COMMENT AND ANALYSIS

THE "PRICE STANDARD" OR THE "EFFICIENCY STANDARD"? COMMENTS ON THE HILLSDOWN DECISION

By: Lawrence P. Schwartz, Ph.D.*

HILLSDOWN AND EFFICIENCIES

In its recent decision regarding Hillsdown Holdings (Canada) Limited's acquisition of Canada Packers Inc. ("*Hillsdown*"), the Competition Tribunal indicated its views on the proper treatment of efficiencies under the *Competition Act* (" the Act").[1] These views surprised many observers of Canadian competition policy, who expected efficiencies to be given greater prominence than the Tribunal is apparently prepared to concede.

How did the Tribunal reach its conclusions in *Hillsdown*? Is this what Parliament had in mind when it passed the extensive amendments to the Act? What are the economic implications? The answers to these questions reveal the basic and apparently continuing dilemmas of competition policy in both Canada and the United States.

What the Tribunal Said

In assessing the efficiencies claimed by *Hillsdown* and the other respondents, the Tribunal accepts some claims and rejects others, as it might usually be expected to do. However, the Tribunal's decision observes that "the respondents based their trade-off analysis on a legal interpretation of section 96 which the Tribunal does not think is correct".[2] As *Hillsdown* is the first contested merger case to be decided by the Tribunal, the Tribunal's initial views on the correct interpretation of the s. 96 efficiency exception are significant.

What does the Act require of the Tribunal in regard to efficiencies? At its simplest, s. 96 states that the Tribunal may not make an order if it finds that efficiency gains from a merger will be greater than, and will offset, the effects of any prevention or lessening of competition that would result from the merger. Subsection 96(1) calls for a trade-off: a merger resulting in enhanced market power may nonetheless be acceptable if the resulting efficiencies exceed the negative competitive effects. In measuring the efficiencies of a merger, the Tribunal may not include re-distributed income, pursuant to s. 96(3).

Nothing in the Hillsdown decision is contrary to these provisions of the *Competition Act*. However, the Tribunal finds great difficulty in accepting the view that the trade-off decision requires a simple comparison of the efficiency gains and inefficiencies (or deadweight loss) caused by the merger. It chooses to interpret the negative competitive effects (i.e. the "effects of any prevention or lessening of competition that would result from the merger") more broadly than a sole concern with economic inefficiencies implies.

Given its decision to go beyond economic inefficiencies in conducting the trade-off analysis, the Tribunal examines the various purposes of competition law generally and the Act in particular. With reference to the purpose clause (s. 1.1) of the Act and related parliamentary debate, it concludes that there are so many objectives sought, that securing allocative efficiency (i.e. the most productive use of all assets) ought not to be viewed as the sole, or even the most important, goal of the Act.

Finally, the Tribunal, citing the American Bar Association's 1986 monograph on horizontal mergers ("ABA 1986 Monograph")[3] at length, suggests that a proper interpretation of s. 96(1) requires a comparison of efficiency gains against both economic inefficiencies and other detrimental effects. The *Hillsdown* decision then suggests that, although this type of analysis might not always be easy to do, mergers where the efficiency gains would lead to lower consumer prices could be approved without further analysis.[4]

So there we have it. In the *Hillsdown* decision, the Tribunal invites the view that the main purpose of Canadian competition law is to lower prices to consumers (the "price standard"). For those market-power enhancing mergers that do not achieve this, it would not suffice that efficiency gains exceed the inefficiencies (the "efficiency standard") to get the transaction approved.

Standard for efficiencies

What level of efficiencies would suffice under a price standard? In essence, the efficiency gains generated by a merger would have to be large enough that the marginal cost of production would decline, output would increase, and prices would fall, or at least not increase.

Under a price standard, moreover, certain types of efficiencies would be ignored. For example, the reduction of fixed costs has no impact on output levels; only changes in marginal costs will do this. Hence, under a price standard, the savings in fixed costs through elimination of redundant management and head office expenses that are unrelated to output levels cannot be considered as efficiencies.

Generally therefore, under a price standard, there is to be no trade-off at all between efficiency gains and the anti-competitive effects of a merger. Only those mergers presenting a level of efficiency gains sufficient to prevent price increases would be approved.

CRITIQUE OF AMERICAN MODEL

In *Hillsdown*, the Tribunal records that "[it] is not unaware of the debate which has raged south of the border as to whether allocative efficiency should be the only goal of merger policy."[5] This is an understatement: what it would do is import into Canada many of the debilitating aspects of American antitrust.

Populism

American antitrust law and policy have always had great difficulty with the concept of efficiencies. Historically, antitrust legislation has had a distinct populist flavour. As noted in the ABA 1986 Monograph, the *Sherman Act (1890)* was passed during the "Populist Era"; the *Clayton Act (1914)* and the *Federal Trade Commission Act* were passed during the "Progressive Era"; and the *Celler-Kefauver Act (1950)* amending s. 7 of the *Clayton Act* was passed during a merger wave following World War II and during a post-war populist resurgence.[6]

All of these laws were designed to counteract the power of large business corporations and, *inter alia*, to prevent the exploitation of the consumer (i.e. the transfer of wealth from consumers to owners of businesses) through the exercise of market power. On this basis, there was to be no trade-off between consumer welfare and economic efficiency. In the U.S., the "price standard" prevailed at the expense of efficiency as the basis for evaluating monopoly conduct and mergers.

