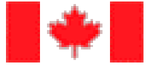

Government of Canada   Gouvernement du Canada

Merger Enforcement Guidelines

COMPETITION BUREAU

March, 1991

Merger Enforcement Guidelines

Notice: These Guidelines were issued in March 1991. A number of changes to the Competition Act have occurred since then. In particular, section 6.2 and section 6.5 of Part 6 of the Merger Enforcement Guidelines no longer reflect current provisions of Part IX of the Competition Act addressing Notifiable Transactions and timing issues. Please refer to the Procedures Guide for Notifiable Transactions and Advance Ruling Certificates and the Fee and Service Standards Handbook. Readers should also note that in light of the decision of the Federal Court of Appeal in the Commissioner of Competition v. Superior Propane Inc., The Efficiency Exception Part 5 of the guidelines no longer applies. In cases where efficiencies are claimed, the Competition Bureau will apply the principles set out in the Commissioner of Competition v. Superior Propane Inc. and ICG Propane Inc. 2001 FCA 104.

These guidelines are issued to provide general guidance. Parties are encouraged to enter into early contact with the Bureau to discuss proposed transactions. The particular facts will determine how the Bureau assesses any proposed transaction. Parties contemplating a merger or acquisition should obtain appropriate legal advice when contemplating a possible transaction. The final interpretation of the Competition Act rests with the Competition Tribunal and the Courts.

INTERPRETATION

These Guidelines supersede all previous statements made by the Director of Investigation and Research or other officials of the Bureau of Competition Policy, including Information Bulletin No. 1 (entitled The Merger Provisions), that may differ from anything stated herein.

This document is intended solely to provide enforcement guidelines. As such, it sets forth the general approach that is taken to merger review, and is not a binding statement of how discretion will be exercised in a particular situation. Specific guidance regarding a specific merger may be requested from the Bureau through its program of advisory opinions. The Guidelines are not intended to be a substitute for the advice of merger counsellors. They do not represent a significant change in enforcement policy or restate the law. Final interpretation of the law is the responsibility of the Competition Tribunal and the courts.

For the sake of brevity the following abbreviations are used throughout these Guidelines:

- The Act refers to the Competition Act, R.S.C. 1985, c. C-34, as am. R.S.C. 1985, c. 27 (1st Supp.), ss. 187, 189; R.S.C. 1985, c. 19 (2nd Supp.), Part II; R.S.C. 1985, c. 34 (3rd Supp.), s. 8; R.S.C. 1985, c. 1 (4th Supp.), s. 11;R.S.C. 1985, c. 10 (4th Supp.), s. 18; S.C. 1990, c. 37 ss. 27-32.
- "The Department" refers to Consumer and Corporate Affairs Canada
- "The Bureau" refers to the Bureau of Competition Policy, Consumer and Corporate Affairs Canada.

- "The Director" refers to the Director of Investigation and Research, of the Bureau of Competition Policy.
- "The Tribunal" refers to the Competition Tribunal.
- "The Guidelines" refers to this publication i.e. Merger Enforcement Guidelines.
- References to sections of the Act are referred to as "sections".
- References to parts of these Guidelines are referred to as "parts".

Executive Summary

- Part 1 - The Definition of "Merger"
- Part 2 - The Anticompetitive Threshold
- Part 3 - Market Definition
- Part 4 - Evaluative Criteria
- Part 5 - The Efficiency Exception
- Part 6 - Process Matters
- Appendix I - Background Information on Sunk Costs
- Appendix II - Types of Efficiency Gains Generally Considered

Executive Summary

What Constitutes a Merger

In Part 1, the Guidelines address the Director's enforcement policy regarding section 91 of the Act, which sets forth the definition of the term "merger". In general terms, section 91 deems a "merger" to occur when direct or indirect control over, or significant interest in, the whole or a part of a business of another person is acquired or established. If a transaction does not come within the scope of section 91, it will not be subject to the merger provisions of the Act. The principal issue highlighted in Part 1 is the interpretation of the words "significant interest". The acquisition or establishment of a significant interest in the whole or a part of a business of another person is considered to occur when a person acquires or establishes the ability to materially influence the economic behaviour of the business of a second person; (e.g., block special or ordinary resolutions or make decisions relating to pricing, purchasing, distribution, marketing or investment). In general, a direct or indirect holding of less than a 10 percent voting interest in another entity will not be considered a significant interest.A significant interest may be acquired or established pursuant to shareholder agreements, management contracts and other contractual arrangements involving incorporated or non-incorporated entities.

The Anticompetitive Threshold

Part 2 deals with the Director's enforcement policy regarding the statutory standard set forth in section 92(1) of the Act . In general, a merger will be found to be likely to prevent or lessen competition substantially when the parties to the merger would more likely be in a position to exercise a materially greater degree of market power in a substantial part of a market for two years or more, than if the merger did not proceed in

whole or in part. Market power can be exercised unilaterally or interdependently with other competitors. To date, most of the mergers that the Director has concluded would likely have prevented or lessened competition substantially have raised concerns about the ability of the merging parties to unilaterally exercise market power. However, the Guidelines indicate that a merger can also facilitate the ability of two or more competitors to exercise market power interdependently, through an explicit agreement or arrangement, or through other forms of behaviour that permit firms implicitly to coordinate their conduct. In the assessment of the extent to which market power will likely be acquired or entrenched as a result of a merger, the focus is primarily upon the price dimension of competition. Nevertheless, competition can be substantially prevented or lessened with respect to service, quality, variety, advertising or innovation, where rivalry in the market in respect of these dimensions of competition is important.

Market Definition

Part 3 of the Guidelines outlines the conceptual framework that underlies the approach taken to market definition, and describes the various factual criteria that are typically assessed in the case-by-case application of this framework. In general, a relevant market is defined as the smallest group of products and the smallest geographic area in relation to which sellers could impose and maintain a significant and nontransitory price increase above levels that would likely exist in absence of the merger.In most contexts, the Bureau considers a 5 percent price increase to be significant, and a one year period to be nontransitory. However, a different price increase or time period may be employed where the Director is satisfied that the application of the 5 percent or one year thresholds would not reflect market realities.

Where potential competition from new entrants or expansion by fringe firms within the market would require significant construction or adaptation of facilities, or overcoming significant difficulties related to marketing and distribution, it is considered subsequent to market definition, in the assessment of whether new entry into the relevant market would ensure that competition would not likely be prevented or lessened substantially.

Evaluative Criteria

Part 4 addresses the various evaluative criteria that are analyzed in the determination of the likely effects of a merger on competition in a relevant market. The first matter discussed is the significance of information relating to market share and concentration. Mergers generally will not be challenged on the basis of concerns relating to the unilateral exercise of market power where the post-merger market share of the merged entity would be less than 35 percent. Similarly, mergers generally will not be challenged on the basis of concerns relating to the interdependent exercise of market power, where the share of the market accounted for by the largest four firms in the market post-merger would be less than 65 percent. Notwithstanding that market share of the largest four firms may exceed 65 percent, the Director generally will not challenge a merger on the basis of concerns relating to the interdependent exercise of market power where the merged entity's market share would be less than 10 percent. These thresholds merely serve to

distinguish mergers that are unlikely to have anticompetitive consequences from mergers that require further analysis, of various qualitative assessment criteria such as those highlighted in section 93. No inferences regarding the likely effects of a merger on competition are drawn from evidence that relates solely to market share or concentration. In all cases, an assessment of market shares and concentration is only the starting point of the analysis.

The Guidelines then address the seven qualitative assessment criteria specifically mentioned in section 93 of the Act, together with two additional criteria that are often important to consider. As is the case with high market share and concentration, the presence of impediments to new competition that would impose on entrants a significant cost disadvantage, irrecoverable costs, or time delays is generally a necessary, but not sufficient precondition to a finding that competition is likely to be prevented or lessened substantially. In the absence of such impediments, a significant degree of market power generally cannot be maintained. Where future entry or expansion by fringe firms within the market would likely occur on a sufficient scale within two years to ensure that a material price increase could not be sustained beyond this period in a substantial part of the relevant market, the Bureau would likely conclude that the merger does not require enforcement action.

Similarly, information relating to either the failing firm or the effective remaining competition factors can be sufficient to warrant a decision not to challenge a merger. In cases where one of the merging parties is likely to exit the market in absence of the merger, and there are no alternatives to this exit that would result in a materially higher degree of competition than if the merger proceeded, the merger will generally not be found to be likely to contravene the Act. Likewise, where the degree of effective remaining competition that would remain in the market is not likely to be reduced, the merger likely will not be challenged.

Vertical and Conglomerate Mergers

At the end of Part 4, the Guidelines address vertical and conglomerate mergers. Such transactions rarely present sufficient grounds for enforcement action. Nonetheless, the Guidelines describe two limited situations where a vertical transaction may prevent or lessen competition substantially, and one circumstance where a "conglomerate" merger may do so. In each of these three situations, the potential anticompetitive effect of the merger is horizontal.

The Efficiency Exception

Please Note: This Part no longer applies. Readers should consult the decision of the Federal Court of Appeal in the Commissioner of Competition v. Superior Propane Inc. and ICG Propane Inc 2001 FCA 104.

In Part 5, the Guidelines address in detail the approach taken to the efficiency exception provisions of section 96. These provisions become operative where a merger has been

found to be likely to substantially prevent or lessen competition. The review of submissions relating to efficiency gains focuses primarily upon quantifiable production related efficiency gains. However, qualitative dynamic efficiencies can in certain circumstances also receive significant weight. The total efficiency gains that would not likely be attained if the merger did not proceed are balanced against the effects of any prevention or lessening of competition likely to be brought about by the merger. The focus of the evaluation of the magnitude of these anticompetitive effects is upon the part of the total loss likely to be incurred by buyers or sellers that is not merely a transfer from one party to another but represents a loss to the economy as a whole, attributable to the diversion of resources to lower valued uses.

Process Matters

Finally, in Part 6 the Guidelines briefly address various process related considerations such as timing, prenotification, confidentiality, information exchanges between merging parties and the relationship between the review processes of the Bureau and Investment Canada.

PART 1 - The Definition of "Merger"

Section 91 of the Act defines a "merger" in terms of: "... the acquisition or establishment, direct or indirect, by one or more persons, whether by purchase or lease of shares or assets, by amalgamation or by combination or otherwise, of control over or significant interest in the whole or a part of a business of a competitor, supplier, customer or other person."

These words are broad enough to cover any manner in which control over, or a significant interest in, the whole or a part of a business of another person is acquired or established. With respect to corporations, "control" is defined in section 2(4) of the Act to mean de jure control, i.e., a direct or indirect holding of more than 50 percent of the votes that may be cast to elect directors of the corporation, and which are sufficient to elect a majority of such directors. However, the Act provides no guidance with respect to the meaning of the words "significant interest". Given that the Act is concerned with the market behaviour of firms, it is the Bureau's position that a "significant interest" in the whole or a part of a business is held when one or more persons have the ability to materially influence the economic behaviour (e.g., decisions relating to pricing, purchasing, distribution, marketing or investment) of that business or of a part of that business. Given the range of management and ownership structures which exist, a determination of whether a significant interest is likely to be acquired or established can only be made on a case by case basis.

A significant interest in a corporation may be found to exist when one or more persons, directly or indirectly, hold enough voting shares:

> (i) to obtain a sufficient level of representation on the board of directors of the corporation to materially influence that board; or
>
> (ii) to block special or ordinary resolutions of the corporation.

In the Bureau's experience, direct or indirect ownership of less than 10 percent of the voting shares of a corporation has generally been found not to constitute ownership of a "significant interest" in the corporation. Inferences are difficult to make about situations which result in a direct or indirect holding of between 10 percent and 50 percent of the voting shares of a corporation. However, within this range, a much greater level of voting interest is ordinarily required to materially influence a private company than a widely held public company. In recognition of this, the prenotification requirements of Part IX of the Act pertaining to private and public corporations are triggered at the 35 percent and 20 percent thresholds, respectively[1].

A significant interest can also be acquired or established pursuant to shareholder agreements, management contracts and other contractual arrangements involving corporations, partnerships, joint ventures, combinations and other entities. In addition,

---

[1] The prenotification provisions, which apply to high transaction-value mergers involving large firms are discussed in part 6.2 below.

loan, supply and distribution arrangements that are not ordinary course transactions and that confer the ability to influence management decisions of another business may constitute a "merger" within the meaning of section 91. Asset transactions that generally fall within the scope of section 91 include the purchase or lease of an unincorporated division, a plant, distribution facilities, a retail outlet, a brand name or intellectual property rights.

Persons already holding a significant interest in the whole or a part of a business may trigger the merger provisions of the Act by acquiring or establishing a significantly greater ability to influence the economic behaviour of the business. Therefore, movement from a minority, yet significant, interest to control would likely be found to constitute a merger. A merger can occur both at the time of the purchase of convertible debentures, non-voting shares or options and at the time of their conversion or their exercise[2].

Section 91 is broad enough to cover horizontal, vertical and conglomerate transactions. These Guidelines focus primarily on horizontal mergers. The two limited situations in which a vertical merger may prevent or lessen competition substantially, and the single situation in which a conglomerate merger may do so, are discussed in parts 4.11 and 4.12 of the Guidelines. Transactions that fall within the scope of section 91 because one company may directly or indirectly obtain the ability to elect a sufficient number of directors to the boards of directors of two competitors to materially influence these boards, or because representatives of two competitors respectively may be able to materially influence the board of directors of a third company, will be assessed in terms of whether competition is likely to be substantially prevented or lessened in the market in which the two competitors compete. In either case, concerns will generally not be presented if the board representation pertaining to one of the competitors is solely through "independent" directors, e.g., persons who are not employees, executives or members of the board of directors of the company being represented, and who do not have any other interest in that company.

[2] However, the prenotification provisions would only be triggered upon conversion or exercise, provided that the thresholds discussed in part 6.2 are exceeded.

PART 2 - The Anticompetitive Threshold

2.1 Overview

The anticompetitive threshold for mergers is set forth in section 92(1) of the Act, which provides that the Tribunal may make an order in respect of a merger[3] where it finds that the merger "prevents or lessens, or is likely to prevent or lessen, competition substantially".

A prevention or lessening of competition can only result from a merger where the parties to the merger are, or would likely[4] be, able to exercise a greater degree of market power, unilaterally or interdependently with others, than if the merger did not proceed[5].

Market power refers to the ability of firms to profitably influence price[6], quality, variety, service, advertising, innovation or other dimensions of competition in the manner described below. In evaluating whether the market power of the merging parties is likely to be greater than if the merger does not proceed, the focus is primarily on the price dimension of competition. Specifically, an assessment is made of whether prices would likely be higher than if the merger did not proceed. Alternatively, where the concern is with market power on the buying side, the focus of the assessment is upon whether the merger is likely to confer upon the merged entity, acting unilaterally or interdependently with others, an ability to depress the prices it pays to sellers to a level that is below the price that would likely prevail in absence of the merger[7]. To simplify the discussion, these Guidelines will focus solely on the price effects of a merger between sellers. However, where there is a significant level of non-price competition in a market that is defined in terms of either buyers or sellers, an assessment will be made of whether the exercise of market power is likely to result in lower benefits provided by this form of rivalry than if the merger did not proceed.

Where a merger is not likely to have adverse market power effects, it generally cannot be demonstrated that competition is likely to be adversely affected as a result of the merger,

---

[3] All references to "merger" in these Guidelines include a "proposed" merger.
[4] In the Director's view, the word "likely" means "probably", and not "possibly". Therefore the word "likely" connotes "probably" throughout this document.
[5] Where the Director is concerned with only a part of a merger, or where a remedial order with respect to only part of a merger would sufficiently address the Director's concerns, then the comparison would be between the market power that would likely be exercised if no order where made and that which would likely be exercised if an order were made in respect of part of the merger. Future references in this document to the making of an order in respect of a merger should be taken to include the making of an order in respect of a part of a merger.
[6] The assessment of the likely price effects of a merger generally involves an assessment of the merger's likely effect of on output. Output and price may also be affected by anticompetitive effects of a merger on non-price dimensions of competition.
[7] However, a merger which simply enables a buyer to gain volume discounts that are, or would be, available to others who purchase similar quantities would not, on this ground alone, be considered to be anticompetitive. The same may be true where a merger is likely to enable buyers to offset the exercise of market power by sellers in the upstream market.

notwithstanding that the merger might have additional implications for other industrial policy objectives.

2.2 Lessening Competition

A merger can lessen competition in two different ways. The first is where it is likely to enable the merged entity to unilaterally raise price in any part of the relevant market. The second is where it is likely to bring about a price increase as a result of increased scope for interdependent behaviour in the market. To date, most of the mergers that the Director has concluded would likely have prevented or lessened competition substantially have raised concerns about the ability of the merging parties to unilaterally raise prices. Interdependent behaviour includes an explicit agreement or arrangement with respect to one or more dimensions of competition, as well as other forms of behaviour that permit firms to implicitly coordinate their conduct, e.g., through facilitating practices, the interplay of market signals, or conscious parallelism[8].

