



Competition Bureau  
Canada

Bureau de la concurrence  
Canada

# **MERGER ENFORCEMENT GUIDELINES**

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Canada<sup>!</sup>

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## FOREWORD

The Competition Bureau [hereinafter “the Bureau”] is issuing these guidelines to provide general guidance on its analytical approach to merger review. They describe, to the extent possible, how the Bureau will conduct its analysis of merger transactions. Given that merger law is applicable to a wide variety of factual circumstances, these guidelines cannot be applied rigidly. As such, this document sets forth the general approach taken to merger review, and is not a binding statement of how the analysis will be carried out in a particular situation. The specific facts of a case, as well as the nature of the information and data available, will determine how the Bureau assesses a proposed transaction and may sometimes require different methodologies.

Merging parties are encouraged to contact the Bureau early to discuss proposed transactions. Merging parties should obtain appropriate legal advice when contemplating a possible transaction. The final interpretation of the *Competition Act* rests with the Competition Tribunal [hereinafter “the Tribunal”] and the courts.

To the extent of any inconsistency, these guidelines supersede previous merger enforcement guidelines and statements made by the Commissioner of Competition or other officials of the Bureau. They are subject to future amendments to the law.

## PART 1 – DEFINITION OF MERGER

- 1.1 Section 91 of the *Competition Act* defines a “merger” as “...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, buyer or other person.”<sup>1</sup>
- 1.2 The definition of “merger” includes 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. While these guidelines focus primarily on horizontal mergers, section 91 also encompasses vertical and conglomerate transactions.

### Control

- 1.3 With respect to corporations, “control” is defined in section 2(4) of the Act to mean *de jure* control, that is, a direct or indirect holding of more than 50 per cent of the votes that may be cast to elect directors of the corporation, *and* which are sufficient to elect a majority of such directors. Acquisition of *de jure* control constitutes a merger. The Bureau applies a similar analysis in assessing whether a transaction results in the establishment or acquisition of control over an unincorporated business. Specifically, the Bureau considers the nature of the legal and beneficial

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<sup>1</sup>R.S.C. 1985, c. C-34 [hereinafter, the “Act”].

ownership of the business, voting rights of persons affiliated in the business and the rights and obligations associated with the division of profits and expenses associated with the business.

## Significant Interest

- 1.4 The Act provides no guidance on the meaning of the words “significant interest”, leaving them to be construed in the context of the Act.
- 1.5 In determining whether an interest is significant, the Bureau considers both the quantitative nature and qualitative impact of the acquisition or establishment of the interest. Given that the Act is concerned with the competitive market behaviour of firms, a “significant interest” in the whole or a part of a business is held qualitatively when the person acquiring or establishing the interest obtains the ability to materially influence the economic behaviour of the business (including decisions relating to pricing, purchasing, distribution, marketing, investment, financing or the licensing of intellectual property rights).

## Notifiable Transactions

- 1.6 In the absence of any evidence to the contrary, the proposed transactions described in section 110 of the Act constitute the acquisition or establishment of a significant interest in the whole or a part of a business. However, transactions, which fall outside of those described in section 110, may nevertheless constitute the acquisition or establishment of a significant interest as stated above, if the person(s) acquiring the interest are able to materially influence the economic behaviour of the business.<sup>2</sup>

## Acquisition of Voting Equity Interests

- 1.7 The Bureau finds that a significant interest in a corporation exists when one or more persons, directly or indirectly, hold enough voting shares:
  - to obtain a sufficient level of representation on the board of directors of the corporation to materially influence that board; or
  - to block special or ordinary resolutions of the corporation.
- 1.8 In the absence of other relationships, a direct or indirect ownership of less than 10 per cent of the voting interests in a business does not generally constitute ownership of a “significant interest”.<sup>3</sup> While inferences about situations that result in a direct or

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<sup>2</sup>See for example *Nova Corporation of Alberta / Polysar Energy & Chemical Corporation, Canada, Annual Report, Director of Investigation and Research, Competition Act*, March 31, 1989, at p.11. See also *Miller Brewing Company / Molson Companies and Foster's Brewing Group, Canada, Annual Report, Director of Investigation and Research, Competition Act*, March 31, 1993, at p.8.

<sup>3</sup>This position is consistent with other Canadian statutes. See for example *Bank Act*, S.C. 1991, c.46, s.8. (See also *Cooperative Credit Associations Act*, S.C. 1991, c.48, s.9; *Insurance Companies Act*, S.C. 1991, c.47,

indirect holding of between 10 per cent and 50 per cent are more difficult to make, a greater level of voting interest is ordinarily required to materially influence a private company than a widely-held public company. The merger notification requirements in Part IX of the Act are triggered at 35 per cent for private corporations and 20 per cent for public corporations.<sup>4</sup>

### **Non-voting & Convertible Securities**

1.9 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 exercise.<sup>5</sup> To determine whether the purchase of convertible securities constitutes a significant interest, the Bureau examines the nature of and circumstances in which the rights attached to these securities may be exercised.

### **Asset Acquisitions**

1.10 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. The Bureau treats the acquisition of any or part of these essential assets to be the acquisition or establishment of a significant interest in that business. Further, acquiring part of the assets of a business that is capable of being used to carry on a separate business is also considered as the acquisition or establishment of a significant interest in the business.

### **Increasing an “Interest” in a Business**

1.11 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 materially 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. Notably, the merger notification requirements under Part IX that pertain to the acquisition of voting shares of corporations are also triggered when holdings are increased above 50 per cent.

### **Other Considerations**

1.12 Depending on the specific terms of the arrangements, a significant interest can be

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s.8; *Trust and Loan Companies Act*, S.C. 1991, c.45, s.8).

<sup>4</sup>The notification provisions, applying to high transaction-value mergers, are discussed in the Bureau’s *Notifiable Transactions and Advance Ruling Certificates under the Competition Act: Procedure Guide* and the *Interpretation Guidelines for Notifiable Transactions under Part IX of the Competition Act*.

<sup>5</sup>However, the notification provisions will only be triggered upon conversion or exercise of such rights, provided that the thresholds in Part IX of the Act are exceeded.

acquired or established pursuant to shareholder agreements, management contracts and other contractual arrangements involving corporations, partnerships, joint ventures, combinations and other entities.<sup>6</sup> In addition, loan, supply and distribution arrangements that are not ordinary-course transactions and that confer the ability to materially influence management decisions of another business (that is, financing arrangements and terms of default relating to such arrangements; long-term contractual arrangements or pre-existing long-term business relationships and the economic significance of these relationships) may constitute a “merger” within the meaning of section 91.<sup>7</sup>

- 1.13 In determining whether the acquisition or establishment of a significant interest constitutes a merger, the Bureau examines the relationship between the parties prior to the transaction; the likely relationship between the parties subsequent to the transaction; the access that an acquiring party obtains to confidential business information of the target business; and any evidence of intentions to affect the behaviour of the target business or to change the behaviour of the acquiring party.

## **PART 2 – THE ANTI-COMPETITIVE THRESHOLD**

### **Overview**

- 2.1 As set out in section 92(1) of the Act, the Tribunal may make an order when it finds that a merger “prevents or lessens, or is likely to prevent or lessen, competition substantially.” A substantial prevention or lessening of competition results only from mergers that are likely to create, maintain or enhance the ability of the merged entity, unilaterally or in coordination with other firms, to exercise market power.
- 2.2 In general, when evaluating the competitive effects of a merger, the primary concerns are price and output. The Bureau also assesses the effects of the merger on other dimensions of competition such as quality, product choice, service, innovation, and advertising especially in markets where there is a significant level of non-price competition.<sup>8</sup> To simplify the discussion, unless otherwise indicated, the

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<sup>6</sup>See for example *Shell Canada Products Ltd. / Pay Less Gas Co. (1972) Ltd.*, Canada, *Annual Report, Director of Investigation and Research, Competition Act*, March 31, 1991 at p.8, where the Bureau determined that contractual arrangements collectively resulted in obligations of Pay Less to Shell that would give Shell a considerable measure of control over the business operations of Pay Less and therefore constituted the establishment of significant interest.

<sup>7</sup>See *D.I.R. v. Dennis Washington et al.*, Second Amended Notice of Application, Statement of Grounds and Material Facts (December 17, 1996), CT-1996/001 (Comp. Trib.), hereinafter “*Seaspan Statement of Grounds*”) at ¶ 8. The Bureau’s determination that a significant interest was acquired or established was based on several factors including: the indirect acquisition of voting equity interest; the acquisition of equity warrants; board representation; the purchase of senior subordinated debentures; and the terms of a Joint Investment Agreement between Dennis Washington and the largest shareholder of Seaspan.

<sup>8</sup>As noted by the Tribunal in its first decision in *Canada (Commissioner of Competition) v. Superior Propane Inc.* (August 30, 2000), CT-1998/002 (Comp. Trib.) (hereinafter “*Superior Propane*”), at ¶ 504, a decline in service levels may reduce real output of the industry.

term *price* in these guidelines refers to all aspects of firms' actions that affect the interest of buyers. References to an increase in price include an increase in the nominal price and a reduction in quality, product choice, service, innovation or other dimensions of competition that buyers value.<sup>9</sup>

- 2.3 These guidelines describe the analytical framework for assessing market power from the perspective of a seller of a product or service [hereinafter "product" as defined in section 2(1) of the Act]. Market power of sellers means the ability of a single firm or group of firms to profitably maintain prices above the competitive level for a significant period of time.
- 2.4 The analytical framework is equally applicable when assessing market power by buyers of a product.<sup>10</sup> Market power of buyers means the ability of a single firm or group of firms to profitably depress prices paid to sellers (for example, by reducing the purchase of inputs) to a level that is below the competitive price for a significant period of time.
- 2.5 The analysis of competitive effects falls under two broad theories of competitive harm. Competitive harm may result when market power is exercised unilaterally or through coordinated behaviour.
- 2.6 A unilateral exercise of market power can arise when a merger enables the merged entity to profitably sustain higher prices than would otherwise exist in the absence of the merger without relying on an accommodating response from its competitors.
- 2.7 A coordinated exercise of market power can arise when a merger reduces the competitive vigour in a market by, for example, removing a particularly aggressive competitor or enabling the merged entity to coordinate its behaviour with that of its competitors. In this case, higher prices post-merger are profitable and sustainable only because other competitors in the market have accommodating responses.<sup>11</sup>
- 2.8 Where a merger is not likely to have market power effects, it generally cannot be demonstrated that competition is likely to be prevented or lessened substantially as a result of the merger, even though the merger might have implications for other industrial policy objectives that are beyond the scope of the Act.

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<sup>9</sup>The Bureau's analysis is not confined to pricing measures and will consider any impact on quality, product choice, service, etc., to the degree that competition is substantially lessened or prevented.

<sup>10</sup>See for example *Canada (Director of Investigation and Research) v. Hillsdown Holdings (Canada) Ltd.* (1992), 41 C.P.R. (3d) 289 (Comp. Trib.) (hereinafter "*Hillsdown*") at 299 where the Tribunal stated that it could analyse the competitive effects of the merger from the perspective of a monopsonist (a buyer of the rendering material) or a monopolist (a seller of rendering services). It concluded that no significant difference resulted from the two characterizations.

<sup>11</sup>Previously, the Bureau referred to a coordinated exercise of market power as "interdependence". This change in terminology is not a change in the Bureau's approach to analyzing market power. Further explanation of the anti-competitive effects that may arise from a coordinated exercise of market power is found in Part 5 of these guidelines.



## Lessening of Competition

2.9 A merger can lessen competition when the merged entity, unilaterally or in coordination with other firms, is able to sustain higher prices than would exist in the absence of the merger by diminishing existing competition. This typically occurs with horizontal mergers where there is direct or existing overlap between the operations of the merging parties. This can also occur with vertical mergers such as those that increase barriers to entry or facilitate coordinated behaviour.

## Prevention of Competition

2.10 Competition can be prevented when a merger enables the merged entity, unilaterally or in coordination with other firms, to sustain higher prices than would exist in the absence of the merger by hindering the development of future competition. This typically occurs where there is little or no direct overlap between the merging parties' existing business(es) and direct competition between the merging parties' business(es) was expected to increase in the absence of the merger.

2.11 In these circumstances, the Bureau examines the type, scope and timing of the potential entry or expansion by either one of the merging parties. An assessment is made of whether entry or expansion by the merging firms is likely, even though effective entry or expansion by rival firms is not likely to occur. Evidence of pre-existing market power held by at least one of the merging parties is also relevant if prices would decrease towards the competitive level in the absence of the merger. The Bureau may examine a merger as a “prevent” case when either the acquirer, the acquiree or a potential competitor has entry or expansion plans that are forestalled because of the merger.

