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

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Contents

Introduction and History: An Overview and Summary

Senator Howard Wetston established a consultation process on October 27, 2021 and requested comments from the public in order "to promote additional dialogue on paths forward for Canadian competition law". A good number of papers have been submitted to Senator Wetston in relation to the consultative process. This paper is focused on the interpretation and application of the efficiency defence contained in s. 96 of the *Competition Act*.

Section 96 of the *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. A number of years after s.96 was incorporated in the 1986 *Competition Act*, the landmark decision in the "Propane" merger case (2002), and subsequently the Supreme Court's decision in the Tervita merger case (2015) have made the interpretation and application of s.96 more controversial in the context of merger reviews.

Here is a relatively short synopsis on the history of the section.

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

Arising out of concerns with the Combines Investigation Act, the federal government mandated the Economic Council of Canada in 1966 to review all aspects of competition policy and make recommendations. The Council's Interim Report on Competition Policy (1969) 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".

The Council identified the criminal-law treatment of mergers and monopolies in the Combines Investigation Act as an obstacle to modernization of Canadian industry and recommended a civil-law approach. The Council also noted that mergers among competitors could be anti-competitive and create market power and higher prices that would distort consumer and producer decisions and lead to reduced economic output and inefficiency.

However, the Council also noted that such mergers could result in cost-savings that would increase economic efficiency. Consistent with its single objective, the Council proposed an "efficiency defence" that would consider both the economic distortions due to market power and the cost-savings from an anti-competitive merger. If the latter exceeded and offset the former, the proposed merger would not be stopped or re-structured. This determination would be undertaken by an independent tribunal with expertise in law, economics and business.

The Council acknowledged that other jurisdictions' competition policies, particularly those of the United States, focused on objectives such as low consumer prices and protection of small businesses. The Council declared that in light of the small size of the Canadian economy, those objectives would create inefficiencies that Canada could not afford. It recommended that other policy instruments such as tax policy and social programs were more effective ways to deal with distributional concerns.

The government largely accepted the recommendations of the Economic Council and introduced Bill C-256 in 1971. For a variety of reasons, the Bill received strong opposition and was withdrawn.[1]

Skeoch-MacDonald Report (1976)

Responding to those criticisms, the Minister established an independent committee for advice on the contentious matters. The committee report by Lawrence Skeoch, an economist, and lawyer Bruce MacDonald, was released in 1976. It endorsed the single goal of economic efficiency and criticized the judicial treatment of mergers under the Combines Investigation Act. The report endorsed the efficiency defence, stating 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.[2]

Bill C-91 (1985)

In 1985, the government introduced Bill C-91 that followed the recommendations of the Economic Council and the Skeoch-MacDonald report and provided in conjunction with the new Merger Review provisions, an efficiency defence to an anti-competitive merger in s.96. The bill became law in June 1986 creating the *Competition Act* and the *Competition Tribunal Act*.[3]

Merger Enforcement Guidelines 1991

Based on the experience with the enforcement of the new law over the course of about 5 years, in 1991, the Competition Bureau ("Bureau") published its first Merger Enforcement Guidelines ("MEGs") under the *Competition Act*. The Bureau interpreted the efficiency defence in s.96 as calling for a "trade-off" that balanced efficiency gains from an anti-competitive merger against the anti-competitive effects that such merger would produce. The guidelines emphasized that those effects referred to the part of the total loss incurred by buyers and sellers in Canada that

[1] A more detailed review of the recommendations of the Economic Council is addressed in Appendix I.
[2] A more detailed review of the Skeoch-MacDonald Report is addressed in Appendix I.
[3] A more detailed review of Bill C-91 is addressed in Appendix I.

were not merely a transfer of income from one party to another but represented a loss to the economy as a whole.[4]

The "Propane Merger" Case

Although the efficiency provisions were considered and applied in a number of cases in the period following the passage of the *Competition Act* in 1986, the efficiency defence was the particular focus of the contested litigation before the Competition Tribunal ("Tribunal") in the landmark case of *The Commissioner of Competition v. Superior Propane Inc.* which addressed the proposed acquisition in 1998 of ICG Propane Inc by Superior Propane Inc.

