

COMMENT AND ANALYSIS

DECISION MAKER'S SUMMARY PUT TO THE TEST FREE TRADE: YEAR THREE*

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Since the ratification of the Canada-USA free trade agreement in January 1989, **Strategico Inc.** has presented an annual report on the progress of free trade. This third annual report reaches a number of disturbing conclusions:

- Canadians enjoy a highly advantageous position, as the economic union itself ranks as the seventh largest industrialized nation, with a preferential free trade agreement with the largest, the United States.
- The direct economic impact of the Canada-USA free trade agreement, or FTA, has been small but positive, very much as expected, with measurable increases in business investment, trade and output and decreases in prices.
- Overall Canadian competitive performance has, however, been disastrous, with the combined effects of low or declining productivity, rising wages, high capital costs, and excessively tight monetary policy contributing to a massive deterioration of Canadian cost competitiveness—with the cost gap relative to the USA widening by 25 per cent since the FTA was signed.
- American authorities have been protecting special interests through an array of aggressive actions—including continued breaches of the agreement (on plywood), customs harassment (on automotive products), excessive standards inspection (meat), etc.—getting dangerously close to systematic abuse of the letter and spirit of the agreement.
- In the major dispute resolved to date through the FTA system of binding binational panels (involving Canadian pork exports to the USA), Canada won every decision at every step of the process, but not before the US Administration had gone to extraordinary lengths to delay the outcome until a full two-and-one-half years after the case was first initiated.
- The long festering case of softwood lumber will come to a head in 1992 and provide an even more serious test of the willingness of the American Administration and Congress to be bound by the rules and principles of the agreement in the face of intense political pressure from protectionist interests.
- The North American Free Trade Area (NAFTA) negotiations are proceeding slowly as the issues are getting more difficult—such as automotive products, cultural industries, government procurement—and the political mood is turning sour, particularly in the United States but also in Canada, leading to the possible postponement of any agreement until at least 1993.
- Meanwhile, Canadians will face the decision whether to “improve” the existing economic union (as proposed by the federal government) or to break up the country into independent states (as advocated by the separatists) at very substantial economic cost to all Canadians, particularly in Québec and, to a lesser extent, Ontario.

*This article is reproduced as it appeared in a report prepared by Strategico Inc. in December 1991.

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- The best possible outcome, if Québec does indeed become a separate nation, would require the difficult negotiation of a new set of free trade arrangements encompassing Québec, the rest of Canada, the USA (and potentially Mexico), arrangements offering substantially less economic benefit to all Canadians than the current system.

In sum, the fourth year under the FTA promises to be the year that free trade is seriously **put to the test**.

PUT TO THE TEST—FREE TRADE: YEAR THREE

On the trade front, 1992 promises to be a difficult and dangerous year for Canadians. Our international competitiveness is at a low ebb and the steps required to improve our performance are likely to be politically unpopular. There will be serious stresses on the Canada-USA FTA as vital trade disputes come to a crunch with an increasingly protectionist America. The prospects are poor for trade liberalization, whether through a successful negotiation of a North American Free Trade Area or through the GATT negotiations in Geneva. Finally, the most serious threat is the potential breakup of the economic union on which so much of our current prosperity depends.

This third annual Strategico Free Trade Report reviews the status of these issues as a basis for business decisions over the coming year. We predict 1992, Year Four of the FTA, will be the year free trade is truly "put to the test."

Impact of the FTA

The unsatisfying but inescapable fact remains that it is premature to reach any firm conclusions about the economic impact of the FTA. The most recent econometric analysis by the prestigious Institute for Quantitative Analysis of the University of Toronto concludes that over its life the FTA alone has:

- increased business investment by around 1 per cent;
- increased both exports and imports;
- slightly increased overall output of the economy; and
- slightly decreased the rate of price inflation.

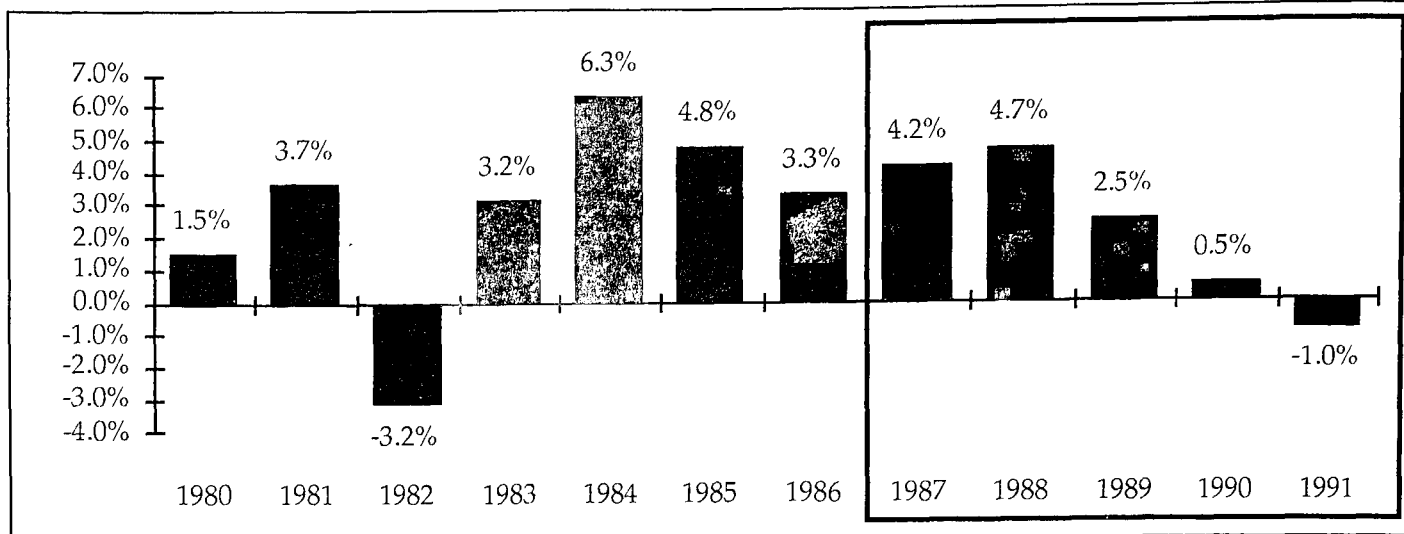
These effects are positive and fully consistent with what was projected. As we are in the third year of a 10-year transition period, these effects are, as expected, relatively small.

The difficulty in sorting out the effect of the FTA has not stopped critics of the agreement from trying. The most recent flood of creative misrepresentation comes from Alberta publisher Mel Hurtig, a self-proclaimed nationalist, in his best-selling polemic on "The Betrayal of Canada." To add spurious credibility to his case, Hurtig points to charts based on data from Statistics Canada—charts which on closer examination prove the opposite of his claims.

The following chart on output (next page) captures his argument. Hurtig presents only the data from 1987 to 1991 (shown in the black box) in an attempt to trick his reader into believing that the FTA, which entered into force in January 1989, is directly to blame for the slowdown in output. He pointedly does not include the earlier data for 1980-1986 which show a much sharper decline in 1982, long before the FTA was in place or even under consideration. He does not explain why the USA, which he claims has gained so much at Canada's expense, is in serious and prolonged recession. Nor does he explain why so many other countries have faced similar recessions without any help from the FTA—including the U.K., Australia, Italy, Spain, Sweden, etc.

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Annual Percentage Change in Canadian Gross Domestic Product—1980-91



Source: Bank of Canada Review, October 1991.

Note: Illustrates percentage change in Canadian Gross Product at constant 1986 prices, seasonally adjusted at annual rates. 1991 data estimated by Department of Finance.

As the recovery gets underway, output and employment should increase over the coming year. Most Canadian and international experts forecast economic growth of more than 3 per cent next year, placing Canada at the top of the G-7 countries in the performance charts. Strategico continues to be much less sanguine, as we believe the recession will last longer and the recovery will be slower than forecast. Even if a rapid rate of economic growth is achieved, however, it would be equally dishonest to credit these gains solely to the FTA. The main factor in the recovery will be the normal operation of the business cycle in our major markets and in Canada.

The much more fundamental issue remains the underlying competitiveness of the Canadian economy. The picture has not greatly improved over the 12 months since our last report: the Canadian dollar, buoyed by foreign borrowings to finance federal and provincial spending, remains at a level far above that at which most industry would be competitive; and Canadian unit costs continue to rise relative to American competition as wages and other claims outstrip our stagnant productivity performance. The result is that unit labour costs in Canada between the beginning of 1988 (when the FTA was signed) and the beginning of 1991 increased by almost 25 per cent relative to the USA. One-third of this gap is due to higher wages and lower productivity in Canada.

The remaining two-thirds of this disadvantage flows from the appreciation of the Canadian dollar. This issue was discussed in last year's Strategico Trade Report, Making it Work, and the argument will not be repeated here.¹ The Bank of Canada's response to earlier fiscal mismanagement (which saw the federal debt quadrupled during the 1980s) was to tighten the monetary screws to the point where it seriously eroded Canadian competitiveness and deepened the current recession. The timing could not have been worse for a country adjusting to the challenges of free trade.

Some faltering steps are being taken, far too late and far too limited, to address these basic problems. Inflation rates have been driven down to levels below those in the USA. Indeed, overall price levels actually declined in September and October. Increases in wages have slowed significantly. As a result, the Bank of Canada has begun to relax its monetary policies and interest rates have declined sharply to the lowest levels in decades. Nonetheless, the dollar continued strong through early December amid continuing forecasts that it should move downward significantly in 1992.

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Lastly, the Government is committed to tackling the productivity challenge, armed with a million-dollar study by a leading Harvard Business School professor (and co-financed by the Business Council on National Issues). The only "action" announced to date is yet another round of "town hall" meetings to "consult with Canadians" on the issue.

Provided Canada regains its competitive strength, we should be strongly positioned to take advantage of this new environment. Indeed, the FTA will make a substantial contribution to increasing productivity to serve the broader, North American market. If, however, we continue to see the erosion of Canadian economic advantage, free trade will make Canadian output and jobs more vulnerable to foreign, particularly American, competition.

Freedom of Access

The benefits of free trade will not be realized, and the problems will be worsened, if both countries do not respect the spirit and the letter of the FTA. There are serious indications that this good faith cannot be taken for granted. Breakdown of good faith could jeopardize the FTA itself and put Canada in an untenable economic situation.

Generally, the FTA has operated as planned. Tariffs have come down, and other barriers have been dismantled, on schedule. Indeed, tariffs have been eliminated ahead of the timetable for a broad range of items covering some \$8 billion in two-way trade.

Against this background of success, some serious problems have emerged. The Americans have taken very aggressive and highly protectionist actions which defy the spirit and in some cases the letter of the FTA. Examples include the following issues:

- rules of origin, particularly for automotive products;
- overzealous American border inspection and enforcement; and
- tariffs on plywood, waferboard and related products.

The cumulative result is a high and rising level of friction in the operation of the cross border provisions of the FTA.

1. Automotive Content Rules —The Honda Case

Earlier Strategico reports have analyzed continuing problems of interpretation of the rules determining what products and services qualify for the benefits of the FTA. By far the most serious problems have emerged in the automotive industries.

In the original negotiations, the Americans attempted to choke off plans by Asian assemblers locating in Canada to expand production based on export to the USA. Targets included Honda (Alliston) and Toyota (Cambridge) in Ontario, and Hyundai outside Montréal. Canada agreed that these manufacturers would not be entitled to qualify under the Canada-USA Auto Pact and that their existing duty remission programs would be allowed to expire by 1994. Despite intense pressure, Canada insisted that these producers benefit from the same rules applied to other products—i.e., free trade in products for which at least 50 per cent of the direct processing cost was incurred in Canada or the USA. The Americans sought a higher level to make it even more difficult, if not impossible, for transplant producers to qualify for free entry to the USA.

The agreement established a blue ribbon panel to make recommendations on the future of the North American automotive industry. In short order, the panel recommended the processing requirement be raised from 50 to 60 per cent, as sought by the Americans. The Government of Canada rejected this recommendation, to the displeasure of American authorities.

American customs officials proceeded to undertake an intensive audit of shipments from the Canadian transplants. The first target was CAMI, a joint venture between Suzuki and General Motors. American authorities proposed a rather bizarre construction of the FTA rules to exclude certain

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financial charges from the cost of processing in North America. The effect would be to disqualify CAMI production under the FTA.

In March, a preliminary report on the audit of Honda Canada was leaked to the press and the Congress. Auto state representatives seized on allegations that Honda's shipments did not meet the FTA's 50 per cent requirement. In mid-October, before a House of Representatives Ways and Means sub-committee, Deputy Treasury Secretary Robson admitted that the leaked report was simply a "white paper" and confirmed the actual audit would not be complete until February 1992.

Until that time, it would be wrong to prejudge the outcome of this audit. The manner in which the story was leaked, including damaging commercial confidential information, leads to suspicion that American officials clearly appear to have attempted to achieve through aggressive enforcement what their representatives have failed to get through negotiations. Indeed, the very process of an onerous audit coupled with the damaging leak may have achieved the desired result—discouraging Honda from shipping increasing numbers of vehicles from Alliston into the USA.

2. Overzealous Enforcement — The Case of Meat Inspection

Previous annual reports have discussed difficulties encountered at the USA border by Canadian exporters and service providers. These have included tariff reclassifications that are often arbitrary and sometimes perverse (resulting, for example, in higher tariffs under the FTA), and excessive demands for documentation before and after border crossing.

The most dramatic problems have come in what was supposed to be free cross-border trade in red meats. Under the FTA, tariffs and quotas were to be eliminated. Each side was to accept the health and safety inspections of the other.

American authorities soon moved to slow down the flow of Canadian meat across the border. The frequency of spot checks greatly increased and the fees charged to the Canadian shipper were raised substantially. The situation was exacerbated by a system which rewarded private inspection stations in the USA for additional inspections. By Year Two of the FTA, the issue had escalated to discussions between the Canadian and American agriculture ministers. Eventually, both countries agreed to the harmonization of meat and poultry inspection standards during a one year trial period in which meat and poultry were to be allowed to move freely across the Canada-USA border.