2.12 The following are examples of mergers that may result in the prevention of competition:

- the acquisition of an increasingly vigorous competitor or a potential entrant;
- an acquisition, by the market leader, preempting the acquisition by another competitor;
- the acquisition of an existing business by a firm that would likely have entered the market in the absence of the merger;<sup>12</sup>
- an acquisition that prevents expansion into new geographic markets;<sup>13</sup>
- an acquisition that prevents pro-competitive effects of new capacity;<sup>14</sup> and

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<sup>12</sup>See for example, *Seaspan Statement of Grounds supra* note 7 at ¶ 130, where the Commissioner concluded that “any influence Norsk had or would in the future have on Seaspan's ability to exercise market power in the B.C. barging market has been foreclosed by the Norsk Merger.”

<sup>13</sup>See for example *Superior Propane, supra* note 8 at ¶ 246 where the Tribunal found that the merger would likely result in a substantial prevention of competition “in light of the ICG's plans to vigorously expand its activities in Atlantic Canada.”

<sup>14</sup>See for example *Canada (Commissioner of Competition) v. Canadian Waste Services Holdings Inc.* (2001), 11 C.P.R. (4th) 425 (Comp. Trib.) (hereinafter “*Canadian Waste*”) at ¶ 204 where the Tribunal concluded that “by increasing CWS's expected significant share of excess capacity..., the acquisition of the Ridge (landfill)

- an acquisition that prevents or limits the introduction of new products.<sup>15</sup>

## Substantiality

2.13 When the Bureau assesses whether competition is likely to be substantially prevented or lessened, it evaluates whether the merger is likely to provide the merged entity (unilaterally or in coordination with others) with an ability to materially influence price.<sup>16</sup> In doing so, it considers the likely magnitude, scope and duration of any price increase that is anticipated to arise as a result of the merger. Generally speaking, the prevention or lessening of competition is considered to be “substantial” where:

- the price of the relevant product(s) would likely be materially greater in a substantial part of the relevant market<sup>17</sup> than it would be in the absence of the merger [hereinafter “material price increase”],<sup>18</sup>; and
- the material price increase is not likely to be eliminated by existing or new competitors within two years.<sup>19</sup>

2.14 The Bureau does not apply a numerical threshold for the material price increase.<sup>20</sup> Instead, its conclusions about whether a lessening or prevention of competition is

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enhances CWS's market power over such capacity and prevents competition substantially.”

<sup>15</sup>See for example News Release – “Competition Bureau Resolves Concerns in Pfizer’s Acquisition of Pharmacia”, April 11, 2003 (hereinafter “*Pfizer/Pharmacia*”) where the Bureau concluded that competition would be substantially prevented by the merger of two companies whose products under development (that is, in the “pipeline”) would compete in the same relevant product markets once they were introduced. See also *Commissioner of Competition v. Bayer AG et al.*, Statement of Agreed Facts (May 31, 2002), CT-2002/003 (Comp. Trib.), (hereinafter “*Bayer/Aventis Statement of Agreed Facts*”) at ¶ 116 where the Commissioner concluded that “in the absence of the Acquisition, the market would likely enjoy significantly greater potential competition from Bayer’s newly-introduced product”.

<sup>16</sup>As discussed above at ¶ 2.2, “price” is shorthand for other dimensions of competition. Also, as noted in *Superior Propane*, *supra* note 8 at ¶ 258, there is no requirement under the Act to find that the merged entity will likely raise the price (or reduce quality, service or product choice) but rather that the merged entity has the *ability* to do so.

<sup>17</sup>The material price increase need not occur throughout the entire relevant market. Competition may be substantially lessened or prevented even if, for instance, only some buyers will face higher prices.

<sup>18</sup>In prevent cases, a determination that prices will likely be materially higher with the merger generally means that price levels are expected to fall (or quality, etc. is expected to increase) in the absence of the merger.

<sup>19</sup>A two year period is typically used as a rule of thumb, recognizing that some time is required for potential competitors to become aware of a material price increase, to develop products and marketing plans, to build facilities or make adjustments to existing facilities, and to achieve a level of sales sufficient to prevent or eliminate a material price increase.

<sup>20</sup>A material price increase is distinct from (and may be less than) the “significant and non-transitory price increase” that is used to define relevant markets as described in Part 3. What constitutes a “materially greater” price varies from industry to industry. In the present context, materiality includes not only the magnitude and scope but also the sustainability of the price increase.

substantial are based on an assessment of market-specific factors listed in section 93 that could have a constraining influence on price following the merger.<sup>21</sup> These factors are assessed over a two-year period commencing from when market power could likely be exercised, not necessarily when the merger review is taking place.<sup>22</sup>

## PART 3 – MARKET DEFINITION

### Overview

- 3.1 Typically, the first stage in the Bureau's review of a merger involves defining the relevant market(s) in which the merging parties operate.<sup>23</sup> The overall objective of market definition in merger analysis is to identify a set of buyers that could potentially face increased market power due to the merger. Relevant markets are assessed from two perspectives: the product dimension and the geographic dimension.
- 3.2 As a general principle, it cannot be assumed that merging parties operate in the same relevant market(s), even where there appears to be some overlap between their products and the geographic areas in which they conduct business. In addition, the relevant market(s) being analysed for competitive effects may not necessarily correspond to the product categories or service areas established by the managers of the merging firms or their rivals for operational purposes.<sup>24</sup>
- 3.3 Market definition is based on substitutability and focuses on demand responses to changes in relative prices. The ability of a firm or group of firms to raise price without losing sufficient sales to make the price increase unprofitable ultimately depends on buyers' willingness to pay the higher price.<sup>25</sup> Supply responses are also important when assessing the potential for the exercise of market power, but are examined later in the analysis, either when identifying the participants in the relevant market or when examining entry or expansion into the relevant market.
- 3.4 Conceptually, a relevant market is defined as the smallest group of products,<sup>26</sup> including at least one product of the merging parties, and the smallest geographic

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<sup>21</sup>See for example *Superior Propane*, *supra* note 8 at ¶¶ 311-312. See also *Canadian Waste*, *supra* note 14 at ¶¶ 204 and ¶¶ 224.

<sup>22</sup>The Bureau may challenge a merger even when the anti-competitive effects that are foreseeable at the time of the merger may not occur until more than two years after the merger is substantially completed.

<sup>23</sup>In some circumstances, particularly where empirical methods are used, the Bureau may define relevant markets concurrently with analyzing competitive effects.

<sup>24</sup>See *Superior Propane*, *supra* note 8 at ¶¶ 85, 101 and *Canadian Waste*, *supra* note 14 at ¶¶ 72.

<sup>25</sup>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) of the Act. When products within a relevant market are differentiated, some may be closer substitutes to each other than others.

<sup>26</sup>A market may consist of a single homogeneous product or a group of differentiated products.

area in which a sole profit-maximizing seller (a "hypothetical monopolist") would impose and sustain a significant and non-transitory price increase above levels that would likely exist in the absence of the merger. In most cases, the Bureau considers a five per cent price increase to be significant and a one-year period to be non-transitory.<sup>27</sup>

- 3.5 The market definition analysis begins by postulating a candidate market for each product of the merging parties. For each candidate market, the analysis proceeds by determining whether a hypothetical monopolist controlling the group of products in that candidate market would be able to impose a five per cent price increase assuming the terms of sale of all other products remained constant. 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 postulated candidate market is not the relevant market, and the next-best substitute is added to the candidate market.<sup>28</sup> The analysis then repeats by determining whether a hypothetical monopolist controlling the set of products in the expanded candidate market would be able to profitably impose a five per cent price increase. This process continues until the point at which the hypothetical monopolist would impose and sustain the price increase for at least one product of the merging parties in the candidate market. The smallest set of products in which the price increase can be sustained is defined as the relevant product market.
- 3.6 The same general approach applies to assessing the geographic scope of the market. In this case, an initial candidate market is proposed for each location where the merging parties produce or sell the relevant products. As above, if buyers are likely to switch their purchases to sellers in more distant locations in sufficient quantities to render a five per cent price increase by a hypothetical monopolist unprofitable, the location that is the next-best substitute is added to the candidate market. This process continues until the smallest set of areas over which a hypothetical monopolist would impose and sustain the price increase is identified.
- 3.7 The base price used to postulate a price increase is generally the prevailing price in the relevant market. The Bureau may not use the prevailing price if it is likely that market conditions (absent the merger) would result in a lower or higher price in the future.<sup>29</sup>
- 3.8 In general, the base price used to postulate a price increase is whatever is ordinarily considered to be the price of the product in the sector of the industry (for example, manufacturing, wholesale, retail) being examined.

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<sup>27</sup> Market characteristics may sometimes necessitate using a different price increase or time period.

<sup>28</sup> The next-best substitute refers to the product that would represent the greatest diversion in demand by buyers in response to the postulated price increase assuming that it is available in unlimited quantities at constant prices.

<sup>29</sup> As noted in *Canadian Waste*, *supra* note 14 at ¶¶ 90-94, where the evidence suggests that a change in the future price (absent the merger) can be predicted with confidence, it is appropriate to delineate markets based on the likely future price, even if the future level of that price cannot be predicted precisely.

- 3.9 In some circumstances, sellers may identify and charge different prices to targeted sets of buyers. Sellers may price discriminate when certain buyers cannot effectively switch to other products or geographic locations and cannot engage in arbitrage with other buyers by taking advantage of price differences. When price discrimination is feasible, it may be appropriate to define relevant markets with reference to the characteristics of the classes of buyers or to the particular locations of the targeted buyers.<sup>30</sup>
- 3.10 Factors considered in the analysis of product and geographic dimensions of market definition are addressed below.

## Product Market Definition

- 3.11 For the purpose of product market definition, what matters is not the identity of sellers, but the characteristics of the products and buyers' ability or willingness to switch from one product to another in sufficient quantity in response to changes in relative prices.<sup>31</sup> A relevant product market consists of a given product of the merging parties and close substitutes for it.
- 3.12 When detailed data on the prices and quantities of the relevant products and their close substitutes are available, statistical measures may be used to define relevant product markets.<sup>32</sup> Demand elasticities indicate how buyers change their consumption of a product in response to changes in the product's price (own-price elasticity) or in response to changes in the price of another identified product (cross-price elasticity). While cross-price elasticities do not in themselves directly measure the ability of a firm to raise price, they are particularly useful when determining whether differentiated products are close substitutes for one another and whether such products are part of the same relevant market.<sup>33</sup>
- 3.13 Whether or not reliable statistical evidence on demand elasticities is available, consideration is given to factors that provide indirect evidence of substitutability, including evidence from market participants and the functional indicators highlighted below.
- 3.14 The views, strategies and behaviour of buyers often provide a reliable indication of whether buyers would likely switch to other products in response to a five per cent price increase. For example, the Bureau examines what buyers have done in the past and what they are likely to do in the future as options become available, for instance, through advances in technology. Additional information from industry surveys and industry participants, such as competitors and manufacturers of the

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<sup>30</sup>See for example *Canadian Waste*, *supra* note 14 at ¶¶ 78 - 80 and *Superior Propane*, *supra* note 8 at ¶¶ 81.

<sup>31</sup>As noted in *Superior Propane*, *supra* note 8 at ¶ 49, in this context, switching refers to "economic substitutability" defined as a change in consumption patterns in response to a price change, holding all other factors constant.

<sup>32</sup>See for example *Superior Propane*, *supra* note 8 at ¶¶ 58 and ¶ 63.

<sup>33</sup>A more detailed discussion on differentiated products is contained in Appendix I.

relevant product, is also taken into account. This information advances the analysis by providing details on historical developments and likely future developments in the industry (including the past behaviour of the merging parties and their rivals) relative to other products that are alleged to provide a significant constraining influence. Documents prepared by the merging parties in the ordinary course of business are also very useful in this regard.