Notably, the Commissioner of Competition disavowed the 1991 MEGs' approach to the efficiency defence in s.96 and advocated a consumer-welfare approach that gave specific attention to the redistribution of income as an effect of the merger.

The Tribunal found that the merger lessened competition substantially and violated s.92. And, while it also found that the efficiency gains exceeded and offset the effects of the merger, it disagreed with the Commissioner and held that income-redistribution was not an effect that could be considered under the Competition Act. Accordingly, the merger was allowed.

On appeal, the Federal Court of Appeal held that the Tribunal had erred by excluding the income-redistribution effect and remanded the case back to the Tribunal for reconsideration. In its second decision, the Tribunal provided a detailed history of Canada's competition policy and the single approach of economic efficiency. The Tribunal again allowed the merger to proceed, and its remand decision was upheld on further appeal.[5]

Merger Enforcement Guidelines 2011

The Bureau's 2011 Merger Enforcement Guidelines take 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.[6]

Tervita (2015)

The Tribunal's decision in the Propane case stimulated much discussion on whether the Competition Act should give greater attention to objectives other than economic efficiency, especially in merger review. In the subsequent *Tervita* case (2015), the Supreme Court of Canada provided further guidance on the respective burdens of the Commissioner and the

[4] A more detailed review of the Merger Enforcement Guidelines (1991) is addressed in Appendix I.
[5] A more detailed review of the Propane Merger case is addressed in Appendix I.
[6] A more detailed review of the Merger Enforcement Guidelines (2011) is addressed in Appendix I.

merging parties when the efficiency defence in s.96 was invoked. The Supreme Court ultimately ruled that it was incumbent on the Commissioner of Competition to quantify the quantifiable anticompetitive effects from the merger such that the merging parties would know the case against them when invoking the efficiency defence. As the Commissioner of Competition had failed to introduce any quantifiable anti-competitive effects into evidence, the Supreme Court held that such effects had a value of zero. As such, the very modest efficiency gains claimed by the parties were larger than the anti-competitive effects and the efficiency defence was allowed.[7]

Summary of Proposed Revision

Professor Edward Iacobucci was one of the scholars commissioned by Senator Wetston to prepare a submission as part of the consultation process to address Canadian competition law. In his submission[8], Professor Iacobucci discussed a number of areas of law he considered for possible amendment, including the efficiency defence. In this regard, Professor Iacobucci noted that in its first decision in the Propane merger case the Federal Court of Appeal had relied on s.1.1 of the *Competition Act* (the "purpose clause"), and accordingly he recommended that it be amended to clarify that the purpose of the statute is to "maintain and encourage competition in Canada in order to promote the economic efficiency of the Canadian economy".[9] As part of his submission, Professor Iacobucci reviewed the Supreme Court's Tervita decision. In his view, the merging parties should have the burden of proving all elements of the efficiency defence in s.96. We agree with that position.

In our view, the Commissioner of Competition should bear the entire burden of proving every element of s. 92 of the *Competition Act*, including that the merger or proposed merger is likely to prevent or lessen competition substantially in the relevant market. The respondents may then contest all of the elements in this respect through cross-examination or leading independent evidence in the usual course of litigation. In the event that the respondents then also elect to rely on s. 96 of the *Competition Act*, the respondents should bear the entire burden of proving every element of s. 96, including the quantitative and qualitative gains in efficiency arising from the merger and that such will be greater than and offset anti-competitive effects of the merger. Thereafter, the Commissioner of Competition has the right to respond and to engage in cross-examinations and lead independent evidence in this respect. In this manner, there is a clear delineation of the respective burdens of proof under ss. 92 and 96 of the *Competition Act*.

[7] A more detailed review of the Tervita case is addressed in Appendix I.
[8] Edward M. Iacobucci, "*Examining the Canadian Competition Act in the Digital Era*" Faculty of Law, University of Toronto, September 27, 2021.
[9] Ibid. at p. 62.

