RESPONDENT [redacted] from L. Waverman to T.A. Wilson

THE COMPETITION TRIBUNAL

IN THE MATTER OF an Application by the Director of Investigation and Research for an order pursuant to section 75 of the Competition Act, R.S. 1985, c. C-34, as amended, requiring that the Respondent accept the Exdos Corporation as a customer for the supply of a product

B E T W E E N:

THE DIRECTOR OF INVESTIGATION AND RESEARCH

Applicant

- and -

XEROX CANADA INC.

Respondent

REPLY AFFIDAVIT OF LEONARD WAVERMAN

I, LEONARD WAVERMAN, of the City of Toronto in the Judicial District of York, MAKE OATH AND SAY AS FOLLOWS:

1. Attached hereto and marked as Exhibit "A" to this my affidavit is a true copy of my reply to the Affidavit of Thomas A. Wilson sworn the 14th day of May, 1990.

SWORN BEFORE ME at the City of Toronto, in the Judicial District of York, this 29th day of May, 1990.

A Commissioner, etc.

LEONARD WAVERMAN

In the Matter of the Director of Investigation and Research and Xerox Canada Inc.

Reply to the Report prepared by Professor Thomas A. Wilson for the Director of Investigation and Research

Statement of: Leonard Waverman
Centre for International Studies
University of Toronto
Toronto, Ontario

Date: May 29, 1990

This is Exhibit A referred to in the affidavit of Leonard D. Waverman sworn before me, this 29th day of May 1990

A COMMISSIONER FOR TAKING AFFIDAVITS

Summary

1. Below I rebut in detail the specific assertions made by Professor Wilson. In my view, Professor Wilson's Report is mainly argument, with little factual basis to back up hypotheses advanced. The hypotheses and arguments themselves are based on an exceedingly narrow perspective of economic efficiency and market power. Therefore, Professor Wilson's conclusion in support of an Order to supply Exdos rests on suspect economic reasoning and a lack of understanding of the reprographics market.

2. Professor Wilson's Report begins with definitions of economic efficiency and market power which set unreasonable standards against which to judge any firm's actions. The basis of Professor Wilson's definitions are that firms *should* obey the textbook perfectly competitive model. Firms *should* produce small quantities of homogeneous products, where price equals marginal cost. In such cases, static neoclassical economic efficiency is maximized and firms have no above normal profits or, what is equivalent to Professor Wilson, market power.

3. It is obvious that the reprographics industry and most real world industries would be judged harshly against this standard of homogeneous products and perfect competition. The

competition in the reprographics industry, in all high - tech industries and in most other industries as well, is via new technology, new products, new services, i.e. product differentiation. *Because* the reprographics market consists of many firms competing through research and development (R&D) to provide better and lower cost means of delivering imaged copies, Professor Wilson argues that large firms would possess "non-trivial market power." (paragraph 11, p. 6) In my opinion, this assertion is unwarranted, is derived from the assumptions made and ignores the nature of competition in the reprographics market. There is no factual basis that appears in the Director's experts' affidavits to back up this assertion.

As Benjamin Klein has recently written ("The Use of Economics in Anti-Trust Litigation: Realistic Models of the Competitive Process", The Law and Economics of Competition Policy, Fraser Institute, Vancouver, 1990):

> It is important not to confuse the existence of economic power in this sense of a negatively sloped demand curve with the anti-trust concept of market or monopoly power. A firm has economic power only in the sense that it is not a perfectly competitive firm, that is, that it is not the type of firm assumed to exist in the perfectly competitive model. However, every firm in the economy, except possibly the wheat farmers of economic principles textbooks, faces a negatively sloped demand curve. This is a natural result of the lack of product homogeneity and imperfect consumer information that exists in the real world... Nevertheless, although the conditions of the abstract, perfectly competitive model are not present, this does not imply a

condition of competitive concern or the necessity for anti-trust remedy. (p. 425)

4. I disagree with the Competition Policy principle presented in Professor Wilson's Report. In Paragraph 47 he states, in essence, that a firm cannot change a business practice "unless the increased costs imposed on buyers and their customers are ... offset by actual or prospective efficiency gains...." (p. 12). In my view, it is incorrect to review individual practices under such a policy principle. Moreover, the facts in this case do not support Professor Wilson's conclusions.