2.3 Preventing Competition

Similarly, competition can be prevented by conduct that is either unilateral or interdependent. Competition can be prevented as a result of unilateral behaviour where a merger enables a single firm to maintain higher prices than what would exist in absence of the merger, by hindering or impeding the development of increased competition. For example, the acquisition of an increasingly vigorous competitor in the market or of a potential entrant would likely impede the development of greater competition in the relevant market. Situations where a market leader pre-empts the acquisition of the acquiree by another competitor, or where a potential entrant acquires an existing business instead of establishing new facilities, can yield a similar result.

Competition can also be prevented where a merger will inhibit the development of greater rivalry in a market already characterized by interdependent behaviour. This can occur, for example, as a result of the acquisition of a future entrant or of an increasingly vigorous incumbent in a highly stable market.

---

[8] In DIR v. Imperial Oil et al, (CT-89/3, #390, January 26, 1990), the Tribunal observed that the two issues that should be "the focus of attention in any merger case (are): possible emergence of a dominant firm; (and) enhanced ability for tacit collusion". (p.54). Earlier in the same decision it observed:

- "(One of the experts for the respondent) set out what he considered to be the two possible anticompetitive effects which the Tribunal should focus upon in considering any merger: whether the merger would lead to the merged firm acquiring a dominant market position; whether the merger would enhance the ability of firms in the market (in an oligopolistic situation) to engage in various implicit forms of collusion (with respect to price, market share, etc.). No one disputed the appropriateness of (this) conceptual framework...(p.36)."

Cf. DIR v. Air Canada et al, (1989) 27 C.P.R. (3d) 476 at 498, where the Tribunal observed: "It is generally accepted that where there are only two major competitors in a market there is increased opportunity to engage in collusive behaviour".

2.4 Substantiality

In assessing whether competition is likely to be prevented or lessened substantially, the Bureau generally evaluates the likely magnitude, scope and duration of any price increase that is anticipated to arise as a result of a merger. In general, a prevention or lessening of competition will be considered to be "substantial" where the price of the relevant product is likely to be materially greater, in a substantial part of the relevant market, than it would be in the absence of the merger[9]; and where this price differential would not likely be eliminated within two years[10] by new or increased competition from foreign or domestic sources. What constitutes a "materially greater" price varies from industry to industry, and may be a differential that is less than the "significant" price increase that is postulated for the purpose of market definition.

---

[9] This price differential will be referred to as "a material price increase" for the remainder of these Guidelines. Given that relevant markets are ordinarily defined on the basis of a 5 percent test, price increases of 5 percent or greater will occur across the entire relevant market, whereas lesser price increases may occur in only a part of the relevant market.

[10] Cf., note 45.

PART 3 - Market Definition

3.1 Conceptual Framework

The first stage in the Bureau's review of a merger involves identifying the relevant market or markets in which the merging parties operate. In merger analysis, relevant markets are defined by reference to actual and potential sources of competition that constrain the exercise of market power. As a general principle, it cannot be assumed that the products of merging parties are in the same relevant market, even where there appears to be some overlapping of the products that they sell and of the geographic areas in which they operate. It may be that the "overlap" is such that the constraining influence exercised by one of the merging parties is not sufficient to warrant including the two firms in the same relevant market.

Conceptually, a relevant market for merger analysis under the Act is defined in terms of the smallest group[11] of products and smallest geographic area in relation to which sellers, if acting as a single firm (a "hypothetical monopolist") that was the only seller of those products in that area, could profitably impose and sustain a significant and nontransitory price increase above levels that would likely exist in the absence of the merger.

The assessment of whether a significant and nontransitory price increase would likely be made unprofitable involves an examination of likely responses from sources of product and geographic competition, on both the demand and supply sides of the market. On the demand side, it is necessary to evaluate the extent to which:

> (i) buyers would likely switch to substitute products; and,
>
> (ii) buyers would likely switch to the same product sold in other areas. On the supply side, it is necessary to evaluate the extent to which:
>
> (iii) new entry would likely occur through the construction of facilities[12], or as a result of sellers of other products adapting existing facilities, to commence production[13] of the product or a substitute; and,
>
> (iv) sellers of the product or of a substitute who are located in distant areas would likely divert their product into the area in question.

In most contexts, the Bureau considers a 5 percent price increase to be significant, and a one year period to be nontransitory. However, a different price increase or time period may be employed where the Director is satisfied that the application of the 5 percent or

---

[11] A market may also consist of a single homogenous product.

[12] This particular supply response is considered subsequent to market definition, in the assessment of ease of entry.

[13] The word "production" is employed for simplicity. The supply responses contemplated throughout these Guidelines are not confined to manufacturers. For example, a wholesaler that does not carry a particular product may begin to do so in response to a significant and nontransitory price increase.

one year thresholds would not reflect market realities[14]. For example, a larger price increase may be required where rigid application of the 5 percent threshold would fail to identify an obvious horizontal relationship between the merging parties. Situations where a 5 percent price increase involving products purchased by consumers would be measured in cents rather than in dollars occasionally fall within this category. Conversely, a lower postulated price increase may be appropriate where the products are particularly good substitutes for one another, relative to other substitutes.The price in relation to which the increase is postulated is the price that would likely prevail in the absence of the merger[15].

The potential constraining influence of competition from sellers who would not likely respond to the postulated price increase in the relevant market within the postulated period of time[16] is considered subsequent to market definition, in connection with the assessment of future entry into the market. For the purposes of assessing what would likely occur over a nontransitory period in response to the threshold price increase, it is assumed that buyers and sellers in the industry immediately become aware of the price increase.

Markets are typically defined in terms of the smallest group of products and geographic area in relation to which a significant and nontransitory price increase can be profitably[17] imposed, because this is generally where a merger is most likely to adversely affect competition. However, circumstances may arise in which it will be appropriate to define broader markets. For example, an exception to the smallest market principle may be made to include product or geographic substitutes on the fringe of the market that would not likely be able to constrain a significant and nontransitory price increase by the hypothetical monopolist, but that obviously compete, as a matter of commercial reality, with the products in the relevant market.

---

[14] The objective of market definition is to define the smallest market in which a substantial prevention or lessening of competition would be possible. A 5 percent threshold is generally sufficient for this purpose. In the course of reviewing particular mergers, Bureau staff may request information about likely responses to larger price increases in order to gain a better appreciation of market dynamics and of the nature of the responses that would be elicited by a 5 percent price increase. Cf. part 2.4 of these Guidelines.
[15] The "significant" price increase postulated is therefore net of inflation and other common variables.
[16] A period of less than one year is not generally considered to be appropriate for the purpose of defining markets, because even sellers of products that actually constrain the ability of the respective merging parties to raise a price above the prevailing pre-merger level may require several months to recognize and respond to an attempted price increase. A period longer than one year is not generally considered to be appropriate because sellers that would require more than this amount of time to respond to an increase in the price of a product generally do not exercise a significant constraining influence on the price of that product.
[17] This condition ensures that markets will not be defined around narrow segments consisting of products purchased by buyers who would not be willing to switch to another source of supply in the event of a significant and nontransitory price increase, but who either cannot be identified by sellers in the market or cannot be subjected to price discrimination confined to them alone. In such cases, it can be expected that sellers will not risk losing greater profits earned on sales to buyers who would likely switch, by attempting to reap additional profits from buyers who would not likely switch. For the purposes of its analysis, the Bureau assumes that there is no price regulation.

In some circumstances, sellers[18] can identify and discriminate against particular buyers within a relevant market who would not likely switch to product or geographic substitutes available elsewhere within the relevant market, in response to a significant and nontransitory price increase. Where sellers could profitably impose a significant and nontransitory price increase in relation to customized products or products sold in specific geographic areas, additional, narrower, relevant markets, consisting of these products, may be defined[19]. Examples of buyers who may be particularly susceptible to such discrimination include buyers who do not purchase in sufficiently large quantities to justify switching to a more distant source of supply; and buyers who would incur substantial retooling, repackaging or marketing costs, if forced to switch to a substitute product. For price discrimination to be successful, it cannot be possible for other buyers to arbitrage by profitably purchasing and reselling to the buyers who may be the subject of discrimination.

In general, the base price that is employed in postulating a significant and nontransitory price increase is whatever is ordinarily considered to be the price of the product at the stage of the industry (e.g., manufacturing, wholesale, retail) being examined. This is typically the cumulative value of the product, inclusive of the value added (mark-up) at the industry level in question. However, in certain industries, the value added is billed as a separate fee, and no mark-up is applied to the product in relation to which the service (or other value added) is performed. In such cases, the price increase will usually be postulated in relation to the fee. Situations where there is no standard industry billing practice, or generally recognized base price, will be considered on a case by case basis. Where a merger would likely lead to an increase in the cumulative or value added price, but not to an increase in the price at which the product is ultimately purchased by consumers, this fact will be taken into account subsequent to the market definition stage, in the exercise of the Director's discretion to challenge the merger. A similar approach is taken where an increase in the price of an intermediate product would not likely translate into an increase in the price of the downstream product.

Although the approach to delineating the product and geographic bounds of the market is addressed in two distinct discussions below, sources of product and geographic

---

[18] As is indicated in part 2.1 of these Guidelines, a merger can also raise concerns about market power on the buying side. In such a case, the term "hypothetical monopsonist" would be substituted for "hypothetical monopolist", and "significant and nontransitory price decrease" would be substituted for "significant and nontransitory price increase".

[19] For example, in one case Bureau staff concluded that glass containers competed in a broad relevant market that included various other rigid wall containers, such as aluminum and steel cans, and certain types of plastic containers. However, within this relevant market, Bureau staff found that there were several additional, narrower relevant markets, consisting of customized products such as wine bottles, pickle jars and soluble coffee jars. It was determined that purchasers of these products could be the subject of price discrimination, because they would not be prepared to switch to an alternative rigid wall packaging product in the event of a 5 percent price increase with respect to their customized glass containers. As employed here, the term "price discrimination" means a sale of the relevant product to two or more different purchasers at two or more different prices. This is broader than what is contemplated by section 50(1)(a) of the Act.

competition must be considered together, because they are interacting dimensions of one market[20].

3.2 The Product Dimension
3.2.1 General Approach

The following approach to relevant market analysis is applied separately to each of the products in relation to which the merging parties appear to compete or are likely to compete. The analysis of the product scope of specific relevant markets commences by focussing upon what would happen if one of the merging parties attempted to impose a significant and nontransitory price increase in relation to the product. If the price increase would likely cause buyers to switch their purchases to other products in sufficient quantity to render the price increase unprofitable, the product that is the next best substitute[21] will be added to the relevant market. The Bureau will then ask what would happen if the seller of this product and the merging party in question, acting as a hypothetical monopolist, attempted to impose a significant and nontransitory price increase with respect to the two products in the group. The process of adding the product that is the next best substitute for the products already included within the market continues until it would be possible for the sellers of these products, acting as a hypothetical monopolist, to profitably impose and sustain a significant price increase for a nontransitory period of time.

3.2.2 Evaluative Criteria

In assessing the nature and magnitude of likely supply and demand responses to a future price increase in the context of particular cases, all relevant information is considered. However, particular weight is given to the factors highlighted below, which provide indirect evidence of substitutability. Direct evidence, in the form of statistical measures of cross-elasticities of demand and supply, is rarely available. In some situations, the results of the analysis of each of these factors are not consistent with a single conclusion. When this occurs, an attempt is made to arrive at the market definition that is most supportable by the available information.

---

[20] To illustrate, it may be that the sellers who are being considered as the sole seller of product A in area X could not profitably impose and sustain a significant and nontransitory price increase, due to the existence of an additional seller of product A in area Y and/or due to the existence of a seller of product B in area X. In order to determine whether the market should be expanded to include product A, from area Y, and/or product B, from area X, these sources of competition must be assessed together. If the latter is the next best substitute for product A in area X, the relevant market will be expanded solely in product terms, whereas if the former is the next best substitute, the relevant market will be expanded in geographic terms only. If the market is ultimately expanded to include both products, and the presence of the next best substitute, product C in area Z, would prevent the postulated 5% price increase from being profitably imposed, then the market would have to be expanded in both geographic and product terms.

[21] The Director considers the "next best substitute" to be the product that would account for the largest percentage of the volume that would be lost by the hypothetical monopolist.

3.2.2.1 Views, Strategies, Behaviour and Identity of Buyers

The views, strategies and behaviour of buyers are often among the most important sources of information considered in the assessment of whether buyers will likely switch to another product in the event of the postulated significant and nontransitory price increase. What buyers state they are likely to do, what they have done in the past, and their strategic business plans, often provide a reliable indication of whether the postulated price increase is likely to be imposed and sustained. Where buyers have not substituted product B for product A in the past, and indicate that they would not likely do so in the event of the price increase, it may be inappropriate to conclude, on the basis of hypothetical considerations, that these products compete in the same relevant market. The same can be true where two products are sold to buyers that have distinct characteristics, e.g., where product A is sold to consumers and product B is sold to businesses.

3.2.2.2 Trade Views, Strategies and Behaviour

Helpful information regarding historical and likely future developments in the relevant market is often provided by third parties knowledgeable about the industry, such as persons who supply the sellers of the relevant product. Similarly, industry surveys often provide data that assists the analysis. Another source of useful information is the past behaviour of the merging parties, or others who sell the relevant product, in relation to other products that are alleged to provide a significant constraining influence. For example, modifications to product design or packaging that follow similar developments made to a second product may suggest that the two products are in the same relevant market.

3.2.2.3 End Use

The extent to which two products are functionally interchangeable in end use is an important source of information regarding whether substitution between them is likely to occur. Indeed, functional interchangeability is generally a necessary, but not a sufficient, condition that must be met for two products to warrant inclusion in the same relevant market. Products that are purchased for similar end uses may be in the same relevant market notwithstanding the fact that they have very different physical characteristics, e.g., matches and disposable lighters.

Two products are more likely to be found to be in separate relevant markets as the difference between their prices increases or as their individual end uses are, or are perceived to be, more unique. For example, premium products such as gold plated lighters, luxury cars and writing instruments may be found to be in separate relevant markets from discount lighters, compact cars and disposable pens, respectively, notwithstanding that the premium and discount products have similar end uses.

3.2.2.4 Physical and Technical Characteristics

Although two products with unique physical or technical characteristics may be found to be in the same relevant market on the basis of functional interchangeability, such products are often found to be in separate relevant markets. In general, the greater is the value that buyers place on the actual or perceived unique physical or technical characteristics of a product, the more likely it is that the product will be found to be in a distinct relevant market. Product warranties, post-sales service, order turn-around time, etc., are all included in the bundle of characteristics that make up a product.

3.2.2.5 Switching Costs

Notwithstanding that two products may be functionally interchangeable, it is important to assess the extent to which the transaction costs which buyers would have to incur in order to retool, repackage, adapt their marketing, breach a supply contract, learn new procedures, etc., are likely to be sufficient to render switching unlikely in response to a significant and nontransitory price increase. In addition, account is taken of the extent to which failure of the product to satisfy expectations or to perform as expected would impose significant costs on the buyer, and of whether the risk associated with incurring these costs is likely to render switching unlikely in response to a significant and nontransitory price increase. Such costs could include damage to the buyer's reputation as a reseller, or the expense of shutting down an entire production line as a result of failure of a product that is a component in this line.

It is also important to consider whether buyers place such a premium on sourcing a full line of products that sellers of only one of these products would not be able to constrain a significant and nontransitory price increase imposed by the full line supplier in relation to that product alone.

3.2.2.6 Price Relationships and Relative Price Levels

The absence of a strong correlation in price movements between two products over a significant period of time immediately prior to a merger generally suggests that the products are not in the same relevant market. Conversely, a high correlation in the price movements of products A and B is often indicative of significant competition between these products. However, the correlation may be attributable to price changes in common inputs, inflation, pricing policies of multi-product firms, or other variables that cannot be said to suggest the presence of a high degree of substitutability. Accordingly, it will generally be necessary to determine whether parallel price movements can be explained by one or more of these reasons, before this source of information will be considered to be indicative of significant competition between A and B.

Similarly, a determination will be made of the extent to which historical price responses suggests that sellers of product B are likely to constrain the postulated significant and nontransitory price increase in relation to product A. Where it can be established that the sellers of product B have this ability, a further issue that must be addressed is the

likelihood that they will employ it in the manner described in part 3.21 of these Guidelines. The persuasiveness of information with respect to price movements and levels is often reduced by the difficulty associated with ascertaining the net price at which sales are actually transacted.