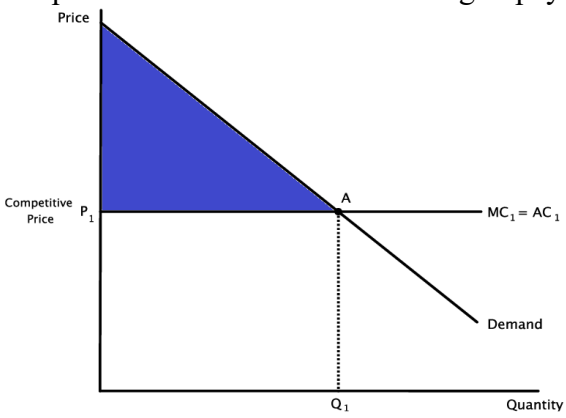
Economics of the Efficiency Defence: An Overview

The Economic Council had recommended the "single objective" of economic efficiency for Canada's new competition policy. Correspondingly, its recommended approach to merger review focused on gains in efficiency from an anti-competitive merger and on the efficiency losses due to the economic distortions arising from market power. The net balance of these two forces would determine whether the merger would be allowed.

This approach would be later referred to as the "total-surplus" standard in the American antitrust literature which had traditionally downplayed efficiency considerations in merger review. This approach to the efficiency defence in s.96 of the Competition Act had been adopted in the Competition Bureau's 1991 Merger Enforcement Guidelines.

The Total-Surplus Standard

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 additional amounts 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.

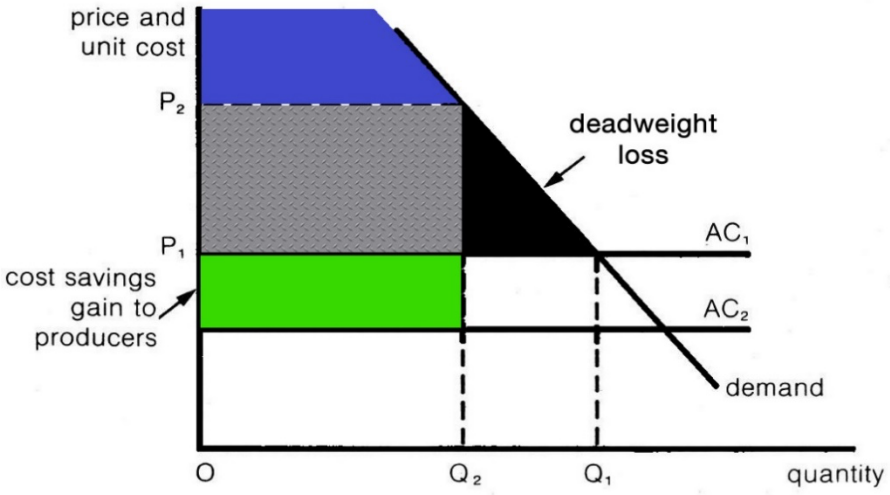


Williamson Trade-Off Model prior to consolidation.

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 market, producers earn "normal profits" sufficient to keep their business going, 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.

The higher price generates two effects. It leads consumers to reduce purchases and/or substitute other commodities. The black triangular area of the chart below shows the resulting economic



Williamson trade-off model.

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 some of the 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 mirror 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.

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.

The impact of the merger on the total resources of the economy is determined by comparing only the cost-savings with the deadweight loss. The transfer is excluded because it does not affect resources; rather, it redistributes income between buyers and sellers.

Deadweight Loss, the Pre-Merger Price and the Propane Case

At the outset of the Propane merger case, the Commissioner abandoned the Total-Surplus Standard in the Bureau's 1991 MEGs. However, the Tribunal found that it was correct in law. It accepted the Commissioner's $3.0 million of annual deadweight loss for ten years; it also found

that the cost-savings amounted to $29.2 million per year. It therefore permitted the anti-competitive merger proceed based on its Total-Surplus understanding of the efficiency defence.

There is evidence that the Commissioner's deadweight loss estimate was too low because its calculation was premised on the pre-merger price being the competitive price. At the actual supra-competitive pre-merger price, the deadweight loss would be much larger. In final argument, the Commissioner took this error into account and submitted new, larger estimates of the deadweight loss. However, the Tribunal excluded this evidence as there was no opportunity for cross-examination. 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 and stopped the merger based on the Total-Surplus Standard.

Other Standards for Efficiency in Merger Review

The Total-Surplus standard is criticized by those who advocate a much broader scope for competition policy. In particular, they feel that the transfer of income should be regarded as a negative effect of the merger.