- 3.15 Various functional indicators help to determine what products are considered close substitutes, including end use, physical and technical characteristics, price relationships and relative price levels, as well as the switching costs incurred by buyers as discussed below.
- 3.16 Products purchased for similar end uses may not be close substitutes from the perspective of buyers. Therefore, functional interchangeability is not sufficient to warrant inclusion of two products in the same relevant market.<sup>34</sup> In general, if buyers place a high value on the actual or the perceived unique physical or technical characteristics of a product (including product warranties, post-sales service, and order turn-around time), it may be necessary to define distinct relevant markets based on such characteristics.
- 3.17 Buyer switching costs may discourage a sufficient number of buyers from switching to products that are functionally interchangeable, thereby allowing a hypothetical monopolist to raise price by five per cent. Products are not included in the same relevant market when costs that must be incurred by buyers are sufficient to render switching unlikely in response to a five per cent price increase. Examples include costs for buyers to retool, re-package, adapt marketing, breach a supply contract, learn new procedures, or convert essential equipment.<sup>35</sup> Other costs include the expenses (and risk) that must be incurred if a product fails to satisfy expectations, which may lead to damaging a buyer's reputation as a reseller, or requiring the shutdown of an entire production line.
- 3.18 A relevant market may consist of a grouping of diverse products that are not themselves close substitutes for each other. This occurs where a sole seller would be able to sustain a profitable increase in the price of the grouping of products because a sufficient number of buyers will not respond to the price increase by purchasing the various components separately from different sellers. This reaction may occur when there are significant transaction costs associated with using a number of sellers, including physical transportation costs and the time taken to negotiate with various sellers. In these circumstances, the Bureau examines buyers' propensity to purchase a number of products from a single seller and the extent to which buyers have broken up their purchases of a grouping of products in response

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<sup>34</sup>See *Canada (Director of Investigation and Research, Competition Act) v. Southam Inc.* (1997), 1 S.C.R. 748, reversing (1995), 127 D.L.R. (4<sup>th</sup>) 263 (F.C.A.).

<sup>35</sup>See, for example, *Superior Propane*, *supra* note 8 at ¶¶ 30-31, 49 and 54.

to relative price changes.

## **Geographic Market Definition**

- 3.19 For the purpose of geographic market definition, what matters is not the identity of the sellers, but buyers' ability or willingness to switch their purchases in sufficient quantity from one location to another in response to changes in relative prices. A relevant geographic market consists of all supply points that are regarded as close substitutes by buyers.<sup>36</sup>
- 3.20 When defining the boundaries of geographic markets, the Bureau generally relies on indirect evidence of substitutability including evidence from market participants and the functional indicators described below.
- 3.21 The views, strategies and behaviour of buyers in a given geographic area often provide a reliable indication of whether buyers would likely switch their purchases to sellers located in other geographic areas in the event of a five per cent price increase. For example, the Bureau examines what buyers have done in the past and what they are likely to do in the future as options become available, for instance, through advances in technology. Industry surveys and the views, strategies and behaviour of industry participants also inform the analysis by providing information on how buyers of a relevant product in one geographic area respond or have responded to changes in the price, packaging or servicing of the relevant product in another geographic area. The extent to which distant sellers are taken into account in business plans, marketing strategies and other documentation of the merging parties and other sellers are also useful indicators for geographic market definition.
- 3.22 Various functional indicators can assist in determining whether geographic areas are considered to be close substitutes, including particular characteristics of the product, switching costs, transportation costs, price relationships and relative price levels, shipment patterns, and conditions regarding foreign competition.
- 3.23 Several price and non-price factors could affect a buyer's ability or willingness to consider distant options. Non-price factors include the fragility or perishability of the relevant product, convenience, frequency of delivery, and the reliability of service or delivery.
- 3.24 As with product market definition, high switching costs incurred by buyers may also discourage substitution between geographic areas. In addition, transportation costs play a central role in defining the geographic scope of relevant markets because they directly affect price. For example, if the price of a product in a distant area plus the cost of transporting that same product to a candidate geographic market is found to exceed the price in the candidate market including a five per cent price increase,

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<sup>36</sup> This presumes that the market is not defined on the basis of price discrimination as described in ¶ 3.9 above. When price discrimination is present (and buyers and third parties are unable to arbitrage between low and high price areas), geographic markets are defined around the location of each targeted group of buyers.

the products of sellers located in the distant area will not generally be included in the relevant market.<sup>37</sup>

- 3.25 Evidence that prices in a distant area have historically either exceeded or have been lower than prices in the candidate geographic market by more than transportation costs may indicate that the two areas are in separate relevant markets, for reasons that go beyond transportation costs.<sup>38</sup> However, before reaching this conclusion, the Bureau determines whether a five per cent price increase in the candidate geographic market may change the pricing differential to the point where distant sellers may be able to constrain such an increase.
- 3.26 Significant shipments of the relevant product from a more distant area into an area in relation to which a price increase is being postulated may suggest that the distant area is in the geographic market. However, pre-merger shipment patterns do not, by themselves, establish the constraining effect of distant sellers and may be insufficient to justify broadening the geographic market. Further analysis is necessary to determine whether shipments from the distant area would result in making the five per cent price increase unprofitable.

### **Foreign Competition**

- 3.27 Buyers' willingness or ability to turn to foreign sellers may be affected by buyer tastes, preferences, and border-related considerations. Buyers may be less willing or able to switch to foreign substitutes when faced with exchange rate risk, industry imposed standards,<sup>39</sup> or initiatives to "buy local" due to difficulties or uncertainties when crossing the border. Conversely, buyers may be more willing to turn to foreign substitutes when they have a high level of information about foreign products and how to source them, when foreign sellers or their products have already been placed on approved sourcing lists, or when technology licensing agreements, strategic alliances or other affiliations exist between domestic buyers and foreign firms.
- 3.28 Where it is clear that the sales area of the merging parties and that of foreign sellers belong in the relevant market (because sufficient buyers would be willing to respond to a five per cent price increase by turning to these sellers), the boundaries of the market are expanded beyond Canada to include the locations of foreign sellers.<sup>40</sup>

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<sup>37</sup> However, it is recognized that distant firms that have excess capacity may in certain circumstances be willing to ship to another market even when the net price received is less than the price in their own market.

<sup>38</sup> For example, the existence of tariffs or other trade-related factors may create price differentials.

<sup>39</sup> See for example *Director of Investigation and Research v. ADM Agri-Industries Ltd.*, Notice of Application for a Consent Order, Schedule "A" Statement of Grounds and Material Facts (March 21, 1997), CT-1997/002 (Comp. Trib.) at ¶ 10. See also ¶ 42.

<sup>40</sup> *Supra* note 1, section 93(a). In addition to its relevance to market definition, the extent to which foreign products or foreign competitors provide or are likely to provide effective competition is evaluated in the context of the analysis described in Parts 4, 5 and 6 below.



## Delineating Geographic Boundaries

- 3.29 The geographic locations of buyers and sellers are relevant in delineating boundaries, particularly when markets are local or regional in nature. The underlying assumption is that profit-maximizing firms make decisions about where to locate based on the density of their buyer base and an attempt to avoid the potential cannibalization of their own sales when one of their locations is closely situated to another. In this way, demand responses are still a key determinant of market boundaries. Spatial competition analysis can usefully assist in delineating the boundaries of localized geographic markets.<sup>41</sup> The methodology for applying spatial competition analysis depends on the characteristics of the industry and the market under consideration.<sup>42</sup>
- 3.30 It is important to emphasize that market boundaries are not, in many instances, precise.<sup>43</sup> In addition, constraints on a merged firm's pricing behaviour can come from both inside and outside the relevant market as defined. These issues are discussed further below.

## PART 4 – MARKET SHARE AND CONCENTRATION

- 4.1 Once relevant markets have been defined, the next step in the analysis is to identify participants in the relevant markets in order to determine market shares and concentration levels. Such participants include current sellers of relevant products and those that would begin selling relevant products if price rose by five per cent. In the latter case, a firm is deemed a participant in a relevant market if it does not require significant sunk investments to enter or exit the market and would be able to do so within a one year period [hereinafter a "supply response"].<sup>44</sup> Situations where firms would need to incur significant sunk investments or would take longer than one year before initiating sales of the relevant products are considered in the analysis of entry as described in Part 6.

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<sup>41</sup> When using spatial competition analysis, the Bureau identifies all locations (such as stores, branches, hubs, outlets) of both the merging parties and their product market competitors, to determine how firms are situated relative to one another.

<sup>42</sup> See for example *Superior Propane*, *supra* note 8 at ¶¶ 87-91, where delineating market boundaries was based on locations of sellers. See also *Canadian Waste*, *supra* note 14 at ¶¶ 76 and 78, where delineating market boundaries was based on locations of buyers.

<sup>43</sup> As noted by the Tribunal in *Hillsdown*, *supra* note 10 at 310, "as long as market share statistics are not taken as the only indicators of the existence of market power, the exact location of those boundaries becomes less important."

<sup>44</sup> In some cases, the ability of firms to use their assets to produce several different products may factor into market definition. For example, in a scenario where the merging parties compete across several markets and essentially face the same competitors in each market, the Bureau may use an aggregate description of these markets simply as a matter of convenience.

## Participating in the Market Through a Supply Response

- 4.2 The Bureau determines whether sellers who are not currently supplying the relevant market are able to profitably divert sales from their existing buyers to those in the relevant market in the event of a five per cent price increase. Similarly, the Bureau determines whether these sellers are able to profitably utilize excess capacity to begin supplying products in the relevant market. The Bureau examines:
- switching costs, such as the cost of adapting facilities (including distribution) in order to substitute production and/or sales in the relevant market for current production;<sup>45</sup>
  - whether the firm is able to reposition its products or extend its product line;
  - whether and to what extent the firm is committed to producing other products;
  - to what extent the firm has excess capacity;
  - applicable intellectual property rights; and
  - applicable regulations that impose product quality or labelling standards and specifications, or that impose licence/permit requirements.
- 4.3 When assessing whether foreign sellers participate in the relevant market through a supply response, additional considerations include:
- the existence of tariffs, import quotas or export constraints;
  - domestic ownership restrictions;
  - difficulties presented by exchange rate fluctuations;
  - the threat of trade actions, such as an antidumping complaint being initiated by domestic firms or the imposition of countervailing duties;
  - formal and informal market allocation arrangements within multinationals that have Canadian affiliates or between independent multinational firms;
  - the terms of licence, franchise and non-competition contracts between foreign firms and their Canadian subsidiaries or third parties that have purchased shares or assets of such subsidiaries;
  - conditions in home markets of such foreign sellers;
  - whether the industry is susceptible to supply interruptions from abroad;
  - the degree of familiarity with the Canadian market; and
  - difficulties presented by customs and other requirements associated with processing imports.
- 4.4 A seller is not included in the relevant market at this stage of the analysis when:
- the seller is likely to encounter significant difficulty distributing or marketing the relevant product; or,
  - significant sunk investment in production or distribution facilities (such as warehouse requirements, a direct-store-delivery network, marketing costs, the need to hire local salespersons, and the costs associated with obtaining

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<sup>45</sup>The product currently produced by these sellers is not included within the market.

local regulatory approval) are required to supply the relevant market.

Under these circumstances, as mentioned above, the impact of such sellers is analysed later when examining the likelihood of entry or expansion.

## Calculating Market Shares

- 4.5 Market shares are calculated for all sellers who have been identified as participants in the relevant market.
- 4.6 Market shares can be measured in terms of dollar sales, unit sales, capacity<sup>46</sup> or, in certain natural resource industries, reserves. When calculating market shares, the Bureau uses the best indicators of sellers' future competitive significance. In cases where products are undifferentiated or homogeneous (for example, having no unique physical characteristics or perceived attributes), and where firms are all operating at full capacity, market shares based on dollar sales, unit sales and capacity should yield similar results. In such situations, the basis of measurement depends largely on the availability of data.
- 4.7 Where firms producing homogeneous products have excess capacity, market shares based on capacity may best reflect a firm's relative market position and competitive influence in the market. Excess capacity may be less relevant in calculating market shares when it is clear that some of a firm's unused capacity does not have a constraining influence in the relevant market (for example, because the capacity is high-cost capacity or the firm is not effective in marketing its product).
- 4.8 As the level of product differentiation in a relevant market increases, market shares calculated on the basis of dollar sales, unit sales and capacity increasingly differ. 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 calculated on the basis of total capacity would be greater than if they were calculated on the basis of actual unit or dollar sales. In this case, market shares based on total capacity would be a misleading indicator of the relative market position of the discount sellers.<sup>47</sup> In such circumstances, dollar sales may be considered to be the better indication of the size of the total market and of the relative positions of individual firms. Because unit sales may also provide important information about relative market positions, both dollar sales and unit sales data are

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<sup>46</sup>Throughout these guidelines, the term capacity means the ability to *produce* or *sell* a product. Capacity to sell refers to marketing and distribution capabilities, such as a sales force, distribution networks and other infrastructure.

<sup>47</sup>Similar results occur as the level of differentiation between sellers increase. For instance, two firms may operate with the same capacity (such as number of trucks) but have significantly different revenue streams (because one firm may have many buyers along a truck route, i.e. have route density). In such cases, market shares based on capacity and revenues provide different information regarding relative market positions.

often requested from the merging parties and other sellers.<sup>48</sup>

- 4.9 The total output or total capacity of current sellers located within the relevant market is generally included in the calculation of the total size of the market and the shares of individual competitors. However, where significant quantities of output or capacity are committed to business outside the relevant market and where they are not likely to be available to the relevant market in response to a five per cent price increase within one year, this output or capacity is generally not included in the calculations.
- 4.10 For firms that participate in the market through a supply response, only the output or capacity that would likely become available to the relevant market without incurring significant sunk investments will be included in the market share calculations.