This program came under intense fire from Capitol Hill. A number of Senators, from meat producing states, became suddenly preoccupied with the health and safety of American consumers. American inspectors stepped up the harassment at the border. Finally, in October 1991, the US Department of Agriculture formally withdrew its proposal for an open border inspection regime with Canada. Canada responded by implementing a parallel inspection system for meat imports from the USA—also citing the health and safety of the consumer. This seriously undermines one of the very few areas of agricultural trade to benefit under the FTA.

3. Breaches of the FTA — Plywood Tariffs and Standards

The USA has technically been in breach of the FTA since it entered into force on 1 January 1989. On that day, the USA withheld the scheduled cuts in the tariffs on plywood, waferboard and related products and Canada was content to follow suit, despite the fact that a significantly larger volume of Canadian exports was affected. This issue was reviewed in last year's Strategic Trade Report, FTA Year Two: Making it Work. After more than three years of wrangling, the issue has yet to be resolved and the tariffs remain in place.

Meanwhile, industry experts have been working to resolve the standards issue. Indeed, a binational technical group agreed to recommend a new regime, largely based on the Canadian practice. The Americans chose, however, to withhold the long overdue tariff cuts until the new regime had worked

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its way through the highly decentralized and cumbersome American standards organizations, a process that could take many months if not years. Ironically, Canada was castigated by American politicians for showing bad faith in not proceeding at once to implement the new system!

Security of Access

In its review of the FTA, the GATT working group singled out the procedures for resolving disputes over the imposition of countervailing and anti-dumping duties as the most important preferential advantage in the agreement. Ironically, Year Three of the FTA has seen a significant escalation of those disputes. Many of these cases have been resolved on a technical basis by the binational panels of trade experts. Several of these cases raise vital political and policy issues and are potentially explosive.

1. The Case of Pork

The most dramatic development was the conclusion of the dispute over countervailing duties (CVD) applied by the USA to imports of Canadian pork. For years, American producers have sought protection against competition from Canadian hog producers and pork processors. In April 1985, a CVD was slapped on Canadian hogs on grounds that the tripartite stabilization programs subsidized imports which were injuring American producers. The American industry was still not satisfied and kept up the political pressures. In 1988, the U.S. Congress approved legislation under which the Department of Commerce applied a CVD on grounds that pork imports from Canada were subsidized and were threatening injury to American producers. Some \$400 million of Canadian exports was affected. Canada immediately challenged these decisions on every count, under both the GATT and the FTA.

Canada won the GATT case. A panel determined that the American decision was contrary to the GATT rules. The results of the FTA review were decisive and devastating to the American position. One binational panel of experts rejected the Commerce Department's calculation of the margin of subsidy—and thus the level of CVD to be applied. In response, Commerce reduced the penalty from 8 cents per Kg. to 6.6 cents and, when this was rejected, to 3 cents.

The issue became moot when another panel turned back the International Trade Commission's determination that American producers were threatened with injury from the subsidized imports. When the ITC stuck to its guns, the panel sent them back again. Finally, the ITC bowed to the binding authority of the panel and reversed its injury determination, but under strong protest.

This occurred at the height of the debate on Capitol Hill over President Bush's request for "fast track" negotiating authority to complete the Uruguay Round and to launch the NAFTA negotiations. To placate a number of Senators with strong pork producer interests, the Administration put the case to the Extraordinary Challenge Committee of the FTA. This provided for three judges to rule on whether the binational panel had "manifestly exceeded its powers" to the point where it has "materially affected the panel's decision" and "threatens the integrity of the binational panel review process."

The Canadian Government was outraged over this transparently political action. Strategico welcomed the American move as an important test of the agreement—better sooner than later, and on a patently weak case. In June 1991, the extraordinary review committee did, indeed, throw out the American challenge in the most scathing terms. The Canadian pork producers were finally relieved of the CVD penalties.

This marks a crucial landmark for the FTA dispute settlement procedures. When the "quasi-judicial" American trade authorities bowed to domestic political pressures, the FTA system did provide the Canadian exporters with a fair result at the end of the day. That said, the judgment day was unconscionably long in coming, as American stalling tactics postponed a final decision until nearly two years after the original final CVD determination, or a total of two and one half years after the case was first initiated.

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2. Softwood Lumber

This ultimately successful result was a factor in the Canadian Government's decision shortly thereafter to terminate the Canada-USA Memorandum of Understanding on Softwood Lumber (MOU). This MOU was concluded in 1986 to avert a countervailing duty determination. The case had first been raised in 1982, and settled in Canada's favour. Three years later, the political mood was very different. To curry support on Capitol Hill for, among other things, the authority to negotiate the FTA with Canada on the "fast track," the Reagan Administration made secret commitments to the American forest products industry.²

Canada was unprepared to face a final CVD decision, which could have resulted in \$300 million per annum in duties being paid to the USA Treasury—unless and until the Canadian industry could win its case in the American courts (since the FTA with its protections did not come into force until two years later). Instead, the federal government, at the strong urgings of a number of provincial governments, pledged to the USA that an equivalent penalty of at least 15 per cent would be collected from the Canadian industry by the federal or provincial governments. This understanding contained no "sunset" clause nor provision for adjustment or review. It did, however, provide for termination by either country on 30 days' notice.

Five years later, the MOU was still in place. In the interim, much had changed. There were important provincial differences:

- The British Columbia government established a new forestry regime which imposed substantially greater charges on its industry, which accounts for nearly 80 per cent of all Canadian lumber exports to the USA, and agreed to get American approval for any future changes in the BC system.
- Québec also gradually introduced a new forest regime. Charges to the industry for silviculture and other services increased by over \$50 million—a subsequent agreement with the US Commerce Department permitted the export charge on Québec shipments to be reduced from 15 per cent to 6.2 per cent in November 1990 and 3.1 per cent in November 1991.
- In Alberta, changes were also made, imposing additional costs on the industry, but no agreement was reached with the Americans to reduce the export charge.
- In Ontario, the 15 per cent export charge remained in place as the provincial government refused to contemplate any such "replacement measures."
- The Atlantic Provinces were exempted from the MOU and the resulting export tax and increased their market share at the expense of the other producers.

The combination of the MOU with depressed market conditions was devastating for the Canadian lumber industry. If the industry had lost the CVD case—which was not a foregone conclusion—it would have faced charges totalling about \$300 million annually, reviewable every year. Under the original export tax, the same amount was to be imposed, by the Canadian Government, under an MOU of indefinite duration. Once the provincial measures were in place, the industry was in fact paying a total of about \$700 million annually in additional charges, through the combination of provincial charges and what was left (about \$40 million) of the export tax. By any measure, including that used by the US Forest Service, government revenues significantly exceeded expenses on the lumber industry, overall and in each of the major producing provinces.

Inevitably, the impact was to significantly reduce Canada's share of the USA lumber market, from nearly 33 per cent in 1985 to just over 26 per cent in early 1991.

The federal government came under intense pressure from the Canadian industry and the major producing provinces to reconsider the MOU. Last year, Strategico's Trade Report, *Making it Work: FTA Year Two*, reported that trade minister John Crosbie had put his American counterpart on notice of Canada's intention to terminate the MOU, as early as the Spring of 1990. More than a year later, on 4 October 1991, Canada announced its intention to terminate the MOU at the end of the prescribed 30 days. If the American industry really believed it was being injured by "subsidized" Canadian lumber,

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the government noted, it could always initiate a countervailing duty investigation subject, this time, to the protections of the free trade agreement.

The American reaction, predictably, was howls of outraged indignation from the industry and from Capitol Hill. Mobilized by Senator Bob Packwood, who faces an uphill re-election battle in his home state of Oregon, more than 60 senators signed a letter calling on the Administration to respond in the strongest terms to this alleged breach of a sacred agreement. Bowing to these pressures, the Administration took two extraordinary steps:

- the Commerce Department itself initiated a CVD case against Canadian softwood lumber, thus relieving the American industry of much of the cost and burden of proof; and
- unprecedented "interim customs measures" were put in place, requiring importers of Canadian lumber to post bonds, equivalent to the export tax previously collected, in anticipation of the results of the CVD investigation.

Given the substantial volumes of trade involved (\$3 billion in 1990) and the intense political pressure, this case should fully put to the test the American willingness to be bound by the FTA rules. The issue should play out over the next 18 months.

Irrespective of the merits of the case, the preliminary determinations of subsidy and injury will almost certainly go against the Canadian imports. Key issues will include the amount of the CVD margin imposed and the differentials, if any, among Canadian producing provinces.

The real test of the American process will be the final determination, expected by the end of May. It would require considerable creative imagination for American authorities to conjure up a final CVD determination from the facts described above. Given the political pressures, however, an adverse outcome cannot be ruled out.

In that case, the FTA procedures would be triggered. Binational panels would review the Commerce determination that significant subsidies are involved and the ITC determination that the American industry is threatened by these imports. These panels would be given a total of 315 days to complete their work—unless the Americans again resort to extraordinary measures in order to delay the process further.

Based on the current GATT and FTA rules, we believe that it is very probable that the final decision will be in Canada's favour. Any CVD would be repealed and any deposits or bonds returned, with interest. At a minimum, however, the American industry will have succeeded in tying up the Canadian industry in a lengthy and expensive process. (The preceding cases cost the industry more than \$20 million in legal fees alone.) The issue should be resolved as early as April of 1992—if Commerce finally determines there is no subsidy. It could be as late as the Fall of 1993 or even beyond—if the American administrative authorities rule against Canada and the process is dragged out to the maximum possible extent under the FTA.

Realistically, the American industry has probably—and the Administration almost certainly—come to the same conclusion, i.e., that if there ever was a case in 1986, there is no case today for maintaining that subsidized imports from Canada are injuring the American producers. Consequently, the political pressures will become all the more intense as the American industry, and their political surrogates, attempt to find some other way to tie up the Canadian industry again. At the extreme, this could take the form of a legislated result, imposed by the Congress, without regard for the FTA. This would be tantamount to a declaration of outright trade war and would seriously jeopardize the entire FTA.

The more likely outcome is for the American authorities to press for a new Understanding as the best way to head off congressional action. Such an offer would be accompanied by intense pressure on one or more provinces in an attempt to breach Canadian solidarity. This was, after all, the successful strategy followed in 1986. On this occasion, however, it would be extremely difficult for Canadian federal and provincial governments to agree to such a settlement without, in effect, declaring the FTA provisions to be worthless.

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In either case, whether the Americans directly violated the FTA or coerced the Canadians into settling outside the FTA, the integrity and credibility of the whole free trade agreement would be destroyed.

3. Hydro Electricity

Another set of cases could have profound consequences for Canadian industrial strategies. At issue is the provision of hydro electric power under contracts which are highly advantageous to large industrial users. The trigger is the case brought against Norsk Hydro, a Norwegian magnesium producer, operating a facility in Québec based on power from Hydro Québec. The issues raised by the case could, however, be extended to other Québec industries, including aluminum, to other industrial assistance programs in Québec, and to other provinces attempting to attract heavy industry.

Opposition to Hydro Québec's plans for phase two of the James Bay development has been unrestrained and highly effective. The Cree have combined with environmental groups in a "no holds barred" effort to discredit the project and the corporation. This included the publication of the commercially confidential contracts between Hydro Québec and 13 industrial users, including Norsk Hydro. The contract became the principal basis for a complaint brought by an American competitor, MagCorp, leading to countervailing and anti-dumping duty investigations by US authorities.

The arrangements are specially tailored to the requirements of heavy power using industries. They reportedly provide for Hydro Québec to share in the commercial risks of the project through a complicated formula tying a portion of the power rate to the international selling price of magnesium. Hydro Québec has pointed out that such arrangements could eventually increase the rate of return to the utility. They also note that similar arrangements are not unique but are used by, for example, the Bonneville Power Authority in the USA.

The case will, however, proceed on the basis of American trade law which is sometimes remote from sound economic analysis or good business practice. Consistent with the GATT rules, American CVD law disregards comparable domestic "subsidies" (i.e., Bonneville Power). Anti-dumping laws strictly constructed could penalize any supplier of commodities priced through the London Metals Exchange which, for unrelated reasons (eg. the flood of Russian metal into the market) may set a lower price than the long run average price for the product. The case has been initiated by a marginal producer, accounting for less than one-quarter of the American industry raising serious questions about its legitimacy. The process has, nonetheless, passed the preliminary stage, with the provisional application of a CVD of 33.22 per cent to imports of magnesium from Norsk Hydro's Québec facilities.

These cases will work their way through the system in 1992. It is highly probable that, whichever way they go, the final determinations by American authorities will be put to binational FTA panels for review. The case will be of strategic importance for policies in Québec and other provinces.

Related Trade Issues

As the Canadian economy continues to adjust to free trade with the United States, a number of related issues are crowding onto the trade agenda. These include: the Uruguay Round of GATT negotiations, the North American free trade area negotiations with Mexico, and the constitutional discussions around the future of the Canadian economic union.

1. The GATT Negotiations

The current round of GATT negotiations was launched during the FTA negotiations, at Punta del Este in September 1986. The original deadline was passed last year when the talks broke down over the central issue of agricultural subsidies. The US Administration sought and obtained authority to

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continue these negotiations on the "fast track" until March of 1993. To keep up momentum, however, a political deadline of the end of 1991 has been set. Negotiators are working toward this goal.

As of this writing, in December 1991, both the Americans and the Europeans have sent up promising signals that progress is being made on resolving the agricultural issues. It remains to be seen whether this progress is real. The critical negotiations are, in fact, within the European Community. The French, as the principal beneficiaries of the Common Agricultural Policy—arguably the most protectionist regime in the world today—are desperately working to keep the Germans on side. If they succeed, there is little likelihood the European position will move nearly far enough to meet the minimal American requirements. If the agricultural issues are unresolved, none of the other subjects of negotiation will be brought to a decision. The result will be stalemate continuing into 1993. This would not necessarily distress President Bush who will be facing a campaign for reelection made much more difficult by increasing concern over domestic economic issues.

Nor would this necessarily displease the Mulroney government. Any final deal on agriculture would, however, almost certainly mean dismantling the import controls that protect the supply management regimes for poultry and dairy production, concentrated in Central Canada, particularly Québec. The proposed "tariffication" of quota restrictions would painfully reveal the burden carried by the Canadian consumer of these products which currently sell at close to twice the world price. These producers would bitterly oppose any steps that would force them to face competitive market pressures. On the other hand, the conservatives' traditional western Canadian constituency has been hard hit by the collapse of international grain markets under the pressure of competing subsidies and would welcome a GATT agreement. This is a "no win" situation for a government beset by other political woes and facing a constitutional crisis.