Fisher *et al.* further argue that the simple economic analysis of the inefficiency (or deadweight loss) of monopoly was so poorly developed at the turn of the century that Congressional concern could not possibly have been guided by it; policymakers were simply unaware of the losses to society as a whole that are produced by market-power-induced price increases.[7]

Thus, we have two reasons to question the Tribunal's approach as suggested in *Hillsdown*. Firstly, unlike the American tradition in antitrust, Canada's *Competition Act* does not give exclusive attention to consumer interests, although concern with abuse by dominant firms is apparent.

Secondly, we know a great deal more about the resource-allocation effects of monopoly than was understood at the turn of the century. For example, economic theory is confident that, in addition to charging higher prices, monopolized industries produce less than their competitive counterparts, and demonstrates that the distortion of consumer choice due to monopoly prices itself reduces allocative efficiency and welfare.

To import one side of the American debate, as the Tribunal has seemed to do in *Hillsdown*, is to ignore these improvements in our knowledge in the name of populist sentiment.

Lack of Broad Support

The history of American antitrust is dominated by the gradual increase in the extent to which efficiencies are considered. To this extent, the Tribunal's comments in *Hillsdown* convey a greater degree of acceptance of the price standard in the U.S. than actually exists.

The perverse side of the pro-consumer, anti-efficiency price standard was clearly seen during the acquisition by Proctor & Gamble of Clorox in the mid-1960's. Proctor & Gamble insisted that its acquisition of Clorox was unobjectionable because the government was unable to definitively establish that any efficiencies would result; in support of its action, Proctor & Gamble asserted:

> [The Government is unable to prove] any advantages in the procurement or price of raw materials or in the acquisition or use of needed manufacturing facilities or in the purchase of bottles or in freight costs... [T]here is no proof of any savings in any aspect of manufacturing. There is no proof that any additional manufacturing facilities would be usable for the production of Clorox. There is no proof that any combination of manufacturing facilities would effect any savings, even if such combination were feasible.[8]

The acquiror's claim that the absence of efficiencies justifies the merger clearly illustrates the topsy-turvy world of the price standard.

Merger Guidelines

At the U.S. enforcement agencies, the move toward greater acceptance of efficiencies has been slow but sure. The 1968 Department of Justice Merger Guidelines allowed that efficiency gains could serve as justification for an anti-competitive merger only under "exceptional circumstances".[9]

This hostility toward efficiencies was carried forward in the 1982 Guidelines. Difficulty of measurement and a preference for growth via internal expansion seemed to be the main reasons against accepting efficiencies except in "extraordinary cases".

With the 1984 Guidelines, acceptance of efficiencies through horizontal merger commenced. Henceforth, the Justice Department would consider economies of scale, integration of production costs, plant specialization, and lower transportation costs, *inter alia*, when deciding whether to challenge a merger.

The treatment of efficiencies is substantively unchanged in the Department's recently-announced 1992 guidelines. As noted by the Assistant Attorney General, Antitrust Division:

> The only change is to eliminate the requirement that efficiencies be proven by "clear and convincing" evidence. This heightened evidentiary standard was interpreted by some as suggesting a certain hostility to efficiency-enhancing mergers. Under the new Guidelines, all elements of the analysis are treated the same, and the Department's policy continues to recognize economies of scale and other fixed cost savings as cognizable efficiencies, even though they might not in every case inure to the benefit of consumers in the short term.[10]

Noting that the 1992 Horizontal Merger Guidelines were announced jointly by the Antitrust Division, Department of Justice and the Federal Trade Commission, it would appear that the American enforcement agencies are moving away from the price standard that the Tribunal finds so appealing.

Foreign Trade Schizophrenia

As Canada knows all too well, the U.S. Congress is sensitive to the impact of foreign competition on American workers and companies. Whatever else they may do, subsidized imports and "dumped" goods provide U.S. consumers with lower prices. The application of trade remedies in the form of countervailing and anti-dumping duties by U.S. authorities run counter to this concern. By permitting the application of trade remedies, especially in politically-motivated cases which go beyond applicable international trade agreements as encoded in U.S. law, Congress is clearly motivated to protect the jobs of U.S. workers from the pressures of foreign competition, even if it results in higher domestic prices for consumers.

The ignoring of the consumer and the politicization of U.S. antitrust are seen most recently in the Justice Department's April 3 Statement of Enforcement Policy.[11] Under this policy, the antitrust authorities will take action against conduct occurring overseas that restrains United States exports, whether or not there is direct harm to U.S. consumers.

Given Congressional and Administration schizophrenia in which consumer interests get traded away for jobs and exports, we cannot continue to adopt the scholarly position that American legislators remain devoutly committed to lower consumer prices.

IMPLICATIONS FOR CANADA

There is cause for concern in the Tribunal's direction as expressed in *Hillsdown*.

The Purpose Clause

By giving statutory recognition to the consideration of efficiencies from a merger, Canada's *Competition Act* goes well beyond the American legislation and the consumer protection orientation thereof that the Tribunal is considering importing. Other parts of the Act are also unique, however.

The purpose of the *Competition Act* as provided in s. 1.1 is clear: to maintain and encourage competition in Canada. As a result of the pursuit of competition, the achievement of several desirable outcomes will be promoted, *inter alia*, the efficiency and adaptability of the Canadian economy, the participation by small and medium-sized businesses in the Canadian economy, and the provision of consumers with competitive prices and product choices. Thus, there is no clear basis in the purpose clause for according consumer prices a higher standing than economic efficiency, or vice versa.

