PROPOSED REVISION OF THE EFFICIENCY DEFENCE FOR MERGERS IN CANADA'S COMPETITION ACT

A Submission to Senator Howard Wetston with respect to Examining the Canadian *Competition Act* in the Digital Era

Appendix I: Introduction and History
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April 6, 2022

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APPENDIX I: Introduction and History of the Efficiency Defence

S.96 of Canada's Competition Act is unique in providing a statutory efficiency defence to an anti-competitive merger. The introduction of the efficiency defence resulted from a lengthy reconsideration of the Combines Investigation Act (1910) and Canadian competition policy generally. Following the landmark decision in the "Propane" merger case (2002), s.96 has become controversial because it holds that efficiency is the overriding goal in merger review.

Initially, Canada's Criminal Code prohibited conspiracies and combinations in restraint of trade. In 1910, the Combines Investigation Act was passed to remedy the lack of any special machinery for investigation of alleged combines offences. However, as a criminal offence, few merger cases were brought because the Crown could not prove guilt "beyond a reasonable doubt." For a variety of reasons including constitutional considerations, it was recognized by the early 1960's that the Combines Investigation Act, especially its merger provisions, had become unenforceable.

Economic Council of Canada Interim Report on Competition Policy (1969)

In 1966, the government asked the independent Economic Council of Canada to study all aspects of competition policy. In its study of the structure of Canadian manufacturing industries, the Council found that Canadian firms generally lacked the scale and specialization to produce at the efficient, minimum-cost levels. It identified the small size of the domestic market and the limited intensity of competition from foreign producers due to high tariffs as two of the factors leading to a weak industrial base consisting of too many small firms producing too many products.

The Council also noted that under the Combines Investigation Act, merger was a criminal offence that inhibited the required modernization of Canadian industry in light of the more liberal global trading environment that it foresaw. It also warned that the United States anti-trust laws' foci on consumer prices and small-business protection paid little attention to economic efficiency and should be avoided in Canada's much smaller economy.

The Economic Council's Interim Report on Competition Policy (1969)[1] advocated a new approach premised on "the adoption of a single objective for competition policy: the improvement of economic efficiency and the avoidance of economic waste, with a view to enhancing the well-being of Canadians."[2]

In this new approach, competition policy as a whole, and merger review in particular, should focus primarily on bringing about more efficient performance by the economy generally. Competition per se would not be the objective; rather it would be the most important single *means* by which efficiency is achieved.[3]

In regard to merger policy, the Council noted that permitting mergers among competitors is one means of addressing the lack of scale and specialization in Canadian industry. To illustrate the static efficiency gain, if a merger of two such firms could produce the same total output as the two firms separately but at a lower total cost, the merger would increase economic efficiency and contribute to growth in productivity and living standards.[4]

The Council also noted that such efficiency-enhancing mergers could also create market power and lead to higher prices that would distort consumer and producer decisions thereby reducing economic output and efficiency (the "deadweight loss"). Notably, the impact of such higher prices on consumer welfare was not the Council's concern.

Consistent with its single objective of economic efficiency, the Council proposed an efficiency defence that would balance efficiency gains from an anti-competitive merger with the deadweight loss from the output distortions. If the former exceeded and offset the latter, the proposed merger would not be stopped or re-structured.

While acknowledging the redistributive effects of anti-competitive practices and mergers, the Council advised that other policy instruments such as tax policy and social programs were more effective ways to deal with distributional concerns.[5]

Absent hard-and-fast policy conclusions based on sound economic research, the Council recommended that merger policy should be implemented on a case-by-case basis rather than rely on *per se* rules. Accordingly, it also recommended that merger offences be de-criminalized and reviewed under a civil-law approach. It advocated the creation of an independent tribunal that would "be primarily concerned with whether the merger was likely to lessen competition to the detriment of final consumers, and whether there were likely to be any offsetting public benefits."[6]

The government largely accepted the Economic Council's new approach to competition policy and mergers in Bill C-256 (1971). Notably however, the efficiency defence in that bill required a "passing on" of the benefits of the merger to the public. Other elements of the Bill provoked strong opposition and it was withdrawn.

Skeoch-MacDonald Report (1976)

In 1975, the government established an independent committee for advice on the remaining contentious matters including mergers, monopolization, price discrimination and other non-criminal matters. Lawrence Skeoch, an economist, and lawyer Bruce MacDonald prepared the report.[7]

Their report accepted the Economic Council's insistence on the single goal of economic efficiency. It was particularly critical of the treatment of mergers in Canadian courts, and it heavily criticized the purely structural approach to merger review, in which the principal considerations were firm size and industrial concentration. It also emphasized the greater harm to smaller economies than to larger, more dynamic economies of evaluating mergers based purely on structural indices.

