PRB 02-22E

BILL C-249: AN ACT TO AMEND THE COMPETITION ACT

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15 November 2002

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BILL C-249: AN ACT TO AMEND THE COMPETITION ACT *

INTRODUCTION

Section 96 of the *Competition Act* sets Canada's competition legislation apart from those of other countries. This section states that: "The Tribunal shall not make an order under section 92 if it finds that the merger … is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition …"; the order to which the Act refers is one that would dissolve or restructure a completed or proposed merger. This test, which would have the Competition Tribunal balance the social benefits and costs of the merger, has been interpreted by some as being consistent with what is known as the "total surplus standard." There are, of course, other interpretations on which standard should be used (i.e., the "consumer surplus standard," the "U.S. price standard," the "balancing weights standard") and, therefore, on what factors should be included in the review, as Parliament was not explicit on this issue when it passed the Act in 1986.

Although Canada's legislative defence of a merger because its resultant efficiencies outweigh the adverse effects of less competition is unique among the industrialized countries of the world, its 16-year history has not been very hospitable to merger proponents. The Commissioner of Competition has not even once found the efficiency gains to a merger proposal sufficient to offset any lessening of substantial competition also found. In this 16-year period, the Tribunal had only once decided on efficiency gains (*Superior Propane*) and twice commented on them (*Imperial Oil* and *Hillsdown*).(1) The elucidations, however, have been

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* Notice: For clarity of exposition, the legislative proposals set out in the Bill described in this text are stated as if they had already been adopted or were in force. It is important to note, however, that bills may be amended during their consideration by the House of Commons and Senate, and have no force or effect unless and until they are passed by both Houses of Parliament, receive Royal Assent, and come into force.

(1) *Canada (Commissioner of Competition)* v. *Superior Propane Inc.* (2000), 7 C.P.R. (4th) 385; *Canada (Commissioner of Competition)* v. *Superior Propane Inc.*, 2001 FCA 104; *Canada (Director of Investigation and Research)* v. *Hillsdown Holdings Canada Ltd.* (1992), 41 C.P.R. (3rd) 289; *Canada (Director of Investigation and Research)* v. *Imperial Oil et al.*, CT-89/3.

confusing, to say the least. Just when the Tribunal had come to agree with the Competition Bureau's Merger Enforcement Guidelines (MEGs) on the treatment of efficiencies according to the "total surplus standard" in *Superior Propane*, the Bureau abandoned its guidelines. To make matters less clear, the Federal Court weighed in and overturned the Tribunal's decision in favour of expanding the strictly quantitative analysis of the "total surplus standard" (which is designed to evaluate only the overall economic impact of the merger) to include redistributional effects of the merger. At the same time, the Federal Court advocated neither the "consumer surplus standard" nor the "U.S. price standard" approach.

This court direction opened the door for the Commissioner, as well as the lone dissenting Trial judge sitting on *Superior Propane*, to advocate the "consumer surplus standard" in the Tribunal's re-decision. However, sensing that such a restrictive standard would render section 96 virtually ineffective, the majority opinion of the Tribunal panel chose to supplement the "total surplus standard" with a calculation of what is described as the "adverse social effects" of the merger; that is, the wealth redistributed from "poor" consumers to the shareholders of the merging entity. The Commissioner has since appealed this decision.

These series of events led many eminent competition law commentators to suggest that the efficiencies of a merger do not seem to count for much in Canada. The House of Commons Standing Committee on Industry, Science and Technology, which had been engaged in a thorough review of Canada's competition regime while *Superior Propane* was being decided, came to the conclusion that more study of the issue was warranted and thus recommended:

> That the Government of Canada immediately establish an independent task force of experts to study the role that efficiencies should play in all civilly reviewable sections the *Competition Act*, and that the report of the task force be submitted to a parliamentary committee for further study within six months of the tabling of this report.

The Government of Canada, in its reply to the Committee, declined to follow this recommendation, citing ongoing litigation of the issue and the intent to commission a study of the treatment of efficiencies internationally that would be submitted for parliamentary review.

This document provides background information on the *Competition Act* as it pertains to mergers, most importantly its treatment of efficiencies. It also describes and clarifies the single substantive clause of Bill C-249, An Act to Amend the Competition Act, and provides

a commentary on the overall impact of the bill in terms of its treatment of efficiencies under merger review. Finally, this document includes two appendices that: go into considerable detail on the issues raised in *Superior Propane*; offer a more complete context on the current state of affairs with respect to efficiencies and mergers; and provide some in-depth analysis of alternative welfare standards, including that proposed by Bill C-249, for dealing with efficiencies in the context of merger review.

BACKGROUND

A. Mergers, the Competitive Process and the *Competition Act*

The interplay between the process of competition and competition policy and law is an interesting one. Competition is a means to an end, not an end in itself. We have competition so that the business sector can deliver the best combination of products at the best prices to consumers. The best deal a consumer can receive usually comes from a free and open market, one with as few barriers as possible to entry by new competitors and as few exit barriers, including government-imposed barriers such as product, investment or trade regulations.(2) However, even in the absence of government-imposed barriers, unfettered competition alone may not be enough. A complementary competition law is usually required in circumstances where, owing to technological barriers, competition will not automatically and immediately flourish.

The *Competition Act* can be said to have three general targets: conspiracies to raise prices; mergers and acquisitions that would monopolize markets; and a dominant firm's abusive business practices and predator policies that would injure, rein in or drive out its smaller rivals. In terms of mergers, very few of them would be classified as anticompetitive. In fact, they are often sought to achieve efficiencies in production or to foster innovation. For this reason, the vast majority of mergers pose no threat, or raise no issue, under the *Competition Act*. Expert analysis reports that about 1.6% of all publicly reported mergers (7.5% of those

(2) Government policies – such as CRTC telecom and cable and satellite television regulations, the dairy and poultry quota systems, airline ownership and cabotage services restrictions, Ontario's beer and liquor distribution system, first-class mail and interprovincial trade restrictions – represent a number of such barriers.

examined) between 1986 and 1994 raised an issue under the Act.[3] Indeed, the number of issues raised in merger cases further declined in the latter half of the 1990s. When one subtracts mergers in which monitoring was the chosen enforcement response by the Commissioner – because they were never later challenged or brought back under investigation – the number of mergers that raised an issue under the Act since its inception in 1986 has averaged only 2% of examinations undertaken by the Bureau.

B. Merger Enforcement Guidelines and Efficiencies

The Bureau's MEGs recognize and identify two broad classes of efficiency gains: production efficiencies and dynamic efficiencies. Production efficiencies arise from real savings in resources that permit a firm to produce more output and/or better-quality output from the same amount of input. These efficiencies can be measured and supported by engineering, accounting or other data, and they include:

1. Product-level, plant-level and multi-plant-level operating and fixed-cost efficiencies;[4]
2. Savings associated with integrating new activities within the firm; and
3. Savings attributable to the transfer of superior production techniques and know-how from one of the merging parties to the other.

Dynamic efficiencies include gains achieved through the early introduction of new products and services, the development and adoption of better and more efficient productive processes, and the improvement of product and service quality and diversity. However, given

(3) Donald G. McFetridge, *Competition Policy Issues*, Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, September 1998, p. 11.

(4) Product-level efficiencies commonly accrue to the firm through the exploitation of "economies of scale"; these efficiencies reduce the long-run average unit cost of a good or service through an increased volume of production. These scale economies can also occur at the plant level when plants expand to their optimal size (assuming they have not already reached minimum efficient scale). Furthermore, at higher production rates, the mechanization of specific production and assembly functions previously carried out manually can yield scale-related resource savings. Economies of scope, whereby plant-level unit costs can be reduced when two or more products are produced together rather than separately, are also possible; these efficiencies are common in many service industries. Other efficiencies that can arise at the plant level include savings that flow from specialization, the elimination of duplication, reduced downtime and set-up costs, and a proportionately smaller base of spare parts and inventory requirements. Multi-plant-level savings can arise from plant specialization and the rationalization of various administrative and management functions, as well as R&D activities.

the difficulty in ascertaining these efficiencies (since they are speculative about the future), they are accorded a small weight and will generally be treated qualitatively.

C. The *Competition Act* and its Merger Provisions

The *Competition Act* provides for the civil review of mergers (sections 91 through 97) by the Tribunal. On application by the Commissioner, the Tribunal may issue a prohibition or divestiture order with respect to a merger that is deemed to "prevent or lessen competition substantially"; the Tribunal may also vary or deny such a requested order.

In general, a merger will be found "likely to prevent or lessen competition substantially" when the parties to the merger would more likely be in a position to exercise a materially greater degree of market power in a substantial part of a market for two years or more. Market power can be exercised unilaterally or interdependently with other competitors, and determining whether it exists and can be exercised is done according to a well-established review process. This process will be explained in two parts: (1) the entire merger analysis before the consideration of efficiencies (sections 91-95), which, for convenience, can be called the substantial lessening of competition or "SLC" test; and (2) the consideration of efficiencies (section 96). This approach to the explanation is justified on the grounds that, before an analysis of efficiencies related to the merger even commences, the merger must have failed the tests related to "is likely to prevent or lessen competition substantially" in a market determined under section 93. If the merger does not fail the Section 93 tests, the efficiencies defence is not required (as in *Hillsdown*).

Section 97 does not deal with merger analysis *per se*, but does impose a limit on the application for a section-92 order to a period of three years from the time when the merger was substantially completed.

