Canadian merger enforcement guidelines

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The Canadian Competition Bureau ('the Bureau') has recently issued for comment its draft revised merger enforcement guidelines ('RMEGs').[1] In the first update since their original publication in March 1991, the draft RMEGs exhibit greater convergence with US merger enforcement policy, while retaining some distinctly Canadian policy choices reflective of the provisions of the Canadian Competition Act ('the Act'). The RMEGs are also largely consistent with the new merger control guidelines of the European Commission. The RMEGs are expected to be finalised by the fall of 2004.

The first part of this chapter will briefly outline the RMEGs, highlighting some of the changes from the existing Merger Enforcement Guidelines ('MEGs').[2] The second part will discuss some of the similarities and differences between the Canadian merger enforcement guidelines with those of the United States and Europe.

Overview of the RMEGs

Anti-competitive threshold

The Competition Tribunal may issue an order when it finds that a merger has or is likely to prevent or lessen competition substantially. The RMEGs indicate that this test is satisfied where a merger is likely to create or enhance the ability of the merged firm, alone or in concert with other firms, to exercise market power. Market power by a seller is defined as the ability of a single firm or group of firms to profitably maintain prices above the competitive level for a significant period of time.[3]

According to the MEGs and the RMEGs, competition will be lessened or prevented substantially if the price of the relevant product is likely to be materially greater in a substantial part of the relevant market as a result of the merger. This condition means that material price increases could be less than the typical 5 per cent price increase used for market definition purposes. Both the MEGs and RMEGs indicate that if existing or new competitors will likely eliminate the ability to materially increase price within two years of the exercise of market power, the substantiality element of the test will not be met.

The RMEGs provide somewhat greater detail than the MEGs on what the Bureau would consider to be a prevention of competition resulting from the merger. The Bureau may examine a merger as a 'prevent case' when either the acquirer or the acquiree has entry or expansion plans that are eliminated because of the merger. Mergers that prevent expansion into new geographic markets, the introduction of new products, or prevent pro-competitive effects of new capacity are new examples cited in the RMEGs that will warrant investigation.

Market definition

The first step in the analysis is to identify economic markets that could be the subject of the exercise of market power. As noted by the Competition Tribunal[4], relevant markets defined for anti-trust purposes may not correspond to the way that industry participants have defined their markets for business purposes. Relevant markets have both product and geographic dimensions.

Both the existing MEGs and the RMEGs use the hypothetical monopolist paradigm to define product and geographic markets. The idea is to identify the smallest group of products and the smallest geographical area in which a single seller (the 'hypothetical monopolist') would profitably impose a significant price increase for an extended period of time. In both the existing MEGs and the RMEGs, the significant price increase used in the test is generally 5 per cent and the time period used is one year.

The existing MEGs indicate that the assessment of the profitability of a significant price increase depends on the likely responses from buyers and sellers in the one year period. The RMEGs however, indicate that relevant market definition focuses solely on responses from buyers to changes in relative prices. Responses from sellers are considered later in the analysis, either as firms identified as currently in the relevant market or as likely future entrants. This approach more accurately reflects actual Bureau merger enforcement approach over the past decade than the existing MEGs. While it has the potential to lead to a greater number of relevant markets being defined, a pragmatic approach will aggregate defined markets where it makes sense to do so because of commonality of buyers and sellers and data limitations.

Both the MEGs and RMEGs note that where sellers can identify and sell to buyers who are willing to pay different prices for the same products, and that such price differentials can be maintained because buyers will not resell or trade these products in sufficient quantities, relevant markets may be defined with respect to the classes of buyers or the particular location of targeted buyers.

The RMEGs set out in detail the type of analysis and evidence that the Bureau would consider in defining relevant markets. Where detailed price and quantity data are available, it may be possible to estimate the own-price elasticity of demand, which directly measures the change in quantity demanded by buyers in response to an increase in price.[5] More commonly, this information is unavailable and the Bureau will be relying on indirect evidence of substitutability from market participants in response to a 5 per cent price increase. The views, strategies and behaviour of buyers in the past will be considered, along with functional indicators. In the case of determining which products are close substitutes, the RMEGs discuss end use, physical and technical characteristics, price relationships and switching costs faced by buyers. In the case of geographic markets, functional indicators of substitutability among geographic areas include transportation costs, shipment patterns, price relationships and foreign competition. The RMEGs include a new reference to spatial competition analysis that was accepted by the Competition Tribunal in one case[6] to determine the boundaries of local markets.

