DAVIES WARD PHILLIPS & VINEBERG LLP

June 1, 2004

COMMENTS ON DRAFT MERGER ENFORCEMENT GUIDELINES

Davies Ward Phillips & Vineberg LLP is pleased to have the opportunity to comment on the Draft Merger Enforcement Guidelines (the "Draft MEGs"), released by the Competition Bureau (the "Bureau") in March 2004. We strongly support the Bureau's commitment to the stakeholder consultation process as well as its public education program, including guidelines, bulletins and other interpretive aids made widely available to the business community in Canada.

As a general comment, we applaud the Bureau's initiative in reviewing and revising the 1991 Merger Enforcement Guidelines (the "1991 MEGs"). The Draft MEGs take some important steps towards improving upon the 1991 MEGs and clarifying the Bureau's merger review process. In particular, we note that the Draft MEGs are presented in a clear and well-organized manner and contain extensive references to cases and Bureau filings, which are helpful and informative with respect to the Bureau's position. However, in our view, there are certain issues in the Draft MEGs which would benefit from further consideration and elaboration, as outlined below.

PURPOSE

The Purpose section of the MEGs sets the stage for how the MEGs are applied by the Bureau and interpreted by the business community. In our view, it is important that this section articulate a clear vision for the purpose and application of the MEGs. As compared to the Preface to the 1991 MEGs, this paragraph of the Draft MEGs is quite vague and reads like a disclaimer to the application of the MEGs rather than a framework for their application. We recognize that the MEGs are intended to be working guidelines and are not intended to be legally binding upon the Commissioner and her staff. That said, it would be helpful for the Purpose section to include a statement with respect to the purpose and aim of the MEGs. It would also be helpful for the MEGs to state that the Bureau is committed to following the MEGs in its merger review process. It would also be helpful for the Bureau to keep the MEGs updated to reflect any changes in the Bureau's policies and practices.

PART 1 – DEFINITION OF A MERGER

De facto Control

In paragraph 1.4, the Draft MEGs propose to expand the concept of "control" to include *de facto* control. The rationale behind this expansion is unclear and should be explained. Given that the concept of *de facto* control is imprecise, if the Bureau does choose to use this concept in the MEGs, then it should provide additional guidance such as a list of the factors that the Bureau will consider in determining whether *de facto* control exists.

Other Considerations

In footnote 8 to paragraph 1.14, the Bureau cites its own determination in the *Seaspan* case. While citing the Bureau's own determination rather than the Tribunal's ultimate determination provides helpful insight from an enforcement perspective, and should be included in the MEGs, in our view, such statements should be clearly differentiated from decisions of the Tribunal or the courts when cited in support of a particular proposition in the MEGs.

Paragraph 1.16 states that "movement from a minority, yet significant interest to control would likely be found to constitute a merger". While this is probably true, given the Part IX triggers, it would be helpful for the Bureau to clarify that it does not intend to substantively re-visit mergers in the absence of demonstrating that significantly greater rights or influence has been acquired.

PART 2 – ANTI-COMPETITIVE THRESHOLD

Paragraph 2.1 of the Draft MEGs states that a "substantial prevention or lessening of competition results from mergers that are likely to create or enhance the ability of the merged entity, alone or in concert with other firms, to exercise market power". In contrast, the 1991 MEGs state that a "substantial prevention or lessening of competition results only from mergers that are likely to enhance..". In our view, this subtle change could signal that the Bureau will look to other considerations when making a substantial lessening of competition ("SLC") determination. If this signal is intended, then further elaboration on this point should be provided. Otherwise, the Bureau should revert to the language contained in the 1991 MEGs.

In paragraph 2.3 of the Draft MEGs, the Bureau defines market power held by a buyer as "the ability of a single firm or group of firms to profitably depress prices paid to sellers (by reducing the purchase of inputs) to a level that is below the competitive price for a significant period of time". In our view, buyer market power could also be exercised through means other than "reducing the purchase of inputs". We suggest that the Bureau consider removing the phrase "by reducing the purchase of inputs" from this paragraph, or citing that only as an example.

In paragraph 2.4, the Bureau refers to the possibility of evaluating the effect of mergers on non-price dimensions of competition. It may be helpful for the Bureau to provide

some guidance on the types of non-price dimensions that would be considered and how these effects would be evaluated.

