COMMENT AND ANALYSIS
THE *SUPERIOR PROPANE* CASE

SUPERIOR PROPANE: AN OVERVIEW OF THE FIRST EFFICIENCY CASE

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Introduction

The Competition Tribunal has now confirmed that Canada has the most economically sophisticated merger law in the world. On August 30, 2000, the Tribunal dismissed the case brought by the Commissioner of Competition against the acquisition of ICG Propane Inc. by Superior Propane Inc.[1] Although the Tribunal found that the merger was likely to lessen and prevent competition substantially and that the appropriate remedy was the complete divestiture of ICG, it held that the merger was saved by the efficiency defence in section 96 of the *Competition Act*. That provision precludes the making of an order against a merger that is likely to lessen or prevent competition substantially where the efficiencies likely to be generated by the merger will be greater than, and will offset, the effects of the lessening or prevention of competition. The decision is the first to be decided on the basis of the efficiency defence, and it makes one thing very clear: the goal of Canadian merger law is to maximize total surplus through the promotion of economic efficiency.

Background

Superior and ICG were the two largest retail distributors of propane and related equipment in Canada. Superior agreed to acquire ICG in July 1998. The parties filed a pre-merger notification pursuant to Part IX of the Act, along with extensive submissions and information relating to both the competition issues and the efficiencies that the merger would give rise to. The Commissioner later obtained an order for production of information pursuant to section 11 of the Act. In doing so, the Commissioner declined the parties' offer to provide information under oath a month before the section 11 order was issued, thus adding a period of delay in the Competition Bureau's review of that information.

In late October 1998, the Commissioner provided the parties with his preliminary views regarding the merger. At that time, the Commissioner declined to express any views on his approach to the efficiency trade-off mandated by section 96. The position that the Commissioner later took before the Tribunal ("balancing weights") on the question of efficiencies was never raised. The Commissioner provided the parties with his final views on the merger in late November, following the completion of the Bureau's review. Even then, the Commissioner gave no indication of his new approach to the efficiency trade-off, other than to say that he would put the matter

before the Tribunal in the course of an application under section 92 of the Act if the parties intended to proceed with the merger.

On December 1, 1998, the Commissioner filed an application for an interim order to prevent Superior from taking up the shares of ICG. On December 6, 1998, the Tribunal dismissed the Commissioner's application. The parties completed the transaction on December 7, 1998. Subsequently, the Commissioner filed his main application under the merger provisions in section 92 of the Act to challenge the merger post-closing. On December 11, 1998, the Tribunal granted an interim hold-separate order on consent of the parties pending the ultimate decision by the Tribunal. The main hearing commenced on September 23 and was completed on February 9, 2000.

Substantial Lessening and Prevention of Competition

On the issue of whether the merger would lead to a substantial lessening of competition, the Tribunal first defined two categories of "competition markets": (1) retail markets for propane; and (2) the provision of "national account coordination services", which involved providing propane and related services to major or national accounts in multiple local markets. (The Tribunal declined to further segment the market on the basis of various end-uses and customer classifications.) The Tribunal found local geographic markets in respect of the retail markets and a national geographic market in respect of national account coordination services.

The Tribunal then found that, within the local retail propane markets, the parties accounted for a large share of most such markets and that barriers to entry were high. Barriers to entry were found to include (1) the parties' long term customer contracts with exclusivity provisions, automatic renewals and rights of first refusal, (2) ownership by the parties of customers' propane tanks, (3) the time required for an entrant to establish a reputation, and (4) the need for an entrant to incur significant sunk costs. The Tribunal also found that the merger would remove ICG as a vigorous competitor and that remaining competition would be insufficient to constrain the exercise of market power by the merged entity.

The Tribunal concluded that there would be no substantial lessening of competition in 19 of these local markets, because the merger would have a minimal effect on competition and fringe competitors. In the remaining markets, however, even though the Commissioner's experts were unwilling and unable to testify that a price increase of any magnitude in any market was "likely" (only that one was possible),[2] the Tribunal found that, in 16 local markets where the parties would have a post-merger market share of 95% or more, the merged entity would have the ability to exercise market power by imposing a unilateral price increase. In another 49 local markets, where there were at least three competitors, including the parties, the Tribunal found that the merger would likely enhance interdependence with remaining competitors. The Tribunal further concluded that the merger was likely to substantially "prevent" competition in Eastern Canada because it found that ICG had plans to expand in this area, even though ICG had no operations there and Superior was not the market leader in that region. Finally, the Tribunal concluded that there would be a substantial lessening in respect of national account coordination services. Thus, but for the efficiencies defence, in the Tribunal's view, the appropriate remedy was the complete divestiture of ICG.

The Efficiency Defence

As noted above, the majority of the Tribunal held that the efficiencies attributable to the merger were greater than and offset the anticompetitive effects of the merger. In so doing, the Tribunal held that the objective of Canadian merger law is economic efficiency. According to the Tribunal, the standard to be applied in reviewing mergers is the "total surplus standard". Under the total surplus standard, the critical consideration is the net effect of a merger on the use by society as a whole of its economic resources. Where the likely gains to society from a merger in terms of cost (or resource) savings exceed the misallocation of resources caused by likely price increases from the merger (*i.e.*, the deadweight loss), mergers are permitted under this standard. Any transfer of wealth from consumers to shareholders of the producers (*i.e.*, from a price increase) is considered neutral from an economic perspective and, consequently, irrelevant under this standard. The total surplus approach is the approach set forth in the Commissioner's 1991 *Merger Enforcement Guidelines* ("MEGs").

As a factual matter, the Tribunal found that the annual efficiencies likely to be brought about from the merger would be approximately $29.2 million annually for ten years. These gains related to three areas of operation: corporate centre, customer support and field operations:

- Corporate centre comprises the functions of corporate management. In this area, Superior claimed cost savings arising from, among other things, head office management activities, personnel and facilities, information systems technology, wholesale propane dealing and purchasing.
- Customer support functions include sales force and related management, customer service and administration, and regulatory and safety activities. In this area, Superior claimed cost savings arising from the elimination of duplicate facilities and redundant personnel in areas where both companies operated.
- Field operations consist of field sites, branches and plant operations, delivery and service fleets, propane and tank inventory, and supply and transportation. Superior argued that cost savings would result from the elimination of redundancies due to overlapping geographic markets and from the larger delivery volumes in each territory that would enable the merged entity to reduce supply and transportation costs.

The Trade-off

While Superior had claimed efficiencies in these three areas totalling $40 million annually over a ten-year period, the Tribunal determined that the total cost savings likely to arise out of the merger that were non-pecuniary and that would not be obtained if the order for divestiture were made, amounted to $29.2 million per year over a ten-year period.

The majority of the Tribunal found that the quantitative deadweight loss resulting from the merger (*i.e.*, from a likely price increase) would be at most approximately $3 million per year for the same ten-year period, and that the qualitative anticompetitive effects of the merger (*i.e.*, from changes in quality of service) should not be given a weighting in excess of a further $3 million per year. Therefore, taking bot h quantitative and qualitative anticompetitive effects into account, the trade-off analysis came out in favour of efficiencies almost five to one.

The Tribunal rejected the Commissioner's position that, as a matter of law, efficiencies could never save a merger to monopoly. The Tribunal rejected the suggestion that distributional considerations be given weight in the trade-off analysis. As a result, the wealth transfer was not considered in its analysis: "nothing in the Act allows us to consider distributional goals in merger review". The Tribunal added that it "does not regard the redistributive effects of a merger as anti-competitive". The Tribunal specifically rejected the consumers' surplus standard and the price standard.

The Tribunal also rejected the Commissioner's suggestion that it adopt a "balancing weights standard", pursuant to which different values could be placed on a dollar in a producer's hands and a dollar lost by consumers. Instead, the Tribunal gave five reasons for applying the total surplus standard: (i) distributional concerns do not fall within the ambit of the Act, (ii) merger review must be predictable - adopting the balancing weights standard would result in decisions that vary from case to case depending on the views of the sitting members of the Tribunal regarding the groups affected by the mergers, (iii) a standard that includes the wealth transfer as an effect under subsection 96(1) would effectively result in the unavailability of the section 96 defence, (iv) the government has other fiscal tools at its disposal to more efficiently address distributional concerns, such as tax and other social policy measures, and (v) the MEGs endorse the total surplus standard. In this latter regard, the majority decision stated that, while the MEGs are not binding on the Tribunal or the Commissioner, they should be given very serious consideration.

The Tribunal stated that other adverse economic and social effects of a merger, such as job terminations and plant closures, cannot be considered as anticompetitive effects within the meaning of the Act: " . the only effects that can be considered under subsection 96(1) are the effects on resource allocation, as measured in principle by the deadweight loss which takes both quantitative and qualitative effects into account."[3]

The dissenting member of the Tribunal, Christine Lloyd, was not persuaded that the quantum of efficiencies would be greater than and would offset the anticompetitive effects of the merger, in part because she did not believe that most of the efficiencies "likely" would have been achieved, and in part because she did not believe that the wealth transfer should be excluded from the trade-off analysis. With respect to the former, Member Lloyd would have required "[a] business plan setting out the implementation process . . . [and] outlining the time frames for each step of the integration of the merger"[4] before accepting the claimed efficiencies. Regarding the wealth transfer, she stated that it should be given weight in the assessment of qualitative anticompetitive effects of the merger. Member Lloyd was also of the view that Superior had failed to prove that the gains in efficiency would not likely be achieved through alternative means if an order for total divestiture had been made.

The Welfare Standard

Prior to *Superior Propane, Hillsdown* was the only contested Canadian merger case to have considered merger efficiencies and the application of section 96. In *Hillsdown*, the Tribunal raised as a question whether the wealth transfer from an anticompetitive merger is always neutral. The Tribunal did not need to rule on this issue in that case because it had already found that the merger would not lessen competition substantially. As pointed out elsewhere, "the Tribunal's reasoning [on section 96 in *Hillsdown*] may be taken to imply any one of three

standards for the efficiencies' defence. One is that efficiencies must exceed the loss in consumer's surplus resulting from the merger. The second is that all efficiency gains must be passed on to consumers. And the third is that the merger must not result in any reduction in consumer surplus."[5]

In *Superior Propane*, the Commissioner asserted another interpretation of section 96:

> [The Commissioner] offers an approach ("balancing weights") in which the members of the Tribunal are invited to use their individual judgment and discretion to evaluate whether the gains to shareholders are more or less important to society than the losses of surplus imposed on consumers by the exercise of market power.[6]

The Tribunal rejected the Commissioner's balancing weights standard as follows:

> . . . the members of the Tribunal are selected for their expertise and experience in order to evaluate evidence that is economic or commercial in nature, not to advance their views on the social merit of various groups in society.[7]

As noted above, the Tribunal considered the Commissioner's past and current views on the appropriate welfare standard. It considered the MEGs issued in 1991 and Bank Merger Guidelines issued in 1998,[8] both of which continue to take a total surplus approach. It also noted that a former head of the Bureau stated after the *Hillsdown* decision that there was no need to revise the MEGs as the comments in that case were in *obiter dictum*.[9] The Tribunal noted that it was not bound by the Commissioner's MEGs, but it concluded that the MEGs should be given very serious consideration. In this regard the Tribunal noted:

> It is only after the Commissioner decided to file the application against the respondents in this case that changes to his position became apparent.
>
> . . .
>
> This change in position is quite surprising. It must not be forgotten that the point of view put forward in the MEG's represents the considered opinion of the Commissioner, the official appointed by the Governor-in-Council to administer and enforce the Act. That view, it goes without saying, is a view arrived at by the Commissioner following careful advice given to him by his legal and economic advisers regarding the meaning of the various provisions of the Act.[10]

One of the key arguments in support of the total surplus interpretation of section 96 was that Parliament intended section 96 to play an important role in Canadian merger policy.[11] In *Superior Propane*, the Tribunal accepted this reasoning and in doing so adopted an interpretation that, in our view, breathes life into section 96.

Post Script: The Appeal and the Hold-Separate

On September 6, 2000, the Commissioner announced that he was appealing the Tribunal's decision to the Federal Court of Appeal. The appeal is scheduled to be heard on January 9, 10 and 11, 2001.

As noted above, the parties completed the transaction on December 7, 1998. Subsequently, the Commissioner filed his main application under the merger provisions in section 92 of the Act to challenge the merger post-closing. On December 11, 1998, the Tribunal granted an interim hold-separate order on consent of the parties pending the ultimate decision by the Tribunal. On September 8, 2000, the Commissioner moved before the Tribunal to stay its order and, in effect, attempt to keep the hold separate order in place pending disposition of the Commissioner's appeal. The Tribunal dismissed the Commissioner's motion, holding that the Tribunal's jurisdiction and the hold separate order terminated upon the issuance of the Tribunal's final order on August 30.

The Commissioner subsequently brought a motion to the Federal Court of Appeal for a stay of the Tribunal's order pending his appeal. That motion was dismissed by a judge of the Federal Court of Appeal on September 19, 2000 on the grounds that the Commissioner had failed to establish irreparable harm in the absence of the stay. The Court recognized that, if Superior were allowed to integrate the ICG assets into its business, it may be difficult to "unscramble" them in the event of a reversal of the Tribunal's decision on the efficiency defence, but found that it could be done. The Court noted that, in the past, corporations like AT&T and Standard Oil have been divided up in the United States, and the U.S. Department of Justice is currently seeking to split up Microsoft. The Court noted that a subsequent split-up of Superior might be costly, but Superior was willing to assume the cost, if necessary, and it was clear that the efficiencies would more than offset the cost of a split-up.[12]

What is the Status of the Merger Enforcement Guidelines?

We cannot conclude this article without addressing what is perhaps the most significant question raised by this case on a going forward basis: what is the status of the MEGs? As noted by the Tribunal, the MEGs are intended to reflect the view of the Commissioner as to how the Act applies to mergers. That view, "it goes without saying",[13] is a view arrived at following careful advice from the Department of Justice, the Bureau and economic advisers regarding the meaning of the merger provisions of the Act. *Superior Propane*, however, raises questions about whether the Bureau still follows the MEGs or will follow the MEGs in tough cases, an uncertainty emphasized by public comments to the effect that the Bureau is looking at amending the MEGs.[14]

While it is common knowledge that the Commissioner did not apply the MEGs in *Superior Propane* in relation to section 96, it should also be noted that the Commissioner took positions contrary to the MEGs in relation to the application of section 92 as well. Differences in position include the following:

Commissioner's Statement In Memorandum of Fact and Law	Merger Enforcement Guidelines
1. Deadweight Loss and Wealth Transfers	
"The economic literature identifies various approaches that can be used to perform this tradeoff. Three of these approaches, the price standard, the total surplus standard and the consumer surplus standard, each apply a fixed predetermined, albeit very different, weight to the transfer from consumers to producers that results from a price increase due to a merger. Applying a fixed predetermined weight to the transfer would, as a matter of law, be contrary to section 96." **(para. 552 - see also paras. 589-618)**	"Section 96(1) creates a tradeoff framework, in which efficiency gains that are likely to be brought about in Canada, are balanced against the anticompetitive effects that are likely to result from the merger. In this context, anticompetitive effects refer to the part of the total loss incurred by buyers and sellers in Canada that is not merely a transfer from one party to another, but represents a loss to the economy as a whole, attributable to the diversion of resources to lower valued uses. This loss is sometimes referred to as the deadweight loss to the Canadian economy." [emphasis added] **(Part 5.1)**
" The Commissioner submits that the application of the balancing weights standard represents a realistic and practical approach to the tradeoff between efficiency gains and anticompetitive effects that is consistent with the proper interpretation of section 96." **(para. 553)**	"Where a merger results in a price increase, it brings about both a neutral redistribution effect and a negative resource allocation effect on the sum of producer and consumer surplus (total surplus) within Canada. The efficiency gains described above are balanced against the latter effect, *i.e.*, the deadweight loss to the Canadian economy." [emphasis added] (Part 5.5)
"... The term 'effects' refers to all consequences of any lessening or prevention of competition resulting from the merger." **(para. 576)**	"When a dollar is transferred from a buyer to a seller, it cannot be determined a priori who is more deserving, or in whose hands it has a greater value." **(Part 5.5, footnote 57)**
2. Market Share and Concentration	
"It is established that injury to competition occasioned by the merger, in the presence of such high market shares need not be of the scale as in the case involving smaller market shares." **(para. 7)**	"These [market share] thresholds simply serve to identify mergers that are unlikely to have anticompetitive consequences from mergers that require a more qualitative analysis, before any conclusions regarding likely competitive impact can be reached. All else being equal, as market share and concentration increase above these thresholds, the potential increases for a merger to give rise to concerns about its likely effect on competition. However, in all cases, an assessment of market shares and concentration is only the starting point of the Bureau's analysis. In addition to the level of market shares or concentration in the relevant market, an assessment is made of the nature of market share distribution and the extent to which market shares have changed or remained the same over a significant period of time." [emphasis added] **(Part 4.2.1)**
"While market share information in and alone is not determinative (save for the instance of monopoly) of the presence of a substantial lessening of competition, high market shares in the presence of other evaluative criteria listed under section 93 of the Act will lead to such a conclusion. Indeed a 100% market share has been accepted prima facie as a finding of substantial lessening." [emphasis added] **(para. 8)**	
"The Commissioner's position is that the efficiencies defence in section 96 is not available, as a matter of law, in those cases where a merger eliminates competition and results in the creation of a monopoly in the relevant market." **(para. 551 - see also paras. 563 - 570 and 764 - 765)**	

Commissioner's Statement In Memorandum of Fact and Law	Merger Enforcement Guidelines
3. Benchmark Price	
"Pre-merger prevailing prices are not appropriate as the base price in a case if there is a concern that market power was excessive prior to the merger." **(para. 9)**	In respect of market power the MEGs provide: ". in evaluating whether the market power of the merging parties is likely to be greater than if the merger does not proceed, the focus is normally on the price dimension of competition. Specifically, an assessment is made of whether prices would likely be higher than if the merger did not proceed." [emphasis added] **(Part 2.1)**
4. Meaning of "Likely To"	
The Commissioner cited the *Tillmanns*' case, an Australian case decided in the labour context under the *Trade Practices Act* to say that, in some contexts, "likely" may mean "a real or not remote chance or possibility. . .", [emphasis added] citing the law of negligence as an example. He states in that paragraph that ["likely"] has some ambiguity, [but] it clearly does not require an assessment of certainty.	"In the Director's view, the word 'likely' means 'probably', and not 'possibly'. Therefore the word 'likely' connotes 'probably' throughout this document." **(Part 2.1, footnote 4)**
5. Small Competitors can be Vigorous and can be Looked at Collectively	
"The Respondents also frequently speak of these competitors as competing in a monolithic aggregate sense, rather than in any independent fashion. Presumably, this is a means of addressing the fact that many of these competitors have, individually, extremely small market shares." **(para. 456)**	"Effective remaining competition is a broad concept that refers to the collective influence of all sources of competition in a market." [emphasis added] **(Part 4.7)**
"These remaining competitors in many local markets are small and provide fragmented competition." **(para. 458)**	"A firm does not have to be among the larger competitors in a market in order to be a vigorous and effective competitor. Smaller firms can exercise an influence on competition that is disproportionate to their size." [emphasis added] **(Part 4.8)**

It is trite to say that the point of guidelines is to provide guidance, to reduce uncertainty and allow lawyers to provide sound advice to business people to facilitate business planning. Certainty and predictability have long been among the goals most frequently articulated by the Bureau.[1] Even though the Tribunal has now said that it will give the MEGs significant consideration in interpreting the Act, in light of the positions advanced by the Commissioner in *Superior Propane*, there would appear to be some uncertainty among members of the competition bar as to whether it is appropriate to rely on the MEGs in getting complex transactions through the Bureau.