### **Market Share and Concentration Thresholds**

- 4.11 Information that demonstrates that market share or concentration is likely to be high does not, in and of itself, provide a sufficient basis to justify a conclusion that a merger is likely to prevent or lessen competition substantially<sup>49</sup>. However, market shares and concentration can inform the analysis of competitive effects when they reflect the market position of the merged entity relative to its rivals. In the absence of high post-merger concentration and market share, effective competition in the relevant market is generally likely to constrain the creation, maintenance, or enhancement of market power by reason of the merger.<sup>50</sup>
- 4.12 The Bureau has established thresholds to identify mergers that are unlikely to have anti-competitive consequences from those that require a more detailed analysis. In particular:
- the Commissioner generally will not challenge a merger on the basis of a concern related to unilateral exercise of market power when the post-merger market share of the merged entity would be less than 35 per cent.
  - the Commissioner generally will not challenge a merger on the basis of a concern related to a coordinated exercise of market power when:
    - the post-merger market share accounted for by the four largest firms in the market (known as the four-firm concentration ratio or CR4) would be less than 65 per cent; or
    - the post-merger market share of the merged entity would be less than

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<sup>48</sup>While publicly available or readily observable information may be useful for estimating market shares, when necessary, the Bureau will rely on data from individual market participants as the most accurate measure of market shares. See for example *Superior Propane*, *supra* note 8 at ¶ 113.

<sup>49</sup>Section 92(2) of the *Act* directs that the Tribunal cannot find that a merger lessens or prevents competition substantially based solely on evidence of market shares or concentration.

<sup>50</sup>Effective competition may come from individual competitors or the collective influence of a number of fringe competitors.

10 per cent.

- 4.13 Mergers that give rise to market shares or concentration that exceed these thresholds are not necessarily anti-competitive. Under these circumstances, the Bureau examines various factors to determine whether such mergers will likely create, maintain or enhance market power and thereby result in a substantial lessening or prevention of competition.
- 4.14 When other information suggests that current market shares do not reflect the competitive role of one of the merging parties relative to its rivals, the Bureau considers this information in determining whether competition is likely to be substantially lessened or prevented by a merger. In all cases, examining market shares and concentration is only the starting point of the Bureau's analysis of competitive effects.
- 4.15 In addition to the level of market shares or concentration in the relevant market, the Bureau examines the distribution of market shares across competitors and the extent to which market shares have changed or remained the same over a significant period of time.
- 4.16 All else equal, the likelihood that a number of firms may be able to bring about a price increase through coordinated behaviour increases as the level of concentration in a market rises and as the number of firms declines.<sup>51</sup> By contrast, coordinated behaviour becomes increasingly difficult as the number or size of firms that have the ability to increase output expands.
- 4.17 When evaluating market share information, the Bureau considers the nature of the market and the impact of forthcoming change and innovation on the stability of existing shares.<sup>52</sup> While a small incremental increase in concentration post-merger may suggest that the merger does not have a significant impact on the market, the Bureau assesses the growth expectations for one or both of the merging parties to determine whether the merger may eliminate an important competitive force.<sup>53</sup>

## **PART 5 – ANTI-COMPETITIVE EFFECTS**

5.1 When the above-mentioned market share and concentration thresholds are

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<sup>51</sup>In addition to the CR4, the Bureau may examine changes in the Herfindahl-Hirschman Index (“HHI”) (calculated by summing the squares of the individual market shares of all market participants) to observe the relative change in concentration before and after a merger. While the change in HHIs may provide useful information about changes in the market structure, the Bureau does not use HHI levels as a safe harbour threshold.

<sup>52</sup>For example, historical or existing market shares may be less relevant in bidding markets where rapid fluctuations in market shares are common. In such cases, the analysis will be more focussed on the likely future effectiveness of independent sources of competition regardless of their current shares.

<sup>53</sup>See for example *Bayer/Aventis Statement of Agreed Facts*, *supra* note 15 at ¶ 112.

exceeded or when other information suggests that a merger may result in a substantial lessening or prevention of competition, the Bureau undertakes a competitive effects analysis of the merger based on the factors listed in section 93 of the Act.<sup>54</sup> Such an analysis falls under the broad categories of unilateral effects and coordinated effects as described below.

- 5.2 When it is clear that the level of effective competition that is to remain in the relevant market is not likely to be reduced as a result of the merger, this alone generally justifies a conclusion not to challenge the merger.
- 5.3 To determine the ability and effectiveness of remaining competitors to constrain an exercise of market power by the merged entity, the Bureau examines existing forms of rivalry, such as discounting and other pricing strategies, distribution and marketing methods, product and package positioning, and service offerings.<sup>55</sup> The stability of their market shares over time is also relevant, as is the extent to which product differentiation affects the level of direct competition among firms.<sup>56</sup> Furthermore, an assessment is made of whether competitors are likely to remain as vigorous and effective as prior to the merger.
- 5.4 The extent of excess capacity held by merging and non-merging firms provides useful information about whether the merger could result in the exercise of market power.<sup>57</sup> Excess capacity held by rivals to the merged entity improves their ability to expand output should the merged entity attempt to exercise market power. On the other hand, if the merged entity holds a significant share of excess capacity in the relevant market, this may discourage expansion by rivals.<sup>58</sup>
- 5.5 The competitive attributes of the acquired firm are assessed to determine whether the merger will likely result in the removal of a vigorous and effective competitor.<sup>59</sup> In addition to the forms of rivalry discussed above, the Bureau considers whether one of the merging parties:
  - has a history of not following price increases or market stabilizing initiatives by competitors;

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<sup>54</sup> Several of the section 93 factors also play a major role in market definition and in identifying market participants.

<sup>55</sup> *Supra* note 1, the Act, section 93(e). Considerations that are particularly relevant to foreign competition include the factors that are examined in delineating relevant markets or determining what firms participate in the relevant market through a supply response. See ¶¶ 3.27, 3.28 and 4.3 above.

<sup>56</sup> See, for example, *Superior Propane*, *supra* note 8 at ¶¶ 227-228.

<sup>57</sup> See, for example, *Canadian Waste*, *supra* note 14 at ¶¶ 196 and 210.

<sup>58</sup> Excess capacity is discussed further at ¶¶ 4.7, ¶¶ 5.17, and ¶¶ 5.25.

<sup>59</sup> *Supra* note 1, the Act, section 93(f). A firm that is a vigorous and effective competitor often plays an important role in pressuring other firms to extend the limits of competition toward new frontiers. 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.

- provides unique service/warranty benefits to the market<sup>60</sup>;
  - has recently expanded capacity, or has plans to do so;
  - has recently made gains in market share, or is positioned to do so; or
  - has recently acquired intellectual property rights that enhance its ability to compete in the market, or will soon do so.
- 5.6 While the removal of a vigorous and effective competitor through a merger is likely to prevent or lessen competition to some degree, it is generally not sufficient to warrant enforcement action under the Act. The Bureau also examines the extent to which remaining competition may be limited or ineffective as described above, whether there are factors that are likely to deter or impede entry or expansion by other firms, and other relevant factors under section 93 of the Act.
- 5.7 The Bureau evaluates the general nature and extent of change and innovation in a market.<sup>61</sup> In addition to assessing the competitive impact of technological developments in products and processes, the Bureau examines change and innovation in relation to: distribution, service, sales, marketing, packaging, buyer tastes, purchase patterns, firm structure, the regulatory environment and the economy as a whole.
- 5.8 The pressures exerted by change and innovation on competitors in a market (including the merging parties) may be such that a material price increase is unlikely to be sustainable, especially where a merger reduces barriers to entry or stimulates or accelerates the change or innovation in question.<sup>62</sup> Such pressures may have important implications for efficient markets in the medium-to-long term. However, for the purpose of the Bureau's analysis of competitive effects, the resulting competitive pressures are generally relevant when they are expected to have a constraining influence within two years of a likely exercise of market power.<sup>63</sup>
- 5.9 A merger may also facilitate the exercise of market power by impeding the process of change and innovation. For example, when a merger eliminates an innovative firm that presents a serious threat to incumbent firms, the merger itself may hinder or delay the introduction of new products, processes, marketing approaches, aggressive research and development initiatives or business methods.<sup>64</sup>

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<sup>60</sup>See for example, *Superior Propane*, *supra* note 8 at ¶ 218.

<sup>61</sup>*Supra* note 1, the Act, section 93(g).

<sup>62</sup>When a merger is likely to enhance existing market power, representations regarding how the merger may likely give rise to innovation-related synergies and other efficiencies (as well as information that a merger could impede the introduction or dissemination of technology) will be considered pursuant to section 96.

<sup>63</sup>See for example *The Competition Bureau's Letter to the CIBC and TD Bank*, December 11, 1998 and *The Competition Bureau's Letter to the Royal Bank and Bank of Montreal*, December 11, 1998.

<sup>64</sup>See for example *Bayer/Aventis Statement of Agreed Facts*, *supra* note 15 at ¶ 125. As further described in the *Intellectual Property Enforcement Guidelines*, while it is important to evaluate conduct that directly reduces or prevents innovation efforts, the Bureau does not define markets based on research and development

5.10 The Bureau also examines the competitive effects of a merger resulting from, or enhanced by, the existence of particular relationships such as interlocking directorships between and among the merging parties or their affiliates and their competitors, customers and suppliers. For example, the Bureau may determine that a pre-existing relationship or arrangement between one of the merging parties and a third party raises concerns due to the merger because the third party is a direct competitor to the other merging party.<sup>65</sup> Similarly, where directors of one of the merging parties are employees, executives, partners, owners, or members of the board of directors of another firm, or who have other interests in the business, such that confidential business information could be communicated, the Bureau assesses the competitive effects of those relationships. The Bureau is not generally concerned if board representation in these circumstances occurs solely through “independent” directors where the businesses do not directly compete.

## **Unilateral Effects**

5.11 By placing pricing and supply decisions under common control, a merger can create an incentive to increase price and restrict supply or limit any other dimension of competition. A unilateral exercise of market power occurs when the merged entity can profitably sustain a material price increase without effective discipline from competitive responses by rivals.

5.12 Where buyers can choose among many sellers offering comparable products, a firm's ability to profitably increase price is limited by buyers diverting their purchases to substitute products in response to the price increase. When two firms in a market merge and the price of one firm's product(s) rises, some demand may be diverted to product(s) of the firm's merger partner, thereby increasing the overall profitability of the price increase and providing the impetus to raise the price. A price increase is more likely to be profitable when the merging parties account for a significant (even if not dominant) share of the market.

5.13 Unilateral effects can occur in different market environments that are defined by the primary characteristics that distinguish firms within those markets and determine the nature of their competition. Two types of market environments are described below.

### **Firms Distinguished Primarily by their Products**

5.14 In markets with differentiated products, a merger may create, enhance or maintain the ability of the merged entity to exercise market power unilaterally when a significant number of buyers view the product offerings of the merging parties to be their first and second choices. In these circumstances, a post-merger price increase

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activity or innovation efforts alone.

<sup>65</sup> See for example News Release - “Competition Bureau Review of Cinema Mergers Opens the Door to Competition”, April 22, 2002.



may be profitable because a price increase by one of the merging parties diverts demand toward the other merging party. This is particularly true when a merger removes a vigorous competitor from the market. If, on the other hand, the merging parties' products are not first and second choices for a significant number of buyers, then a material price increase in the product of one of the merging parties is less likely to be profitable when demand would be diverted almost entirely to the products of other competitors with available capacity.

- 5.15 In order to assess whether a merger among sellers of differentiated products is likely to create, enhance or maintain the ability of the merged entity to unilaterally exercise market power, the Bureau examines product purchase and pricing information to determine whether the products of the merging parties are first and second choices for a significant number of buyers. Evidence of past buyer-switching behaviour in response to changes in relative prices is particularly useful, including information based on buyer preference surveys, own-price and cross-price elasticities, purchasing patterns and diversion ratios.<sup>66</sup>
- 5.16 The Bureau also evaluates whether rivals in the market are likely to re-position their products to discipline unilateral market power that would otherwise occur as a result of the merger.<sup>67</sup> Consideration is also given to existing sellers that may only occupy a particular niche within the relevant market and whether they provide competition for a sufficient number of buyers.