In its legislative recommendations, the report stated that if a merger's "artificial restraints in a market" were offset by real-cost economies or by the diminution of certain specified artificial constraints, then the merger should be allowed.[8]

Bill C-91 (1985)

In 1986, Parliament passed Bill C-91 into law, changing the Combines Investigation Act into the Competition Act ("the Act") and creating the Competition Tribunal Act. Following the recommendations of the Economic Council Interim Report and the Skeoch-MacDonald report, it introduced a new civil-law regime for merger and monopolization offences.

Under s.92, the Act generally condemns mergers found to lessen or prevent competition substantially. The case law has accepted that s.92 requires a showing of market power, defined as the ability of the merged firm to increase the price above the pre-merger level. Hence, a merger that creates market power or increases any pre-existing market power lessens competition and violates s.92.

However, s.96(1) is an exception: an anti-competitive merger can be permitted if it brings about efficiency gains that exceed and offset the effects of any prevention or lessening of competition that will result from the merger. Unlike the defence in Bill C-256, it contains no "passing on" requirement.

Merger Enforcement Guidelines 1991

Adopting the approach of the Economic Council of Canada Interim Report, the Competition Bureau's first Merger Enforcement Guidelines issued in March 1991[9] clarified that the relevant "effects" are the distortions of consumer and producer decisions as measured in principle by the deadweight loss to the economy as a whole that results from the exercise of market power. The guidelines referred to this approach as the "total-surplus standard".[10]

Although the redistribution of income that results from an anti-competitive merger is an effect of that merger, the 1991 guidelines do not consider that effect:

> "Section 96(1) creates a tradeoff framework, in which the efficiency gains that are likely to be brought about by the merger in Canada, are balanced against the anticompetitive effects that are likely to result from the merger. In this context, the anticompetitive effects refer 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 the diversion of resources to lower valued uses. This loss is sometimes referred to the deadweight loss to the Canadian economy."[11]

The "Propane Merger" Case

The efficiency defence was first raised in the case of *The Commissioner of Competition v. Superior Propane Inc.* that came before the Competition Tribunal in 1998 in its inquiry relating to the proposed acquisition of ICG Propane Inc. by Superior Propane Inc.

At the commencement of the hearing, the Commissioner renounced the total-surplus standard in the Bureau's published 1991 Merger Enforcement Guidelines in favour of a consumer-oriented approach in which the redistribution of income would not be treated neutrally but rather would be analyzed as a negative effect of a merger under s.96. In the Commissioner's "balancing weights" approach, the Tribunal would attach the socially-appropriate weights to the consumer loss and to the shareholder gain from a merger in order to determine whether the efficiency defence had been met.

The Tribunal decided that, as a matter of law, the redistribution of income was not an effect that could be considered under s.96. It adopted the neutral, total-surplus interpretation of s.96 and, since proven efficiency gains were $29.2 million per year for 10 years versus the Commissioner's estimated annual deadweight loss of $3 million, the anti-competitive merger was allowed to proceed.[12]

Notably, in final argument, the Commissioner submitted a much larger estimate of the deadweight loss which the Tribunal excluded because it constituted new evidence that required cross-examination.[13]

On appeal, the Federal Court of Appeal held that the total-surplus interpretation of s.96 was incorrect in law, relying largely on the approach to merger review in American antitrust law. It declared that the Commissioner's "balancing weights" approach was valid, and it remanded the case back to the Tribunal for reconsideration, although it did not prescribe how the Tribunal should take income-redistribution into account.

While accepting the Tribunal's conclusion that the existence of s.96 makes efficiency the paramount goal of the merger provisions of the Act, it also instructed the Tribunal to consider the listed objectives of competition policy in s.1.1 (the “purpose clause”) when applying the efficiency defence.

In the second Tribunal hearing following remand, the Commissioner did not rely on the balancing-weights approach. Instead, he argued that the entire amount of redistributed income from consumers to shareholders (the “wealth transfer”) should be included as an effect of the merger.

In its second decision[14], the Tribunal reviewed Canadian competition policy emphasizing the Economic Council Interim Report on Competition Policy (1969), the statutory history beginning with Bill C-250 (1971) and related Parliamentary debates and ministerial statements. It also contrasted the Act with US antitrust law.[15]

The Tribunal discussed the “balancing weights” approach to the re-distributional effect proposed by the Commissioner’s expert and called attention its statutory mandate and to the problem of identifying the correct social weights and noted that the tax system was only modestly progressive. The Tribunal did not accept the Commissioner’s argument that the entire transfer was an effect under s.96. However, in light of the Court’s instruction on the total-surplus standard, it identified the impact of the merger on low-income households as an adverse redistributive effect and included that impact in its analysis.[16] The Tribunal found that the requirements of the s.96 efficiency defence were met and allowed the merger to proceed.