In our view, the MEGs remain cutting edge. Indeed, the MEGs are widely used and highly regarded. A copy of the MEGs can be found on the desk of every competition lawyer in Canada. Indeed, in our experience they are frequently consulted by lawyers around the world in respect of transactions with a Canadian component.

Conclusion

The *Superior Propane* Decision has significant implications for the analysis of efficiencies in merger cases in Canada and around the world. For example, a major reason why some have suggested that efficiency claims should not be considered in merger analysis is that the quantification of efficiencies can be very difficult. The *Superior Propane* Decision, however, shows that efficiencies are not an "intractable subject for litigation".[2] Because the burden to quantify the efficiencies is on the merging parties, they have an incentive to put their best foot forward. In this regard, Superior was able to provide evidence of likely efficiencies. These estimates were challenged, successfully in some instances, by contrary expert evidence and on cross-examination. Ultimately, however, the Tribunal found that the merger would generate non-pecuniary annual efficiencies of $29.2 million and that these gains would not likely be achieved through alternate means.

Superior Propane also has significant implications for the business community and the competition bar in relation to the future application of the MEGs. In this regard, it would be useful to have a clear understanding regarding the continued application of the MEGs to all merger cases.

Notes

* Partners, Davies, Ward & Beck LLP, Toronto, Canada. Davies represents Superior Propane Inc. We would like to thank Caroline Abela, student-at-law, for her assistance in preparing this paper. The views expressed herein are solely those of the authors.

[1] *The Commissioner of Competition* v. *Superior Propane Inc. and ICG Propane Inc.*, CT 1998 002, Reasons and Order, August 30, 2000 [hereinafter *Superior Propane*]. The Tribunal's decision is available on its website at http://www.cttc.gc.ca/english/cases/propane/propane.html.

[2] The following is from the cross-examination of Professors Schwindt and Globerman, vol. 23, pp. 4186, 4190 and 4194.

> "MR. FINKELSTEIN: No. I would like to know whether it is likely that, as a consequence of the merger, there is going to be a 5 percent increase in the Category 1 markets.
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> DR. SCHWINDT: We didn't address likelihood. The answer isn't in this report. So it follows that we don't know that.
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> . . .
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> DR. GLOBERMAN: I am giving an opinion about possibilities.
>
> MR. FINKELSTEIN: Not probabilities?
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> DR. GLOBERMAN: Mr. Finkelstein, I am not quantifying the probabilities, but if something is possible, then it has a certain probability. I am not quantifying it, but it has a probability greater than zero, certainly.
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> . . .
>
> MR. FINKELSTEIN: Sir, again my question is not whether there is a potential. My question is: In which markets is there likely to be a price increase as a consequence of the merger?
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> DR. GLOBERMAN: We haven't done that analysis.
>
> MR. FINKELSTEIN: And to speed this along, I take it you haven't done that analysis for any of Professor West's 74 markets.
>
> DR. GLOBERMAN: That's correct." [emphasis added]

[3] *Superior Propane*, para. 447.
[4] *Ibid.* at para. 490.
[5] See D. McFetridge, *Competition Policy Issues*, September 1998, research paper prepared for the Task Force on the Future of the Canadian Financial Services Sector, at 98. See also P. Crampton, "The Efficiency Exception for Mergers: An Assessment of Early Signals from the Competition Tribunal", 21 *Canadian Business Law Journal* (1993).
[6] *Superior Propane*, para. 431.
[7] *Ibid.*
[8] *Bank Merger Enforcement Guidelines*, Director of Investigation and Research (1998).
[9] See H. Wetston, *Developments and Emerging Challenges in Canadian Competition Law*, paper delivered at Fordham Corporate Law Institute (New York, New York), October 22, 1992, at 16.
[10] *Superior Propane*, paras. 395 - 397.
[11] See P. Crampton, *supra*, note 5, at 7.
[12] *Commissioner of Competition* v. *Superior Propane Inc. and ICG Propane Inc.*, September 19, 2000, Federal Court of Appeal, unreported, para. 12.
[13] *Supra*, note 10.
[14] See Konrad von Finckenstein, Address to the Canadian Bar Association, Competition Law Section, Annual Meeting, September 21, 2000 at 23.
[15] Competition Bureau website at http://strategis.ic.gc.ca/SSG/ct01323e.html
[16] See R. Pitofsky, "Proposals for a Revised United States Merger Enforcement in a Global Economy", (1992) 81 Geo. L. J. 196 at 209-210 (claims of efficiencies are "easy to assert and sometimes difficult to disprove") and R. Posner, *Antitrust Law: An Economic Perspective* (1976) (noting that "[t]he measurement of efficiency . . . [is] an intractable subject for litigation") at 112.

LONG LIVE THE *MERGER ENFORCEMENT GUIDELINES*? A REVIEW OF THE *SUPERIOR PROPANE* DECISION[1]

By: Jason L. Gudofsky and Patrick Gay
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Introduction

On August 30, 2000, the Competition Tribunal published its much anticipated decision in *The Commissioner of Competition* v. *Superior Propane Inc.*[2] In Canada, where there is a general dearth of merger-related case law, any decision by the Tribunal is certainly of keen interest to the competition law bar, economists, regulators and to corporate Canada generally. The decision in *Superior Propane* is of a special nature, however, because it represents the first time that the Tribunal has refused the invitation to issue an order requiring a merged party to divest its interest solely on the basis of the so-called efficiency defence under section 96 of the *Competition Act* (the "Act").[3] The Commissioner of Competition (the "Commissioner") has already filed his appeal of the Tribunal's decision to the Federal Court of Appeal,[4] thus ensuring that the proper scope and application of the efficiency defence to contested mergers will remain in flux for some time. Regardless of the outcome of the appeal, the Commissioner's decision to appeal the Tribunal's decision may foreshadow future legislative changes to section 96.[5] Furthermore, there has been some mention, albeit unconfirmed, that the Commissioner may pre-emptively change his *Merger Enforcement Guidelines* (the "MEGs") to reflect the Commissioner's views regarding section 96. *Superior Propane* raises interesting issues that merit discussion. This is true of the *dicta* pertaining to both the finding of a "substantial lessening and prevention of competition" pursuant to section 92 of the Act and to the application of section 96.

In our opinion, there is little doubt that the Tribunal interpreted section 96 in a manner consistent with what the competition law bar has generally understood that section to mean. Indeed, the decision is a virtual "win" for the MEGs in that, except in a few limited instances (as discussed below), they were followed and effectively endorsed by the Tribunal. That is also to say that, in our view, the Tribunal's interpretation of the law was correct. However, now that the efficiency defence in Canada has graduated from being the statutory encapsulation of industrial organization economics to a provision with practical significance, it is a good time to re-evaluate the merits and application of the defence. This is not to suggest that it necessarily needs fixing, just that we should now take stock of whether we are satisfied with the outcome in *Superior Propane*. To assist that consideration, in the section below entitled "Considerations Going Forward" we pose various questions that should be measured against the traditional total surplus standard.

We are, however, troubled by the Commissioner's decision not to follow his anticipated practice regarding the application of section 96, as stated in the MEGs. By deciding in the context of a specific merger to abandon his own MEGs, the Commissioner has called into question the reliability of his published policy statements generally. The full repercussions of the Commissioner changing his views mid-stream remain uncertain. However, as he introduces new enforcement guidelines and interpretation bulletins on a wide range of topics, most recently to cover intellectual property rights and immunity programs, the efficacy and reliability of those guidelines must be considered to be somewhat diminished. However, without doubt, absent legislative amendment to section 96 or a successful appeal of the Tribunal's decision, the Commissioner must follow the Tribunal's *dicta* in future cases. He certainly lacks the authority to attempt a "fix" through his MEGs. Further discussion of the Commissioner's conduct is provided at the section below entitled "Role of the Commissioner"

The *Superior Propane* Decision

1. Overview of *Superior Propane*

Although the Tribunal devoted considerable attention to reviewing the background facts to the case, the pertinent facts can be synthesized in relatively short order.

The case arose from the proposed acquisition by Superior Propane Inc. ("Superior") of all of the voting shares of The Chancellor Holdings Corporation ("Chancellor") which, in turn, owned all of the shares of ICG Propane Inc. ("ICG"). Chancellor itself is a wholly-owned subsidiary of Petro-Canada, a major Canadian integrated oil and gas company.

Superior and ICG were both engaged in the retailing and wholesaling of propane, as well as, to a lesser extent, the sale of propane consuming appliances and equipment and other related businesses. The proposed merger represented the combination of the only two national retail sellers of propane in Canada, with other industry participants being only local or regional in scope. According to ICG's 1998 prospectus, ICG and Superior, on an aggregated basis, served approximately 70 % of the Canadian propane market, a figure which was later accepted by the Tribunal. Such high levels of concentration made it inevitable that the merger would attract a significant degree of scrutiny from the Commissioner. By the same token, the merger of the two major companies within a mature industry with undifferentiated products and overlapping distribution networks made it likely that significant efficiency gains would emerge from the merger. As such, insofar as the merger was likely to be contested, it appeared, almost by design, to require the Tribunal to determine the scope of the efficiency defence prescribed under section 96 of the Act. Of course, this is precisely what occurred.

In July 1998, Superior entered into an agreement to purchase ICG. On December 1, 1998, the Commissioner filed an application for an interim order with the Tribunal to prohibit Superior from taking up the shares of ICG. Following a two day hearing, the Tribunal rejected the Commissioner's application. Following that decision, on December 7, 1998, Superior completed its acquisition. The Commissioner subsequently filed an application under section 92 of the Act to challenge the merger, post-closing. On December 11, 1998, the Tribunal granted a hold-separate order on consent of the parties whereby ICG would continue to be run as a separate entity pending a decision by the Tribunal on the Commissioner's primary application. Hearings in that application began on September 23, 1999, and were completed on February 9, 2000. Extensive written evidence and oral testimony was given during the course of the proceedings. In total, 91 witnesses were called by both sides, including 17 expert witnesses. Not surprisingly, much of the expert testimony was dedicated to the issue of efficiencies. In the end, a majority of the Tribunal agreed to permit Superior to proceed with its merger on the grounds that the efficiency savings likely to arise from the merger were greater than, and offset, the detrimental competitive effects arising therefrom.

2. Lessening and Preventing Competition Substantially – a Case Review

While *Superior Propane* will certainly be known for its application of the efficiency defence, it should not be lost that the decision devotes considerable attention to merger analysis generally. This includes a reasoned discussion of the application of the factors for determining whether a proposed merger transaction will, or is likely to, result in the lessening or prevention of competition substantially in a particular market or markets (for the purposes of this paper, the acronym "SLC" is used in the place of the term "substantially lessen competition").

Unlike on the issue of efficiencies, the Tribunal's conclusion on the SLC issue was unanimous. The Tribunal stated its views on most aspects of merger analysis, including a fairly comprehensive discussion of the various evaluative factors set out in section 93 of the Act.

(a) Overview of the SLC and Prevention of Competition

(i) Market Definition

The Tribunal noted that there is no specific requirement under the Act to define a market. The sole purpose for defining a relevant market, according to the Tribunal, is to develop the boundaries from which to measure market power, and hence whether the merged entity will be able to act in an anti-competitive manner following the completion of the merger.[6] Specifically, the Tribunal explained that:[7]

> The Tribunal notes that the Act does not require that markets be delineated. However, the Tribunal accepts that the delineation of competition markets is one way of demonstrating the likely competitive effect of a merger and that, where such an approach is valid, the competition market adopted must be relevant to the purposes and goals of the merger provisions of the Act, which focus on the creation or enhancement of market power.

Accordingly, while the Tribunal should seek to define a relevant market with as much precision as possible, it should not do so at the expense of the ultimate purpose for conducting that exercise, namely to measure market power. The Tribunal mostly followed this approach in determining the appropriate product and geographic markets, although, as discussed below, it was not completely married to it in all circumstances.

A. Product Market

The Commissioner ultimately argued for a product market of retail propane sales disaggregated to delineate between various end-uses, such as residential, agricultural, commercial, industrial and automotive, as well as between the various services related to propane sales, such as propane equipment sales and services.[8] The Commissioner acknowledged that the practical implication of defining the market so narrowly is that if the merged entity could exercise market power in a single end-use segment, then that segment must constitute a product market for merger analysis purposes.[9]

In arguing for the existence of narrow product markets, the Commissioner presented expert evidence to suggest that propane is not substitutable with other types of fuel, such as natural gas, electricity and oil, and that the high

cost of switching to alternative fuels has a "lock-in effect for customers" that results in low cross-elasticity of demand.[10] For propane customers to switch to an alternative fuel, they must incur switching costs in order to convert their propane equipment, such as a car, furnace or appliance, to accept that alternative fuel. The Commissioner argued that the short-term and medium-term costs of switching in most cases would be prohibitively expensive. According to the Commissioner, in determining the true cost of switching, one must consider the actual conversion costs, the savings that will accrue as compared to the cost of conversion or replacement of equipment, and the difficulty and inconvenience of breaking existing supply and equipment contracts.[10] In addition to the barrier caused by the high cost of substitution, the Commissioner's experts also argued that, in general, propane demand is inelastic.[12]

The Respondents did not agree with a restrictive definition of the market, and instead argued for the adoption of a broader "energy market".[13] The Respondents argued for this broad definition on the basis of interchangeability, inter-industry competition, the Tribunal's jurisprudence and supply-side substitutability.

The Tribunal ultimately accepted the Commissioner's narrow definition of the relevant product market. The Tribunal adopted the approach recommended by the MEGs of identifying a product market by examining the likely impact on the price of a product should the merged entity raise the price of that product over a non-transitory period. If consumers are likely to substitute the subject product, in this case propane, for an alternative product, then that alternative product is also included in the definition of the relevant product market. This process is continued with alternative products until no further substitution is likely. The key factors for delineating the relevant product market as part of this process are, according to the Tribunal, substitutability and own-price elasticity.

In terms of substitutability, the Tribunal drew a distinction between switching and substitutability, with only the latter being relevant for determining the relevant product market. The Tribunal noted that substitution refers to the process of selecting an alternative product in response to a price increase; specifically: "changing a consumption pattern in response to a price change with all other determinants of change, including the age of equipment, held constant".[14] In order to constitute true substitution, as distinct from switching, the consumption response by consumers must be relatively immediate. From an economic perspective, the direct nexus between the price of two products is necessary so that the price of one product disciplines the price of the other. For that reason, the Tribunal stated that the decision by consumers to switch between propane or an alternative fuel at the beginning or end of a piece of equipment's life-cycle is not evidence of price-based substitution since such response does not occur at the time of the price increase and does not, therefore, truly discipline the price of propane. In the end, the Tribunal found that there was little substitutability between propane and other fuels owing to the significant switching costs between propane and other fuels.

The Tribunal also examined the own-price elasticity of demand of propane; namely, the change in quantity of propane consumed as a result of a one % increase in the price of propane. Accepting the Commissioner's evidence, the Tribunal was satisfied that the demand for propane is inelastic. The Tribunal explained that "[t]he evidence demonstrates that the demand for propane is inelastic with respect to changes in price, *i.e.*, that consumers

reduce their consumption of propane only slightly when the price rises."[15] Having found that consumers are not likely to substitute propane for an alternative fuel, and that the demand for propane is relatively insensitive to price changes, the Tribunal concluded that propane constitutes a single product market.

In addition to a market defined as retail propane sales, the Tribunal also concluded that there was a separate market defined as "national account co-ordination services". This market consisted of national customers who consumed propane at numerous points in Canada through a single, national contract from a single propane provider who supplied these customers at their many locations or within a specific region or across Canada. While the national account co-ordination services market presumably consists of the service of co-ordinating propane sales, it is unclear whether such services are unique to propane such that national accounts for propane sales should constitute a separate product market apart from other types of co-ordination services generally. The Tribunal merely concluded that national customers "seek the administrative efficiencies from doing business with a sole supplier".[16] A separate possibility, and one which was not discussed by the Tribunal, was to consider the national accounts as a geographic market issue only rather than one concerning the definition of the relevant product market.[17] To that end, the product market for these customers would continue to be retail propane sales, except that the geographic market would be national in scope. In any event, the Tribunal accepted the Commissioner's evidence that national account co-ordination services constitutes a separate product market, but proceeded to evaluate it in the same manner as the retail propane sales market.

Before concluding on the product market, it is worth noting what the Tribunal did not consider to be particularly instructive or useful for delineating the appropriate product market.