D. Sections 91-95: The "SLC" Test

Section 91 of the *Competition Act* sets forth the definition of a "merger," which is deemed to occur when direct or indirect control over, or significant interest in, the whole or a part of a business of another person is acquired or established. The principal issue in this section is the interpretation of the words "significant interest," which is considered to occur when a person acquires or establishes the ability to materially influence the economic behaviour of the

business of a second person (e.g., block Director resolutions or make executive decisions relating to pricing, purchasing, distribution, marketing or investment). In general, a direct or indirect holding of less than a 10% voting interest in another entity will not be considered a significant interest. However, a significant interest may be acquired or established pursuant to shareholder agreements, management contracts and other contractual arrangements involving incorporated or non-incorporated entities.

Section 92 authorizes the Tribunal, upon application by the Commissioner and upon determining that a completed or proposed merger "is likely to prevent or lessen competition substantially" in a market as provided under sections 93 through 96, to dissolve the completed merger, dispose of assets or shares of the completed merger, or prohibit the consummation of the proposed merger in whole or in part. Section 92 also prohibits the Tribunal from determining that a merger "is likely to prevent or lessen competition substantially" in a market solely on the basis of evidence of concentration or market share.

Section 93 lists a number of factors to be considered when determining whether a completed or proposed merger "is likely to prevent or lessen competition substantially" in a market. These factors include: (a) the extent of foreign competition; (b) the likelihood that the business, in whole or in part, of one of the parties to the merger is going to fail; (c) the availability of acceptable substitutes; (d) any barriers to entry, whether due to absolute cost advantages, sunk costs, tariff or non-tariff barriers to international trade, interprovincial trade barriers, or regulatory control over entry; (e) the extent to which effective competition remains, including the time it would take a potential competitor to become an effective competitor; (f) the removal of a vigorous and effective competitor; (g) the nature and extent of change and innovation in the relevant market; and (h) other relevant criteria that would be affected by the completed or proposed merger.

An initial screen usually precedes the section-93 analysis: the Commissioner will calculate and analyze market share and concentration thresholds to be able to distinguish markets that are unlikely to be prone to anticompetitive conduct. The markets that do not surpass the requisite thresholds will be screened out of the review. The threshold for unilateral exercise of market power is 35% of the post-merger *pro-forma* market share of the merging parties (sales volume or production capacity). The threshold for interdependent exercise of market power incorporates a 65% market share held by the four largest firms in a post-merger market and a 10% market share held by either of the merging parties.

Sections 94 and 95 provide exceptions to an order under section 92. Section 94 deals with a completed or proposed merger under the *Bank Act*, the *Trust and Loans Companies Act* or the *Insurance Act*. Section 95 deals with a joint venture, other than as formed by a corporation, to undertake a specific project or research and development.

E. Section 96: The Treatment of Efficiencies

Section 96 of the *Competition Act* sets Canada's competition legislation apart from those of other countries. This section states that: "The Tribunal shall not make an order under section 92 if it finds that the merger … is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition that … is likely to result from the merger …"; the order to which the Act refers is one that would dissolve or restructure a completed or proposed merger. Some, including the Bureau's MEGs, have interpreted this test, which weighs the two opposing economic factors, as the "total surplus standard."

The Act also defines that "the gains in efficiency" to be considered are those that "would not likely be attained if an order were made in respect of the merger"; that is, these efficiencies must be merger-specific. This implies that if the efficiencies could be realized in a manner that generates less anticompetitive harm than that created by the merger, the efficiencies would not be ascribed to the merger. For example, efficiencies that could occur through internal growth or unilateral rationalization would not be attributed to the merger. Alternatively, there may exist other cooperative means of achieving the efficiencies, such as joint ventures or a restructured merger, which would create smaller anticompetitive effects. Finally, the efficiencies must be real and not just pecuniary; that is, the merger must bring about real savings in resources, and not simply savings that stem from greater bargaining or purchasing power that is essentially redistributive among members of society.

In effect, section 96 provides an exemption to section 92; that is, it introduces the notion of a trade-off between the social losses attributed to the prevention or lessening of competition and the social benefits related to the cost savings resulting from a merger. When the latter exceed the former, society benefits and thus the merger would be allowed. The consideration of efficiencies becomes relevant to the review only once a substantial lessening of competition has been established; otherwise, a merger that passes the section-93 tests need not consider them at all. Finally, the onus of proof is placed on the merging parties to establish that the merger creates efficiencies.

DESCRIPTION AND CLARIFICATION

Bill C-249 would amend the *Competition Act* to clarify the Competition Tribunal's powers to make or not an order in the case of a merger when gains in efficiency are expected or when the merger would create or strengthen a dominant market position. The bill contains one clause that would amend section 96 of the Act by adding two subsections following subsection (3). They are:

> (4) For the purpose of subsection (1), gains in efficiency cannot offset the effects of a lessening or prevention of competition unless the majority of the benefits derived or to be derived from such gains in efficiency are being or are likely to be passed on to customers within a reasonable time in the form of lower prices.
>
> (5) This section does not apply where, after the transaction has been completed, the merger or proposed merger, will result or is likely to result in the creation or strengthening of a dominant market position.

The bill proposes two additional conditions on the balancing requirement established in subsection 96(1). If those conditions are added to the Act, the efficiencies resulting from the merger would, at face value, be less significant. Moreover, some of the eligible efficiencies under the current framework may be made ineligible under Bill C-249 amendments. Without qualification, the introduction of these additional burdens would make the section-96 test more difficult and would, therefore, reduce the prospects of a merger passing the review despite the fact that the evidentiary burden appears to be imposed mostly on the Commissioner in both cases.

The first of the two subsections proposed by the bill would require that the merging entity pass on at least 50% of its efficiency gains that are attributable to the merger to consumers before these efficiencies are determined to "offset the prevention or lessening of competition substantially." Indeed, the eligibility of a claim of efficiency under subsection (1) would be conditional on more than 50% of it being passed on to consumers. This subsection further requires that the transfer of the efficiency gains from the merging entity to consumers must be in the form of lower prices and by no other means (e.g., rebates, coupons, better products and services at the same prices).

Presumably, Bill C-249 envisions the benchmark prices of its test to be those of the post-merger entity that are expected to prevail in the absence of the efficiencies being passed on to consumers, rather than existing prices; more clarification here would be helpful. In *Superior Propane*, the post-merger prices were said to be based, in part, on the realization of

efficiencies that would reduce variable unit costs and the degree to which they would be passed on to consumers (through a consideration of the elasticity of demand). Presumably, the Tribunal had the ability (through the pleadings of the contesting parties) to determine the post-merger prices in the absence of any efficiencies being passed on to consumers as well. This determination will be critical if the proposed test under Bill C-249 is to be technically feasible. In the alternative, if the Tribunal is not able to determine the post-merger prices in the absence of any efficiencies being passed on to consumers as a benchmark price, then it is unclear whether the proposed test of Bill C-249 is at all practical.

In *Superior Propane*, the Tribunal accepted a 10-year period for the realization of efficiencies attributable to the merger; presumably, a 10-year period satisfies the "within a reasonable time" requirement even though the higher prices expected because of the exercise of increased market power begin almost immediately upon final completion of the merger.

The second of the two subsections contained in Bill C-249 vitiates section 96 altogether (including the Bill's proposed new subsection (4)) in cases where the merger is likely to result in the creation or strengthening of a dominant market position. The bill does not define "dominant market position," therefore it *de facto* defers this definition to judicial interpretation.

ANALYSIS AND COMMENTARY

Bill C-249, like the Commissioner and the Federal Court, advocates that the "total surplus standard," as set out in the Bureau's MEGs and in the Tribunal's original ruling in *Superior Propane*, does not provide a sufficient test for a merger that is deemed to "prevent or lessen competition substantially" to be in the "public interest." It also appears that the bill implies a similar judgment of the Tribunal's *Superior Propane* re-decision, which tacked on a social redistribution test – limited to those considered "poor" final consumers of a "necessity" – to the "total surplus standard." Yet many expert commentators argue the opposite. They claim that, properly applied, the "total surplus standard" is a sufficient test under merger review in which to determine the "public interest" (see Appendix I). Furthermore, had the Bureau not erred in the calculation of the "deadweight loss" (see Appendix I) attributable to the merger of Superior Propane Inc. with ICG Propane Inc., it is likely that the Tribunal would have ordered the merger's dissolution. These commentators further argue that the Commissioner's latest favourite, the "consumer surplus standard," represents overkill, as was implied by the Tribunal in both of its *Superior Propane* decisions (see Appendices I and II).

Efficiencies: A Hot Issue

Treatment of efficiencies in the merger context, and by extension in competition policy generally, has been a subject of great attention. Canada's 1986 merger law dates from the high water mark of "Chicago" economics, and thus it takes a strong position about efficiencies. A merger that reduces competition may proceed if that loss is offset by gains in efficiency. The Bureau's 1991 merger guidelines followed the Chicago tradition and interpreted this balancing in terms of the lenient "total surplus" standard. If the gains in productive efficiency, making resources available for other purposes, exceed the "deadweight loss" from the reduction in output due to market power, then the merger would be permitted.

