

COMPETITION TRIBUNAL/TRIBUNAL DE LA CONCURRENCE

Court File No.: CT-88/1

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. 1985, c. C-34 to vary the Consent Order of the Tribunal dated July 7, 1989.

B E T W E E N :

The Director of Investigation and Research

- and -

Air Canada
Air Canada Services Inc.
PWA Corporation

Canadian Airlines International
Pacific Western Airlines Ltd.
Canadian Pacific Air Lines, Limited
154793 Canada Ltd.

153333 Canada Limited Partnership

The Gemini Group Automated Distribution Systems Inc.

Respondents

- and -

Consumers' Association of Canada
American Airlines, Inc.
Attorney General of Manitoba
Alliance of Canadian Travel Associations
Bios Computing Corporation
Air Atonabee Limited

Intervenors

NOTICE OF APPLICATION

COMPETITION TRIBUNAL TRIBUNAL DE LA CONCURRENCE	
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AND TO: Air Canada Services Inc.
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AND TO: PWA Corporation
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AND TO: Canadian Airlines International Ltd.
Suite 2800
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AND TO: The Gemini Group Limited Partnership
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Toronto, Ontario
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AND TO: The Gemini Group Automated Distribution Systems
Inc.
330 Front Street West
5th Floor
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AND TO: Covia Canada Partnership Corp.
c/o Covia Partnership
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60018 U.S.A.

THE DIRECTOR OF INVESTIGATION AND RESEARCH will make an Application to the Competition Tribunal on a date to be fixed by the Registrar.

THE APPLICATION is for an Order, pursuant to section 106 of the *Competition Act*, varying the Competition Tribunal's Consent Order dated July 7, 1989, as follows:

1. To require the parties to provide for early termination of the Gemini Hosting Contract dated as of June 30, 1989, among The Gemini Group Partnership, Air Canada ("AC") and Canadian Airlines International Ltd. ("CDN") by CDN or AC on such terms as the Tribunal may determine; and
2. To require the parties to provide for early termination of all other hosting contracts between The Gemini Group Partnership and affiliates of PWA Corporation ("PWA") or AC on such terms as the Tribunal may determine; or
3. In the alternative, to require dissolution of the Gemini Group Partnership.

THE GROUNDS for the Application are the following:

1. The circumstances that led to the making of the Consent Order have changed in that:
 - (a) PWA and CDN have stated that their financial position has deteriorated to the point that they cannot survive on their own;
 - (b) on September 9, 1992, PWA accepted a merger proposal from Air Canada. The parties executed a Pre-Merger Agreement on October 8, 1992. On November 3, 1992, AC announced its position that the transaction contemplated

by the Pre-Merger Agreement was "unachievable", but that discussions could continue;

- (c) if an AC/PWA merger was to take place, or if PWA was to cease operations, the result would be a virtual monopoly in most domestic airline markets in Canada;
- (d) airlines have become increasingly information driven. Today, when an airline seeks a strategic alliance partner, it is important that they not only share and co-ordinate marketing, but that they also share and co-ordinate information services;
- (e) the inability of CDN and PWA to terminate the Gemini Hosting Contract precludes alternative, pro-competitive solutions to PWA's financial difficulties.

- 2. In the present circumstances, the Consent Order would not have been made at all, or without provision for early termination of the Gemini Hosting Contract.
- 3. In the present circumstances, the Consent Order is ineffective to achieve its intended purpose in relation to domestic airline markets.

STATEMENT OF MATERIAL FACTS

The Director submits that the following facts are material to the Tribunal's consideration of this application:

PARTIES

- 1. PWA Corporation ("PWA") is a public holding company with investments primarily in the airline industry. The principal

subsidiaries of PWA are Canadian Airlines International Ltd. ("CDN"), Canadian Regional Airlines Ltd., Canadian Holidays Ltd., and Transpacific Tours (Canada) Limited. Canadian Regional Airlines Ltd. controls the following airlines: Time Air Corporation, Ontario Express Ltd., and Inter-Canadien Inc. PWA Corporation also has a 45% equity interest in Air Atlantic Ltd. and Calm Air International Ltd. CDN is the second largest carrier in Canada. CDN, together with its airline affiliates, serves an extensive network of domestic, transborder and international scheduled passenger city pair markets.