Market share and concentration

As noted above, unlike the MEGs, the RMEGs identify sellers of the relevant products in the market share stage of the analysis. Firms that currently participate in the relevant markets are included, as well as firms that could readily and profitably sell into the relevant market without incurring significant sunk costs. This type of supply response could occur, for example, if a firm can easily reposition a product or extend its product line to compete in the relevant product market. New entrants that incur significant sunk costs are considered in the entry part of the analysis and are not assigned a market share.

Special considerations apply to foreign suppliers. The RMEGs outline a large number of factors, such as the existence of tariffs, quotas, non-tariff barriers, exchange rate fluctuations and anti-dumping actions that can impair the ability of foreign competition to participate in the relevant market.

The Act makes it clear that the Competition Tribunal cannot find that a merger substantially lessens or prevents competition based solely on the evidence of market share or concentration.[7] Nevertheless, it is an important factor. The absence of high post-merger market share or concentration means that effective competition likely remains in the relevant market sufficient to defeat the exercise of market power.

The Bureau will consider not only the current level of market share, but also how that market share has changed in the past and the potential for significant changes in the future due, for example, to changes in technology. The RMEGs note historical market share may be less relevant in bidding markets where rapid changes in market position are common.

The RMEGs retain the safeharbour market-share thresholds set out in the MEGs. The Bureau will not generally challenge a merger on the basis of a unilateral exercise of market power where the merged firm has less than 35 per cent market share. It will not generally challenge a merger on the basis of a coordinated exercise of market power when the post-merger market share accounted by the four largest firms would be less than 65 per cent[8] or when the post-merger market share of the merged entity would be less than 10 per cent. Mergers that exceed these thresholds are not necessarily anti-competitive and the Bureau will consider the other factors set out in the Act, most notably entry conditions.

Anti-competitive effects

The RMEGs contain a new section outlining in detail the two types of competitive effect analysis that the Bureau undertakes: unilateral effects and coordinated effects.[9]

A unilateral exercise of market power occurs when the merged entity can impose a material price increase without regard to a competitive response by its rivals. This is more likely when the merging firms account for a significant share of the market, since the customers of the merged firm have limited options to turn to in response to a price increase. In markets with differentiated products, a significant price increase by the merged firm may be profitable even at a less than dominant market share if the products of the merging partners are seen as very close substitutes by customers, thereby limiting the loss of sales to other firms. In markets where firms compete based on capacity, a unilateral exercise of market power may be possible where the competing firms are capacity constrained.

Coordinated effects occurs where a group of firms is able to profitably coordinate its behaviour because of each firm's accommodating reaction to the conduct of others. The Bureau assesses whether a merger makes such coordinated behaviour more likely or effective.[10] Such behaviour can involve tacit understandings on price and non-price dimensions of competition. The Bureau will consider what market conditions exist that help firms reach such understandings and that allow firms to sustain such conduct by being able to monitor one another's conduct and credibly punish firms that deviate from the understandings. The Bureau will also consider the ability to sustain such conduct in the face of reactions by non-coordinating suppliers or buyers.

The most significant change in the RMEGs compared with the MEGs is the increased emphasis and guidance given by the Bureau in its analysis of coordinated effects. This topic received little attention in the MEGs because, until recent years, the focus of the Bureau's attention had been on determining whether a merger lessened or prevented competition based on a unilateral exercise of market power.[11]

In 1998 the Bureau published the Merger Enforcement Guidelines as Applied to a Bank Merger ('BMEGs'). The BMEGs were intended to provide further guidance on the application of the MEGs to the financial services sector. They contained a more detailed explanation of coordinated effects and the factors the Bureau would consider in any such analysis. What followed was a series of cases where competition concerns were raised based in some measure on coordinated effects.[12] In the *Superior Propane* case,[13] the Competition Tribunal made a finding of a substantial lessening of competition in a number of markets based on an increased likelihood of interdependent (the equivalent of coordinated) behaviour.