In my opinion, firms should be allowed to choose the means by which they do business unless those means are anti-competitive. Surely there must be a difference between contract law, which mediates the rights of parties to an agreement, and competition law, which examines the competitive conditions in the market. The effect of the Director's experts arguments is that the Competition Act would be used to ensure the "rights" of a single firm (in this case, Exdos). My analysis rests on the principle that the Competition Act is grounded in the principles of competition.

5. Finally, Professor Wilson's recommendation that an Order be granted in this and similar cases is incorrect, even under the principle of "economic efficiency" that he articulates.

Professor Wilson is implying, irrespective of any contractual terms (or in this case, even purchases outside a contract), that the buyer be given by the Tribunal an indefinite right to purchase with only the buyer being able to terminate. This is a highly inefficient form of contracting. It would result in firms with Professor Wilson's definition of market power (i.e. a significant market share) and Professors Wilson's and Gillen's definitions of the relevant market (that firm's production of proprietary parts) deciding to vertically integrate even when that was not an efficient choice.

Xerox Canada Inc. faces competition in the relevant end-market (reprographic services). XCI is alone in the best position to know which structure delivers its broad product line in the best manner to consumers and makes XCI as competitively efficient as possible.

What follows is organized under the headings in Professor Wilson's Report.

Economic Efficiency and its Relevance and Market Power and Efficiency

(Wilson paragraphs 2-18, pages 1-6)

6. Professor Wilson defines economic efficiency as a firm's minimizing unit costs and pricing at marginal costs. In this definition, efficiency occurs only when the industry mimics

the textbook model of perfect competition and when "a normal rate of return on investments (including investments in intangible capital such as advertising and research and development [R&D])..." is earned (paragraph 4, p. 2). As a corollary, market power is defined as the absence of perfect competition; market power exists to Professor Wilson when the firm has the ability to maintain prices above long-run costs. Professor Wilson ties efficiency and the definition of market power together. "Market power is generally incompatible with complete economic efficiency" (paragraph 12, p. 4).

In my opinion, Professor Wilson uses unrealistic and thus artificial standards for judging market power and welfare losses (deviations from complete economic efficiency). Any long-run deviation from the idealized notion of perfect competition and price equaling marginal cost he sees as evidence of market power and a reduction in welfare. Under this standard, virtually every industrial firm would have welfare reducing market power, since most firms can price above marginal costs. A definition of welfare reducing market power that includes most firms is inadequate.

Professor Wilson equates long-run above normal rates of return with market power; and market power, he says, is incompatible with economic efficiency. The fact that long-run, persistent, above normal returns can reflect competitive superiority is

ignored. Competitively superior firms earn rates of return (rents) on their superiority, and therefore the rate of return above the industry norm need not be excessive. There is a wide distribution of return on capital in most industries, indicating that some firms are more efficient than others.

Contrary to Professor Wilson's views, above normal returns are not incompatible with competition and economic efficiency. Firms and individuals do, in fact, earn above normal returns in highly competitive markets, so equating normal returns with competitive markets is inconsistent with actual market competition in the real world (see Harold Demsetz, "Industry Structure, Market Rivalry and Public Policy", Journal of Law and Economics, April 1973). Differential firm profitability moves resources from lower to higher valued uses, improving economic efficiency. Moreover, some firms grow relative to rivals due primarily to competitive superiority. With superiority and growth comes larger market share. Therefore, large market share need not imply economic inefficiency, as Professor Wilson suggests, but the opposite.

Professor Wilson quotes Landes and Posner in their definition of market power. He does not, however, quote Landes and Posner on the misuse of market share data to conclude that market power exists when in fact little exists.

> "Suppose firm 'i' has 80% of the market, there are no good substitutes, and existing firms are

> currently operating at full capacity, but entry is relatively easy. It might be a mistake to conclude that firm 'i' had market power. Suppose that in the previous decade there had been both a rapid expansion in demand and a lot of entry into the industry. Assume further that this entry was responsible for a fall in firm 'i's' market share from an original level of nearly 100% to its present 80% level. This suggests a high supply elasticity of the competitive fringe... Yet there is no ready adjustment to the market share measure of 80% that would show that firm 'i' lacked market power. Since in these circumstances market share is not a good measure of market power, we might want a rule that a finding of significant recent entry and output expansion negates an inference of market power based on market share alone." (Landes and Posner, p. 950, emphasis added)

The Fraser Institute of Vancouver published last week the proceedings of a conference held at the University of Toronto in 1988 (The Law and Economics of Competition Policy).

