New merger enforcement guidelines in Canada strike harmony with the EU and US

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The Canadian Competition Bureau (the 'Bureau') updated its Merger Enforcement Guidelines ('MEGs') in September 2004. The MEGs reflect incremental evolution of the Bureau's 1991 Merger Enforcement Guidelines, with new coverage of "unilateral effects", significantly expanded commentary on "coordinated effects", detailed discussion of "prevention of competition" cases, and updated guidance regarding the efficiencies defence. These innovations generally reflect mainstream micro-economic thinking and are consistent with the approaches of Canada's key trading partners, the United States and the European Union. Readers familiar with EU and US merger guidelines will find the MEGs a comfortable read.

However, the Bureau has also included tantalisingly oblique references that suggest controversial "raising rivals' costs" and "portfolio effects" theories may be employed, without providing guidance on how such issues will be analysed. In addition, the Bureau continues to demonstrate (some would say unwarranted) hostility towards product differentiation and efficiencies.

Unilateral effects

The MEGs discussion of unilateral effects generally is consistent with modern economic theory and the current approaches followed in Canada, the EU and US. Indeed, the MEGs adopt the two major sub-categories in the US Merger Guidelines: "Firms Distinguished Primarily By Their Capacities" and "Firms Distinguished Primarily By Their Products". The former focuses on the traditional high unilateral market share scenario which has grounded much of the Bureau's enforcement activities, but the latter is more relevant in the many industries where products are differentiated.

By focusing on whether products of the merging parties are (or are not) particularly close substitutes within a market containing various differentiated products, an attempt is made to predict whether a price increase of one party's products would (or would not) become profitable once the firm can capture the portion of switching customers who would select the product of the other merging party. The MEGs also properly acknowledge that ease of repositioning, which is analysed analogously to supply/entry responses in other contexts, may discipline a unilateral exercise of market power that would otherwise be expected to occur. While such an approach should not be controversial in principle, the recent *Oracle/PeopleSoft* decision in the US underscores the importance of probative evidence and rigorous analysis in order to prove that unilateral anti-competitive effects are likely to occur in a concrete case.

Coordinated effects

Despite relatively sparse jurisprudence on coordinated behaviour in Canada, coordinated effects are a major focus of merger review in the US, EU and, increasingly, Canada. Thus the extensive discussion of these issues is a most welcome addition to the MEGs.

The MEGs have converged on the EU and US terminology of "coordinated effects" as a replacement for the references to "interdependent behaviour" in the Bureau's 1991 guidelines. The substantive discussion is almost entirely new and is heavily inspired by the US approach as well as the discussion in the EU's 2004 merger guidelines. The main improvements include a clear explication of the fundamental economic framework for establishing anti-competitive harm, the linking of relevant analytical factors to the essential framework elements, and attention to causation issues.

The MEGs embrace the widely accepted Stigler framework for assessing the likelihood that cooperative behaviour will occur in an oligopolistic industry. The final version of the MEGs improved upon the consultation draft that had placed substantial emphasis on so-called "facilitating factors". By focusing on a lengthy and loose factor list that would generate some "hits" in most industries, there was a risk that Bureau staff would have been encouraged to develop concerns about coordinated behaviour that were not explicitly organised and linked through probative evidence and analysis to the four necessary elements in the Stigler model. There was a widespread perception that this had occurred in previous cases. Canada has now joined the EU and US agencies in abandoning this type of checklist approach. The MEGs instead identify the key factors that will be examined during the assessment of each of the Stigler conditions. For example, product homogeneity, market transparency and cost symmetries are the main considerations in determining whether formation of a cooperative understanding is likely to be possible.

While the term causation is not used, the Bureau (like its counterparts in the EU and US) acknowledges that there is no basis for interfering with a proposed merger on the basis of coordinated effects unless there is a linkage between the transaction and the creation or enhancement of the ability of the merged firm to exercise market power in conjunction with accommodating responses from other significant competitors in an oligopolistic industry. The causation requirement is fundamental in any coordinated effects analysis because an agency must be able to either: identify how a merger enables such market power to begin to be exercised when it previously has not been; or demonstrate that there will likely be a substantial increase in the magnitude of coordinated effects where such market power is already believed to exist pre-merger.

Safe harbours

The MEGs maintain the safe-harbour thresholds from the 1991 guidelines, which slightly suggest a greater tolerance for concentration in Canada than in the EU and US. Generally, mergers which result in a combined market share of 35 per cent will not be challenged on the basis of unilateral effects

concerns; coordinated effects will be of concern only if the merger results in a CR4 ratio of more than 65 per cent and the post-merger market share of the merged entity is more than 10 per cent. Herfindahl-Hirschman indices may be observed (particularly in the context of a coordinated effects analysis), but are not used in Canada as a safe-harbour threshold.

Prevention of competition

Since its 1991 guidelines, the Bureau has acquired significant experience with cases where the anti-competitive effects are expected to arise from a prevention of future competition rather than a lessening of current competition. Like the EU and US guidelines, the MEGs outline the approach used for assessing prevention of competition issues and include several scenarios in which these concerns would be expected to arise. Moreover, the MEGs properly note the importance of assessing the extent of any pre-existing market power and determining whether other potential entrants would face entry barriers (an essential condition for market power concerns to arise) that would not have deterred entry by one of the merging parties.