The Tribunal’s second decision also provided greater detail regarding the excluded evidence on the deadweight loss that the Commissioner had introduced in final argument in the first hearing. This new evidence indicated that the true deadweight loss was in the range of $23.44 million and $54.89 million annually for 10 years because the pre-merger price was above the competitive level.[17]

This suggests that the Commissioner could have stopped the merger under the total-surplus standard in the Bureau’s 1991 Merger Enforcement Guidelines and raises troubling questions about the Bureau’s handling of the case.

On second appeal, the Federal Court of Appeal found that the Tribunal had followed instruction and did not criticize Tribunal's historical and statutory reviews and contrasts with US antitrust law.

Merger Enforcement Guidelines 2011

The Bureau's 2011 Merger Enforcement Guidelines took a very different view of the efficiency defence. In particular, the effects of an anti-competitive merger are not limited to resource-allocation effects, and include all the anti-competitive effects that are likely to arise from a merger "having regard to all the objectives of the Act" (s.12.21). This appears to be a reference to s.1.1 of the Act.

They further state that price-increase resulting from an anti-competitive merger causes a wealth transfer from buyers to sellers. Providing buyers with competitive prices and product choices is an objective of the Act (s.12.28).

It is not clear what standard the Bureau will apply when considering a merger to which the efficiency defence may apply. It rejects the total-surplus standard, but there is no commitment or mention of the balancing-weights approach that it first advocated and then de-emphasized in the Propane merger case.

However, the Guidelines' apparent reliance on s.1.1 is problematic. That provision states that the purpose of the Act is to maintain and encourage competition in order, inter alia, to provide buyers with competitive prices and product choices and also create "efficiency and adaptability of the Canadian economy". Indeed, the Court's instruction that the Tribunal consider all of the listed objectives in s.1.1 when applying the efficiency defence appears to conflict with the overall purpose of the Act.

Tervita (2015)

On January 22, 2015, the Supreme Court of Canada issued its decision in the Tervita case.[18] The Supreme Court of Canada allowed a merger in the hazardous waste landfill market in Northeastern British Columbia to proceed over the objections of the Commissioner. The decision has significant implications for merger review and for how efficiencies will be evaluated, in particular the distinction between quantitative and qualitative evidence and the proper sequence in which evidence of anti-competitive effects and merger efficiencies should be presented.

(A) The meaning of "offset" in s.96: one step or two?

S.96(1) requires that the gains in efficiency must "exceed and offset" the effects on competition that result from an anti-competitive merger. The word "offset" has been given different interpretations.

- *Economic Council Interim Report on Competition Policy (1969)*

The term was first used by the Economic Council:

> "In its examination of a merger, the tribunal might be expected to have regard to all aspects of the merger that were related in any important way to the tribunal's general terms of reference. It would be primarily concerned with whether the merger was likely to lessen competition to the detriment of final consumers, and whether there were likely to be any **offsetting public benefits**. In addition, and without restricting the generality of the foregoing, the tribunal would be requested to pay attention to the following matters *in so far as they appeared to be of substantial economic importance in any particular case*:
>
> …
>
> (8) the likelihood that the merger would be productive of substantial "social savings, i.e. savings in the use of resources (including resources used for such purposes as research and development), viewed from the standpoint of the Canadian economy as a whole."[19]
>
> (**bolded** emphasis added)

- *1991 Merger Enforcement Guidelines*

In its first merger guidelines, the Competition Bureau distinguished between the "greater than" and "offset" assessments:

> "To be assessed in terms of "greater than", efficiency gains must be capable of being weighed in similar terms as all or some of the anticompetitive effects that will likely result from the merger. Efficiency gains and anticompetitive effects that cannot be weighed in similar terms will be evaluated in terms of whether the gains offset the anticompetitive effects."[20]

Accordingly, it envisaged a two-step analysis in which the quantitative evidence would be considered separately from the qualitative evidence, in effect creating two separate tests.

- *Propane Merger Case*

In its first Propane decision, the Tribunal did not follow this two-step approach. It held that under s.96, all quantitative and qualitative evidence on the anti-competitive effects should be compared with all such evidence on the efficiency gains, in effect a one-step analysis, to determine whether efficiency gains exceeded and offset the effects on competition.

Accepting the usual judicial understanding of "offset", the Tribunal did not link its one-step approach to that meaning.

- *Supreme Court*

In Tervita, the Supreme Court endorsed and elaborated on a 2-step approach. In the first step, quantitative efficiencies should be compared with the quantitative anti-competitive effects. If the former exceeded the latter, the requirements of the efficiency defence would be met and the result would normally be dispositive.

In the second step of the s.96 analysis, the qualitative evidence on efficiencies would be balanced against the qualitative anti-competitive effects. Then, "a final determination must be made as to whether the total efficiencies offset the total anti-competitive effects of the merger at issue (the "offset" prong of the inquiry)."[21]

In short, the Supreme Court attempted to resolve doubt about the meaning of the word "offset" in s.96 by linking it to the distinction between quantitative and qualitative evidence.

