

# Efficiency-dependent mergers: lessons from Canada

Decisions in some recent Canadian court cases have illuminated the arguments concerning the efficiencies defence of mergers in Canada. **John F Clifford, Mark Opashinov** and **Michael Hollinger**, *McMillan Binch LLP*, summarise developments

The Canadian economy is small on a world scale, with most industry located in very close proximity to much larger competitors in the United States. This, combined with a desire for Canadian industry to be competitive on a world scale, underlies Canada's traditional tolerance for higher concentration levels in many leading industries—much higher than would be tolerated in the United States, for example—and an acceptance of efficiency-enhancing mergers in highly concentrated industries (think airlines, breweries, railways, shipping, book stores, grain handling—the list is long.)

The importance of efficiencies is recognised by an explicit defence in the Competition Act ('the Act') to anti-competitive mergers. Yet, the efficiency defence is much maligned—perhaps the defence is too efficient for its own good. Recent judicial pronouncements on the defence have not been to the liking of the Commissioner of Competition. He now is pressing for legislative amendments to correct the perceived wrongs. But, it is not clear that the law is wrong; it may be that the Commissioner just didn't do what he needed to do to prove a tough case.

This article surveys Canada's efficiency defence—its evolution and current standing—and provides observations about what the law now means for interested stakeholders.

## Treatment of efficiencies

In the international context, Canada's antitrust regime is unique in that it makes an explicit, statutory efficiency defence available to merger parties. Indeed, the Commissioner of Competition recently commissioned a study on the treatment of efficiencies in international merger review ('the Efficiencies Study') which found that none of the four jurisdictions studied—

Australia, the European Union, the United Kingdom and the United States—have an explicit statutory efficiency defence like Canada's. Additionally, none of them apply a Total Surplus Standard that was, for the first 12 years of Canada's modern merger review regime, the economic standard applied when considering the effect of efficiencies in the merger context and the appropriateness of which formed the key substantive competition law question in the recently concluded *Superior Propane* case.

Although the Efficiencies Study noted that enthusiasm for efficiencies is more tepid in the jurisdictions studied and tends to gravitate towards the Consumer Surplus Standard rather than the Total Surplus Standard, the Efficiencies Study noted that the treatment of efficiencies abroad is evolving and the trend seems to be toward giving efficiencies a greater role. The Efficiencies Study concluded that there is a place for efficiency arguments to be made in support of mergers that might have some potential for anti-competitive harm. In Canada, however, the Commissioner's incoherent approach to efficiencies, as evidenced in the *Superior Propane* case, suggests a contrary trend in this country—from the most efficiencies-friendly competition regime among major industrialised countries to one which treats efficiencies as just another factor to be considered in the merger review process.

## Interpreting the efficiency defence

Under Section 96, the Tribunal may not issue a remedial order against a merger that prevents or lessens competition substantially if the merger is likely to result in gains in efficiency that are greater than, and will offset, the likely anti-competitive effects of the merger. Specifically, the section provides that:

- (i) The Tribunal shall not make an order under Section 92 if it finds that the merger or proposed merger in respect of which the application is made has brought about or 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 will result or is likely to result from the merger or proposed merger and that the gains in efficiency would not likely be attained if the order were made.
- (ii) In considering whether a merger or proposed merger is likely to bring about gains in efficiency described in subsection (i), the Tribunal shall consider whether such gains will result in:
  - a) a significant increase in the real value of exports; or
  - b) a significant substitution of domestic products for imported products.
- (iii) For the purposes of this section, the Tribunal shall not find that a merger or proposed merger has brought about or is likely to bring about gains in efficiency by reason only of a redistribution of income between two or more persons.

The section does not require that the efficiencies actually be realised; it is enough that efficiencies are likely to be brought about. If the Commissioner decides not to challenge a merger based on efficiency arguments (ie, decides not to seek an order of the Competition Tribunal to prohibit the merger because of off-setting efficiencies, something that he has never done), he could challenge the merger within three years of its completion if the claimed efficiencies do not materialise. Likewise, if the Tribunal makes an order approving a merger because of saving efficiencies, there is scope under Section 106 of the Act for the Commissioner

later to seek an alternative order if the efficiencies are not realised.

#### A) The 1991 merger enforcement guidelines

As it is broadly framed, Section 96 is capable of supporting various interpretations. Before *Superior Propane*, the Commissioner's approach to section 96 was set out in the 1991 Merger Enforcement Guidelines ('the MEGs'). According to the MEGs, Section 96(1) creates a "trade-off framework" within which the likely efficiency gains of a merger are balanced against its anti-competitive effects.

The MEGs define "anti-competitive effects" in this context as referring to:

*"...the part of the total loss incurred by buyers and sellers in Canada that is not merely a transfer from one party to another, but represents a loss to the economy as a whole, attributable to diversion of resources to lower valued uses. This loss is sometimes referred to as the deadweight loss to the Canadian economy..."*

Importantly, while the phrase is never used, economists would recognise the MEGs' approach to the consideration of the "effects" of a merger as a Total Surplus Standard of efficiencies review:

*"Where a merger results in a price increase, it brings about both a neutral redistribution effect and a negative resource allocation effect on the sum of producer and consumer surplus (total surplus) within Canada. The efficiency gains described above are balanced against the latter effect, ie, the deadweight loss to the Canadian economy."*

Until *Superior Propane*, the Commissioner's approach to efficiencies review using the Total Surplus Standard remained unimpeached by either the Tribunal or by the Commissioner himself.

