PART 3 - Market Definition

3.1 Conceptual Framework

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

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

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

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

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

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

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

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

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

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

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

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[14] The objective of market definition is to define the smallest market in which a substantial prevention or lessening of competition would be possible. A 5 percent threshold is generally sufficient for this purpose. In the course of reviewing particular mergers, Bureau staff may request information about likely responses to larger price increases in order to gain a better appreciation of market dynamics and of the nature of the responses that would be elicited by a 5 percent price increase. Cf. part 2.4 of these Guidelines.

[15] The "significant" price increase postulated is therefore net of inflation and other common variables.

[16] A period of less than one year is not generally considered to be appropriate for the purpose of defining markets, because even sellers of products that actually constrain the ability of the respective merging parties to raise a price above the prevailing pre-merger level may require several months to recognize and respond to an attempted price increase. A period longer than one year is not generally considered to be appropriate because sellers that would require more than this amount of time to respond to an increase in the price of a product generally do not exercise a significant constraining influence on the price of that product.

[17] This condition ensures that markets will not be defined around narrow segments consisting of products purchased by buyers who would not be willing to switch to another source of supply in the event of a significant and nontransitory price increase, but who either cannot be identified by sellers in the market or cannot be subjected to price discrimination confined to them alone. In such cases, it can be expected that sellers will not risk losing greater profits earned on sales to buyers who would likely switch, by attempting to reap additional profits from buyers who would not likely switch. For the purposes of its analysis, the Bureau assumes that there is no price regulation.

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

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

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

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

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

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

3.2 The Product Dimension
3.2.1 General Approach

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

3.2.2 Evaluative Criteria

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

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

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

3.2.2.1 Views, Strategies, Behaviour and Identity of Buyers

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

3.2.2.2 Trade Views, Strategies and Behaviour

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

3.2.2.3 End Use

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

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

3.2.2.4 Physical and Technical Characteristics

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

3.2.2.5 Switching Costs

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

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

3.2.2.6 Price Relationships and Relative Price Levels

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

Similarly, a determination will be made of the extent to which historical price responses suggests that sellers of product B are likely to constrain the postulated significant and nontransitory price increase in relation to product A. Where it can be established that the sellers of product B have this ability, a further issue that must be addressed is the likelihood that they will employ it in the manner described in part 3.21 of these Guidelines. The persuasiveness of information with respect to price movements and levels is often reduced by the difficulty associated with ascertaining the net price at which sales are actually transacted.

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

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

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

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

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

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

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

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

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

3.2.2.8 Existence of Second Hand, Reconditioned or Leased Products

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

3.3 The Geographic Dimension
3.3.1 The General Approach

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

3.3.2 Evaluative Criteria

3.3.2.1 Views, Strategies, Behaviour and Identity of Buyers

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

3.3.2.2 Trade Views, Strategies and Behaviour

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

3.3.2.3 Switching Costs

See section 3.2.2.5 above and section 3.3.2.4 below.

3.3.2.4 Transportation Costs

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

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

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

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

3.3.2.5 Local Set-up Costs

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

3.3.2.6 Particular Characteristics of the Product

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

3.3.2.7 Price Relationships and Relative Price Levels

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

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

3.3.2.8 Shipment Patterns

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

3.3.2.9 Foreign Competition

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

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

[24] See Part 4.22 below.