3.2.2.7 Cost of Adapting or Constructing Production Processes, Distribution and Marketing

In assessing the extent to which sources of potential competition exercise a constraining influence on the pricing of products sold within the relevant market, account must be taken of sellers who do not actually produce the relevant product, but who have facilities that could be adapted to produce the relevant product. Where it can be established that such a seller would likely adapt its existing facilities to produce the relevant product in sufficient quantities to constrain a significant and nontransitory price increase in the relevant market, this source of competition will generally be included within the relevant market[22]. However, potential competition from sellers who could produce the relevant product by adapting facilities that are actually producing another product will not be assessed at the market definition stage of the assessment of the merger where:

> (i) such a seller would likely encounter significant difficulty distributing or marketing the relevant product; or,
>
> (ii) new production or distribution facilities would be required to produce and sell on a significant scale.

In these circumstances, this source of competition will instead be considered subsequent to the delineation of the relevant market, in assessment of the likelihood of future entry pursuant to section 93(d) of the Act. These and related matters are discussed in greater detail in part 4.6 below.

A similar approach is taken where a vertically integrated seller that produces a product entirely for its own internal use as an input into, or component of a downstream product, clearly exercises a constraining influence on the relevant market. The products of these sellers will generally be included within the relevant market unless:

---

[22] It is important to recognize that the product actually produced by this potential competitor is not included within the market. For example, if a gadget producer would likely divert sufficient production capacity away from the manufacture of gadgets to the manufacture of widgets to render unprofitable a significant and nontransitory price increase by a hypothetical monopolist of widgets, the widget market is not expanded to include gadgets. Rather, this source of potential competition from the gadget seller is included in the widget market. However, the difficulty associated with accurately estimating the gadget seller's future sales of widgets or allocation of capacity is such that a market share cannot reasonably be attributed to this future production. Accordingly, it must be recognized that the market shares attributed to sellers whose products are actually sold within the relevant market, (e.g., widgets, in the above example), will overstate the relative market position of these sellers in such circumstances.

(i) these sellers would likely encounter significant difficulty diverting production away from their downstream needs, or in distributing or marketing the product in the relevant market; or,

(ii) they would likely have to make a substantial investment to expand their existing production facilities to produce and sell on a significant scale.

The same approach is adopted in the assessment of other situations where a firm's production has historically been allocated entirely to specific buyers. In assessing the constraining influence of vertically integrated sellers, an evaluation will be made of whether the potential for increased downstream production by the vertically integrated seller of the product in which the relevant product is embodied exercises a significant constraining influence on actual sellers of the relevant product.

3.2.2.8 Existence of Second Hand, Reconditioned or Leased Products

Where the availability of second hand, reconditioned, refurbished, recycled or leased products would prevent the postulated significant and nontransitory price increase from being profitably imposed, this will be taken into account at the market definition stage, in the manner described in part 3.2.1.

3.3 The Geographic Dimension

3.3.1 The General Approach

The following approach to defining the geographic scope of relevant markets is applied separately to each location at which the merging parties sell the relevant product. It is not uncommon to find that a single firm competes in several distinct relevant geographic markets, e.g., parts of a city, a region, a province, Canada, North America or the world. The Bureau begins the process of defining the geographic bounds of specific relevant markets by asking what would happen if one of the merging parties attempted to impose a significant and nontransitory price increase at the location where it sells the relevant product. If this price increase would likely cause buyers to switch a sufficient quantity of their purchases to products sold at other locations to render the price increase unprofitable, the Bureau will add to the relevant market the location at which the sale of the relevant product is the next best substitute for sales at the location of the merging party in question. It will then ask what would happen if the seller at this second location and the merging party in question, acting as a hypothetical monopolist, attempted to impose a significant and nontransitory price increase at the two locations. The process of adding the location at which the sale of the relevant product is the next best substitute for sales within the tentatively defined relevant market continues until it would be possible for a seller located within the relevant market, acting as a hypothetical monopolist, to profitably impose and sustain a significant and nontransitory price increase.

3.3.2 Evaluative Criteria

3.3.2.1 Views, Strategies, Behaviour and Identity of Buyers

The discussion in part 3.2.2.1 of the importance of information relating to the views, strategies, past behaviour and identity of buyers is equally applicable to the analysis of the geographic scope of relevant markets. Moreover, it is important to assess the extent to which considerations relating to convenience influence what buyers are likely to do in the event of the postulated significant and nontransitory price increase. This is particularly so in the case of service industries, the products of which often cannot be arbitraged.

3.3.2.2 Trade Views, Strategies and Behaviour

Helpful information regarding historical and likely future developments in the relevant market is often provided by third parties who are knowledgeable about the industry, such as persons who supply the sellers of the relevant product. Similarly, industry surveys often provide data that assists the analysis. An additional source of useful information is the extent to which persons who sell the relevant product in one area respond to changes in the price, packaging, servicing, etc., of the relevant product in a second area. The extent to which distant sellers are taken into account in business plans, marketing strategies and other documentation can be a further source of important information.

3.3.2.3 Switching Costs

See section 3.2.2.5 above and section 3.3.2.4 below.

3.3.2.4 Transportation Costs

Transportation costs ordinarily play a central role in the delineation of the geographic scope of relevant markets. In general, where the price in a distant area, plus the cost that would be incurred to transport the product to the relevant geographic area, exceeds the price in the latter area plus the postulated a significant and nontransitory price increase, the products of sellers located in the distant area will not be included in the relevant market[23].

Where prices in a distant area have historically exceeded prices in the relevant geographic area by more than transportation costs, this is usually a good indication that the two areas are in separate relevant markets, for reasons that go beyond transportation costs. However, it may not be conclusive, because the postulated significant and nontransitory price increase in the relevant market may elevate prices to a level above the distant price plus transportation costs. In this case, and absent evidence suggesting other reasons why the distant supplier would not likely commence sales in the relevant market, it will generally be assumed that the supplier would likely do so.

---

[23] It is recognized that distant firms that have excess capacity may in certain circumstances be willing to ship to another market when the net price received is less than the price in their own market. Cf., note 30 below.

Where prices in a distant area have been historically lower than prices in the relevant geographic area by an amount which exceeds transportation costs, this is usually a good indication that the distant area is in a separate relevant market, for reasons that go beyond transportation costs. However, it may be that these additional reasons, together with transportation costs, would not be sufficient to prevent distant suppliers from constraining the further increase in the price differential that would be brought about by the postulated significant and nontransitory price increase. Where this would likely be the case, the relevant market would have to be expanded to account for this source of competition.

3.3.2.5 Local Set-up Costs

In assessing the extent to which sellers of the relevant product in a second area are likely to respond to the postulated significant and nontransitory price increase in the relevant geographic area, it is necessary to evaluate the extent to which they would face non-recoverable local set-up costs, e.g., warehouse requirements, a direct-store-delivery network, marketing costs, the need to hire local salespersons, and the costs associated with obtaining local regulatory approval. These and related matters are further discussed in part 4.6 below.

3.3.2.6 Particular Characteristics of the Product

In assessing whether distant suppliers are likely to divert the relevant product to the relevant geographic area in response to the postulated significant and nontransitory price increase, it is important to examine whether the particular product would not likely be transported into the relevant market because of fragility, perishability, etc.

3.3.2.7 Price Relationships and Relative Price Levels

The absence of a strong correlation in price movements of the relevant product in two distinct geographic areas over a significant period of time immediately prior to a merger generally suggests that the two regions are not in the same relevant market. Conversely, a high correlation in the price movements of the relevant product in two different areas is often indicative of significant competition between these products. However, the correlation may be attributable to price changes in common inputs, inflation, pricing policies of multi-market firms, or other variables that cannot be said to suggest the presence of a high degree of substitutability. Accordingly, parallel price movements will generally be examined to determine whether they can be explained by one or more of these reasons, before they are considered to be indicative of significant competition between sellers in the two areas.

In addition, an attempt will be made to determine the extent to which historical price responses accurately convey whether sellers in the second area are likely to constrain the future significant and nontransitory price increase in the area where the merging parties compete. The value of information on price movements and price levels is often undermined by difficulty in ascertaining the price at which sales are actually transacted.

3.3.2.8 Shipment Patterns

Significant shipments of the relevant product from a second area into the area in relation to which a significant and nontransitory price increase is being postulated generally suggest that the second area is in the relevant market. However, past trading patterns can be a poor indicator of the extent to which supply sources in the second area are likely to be able to constrain the ability of sellers in the first area to profitably increase prices. Information demonstrating significant shipments from the first area into the second, in and of itself, provides little information regarding the extent to which sellers in the first area are likely to be prevented from being able to profitably increase prices. The absence of significant shipments between two areas suggests that they are not in the same relevant market, yet cannot be relied upon as conclusively demonstrating this fact, because shipments from the second area into the first may commence in response to the postulated significant and nontransitory price increase. Sellers in the respective areas may have prevented buyers in their area from switching to the other area by keeping prices just below the level at which such switching would occur.

3.3.2.9 Foreign Competition

In general, the principles articulated above will be applied in assessing both domestic and international sources of competition. Accordingly, when a source of foreign competition would likely constrain the postulated significant and nontransitory price increase, it will be accounted for in one of two ways. Where it is clear that the entire area between the sales location of the merging party in question and the source of foreign competition being assessed belongs in the relevant market, the bounds of the market will be expanded beyond Canada to include the sales location of the foreign seller of the product being assessed. In such circumstances, market shares will be calculated in the same manner in which market shares of domestic firms are calculated[24]. Alternatively, when there are foreign sellers of the relevant product who are located between the Canadian border and the more distant source of foreign competition in question, and when these sellers would not likely prevent the postulated price increase, the market will not be expanded beyond Canada. In such circumstances, the market share attributable to the products of the distant foreign seller in question will be calculated on the basis of its actual sales in the relevant market, and it will be recognized that the market share so calculated may not fully reflect the relative competitive significance of that competitor. (This approach is also adopted when the relevant market does not warrant being expanded to include the location of a distant seller located in Canada.)

Where tariffs exist and the postulated significant and nontransitory price increase would not raise prices above the maximum level permitted by the tariff protection, the likely impact of foreign competition will generally be assessed subsequent to market definition. However, where the significant and nontransitory price increase would elevate prices above this level, foreign competition will be assessed in accordance with the general principles articulated in this part. The various matters that are addressed in the assessment of foreign competition are discussed in part 4.3 below.

---

[24] See Part 4.22 below.

PART 4 - Evaluative Criteria

4.1 Overview

Several of the section 93 factors play a major role at the market definition stage. It is important to assess each one of them once the relevant market is defined. For example, as indicated in part 3.2.2.7, identifiable sources of potential production substitution are generally not included in the relevant market where:

> (i) significant difficulty would be encountered in distributing or marketing the relevant product; or,
>
> (ii) new production or distribution facilities would be required to produce and sell on a significant scale.

These sources of competition are considered subsequent to market definition, in terms of the section 93(d) assessment of likely future entry into the relevant market.

Likewise, an assessment must be made of the likely role of sources of identifiable domestic or foreign potential competition that may have been excluded from the relevant market because it would not likely constrain a significant and nontransitory price increase by the hypothetical monopolist. The same is true with potential sources of domestic or foreign competition that cannot be identified, and that therefore cannot be included within the relevant market. The extent to which competition is likely to be provided by sources of competition that have not been included within the relevant market is pertinent not only to whether there will likely be a substantial prevention or lessening of competition, but also to how substantial the prevention or lessening of competition is likely to be. An analysis of the various factors discussed in parts 4.2 to 4.11 below may reveal that a merger is likely to raise price across the market by more than the significant level postulated for the purposes of market definition, for longer than two years.

Moreover, the extent to which sellers of particular substitutes that have been included within the relevant market would likely be able to make their product "available" in increased quantities in response to an attempted material price increase by the merged entity must be examined pursuant to section 93(c). Similarly, an evaluation must be made, pursuant to section 93(d), of the barriers to expansion that would likely be faced by firms within the market in responding to a material price increase.

Although it is important in every case to address the relevance of each of the factors highlighted in section 93 in assessing the effects that a merger is likely to have on competition, some factors may have more importance than others. Indeed, the assessment of information relating to future entry [s.93(d)], business failure and exit [s.93(b)], or effective remaining competition [s.93(e)] may, in certain circumstances, provide a sufficient basis, in and of itself, for concluding that a merger is not likely to prevent or lessen competition substantially. That is to say, this conclusion may be arrived at

notwithstanding the existence of information that is, on balance, unfavourable to the merger in terms of each of the other factors that may be relevant under section 93.

In general, the Director will conclude that a merger is not likely to prevent or lessen competition substantially where it can be established that, in response to the merger or to the exercise of increased market power resulting from the merger, sufficient entry into the relevant market would occur to ensure that a material price increase would not likely be sustainable in a substantial part of the relevant market for more than two years. Conversely, information indicating that barriers to entry are high cannot provide a sufficient basis, in and of itself, for concluding that a merger is likely to prevent or lessen competition substantially.

The Director will also generally conclude that a merger is not likely to prevent or lessen competition substantially where one of the parties to the merger is likely to fail or exit the market if the merger in question does not proceed, and there are no alternatives to which the firm would likely turn, in the event of a challenge to the merger[25], which would likely result in a materially higher level of competition in the relevant market.

Similarly, where it is clear that the level of effective competition that would remain is not likely to be reduced, this will generally justify a conclusion that enforcement action is not warranted. Conversely, although it may be concluded that information relating to this factor [s.93(e)] warrants a negative weighting, there are circumstances where such a conclusion may not lead to a finding that the merger is likely to prevent or lessen competition substantially. For example, the effects on competition that are likely to result solely from the elimination of a vigorous and effective competitor [s.93(f)] may not be of sufficient magnitude to enable the Bureau to conclude that competition is likely to be substantially prevented or lessened, i.e., that there is likely to be a material price increase in a substantial part of the relevant market for at least two years.

The importance attributed to the other assessment criteria generally varies considerably according to the facts of individual cases. In some cases, information relating to these factors may be given substantial weight. This is particularly so with foreign competition and the availability of acceptable substitutes.

4.2 Market Shares and Concentration
4.2.1 General Approach

Although information which demonstrates that market share or concentration will be high cannot provide a sufficient basis, in and of itself, to justify a conclusion that a merger is likely to prevent or lessen competition substantially, it is a necessary condition that must exist before such a finding can be made. Absent high post-merger concentration or market share, the effectiveness of remaining competition in the relevant market is

---

[25] The various alternatives that must be assessed and dismissed as being unlikely before the Bureau will conclude that the market power effects that are likely to arise subsequent to the merger cannot be attributed to the merger are discussed in part 4.4 below.

generally such as to be likely to constrain the merged entity from acquiring, increasing or maintaining market power by reason of the merger.

Accordingly, the Director generally will not challenge a merger on the basis that the merging parties will be able to unilaterally exercise greater market power than in the absence of the merger, where the post-merger market share of the merged entity would be less than 35 percent. Similarly, the Director generally will not challenge a merger on the basis that the interdependent exercise of market power by two or more firms in the relevant market will be greater than in the absence of the merger, where:

> (i) the post-merger share of the market accounted for by the four largest firms in the market would be less than 65 percent, or
>
> (ii) the post-merger market share of the merged entity would be less than 10 percent[26].

These thresholds simply serve to identify mergers that are unlikely to have anticompetitive consequences from mergers that require a more qualitative analysis, before any conclusions regarding likely competitive impact can be reached. All else being equal, as market share and concentration increase above these thresholds, the potential increases for a merger to give rise to concerns about its likely effect on competition. However, in all cases, an assessment of market shares and concentration is only the starting point of the Bureau's analysis.

In addition to the level of market shares or concentration in the relevant market, an assessment is made of the nature of market share distribution and the extent to which market shares have changed or remained the same over a significant period of time. Other things being equal, the likelihood that a single firm may be able to raise price increases as its individual market share increases, and as the disparity between its market share and the market shares of its competitors increases. Similarly, other things being equal, the likelihood that a number of firms may be able to bring about a price increase through interdependent behaviour increases as the level of concentration in a market rises and as the number of firms declines[27]. In addition, interdependent behaviour often becomes increasingly likely as the market share disparity between significant competitors decreases. By contrast, interdependent behaviour becomes increasingly difficult as the number or size of fringe firms that have the ability to increase output expands.

---

[26] Given that calculation of market shares is reasonably, but not entirely, accurate, and given that the Bureau's definition of the market may differ from that of the parties, full information should be provided to the Bureau regarding the merger and its likely effect on competition, where either the anticipated four-firm concentration level (CR4), or the market share accounted for by the merged entity, is close to the above-described thresholds.

[27] Generally speaking, as the number of significant firms in a market decreases, the difficulties and costs associated with coordinating behaviour decrease and the probability of detecting departures from implicit or explicit arrangements increases.

4.2.2 Calculating Market Shares

The entire actual output of firms that are located within the relevant market, or, in the circumstances described below, the total (used and unused) capacity of such firms, is generally included in the calculation of the total size of the market and the market shares of individual competitors. However, where such firms typically ship significant quantities of output beyond the bounds of the relevant market, and where this output would not likely be diverted to the relevant market in response to the postulated significant and nontransitory price increase, this capacity or output will not generally be included in the relevant market.