First, the Tribunal did not place significant weight on the Respondents' evidence regarding cross-price elasticity of demand (*i.e.*, as stated by the Tribunal, the measure that identifies a product as a substitute if its quantity demanded rises when the price of the good in question rises).[18] Citing the Respondents' expert, the Tribunal stated that in order to establish cross-price elasticity of demand there must be evidence of reciprocity between the two goods alleged to be in the same market. According to the Tribunal, it is not sufficient to show that product "A" has an impact on the price of product "B", as it must be equally shown that the price of product "B" has an impact on the price of product "A". In the case of propane, the Tribunal was of the view that propane is not in the same product market as natural gas since while the price of natural gas affects the price of propane, the converse is not true. The Tribunal found that, owing to the low price of natural gas, consumers that switch from propane to natural gas do not switch back. On that basis, the Tribunal concluded that natural gas and propane could not be in the same product market.

The Tribunal's comments regarding cross-price elasticity of demand are difficult to reconcile with its view that the sole purpose of defining a market is to determine the potential of the merging parties to exercise market power post-closing. If the Tribunal is correct in its explanation of the purpose for defining a market, then there is little reason to require evidence of reciprocity. It is only necessary to determine what influences the price of the subject product, and not whether the subject product influences the price of any other product(s) that is not part of the merger analysis. In this case, the Tribunal found that consumers of propane would switch to natural

gas, while the converse did not occur. If determining the existence of market power is the purpose for defining a relevant product market, then the Tribunal's decision that natural gas is not in the same market as propane because there is no reciprocity between the two products must be incorrect.[19]

Finally, the Tribunal also was not willing to place any weight on the product market definition accepted by the Tribunal in the earlier injunction proceedings[20]. The Tribunal noted that, unlike in the present proceedings, when Justice Rothstein considered the relevant market he did not have the benefit of an extensive record and expert opinions,[21] and had to instead rely on anecdotal evidence presented in the merging parties' securities filings. In light of the significant amount of evidence presented to the Tribunal, it did not place any weight on Justice Rothstein's earlier conclusion regarding market definition.

B. Geographic Market

Next, the Tribunal set out to define the relevant geographic market. Effectively following the MEGs, the Tribunal noted that, for purposes of competition analysis, a geographic market is "the smallest area over which market power could be exercised".[22] In other words, it is the smallest distance in which a party can raise its prices over a non-transitory period without its customers moving a significant proportion of their purchases to an alternative provider of the relevant product at a further distance. The Tribunal noted that, in the circumstances, geographic market is of particular significance "because delivery is an important component of the product", and that, therefore, failure to properly define the geographic market "would lead to the incorrect measure of market shares and hence of the ability to exercise post-merger market power".[23]

The Commissioner and Respondents agreed that the geographic market for the retail sale of propane is local. They did not agree, however, on the precise dimension of local markets. The Commissioner effectively argued that the geographic market can be determined by drawing a radius around each branch and satellite location and then extending the radius around each such location to equal the approximate distance that customers typically travel[24]. Branches and satellite facilities that fall within the same circle would be part of the same geographic market. Using that approach, the Commissioner argued that the geographic market was between 60 and 100 kilometres from each Superior and ICG location. The Respondents, on the other hand, argued that the distance should be measured as the furthest distance that (effectively) at least one customer (referred to by the Tribunal as the "exceptional customer")[25] travels to acquire propane. In so doing, Superior argued that its trading areas have radii of 50 to 620 kilometres, and that some competitors have even larger drawing areas.

The Tribunal preferred the Commissioner's definition of the relevant market to the Respondents' definition. The Tribunal drew a sharp distinction between the definition of a service area for commercial purposes and the definition of a geographic market for competition analysis, noting that "... there is no necessary correspondence between a competition market, which is an analytical construct, and a market defined by management for operational purposes."[26] With respect to the market for retail propane sales, the Tribunal accepted a geographic market with a radius of between 60 and 100 kilometres.[27] The Tribunal also found that Canada is the appropriate relevant geographic market for the national account co-ordination services product market.[28]

While the Tribunal's definition of the relevant geographic market is generally satisfactory, and the approach is otherwise consistent with the MEGs, it is questionable whether the same approach would necessarily be appropriate for an industry that relies on drawing areas rather than service areas (*i.e.*, rather than service providers delivering a product to their customers, an industry where consumers travel to service providers or sellers). Examples of industries that rely on drawing areas are the retail sector (e.g. grocery and department stores), financial services and grain elevation services. In these industries, customers go to the service provider or the seller of a good, which is the converse to what takes place in the propane industry. It may not be appropriate in these industries to draw radii around service providers since the starting point begins at each customer's home base. Drawing a circle around service providers may not, therefore, capture the true competition for a customer's business.[29] In the case of propane, however, since service providers are responsible for delivery, it is reasonable to draw circles around the service providers and not their customers.

Finally, while the Tribunal was not willing to define the geographic market by reference to the furthest customer from a Superior or ICG branch or satellite location, it accepted this approach for calculating possible efficiency gains arising from the proposed merger. Although considered below, it is worth noting at this point that, in discussing the relevant geographic market, the Tribunal did not discuss why a different approach should be used for delineating a market than is used for the purposes of a section 96 analysis.

(ii) Evaluative Factors

Having defined the relevant markets, the Tribunal set out to determine whether the proposed merger would result in either a SLC or would prevent competition substantially in each relevant market.

The Commissioner argued that the proposed merger would be anti-competitive in that: first, it would result in a SLC in many local retail propane markets; second, it would result in a SLC with respect to the provision of national account co-ordination services; and third, it would prevent competition substantially in Atlantic Canada. According to the Commissioner, the proposed merger would have anti-competitive effects on the basis of the following factors: high market shares; significant barriers to entry; removal of ICG as a vigorous competitor; absence of foreign competition; and no effective remaining competition.[30] As we will see, the Commissioner won these three points.

For their part, the Respondents denied that the proposed merger would be anti-competitive. The Respondents argued that a SLC is synonymous with a "likely price increase", and since there was no positive evidence that prices would increase following the proposed merger, the proposed merger could not be considered anti-competitive.[31] The Respondents further argued that the proposed merger would not have adverse competitive consequences on the basis that barriers to entry are low, that there are numerous independent propane sellers, and that ICG is not an effective competitor.

A. Market Shares and Concentration

Subsection 92(2) of the Act provides that market shares and concentration are not determinative as to whether a proposed merger will result in a SLC. For example, in a highly contestable market where there are no barriers to entry, significant market shares generally will not be fatal to the proposed merger. However, where there are significant barriers to entry and important customer relationships, as was found to be the case in the retail propane industry (as discussed below), evidence of high market shares is generally evidence of a resulting SLC.

In the present case, the Commissioner's expert – Professor West - found that, for 1997, of the 74 local markets that he examined, a combined Superior/ICG would have a market share in excess of 60% in 66 of those markets. In 32 of these markets, Superior/ICG would have a market share in excess of 80%, while in 17 of these markets, Superior/ICG would have a market share in excess of 95%.[32] It was also alleged that the combined entity would have a market share in excess of 70% when measured on a national basis. While the Respondents criticized Professor West's evidence, the Tribunal placed significant weight on the fact that the Respondents' own expert concluded that in 15 markets a combined Superior/ICG would have market shares in excess of 95%.[33]

Next, the Commissioner presented the evidence of his experts, Professors Schwindt and Globerman, who, using Professor West's definition of the relevant geographic markets and market share levels, developed the following three categories of markets:[34]

> "Category 1": Identified eight markets where Superior's and ICG's market shares were relatively small. The concern expressed by the Commissioner in this market category is that it would remove ICG as a potential future competitor.
>
> "Category 2": Identified 33 local markets where Superior and ICG are the largest propane sellers. The concern expressed by the Commissioner in this market category is that the proposed merger would result in a SLC by creating a dominant player. Further, as this category includes numerous fragmented competitors, the Commissioner was concerned that having a single dominant player would increase the likelihood of interdependence.
>
> "Category 3": Identified 16 markets where ICG has a substantial market share and, in addition to ICG, there are at least two other competitors, including Superior. The concern expressed by the Commissioner in this market category is that the proposed merger would enhance interdependence and lead to a SLC.

Additionally, Professors Schwindt and Globerman identified 16 "merger to monopoly markets" (95% market share or greater).

In the end, the Tribunal accepted Professors Schwindt and Globerman's conclusions "regarding the anti-competitive effects of the merger".[35] After having determined that the relevant geographic market is local, the Tribunal was entirely unwilling to place any importance on the fact that the Respondents' combined national market share was declining. The Tribunal would only consider market share data in the context of and consistent with its delineation of the appropriate market(s).

B. Barriers to Entry

The Tribunal paid considerable attention to the degree by which the retail propane industry is characterized by high barriers to greenfield entry or expansion by incumbents. To that end, paragraph 4.6.1 of the MEGs provides that "[t]he assessment of potential competition is a central and fundamental aspect of merger review under the Act".

The Tribunal accepted Madame Justice Reed's conclusion in *Hillsdown* that, in an industry with very low barriers to entry, a merged firm is not going to be in a position to charge supra-competitive prices for any significant length of time since that conduct will be met by either new entry or expansion by existing firms, or a combination of both, thereby pushing prices towards the competitive level as the supply and suppliers of the subject product or products flourish.[36] The Tribunal further noted that it is not the simple fact of entry that is important as much as it is the ability of firms to enter or expand to a sufficient scale and over a sufficiently short period of time so as to be in a position to discipline the merged entity. The Tribunal, thus, stated that:[37]

> Evidence of commencement of operations, per se, is insufficient to establish the competitive restraint on a supra-competitive price or a likely exercise of market power. Moreover, if the impact on price is delayed beyond a reasonable period, then entry for the purpose of the Act has not occurred even if new businesses have started their operations.

Interestingly, the Tribunal did not tie itself to the two year period which the MEGs suggest for determining the impact of entry, and instead asserted that it is a "matter of opinion" to be left to a Tribunal to consider in the circumstances.

After considering the evidence provided separately by the Commissioner and the Respondents, the Tribunal concluded that significant barriers to entry or expansion exist in the retail propane business. The Tribunal reached that conclusion on the basis of the following factors, among certain others:

- Contract Terms: The Tribunal concluded that as Superior and ICG both had exclusive contracts with most of their customers, and that such contracts had staggered terms such that, in any given year, only a portion of their customers were actually contestable, the contracts served as a significant deterrence to entry. The Tribunal's opinion was further bolstered by the fact that, among other things, Superior's supply contracts also contained automatic renewals on failure to give 180 days notice, a right of first refusal on a lower price and termination fees.

- Competitive Response to Entry: The Tribunal was satisfied that Superior's traditionally aggressive response to new entry, which primarily involves retaliation with intense price competition, is "[a]n important component in the decision to enter the market" and, therefore, serves as a barrier to entry.[38]

- Reputation: Evidence was presented to suggest that customers tend to only use propane suppliers they know and have experience with. Customer loyalty is thus an important factor since loyal customers are more likely to return than switch to a competing firm, particularly where they are not familiar with the latter company. In the case of retail propane sales, the Tribunal "accepts that reputation is an important feature ... to which customers attach value", and that "... the time to gain a reputation may make profitable entry more difficult and hence delays the competitive impact that an entrant would have in the marketplace."[39]

- Maturity of the Market: The Tribunal accepted the Commissioner's evidence that the retail propane business is mature, as represented by a relatively flat demand curve, and, by implication, that greenfield entry and/or expansion by incumbent firms is not facilitated by expanding markets.

- Capital Requirements and Sunk Costs: The Tribunal was not convinced that the absolute capital costs of entry or expansion were particularly relevant to a consideration of barriers to entry since, provided that a project is viable, an entrant can always seek financing in capital markets. On the other hand, the Tribunal concluded that sunk costs, which refer to the costs invested and which are not recoverable on exit from a market, are the costs that are relevant to consider. The Tribunal was of the view that the sunk costs in the retail propane business are sufficiently high so as to constitute a barrier to entry.

In making the above findings, the Tribunal effectively accepted each of the Commissioner's arguments regarding the existence of significant barriers to entry. The only factor that the Tribunal was not willing to accept as constituting a barrier to entry was the Commissioner's evidence that new entrants and expanding firms experience barriers in obtaining propane supplies on the basis that Superior and ICG can, and often do, use their considerable buying power and national presence to secure better trade terms, lower prices and a more flexible supply. Rejecting the claim that access to propane supplies constituted a barrier to entry, the Tribunal stated that:[40]

> The Tribunal accepts that new entrants and small firms seeking to expand bear the costs of investing in reputation with propane suppliers that incumbents do not have to bear and, to that extent, they face entry barriers. However, these costs are not a result of the merger and are not increased by it. Other advantages that reduce the costs of propane acquisition (such as buying at low "off season" prices and storing) to the Respondents and the merged entity reflect efficiencies and do not create barriers to propane acquisition. The Tribunal does not agree that the new entrants and expanding firms face significant barriers to obtaining propane supply. (emphasis added)

The Tribunal's conclusion as to whether access to propane supplies constitutes a barrier to entry seems wholly reasonable. For example, there was no evidence of a practice by Superior and ICG to enter into exclusive arrangements for the supply of propane from upstream producers which, if sufficiently widespread, may have constituted a barrier to entry. However, the Tribunal's statement to the effect that the costs facing entrants and incumbents associated with developing supply arrangements do not represent barriers because they "are not a result of the merger and are not increased by it" was curious. If this were the appropriate test, then it is not clear why things like reputation and maturity of the market are considered barriers to entry, since neither are directly related to the merger. The guiding factor is, and must remain, whether the existence of a particular condition (which may or may not be related to a merger) in the subject industry serves to deter or impede entry or expansion. As a result, the Tribunal's comments with respect to access to propane muddies the water somewhat.

For the most part, the Tribunal's conclusions regarding the various factors relating to barriers to entry were relatively straight-forward. The only area that deserves particular mention is with respect to sunk costs.

The Tribunal gave sunk costs relatively brief analysis. It correctly affirmed that sunk costs, because they are not recoverable, are the only costs relevant to a consideration of barriers to entry. Other costs, although potentially large, can be financed and ought not to be considered a barrier to entry. The costs it considered to be sunk

included (for the retail propane industry at least) market development costs, site-preparation costs, discounts to purchase price that would be incurred on asset disposals, and salaries and operating costs incurred to the date of exit. The evidence of two witnesses suggested that sunk costs in the retail propane business range from between 30% and 80% of start up costs. Without any further discussion, the Tribunal stated that it "is satisfied that sunk costs are meaningful in the industry and constitute a significant obstacle to a new entrant."[41]

In arriving at the above conclusion, it is noteworthy that the Tribunal seems to have placed weight on the absolute value of the sunk costs rather than the proportionality of the sunk costs relative to the possible returns. Simply stated, *ex ante*, sunk costs represent risk. Presumably, the greater the possible returns on investment, the greater are the total amount of sunk costs that an investor or firm will be willing to risk. The MEGs confirm this as follows: "The focus of the Bureau's assessment of sunk costs is upon whether the likely rewards of entry, the likely time required to become an effective competitor and the risk that entry will not ultimately be successful, taken together, justify making the sunk investments that would be required to undertake the entry initiative" [42] In *Superior Propane*, however, the Tribunal did not give any mention to the proportionality of the sunk costs to these stated factors.

C. Removal of a Vigorous and Effective Competitor

The next evaluative factor considered by the Tribunal was whether the proposed merger would result in the removal of a vigorous and effective competitor, in this case ICG.

The Respondents argued that ICG is an "ineffective and inefficient competitor".[43] In support of their contention, the Respondents argued that first, the various independent propane suppliers, and not ICG, discipline Superior's prices. Next, the Respondents presented financial performance comparisons between Superior and ICG to suggest that, as ICG is not as profitable as is Superior, ICG is not a vigorous and effective competitor. The Respondents also argued that, as ICG does not compete for all of Superior's customers, ICG is not a strong competitor.

The Tribunal rejected the Respondents arguments, instead finding that ICG is, in fact, a vigorous and effective competitor in the retail propane industry. The Tribunal was not convinced that Superior's approach of comparing the financial performance of both companies is appropriate, not to mention the fact that the Tribunal was of the view that there was not a significant disparity in the two companies' financial performance. Furthermore, the Tribunal appeared to chastise the Respondents' focus on financial performance rather than on ICG's impact on competition. [44] The Tribunal also stated that there is no requirement that a competitor compete for all of a company's business in order to be a vigorous and effective competitor. Instead, the Tribunal noted that "... what appears to Superior as weak competition from ICG may simply be ICG's strategy of competing more intensively for larger accounts which are smaller in number than smaller accounts" [45] Finally, the Tribunal placed some significance on the fact that ICG was Superior's only competitor that was offering innovative programs designed to attract customers, ostensibly away from Superior.

D. Foreign Competition and Effective Remaining Competition

Pursuant to paragraphs 93(a) and (e) of the Act, the Tribunal next considered the extent to which foreign products, foreign competitors and/or domestic competitors would provide effective competition to a merged Superior/ ICG following the completion of the proposed merger.

With respect to foreign competition, the Tribunal was of the firm view that there was little chance that foreign entities or products would compete with a combined Superior/ICG. In particular, the Tribunal stated that, "for a variety of reasons, including billing systems, foreign currency, language and different measurement systems, it appears to the Tribunal that American firms are unlikely to provide effective competition to the merged entity in the Canadian retail propane market."[46]

The Tribunal was also of the view that, following the proposed merger, there would be a loss of effective competition, thereby noting that "the Commissioner's concern for effective remaining competition is well founded."[46] First, the Tribunal took stock of the fact that, following the merger, there would remain only one provider of national co-ordination services. Second, the Tribunal accepted that a combined Superior/ICG would be the price leader while independents would be price followers. With the loss of ICG to discipline Superior's prices, the Tribunal felt that there was little chance that independent propane sellers would challenge Superior's prices; thus, giving weight to the Commissioner's concerns regarding interdependence. Finally, the Tribunal rejected the Respondents' arguments pertaining to the possibility of new competitors arising as a result of supply-side substitutability.