In fact, the purpose clause is quite clear in its separation of means and ends. The "means" of the Act, (i.e. what the Act is to achieve) is competition itself. The "ends" (i.e. efficiency, competitive consumer prices, etc.) are not legislative requirements, but rather are seen under the Act as flowing from statutory requirements of competition. Under the purpose clause, the government, the Director of Investigation and Research, the Tribunal and all others in authority should be solely concerned with maintaining and encouraging competition, not with achieving the several positive consequences that flow therefrom.

In *Hillsdown*, the Tribunal clearly states that it is concerned with the end-product of competition:

> With this background in mind, then, one turns to the purpose clause of the *Competition Act*. That clause makes it clear that several objectives are meant to be served by the Act.[12]

Citing the objectives of efficiency and competitive prices to consumers, the Tribunal fails to distinguish between the means and the ends of the purpose clause.

This distinction between means and ends in the purpose clause is particularly important given the possibility for conflict among competing ends. For example, if the Tribunal were to focus on achieving efficiency and adaptability, it might diminish the opportunities for small and medium-sized businesses. Fortunately, the purpose clause does not require the Tribunal to choose among competing ends.

Accordingly, it is not up to the Tribunal to rank consumer prices against efficiency.

In order to divert from promoting competition, the Tribunal must find a statutory exemption to the purpose clause. Of course, s. 96 is such an exemption, but clearly, it does not provide the scope to rank price effects of a merger over efficiencies.

These aspects of the *Competition Act* make it more balanced than American antitrust law. The thrust of the Tribunal's approach to efficiencies in *Hillsdown* would deny the unique aspects of Canadian law in favour of an American tradition grown increasingly suspect.

Sole Efficiency Focus

Nevertheless, there may be some objection to a competition policy that is solely oriented toward allocative efficiency. Such a policy would countenance market-power-enhancing mergers when the efficiency gains expected from a merger exceeded the inefficiencies.

Imagine, for example, a merger of two domestic cigarette manufacturers. Given that cigarette consumption is highly insensitive to changes in cigarette prices (i.e. demand is highly price-inelastic), the deadweight loss of a post-merger price increase as high as 50 percent would be negligible, and would likely be dwarfed by the savings due to elimination of fixed costs. By virtue of market power, such a merger would transfer significant income and wealth from the consumers of cigarettes to shareholders of the merged manufacturer, and yet would be approved since the efficiency gains exceeded the deadweight loss.

To the economist, the wealth transfer effect is real, but irrelevant to the question of the optimal use of society's resources. How are we to know whether post-merger excess profits to shareholders outweigh the losses to consumers? Should the comparison be done on a dollar-for-dollar basis, or should a dollar of consumer loss be given greater weight than a dollar of gain to shareholders? The simple economic theory that provides the intellectual backbone to competition law provides no way of comparing these magnitudes in order to determine whether society as a whole benefits or not. Lacking a basis for determining social values, the economist limits the analysis to the question of efficiency.

The more practical issue is whether there are not better ways of redressing wealth transfers than through competition policy. Here the answer is clear: gains in income and wealth that are deemed socially undesirable can be attacked through a suitably-designed tax system and returned to consumers at a lower cost to society than through a competition policy that restrains efficiency-enhancing mergers.

Accordingly, there is no conflict between an efficiency-oriented competition policy and fairness to consumers or other groups so long as there are enough policy levers with which to achieve both objectives. Competition policy should be allowed to work with minimal concern about these other social objectives in these instances.

"Workability" Considerations

Substantive concerns are not the only ones that may conceivably justify a price standard over the efficiency standard when determining a policy stance on efficiency gains. In their article, which the Tribunal cites, Fisher *et al.* (1989) argue that in addition to being the proper standard, the price standard is also more easily implemented by the courts and thus is more "workable" than an efficiency standard.

However, their approval of the price standard is only relative. Fisher *et al.* write that whereas the information requirements of a price standard (i.e. to determine how large cost savings must be to prevent price from rising or output from falling) present a task that "probably exceeds the abilities of the litigation system...[a] model that incorporated an efficiency standard would be even more complex and require more information to solve."[13]

Thus, Fisher et al.'s claim for the superior workability of the price standard is based mainly on theoretical grounds. In fact, they argue that because either standard presents great empirical problems, the trade-off between efficiency gains and anti-competitive effects is itself problematic and should be replaced with bright line rules for courts to apply which would relate "average efficiency gains" to various levels of industrial concentration.

Fisher et al. are right to note the complexity involved with any inquiry into efficiencies. However, their call to replace the rule of reason with fixed rules highlights the problem in the United States: how to simplify the problem of assessing efficiencies for judges and courts. Why the Canadian Competition Tribunal, which was purposefully constituted differently from a court, should pay much attention to these problems is not so clear.

CONCLUSION

By suggesting support for a price standard, the Tribunal's approach to efficiencies in *Hillsdown* leads unavoidably down the American antitrust path, with all its inconsistencies, political compromises, and economic inefficiencies.

There is no doubt that the framers of Canada's *Competition Act* sought to avoid many of these difficulties. If the Tribunal insists on implementing the price standard, then it may well be that Parliament should re-examine and clarify section 96.