2. North American Free Trade

As of this writing, the Canadian, American and Mexican trade ministers continue to insist that their plan is to complete the negotiation of a trilateral free trade agreement early in the New Year. There are no compelling technical reasons why this target will not be met. The political imperatives are quite another matter.

Despite the initial rhetoric, the American negotiators have responded to an increasingly protectionist political environment by pushing American producer interests aggressively at the table with the Mexicans. On items where the Americans see real opportunities in a preferential opening of the Mexican market they have been pressing very hard. On items where the Mexicans could compete successfully if barriers were removed around the American market, the USA has proposed the existing restrictions be phased out very slowly and in some cases maintained.

The most controversial issues for Canada relate to the negotiations with the USA. The Americans have returned to the attack in a number of sensitive areas for Canada while holding firm in areas where they refused to open markets under the FTA. These include the following:

- the cultural industries, where the Americans have voiced their determination to eliminate the remaining protections for Canadian producers, who are already reduced to competing for a small fraction of their home market;
- the automotive sector, where the Americans continue to press to stifle the development of the transplants in Canada by tightening the restrictions on cross-border trade;
- government procurement, where the Americans remain unwilling to give national treatment to Canadian suppliers for the overwhelming bulk of purchases by federal and state authorities; and
- dispute settlement where it appears most unlikely that a trilateral arrangement will extend the protections of the FTA.

It remains our assessment that Canada stands to gain relatively little from the success of these negotiations. On the other hand, Canada will have to be very firm in withholding major concessions from the Americans in a number of sensitive areas.

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Meanwhile, the political timetable is turning very awkward. In the United States, this November's election results (particularly in Pennsylvania) and the current polling data suggest that President Bush will face an uphill struggle for re-election. The American public is increasingly pre-occupied with the continuing recession. They are in the mood for protectionism, not free trade, with Mexico or anyone else. In Mexico, President Salinas is approaching the point at which he will lose the authority to push through the remaining elements of his policy of "apertura" including a free trade agreement with the USA. If the Americans drive a very hard bargain—some would say over-negotiate—it may become impossible for the Salinas Administration to reach an agreement. In Canada, the Mulroney Government would be unlikely to use up the remaining vestiges of its political credit to push through a highly controversial agreement in a highly charged political atmosphere.

A great deal of time and effort has been invested in these negotiations. Nonetheless, it remains Strategico's judgment that:

- The odds are against the USA and Mexico reaching agreement on that timetable.
- If they fail, prospects are not good for picking up the task again following the American presidential elections.
- If they succeed, it is by no means certain that Canada will be a party to the final agreement.

Fortunately, the failure of these negotiations would not be seriously damaging to Canadian interests. Indeed, in many respects the Canadian interest would be better served by maintaining the status quo.

3. Economic Union

The most dangerous threat to free trade is internal. The latest, and possibly the last, round of constitutional negotiations is scheduled to reach a conclusion in 1992. Québec's Assemblée nationale has approved the holding of a referendum on independence or on a federal alternative by October of next year. The heart of the political debate is not about economic issues but about more visceral and emotional questions. Economics does matter, however, and the Canadian economic union is at the centre of the discussions.

The initial proposals by the federal government call for several steps to be taken to strengthen the economic union. These include:

- the constitutional guarantee of the free movement of people, goods and services, and capital across inter-provincial boundaries;
- constitutional provision for the federal government to make laws for the effective functioning of the economic union; and
- provision for the federal and provincial governments to work out guidelines to improve the coordination of fiscal policies and their harmonization with monetary policies.

These proposals have encountered sharp opposition from leaders in Québec and other provinces who fear the centralization of economic authority.

Meanwhile, further analysis is uncovering the very significant costs of breaking up the federal system. Together, the Canadian economic union constitutes the seventh largest economy in the world, enjoying a free trade agreement with the largest. The economic benefits to producers and consumers are substantial. They would be at risk in the event of a breakup.

In a recent study for the C.D. Howe Institute, Strategico's Gordon Ritchie joined a number of leading economists in presenting an analysis of the options.³ The bottom line is this:

- It is completely unrealistic to expect that some form of "sovereignty-association" could be negotiated which would maintain the economic union intact, or even establish a common market arrangement.
- The most that could be negotiated would be some form of free trade arrangement which would mean, sooner rather than later, customs posts at the border to control the flow of people, goods and services.

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mean, sooner rather than later, customs posts at the border to control the flow of people, goods and services.

- Some industries would be heavily affected by the loss of protection and these are concentrated in Québec, notably the dairy industry and the "soft sectors" of textiles, clothing, footwear and furniture.
- The Canada-USA FTA would no longer automatically apply to Québec and, indeed, the rest of Canada could not assume the Americans would not require a renegotiation of its arrangements as well.
- With both Canada and the USA, Québec would have to accept significant new responsibilities as a "national" government which would require the dismantling of important elements of current policies.
- The very best that could be achieved following Québec's independence would therefore be to renegotiate some form of free trade arrangement among Canada, Québec and the USA on significantly less favourable terms than now apply.
- Under the best of circumstances, these would be difficult negotiations with no guarantees of success—an acrimonious breakup could obviously lead to catastrophic results.

Concluding Comment

The real threat to Canadian prosperity is not free trade, but the possibility that free trade will not be allowed to work to our advantage. The Americans are in an increasingly protectionist mood, as the economy continues to falter and the electorate feels increasingly threatened. This has translated into very aggressive behaviour at the border with Canada, including breaches of the FTA and actions to subvert the workings of the FTA. The Administration has fought to defeat the application of the FTA rules to trade disputes over pork and lumber while applying American laws aggressively against Canadian producers. The cumulative result is to put the FTA under extraordinary strains which will come to a head next year, Year Four under the FTA.

Meanwhile, the American agenda in the trilateral negotiations with Mexico includes a number of areas where Canada stood firm against USA demands in the FTA. Prospects for a genuinely trade liberalizing agreement are slim under NAFTA as they are under the current GATT round.

Finally, Canada's own house is in disorder. Our competitive position is significantly weakened and action to correct the situation is proving highly unpopular politically. Proposals to strengthen the economic union within Canada are meeting with fierce opposition. On the other hand, a breakup of confederation would impose very heavy costs on Canadians, including Quebeckers.

*The following article was first published in International Merger Law, July 1991
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A COMPARATIVE REVIEW OF CANADA'S MERGER ENFORCEMENT GUIDELINES

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Prior to the drafting of Canada's new *Merger Enforcement Guidelines (MEGs)*, a review was undertaken of various merger guidelines and policy statements that have been released by enforcement authorities around the world, and of the literature they have spawned. The underlying objective was to avoid reinventing the wheel where there had been obvious successes while addressing perceived shortcomings where appropriate. This article discusses key aspects of the MEGs and how they compare to the merger policies reflected in the U.S. Department of Justice (DOJ) 1984 *Merger Guidelines*, the

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1987 *Horizontal Merger Guidelines* issued by the U.S. National Association of Attorneys General (NAAG), the 1986 *Guidelines for the Merger Provisions of the Trade Practices Act* issued by the Australian Trade Practices Commission, the 1991 *Mergers Guide* circulated by the U.K. Office of Fair Trading, the *Checklist for Merger Control Procedures* released in 1990 by the Federal Cartel Office in Germany, and the Commission of the European Communities' *Form CO* Relating to the Notification of a Concentration Pursuant to Council Regulation (EEC) No. 4064/89. Past enforcement practice in these jurisdictions is also discussed.

Horizontal Merger Focus

The Executive Summary to the *MEGs* states that vertical and conglomerate mergers "rarely present sufficient grounds for enforcement action." As a result, the *MEGs* focus almost exclusively on horizontal mergers, and reflect even less of a concern with non-horizontal mergers than do the U.S. 1984 *Merger Guidelines*. The first of the two vertical "limited situations" addressed in the *MEGs* involves facilitating interdependent behaviour in a market that is otherwise conducive to interdependent behavior by raising barriers to entry. Such an effect could occur through a merger that eliminates one of the last remaining unintegrated sources of supply or distribution outlets in a related upstream or downstream market, thereby forcing a potential entrant into the primary market to enter that other market as well in order to ensure access to supply or distribution.

The other vertical situation addressed is where a merger facilitates upstream interdependence through forward integration into the retail level. These two narrow theories of challenge are virtually identical to two of the four vertical merger theories of challenge highlighted in the U.S. DOJ *Merger Guidelines*. The fact that the other two theories, facilitation of upstream collusion through the elimination of a disruptive buyer and the evasion of rate regulation through backward integration into an unregulated upstream market, are not mentioned should not be taken to signal that they have been rejected by the Bureau. These situations simply do not arise in Canada with sufficient frequency to warrant explicit treatment.

The concerns raised in both of the situations discussed in the *MEGs* are horizontal in nature, *i.e.*, the facilitation of interdependent behavior at one of the levels in question. Foreclosure is not *per se* a concern. This contrasts with the approach that appears to be taken in Germany, the EEC, and the U.K., where non-horizontal effects of transactions have attracted significant attention from enforcement authorities.

The Canadian approach to conglomerate mergers is substantially narrower than the approach reflected in Germany's 1990 Checklist, Australia's 1986 Merger Guidelines, and the EEC's Form CO. This is somewhat ironic, given that these jurisdictions all have a "market dominance" test that is more lenient with respect to horizontal mergers than is the "substantial lessening of competition" test enshrined in Canadian and U.S. legislation. (Note that there was no horizontal overlap in the recent *Matsushita/MCA* case, which, as IML reported in its March 1991 issue, caused some concerns for the EEC's Merger Task Force).

The "potential competition" theory described in the *MEGs* is conceptually similar to the "actual potential competition" theory highlighted in the U.S. DOJ Merger Guidelines. In short, in exceptional cases that raise *prima facie* concerns, the Bureau will assess whether the merger would likely prevent competition substantially by facilitating the maintenance of market power held by a powerful incumbent firm that would otherwise have been forced to compete more vigorously as a result of the *de novo* entry into the market by the other party to the merger. The *MEGs* make clear that the Director will not speculate as to whether *de novo* entry would likely have occurred in the absence of the merger. He will generally require "objectively verifiable information that clearly supports this proposition, *e.g.*, internal documents that pre-date the merger, recent initiatives by the firm to contest the market, an application for regulatory approval, or the registration of a patent." No mention is made of the

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"perceived potential competition" theory described in the U.S. DOJ Merger Guidelines. (Unlike the 1985 U.K. Mergers Guide, the recently released 1991 U.K. Mergers Guide makes no mention of possible grounds of challenge of conglomerate mergers. This suggests that the U.K. may have a more *laissez faire* attitude toward conglomerate mergers than any of the other jurisdictions considered in this review).

The Definition of "Merger"

Section 91 of the *Act* defines a "merger" in terms of the direct or indirect acquisition or establishment of control over or a significant interest in the whole or a part of a business of another person. "Control" is defined in subsection 2(4) of the *Competition Act* (the *Act*) in terms of de jure control. However, there is no guidance anywhere in the *Act* regarding the meaning of the term "significant interest." The *MEGs* state that a significant interest in the whole or part of a business "is held when one or more persons have the ability to materially influence the economic behavior (*e.g.*, decisions relating to pricing, purchasing, distribution, marketing or investment) of that business or of a part of the business". This closely resembles the lowest of three levels of "merger" defined in the U.K. *Fair Trading Act*, 1973, as well as the test that appears to be a lower threshold than the EEC's "decisive influence" standard set forth in Article 3(3) of the Merger Regulation, Australia's "substantial degree of influence" threshold embodied in subsection 50(2A) of the *Trade Practices Act*, and Germany's "controlling influence" test articulated in subsection 23(2)5 of the *Act Against Restraints on Competition*. As with the U.K. "materially to influence the policy" test, and the U.S. "solely for investment" exemption, there is no specific share threshold at which a reviewable "merger" is considered to occur.

However, the *MEGs* indicate that "ownership of less than ten percent of the voting shares of a corporation has generally been found not to constitute ownership of a 'significant interest' in the corporation." This ten percent "significance" threshold appears in various banking, foreign investment and securities legislation around the world, and is also the notification exemption threshold set forth in section 4 of the EEC's Form CO. Interestingly, the ten percent rule of thumb that appeared in the 1985 edition of the U.K. Mergers Guide has been dropped in favour of a fifteen percent standard in the 1991 edition.

The Draft *MEGs* that were circulated in November 1990 suggested that direct or indirect ownership of over 25 percent of the voting shares of a corporation would ordinarily be found to constitute the ownership of a "significant interest" in the corporation. However, this rule of thumb (which appears in the 1991 version of the U.K. Mergers Guide, and which is embodied in subsection 23(2)2 of Germany's *Act Against Restraints of Competition*), was dropped after the Bureau received several briefs indicating that there are various common corporate and non-corporate ownership and management structure in which parties with voting interests that exceed 25 percent are not able to materially influence the economic behavior of the corporation whose shares they hold.

With respect to interlocking directorates, *MEGs* follow the lead of Germany but confine the area of potential concern to situations that meet the following conditions:

- 1(a) the transaction enables one company to directly or indirectly obtain the ability to elect a sufficient number of directors to the boards of directors of two competitors to materially influence these boards; or
- 1(b) the transaction enables representatives of two competitors, respectively, to materially influence the board of directors of a third company; and
2. the board representation pertaining to each of the competitors involves at least one director who is not "independent."

In such cases, the merger "will be assessed in terms of whether competition is likely to be substantially prevented or lessened in the market in which the two competitors compete."

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The Anticompetitive Threshold

The anticompetitive threshold for mergers is defined in subsection 92(1) of the Act, which provides that the Tribunal may make an order in respect of a merger where it finds that the merger "prevents or lessens, or is likely to prevent or lessen, competition substantially." This is similar to the "substantially to lessen competition" requirement of section 7 of the U.S. *Clayton Act*, and to the "substantially lessening competition" test that prevailed in Australia from 1974 to 1976. The MEGs indicate that the "prevent" and "lessen" branches of subsection 92(1) are assessed within a common "market power" analytical framework that, like the U.S. DOJ Merger Guidelines, is the unifying theme of the entire document.