2. Air Canada ("AC") is a public company and is the largest air carrier in Canada. AC serves an extensive network of domestic, transborder, and international scheduled passenger city pair routes. AC controls the following airlines which provide scheduled passenger service to regional and local city pair markets: Air Nova Inc., Air B.C. Ltd., Air Ontario Inc., Northwest Territorial Airways Ltd. and Air Alliance Inc.

3. The Gemini Group Automated Distribution Systems, Inc. ("Gemini") is the general partner of The Gemini Group Limited Partnership ("Gemini Partnership"). Gemini is the largest provider of computer reservations system ("CRS") services in Canada. AC, PWA and Covia Canada Partnership Corp. are the limited partners of the Gemini Partnership, each owning a one-third interest in the Gemini Partnership and in Gemini.

4. Covia Canada Partnership Corp. ("Covia") is incorporated under the laws of Ontario and is an affiliate of Covia Partnership, which owns the second largest CRS in the United States. United Airlines has a 50% interest in the Covia Partnership.

CONSENT ORDER OF JULY 7, 1989

5. By an agreement dated June 1, 1987 and made among AC, PWA and Gemini, the Gemini Partnership was formed for the purpose of providing an electronic distribution and reservation system for the travel and tourism industry, including air, rail and marine travel, event ticketing and hotel and car rentals. Gemini would provide distribution of airline and other information to travel agents ("distribution services"). It would also provide the computer services necessary for AC and CDN to manage their respective internal reservations systems as well as provide a number of other related computer services ("hosting services").

6. On March 3, 1988, the Director of Investigation and Research (the "Director") made an application to the Competition Tribunal (the "Tribunal") under section 64(1) of the Competition Act for an order dissolving the Gemini Partnership. The Director alleged that the Gemini Partnership created a dominant firm that would be able to maintain its dominant position because it was vertically integrated with AC and CDN and because it would have the most complete, timely and accurate information on these carriers as a result of hosting AC and CDN. In addition, the Director alleged that the merger raised competition concerns in airline markets because AC and CDN had the ability and incentive to exclude, deter or raise the cost of entry for airline competitors of AC and CDN by operating Gemini in an anti-competitive fashion.

7. On April 24, 1989, the Director moved to amend his Application to seek a Consent Order under section 105 of the Competition Act. In response to concerns raised during the course of the hearing and to suggestions made by the Tribunal, an amended Consent Order was filed on June 2, 1989. The Tribunal issued the amended Consent Order ("Gemini Order"), along with reasons, on July 7, 1989.

8. The Gemini Order and accompanying CRS rules, which form part of the Order, address competition concerns raised by the Gemini Partnership in CRS markets and airline markets in Canada. In CRS markets, the Gemini Order and rules reduce competition concerns of the Director by, inter alia, requiring full participation by AC and PWA in competing CRSs in Canada, and by requiring that AC and CDN agree to electronic links being established between their internal databases and CRSs competing in Canada, if such links are offered on a reciprocal basis by the owning carriers of the competing CRSs.

9. In relation to airline markets, the Gemini Order and CRS rules address competition concerns of the Director by, inter alia, requiring that primary displays do not use any factors related to carrier identity, that fees to participating carriers be non-discriminatory and that Gemini not be used by AC or PWA to collude to share markets or fix prices. The Tribunal expressed concern about the prospects for collusion and noted that the proposed acquisition of a one-third interest in the Gemini Partnership by a neutral third party, Covia, reduced the incentive for collusion. The collusion provision in the draft Order filed on April 13, 1989 was amended as a result of the Tribunal's concerns over this issue.