The facts of the 1998 *Superior Propane* transaction challenged that position starkly. The merger, to near-monopoly, would produce dead-weight loss and other inefficiencies totalling about CAD 6 million, but it would save the combined firms about CAD 30 million. And the market power would lead to an increase in consumer prices for bottled petroleum gas, which is sold mostly to lower-income rural users and small businesses, of about CAD 40 million, or nearly 10%. The Bureau challenged the merger and in doing so did not follow its own guidelines. The Tribunal looked only at the dead-weight losses and upheld the acquisition because those losses were outweighed by the cost savings. The Federal Court of Appeal disagreed, finding that the Tribunal had improperly limited the balancing of effects and efficiencies. The court instructed the Tribunal to consider whether other anti-competitive effects, such as wealth transfers from consumers to producers or impacts on smaller businesses, should be compared to the claimed efficiency benefits. Noting that the original competition law had been justified as a measure to protect consumers, the judges were not convinced that it should permit a transaction that significantly increased consumer prices. They were dubious about the "consumer protection" credentials of a decision rule that would find it good to increase prices most to those consumers who were least able to avoid the increase by switching to other products.

The Tribunal has reopened the matter, after the merging parties' application to appeal to the Supreme Court was rejected. The general principle has changed prospectively, in any event. The Commissioner announced in May 2001 that his approach to the statutory balance of efficiencies would consider factors other than the net of losses in total surplus and gains in productive efficiency.

Source: OECD, *OECD Reviews Regulatory Reform: Canada Maintaining Leadership Through Innovation*, 2002, Box 9, p. 79.

The contrast between the "total surplus standard" and all other relevant social welfare standards, including the "consumer surplus standard" and that which is embodied in Bill C-249, begins with their philosophical underpinnings. The "total surplus standard" weighs only the social benefits (i.e., the efficiency gains) against the social costs (i.e., the deadweight loss) of

the merger. Although those who use this welfare standard acknowledge that increased prices due to the ability to exercise market power redistribute wealth from consumers to shareholders of the merging entity, they treat this transfer as neutral and, therefore, it does not enter the social calculus. Accordingly, this analysis *de facto* treats "a dollar in the hands of the shareholders of the merged entity as equal to the dollar in the hands of the consumer" even though those who use this standard rarely believe this statement to be true. Those who advocate the "total surplus standard" recognize that the standard is simply a means for determining and enhancing economic efficiency; on its own, this welfare standard does nothing for social equity. However, they nevertheless justify this standard's use over others on social grounds because they contend that the *Competition Act* is a very blunt instrument of social redistribution and the government has other and more effective means, such as progressive taxation, special status through tax exemptions, subsidies, social welfare, etc., for addressing social inequities.

On the other hand, Bill C-249's proposed subsection (4) to section 96, like the "consumer surplus standard," adopts the notion that "a dollar in the hands of the consumer is worth more than a dollar in the hands of the shareholders of the merged entity." This position can be inferred from the fact that the bill does not accept section 96 in its current form, which requires that the social benefits exceed the social costs of the merger only as per the "total surplus standard." The bill would, however, accept section 96 as currently interpreted provided that more than 50% of the efficiency gains derived from the merger are put in the hands of consumers in the form of lower prices. In effect, this additional condition does not change the aggregate social cost-benefit data one iota, but instead prescribes a social distribution of the efficiencies to be deemed eligible for inclusion in the social cost-benefit determination. Consequently, in determining what is in the "public interest" it is necessary to calculate not only whether the merger will create wealth, but also how much and in whose hands this wealth is held. This begs the question: why 50% plus and not 40%, 60%, etc.?

In terms of efficiency and equity, when one compares the pre- and post-*Superior Propane* interpretations of the Act with that of the "consumer surplus standard" and that which Bill C-249 would add, several interesting observations emerge. Barring error in its application, the "total surplus standard" incorporated in the merger review process (sections 91 to 97) would permit all mergers that are determined to be likely to enhance economic efficiency and social welfare, even if they prevent or lessen competition substantially. Those that would not enhance social welfare would be rejected. This welfare standard does not address (except by

coincidence) any equity issues that might arise and, therefore, would be situated relatively close to the "efficiency polar" on a hypothetical efficiency-equity continuum.

The modified "total surplus standard," as rendered in the *Superior Propane* re-decision, would permit all mergers that are determined to be likely to prevent or lessen competition substantially but that would enhance economic efficiency and social welfare, after considering and incorporating the adverse social effects on those consumers deemed "poor" (those in the bottom quintile of income earned) and products deemed a "necessity." Given that these adverse social effects can be determined, this modified standard would be situated somewhere in the middle of a hypothetical efficiency-equity continuum.

The adoption of the "consumer surplus standard," as advocated by the Commissioner, or the conditions established in Bill C-249, would permit very few mergers that are deemed likely to prevent or lessen competition substantially even though they would enhance economic efficiency and social welfare (see Appendix II). The equity considerations of these welfare standards are substantial, and these standards would be situated relatively close to the "equity polar" on a hypothetical efficiency-equity continuum.

Two related issues must be resolved in order to arrive at a critical judgment on Bill C-249. First, it must be determined whether a better solution can be obtained by having the government's antitrust instrument, the *Competition Act*, specializing in matters of efficiency and disregarding some but not all matters of equity, while employing other policy instruments, such as progressive taxation, special status through tax exemptions, subsidies, social welfare, etc., for dealing with the more pressing social equity issues. Or would a better solution come from crafting a new antitrust instrument that would incorporate more explicitly both efficiency and equity considerations in order to provide a social balance through the *Competition Act* itself, while continuing to employ the above-mentioned social equity instruments, possibly in a more redundant fashion? Second, and closely related to the first issue, could and should the bluntness of the *Competition Act* be reduced in favour of a public policy instrument that works on both efficiency and equity matters with scalpel-like precision?

Beyond philosophical matters, subsection (4) would introduce a number of practical obstacles to the review of mergers that are deemed "likely to prevent or lessen competition substantially." Subsection (4) would restrict eligible efficiency gains under section 96 to those that are likely to be passed on to consumers in the form of lower prices within a reasonable time. If this means that prices must be lower than the expected post-merger prices in the absence of efficiency gains, then this condition will severely restrict the application of

section 96. If it means that existing prices must fall post-merger in relation to the amount of these efficiency gains, then this condition will, in all probability, vitiate section 96 altogether.

Subsection (4) also appears to restrict efficiency gains that are eligible for purposes of section 96 to those that affect variable (marginal) unit costs. As the Tribunal has not provided sufficient judicial interpretation on what types of costs are variable and what are not in the few predatory pricing cases held to date, subsection (4) would be highly problematic. The uncertainty permeating the predatory pricing provision (paragraphs 50(1)(b) and 50(1)(c)) would soon be imported into merger review and could potentially bog down merger enforcement in the more controversial and borderline cases. Furthermore, a merger that realizes efficiency gains through savings in fixed costs would not be able to use the efficiencies defence under section 96. These savings are usually windfall gains that do not influence pricing decisions and thus accrue mostly to the merging parties. Consequently, the proposed subsection (4) would rule out efficiencies that bring about economies of density and efficiencies that bring about industry rationalization, such as the elimination of set-up or change-over costs. However, once the anticompetitive effects of increased market power have been established under section 93, there is no economic rationale for making an efficiencies defence available based on the type of efficiency.

Subsection (5) would vitiate section 96 altogether, including the proposed subsection (4) of Bill C-249, in cases where the merger is likely to result in the creation or strengthening of a dominant market position. This additional condition implies that there is something inherently anticompetitive about acquiring or reinforcing the status of being “dominant” within a market beyond that of being able to exercise market power, and thus requires special attention in the form of an extraordinary provision within the Act. The Commissioner made a similar argument about the status of having a dominant market position in *Superior Propane* without recourse to a special provision in the Act – the actual argument advanced was the case of “a merger to monopoly” – but that argument was rejected by the Tribunal.

Conventional economic thinking holds that the creation or strengthening of a dominant market position is just another way of describing market power. The anticompetitive effects of an increase in market power are issues for determination under section 93. Although some factors listed in section 93 are more important than others in some circumstances and just the opposite in other circumstances, it is their impact on market power and not on the label of being “dominant” in a market that matters. And once the anticompetitive effects of an increase

in market power have been established under section 93, there is no economic rationale for making available the efficiencies defence in some cases and not in others.

A secondary consideration would be the working definition of the term "dominant market position." Would the 35% market share "safe harbour" threshold currently used by the Bureau's MEGs in determining the potential for acquiring "market power" be the appropriate distinguishing criterion? Or would the "dominance" definition used in the Abuse of Dominant Position provision (section 79) be more appropriate? In *Laidlaw*, the Tribunal held that dominance would not be presumed where market share is below 50%.[5] Clearly, the 35% market share threshold would have been considered in section 93, so this definition would be redundant and would vitiate section 96 in every case that failed section 93.

Notwithstanding the above criticisms of the substance of Bill C-249, there is merit in reformulating the amendments introduced by the bill to achieve the same intended objectives by de-linking them from the test established in subsection 96(1). Subsection 96(1) establishes a single test for a merger that "is likely to prevent or lessen competition substantially," and subsections 96(2) and 96(3) limit the eligibility of certain claims of efficiency. Instead of treating the two subsections of Bill C-249 as further limiting factors – which means that the current subsection 96(1) would have to look to subsections 96(2) through 96(5) for eligibility in the test – these two new subsections could be integrated directly into the current subsection 96(1). In this case, subsection 96(1) would refer to three conditions that must be satisfied for a merger to be in the "public interest," and then list these three conditions (the current condition and the two proposed in Bill C-249), which could be set up as paragraphs 96(1)(a) through (c). Subsections 96(2) and 96(3) would then be amended to limit the eligibility of claims of efficiency for all three tests.