Market shares can be measured in terms of dollar sales, unit sales, production capacity or, in certain natural resource industries, reserves. Where the relevant market is composed of a single product that is undifferentiated (e.g., having no unique physical characteristics or perceived attributes), and where firms are all operating at full capacity, dollar sales, unit sales and capacity allocation should yield virtually identical market shares. In such situations, the basis of measurement will largely depend on the availability of data. However, where firms in such markets have excess capacity, the proportion of the total market capacity that is accounted for by a firm's own total capacity is considered to better reflect the firm's relative market position and competitive influence in the market. Accordingly, in these circumstances, market shares will generally be measured on the basis of total capacity. Where it is clear that some of a firm's unused capacity does not exercise a constraining influence in the relevant market (e.g., because the capacity is high-cost capacity, or because the firm is not effective in marketing its product), this capacity will not be taken into account in calculating market shares.

In general, given the difficulty associated with estimating the amount of output that is likely to be diverted to the relevant market by distant sellers located outside of the relevant market, the market shares accounted for by these sellers will be calculated on the basis of their actual dollar sales in the relevant market immediately prior to the merger, whether or not there is a significant degree of differentiation within the market[28]. It is recognized that the market shares so calculated may understate the relative market position and competitive influence of these sellers.

As the level of differentiation between the products in a relevant market increases, the calculation of market shares on the basis of dollar sales, unit sales and capacity produces increasingly dissimilar results. For example, if most of the excess capacity in the relevant market is held by discount sellers in a highly differentiated market, the market shares of these sellers would be greater if shares were calculated on the basis of total capacity than they would be if calculated on the basis of actual unit or dollar sales. If, in response to a material price increase elsewhere in the relevant market, the discount sellers would not likely be able to increase sales to the extent that all of their excess capacity was employed, market shares based on total capacity would be a misleading indicator of the

[28] Cf., part 3.3.2.9 and note 22 above. This approach contrasts with that taken with regard to firms located within the relevant market, the shares of which may be calculated on the basis of total (used and unused) capacity, in the circumstances described below.

relative market position of these sellers. In such circumstances dollar sales will generally be considered to provide the best indication of the size of the total market and of the relative positions of individual firms. However, unit sales are also considered to provide important information. Accordingly, both dollar sales and unit sales data are generally requested from the merging firms and third parties.

4.3 Foreign Competition

Section 93(a) highlights the importance of assessing the constraining influence of foreign competition in merger analysis, by drawing attention to: "the extent to which foreign products or foreign competitors provide or are likely to provide effective competition to the businesses of the parties to the merger or proposed merger". This complements the section 1.1 statement of underlying purpose for the Act, which provides that the objective of the Act is to maintain and encourage competition in Canada in order to "... expand opportunities for Canadian participation in world markets while at the same time recognizing the role of foreign competition in Canada".

The assessment of foreign competition is particularly important in the context of the globalization of markets, the continuing growth in foreign direct investment and strategic alliances in Canada, the Canada-U.S. Trade Agreement (CUSTA), the rationalization of European industry that is being facilitated by the integration of the European Community member states, and increasingly vigorous competition from firms based in newly industrialized countries.

The constraining influence of foreign firms on competition in Canada can range from non-existent to sufficient to ensure that the merger of the last two domestic firms in a market would not likely prevent or lessen competition substantially. The majority of cases fall between these two extremes. As indicated in part 3.3.2.9, the same principles are applied in assessing the likely constraining influence of both domestic and foreign sources of competition on a merged entity.

However, in evaluating the extent to which foreign products or foreign competitors are likely to provide effective competition to the businesses of the parties to a merger, there are a variety of considerations unique to the assessment of foreign competition[29]. One of the more important factors in this regard is tariffs. In some markets, foreign competition is completely absent due to a tariff, and would remain absent for this reason even if a merger resulted in a material price increase. In these situations, where competition among domestic firms has kept prices significantly below the level at which imports would be competitive and would likely continue to do so after the merger, foreign competition cannot be relied upon to ensure that competition will not be prevented or lessened substantially. By contrast, where domestic firms are pricing just below the tariff ceiling prior to a merger, it is usually the case that further price increases would likely be

[29] Given that domestic and foreign competition is assessed in the same manner, the matters discussed in part 3 are equally applicable when assessing the likely constraining influence of foreign sources of competition. Some of the considerations highlighted in this section may also hinder or facilitate the ability of firms in one area of Canada to constrain the market power of firms in another area of Canada.

prevented by foreign competition[30]. Between these two extremes, the constraining influence of foreign competition ordinarily varies directly with the level of the tariff.

For example, in some markets for differentiated products, the tariff is low enough to permit foreign products to occupy a particular niche. In these situations, the extent to which a merger between two competitors in other segments of the relevant market would be likely to lead to a material price increase would depend upon:

(i) the extent to which buyers would likely switch to the foreign product(s) in response to such a price increase; and,

(ii) the extent to which the foreign suppliers of these products would likely expand their production of the niche product to meet the increased demand.

In evaluating the feasibility and likelihood of success of potential responses of foreign firms, such as commencing the production and sale of products outside of this niche, the various matters discussed in part 4.6 are relevant.

In assessing the effects of tariffs, it is important to evaluate the extent to which reductions pursuant to the CUSTA and the General Agreement on Tariffs and Trade (GATT) are likely to result in increasing the actual constraining influence of foreign competition. The impact of the CUSTA and the GATT varies from one market to another. In some industries, annual tariff reductions will result in a gradual increase in the role of foreign competition. In others, foreign competition will not become significant until the final stages of a ten year reduction in the tariff. Alternatively, the effectiveness of foreign competition may be likely to increase substantially, subsequent to a particular annual or one time reduction. The scheduling of reductions in tariffs (and other non-tariff trade barriers) can therefore be very important to merger review.

Where import quotas and "voluntary" restraint agreements exist, they place a ceiling on the extent to which foreign products that are subject to these quotas can provide effective competition in domestic markets[31]. In situations where the limit permitted by such restraints is already met prior to the merger, these sources of competition cannot be relied upon to ensure that a merger will not result in a substantial prevention or lessening of competition.

---

[30] In these circumstances, the merger would not likely lead to a substantial lessening of competition. However, if one of the parties to the merger is a foreign firm that would likely have stimulated a future price reduction in the market in the absence of the merger, an assessment would be made of whether competition would likely be substantially prevented. This could occur, for example, where the foreign firm has new excess capacity and its marginal cost of increased production is such that it would likely make profitable sales in the relevant market at a price that is less than the sum of the price in its home market, transportation costs and the fixed tariff.

[31] Where products that are subject to such restraints are included within the relevant market, the market shares of these products will not exceed the percentage of the market that they would represent if the maximum amount permitted by the restraint was shipped into the market. In some cases, it may be appropriate to assign a single market share to a group of products sold by several firms from a specific country, e.g., where they function as an export consortia, or where the government of a country that is subject to a quota allocates production among these firms.

In addition to the foregoing, it is important to assess the extent to which the effectiveness of foreign competition is likely to be hindered or impeded by the following:

- regulations that impose product quality or labelling standards and specifications, or that impose licence/permit requirements;
- the difficulties or time delays in obtaining service and spare parts;
- uncertainties regarding shipping delays;
- the threat of an antidumping complaint being initiated by domestic firms;
- government procurement policies;
- intellectual property laws;
- domestic ownership restrictions;
- initiatives to "buy local";
- exchange rate fluctuations;
- technological trends;
- formal and informal global market allocation arrangements within multi-national enterprises that have Canadian affiliates or between independent multinational firms;
- international product standardization within such enterprises;
- the terms of license, franchise and non-competition contracts between foreign firms and their Canadian subsidiaries (which may extend to third parties that have purchased the shares or assets of such subsidiaries);
- the extent to which developments relating to any of the above matters[32] are likely to reduce the likelihood that long term contracts with foreign firms will be renewed;
- conditions in the home markets of foreign competitors; and,
- whether the industry has a particular susceptibility to supply interruptions from abroad.

An assessment is also made of the role that the following considerations are likely to play in creating disincentives to international transactions: unfamiliarity with Canadian market[33]; difficulties presented by exchange rate fluctuations[34] and customs and other requirements associated with processing imports; and a general reluctance of domestic intermediate buyers to purchase from a foreign country.

---

[32] e.g., changes in technology, input availability or exchange rates.

[33] Foreign firms often indicate that they are simply not interested in investing the time and resources that would be required to learn about and enter a Canadian market. Such statements are considered in the context of any interest that these firms may have in the outcome of the Bureau's review.

[34] This point is distinct from the one made in the previous paragraph, which addressed the direct effects that exchange rates have on foreign competition when the Canadian dollar depreciates relative to the currency of the country in which company in question is located. In addition to these effects, indirect disincentives to international transactions can arise. For example, foreign suppliers or domestic purchasers may consider the difficulties and uncertainties associated with such movements to provide a separate disincentive to cross-border transactions. In evaluating the effect of exchange rate movements, account will be taken of the extent to which domestic purchasers are likely to facilitate foreign competition by buying forward in currency markets.

It is equally important to assess factors that may be likely to facilitate the entry of foreign products into Canada, such as: the existence of cross-border distribution systems that can accommodate additional volume; a high level of information possessed by domestic buyers about foreign products and how to source them; the fact that foreign suppliers or their products have already been placed on approved sourcing lists; the existence of a significant level of excess capacity held by foreign firms; a high degree of similarity between the needs of domestic buyers and the needs of customers of foreign firms; exchange rate trends; and the existence of technology licensing agreements, strategic alliances and other affiliations between domestic buyers and foreign firms.

4.4 Business Failure and Exit

4.4.1 Underlying rationale

Section 93(b) draws attention to the importance of assessing "whether the business, or a part of the business, of a party to the merger or proposed merger has failed or is likely to fail". The opening clause of section 93 makes it clear that this information is to be considered "in determining, for the purpose of section 92, whether or not a merger or proposed merger prevents or lessens, or is likely to prevent or lessen, competition substantially". The impact that a firm's exit can have in terms of matters other than competition are generally beyond the scope of the assessment contemplated by section 93(b).

It is important to assess the financial health of the parties to a merger from a competition perspective, for three principal reasons. First, the loss of the actual or future competitive influence of a failing firm cannot be attributed to the acquisition[35] of such a firm where the firm would have exited the relevant market in any event . Second, the extent to which the acquisition of a failing firm can increase the market power of the acquiror is often reduced as the failure of the former becomes increasingly likely, and as its relative market position weakens. Third, the likelihood that any market power effects that will materialize subsequent to the merger can be avoided through one of the alternatives discussed below is typically reduced as the failure of the firm in question becomes increasingly likely.

However, probable failure of a party to a merger is not sufficient to warrant a conclusion that the merger is not likely to prevent or lessen competition substantially. An assessment must be made of whether acquisition of the failing firm by a third party, retrenchment by the failing firm, or liquidation would likely result in a materially higher level of competition in the relevant market than if the merger proceeded. Conversely, the absence of such an alternative to the merger is sufficient to warrant a conclusion that a merger is not likely to prevent or lessen competition substantially. For this reason, careful consideration of these alternatives is required in every case where submissions are made in terms of section 93(b). The approach to the assessment of these matters is discussed below.

---

[35] Although most failing firm situations involve the acquisition of a failing firm by a healthy firm, the underlying rationale of section 93(b) is equally applicable where the failing firm is the acquiror.

The underlying rationale of section 93(b) is equally applicable to situations where a firm wishes to exit a market for reasons other than failure, such as unsatisfactory profits, or a desire by a diversified firm to focus its efforts elsewhere. In short, the anticompetitive effects that may arise in a market subsequent to the acquisition of a failing firm cannot be attributed to the merger, where there are no likely alternatives that would result in maintaining a materially higher level of competition in the relevant market than if the merger proceeded. Accordingly, likely failure is not a necessary condition that must exist in order for the approach described in parts 4.4.3 to 4.4.5 to provide a justification for concluding that a merger is not likely to prevent or lessen competition substantially. However, as failure becomes less likely, it generally becomes more difficult to establish that if the merger did not proceed:

(i) a sale to a third party would not occur;

(ii) the firm proposing to exit would not likely remain in the market in its actual state or in a retrenched form; and,

(iii) that liquidation would likely occur.

4.4.2 Assessing Failure

A firm is considered to be failing where:

(i) it is insolvent or is likely to become insolvent;

(ii) it has initiated or is likely to initiate voluntary bankruptcy proceedings; or,

(iii) it has been, or is likely to be, petitioned into bankruptcy or receivership.

Technical insolvency is considered to occur when liabilities exceed the realizable value of assets, or where a firm is unable to pay its liabilities as they come due.

In assessing the extent to which a firm is likely to fail, the Bureau typically seeks the following information:

- the most recent, audited, financial statements, including notes thereto, and qualifications in the auditor's report;
- projected cash flows;
- whether any of the firm's loans have been called, or further loans/line of credit advances at viable rates have been denied and are unobtainable elsewhere;
- whether suppliers have curtailed or completely eliminated trade credit;

- whether there have been persistent operating losses[36] or a serious decline in net worth or in the firm's assets;
- whether such losses have been accompanied by an erosion of the firm's relative position in the market;
- the extent to which the firm engages in "off balance-sheet" financing - e.g., leasing;
- whether the value of publicly traded debt of the firm has significantly dropped;
- whether the firm is unlikely to be able to successfully reorganize pursuant to Canadian or foreign bankruptcy legislation, the Company Creditors Arrangement Act, or through a voluntary arrangement with its creditors.

These considerations are equally applicable to failure-related claims concerning a division or a wholly owned subsidiary of a larger enterprise. However, in assessing submissions relating to the failure of a subsidiary or a division, particular attention will be paid to: transfer pricing within the larger enterprise, intra-corporate cost allocations, management fees, royalty fees, and other matters that may be particularly relevant in this context. These allocations will generally be assessed in relation to the values of equivalent arm's length transactions.

Objective verification of matters addressed in financial statements will ordinarily be considered to be provided by financial statements that have been audited or prepared by a person who is independent of the firm that is alleging failure. The Bureau's assessment of financial information will include a review of historic, current and projected income statements and balance sheets. The reasonableness of the assumptions underlying financial projections will also be reviewed in light of historic results, current business conditions and the performance of other businesses in the industry.

The Bureau generally requires up to six week so assess the extent to which a firm is likely to fail if the merger in question does not proceed[37]. The time required to make this assessment will vary from case to case. Parties intending to invoke the failing firm rationale are therefore encouraged to make their submissions in this regard as early as possible.

4.4.3 No competitively preferable purchaser

The assessment of section 93(b) cases focuses primarily upon whether there exists a third party whose purchase of the exiting firm would likely result in a materially higher level

---

[36] Persistent operating losses may not be indicative of failure, particularly in a "start-up" situation, where such losses may be normal, and indeed anticipated.

[37] Where submissions relating to failure are made at the outset of the Bureau's review, they will be evaluated concurrently with the analysis of matters that do not relate to business failure. However, where parties do not raise the issue of failure until the end of the Bureau's merger review, an additional period of up to six weeks generally will be required.

of competition in a substantial part of the market[38], and who would be willing to pay a price which, net of the costs associated with making the sale[39], would be greater than the proceeds that would flow from liquidation, less the costs associated with such liquidation. For the remainder of these Guidelines, this will be referred to as the "net price above liquidation value". Where it is determined that such a third party (a "competitively preferable purchaser") exists, it can generally be expected that if the merger under review could not be completed, the acquiree would either seek to merge with that competitively preferable purchaser, or remain in the market.

Where a competitively preferable purchaser exists, the likely effects that can be attributed to the first proposed merger include:

(i) the loss of the competitively preferable purchaser's less anticompetitive, or even procompetitive, merger; and,

(ii) the acquisition or preservation of a greater degree of market power by the acquiror than would otherwise be the case.

It is recognized that when a merger is likely to result in a substantial prevention or lessening of competition, the acquiring party may be able to offer a premium over what competitively preferable purchasers have offered or are likely to offer. The Bureau's analysis focuses solely upon whether a competitively preferable purchaser has offered a net price above liquidation value, or is likely to do so if the proposed merger does not proceed.

Searches for alternative buyers will ordinarily be required to be conducted by an independent third party, e.g., an investment dealer, trustee or broker who has no material interest in either of the merging parties or the proposal in question. In general, this third party should be:

(i) provided with all such information as is generally required by a purchaser of a business;

(ii) given permission to release this information to prospective buyers;

(iii) given access to the premises of the exiting firm if desired;

(iv) given authority to determine whether access to these premises by prospective purchasers is necessary;

---

[38] An important factor in the assessment of whether competition is likely to be substantially prevented or lessened, relative to what is likely to occur if the exiting firm merges with an alternative party, is whether the latter is capable of exercising a meaningful influence in the market. Where an alternative buyer does not intend to keep the exiting firm's assets in the relevant market, an assessment will be made of the extent to which the market power of the original proposed acquiror is likely to be less than if the merger proceeds.