Notes

* Dr. Schwartz is a Toronto-based economist specializing in economic support for merger review cases. He is grateful to several legal practitioners for their review and comments on previous drafts of this article.

[1] See Madame Justice Reed's obiter comments in *D.I.R.* v. *Hillsdown Holdings Ltd.* (Competition Tribunal, 9 March 1992) at 86-100.

[2] Ibid., at 86.

[3] American Bar Association, Antitrust Section. "Horizontal Mergers: Law and Policy", Monograph No. 12, (1986).

[4] Ibid., at 99.

[5] Ibid., at 95-96.

[6] Ibid., at 12, fn. 39.

[7] See A.A. Fisher, F.I. Johnson, and R.H. Lande, "Price Effects of Horizontal Mergers", (1989) 77 Calif. L.R. at 785-788.

[8] Cited in Oliver E. Williamson, The Economic Institutions of Capitalism, (New York: The Free Press, 1985) at 367.

[9] These brief comments on the development of the U.S. merger guidelines are drawn from the ABA 1986 Monograph at 224-225.

[10] See U.S. Department of Justice, "60 Minutes with the Honorable James F. Rill", before the American Bar Association's 40th Annual Antitrust Spring Meeting, April 3, 1992.

[11] See "Justice Department's April 3 Statement of Enforcement Policy", (9 April 1992) Antitrust & Trade Regulation Report 483.

[12] Ibid., at 93.

[13] See Fisher et. al (1989), *supra*, note 7 at 809.

EUROPE 1992 AND THE REGULATED SECTORS: ITS IMPLICATIONS FOR CANADIAN BUSINESSES AND THE SCOPE FOR EXPANSION OF COMPETITION POLICY

By: Joseph Monteiro*

An important part of the Europe 1992 initiatives is liberalization in a number of important regulated sectors. Due to the opening of these markets to competition for the first time in a meaningful way, it will have implications for Canadian businesses. However, it should be noted that since the Economic Community ("EC") is undergoing a transition phase involving a considerable degree of uncertainty these implications are of a tentative nature. As a result of the liberalization and potential for increase in competition there will also be scope for the expansion of competition policy.

AIR TRANSPORT SERVICES

Since the start of the Europe 1992 initiative, two packages of measures have been implemented, one in December 1987 and the other in November 1990 for expanding the scope of competition between airlines in the Economic Community.[1] Recently, a third package of measures has been adopted which are to go into effect on January 1, 1993.[2] In addition, measures have been adopted to apply the EC Competition Law to air transport services.[3]

Implications for Canadian Businesses in Air Transport Services

The major implication for Canadian airlines from the *price competition reforms* pertains to fifth-freedom operations within the Economic Community. On fifth-freedom routes only Community airlines can become the price leader.[4] This should affect the competitive position of Canadian airlines even with the price matching provision. This is because Canadian airlines may not be able to introduce fares based on their fully allocated costs if they are lower than Community airline fares and because the matching provision pertains to the normal economy fare and not the lowest fare on that route.

A number of implications for Canadian airlines flow from the *market access reforms.* The elimination of ranges on capacity shares for Community carriers on intra-Community services should sharpen competition among Community airlines and perhaps, by extension, between Community airlines and Canadian airlines on fifth-freedom segments within the Community. Further, the removal of restrictions on third- and fourth-freedom air services should enable Community airlines to develop and mobilize an even more efficient sixth-freedom network. This could leave Canadian airlines at a competitive disadvantage due to lower load factors as opportunities for sixth-freedom services from the U.S. are rather limited.[5] Furthermore, the introduction of cabotage within a Member State as a result of the third package, when joined with fifth-freedom rights, would place Community carriers in an even stronger competitive position as a result of a superior airline network.

The most important implications flow from *proposals regarding other airline measures*, particularly those pertaining to cabotage. Since the Community is now considered as one market or entity, traffic between the Member States or fifth-freedom rights with third countries are considered to be equivalent to cabotage. As a result, the Community may want to redress any perceived imbalance in reciprocity. Accordingly, Canada may want to hold on to any existing fifth-freedom rights with Member States as they are safeguarded. However, globalization, alliances, pooling and marketing arrangements may diminish the importance of cabotage and fifth-freedom issues over the longer term.

Scope for Expansion of Competition Policy in Air Transport Services

The scope for the application of competition rules to business undertakings in air transport services has been particularly enhanced in the areas of collusion, abuse of dominance and mergers. Commissioner Brittan recently came out against a proposed Brussels-based alliance involving British Airways, Sabena of Belgium, and KLM Royal Dutch Airways on the basis that it would reduce passenger choice. Agreements may also be exempted.[6] In the area of abuse of a dominant position, the first air transport services case on reservation systems was brought to the Commission.[7] The Commission decided that Sabena had abused its dominant position in the market for computerized flight reservations in Belgium and imposed a fine.[8] In a case involving a merger, the Commission has intervened in the British Airways acquisition of British Caledonian Airways, obtaining undertakings in addition to those given to the United Kingdom Mergers and Monopolies Commission.

TELECOMMUNICATIONS

Implications for Canadian Businesses in Telecommunications[9]

A number of implications flow from reforms on *access to the telecommunications terminal market.*[10] Economic operators are granted the freedom in the EC to import, market, connect, bring into service and maintain terminal equipment. While these reforms were basically intended to promote intra-EC competition, the absence of any exclusion of non-EC operators appears to imply that the market will be opened to Canadian telecommunication terminal operators. In practice, it has been suggested, this would require the establishment of a Canadian subsidiary in the EC, because of Community content rules. However, a Canadian telecommunication company, already with a subsidiary located in any Member State, will now be able to sell anywhere within the Community.