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(5) *Director of Investigation and Research* v. *Laidlaw Waste Systems Ltd.* (1992), 20 C.P.R. (3rd) 289.

APPENDIX I

CANADIAN COMPETITION RECORD

THE FIRST SECTION

COMPETITION TRIBUNAL'S REDETERMINATION DECISION IN *SUPERIOR PROPANE*: CONTINUED LESSONS ON THE VALUE OF THE TOTAL SURPLUS STANDARD

By: Margaret Sanderson
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As the facts of *Superior Propane* are discussed elsewhere,[1] this note focuses solely on the efficiency trade-off debate arising from the most recent Competition Tribunal redetermination decision.[2] While there are undoubtedly many explanations for the Commissioner's decision to abandon the total surplus standard as it is articulated in the *Merger Enforcement Guidelines* when arguing the case before the Tribunal in the original hearing, the Decision underscores the tragic consequences of this decision. In fact, the Tribunal notes that had the Commissioner properly argued the total surplus standard in the first instance, the Tribunal might have reached a different conclusion in respect of allowing the transaction to proceed. Instead, having argued for a balancing weights standard to replace the total surplus standard during the original Tribunal hearing, followed by the Federal Court of Appeal's decision and the Commissioner arguing for a consumer surplus standard before the Tribunal during the redetermination hearing, we are currently left with a standard which for all intents and purposes "fixes something that was never broken". Indeed, the evidentiary burden upon the Commissioner under the balancing weights standard appears to be more onerous than a properly articulated total surplus standard.

Total Surplus Standard: Yet Again

As the total surplus standard is widely misunderstood, it is useful to briefly review it. In economic terms, use of the total surplus standard means that a merger will not be challenged where it has, or is likely to have, the effect of increasing the sum of producer and consumer surplus. When a merger is anticompetitive it results in price increases, thereby giving rise to both a redistribution effect from consumers to producers and a negative resource allocation effect. The total surplus standard dictates that no differential weight will be accorded to the transfer from consumers to producers, instead viewing this redistribution as neutral.[3]

The rationale for a total surplus approach is firmly grounded in economics. Economists generally advocate treating the wealth transfer effects of mergers as neutral, because of the difficulty of assigning weights to certain effects *a priori* based on who is more deserving of a dollar. In contrast, a consumer-oriented approach, such as the consumer surplus standard, advocates treating consumers as more deserving of the wealth transfer than shareholders. This is not to say that it is not theoretically possible to assign differential weights to consumers and producers, which is precisely what the balancing weights approach does.

In particular, there are two common misconceptions about the total surplus standard: (1) mergers in industries with inelastic demand necessarily result in small deadweight losses; and (2) minimal cost savings almost always outweigh deadweight losses, which fails to take into account the possibility of pre-existing market power. Both misconceptions are effectively dealt with by the Tribunal in the Decision.[4] Moreover, the *Merger Enforcement Guidelines* clearly articulate that:

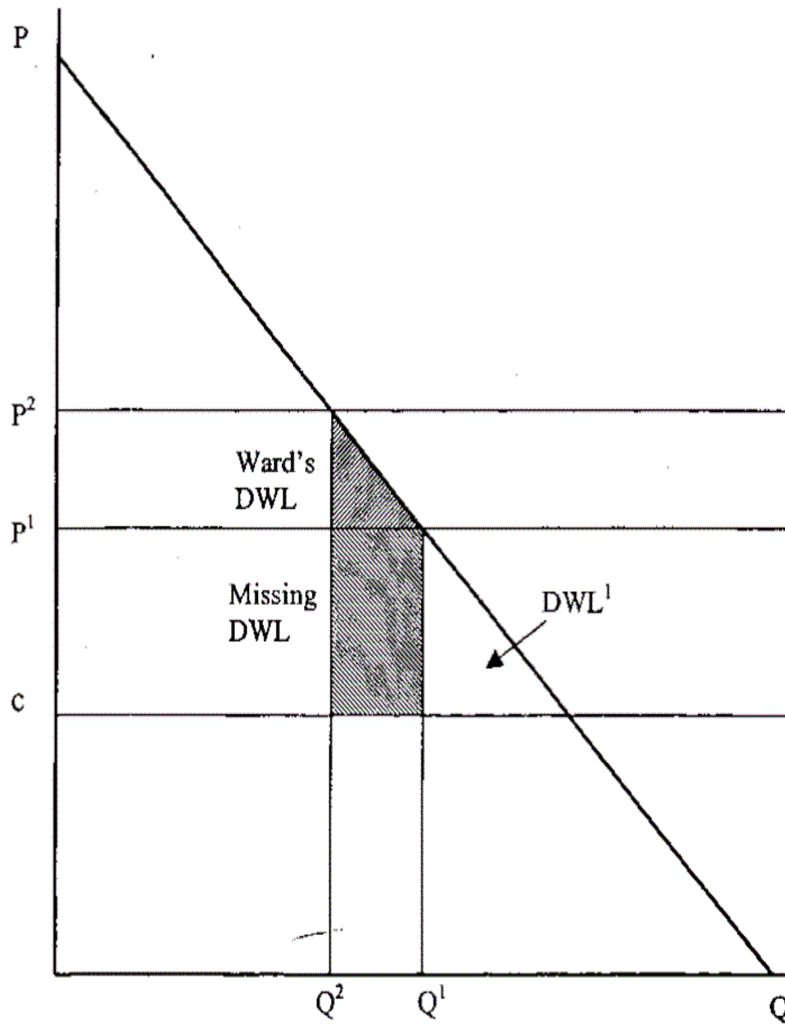
> [i]n estimating the extent of negative resource effects of mergers, the Bureau includes the additional losses in total surplus that arise when market power is being exercised in the relevant market prior to the merger.[5]

With respect to the first misconception, the magnitude of the deadweight loss resulting from the exercise of market power depends upon the percentage change in price, the change in quantity and the demand elasticity. The more inelastic is demand, the larger is the expected price increase post-merger. In his concurring opinion, Dr. Lawrence Schwartz illustrates this issue using the evidence presented by one of the Commissioner's economic experts, Professor Ward. Below, the table presented at paragraph 396 of the Decision is reproduced.

	Elasticity = -1.5	Elasticity = -2.0	Elasticity = -2.5
Residential propane price increase	8.0% DWL = 0.5%	4.1% DWL = 0.2%	2.1% DWL = 0.1%
Industrial propane price increase	8.9% DWL = 0.6%	5.4% DWL = 0.3%	3.3% DWL = 0.1%
Automotive propane price increase	7.7% DWL = 0.5%	4.5% DWL = 0.3%	2.7% DWL = 0.1%

Reading the columns in the above table from right to left, it is evident that as demand becomes more inelastic, the price increase expected post-merger rises and the associated deadweight loss also rises. Thus, it is not the case that inelastic demand necessarily implies smaller deadweight losses. In the case of *Superior Propane* the opposite is true – the more inelastic the demand, the higher the deadweight loss given the higher expected post-merger price increases.

The second misconception that was addressed by the Tribunal in the Decision relates to pre-existing market power. When pre-merger conditions are not competitive, a market-power increasing merger increases the size of the pre-merger deadweight loss by an amount that is much larger than a triangle. The following diagram taken from an article by Mathewson and Winter that appeared in the Fall 2000 issue of the *Record* illustrates the issue:[6]



The pre-merger deadweight loss is identified as DWL^1. The post-merger deadweight loss is equal to the shaded area plus DWL^1. Thus, the change in deadweight loss as a result of the merger is given by the shaded area. In the case of *Superior Propane*, the Commissioner's expert, Professor Ward, only identified the area labeled "Ward's DWL" as the deadweight loss resulting from the merger. The rectangle below this triangle (labeled "Missing DWL") was not introduced until final argument, as the Tribunal describes at paragraphs 165-167 of the Decision.

Despite the fact that the evidence put forward at final argument was excluded by the Tribunal, Mathewson and Winter use the evidence accepted by the Tribunal in the original hearing to quantify the Missing DWL area. The critical inputs to their calculation are the Tribunal's finding that the firm elasticity of demand equals –3.0, which implies a price-marginal cost mark-up of 50% given pre-merger price levels, together with the market demand elasticity relied upon by the Tribunal in the original decision, which equals –1.5. The true deadweight loss from the merger is calculated to be $25.5 million rather than the $3.0 million estimated by Professor Ward. Since the Tribunal accepted total cost savings of $29 million, the mistake of not including pre-existing market power as part of the deadweight loss calculation is clearly a major one. Indeed, in the Decision, the Tribunal states at paragraph 169:

> it appears to the Tribunal that the typical analysis of effects, based on the assumption that pre-merger conditions were competitive, may not have been appropriate in this case and that the deadweight loss may be much larger than the estimate thereof on which the Commissioner now relies. It therefore cannot be said that the Total Surplus Standard necessarily would have led the Tribunal to approve the instant merger had the deadweight loss been measured properly. [emphasis added]

Efficiency Trade-offs: Where Are We Now?

Given the failure to properly understand and apply the total surplus standard in *Superior Propane* at the time of the original hearing, a new standard – that of balancing weights – was argued by the Commissioner, although abandoned during the Redetermination hearing, when a consumer surplus standard was advocated. Having determined that use of a consumer surplus standard made section 96 ineffective or inoperative, the Tribunal adopted the balancing weights standard, in light of the Federal Court of Appeal's directions to it.

