaningful airline competition in Canada. He has concluded that "Canada cannot support two profitable national airlines" [Paragraph 60] and admits that "if CAI [Canadian Airlines] were to fail, AC [Air Canada] would gain most of the current CAI traffic" [Paragraph 52]. I do not believe that the goal of preserving airline competition in Canada should be abandoned so hastily, but I will leave the detailed analysis of this issue to other experts.

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3. Turning to the secondary issue in this proceeding--CRS competition in Canada--Professor Hausman's analysis suffers from several major defects. First, he clearly recognizes what he has termed the "predisposition effect," where an "important component of travel agents' choice of a CRS is which airline their customers most often use." [Paragraph 17.] Professor Hausman uses his own econometric model of the predisposition effect to project that "if CAI's share of Gemini base shifts to Sabre, Gemini's share of Canadian CRS bookings is estimated to decrease from its current 55% to about 31%." [Paragraph 21.]

4. This figure is three times the share shift estimated by American Airlines itself in the 1991 document cited repeatedly by Professor Hausman in his testimony. Furthermore, as the American Airlines document clearly states, that estimated share shift of 8.2 percentage points "assumes current market conditions prevail (a weak Gemini product and a non-aggressive competing CRS)." ["Appendix, Aurora Valuation Analysis," page 6, emphasis added.] With the recent replacement of the inferior Reservec and Pegasus products with the competitive "Apollo by Gemini" CRS, that assumption is no longer valid and the resulting estimate of the share shift would need to be reduced. Indeed, the second scenario analyzed in that document, where "the Gemini product is improved and is aggressively marketed," results in a "potential market share risk" to SABRE of 12.0 percentage points.

5. Moreover, Professor Hausman does not apply symmetrically the results of his econometric model of the predisposition effect. Even after a transfer of Canadian Airlines hosting from Gemini to SABRE, the Gemini CRS will still be associated with Air Canada, a larger carrier than Canadian Airlines. With the recent achievement of

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comparable functionality between Gemini and SABRE, it is SABRE which will be at a competitive disadvantage relative to Gemini. Even if one adds together the traffic of Canadian Airlines with that of American Airlines' operations in Canada, SABRE is still backed by a smaller airline presence than Gemini, which is associated with all of the following airlines: Air Canada, United, USAir, British Airways, Swissair, KLM and Alitalia.

6. In short, the fundamental flaw of Professor Hausman's analysis is that he considers only those present Gemini accounts which SABRE may gain by reason of its perceived sponsorship by Canadian Airlines. However, he ignores entirely those current SABRE accounts which may be gained by Gemini--which has only had a competitive CRS since July 1992--because of Gemini's perceived sponsorship by Air Canada and the other carriers affiliated with the Apollo system. He makes this error even though he concedes [Paragraph 45] that the predisposition effect can work in favor of Gemini. Indeed, if Canadian Airlines ceases operations and most of its traffic shifts to Air Canada (as admitted by Professor Hausman in Paragraph 45), or if Canadian Airlines were to survive and remain affiliated with Gemini, how could SABRE hope to compete with Gemini in Canada given comparable functionality and Gemini's overwhelming airline presence?

7. A second major defect in Professor Hausman's analysis relates to the issue of economies of scale. His conclusions rely in part on U.S. CRS cost data obtained from the U.S. Department of Transportation (DOT) [Paragraph 15]. These data are not comparable across CRS vendors, as the DOT recognized [Study of Airline Computer Reservation Systems, May 1988, pages 49-50]:

Similar firms operating within the same industry have the discretion to adopt different but equally acceptable accounting practices, and these differences can contribute to variation in accounting profits and rates of return reported by firms that are

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actually earning identical economic returns. The definition and measurement of revenues and expenses reported by the different airline vendors reflect their exercise of this discretion, and require their reported data to be adjusted in various ways to develop consistent measures of the returns earned on their CRS activities, a process subject to potential errors of misclassification. Finally, the Department's Information Directive required the vendors to allocate certain costs (such as those for central computer operations) between airline and CRS operations, a procedure that is somewhat arbitrary.

Therefore, inter-firm comparisons of CRS costs per booking based on the DOT data are not a reliable basis for measuring economies of scale in this industry.