In one of the papers in this volume, Herbert Hovenkamp ("The Measurement of Market Power: Policy and Science") states:

> No markets are perfect; as a result, most firms in the real world maximize their profits at prices above marginal cost. A competition policy vigorously dedicated to eliminating market power in society would be so costly that it would drive us back into the Stone Age. (p. 45)

Markets and Competition

7. Professor Wilson describes the end market (the reprographics market) as "a differentiated oligopoly with an active competitive fringe" (paragraph 16, p. 5). He also states that "the evidence presented indicates that there obviously is

competition in the end product market, but it is insufficient to warrant the conclusion that Xerox has little market power" (paragraph 16, p. 5).

I agree that the reprographics market is a "differentiated oligopoly", simply meaning that products are not homogeneous and that less than the perfectly competitive infinite number of firms exist. I categorically reject the implicit pejorative meaning in the words "differentiated oligopoly" that any oligopolistic firm has substantial market power.

It is important to analyze the means by which firms differentiate their products in the reprographics market. Competition between products is based on machine-specific features (speed; two-sided copying ability; magnification; document handling; etc.); reliability of the vendor; distribution; costs and price; and technology. Photocopiers also differ in their ability to provide image sharpness, copy uniformity, background whiteness, and resistance to smudging. Buyers are generally knowledgeable, especially for the higher speed, more expensive photocopiers. Firms compete through service, price, differentiation, and R&D. In 1989, there were 113 new copiers introduced to the U.S. market, "the highest number to date" (Dataquest, CDIS Research Newsletter, 1990-91, p. 1). Competition in reprographic services is not as in the simple textbook perfectly competitive model where firms

with known technology, perfect information and perfect foresight compete to minimize static production costs. Competition in reprographic services is competition in providing new technology, new features, and better and lower cost means of delivering imaged copies. Differentiation in reprographic services is not a means of increasing market power, but a means of competition.

Since Professor Wilson has perfect competition as the criterion against which to judge an industry, R&D and product differentiation are implicitly market power enhancing and welfare reducing. Professor Wilson's view implies that any deviation from homogeneous products is harmful, just as any long-run deviation from normal returns he sees as potentially harmful. Superior goods and services, by virtue of innovation in such factors as quality, design, cost, distribution, technological advances, etc., and the returns they generate, are not inefficiencies but the very things that a competitive market system is designed to foster.[1]

In his paper in the Fraser Institute volume, "The Use of Economics in Anti-Trust Litigation", Professor Benjamin Klein has written much which is directly relevant to this case.

> However, some of the assumptions upon which the perfectly competitive model is built are extremely

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[1] See the discussion by Reuven Brenner, "Market Power: Innovations and Anti-Trust" in The Law and Economics of Competition Policy, Fraser Institute 1990.

> unrealistic and often inappropriate for anti-trust analysis... Although firms in the real world differ, for example, in location, types of products and services, and perceived quality (reputation), the assumption of product homogeneity in the perfectly competitive model leads to the "efficient" result that price will equal marginal cost. This result, that the price of a product will equal the opportunity cost in terms of the foregone real resources needed to produce an additional unit of the product, has desirable properties regarding economic efficiency. <u>However, this does not imply that the greater the deviation from the perfectly competitive model, the less efficient the result. The model is merely an abstract economic construct, not a criteria for governmental intervention in the real world marketplace.</u> (pp. 420-421, emphasis added)

8. The recent history of entry and exit indicates that the market in which XCI operates in is competitive (as Professor Wilson agrees) and that XCI has little market power (where Professor Wilson disagrees). My rebuttal consists of examining entry and exit.

<u>World and U.S. Markets</u>

In 1972, Canon introduced its liquid toner process, which was licensed to Addressograph/Multigraph (AM), Saxon, Ricoh and Copyer. In 1972, IBM and Litton entered the plain paper copying market. In 1975, Xerox Corporation signed a consent decree with the U.S. Federal Trade Commission allowing certain of its copier patents to be licensed by other manufacturers. The Eastman Kodak Company entered the medium and high volume segments in 1975. The 3M Company also entered in this period.