The opening of the telecommunication services market to any operator through *market access reforms in telecommunication services* is expected to have a few implications for Canadian businesses.[11] The absence of any specific exclusion of non-EC operators implies that the market could be open to Canadian telecommunication operators. However, the supply of such services will be subject to licensing procedures. EC content rules may require the establishment of a Canadian subsidiary before it can provide services anywhere in the Community.

The *open network provision measures* (ONP)[12] should enable Canadian based EC firms to provide telecommunications services more readily within the Community, thereby opening up opportunities and reducing costs. *Public procurement measures*[13] imply that Canadian communication firms will have to locate a subsidiary in Europe to meet the EC content rule or to enter into reciprocal procurement agreements with a Community firm.

Scope for Expansion of EC Competition Policy in Telecommunications

The scope for the application of competition rules to business undertakings in telecommunications has been particularly enhanced in the areas of collusion and abuse of dominance. Regarding collusion, Telecom Administrations decided to abolish a clause fixing terms for leasing, following the recommendation of the Commission that it violated Article 85 of the *EEC Treaty.*[14] In the area of abuse of dominance, British Telecommunications prohibited private message-forwarding agencies in the United Kingdom from relaying telex messages received from and intended for other countries on grounds that it abused its dominant position.[15]

FINANCIAL SERVICES

Implications for Canadian Businesses in Financial Services[16]

The *measures to facilitate entry into the banking market* have several implications. A Canadian bank with an incorporated subsidiary in a Member State will be granted a single licence to do business throughout the Community on the same basis as an EC bank, thereby receiving identical treatment. As a result, opportunities could now be available for Canadian banks to do business in any other EC Member State either by way of establishment without prior authorization or through the provision of services. However, a Canadian bank with only a branch in an EC Member State will not be permitted access throughout the Community, as it will not qualify for a single licence.[17]

A single banking licence could also create anomalies because banks from non-EC countries would be allowed to perform services in the EC not permitted in their home country. However, with the recent Canadian legislative reforms, this possibility appears to have been reduced. Significant Community market penetration is not expected due to restructuring from the wave of mergers, acquisitions and alliances.

Canadian banks planning to open up subsidiaries or planning to acquire EC Community credit institutions will require authorization from the competent authorities of a Member State. Before granting authorization, the Commission will determine whether EC banks are provided with "effective market access" (i.e., the right of establishment) and "national treatment" (i.e., non-discrimination of EC banks in comparison to Canadian domestic banks) in Canada. Where comparable market opportunities do not exist—for example because of differences in the ranges of permissible banking activities or opportunities as a result of less liberal banking laws—these differences will be a matter for negotiation. This lack of equivalent treatment will not be a basis for retaliation. Member States however may limit or suspend requests for authorization or acquisitions by financial entities governed by the laws of third countries, if EC companies encounter difficulties in establishing themselves in those countries. This reciprocity issue will not be retroactive and should be taken advantage of before January 1, 1993 by Canadian banks planning to open in the EC. Similar implications will result from *measures to facilitate entry into the non-life insurance and life assurance market.*

Scope for Expansion of EC Competition Policy in Financial Services

The scope for the application of competition rules to undertakings in financial services has already been enhanced in the area of collusion. In the *Dutch Banking* case, the Commission's strong pro-competitive stance has prompted several associations of Dutch banks to end agreements following objections raised by the Commission.[18] Notwithstanding its stance, the Commission granted exemption from Article 85(1) to the circulars concerning simplified clearance procedures for cheques and other banking procedures on grounds that the procedures have redeeming benefits. Recently, the Commission wrote to the European Banking Federation indicating that agreements on interest rates at national levels should be avoided or abandoned as the practice restricts competition having an effect similar to a cartel.[19]

ENERGY

Implications for Canadian Businesses in Energy

The *measures to facilitate cross-frontier transit* between high pressure grids in natural gas, or cross-frontier transit between high voltage grids in electricity[20] will not have significant implications for Canadian businesses. State-owned monopolies will continue to dominate the gas and electricity

subsectors leaving little room for competition within any of these subsectors. A recent Court ruling and Commission action, however, could open the door for competition between State owned monopolies and possibly third party competition including potential Canadian companies in the Community at a later date.[21]

Measures to provide *third-party access* recently were proposed.[22] Beginning on January 1, 1993 a system of third-party access to large industrial consumers and distributors will be introduced. The system of third-party access will be extended on January 1, 1996.

The *price transparency reforms* do not have any direct implications for Canadian businesses.[23] It is possible, however, that over the longer term the publication of energy prices prevailing in the EC and other countries could create an incentive for Community industrial end users to push for measures to abolish exclusive export and import rights of the State-owned monopolies and to provide possible opportunities for non-Member States in the EC market.