10. On June 30, 1989, the original Gemini partnership agreement of June 1, 1987 was amended and restated to provide for the admission of Covia as a limited partner. On June 30, 1989, the amended Gemini Partnership, AC and CDN entered into a hosting contract (the "Gemini Hosting Contract") whereby the Gemini Partnership agreed to provide hosting services to each of the airlines.

11. Article 2.2 of the Gemini Hosting Contract with CDN and AC requires each airline to use the Gemini Partnership exclusively for hosting services. Article 9.1 of the Gemini Hosting Contract provides that the agreement shall terminate upon written consent

of all parties or upon termination of the Partnership. Unless dissolved by insolvency of Gemini or the operation of law, the Gemini Partnership can only be dissolved with the consent of all three limited partners. After July, 1997, PWA can sell its units in the Gemini Partnership, but only with the consent of Gemini and another limited partner. In that event, the hosting contract would be terminated with respect to CDN two years thereafter (ie. not before July 1, 1999). The same condition applies to AC. The Gemini Partnership and the Gemini Hosting Contract will otherwise terminate on December 31, 2067.

CHANGED CIRCUMSTANCES

12. At the time of the Gemini Order, the financial viability of PWA was not an issue before the Tribunal. PWA has stated that it is now in serious financial difficulty. It has not reported an annual profit since fiscal year 1988. Losses from January 1, 1989 to June 30, 1992 totalled \$340.6 million, including a loss of \$108.3 million for the first 6 months of 1992. At the end of 1991, current liabilities exceeded current assets and long term and perpetual debt was \$1,195.4 million as compared to \$819.8 million for shareholder's equity and convertible subordinated debentures.

13. In order to remain financially viable, PWA has been looking for an airline investor that would provide a "good strategic fit" with PWA and which would be willing to purchase an equity interest in PWA. Two airlines, AC and AMR Corporation ("AMR"), holding company of American Airlines, Inc. ("AA") have expressed interest to date.

14. Discussions between AC and PWA concerning some form of merger or purchase of international routes occurred during the fall of 1991 and winter of 1992, culminating in an offer by AC to merge the two companies in early March, 1992. This offer was rejected by PWA.

15. On March 19, 1992, AMR and PWA initiated discussions concerning the formation of a strategic alliance that would involve equity, marketing programs and reciprocal service agreements. PWA indicated publicly that a strategic alliance between CDN and AMR would maximize shareholder value, minimize job loss and maintain competition in Canada.

16. On March 30, 1992, AC indicated it would file an objection with the National Transportation Agency to a proposed PWA/AMR transaction.

17. Since the date of the Gemini Order, the partners of the Gemini Partnership have at various times considered a reorganization of Gemini.

18. On April 3, 1992, Gemini advised CDN that Gemini would sue CDN for breach of the Gemini Hosting Contract if CDN transferred its inventory management system to the CRS owned and operated by AA ("Sabre"), and in addition, would seek an injunction to stop any anticipatory breach of the Gemini Hosting Contract. Gemini also advised AA on April 3, 1992 that Gemini would sue AA for inducing breach of contract and for intentional interference with the economic interests of Gemini if Sabre hosted CDN. In an article appearing in the Financial Post on April 14, 1992, the President of AC indicated that AC would sue PWA if PWA terminated its hosting relationship with Gemini.

19. On July 3, 1992, Gemini filed a complaint with the Director alleging that Sabre was engaged in predatory pricing behaviour in Canada contrary to the provisions of the Competition Act.

20. By late July 1992, draft stock purchase, shareholder, and services agreements for the proposed AMR/PWA transaction were ready for execution, with the complete proposal and closing conditions scheduled to be presented to the PWA board of directors

by mid-August. AMR's proposal was conditional upon CDN being hosted on AA's Sabre CRS.

21. On July 27, 1992, PWA announced that it had terminated discussions with AMR and had agreed to resume merger discussions with AC, on a non-exclusive basis. AMR announced that it was still interested in pursuing an alliance with CDN.