In 1975, the Stanford Research Institute designed a liquid toner transfer technology for Savin, who awarded manufacturing rights to Ricoh, Konishiroku (Konika), Toshiba, Sharp and Minolta -- all of whom entered the North American market post 1975. Van Dyk, SCM, and A.B. Dick also entered. A Dutch firm, Oce van der Grunten, developed a plain paper copier technology in the early 1970s, which was marketed in North America by Pitney Bowes (OCE now is its own distributor). By 1975 there were approximately 20 plain paper manufacturers in the world. A number of vendors purchased manufactured copiers and placed their brand names on the machines. In the early 1980s, a number of firms exited from the plain paper copier market -- Van Dyk, Dennison, Apsco, SCM, Saxon and AM. In 1981, IBM ended its research into a low volume copier and in 1988 IBM exited totally, selling its installed base to Kodak. 3M reorganized its reprographics business as a joint venture with the Harris Corporation in 1986; and exited in June, 1989, wholly selling out to the Harris Corporation. New entrants, however, appeared in the 1980s -- Matsushita, Kyotah Ceramic (Cybernet) and Sanyo. In 1983, Canon launched the desktop convenience copier. In 1983, there were more than 30 firms supplying plain paper copiers.

New technologies continue to proliferate. Canon developed a new colour copying process -- Cycolor -- which has been licensed to Brother, Geetetner, Savin and Seiko Mead. Canon,

Panasonic, Savin and Sharp have introduced dual-function (colour as well as black and white) machines. As noted in my affidavit, Xerox has introduced its Remote Interactive Diagnostics process. Many suppliers are researching full digital technology machines, where the document to be copied is received as a digital input and "reprographic services" then entails a convergence of computer, photocopier and fax machine -- an intelligent information production machine.

Industry magazines and reports discuss the highly competitive nature of markets. For example, the March 1990 Dataquest CDIS Research Newsletter states:

> "Copier vendors are filling out their product lines by moving into high-end, highly featured, and specialty copier markets to meet the increasing competition the copier industry has been facing." (p. 1)

An article in the Rochester Times-Union of May 2, 1990, discussed the ailing fortunes of Kodak's business system operations. Analyst Michael Ellmann of Wertheim Schroder & Co. estimated Kodak's profit margin on copiers to be 5% in 1989 and that "Japanese competitors such as Canon, Sharp, Mita, and Ricoh -- formidable, low-cost producers that once confined their efforts to the low end of the copier market now are launching an assault on the high-volume, high-dollar arena." Ellmann said this escalating competition may keep the squeeze on margins indefinitely.

Louis E. Slawetsky, president of Rochester-based Industry Analysts Inc., is quoted as saying, "[Kodak] looks across the street and sees Xerox continuing to introduce innovative technologies, then looks overseas and sees no fewer than 10 Japanese competitors... There's significant competition no matter where you look." (Rochester Times-Union, May 2, 1990)

A November 8, 1989, Report by CAP International Inc., entitled "US Copier Battleground -- a Candid Perception", states:

> Although Japanese manufacturers are compelled to move upstream with more productive and reliable copiers in the U.S. marketplace, they continue at a startling rate to produce new models to replace existing machines. This intense competition not only considerably shortens product life cycles, but is a drain on U.S. profitability in the lower to middle sector of the market... (p. 9)

and

> The average convenience copier unit price fell at the rate of 9% per year between 1975 and 1985. (p. 11)

Canada

Professor Wilson suggests that XCI may have market power in the end market if:

a) cross price elasticities of demand are low;

b) it is a lower cost competitor;

c) entry barriers are high;

d) cross price elasticities of supply with rivals are low. (pp. 5-6)

Professor Wilson concludes that "in the absence of this information, we cannot conclude that Xerox has little market power." Professor Wilson, however, does come to a conclusion.

> "Since the products are differentiated and R&D is an important element of competition, I would anticipate that a producer with a large share in this market would possess non-trivial market power." (p. 6)

Photocopiers are not currently manufactured in Canada. The 15 or so Canadian suppliers of reprographic services (the Appendices of my initial Report) all import photocopiers and supply service, parts and supplies.

Once distribution in Canada is set up, increased supply is easy as product has only to be delivered. As noted earlier, users demand photocopying services and can substitute different brands to satisfy demand. The sales data indicate the ability of firms to penetrate the market. Exhibit 2 (Confidential) to my original affidavit provided Canadian photocopier placement data by firm for the 1983 to 1988 period as compiled by Dataquest. XCI's market share was above 40% in 1983 in three market segments (#3, #5, #6), but only in two market segments in 1988 (#5, #6). XCI's market shares are

clearly far below what they were in 1975 (the year of Xerox's Consent Decree with the FTC) in all segments but number 6.