Scope for Expansion of EC Competition Policy in Energy

The scope for the application of competition rules to undertakings in energy has been enhanced in the areas of collusion, monopoly and mergers. The Commission granted an exemption from the application of Article 85(1) to parts of an agreement regarding the supply of German coal, known as the *Jahrhundertvertag*, to that country's public electricity supply industry. The exemption was granted because the agreement serves to safeguard electricity supplies for the consumer and therefore contributes to improving the generation and distribution of electricity.[24] However, since the agreement limits the possibility of intra-Community trade, the exemption was not intended to be granted in its entirety and the agreement will apply to a reduced quantity of coal in line with the Commission's proposal. The Commission recently concluded an examination of a complaint against an agreement entered into by CAMPSA, the Spanish petroleum monopoly which was considered as being contrary to Articles 85 and 86 of the *EEC Treaty*.[25] With respect to mergers, an investigation has been started recently into the acquisition by the West German Ruhrgas AG of 35 percent of the East German Verbundnetz AG, which owns the gas pipeline network in the German Democratic Republic.[26]

CONCLUDING COMMENTS

In light of the importance of the regulated sectors which account for more than fifteen percent of the Economic Community's gross domestic product of approximately five trillion Canadian dollars, a number of supplementary reforms are being planned so that the key reforms have their maximum effect. In air transport services, measures are being considered in areas pertaining to external policy, harmonization, and infrastructure. In telecommunications, measures are being planned to liberalize the market based on the proposals of the Green Paper which have not been implemented; for example in areas such as receiving antennae and satellite broadcasts, alignment of tariffs and costs, and numerous accompanying measures. In financial services, reforms are being planned to harmonize policies; for example in value added tax and withholding tax, on stock exchange listing prospectus, and prohibition of insider trading. In energy, the Commission is considering important measures related to removal of barriers to trade, and other measures to improve competition.

Increased opportunities for Canadian businesses as a result of the regulatory reforms are likely to arise particularly in telecommunications and financial services. In telecommunications, market niches are likely to exist for Canadian subsidiaries in the Economic Community where economies of scale in production are not important, such as the specialized computer equipment market and the specialized information services market. In financial services, opportunities are likely to arise particularly in niches where Canadian businesses have a recognized expertise; for example in mergers and acquisitions, marketing of life insurance and pension products by life assurance companies,

management of large pension funds, unit trusts and mutual funds, and the securities business.

In the past, the regulated sectors examined in this paper were exempt from the application of the Competition Law. However, in light of the recent developments, the competition rules in the *EEC Treaty* are now applicable. The scope for the application of competition rules has particularly been enhanced in the areas of collusion, abuse of dominance and mergers. This has resulted in a number of initial cases where the Commission has successfully put an end to infringements of the competition rules.

Notes

* Economics and International Affairs Branch, Bureau of Competition Policy, Consumer and Corporate Affairs Canada. Mr. Derek Ireland is to be credited for the encouragement, valuable discussion and patience for reading this article.

[1] See EC, Council Directive (EEC) No. 87-601 of 14 December 1987, OJ No. L 374-1, 31.12.87, Articles 3, 4 and 5; EC, Council Regulation (EEC) No. 2342-90 of 24 July 1990, OJ No. L 217-1, 11.8.90, preamble and Articles 3(6), 4(3)(b), 4(5) and 7; EC Council Decision (EEC) No. 87-602 of 14 December 1987, OJ No. L 374-1, 31.12.87, Articles 3, 5, 6 and 8; EC, Council Regulation (EEC) No. 2343-90 of 24 July 1990, OJ No. L 217-8, 11.8.90, Articles 4, 5(3)(c), 5(4), 6, 7, 8(1), 11 and 12.

[2] See "Commission Adopts Third Package of Air Transport Measures," Information P 90, Brussels, 17 July 1991.

[3] See EC, Council Regulation (EEC) No. 3975-87 of 14 December 1987, OJ No. L 374-1, 31.12.87; EC, Council Regulation (EEC) No. 3976-87 of 14 December 1987. OJ No. L 374-9, 31.12.87.

[4] "Third freedom" refers to the right to set down in a State passengers emplaned in the State of registry of the aircraft. "Fourth freedom" refers to the right to emplane in a State passengers whose destination is the State of registry of the aircraft. "Fifth freedom" refers to the right to emplane passengers in the State other than the State of registry and to set down those passengers in a third State. "Sixth freedom" rights refers to "behind the gateway" traffic from other Member States feeding third- and fourth-freedom services.

[5] See "The European Community's Common Air Transport Policy and Implications for Bilateral Service Agreements Between Member States and Third Countries," by Randolph Gherson, London, September 24-27, 1990, pp. 23, 24, 32 and 33.

[6] See EC, Commission Regulation (EEC) No. 2671-88 of 26 July 1988, OJ No. L 239-9, 30.8.88; EC, Commission Regulation (EEC) No. 2672-88 of 26 July 1988, OJ No. L 239-13, 30.8.88; EC, Commission Regulation (EEC) No. 2673-88 of 26 July 1988, OJ No. L 239-17, 30.8.88.

[7] For example, see "Sabena Agrees to Give London European Airways Access to its Computer Reservation System SAPHIR,"Press Release IP(87)215, Brussels, 3 June 1987.

[8] See "Commission Fines Sabena," Press Release IP(88)677, Brussels, 4 November 1988.

[9] 1992 Implications of a Single European Market, Telecommunications and Computers, December 1989, External Affairs and International Trade Canada, pp. 4, 16, 19, 20, 21, 23, and 25. Europe 1992 and the Telecommunications and Informatics Sectors, Ottawa, December 4, 1989, External Affairs and International Trade Canada, pp. 3, 4, and 5.