The RMEGs reflect the increased attention that the Bureau is giving to competitive concerns arising from coordinated effects. This change has generated concern among competition law practitioners in Canada. The fear is that because of its small population base, Canada has many markets that are already highly concentrated and subject to some degree of oligopolistic or coordinated behaviour. In this environment, a strict application of coordinated effects analysis could lead to very active and interventionist merger enforcement. However, the RMEGs indicate the Bureau's analysis will consider how the merger changes the competitive dynamic, for example, by removing or reducing pre-merger constraints on coordination.[14] In other words, how exactly does reducing the number of market participants by one, changing the distribution of market share or the cost structure of the merging parties increase the risk for coordinated effects? The burden of proof will rest with the Bureau to demonstrate how these changes to pre-merger conditions will likely lead to anti-competitive effects.

Entry

The RMEGs continue the policy choices made by the Bureau in the MEGs on its analysis of entry conditions. Emphasis in the RMEGs is placed on the timeliness, likelihood and sufficiency of entry. In order to be relevant, entry must be on a sufficient scale to defeat a material price increase in a substantial part of the relevant market within two years of the exercise of market power. In conducting this analysis, the Bureau will make an assessment of the likelihood and sufficiency of potential entry in the two year period. The analysis will consider a host of entry conditions that can impact on the decision to enter and affect the viability of any such entry, such as the presence of substantial sunk costs, the existence of long term contracts with terms that impede customer switching, changes in technology and regulatory barriers.

The analysis of potential future entry or expansion by incumbents is a particularly difficult exercise. In two cases, the Bureau has been forced to amend or withdraw its application to contest a merger based on entry that occurred while the case was pending.[15]

Countervailing power

The RMEGs contain an important new section on countervailing market power held by buyers. The RMEGs suggests that buyer concentration can prevent the exercise of seller market power if buyers can easily switch to other suppliers, can credibly expand into upstream markets or can sponsor effective new entry due to the size of business they can offer suppliers. Where price discrimination by sellers is practised in a relevant market, market power held by large buyers may be insufficient to stop the merged entity from materially increasing price to smaller buyers accounting for a significant portion of the market.

Failing firm

The RMEGs largely repeats the MEGs in the description of how the Bureau will treat the failing firm factor in its merger assessment.

The one notable exception is the RMEGs emphasise that the firm must be failing, that other less anti-competitive alternatives to the merger do not exist, and that in the absence of the merger, the assets of the firm will likely leave the market. In the MEGs, the failing firm factor included situations where a firm wished to exit a market for reasons other than failure, such as unsatisfactory profits. The MEGs policy choice was vulnerable to strategic utilisation by merger proponents and it was very difficult to objectively verify whether in fact the assets would leave the market in the absence of the proposed transaction.

Efficiency exception

Canada is one of the few jurisdictions in the world that contain an explicit legislated trade-off between anti-competitive effects and efficiency gains. Considerable controversy has surrounded the application of this provision in Canada, raising fundamental questions about the objectives of the Competition Act.

In the MEGs, the Bureau adopted a total surplus approach where the only anti-competitive effects that are taken into account in the trade-off are those losses in surplus that result from a reduction in output, referred to by economists as the 'deadweight' loss. Under this approach, wealth transfers from buyers to sellers when prices are increased are ignored because they do not represent losses to the economy as a whole. This approach assumes that allocative efficiency is the paramount objective of the Act.

In the *Superior Propane* case, the Bureau advanced a different standard that would include a broader range of anti-competitive effects, including some portion of the wealth transfers from buyers to sellers. The Competition Tribunal in that case ultimately adopted a standard that encompassed the deadweight loss and the "socially adverse" portion of the transfer. This approach requires the Bureau to assess the socio-economic profiles of buyers and sellers to determine what value each places on income.

The Bureau has stated that in light of the *Superior Propane* jurisprudence, it supports a change in the efficiency standard to provide a more workable approach that recognizes all of the objectives of the Act, including consumer interests.[16] In the interim, the RMEGs indicate that the Bureau will consider a broader range of anti-competitive effects than the deadweight loss when performing the trade-off analysis. These effects will include redistributive effects, non-price effects in the reduction of service, quality and choice, losses of productive efficiency[17] and losses of dynamic efficiency. On the other side of the trade-off, the Bureau will also consider gains in productive and dynamic efficiency that may result from the merger.