- Observation

Neither the Bureau nor the Supreme Court noted that, in regard to the efficiency defence, the word "offset" was first used by the Economic Council.[22] Consistent with "total surplus" approach that the Council had proposed, cognizable efficiency gains realized, for example, in one part of Canada by an anti-competitive merger would "offset", but need not prevent, the deadweight losses therefrom in other parts of the country.

The Supreme Court's approach to "offset" in Tervita does not reflect the more general sense of that word that the Economic Council had in mind. Accordingly, the Court's two-step approach is also problematic because the Act does not distinguish between "quantitative" and "qualitative" evidence.

There is a further problem with two tests. If both tests must be met under s.96(1), then it is entirely possible that (i) quantitative efficiencies exceed quantitative effects by a sizeable amount while (ii) qualitative effects are not balanced by qualitative efficiencies but the difference is not very large. Then, then the merger would be stopped because both tests have not been met.

(B) The sequencing of evidence in merger review

The Supreme Court also appears to have adopted a new review process in the interest of procedural fairness. It held that

> "The Federal Court of Appeal's "undetermined" approach also raises concerns of fairness to the merging parties…The difficulty with assigning non-quantified qualitative effects a weight of "undetermined" is that is places the merging parties in the impossible position of having to demonstrate that the efficiency gains exceed and offset an amount that is undetermined. Under this approach, to prove the remaining elements of the defence on a

> balance of probabilities becomes an unfair exercise as the merging parties do not know the case they have to meet."[23]

The Court appears to suggest a procedure in which the Commissioner must first present all the quantified evidence of anti-competitive effects <u>*before*</u> the merging parties present their evidence on efficiencies.

This sequence bears on the related issue of burdens. In its first Propane hearing, the Commissioner argued that the merging parties bore the burden of convincing the Tribunal of all of the elements under s.96, i.e., that the efficiency gains exceeded and offset all of the anti-competitive effects.

The judicial chair of the Tribunal panel decided that the merging parties must lead evidence on efficiency gains and the Commissioner must lead evidence on the deadweight loss. In the first Federal Court of Appeal decision, the Court stated that the judicial chair had allocated the burdens appropriately, although it also held that redistributive effects of the merger must be considered.

The Tervita decision raises important questions of legal interpretation and procedure that require reconsideration.

ENDNOTES TO APPENDIX I

[1] Available at: https://publications.gc.ca/site/eng/9.862585/publication.html
[2] Ibid., at p.19
[3] Ibid., at p.9
[4] The Council was also concerned with potential economic gains from "dynamic efficiency" arising invention and innovation even if, citing Schumpeter, obtaining these gains might require a departure from competition. Ibid., at p.12.
[5] Ibid., at p.19
[6] Ibid., at pp.115-116
[7] "Dynamic Change and Accountability in a Canadian Market Economy" (1976). Available at: https://publications.gc.ca/site/eng/9.883678/publication.html
[8] Ibid., at p.125
[9] Available at: https://publications.gc.ca/site/archivee-archived.html?url=https://publications.gc.ca/collections/collection_2021/isde-ised/RG54-2-5-1991-eng.pdf
[10] Ibid., at p.49. "Section 96(1) requires efficiency gains to be balanced against "the effects of any prevention or lessening of competition that will result or is likely to result from the merger or proposed mergers". 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, i.e., the deadweight loss to the Canadian economy."
[11] Ibid., at p.45.
[12] The Tribunal's first decision is available at: https://decisions.ct-tc.gc.ca/ct-tc/cdo/en/item/464664/index.do
[13] Ibid., at paragraph 451.
[14] The Tribunal's second decision is available at: https://decisions.ct-tc.gc.ca/ct-tc/cdo/en/item/464511/index.do
[15] The Tribunal addressed the redistributional effect on consumers:

> "In the Tribunal's view, there is no policy choice to favour consumers in the merger provisions of the Act. The Tribunal concluded the efficiency was the paramount objective of the merger provisions of the Act, and the Court agreed while requiring that the transfer be considered under subsection 96(1). A similar policy choice to favour efficiency is found in section 86 of the Act which permits higher prices to consumers if efficiencies are large enough to justify the specialization agreement." Ibid., at paragraph 186

[16] Ibid., at paragraphs 365-368.
[17] Ibid., at paragraphs 165-169.
[18] Tervita Corp. v. Canada (Commissioner of Competition) 2015 SCC 3.
[19] Op. cit., pp.115-116.
[20] Op. cit., at p.49
[21] Ibid., at paragraph 147.
[22] The Tribunal did so in its second decision in the Propane case following remand. Op. cit., at paragraph 45.
[23] Op. cit., at paragraph 131.