The Tribunal's conclusions regarding foreign competition and effective remaining competition may have implications on the appropriateness of a rigid total surplus standard for the efficiency defence. This would certainly be the case if, on appeal, the Federal Court of Appeal were to determine that section 1.1 of the Act informs section 96 since, among other things, that section states that one of the objectives in promoting competition is "to promote the efficiency and adaptability of the Canadian economy, in order to expand opportunities for Canada's participation in world markets while at the same time recognizing the role of foreign competition in Canada ...". Having found that the merger will not result in a merged Superior/ICG being better placed to compete in international markets, or that foreign companies will not be able to more vigorously compete in Canada, the true benefit of the resulting efficiency savings from the merger, as compared to the resulting negative price effects, becomes unclear. In other words, if section 96 is intended to facilitate an efficient Canadian industrial sector (*i.e.*, by placing the goal of efficiency ahead of competition) so that Canadian companies can better compete in domestic and world markets, and if the facts reveal that in the context of a particular merger – such as in *Superior Propane* – there are natural barriers against this from happening, then the appropriateness of section 96 in such circumstances is questionable.

(iii) Prevention of Competition

In addition to finding a SLC in numerous local markets, the Commissioner submitted that the proposed merger would, or would be likely to prevent competition in Atlantic Canada substantially. As the Respondents did not

call any evidence or make any submissions regarding this allegation,[48] it is not surprising that the Tribunal agreed with the Commissioner's assessment regarding the impact of the proposed merger on competition in the Maritimes.

In finding that the proposed merger would lead to a substantial prevention of competition, the Tribunal followed the approach recommended in the MEGs, as well as that followed by the Supreme Court of Canada in *Howard Smith Paper Mills Ltd. et al.* v. *The Queen*,[49] whereby the term "prevention" is to be treated as akin to the ability to "hinder or impede" competition. In this case, the Tribunal relied on ICG's internal corporate plans that discussed ICG's intention to expand into Atlantic Canada. As the merger removed ICG as an independent competitor to Superior, those plans would not be carried out and, therefore, competition in Atlantic Canada was hindered or impeded, (*i.e.*, "prevented").

(iv) Enhanced Market Power Following the Completion of the Proposed Merger of Superior and ICG

Having concluded that the merged entity would have very high market shares in a substantial number of local markets, and that numerous factors existed to suggest that the proposed merger would result in a SLC and a substantial prevention of competition, the Tribunal firmly rejected the Respondents' argument that evidence of an actual or likely price increase was a condition precedent to finding that a proposed merger would likely result in a SLC or a substantial prevention of competition. Instead, the Tribunal held that it is the ability of the merged party to exert market power and, therefore, to act in an anti-competitive manner that is important. In particular, the Tribunal stated the following:[50]

> The Tribunal concludes that evidence of an actual or likely price increase is not necessary to find a substantial lessening of competition. What is necessary is evidence that a merger will create or enhance market power which, according to paragraph 2.1 of the MEG's, cited at paragraph [57], is "the ability to profitably influence price, quality, variety, service, advertising, innovation or other dimensions of competition" There is no requirement under the Act to find that the merged entity will likely raise the price (or reduce quality or service). The only requirement under section 92 is for the Tribunal to decide whether the merged entity has the ability to do so.

According to the Tribunal, therefore, the key issue was not whether the merged entity will raise prices, but whether it can do so (among other possible things). In determining the extent to which a combined Superior/ ICG could raise prices, the Tribunal examined the substitutability between their products, thereby determining the impact that each company had on the other's sales. The Tribunal accepted the evidence of the Commissioner's expert, Professor Ward, that, based on certain price and volume data pertaining to Superior and ICG, an increase in ICG's prices would result in a gain in Superior's market share in the residential and industrial segments. As well, an increase in Superior's prices would result in a decrease in its market share, presumably in favour of ICG.[51] According to Professor Ward, this trend is evidence of consumer substitution between Superior's and ICG's propane. On the basis of the market simulation models employed by Professor Ward, the Tribunal was satisfied that the proposed merger would lead to price increases of 8% or more.

Interestingly, although the Tribunal was of the view that market power rather than evidence of price increases is the key factor for determining an SLC, it noted that evidence of the anticipated price increase is necessary for calculating the deadweight loss for the purposes of the efficiencies defence under section 96 of the Act.

(b) Conclusions on SLC and Substantial Prevention of Competition

As stated above, the Tribunal was most concerned with whether the proposed-merger would result in enhanced market power by a combined Superior/ICG[52]. Ultimately, the Tribunal was more satisfied than not that the proposed merger would likely create additional market power for a combined Superior/ICG.

In particular, the Tribunal concluded that the proposed merger would lead to a SLC or prevention of competition in the following market categories and regions:

- the 16 local markets where a combined Superior/ICG's market share would exceed 95%, the so-called merger-to-monopoly markets, such that Superior/ICG would be able to unilaterally raise prices;
- the 16 local "category 3" markets where, pre-merger, ICG had a substantial market share and both Superior and at least one other company participated. The Tribunal was concerned that within this category the proposed merger would enhance interdependence and reduce competition;
- in Atlantic Canada where the possibility of future *de novo* entry by ICG would be lost, thus resulting in a substantial prevention of competition; and
- in national co-ordination services whereby only one national retail propane supplier would remain.

Also, the Tribunal expressed concern over the impact of the proposed-merger on the 33 "category 2" markets in that the merger might result in increased interdependence in those markets, although it did not reach any definitive conclusions on this point. The Tribunal accepted that the combined entity would have a market share in excess of 70% nationally. The only markets where the Tribunal was definitively of the view that there would be no SLC were the 8 "category 1" markets on the basis that the proposed merger would have little impact on these markets.

(c) Remedy

After finding that a combined Superior/ICG would have enhanced market power, ultimately resulting in a SLC and substantial prevention of competition in numerous markets, the Tribunal stated that it "is of the view that the sole remedy appropriate in this case would be the total divestiture by Superior of all of ICG's shares and assets (including those of the previously integrated branches thereof)."[53] The Tribunal did not believe that a partial divestiture was appropriate in the circumstances.

On its face, having found that the proposed-merger would result in a SLC and substantial prevention of competition in numerous markets throughout Canada, the Tribunal's decision regarding the appropriate remedy under section 92 seems reasonable. However, in light of the lack of case law pertaining to the remedies under section 92, we believe that the Tribunal missed a good opportunity to discuss the scope of its powers under that section.

Paragraph 92(1)(e) of the Act provides that in the case of a completed merger, the Tribunal can "order any party to the merger or any other person" to "dissolve" the merger or "dispose" of assets or shares. In this case, the Tribunal noted at the outset of its decision that it was considering an application "for an order to dissolve the merger" of Superior and ICG.[54] Yet, when it came to setting out its remedy, the Tribunal dealt exclusively with the divestiture option and did not pay any attention to "dissolving the merger", whatever that may mean in the context of section 92 of the Act. For example, does the reference to "any other person" mean that, barring some other exceptional circumstance, the Tribunal could have required Petro-Canada, as Chancellor/ICG's parent, to take back the shares of ICG? Or is the dissolution provision only intended to deal with combination or amalgamation type arrangements whereby the parties could more easily take back what they contributed? While we are not suggesting that dissolution was necessarily an appropriate remedy in the circumstances, it should have received some mention. Indeed, as the Tribunal had already stated or concluded that foreign corporations are not likely to enter the market, that ICG's business had already been shopped around for possible buyers when Superior came along, and that Imperial Oil Limited had exited the market within the past ten years, requiring divestiture is an uncertain remedy. As it was not even addressed by the Tribunal, the scope of the dissolution option under section 92 of the Act will remain a live issue for future Tribunals to consider.

3. The Efficiency Defence – A Case Review

Having determined that an order should be made under section 92, the Tribunal turned its attention to section 96 of the Act, the efficiency defence.[55] Subsection 96(1) of the Act provides that:

> The Tribunal shall not make an order under Section 92 if it finds that the merger or proposed merger in respect of which the application is made has brought about or is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition that will result or is likely to result from the merger or the proposed merger and the gains in efficiency would not likely be attained if the order were made.

In evaluating and applying section 96, the Tribunal grappled with a number of evidentiary and interpretative issues, including the following: (i) the appropriate burden and onus of proof; (ii) the scope and measurement of the likely efficiencies; (iii) the meaning to be given to the phrase "not likely ... attained if the order is made"; and (iv) the trade-off analysis. The most contentious, and perhaps critical, issue in the section 96 analysis is the meaning of the phrase "effects of any prevention or lessening of competition" against which efficiencies are to be balanced.

In *Superior Propane*, the Commissioner argued that the relevant effects of a merger include the transfer of surplus from consumers to producers as a result of anticipated post-merger price increases, while, conversely, the Respondents argued that examined effects are to be limited to allocative inefficiencies as captured by the size of the deadweight loss. In the subsections that follow, we outline the key issues considered by the Tribunal in assessing these competing views.

(a) Background to the Efficiencies Determination in *Superior Propane*

(i) Overview: Efficiencies and Merger Analysis

Modern antitrust analysis, at least with respect to issues surrounding merger review, has increasingly focused on the correct role and weight to be given to efficiencies in evaluating the utility of mergers. Generally speaking, there are two primary views, or "camps", as to the appropriate role and weight to be accorded to efficiencies in merger review. On the one hand are those who view the primary criterion of merger policy as the maximization of overall economic efficiency. On the other hand are those who emphasize the role of competition policy in protecting consumers from the price rising tendencies of a dominant firm.

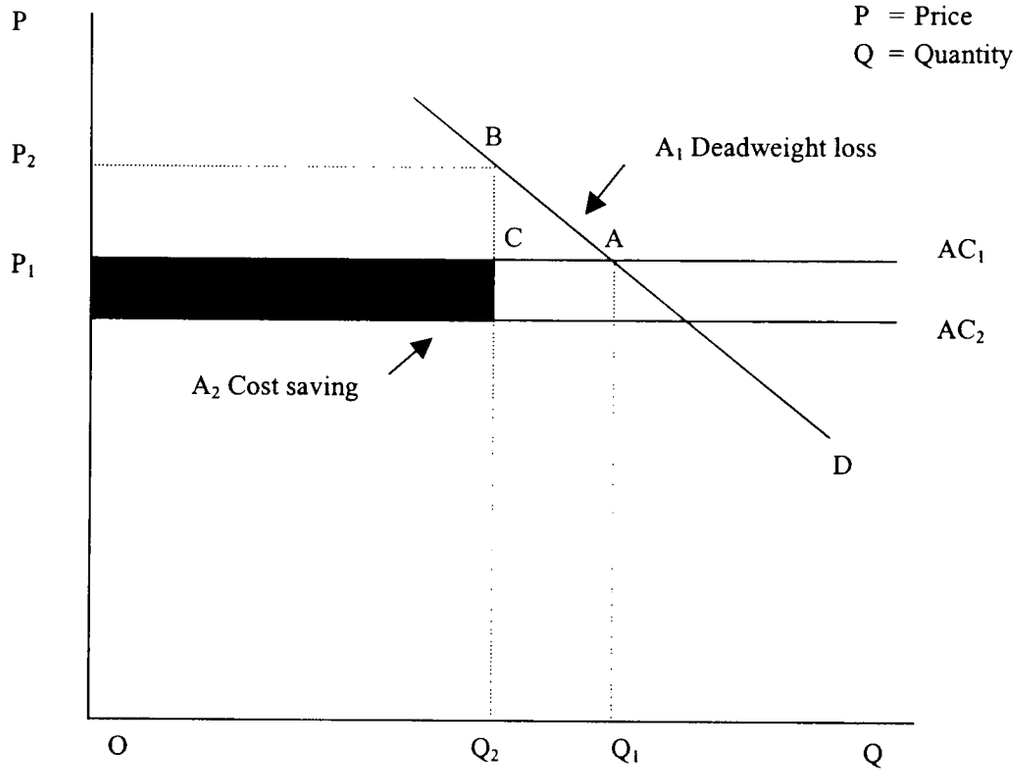
The proponents of efficiency as the sole objective of merger review policy have rallied around what is generally referred to as the "total welfare" or "total surplus" standard. Under this standard, except in the circumstances described below, market power is undesirable as it leads to allocative inefficiencies. However, where it can be demonstrated that the economic efficiencies generated by a merger are likely to outweigh the post-merger allocative inefficiencies resulting from the exercise of market power — which stems from an anticipated post-merger decline in the quantity produced and a corresponding increase in price — a merger should be permitted. Furthermore, in accordance with this view, transfers of wealth from consumers to producers are held to be irrelevant in that a dollar in the hands of the consumer is to be treated no differently than a dollar in the hands of the producer (or the producer's shareholders).

Opponents of the total surplus model maintain that merger policy should be focused on the effects that a merger has on consumers. Wealth transfers are thus not neutral, but form a fundamental part of merger analysis. Protecting consumer surplus means that anti-competitive mergers should be allowed only if: (i) the expected efficiencies are sufficiently large such that prices will not increase post-merger (the "price standard");[56] or (ii) that the efficiency gains that will result from the merger are greater than the entire expected loss of consumer surplus (the "consumer surplus standard"); or (iii) more moderately, the degree of the loss of consumer welfare or surplus is, in some manner, part of the analysis when assessing the acceptability of a merger due to anticipated efficiency gains.[57]

Much of the theoretical framework underlying the total surplus standard stems from the writings of Professor Oliver Williamson beginning in the late 1960s.[58] Williamson's basic model is set out in the following diagram:

The Williamson Model

AC_1 = pre-merger average cost
AC_2 = post-merger average cost
D = demand
P = Price
Q = Quantity



In the above model, which describes the movement from a duopoly to a monopoly market, the pre-merger price is represented at P_1, while the post-merger price is represented at P_2. AC_1 represents each duopolist's average cost before a merger. Post-merger average cost is represented by AC_2 which demonstrates the existence of cost savings or efficiency gains. The area within the triangle A_1 represents the loss of allocative efficiency to the economy which follows the anticipated post-merger drop in production if costs were to remain constant. This is referred to as the "deadweight" loss. However, as average costs will decrease post-merger, cost savings must be measured against the deadweight loss. Thus, as long as the area representing the deadweight loss is smaller than the shaded area at A_2, which represents the increase in producer surplus attributable to efficiency gains, the net allocative efficiency effect of the merger is regarded to be positive. Insofar as the promotion of efficiencies is the fundamental goal, the situation represented in the above model would result in a merger being permitted to proceed.

The Williamson model suggests that "a relatively modest cost reduction is sufficient to offset relatively large price increases even if the elasticity of demand is as high as two, which for most commodities is probably a reasonable upper bound".[59] The model, as generally demonstrated, indicates that deadweight loss is small relative to the total loss of consumer surplus which includes both the deadweight loss and the area of the rectangle formed by P_1, C, B and P_2. However, it is understood that the relative size of the deadweight loss may be changed when factors such as pre-existing market power, the amount of the market controlled by the post-merger entity, demand assumptions and assumptions concerning competitive reactions are adequately accounted for.[60] While the addition of these complexities to the basic model may increase the size of the efficiencies needed to outweigh the deadweight loss, they do not alter the basic conclusion derived through the model; namely that including considerations of consumer welfare in merger analysis will require the demonstration of larger efficiency savings.[61]

(ii) Pre-*Superior Propane* Consensus

To some extent, the Canadian debate between the proponents of the total surplus standard and the proponents of the consumer surplus standard has been, until recently, less wide-ranging than the debate among scholars of United States merger law. In the U.S., the decades old debate has focussed upon both the economic assumptions of the Williamson model and on notions of Congressional intent with respect to the relevant legislation. It is noted that there are no explicit references to efficiencies within U.S. antitrust legislation, and that at least some scholarly examinations of the legislative history of the *Sherman* and *Clayton Acts* suggest that consumer protection concerns, not economic efficiency generally nor allocative inefficiency in particular, was the rationale behind Congress's concerns over the ability of a post-merger entity to raise prices.[62] As a result, the role of efficiencies within the U.S. is less certain as it effectively derives from (contradicting) judicial decisions and the Department of Justice/Federal Trade Commission's *Horizontal Merger Guidelines* (the "Guidelines"), rather than from explicit legislative reference.[63]

Certain components of the U.S. debate concerning legislative intent do not inform the discussion in Canadian merger analysis. For example, there can be no doubt that the drafters of Canada's Act were aware of the

Williamson model and the debate in the U.S. concerning the appropriate measure of economic "harm" against which to balance efficiencies. Indeed, in our view, the very existence of an efficiency defence indicates legislative intent with respect to the promotion of efficiency. As such, the current debate in Canada is not about whether efficiencies have a role in merger analysis, but on the precise nature of that role. Even this debate has been muted by the fact that, prior to *Superior Propane*, the private competition law bar and the Commissioner agreed that the balancing between efficiencies and effects required under section 96 was that contemplated by the total surplus standard. Indeed, the MEGs effectively endorse this approach as follows:

> Section 96(1) creates a trade-off framework, in which efficiency gains that are likely to be brought about in Canada are balanced against the anti-competitive effects that are likely to result from the merger. In this context, anti-competitive effects refer to the part of the total loss incurred by buyers and sellers in Canada that is not merely a transfer from one party to another, but represents a loss to the economy as a whole, attributable to the diversion of resources to lower valued uses. This loss is sometimes referred to as the deadweight loss to the Canadian economy. An order cannot be made in respect of a merger where it can be established that gains in efficiency that would likely be brought about by the merger will be greater than, and will offset, the effects of any prevention or lessening of competition that will result or is likely to result from the merger.[64]

In 1998, the Commissioner confirmed the total surplus standard in his *Merger Enforcement Guidelines as Applied to a Bank Merger* (the "Bank MEGs").[65]

The Act, however, does not explicitly endorse the total surplus standard; for example, section 96 does not use the terms "total surplus", "deadweight loss" or "consumer surplus" As indicated above, the section 96 trade-off simply calls for the balancing of efficiency gains against "the effects of any prevention or lessening of competition that will result or is likely to result from the merger or proposed merger". As noted elsewhere, the word "effects", as it relates to a lessening or prevention of competition, is capable of supporting numerous interpretations, including ones which take into consideration social and distributional effects.[66] The total surplus standard is thus dependent upon a narrow interpretation of the word "effects", namely being restricted to those contemplated by the Williamson model (*i.e.*, the economic effects measured by the shift in production).