Comparison to US merger enforcement policy

The analytical approach outlined in the RMEGs will be instantly familiar to readers of the Horizontal Merger Guidelines of the US Department of Justice and the Federal Trade Commission ('US HMGs'). The two guidelines share far more similarities than differences.

The original MEGs are already similar in approach to the US HMGs. Both use the hypothetical monopolist paradigm for market definition, both call for an extensive entry analysis and both outline many common analytical factors.

The RMEGs strengthen that convergence by providing greater detail and emphasis on coordinated effects, more detail on unilateral effects and by moving supply side substitution from market definition to the market share part of the analysis. The organization of the RMEGs also more closely resembles the US HMGs by integrating the various factors to be considered under s.93[18] of the Act into categories of competitive effects and entry conditions.

Nevertheless, differences arise because of distinct governing legislation, jurisprudence and enforcement policy choices. In relation to concentration, the Canadian safeharbour thresholds are based on market share and CR4, not the Herfindahl-Hirschman Index ('HHI') set out in the US HMGs. The RMEGs allow a material price increase to persist for up to two years before it is found to be substantial. While this concept is not included in the US HMGs, it is the case in the US that committed entry that is likely to occur, and that would be sufficient to counteract the competitive concerns, will be considered if it happens within two years.

In terms of entry, the US HMGs indicate that "entry that is sufficient to counteract the competitive effects of concern will cause prices to fall to their premerger levels or lower".[19] There is no requirement in the RMEGs that entry must drive prices to the pre-merger level, only that they eliminate a material price increase. This is consistent with Canadian jurisprudence which indicates that merger remedies do not have to return the market to a pre-merger level of competition, only that they reduce any lessening or prevention of competition below the "substantial" threshold.[20]

Efficiencies, in the US, must be large enough to reverse the potential harm to consumers caused by the merger in the relevant market, for example by preventing price increases to consumers. There is no such consumer welfare requirement in the RMEGs.

Comparison to European merger enforcement guidelines

The European guidance on merger enforcement is contained in two documents, one related to market definition[21] for merger and non-merger provisions, and another guideline on issues specific to merger review[22] (collectively, 'EU MEGs').

In terms of market definition, the EU MEGs appear to adopt a hypothetical monopolist approach since they posit a small non-transitory price increase of 5 per cent to 10 per cent and examine the degree of buyer substitution in response. However, the analysis is not limited to demand substitution but can include supply substitution at the market definition stage, if it has the same degree of immediacy and effectiveness as demand substitution. This is consistent with the current MEGs approach that includes supply responses that occur within one year in the market definition analysis, although inconsistent with the RMEGs and US HMG approach of including this type of supply response in the market share analysis after the market has been defined.

In relation to market share and concentration, the EU MEGs utilise a blended approach of the HHI and market share to delineate safeharbours. One safeharbour indicates that if the merged firm has a combined market share of less than 25 per cent, it would generally not be problematic. The equivalent Canadian safeharbour of 35 per cent is somewhat more permissive that the EU standard. There is no Canadian safeharbour based on the HHI.

The EU MEGs have an extensive discussion of unilateral (referred to as "non-coordinating") effects and coordinated effects as the two main categories of competitive harm. This discussion is very similar to that contained in the US and Canadian guidelines, and in fact is more extensive in providing guidance on coordinated effects than the RMEGs. Particular mention is made of joint ventures and cross-shareholdings in the EU MEGs in relation to the potential for coordinating effects.

The entry analysis is consistent with the US and Canadian requirements of likelihood, timeliness and sufficiency. Entry normally should occur within two years. It must be sufficiently profitable taking into account the additional output of that entry into the market.

Like the RMEGs, the EU MEGs contain a section on countervailing buyer power, although no discussion of this concept is found in the US HMGS.

Finally, in relation to efficiencies, the EU MEGs require that consumers be no worse off as a result of the merger. Efficiencies must be timely and passed on to produce benefits to consumers. This consumer welfare approach is clearly not the law in Canada at this time.