As the Tribunal employed it in *Superior Propane*, the balancing weights approach involves assigning a weight equal to "unity" (or one) to all producer gains from the merger and then solving for the value of the weight "*w*" that is assigned to all consumers such that the weighted surplus is zero (where the "transfer" is the transfer from consumers to producers) as follows:

$$1 \times (\text{transfer} + \text{cost savings}) - w \times (\text{transfer} + \text{deadweight loss}) = 0$$

To make the equation concrete, in *Superior Propane* and given the evidence before it, the Tribunal found that *w* equals 1.6, which means that to allow the merger the Tribunal must find that the weight that properly reflects the consumer loss is at least 60% higher than the weight on shareholder gains. (If one incorporates pre-existing market power using the calculus undertaken by Professors Mathewson and Winter noted above, the value of w is 1.1, meaning that the weight accorded to consumers would need to be at least 10% higher than the weight accorded to shareholders to cause the consumer losses to outweigh the producer gains.)

The devil was then in the proverbial details, when the Tribunal sought evidence on the income distribution for the various parties that would face higher prices in order to determine whether consumers did warrant a weight that was so much higher than that accorded to producers. Of course, this request for such detail is a natural consequence of use of the test. Indeed, it is one of the reasons why most economists are in favour of a total surplus standard – it is very difficult to value who is more deserving of a dollar.

With the Tribunal's Redetermination decision once again under appeal, it is unclear where the efficiencies trade-off standard will head next. Added to this is the resurgence of Bill C-248, proposing further amendments to section 96. In light of this uncertainty, the recommendation by the House of Commons Standing Committee on Industry, Science and Technology in its Report *A Plan to Modernize Canada's Competition Regime* that the:

> Government of Canada immediately establish an independent task force of experts to study the role that efficiencies should play in all civilly reviewable sections of the *Competition Act*, and that the report of the task force be submitted to a parliamentary committee for further study within six months of the tabling of this report (Recommendation 28)

is opportune, and a recommendation which hopefully the Commissioner will endorse.

In moving forward, we might consider how this particular turn of events brought us to this juncture. From an outside economist's perspective, the most important contributing factor appears to be the failure to understand all dimensions of the total surplus standard as it is articulated in the *Merger Enforcement Guidelines*. This should no longer be the case given the clear correction by the Tribunal of some of the more common misconceptions with respect to the total surplus standard. In particular, it is very important to account for pre-existing market power in measuring the anticompetitive effects from the merger, as is clearly outlined in the *Merger Enforcement Guidelines*.

Enforcement officials and litigators may resist accepting the fact of pre-existing market power under the misconception that this reduces the magnitude of the substantial lessening of competition that may result from the merger. Again, the case of *Superior Propane* is instructive on this point. Notwithstanding the Tribunal's mention of the likely existence of pre-existing market power in this industry, it still found that the merger was likely to substantially lessen competition, with prices rising, on the Commissioner's evidence, by 7% to 11% depending upon the product and after taking into account the pass-through of cost savings (at [453] of the Tribunal's original decision). Mergers in markets with pre-existing market power can still give rise to a substantial lessening of competition. Further, the greater the amount of pre-existing market power, the greater the efficiencies must be in order to offset the resulting welfare loss. As a consequence, the more closely a merger approaches a merger to monopoly, the less likely it is that any efficiency accompanying the merger will offset the resulting welfare loss. The total surplus standard does not need to be abandoned to achieve this result. It only needs to be properly applied as articulated in the *Merger Enforcement Guidelines*.

Notes

1 See the articles on *Superior Propane* in this issue and the Fall 2000, Summer 2001 and Winter 2001-2002 issues of the *Record*.

2 [2002] C.C.T.D. No. 10 (the "Decision"). The Commissioner has subsequently appealed the Decision.

3 For a fuller discussion of the economics, see D.G. McFetridge, "The Efficiencies Defense in Merger Cases" in M. Coate & A. Kleit, eds., *Competition Policy Enforcement: The Economics of the Antitrust Process* (Boston: Kluwer Academic Publishers, 1996).

4 The Tribunal corrects the first misconception at paragraphs 393-398, and the second misconception at paragraphs 165-169.

5 *Merger Enforcement Guidelines* at section 5.5, page 50.

6 Mathewson and Winter, "The Analysis of Efficiencies in *Superior Propane*: Correct Criterion Incorrectly Applied" (2000) 20:2 Can. Comp. Rec. 88.

APPENDIX II

EFFICIENCIES STANDARDS: TAKE YOUR PICK

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Introduction

The question posed for a session at a recent conference on competition policy was whether the merger review process has become dysfunctional. This is a strong term. It implies that something more is needed than routine procedural reforms. Presumably, it was the decision of the Federal Court of Appeal[2] in the appeal of the Competition Tribunal's initial decision in *Superior Propane*[3] that led the planners of the conference to pose the question in these terms. The issue is presumably whether the lack of statutory clarity with respect to section 96 of the *Competition Act* together with the jurisprudence with which it has now been burdened make the merger provisions of the Act unworkable in the sense that the evidentiary requirements are too great, the proceedings are too complex and the likely outcomes too idiosyncratic. To some, there is a need for a review of section 96, to others there is a need to amend it.

The situation is certainly not a pretty one but there are some indications in the decision of the Competition Tribunal in the *Superior Propane* redetermination that there may be light at the end of the tunnel.[4] There is plenty of bad news but perhaps also some good news. The bad news is, first, that to comply with a poorly-reasoned decision of the Federal Court of Appeal, the Tribunal has adopted a balancing weights interpretation of section 96. This approach will not be workable and, indeed, is no longer advocated by the Commissioner of Competition who was its sole champion. Second, the Tribunal and the Commissioner remain seriously at odds with respect to the interpretation of section 96. The Commissioner has moved on to advocate a consumer surplus interpretation of section 96. This is the Commissioner's third interpretation of section 96 in three years. The consumer surplus interpretation of section 96 has little to commend it. Criticisms of it by the Commissioner's own expert witness in *Superior Propane*, Professor Townley, are cited at some length by the Tribunal in the Redetermination Decision.

The good news is that the total surplus interpretation of section 96 which had come to be the Tribunal's preferred interpretation may yet survive as the default standard where evidence of adverse redistributive effects or the weight to be attached to them is inconclusive. The Redetermination Decision leaves the clear impression that, in the absence of persuasive evidence to the contrary, the Tribunal will assume that income transfers are neutral. The assumption that redistributive effects are neutral is the essence of the total surplus standard. The implication is that the Tribunal may ultimately be able to comply with the Appeal Judgment without changing the fundamentals of merger review. If this turns out to be the case, it would be a welcome outcome. While there are issues to resolve, there is nothing fundamentally wrong with the way section 96 was interpreted by the Competition Bureau for 15 years. As the Tribunal makes clear in the Redetermination Decision, the argument that a total surplus interpretation of section 96 allows a successful efficiencies defence for any merger, no matter how anti-competitive, is simply incorrect. There was and is no persuasive case to be made for abandoning the total surplus standard on the grounds that it constitutes a free pass to monopoly or dominance.

Of course, the Commissioner may have other ideas. He is also appealing the Redetermination Decision. While it is difficult to imagine an appellate court directing the Tribunal to adopt a consumer surplus standard, stranger things have already happened. Amendments to section 96 have also been proposed in Bill C-248.[5] As written, Bill C-248 would limit the situations in which section 96 could be applied, restrict the type of efficiencies that could be considered under section 96 and, possibly, change its interpretation yet again.

Efficiencies Standards: What's Hot, What's Hot

The Tribunal examined five possible interpretations of the efficiencies defence in the Redetermination Decision. Of these, four can be considered "in play."

The first interpretation considered is what the Tribunal calls the "pure price standard" [86]. The pure price standard requires prices to fall post-merger by the full amount of the efficiency gains. Put another way, prices must fall post-merger by the same percentage as unit costs. This can only occur if the merger does not increase market power in the first place. For this reason, Robert Pitofsky calls the full pass-on requirement "a killer qualification."[6] Bill C-248 contains a pass-on requirement that could be interpreted in this way.

The second interpretation of the efficiencies defence considered by the Tribunal is what it calls the modified price standard [87]. This is generally known simply as the price standard. It requires efficiency gains to be large enough to keep the price from rising post-merger. The price standard says that consumers (as consumers) cannot lose from a merger. The United States appears to use a price standard although the Tribunal suggests that it could also be interpreted as using the consumer surplus standard. As will be illustrated below, the price standard is extremely difficult to satisfy and there has been no suggestion from the Commissioner or from others that it is the appropriate interpretation of section 96.

The third possible interpretation of section 96 is the consumer surplus standard. The consumer surplus standard requires that the value of the efficiency gains resulting from the merger exceed the loss (deadweight loss plus transfer) in consumer surplus. It treats a dollar transferred from a consumer to a producer as a dollar lost by the economy regardless of the wealth of the consumer or the wealth of the producer. The consumer surplus standard was suggested by the Competition Tribunal in an *obiter dictum* in its 1992 *Hillsdown* decision.[7] The Commissioner argued in favour of a consumer surplus standard in the *Superior Propane* redetermination and his arguments were rejected by the Tribunal [334]. Presumably, the Commissioner will argue in his appeal that the Tribunal erred in law when it rejected the consumer surplus interpretation of section 96.