PART 3 – MARKET DEFINITION

In the current MEGs, supply side substitution is taken into account for market definition along with demand side substitution. This means that the relevant market may include suppliers of other products, or more distant suppliers of the relevant product, who would respond to a 5% price increase by selling into the hypothetical market in sufficient quantities to make a price increase unprofitable.

The Draft MEGs eliminate supply side responses as a factor in market definition, stating that the Bureau's analysis will focus only on demand responses to changes in price. Supply responses can be a factor in the Bureau's analysis, but only when "identifying the participants in the relevant market or when examining entry or expansion into the relevant market".

In some cases, the threat of supply side substitution has a real disciplining effect on market participants and defining the market only with regard to demand side factors may present a misleading picture of the state of competition.

This issue is important for more than purely theoretical reasons. Given the Bureau's statements in some prior merger cases that post-merger market shares exceeding 45% will presumptively require divestitures (e.g., the bank mergers), and the Bureau's view in the *Superior Propane* case that "mergers to monopoly" are inherently anti-competitive, it is important to ensure that the Bureau's approach to market definition does not result in artificially narrow markets and inflated market shares. Accordingly, the Bureau should leave itself the flexibility to take supply side considerations into account in its market definition analysis where that would better reflect the competitive dynamics in the market.

Paragraph 3.4 states that in "most" cases the Bureau uses a 5% threshold for a "significant" price increase in determining product and geographic markets, i.e. the smallest area and group of products where a seller could impose and sustain a significant and non-transitory increase in price. Although there is value in having a clear 5% standard, we recommend changing "most" to "many" in paragraph 3.4. As well, the Bureau should clarify that the use of 5% is for illustrative purposes, but a higher threshold may be appropriate in some cases.

Paragraph 3.13 of the Draft MEGs states that where evidence of demand elasticities is not available, weight is given to factors that provide indirect evidence of substitutability. In our view, however, such evidence can be important even where evidence of demand elasticities is available, as it can be used to confirm or question demand elasticity data. We suggest that such evidence should be reviewed and considered in all cases where market definition is an issue and that the Draft MEGs be revised to contemplate such consideration.

PART 4 – MARKET SHARE AND CONCENTRATION

As a general comment, we question whether the introduction of HHIs should be viewed as a helpful indication of concentration given Canada's small market economy. However, if the Bureau is committed to introducing the concept of HHIs to the merger review process, then further guidance on the applicable thresholds should be provided. In particular, if HHIs are used, it is important to recognize that Canadian industries are generally more concentrated than in the U.S., such that significantly higher thresholds are warranted.

Paragraph 4.15 of the Draft MEGs states that mergers that give rise to market shares or concentrations that exceed the safe-harbour thresholds are not necessarily anti-competitive. We support this approach, however, this statement is at odds with the Bureau's approach to market shares in the 1998 proposed Bank Mergers where certain market shares were treated as presumptively problematic.[1] Given the high public profile of these merger reviews, some express renunciation of these prior statements, either in MEGs or revised Bank MEGs, would be helpful.

At paragraph 4.20, the Draft MEGs state that, in calculating market shares, the Bureau will take into account not only current sales figures but also anticipated growth expectations of the merging parties. Although we do not disagree with this proposition, the Bureau should make it clear that the use of these growth projections will occur only where there is clear evidence to that effect. In addition, to be consistent, the Bureau should indicate that it will not only assess growth projections, but also loss projections of one or both of the parties.

PART 5 - ANTI-COMPETITIVE EFFECTS

While the 1991 MEGs state that a high post-merger concentration level is a "necessary condition" to a finding of an SLC, this language has been omitted from the Draft MEGs. In our view, this omission may be read to suggest that the Bureau may challenge mergers of low concentration and market share, which renders the safe-harbour thresholds less meaningful. The Bureau should reinsert this language in the Draft MEGs.