[10] See EC, Commission Directive 88-301-EEC of 16 May 1988, OJ No. L 131-73, 27.5.88, Articles 2, 3, 4, 5, 6, 7 and preamble (paragraphs 14 and 15).

[11] See EC, Commission Directive 90-388-EEC of 28 June 1990, OJ No. L 192-10, 24.7.90, Articles 1(2), 2, 3, 4, 7, 8 and preamble (paragraph 31).

[12] See EC, Council Directive 90-387-EEC of 28 June 1990, OJ No. L 192-10, 24.7.90, Article 3(1).

[13] See Europe, No. 5201 (new series), 24 February 1990, p. 6, and Europe 1992 Working Group Report on Competition Policy, January 1991, p. 41.

[14] "Telecom Operators Abolish Tariff Recommendations Following Commission Action," Press Release IP(90)188, Brussels, 6 March 1990.

[15] See "Application of the Community's Competition Rules to the Telecommunication Sector," Press Release IP(82)305, Brussels, 14 December 1982.
[16] See 1992 Implications of a Single European Market, Financial Services, September 1990, External Affairs and International Trade Canada, pp. 24., 29, 32, 39 and 40.
[17] See Article 9(4) and preamble, 89-646-EEC.
[18] See address "Developments in Banking Supervision Over the Last Decades and New Challenges," by Sir Leon Brittan, 17 November 1989, Brussels, p. 5.
[19] For example, see EC, Commission Decision 89-512-EEC of 19 July 1989, OJ No. L 253-1, 30.8.89.
[20] "European Commission Calls for Termination of Interbank Agreements on Interest Rates," Information, IP(89)869, Brussels, 16 November 1989.
[21] See Proposal for a Council Directive, Com (89) 0334 final, Brussels, 1989 and Proposal for a Council Directive, COM (89) 0336 final, Brussels, 1989.
[22] See "EC Takes Step Toward Ending State Energy Monopolies," The Journal of Commerce, N.Y., Friday, March 22, 1991, p. 11B.
[23] See footnote 24.
[24] See Draft Council Directive, COM (89) 0332 final, Brussels, 1989.
[25] See "Commission to Exempt German Coal Supply Agreement," CMR 95,522, p. 51,756.
[26] "The Commission Acts on the Agreement Between Campsa, the Spanish Oil Monopoly, and the City of Madrid," Press Release IP(89)744, Brussels, 6 October 1989.
[27] See "Commission to Investigate Ruhrgas Acquisition," CMR 95,541, p. 51,788.

FERC MANDATES RESTRUCTURING OF U.S. NATURAL GAS MARKETS

By: N.J. Schultz
Fraser & Beatty, Ottawa

With its recently released Order 636, the U.S. Federal Energy Regulatory Commission ("FERC") has completed the enunciation of its concept of competitive natural gas markets.

In previous orders over the last decade, the FERC has freed the customers of interstate pipelines from their gas purchase obligations and has given those customers access to interstate pipeline transportation to allow direct purchases from producers. However, these orders maintained the interstate pipelines' obligations to serve customers on demand. The result has been that customers have maintained their contracts for gas supply with interstate pipelines but have utilized those contracts only on a seasonal or peak basis. Pipelines are the suppliers of last resort. The cost to customers for maintaining these contracts has been a demand charge only for the transportation component of the service. The savings to be gained by direct purchases of natural gas from producers in the spot market has been such that customers have been able to maintain their supply contracts with interstate pipelines while purchasing substantial volumes of natural gas directly from producers during much of the year. These direct purchase transactions have been moved on interruptible transportation on the interstate pipelines. However, since this interruptible capacity is created any time a pipeline sales customer does not buy gas, there has been ample interruptible capacity available. The FERC has concluded that the present operation of natural gas markets is distorted and uncompetitive.

Order 636 frees pipelines of their regulated obligation to sell gas. All gas will be sold on commercially-negotiated terms and the obligation of any seller to serve will be no greater than that agreed to by contract. Pipelines may withdraw entirely from their role as gas merchants and confine

their activities solely to the transportation of gas.

Merchant pipelines will be expected to realign their gas purchases to be competitive with other sellers. Provision is made for passing on transition costs to customers. To avoid incurring such transmission costs, the FERC has encouraged pipeline sales customers to take assignments of the pipelines' gas purchase contracts.

Pipelines are required to unbundle firm and interruptible transportation services from firm and interruptible sales. Over the next year there will be a restructuring of transportation entitlements. Firm shippers will be able to release unwanted capacity to those desiring capacity. Pipeline capacity will be allocated through a competitive bidding process. Pipeline sales customers and open access transportation customers will have to be prepared to match the price and term offered by others seeking firm capacity if they wish to retain pipeline access.

Pipelines must provide firm and interruptible transportation services on a basis that is equal in quality for all gas supplies whether purchased from the pipeline or another seller. Unbundling is to take place near the point of production and the Commission believes that the structures it has created will naturally lead to the development of market centers and pooling areas.

The FERC has established a new on-going firm capacity reallocation program so that firm shippers can release unwanted capacity to those desiring capacity. This program is, in essence, a capacity brokering program.

Unless the Commission provides otherwise, pipeline rates are to be set in accordance with the straight fixed variable method instead of the modified fixed variable method which the Commission has used for the past decade. Rate discounts will be permitted only where there is no unsatisfied demand for capacity.

Pipeline tariffs must fully set out all relevant terms and conditions affecting transportation services and access to transportation services. All shippers will be provided equal and timely access to information through the use by pipelines of electronic bulletin boards.