The fourth possible interpretation of the efficiencies defence considered by the Tribunal is the total surplus standard. The total surplus standard requires that the economy as a whole must gain from the merger. This requires, in turn, that producer gains exceed any consumer losses. The total surplus standard assumes that transfers between consumers and producers are neutral, that is, a dollar has the same value in the hands of a producer as it does in the hands of a consumer. The total surplus standard is the interpretation given to section 96 in the Competition Bureau's 1991 *Merger Enforcement Guidelines* and also in its 1998 *Merger Enforcement Guidelines as Applied to a Bank Merger*. The Tribunal applied the total surplus standard in the Initial Decision.

The total surplus interpretation of section 96 was subsequently ruled to be incorrect in law in the Appeal Judgment. In the Redetermination Decision, however, the Tribunal noted in general that, given the information required to identify redistributive effects, " ... the assumption of neutrality could be appropriate in many circumstances." [329] In the case at hand, the Tribunal concluded that there "... is considerable reason to think that portions, perhaps significant portions, of the measured transfer are redistributions of profit among shareholders that society would regard neutrally." [366]

The fifth possible interpretation of section 96 considered by the Tribunal is what has become known as the balancing weights standard. It requires the Tribunal to solve for the relative weights at which producer gains and consumer losses are just equal and then decide if these relative weights are reasonable in the light of any disparity between the respective incomes of the consumers and shareholders involved. The Commissioner advocated the balancing weights interpretation of section 96 both initially before the Tribunal and then before the Federal Court of Appeal but not on the redetermination. The Federal Court of Appeal gave general approval to the balancing weights standard as an appropriate interpretation of section 96 in the Appeal Judgment. In the Redetermination Decision, the Tribunal indicated that, following the Court's ruling in the Appeal Judgment, it would have applied the balancing weights approach had the evidence before it been sufficient to do so. [338] The Tribunal found that the balancing weight was 1.6 (consumer losses would have to be weighted at least 60% more heavily than producer gains in order to kill the merger) but also found that it had no basis on the evidence before it to determine whether a balancing weight of 1.6 was reasonable or not. In essence, the Tribunal ruled in the Redetermination Decision that the balancing weights standard is law but did not apply it. As will become apparent below, it did something quite different.

Total Surplus Versus Consumer Surplus: Licence to Monopolize or Vitiation?

The Commissioner's abandonment of the total surplus standard and his current advocacy of the consumer surplus standard appears to stem from his concern that the total surplus standard is too easy to meet. He appears to believe that under the total surplus approach, any price-increasing merger can successfully be defended simply by firing a president and a vice-president and that mergers to dominance or even monopoly can successfully be defended with little more. He wants a test that is tougher to pass. [170]

The argument that the total surplus standard constitutes a licence to dominate or even monopolize a market is simply and unambiguously wrong. Properly applied, the total surplus standard will be impossible to satisfy for the typical merger to monopoly or to dominance with inelastic demand. In their commentary on the Initial Decision, Mathewson and Winter have argued that the section 96 defence might not have saved the merger under the total surplus standard had the test been properly applied.[8] The Tribunal confirms this in the Redetermination Decision, noting that, had all the relevant evidence been properly introduced, the merger might not have survived the application of the total surplus standard. [167]

In a *Canadian Journal of Economics* paper, Bian and McFetridge calculated the percentage reductions in marginal (unit) cost that would be required to offset the unilateral anti-competitive price effects of mergers between symmetric Cournot oligopolists under the total and consumer surplus standards as well as the price

standard. Some of their calculations are reproduced in Table 1 below.[9] Table 1 shows that a merger to monopoly from Cournot duopoly would require a 13% unit cost reduction to save it under the total surplus standard when the market demand elasticity is 1.5 and a unit cost reduction of almost 9% to save it when the market demand elasticity is 2.

In a subsequent working paper, Bian and McFetridge calculated the percentage reductions in marginal (unit) cost that would be required to offset the unilateral anti-competitive price effects of mergers between members of a Cournot dominant group with a competitive fringe.[10] Some of their calculations are reproduced in Table 2 below. Table 2 shows that a merger to dominance (i.e. a merger leaving one firm in the dominant group) would require a unit cost reduction ranging from over 5% to over 11%, depending on the strength of the competitive fringe, to save it under the total surplus standard when the elasticity of market demand is 1.5.

In the Redetermination Decision, the Tribunal expressed the opinion that mergers will rarely result in eligible efficiency gains in excess of 5% [181]. Based on past experience, this is reasonable. The implication of this is that the efficiencies defence would rarely, if ever, save a merger to monopoly or dominance under the total surplus standard, properly applied.

The consumer surplus standard is generally much harder to satisfy than the total surplus standard. Table 1 shows that it would require an 18% unit cost reduction to save a merger to monopoly when the market demand elasticity is 1.5. But if the 13% required under the total surplus standard is unachievable, which it is, requiring more does not change anything. The point is that from the perspective of making a successful efficiencies defence of mergers to monopoly and mergers to dominance improbable if not impossible, the consumer surplus standard is simply redundant.

What about mergers in tight oligopoly situations? Table 1 shows that, under the total surplus standard, a merger to Cournot duopoly (a three to two merger) requires a unit cost saving of almost 6% to save it when the demand elasticity is 1.5. Again, an efficiencies defence would succeed rarely, if ever, under a total surplus standard. When demand is more elastic, mergers to duopoly or joint dominance could produce sufficient efficiencies to pass a total surplus test. It is in the case of four-to-three mergers that the total surplus standard becomes easier to satisfy and, depending on pre-merger shares, the nature of the cost-savings and the extent of any interdependent anti-competitive effects, can become automatic. With a consumer surplus standard, an efficiencies defence for a merger to duopoly is out of the question. This is also true of four-to-three and even five-to-four mergers when demand is relatively inelastic.

The Tribunal concludes that the consumer surplus standard must be wrong in law because it "vitiates" section 96 [214]. Section 96 would be vitiated by the consumer surplus standard if it were improbable that a merger could lessen competition substantially and avail itself of a successful section 96 defence. On the assumption that efficiency gains in excess of 5% are rarely achieved, the consumer surplus standard can be said formally to vitiate section 96 if it requires efficiencies in excess of 5% to save any merger lying outside the safe harbours in the *Merger Enforcement Guidelines*. It is apparent from Table 1 that the consumer surplus standard marginalizes rather than vitiates section 96. According to Bian and McFetridge's simulations, it is theoretically possible to

mount a successful efficiencies defence of a four-to three merger under the consumer surplus standard provided demand is sufficiently elastic and the efficiencies are substantial.

In essence, as far as mergers raising serious market power concerns are concerned, the adoption of the consumer surplus standard makes no difference. An efficiencies defence would not likely succeed under the total surplus standard, properly applied. It is in cases where market power concerns are less serious and efficiencies are substantial that the consumer surplus standard takes section 96 out of play. This begs the question of whether section 96 has ever been in play in these circumstances and what its effects have been. Have there been any actual cases in which anti-competitive four-to-three mergers resulting in large consumer losses have successfully defended themselves with trivial efficiencies under the total surplus standard? There are no litigated cases and no indication of this in the Commissioner's annual reports.

Balancing Weights Versus Consumer Surplus: Theologians Wanted

The Tribunal interpreted the Appeal Judgment as obliging it to consider the redistributive effects of a merger in the sense of being prepared to weight consumer losses more heavily than producer gains. It interpreted the Appeal Judgment as giving general approval of the balancing weights approach suggested by the Commissioner's economic expert in *Superior Propane*, Professor Townley [335]. According to this approach, the Tribunal must make use of the socio-economic evidence before it to determine the extent and magnitude of any adverse distributional effect of the merger on consumers. Adverse redistributive effects are defined to have occurred if the merger has resulted in transfers of wealth from lower income to higher income groups. Having regard to the size of the transfer and the extent of the income disparity between the relevant consumers and shareholders, the Tribunal is then to assess on the basis of the evidence before it whether the extra weight that must be given to consumer losses to bring them into balance with producer gains is reasonable.

In his evidence in *Superior Propane*, Professor Townley declined to provide any guidance as to how the reasonableness of the balancing weight should be determined, having no basis in economics for doing so. He maintained that the reasonableness of the balancing weight was for the Tribunal to determine on the basis of unspecified public policy criteria. In the Redetermination Decision, the Tribunal responded that it is not a regulator and had no quasi-legislative or policy-development function [24]. Its lay members have expertise in competition matters but no specific industry expertise. They do not represent specific interest groups. The Tribunal views itself as an adjudicator, determining, if it must, the reasonableness of a balancing weight on the basis of the evidence before it rather than striking a balance among contending political interest groups [29]. It is not that the Tribunal ignores the public interest. Rather, it follows the *Competition Act* which itself defines the public interest [34].

In its mandated assessment of redistributive effects in the Redetermination Decision, the Tribunal found that increases in the price of bottled propane could be burdensome to low-income households that use propane for essential purposes and have no good alternatives [367]. It concluded that the balancing weights approach would deem the transfer of wealth from these low income households to Superior and ICG shareholders to be an adverse redistributive effect. It estimated the magnitude of the adverse redistributive effect to be the amount of

the transfer from the lowest income quintile of household consumers of bottled propane to Superior and ICG shareholders [368]. The Tribunal found no reason to believe that the transfers from other households and businesses to Superior and ICG shareholders were adverse and treated them as being neutral. Thus, the vast bulk of the transfer from consumers to producers resulting from the merger was treated by the Tribunal as it would be under the total surplus standard.