Professor Wilson examines the evidence contained in my affidavit and finds "non-trivial market power" seemingly based on the reasoning that I provided no evidence of high cross price elasticities of demand and supply, no evidence of similar costs, and no evidence of low entry barriers. But Professor Wilson provides no evidence that suggests that the relevant factors point to market power. There is not one fact or one reference in Professor Wilson's Report. Instead, the existence of "non-trivial market power" is inferred from firms having significant market share in a differentiated oligopoly.

I would suggest that such reasoning and such lack of evidence should not be the basis of a substantiation of a charge of anti-competitive behaviour under the Competition Act. It is incumbent that a lack of competition in the relevant market -- the end-market be shown. This has not been done in the affidavits produced by the Director to date.

In my opinion, the history of entry and exit and the prospects of new entry into the reprographics market indicate that elasticities are high and entry barriers not a deterrence.

One begins with Landes and Posner, "a finding of significant recent entry and output expansion negates an inference of market power based on market share alone" (quoted on page 7 above).

Landes and Posner's dictum is that one can infer elasticities of demand and supply from the facts without actually measuring elasticity values. Where entry and exist occur, products must be substitutable by users and between suppliers.

Significant recent entry has occurred in the low and medium speed segments where Exdos operates. This entry and turnover of market share between firms is evidence to me of competition and a lack of significant market power for any firm, including XCI.

XCI has a very large share of the high volume market and new entry other than by Kodak Canada has as yet not occurred. Professor Wilson concludes "Xerox would appear to have a dominant position (90% market share) in the high end of the market..."

XCI cannot, however, price in the high volume end without taking account of the intense competition in high volume copiers from Kodak Canada, the competition from lower volume machines, the competition from substitutes such as offset

printing and importantly, prospective entry. As I noted in my affidavit and above, significant entry would appear to be imminent in the high volume segment.

Moreover, XCI's market share in the high end is due to its technological excellence in producing machines which reliably produce 100 copies per minute (cpm) or more. This market share is not evidence of anti-competitive behaviour or entry barriers, but Xerox and XCI's innate ability.

XCI earned its market share in by innovation, high product quality, reliability, and superior service. Rivals have been unable to duplicate, let alone surpass, XCI's technical superiority in high volume copiers. XCI, as a licensee of Xerox Corporation, lost its patent protection in 1975, so rivals have been free to compete against XCI for years and many have entered all segments of the market. In fact, in 1976 a number of firms entered with high volume copiers, including SCM, AM, A.B. Dick, and Royal (Timothy F. Bresnahan, "Post Entry Competition in the Plain Paper Copier Market", American Economic Review, May 1985). The lack of success of these entrants, except Kodak, in high volume copiers is due to the superiority of Xerox products. Thus, product differentiation along these lines indicates XCI's competitive superiority over copier rivals, not anti-competitive market power.

The Relevant Market

9. Professor Wilson states that a firm typically operates in more than one market, but that Xerox copier parts is a relevant sub-market where XCI has market power (paragraph 18, p. 6).

My reply[2] to Professor David Gillen's Report[3] concentrated on why the market relevant to purposes of the Competition Act was the end-market not the parts market, and not the Xerox parts market.

Professor Wilson views Xerox copier parts as a relevant product market, apart from the end market for reprographic services. Since XCI controls 100% of its parts supply, it is a monopolist under Professor Wilson's and Professor Gillen's market definition. If parts for production in a manufacturing process, such as in the production of automobiles, television sets, computers, refrigerators, etc., constitute a separate market, then virtually all manufacturers who produce their own parts are monopolists in their own parts and subject to investigation for purposes of the Competition Act under this logic. According to Professor Wilson, lack of competition produces this monopoly condition. Apparently, he believes

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2 Attached to my affidavit dated May 14, 1990.

3 Attached to his affidavit of April 24, 1990.

there should be numerous producers of parts in every production process. A remedy would be to force manufacturers to have multiple suppliers of their own parts, so other parts buyers, such as downstream ISOs, would not be dependent solely on one supplier. However, if it were more efficient to not be vertically integrated, but to contract with multiple outside vendors for parts, then competition would force firms to do so. When firms are, in fact, vertically integrated and self-sufficient in parts, it is more efficient than relying on outside suppliers. Under Professor Wilson's approach, this competition produced efficiency in production and organizational form is equated with monopoly, and should be ended.