APPENDIX II: Economics of the Efficiency Defence

As previously discussed, the Economic Council Interim Report on Competition Policy (1969) proposed a "single goal for competition policy: the improvement of economic efficiency and the avoidance of waste with a view to enhancing the well-being of Canadians". Regarding mergers, it observed that anti-competitive mergers might bring about efficiency gains and proposed that such a merger be allowed when the cognizable efficiency gains were greater than the effects of the merger on competition.

Importantly, the Council declared that competition policy should not be concerned with the distribution of income and wealth in society as it was in United States antitrust law. Such concerns were better handled through the tax system and social policies.

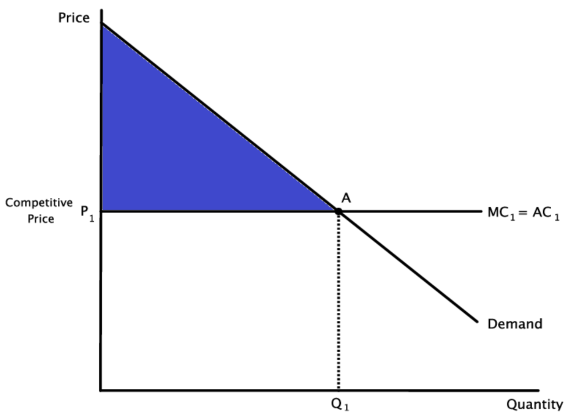
This distinction was critical for merger review. The exercise of market power following an anti-competitive merger would raise the price of the product and distort consumer and business decisions. It would also increase the profits of the merged firm and reduce consumer welfare. In the Council's view, this latter re-distributional effect would not be considered in merger review. The efficiency defence proposed by the Council called for a comparison of the efficiency gains with economic distortions; if the former exceeded the latter, the merger would be allowed.

S.96 of the Act requires a comparison of the efficiency gains from the merger with all of the anti-competitive effects. Since the redistribution of income is such an effect, the only way to give effect to the Council's exclusion thereof is to treat the re-distributional effect <u>as neutral</u>, i.e., *that the shareholder gains in the form of excess profits are exactly offset by the loss of consumer welfare with the result that <u>total welfare</u> is neither increased nor decreased by the redistribution of income.* In this way, the presumption of neutrality is therefore implicitly mandated by the single goal of economic efficiency in competition policy.

<u>Williamson Trade-Off Analysis (1968)</u>
The American economics professor Oliver Williamson articulated these concepts in his landmark paper "Economies as an Antitrust Defense: The Welfare Tradeoffs".[1]

Despite its title, Williamson was not proposing a statutory defence of efficiency to an anti-competitive merger in U.S. antitrust law. Rather, his general concern was the low regard for economic considerations quite generally in US merger review which, in his view, had led to curious decisions. In the *Brown Shoe* merger case, the US Supreme Court unanimously decided that not only were efficiencies no defence to an anti-competitive merger but a showing that a merger resulted in efficiencies could be used affirmatively in attacking the merger since small rivals could be disadvantaged thereby.[2]

To understand Williamson's analysis, consider first a competitive industry for a commodity with the usual downward-sloping demand curve for the product and a pre-merger competitive price of P_1 equal to marginal cost (MC_1) and average (or per-unit) cost of production (AC_1) as shown in this graph. The demand curve shows the prices that consumers are willing to pay for an additional amount of output. In this simple economy, marginal-cost pricing results in industry output Q_1. All of the output produced by producers in the market will equal the total quantity demanded by consumers and accordingly the market is efficient.

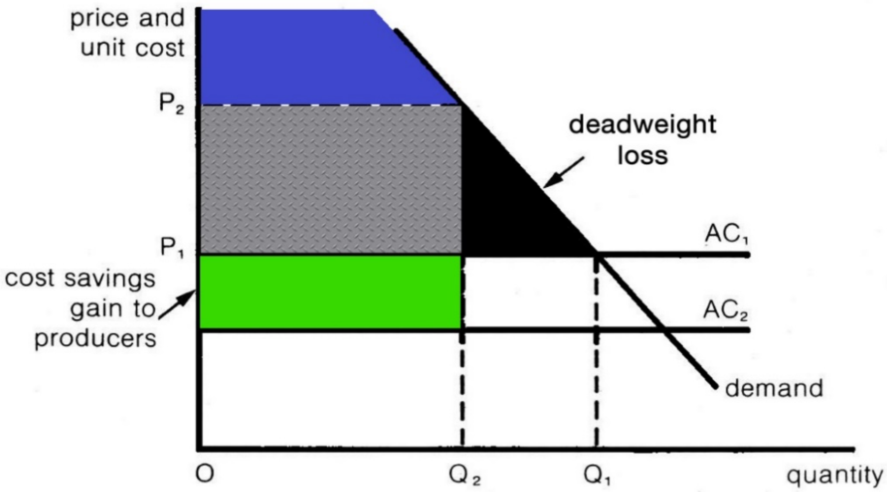


Williamson Trade-Off Model prior to consolidation.