#### B) Tribunal's early consideration of Section 96: *Hillsdown Holdings*

The first decision of the Tribunal to consider the scope of Section 96 was the 1992 *Hillsdown Holdings* case. Although the Tribunal disposed of the case on the grounds that the proposed merger would not likely prevent or lessen competition substantially, ie, on Section 92 grounds alone, the Tribunal's lengthy obiter dictum on Section 96 raised questions about whether it was correct to analyse Section 96 using the MEGs' Total Surplus Standard. The Tribunal flagged a number

of issues that it believed could be relevant in determining the exact meaning of Section 96. These included: (i) whether the wealth transfer that arises in an efficiency-enhancing merger is always a neutral one as the Total Surplus Standard presumes; (ii) whether, in the case of a wealth transfer from Canadian consumers to foreign shareholders, the transfer of wealth should be considered neutral; and (iii) whether "any alleged efficiency gains" ought to be weighed "against the degree of likelihood that detrimental effects (both wealth transfers and allocative inefficiency) will arise from the substantial lessening of competition."

Despite the fact that these comments raised fundamental questions about the appropriateness of using the Total Surplus Standard in Canadian merger review, the Commissioner of the day saw no reason to revise the MEGs as the Tribunal's *Hillsdown* comments were clearly obiter and the Commissioner stood by the MEGs' efficiency defence analysis.

#### C) Tribunal's recent consideration of Section 96: *Superior Propane*

The Tribunal's obiter in *Hillsdown* stands in sharp contrast to its subsequent endorsement of the MEGs' approach to Section 96 in its 30 August 2000 decision in *Canada (Commissioner of Competition) v Superior Propane Inc and ICG Propane Inc* ('*Superior Propane* No. 1'). The case arose from the Commissioner's December 1998 challenge of Superior Propane Inc's acquisition of rival ICG Propane Inc.

The Tribunal concluded that the proposed merger of the two propane businesses was likely to lessen competition substantially in 65 local markets for propane across Canada and in one national market for "national account co-ordination services"; it also found that the proposed transaction would likely prevent competition in the propane market in Atlantic Canada. However, the efficiency gains from the proposed merger, amounting to C\$29.2 million, were greater than and more than offset the deadweight loss of C\$3 million bringing it within the scope of Section 96. In a split decision, the Tribunal allowed the merger to proceed on the basis of this Section 96 trade-off analysis. Importantly, the majority rejected the Commissioner's position (inconsistent with the MEGs) that the Tribunal should adopt the Balancing Weights Approach, and adopted the MEGs' Total Surplus Standard instead.

The Commissioner appealed the Tribunal's decision within days of its release. On 4 April 2001 the Federal Court of Appeal ('the Court') released its decision allowing the Commissioner's appeal, setting aside the Tribunal's decision and sending the matter back to the Tribunal for re-determination. The Court found that the Tribunal erred in law by limiting "the effects of the prevention or lessening of competition" to deadweight loss and that the Tribunal's decision essentially codified the Total Surplus Standard as the efficiency defence. By doing so, the Court said, the Tribunal was negating the consumer protection objectives of the Act in favour of an approach that only considered the net benefit to the economy as a whole. The Court concluded:

- The legislative intent behind the Act clearly favoured a consumer welfare approach.
- The word "effects" should be interpreted to include all the anti-competitive effects to which a merger subject to Section 92 in fact gives rise, having regard to all of the objectives set out in the Act's purpose clause, Section 1.1, such as consumer protection.
- Section 96 requires balancing the competing objectives of the Act and, as such, should remain flexible in its application.
- The Tribunal should consider a wider range of factors when determining efficiencies and the effects of a substantial lessening of competition. These should include: the wealth transfer from consumers to producers that occurs when the merged entity exercises its market power to increase prices above competitive levels, the elimination of smaller competitors from the market, and the creation of a monopoly.

In its decision, the Court accepted the Commissioner's contention that the Total Surplus Standard should not be applied in Section 96 analysis. Thus, the Act's efficiency defence began its shift in emphasis from a welfare-enhancing feature of our system of merger review to one that focuses on a consumer protection policy objective. The Court remanded the case to the Tribunal for redetermination consistent with the Court's findings but, while it rejected the Total Surplus Standard as wrong in law, it declined to prescribe the correct economic standard and left the

determination of the correct standard to the Tribunal.

In the Tribunal's redetermination hearing, the Commissioner changed his approach yet again, this time arguing that the Consumer Surplus Standard should be applied under a Section 96 analysis rather than the Balancing Weights Approach he had advocated at first instance and that the Court had favoured. Once again, a majority of the Tribunal rejected the Commissioner's arguments and on 4 April 2002 handed down its redetermination decision (*Superior Propane No. 2*) approving the merger.