[39] These costs include matters such as ongoing environmental liabilities, tax liabilities, commissions relating to the sale and severance and other labour related costs.

(v) given permission to advertise the search and to circulate a written request for offers, unless a more discrete search is warranted in the circumstances;

(vi) given permission to state that all offers will be considered and to otherwise make it clear that bids do not have to be greater than or equal to the price offered by the person proposing to make the acquisition being reviewed by the Bureau; and,

(vii) provided with as much time as is reasonably necessary, up to maximum of 60 days[40] to conduct the search.

The involvement of an independent third party may not be required where the Director is satisfied that a thorough search has already been undertaken, or where the involvement of such a third party would likely cause significant harm to the exiting firm. In such circumstances, the exiting firm may satisfy the Director in other ways that a thorough search for a competitively preferable purchaser can be made.

Firms that anticipate that they may be required to undertake a search for a competitively preferable purchaser are encouraged to perform the search prior to contacting the Bureau, or at any time during the Bureau's review. It is not necessary to wait until the Bureau has completed its analysis of the likely effects of the merger on competition[41].

Where the Director has concluded that competition is likely to be prevented or lessened substantially by the merger under review, and where one or more conditions attached to an offer made by a competitively preferable purchaser have not been fulfilled within the maximum 60 day period described above, a request may be made to extend this period. In the absence of such an extension, it may be concluded that the existence of a conditional offer is a sufficient basis to warrant a finding that the merger is likely to prevent or lessen competition substantially. Before making a decision to challenge a merger on the basis that a competitively preferable purchaser exists, the Director will assess the prospective alternative buyer's ability to raise the required financing, its managerial expertise, and the extent to which it will likely be an effective competitor.

4.4.4 Retrenchment

As indicated in part 4.4.1, anticompetitive effects, that are likely to arise in the relevant market if the merger proceeds, cannot be attributed to the merger if there are no alternatives to the merger. It is, therefore, relevant to assess whether the firm proposing to exit the relevant market would likely remain in that market, in its actual state or in a

---

[40] Although a period not exceeding 60 days will ordinarily be sufficient to determine whether any competitively preferable purchaser exists, a period that is longer than 60 days may be required where circumstances warrant. The search period generally does not begin until the independent third party has been provided with all of the information that it considers necessary to properly conduct the search. The time required to undertake a thorough search varies from industry to industry and can in some circumstances be completed within a period that is substantially less than 60 days.

[41] As soon as the absence of such alternatives (including the matters discussed below in sections 4.44 and 4.45) is established, the assessment of the likely effects of the merger on competition becomes moot.

retrenched form[42], if the proposed merger does not proceed. Where it appears that the firm would likely remain in the market rather than sell to a competitively preferable purchaser or liquidate, it is necessary to determine whether this alternative to the proposed merger would likely result in a materially greater level of competition than if the proposed merger proceeded. Unless such a difference in the level of competition in the market is likely, the assessment of this aspect of the review of alternatives to the merger will weigh in favor of a conclusion by the Director to not challenge the merger.

4.4.5 Liquidation

Where the Bureau is able to confirm that there are no competitively preferable purchasers for the exiting firm and that there are no feasible and likely retrenchment scenarios, it assesses whether liquidation of the firm would likely result in a materially higher level of competition in a substantial part of the market than if the merger in question proceeded. In some cases, liquidation can facilitate entry[43] into, or expansion in, a market by enabling actual or potential competitors to compete for the exiting firm's customers or assets to a greater degree than if the exiting firm merged with the proposed acquiror.

4.5 The Availability of Acceptable Substitutes

The provisions of section 93(c) recognize that, in addition to identifying which products compete with the products of the merging parties, it is necessary to assess the extent to which the supply of these products would likely increase in response to an attempted exercise of market power. Specifically, section 93(c) draws attention to the relevance of considering: " the extent to which acceptable substitutes for products supplied by the parties to the merger or proposed merger are or are likely to be available". A product is generally not considered to be an acceptable substitute for another product unless it is in the same relevant market as the second product. Similarly, a particular geographic source of supply of the relevant product is generally not considered to be an acceptable substitute for a local source of supply of the relevant product unless it is in the same relevant market as the local source of supply. Conversely, all product and geographic substitutes that are included in a single relevant market are typically considered to be "acceptable" within the meaning of section 93(c).The approach to the determination of whether product and geographic substitutes warrant inclusion in the relevant market is described in part 3 of these Guidelines.

---

[42] The distinction between the Bureau's examination of likely failure and its assessment of whether retrenchment is likely is the following: Where failure is the issue, the Bureau assesses the extent to which steps could be taken to enable the firm to continue to operate at its current level of operations (i.e., to continue to sell all of the products it actually sells in all of the markets where it is actually present, to approximately the same extent as is actually the case). Where retrenchment is the issue, an assessment is made of the extent to which steps could be taken to enable the firm to survive as a meaningful competitor within a relevant market by narrowing the scope of its operations (i.e., by withdrawing from the sale of certain products or from certain geographic areas, or by downsizing its activities in these areas).

[43] Where a firm with excess capacity seeks to acquire an exiting firm, this may be indicative of an attempt to prevent the assets of the latter from being acquired by a third party.

Once the relevant market has been delineated, it is important to consider the extent to which sellers of the "acceptable" substitutes that have been included in the market would likely make these substitutes individually and collectively available in increased quantities in response to a material price increase imposed by the merged entity, alone or interdependently with others.

Where the overall availability of acceptable substitutes is such that the merging parties would likely be able to impose a material price increase in a substantial part of the relevant market, this generally suggests that the merger will likely lessen competition substantially, unless such anticompetitive effects would likely be eliminated within two years by new entry or expansion by foreign or domestic sources of competition. In assessing the extent to which sellers of acceptable substitutes are likely to increase the supply of their products in the relevant market in response to a material price increase, the assessment will not be limited to an evaluation of whether such sellers collectively have, or could easily add, sufficient additional capacity to ensure that the price increase cannot be maintained in a substantial part of the relevant market . An assessment will also be made of whether it is likely that the total supply of acceptable substitutes in the market will in fact increase sufficiently to ensure that a material price increase cannot be sustained for two years.

Furthermore, an assessment will be made of whether buyers are likely to switch a sufficient quantity of their purchases to acceptable substitutes to ensure that a material price increase cannot be profitably maintained in the relevant market post-merger. In this regard, an evaluation will be made of the extent to which the products of the merging parties are significantly better substitutes for one another than are other substitutes in the relevant market.

4.6 Barriers to Entry

4.6.1 General Approach

The assessment of potential competition is a central and fundamental aspect of merger review under the Act. This is implicitly recognized in several of the section 93 factors, and most prominently in section 93(d), which draws attention to the relevance of considering:

> "any barriers to entry into a market, including:
>
> (i) tariff and non-tariff barriers to international trade,
>
> (ii) interprovincial barriers to trade, and
>
> (iii) regulatory control over entry and any effect of the merger or proposed merger on such barriers".

The section 93(d) stage of the Bureau's assessment is directed toward determining whether entry by potential competitors would likely occur on a sufficient scale in

response to a material price increase or other change in the relevant market brought about by the merger, to ensure that such a price increase could not be sustained for more than two years.

In this assessment, consideration is given to any matter or combination of matters that would make entry on this scale within two years less likely or more difficult. This generally involves an examination of whether entry is likely to be delayed or hindered by the presence of absolute cost differences or the need to make investments that are not likely to be recovered if entry is unsuccessful. These investments are referred to in the remainder of these Guidelines as sunk costs.

Some entry impediments are generally found to exist in relation to most markets. Therefore, the analysis of entry conditions does not focus upon whether barriers to entry exist, but upon the following key issues:

> (i) what must be done and what commitments must be made by potential competitors in order to enter on a scale that would be sufficient to eliminate a material price increase in the relevant market;
>
> (ii) what factors are likely to delay entry, and are they collectively likely to prevent the scale of entry described above from occurring within two years; and,
>
> (iii) are potential competitors likely to enter, given the commitments that must be made, the time required to become an effective competitor, the risks involved and the likely rewards.

Unless such entry is likely to occur, it will not generally be considered to provide a sufficient replacement for the loss of actual competition that would result from the merger.

In general, four principal categories of entry are assessed:

> (i) entry from identified potential sources of production substitution that were not included within the relevant market, for the reasons articulated in section 3.2.2.7;
>
> (ii) entry from other identified sources of competition that were excluded from the relevant market on the basis of the "significant" or the "nontransitory" aspects of the test articulated in section 3.1;
>
> (iii) entry from sources that cannot be identified (and therefore cannot be assessed at the relevant market stage) - e.g., entry from unknown potential competitors; and,
>
> (iv) expansion by firms within the market.

In assessing the extent to which future entry would likely occur, the Bureau's analysis generally commences with an assessment of firms that appear to have an entry advantage, i.e., fringe firms already in the market[44], firms that sell the relevant product in adjacent geographic markets, firms that produce products with machinery or technology that is similar to that employed to produce the relevant product, firms that sell in related upstream or downstream markets, and firms that sell through similar distribution channels or that employ similar marketing and promotion methods. These are typically the most important sources of potential competition. Other potential sources of entry are then assessed.

Helpful information regarding commitments that must be made and the time required to become an effective competitor is often provided by firms that have recently entered or exited the market. However, the fact that entry has or has not occurred in the past does not in and of itself indicate that additional new entry would likely take place in response to a material price increase or other change in the market brought about by a merger. Additional useful information is provided by the stage of growth of the relevant market. Generally speaking, new entry is more likely to occur when a market is in its growth stage, where increasing demand accommodates entry, than when a market is stagnating or declining.

As indicated in part 4.1, the Director will generally conclude that a merger is not likely to prevent or lessen competition substantially where it can be established that in response to the merger or to the exercise of increased market power resulting from the merger, sufficient entry into the relevant market would occur to ensure that a material price increase would not likely be sustainable in a substantial part of the relevant market for more than two years.

4.6.2 Time

An important aspect of the assessment of entry conditions involves determining the time that it would take for a potential competitor to respond to a material price increase or other change in the market brought about by a merger, and to become an effective competitor in the relevant market. In general, the longer the period of time that would be required for potential competitors to become effective competitors: the less likely it is that incumbent firms will be deterred by the threat of future entry from exercising market power in the first place; and, the longer any market power that is exercised can be maintained.

---

[44] Expansion by firms already within the market is an important form of "entry". The same factors that constrain new entrants also often constrain significant expansion by fringe producers. The entry advantage that may be enjoyed by these firms and the others mentioned above generally stems from reduced investment and risk, or from the fact that a shorter period of time is likely to be required to learn how to successfully produce and market the product.

In the assessment of whether entry will likely occur within two years[45] on a scale sufficient to ensure that a material price increase cannot be sustained beyond this period, account will be taken of whether the delay and losses that potential entrants can expect to encounter before this scale of sales is attained will likely increase the sunk costs, risk or uncertainty perceived to be associated with such entry, and thereby reduce the likelihood that this entry will occur.

4.6.3 Cost Advantages

Incumbent firms can gain important cost advantages relative to potential entrants through a variety of sources. Sections 93(d)(i), (ii) and (iii) highlight three sources of cost advantage that can present potential entrants with considerable, and in some cases insurmountable, barriers to entry. The extent to which tariff and non-tariff barriers to international trade can facilitate the exercise of market power in domestic markets is discussed in part 4.3.

Interprovincial barriers to trade and regulatory control over entry can take many forms, including:

- local content rules; laws that impose local ownership requirements; regulations that restrict the right to supply to certain persons or classes of persons[46]; local product standards;
- environmental or other laws that impose costs on new entrants that do not have to be borne by incumbents due to "grandfather" provisions in the laws; and,
- licensing and other restrictions on transportation, packaging, advertising and other forms of promotion.

Other potential sources of cost advantages include transportation costs and control over access to scarce or non-duplicable resources, e.g., technology, natural resources and distribution channels. 4.6.4 Sunk Costs

---

[45] A two year period is employed in assessing entry in recognition of the fact that potential competitors need more time than firms within the relevant market (who are typically identified on the basis of a one year response time) to learn about new opportunities therein, to assess these opportunities, to develop products and marketing plans, to build facilities, to qualify as acceptable sources of supply for buyers who only purchase from sellers who have been "qualified", and to achieve a level of sales sufficient to prevent or eliminate a material price increase. Given that section 97 of the Act imposes a three year limitation period in respect of challenges to completed mergers, it is not generally considered to be appropriate to employ a period of longer than two years in this context. Although immediate awareness of a "significant" price increase is assumed for the purpose of market definition, it is not assumed in the assessment of entry.

[46] A two year period is employed in assessing entry in recognition of the fact that potential competitors need more time than firms within the relevant market (who are typically identified on the basis of a one year response time) to learn about new opportunities therein, to assess these opportunities, to develop products and marketing plans, to build facilities, to qualify as acceptable sources of supply for buyers who only purchase from sellers who have been "qualified", and to achieve a level of sales sufficient to prevent or eliminate a material price increase. Given that section 97 of the Act imposes a three year limitation period in respect of challenges to completed mergers, it is not generally considered to be appropriate to employ a period of longer than two years in this context. Although immediate awareness of a "significant" price increase is assumed for the purpose of market definition, it is not assumed in the assessment of entry.

In addition to the various start-up sunk costs that new entrants are often required to incur, such as acquiring market information, making the entry decision, developing and testing product designs, installing equipment, engaging new personnel and setting up distribution systems, potential entrants may face significant sunk costs as a result of a need to:

(i) make investments in market specific assets and in learning how to optimize the use of these assets;

(ii) overcome product differentiation-related advantages enjoyed by incumbent firms; and/or

(iii) overcome disadvantages presented by the strategic behaviour of incumbent firms.

Each of these potential sources of sunk costs can create significant impediments to entry by presenting potential entrants with a situation where they must factor greater costs into their decision making than incumbent firms that have already made their sunk cost commitment, and can, therefore, ignore such costs in their pricing decisions. This asymmetry typically presents potential entrants with a recognition that they face greater risks and a lower expected return[47] than what is faced by incumbent firms. In general, risk and uncertainty increase, and the likelihood of significant future entry decreases, as the proportion of total entry costs accounted for by sunk costs increases. The focus of the Bureau's assessment of sunk costs is upon whether the likely rewards of entry, the likely time required to become an effective competitor and the risk that entry will not ultimately be successful, taken together, justify making the sunk investments that would be required to undertake the entry initiative. The manner in which the three enumerated potential sources of sunk costs can impede the ability of potential entrants to become significant competitors is discussed in greater detail below in Appendix 1.

4.6.5 Effects of Mergers on Barriers

Section 93(d) draws attention to the importance of assessing the extent to which mergers are likely to affect barriers to entry into a market. In evaluating whether entry is likely to be more difficult as a result of a merger, the Bureau focuses primarily upon determining whether the sunk costs that a future entrant would have to commit increase, due to the fact that:

(i) the merger effectively results in requiring any prospective entrant into the relevant market to enter at a second stage as well, as a result of the elimination of one of the few remaining important sources of supply or important distribution outlets (cf. part 4.11.1);

[47] The expected return is simply the anticipated profits from successful entry multiplied by the probability of achieving those profits, plus the anticipated loss multiplied by the probability of the loss.

(ii) the merger removes an important entry opportunity for a potential entrant, who would otherwise have been more likely to enter by acquiring the acquired firm or some of the acquired firm's assets;

(iii) the merger results in potential entrants having to enter the relevant market on a greater scale; and/or,

(iv) the merger increases the risks associated with entry, in either absolute or relative terms.

In addition, the Bureau assesses whether entry is likely to require more time as a result of the foregoing or any other effects of a merger.

4.7 Effective Remaining Competition

Section 93(e) draws attention to "the extent to which effective competition remains or would remain in a market that is or would be affected by the merger or proposed merger". Effective remaining competition is a broad concept that refers to the collective influence of all sources of competition in a market. Some of these sources have already been addressed in parts 4.3, 4.5 and 4.6 above, which highlight the Director's approach to the assessment of the extent to which competition is likely to be provided by foreign competition, acceptable substitutes and new entry. The nature of innovation and change in a market, which is discussed below in part 4.9, can also significantly impact upon the effectiveness of remaining competition.

In addition to these matters, it is important to consider the extent to which the general effectiveness of remaining competition is enhanced by the competitive initiative of individual competitors in the market, and by the collective constraining influence of these sources of competition on the ability of particular firms to exercise market power unilaterally or interdependently. In this regard, an assessment is made of the likely nature and extent of forms of rivalry such as discounting and other aggressive pricing strategies, innovative distribution and marketing methods, product and packaging innovation, and aggressive service offerings. These and other forms of competition give rise to a competitive environment that contrasts sharply with markets where competitors accept stability or are content to follow attempts at price leadership or other initiatives of existing or aspiring market leaders. In addition, an assessment is made of the extent to which competitors are likely to remain as vigorous and effective as prior to the merger.