8. Furthermore, the DOT data on annual costs for individual CRS vendors for a single year (1986) are not appropriate for determining the relationship between the size of a CRS and its cost per booking. This is because the cost data used by Professor Hausman reflect the total cash expenditures made by each vendor in each year, irrespective of whether they are for current-year operating expenses or for long-lived capital investments [DOT Study, pages 50-54]. No effort was made by Professor Hausman to amortize the initial cash expenditures for central computer facilities, communications equipment, subscriber terminals and software development over the useful lives of these assets.

9. Using Professor Hausman's methodology, in the early years of a CRS when cash investments are large and the number of bookings is small, the average cost per booking will appear to be very high. Conversely, in the later years when most of the cash investments have already been made and the number of bookings is large, the average cost per booking will appear to be very low. The consequence of this faulty methodology is a set of data which is biased towards a steep drop in cost per booking as the number of bookings increases. Such data are completely inappropriate for the purpose of attempting to measure CRS economies of scale.

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10. Even if one accepts Professor Hausman's measurement of CRS economies of scale, such economies as are currently achieved by Gemini arise mainly through its use of the Apollo computer facility in Denver where the Gemini CRS processing is done. Professor Hausman forecasts that if Canadian Airlines hosting is moved to SABRE, this would result in a 24 percentage point shift from Gemini to SABRE and 8.4 million fewer segments booked annually on Gemini [Paragraph 26]. When analyzing the effect of any such assumed shift on the achievement of CRS economies of scale, it is necessary to compare those 8.4 million bookings with the total bookings currently being processed at the Apollo computer facility in Denver, which exceed 100 million per year. Such a shift is unlikely to affect significantly the unit costs of providing Apollo CRS services. Therefore, in the event of the failure of the Gemini partnership, Covia's role as a competitive constraint on SABRE in Canada is not threatened by the transfer of Canadian Airlines hosting to SABRE, for all the reasons given in Paragraphs 10-12 of my prior testimony.

11. Finally, Professor Hausman's analysis of CRS economies of scale, if correct, has a disturbing implication. He states that

size differences and the accompanying economies of scale give Sabre a considerable cost advantage among CRS vendors. Thus, Worldspan and System One would be unlikely entrants into Canada, especially given the much higher telecommunications costs in Canada than in the U.S. If the Director succeeds in his goal of the hosting contract termination and Gemini does not continue operation, it is not clear that Covia would offer CRS service in Canada given its cost disadvantage to Sabre arising from its approximate 50% smaller size and the demonstrated lack of contract enforcement in Canada. [Paragraph 37.]

The clear implication of this reasoning is that the CRS business in Canada is a natural monopoly because of the size of the market and the cost advantage of a large firm.

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12. Professor Hausman's analysis seems to have left us with inevitable airline and CRS monopolies in Canada. Under his approach, the only issue remaining is the identity of the monopolist. In the airline market, he warns that "[i]f the Director is successful, and CAI survives, I foresee that AC will soon also face extreme financial difficulties." [Paragraph 63.] Obviously, Air Canada desires to be the survivor, since "if CAI were to fail, AC would gain most of the current CAI traffic" [Paragraph 52]. In the CRS market, he forecasts a SABRE share of 70 percent [Paragraph 7]--an "outcome where Sabre is a near-monopoly CRS operating in Canada or is by far the dominant CRS" [Paragraph 54]. This forecast is suspect given that (1) SABRE has never achieved even half the market when it was competing against the inferior predecessors to Apollo by Gemini, and (2) American Airlines' own forecast shows its share leveling off at 47 percent through 1998 ["Appendix, Aurora Valuation Analysis," Appendix B].

III. CONCLUSIONS

13. Professor Hausman's focus on the CRS market is misplaced. The primary concern should be the preservation of meaningful airline competition in Canada. Moreover, for the reasons given in my prior testimony, the shift of Canadian Airlines hosting to SABRE does not threaten to create a CRS monopoly in Canada. Professor Hausman's analysis of CRS competition is flawed, and does not constitute an adequate basis to reject the Director's proposed remedies. Most importantly, it would likely be an irremediable mistake to permit the eradication of existing airline competition on the basis of an opinion that the Canadian market has room for only one national carrier.