### **Firms Distinguished Primarily by their Capacities**

- 5.17 A post-merger price increase may be profitable if the merger removes a seller to whom buyers would otherwise turn in response to a price increase. In markets where firms are distinguished primarily by their capacities (and their products are relatively undifferentiated), such a price increase is likely to be profitable if other sellers offering close substitutes are not able to absorb the demand that would otherwise be diverted from the merged entity. This occurs when the remaining sellers have insufficient capacity to absorb this demand, and capacity cannot be expanded quickly and at low cost. Therefore, the Bureau examines whether capacity constraints limit the effectiveness of remaining sellers by impeding their ability to make their products available in sufficient quantities to counter an exercise of market power by the merged entity.<sup>68</sup>

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<sup>66</sup>For instance, the diversion ratio from firm A to firm B measures the proportion of total sales lost by firm A that is captured by firm B when firm A raises the price of the relevant product.

<sup>67</sup>This requires a determination of whether repositioning or product line extension will likely be deterred by risk, sunk costs or other entry barriers.

<sup>68</sup>For example, in the presence of existing import quotas or "voluntary" restraint agreements where the limit permitted by such restraints is already met prior to the merger, foreign suppliers will be constrained and unable to increase supply to Canada beyond the quota or restraint agreement in the face of any price increase.

## Coordinated Effects

- 5.18 A merger may result in coordinated effects when a group of firms (that includes the merged entity), is able to profitably coordinate its behaviour because of each firm's accommodating reactions to the conduct of others. The Bureau assesses whether a merger makes such coordinated behaviour among firms more likely or effective.<sup>69</sup>
- 5.19 Coordinated behaviour can involve tacit or express understandings on price, service levels, allocation of customers or territories, or any other dimension of competition.<sup>70</sup> Tacit understandings arise from mutual, yet independent, recognition that, post-merger and under certain market conditions, firms can benefit from competing less aggressively with one another.
- 5.20 Coordinated behaviour is only likely to be sustainable when:
- firms are able to:
    - individually recognize mutually beneficial terms of coordination;
    - monitor one another's conduct and detect deviations; and
    - respond to any deviations from the terms of coordination through credible deterrent mechanisms<sup>71</sup>; and
  - coordination will not be threatened by external factors, such as the reactions of existing and potential competitors not part of the coordinating group of firms or the reactions of buyers.
- 5.21 In its analysis of competitive effects, the Bureau examines whether market conditions will likely allow coordinated behaviour to be sustainable post-merger.<sup>72</sup> While the presence of certain market conditions (often referred to as facilitating factors) may suggest the ability of firms to overcome impediments to coordinated behaviour, neither the absence nor the presence of any single factor or group of factors determines whether there is likely to be a substantial lessening or prevention of competition.
- 5.22 When examining whether firms are able to independently recognize mutually beneficial terms of coordination, the Bureau considers the degree of product

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<sup>69</sup> A merger that changes the competitive dynamic among firms may lead to coordinated behaviour where none existed pre-merger or may materially increase the level of coordination that already exists in a market.

<sup>70</sup> Communication between competitors is not a prerequisite for coordinated behaviour to occur. Furthermore, coordinated behaviour includes explicit agreements or arrangements among competitors. When the Bureau becomes aware of such explicit behaviour in a concentrated market, it will generally commence a criminal investigation under the Act.

<sup>71</sup> These responses, typically known as punishments, may take the form of lowering prices in the relevant market or in other markets.

<sup>72</sup> See for example *Commissioner of Competition v. Abitibi-Consolidated*, Statement of Grounds and Material Facts (December 18, 2001), CT-2001/009 (Comp. Trib.), at ¶ 103.

homogeneity and cost symmetries among firms. Recognizing terms of coordination that all firms find profitable is easier when products are homogeneous and when firms have similar cost structures. On the other hand, complex products and differences in product offerings and cost structure make it more difficult for firms to reach profitable terms of coordination. Similarly, markets with rapid and frequent product innovations are less conducive to coordinated behaviour.

- 5.23 Profit-maximizing firms have an incentive to deviate from coordinated behaviour when the expected profits from deviating are greater than the expected profits from engaging in coordination. Therefore, when evaluating whether coordination is likely, the Bureau considers factors that could affect incentives to deviate, such as the size and frequency of transactions and the elasticity of demand. When individual transactions are large and infrequent relative to total market demand, deviations from the coordinated behaviour are more profitable, making effective coordinated behaviour less likely. The profits available from coordinated behaviour are higher for products with inelastic demand, making effective coordinated behaviour more likely.
- 5.24 The Bureau also considers whether firms can monitor and detect deviations from coordinated behaviour. In so doing, the Bureau evaluates the degree of market transparency that exists.<sup>73</sup> When information about prices, rival firms and market conditions is readily available to market participants, it is easier to monitor coordinated behaviour, which in turn makes effective coordination more likely. The existence of industry organizations that facilitate communication and dissemination of information among market participants may also facilitate coordinated behaviour. Also relevant to the analysis is the stability of underlying costs of firms. When costs fluctuate, it may be difficult to detect whether a price change represents a deviation from coordinated behaviour or whether it is a response to a change in cost conditions, which in turn makes effective coordination less likely.
- 5.25 An evaluation of whether firms can impose credible punishments includes an assessment of the degree of multi-market exposure among firms and the degree of excess capacity that exists. When firms participate in multiple geographic or product markets, there are greater opportunities to discourage firms from deviating from the coordinated behaviour because there is broader scope for punishing deviations. Similarly, excess capacity held by firms within the coordinating group can allow such firms to oversupply the market when they detect deviations from the agreed price, thereby discouraging deviations and making coordination more likely. However, excess capacity may also provide firms with an incentive and an ability to deviate from coordinated behaviour by selling products at lower prices, and could therefore

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<sup>73</sup> This includes information about levels of service, innovation initiatives, product quality, product choice and levels of advertising. Market transparency is typically increased by: 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 favoured nation" clauses in contracts.

- make coordinated behaviour less likely. It is therefore important to consider which firms, if any, hold excess capacity as well as their individual economic incentives.
- 5.26 A history of collusion or coordination in the market is also relevant to the analysis because previous and sustained collusive or coordinated behaviour indicates that firms have successfully overcome the hurdles to effective coordinated behaviour in the past.
- 5.27 Unlike the facilitating factors described above, market concentration coupled with barriers to entry are two necessary (but not sufficient) conditions for a merger to substantially lessen or prevent competition through coordinated effects.<sup>74</sup> Firms find it easier and less costly to engage in coordinated behaviour if there are a small number of firms accounting for a large proportion of total market output. Coordinated behaviour among competitors in a concentrated market is also unlikely to be sustainable if raising prices would lead to significant entry.
- 5.28 The analysis of coordinated effects includes an examination of how the merger changes the competitive dynamic in the market. To do so, the Bureau identifies the constraints on coordinated behaviour that existed pre-merger to determine if the merger reduces or eliminates those constraints.
- 5.29 In highly concentrated markets, effective coordination may nonetheless be constrained by the number of firms that exist pre-merger. A merger could remove this constraint by reducing the number of rivals to a level at which the profitability of coordination makes it a more attractive strategy relative to competition.
- 5.30 When firms differ greatly relative to one another, effective coordination may be constrained by the inability of firms to behave in a way that each finds profitable. If the effect of the merger is to reduce or eliminate asymmetries between the merged firm and its rivals, firms may find it easier to coordinate their behaviour in a way that is profitable to all participants post-merger. Conversely, a merger may increase asymmetries between the merged firm and its rivals, thereby making coordinated behaviour less profitable and therefore less likely.
- 5.31 Pre-merger, effective coordination may be constrained by the activities of a particularly vigorous and effective competitor (a “maverick”).<sup>75</sup> An acquisition of a maverick may remove this constraint on coordination by reducing incentives to behave in an aggressive manner. Such an acquisition increases the likelihood that coordinated behaviour will be effective.

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<sup>74</sup>See for example, News Release “Loblaw Companies Limited - Acquisition of certain assets of The Oshawa Group Limited in Atlantic Canada”, October 16, 1998 and News Release “Divestitures Key To Resolving Competition Concerns In Loblaw Transactions”, August 12, 1999.

<sup>75</sup> A maverick is a firm that has a disproportionate incentive to deviate from coordinated behaviour. For instance, such a firm may realize greater gains by deviating or may be less susceptible to punishment mechanisms if its cost structure is lower than its rivals.

- 5.32 Alternatively, a merger may not remove the maverick but may instead inhibit a maverick's expansion or entry, or marginalize its competitive significance, thereby increasing the likelihood of effective coordination. For example, a merger may have the effect of raising rivals' costs by limiting access to the supply of necessary inputs.
- 5.33 The Bureau also examines the extent to which firms outside the coordinating group have the ability to make the relevant product available in the relevant geographic market in sufficient quantities to thwart a coordinated exercise of market power.

## **PART 6 – ENTRY**

- 6.1 A key component of the Bureau's analysis of competitive effects is whether timely entry by potential competitors would likely occur on a sufficient scale and scope to constrain a material price increase in the relevant market or a substantial part of the relevant market. In the absence of impediments to entry, a merged entity's attempt to exercise market power, either unilaterally or through coordinated behaviour with its rivals, is likely to be thwarted by entry of firms that:
- are already in the relevant market and can expand production or sales;<sup>76</sup>
  - are not in the relevant market but operate in other product or geographic markets and can switch production or sales into the relevant market; or
  - can begin production or sales into the relevant market *de novo*.

### **Conditions of Entry**

- 6.2 Entry is only effective in constraining the exercise of market power if it is viable.<sup>77</sup> When entry is likely, timely and sufficient in scale and scope, an attempt to increase price is not likely to be sustainable as buyers of the product in question turn to other sources of supply.

### **Timeliness**

- 6.3 Assessing the conditions of entry involves determining the time that it would take for a potential entrant to become an effective competitor in response to a material price increase that is anticipated to arise as a result of the merger. In general, the longer it takes for potential entrants to become effective competitors, the lesser the likelihood that incumbent firms will be deterred from exercising market power. When a material price increase occurs in a relevant market, entrants must react and have an impact

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<sup>76</sup> Throughout these guidelines, the term "entry" also refers to expansion by existing firms. The same factors that constrain new entrants also often constrain significant expansion by fringe firms, even though in some cases expansion costs for existing firms may be lower than entry costs for a new entrant.

<sup>77</sup> As noted in *Superior Propane*, *supra* note 8 at ¶ 128, "evidence of commencement of operations, per se, is insufficient to establish the competitive constraint on a supra-competitive price or a likely exercise of market power". See also *Canada (Director of Investigation and Research) v. Southam Inc., et al.* (1992), 43 C.P.R. (3d) 161 (Comp. Trib.) (hereinafter "*Southam*") at 280 and 284.

on price in a reasonable period of time. In the Bureau's analysis, the beneficial effects of entry on prices in this market normally must occur within a two-year period.<sup>78</sup>

## Likelihood

6.4 In assessing whether future entry is likely to occur, the Bureau's analysis generally starts with an assessment of firms that appear to have an entry advantage. While other potential sources of competition may also be relevant, typically the most important sources of potential competition include:

- fringe firms already in the market;
- firms that sell the relevant product in adjacent geographic areas;
- firms that produce products with machinery or technology that is similar to that used to produce the relevant product;
- firms that sell in related upstream or downstream markets;
- firms that sell through similar distribution channels; or
- firms that employ similar marketing and promotion methods.

6.5 A history of entry into and exit from a particular market provides insight into the likelihood of entry occurring in a timely manner and on a sufficient scale to counteract an exercise of market power by a merged entity. It is, however, not the sole determinant as to whether this will likely occur.<sup>79</sup>

6.6 The analysis seeks to determine the extent that entry is likely, given the commitments that must be made by potential entrants, the time required to become effective competitors, the risks involved and the likely rewards. The Bureau considers any delay or loss that potential entrants expect to encounter before becoming effective competitors and the resulting sunk costs and risk associated with such entry that reduce the likelihood that entry will occur. When assessing the likelihood of entry, the Bureau evaluates profitability at pre-merger prices rather than likely post-merger prices.

## Sufficiency

6.7 When considering whether entry is likely to be on a scale and scope that would be sufficient to eliminate a material price increase, the Bureau examines what is required from potential competitors who choose to enter. For instance, if a competitor enters a market on a scale that is below the minimum viable scale, the Bureau would not consider this entry sufficient to eliminate a material price increase

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<sup>78</sup>See footnote 19 above. See also for example *Superior Propane*, *supra* note 8 at ¶ 128 and *Hillsdown*, *supra* note 10 at 326.

<sup>79</sup>See for example *Superior Propane*, *supra* note 8 at ¶ 312 where the Tribunal found that past entry, which had occurred on a small scale, did not have a demonstrable effect on incumbents' market share, and thus questioned entrants' penetration in the market.

since the entrant will be unable to achieve the annual level of sales necessary to achieve profitability at pre-merger prices. Entry by firms who seek to differentiate themselves by establishing a niche to avoid direct competition with the merged entity may also not be sufficient to constrain an exercise of market power.