Other standards, such as the "Price standard" and the "Consumer Welfare standard" give greater weight to the loss of consumer surplus and much less weight to efficiency gains.

In the Propane merger case, the Commissioner's economic expert criticized the Total-Surplus standard because it treats the consumer loss and the shareholder gain as exactly offsetting. He advocated the "balancing weights approach" in which the Tribunal would determine the weight that society assigns to the loss of consumer surplus in comparison to the excess profits to shareholders. The Commissioner submitted that the re-distributional effect was $40.5 million and the deadweight loss was $3 million per year for ten years, and the cost-savings were $29.2 million per year for ten years.

The Tribunal held that its role was purely adjudicative and that it lacked a "public interest" mandate. Accordingly, it was not able to determine the socially-appropriate weighting of the consumer loss.

The Federal Court of Appeal disagreed with the Tribunal and, relying on the approach of U.S. antitrust law, it instructed that the Total-Surplus standard was incorrect as a matter of law. The Court endorsed the "balancing weights approach" but did not mandate it. Tribunal accepted the Court's instruction on total-surplus but did not attempt to apply the balancing weights approach. It quantified the effect of the merger on the lowest-income group at $2.6 million which, when added to the deadweight loss, was still below proven cost-savings; the merger was allowed to proceed. The Tribunal also reviewed the statutory history of the Act, the single goal of economic

efficiency proposed by the Economic Council in 1969, and the differences between Canada's competition policy and U.S. antitrust law.

Accordingly, there is continuing debate on the proper treatment of efficiency in the *Competition Act*.[10]

Proposal to Revise the Efficiency Defence

In a recent submission by the Competition Bureau, the first approximately 20 pages of the 67-page submission was focussed on the merger provisions including the efficiency defence.[11] In our view, this attention is well deserved as the merger provisions of the *Competition Act* are by any objective standard the most significant area of the *Competition Act* being considered for potential amendment at this time. It is well recognized that major mergers can lead to structural changes to the competitive dynamics of a market. CEO's and board members generally spend more time discussing major such proposed mergers than they do other possible issues encompassed by the *Competition Act*.

In its submission, the Competition Bureau recommends that the efficiencies exception should be eliminated:

> *The [Competition] Act may permit anti-competitive mergers when the private benefits of merging outweigh the broader economic harm of the merger. The efficiencies exception should be eliminated, and instead efficiencies should be considered as a factor when considering the effects of mergers*.[12]

This proposed position would give rise to a significant change in the application of the *Competition Act* and to a considerable extent negate the potential benefits of a properly applied efficiency defence, as per the assessment provided by the Economic Council of Canada as well as the Skeoch-MacDonald Report and the Merger Enforcement Guidelines (1991), referred to above. We disagree with the position proposed by the Competition Bureau with respect to the efficiency defence.

In a submission by The Canadian Bar Association ("CBA"), *Examining the Canadian Competition Act in the Digital Era*, the CBA stated that it would not be in favour of amendments that limit the application of the efficiencies defence. The CBA asserts that it is in the best interests of business certainty and predictability that the Commissioner of Competition be required to put forward quantitative evidence estimating the anti-competitive harm that would result from the merger, in accordance with the decision by the Supreme Court in Tervita. In essence, the CBA's position is that the Commissioner of Competition should continue to have

[10] A more detailed review of the Economics of the Efficiency Defence are addressed in Appendix II.
[11] Competition Bureau, *"Examining the Canadian Competition Act in the Digital Era"* February 8, 2021.
[12] Ibid. at p. 11.

the burden of proof under s. 96 as provided in the Tevita decision. We disagree with the position proposed by the CBA with respect to the efficiency defence.

In Tervita, the Supreme Court has described the process of balancing efficiencies against anticompetitive effects in a two-part test, as follows:

(a) The "greater than" prong: the quantitative efficiencies of the merger, as adduced by the merging parties, should be compared against the quantitative anticompetitive effects, as adduced by the Commissioner. Where the quantitative anti-competitive effects exceed the quantitative efficiencies, this step will tend to be dispositive, and the defence will be unavailable unless there are truly significant qualitative efficiencies; and

(b) The "offset" prong: if quantitative efficiencies are larger than the anti-competitive effects, then the qualitative efficiencies should be balanced against the qualitative anti-competitive effects and a final determination must be made as to whether the total efficiencies offset the total anti-competitive effects of the merger.