As with the U.S. DOJ and FTC, the focus of the Bureau's analysis is primarily upon the price dimension of competition, *i.e.*, upon whether prices are likely to be higher than if the merger does not proceed. However, the MEGs make it clear that an assessment will also be made of whether market power is likely to be increased or maintained in relation to non-price dimensions of competition, where rivalry in terms of variables such as quality, variety, service, advertising, or innovation is important. Where a merger is not likely to have adverse market power effects, the fact that it may be likely to have negative implications for other industrial policy objectives (*e.g.*, employment, regional development, cultural industries, the national interest in having secure Canadian sources of supply) is generally not found to be relevant to the assessment of whether competition is likely to be prevented or lessened substantially.

This contrasts with the approach that has been taken in several U.K. Monopolies and Mergers Commission decisions over the years and, to a certain extent, to the approach that was taken by the U.S. Warren Court in the 1960s when Jeffersonian values such as the preservation of small and locally owned businesses, and a disdain for concentration *per se*, were given significant weight in NAAG's Horizontal Merger Guidelines. By contrast, the 1991 version of the U.K. Mergers Guide suggests that future "public interest" references to the MMC which are not grounded in concerns relating to competition will be "exceptional" and will likely be confined to situations involving foreign acquirors who are wholly or partially state owned.

The MEGs articulate two "lessening" and two "prevent" theories of challenge. Competition can be lessened where the merger "is likely to enable the merged entity to unilaterally raise price" or where the merger "is likely to bring about a price increase as a result of increased scope for interdependent behavior in the market." Competition may be prevented where the merger enables "a single firm to unilaterally maintain higher prices" than would otherwise exist "by hindering or impeding the development of increased competition"; and where the merger "inhibit(s) the development of greater rivalry in a market already characterized by interdependent behavior." In the U.S., the latter two theories of challenge have typically been dealt with as "lessening competition" cases, or pursuant to the actual potential competition theory mentioned earlier.

Although the great weight of U.S. DOJ and FTC enforcement activity has historically been directed at mergers that were considered to raise at least *prima facie* concerns that prices would rise as a result of increased scope of interdependent behavior, the MEGs state that most of the mergers that the Director has concluded would likely have prevented or lessened competition substantially have raised concerns about the ability of the merging parties to unilaterally raise prices. This difference is attributable to the different sizes of the two economies and the depth of the markets therein.

In section 2.4 of the MEGs, the central test in the Bureau's merger review is stated as follows:

In general, a prevention or lessening of competition will be considered "substantial" where the price of the relevant product is likely to be materially greater, in a substantial part of the relevant market, than it would be in absence of the merger; and where this price differential would not likely be eliminated within two years by new or increased competition from foreign or domestic sources.

This indicates that the Director's notion of substantiality has three dimensions: magnitude, scope and duration. With respect to magnitude, a *de minimus* difference in the prices that would likely prevail

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with and without the merger is not enough. The price differential must be material. The *MEGs* state that "(w)hat constitutes a 'materially greater' price varies from industry to industry, and may be a differential that is less than the 'significant' price increase that is postulated for the purposes of market definition." Accordingly, a materially higher price in a relevant market that is defined on the basis of a five percent test may be a price that is less than five percent higher than what would prevail in absence of the merger. Indeed, in low margin/high turnover markets such as gasoline and milk, the large misallocation of resources that would result from a price increase of only a few percentage points could well give the Bureau serious grounds for concern. There is no similar "materiality" concept, or tolerance for *de minimus* price increases, explicitly recognized in the U.S. DOJ Merger Guidelines. To date, enforcement authorities in Australia, Germany, the EEC and the U.K. appear to have been reluctant to embrace any price test, material or otherwise.

With respect to the "scope" dimension, the Canadian *MEGs* provide that a prevention or lessening of competition will not be found to be substantial unless it is likely to occur "in a substantial part of the relevant market." This concept is a close cousin of the related notions that appear in the U.K. *Fair Trading Act*, the EEC's Merger Regulations and Germany's *Act Against Restraints on Competition*. In sort, materially higher prices that are only likely to occur at the fringe or in a minor pocket of the market will not be considered to warrant triggering the costly enforcement machinery of the government. Conversely, materially higher prices do not need to extend across the entire market. Given that the price test employed in market definition may be greater than what is considered to be "material" for the purposes of assessing whether the section 92 substantiality threshold is triggered, it is entirely possible that the material price increase will not occur throughout the relevant market.

With respect to the "duration" dimension, the *MEGs* state that a prevention or lessening of competition must last for more than two years before it will be found to be substantial. Therefore, a merger that is likely to result in a material price increase in a substantial part of the relevant market will not generally be challenged if the price increase is likely to be eliminated by new entry or by expansion of incumbent firms within two years. The following passage from a paper given by Judy Whalley, U.S. Deputy Assistant Attorney General, in December 1989 to the Annual Antitrust Seminar of the Practising Law Institute indicates that the same approach is taken by the U.S. DOJ:

Whether the result of easy entry into a market is that market participants perceive the ease of entry and are therefore deterred from raising prices or that the market entrants actually do attempt to raise prices, draw entry and find prices competed down [within two years], the ease of entry precludes the exercise of market power as a result of the merger and protects consumers.

The analytical framework established by the *MEGs* for the assessment of whether competition is likely to be prevented or lessened substantially can be conceptually divided into the following six stages:

1. market definition;
2. calculation of market shares and concentration levels;
3. assessment of ease of entry [s.93(d)];
4. assessment of various other qualitative criteria, in particular those highlighted in subsections 93(a), (c) and (e)-(g);
5. assessment of whether there are alternatives to the merger [s.93(b)]; and, where necessary
6. an efficiency trade-off analysis [s.96].

The first four stages are common to merger review in most jurisdictions around the world; the fifth stage is normally confined to an assessment of the extent to which one of the parties to the merger is likely to fail; and the efficiencies trade-off is very different from the corresponding stage of merger review elsewhere.

Market Definition

The conceptual approach to market definition articulated in the *MEGs* is essentially the same as that described in the U.S. DOJ Merger Guidelines. There is only one material difference between the

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two approaches. Whereas the DOJ requires the hypothetical monopolist to be the only present and future seller of the relevant product in the relevant geographic area, the MEGs simply require that the hypothetical monopolist be the only present seller of that product in that area. The U.S. approach is theoretically narrower because it excludes from market definition potential competition from sources of: (i) production substitution; (ii) production that has historically been "captive"; and (iii) durable products that have been reconditioned or recycled. This potential competition is accounted for at a separate stage in the DOJ's approach, called "Identification of Firms that Produce the Relevant Product." By contrast, under the Canadian MEGs, the actual or future products that would be sold by these four groups of firms are added to the relevant market and given a zero market share, where the hypothetical monopolist would otherwise not be able profitably to raise prices for a significant and nontransitory period of time. This departure from the U.S. DOJ's approach is purely conceptual and should have no practical significance whatsoever.

The MEGs make it clear that market definition involves an examination of likely responses from sources of product and geographic competition on both the demand and supply sides of the market. This is consistent with the approach of the DOJ, the FTC, the Australian Trade Practices Commission and the U.K. Office of Fair Trading/MMC. However, it is significantly different from the narrower approach described in NAAG's Horizontal Merger Guidelines and in the European Commission's Form CO NAAG explicitly de-emphasizes supply side considerations, and Form CO simply makes no mention of them.

As is the case with the U.S. DOJ Merger Guidelines, the MEGs reveal that "(i)n most context," a 5 percent price increase is considered to be significant and a one year period to be nontransitory. The five percent standard is explained by reference to the Bureau's principal objective at the market definition stage, which is "to define the smallest market in which a substantial prevention or lessening of competition would be possible." A five percent price increase is generally considered to be a sufficiently high market power threshold for this purpose. The implication is that a "materiality" threshold in most markets will be at or below the five percent level. Where the five percent "significance" threshold is altered, the "materiality" threshold would presumably also be altered in the same direction.

An important benefit of the virtually identical approaches to market definition approaches to market definition in Canada and the U.S. is that parties to cross-border mergers can have confidence that the same principles will be applied by enforcement authorities in defining markets. Although scope will always remain for the application of this approach to yield different relevant markets (*e.g.*, a North American market when defined from the Canadian perspective but a U.S. market when defined from the U.S. perspective), this should be greatly reduced once tariff and non-tariff barriers have been completely eliminated pursuant to the *Free Trade Agreement*.

After articulating the underlying conceptual approach to market definition, the MEGs depart from their counterparts in other jurisdictions by spending several pages discussing the relevance of the following "real world" assessment criteria, and by providing helpful rules of thumb when possible:

- views, strategies, behavior and identity of buyers
- trade views, strategies and behavior
- end use
- physical and technical characteristics
- switching costs
- price relationships and relative price levels
- cost of adapting or constructing production processes, distribution and marketing
- existence of second hand, reconditioned or leased products
- transportation costs
- local set-up costs
- shipment patterns
- foreign competition.

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The discussion of these factors responds to calls that have been made in other jurisdictions for more guidance about the way in which markets are defined. The discussion of foreign competition here, as distinct from the more detailed treatment of foreign competition that is provided in Part 4.3 of the *MEGs*, simply makes the point that the same principles will be applied to the assessment of domestic and international sources of competition. In most cases, markets will be expanded beyond Canada's borders to include the location of the foreign source of competition. However, where the foreign source of competition is unique, the market will be confined to Canada, and it will be recognized that the market share of the foreign firm in question may not fully reflect the relative competitive significance of that competitor. For example, if there are several firms supplying the relevant product in the U.S. but only one of them, a firm located in Florida, has sufficiently low costs that it could make significant sales in Canada in response to a significant and nontransitory price increase, the market will not be expanded to include all of North America. It will be confined to Canada, and the Florida firm will receive a market share based on its actual sales, if any, in Canada. The willingness of the Director to expand markets beyond Canada is consistent with the approach taken in the U.S.; it contrasts with the approach taken in Germany and, it would appear, in the EEC.

Post-Market Definition Assessment

In recognition of the criticism that the DOJ merger guidelines and those of other authorities fail to provide any indication of the relative significance of criteria assessed at the post-market definition stage of merger review, the *MEGs* provide a detailed discussion of the seven evaluative criteria highlighted in section 93 of the *Act* and of two additional criteria often considered pursuant to the subsection 93(h) "catch-all" factor. In addition, the *MEGs* make it clear that there are circumstances in which information relating to any one of three criteria can "provide a sufficient basis, in and of itself, for concluding that a merger is not likely to prevent or lessen competition substantially." That is to say, even if all of the other factors receive a negative weighing, the merger may be permitted to proceed unchallenged if "trump" findings are made in relation to: (i) the level of effective competition that will likely remain in the relevant market [ss.93(e)]; (ii) future entry into the relevant market [ss.93(d)]; or (iii) the alternatives faced by a merging party that is allegedly failing or exiting the market [ss.93(b)].

Market Shares

Pursuant to subsection 92(2) of the *Act*, information relating solely to concentration or market shares cannot provide a sufficient basis for making an order in respect of a merger. Nevertheless, given that high market share or concentration "is a necessary condition that must exist" before a merger can result in a substantial prevention or lessening of competition, the *MEGs* provide market share and concentration "bright lines" designed to indicate when concerns are not likely to arise. The *MEGs* state:

(T)he Director generally will not challenge a merger on the basis that the merging parties will be able to unilaterally exercise greater market power than in the absence of the merger, where the post-merger market share of the merged entity would be less than 35 percent. Similarly, the Director generally will not challenge a merger on the basis that the interdependent exercise of market power by two or more firms in the relevant market will be greater than in the absence of the merger where:

- (i) the post-merger market share accounted for by the four largest firms in the market would be less than 65 percent, or
- (ii) the post-merger market share of the merged entity would be less than 10 percent.

As "no likely challenge" thresholds, these operate as a preliminary screening device to eliminate from further consideration the vast majority of mergers that come to the Bureau's attention. They do not have any further use. In particular, they do not create any inference that the merger is likely to have anticompetitive results. In this regard, the Bureau's use of market shares is similar to the approach taken by the EEC, where there is a presumption against dominance when the post-merger

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market share is below 25 percent (see the 15th recital of the Merger Regulation). These thresholds take mergers "off the table" rather than the converse. They suggest that the remaining competition is sufficiently effective to ensure that the merger will not enable the merging parties to increase or maintain market power.

This approach stands in sharp contrast to that taken in Germany, the U.S. and Australia, where adverse legal presumptions or *prima facie* cases arise when certain concentration or market share thresholds are exceeded. Whereas the Bureau's 35 percent bright line simply eliminates from further consideration under the unilateral market power theory all mergers where the post-merger market share is below this threshold, the U.S. DOJ Merger Guidelines employ 35 percent as a "likely challenge" threshold in circumstances where the other party to the merger has a market share of "at least one percent." In addition, the Four-Firm Concentration Ratio (CR4) 65 percent "no likely challenge" threshold will virtually always correspond to a much higher level of concentration than the U.S. DOJ's equivalent threshold for raising preliminary concerns about interdependent behavior: an HHI of 1,000 which can be met by ten equally sized firms. The corresponding German Thresholds are CR3 50 percent or CR5 66 percent, and the Australian dominance threshold is "45 percent or more and will be the largest competitor in the market, or will be the largest competitor in the market and have a market share which exceeds that of its nearest competitor by fifteen percent or more."

Barriers to Entry

If the combined market share of the merging parties, or the combined market share of the four largest firms in the market, exceeds the thresholds set forth in the *MEGs*, the Bureau turns its attention to the various qualitative criteria set forth in section 93 of the *Act*. Given that ease of entry can provide a sufficient basis in and of itself for concluding that competition will not likely be prevented or lessened substantially, it warrants consideration first.

In view of the fact that the debate about what constitutes a "barrier to entry" is far from settled, the term is avoided in the *MEGs*. Instead, the Bureau's approach to the subsection 93(d) stage of its assessment is described in terms of a review of any matter or combination of matters that may "impede" or "delay" entry. What really matters for the Bureau is not whether *bona fide* barriers exist or do not exist but whether:

...entry by competitors would likely occur on a sufficient scale in response to a material price increase or other change in the relevant market brought about by the merger, to ensure that such a price increase could not be sustained for more than two years.