The blue triangular area under the demand curve and above the price line measures the benefit to consumers of the competitive market. The demand curve represents what consumers are willing to pay for the product, while the price-line shows what they actually pay. The difference is called "consumer surplus".

In this competitive market, producers earn "normal" profits, just sufficient to maintain their investments in the businesses. Any lower profits would cause some of them to shut down and exit. However, there are no "excess profits".

Now, consider the effect of a merger in the industry which creates market power and a higher price (P_2) for the commodity. At that price, the market demands a quantity of only Q_2 units of output.



Williamson trade-off model.

The higher price generates two effects. It leads consumers to reduce purchases and/or substitute other commodities. The black triangular area of this chart shows the resulting economic cost of the merger: the value of the lost consumption and output due to the distortions that the merger brings about. It is a loss of economic efficiency and is referred to as the "deadweight loss" as it falls on the economy as a whole. This loss is a loss of consumer surplus that the consumers had previously benefitted from under the competitive price.

In addition, the price increase creates "excess profits" for shareholders at the lower level of output. These profits are shown in the chart as the grey rectangular area between P_2 and P_1. These excess profits also reduce the consumer surplus that consumers previously enjoyed. Graphically, the excess profits exactly displace this portion of lost consumer surplus. In effect, the anti-competitive merger has "transferred" this amount of consumer surplus to producers in the form of excess profits.

So, before considering efficiencies, there are two effects of the anti-competitive merger: economic inefficiency in the form of the deadweight loss to the economy, and the transfer of income from consumers to shareholders which affects only those two groups.

Unlike the deadweight loss, the latter effect does not increase or decrease economic resources; rather, it redistributes income between the two groups. In the Williamson framework, the redistribution of income is therefore treated as neutral as it has no economic impact.

Now suppose that the same merger results in cost-savings to the merging firms. As a result, total and average (unit) costs of production in the industry fall from AC_1 to AC_2. These savings are savings of real economic resources in the production of Q_2 units of output and are shown in the above chart as the green rectangular area between AC_1 and AC_2. These savings represent efficiency gains that the merger brings about in the economy as a whole.

From a strictly economic perspective, should this anti-competitive merger be allowed?

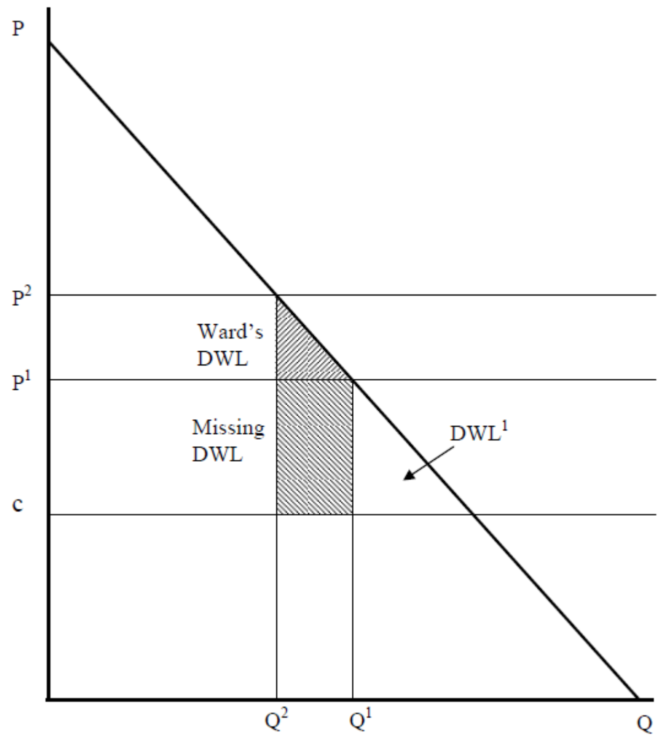
Williamson asks whether the merger has overall positive economic effects, so the decision depends only on the relative magnitudes of the cost-savings (efficiencies) and the deadweight loss (the inefficiencies). Stated differently, does the merger increase or decrease the total resources available to the economy? If the former exceeds the latter, the merger produces a net economic surplus. Accordingly, his framework is referred to as the "total surplus" approach to merger review.[3]

<u>Deadweight Loss, the Pre-Merger Price and the Propane Case</u>

Subsequent to the publication of his seminal paper, Williamson acknowledged that the deadweight loss would be larger if the pre-merger price was above the competitive price in his example. Others have noted that even a slight elevation in the pre-merger price over the competitive level can cause significant increases in the deadweight loss.[4]

As noted previously, this issue arose in the first hearing of the Propane merger case. Professor Ward, the Commissioner's expert economic witness, estimated the deadweight loss assuming that the pre-merger price was the competitive price (c) in the graph below.