Order 636 does not constitute deregulation. Rather, the FERC contemplates that the new regulatory framework it is creating will lead to lighter regulation and a more competitive gas market consistent with the Commission's statutory authority. The Commission has determined that conditions exist for a workably competitive natural gas sales market such that consumers can be assured just and reasonable prices for natural gas through competition. The regulatory framework for pipeline transportation established by the FERC is intended to provide the non-discriminatory access necessary to permit competitive selling and buying of gas. Thus, the FERC considers that it has fulfilled its statutory authority with respect to the establishment of non-discriminatory, just and reasonable pipeline rates and terms of service.

Order 636 has implications for Canadian gas exports. The restructuring now taking place will result in less interruptible capacity being available from pipelines for spot or short-term gas sales. Unused capacity may become available through capacity brokering from shippers themselves. However, the straight fixed variable method of determining rates will provide shippers a significant incentive to contract only for the capacity they need and to utilize the capacity which is contracted. The obligations which shippers will have in relation to firm transportation capacity will lead to a tendency for some firming up of gas supply contracts.

Canadian sellers should, therefore, be seeking to firm up sales arrangements in the United States. At present, a substantial volume of Canadian natural gas is moving into the United States under short-term export orders. In the 1990/91 year, 45 percent of exports were under short-term orders and just over half of that amount was classified by the NEB as interruptible exports. A good part of this moves on interruptible transportation in the United States.

A substantial volume of Canadian natural gas is also contracted for sale to U.S. interstate pipelines. The U.S. pipelines have typically taken that gas at low load factors because their sales markets have been eroded by competition from direct sales. As a result, restructuring of gas sales contracts between

Canadian suppliers and U.S. pipelines should be a common goal of all parties.

The challenge in realigning Canadian gas exports presently committed to U.S. pipelines will be significant. The pressure from California to restructure the Alberta & Southern export sales contract has already created severe stress in relations between California and Canada. At the same time, the National Energy Board has recognized that change is a fact of life in the evolving competitive North American market and that change can be accepted provided appropriate provision is made for a transition.

Restructuring will result in the creation of many new rules for all open access pipelines together with new rates and a reallocation of transportation entitlements on those pipelines. Gas supply contracts will be negotiated or renegotiated in the process. The result is a lot of activity and a lot of uncertainty in which Canadian gas sellers and pipelines have a vital interest. In the end, the U.S. gas transportation market will be more complex with a great deal more information for players to try to absorb if they choose to try. Complexity reinforces the opportunities for those in the middle who wish to act as marketers and so provide a service to those less able to manage complexity while, of course, sharing the potential rewards.

The restructuring taking place in the U.S. is also of interest to Canadian consumers. Gas prices are, as a result of relatively open, competitive markets, reflective of conditions in both countries. Canadian consumers have also benefited from the inability of U.S. pipelines to purchase gas which has been contracted from Canadian suppliers. Firm capacity has been built in Canada to transport that gas to the border. When that capacity is not being used for its original purpose, it is available for many other purposes, including spot or short-term sales to Canadian customers. If Canadian suppliers to U.S. pipelines are able to restructure successfully their contracts to secure firm positions in the U.S. market then this capacity should be well-utilized for its original purpose and thus tend to become less available for sales to Canadian customers. Alternatively, if Canadian suppliers to U.S. pipelines are unable to firm up their positions in the U.S. market, then Canadian customers might still enjoy the benefit of excess capacity for spot and short-term transactions.

The FERC's decision is premised on the belief that there are substantial volumes of natural gas available to consumers. The supply which is available to the marketplace is, of course, a function of price. When prices are not attractive, producers do not make the effort necessary to replace supplies through continued exploration and development. The result can be a supply shortfall even though there is gas in the ground which can be developed. Recently, NOVA, the pipeline system in Alberta which gathers Alberta natural gas and brings it to border delivery points for transportation to ex-Alberta markets, has raised concerns about supply reliability. NOVA has reported that gas suppliers have been unable to satisfy the total nominations of downstream, connected pipelines on all occasions even though NOVA had the capability to move the nominated volumes. This occurred in February 1989, December 1990, October 1991, and January 1992. These incidents are characterized by rapid drops in temperature in the order of 20° C. NOVA's analysis shows that the functional supply, i.e. the supply actually available, is about 87 percent of peak nominations. So far, consumers have not felt the problem because temporary solutions were, in each case, found.

Canadian producers are clearly looking for relief from continued low profits and are seeking a sympathetic ear. Canadian regulators responding to producer constituencies will wish to be careful in the balance they strike. With FERC Order 636, it has never been clearer that all producers are pitted in a contest for survival. Sustained continent-wide competition is no respecter of local interests.

CANADIAN COMPETITION POLICY RECORD

HIGHLIGHTS

UNDERTAKING BY DIGITAL TO STOP TIED SELLING

CONSPIRACY CASES PROCEED AFTER N.S. PHARMACEUTICALS

BUREAU INVESTIGATES NHL

ANTITRUST UNDER CLINTON ADMINISTRATION

FEDERAL COURT REFUSES APPEAL OF CRTC COMPETITION DECISION

INTERNATIONAL COMPETITION LAW UPDATE

FEATURE ARTICLES

VOL.13, NO. 4

DECEMBER 1992

CANADIAN COMPETITION POLICY RECORD