As indicated earlier, this is consistent with the approach taken by the DOJ. The Bureau's analysis generally focuses upon whether future entry "is likely to be delayed or hindered by the presence of cost differences or the need to make investments that are not likely to be recovered if entry is unsuccessful." These investments are referred to as "sunk costs." In the absence of a significant "sunk" component, the absolute cost of entry *per se* is ordinarily not considered to present an impediment to entry. If a profitable opportunity exists, there will generally be someone who will be able to find the money required to capitalize on that opportunity. This view appears to contrast with the approach reflected in the EEC's Form CO, where it is suggested that "the total costs of entry" may be given significant weight in the assessment of ease of entry [Section 6(4)]; and with wording to the same effect in the Australian Merger Guidelines (p.10). Similarly, "firm size and financial strength" and "economies of scale or scope", which are considered to be a barrier to entry in Germany (Checklist, pp.5-7 and 12) are not *per se* treated as barriers in the *MEGs*.

The Bureau recognizes that potential entrants may be deterred from entering, or impeded from becoming effective competitors, where they face cost disadvantages relative to incumbent firms. Three such sources of asymmetry highlighted in section 93(d) of the *Act* are tariff and non-tariff barriers, interprovincial barriers and regulatory control over entry. Other potential cost disadvantages mentioned in the *MEGs* include transportation costs and control over access to scarce or non-duplicable resources, *e.g.*, technology, natural resources and distribution channels.

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The extent to which various investments required for successful entry represent "sunk costs" is the unifying theme of the balance of the Bureau's assessment of whether new entrants are likely to face significant impediments or encounter significant delays. Canada's *MEGs* distinguish between, and discuss in detail, five types of sunk costs that may have to be incurred by potential entrants, each of which appears to be recognized as potential sources of entry impediments in the U.S., the U.K., Germany, the U.K. and the EEC:

- (i) investments in various "start-up" costs;
- (ii) investments in market specific assets;
- (iii) investments in learning how to optimize the use of those assets;
- (iv) investments required to overcome product differentiation related advantages enjoyed by incumbent firms; and
- (v) investments required to overcome disadvantages presented by the strategic behaviour of incumbent firms.

The *MEGs* address a common source of confusion by making it clear that evidence relating to post entry and exit is only relevant as a source of information regarding the commitments that must be made and the time required to become an effective competitor. A number of examples of recent entry is not in and of itself evidence that successful entry is easy because the market may now be full and unable to accommodate additional firms. Similarly, a number of examples of recent exit is not in and of itself evidence of the fact that new entry is unlikely. An absence of entry or exit may simply indicate that the market is performing competitively.

Foreign Competition

In section 4.3 of the *MEGs* various matters are highlighted that typically have unique relevance to the assessment of foreign sources of actual and potential competition. These matters are considered both in the determination of whether foreign products and sales locations should be included in the relevant market and, in the event of a negative finding in this regard, in the assessment of whether the foreign sellers in question would likely be able to enter the market on a sufficient scale within two years to eliminate any material price increase that might result from the merger.

In addition to providing insights into the Bureau's approach to tariffs, the section of the *MEGs* highlights a wide range of factors that can influence the nature of the constraints imposed upon firms in the relevant market by foreign sellers. Among the impeding factors mentioned are: import quotas; "voluntary" export restraints; regulations that impose product or labelling standards and specifications, or that impose licence/permit requirements; the difficulties, time delays or uncertainties associated with making orders or obtaining post-sale service or spare parts; buyer (*e.g.*, government) procurement policies; and global inter- or intra-firm market allocation agreements.

As a result of the public consultation process, a paragraph was added to the *MEGs* which highlights various "pull" factors, including: the existence of cross-border distribution systems; a high level of information possessed by domestic buyers about potential foreign sources of supply; and the fact that foreign suppliers or their products have already been placed on approved sourcing lists.

Other Evaluative Criteria

If ease of entry cannot be relied upon to ensure that the merger will not contravene the *Act*, the Bureau assesses various other qualitative criteria set forth in section 93 of the *Act*, or that may be relevant pursuant to the subsection 93(h) "catch-all" factor. These include: the extent to which sellers of products that have been included in the relevant market are likely to be able to make their products available in sufficient quantities to constrain a material price increase; whether the merger is likely to result in the removal of a vigorous and effective competitor; and nature of change and innovation in

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the market; the degree of market transparency; and the size and frequency of transactions in the market, the *MEGs* provide helpful insights into how the Bureau assesses these factors.

Countervailing power, which is a factor given significant weight in Australia and Germany, is not specifically mentioned because, as is the U.S. DOJ's practice, it is assessed in connection with entry. That is to say, at the section 93(d) stage of the Bureau's analysis, an assessment is made of whether buyers might be able to prevent the exercise of market power by credibly threatening to integrate backward into the merged entity's market, or to switch to a new source of supply. Submissions that simply suggest that the exercise of market power is unlikely because buyers are also large are in essence submissions about the likely bargaining outcome of a bilateral oligopoly or a bilateral monopoly. It is generally extraordinarily difficult, if not impossible, to substantiate such submissions *ex ante*.

Business Failure and Exit

The key to understanding the Bureau's approach to the "failing firm" factor is to realize that what is of paramount importance in the Bureau's analysis is whether there are likely alternatives to the merger that would result in a materially higher level of competition than what would prevail if the merger proceeded. If there are no such alternatives, any prevention or lessening of competition that can be expected to arise in the market subsequent to the merger cannot be attributed to the merger because it would have occurred in any event.

Once this fundamental insight is grasped, it should quickly become apparent that the underlying logic of the approach to failing firm mergers applies to all mergers regardless of the financial state of the parties. In short, whether a firm is exiting the market because it has failed, is likely to fail, is unhappy with its returns or simply wishes to focus its efforts on other product lines, is a detail.

The three alternatives typically canvassed are: (i) whether there is a competitively preferable purchaser who is willing to pay a net price that is greater than the net proceeds that would be received upon liquidation; (ii) whether the firm would likely be able to survive in its actual state or by retrenching its operations; and (iii) whether liquidation would yield a materially higher level of competition in the market. If, when faced with a challenge by the Bureau, the most attractive alternative available to the exiting firm would be to exit the market, and if its exit from the market would not yield a materially more competitive market than what would prevail if the merger proceeded, the firm's decision to leave the market, and not the merger, is what is responsible for any prevention or lessening of competition that can be expected to arise subsequently.

Within this framework, the financial health of the exiting firm is only relevant for the following reasons. First it typically becomes easier for the Bureau to confirm: (i) that there are no alternative purchasers willing to pay a price that is more attractive than the net proceeds that would be realized if it exited via the liquidation route; and (ii) that the exiting firm is not likely to be able to survive in a retrenched form if the merger is not permitted to proceed. Second, the extent to which the acquisition of an exiting firm can increase the market power of the acquiring firm is often reduced as the financial health of the exiting firm and its relative market position deteriorates. Third, where the firm would in any event have exited the market, the loss of its actual or future competitive influence cannot be attributed to a merger involving any particular acquiror.

The approach is conceptually very different from the analysis that has been adopted in the U.S. in two fundamental ways. First, unlike the "failing firm doctrine" that has developed in American jurisprudence, the framework articulated in the *MEGs* does not create a defence to a finding that the merger is likely to prevent or lessen competition substantially. If the failing/exiting firm can establish that in the event of a challenge to the merger it would not likely resort to an alternative that would yield a materially higher level of competition than if the merger in question proceeds, the Bureau will not attribute to the merger any prevention or lessening of competition that is expected to arise subsequent to the merger. Therefore, there would never be a finding that the merger substantially lessened

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competition. Second, there is no subordination of competition concerns to other industrial policy considerations. Simply put, the likely effect of the merger on employment, regional development, creditors, shareholders, etc. is not relevant to the Bureau's analysis of failure/exit or any other aspect of its merger review.

As a matter of practice, in true failing cases, the Canadian and U.S. approaches converge. Like the Canadian approach, the U.S. approach requires a demonstration that there are no competitively preferable purchasers who are willing to pay a net price that is more attractive to the failing firm than exit. In addition, the U.S. approach implicitly requires that the firm not be likely to survive in a retrenched state as an effective competitor. Although there is no legal impediment such as the failing firm doctrine that would prevent the Bureau from blocking a merger where liquidation would produce a materially higher level of competition in the market, it would be unusual for this course of action to be taken.

To ensure that a proper search is conducted for a competitively preferable purchaser, the MEGs state that the Bureau ordinarily requires that an independent third party be given up to sixty days to establish that there is no such alternative buyer. This condition will not be required where the Director is satisfied that a thorough search has already been undertaken, or where the involvement of an arm's-length broker would likely cause significant harm to the exiting firm.

The Efficiency Exception

When a determination has been made that a merger is likely to prevent or lessen competition substantially, merging parties can avoid being subjected to an order for dissolution, divestiture or other relief by meeting the requirements of the efficiency "exception" set forth in section 96 of the Act.

Subsection 96(1) contemplates a balancing process that resembles, in very general terms, Oliver Williamson's "naive" trade-off model. (See Williamson, 3. "Economies as an Antitrust Defense Revisited," 125 *U. Pa. L. Rev.* 699(1977). Generally speaking, estimates of the likely increase in producers' surplus resulting from anticipated efficiency gains are balanced against the estimated "deadweight loss" to the Canadian economy that is expected to result from the likely price increase and corresponding output reduction. (Efficiency gains are not required to be passed on to consumers.) In practice, several adjustments to Williamson's approach are required to account for: pre-existing market power; the costs required to achieve efficiencies; timing differences between efficiencies and anticompetitive effects; the fact that the cost reduction is not across the entire market; and dynamic efficiencies, such as R&D synergies, that cannot be quantified.

The trade-off approach is very different from the treatment given to efficiencies in other jurisdictions. In the U.S., efficiencies can only justify permitting an otherwise anticompetitive merger proceed where they would be so great that there would not likely be any price increase whatsoever. Whereas section 96 of the Act clearly subordinates the policy objective of competitive prices to the goal of enhanced efficiency (where the effects of increased prices on total welfare are likely to be outweighed by the efficiency gains likely to be brought about by the merger), it appears that the paramount policy goal underlying U.S. merger policy is the prevention of wealth transfers. As a result, there is no trade-off between efficiencies and anticompetitive effects in U.S. merger policy. Efficiencies have to be so great that there are no anticompetitive effects.

In Australia the Trade Practices Commission considers efficiencies together with employment, environmental matters, export potential and international competitiveness when assessing, in very broad terms, whether to authorize the merger on the ground that it is likely to result in "net benefits" to the public. Similarly, in Germany, efficiency arguments can only be made to the Minister for Economic Affairs pursuant to a special exemption on the grounds that "the restraint of competition is out balanced by the overall economic advantages of the merger, or the merger is justified by an overriding economic interest." [s.24(3), *Act Against Restraints of Competition*]. Since 1973, only six

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ministerial exemptions have been granted pursuant to this provision for reasons relating to matters that have included energy policy, regional employment, preserving technology and enhancing international competitiveness.

Turning to the EEC, Colin Overbury, head of the Merger Task Force, recently made clear in an interview in this journal (*IML*, March 1991, at p.8) that the "technical and economic progress" factor that is mentioned together with other evaluative criteria in Article 2(1)(b) of the Merger Regulation "is not an efficiencies defence in order to make an otherwise anticompetitive merger compatible with the common market. It is ... an invitation to the parties to claim some efficiencies so that the Merger Task Force will have a more friendly attitude toward their merger."

The Canadian *MEGs* discuss in some detail the Bureau's approach to the last clause in subsection 96(1), and subsection 96(3), which eliminate two broad classes of gains from consideration in the trade-off analysis:

- (i) gains that would likely be attained even if the order that would be required to remedy the anticompetitive effects of the merger were made; and
- (ii) gains that would likely be brought about by reason only of a redistribution of income between two or more persons.

The determination of whether particular sources of efficiencies would likely be attained if the order were made involves an assessment of whether the order would prevent these gains, and if so would the merged entity likely find alternative ways of achieving them. Where only part of a merger raises competition issues, any order sought will likely be confined to the relevant market where the issues are raised. If the rest of the merger proceeds, efficiencies in the markets not targeted by the order should not be prevented, unless they are economies of scope or other sources of savings that are inextricably related to the efficiencies in the relevant market that would be blocked by the making of the order. If efficiencies expected to arise in other markets would not be prevented by the order, they are not considered in the s.96 balancing process because they would not represent a "cost" of making the order. They would still be attained even if the order is made.

The same is true with respect to efficiencies that would be prevented by the order but which would likely be attained in other ways subsequent to the making of the order. The *MEGs* state that efficiency gains that would likely be attained through alternative means if the order is made cannot be attributed to the merger and cannot be considered to represent a "cost" of making the order. The alternative means typically canvassed by the Bureau include internal growth (within the reasonably foreseeable future), a merger with a competitively preferable third party that has expressed a serious interest in merging with the seller, a joint venture, a specialization agreement, or a licensing, lease or other contractual arrangement.

Unlike the approach of U.S. enforcement authorities, the Bureau does not exclude efficiencies from consideration merely because they could be attained through alternative means. It has to have a reasonable basis for believing that attainment through other means would be likely. Accordingly, the *MEGs* provide that "(i)f the common industry practice is such that the alternative in question would not likely be resorted to if the order were made, the efficiencies in question will ordinarily be included in the balancing process." However, it is made clear that the onus will be on the merging parties to provide "a reasonable and objectively verifiable explanation of why efficiencies that are available would not likely be sought by alternative means if the order were made."

With respect to efficiencies that could be attained through a merger with an alternative party, the Bureau will not exclude such savings from consideration "on the speculative basis that they could be attained" through another merger, as is the practice in the U.S. In addition, it will not go on a fishing expedition to establish whether there are competitively preferable third parties who are interested in merging with the proposed acquiree. Efficiencies will only be excluded from the balancing process where they would likely be attained through "existing alternative merger proposals that are less anticompetitive and that can reasonably be expected to proceed if the order in respect of the first merger is made."

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The second category of gains that are not considered in the Bureau's trade-off analysis are gains that subsection 96(3) excludes because they will be brought about "by reason only of a redistribution of income between two or more persons." These are mere pecuniary gains that do not represent a real saving in resources. The *MEGs* indicate that the following classes of gains are generally excluded from consideration on this basis: tax-related gains; savings that flow from a reduction in output, quality or variety; revenues resulting from a price increase; proceeds from the sale of an asset; and gains resulting from the exercise of increased bargaining leverage.