Having estimated the magnitude of the adverse wealth transfer, the Tribunal then turned to the question of the differential weight to be attached to it. The Tribunal found that if it simply added the $2.6 million adverse redistributive transfer to the $6 million deadweight loss in consumer surplus resulting from the merger, the anti-competitive effect would be $8.6 million, still well below the $29 million in efficiencies. Adding the adverse transfer to the deadweight loss is equivalent to giving the adverse transfer a balancing weight of 2 or to adopting the consumer surplus standard for those portions of the transfer deemed to be adverse. The Tribunal notes, however, that it has no statutory basis for this weighting. Transfers could as easily be weighted at half the deadweight loss because they are not lost to the economy. In the present case it doesn't matter since the excess of the efficiencies over the anti-competitive effect is so large [371]. The Tribunal gives no indication what it would have done had the choice of weight mattered. It is clear, however, that the Tribunal will not simply make up a weight.

The Tribunal rejected the consumer surplus standard for a variety of reasons, the most prominent being that it is inconsistent with the balancing weights test approved by the Court in the Appeal Judgment as an acceptable interpretation of section 96 [335, 366]. The Tribunal also concluded that the consumer surplus standard could not be correct in law because it vitiated section 96. As argued above, the Tribunal probably overstates the case with respect to vitiation.

The consumer surplus standard treats all consumer losses as if they were losses to the economy. It puts a zero value on the gains producers make at the expense of consumers. In Professor Townley's terms, it effectively assigns a balancing weight of 2 to the transfer from consumers to producers due to supra-competitive pricing post-merger.[11] The consumer surplus standard does not distinguish adverse from neutral transfers. All transfers from consumers to producers resulting from anti-competitive pricing are equally adverse regardless of differences in the socio-economic status of those involved.

The Commissioner referred to the jurisprudence under section 45 of the *Competition Act* in support of his choice of the consumer surplus standard [71]. The usual interpretation of section 45 is that there is no defence for an undue lessening of competition. The public has a right to the benefits of free competition and an undue impairment of that right violates the Act regardless of how beneficial it might be to the parties to the agreement. This begs the question of what constitutes an undue lessening of competition. The Tribunal properly questions the relevance of jurisprudence on the interpretation of undueness in criminal conspiracies to a "full-blown" rule of reason analysis under civil law [77].

The Commissioner argued in the redetermination that all transfers from consumers to producers resulting from an anti-competitive merger are adverse regardless of whether the consumers are richer or poorer than the producers. In his view, the *Competition Act* does not distinguish between rich and poor consumers or between luxuries and necessities [184]. It is, however, one thing to argue that any transfer from consumers to producers resulting from an anti-competitive merger is necessarily adverse, it is quite another to argue that it is so adverse that it should always be treated as if the wealth involved had simply vaporized.

In the Tribunal's view, assuming that the redistribution of wealth from consumers to producers resulting from anti-competitive pricing can never be neutral or even weakly adverse is not the correct interpretation of the Act [186]. The Tribunal is not obliged mindlessly to assign a balancing weight of 2 to all transfers from consumers to producers. It is up to the Tribunal to determine the magnitude of any adverse transfers and the differential weight to assign to them in the light of the evidence before it. The Tribunal may treat some transfers of wealth between consumers and producers as if this wealth had vanished off the face of the earth but it is not obliged to do so in all cases.

The Tribunal argues that if the Court had wanted the Tribunal to adopt the consumer surplus standard, it would surely have stated so in the Appeal Judgment. Beyond being required to recognize that the anti-competitive effects of a merger are not confined to those implied by the total surplus standard, the choice of methodology for determining the magnitude of the anti-competitive effects has been left by the Federal Court of Appeal to the Tribunal [369].

While it recognized that it must depart from the total surplus standard if confronted with evidence of adverse redistributive effects, the Tribunal nevertheless defended the fundamental soundness of the total surplus approach. It rejected the general argument that the total surplus standard results in the automatic acceptance of an anti-competitive merger [173]. With respect to *Superior Propane*, the Tribunal suggests that if the Commissioner had introduced the available evidence on the effects of the lessening of competition properly, the efficiencies defence might well have failed under the total surplus standard and the Commissioner would have been granted the divestiture order he sought [167-169].

The Tribunal also defended the clarity of the total surplus approach. Dr. Schwartz stated in his concurring opinion in the Redetermination Decision that section 96 is clear if one adopts a total surplus standard [383]. It becomes murky only when laden with distributive and other public policy concerns as the Court attempted to do in the Appeal Judgment.

The Tribunal also signalled that the total surplus standard could survive as a default standard when there is no conclusive evidence regarding the adverse redistributive effects resulting from a merger. The key assumption of the total surplus standard is distributive neutrality. The Tribunal noted that, given the information required to identify redistributive effects, "... the assumption of neutrality could be appropriate in many circumstances." [329]

The Tribunal's Response to Other Competition Issues Raised on Appeal

The Appeal Judgment obliged the Tribunal to reconsider its initial decision in the light of a number of arguments raised by the Commissioner. In the Redetermination Decision, the Tribunal disposed of some of these arguments and fitted others into the existing merger review framework.

The Tribunal disposed of a number of the Commissioner's arguments on the grounds that: (1) he had not made them during the initial hearing or; (2) if he had made these arguments, he had led no evidence or insufficient evidence to support them or; (3) they were already incorporated in the Tribunal's findings with respect to the anti-competitive effect of the merger. Arguments dismissed in this manner include: (1) additional consumer losses from interdependent pricing; (2) additional consumer losses from the prevention of competition in Atlantic Canada; (3) loss of dynamic efficiencies; (4) loss of service quality and discontinuation of special programs.

The Tribunal also addressed the Commissioner's conceptual arguments. These arguments were: (1) that the creation of a monopoly has anti-competitive consequences beyond its market power consequences as assessed under section 93; (2) that the section 96 defence should not be available in cases of merger to monopoly; (3) that the anti-competitive effects of a merger include any adverse effects on the opportunities for equitable participation by small and medium-sized business in the Canadian economy and; (4) that consumer losses in related downstream markets should be added to consumer losses in the relevant market in the determination of the magnitude of the anti-competitive effect. The Tribunal also revisited statements made in the Appeal Judgment regarding the role of the elasticity of demand in the determination of the deadweight loss.

Monopoly!

The Tribunal has correctly rejected the argument that the term "monopoly" has some meaning beyond its normal market power interpretation. Labelling the merged entity as a monopoly neither adds to nor detracts from the determination of its ability to exercise market power [272]. The related proposition that section 96 is not available in cases where the merged entity's market share is 100% while remaining available when the merged entity's market share is, say, 96% has now also been disposed of and properly so [277].

Small and Medium-Sized Business

With respect to small and medium-sized business, the Tribunal has properly considered this factor in conventional section 93 terms. Specifically, it asks whether the merger will result in a reduced intensity of fringe competition or increased barriers to entry or mobility [301]. The Tribunal found that small and medium-sized competitors would probably behave more interdependently, pricing up to the dominant firm but that this was part of the lessening of competition it had already found.

The Tribunal also accepted that it now had an obligation to consider any harm to small and medium-sized business resulting from the merger. It interpreted this obligation as requiring it to inquire whether the merger would give rise to predatory or exclusionary conduct that would be offensive under section 50 or 79 [305]. The Tribunal found that it could not infer this outcome on the basis of the evidence before it.

Related Markets

The Tribunal accepted the principle that deadweight consumer losses in related (downstream) markets should be added to the anti-competitive effects of a merger [255]. It also accepted that there may be adverse redistributive consequences in related markets and these should be taken into account if they can be identified.

Simply adding consumer losses in related downstream markets to consumer losses in the relevant market is double-counting if downstream markets are competitive. The demand for propane by intermediate goods producers is a derived demand. The area under the derived demand schedule represents the surplus of downstream users. There is no need to count it again. The issue is more complicated if the downstream is imperfectly competitive.

The Elasticity Gaffe

In his concurring opinion, Dr. Schwartz, a lay member of the Tribunal, pointed out that the Appeal Judgment erred in asserting that the total surplus standard has paradoxical consequences in that it makes it easier to justify a merger between suppliers of goods for which demand is relatively inelastic than of goods for which demand is relatively elastic [396-398]. The Federal Court of Appeal was indeed quite wrong in its assertion. The opposite is true. The lower the price elasticity of demand, the greater is the efficiency gain required to satisfy the total surplus standard. Professor Ware has pointed this out.[12] It is also apparent from Tables 1 and 2 in this paper and from the discussion above. The related argument (Appeal Judgment, para. 106) that the total surplus standard is defective because it implies a differential treatment of mergers based on the elasticity of market demand is also incorrect. It is true that the lower is the elasticity of demand, the *more* difficult it is to satisfy the total surplus standard. But this is also true of the price, consumer surplus and balancing weights standards.

Where Do We Stand?

If it stands, the Redetermination Decision could leave the merger review process essentially intact if somewhat more complex. The total surplus standard appears to remain in place as the default standard from which the Tribunal will deviate when presented with evidence that the price increases resulting from an anti-competitive merger will be visited on the lowest tier (perhaps fifth) of the income distribution for whom the product involved is a necessity. If he wants redistributive effects to be considered, the Commissioner will have to prove them. In this sense, it appears as if the Commissioner has increased the evidentiary burden on himself.