The expansion of the discussion regarding coordinated effects is welcomed. That said, it should be made clear in the MEGs that the mere likelihood that the presence of some of

---

[1] The Commissioner's letters to the four banks (Bank of Montreal, the Royal Bank, CIBC and TD Bank) regarding the 1998 bank merger proposals stated that a post-merger market share of 45% or greater in any geographic area would lead the Bureau to conclude that the proposed transaction "will result in a substantial lessening of competition and would require a remedy". In addition, the Commissioner stated that where the combined market shares of the merging parties is between 35% to 45%, the transaction "may" result in a substantial lessening of competition. The Commissioner took a similar approach in the grocery mergers, see for example, Backgrounders for Loblaw Companies Limited acquisitions of Provigo Inc. and certain assets of The Oshawa Group Limited.

the factors could be increased as a result of the merger will not be considered sufficient to challenge a merger and that some substantive evidence will be required.[2]

PART 6 - ENTRY

Timeliness

In paragraph 6.3, the Draft MEGs state that "the beneficial effects of entry upon prices in this market must occur within a two-year period". Footnote 74 refers to *Hillsdown* and states that, in some cases, poised entry may be sufficient to discipline market power. Reading these two statements together, it follows that a poised entrant need never enter to be able to sufficiently discipline market power. Although it may be that this result is already contemplated by the MEGs, the Bureau should consider clarifying paragraph 6.3 to read that the "beneficial effects of entry or poised or anticipated entry upon prices in this market must occur within a two year period".

Similarly, an entrant may enter outside of the two year period and yet still have a disciplining effect on prices within these two years. The U.S. MEGs[3] note that where the relevant product is a durable good, consumers may delay purchasing the durable good in anticipation of this entry. Although this entry is technically outside of the two year period, this entry will nevertheless be considered timely under the U.S. MEGs so long as the anticipation of this entry has a disciplining effect on prices within the two year period. Although the approach of the U.S. MEGs appears to be consistent with paragraph 6.3 of the Draft MEGs, the Bureau should consider adding an additional statement to this effect in the MEGs text or footnotes.

Sufficiency

Paragraph 6.7 of the Draft MEGs states that "if a competitor enters a market on a scale that is below the minimum efficient scale, accepting the cost disadvantage associated with a sub-optimal level of production, the entry is not considered sufficient to eliminate a material price increase". This example raises a number of questions. It is not clear what will be considered a "minimum efficient scale" or "sub-optimal level of production" – is minimum efficient scale intended to be a proxy for entry that is not profitable? What does "sub-optimal level of production" mean? Further clarification would be helpful.

An entrant could choose to enter initially below what could be considered a "minimum efficient scale" or at a "sub-optimal level of production" with the hope of attracting more customers and eventually boosting its production levels. Such entry, although arguably not at an optimal level of production, could still be sufficient to discipline prices. Furthermore, in a

---

[2] See, for example, the recent decision of the European Court of First Instance in the *Airtours/First Choice*, which illustrates the challenges in the application of interdependence theories.

[3] *Horizontal Merger Guidelines*, U.S. Department of Justice and the Federal Trade Commission, Revised April 18, 1997.

small-market economy such as Canada, there are likely many firms that would be considered to be operating at a sub-optimal level of production that are still effective competitors.

The Bureau should consider amending the above-quoted sentence to read "the entry may not be considered sufficient" as opposed to categorically stating that such entry will not be sufficient. Alternatively, if this statement truly reflects the Bureau's practice with respect to the analysis of sufficiency of entry, then more guidance should be provided with respect to what is meant by sub-optimal and minimum efficient scale. Are there any examples from past merger cases that the Bureau can use to illustrate these concepts?

Types of Barriers to Entry

At footnote 79 to paragraph 6.8, the Draft MEGs state that "while commencing a business may in some cases be easy, new entrants may find it difficult to survive for a variety of reasons". It is not clear what point the Bureau is making here. Should this statement be read to suggest that the Bureau will be evaluating the longer-term viability of entrants when considering entry? If so, then the Bureau may consider expanding on this statement.

Sunk Costs

At paragraph 6.10, the Draft MEGs state that "sunk costs directly affect the likelihood of entry and, where present, constitute a significant barrier to entry". The presence of any measure of sunk costs cannot be seen to constitute a significant barrier to entry. Every business will have some element of sunk costs associated with its start-up/entry – especially when sunk costs are defined so broadly as to include such intangible items as the time invested in establishing a reputation.