The relevant market is, however, the end-market -- reprographic services -- for it is there that market power must exist for it to be exercised. That end-market, as I have shown, and as Professor Wilson agrees, is competitive.

Impact of Refusal to Supply on the Operating Efficiency of Exdos and its Customers

10. Professor Wilson holds that Exdos customers will unambiguously lose if XCI will not supply Series '10' parts (paragraphs 22 and 23, p. 7). This is unclear if Professor Wilson's definition of the market is adopted. Using Professor Wilson's market definition, XCI is a monopolist in its own parts. If

this is the case, it makes no difference whether XCI sells parts to Exdos or directly to final end users. If XCI is a monopolist it will charge a monopoly price, whether it sells to Exdos or to final customers, so end users will not by harmed by higher parts prices in the absence of Exdos. If the market is not as defined by Professor Wilson, but rather consists of the joint supply of copiers and service as I contend, then XCI cannot charge a monopoly price for parts and service since it faces competition from numerous other copier manufacturers.

Impact of Refusal to Supply on Xerox's Operating Costs

11. In my initial Report I stated that vertical integration between photocopiers and service was the common form of product delivery in the reprographics market, and was an efficient (i.e. low cost) means of providing reprographic services. Professor Wilson ignores this feature of competition and ignores the fact that third-party leasing companies insist on vertical integration (by requiring that the lessee utilize the service of the manufacturer and not ISO's). Professor Wilson instead suggests that many of the advantages of vertical integration (information flows for improved products and R&D -- externalities) are not disturbed by having one small ISO and that, in any event, XCI could price its service and parts properly to ISO's to account for

any externality. Professor Wilson devoted paragraphs 25 to 45 to this exposition.

Professor Wilson is correct in one point -- I did overstate the need for 100% vertical integration to maintain proper information flows (a large random sample would provide the information). Professor Wilson is, however, incorrect in the main thrust of his remarks. Exdos does free ride, and the relevant "externalities" cannot be properly priced. Vertical integration is an efficient form of competitive distribution.

In the remainder of this section, I deal with Professor Wilson's arguments paragraph by paragraph.

para. 27

Professor Wilson admits that vertical integration can increase the use of preventive maintenance relative to ISOs. But he also claims that this does not justify any refusal to supply Exdos. Instead, in his view XCI should drive Exdos out of business by superior efficiency. Professor Wilson's argument ignores the free riding advantages of Exdos and the costs to XCI of having Exdos neglect preventive maintenance. The cost consequences to XCI of lax preventive maintenance accumulates over many years. In the interim period, XCI suffers a reduction in brand name capital, as its machines fail more often, and a reduction in the present value of future sales.

para. 29

Professor Wilson's plan for eliminating the higher costs of lumpy ISO orders is to provide price incentives for ISOs to order more continuously. Such pricing incentives entail costs for XCI, including price discounts, lumpy orders, and inefficient inventory levels.

In addition, Professor Wilson's proposed solution of wait-listing ISOs' parts orders in the event of supply shortages has the potential to impose even further costs on XCI. Any parts stock-out and downed copier machine time rebounds to XCI, reducing its reputation for reliability. Hence, the suggestion is no solution to the incompatibility of ISOs with XCI's inventory control.

para. 30

For the reasons given above, the per unit cost of inventory maintenance for XCI increases if ISOs exist. Moreover, the issue is not the division of total inventory costs between two parties, but the costs of the entire distribution system -- Exdos plus XCI.

para. 31

Professor Wilson concludes that the <u>evidence</u> he reviewed shows that refusal to supply will not reduce XCI's operating costs.

However, he provides no supporting evidence to discount the impact of an Order on -- disturbing potential economies of scale and of scope, inventory cost changes, brand name reputation effects, and impacts on future XCI sales.