## Types of Barriers to Entry

6.8 Barriers to entry affect the timeliness, likelihood and sufficiency of entry. They can take many forms, ranging from absolute restrictions that preclude entry to sunk costs and other factors that raise the cost and risks associated with entry and thereby deter it.<sup>80</sup> While, in some cases, each individual “barrier” may be insufficient to impede entry, the Bureau considers the collective influence of all barriers, which, when taken together, can effectively deter entry.

## Regulatory Barriers

6.9 The types of barriers identified in section 93(d) of the Act, namely tariff and non-tariff barriers to international trade, inter-provincial barriers to trade, and regulatory control over entry, can provide incumbents with absolute cost advantages over potential entrants, presenting considerable and in some cases insurmountable impediments to entry.<sup>81</sup>

## Sunk Costs

6.10 Substantial sunk costs directly affect the likelihood of entry and, where present, constitute a significant barrier to entry.<sup>82</sup> Costs are sunk when they are not recoverable if the firm exits the market. In general, since entry decisions are typically made in an environment where success is uncertain, the likelihood of significant future entry decreases as the absolute amount of sunk entry costs relative to the estimated rewards of entry increases. The Bureau’s assessment of sunk costs also focuses on the time required to become an effective competitor and the probability of success, and whether these factors justify making the investments required.

6.11 New entrants must often incur various start-up sunk costs, such as acquiring market information, developing and testing product designs, installing equipment, engaging personnel and setting up distribution systems. Potential entrants may also face

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<sup>80</sup>As noted in *Canada (Director of Investigation and Research) v. Laidlaw Waste Systems Ltd.* (1992), 40 C.P.R. (3d) 289 (Comp. Trib.) (hereinafter “*Laidlaw*”) at 331, while commencing a business may in some cases be easy, new entrants may find it difficult to survive for a variety of reasons, including the strategic behaviour of incumbents. See Appendix 1 for further discussion on strategic behaviour. See also *Southam supra* note 77 at p. 212 and at p 219.

<sup>81</sup>See for example *Bayer/Aventis Statement of Agreed Facts, supra* note 15 at ¶¶ 57-59 and *Canadian Waste, supra* note 14 at ¶¶ 122.

<sup>82</sup>See for example *Superior Propane, supra* note 8 at ¶¶ 172-175 and *Canadian Waste, supra* note 14 at ¶¶ 122.

significant sunk costs due to the need to:

- make investments in market specific assets and in learning how to optimise the use of these assets;
- overcome product differentiation-related advantages enjoyed by incumbents; or
- overcome disadvantages presented by the strategic behaviour of incumbents.

- 6.12 As more fully described in Appendix I, these potential sources of sunk costs can create significant impediments to entry when they require that potential entrants factor greater costs into their decision-making relative to incumbents who can ignore such costs in their pricing decisions because they have already made their sunk cost commitment.
- 6.13 The investment required in establishing a reputation as a reliable or quality seller is also a sunk cost and it constitutes a barrier to entry when it is a crucial element in attracting buyers, particularly in industries where services are an important element of the product. Under these circumstances, the time to establish a good reputation may make profitable entry more difficult and therefore, delays the competitive impact that an entrant may have in the marketplace.<sup>83</sup>
- 6.14 Long-term exclusive contracts with automatic renewals, rights of first refusal and termination fees may constitute a barrier to entry. Contracts with attributes that limit buyer switching may make it difficult for firms to gain a sufficient buyer base to be profitable in one or more markets (even when barriers to entry in the industry are otherwise relatively low) and can thus make entry unattractive.<sup>84</sup> The deterring effects of such contracts are more pronounced when, for example, economies of density or scale are important and make it difficult for new or smaller firms to achieve minimum efficient scale of operations.<sup>85</sup>

### **Other Entry-Deterring Factors**

- 6.15 In markets where economies of scale are significant, entry on a small scale may be difficult unless the entrant can successfully exploit a niche. Conversely, entry in such markets on a large scale may expand available capacity to supply beyond market demand, thereby depressing market prices and making entry less attractive.<sup>86</sup>

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<sup>83</sup>See for example *Superior Propane*, *supra* note 8 at ¶ 157. See also, *Canada (Competition Act, Director of Investigation and Research) v. Tele-Direct (Publications) Inc.* (February 26, 1997), CT-1994/003 (Comp. Trib.).

<sup>84</sup>See for example *Laidlaw*, *supra* note 80 at 341 and *Superior Propane*, *supra* note 8 at ¶ 150.

<sup>85</sup>See for example *Laidlaw*, *supra* note 80 at 347-348 and *Superior Propane*, *supra* note 8 at ¶ 134-135.

<sup>86</sup>See for example *Director of Investigation and Research v. The NutraSweet Company* (1989), 32 C.P.R. (3d) 1 (Comp. Trib.) at 26-27 and *Southam*, *supra* note 77 at 281-282.



- 6.16 Market maturity can also impede entry. Entry may be less difficult and time-consuming in the start-up and growth stages of a market, where the dynamics of competition generally change more rapidly. Mature markets exhibit flat or declining demand, making it more difficult for potential entrants to profitably enter the business because the entrants' sales have to come from existing rivals.<sup>87</sup>
- 6.17 Other cost advantages for incumbents that may deter entry include: transportation costs, control over access to scarce or non-duplicable resources such as technology, land, natural resources and distribution channels, and capital costs.<sup>88</sup>

## PART 7 – COUNTERVAILING POWER

- 7.1 In determining whether a merger is likely to result in a material price increase, the Bureau assesses whether one or more buyers have a countervailing ability to constrain an exercise of market power.<sup>89</sup> When credible options are available to buyers, buyer concentration can prevent a price increase and make it difficult for sellers to exercise market power.<sup>90</sup>
- 7.2 Buyers may credibly constrain the ability of a seller to exercise market power if:
- they have the ability to switch to other sellers in a reasonable amount of time;
  - they can vertically integrate their operation into the upstream market; or,
  - the promise of substantial orders can induce expansion of an existing smaller player and/or can sponsor entry by a potential seller not currently in the market, thereby inducing *de novo* new entry.
- 7.3 Where price discrimination is a feature of the relevant market, it may be possible for some but not all buyers to counter the effects of an exercise of market power. For example, a merged entity may be able to increase price to small buyers who may not have the option to vertically integrate their operations, even though large buyers with this option may be able to resist such a price increase. In such cases, countervailing power may be insufficient to prevent the merged entity from exercising market power in a substantial part of the market.<sup>91</sup>

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<sup>87</sup>See for example *Superior Propane*, *supra* note 8 at ¶ 160.

<sup>88</sup>While it is recognized that capital costs alone may not be an absolute barrier to entry, the need to raise capital may have a significant impact on the timeliness of entry.

<sup>89</sup>Though not specifically addressed in the legislation, “countervailing power” is considered pursuant to section 93(h) of the Act. Countervailing power is also discussed in the Bureau’s *Enforcement Guidelines on the Abuse of Dominance Provisions* (Ottawa: Industry Canada, 2001) at p. 2. In monopsony cases involving the potential exercise of market power by a *buyer* through its ability to *decrease* price, the Bureau will assess whether one or more *sellers* have a countervailing ability to constrain this exercise of market power.

<sup>90</sup>See News Release – “Director Does Not Challenge the Luscar Acquisition of Manalta”, September 11, 1998; and Information Notice, “Fording Coal Merger Passes Bureau Scrutiny”, April 15, 2003.

<sup>91</sup>Consideration may be given to whether the formation of a buying group among individually small buyers is a

## PART 8 – THE EFFICIENCY EXCEPTION

### Overview

- 8.1 Section 96 of the Act provides an efficiency exception to the provisions of section 92. When a merger creates, maintains or enhances market power, subsection 96(1) creates a trade-off framework in which efficiency gains that are likely to be brought about by a merger are balanced against the anti-competitive effects that are likely to result.<sup>92</sup>
- 8.2 As the starting point, when determining the relevant anti-competitive effects for the purpose of performing the trade-off, the Bureau recognizes the significance of all of the objectives set out in the statutory purpose clause contained in section 1.1 of the Act.<sup>93</sup>
- 8.3 In general, categories of efficiency that are relevant to the trade-off analysis in merger review include:
- allocative efficiency: the degree to which resources available to society are allocated to their most valuable use;
  - technical (productive) efficiency: the creation of a given volume of output at the lowest possible resource cost; and
  - dynamic efficiency: the optimal introduction of new products and production processes over time.
- 8.4 These categories are examined in reference to both gains in efficiency and anti-competitive effects (which include losses in efficiency).
- 8.5 For the purpose of the trade-off analysis in litigated proceedings before the Tribunal, the Bureau must show the anti-competitive effects of a merger. The merging parties must show all other aspects of the trade-off, including the nature, magnitude and likelihood of efficiency gains, and whether such gains are greater than and offset the anti-competitive effects.<sup>94</sup> Whether or not a case proceeds to litigation, in order to effectively carry out the analysis, the Bureau seeks information from the merging parties and other sources to enable it to evaluate both gains in efficiencies and anti-competitive effects.
- 8.6 Merging parties are encouraged to make their efficiency submissions to the Bureau

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credible option such that the group could have countervailing power.

<sup>92</sup> The nature of the efficiency exception was considered by the Tribunal in *Hillsdown*, *supra* note 10, and by the Tribunal and the Federal Court of Appeal in four decisions in the Superior Propane proceedings. While existing jurisprudence provides some guidance on the principles for interpreting and applying section 96, it does not prescribe how the trade-off is to be applied in all cases.

<sup>93</sup> *Superior Propane Inc. v. Canada (Commissioner of Competition)* (2001), 11 C.P.R. (4<sup>th</sup>) 289 (F.C.A.) (hereinafter "FCA1") at ¶ 88.

<sup>94</sup> FCA1, *supra* note 93 at ¶ 154

at an early stage of the transaction. This facilitates an expeditious assessment of the nature, magnitude and likelihood of the efficiency gains and of the trade-off between relevant efficiency gains and anti-competitive effects.

## **Gains in Efficiencies**

- 8.7 In order to be considered under subsection 96(1), it must be demonstrated that the efficiency gains “would not likely be attained if the order (before the Tribunal) were made”. This involves considering the nature of potential orders that may be made, including those that may apply to the merger in its entirety or are limited to parts of the merger. Each of the anticipated efficiency gains are then assessed to determine whether these gains would likely be attained by alternative means if the potential orders are made.<sup>95</sup> Where the order sought is limited to parts of a merger, efficiency gains that are not affected by the order are not included in the trade-off analysis.<sup>96</sup>
- 8.8 To facilitate its review of efficiency claims, the Bureau requires information that describes the precise nature and magnitude of each type of anticipated efficiency gain. The information should also address the likelihood that such gains will be achieved and why those gains are not likely to be achieved if the potential Tribunal orders are made.
- 8.9 To enable the objective verification of anticipated efficiency gains, efficiency claims should be substantiated by documentation prepared in the ordinary course of business, wherever possible. This includes plant and firm-level accounting statements, internal studies, strategic plans, integration plans, management consultant studies and other available data.
- 8.10 Section 96(2) requires the Tribunal to consider whether the merger is likely to bring about gains in efficiency described in subsection 96(1) that will result in (i) a significant increase in the real value of exports; or (ii) a significant substitution of domestic products for imported products. To assist this analysis, firms operating in markets that involve international trade should provide the Bureau with information which establishes that the merger will lead them to increase output due to greater exports or import substitution.<sup>97</sup>

## **Types of Efficiencies Generally Included in the Trade-off**

- 8.11 As part of its assessment of gains in efficiencies, the Bureau examines claims that productive efficiency and dynamic efficiency are likely to be attained through the merger.

### ***Gains in Productive Efficiency***

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<sup>95</sup>When efficiency gains are likely to be attained in any event, but the merger enables such gains to be achieved earlier, this timing advantage is considered as part of the analysis.

<sup>96</sup>This is discussed further below under Types of Efficiency Gains Generally Excluded.

<sup>97</sup>Increased output in this context is generally only possible with an associated decrease in price.