As indicated in part 4.1, where it is clear that the level of effective competition that would likely remain in the relevant market is not likely to be reduced as a result of the merger, this alone will generally justify a conclusion not to challenge the merger. This is so whether the absolute level of effective competition in the market in question appears to be high or low.

4.8 Removal of a Vigorous and Effective Competitor

By orienting the analysis toward an assessment of the competitive attributes of the acquired firm, section 93(f) draws more direct attention to what is likely to be lost as a result of the merger than any other provision of section 93. This clause contemplates an examination of the extent to which there is "any likelihood that the merger or proposed merger will or would result in the removal of a vigorous and effective competitor".

A firm that is a vigorous and effective competitor often plays an important role in pushing, or pressuring other firms to extend the limits of competition in a market toward new frontiers. Alternatively, a firm may be characterized as vigorous and effective because it makes an important contribution toward maintaining a higher level of competition than that which would exist in its absence. When such a firm is eliminated through a merger, competition is prevented or lessened to some degree.

There can be a wide variety of indications that a competitor may be vigorous and effective. These include information which indicates that the firm in question:

- is innovative in terms of product offerings, distribution, marketing, packaging, etc.;
- engages in discounting or other aggressive pricing strategies;
- has a history of not following price leadership and other market stabilizing initiatives by competitors;
- is a disruptive force in a market that appears to be otherwise susceptible to interdependent behaviour;
- provides unique service/warranty benefits to the market, or helps to ensure that similar benefits offered by other competitors are not reduced; has recently expanded capacity, or has plans to do so;
- has recently made impressive gains in market share, or is positioned to do so; or,
- has recently acquired patents, or will soon do so.

A firm does not have to be among the larger competitors in a market in order to be a vigorous and effective competitor. Small firms can exercise an influence on competition that is disproportionate to their size.

In the Director's view, the removal of a vigorous and effective competitor through a merger is not generally sufficient, in and of itself, to warrant enforcement action under the Act. It must also be established that as a result of the removal of a vigorous and effective competitor, prices will be materially higher than in absence of the merger; i.e., there must also be findings unfavorable to the merger in terms of other factors, in particular, effective remaining competition and future entry.

4.9 Change and Innovation

Section 93(g) highlights the importance of taking into account "the nature and extent of change and innovation in a relevant market" in assessing the likely effects of a merger on

competition. An assessment of the extent of likely change and innovation plays a fundamental role in the analysis of several of the matters that have already been discussed, e.g., market definition, foreign competition, the availability of substitutes, future entry and effective remaining competition. In the context of section 93(g), a further evaluation is made of the general nature and extent of change and innovation to determine whether there are broader considerations that should be taken into account in deciding whether enforcement action is warranted.

In addition to technological change and innovation in products and processes, an assessment is made of the general impact on competition of the nature and extent of other forms of change and innovation, e.g., in relation to distribution, service, sales, marketing, packaging, buyer tastes, purchase patterns, firm structure, the regulatory environment and the economy as a whole. The pressures imposed on remaining competitors in a market by the nature and extent of dynamic developments in any of these areas may be such as to ensure that a material price increase is unlikely to occur or will not be sustainable. This may be especially the case where a merger stimulates or accelerates the change or innovation in question.

A further source of information that is relevant in the section 93(g) analysis is the stage of market growth. In the start-up and growth stages of a market, the dynamics of competition generally change more rapidly than in the mature stage, which is typically characterized by a higher degree of stability. In addition, entry into start-up and growth markets is less difficult and time consuming than it is in relation to mature markets. For these and other reasons, it may be more difficult to establish that a merger is likely to facilitate the exercise of market power in the expansive start-up and growth stages of a market than in the mature stage of a market.

It is equally important to assess the extent to which a merger is likely to facilitate the exercise of market power by impeding the process of change and innovation. This can occur, for example, where the introduction of new products, processes, marketing approaches, aggressive R&D initiatives or business methods, etc., is hindered or delayed by a merger which eliminates a new and innovative firm that presents a serious threat to incumbent firms.

When a merger is likely to enhance or facilitate the maintenance of existing market power, representations regarding how the merger may be likely to give rise to innovation-related synergies and other efficiencies will be considered pursuant to section 96.

4.10 Additional Evaluative Criteria

Section 93(h) recognizes that evaluative criteria in addition to those discussed in parts 4.2 to 4.9 may be relevant to an assessment of whether a merger is likely to prevent or lessen competition substantially. This provision draws attention to "any other factor that is relevant to competition in a market that is or would be affected by the merger or proposed merger". In parts 4.10.1 and 4.10.2, these Guidelines highlight two criteria that are generally assessed, together with the factors discussed in parts 4.2 to 4.9, when the

Bureau is concerned that the merger may be likely to facilitate the exercise of interdependent behaviour.

4.10.1 Market transparency

Where a merger raises concerns that it may be likely to facilitate interdependent behaviour, the extent of transparency in the relevant market will ordinarily be assessed. Transparency in this context connotes information that is readily available in the market about competitors': prices, levels of service, innovation initiatives, product quality, product variety, levels of advertising, etc. In general, as the level of transparency in a market decreases, coordinated behaviour becomes increasingly difficult, because firms find it harder to detect and retaliate against secret discounts and other deviations from interdependent situations.

Market transparency is typically increased by the following: delivered or basing point pricing schemes; posted pricing; circulation of price books; product, service or packaging standardization; exchanges of information (whether through a trade association, trade publication, or otherwise) regarding matters such as pricing, output, innovation, bids won and lost, and advertising levels; public disclosure of this information by buyers or through government sources; and "meet the competition" or "most favored nation" clauses in contracts.

4.10.2 Transaction value and frequency

Where a merger raises the concern that it may be likely to facilitate interdependent behaviour, an assessment will ordinarily be made of the extent to which the value and frequency of the typical transaction in the relevant market render this type of conduct more difficult to sustain. Interdependent behaviour often becomes increasingly difficult as the frequency and regularity of sales of the relevant product decrease, and as the value of each sale increases. This is due to the fact that departures from interdependent situations become harder to detect and retaliate against as the frequency and regularity of sales decrease. In addition, the incentives to engage in secret discounting and other concealable competitive initiatives increase with the value of individual sales.

4.11 Vertical Mergers

Vertical mergers generally only raise concerns in the circumstances described below in parts 4.11.1 and 4.11.2. However, these circumstances cannot, in and of themselves, provide a sufficient basis for concluding that a merger is likely to prevent or lessen competition substantially. When they are found to exist, an assessment of the evaluative criteria discussed in parts 4.2 to 4.10 above must be undertaken before conclusions can be made about the likely effects of the merger on competition.

4.11.1 Increased Barriers to Entry

A vertical merger may raise concerns where the elimination of an independent upstream source of supply (or downstream distribution outlet) leaves only a small amount of unintegrated capacity[48] at either of the stages at which the acquiror or the acquiree operate. In particular, concerns may be raised when the amount of unintegrated capacity at one stage (the secondary market) is sufficiently small that an entrant into the other stage (the primary market) would consider it necessary to simultaneously enter the secondary market. In general, where such simultaneous entry into both the primary and secondary markets would involve incurring greater sunk costs than what would be required to enter into the primary market alone, barriers to entry into the primary market are effectively raised[49].

However, an increase in the height of barriers to entry into a primary market only presents grounds for concern under the merger provisions of the Act where the degree of actual competition that would remain subsequent to the merger would be so low that it would be possible for a successful new entrant to exercise an important constraining influence on prices in the market. An assessment of this matter necessarily involves an evaluation of the criteria discussed in parts 4.2 to 4.10 above.

The Director is not likely to conclude that a vertical merger is likely to prevent or lessen competition substantially unless:

(i) the merger results in rendering unlikely entry into the primary market on a scale sufficient to eliminate a material price increase within two years, due to the need to simultaneously enter the secondary market[50]; and,

(ii) the exercise of market power in the primary market is likely to be facilitated by the merger in the absence of such entry.

In considering whether a requirement for simultaneous entry at two stages is likely to make successful, effective entry within two years more difficult or less profitable, an assessment will be made of whether entrants in such circumstances are likely to be faced with higher costs of capital than incumbent firms, as a result of the fact that greater risk is involved in attempting successful two-stage entry. An assessment will also be made of whether a difference in the levels of minimum-efficient-scale in the primary and secondary markets would likely impose significant additional costs on a two stage entrant.

---

[48] i.e., capacity that produces output at only one of the stages in question.

[49] Cf., Appendix 1.

[50] The Director is unlikely to consider that second stage entry is required where post-merger sales (or purchases) by unintegrated firms in the secondary market would be sufficient to service two minimum-efficient-scale operations in the primary market.

4.11.2 Upstream interdependence facilitated by forward integration into retail

A merger that results in, or increases, an existing high degree of vertical integration getween an upstream market and a downstream retail market can facilitate interdependent behaviour by firms in the upstream market by making it easier to monitor the prices charged by rivals at the upstream level. In general, such mergers will not likely be found to be likely to prevent or lessen competition substantially unless:

> (i) the prices at which transactions are actually made at the retail level are more visible than the prices at which upstream transactions are actually made;
>
> (ii) conditions in the upstream market are otherwise conducive to the interdependent exercise of market power; and,
>
> (iii) the percentage of upstream output that is sold through unintegrated firms is so low that post-merger sales to such firms on concealable terms would not likely result in preventing a material price increase from being imposed and maintained for two years.

4.12 Conglomerate Mergers

In general, conglomerate mergers[51] can only give rise to concerns under the Act where it can be demonstrated that, in absence of the merger, one of the merging parties would likely have entered the market de novo. In such circumstances, enforcement action will only be warranted where it can be established that prices would likely be materially higher in a substantial part of the market for more than two years than they would be if the merger did not proceed. For example, concerns could be raised under the Act when a dominant firm that is exercising market power in the relevant market acquires a firm in an adjacent market that has signaled an intention to enter the relevant market by attempting to negotiate contracts with customers of the dominant firm that are very favorable, from the perspective of those customers. Conversely, a similar anticompetitive effect can result where a large firm that would otherwise have entered the relevant market de novo, thereby increasing capacity and introducing a new and independent source of competition in the market, simply replaces a significant incumbent firm through merger.

Before concluding that de novo entry would likely have occurred in absence of the merger, the Director generally requires objectively verifiable information that clearly supports this proposition, e.g., internal documents that pre-date the merger, recent initiatives by the firm to contest the market, an application for regulatory approval, or the registration of a patent.

[51] A conglomerate merger is a merger between parties that do not compete in the same relevant market or in relevant markets that are vertically related.

PART 5 - The Efficiency Exception

Please Note: This Part no longer applies. Readers should consult the decision of the Federal Court of Appeal in the Commissioner of Competition v. Superior Propane Inc. and ICG Propane Inc 2001 FCA 104.

5.1 Overview

Section 96 of the Act provides an efficiency exception to the provisions of section 92 of the Act.The importance of economic efficiency to the Canadian economy is highlighted in the purpose clause that is set forth in section 1.1 of the Act, which states: "The purpose of this Act is to maintain and encourage competition in Canada in order to promote the efficiency and adaptability of the Canadian economy, in order to expand opportunities for Canadian participation in world markets while at the same time recognizing the role of foreign competition in Canada, in order to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the Canadian economy and in order to provide consumers with competitive prices and product choices."

The purpose clause makes it clear that competition is not desired as an end in itself, but rather to further various other objectives. The first objective that is mentioned in section 1.1 is the promotion of the efficiency and adaptability of the Canadian economy. In general, maintaining and encouraging competition results in promoting the efficiency and adaptability of the Canadian economy. However, in certain circumstances, the dual goals of maintaining and encouraging competition, on one hand, and promoting the efficiency and adaptability of the Canadian economy, on the other hand, cannot both be advanced.

One such circumstance is highlighted in section 96 of the Act, where it is recognized that some mergers may be both anticompetitive and efficiency enhancing. When a balancing of the anticompetitive effects and the efficiency gains likely to result from a merger demonstrates that the Canadian economy as a whole would benefit from the merger, section 96(1) explicitly resolves the conflict between the competition and efficiency goals in favor of efficiency.

Section 96(1) creates a tradeoff framework, in which efficiency gains that are likely to brought about in Canada are balanced against the anticompetitive effects that are likely to result from the merger. In this context, anticompetitive effects refer to the part of the total loss incurred by buyers and sellers in Canada that is not merely a transfer from one party to another,but represents a loss to the economy as a whole, attributable to the diversion of resources to lower valued uses. This loss is sometimes referred to as the deadweight loss to the Canadian economy. An order cannot be made in respect of a merger where it can be established that the gains in efficiency that will likely be brought about by the merger will be greater than, and will offset, the effects of any prevention or lessening of competition that will result or is likely to result from the merger . Claimed efficiency gains cannot be considered in this trade-off assessment where:

i) they would likely be attained if the order that would be required to remedy the anticompetitive effect of the merger were made; or,

(ii) they would likely be brought about by reason only of a redistribution of income between two or more persons.

The types of legitimate efficiency gains that are generally considered by the Bureau are highlighted in Appendix 2. Where the efficiency gains would likely result in a significant increase in the real value of exports or in a significant substitution of domestic products for imported products, this should be documented in submissions made relating to efficiencies.

The foregoing matters and related issues are described in greater detail in parts 5.2 to 5.7 below.

To facilitate expeditious assessment of the nature and magnitude of merger-related efficiencies, merging parties are encouraged to make their efficiency submissions to the Bureau at an early stage of its review of the transaction. It is not necessary to wait until a finding is made that the merger is likely to prevent or lessen competition substantially.

5.2 Gains That Would Otherwise Likely be Attained

The last clause in section 96(1) requires a finding that claimed efficiency gains "would not likely be attained if the order were made". The order referred to is the proposed order requested in the Director's application, or such other order as the Tribunal may make. Where an application has not yet been made, parties can generally obtain from the Bureau a general description of the order, if any, that would likely be sought by the Director[52].

This proviso within section 96(1) requires an assessment of whether each of the particular gains that it is anticipated will be realized subsequent to the merger would likely be attained by alternative means if the order being sought, or that would likely be sought, were made. This assessment generally involves an evaluation of whether any of the gains that are identified as being likely to be realized post-merger would also be likely to be attained through less anticompetitive means such as internal growth; a merger with a third party; a joint venture; a specialization agreement; or a licensing, lease or other contractual arrangement, if the order in question were made. Where some or all of the claimed efficiency gains would likely be attained through these or other means if the order were made, they cannot be attributed to the merger, they would not represent a "cost" of making the order, and they are not considered in the section 96 trade-off analysis.

Similarly, where an order is sought in respect of part of a merger, efficiency gains that would likely be attained in markets that are not the focus of the order are not considered

---

[52] It is necessary to know the nature of the order because efficiencies are only considered in the section 96 balancing process if they "would not likely be attained if the order were made"

in the balancing process contemplated by section 96(1). They would not be affected by the order. However, where the nature of particular efficiencies that are anticipated to arise in these other markets is such that they would not likely be attained if the order were made, because they are inextricably linked to the efficiencies that the order would prevent in the relevant market, these will be considered in the trade-off analysis[53].

In the assessment of whether efficiencies that have been claimed would likely be attained through a merger with a third party if the order were made, consideration will only be given to existing alternative merger proposals that are less anticompetitive and that can reasonably be expected to proceed if the order in respect of the first proposed merger is made. Efficiencies generally will not be excluded from the balancing process on the speculative basis that they could be attained through a merger with an unidentified third party.[54]

In determining whether particular categories of efficiencies can reasonably be expected to be attained through non-merger alternative means if the order is made, the market realities of the industry in question are considered. In general, efficiencies will not be excluded from consideration on the basis that they theoretically could be attained through internal growth, a joint venture, a specialization agreement, or a licensing, lease or other contractual arrangement. If the common industry practice is such that the alternative in question would not likely be resorted to if the order were made, the efficiencies in question will ordinarily be included in the balancing process. In general, parties should provide a reasonable and objectively verifiable explanation of why efficiencies that are available would not likely be sought by alternative means if the order were made. This is particularly so in the case of economies of scale and other efficiencies that could be attained through internal growth and investment within the reasonably foreseeable future. In assessing whether efficiencies are likely to be attained through internal expansion, the Director considers the growth prospects of the market in question, the extent of excess capacity therein, and the extent to which the expansion can be carried out in increments.

---

[53] For example, assume that a merger will affect four markets, A, B, C and D, and that it will likely result in efficiency gains valued at 25 hypothetical units in each of markets A, B and C, respectively. Efficiency gains of 15 units would likely be attained in market D. The only anticompetitive effect is in market A. Accordingly, the order would likely seek divestiture of the acquiree's business in market A. Of the 25 units of efficiencies that would likely be attained in market A, 5 would likely be realized by internal growth or reorganization in the reasonably foreseeable future, and 5 would likely be attained through a distribution arrangement with a third party, if the order were made. None of the efficiencies that are expected to be attained in market D would likely be attained if the order were made, because they are economies of scope that are inextricably linked to some of the efficiencies that would be prevented in market A by the order. All of the efficiencies in markets B and C would likely be attained even if the order were made. Accordingly, the efficiencies that would be considered in the balancing process would be the 15 units in market A and the 15 units in market D that would not likely be attained if the order were made. Ten units in market A, and the entire efficiencies likely to be realized in markets B and C, would not be considered because they would not be affected by the order.