Implications of Refusal to Deal for Incentives...

para. 33-35

Professor Wilson contends that Exdos presents no free rider problems for XCI and has never engaged in any manner of free riding on XCI. Professor Wilson does not address the free rider problem properly. On complex, reputation dependent machines, requiring strong service support, outside service companies have an incentive to lower costs by taking short cuts on required service. Since customers have difficulty detecting whether maintenance problems are due to XCI or an ISO, and the ISO can shift blame to XCI by faulting Xerox, an ISO can invest less than XCI and free ride on XCI's reputation for high quality. Alternatively, the ISO can reduce preventive maintenance service, causing photocopiers to be less useful and less valuable in the future. Hence, an ISO has an incentive to increase its wealth at the expense of XCI, who has no incentive to take cost-cutting, quality and reputation reducing short cuts.

para. 35-36

Professor Wilson argues that Exdos is also hurt if Exdos provides poor service. The point is correct, but does not come to terms with the essential economic issue. The question is not whether the service provider suffers some economic loss from poor service, but whether it suffers all the economic loss. Under vertical integration, if XCI offers poor service, XCI bears all the related costs in terms of loss of machine value, loss of reputation, etc. If Exdos provides poor service on an XCI machine, Exdos does not bear that loss that falls on XCI. Exdos imposes an externality on XCI (and XCI in making poor machines an externality on Exdos) which vertical integration internalizes.

Professor Wilson also argues that Exdos has invested in its own reputation as a service provider. It is clear from the evidence (see Responses to Undertakings Number 8, May 7, 1990) that the brochures and proposals to customers by Exdos reflect and play upon the XCI experience of Reid and the service representatives employed by Exdos. The brochures used by Exdos are mere reproductions (verbatim) of the XCI product brochures, with the only addition being that Exdos indicates it will be the seller or lessor of the equipment and that it can also provide service. There is little evidence that Exdos

has invested in its own reputation; instead, it is free riding on its association with XCI.

Professor Wilson also states that used equipment is more likely to suffer breakdown and require repair when compared to new equipment. This statement shows a lack of understanding of the reprographics industry and reprographics equipment in particular. Reprographics equipment is designed to be maintained and repaired on a regular basis from the time it comes off the manufacturing line and once installed in customer locations. The standard of maintenance applied by XCI, or any authorized distributor of a brand of equipment, to newly manufactured first-off-the-line equipment and that refurbished and installed in customer locations for a number of years is the same, provided it is current technology. In addition, the basic models go through a maturity cycle from the time of their introduction. As service/maintenance experience is gained while installed in customer locations, design changes/improvements are made at the manufacturing level which incorporate the experience so gained. The installed units benefit from such improvements by having changes incorporated into the installed units by authorized service representatives. There is, therefore, no difference in the service required between newly manufactured and installed units of current technology. For older technology, there may be a different standard. For example, for currently

marketed "10" series units, the standard is the same; for pre-"10" series, the standard of maintenance may be different with the result that the pre-"10" series equipment may require more repairs.

In essence, the distinction between "new" and "used" is not apt here. The better distinction is between current technology as "new" and old technology as "used".

para. 37

Professor Wilson claims that providing service of last resort will not harm XCI. It is hard to imagine how it could do otherwise. XCI's reputation suffers every time Exdos is unable to service a photocopier properly and then calls on XCI to fix the machine. Exdos can easily shift blame to XCI, claiming defects in Xerox parts or design that XCI must repair. The longer a photocopier is down due to Exdos' failure to repair, the greater the harm to XCI's reputation and future sales. Again, poor service by XCI is also costly, but no shifting of the blame (or the losses) is possible.

Nor would correct pricing solve the problem. The higher XCI raises the time and materials price to account for externalities, the longer will ISOs wait before calling XCI -- the greater is the reputation loss to XCI.

para. 38

Cream skimming is a problem of unregulated markets that causes market failure and thus can bring about regulation. See the book by William J. Baumol, John C. Panzar and Robert D. Willig, Contestable Markets and the Theory of Industry Structure, (Harcourt, Brace, Jananovich, New York, 1982).

para. 41-42

Professor Wilson claims that if ISOs are to be terminated on the grounds of their relative inefficiency, then, instead of termination, XCI should simply compete them away with superior efficiency. Professor Wilson can come to this conclusion only by ignoring the serious problem of free riding. Exdos can free ride in many areas. Exdos can hired experienced XCI repair personnel and not incur the costly process of screening and training job candidates. Exdos does not have to engage in the large-scale advertising and product promotion expenses, as does XCI, free riding on XCI's investment in brand name capital. Exdos can engage in short cuts by ignoring preventive maintenance, contrary to XCI who has a strong incentive to promote preventive maintenance. Since XCI is the lessor on most of its copier placements, its incentive is to maintain their future value. Exdos has no incentive to maintain the resale value of newer XCI copiers.