- 8.12 Productive efficiencies result from real cost savings in resources, which permit firms to produce more output or better quality output from the same amount of input. In many cases, such efficiencies can be quantifiably measured, objectively ascertained, and supported by engineering, accounting or other data. Timing differences in the realization of these savings are accounted for by discounting to the present value.
- 8.13 Productive efficiencies include:
- product, plant level and multi-plant level savings in both variable and fixed costs;<sup>98</sup>
  - savings associated with integrating new activities within the firm;<sup>99</sup> and
  - savings arising from transferring superior production techniques and know-how from one of the merging parties to the other.<sup>100</sup>
- 8.14 When considering savings of either variable or fixed costs, the Bureau examines claims related to:
- economies of scale: product and plant level reductions in the average unit cost of a product through increased production;
  - economies of scope: savings that arise when the cost of producing more than one product at a given level of output is reduced by producing the products together rather than separately;
  - economies of density: savings that arise from more intensive use of a given network infrastructure;
  - 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;
  - savings that arise from plant specialization, the rationalization of various administrative and management functions (for example, sales, marketing, accounting, purchasing, finance, production) and the rationalization of research and development activities; and
  - savings relating to distribution, advertising and raising capital.

### ***Gains in Dynamic Efficiency***

- 8.15 The Bureau also examines claims that the merger has or is likely to result in gains in

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<sup>98</sup> Both variable and fixed cost savings are relevant to the analysis because both generate producer surplus (even though it is recognized that generally only variable (i.e. marginal) cost savings lead to price reductions).

<sup>99</sup> These include reduced transaction costs associated with contracting for inputs, distribution and services that were previously performed by third parties. However, as noted in *Superior Propane*, *supra* note 8 at ¶ 364-366, this excludes pecuniary savings such as those related to bringing idle equipment into use if such idle capacity will be transferred from the merged entity to third parties.

<sup>100</sup> While such legitimate production-related savings may exist, it will generally be difficult to demonstrate that efficiencies will arise due to “superior management”, that savings are specifically attributable to management performance, or that they would not likely be sought and attained through alternative means.

dynamic efficiency, including those 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 attaining dynamic efficiency is crucial to both the general evolution of competition and the international competitiveness of Canadian industries. Because dynamic efficiency is ordinarily extremely difficult to measure, the Bureau generally relies on documents prepared in the ordinary course of business to assess the validity of such claims. Such efficiencies are generally considered from a qualitative perspective.

### **Deductions to Gains**

8.16 Once all efficiency claims have been valued, the costs of retooling and other costs that must be incurred to achieve efficiency gains are deducted from the total value of the efficiency gains that are considered pursuant to section 96(1).<sup>101</sup> Integrating two complex, ongoing operations with different organizational cultures can be a costly undertaking and ultimately may be unsuccessful. Integration costs are deducted from the efficiency gains.<sup>102</sup>

### **Types of Efficiencies Generally Excluded from the Trade-off**

8.17 Not all efficiency claims qualify for the trade-off analysis. The Bureau excludes:

- gains that would likely be attained in any event through alternative means if the potential orders were made<sup>103</sup> (examples include internal growth, a merger with a third party,<sup>104</sup> a joint venture, a specialization agreement, and a licensing, lease or other contractual arrangement);<sup>105</sup>
- gains that would not be affected by an order, where the order sought is limited to part of a merger;<sup>106</sup>
- gains that are redistributive in nature, as provided in section 96(3) of the Act (examples include gains anticipated to arise from increased bargaining

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<sup>101</sup> See for example *Superior Propane*, *supra* note 8 at ¶¶ 340 and 380, where the Tribunal deducted certain management fees because they represented compensation payments for providing additional management services.

<sup>102</sup> Losses in dynamic efficiency described in ¶ 8.30 may also be deducted from gains in efficiency at this stage of the analysis provided they are not double-counted.

<sup>103</sup> In *Superior Propane*, *supra* note 8 at ¶¶ 349-352, the Tribunal indicated the need to establish whether the merged entity would or would not likely take another course of action in the event of total divestiture (i.e. in the absence of the merger).

<sup>104</sup> Consideration will only be given to alternative merger proposals that could reasonably be expected to proceed if the potential orders were made.

<sup>105</sup> The market realities of the industry in question will be considered in determining whether particular efficiencies could reasonably be expected to be achieved through non-merger alternatives. This includes growth prospects for the market in question, the extent of excess capacity in the market, and the extent to which the expansion can be carried out in increments.

<sup>106</sup> Efficiencies expected to arise in other markets that are inextricably linked to efficiencies that the order would prevent in the relevant market may qualify if these efficiencies would also be precluded by the order.

leverage that enables the merging parties to extract wage concessions or discounts from suppliers that are not cost-justified,<sup>107</sup> and tax-related gains);<sup>108</sup> and

- savings resulting from a reduction in output, service, quality, or product choice.

## Anti-Competitive Effects

- 8.18 Subsection 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”. The effects to be considered are not limited to resource allocation effects and include all the anti-competitive effects that are likely to arise from a merger, having regard to all of the objectives of the Act.<sup>109</sup> Determination of the relevant anti-competitive effects depends upon the particular circumstances of the merger in question and the markets affected by the merger.
- 8.19 The Bureau examines all relevant price and non-price effects, including: negative effects on allocative, productive, and dynamic efficiencies; redistributive effects; and effects on service, quality and product choice.
- 8.20 In addition to direct effects in the relevant market, the Bureau also considers price and non-price effects in interrelated markets. For example, mergers that are likely to result in increased prices and lower output can impair both domestic and exporting industries that use the merged firm’s products as inputs.
- 8.21 Some examples of potential anti-competitive effects that can result from a merger are described below. This list is not intended to be exhaustive. While, in some cases, the negative impacts of a merger may be difficult to measure, all of the relevant anti-competitive effects of a merger are considered for the purposes of the tradeoff. Where anti-competitive effects (such as redistributive effects and non-price effects) cannot be quantified, they are considered from a qualitative perspective.

## Price Effects

### ***Loss of allocative efficiency (Deadweight Loss)***

- 8.22 A merger that results in a price increase brings about a negative resource allocation effect (referred to as “deadweight loss”), which is a reduction in total consumer and producer surplus within Canada. This reflects a loss of allocative efficiency that is contrary to promoting the efficiency and adaptability of the Canadian economy.

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<sup>107</sup> Discounts from a supplier resulting from larger orders that would enable the supplier to achieve economies of scale, reduced transaction costs or other savings may qualify, to the extent that the savings by the supplier can be substantiated. See for example *Superior Propane*, *supra* note 8 at ¶¶ 346-348.

<sup>108</sup> See for example *Superior Propane*, *supra* note 8 at ¶¶ 376.

<sup>109</sup> *FCA1*, *supra* note 93 at ¶ 92.

8.23 In view of the difficulties associated with estimating the magnitude of a material price increase that is likely to be brought about by a merger and other variables, various estimates of the deadweight loss are usually prepared over a range of price increases and market demand elasticities.

8.24 The estimate of deadweight loss generally includes:

- losses to consumer surplus resulting from reductions in output due to the merger;
- losses in producer surplus that arise when market power is being exercised in the relevant market prior to the merger; and
- losses to consumer and producer surplus anticipated to result in interrelated markets.<sup>110</sup>

### **Redistributive Effects**

8.25 Price increases resulting from an anti-competitive merger cause a redistributive effect (“wealth transfer”) from buyers to sellers. Providing buyers with competitive prices and product choices is an important objective of the Act.<sup>111</sup> Therefore, the Bureau examines the extent to which the wealth transfer is part of the trade-off analysis.

8.26 There are different ways in which the wealth transfer could be taken into account when evaluating a merger. One approach to the wealth transfer is the “socially adverse effects approach”, which attempts to quantify the portion of the transfer that is considered socially adverse.<sup>112</sup> The type of information that would assist in applying this approach includes detailed information regarding the type of products produced by the merging parties, the nature of their buyers, the uses to be made of those products by their buyers and the socio-economic profiles of their buyers.

8.27 Other approaches to the wealth transfer may be appropriate, depending on the circumstances of a particular case.

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<sup>110</sup> For example, where the products produced by the merged firm include intermediate goods that are used as inputs in other products, price increases in the intermediate goods can contribute to allocative inefficiency in other markets.

<sup>111</sup> This is consistent with the Federal Court of Appeal which acknowledged the “consumer protection objectives of the Act”, the significance of “the availability to consumers of a choice of goods at competitive prices” when determining the effects to be considered under section 96, and the need to take into account “the interests of the consumers of the merged entity’s products” when the trade-off is made between efficiencies and anti-competitive effects”. See *FCA1*, *supra* note 93 at ¶¶ 100, 103, 88 and 109.

<sup>112</sup> This approach was applied by the Tribunal in the *Superior Propane* Redetermination Decision, where the Tribunal gave full weight only to the socially adverse portion of the transfer. See *Canada (Commissioner of Competition) v. Superior Propane Inc.* (April 4, 2002), CT-1998/002 (Comp. Trib.) (hereinafter, “*Superior Propane Redetermination*”). The Federal Court of Appeal concluded that the application of that approach in that case was within the Tribunal’s discretion. See: *Canada (Commissioner of Competition) v. Superior Propane Inc.* (2003), 23 C.P.R. (4<sup>th</sup>) 316 (F.C.A.) (hereinafter “*FCA2*”).

## Non-price effects

### ***Reduction in Service, Quality, Choice***

8.28 A substantial prevention or lessening of competition resulting from a merger can have a negative impact on service, quality, product choice and other dimensions of competition that buyers value. Considering these effects is consistent with ensuring that buyers are provided with competitive prices and product choices.

### ***Loss of Productive Efficiency***

8.29 Mergers that prevent or lessen competition substantially can also reduce productive efficiency as resources are dissipated through x-inefficiency<sup>113</sup> and other distortions.<sup>114</sup> For instance, x-inefficiency may arise when firms, particularly in monopoly or near monopoly markets, are insulated from competitive market pressure to exert maximum efforts to be efficient.

### ***Loss of Dynamic Efficiency***

8.30 Mergers that result in a highly concentrated market may reduce the rate of innovation, technological change, and the dissemination of new technologies with a resulting opportunity loss of economic surplus.<sup>115</sup>

## **The Trade-Off**

8.31 To satisfy the section 96 trade-off, the efficiency gains must both “be greater than and offset” the relevant anti-competitive effects.

8.32 The “greater than” aspect of the test requires that the efficiency gains be more extensive or of a larger magnitude than the anti-competitive effects. The “offset” aspect requires that efficiency gains compensate for the anti-competitive effects.<sup>116</sup>

8.33 Both the efficiency gains and the anti-competitive effects can have quantitative (measured) and qualitative aspects to them. To enable appropriate comparisons to be made, timing differences between measured future anticipated efficiency gains and measured anti-competitive effects are addressed by discounting to the present value.<sup>117</sup>

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<sup>113</sup> “X-inefficiency” typically refers to the difference between the maximum (or theoretical) productive efficiency achievable by a firm and actual productive efficiency attained.

<sup>114</sup> For example, increased market power can lead to rent-seeking behaviour (such as lobbying) which can cause real economic resources to be consumed in activities directed towards redistributing income, rather than used in producing real output.

<sup>115</sup> Losses in dynamic efficiency may be considered under anti-competitive effects or may be deducted from gains in efficiency at the outset as indicated in ¶ 8.16, provided they are not double-counted.

<sup>116</sup> See for example *Superior Propane*, *supra* note 8 at ¶ 449.

<sup>117</sup> See for example *Superior Propane*, *supra* note 8 at ¶ 371.



- 8.34 There is currently no statutory basis for assuming any fixed set of weighting between redistributive effects, deadweight losses and efficiency gains.<sup>118</sup> Such weighting depends on the facts of a particular case. Because all gains must be weighed against all effects, the exercise of judgment is required when combining measured gains (effects) with qualitative gains (effects) for the purpose of performing the trade-off.<sup>119</sup>
- 8.35 Merging parties intending to invoke the efficiencies exception are encouraged to address how they propose that qualitative and quantitative gains and effects be combined and weighed for the purpose of performing the “greater than and offset” aspect of the trade-off; and to explain how and why the gains “compensate for” the anti-competitive effects.<sup>120</sup>

## **PART 9 – FAILING FIRM**

### **Business Failure and Exiting Assets**

- 9.1 Among the factors that are relevant to an analysis of a merger and its effects on competition, section 93(b) lists “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).
- 9.2 Probable business failure does not provide a defence for a merger that is likely to prevent or lessen competition substantially. Rather, the loss of the actual or future competitive influence of a failing firm is not attributed to the merger if imminent failure is probable and, in the absence of a merger, the assets of the firm are likely to exit the relevant market. Merging parties intending to invoke the failing firm rationale are encouraged to make their submissions in this regard as early as possible.
- 9.3 A firm is considered to be failing if:
- it is insolvent or is likely to become insolvent;<sup>121</sup>
  - it has initiated or is likely to initiate voluntary bankruptcy proceedings; or,
  - it has been, or is likely to be, petitioned into bankruptcy or receivership.