[54] Accordingly, to return to the example discussed in the previous note, if 5 of the 15 units of market A-related efficiencies to be considered in the balancing process could be attained by any merger, but the Director is not aware of any third parties who have expressed a serious interest in proposing an alternative merger, these 5 units would not be excluded from assessment under section 96(1).

5.3 Gains that are Redistributive in Nature

A second essential characteristic that efficiency gains must have before they are considered in the trade-off analysis contemplated by section 96(1) is that they cannot be brought about "by reason only of a redistribution of income between two or more persons". This provision of section 96(3) recognizes that all gains realized pursuant to a merger do not necessarily represent a saving in resources. For example, gains that are anticipated to arise as a result of increased bargaining leverage that enables the merged entity to extract wage concessions or discounts from suppliers that are not cost justified represent a mere redistribution of income to the merged entity from employees or the supplier, as the case may be. Such gains are not brought about by a saving in resources. This contrasts with the situation where the supplier is able to offer better terms as a result of the fact that larger orders from the merged entity will enable the supplier to attain economies of scale, reduce transaction costs or achieve other savings. Where it can be demonstrated that the source of gains to the merged entity is a legitimate saving for the supplier, the gains will not be excluded from the balancing process by reason of section 96(3).

In addition to gains attributable to increased bargaining leverage, tax related gains brought about by mergers are generally found to represent nothing more than a redistribution of income from taxpayers to the merged entity. Similarly, savings that flow from a reduction in output, service, quality or variety are generally found to represent a transfer of wealth from buyers to the merged entity. The same is true of the increased revenues resulting from a price increase.

The sale of an asset is generally considered to bring about a reallocation, rather than a saving, of resources. However, where the sale of machinery, a plant or other assets facilitates a reduction in ongoing expenditures associated with operating the assets, or results in a lower overall cost of capital to the firm, this source of savings will ordinarily not be excluded by reason of section 96(3).

5.4 "Greater Than" and "Offset"

The words "greater than" are considered to signify that the efficiency gains must be more weighty than, more extensive than, or of larger magnitude than the anticompetitive effects that are likely to result from the merger. By comparison, the term "offset" is considered to suggest that the efficiency gains must neutralize, counterbalance or compensate for the likely anticompetitive effects of the merger.

The expressions "greater than" and "offset" are considered to each have qualitative and quantitative connotations. That is to say, the efficiency gains must be greater than the anticompetitive effects that are likely to result from the merger, in both a qualitative and quantitative sense; and the efficiency gains must offset these anticompetitive effects, in both a qualitative and quantitative sense. To be assessed in terms of "greater than", efficiency gains must be capable of being weighed in similar terms as all or some of the anticompetitive effects that will likely result from the merger. Efficiency gains and

anticompetitive effects that cannot be weighed in similar terms will be evaluated in terms of whether the gains offset the anticompetitive effects. This evaluation can be subjective in nature and will ordinarily require the exercise of the Director's discretion[55]. In short, efficiency gains and anticompetitive effects that can be measured in dollar or other similar terms are weighed to determine whether the "greater than" requirement is met; whereas efficiency gains and anticompetitive effects that cannot be balanced in such terms are compared to determine whether the "offset" requirement is met. Where all of the efficiency gains and anticompetitive effects can be measured in similar terms, and where the efficiency gains are "greater than" the anticompetitive effects, they will also be considered to "offset" the anticompetitive effects[56].

5.5 Anticompetitive "Effects"

Section 96(1) requires efficiency gains to be balanced against "the effects of any prevention or lessening of competition that will result or is likely to result from the merger or proposed merger". Where a merger results in a price increase, it brings about both a neutral redistribution effect[57] and a negative resource allocation effect on the sum of producer and consumer surplus (total surplus) within Canada. The efficiency gains described above are balanced against the latter effect, i.e., the deadweight loss to the Canadian economy.

The calculation of the likely anticompetitive effects of mergers is generally very difficult to make. This is particularly so with respect to the measurement of losses related to a reduction in service, quality, variety, innovation and other non-price dimensions of competition. Insofar as such losses often cannot be quantified, they receive a weighting that is essentially qualitative in nature. In view of the difficulties associated with arriving at precise estimates of both the elasticity of market demand and the magnitude of the prevention or lessening of competition that is likely to be brought about by the merger, several trade-off assessments are generally performed over a range of price increases and market demand elasticities.

In calculating the magnitude of likely efficiency gains, cost savings are generally measured across the reduced level of output that will be required to bring about the

---

[55] Accordingly, if part of the efficiencies likely to result from the merger include dynamic R&D efficiencies, (which cannot be measured in similar terms as any of the likely anticompetitive effects), and if part of the anticompetitive effects likely to result from the merger include a reduction in service, quality or variety, (which cannot be measured in terms that are similar to any of the likely efficiencies), the Director would exercise his discretion in assessing whether the R&D efficiencies would likely "offset" the effects of a reduction in service, quality or variety.

[56] Returning to the example discussed in note 53, if the anticompetitive effects in market A were solely quantitative in nature and were likely to amount to 29 units, the 30 units of legitimate efficiency gains (15 in market A and 15 in market D) would meet both the "greater than" and the "offset" requirement. If there were additional dynamic R&D efficiencies, on one hand, and a reduction in service on the other hand, it would require the exercise of discretion to determine whether, on the basis of the particular facts of the case, it could be concluded that the "offset" requirement was met. If the anticompetitive effects were likely to amount to 30 units, the "greater than" requirement would not be met.

[57] When a dollar is transferred from a buyer to a seller, it cannot be determined a priori who is more deserving, or in whose hands it has a greater value.

anticipated material price increase. In estimating the extent of negative resource allocation effects of mergers, the Bureau includes the additional losses in total surplus that arise when market power is being exercised in the relevant market prior to the merger. Similar losses that arise as a result of foregone contribution to fixed costs (due to restricting levels of output) are also recognized.

Given that section 96(1) requires efficiencies to be balanced against the effects of "any" prevention or lessening of competition that will result from the merger, anticompetitive effects that are likely to arise in other markets affected by the merger are also considered in the trade-off analysis. However, anticompetitive effects in markets that are not targeted by the order sought generally will not be substantial in nature.

5.6 Increased Exports and Import Substitution

In the determination of whether a merger is likely to bring about gains in efficiency described in section (1), section 96(2) requires that account be taken of whether such gains will result in:

(i) a significant increase in the real value of exports; or,

(ii) a significant substitution of domestic products for imported products.

The words "described in section (1)" make it clear that section 96(2) does not operate to expand the class of efficiency gains that may be considered in the trade-off analysis. Accordingly, this provision is simply considered to draw attention to the fact that, in calculating the merged entity's total output for the purpose of arriving at the sum of unit and other savings brought about by the merger, the output that will likely displace imports, and any increased output that is sold abroad, must be taken into account.

5.7 Other Enforcement Policy Matters

5.7.1 Timing differences

Timing differences between the future anticipated efficiency gains and anticompetitive effects must be addressed by discounting back to present constant dollar values by:

(i) removing the effects of future anticipated inflation; and,

(ii) applying a standard real discount rate to allow the appropriate comparison of efficiency gains and anticompetitive effects which are likely to occur at different points in the future.

Dollar values for efficiency gains should be presented in terms of constant dollars, i.e., with the effects of inflation removed. Where the prices of products are expected to increase or decrease at more or less than the general rate of inflation, this should be highlighted. The inflation rate assumptions which are employed should also be provided in documentation submitted to the Bureau.

The real discount rate employed to compute present values should be consistent with the discount rates used to evaluate investment projects funded in whole or in part by the federal government. These standard rates are generally found in the Treasury Board's Benefit - Cost Guidelines and similar federal government documents. A range of discount rates should be utilized in order to test the sensitivity of the results to different assumptions regarding the real discount rate[58]. In general, one of the discount rates employed for sensitivity analysis purposes will be the "cost of capital" or "industry hurdle rate" for the specific industry in question. The same discount rate is ordinarily applied to the likely efficiency gains and the anticompetitive effects attributable to the transaction.

5.7.2 Costs required to achieve gains

Retooling and other costs that must be incurred to achieve efficiency gains are deducted from the total value of the efficiencies that are considered pursuant to section 96(1).

5.7.3 Documentation of efficiency gains

Objective verification of particular sources of efficiency gains may be provided by plant and firm-level accounting statements, internal studies, strategic plans, capital appropriation requests, management consultant studies (where available) or other available data. To facilitate the Bureau's review of efficiency claims, information provided should describe the precise nature and magnitude of each type of efficiency gain that it is expected will be brought about by the merger.

---

[58] At the present time, the federal government is generally employing a rate of 8 percent with 4 percent and 12 percent used for sensitivity testing.

PART 6 - Process Matters

6.1 Compliance Approach

The Director's enforcement of the Competition Act emphasizes compliance. Increased compliance with the Act benefits all parties, and is best facilitated by ensuring that persons involved in or affected by mergers are fully informed with respect to the Director's enforcement policy. However, Merger Enforcement Guidelines are no substitute for early contact with the Bureau to discuss proposed or hypothetical transactions. Early contact usually provides helpful insights into:

- the competition issues that are likely to be raised by a particular transaction;
- the manner in which the assessment of these issues can be best facilitated;
- the time that will likely be required to complete the review of the merger; whether the transaction is a good candidate for an Advance Ruling Certificate[59];
- whether short form or long form prenotification is likely to be required; and
- whether restructuring will likely be necessary to ensure that competition will not be prevented or lessened substantially[60].

6.2 Prenotification

Part IX of the Act requires that the Director be notified of proposed transactions where two thresholds are exceeded, relating to:

(i) the combined size of the merging parties and their affiliates; and,

(ii) the size of the transaction.

With respect to the first threshold, section 109 requires notification of a proposed transaction only when the transacting parties, together with their affiliates[61], have assets in Canada or have gross annual revenues from sales in, from, or into Canada that exceed $400 million.

The second threshold is addressed in section 110, where four types of notifiable transactions are distinguished: asset acquisitions, share acquisitions, corporate amalgamations, and business combinations otherwise than through a corporation, e.g., a joint venture. With respect to asset acquisitions, unless a transaction falls within one of the exemptions set out in sections 111 to 113[62], notification is required for a proposed

[59] The Director's approach to advance ruling certificates is discussed in the Advance Ruling Certificates bulletin, released by the Bureau in December 1988.
[60] Additional information regarding the compliance approach is set forth in the Bureau's Program of Compliance bulletin, released by the Bureau in June 1989.
[61] Affiliates, for purposes of the Act, are defined in section 2 (2) on the basis of de jure control. Cf. Part 1 of these Guidelines.
[62] Cf., Appendix 3.

acquisition of any of the assets in Canada of an operating business[63], if the aggregate value of the assets or the gross annual revenue from sales in or from Canada generated by those assets exceeds $35 million.

With respect to share acquisitions, subject to the exemption provisions in sections 111 to 113, notification is required for a proposed acquisition of "voting shares"[64] of a corporation that carries on an operating business or that controls a corporation that carries on an operating business, where:

> (i) the corporation has assets in Canada, or gross annual revenues from sales in or from Canada, that exceed $35 million; and,
>
> (ii) the acquiror will have a greater than 20 percent voting interest in a public company or a greater than 35 percent voting interest in a completely private company.

Where the proposed acquiror already has a greater than 20 percent or 35 percent voting interest prior to the proposed transaction in question, but less than a 50 percent voting interest, notification is also required where that acquiror together with its affiliates will have a greater than 50 percent voting interest in the target corporation subsequent to the transaction[65].

Amalgamations are also subject to the exemptions in sections 111 to 113. Notification is required for a proposed amalgamation of two or more corporations where:

> (i) the value of the assets in Canada or the annual gross revenue from sales in or from Canada of the continuing corporation exceeds $70 million; and,
>
> (ii) one or more of the amalgamating corporations carries on an operating business or controls a company that carries on an operating business.

Notification is required in respect of a proposed combination of two or more persons to carry on business, otherwise than through a corporation, if one or more of those persons propose to contribute assets of an operating business to the combination, and if the value of the assets in or sales in or from Canada of the combination exceeds $35 million. The various exemptions set forth in sections 111 to 113 apply equally to combinations.

In all cases, notification must be made by the person proposing the transaction. For amalgamations, combinations and other circumstances where the transaction is proposed

---

[63] The term "operating business" is defined in subsection 108(1) as "a business or undertaking in Canada to which employees employed in connection with the undertaking ordinarily report for work.

[64] The term "voting share" is defined in subsection 108(1) as "any share that carries voting rights under all circumstances or by reason of an event that has occurred and is continuing"

[65] Provision is made in section 115 for a proposed acquiror to notify with respect to both voting thresholds at the same time if it is anticipated that sufficient additional shares to cross the fifty percent threshold will be purchased within one year of notice being given for an acquisition that results in a crossing of either the 20 percent or the 35 percent thresholds.

by more than one person, one of the parties may be authorized by the others to give notice and supply information on their behalf.

The prenotification provisions cover both direct and indirect acquisitions. Accordingly, if a foreign or Canadian company purchases a foreign company and thereby indirectly acquires a Canadian operating business, the transaction is notifiable under the Competition Act, if the abovementioned thresholds are crossed. The same rules apply if a foreign company is buying a Canadian company.

A notifier has the option of supplying information set out in either section 121 (short form) or section 122 (long form). The information required under both sections includes:

- any legal documents that have been prepared in relation to the transaction;
- a description of the proposed transaction and its underlying objectives; information relating to the parties to the transaction, their principal businesses and the businesses of their affiliates;
- sales figures;
- asset values;
- principal categories of products produced;
- significant customers and suppliers; and,
- to the extent available, pro forma financial statements.

The main difference between the short and long form filings is that the long form requires considerably more information on affiliates and products.

Parties must wait seven days, where a short form filing is made, and 21 days in the case of a long form filing, before completing a proposed transaction. Where shares are to be acquired through a stock exchange, parties filing long form information may complete the transaction after 10 trading days, or such longer period, not exceeding 21 days, that may be allowed by exchange rules[66]. The waiting period runs from the time that complete information, as determined by the Director, is received by the Director. Pursuant to section 123, the abovementioned periods may be reduced by the Director.

Failure to notify in accordance with sections 114 or 123 is a criminal offense under section 65(2) and is subject to a fine of up to $50,000. In addition, the Director may apply to the Tribunal pursuant to section 100 for an order preventing the completion or implementation of the proposed merger until proper notification is filed.

Pursuant to section 119 a notification in respect of a merger lapses if the merger is not completed within one year or such longer period as the Director may specify in any particular case.

---

[66] Securities commissions and stock exchanges in Canada allow takeover bids to be conditional on compliance with Part IX of the Act.

Parties are encouraged to contact the Bureau's Prenotification Unit before filing, to discuss whether a short-form or long form filing should be made; to discuss the possibility of pursuing an Advance Ruling Certificate (as an alternative to prenotification)[67]; to expedite review of the transaction; or to seek any other assistance that may be required regarding the review process or the Director's interpretation of specific provisions of the Act.

6.3 Confidentiality

Section 29[68] of the Act prohibits the Director and his authorized representatives from communicating to another person information obtained pursuant to the provisions of sections 11, 15 and 16[69]; and information obtained pursuant to a prenotification filing or from a person requesting an advance ruling certificate. Section 29 also prohibits disclosure of the identity of any person from whom information has been obtained pursuant to the Act; and the communication of whether notice has been given or information obtained in respect of a particular transaction that has been prenotified under section 114. The prohibitions of section 29 do not apply in respect of information that has been made public. In addition, the Director may communicate information obtained to a Canadian law enforcement agency or for the purpose of the administration and enforcement of the Act.

In general, the Bureau will respect requests by merging parties that information not be sought from third parties about the likely effects on competition of mergers that have not been made public. However, such a request for confidentiality may seriously restrict the ability of the Director to assess fully the likely impact on competition of a merger, and may extend the period that would otherwise be required for the Bureau's review. Accordingly, information from third parties may be sought if the merging parties indicate an intention to proceed with their merger before the Director's assessment is completed and it has not been determined that the merger will not prevent or lessen competition substantially. In deciding whether to seek third party views, the Director will take into account whether the merging parties have provided an undertaking to ensure that the ability of the Tribunal to remedy the effect of the merger on competition would not be impaired. Parties who intend to proceed with their merger before the Director's assessment is completed face the risk that the Director will make an application for an interim order under section 100 or that the Director will bring an application for an order

---

[67] See note 59 above.