Professor Wilson's arguments seem to suggest that XCI's interests are in conflict with its end clients. This is incorrect. If ISOs were an efficient delivery system for the majority of its clients, I presume XCI would use them. If a mixed distribution system were efficient (vertical integration and ISOs) from XCI's perspective, again I presume XCI would use this mixed system.

para. 44

Professor Wilson argues that failure of this Tribunal to compel supply will discourage small firms from entering into exclusive relationships with large sellers since small firms will have no protection against subsequent termination. Professor Wilson is stating that such buyers should have contracts in perpetuity and that only the buyer should be allowed to terminate the contract.

What is being called for is the equivalent of lifetime employment, with only the smaller firm free to terminate. This is a highly inefficient form of contracting. Parties must be free to terminate for cause as long as it is not for malicious reasons. We do have courts which examine contract rights. When firms contract exclusively with one supplier they know the risks of single source dependency. Presumably, they are adequately compensated or they would not enter such contracts. Moreover, Professor Wilson's claim that smaller

firms have no protection against an opportunistic future refusal to supply once a contract expires, ignores contract remedies and the costs to opportunistic firms from such behaviour. Contract terms can be designed to guard against opportunism. More importantly, a large supplier dealing with a network of ISOs has a strong incentive to not terminate without proper cause. Opportunistic termination will breed retaliation by the remaining ISOs and lower greatly the quality of future ISOs seeking to deal with the larger firm. It will severely weaken the ISO network, harming the large supplier. Hence, there are also strong non-contractual incentives to never terminate opportunistically.

para. 46-47

To this point in his Report, Professor Wilson had suggested the *possibility* of inefficiencies because the reprographics market does not mimic the ideal of perfect competition and because I presented no evidence on the values of the efficiencies.

In paragraph 47, Professor Wilson *concludes* "that the increased costs imposed on buyers and their customers are not offset by actual or prospective efficiency gains to Xerox and others..."

This conclusion is unfounded.

First, no facts are presented to back up this assertion. Second, an economic principle is used in an usual manner, as a Competition Policy principle. Professor Wilson began his paper by examining pareto optimality (paragraph 2, p. 2); here he is suggesting that individual business practices be conditioned by a "Pareto optimum" -- an unworkable rule. Third, as I indicated above, the facts show the opposite of the assertion -- there are efficiency gains from vertical integration.

Conclusion

In conclusion, Professor Wilson argues that vertical integration into servicing by XCI is inefficient because XCI has market power in parts (and copiers) and will achieve no added efficiencies. However, XCI does face competition and potential competition in copiers; it has no long-run anti-competitive market power in parts.

Professor Wilson's position on vertical integration and compelling continued supply is illogical. First, if XCI has a monopoly position in parts then forcing it to supply Exdos will not end its monopoly position. Second, if XCI cannot choose vertical integration in servicing under Section 75, then it should not be free to choose vertical integration in any of its activities, such as sales, parts manufacturing, R&D, etc. Using Professor Wilson's reasoning, anyone who wants to sell XCI copiers or manufacture XCI

parts should be free to do so, since XCI has a monopoly over its parts manufacturing and copier sales. Thus, XCI should be forced to use outside parts and sales firms in order to eliminate its monopoly power. Such a solution would, of course, destroy XCI.

It opens up XCI to all the opportunism that vertical integration serves to internalize. In short, it denies the whole basis for the existence of firms and their organizational boundaries. Whatever the potential pro-competitive merits of Section 75, Professor Wilson's interpretation of it has decidedly anti-competitive consequences.

As stated in my affidavit and reply, a firm should be able to choose that competitive distribution system which maximizes its own profits. Unless it can be demonstrated that <u>competition</u> suffers because of a distribution practice, the losses of a particular distributor is irrelevant to <u>Competition Policy.</u>

The recently circulated "Draft for Discussion Only on Predatory Pricing" (April 20, 1990) by the Director of Investigation and Research discusses when the Director would view a firm's pricing practices as warranting investigation. In that Draft, short-run market power is suggested as occurring when a firm has a market share threshold of 35 per cent and is at least twice the size of its next largest competitor.

The Bureau's criteria show that XCI has no short-run market power in the low and medium speed segments. The evidence in industry reports and surveys shows that XCI has no long-term market power in the reprographics market.