The general consensus in support of the total surplus welfare model was initially brought into question by Madame Justice Reed in *Hillsdown*. Having reviewed section 96, Madame Justice Reed was perplexed by the fact that the (then) Director of Investigation and Research (the "Director")[67] and the merging parties both assumed that section 96 contained a total surplus standard when, in actual fact, a specific standard has not been prescribed by that section. Accordingly, Reed J. remarked that:[68]

> If only allocative inefficiency or the deadweight loss to the Canadian economy was intended by Parliament to be weighted in the balance, then one would have thought that the section would have been drafted to specifically so provide. The interpretation which both the Director and Respondents put on s.96 requires a reading down of the phrase "effects of substantial lessening of" so that it does not include the transfers from consumers to producers which will generally be the largest effect of the substantial lessening.

However, as the above remark was made after Madame Justice Reed had found that the proposed merger would not likely result in a substantial lessening or prevention of competition, it was expressed in *obiter*. Even so, Madame Justice Reed's interpretation of section 96 caused a certain degree of consternation amongst economists and the competition law bar. However, the effects of her comments were minimized by the Director's reaction to them. Clearly viewing Madame Justice Reed's interpretation as inaccurate, and noting that her comment was made in *obiter*, (former) Director Wetston indicated that he felt no obligation to alter the MEGs in light of the *Hillsdown* decision.[69] As a result of the Director's statements in response to *Hillsdown* and coupled with the reaffirmation of the total surplus standard in the Bank MEGs, prior to *Superior Propane*, merging parties could take comfort in the fact that the Commissioner — the investigator and prosecutor under section 92 of the Act — was committed to the total surplus standard. This supposed uniform interpretation of section 96 amongst competition law practitioners and the Commissioner was, of course, shattered in *Superior Propane* when the Commissioner abandoned his stated view.

(b) The Decision in *Superior Propane*

(i) Burden of Proof

As to the appropriate standard of proof required under section 96, there appeared to be no issue in contention between the parties. Owing to the fact that merger review is contained in the civil reviewable matters section of the Act, the Tribunal correctly held that the appropriate standard is "a balance of probabilities."

With respect to the burden of proof, the Commissioner was of the view that the Respondents bore the burden of proving all of the elements of the efficiency defence, including demonstrating the anti-competitive effects of the merger. The Respondents appeared to acknowledge that they were required to demonstrate the likelihood and size of post-merger efficiencies. However, they also argued that it fell to the Commissioner to demonstrate that the efficiencies could be achieved other than through the merger, as well as to demonstrate the extent of the "effects" of any prevention or substantial lessening of competition. The Tribunal determined that the burden resided with the Respondents to demonstrate all elements of the defence, save for demonstrating the anti-competitive effects element.

In our view, the Tribunal's discussion in this regard is sensible. To begin, notwithstanding the Commissioner's investigative powers under section 11 of the Act, the Commissioner is clearly not as knowledgeable as are the merging parties of other options and strategies for generating cost savings in lieu of the proposed merger. Should a respondent wish to rely on the efficiency defence, it should be the respondent's burden to demonstrate why efficiencies would not likely be gained in a manner other than through the proposed merger. This seems especially so as a respondent need not demonstrate that the efficiencies are unique to the merger, but only that they would not likely be obtained in some other manner.[70] Although the Commissioner cited both *Hillsdown* and *Canadian Pacific*[71] for the proposition that the entire burden of the efficiency defence resided with the Respondents, neither case is determinative, or for that matter, particularly helpful. In *Hillsdown*, the Tribunal's comments can rightly be dismissed as being made in *obiter*, while its comments in *Canadian Pacific* were with respect to a request for particulars.

In our view, the Tribunal's decision to allocate to the Commissioner the burden to establish the likely magnitude of anti-competitive "effects" of the merger is entirely appropriate in the circumstances. Intuitively, requiring the Respondents to establish the deadweight loss makes little sense since it would be in the Respondent's best interest to argue for the smallest figure possible. Instead, requiring the Respondents to quantify the efficiency gains and the Commissioner to quantify the deadweight loss should result in the most accurate comparison since, presumably, both parties would be driven to derive the largest figure possible.

(ii) Quantum of Efficiency Gains

The MEGs recognize two broad classes of efficiencies, namely production efficiencies and dynamic efficiencies. Production efficiencies include product level, plant level and multi-plant level operating and fixed cost efficiencies; savings associated with integrating new activities within the merged entity; and savings attributable to the transfer of superior production techniques and know-how from one of the merging parties to the other.[72] Dynamic efficiencies include gains attained through the optimal use of new products, the development of more efficient productive processes, and the improvement of product quality and service. As recognized in the MEGs, dynamic efficiencies are difficult to quantify because they are generally qualitative in nature.

In *Superior Propane*, the Tribunal did not pay any attention to possible resulting dynamic efficiencies. Presumably, the dynamic efficiencies arising from companies engaged in retail propane sales would not have been significant, at least, for example, as compared to a merger involving companies heavily engaged in research and development. However, some mention of this efficiency type would have been welcome. As such, the full scope of the dynamic efficiencies to be considered by the Tribunal, as well as how they are to be quantified, is left for another day.[73]

A. Measuring the Efficiency Gain

According to the Respondents' expert report, referred to as the "Cole-Kearney" report after its authors, the efficiency gains arising from the merger would benefit three major areas of Superior's operations: corporate centre, customer support and field operations. A discussion of the specific details of these claims is beyond the scope of this paper. However, in brief, the Respondents argued that reductions in personnel, facility requirements and cost savings resulting from the elimination of redundancies in overlapping field and distribution operations in combination with larger delivery volumes would amount to cost savings of $440.8 million over a ten year period,[74] or a projected annual efficiency gain of $40.08 million.[75] While accepting $440.8 million as the starting point for an examination of cost savings, the Tribunal posited that the most appropriate method to value costs and receipts resulting from mergers is through the discounting of cash flows at the time of disbursement or receipt at an appropriate discount rate to present value. The Tribunal noted that this net present value approach was apparently abandoned by the Respondents at the time of the hearing.[76]

The Commissioner elected not to lead evidence on the question of efficiency gains, but opted instead to rebut the assumptions and attack the underlying methodologies made in the Respondents' expert report. The Commissioner argued that the Respondents' report overstated the size of the non-pecuniary cost savings from the merger. The

Commissioner instead argued that reasonably expected post-merger efficiencies would amount to only $21.2 million per year and that this figure should then be further reduced to account for contingencies.

The Tribunal ultimately accepted that post-merger efficiencies arising from the merger were likely to be $29.21 million per year. In arriving at this figure, the Tribunal clearly did not agree with the sum total of the Respondents' quantification of the efficiency gains. The Tribunal made reductions to the Respondents' total claimed efficiencies in the areas of procurement, avoided public costs related to plans to take ICG public, fleet and driver reductions, supply and transport reductions, as well as certain additional reductions to account for management fees and other incidentals.

The precedent setting value of the Tribunal's quantification of the efficiencies is somewhat diminished by the fact that its considerations were particular to the specific facts of the case and that the Tribunal failed to provide, in any extensive manner, its methodology and rationale for determining the appropriate value of the efficiency-related savings. Having said that, the Tribunal did provide explanations with respect to certain types of items which may have some relevance in determining the quantum of efficiencies in future cases. Accordingly, below is a brief discussion of such items which may have more general application.

B. Management Incentive Programs

Evidence before the Tribunal indicated that Superior was managed pursuant to a Management Agreement (the "Management Agreement") by Superior Management Services Limited Partnerships ("SMS"). The Superior Incentive Trust (the "Incentive Trust") held the class A units of SMS and, as such, received distributions of the management fees paid to SMS by Superior. A three person management group at Superior held 28 percent of the units in the Incentive Trust, with the remainder being held by a group of investors comprising Enterprise Capital Management Inc. Profit incentives were a component of the Management Agreement. As such, the Commissioner pointed out that if the merger resulted in $40 million in efficiency-related gains, this would amount to distributions to the unitholders of approximately $7.5 million per year. The Commissioner further argued that this entire $7.5 million amount should be deducted from the claimed efficiencies, and not just the 28% of the fees that would be distributed to the management group, since all investors had management obligations, either through board representation or as part of the management team.

The Respondents, on the other hand, argued that no deduction was proper on the basis that the fees did not constitute an economic cost to the firm since management was fully charged with management obligations prior to the distribution of the fees. In addition, the Respondents submitted that the arrangement should be more properly seen as an investment, with payments from the Incentive Trust being categorized as distributions of profit rather than compensation for management services. In this respect, the Respondents pointed to interest-free loans that management received from the other investors to facilitate their 28% purchase of the Incentive Trust units, as well as the transferability of the units.

The Tribunal ultimately disagreed with the Respondents regarding the treatment to be given to the distributions. According to the Tribunal, although management may receive investment income from a corporation, insofar as

the provision of such investment income can be described as a technique for improving the quality and quantity of managerial efforts, they are properly deducted from any claimed efficiencies as a true economic cost. The Tribunal did, however, disagree with the Commissioner's view that anticipated distributions to non-management group investors should be deducted.

C. Municipal Property Taxes

The Respondents argued that post-merger savings in municipal property taxes, presumably resulting from the consolidation and closing of facilities, are not just pecuniary in nature because they also represent real savings to the municipalities who will not have to supply the same level of services to the merged entity that they had to provide to Superior and ICG separately. The Tribunal noted that under the MEGs property tax savings are said to represent a redistribution of income from taxpayers to firms and, as such, are pecuniary. Furthermore, the Tribunal noted that the provision of certain services funded by taxes, such as education and health care, will not be reduced by the combination of Superior and ICG. That said, the Tribunal suggested that certain deductions may be classified as cost savings, as follows:[77]

> [T]he Tribunal suggested a principled way of distinguishing between pecuniary and real savings in the area of local services and taxes. If the firm receives an invoice for products or services provided by local government (e.g., the water bill from the local authority) and if the merged entity will use less of that product or service, then the savings are appropriately regarded as resource savings. Where it is not possible to determine whether property tax savings represent real resource savings or pecuniary redistribution, the Tribunal agrees with the Commissioner that no claimed efficiency savings should be allowed. However, in this case, as the amount claimed by the Respondents is relatively small, the Commissioner does not seek to reduce the efficiencies by that amount.

D. Pre-Merger Planning Costs

The Commissioner argued that the costs attributable to pre-merger planning and the costs of preparing the expert report for the proceedings before the Tribunal should be deducted from the claimed efficiencies. The Tribunal rejected this argument, instead finding that:[78]

> [T]he costs of the Cole-Kerney Report and the pre-merger planning costs should not be deducted from the claimed efficiencies. The reason is that these costs have been incurred and do not depend on whether the merger is allowed to proceed or on whether the efficiencies will be achieved. These costs are sunk costs and hence differ from the costs (e.g., severance payments) that will be incurred as a result of implementing the merger. Thus, as an economic matter, it would be appropriate to deduct the consulting fees only, for example, if they were contingent on the outcome of the instant hearing, for in such a case they would not be sunk.

(iii) The Dissent and the Quantum of Efficiency

On the issue of determining the quantum of efficiencies, Ms. Christine Lloyd was of the view that since the Respondents were unable, on a balance of probabilities, to demonstrate the claimed efficiency savings, she effectively attributed no efficiency savings to the proposed merger. This conclusion is somewhat curious in light

of the fact that even the Commissioner was satisfied that the merger would result in excess of $20 million per annum in savings, albeit subject to deductions for contingencies.

In reaching the above conclusion, it is noteworthy that Ms. Lloyd distinguished between theoretical efficiencies and efficiencies that were likely to materialize post-merger. She specifically noted that the Respondents had not presented the Tribunal with developed business plans and that this cast doubt on whether the Respondents' claimed efficiencies were likely to be realized. Ms. Lloyd thus noted that:[79]

> A business plan setting out the implementation process/action plan outlining time frames for each step of the integration of the merger is necessary to achieve the claimed efficiencies. I take note that Mr. Inglis mentioned that Superior had a plan that was well articulated and that had been scrutinized over a long time frame. Unfortunately, the Tribunal was not presented with that alleged plan or any other plan. In fact, no such evidence was presented at the hearing. ...It appears to me that a detailed business plan which expresses clearly the commitment and accountability of Superior's management (including the commitment of the chief executive officer) should have been demonstrated. Further, there is no evidence that any study or due diligence was conducted to determine the cost effectiveness of merging the two companies prior to the decision by Superior to acquire ICG. Had this exercise been undertaken, the cost savings presented by Cole-Kearney would have had more credibility. Consequently, it appears to me that the realization of efficiencies claims strictly remain possibilities and not probabilities. Hence, the respondents have not demonstrated on a balance of probabilities that the efficiencies are likely to be realized.

Ms. Lloyd's concerns regarding the paucity of internal company evidence regarding the Respondents' plans to achieve the claimed efficiencies are well taken. Subsection 96(1) of the Act explicitly requires the Tribunal to consider whether efficiency savings have been "brought about" or are "likely" to be brought about. Ms. Lloyd's concerns go to the evidence necessary to establish the likelihood of the claimed efficiencies being achieved. In *Canadian Pacific*,[80] for example, the Director brought a motion before the Tribunal for an order requiring the Respondents to better particularize the efficiency gains that they claimed would be derived from their merger. The Tribunal agreed with the Director's assessment that the Respondents claims were insufficient and unsubstantiated, and required the Respondents to "provide further particulars that contain a meaningful list of the types of efficiency gains."[81] The Tribunal further noted in that case "[t]o be meaningful, the further particulars are to include a brief description of the manner by which efficiency gains were or will be achieved for each of the items now listed in the CP Reply."[82]

In *Superior Propane*, Ms. Lloyd effectively tried to build on the Tribunal's decision in *Canadian Pacific* by requiring not only particulars of the types of efficiencies to be achieved, which the Respondents accomplished successfully, but also evidence of the Respondents' actual plans for achieving their claimed efficiency savings and other evidence to indicate their likelihood of being achieved. To the outside observer, it is odd that the Respondents did not present evidence of business plans and other internal documents outlining strategies for realizing efficiency gains arising from the merger. One would be hard-pressed, we would have thought, to find a company that does not do any forward-looking analysis in the face of a pending merger. Furthermore, Ms. Lloyd was quite correct to draw a distinction between theory and reality. The Tribunal should look behind the

theoretical efficiency savings and determine what savings are likely to be achieved and what are the parties committed to achieving. Ms. Lloyd's comments regarding the lack of business plans and internal studies submitted by the Respondents are fair, and should serve as a warning to future parties who seek to rely on section 96.

(iv) "Effects" and the Appropriate Balance

As has been previously mentioned, one of the most controversial aspects of the *Superior Propane* case was the Commissioner's revival and, indeed adoption, of the general tenor of Madame Justice Reed's views in *Hillsdown* regarding the inclusion of consumer wealth transfers when calculating the anti-competitive effects of a merger for purposes of balancing against efficiencies. The Commissioner, through evidence led by his expert, Professor Peter Townley, advocated a "distributional weights" standard. Under this standard, a certain amount of weight is accorded to the loss of consumer surplus arising from a merger. The appropriate degree of weight to be accorded depends on such things as the elasticity of demand for an examined product and the social and personal economic conditions facing consumers of the product in question. When quantified, the weighted loss of consumer surplus would be a component of the measured "effects" of the merger to be balanced against the efficiency gains arising therefrom. Owing to differing distributional weights, the Commissioner's proposed standard would mean that consumer surplus would count for more in situations of inelastic demand where a significant proportion of relevant consumers have a lower income base.

Much of the Commissioner's argument in support of a distributional weights standard stems from his interpretation of section 1.1 of the Act, the so-called "purpose" clause, and its role in aiding in the interpretation of section 96. Section 1.1 provides that:

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

With reference to the above, the Commissioner argued that section 96 can save a merger only when, on balance, it enhances the objectives of competition policy as stated in section 1.1 more than it diminishes them. To that end, the Commissioner pointed to the reference in the purpose clause to competitive prices and posited that the "effects" under section 96 of the Act include — to some degree — the loss of consumer welfare arising from increased post-merger prices.

The Tribunal rejected the notion that the listed objectives in section 1.1 inform the interpretation of section 96 of the Act, instead indicating that the goal of the Act is to maintain and encourage competition and that "the listing of objectives of competition policy simply presents the rationale for maintaining competition" [83] The Tribunal also stated that distributional concerns are not amongst the listed objectives in the purpose clause. In particular, the Tribunal stated that:[84]

> There are, of course, other objectives that could be sought, one such being the proper distribution of income and wealth in society. It is clear, however, that when competition is maintained and encouraged, the resulting distribution of income and wealth may not be the proper one depending on one's political and social outlook. By not including distributional considerations in the list of objectives in the purpose clause, Parliament appears to have recognized this. Indeed, if distributional issues were a concern, Parliament might have felt it necessary to restrict or place limits on competition in order to achieve the proper distribution of income and wealth in society.

We are in general agreement with the Tribunal's view of the (non)application of the purpose clause for interpreting section 96. A cursory examination of section 1.1 reveals that the goal of the Act is to maintain and encourage competition in Canada, and that the objectives – or "ends" - listed thereunder are examples of benefits expected to flow from competition. Having reference to the overall purpose of the Act, there is no need, in our opinion, to consider the obvious tensions between the stated ends to be achieved under section 1.1 (*e.g.* as between efficiency and maintaining opportunities for small businesses) and what consequences, if any, should be given to the order in which these ends are listed. The Act assumes, in general terms, that the listed objectives will be met through the promotion and maintenance of competition generally.

While the purpose of the Act is to maintain and encourage competition, it is certainly within Parliament's prerogative to subordinate this general goal in a specific context. In our view, this is precisely what Parliament has done by establishing section 96, which makes allocative efficiency the paramount goal in merger review by making it a defence to a SLC determination under section 92. In other words, a floor level of efficiency saving is a defence to the attainment of the purpose set out in section 1.1. For the purposes of merger review, therefore, beyond any other factor, efficiency takes precedence.

The Tribunal acknowledged the supremacy of efficiencies in merger review. In particular, the Tribunal stated that section 96 "signals the importance that Parliament attached to achieving efficiency in the Canadian economy" and that "section 96 makes efficiency the paramount objective of the merger provisions of the Act and this paramountcy means that the efficiency exception cannot be impeded by other objectives".[85] The existence of a separate statutory defence clearly indicates, in our view, Parliament's intention to promote the goal of fostering efficiency through merger transactions and that this goal transcends the goal of competition. By taking into account the inclusion of an exception to the general purpose of promoting competition, the Tribunal gave life to Parliament's clear intention.