The situation may be changed yet again depending on the outcome of the Commissioner's appeal. Whatever the Federal Court of Appeal does, it seems unlikely to order the Tribunal to adopt the consumer surplus standard proposed by the Commissioner. The Court has already stated in the Appeal Judgment that the choice of an alternative to the total surplus standard is beyond the limits of its competence (Appeal Judgment, para. 139). The Tribunal is quite clear that an order to adopt the consumer surplus standard would be an intrusion on the Tribunal's area of expertise [369]. The Commissioner could seek other remedies at the appellate level.

These might curtail the Tribunal's use of the total surplus standard as a default standard or oblige the Tribunal to promulgate distributional weights even when it has no evidentiary basis for doing so.

Are Amendments to Section 96 Required?

If past experience is any guide, there will be continued legislative tinkering and, of course, stakeholder consultations. While the task force recommended by the Industry Committee in its recent report might be a means of providing the Tribunal with some direction as to how it should determine the reasonableness of a balancing weight, it would not necessarily clarify matters and the status of its recommendations would be uncertain.[13] There is also reason to be sceptical about the ongoing amendment process which appears to be driven by the cases the Commissioner loses rather than by objective analysis of defects in the statute (section 61 of the *Competition Act* being the most glaring example of this).

The most obvious amendments to section 96 are those currently before Parliament in Bill C-248.[14] Bill C-248 would restrict eligible efficiency gains under section 96 to those which are being or are likely to be passed on to customers in the form of lower prices within a reasonable period of time. If this means that prices must fall post-merger by the amount of the efficiency gains, then this is Pitofsky's "killer qualification." It could also mean that only savings in marginal or variable costs are eligible to be considered for purposes of section 96. As participants in predatory pricing cases can attest, determination of what costs might be variable in any given instance is highly problematic. If savings in fixed costs were not eligible under section 96, this would rule out economies of density. It would rule out economies derived from rationalization such as the elimination of set-up or change-over costs. It would rule out efficiencies in R&D, marketing and capacity expansion.

Bill C-248 also proposes to make a section 96 defence unavailable in situations in which a merger creates or strengthens a dominant position. This proposed dominance exclusion is a variant on the Commissioner's argument, already rejected by the Tribunal, that section 96 cannot apply in cases of merger to monopoly. It reflects the misapprehension, discussed at length above, that a successful defence for mergers to dominance is routinely available under a total surplus interpretation of section 96. The creation or strengthening of dominance is simply a way of describing an increase in market power. The anti-competitive effects of an increase in market power depend on the section 93 factors. While some of these factors may be more important in some instances than in others, it is the resulting increase in market power rather than the label attached to it that matters. Once the anti-competitive effects of an increase in market power have been established, there is no reason to allow for an efficiencies defence in some cases and not in others.

If the Commissioner does not succeed in doing so through the appeal process, he might seek to amend section 96 to require that it be given a consumer surplus interpretation. The Commissioner has apparently embraced the consumer surplus standard, first, in the mistaken belief that the total surplus standard is too easy to meet and, second, in the belated recognition that the balancing weights standard that he and his expert originally proposed is unworkable. As argued above, it is highly unlikely that mergers either to monopoly or to dominance could pass a properly-applied total surplus test. For these kinds of mergers, the consumer surplus standard is overkill. While the consumer surplus standard may have the added attraction to the Commissioner of limiting

the application of the efficiencies defence in more competitive market situations, this is not or should not be the point. The consumer surplus standard will allow mergers that hurt consumers as consumers and forbid mergers that benefit the economy as a whole. It does not distinguish between the transfer of wealth and the destruction of wealth. The consumer surplus standard is acknowledged to have no basis in welfare economics. Proposing to interpret a statute that is often touted as being one of the most economically literate in the world in this way is ironic but it is hard to appreciate the irony.

If It Ain't Broke ...

The Redetermination Decision appears to have given the Commissioner another possible course of action. He could simply enforce the *Competition Act* as interpreted by the Tribunal. The Commissioner now has the option of introducing evidence that the transfer from consumers to producers resulting from an anti-competitive merger is regressive. If he does not avail himself of this opportunity, the Tribunal is likely to revert to the total surplus standard as a default interpretation of section 96. Other than *Superior Propane* in which the Commissioner might have prevailed had he presented his evidence differently, there is absolutely nothing in the public record to indicate that the total surplus standard has thwarted the Commissioner's enforcement efforts or that anti-competitive mergers have slipped through on the basis of trivial efficiencies. The Commissioner could devote additional attention, first, to the measurement of anti-competitive effects. Second, if he truly thinks that efficiencies typically adduced for purposes of section 96 are exaggerated or even contrived, he could devote more effort to demonstrating that this is the case.[15]

Table 1

Percentage Cost Reductions Required to Satisfy the Profitability Requirement and the Price, Total Surplus and Consumer Surplus Standards

Number of Firms Post-Merger	Elasticity of Demand	Percentage Reduction in Cost Required to Satisfy:			
		Profitability Requirement	Price Standard	Total Surplus Standard	Consumer Plus Standard
1 1 1	1.5 2.0 2.5	0.00 0.00 0.00	50.00 33.33 25.00	13.30 8.87 6.65	17.70 11.80 8.85
2	1.5	3.47	28.57	5.84	10.81
2	2.0	2.43	20.00	4.09	7.57
2	2.5	1.87	15.38	3.14	5.82
3	1.5	4.38	20.00	3.34	7.78
3	2.0	3.13	14.29	2.39	5.56
3	2.5	2.43	11.11	1.86	4.32
4	1.5	4.12	15.38	2.18	6.07
4	2.0	2.98	11.11	1.58	4.38

Source: L. Bian & D. McFetridge, "The Efficiencies Defence in Merger Cases: Implications of Alternate Standards", *infra* note 9, equations (8), (9), (10), (13) and (15).

Table 2

Percentage Cost Reduction for an Efficiencies Defence of a Merger to Dominance

Fringe Market Share (%)	Fringe Supply Elasticity	Market Demand Elasticity	Price Standard %	Total Surplus Standard %	Consumer Surplus Standard %
0	0	1.5	50.00	13.33	17.70
10	0	1.5	42.86	11.40	16.59
20	0	1.5	36.36	9.67	15.49
30	0	1.5	30.43	8.10	14.38
10	1	1.5	39.13	10.41	15.23
20	1	1.5	30.77	8.18	13.22
30	1	1.5	24.14	6.42	11.53
10	2	1.5	36.00	9.58	14.08
20	2	1.5	26.67	7.09	11.54
30	2	1.5	20.00	5.32	9.62
0	0	2	33.33	8.87	11.80
10	0	2	29.03	7.72	11.24
20	0	2	25.00	6.65	10.65
30	0	2	21.21	5.64	10.02
10	1	2	27.27	7.25	10.60
20	1	2	22.22	5.91	9.53
30	1	2	17.95	4.77	8.55
10	2	2	25.71	6.84	10.03
20	2	2	20.00	5.32	8.66
30	2	2	15.56	4.14	7.46

Source: L. Bian & D. McFetridge, "Efficiencies Defences for Mergers within a Dominant Group", *infra* note 10, equations (15), (16), (17) and (19) with consumer surplus standard added.

Notes

[1] Department of Economics, Carleton University, Ottawa.

[2] *Canada (Commissioner of Competition)* v. *Superior Propane Inc.*, 2001 FCA 104 (the "Appeal Judgment").

[3] *Canada (Commissioner of Competition)* v. *Superior Propane Inc.* (2000), 7 C.P.R. (4th) 385 (the "Initial Decision").

[4] *The Commissioner of Competition* v. *Superior Propane Inc.*, [2002] C.C.T.D. No. 10 (the "Redetermination Decision") [numbers cited refer to paragraph numbers in the decision unless otherwise specified].

[5] Bill C-248, *An Act to amend the Competition Act*, 1st Sess., 37th Parl., 2001 (1st reading 7 February 2001).

[6] R. Pitofsky, "Proposals for Revised United States Merger Enforcement in a Global Economy" (1992) 81 The Georgetown Law Journal 207.

[7] *Canada (Director of Investigation and Research)* v. *Hillsdown Holdings Canada Ltd.* (1992), 41 C.P.R. (3d) 289.

[8] Mathewson and Winter, "The Analysis of Efficiencies in *Superior Propane*: Correct Criterion Incorrectly Applied" (2000) 20:2 Can. Comp. Rec. 88.

[9] L. Bian & D. McFetridge, "The Efficiencies Defence in Merger Cases: Implications of Alternate Standards" (2000) 33 Canadian Journal of Economics 297.

[10] L. Bian & D. McFetridge, "Efficiencies Defences for Mergers within a Dominant Group" Carleton University Department of Economics Working Paper 00-09 (October 2000).

[11] See also D.G. McFetridge, "The Efficiencies Defense in Merger Cases" in M.B. Coate & A.N. Kleit, eds., *The Economics of the Antitrust Process* (Boston: Kluwer Academic Publishers, 1996) 103.

[12] Ware, "Is Competition Economics "Beyond the Ken of Judges"? The Federal Court of Appeal Ruling in *Superior Propane*" (2001) 20:3 Can. Comp. Rec. 1.

[13] "A Plan to Modernize Canada's Competition Regime" (Report of the Standing Committee on Industry, Science and Technology, House of Commons, April 2002) at 101.

[14] *Supra* note 5.

[15] For a commentary on eligible efficiencies and standards of proof in *Superior Propane*, see Gudofsky and Gay, "Long Live the *Merger Enforcement Guidelines*? A Review of the *Superior Propane* Decision" (2000) 20:2 Can. Comp. Rec. 46.