The *MEGs* acknowledge that the calculation of the likely anticompetitive effects of mergers is generally very difficult to make, particularly with respect to the measurement of losses related to a reduction in service, quality, variety, innovation and other non-price dimensions of competition. As a result "several trade-off assessments are ordinarily performed over a range of price increases and market demand elasticities." For example, the analysis might be performed with respect to price increases of three percent, five percent and ten percent, assuming demand elasticities of 0.5, 1, 1.5 and 2. If the trade-off is only likely to be unfavorable for the merging parties where the price increase and the demand elasticity are both at the upper extremes of these ranges, and if this scenario is unlikely, it would be surprising if the merger were challenged.

Process Matters

Part 6 of the *MEGs* addresses the Bureau's compliance approach, prenotification, confidentiality, the notion of "substantial completion", timing, information exchanges between merging parties, and the relationship between the Bureau and Investment Canada. Given space constraints, only the section on timing will be reviewed here.

This section divides mergers reviewed by the Bureau into three categories and briefly discusses what is required to assess each of these types of mergers. Whether a transaction is prenotifiable or not, the Bureau generally indicates to parties within three weeks of first receiving notice of a merger either that the merger raises no concerns under the *Act* or that its assessment is not yet complete. The vast majority of mergers, probably in excess of 95 percent, fall into the former category. This stage is roughly equivalent to the thirty-day waiting period required after initial filing under Hart-Scott-Rodino in the U.S.; the three-week period that the U.K.'s Office of Fair Trading normally requires before providing its initial view of a non-notifiable merger, or the twenty working days that it requires when the voluntary prenotification procedure has been invoked; the twenty working days within which the EEC's Merger Task Force must decide whether a transaction is a concentration with a community dimension which raises serious doubts as to its compatibility with the Common Market; and the one month that the German Federal Cartel Office has to indicate that further investigation is required.

The timing required for the review of cases that have not been closed within three weeks is largely a function of when the Bureau is provided with sufficient information to assess the likely effects of the merger on competition. The *MEGs* state that in most cases a determination can be made of whether a merger prevents or lessens competition substantially within eight weeks after the merging parties have provided all requested information. The most complex of cases that are not resolved within eight weeks can require up to six months (i.e., an extra four months) after all requested information has been obtained, before the Director's position is finalized. This informal six-month maximum period contrasts with the four months that the German and EEC authorities have to make their final decision.

Legally, there is no required waiting period in Canada for mergers that fall below the prenotification thresholds of the *Act*; parties to prenotifiable transactions need only wait a seven-day (short form), ten-day (exchange bids), or twenty-one-day (long form) period following notification before being entitled to proceed with their transaction. However, if the Director has not completed his review of the merger at the end of this period and there is a significant risk that he may ultimately determine that the merger is likely to prevent or lessen competition substantially, parties normally postpone their transaction or

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provide a written undertaking to the Director to hold all or some of the assets or shares in question separate and apart pending completion of his review.

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NEW FEDERAL TELECOMMUNICATIONS LEGISLATION — A COMMENTARY

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Introduction and Overview

New federal legislation for the regulation of the telecommunications services industry was introduced in Parliament on February 27, 1992 (Bill C-62, the *Telecommunications Act*, hereinafter referred to as the *Act*). It has had a long gestation. Comprehensive revisions to consolidate and modernize the existing statutory framework were first presented to Parliament in the late 1970s. Many attempts at both comprehensive and selective legislative revision since then have died on the Order Paper. Over the last decade, the federal government has successfully enacted only special legislation for Bell Canada, Teleglobe Canada and Telesat Canada. These company-specific Acts contain regulatory provisions—including service obligations, Cabinet and company direction authorities, regulatory forbearance authorities and change of control conditions—which the government now proposes to extend to all telecommunications service suppliers subject to federal legislative authority.

The process of drafting the *Act* actually began as far back as 1984, when the federal Minister of Communications (of the then Liberal government) issued a general notice for public comment on telecommunications policy. In 1985-86, the Minister of Communications for the new Conservative government entered into negotiations with provincial communications Ministers concerning federal-provincial regulatory responsibilities and competition policy. In mid-1987, in order to ensure the grandfathering of further general telecommunications entry restrictions under the upcoming *Canada-U.S. Free Trade Agreement (FTA)*, the Minister of Communications published a policy framework (with no immediate legal effect) which distinguished between facilities-based commercial telecom service suppliers (Type I carriers) and resellers and local specialized service suppliers (Type II carriers). This dichotomy loosely resembles the Japanese model for telecommunications industry regulation. The policy stated that foreign investment in Type I carriers would be capped at twenty percent (hence the need for *FTA* grandfathering). It was also suggested that new Type I carriers would have to receive a federal operating licence which would be issued only if the applicant met a "public convenience and necessity" (PC&N) test similar in content to the PC&N tests which had been used to control new entry into transportation services prior to their deregulation (i.e., entry would be permitted as long as the viability of established competitors would not be threatened).

Another step in the process leading up to the *Act* occurred in August 1989, when the Supreme Court of Canada confirmed that the federal Parliament had exclusive competence to regulate Telecom Canada's member companies (renamed Stentor Canadian Network Management in February), a consortium which plans and operates an interprovincial long-distance network, even though the member companies were by and large intra-provincial monopolies.¹ As will be discussed below, the Court did not identify all the existing carriers which were subject to federal regulation exclusivity, and this uncertainty carries over to the *Act*.

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To a very large extent, the *Act*:

- (1) *consolidates* relevant provisions presently located in several federal statutes (the most notable being the *Railway Act*);
- (2) *modernizes* existing regulatory provisions to make statutory language clearer, less subject to legalistic interpretation disputes and more relevant to the current operations of telecommunications service suppliers (rather than 19th century railways); and
- (3) *generalizes* the application to the industry of most regulatory innovations included over the last decade in company-specific legislation.

These changes are principally of interest to practitioners, and will not be examined in detail in this commentary except where they involve a substantial change in regulatory powers. (Changes in CRTC powers are summarized below under the heading "CRTC Regulation of Rates, Facilities and Services.") Rather, this commentary will focus on the new regulatory powers and processes in the legislation and how they relate to the existing regulatory framework for the industry. In particular, the scope of the legislation will be examined, followed by an analysis of the measures to increase control over the industry on the part of Parliament and the executive branch of the federal government, including the new statutory policy objectives, the licensing requirement for Canadian carriers, and Cabinet direction powers and measures to increase provincial influence over federal regulation of the industry.

These measures, if enacted, will have a significant impact on the investment and business planning decisions of participants in the Canadian telecommunications services industry, including equipment suppliers, private network owners and customers, in addition to commercial suppliers of such services to the public, whether or not they are currently subject to federal price and service regulation.

Scope of the Telecommunications Act

In Canada, the determination of whether a business is subject to federal telecommunications service regulation has primarily been a constitutional law issue. This will continue to be the case under the *Act*, but the legislation also invokes some new statutory conditions.

The current *Railway Act* makes all telephone or telegraph "companies" subject to federal regulation. But the *Railway Act* defines a "company" in a constitutionally circular fashion as any company subject to federal legislative authority that has the authority to construct or operate a telephone line or system. Federally incorporated business corporations have unrestricted powers, so the second element of the definition has become meaningless.

Constitutionally, federal authority to regulate extends only to companies whose works are declared by Parliament to be for the general advantage of Canada (this captures Teleglobe Canada, Bell Canada, BC Tel and possibly Unitel and Northwestel which are former railway divisions), or which are in fact "works and undertakings connecting the Province with any other or others of the Provinces or extending beyond the limits of the Province" (i.e., "extra-provincial" undertakings—this captures Telesat Canada and the members of Stentor).

The significance of whether a telecommunications business is an extra-provincial undertaking will increase tremendously once the *Act* becomes law since, as is discussed further below, any business which fits under the rather sweeping definition of "Canadian carrier" is prohibited from operating as such without a licence from the federal Minister of Communications and is prohibited from having more than twenty percent foreign ownership.

A firm wishing to avoid the *Act's* requirement for a federal telecommunications operating licence and consequent CRTC rate regulation would therefore have the following options:

- (1) structure its business so as not to be an extra-provincial undertaking;
- (2) structure its business so as not to be a "Canadian carrier" as defined in the *Act*; or
- (3) obtain, or fit within, a class of carrier exemption from the *Act* that may be established by the Governor in Council (i.e. Cabinet).

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Given the breadth of the Act's definition of "Canadian carrier" and the uncertainties surrounding what kinds of telecommunications businesses qualify as federal undertakings, it would appear that the government hopes to rely on the Governor-in-Council exemption power to avoid both continued jurisdictional uncertainty and possible regulation of competitive telecommunication businesses that, by historical accident or conscious interpretation of the current legislation, have not to date been subject to CRTC regulation.

Nevertheless, it may be impractical to attempt to ensure that, with continued innovation in business organization in response to increased opportunities for competition, this exemption power will be used consistently and in a pro-active fashion to avoid unnecessary regulation of competitive markets. Rather, the need for a Cabinet exemption from entry licensing in competitive activities presents an opportunity to incumbents to lobby for additional administrative hurdles or at least delays to frustrate competitive entry, thus allowing them to retain market power and other advantages of incumbency in a multi-product supplier environment.

Extra-provincial or Federal Undertaking

Over a broad range of business activities, Canadian constitutional law does not provide very clear guidance on whether a business is or is not an extra-provincial undertaking, and thus subject exclusively to federal regulation. In the *AGT* decision, the Supreme Court of Canada concluded that the following principles should be applied to decide if a telecommunications service business is an extra-provincial undertaking:

- (1) The primary concern should not be the physical structures or their location, but the service provided by the undertaking through the use of its physical assets. The crucial issue is the nature and character of the undertaking that is in fact being carried on.
- (2) The location of the physical assets and all service recipients in one province does not preclude an undertaking from being interprovincial in scope.
- (3) Mere physical interconnection between complementary assets of separate businesses may not be enough (how much more integration is required will vary among businesses).
- (4) Corporate structure is not relevant.

The Supreme Court in *AGT* followed and applied the criteria for detecting an extra-provincial undertaking presented in *Northern Telecom Ltd. v. Communications Workers of Canada*.²

Of the six criteria set out in *Northern Telecom*, four relate specifically to federal competence to regulate labour relations. The remaining two are of general application:

- (1) The question of whether an undertaking service or business is federal depends on the nature of its operations;
- (2) In order to determine the nature of the operation, one must look at the normal habitual activities of the business as those of a "going concern," without regard to exceptional or casual factors; otherwise, the Constitution could not be applied with any degree of continuity and regularity.

Perhaps unhelpfully, the Chief Justice of the Supreme Court then concluded in the *AGT* decision:

It is impossible, in my view, to formulate in the abstract a single comprehensive test which will be useful in all cases involving [the extra-provincial undertakings power]. The common theme in the cases is simply that the court must be guided by the particular facts in each situation, an approach mandated by this Court's decision in *Northern Telecom, supra*. Useful analogies may be found in the decided cases, but in each case the determination of this constitutional issue will depend on the facts which must be carefully reviewed.

Clearly the courts will not be bound by the location of a business's assets or operations but will look instead at where and how it sells its products.

Beyond that, however, there is little judicial guidance on how much extra-provincial activity needs to be conducted by an undertaking for it to become an extra-provincial undertaking constitutionally. In *Northern Telecom*, the Supreme Court merely noted the obvious principles that a single enterprise may entail more than one undertaking; two separate corporate enterprises may be found to be included within one single and indivisible undertaking; and the physical and operating connection between

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separate undertakings needs to be addressed in determining, if one undertaking is clearly federal, whether two related undertakings are federal.

The Supreme Court's discussion of the relevant facts in *AGT* does not contribute much guidance either since, on the facts, Alberta Government Telephone was clearly an extra-provincial undertaking under even the most restrictive reading of the case law. The key facts were:

- (1) *AGT* was involved through its own facilities in the transmission and reception of electronic signals at the provincial boundaries of Alberta;
- (2) Through bilateral contracts arranged through Telecom Canada, *AGT* planned interprovincial services and the development of an interprovincial telecommunication network; and
- (3) *AGT* could not separate itself from these Telecom Canada arrangements without, as the Court noted, "significantly altering the fundamental nature of [its] enterprise."

Thus, there is uncertainty as to whether a telecommunications service supplier located within a province would be an extra-provincial undertaking solely on the basis of a traffic sharing arrangement with an extra-provincial undertaking for the purpose of providing inter-provincial services through the latter. A lower Québec court has recently applied *AGT* in finding that a municipal telephone company was an extra-provincial undertaking because it had such a traffic exchange and revenue sharing agreement with a Stentor member, Bell Canada. However, this decision is presently under appeal.

Increased competition in this industry will encourage novel business structures, and a key business planning issue is the risk that a particular structure is an extra-provincial undertaking, either as initially established or as it is intended to evolve. Possible examples of structures that fall into the constitutional grey areas are:

- (1) A service reseller which provides both switched voice services and data transmission and processing services interconnects with local telephone company exchanges and only leases interprovincial transmission capacity from federally regulated telephone companies under CRTC-approved tariffs;
- (2) A service reseller which predominantly leases interprovincial services as in (1), but owns a fibre-optic transmission path to a communications satellite uplink facility (where the satellite footprint falls across provincial or national boundaries), and has a long-term lease of satellite capacity that effectively makes the reseller a risk-sharer in the satellite business;
- (3) An office-space supplier which provides local area network (LAN) services to its tenants and which, on special order from tenants, will link LANs among buildings in different provinces for a fee, using transmission services rented by and billed to the tenant(s), or transmission services rented by and billed to the landlord;
- (4) A supplier which segregates assets and business into separate intra-provincial and interprovincial companies. The interprovincial company buys and sells transmission services from and to other companies and resells this service to the intra-provincial affiliate without any network-planning or revenue-sharing arrangements (i.e., Stentor-type oversight does not exist and interprovincial traffic suppliers and buyers are arm's-length parties operating under contracts for the sale of services); and
- (5) A Canadian sales agent for a U.S. carrier that arranges access to the U.S. market using a variety of facilities and services leased from Canadian carriers, which services are packaged and released to Canadian users under its own price structure with additional value-added options provided on its own local switching and data-processing equipment.

Canadian Carriers

In order to determine whether or not they are subject to the new Act, firms that qualify constitutionally as federal undertakings must look to the statutory definition of the attributes of a business requiring an operating licence under the Act i.e., a "Canadian carrier". These attributes are

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presented in a set of interwoven definitions. Perhaps by design, the key terms in these definitions potentially have a very broad interpretation, and there has been almost no judicial interpretation of these terms in analogous situations to shed light on how courts should apply them or how the government should be expected to behave.