Having found that allocative efficiency is the primary objective of merger review, the Tribunal adopted the total surplus standard which, as already explained, ignores the wealth transfer effects of a merger. The Tribunal accepted the Respondents' expert evidence as to the relative efficiency gains needed under the total surplus standard as compared to a consumer surplus standard. Such evidence indicated, in part, that when the price elasticity of demand is -1.5 and considering a price increase of 15%, the deadweight loss is 1.7% of sales but the transfer of consumer surplus is 11.6% of sales. As such, a merger that offered gains in efficiency of at least 1.7% of sales would be approved under the total surplus standard, while under a consumer surplus standard gains would need to be at least 13.3% of sales. In the Tribunal's view, the adoption of a standard which included the transfer of consumer surplus would effectively render the defence unachievable and, thus, in contradiction to

Parliament's intent. To that end, the Tribunal noted that it is "not prepared to adopt a standard that frustrates the attainment of that objective"[86] (*i.e.*, Parliament's intent). In our view, the Tribunal correctly examined the consequences of adopting a standard other than total surplus and then determined which consequences were most in line with the importance attached by Parliament to efficiencies.[87]

Before proceeding with an examination of the additional comments made by the Tribunal regarding the appropriateness of adopting the total surplus standard, a brief discussion regarding the Tribunal's comments on wealth distribution is merited.

Having correctly recognized the impropriety of engaging in a myopic ends focused examination of the purpose clause, the Tribunal muddied the water by nevertheless stating that the failure of section 1.1 to address distributional issues within its listed objectives confirms that such issues do not form a part of the analysis under section 96 of the Act. In particular, the Tribunal examined the purpose clause and concluded that distributional concerns are not enumerated as an "end" therein. The Tribunal pointed to this as evidence that distributional concerns are not intended to be a component of the required balancing of benefits and costs under section 96. In our view, the Tribunal should not have engaged in an examination of whether section 1.1 includes a recognition of distributional concerns. Instead, the Tribunal should have examined this exclusively within the context of section 96 — after having found that the goal of competition expressed in section 1.1 is subordinate to the goal of efficiency under section 96. Distributional concerns are not, of course, prescribed under section 96.

While the Tribunal was satisfied that the paramountcy of efficiency in merger review and the lack of distributive objectives within the Act support the total surplus standard, the Tribunal offered the following three additional reasons as to why the total surplus standard is appropriate: (i) it is predictable; (ii) Parliament has more effective tools than competition policy to deal with distributive concerns; and (iii) the Commissioner's own MEGs endorse the total surplus standard. We briefly review each of these three reasons below.

First, the Tribunal was critical of the balancing weights standard since it lacks predictability. Under that standard, the Tribunal would be asked to determine, on an *ad hoc*, case-by-case basis, whether the "gains to shareholders are more or less important to society than the losses imposed on consumers by the exercise of market power".[88] Presumably having reference to the previous "public interest test"[89], the Tribunal was concerned that such an examination would unnecessarily introduce unpredictability to the review process. Furthermore, the Tribunal noted that its lay members were chosen for their expertise in economic and commercial affairs and that the Tribunal's decisions should stem from such expertise, rather than socio-political considerations. The Tribunal thus noted that:[90]

> Adopting Professor Townley's approach would result in decisions that vary from case to case depending on the views of the sitting members of the Tribunal regarding the groups affected by the mergers.

Second, the Tribunal was of the view that merger law is not the appropriate framework within which to analyze distributional issues. In particular, the Tribunal noted that:[91]

> [G]overnments at all levels have adopted specific tax and social policy measures to address their distributional objectives. The Tribunal regards these measures as more effective ways of meeting social policy goals.

Third, the Tribunal took solace from the fact that the Commissioner's own MEGs endorse the total surplus standard. The Tribunal was clearly displeased that the Commissioner was advancing an approach to section 96 that contradicted the approach stated in the MEGs:[92]

> The change in position is quite surprising. It must not be forgotten that the point of view put forward in the MEGs represents the considered opinion of the Commissioner, the official appointed by the Governor In Council to administer and enforce the Act. That view, it goes without saying, is the view arrived at by the Commissioner following careful advice given to him by his legal and economic advisors regarding the meaning of the various provisions of the Act. Although the Commissioner is not bound by the MEGs nor are they binding upon this Tribunal, the MEGs should be given very serious consideration by this Tribunal.

The Tribunal clearly recognized that the MEGs did not have force of law, and therefore that neither the Commissioner nor it were bound by the positions put forth therein. Given such an understanding, we believe that the Tribunal was well within its authority to question the propriety of the Commissioner in changing his position and to suggest a certain reliance on the legal opinions and any legal resources which would have been marshalled so as to reach the interpretation of section 96 contained within the MEGs (especially, we would add, when such views were formulated without reference to any particular litigation). In the section below entitled "Role of the Commissioner", we provide further thoughts on the appropriateness of the Commissioner's actions with respect to the MEGs.

(v) "Effects" and the Appropriate Balance: the Dissenting View

Ms. Lloyd, in dissent, generally adopted Madame Justice Reed's comments in *Hillsdown* that the Act "should not be given such a restrictive interpretation as to exclude the transfer from consumers to producers".[93] In arriving at this conclusion, Ms. Lloyd indicated that the majority's view has the following perverse result:[94]

> In my view, if the analysis under section 96 was so simplistic as to only require the comparison between quantitative efficiency gains and the deadweight loss to the economy, this could lead to distorted outcomes. For instance, such a narrow interpretation would mean that an anti-competitive merger would more easily meet the test set out in this section as the demand for the relevant product becomes less elastic (*i.e.*, less price-sensitive). This perverse result arises from the fact that the calculated deadweight loss is proportional to the elasticity of demand. Therefore, following the interpretation of the majority, smaller gains in efficiency are required to outweigh and offset the deadweight loss to the economy when the demand is inelastic. In my view, there is no obvious reason to explain why Parliament would have written section 96 to give preference to anti-competitive mergers involving products for which demand is relatively inelastic (e.g., commodities).

While we recognize Ms. Lloyd's comments regarding the relationship between elasticity and the size of the deadweight loss with respect to a given price increase, we are nonetheless of the view, as indicated above, that the total surplus standard is the standard effectively prescribed under section 96, whether or not it has a "perverse" result.

(vi) Merger-to-Monopoly

In addition to advocating a balancing of weights standard, the Commissioner argued that, as a matter of law, the efficiency defence could not be interpreted as applying to a "merger-to-monopoly". The Commissioner suggested that, as the over-arching purpose of the Act is to "maintain and encourage competition", a merger-to-monopoly situation, because it eliminates competition altogether, could not be saved by the efficiency defence.

In our view, the Commissioner's position on this point is entirely untenable. The Tribunal rightly pointed out that since section 96 makes no distinction between the elimination and the substantial lessening of competition (indeed, no similar distinction is made under any provision of the Act), its application cannot be barred in the face of a particular merger result. The only applicable threshold for invoking section 96 is that the subject merger must be one in which the Tribunal intends to otherwise issue an order pursuant to section 92 of the Act. Since the Tribunal found that an order was appropriate in the circumstances, section 96 applied, including in respect to merger-to-monopoly markets.

Not only did the Commissioner's submission regarding the non-application of the efficiencies defence have no grounding under sections 92 and 96, it defied logic. First, if the Commissioner were correct that the primary purpose of the Act is to promote competition, then there should be no distinction between a SLC and the elimination of competition. Presumably, both would justify the non-application of section 96 since competition in both cases would be thwarted. Applying section 96 in this manner, however, would effectively relegate it to being akin to an evaluative factor, similar to those under section 93 of the Act. This must not be correct.

The Commissioner's line of argument with respect to merger-to-monopoly is also difficult to reconcile with economics. In particular, the Commissioner asserted that section 96 of the Act is available as a defence (although difficult to meet) in the case of a merger that results in a market share of 96%, or even 98%, but not to 100%.[95] The Commissioner (at least in the portion transcribed in the decision) did not offer any justification as to why, from a policy perspective, the goal of the Act is being furthered by employing the efficiency defence in the case of an entity that will have a 98% market share but not one that will have a 100% market share. The Chairman recognized the silliness of the Commissioner's argument on this point when he noted that "[a] 98% market share and a 100% market share, the difference may simply be theoretical. Practically, it may not mean anything insofar as consumers are concerned."[96] Notwithstanding the Chairman's comments, the Commissioner confirmed his interpretation of section 96 as applying to only non-merger-to-monopoly situations, regardless of how close the merged entity is to having 100% market share .[97]

(vii) Measuring The Deadweight Loss

Having determined the applicable balancing standard, the Tribunal turned its attention to the actual measurement of deadweight loss. The Commissioner presented expert evidence which estimated post-merger price increases of 11.1%, 7.1% and 8.1% for the residential, industrial and automotive end use segments of the relevant market, respectively. By using a demand elasticity of -1.5 and coupled with 1998 sales data, the Commissioner concluded that the deadweight loss arising from the transaction was approximately $3 million. Although the Tribunal was

of the view that this calculation was likely overstated, the majority accepted this figure as it was inconsequential when compared to the expected efficiency gains (*i.e.*, which the Tribunal found to total $29.2 million).

Finally, the Tribunal considered the Commissioner's submission that qualitative effects, including changes to levels of service, product quality and product choice, increased probability of co-ordinated behaviour and innovation, need to be included in the measurement of the "effects" of a merger. Although it accepted the Commissioner's point as a general proposition, the Tribunal did not provide a detailed explanation of the manner by which it should quantify the qualitative losses arising from a merger. Furthermore, the Tribunal took the view that certain of the Commissioner's alleged qualitative effects, including the increased probability of co-ordinated behaviour and changes in service, were already reflected in the presumed higher price and, therefore, already included in the deadweight loss estimate. Accordingly, the Tribunal noted that:[98]

> The Tribunal must determine whether all of the gains in efficiency brought about or likely to be brought about by this instant merger are greater than the estimated deadweight loss and the negative qualitative effects resulting or likely to result therefrom. As noted above, this determination requires that the latter two components be combined and then compared with total efficiency gains. The Tribunal views the impact on resource allocation of the negative qualitative effects as minimal and as most unlikely to exceed in amount the estimated deadweight loss. Thus, the combined effects of lessening or prevention of competition from the instant merger cannot exceed, in the Tribunal's opinion, $6 million per year for 10 years. On this basis, the Tribunal finds that the gains in efficiency are greater than those effects.

Having found that the expected efficiency gains arising from the merger amounted to approximately $29.2 million and that the deadweight loss and qualitative effects amounted to $6 million, the Tribunal refused the Order on the basis that the expected gains in efficiency of the merger "will be greater than, and will offset," the SLC.

Considerations Going Forward

1. Time for a Review of Section 96 of the Act

As noted in the Introduction, given the construction of the Act and Parliament's clear intention to make available an efficiency defence to the issuance of an order under section 92 of the Act, the Tribunal's decision is undoubtedly the correct one and should withstand the Commissioner's appeal. However, now that we have practical experience with section 96, the time is ripe for interested economists, the competition law bar, corporate Canada, public interest groups and the Commissioner to consider the efficacy of the defence and whether it should be modified, either entirely or, for example, by including various evaluative factors to be considered by the Tribunal. Since the Tribunal did a good job explaining the rationale for section 96, and in light of the fact that there is a substantial amount of Canadian literature in support of the efficiency defence, we set out below various considerations on the other side of the debate. Accordingly, to initiate this debate, we note the following:

- One of the underlying assumptions behind section 96 is that because Canada is a relatively small economy, high levels of industry concentration in certain sectors may be necessary to produce goods at levels

approaching an efficient scale. It is no coincidence that the (modern) Act was enacted during a period of unprecedented globalization which, in turn, gave rise to the view that even greater economies of scale would need to be achieved so as to allow Canadian companies to compete globally. As such, the efficiency defence can be seen as a component of Canada's globalization policy. However, in *Superior Propane*, the Tribunal clearly found that there was no global commerce dimension to the merger. In such a situation, should the efficiencies defence be applicable?

- A key assumption of the total welfare model is that welfare transfers are neutral, as the transfers will be recirculated within the economy. However, when shareholders are mostly foreign-based (which may or may hot have been the case in *Superior Propane*) it may be questioned whether this recirculation justification is valid. This may be particularly true where the foreign shareholders reside in a country that does not have an efficiency defence comparable to Canada's, such as in the United States. Should the residency of the shareholders of the merging companies form a part of the section 96 analysis? If so, is this exception inconsistent with Canada's international trade obligations (*i.e.*, discriminatory treatment) and, if so, does it justify eliminating section 96 altogether?[99]

- Even if considerations of foreign capital flows were considered irrelevant or held to be unworkable, the notion that a dollar is a dollar on which the total welfare standard is based may be questioned. It was suggested by the Commissioner's expert in *Superior Propane* that, at least with respect to residential propane use, a rise in prices would fall disproportionately on rural, low income and older segments of the population. The marginal utility of a dollar spent on home heating for such persons is presumably greater than that of a dollar given to a wealthy shareholder. To the extent that such information is available and discernible, should the efficiencies defence take such factors into consideration?

- As noted above, a factor in favour of the total surplus model is its apparent predictability. The Tribunal criticized the balancing weights approach as one which would be considered, and thus vary, on a case-by-case basis, depending very much on each Tribunal member's individual values. However, it may be possible to legislate some predictability into a system which called for balanced weights. For example, in the same manner that evaluative factors for determining the existence of a SLC are set out under section 93, section 96 could contain a list of factors which the Tribunal would examine. Is this a workable approach and, if so, what factors should be considered under section 96?

- When determining the existence of a SLC, it is well understood that the focus is upon a relevant market(s) and that each market(s) has a product and a geographic dimension. Given that geographic dimension, one might assume that when balancing the effects of a SLC against post-merger efficiencies, such efficiencies should be geographically isolated and balanced individually against the anti-competitive effects in each and every market where a SLC is demonstrated. This could result in the Tribunal finding that the efficiency defence is met with respect to certain markets but not for others. However, in *Superior Propane* the Tribunal seemed prepared to aggregate anti-competitive effects and compare them against any and all demonstrable efficiencies. Accepting that difficulties would arise in attempting to isolate efficiencies within a particular geographic market, might this not be what is contemplated by the Act (*i.e.*, that the efficiencies are to be balanced against effects in the very markets where a SLC is found)? Should the efficiency trade-off be restricted to a market-by-market examination? For example, take the case of a merger that would result in a SLC in a market defined to be a local New Brunswick market. In that case, is it satisfactory that a negative impact be experienced in one local New Brunswick market while there is

a resulting gain in a separate New Brunswick market(s)? What if that gain were instead realized in British Columbia, or, for that matter, what about outside of Canada?

- With respect to the determination of the geographic size of the retail propane market for the purpose of ascertaining the SLC, the Tribunal accepted the evidence of the Commissioner's expert that retail markets were local in scope extending to a 60 to 100 kilometre radius around Superior/ICG branches and satellites. However, for the purposes of determining efficiencies, the Tribunal seemed to accept a trade area defined on the basis of the customer located furthest from each branch.[100] Given the difference in approach, it is perhaps surprising that the Tribunal did not discuss these differences, nor did it elaborate as to its rationale in accepting such a methodology. It may simply be that for the purposes of determining the market, the focus is upon economic theory of substitutability and demand, whereas efficiencies are concerned with the objectives and possibilities facing businesspersons in rationalizing operations and reducing costs (*i.e.*, supply-side issues). Nevertheless the appropriateness of this method of measurement may be worth further debate.

- Finally, some discussion may be warranted as to the extent to which planned efficiencies are actually realized. The existence of the efficiency defence is premised on the ability of firms to predict, presumably with some degree of accuracy, what the efficiency effects of a merger will be. Empirical evidence may suggest, however, that significant portions of planned efficiencies are not realized in every case.[101] With this in mind, should a somewhat higher standard be imposed with respect to the likelihood of achieving efficiencies rather than the current accepted balance of probabilities, or should an amount be factored in for discounting?

The above issues, among many others, deserve consideration, regardless of the outcome of the Commissioner's appeal. Now that section 96 has been applied in the context of a specific case, the time is ripe to develop a broad understanding and consensus on the meaning and appropriateness of section 96.

2. Role of the Commissioner

With respect to the civil provisions of the Act, it is clear that the Commissioner is both an investigator and prosecutor. It is also noted however, that the Commissioner plays an equally important role as the administrator and communicator of competition policy and law in Canada. In this role, the Commissioner liases with interested stakeholders not only with respect to administrative functions (in a strict sense) but also with respect to questions of legal interpretation. It is within this capacity that the Commissioner establishes enforcement guidelines, bulletins and reports, such as the MEGs. While recognizing that the MEGs do not have the force of law, business parties and counsel rightly rely on them as, at the very least, representing the Commissioner's view and interpretation of the law.

We urge the Commissioner to reconsider the appropriateness of having gone squarely against the stated position of his office. The MEGs, statements made by the former Director (Mr. Howard Wetston) and the Commissioner's Bank MEGs all endorse the total surplus standard. Indeed, the Bank MEGs were published a few short months prior to the initiation of *Superior Propane*. Yet, in *Superior Propane* the Commissioner argued in favour of an approach other than the total surplus standard. The potential ramifications of this must be understood.

While we understand that the MEGs are not law, they must be taken to represent the Commissioner's view of the law since the opposite conclusion would be perverse. At the same time, when faced with a proposed merger that would result in a SLC, the Commissioner was fully entitled to exercise his prosecutorial discretion to bring the matter before the Tribunal for determination. Indeed, one could argue that, as a matter of policy alone, the Commissioner should have referred the matter to the Tribunal since it is not up to the Commissioner, the investigator and prosecutor, to decide what section 96 definitively means, but rather it is the duty of the Tribunal, the adjudicator, to make that determination. However, unlike in *Hillsdown* where both the Director and the Respondents argued in favour of the total surplus standard, the Commissioner rejected his stated view of the law.