[68] Section 29 states: (1) No person who performs or has performed duties or functions in the administration or enforcement of this Act shall communicate or allow to be communicated to any other person except to a Canadian law enforcement agency or for the purposes of the administration and enforcement of this Act: (a) the identity of any person from whom information was obtained pursuant to this Act; (b) any information obtained pursuant to section 11, 15, 16 or 114; (c) whether notice has been given or information supplied in respect of a particular proposed transaction under section 114; or (d) any information obtained from a person requesting a certificate under section 102. (2) This section does not apply in respect of any information that has been made public.

[69] These sections provide for the obtaining of information through oral examination, production of documents, written returns, searches and seizure and computer searches

after the merger has been substantially completed, within the three year period permitted by section 97.

In addition to the provisions of section 29, where an inquiry is commenced by the Director, section 10(3) provides that all inquiries are to be conducted in private. Accordingly, the Director will not comment on whether a section 10 inquiry has been initiated, unless the existence of the inquiry has otherwise been made public.

Where an application is made to the Tribunal, the Director will advise the Tribunal of any request that has been made for confidentiality.

6.4 Substantial Completion

In general, substantial completion of a merger is considered to arise when:

> (i) an ability to materially influence the economic behaviour of the business that is the subject of the transaction has been acquired or established; and,
>
> (ii) it is no longer possible for one of the parties to withdraw from the merger if an outstanding condition is not met or a regulatory approval is not obtained.

6.5 Timing

The time required by the Bureau to review a merger is largely a function of when the Bureau is provided with sufficient information to assess the likely effects of the merger on competition. Accordingly, the time periods set forth in this section are contingent on obtaining such information, and are only approximate guides.

Persons who have submitted prenotification filings are generally informed on the day that the relevant waiting period expires either that the transaction does not raise concerns under the substantive provisions of the Act or that the Bureau's assessment is not yet complete. Merging parties who have notified the Bureau with respect to a merger that falls below the prenotification thresholds are generally informed, either that the transaction does not raise concerns under the Act or that the merger requires further review, within three weeks of providing the Director with sufficient information to make this preliminary determination. Regardless of whether a merger is subject to the prenotification provisions of Part IX of the Act, the Bureau ordinarily endeavors at this time to communicate to the merging parties any preliminary concerns that have been identified. Similarly, it generally endeavors to communicate with the parties as additional issues are identified.

Where parties are informed that no concerns have been identified, they can generally proceed with their transaction without facing a significant risk that the merger will be challenged within the three year period permitted by section 97, unless new information which would affect the Director's decision comes to the Bureau's attention. By contrast, where the parties are informed that the review of the merger has not been completed, they

may be requested to provide an undertaking not to proceed with the closing of their transaction without giving the Bureau a minimum of ten working days notice of an intention to do so. Where such an undertaking is not provided:

> (i) any attempt to complete or implement the merger may cause the Director to bring an application for an interim order pursuant to section 100 of the Act; or,
>
> (ii) subsequent to the merger, an application challenging the merger may be brought pursuant to section 92, together with an application pursuant to section 104 for an interlocutory order.

When competition concerns have been identified, they are conveyed to the notifying party and additional information is generally requested. The time that it takes for the review of the merger to be completed is then largely a function of the speed with which this information is provided.

In general, at this stage parties are advised to provide a thorough competitive assessment document, if they have not already done so, together with responses to a detailed information request. The competitive assessment document should address the matters highlighted in these Guidelines. To the extent that documentation prepared for the purpose of making the decision to merge exists, it should also be provided to the Bureau, together with identification of its authorship.

In most cases, a determination can be made of whether a merger prevents or lessens competition substantially within eight weeks after the merging parties have provided all requested information. This period of time is required in order to review this information, to review information relating to the industry that is already in the Bureau's files, and to gather and review information provided by customers, suppliers, competitors, experts, others in the industry and government departments that have information pertaining to the market(s) in question. Where information is not provided upon request by merging parties or others, the Director may initiate a formal inquiry and seek to exercise the powers provided under sections 11, 15 or 16 of the Act.

In those cases where a determination cannot be reached within this time frame, additional information may be sought with respect to contentious issues. At this stage, the timing of a final determination can vary significantly from case to case. In the Bureau's experience, the most complex of these cases can require up to six months after all requested information has been obtained from the merging parties, before the Director's position is finalized. This additional time has in part been attributable to continued discussions initiated by the parties to the merger. The Director will be briefed throughout the assessment process, and will provide merging parties with an opportunity to discuss a determination before it is finalized.

6.6 Information Exchanges Between Merging Parties

Information exchanged during merger negotiations which do not ultimately lead to a merger[70] could raise questions which may require examination pursuant to the conspiracy provisions of section 45 of the Act. This risk can be reduced by limiting the information exchanged to that which is reasonably necessary to make a decision to merge, and by ensuring to the extent possible that such information is restricted to persons involved in negotiating the transaction, e.g., lawyers, accountants, chief executive officers or merger counsellors. Unless there are legitimate reasons why commercially sensitive information needs to be shared in both directions, such risk can also be reduced by ensuring that information flow is one way.

6.7 Investment Canada

Investment Canada reviews certain acquisitions in Canada by non-Canadians in terms of a "net genefit to Canada" test. One of the six factors considered in the assessment of this test is the likely effect of the merger on competition. Investment Canada generally seeks, but is not bound by, the Director's assessment of the likely implications of a transaction on competition. Similarly, decisions reached pursuant to the Investment Canada Act do not bind the Director.

As a matter of practice, the Bureau receives all Investment Canada filings and attempts to complete the competition evaluation of Investment Canada cases that do not appear to raise concerns under the Competition Act within l5 days of receiving notification from Investment Canada. Where the documentation provided in the parties' filing to Investment Canada is insufficient to enable a proper assessment to be made under the Competition Act, the companies involved are ordinarily approached directly. The Director will normally communicate to Investment Canada officials a conclusion that the competition factor should be given a positive, neutral or negative weight in Investment Canada's overall net benefit assessment[71]. Investment Canada may conclude that the merger is of net benefit to Canada notwithstanding that the competition factor has been given a negative weighting.

---

[70] It should be noted that even where a such negotiations lead to a agreement to merge, section 98 of the Act contemplates that the Director can elect to proceed pursuant to section 45 rather than the merger provisions.

[71] A negative weighting may be given even if the merger does not prevent or lessen competition substantially.

Appendix I: Background Information on Sunk Costs

Market Specific Assets and Learning

Where entry on the scale described in part 4.6.1 would require investments in assets whose total cost comprises a significant sunk cost component[1], potential entrants will generally recognize that it may be profit maximizing for incumbent firms to maintain their output at levels that would render entry unprofitable, i.e., at levels which would enable the incumbents to recoup some of their sunk costs, and which would yield prices below the potential entrant's long run average total costs. Where significant economies of scale[2] or scope[3] exist, a potential entrant will recognize that output added to the market by any new entry on a minimum efficient scale will exert downward pressure on prices.

The greater the ratio of minimum efficient scale to total market output, the greater will be the price depressing effect of entry at that scale, and the less likely it will be that such entry will occur. Given that the relevant price to a potential entrant is the post-entry price, entry ordinarily will be increasingly deterred the longer that this price is expected to be below a level that would enable the entrant to recoup its entire investment if the entry initiative fails[4]. This deterrent effect will be enhanced by the recognition that risk and uncertainty are increased by virtue of the likelihood that incumbents will vigorously fight to defend their market position, particularly in stable or declining markets, or where they have significant excess capacity[5]. If potential entrants decide in the alternative to enter on a lesser scale and accept the cost disadvantage associated with a sub-optimal level of production, this entry will not ordinarily be sufficient to eliminate a material price increase or other exercise of market power in a substantial part of the relevant market.

---

[1] ie., the component of the purchase price of the highly specialized asset (less depreciation for use), that will not be recovered if entry fails and the asset must be sold at liquidation prices, moved to less valuable uses, or scrapped. If entry fails, variable costs associated with the entry initiative will also be irrecoverable, and must therefore be factored into the entrant's estimation of the irrecoverable costs associated with a failed entry initiative.

[2] Economies of scale arise when the unit cost of producing a product decreases as the amount produced increases. Economies of scale may also exist in relation to other aspects of a business, such as distribution, marketing and management.

[3] Economies of scope arise when it is less costly to produce two or more products together than to produce them separately. As with economies of scale, economies of scope can also exist in other areas, such as distribution and marketing a full-line of products.

[4] Incumbents can price below their average total costs until an entry initiative fails because their sunk costs have already been committed and may therefore no longer be considered to be relevant to pricing decisions. It is this asymmetry between incumbents and persons contemplating entry that confers the advantage on the former. By contrast, in the absence of sunk costs, it would be difficult for the incumbent to credibly commit to maintaining output, because it could maintain prices and profit margins by accommodating entry, and moving to another market the production capacity formerly used to produce the output ceded to the new entrant. Given that potential entrants will ordinarily recognize this fact together with the fact that they would not face the prospect of making an investment that could not be recovered, they would not be deterred.

[5] Due to the fact that many Canadian markets support only a small number of firms, as a result of the existence of scale economies, the Bureau is frequently presented with this source of entry impediment. This is particularly so in relation to markets that are insulated by tariffs or are stable or contracting. In such markets, the scope for strategic interaction among firms is heightened.

The assessment undertaken pursuant to section 93(d) also involves a determination of whether entry within two years on a scale sufficient to eliminate a material price increase is likely to be deterred by the existence of advantages that accrue to incumbents through "learning by doing" and experience. In some markets, entry by potential entrants may be deterred or hindered by the fact that it takes several years to debug plants, acquire essential production and marketing experience and otherwise learn the tricks of the trade. In other markets, entry may be deterred or hindered by virtue of the fact that learning is an ongoing process and knowledge may only be acquired in such a way that potential entrants cannot realistically expect to catch up with incumbents in the foreseeable future.

Product Differentiation

Firms typically attempt to differentiate their products from the products of their competitors in one or more of the following ways:

(i) by distinguishing the physical nature of the product, in terms of features, durability and quality;

(ii) by offering superior pre or post-sales service, including warranties;

(iii) by selling from locations that are more convenient to access, or that require less transportation costs to reach, than rival sales locations; and,

(iv) by creating perceived attributes through advertising, labelling, packaging, etc.

When products are successfully differentiated in these or other ways, buyers are generally not indifferent between branded and unbranded products that compete within a single relevant market, in the way that they typically are with respect to competing sources of an undifferentiated product. When buyers in a differentiated market find a brand that they like, that brand will often become the standard against which products of new entrants are judged. In essence, buyers develop brand loyalty which is generally rooted in satisfactory past experience and in the assurance of quality that is provided by the brand name. This quality assurance is in turn ordinarily reinforced through advertising and other forms of promotion.

Where significant brand loyalty exists in a market, buyers will often be reluctant to immediately switch to a new product in response to an increase in the price of the product that commands their loyalty. This reluctance can be exacerbated by the significant risk associated with purchasing a new product where the product:

- is a component in a production process that will have to be shut down if the product fails to perform as expected;
- is resold, either as is or embodied in another product, by buyers who must therefore place their own reputation at risk if they decide to purchase the new product;

- is not one which is cheaply sampled; is a durable good that is infrequently purchased; or,
- where timeliness of delivery and technical support are important.

Given the foregoing, new entrants often must offer a lower price, a superior product, and/or engage in more extensive and more frequent advertising and promotion than incumbent firms to convince buyers to sample their product(s) and ultimately abandon the product(s) of the incumbent firm(s). Each of these sources of asymmetry between new entrants and incumbent firms is a source of additional sunk costs which ordinarily serve to deter or delay entry. This is particularly so with goods that are purchased on a self-serve basis, without significant in-store assistance from salespersons; and where there are significant costs associated with obtaining information about a product and its performance relative to other products in the relevant market.

These disadvantages increase as the proportion of total market output that is accounted for by minimum efficient scale increases. In short, the more sales that must be made to attain minimum efficient scale, the greater are the sunk entry costs that must be incurred in terms of product discounts, advertising and other forms of promotion[6], and the longer it will generally take an entrant to gain sufficient sales to eliminate a price increase by incumbents. Moreover, as the level of minimum efficient scale increases, potential entrants are more likely to fear that they will not gain sufficient sales to justify committing to these sunk costs, and/or that the prospect of slow buyer-acceptance will increase their exposure to additional sunk costs.

Strategic Behaviour

There are several kinds of strategic behaviour that can serve to impose sunk costs on new entrants or delay the ability of a new competitor to eliminate a material price increase. Such behaviour may occur prior or subsequent to entry, and may not be designed to have an entry deterring effect. For example, the offering of discounts for full-line purchases often effectively serves to prevent suppliers of less than a full line of products from being able to constrain a price increase with respect to a single product within the full line, yet this is not typically the primary reason why incumbent firms may offer such discounts.

In assessing the extent to which a material price increase or other change in the market brought about by the merger is likely to induce entry on a scale that is sufficient to eliminate such a price increase within two years, particular attention will be paid to determining whether entry is likely to be impeded or delayed by one or more of the following:

- existing exclusive dealing or tying arrangements;

---

[6] It is important to recognize that there are often economies of scale in advertising that disadvantage new entrants until they reach the level of sales where their per-unit advertising costs are comparable with those of incumbents.

- buyers facing significant switching costs[7];
- existing contracts that are long term in nature, and/or that include "meet the competition" or "unilateral renewal" clauses;
- high levels of investment in R&D or advertising by incumbents, or a likelihood that such investments will be made;
- incumbents having filled most significant product niches or geographic location opportunities;
- incumbents having acquired patents for a variety of ways of making a product;
- incumbents having signalled through responses to past entry initiatives that existing excess capacity will be employed to depress prices in response to an attempt to enter; and/or,
- an expectation that incumbents will likely respond to entry by vigorously defending their market positions

---

[7] Suppliers can advertently or inadvertently impose significant switching costs on buyers in various ways, including: by making rebates or discounts contingent on total fidelity, or on purchases made over a long period of time; by negotiating substantial liquidated damages for breach of contract; by requiring the purchaser to include the trade mark of the relevant product on the packaging when it is resold; or by manipulating the compatibility of product components.

Appendix II: Types of Efficiency Gains Generally Considered

Efficiency gains that are assessed pursuant to section 96 fall into two broad classes: production efficiencies and dynamic efficiencies. Production efficiencies result from real long run savings in resources which permit firms to produce more output or better quality output from the same amount of input. These efficiencies are generally the focus of the evaluation, because they can be quantifiably measured, objectively ascertained, and supported by engineering, accounting or other data.

Production efficiencies include:

> (i) product-level, plant-level and multi-plant level operating and fixed-cost efficiencies;
>
> (ii) savings associated with integrating new activities within the firm; and,
>
> (iii) savings attributable to the transfer of superior production techniques and know-how from one of the merging parties to the other.

Product-level efficiencies that are most commonly recognized are those that arise when a firm generates "economies of scale" by reducing the long run average unit cost of a product through increased volume production. Economies of scale can also arise at the plant level as plants are expanded toward their optimal size. In addition, at higher rates of output, mechanization of specific production functions previously carried out manually can give rise to scale related resource savings. Economies of scope can be generated at the plant level when the cost of producing more than one product at a given level of output is reduced by producing them together rather than separately. These efficiencies are particularly common in service industries.

Other efficiencies that can arise at the plant-level include savings that flow from specialization, the elimination of duplication, reduced downtime, a smaller base of spare parts, smaller inventory requirements and the avoidance of capital expenditures that would otherwise have been required. Multi-plant level savings can arise from plant specialization, the rationalization of various administrative and management functions, (e.g., sales, marketing, accounting, purchasing, finance, production) and the rationalization of R&D activities. In addition, mergers can bring about plant and multi-plant efficiencies in relation to distribution, advertising and capital raising.

Production-related efficiencies can also result from integrating activities within the merged entity that were previously performed by third parties. Attainment of these gains generally involves a reduction in transaction costs associated with matters such as contracting for inputs, distribution and services.

In addition to the foregoing, it is recognized that mergers can give rise to legitimate production-related savings attributable to the transfer of superior production techniques and know-how from one of the merging parties to the other. However, claims that a

merger is likely to give rise to efficiencies by reason of "superior management" are generally difficult to establish objectively. Moreover, it is generally difficult to demonstrate that particular savings are specifically attributable to management performance. Similarly, it is typically hard to establish that the efficiencies would not likely be sought and attained through alternative means if the merger did not proceed.

The second class of efficiencies considered in the section 96 assessment, dynamic efficiencies, include gains attained through the optimal introduction of new products, the development of more efficient productive processes, and the improvement of product quality and service. It is recognized that the attainment of dynamic efficiencies is crucial to both the general evolution of competition and the international competitiveness of Canadian industries. However, claims that a merger will lead to dynamic efficiencies are ordinarily extremely difficult to measure. Accordingly, the weight given to claims regarding such efficiencies will generally be qualitative in nature.