A "Canadian carrier" is a "telecommunications common carrier (TCC) that is subject to the legislative authority of Parliament," i.e. a TCC that is a federal undertaking.

ATCC is "a person who owns or operates transmission facilities used to provide telecommunications services to the public for compensation." The limiting terms in this definition are "transmission facilities," "telecommunications services" and "to the public."

"Transmission facilities" are in turn defined in an unusual way that contains a potentially uneasy tension between positive and negative elements:

any line, radio, or electromagnetic or optical system or any similar technical system, but does not include:

(a) any apparatus that performs only a switching or processing function, including the processing of telecommunications signals into speech, text, or any other intelligible form, or

(b) any facility, such as wiring located on the premises of a user of telecommunications services, that is auxiliary to an apparatus referred to in (a).

Telecommunications service has been defined very broadly to include both a sale or a lease of services or goods, or conceivably any other possible commercial transaction structure:

telecommunications service means a service provided by means of telecommunications facilities and includes the provision in whole or in part of telecommunications facilities and any related equipment whether by sale, lease or otherwise.

The final limiting element of the TCC definition is the requirement for the provision of telecommunications services "to the public for compensation." There is no definition of this term in the *Act*. To satisfy this requirement, it is the writer's opinion that there must at least be a third-party contract of sale for goods or services. As well, the concept of "to the public" would suggest that a single sale or perhaps a few isolated sales not forming part of an ongoing business may not be sufficient to make a business a "telecommunications common carrier." There is, however, no evident support for this approach in Canadian trade regulation law. Under the *Competition Act*, only material product misrepresentations "to the public" attract criminal sanctions. The few cases that have commented on this phrase have suggested that a course of conduct in individual negotiations could constitute representations to the public even though advertising of the representations was not involved. Thus, it is arguable that the provision of telecommunications services "to the public for compensation" could include two or more sales of products which are neither advertised nor held out as being generally or publicly available and which may be incidental to the seller's principal line(s) of business.

The impetus behind revising these key jurisdictional terms, and arguably for adopting a generalized operating licence régime, is the fact that the Minister of Communications presently has no capacity to regulate the establishment of cable-based commercial telecommunications systems. The comparatively low cost and high capacity of digitized fibre-optic networks laid on private rights of way are now perceived by the government to be an immediate competitive threat to terrestrial and satellite-based microwave-based inter-urban networks—the facilities for which the Minister can and has actively regulated under the *Radiocommunications Act* in order to restrict competition in the commercial supply of telecommunications services. Such entry threatens the most profitable segment of the incumbent carriers' business, the profits from which have traditionally been used to subsidize the prices of intra-locality telephone service.

Given rapid technological change and the inability of Parliament to catch up with fibre-optic technology before it became a significant competitive force, the desire to have a sweeping, non-technological definition for transmission facilities is understandable.

However, the proposed definition also makes it apparent that the government does not want all such facilities to attract regulation. By express exclusion, neither switching or processing apparatus nor internal premises wiring would qualify. In addition, a facility that is "auxiliary to" a switching or

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processing apparatus also is not a transmission facility. "Auxiliary" is generally defined as "aiding, attendant on, or ancillary." Unfortunately for those seeking some definitional certainty, telecommunications networks are nothing but a combination of switching nodes of differing sizes and capabilities, and transmission paths of differing capacities and lengths. Switches have no value on their own. Arguably then, all transmission facilities could be regarded as "auxiliary to" switching facilities because they are necessary to give economic value to switching facilities. Of course, this position would be hard to sustain before the courts because it would make regulatory elements of the *Act* apply to nothing. There is, unfortunately, no logical stopping point provided by the *Act* between the first position and the opposite and equally untenable position that only inside premises wiring is "auxiliary" to a switch. This latter position is untenable because it effectively repeals the broader principle of part (b) of the definition, leaving only the illustration intact.

It may be possible to inject some greater certainty into this term when the *Act* is reviewed in Parliament by the Legislative Committee. However, it is doubtful that any conceptual definition using an "everything but..." approach will provide greater certainty to business. It is probable that sufficient certainty could not be achieved short of an explicit functional identification of facilities that should be regarded as "transmission facilities."

Broadcasting

In order to create a clear boundary with the federal *Broadcasting Act*, the proposed *Act* would not apply "in respect of broadcasting by a broadcasting undertaking." Still, the supply of telecommunications services to the public for compensation would make a broadcasting undertaking a TCC. Given that such broadcasting undertakings are clearly federal undertakings, a strong argument could be made that a Ministerial operating licence would be required prior to their supplying any telecommunications services. This would affect a number of existing telecommunication activities of broadcasters: cable companies supplying local telecommunications services, broadcasters reselling space satellite capacity as a private line service, or TV and radio stations supplying data transmission capacity on their Vertical Blanking Intervals or Sub-Carrier Bandwidths, respectively.

Crown Agents

The *Railway Act* does not apply expressly to federal or provincial Crown agents. Consequently, the CRTC is at present unable to regulate the Manitoba and Saskatchewan members of Stentor (Manitoba Telephone Systems and Sasktel). This problem will be solved by a provision making the *Act* applicable to federal and provincial Crown agents.

Statement of Telecommunications Policy: The Flavour of the Legislation

Complex and internally contradictory legislated policy statements are now popular elements of federal regulatory statute revisions. The *Act* is no exception. Its proposed policy statement is intended to guide and constrain the regulatory discretion of both the government and the CRTC. Different readers can readily discern radically different industrial development models underlying the various policy goals, thus diminishing the effectiveness of this statement. Significantly, however, the basis for regulation under the *Act* is not presented in terms of control of market power, but rather in terms of a strategic industry that helps to define Canadian national identity:

It is hereby affirmed that telecommunications performs an essential role in the maintenance of Canada's identity and sovereignty...

The competing specific policy objectives that follow involve treating the industry simultaneously as a social service the subject of a public trust, and as a private competitive industry.

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The social service or public trust model is reflected in objectives which speak of facilitating the orderly development of a system that safeguards and enriches the fabric of Canada, of promoting Canadian ownership and control, and of maximizing use of Canadian facilities. The private enterprise model is reflected in objectives that refer to enhancing efficiency and competitiveness, and to fostering increased reliance on market forces. Between these polarities are objectives which refer to providing reliable, affordable and high-quality service in both urban and rural areas, stimulating research and development, and responding to the economic and social requirements of users.

The overall impression of this carefully balanced and generalized set of fundamentally incompatible objectives is that the government is essentially comfortable with the regulatory *status quo*, which for this industry entails:

- strict entry and ownership control;
- national self-sufficiency in productive capacity;
- extensive service cross-subsidization driven by socio-economic norms and regional sensitivities;
- reliance on public utility regulation to create efficiency incentives; and
- allowing regulated competition in marginal markets subject to careful market share controls which protect incumbent firms and entrenched social pricing policies.

The government's backgrounder on the new *Act* concludes that "an efficient and dynamic telecommunications industry is a prerequisite for economic prosperity."³ The means to this goal are to be comprehensive entry and price regulation by the government and the CRTC respectively, with an opportunity for exemption from regulation (as discussed further below) at the discretion of these players if there is proof of sufficient competition in the relevant market. It is perhaps unfortunate that the background discussion does not explain why this extensive and elaborate regulatory structure, which remains consistent with classic public utility regulation as practised in transportation, energy and communications, should remain the overall governing instrument of choice. Nor does it explain how such regulation will enhance prosperity in the telecom industry or, indeed, in the country as a whole.

Many would argue that the telecommunications service sector has become intrinsically competitive, even at the local service level. The *Act* adopts the regulatory *status quo* with its focus on the CRTC, and adds to it a further layer of potentially detailed and sweeping Ministerial regulation, without providing any indication of why this further layer of regulation is necessary.

Telecommunications Licences

The general requirement that all Canadian carriers hold an operating licence is the principal substantive innovation of the new *Act*. Until the 1990s, the Minister of Communications could effectively control the structure of the telecommunications services sector through the microwave facilities licensing requirements of the *Radiocommunications Act*, and control over marine cable landings under the *Telegraphs Act*. However, this control has been undermined, particularly in relation to telephone and data services, by economical fibre-optic technology and by the provision of "non-programming" services over co-axial cable TV networks, free of CRTC interference. The Minister would regain control over the industry with the new licensing requirements.

Licence eligibility would depend upon a carrier being Canadian owned and controlled, which the *Act* defines as having eighty percent of "prescribed interests" being owned and controlled by Canadians in the "prescribed manner," i.e. the relevant interests and manner of ownership will be set out in regulations under the *Act*. Companies that breach this foreign ownership ceiling are obliged to advise the Minister of Communications of their licence ineligibility. The Minister would then be given a discretion to accept undertakings to wind down the excess foreign investment over a maximum two-year period, provided that the excess foreign investment is temporary and that throughout the period the licensee will be controlled by Canadians.

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The eighty percent ceiling is not, however, the whole story. Investors and Canadian carriers should not assume that compliance with the eighty percent Canadian ownership condition on terms established by regulation is sufficient to insure against government intervention into the ownership of the firm and possible action in relation to an operating licence, even though a reading of the Act's licence eligibility provision would clearly suggest that such compliance is sufficient to establish or maintain licence eligibility.

In what may be intended to be an escape clause designed to prevent regulatory loopholing which results in *de facto* non-Canadian control or beneficial non-Canadian share ownership over the twenty percent limit, the Governor in Council is to be authorized to make regulations

authorizing the Minister to determine whether a corporation is conducting its affairs with regard to the direct and indirect ownership of its shares in a manner contrary to the object and spirit of this Act, and where the Minister determines that to be the case, to deem the shares not to be beneficially owned directly or indirectly by Canadians for the purpose of the regulations.

Interestingly, this escape clause does not require the Minister to find that as a result of the relevant share transactions, the Canadian carrier is not in fact Canadian owned and controlled (which is the apparent purpose of the provision). Instead, the Minister may deem shares not to be beneficially owned by Canadians based upon a much broader and vaguer standard, namely, whether the transactions are contrary to the object and spirit of the Act. This may create an opportunity for the Minister to interfere in the ownership structure of a Canadian carrier even where there is outright compliance with the ownership regulations and no case could be made that the Canadian carrier is not in fact controlled by Canadians.

The Act provides no details on the form, manner, process or evidence required for licence applications. These matters are to be left to the regulations.

A CRTC report on each licence application, including an application for a renewal or an amendment of licence conditions, would be required. The CRTC's report on new licence applications must be made following a "public proceeding," which could be a paper-based notice and comment process.

No criteria is established for the Minister's exercise of this licensing discretion other than that he or she must be "satisfied that the issuance of the licence will further the Canadian telecommunications policy objectives."

The Minister is under no obligation to grant a licence and may attach any conditions that are "consistent with the Canadian telecommunications policy objectives." Initial licence terms may not exceed five years and renewals may not exceed ten years.

The Minister is not obliged to give reasons even when he or she is not accepting the CRTC's report.

Given the breadth and multi-faceted philosophical basis of the Act's policy statement, there would appear to be no real constraint imposed on the Minister by these statutory conditions. Nor is the Minister under any statutory obligation to act fairly or to demonstrate a reasoned or considered approach, regardless of the amount invested by the applicant in making its application, including the cost of persuading the CRTC to give a favourable report. (On the other hand, the Minister could issue a licence even if the CRTC recommended against it.)

Nonetheless, as the legislation is implemented, an important issue will be the extent to which the courts might impose an obligation on the Minister to act fairly toward prospective and incumbent licensees and their competitors, through hearing-like procedural safeguards. Arguably, there would be a very high expectation of procedural fairness with respect to the renewal, amendment, suspension or cancellation of a licence in reliance upon which a business has invested hundreds of millions of dollars. To this end, the Act states that the Minister may not suspend or revoke a licence unless he or she "believes on reasonable grounds that the licensee" has ceased to be eligible to hold the licence.

Grounds for ineligibility are:

- (a) absence of Canadian ownership and control in a situation that does not qualify for a winding down of temporarily excess foreign investment;
- (b) contravention of the requirements of the licensing régime of the Act, the Regulations, or a condition of licence; or

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(c) a material misrepresentation or omission in an application or document provided under the licensing régime (which presumably can include any document provided to the CRTC as part of its reporting function).

The Minister may not suspend or revoke an operating licence without first having provided the licensee with a reasonable opportunity to make representations.

The *Act* authorizes the Governor in Council (i.e. the federal Cabinet) to prescribe procedures governing licence applications, and this regulation power may be used to provide procedural safeguards for initial licence applicants. Even without such regulations, it may be hoped that the Minister might commit to licensing procedures designed to avoid any risk of judicial intervention to impose minimum standards of procedural fairness.

It is worth noting that the licensing régime contains special provisions for licensing international submarine cable facilities. These provisions will replace the submarine cable licensing régime of the *Telegraphs Act* and are primarily relevant to Teleglobe Canada. They relate to the ownership and operation of particular assets. A business receiving such a facilities licence must still obtain a Canadian carrier licence under the *Act*; however, under the international submarine cable licence provisions, the Minister may only issue such facility licences to corporations made eligible by regulation.

The Minister may suspend or revoke a submarine cable licence upon reasonable grounds which are essentially the same as those relating to Canadian carrier licences, but the *Act* requires that "the licensee must first be given notice in writing of the reasons for the suspension or revocation and a reasonable opportunity to make representations to the Minister." This requirement for a reasonable opportunity to make representations may well be seized upon by Canadian courts as a basis for imposing satisfactory procedural safeguards where existing government practices are shown to be insufficient. The extent of these procedural safeguards is very hard to anticipate. There is little judicial guidance interpreting the reasonable opportunity "requirements" in economic regulation.

CRTC Regulation of Rates, Facilities and Services

There are no legislative epiphanies in the provisions providing regulatory powers to the CRTC. The new legislation consolidates, modernizes language, fills some regulatory gaps, clarifies some uncertainties and generalizes provisions enacted over the last decade in company-specific legislation, i.e. for Bell Canada, Telesat Canada and Teleglobe Canada.