In our view, this statement should be tempered with some qualification – e.g. if the sunk costs involved are substantial, these substantial costs will directly affect the likelihood of entry and, where present, constitute a significant barrier to entry.

At paragraph 6.14, the Draft MEGs state that "long-term exclusive contracts with automatic renewals, rights of first refusal and termination fees constitute a barrier to entry". In our view, not all such contracts will necessarily constitute a significant barrier to entry. That assessment will depend on a number of factors including the precise terms of the contracts and the proportion of customers subject to such contracts. Thus, the Bureau should consider modifying this statement to read that such long-term contracts may constitute a barrier to entry.

PART 7 – COUNTERVAILING POWER

In paragraph 7.3, the Draft MEGs seem to suggest that there may be situations where small buyers in a market are not able to exercise countervailing power whereas large buyers are. In this scenario, the countervailing power exercised may not be sufficient to prevent a price increase. However, if the Bureau has defined the relevant market to consist of customers against whom sellers can price discriminate (as the Draft MEGs state they may in section 3.9), then this situation would never arise. In addition, the Draft MEGs do not appear to consider the

possibility of arbitrage between the two different groups of buyers. If arbitrage were to occur between the two different types of buyers, the buyers would still be able to exercise countervailing power which could be sufficient to prevent a price increase. The Bureau may consider deleting this paragraph and instead refer to some examples of countervailing power. Alternatively, the Bureau could consider qualifying its statements in this paragraph with a reference to the possibility of arbitrage.

PART 8 – THE EFFICIENCY EXCEPTION

The state of this section of the Draft MEGs is largely dependent upon whether Bill C-249 is enacted as it is currently proposed. If Bill C-249 is enacted, then section 8 of the Draft MEGs will need to be entirely re-drafted. Bill C-249 aside, we have some minor comments on section 8 of the Draft MEGs as it is currently drafted.

In paragraph 8.9, the Draft MEGs state that the parties should provide objective verification of the efficiencies to be achieved by providing "documentation prepared in the ordinary course of business, wherever possible". It would be helpful for the Bureau to consider providing some examples of the types of documents which it would consider to be objective verification, noting also that detailed information on the extent of efficiencies may not be available until a due diligence process is undertaken in the context of pursuing a transaction. We are hopeful that the Bureau would take a flexible approach to and consider documents specifically prepared to describe and demonstrate the likely efficiencies even if they are prepared in the context of analyzing the proposed merger. As such, we would suggest that the Bureau eliminate the phrase "prepared in the ordinary course of business" in this paragraph.

With respect to the section on types of efficiencies (8.11 - 8.15), it should be made absolutely clear that all merger-specific efficiencies are counted, irrespective of their "type". The listing of types of efficiencies may be helpful as a check-list of savings not to forget; however, they should not in any way limit the scope of the savings that are claimed.

Paragraph 8.26 states that one approach to taking wealth transfer into account is the "socially adverse effects approach". The Draft MEGs go on to state that the Bureau "may also consider other approaches, depending on the circumstances of a particular case". In our view, the Draft MEGs should describe the other approaches and explain when and if the different approaches would be preferred. It would also be helpful if the Bureau would explain how these approaches to wealth transfer would be applied.

The discussion of the efficiency trade-off is framed from the perspective of single firm market power. The Draft MEGs should also acknowledge that efficiencies can lead to a lower cost structure for the merged entity that reduces incentives to coordinate pricing.

Finally, we recommend deleting the last sentence of footnote 97, as it is not clear what it means and it could lead to unnecessary confusion.

PART 9 – FAILING FIRM

In contrast to the 1991 MEGs, section 9 of the Draft MEGs does not reflect the fact that a failing firm analysis might be appropriate in situations where a firm wishes to exit a market for reasons other than complete failure. In our view, this consideration is important and should be addressed in this section.

Similarly, this section leaves out the reference contained in the 1991 MEGs to the effect that "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)". Again, if this statement is still indicative of the Bureau's approach to section 93(b), then the Bureau should consider including it.

CONCLUSION

We are hopeful that our comments have been of assistance to the Bureau in its revision of the Draft MEGs. Should any of our comments require further elaboration or discussion, please do not hesitate to contact any member of our Competition & International Trade Law group. We would be happy to meet with you to discuss our submission in greater detail.