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<sup>118</sup> See *Superior Propane Redetermination*, *supra* note 112 at ¶ 371.

<sup>119</sup> *Superior Propane*, *supra* note 8 ¶ 461.

<sup>120</sup> *FCA1*, *supra* note 93 at ¶s 88, 92, and 109.

<sup>121</sup> Technical insolvency occurs when liabilities exceed the realizable value of assets, or when a firm is unable to pay its liabilities as they come due.

9.4 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 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 eliminated trade credit;
- whether there have been persistent operating losses or a serious decline in net worth or in the firm's assets<sup>122</sup>;
- 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 (such as 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 Companies' Creditors Arrangement Act, or through a voluntary arrangement with its creditors.

9.5 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 division or subsidiary, particular attention is paid to: transfer pricing within the larger enterprise, intra-corporate cost allocations, management fees, royalty fees, and other matters that may be relevant in this context. Such payments or charges are generally assessed in relation to the values of equivalent arm's-length transactions.

9.6 Matters addressed in financial statements are ordinarily considered to be objectively verified when these statements 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 includes a review of historic, current and projected income statements and balance sheets. The reasonableness of the assumptions underlying financial projections is also reviewed in light of historic results, current business conditions and the performance of other businesses in the industry.

## **Alternatives to the Merger**

9.7 Before concluding that a merger involving a failing firm or division is not likely to result in a substantial lessening or prevention of competition, the Bureau assesses

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<sup>122</sup> Persistent operating losses may not be indicative of failure, particularly in a "start-up" situation where such losses may be normal and indeed anticipated.

whether any of the following alternatives to the merger exist and are likely to result in a materially greater level of competition than if the proposed merger proceeds.<sup>123</sup>

### **Acquisition by a Competitively Preferable Purchaser**

9.8 The Bureau assesses whether there exists a third party whose purchase of the failing firm, division or productive assets is likely to result in a materially higher level of competition in a substantial part of the market.<sup>124</sup> In addition, such a third party ("competitively preferable purchaser") must be willing to pay a price which, net of the costs associated with making the sale<sup>125</sup>, would be greater than the proceeds that would flow from liquidation, less the costs associated with such liquidation (referred to as the "net price above liquidation value").<sup>126</sup> Where it is determined that a competitively preferable purchaser exists, it can generally be expected that if the proposed merger under review cannot be completed, the acquiree will either seek to merge with that competitively preferable purchaser, or remain in the market. If the Bureau is not satisfied that a thorough search for a competitively preferable purchaser has been conducted, the Bureau will require the involvement of an independent third party (such as an investment dealer, trustee or broker who has no material interest in either of the merging parties or the proposal in question) to conduct such a search before the failing firm rationale is accepted.

### **Retrenchment/Restructuring**

9.9 Where it appears that the firm is likely to 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 is likely to result in a materially greater level of competition than if the proposed merger proceeds. The retrenchment or restructuring of a failing firm may prevent failure and enable it to survive as a meaningful competitor by narrowing the scope of its operations, for instance, by downsizing or withdrawing from the sale of certain products or from certain geographic areas.

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<sup>123</sup> See *Canada (Director of Investigation and Research) v. Canadian Pacific Ltd.*, Notice of Application (20 December 1996), CT-1996/002 (Comp. Trib.); *Canada (Director of Investigation and Research) v. Air Canada* (1989), 27 C.P.R. (3d) 476. (Comp. Trib.); *Canada (Director of Investigation and Research) v. Air Canada* (1993), 49 C.P.R. (3d) 7 (Comp. Trib.); News Release, "No challenge to Wardair and PWA merger", April 24, 1989; and News Release, "Competition Bureau Announces It Will Not Oppose Acquisition of Canadian Airlines", December 21, 1999.

<sup>124</sup> The Bureau considers whether the third party is capable of exercising a meaningful influence in the market. Where an alternative buyer does not intend to keep the failing firm's assets in the relevant market, an assessment is made of the extent to which the market power arising from the original merger proposal is likely to be less than if the alternative merger proceeds.

<sup>125</sup> These costs include matters such as ongoing environmental liabilities, tax liabilities, commissions relating to the sale and severance and other labour-related costs.

<sup>126</sup> Liquidation value is defined as the sale price of assets as a result of bankruptcy or foreclosure proceedings.

## **Liquidation**

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

## **PART 10 – VERTICAL MERGERS**

- 10.1 A vertical merger involves the combination of the assets of a firm selling a product with a firm buying that product. As such, vertical mergers generally involve firms that do not operate in the same relevant market and therefore do not lead to an increase in concentration in a relevant market. Vertical mergers may raise concerns when they increase barriers to entry or facilitate coordinated behaviour.<sup>127</sup> In addition to the conditions described below, the Bureau analyzes the competitive effects of such mergers by examining market concentration, the effectiveness of remaining competition, the availability of acceptable substitutes, entry, change and innovation, and the removal of a vigorous and effective competitor.

### **Increased Barriers to Entry**

- 10.2 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 at either of the stages (i.e. sectors of the industry) at which one of the merging parties operates. 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) will consider it necessary to simultaneously enter the secondary market. In general, where such simultaneous entry into both the primary and secondary markets involves incurring greater sunk costs than what is required to enter into the primary market alone, barriers to entry into the primary market are effectively raised.<sup>128</sup> Such an increase in barriers to entry only presents grounds for concern under the merger provisions of the Act where the entry that is impeded by the vertical merger would otherwise have been an important constraining influence on prices in the market.
- 10.3 The Bureau is not likely to conclude that a vertical merger is likely to prevent or

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<sup>127</sup> In addition, a vertical merger could substantially lessen or prevent competition by foreclosing access to inputs or distribution channels, thereby raising the costs of rivals.

<sup>128</sup> See Appendix I.

lessen competition substantially on this basis unless:

- the merger makes it unlikely that entry into the primary market will occur on a sufficient scale to eliminate a material price increase within two years, due to the need to simultaneously enter the secondary market; and,
- the exercise of market power in the primary market is likely to be facilitated by the merger in the absence of such entry.

10.4 In determining whether simultaneous entry will be more difficult or less profitable, the Bureau examines whether entrants in such circumstances are likely to face higher costs of capital than incumbents, due to greater risks involved in attempting successful two-stage entry. An assessment is also made of the difference in the levels of minimum efficient scale in the primary and secondary markets and whether this is likely to impose significant additional costs on a two-stage entrant.

### **Coordinated Effects Facilitated by Vertical Integration**

10.5 A merger that creates or increases a high degree of vertical integration between an upstream market and a downstream retail market can facilitate coordinated behaviour by firms in the upstream market by making it easier to monitor the prices charged by rivals at the upstream level.

10.6 In general, mergers are not likely to prevent or lessen competition substantially on this basis unless:

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

10.7 A vertical merger could also facilitate coordinated behaviour by firms in a downstream market by increasing transparency (through an ability to observe increased purchases of inputs) or by providing additional ways to discourage or punish deviations (through limiting the supply of inputs).

## **PART 11 – CONGLOMERATE MERGERS**

11.1 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.<sup>129</sup>

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<sup>129</sup>The analysis of mergers involving complementary products, which are a type of conglomerate merger, can raise issues similar to those that arise from vertical mergers as described in Part 10. Complementary

Conglomerate mergers may give rise to concerns when, in the absence of the merger, one of the merging parties is likely to have entered the market *de novo*.<sup>130</sup> In such circumstances, consideration is given to whether prices are likely to be materially higher in a substantial part of the market for two years than they would be if the merger did not proceed. Concerns may be raised when a firm that is exercising market power in the relevant market acquires a firm in an adjacent market that has signalled an intention to enter the relevant market by attempting to negotiate favourable contracts with buyers of the incumbent firm. Conversely, a similar anticompetitive effect can result when a firm that may otherwise have entered the relevant market *de novo* (which would have increased capacity and introduced a new and independent source of competition) simply replaces a significant incumbent through merger.

- 11.2 To determine whether *de novo* entry is likely to have occurred in absence of the merger, the Bureau generally examines information such as internal documents that pre-date the merger, recent initiatives by the firm to contest the market, applications for regulatory approvals or licenses, or the registration of intellectual property rights.

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products are products that buyers typically use together such as photocopy machines and paper.

<sup>130</sup> See also the discussion of prevent cases in ¶ 2.10-2.12.

## APPENDIX I: ADDITIONAL INFORMATION ON SUNK COSTS

A.1 This appendix further describes how the potential sources of sunk costs identified in Part 6 can deter entry. Sunk costs are important to the entry analysis because, when present, they provide a cost advantage to incumbents who can ignore such costs in their pricing decisions because they have already been committed.

### Market Specific Assets and Learning

- A.2 Entry that requires sunk cost investments may be deterred by the effect that entry itself has on prices. Entry can be deterred by lower prices for two main reasons. First, where significant economies of scale, scope, or density 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.<sup>131</sup> The greater the ratio of minimum efficient scale to total market output, the greater the price-depressing effect of entry at that scale, and the less likely it is that such entry will occur.
- A.3 Second, a potential entrant recognizes the ability of profit-maximizing incumbents to affect the post-entry price. In particular, incumbents may make new entry unprofitable by maintaining their own output at levels that yield prices that are below the potential entrant's long run average total costs, which includes any sunk costs that would be incurred upon entry.<sup>132</sup> This deterrent effect is enhanced by increased risk and uncertainty based on incumbents vigorously fighting to defend their market position, particularly in stable or declining markets, or where they have significant excess capacity.<sup>133</sup>
- A.4 The assessment of entry also involves a determination of whether viable entry is likely to be deterred by the existence of advantages that incumbents gain through 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 knowledge may only be acquired in such a way that potential entrants cannot realistically expect to catch up with incumbents in the foreseeable future.

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<sup>131</sup> See ¶ 8.14 of these guidelines. Economies of scale, scope and density can also exist in relation to other aspects of a business, such as distribution, marketing and management. As discussed in *Laidlaw, supra* note 80, the need to establish route density to be profitable may be an entry deterrent.

<sup>132</sup> For incumbents, such costs have already been committed and are no longer considered relevant for pricing decisions. The same is not true for new entrants. It is this asymmetry between incumbents and persons contemplating entry that confers the advantage on the former.

<sup>133</sup> 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.

## Product Differentiation

- A.5 Firms typically attempt to differentiate their products in several ways including:
- distinguishing the physical nature of the product (its features, durability and quality);
  - offering superior pre or post-sales service, including warranties;
  - selling from locations that are more convenient to access, or that require less transportation costs to reach, than rival sales locations; and,
  - creating perceived attributes through marketing, advertising, labelling, packaging, etc.
- A.6 When products are successfully differentiated, buyers are generally not indifferent to branded and unbranded products. When buyers find a brand that they like, the brand often becomes 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 quality assurance provided by the brand name. Quality assurance is in turn ordinarily reinforced through advertising and other forms of promotion.
- A.7 Where significant brand loyalty exists, buyers are often reluctant to switch immediately to a new product in response to a material price increase. This reluctance can be heightened 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 by buyers who must therefore place their own reputation at risk;
  - 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.
- A.8 To convince buyers to sample their products, new entrants must often offer a lower price, a superior product, and/or engage in more extensive and more frequent advertising and promotion than incumbent firms. Each of these sources of asymmetry between new entrants and incumbent firms is a source of additional sunk costs that ordinarily deter or delay entry. This is particularly so with goods that are purchased on a self-serve basis, and where there are significant costs associated with obtaining information about a product and its performance relative to other products in the relevant market.
- A.9 These disadvantages increase as the proportion of total market output 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.<sup>134</sup>

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<sup>134</sup> 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



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

- A.10 Several kinds of strategic behaviour 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 necessarily be designed to have an entry-deterring effect.
- A.11 To assess the extent that a material price increase is likely to induce entry on a scale and scope that is sufficient to eliminate such a price increase within two years, particular attention is 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;
  - buyers facing significant switching costs;<sup>135</sup>
  - existing contracts that are long term in nature, and/or that include "meet the competition" or automatic renewal clauses;
  - high levels of investment in research and development 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; or,
  - an expectation that incumbents will likely respond to entry by vigorously defending their market positions.<sup>136</sup>

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incumbents.

<sup>135</sup> Suppliers can impose significant switching costs on buyers in various ways, including: by making rebates or discounts contingent on total fidelity or a long term commitment; by imposing liquidated damages for breach of contract; by requiring the buyer to include the trade mark of the relevant product on the packaging when it is resold; by manipulating the compatibility of product components; or by requiring buyers to purchase the suppliers' equipment. See for example, *Superior Propane*, *supra* note 8 at ¶ 147.

<sup>136</sup> See for example *Superior Propane*, *supra* note 8 at ¶ 152 - 153.