22. On August 18, 1992, AC announced an alliance agreement with United Airlines that includes joint marketing, code sharing, reciprocal privileges for AC and United Airlines frequent flyer members and possible schedule integration. United Airlines owns 50% of Covia, the third member of the Gemini Partnership, whose participation in Gemini was anticipated to help address the Tribunal's concerns about collusion between AC and CDN.

23. As of August 24, 1992 the major components of AMR's proposal to PWA were:

- (a) an equity investment by AMR of \$246 million in PWA in return for 25% of the voting stock;
- (b) a 20-year services agreement whereby CDN would agree to purchase hosting services from Sabre, the CRS owned by AMR;
- (c) a marketing agreement that would link together the frequent flyer plans of AA and PWA;
- (d) provision for bridge financing pending a final resolution of the Gemini issue.

24. During August, 1992, the Council of Canadian Airlines Employees (the "Council") was formed for the stated objective of ensuring that PWA continues as an independent airline by providing PWA with cash and enabling PWA to complete a transaction with AMR.

25. On September 1, 1992, PWA commenced legal action in the Alberta Court of Queen's Bench for a declaration that Gemini is insolvent, supported by an opinion from the chartered accounting

firm of Ernst & Young. The effect of such a declaration would be to terminate the Gemini Hosting Contract. CDN would then be free to pursue a hosting contract with any other CRS. On the same day, PWA and Gemini each issued press releases referring to previous proposals to restructure Gemini.

26. On September 2, 1992, AC made an offer to PWA wherein the two airlines would be owned by a holding company, with AC shareholders owning approximately 60% of the voting shares and PWA shareholders owning approximately 40% of the voting shares. This offer was open for 7 days. The board of directors of PWA scheduled a meeting for September 9, 1992 to consider the AC proposal.

27. On September 8, 1992, AC agreed to provide bridge financing of up to \$100 million to PWA if a Pre-Merger Agreement was executed and an operating, financing and transition plan was agreed upon.

28. On September 9, 1992, PWA's board of directors considered a proposal from the Council as well as the AC proposal of September 2. The Council proposed to invest between \$100 to \$150 million in PWA in exchange for shares at a price to be negotiated, if PWA agreed to pursue the AMR proposal. The shares would be paid for by way of deductions from the salaries of participating employees for a period not to exceed 40 months.

29. On September 9, 1992, the board of directors of PWA accepted the AC offer of September 2. The Chairman of PWA stated publicly that PWA had to make a decision quickly because it was losing approximately \$700,000 daily and "its cash reserves were depleted".

30. On September 10, 1992, the Director started an inquiry under section 10(1)(a) of the Competition Act into the proposed AC/PWA merger following receipt of a six-resident application under section 9 of the Act. The inquiry is ongoing.

31. Notwithstanding the decision of PWA's Board on September 9, 1992,

- (a) PWA indicated that it was still willing to entertain other offers, at least until a merger agreement was executed with AC;
- (b) PWA continued with its insolvency action in relation to Gemini; and
- (c) the Council publicly stated its intention to pursue a further proposal with PWA.

32. On October 8, AC and PWA executed a Pre-Merger Agreement. The Pre-Merger Agreement contemplated the development of an operating, financing and transition plan by October 27, 1992.

33. On October 27, AC and PWA announced that their respective boards of directors had not approved the operating, financing and transition plan developed by the merger committees of the two corporations but that discussions between AC and PWA were continuing.

34. On November 3, 1992, AC announced that it was "unable to conclude that the merged AC/PWA would be viable" and that the transaction contemplated by the Pre-Merger Agreement was "unachievable". It went on to indicate its willingness to continue discussions with PWA.

35. Since October 19, 1992, pursuant to the requirements of the Director, PWA's investment bankers have been searching for alternative purchasers or investors in PWA. AMR and the Council have expressed their continued interest in acquiring an interest in PWA, subject to resolution of the Gemini issue.