The efficiencies from the merger in Tervita were negligible while the merger itself would likely lead to price increases of 10%. Given that the Commissioner of Competition did not quantify the anticompetitive effects, even a conceptional efficiency gain of $1.00 would have been sufficient to satisfy the test. In Tervita, the Supreme Court allowed the merger to proceed as the Commissioner of Competition had failed to introduce any quantifiable anti-competitive effects into evidence, and as a consequence, the Supreme Court held that such effects had a value of zero. As such, the merging parties' very modest efficiency gains were larger than the anti-competitive effects and, therefore, the efficiency defence was allowed and the merger permitted to proceed.

The Tervita decision has created a troublesome precedent. The Commissioner of Competition and the Competition Bureau are not comparatively well placed to bear the burden of proving in the first instance the proof of gains in efficiency having regard to the respondents' much broader first-hand knowledge and experience relating to the quantitative and qualitative potential efficiencies. The respondents in real world terms can be expected to have much greater knowledge of the relevant efficiencies from their years of experience operating and competing in the market. Putting the burden of proof on the Commissioner of Competition also leads to unnecessary uncertainty as to the application of the efficiency provisions going forward.

As stated by Professor Iacobucci in his submission with respect to his concerns about the Tervita decision:

> *This implies that it will be open to merging parties always to advance a credible argument that the Bureau has failed to meet its burden of quantification, and therefore to invoke the efficiencies defence successfully, unless the Bureau successfully quantifies all economic effects of the merger.*[13]

[13] Ibid., Note 8 at p. 30.

Furthermore, Professor Iacobucci also stated in his submission with respect to his concerns about the Tervita decision:

> *On a related note, allowing parties to require quantification of anticompetitive effects simply by invoking the efficiencies defence risks relieving the merging parties of the burden of proving that efficiency gains are likely to materialize, yet they are in the best position to do so.*[14]

We have considered Professor Iacobucci's submission and agree with him that the Commissioner of Competition should not have the burden of proving any element of s. 96, but rather the burden should rest with the respondents to prove all elements of s. 96, as discussed above.

The burden of proof on the Commissioner of Competition in s. 92 of the *Competition Act* is a different burden of proof than that stipulated in s. 96 of the *Act*. Section 92 of the *Act* is concerned with the market-power issue. As generally understood, and reflected in the MEGs, this is about the "ability" to increase the price, not the likelihood or magnitude of such an increase. Hence, in the s.92 inquiry, the Commissioner of Competition may, but need not, quantify the likely price increase but, in any case, the resulting deadweight loss and loss of consumer surplus are not part of that inquiry. The market-power inquiry stands on its own. However, s. 96 of the *Act* concerns the effects of any prevention or lessening of competition that will result or is likely to result from the merger and the offsetting efficiencies therefrom.

In our view, the burden of proving a substantial lessening of competition ("SLC") or prevention and all elements as per s. 92 rests with the Commissioner of Competition, as always. However, the burden of proving the efficiency defence of s. 96 should rest exclusively with the respondents in a one-step process whereby quantitative efficiencies and qualitative efficiencies are balanced against the quantitative anti-competitive effects and qualitative anti-competitive effects to enable a final determination as to whether the total efficiencies exceed and offset the total anti-competitive effects of the merger.

Finally, from the perspective of Calvin Goldman, as the former head of the Competition Bureau and the official responsible under the *Competition Act* for the administration and enforcement of that new legislation in 1986 and the immediate subsequent years, and as the one who conveyed to stakeholders as well as counterpart enforcement authorities across the globe the Competition Bureau's interpretation of the 1986 Act's new provisions, there was never any contemplation of a burden under s. 96 along the lines of the Tervita decision. No such possibility was ever discussed in the course of those stakeholder and counterpart enforcement authority meetings. If it had been raised, it would have been closed down immediately. Rather, it was always the view both within the Competition Bureau and in those discussions over the first few years of the administration and enforcement of the *Competition Act*, that the entire burden of proving all elements of s. 96 rested with the respondents if they chose to argue that those provisions were applicable, after the Commissioner carried the burden of proving the elements of s. 92.

[14] Ibid, Note 8 at p. 31.