The Tribunal rejected the Consumer Surplus Standard, as it had in *Superior Propane No. 1*, because that standard fixes the entire wealth transfer from consumers to producers as an anti-competitive effect *a priori*, thereby ruling out the balancing inquiry that the Court had found necessary to assess the welfare effects of a particular merger. Conscious that the Court had proscribed the Total Surplus Standard, the majority selected a variant of the Balancing Weights Approach as its standard for weighing efficiencies and anti-competitive effects. The majority found that the appropriate weights should reflect social attitudes towards equity among income classes. For example, the portion of the redistribution of wealth that reflects a transfer from low-income consumers to producers was found to be socially adverse and considered an anti-competitive effect alongside deadweight loss to the economy. The Tribunal found that the anti-competitive effects should be assigned a weight, which in most cases would be determined by expert evidence, and weighed against efficient cost savings realised by the producer, and concluded ultimately that the efficiencies created by the merger outweighed its anti-competitive effects even as measured by the Balancing Weights Approach (in part because the Commissioner had not led any evidence with which the Tribunal could assess a) whether affected business consumers were low-income earners; or b) the extent to which price increases in propane were passed on by business consumers to low income households through interrelated markets).

To no one's surprise, the Commissioner appealed the Tribunal's re-determination hearing immediately. On 31 January 2003 the Court handed down its second decision in the case. A two-to-one majority of the

Court upheld the Tribunal's redetermination decision finding that the Tribunal was within the latitude and discretion afforded to it by the Court in applying the variant of the Balancing Weights Approach.

Thus, while the MEGs' Total Surplus Standard has been repudiated by the Commissioner, the Court and the (reluctant) Tribunal, the current law of merger-saving efficiencies in Canada—despite labouring under the awkward Balancing Weights Approach—would seem to permit efficiency-enhancing, price-increasing mergers in very much the same way in which the Total Surplus Standard would have. The Commissioner has since announced that, while he is disappointed with the Court's decision in *Superior Propane No. 2*, he will not seek leave to appeal to the Supreme Court of Canada. Instead, the Commissioner favours legislative amendment to right this perceived wrong.

#### Legislative amendment

A private member's bill, Bill C-249, An Act to Amend the Competition Act was first proposed as a response to the Tribunal's decision in *Superior Propane No. 1*. The Bill has received first reading in the House of Commons and has been referred to the Standing Committee on Industry, Science and Technology ('the Committee') for review. In recent testimony to the Committee on Bill C-249, the Commissioner endorsed the idea of legislative amendment to Section 96 of the Act, remarking that further litigation of the *Superior Propane* case would not have clarified the legal standard for evaluating merger-saving efficiencies (That is: the standard has been set and the Commissioner does not like it). Therefore, he said, only a legislative solution is workable in addressing the two enduring policy problems that remain following *Superior Propane*, namely: that an anti-competitive merger can survive merger review even if it results in substantial harm to consumers and the "perverse" result that application of the Competition Act condones the creation of monopolies.

The Commissioner also supported a proposed amendment to Bill C-249 which would effectively eliminate the efficiency defence in favour of a much weaker 'trade-off' analysis between efficiencies and anti-competitive effects as part of the overall assessment of the merger. Under the amended version, the Tribunal would only

consider efficiencies where the merger leads to a net benefit to consumers in the form of competitive prices or product choices, and only where the efficiencies would not likely be attained in the absence of the merger.

#### Whither efficiencies?

If it becomes law, Bill C-249 would represent the culmination of a strange debate in Canada over merger efficiencies and a refocusing of Section 96 from promoting economic welfare through efficient use of resources to consumer protection. The Commissioner's repudiation of the Total Surplus Standard set out in his own MEGs in favour of the Balancing Weights Approach in *Superior Propane No. 1*, may, on a charitable interpretation, suggest that the Commissioner's approach to the economics of merger review was undergoing a principled rethinking. However, his subsequent repudiation of the Balancing Weights Approach in favour of the Consumer Surplus Standard in *Superior Propane No. 2* makes such a characterisation more tenuous.

Amendments aside, stakeholders are split on the final meaning of the *Superior Propane* case. Some believe the defence essentially is dead, because the Commissioner is unlikely to approve any merger that results in substantial harm to consumers, regardless of the benefits to producers. This sits well with consumer advocates. Others (the authors included) believe efficiencies are still highly relevant, albeit they will only save a merger if they satisfy the Balancing Weights Approach. *Superior Propane* was the first litigated case to consider the efficiency defence; it is not clear that the result would have been the same if more full evidence of total welfare effects had been led by the Commissioner. More cases are needed to further develop the law and see the defence in action.

In the final analysis, *Superior Propane* was an odd vehicle for a debate over the merits of economic efficiency versus consumer protection in dealing with anti-competitive mergers. *Superior Propane* raised a concern that low-income families might face the prospect of paying monopoly prices for heating, a basic necessary of winter life in Canada. Had this only been a matter of having to pay a few more dollars to fill up propane tanks for summer barbecues could the case have possibly taken over four years from the merger's challenge to its final judicial disposition? ●