However, subsequent research[5] showed that the price prevailing prior to the merger (p^1) was elevated over the competitive price (c). This means that p^1 in the graph below already reflected



the existing deadweight loss (shown in the triangular area "DWL1"). Taking the pre-merger price p^1 to be the competitive price, Professor Ward measured the much smaller triangular area shown as "Ward's DWL", approximately $3 million per annum. In doing so, he also failed to take into account the rectangular area shown as "Missing DWL" that the post-merger price increase also produced.[6]

As noted in Appendix I, the Commissioner had evidence of the elevated pre-merger price and the larger DWL but introduced it only in final argument. Had the new evidence been introduced in the evidentiary stage of the first hearing and survived cross-examination, the Commissioner might well have won the case.

Other Standards for Efficiency in Merger Review

There are of course other standards in addition to the total-surplus approach, depending on the policy considerations. The historical approach in US antitrust law was the "price standard"; the only issues were whether the merger would lead to a price increase and/or harm smaller businesses. No consideration of efficiencies was tolerated; indeed, efficiency considerations in merger review were viewed as harming smaller competitors' ability to compete with the more efficient merged firm.

A modest exception allowed consideration of efficiencies in merger review only if the cost-savings were so large that the post-merger price would not increase. Accordingly, US antitrust law treated efficiency claims with “hostility”.

In the 1970’s, hostility to efficiencies in American antitrust law began to diminish. The underlying rationale of the “consumer surplus” standard is that the merger should be allowed if efficiencies exceed the <u>sum</u> of the deadweight loss and the income transfer. Here, the transfer was not viewed neutrally but as an entirely negative effect of the merger on consumers that could be overcome if the efficiency gains were sufficiently large.

In recent years, the view that efficiency should be considered in US antitrust law has been under intense review. In the current debate, advocates of the “neo-Brandeisian” view[7] regard mergers skeptically, especially those that could disadvantage competitors. The premise seems to be that mergers reduce “competitive intensity” and harm consumers even without a showing of market power.

The debate in the United States is fundamentally about whether competition policy should protect the “competitive process” in which some firms may succeed while others may fail or protect competitors <u>from</u> competition, in part by denying any role for efficiency considerations in merger review.

In summary, those (per the Economic Council Interim Report and the Competition Bureau’s first Merger Enforcement Guidelines) who feel that competition policy should focus solely on economic efficiency will favour the total-surplus standard in merger review. Others, who feel that competition policy should take income-redistribution and other social-policy matters into consideration will favour a different approach.

<u>The “Balancing Weights” Approach</u>

As noted above, the Commissioner abandoned the total-surplus standard in the Competition Bureau’s Merger Enforcement Guidelines (1991) at the start of the Propane merger case.

Through his expert on welfare economics, Professor Peter Townley, he took the view that the merger provisions of the Competition Act did not focus solely on economic efficiency and advocated a method that would acknowledge income-distribution concerns.

Also as noted above, the first decision of the Federal Court of Appeal in the Propane merger case held that the total-surplus approach that the Tribunal had adopted was incorrect in law. While the Court did not indicate how the Tribunal should deal with income-redistribution effects, it stated that Professor Townley's "balancing weights approach" appeared to meet the broad requirements of the Act.

The key issue for Professor Townley was whether the distributional considerations were properly addressed in the total-surplus standard in which the shareholder and consumer interests were exactly offsetting or, stated differently, were accorded equal weights. He stated that he, in his professional capacity, could not indicate what the appropriate weights were, but he advocated that the Tribunal had the capacity to do so.[8]

In his formulation, he invited the Tribunal to attach a weight of 1.0 to all producer/shareholder gains. He proposed that a weight (w) be determined for all consumers as a class because information on individual consumers is lacking. Then he asks what value of w will make this equation true:

$$1(A+B) - w(B+C) = 0$$

where:

A represents the value of the cost-savings (efficiency gains) from the merger

B represents the excess profits to shareholders from the merger and also the corresponding portion of lost consumer surplus

C represents the magnitude of the deadweight loss

w is the "balancing weight" on the consumer's loss of surplus that produces a zero value for the weighted sum of consumer loss and shareholder gain.

In the total-surplus approach, w=1 *a priori* and the merger is approved if A>C. Professor Townley disagrees with this approach and others that similarly impose a fixed weight *a priori* for the consumer loss.

In the Propane merger case, the Commissioner submitted evidence that A=\$29.2 million, B=\$40.5 million, and C=\$3 million. The balancing weight (w) is therefore 1.6. If the Tribunal determined that 1.6 overstates the true social weight on the consumer interest, then the merger is allowed. If it finds that 1.6 understates the social weight to be accorded to consumers, the merger is stopped.

Professor Townley's balancing-weights approach is his method for approving mergers that maximize not just efficiency but overall social welfare. It raises two issues: what is the proper goal of competition policy and how is the true social weight determined?