Additional factors for assessing competitive effects

Borrowing from the EU merger guidelines, the MEGs contain a concise new section devoted to countervailing power as well as several references to excess capacity and product differentiation.

The new discussion of buyer power is brief but valuable, particularly since it addresses one of the arguments that companies most commonly raise when dealing with sizeable buyers in a commercial or industrial market. The MEGs indicate conditions where this can be expected to be effective (eg where a buyer can switch to other sellers in response to an exercise of market power), but also correctly note the limitations of countervailing power arguments in situations where sellers can price discriminate between customers.

The MEGs contain fragmented references in several areas where excess capacity is relevant to the assessment of competitive effects. While it would have been useful to present an integrated discussion of this topic, significant substantive guidance has been provided. Moreover, the potential negative impacts of excess capacity in respect of entry deterrence or punishment of deviations from coordinated behaviour have been accompanied by a recognition that under-utilised capacity may also provide incentives for the merging parties and rivals to increase rather than restrict output.

As with excess capacity, references to product differentiation are sprinkled throughout the competitive effects discussion and would have benefited from consolidated treatment under an identifiable heading. More importantly, while the MEGs have moderated some of the references in earlier consultation drafts of the guidelines, there are still signs that the Bureau maintains an unwarranted hostility towards this important dimension of competition in the modern economy.

Vertical and conglomerate mergers

Unlike the EU and US merger guidelines, the MEGs contain discussion (albeit brief) about vertical and conglomerate mergers.

The section on vertical mergers is essentially unchanged from the 1991 guidelines, which is surprising given the renewed attention being paid to vertical mergers in various jurisdictions and the increasing prominence of raising rivals' costs theories of competitive harm. The MEGs continue to focus on two relatively rare theories of harm: increased barriers to entry resulting from the need for two-stage entry; and upstream coordination facilitated by forward integration into retailing. However, the MEGs also contain a brief footnote indicating that a vertical merger "could substantially lessen or prevent competition by foreclosing access to inputs or distribution channels, thereby raising the costs of rivals." It is not a surprise to see such a reference, particularly since the Bureau has been receptive to raising rivals' costs concerns in the past. However, the absence of any substantive guidance or clear analytical framework is disappointing.

Conglomerate mergers receive even less attention in the updated MEGs. The only theory of anti-competitive harm articulated in the MEGs is that such a transaction may pre-empt entry that would otherwise have occurred (which will be assessed using the general framework for analysis of prevention of competition cases). However, there again is a footnote reference suggesting that issues relating to complementary product mergers (presumably a reference to "portfolio effects" theories) may also be considered.

Efficiencies

The Competition Act contains an efficiency defence, which in essence says that a merger should not be blocked if gains in efficiencies resulting from the merger outweigh the anti-competitive effects. The recent *Superior Propane* case, which the Commissioner of Competition challenged (through two appeals) and lost based on efficiency-saving arguments, was one of the motivating reasons for the Bureau to update the merger guidelines. (Controversially, the Bureau abandoned the 1991 guidelines approach to efficiencies when the *Superior Propane* merger was challenged).

The MEGS make clear that the onus is on the merger parties to identify and quantify any gains in efficiency and to satisfy the Commissioner that the gains outweigh anti-competitive effects. All gains in productive and dynamic efficiencies will be considered, and the gains need not benefit only consumers. But, gains that are merely distributive in nature or would likely be achieved through alternative means than the merger will be discounted. Efficiency gains also will be assessed having regard to the so-called "purposes test" in Section 1.1 of the Competition Act, which may result in the value of the gain being enhanced or discounted in light of distributive effects within the economy. (Section 1.1 of the Act identifies a number of purposes of the Act including ensuring that small and medium-sized enterprises have an equitable opportunity to participate in the Canadian economy.)

The discussion about efficiencies in the MEGs is written in a tone and style which sets it apart from the balance of the document, evidencing a continued hostility by the Commissioner to willingly apply the defence to save mergers to monopoly or near-monopoly, even though that was the court ordered result in *Superior Propane*. Paradoxically, the EU and US merger guidelines appear to reflect more openness to consider efficiency arguments. However, lacking the underpinning of a statutory efficiency defence, EU and US regulators make clear in their respective guidelines that efficiencies can never save a merger to monopoly or near-monopoly and the Bureau's relatively strict interpretations are therefore not far removed in practical effect from those of its EU and US counterparts.

The MEGs are based on years of in-depth experience with merger review and, for the most part, sound economic thinking. They properly focus on the necessity of a coherent theory of anti-competitive harm as the basis for finding a substantial lessening or prevention of competition. The increased recognition of causation requirements is also welcome and will hopefully be accompanied by attention to the need for probative evidence in order to establish that anti-competitive effects are likely to flow from a merger. Although sometimes dense and jargon-filled, the MEGs are a very useful, modern resource for the antitrust practitioner.

The MEGs are available on the Bureau's website at http://competition.ic.gc.ca/epic/internet/incb-bc.nsf/en/h_ct01255e.html. ■