The features worth noting are:

- (1) *Service Approval*: The CRTC must still give prior approval to all Canadian carrier rates and service conditions, but it may now specify a maximum or minimum rate to permit some pricing freedom without prior CRTC approval.
- (2) *Services Subject to Regulation*: Through the *Act's* basic definition of "telecommunications service," the sale or lease of telecommunications facilities and related equipment by a Canadian carrier is expressly made subject to CRTC rate regulation. To date, the CRTC has not approved carrier equipment sales prices but has monitored terminal equipment floor prices based on direct costs for the purpose of dealing with competitor complaints of unfair competition. The *Act* would make the sale of any switching and transmission equipment by a Canadian carrier subject to CRTC rate regulation. Moreover, it is arguable that the definition of a telecommunications facility, since it includes anything capable of being used for "any operation directly connected with telecommunications," covers more than just "core" network facilities (switches and transmission links) to include buildings, network management assets, and perhaps even network maintenance and support resources, subscriber information or billing resources.

Moreover, for the purpose of the CRTC provisions, "telecommunications services," also includes "any service" that is "incidental to the business of providing telecommunications services." This addition will likely remove any uncertainty as to whether or not a transaction that is a telecommunications

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service under the general definition is considered to be one for the purpose of CRTC regulation.

It seems the motive behind this breadth of regulatory price control authority may be to confirm the CRTC's practice of requiring approved tariffs for the carrier supply of terminal equipment maintenance services even where non-carrier equipment is being serviced. However, the current definitions would arguably cover sales by Canadian carriers of products that one does not need a Canadian carrier licence to supply, and which are supplied in highly competitive markets in competition with firms that are not Canadian carriers and are therefore not subject to CRTC rate and service regulation.

(3) *Rate Approval Standards*: The key pricing standards of the *Railway Act* are retained. All rates must be just and reasonable at all times, and unjust discrimination in rates or the provision of a telecommunications service in general is prohibited. The *Railway Act* expressly prohibits discrimination in the provision of facilities. This constraint remains since the provision of facilities will be a "telecommunications service". In what is an unnecessary confirmation of the CRTC's discretion to adopt any rate assessment technique that is consistent with the scheme of the enabling legislation, the *Act* now expressly permits the CRTC to adopt any technique the Commission considers to be appropriate, including currently fashionable techniques such as rate base/rate-of-return, price index and productivity incentive.

(4) *Regulatory Forbearance (Quasi-Deregulation)*: The CRTC may now refrain from exercising any or all of its regulatory powers over services of Telesat Canada and Teleglobe Canada, where it finds that competition is sufficient to ensure their provision at just and reasonable rates. This is not deregulation. Rather, this is what has become known as "regulatory forbearance," since the Commission would likely re-regulate if the requisite level of competition no longer existed. In the 1980s, the CRTC tried unsuccessfully to allow certain competitive telecommunications services to be repriced without prior CRTC tariff approval, and to ignore regulated cellular radio service suppliers. The general forbearance power in the new *Act* is designed to permit the CRTC to adjust the intensity of regulation in accordance with the monopoly power of the regulated firm. However, under this power, the onus effectively falls on the supplier to justify any forbearance as an exception to a general scheme that requires prior CRTC approval of virtually every business transaction of a Canadian carrier.

The *Act* generalizes this forbearance power but provides no greater guidance to the CRTC than do predecessor provisions on the criteria for and manner of its exercise. There are, however, three notable innovations:

- (1) The CRTC will now be able to forbear from using some or all of its powers with respect to a *class* of service as well as an individual service;
- (2) Forbearance may occur if the CRTC finds the service or class *will* be subject to sufficient competition (i.e. evidence on future competition may be sufficient); and
- (3) The CRTC *must resume* regulation if it finds that the preconditions for forbearance no longer exist (it has no discretion here).

To date, only one forbearance application has been decided by the CRTC under such a power. In *Telecom Decision CRTC 91-21*, the CRTC turned down Teleglobe Canada's request for complete deregulation of its non-telephone businesses. The denial focussed on the fact that Teleglobe was still the sole source of overseas non-telephone service capacity to Canadian intermediaries. The CRTC did not enter into a detailed assessment of Teleglobe's evidence, which showed that the presence of private international networks using U.S. overseas facilities, international market forces, and the fact that Teleglobe's sole supplier status was derived from a discretionary policy which could be reversed at any time, all combined to ensure just and reasonable non-telephone service rates despite its current facility monopoly. This approach suggests that the CRTC would likely require evidence of stable and direct competition in the supply of a service before agreeing to forbear from regulating it to any degree.

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- (5) *Intercarrier Agreements*: A CRTC prior-approval requirement has been retained for Canadian carrier interconnection, operating and revenue-sharing agreements. However, to overcome jurisdictional uncertainty, the CRTC will be given the express power to delete, alter or add terms to these agreements either at the approval stage or at any time while the agreement is in effect.
- (6) *Provision of Services*: The current *Bell Canada Act* contains a unique "in/out" power authorizing the CRTC to order Bell itself to supply monopoly services currently being offered through an affiliate or to refrain from supplying competitive services (leaving it open to an affiliate to do so). This power, which has never been exercised, is the closest federal communications law has come to the concept of structural separation of competitive and monopolistic businesses. This power is to be generalized in the new *Act* to apply to all Canadian carriers. However, given the very broad definition of a Canadian carrier, the presence of a general regulatory forbearance power, and the CRTC's continuing faith in service category costing systems, it is doubtful that this "in/out" power will be utilized. It is more likely that preference will be given to the direct regulation of a monopolistic affiliate as a Canadian carrier, or forbearance from regulating a Canadian carrier's competitive services subject to a regulatory costing system safeguard against anti-competitive cross-subsidization.
- (7) *Message Content*: To fill a regulatory gap, the *Act* will expressly authorize the CRTC to prohibit unsolicited nuisance calls, "giving due regard to freedom of expression." To date, the CRTC has been unable to find a workable means of acting on subscriber complaints in this regard. The traditional prohibition against carrier influence of message content (which in fact appears only in the *Bell* and *BC Tel Special Acts*) is generalized, but the CRTC will be authorized to permit exceptions.
- (8) *Provision of Information*: The CRTC will now be able to require the person controlling a Canadian carrier to submit information in a form or using a method prescribed by the CRTC. This power currently applies only to the person controlling Bell Canada.
- (9) *Guidelines and Advice*: A novel power will authorize the CRTC to issue non-binding guidelines or statements with respect to any matter within its jurisdiction. In relation to an application to provide a telecommunications service that would utilize telecommunications services obtained from a Canadian carrier, the CRTC will also be permitted to advise either the applicant or the carrier as to the carrier's obligations; again, this advice is not binding. In terms of the potential for judicial review of CRTC actions, it is unclear whether the fact that such guidelines are sanctioned by statute will have any material impact on the bias-avoidance standard applied by the courts to the CRTC as an independent tribunal.
- (10) *Access to Facilities*: The *Act* retains the CRTC's jurisdiction to order Canadian carriers to provide others with access to their facilities. The enabling provision has been streamlined to create a very broad regulatory power, no longer encumbered by railway-oriented drafting that has from time to time led to complex and arcane legal arguments aimed at restricting the availability of this remedy to carrier control of essential "bottleneck" facilities.

Shifting the Government/Regulator Balance of Power

Through the new Canadian carrier licensing régime and other measures discussed below, the *Act* aims at shifting control over the structure and development of the telecommunications services sector away from the CRTC and towards the federal Minister of Communications and the federal Cabinet.

Arguably, such a power shift could be made complete exclusively through the imposition of detailed performance conditions or constraints in Canadian carrier licences which entirely replicate and effectively replace traditional CRTC controls. For example, through operating licence conditions, the Minister could establish corporate profit limits, price floors or ceilings for particular services, service quality standards and investment and service development commitments, all in the name of consistency with the *Act's* policy objectives. If the Minister were to supplant effectively the CRTC in

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this manner, the CRTC would, in practice, be hard pressed to avoid having to tag along with the standards imposed by the Minister, since regulatory action inconsistent with licence conditions would be subject to variance by the Cabinet, and could well make the carrier ineligible to continue to hold an operating licence. This result would be similar to the current relationship between the British government and Oftel, Britain's independent telecommunications industry performance monitoring agency.

The power shift could equally be achieved through vigorous application by the Cabinet of its existing power to vary and rescind any CRTC decision. Given that the courts have refused to impose procedural safeguards on the exercise of this power, it would appear that the Cabinet could make policy statements of considerable effect through announcements on how it would likely treat particular types of CRTC decisions.

Despite the statutory feasibility of such Ministerial or Cabinet actions, such an outright shift of regulatory responsibility has not been suggested by the government, and the *Act* contains more subtle and perhaps more politically acceptable measures for increased executive influence over CRTC action.

Of course, as noted, the Cabinet will retain its current (but seldom asserted) capacity to vary or rescind any CRTC decision, order or regulation at any time upon a petition or its own motion. No statutory or common law procedural rights or safeguards apply to this action, although the new *Act* requires petitioners to deposit a petition document, which may not be the entire submission, with the CRTC for distribution to interested parties.

Further, the *Act* will provide the Governor in Council with the power to issue to the CRTC binding "directions of general application on broad policy matters with respect to Canadian telecommunications policy objections". Proposed directions must first be published in the *Canada Gazette* and laid before both Houses of Parliament, and a reasonable opportunity must be given to interested persons to make representations on the proposal to the Minister. The Minister must consult the CRTC both at the proposal stage and once the order is in its definitive form before it is made. The government must wait forty parliamentary sitting days before issuing the direction. A direction can apply to any matter pending before the CRTC on the day it comes into force, with the exception of a matter in which final submissions have been filed if less than one year has passed since the period for such filings.

The proposed direction power is quite similar to the Cabinet direction powers implemented in the 1987 *National Transportation Act* and the 1991 *Broadcasting Act* revisions. Neither of these direction powers has yet been utilized.

The extent to which this new direction power will actually be used is unclear. The principal reason for its use, of course, would be to influence a contentious CRTC decision such as the introduction of long-distance telephone competition. But this will be hard to do while remaining consistent with the *Act's* requirement that directions concern only "broad policy matters." If the direction becomes very broad, it risks picking and choosing among competing legislated policy objectives, in which case the direction may be vulnerable to judicial review on the basis that it is an unlawful attempt either to repeal provisions of the *Act* indirectly, which provisions govern all executive or regulatory action under the *Act*, or to act inconsistently in relation to them. Moreover, the requirement to lay the direction before the House makes the proposed direction a possible lightning rod for general criticism of the government—perhaps providing a future case study of why governments often send the job of balancing competing social and economic interests over to independent regulatory agencies in the first place.

As noted, the path of least resistance has been retained: any CRTC decision can be changed by Cabinet, and Cabinet is under no obligation to state its motives or to give any interested party a fair hearing before taking action.

Interestingly, the Cabinet will also be authorized to issue a binding direction to any Canadian carrier on any matter relating to national security, foreign policy or the international telecommunications policy of Canada. This is a generalization of a power currently available only in relation to Teleglobe Canada. It anticipates the day when other carriers will be supplying overseas services, and recognizes

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that all domestic carriers are supplying Canada's principal international communications market, that is, the Canada-U.S. market.

Despite this apparent shift in regulatory responsibilities to the federal government, the new *Act* remains faithful to federal undertakings to be sensitive to provincial interests by requiring the federal Minister of Communications to consult his or her provincial counterparts with respect to proposed Cabinet directions or variances of CRTC decisions if the proposed action will have a substantial "impact" on a carrier that is the principal telecommunications carrier in the province, or whose telecommunications operations are carried on principally in one province. Such mandatory provincial consultations are an increasingly common feature of federal regulatory statute revisions; their practical impact will depend entirely upon the politics of the moment.

Conclusion

Commendably, the government has through the *Telecommunications Act* consolidated, modernized and clarified the body of federal statute law applicable to the operations of telecommunications service suppliers subject to federal jurisdiction. Many practitioners will be grateful for these improvements, particularly as at present many relevant provisions employ language and concepts derived from the structure and operations of railways in the 19th century. For future use, the statute goes to considerable length to be tied, not to particular technologies, but instead to particular business activities. These improvements should therefore assist business and investment planning in this sector.

As a statement of public policy, the new *Act* discloses that the government is generally comfortable with the regulatory *status quo*. Detailed price and service control of telecommunications service suppliers, subject to federal jurisdiction by an independent agency, remains the norm. In fact, there is a clear potential that an even broader range of the business conduct of such firms will be subject to CRTC regulation than has occurred to date. The *Act's* statement of policy objectives largely reiterates prevailing government and CRTC policies and practices but, more than any other component of the current legislative framework, identifies telecommunications services as a strategic industry in the promotion of Canadian political and social development, and not just a monopolistic sector requiring price and profit regulation to protect consumers. The CRTC may refrain from regulating competitive activities, but this will occur only if sufficient competition is proven by the applicant carrier in a public proceeding which will undoubtedly be sensitive to such political and social concerns.

The immediate practical significance of the legislation is the additional tier of regulation and increased control by the government itself over the structure and performance of the industry. This is brought about by the new Canadian carrier operating licence requirement to be administered by the Minister of Communications, and the capacity of the Governor in Council to exempt classes of Canadian carriers from the operation of *Act*.

Both new executive powers are discretionary and are not subject to any statutory procedural safeguards on their exercise. The exercise of this executive discretion is constrained under the *Act* only by a requirement to be consistent with the legislated policy objectives which, given their breadth and multiple and competing philosophical underpinnings, are unlikely to provide much practical constraint.

Finally, due to the generality of the *Act's* policy statement, there is no apparent limit to the conditions that may be attached to either executive dispensation. This creates an opportunity for the executive branch to supplant, in all practical respects, both the CRTC and market forces in influencing the structure and performance of the industry.

At the least, in order to create some improved certainty over the intended reach of the legislation, and particularly given the vagueness of available judicial tests to detect an extra-provincial undertaking and the very broad definition of the business characteristics of Canadian carriers, there will be an

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immediate need for Governor in Council action to give more precise boundaries to this very detailed and extensive regulatory régime through the exercise of the statutory exemption power. To avoid procedural uncertainty and the risk of unproductive judicial review, there is also a need for an elaboration of the Minister's licensing procedures which will satisfy the expectations of the public, industry players and the judiciary for procedural fairness.

Notes

- ¹ *Alberta Government Telephone v. CRTC et al.*, [1989] 2 S.C.R. 225, 61 D.L.R. (4th) 193, the AGT decision.
- ² [1980] S.C.R. 115.
- ³ *Telecommunications: New Legislation for Canada* (February 1992), p. 1

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