Starting from the proposition that the Commissioner is not to be concerned with "winning or losing" but with ensuring that competition law, as embodied in the Act, is followed, then it is curious that he would have changed his view of the law in the context of a particular case. Having said that, the Commissioner must understand and appreciate the potential negative effects that may arise from contradicting his MEGs. Above all else, it may bring into question the reliability of the Commissioner's other enforcement guidelines, bulletins and reports, which heretofore the competition law bar has viewed as evidencing how the Commissioner interprets the law (*i.e.*, as distinct from being the law). Indeed, the front page of the Competition Bureau's web page indicates that the four key principles that guide the Competition Bureau are: "transparency ... fairness ... timeliness ... predictability".[102] We certainly hope that *Superior Propane* is the unique exception to that principle.

Conclusions

Although a hollow victory in the Commissioner's eyes, the Tribunal effectively adopted the approach to merger review that he had stated in the MEGs. The Tribunal undertook a methodical examination of the relevant product market, issues pertaining to market power, the evaluative factors under section 93 of the Act, SLC and prevention of competition, appropriate remedies and, ultimately, the efficiencies defence under section 96 of the Act. In each instance, the Tribunal took great pains to refer to jurisprudence and, indeed, the MEGs. Of most importance in this regard, however, is the Tribunal's decision regarding the efficiency defence. The Tribunal flatly endorsed the total surplus standard in applying section 96. Although the Tribunal disagreed with the quantum of certain of the Respondents' claimed efficiencies and, in some cases, disagreed that certain of the claimed efficiencies were in fact true efficiencies, overall, the Tribunal applied the approach urged by the Respondents'. In so doing, the Tribunal refused to issue an order to require Superior to divest its shares of ICG.

There is no reason why merger law needs to be static. Recent experiences with the Act demonstrate that legislative amendments will be adopted where considered to be appropriate. Although the final verdict among the majority of the competition law bar, economists, public interest groups, corporate Canada and the Commissioner may or may not be to amend section 96, the time is ripe for a review of the appropriateness and suitability of the efficiencies defence in the context of merger review. We have attempted to provide possible issues for consideration in order to kick-start this dialogue.

Finally, subject to a successful appeal, now that the Tribunal has confirmed that the MEGs accurately encapsulate section 96, regardless of whether the Commissioner agrees with the law, he must apply and enforce it. The

Commissioner cannot, for example, amend his MEGs to provide for a standard other than the total surplus standard. Furthermore, should the Commissioner be faced with another merger being supported on efficiency grounds, he must apply the total surplus standard. He must take the law as he finds it. The only other option available to the Commissioner is to push for legislative change. In advance of doing so, however, we urge that a full stakeholder consultation process be struck.

Notes

[1] © Jason L. Gudofsky and Patrick Gay. Messrs. Gudofsky and Gay are associate lawyers at Stikeman Elliott where they principally practice competition and international trade law. The views expressed herein are that of the authors alone, and do not necessarily represent the views of Stikeman Elliott. The authors express their gratitude to Susan M. Hutton and Kim Alexander-Cook for reviewing an earlier draft of the paper, as well as to Jeffrey Elliott and Jason Wilson, two articling students at Stikeman Elliott, for their assistance in providing background research.

[2] 2000 Comp. Trib. 15 [hereinafter *Superior Propane]*.

[3] R.S.C. 1985, C. C-B4, as amended.

[4] "Competition Bureau Appeals Decision in Superior Propane Case", News Release, Competition Bureau (September 6, 2000).

[5] Indeed, on October 17, 2000, Mr. Dan McTeague, the M.P. for Pickering-Ajax-Uxbridge, tabled a Private Member's Bill before Parliament to amend section 96 of the Act. However, as a Federal election has been since called, Mr. McTeague's Bill died on the Order Paper.

[6] The Tribunal cited *The Director of Investigation and Research* v. *Southam Inc.* (1992), 43 C.P.R. (3d) 161 at 177 for this proposition.

[7] *Superior Propane,* at para. 56.

[8] *Ibid.*, at paras. 22 and 23.

[9] *Ibid.*, at para. 36.

[10] *Ibid.*, at para. 24-27.

[11] *Ibid.*, at para. 29-30.

[12] *Ibid.*, at para. 34.

[13] *Ibid.*, at para. 23.

[14] *Ibid.*, at para. 49.

[15] *Ibid.*, at para 63. As explained later, Tribunal Member Lloyd chastised the majority's interpretation of section 96 of the Act on the basis that, among other things, finding propane to be inelastic bolstered the Respondents' claim that the efficiencies exceeded the resulting negative effects of the merger (*i.e.*, deadweight loss) since the steeper the demand curve, the smaller the deadweight loss will be. According to Ms. Lloyd, this is counter-intuitive since it would appear, according to her, that the efficiency exception rewards those mergers where prices are most likely to increase.

[16] *Ibid.*, at para. 77.

[17] The importance of this distinction is real. By defining the product market as national co-ordination services, the Tribunal should not have considered this market contemporaneously with the retail propane sales market. One would have thought that establishing national co-ordination services is not particularly difficult. For example, it may be possible for a new (or existing) company to enter into supply agreements with numerous companies across Canada (*e.g.* possibly like a co-operative or an association) and then offer national co-ordination services to national customers by co-ordinating between the various companies with which it has supply agreements. In this scenario, most of the key factors for which the Tribunal found a separate product market of national accounts to exist would be present, most importantly, the opportunity for national customers to deal (from their vantage point) with a single supplier. Presumably, the barriers to entry in this type of business would not be significant. Yet, at the end of the day, the Tribunal evaluated this product market as if it were synonymous with the retail propane sales product market.

[18] *Superior Propane*, at para. 59.

[19] The Tribunal seemed to recognize the inconsistency of its comments in this regard, and, after concluding that (*Ibid.*, at para. 60) "reciprocal substitutability must be demonstrated", noted that the real purpose for determining cross-price elasticity is its (Id., at para. 61) "indirect relevance to the exercise of market power". The Tribunal was of the view that own-price elasticity of demand is much more relevant to defining the proper market than is cross-price elasticity of demand.

[20] See: *Director of Investigations and Research* v. *Superior Propane Inc.* (1998), 85 C.P.R. (3d) 194 (Comp. Trib.)

[21] *Superior Propane*, at para. 55.

[22] *Ibid.*, at para. 84.

[23] *Ibid.*, at para. 83.

[24] *Ibid,* at para. 87, the Commissioner (through his expert, Professor West) stated that in the circumstances the geographic market should be delineated from the point of production rather than from the point of consumption.

[25] *Ibid.*, at para. 104.
[26] *Ibid.*, at para. 101.
[27] *Ibid.*, at para. 106.
[28] *Ibid.*, at para. 107.
[29] While the authors acknowledge that for most industries it would be practically impossible to draw circles around each customer, it is unclear why drawing circles around service providers would be an acceptable substitute. This will have to be resolved at some future date in the context of a merger that is characterized by drawing areas rather than service areas.
[30] *Superior Propane*, at para. 108.
[31] *Ibid.*, at para. 109.
[32] *Ibid.*, at para. 110.
[33] *Ibid.*, at para. 111. In light of the degree by which a combined Superior/ICG's market share exceeds the 35 percent safe-harbour level stated in the MEGs, not to mention the sheer number of local markets in which they exceed the safe-harbour level, there is little doubt that the combined Superior/ICG have market share levels that tend to support a claim of market power. However, the Tribunal appeared far too willing to accept Professor West's evidence on this point. The Tribunal noted that, in order to arrive at his results, Professor West relied on, among other things, a competitor survey and "internal business plans" (Professor West also examined, for example, certain consumption information from Superior and ICG). In particular, the Tribunal noted that (*Ibid.*, at para. 115): "Professor West explained that he used Superior's own market share evaluation when he did not have the sales volume information from other independent competitors and that he reduced Superior and ICG's combined market share in some of the geographic markets by several percentage points to reflect the sales volume of several small competitors for which he did not have specific volume information" (cite omitted). To the extent that Professor West's evidence was based on "internal projections", however, it is unsatisfactory that Professor West or the Tribunal placed any reliance on this information (*i.e.*, it seems unfair to not allow the Respondents to use their internal documents to assist their case while, at the same time, using the same type of documents against them), having concluded that the manner by which Superior and ICG define the market for business purposes is different from how the market is defined for merger analysis. Accordingly, to the extent that Superior and ICG's documents contain any estimates of market share, the Tribunal should have ignored that information, having found that the denominator and numerator used by the companies for business purposes would not be the same for merger analysis under the Act, not to mention the inequities of relying on this information in the circumstances.
[34] *Ibid.*, at paras. 119-121.
[35] *Ibid.*, at para. 124.
[36] *Ibid.*, at para. 127, citing *Director of Investigation and Research* v. *Hillsdown Holdings (Canada) Limited* (1992), 41 C.P.R. (3d) 289 at 324 (Comp. Trib.) [hereinafter *Hillsdown*].
[37] *Ibid.*, at para. 128.
[38] *Ibid.*, at paras. 151-152.
[39] *Ibid.*, at para. 157.
[40] *Ibid.*, at para. 166.
[41] *Ibid.*, at para. 174.
[42] Para. 4.6.4 of the MEGs.
[43] *Superior Propane*, at para. 215.
[44] *Ibid.*, at para. 219.
[45] *Ibid.*, at para. 217.
[46] *Ibid.*, at para. 223.
[47] *Ibid.*, at para. 225.
[48] *Ibid.*, at para. 243.
[49] (1957), 8 D.L.R. (2d) 449 (S.C.C.).
[50] *Superior Propane*, at para. 258.
[51] *Ibid.*, at para 249. It was reported that Professor Ward did not have the required information from ICG to confirm that ICG's market share increases with a price increase by Superior. However, the Tribunal was willing to infer that effect.
[52] The Tribunal explicitly rejected Madame Justice Reed's suggestion in *Hillsdown* that, in addition to proof that a proposed merger either adds to or creates market power, it is sufficient to demonstrate that a merger "preserves" market power. The Tribunal was emphatic that there must be evidence of a nexus between the market power of the merged party and the proposed merger.
[53] *Superior Propane*, at para. 314 (emphasis added).
[54] *Ibid.*, at para. 1 (emphasis added).
[55] It is noted that both the Act and the MEGs use the term "exception" with respect to section 96. However, citing *Canada (Director of Investigations & Research)* v. *Canadian Pacific Ltd.* (1998), 74 C.P.R. (3d) 55 at 63 (Comp. Trib.) [hereinafter *Canadian Pacific*]with approval, the Tribunal confirmed that section 96 is a defence rather than an exception (*Ibid.*, at para. 399).
[56] We note that this is effectively the standard proposed by Mr. McTeague in his recent Private Member's Bill (*supra*, note 5).

[57] See generally, the discussion of the various standards considered by L. Bian and D.G. McFetridge in "The Efficiencies Defence in Merger Cases: Implications of Alternate Standards" in (2000) 33 Canadian Journal of Economics 297.

[58] O. Williamson, "Economies as an Antitrust Defence: The Welfare Trade-offs" in (1968), 58 Am. Econ. Rev. 18; "Economies as an Antitrust Defence: Correction and Reply" in (1968), 58 Am. Econ. Rev., 1372; "Allocative Efficiency and the Limits of Antitrust " (May 1969), in Am. Econ. Rev. Papers & Proc. 105; "Economies as an Antitrust Defence: Reply" in (1969), 59 Am. Econ. Rev. 954; and "Economies as an Antitrust Defence Revisited" in (1977), 125 U. Penn. L.R. 699.

[59] *Ibid.* (1977) at 709, as cited in P. Crampton, Mergers and the *Competition Act* (Toronto: Carswell, 1990) at 500.

[60] See: M. Sanderson, "Efficiency Analysis in Canadian Merger Cases" in (1997) 65 Antitrust L.J. 623 at 639; and P. Crampton "The Efficiency Exception for Mergers: An Assessment of Early Signals from the Competition Tribunal" in (1993) 21 C.B.L.J. 371 at 379.

[61] L. Bian and D.G. McFetridge, *supra*, note 57 at 314. Bian and McFetridge demonstrated that under assumptions of constant marginal cost and pre-merger symmetry where spill-overs are low (meaning that rivals will find it difficult to match the merged entity's efficiency improvements), the price standard requires an efficiency gain that is three to four times greater than the efficiency gain required under the total surplus standard. This conclusion was dependant upon the number of firms and the aggressiveness of competition in the examined market.

[62] See, for example: R. Lande "Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged" in (1982) Hastings L.J. 65; and A. Fisher, F. Johnson and R. Lande "Price Effects of Horizontal Mergers" in (1989) 77 Calif. L. Rev. 777, who noted that (at 788):

> ...Congress was surely unaware of even an intuitive version of the concept of allocative efficiency in 1914 when it approved the Clayton Act the notion that this concept could have caused Congress to pass anti-merger law is hardly credible. Although economists had dramatically increased their understanding of allocative efficiency by 1950 when Congress enacted the Celler-Kafauver Amendment the legislative history of the bill contains absolutely no mention of this concept.

Others have argued that economic efficiency was the primary concern of the authors of antitrust statutes. See, for example: R. Bork "Legislative Intent and the Policy of the Sherman Act" in (1966) 9 J.L. & Econ 7.

[63] Although the *Clayton Act* does not mention efficiencies, and despite U.S. Supreme Court jurisprudence that has rejected the availability of an efficiency defence, lower U.S. court decisions have entertained efficiency arguments. Furthermore, from the time that the 1984 Guidelines were adopted and through the adoption of the 1992 Guidelines, the Department of Justice/Federal Trade Commission has indicated a greater willingness to examine the scope of anticipated efficiencies within the exercise of its prosecutorial discretion. In 1997, significant revisions were made to the 1992 Guidelines with a view to clarifying the role of efficiencies in merger evaluation. It is arguable, however, that the revised Guidelines maintain a consumer oriented focus to merger review (certainly they do not adopt a strict total surplus standard). The Guidelines state, in part, that:

> The Agency will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not *likely* to be anti-competitive in any relevant market. To make the requisite determination, the Agency considers whether cognizable efficiencies *likely* would be sufficient to reverse the merger's potential to harm consumers in the relevant market, *e.g.*, by preventing price increases in that market. In conducting this analysis, the Agency will not simply compare the magnitude of the cognizable efficiencies with the magnitude of the likely harm to competition absent the efficiencies.

For a discussion concerning the scope of the revisions to the Guidelines, please see: R. Vernail, "One Step Forward, One Step Back: How The Pass-On Requirement For Efficiencies Benefit In *CCFTC* v. *Staples* Undermines The Revisions To The Horizontal Merger Guidelines Efficiencies Section" in (1998) 7 G.O. Mason L.Rev. 133; T. Muris, "The Government And Merger Efficiencies: Still Hostile After All These Years" in (1999) 7 G.O. Mason L. Rev. 729; C. Conrath & N. Widnell "Efficiency Claims And Merger Analysis: Hostility Or Humility?" in (1999) 7 G.O. Mason L. Rev. 685; and T. Greaney "Not For Import: Why the E.U. Should Not Adopt The American Efficiency Defence For Analysing Mergers And Joint Ventures" in (2000) 44 St. Louis L. J. 871.

[64] *Merger Enforcement Guidelines*, part 5.1.

[65] The Bank MEGs, which were published on July 14, 1998, state the following with respect to the appropriate standard for measuring the efficiency trade-off:

> Where a merger results in a price increase, it brings about both a neutral redistribution effects and a negative resource allocation effect on the sum of producer and consumer surplus (total surplus) within Canada. Ordinarily, the Director measures the efficiency gains referenced above against the latter effect (*i.e.*, the deadweight loss to the Canadian economy).

[66] Crampton, *supra*, note 60 at 383.
[67] The Director is the predecessor to the Commissioner.
[68] *Hillsdown*, at 337.
[69] H. Wetston, "Developments and Emerging Challenges in Canadian Competition Law", speech given at the Fordham Corporate Law Institute, New York, October 22, 1992.
[70] On this issue the Tribunal relied on its decision in *Hillsdown*, at 332, where it was noted that:

> The Directors' position is that cost savings that do not arise uniquely out of the merger are not to be considered as efficiency gains. The Respondent's position is that the test to be applied is whether the efficiency gains would likely have been realized in the absence of the merger. The Tribunal accepts the Respondent's position

[71] *Hillsdown* and *Canadian Pacific*.
[72] Sanderson, *supra*, note 60 at 632, summarized such production efficiencies as follows:

> Plant level savings refer to those that flow from specialization, elimination of duplication, reduced down time, smaller inventory requirements, or the avoidance of capital expenditures that would otherwise be required. Multi-plant-level savings include those associated with plant specialization, rationalization of administrative and management functions, and the rationalization of research and development activities. Efficiencies also may be brought about in respect of distribution, advertising, and raising capital. A reduction in transaction costs associated with integrating activities that previously were performed by third parties, such as contracting for inputs, distribution, and services, also may constitute production efficiencies.

[73] The Tribunal did, however, attempt to quantify certain qualitative effects of the loss of competition. *Infra*, note 98.
[74] The Tribunal did not discuss the appropriateness of using a ten-year time frame. The implicit acceptance of such a period would seem to suggest that the Tribunal will accept anticipated efficiencies, if adequately demonstrated, at any time into the future. This complies with N. Campbell's stated view, with which we concur, that a long range view maximizes aggregate economic welfare. See: N. Campbell, Merger Law and Practice: The Regulation of Mergers Under the *Competition Act* (Toronto: Carswell, 1997) at 167.
[75] The actual report estimated cost savings at between $381 million and $421 million. The Tribunal distinguished between "annualized savings", as used in the Cole-Kearing report, and "annual savings". The Tribunal explained that (*Superior Propane*, at para. 324):

> The former term is a representative amount of one-year savings in an item when that item's cash flows are measured year by year over ten years, before taking one-time related cash flows (*e.g.*, due to severance payments, or asset disposals) into account. Accordingly, the savings for that item over ten years need not equal the annualized saving multiplied by ten. Adding the annualized savings from the three categories discussed above leads to annualized savings of $39.3 million when rounded to one decimal. The latter terms refers to all cash flow; for example, if the total savings over ten years are $400.8 million, then the annual savings are $40.08 million.