36. On November 3, 1992, AMR advised the Director that it continued to be very interested in pursuing a transaction with CDN. AMR went on to state as follows:

"The most significant impediment to consummating such a transaction is the exclusive hosting arrangement between Canadian and The Gemini Group. Unless Canadian is contractually and legally free to enter into a hosting agreement with AMR, there is no commercial basis for the proposed Canadian/AMR transaction to proceed."

CONSEQUENCES OF AN AC/PWA MERGER

36. The Director anticipates the likely effects of an AC/PWA transaction to be as set out below.

37. In 1990, AC and its affiliates had 59% of all scheduled airline passengers travelling in the top 205 domestic city pair markets ranked by passenger volume. CDN and its affiliates carried 37% of the total number of scheduled airline passengers in these markets over the same period. Based on this data, the merger of AC and CDN, together with their affiliates, would result in one carrier carrying 96% of the domestic scheduled airline passengers in the top 205 city pair markets in Canada. These 205 city pair markets account for 90% of all domestic scheduled airline passengers. In most of the city pair markets, the merged firm would have a virtual monopoly.

38. Since 1990, the two remaining independent scheduled carriers competing with AC and CDN in Southern Canada, City Express and Intair, have ceased scheduled service.

39. Charter airlines carried only 2.5% of all domestic airline passengers in 1990 and 3.7% in 1991. Charter airlines carried more than 10% of the total number of airline passengers in only 3 domestic city pair markets in 1990. There are many restrictions commonly associated with charter tickets, including advance purchase or non-refundability. Charter services are therefore poor substitutes for scheduled service for most business travel.

40. The cumulative height of barriers to entry in scheduled airline markets is high, particularly for a new entrant that intends to serve a network of transcontinental city pairs. The principal market barriers to entry are the need for feed traffic (regional, other domestic, transborder and international), access to infrastructure in some markets, frequent flyer programs, travel agent commission structure, marketing presence, and for unintegrated airlines, CRS display.

41. Under the current regulatory policy, foreign airlines are not allowed access to domestic routes. Foreign ownership is restricted to 25% of the voting shares of a carrier providing domestic service and by the requirement that control in fact is held by Canadians.

CONSEQUENCES OF PWA CEASING OPERATIONS

42. PWA and CDN have stated that their financial position has deteriorated to the point that they cannot survive on their own. If PWA and CDN were to cease operations, similar competition concerns would arise as under an AC/PWA merger. AC would be left with a virtual monopoly in most city pair markets in Canada. Barriers to entry into these markets would remain high. Furthermore, the development of a competitive presence of sufficient scale to constrain the market power of AC as a result of PWA's exit is unlikely.

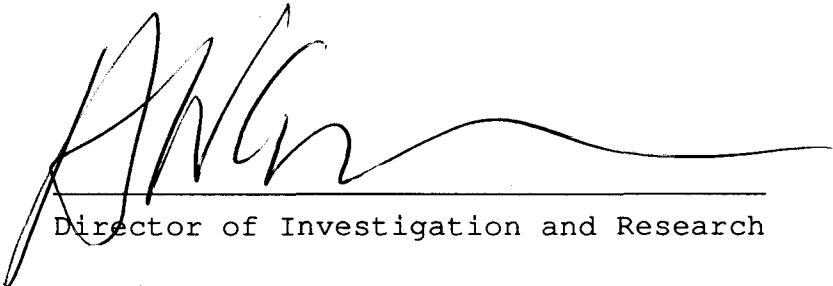
CONCLUSION

43. The Director submits that in the present circumstances, the Tribunal would not have made the Consent Order at all, or at least not without provision for early termination of the Gemini Hosting Contract. According to PWA, its present financial circumstances urgently require it to obtain new equity. The Gemini Hosting Contract impedes pro-competitive solutions to PWA's difficulties.

It increases the likelihood of a virtual monopoly in most domestic airline markets in Canada as a result of either,

- (a) the financial failure of PWA and CDN; or
- (b) a merger of AC and PWA.

DATED at Ottawa this ^{5th} day of November, 1992.



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