In its second decision following remand in the Propane merger case, the Tribunal stated that the social weight for consumer welfare should be determined socially, not by the Tribunal itself. It cited research on the tax system in Canada which showed that effective tax rates are modestly progressive, suggesting that redistribution in merger review should not be treated more harshly than in the socially-established tax system.

<u>The Bureau's Merger Guidelines: Is the Redistributive Effect Neutral?</u>

The Competition Bureau's first Merger Enforcement Guidelines (1991) adopted the recommendation of the Economic Council of Canada Interim Report on Competition Policy (1969) and implemented the Williamson trade-off approach thereby treating redistributive effects of an anti-competitive on consumers and shareholders as exactly offsetting.[9]

The 1991 Guidelines stated that attempting to compare the consumer loss with the shareholder gain would not be straightforward:

> "When a dollar is transferred from a buyer to a seller, it cannot be determined *a priori* who is more deserving, or in whose hands it has greater value."[10]

So, while overall social welfare might possibly be better greater if an additional dollar of income were obtained by one group at the expense of another, there was no obviously-correct way to determine society's weights on the relative merits of those groups. Conventional economic theory holds that this problem is not one that economics can address.

As noted previously, the Commissioner renounced the 1991 MEGs at the start of the Propane merger case. The 2011 Merger Enforcement Guidelines now treat the redistributive effect (the "wealth transfer from buyers to sellers") as a non-neutral effect of the merger under s.96(1).[11] Although it is not entirely clear, the Bureau may determine that the entire amount of the transfer or any portion thereof measures that negative effect on consumers.

The Bureau holds that the "purpose clause" in s.1.1 of the Act identifies providing buyers with competitive prices and product choices is an objective of the Act.[12] However, it ignores the fact that the purpose clause states that efficiency is also an objective. The purpose clause says only that the various listed objectives will be attained by maintaining and encouraging competition and therefore does not prioritize one objective over the other.

Further, the Bureau's position is problematic because, in the Propane merger case, the Federal Court of Appeal agreed with the Tribunal that s.96 makes efficiency the paramount goal of the merger provisions of the Act. When the Court declared that the Tribunal should somehow consider the redistributive effect, it appeared to contradict itself because doing so might make the efficiency defence in s.96 unavailable.

ENDNOTES TO APPENDIX II

[1] O.E. Williamson, Economies as an Antitrust Defense: The Welfare Tradeoffs", American Economic Review, Vol. 58, No.1, (Mar., 1968), pp.18-36. The Economic Council Interim Report does not cite it.
[2] Ibid., at p.19.
[3] It is also commonly referred to as the Williamson "trade-off model" because the decision to allow the merger trades off the efficiency gains against the efficiency (deadweight) loss.
[4] See Whinston, M., Lectures on Antitrust Economics, Chapter 3: Horizontal Mergers, The Center for the Study of Industrial Organization at Northwestern University, Working Paper #0041, 2003 at p.4
[5] Matthewson, F. and R. Winter, "The Analysis of Efficiencies in *Superior Propane*: Correct Criterion Incorrectly Applied", 20 Canadian Competition Record, 2 (Fall 2000).
[6] Op. cit., at pp.5-6.
[7] Named after US Supreme Court Justice Louis Brandeis.
[8] In so stating, Professor Townley was giving an opinion on the proper role of the Competition Tribunal. As an expert economic witness, he was not entitled to do so. In its second decision following remand, the Tribunal emphasized that its functions are strictly adjudicative, that it is not a regulatory body with a "public interest" mandate, and that the Lay Members of the Tribunal are chosen only for their knowledge of economics and business and do not represent any groups in the country.
[9] In 1995, an Industry Canada Occasional Paper endorsed this approach which it referred to as the "total welfare" standard. See "Competition Policy as a Dimension of Economic Policy: A Comparative Assessment", Occasional Paper Number 7, May 1995, esp. p.12. Available at: https://www.ic.gc.ca/eic/site/eas-aes.nsf/eng/ra01918.html
[10] Op.cit., fn. 57 at p.49
[11] Competition Bureau. Merger Enforcement Guidelines, October 6, 2011, s.12.28 at p.44. Available at: https://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03420.html
[12] The purpose clause governs the Act as a whole. It states:

> "The purpose of this Act is to maintain and encourage competition in Canada in order to promote the efficiency and adaptability of the Canadian economy, in order to expand opportunities for Canadian participation in world markets while at the same time recognizing the role of foreign competition in Canada, in order to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the Canadian economy and in order to provide consumers with competitive prices and product choices."

The purpose clause simply states that one of the benefits of maintaining and encouraging competition is competitive prices and product choices to consumers. It provides no basis for denying the merger efficiency defence on the basis of the redistributive effect, because efficiency is also a stated objective.