Conclusion

The RMEGs effectively update the MEGs by incorporating the jurisprudence, new economic thinking and changes in enforcement approaches that have occurred in the 13 years since their original publication. They have achieved even greater convergence with the guidelines of Canada's major trading partners, the United States and Europe. Greater enforcement convergence should improve the efficiency of cross-border merger review, reduce the potential for conflicting decisions and lower compliance costs.

Notes

1 Merger Enforcement Guidelines, Draft for Consultation", Competition Bureau, March 2004 (RMEGs)

2 "Merger Enforcement Guidelines" Director of Investigation and Research Competition Act, Information Bulletin No. 5, March 1991 (MEGs)

3 A parallel analysis follows in the case of market power held by buyers, who would have the ability to depress prices and hence output below competitive levels for a significant period of time.

4 Canada (*Commissioner of Competition) v Superior Propane Inc* CT-1998/002 2000 (Competition Tribunal) 30 August 2000 para.85, 101

5 The Competition Tribunal in *Superior Propane* indicated that the own-price elasticity of demand was the measure to be used for market definition, while cross-price elasticity of demand was a useful but indirect measure of substitutability. (ibid at para 62) Own-price elasticity measures the percentage change in quantity demanded for a given percentage change in price for a product, while cross-price elasticity measures the percentage change in quantity demanded of one good for a given percentage change in price in another good.

6 *Superior Propane*, at para 106. For an explanation of spatial analysis, see *Superior Propane* at para 87-90. In *Commissioner of Competition v Canadian Waste Services Holdings Inc* (CT file 2000/002 Decision dated March 28/01, para.76-83), the Competition Tribunal discusses the spatial analysis of the Commissioner's expert.

7 Section 92(2) of the Competition Act

8 Economists refer to this concentration measure as the CR4 ratio.

9 In the MEGs, the term interdependent behaviour is used to describe the type of conduct covered by coordinated effects as described in the RMEGs.

10 RMEGs, Para 5.17

11 The one notable exception was the acquisition of Canadian operations of Texaco by Imperial Oil. This transaction raised significant competition concerns based largely on coordinated effects. *Canada (Director of Investigation and Research) v Imperial Oil Limited* (unreported, 6 February 1990, Competition Tribunal, file CT89/3).

12 In 1998 the Bureau concluded that the proposed merger of the Royal Bank of Canada and the Bank of Montreal and the merger of the Canadian Imperial Bank of Commerce with the Toronto-Dominion Bank would substantially lessen or prevent competition. This conclusion took into account an increased likelihood of coordinated behaviour following the mergers. In Abitibi's acquisition of Donohue, coordinated effects played an important role (Statement of Grounds and Material Facts, *Commissioner of Competition v Abitibi-Consolidated Inc* unreported 22 Jan.2002 Competition Tribunal file no. CT01/9), as well as in Bayer's acquisition of Aventis (Statement of Grounds and Material Facts, *The Commissioner of Competition v Bayer AG and Aventis CropScience Holding SA* (unreported) 31 May 2002, Competition Tribunal, file no.CT02/3).

13 *Superior Propane*, at Para. 308-309

14 RMEGs, Para 5.23

15 *Director of Investigation and Research v Canadian Pacific Limited Competition Tribunal* CT-1996/002, *Director of Investigation and Research v Dennis Washington et al* (1996) unreported Competition Tribunal CT-1996/001

16 "Bill C249 An Act to Amend the Competition Act Speaking Notes for Sheridan Scott, Commissioner of Competition", before the Standing Senate Committee on Banking, Trade and Commerce, 12 May 2004

17 The idea is that some mergers creating monopolies or near monopolies may increase costs since the incentive to be cost competitive is less if the merged firm is insulated from competitive pressure.

18 Factors to be considered regarding the substantial prevention or lessening of competition.

19 HMG, section 3.0

20 Canada (*Director of Investigation and Research v Southam* [1997] 1 S.C.R. 748 para. 85

21 Commission Notice on the definition of the relevant market for the purposes of Community competition law, Official Journal of the European Union OJ C372 on 9 December1997

22 Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, Official Journal of the European Union 5 February 2004, C31/5-C31/18