[76] *Ibid.*, at para. 371.
[77] *Ibid.*, at para. 378.
[78] *Ibid.*, at para. 376.
[79] *Ibid.*, at para. 490.
[80] *Canada (Director of Investigation & Research)* v. *Canadian Pacific Ltd.* (1997), 73 C.P.R. (3rd) 573 (Comp. Trib.).
[81] *Ibid.*, at 576.
[82] *Ibid.*
[83] *Superior Propane*, at para. 410.
[84] *Ibid.*, at para. 405.
[85] *Ibid* at Para. 413.
[86] *Ibid.* at para. 437.
[87] One principle of statutory interpretation, amongst many others, is that one must take account of the consequences stemming from different possible interpretations of a provision of a statute and must be careful to choose the interpretation which most reflects Parliament's objective in drafting that provision; in other words:

> Before adopting any proposed construction of a passage susceptible of more than one meaning, it is important to consider the effects or consequences which result from it, for they often point to the real meaning of the words. There are certain objects which the legislature is presumed not to intend, and a construction which would lead to any of them is therefore to be avoided. (P. St. J. Langan, Maxwell on the Interpretation of Statutes, (12th ed.) (London: Sweet & Maxwell, 1969) at 105.)

[88] *Superior Propane*, at para. 431.

[89] Under the former *Combines Investigation Act*, R.S.C. 1970, c. C-23, as amended, an element of the finding of entering into a monopoly was proof that the transaction was "to the detriment or against the interest of the public..."

[90] *Superior Propane*, at para. 433.

[91] *Ibid.*, para. 438.

[92] *Ibid.*, at para. 397.

[93] *Ibid.*, at para. 511.

[94] *Ibid.*, at para. 507.

[95] *Ibid.*, at para. 417.

[96] *Ibid.*

[97] *Ibid.*

[98] *Ibid.*, at para. 467.

[99] There have been suggestions that the Act is concerned with domestic surplus, while recognising the potential trade law issues that might arise if attempts were made to distinguish mergers on the basis of domestic surplus. For example, Dr. Frank Roseman, a former member of the Competition Tribunal, suggested in comments made to the Canadian Bar Association Round-Table Discussion of Selected Issues in The Economics Of Competition Policy, University of Toronto, on June 20, 1994, that distributional weights should reflect the proportion of domestic ownership in the economy. As noted by Bian and McFetridge, *supra* note 57 at 299:

> In Dr. Roseman's view, the purpose of the *Competition Act* is to maximize domestic surplus, and this purpose is not served by a standard that treats transfers from domestic consumers to foreign shareholders as neutral. He notes that the maximization of domestic surplus would require the settling of ownership-based distribution weights on a case-by-case basis. Since this would have the effect of discriminating against mergers involving foreign firms and would be contrary to Canada's WTO [World Trade Organization] obligations, Dr. Roseman suggested that economy-wide, ownership-based weights be used for all mergers.

[100] As Ms. Lloyd noted (*Superior Propane*, at para. 473):

> [C]ost savings identified by Cole-Kearney are based on a definition of Superior's trade area size and overlaps with ICG's trade areas. The size of each trade area of Superior is defined on the basis of the farthest customer located from each respective branch as reported in the 1998 Branch Templates. This farthest distance then constitutes the radius of the trade area for each specific branch. The extent of the trade areas and trade area overlaps, in turn, constitute the framework on which the experts calculated the efficiencies claimed to result from the implementation of the merger of Superior and ICG.

[101] See, for example, W. Adams & J. Brock "*Anti-Trust and Efficiency: A Comment*" in (1987) 62 N.Y.U.L.R. 1116 wherein the authors noted various studies and reports suggesting that mergers often do not realize their planned efficiencies. Deriding the assumption that being a large entity equates to being efficient, the authors stated at 1121 that:

> Industrial giants can manipulate the state, insulating themselves from both the compulsions and discipline of the competitive market as well as the social control of government. Corporate giants, almost irrespective of efficiency performance, can survive as federal protectorates in a cosy world of cost-plus operations, safely protected from the ugly spectres of competition, efficiency and innovation.

[102] At *http://www.strategis.ic.gc.ca/SSG/ct01250e.html.* (emphasis added).

CANADIAN COMPETITION RECORD

THE CORRECT TEST TO MEASURE THE EFFECTS OF ANY PREVENTION OR LESSENING OF COMPETITION, FOR THE PURPOSES OF THE EFFICIENCIES DEFENCE: A QUESTION OF LAW? WHAT DIFFERENCE DOES IT MAKE?

By: Barry Zalmanowitz
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In *Superior Propane*,[1] a majority of the Competition Tribunal decided that for the purposes of the efficiencies defence in section 96 of the *Competition Act*, the total surplus standard should be used to measure the effects of any lessening of competition caused by a merger. The Tribunal also rejected the Commissioner of Competition's argument that as a matter of law, section 96 of the Act does not apply in a case where a merger results in a monopoly. The Commissioner has appealed to the Federal Court of Appeal and the notice of appeal states that the Tribunal erred in law in interpreting section 96 of the Act by:

(a) concluding that the efficiencies defence can apply where there is a merger to monopoly;

(b) concluding that the Commissioner had the burden of demonstrating the effects of any lessening or prevention of competition; and

(c) adopting the total surplus standard for measuring the effects of any lessening of competition.[2]

A threshold issue on the appeal will likely be how much deference the Federal Court of Appeal should give to the Tribunal's decision. Linden J.A., in giving reasons for his decision refusing the Commissioner's application for a stay of the Tribunal's order pending the appeal, made the following comment about the standard of review:

> In this case there is a disagreement between the parties about whether the standard of review is correctness or reasonableness in a case like this. There is discord about whether the issues here are questions of law or questions of fact or mixed questions of law and fact. Some deference may well have to be accorded to certain aspects of the decision, but, in my view, there are other issues which are of great legal significance and may well have to be decided on the basis of correctness. ... The court cannot abdicate completely to the Tribunal its task of monitoring the development of competition law. ... [T]o my mind, there is at least one major legal issue involved in this appeal ... that must be resolved by this Court and which amounts by itself to a serious legal question, whatever the standard of review. That issue is the meaning of section 96 of the *Act* in light of the purposes of the *Act* as set out in section 1.1 of the *Act*. It is a key issue of enormous importance in the administration of the *Act*.[3]

Does it make a difference whether the question is characterized as a question of law on the one hand or a question of mixed fact and law on the other? If an issue can be characterized as a question of law that is one factor that may point to less deference to the Tribunal. It is, however, really only one of several factors to be considered in applying "the pragmatic and functional approach" mandated by the Supreme Court of Canada for determining the appropriate standard of review for courts reviewing decisions of administrative tribunals. Still, the most important factor is the expertise of the Tribunal.[4]

In *Pushpanathan*, Bastarache J. said:

> There is no clear line to be drawn between questions of law and questions of fact, and, in any event, many determinations involve questions of mixed law and fact.[5]

Even if the meaning of "effects of any prevention or lessening of competition" is characterized by the court as a question of law, the court must still determine what the appropriate standard of review should be as it seems that this issue is one that requires an understanding of competition policy, economic theory and particularly welfare economics.

The application of the pragmatic and functional approach mandated by *Pushpanathan* should consider the effect of section 12(1)(a) of the *Competition Tribunal Act*. Section 12(1)(a) requires that in proceedings before the Tribunal, questions of law be determined "only by the judicial members sitting in those proceedings". Therefore, if the question at issue is characterized as a question of law, it should have been determined only by the Judicial Member of the Tribunal without participation by the other members, notwithstanding that it is a question which clearly requires an understanding of economic theory and welfare economics.

In *Superior Propane,* it appears that all members of the Tribunal participated and determined this issue and the other issues raised in the appeal, and the Tribunal did not expressly address whether they were questions of law requiring a decision by the Judicial Member alone.

If the central issue in the appeal is found to be a question of law and was not decided by the Judicial Member alone, what impact will this have on the appeal? Should it be sent back to the Judicial Member for reconsideration? How practical would this be since the Judicial Member, together with a lay member, Dr. Schwartz, has already decided this issue against the Commissioner? Moreover, if the Federal Court of Appeal decides that this issue is a question of law that should have been decided by the Judicial Member alone, then is it an issue to which no more deference should be given to the Judicial Member than in any other case where there is an appeal on a question of law from the Trial Division to the Federal Court of Appeal? Generally, in an appeal from a trial court to a court of appeal, the appeal court applies a correctness standard for questions of law. Does a Judicial Member of the Tribunal have any more expertise in matters of competition law than any other member of the Federal Court?

Section 12(1)(a) may be an issue in this appeal, and it is bound to raise issues in future proceedings before the Tribunal. Counsel, in proceedings before the Tribunal, may wish to explicitly consider and address the Tribunal regarding which issues are questions of law to be decided only by Judicial Members. Presumably, whether an issue is a question of law is itself a question of law which should be decided only by Judicial Members.

Given that there may well be many issues that are properly characterized as questions of law, but still require the expertise of members of the Tribunal who have backgrounds in economics and business, does it make sense to exclude their participation from these decisions? What happens if the Judicial Member decides incorrectly that an issue is or is not a question of law? Perhaps section 12(1)(a) of the *Competition Tribunal Act* should be revisited on the next round of amendments.

Notes

[1] *The Commissioner of Competition* v. *Superior Propane Inc.*, 2000 Comp. Trib. 15.
[2] Federal Court of Appeal, Court File A-533-0.
[3] *Commissioner of Competition* v. *Superior Propane Inc. and ICG Propane Inc.* [2000] F.C.J. No. 1518 paras. 8-9 (QL).
[4] *Pushpanathan* v. *Canada (Ministry of Citizenship and Immigration)* (1998), 160 D.L.R. (4th) 193 (S.C.C.) at 211 [hereinafter *Pushpanathan*].
[5] *Pushpanathan* at 213.

THE ANALYSIS OF EFFICIENCIES IN *SUPERIOR PROPANE*: CORRECT CRITERION INCORRECTLY APPLIED

By: Frank Mathewson, University of Toronto and Charles River Associates and
Ralph Winter, University of Toronto and Charles River Associates

Introduction

In the Winter 1999-2000 issue (Vol. 19, No.4) of this publication, Michael Trebilcock and Ralph Winter reviewed the state of the efficiency defence in the assessment of proposed mergers in Canada prior to the decision of the Competition Tribunal in *The Commissioner of Competition* v. *Superior Propane Inc.*[1] In this commentary, we discuss the analysis of efficiencies in the majority decision in *Superior Propane*. We suggest that the criterion for the efficiency defence set out in *Superior Propane* has economic support and adds substantial certainty to merger policy in Canada, but that the criterion was applied incorrectly in the evidence submitted in the case.

Section 96 of the *Competition Act* states that the Tribunal will allow a proposed merger to proceed even if the merger leads to a substantial lessening of competition providing the efficiency gains uniquely attributable to the merger offset and are greater than any lessening of competition. In spite of the treatment of efficiencies in merger cases before the Tribunal, and the publication of *Merger Enforcement Guidelines* ("MEGs") by the Competition Bureau, the interpretation of section 96 and the general role of efficiencies in merger review in Canada were in an uncertain state prior to *Superior Propane*. The MEGs (section 5.5) state that in trading off efficiencies and lessening of competition the Bureau would not challenge a merger if the merger led to an increase in total surplus, i.e. consumer surplus plus seller profits.[2] The MEGs' justification for the use of the total surplus criterion, without regard to distribution of gains between buyers and sellers, is that "[w]hen a dollar is transferred from a buyer to a seller, it cannot be determined *a priori* who is more deserving, or in whose hands it has a greater value".[3] The Tribunal's *obiter dictum* in *Canada (Director of Investigation and Research)* v. *Hillsdown Holdings (Canada) Ltd.*[4] questioned the neutrality of transfers between buyers and sellers and left the law uncertain as to the balancing test in the application of section 96. Howard Wetston, the Director of Investigation and Research at the time of *Hillsdown*, reassured the business community that in enforcing the law, the Bureau would continue to apply the approach adopted in the MEGs.[5] More recently, however, the Bureau has proposed a two-stage test that departs from the simple total surplus standard and which is quite confusing (Trebilcock and Winter, at 110-111). A senior Bureau official has also recently stated that in cases where a merger creates a substantial lessening of competition but would pass under the total surplus standard, the Bureau "feels that it is more appropriate for the Tribunal to determine whether the merger increases aggregate welfare of not."[6]

The Theory of the Total Surplus Criterion in *Superior Propane*

Superior Propane, if it is upheld on appeal, provides a categorical end to the uncertainty in the criteria for balancing efficiencies and competition-lessening effects of a merger. The decision endorses essentially without qualification the total surplus criterion. Issues of income redistribution do not matter in merger assessment

under *Superior Propane*: a dollar received by individuals as shareholders counts as much as a dollar received by individuals as consumers. This endorsement of total surplus by the Tribunal was not qualified in spite of evidence by an expert witness (Professor Peter Townley) that the redistribution of income resulting from the merger would likely be regressive, i.e. from less wealthy individuals to more wealthy individuals. Professor Townley had offered an approach in which the members of the Tribunal were "invited to use their individual judgment and discretion to evaluate whether the gains to shareholders are more or less important to society than the losses of surplus imposed on consumers by the exercise of market power" (431). The Tribunal's endorsement of the total surplus standard and efficiency as an objective of merger policy is strongly phrased: "[E]fficiency was Parliament's paramount objective in passing the merger provisions of the Act and it intended the efficiency exception in subsection 96(1) to be given effect. Accordingly, the Tribunal is not prepared to adopt a standard that frustrates the attainment of that objective." (437)

The endorsement of the total surplus standard, which stands in sharp contrast to both the Tribunal's *obiter dictum* in *Hillsdown* and the recent backtracking by the Bureau on the standard, is justified in *Superior Propane* on the following grounds. First, in the Tribunal's reading of the *Competition Act*, "distributional concerns do not fall within the ambit of the merger provisions of the Act" (432). Second, "merger review must be predictable. Adopting Professor Townley's approach would result in decisions that vary from case to case depending on the views of the sitting members of the Tribunal regarding the groups affected by the mergers" (433). Third, the evidence showed that the transfer from buyers to sellers resulting from the merger was much larger than the deadweight loss.[7] As a consequence "a standard that includes the transfer as an effect under subsection 96(1) would effectively result in the unavailability of the section 96 defence" (434). Fourth, government instruments such as specific tax and other social policy measures are more effective than merger policy as ways of meeting distributional objectives (438). Finally, the Tribunal cites the MEGs' support of the total surplus standard. While noting that it is not bound by these guidelines, the Tribunal "recognizes that they contain a substantial degree of economic expertise" and agrees with the MEGs' observation cited above that when a dollar is transferred from a buyer to a seller, it cannot be determined *a priori* who is more deserving, or in whose hands it has a greater value (439).

The purely legal arguments for total surplus as a criterion to be read directly into section 96 of the *Competition Act* are less than persuasive. Just as the *Superior Propane* Tribunal could state "If Parliament had intended that transfers from consumers to shareholders be considered, it would no doubt have clearly stated this intent in the Act" (432), the *Hillsdown* Tribunal was able to state "If only allocative efficiency or the deadweight loss to the Canadian economy was intended by Parliament to be weighted in the balance then one would have thought that the section would have been drafted to specifically so provide" [8] Section 96 of the Act is ambiguous.

It is obviously within the mandate of the Tribunal to provide an interpretation of the statute, however, and the economic arguments that the Tribunal draws upon to support its interpretation are persuasive. Professor Townley's approach, submitted in evidence on behalf of the Commissioner, invites the Tribunal to apply welfare weights based largely or exclusively on the regressivity of the transfer from consumers to shareholders (a "welfare-weights" approach). Are consumers of the products produced by the merging firms among the less wealthy

members of society, and if so to what extent should the transfer be regarded as a negative outcome of the merger? In Professor Townley's approach, the negative outcome would be incorporated in "balancing weights" or welfare weights attached to surplus accruing to individuals of different wealth levels. The Tribunal's decision to reject this approach has merit. If one were to incorporate redistributive effects in merger analysis, then it would be necessary to consider not just the wealth of consumers but also the wealth of the shareholders of the merging firms. The income redistributive effect of a transfer from one group of individuals to another depends on the wealth levels of both groups. If redistributive effects were consistently accounted for, a merger that was unacceptable when wealthy Canadian families closely held the merging firms would suddenly become acceptable if a teachers' pension fund bought the shares. The incentives for share ownership by wealthy and less wealthy individuals would then be affected, the impact of merger policy on these incentives would become an issue for concern, and merger analysis could become hopelessly complex.

Furthermore, carrying the welfare-weights approach to its full conclusion means that mergers such as the IntraWest acquisition of Whistler Mountain (which combined the adjacent Blackcomb and Whistler mountain ski areas) could be accepted in spite of the prediction of negative cost efficiencies and a positive deadweight loss because the merger produced a favourable redistribution of wealth from very wealthy consumers (on average) to less wealthy shareholders. A welfare-weights approach results in acceptance of some transactions with overall negative net efficiencies, including the deadweight loss, if the distribution of wealth is improved with the transactions. Sections 92 and 96 of the Act do not provide for decisions involving both a lessening of competition and negative efficiencies; therefore this example shows that these sections are not fully consistent with a welfare weights approach to merger policy.

The Application of the Total Surplus Criterion in *Superior Propane*

Deadweight Loss Calculations

The application of a total surplus standard to decide whether a merger increases welfare reduces to a comparison of the total efficiencies that are realized with a merger against the deadweight loss caused by the merger if the merger lessens competition, causing prices to rise. From the evidence submitted in the case, the Tribunal arrived at estimates of total efficiencies from the merger of approximately $29 million (annualized, for a period of ten years) and a deadweight loss associated with the merger of approximately $3 million (383, 455). The Tribunal's estimates of the deadweight loss rest on the evidence submitted by Professor Michael Ward on behalf of the Commissioner (455, 458).

Professor Ward provides estimates of the individual demand elasticities (or price-responsiveness) for the merging parties in his evidence and from these simulates or predicts the price increases and deadweight loss that would result from the merger. The average predicted price increase across subsectors of the propane market is approximately 9% (453, 457). According to Professor Ward, prior to the merger, Superior and ICG each exercised market power: the estimated elasticity of demand facing the individual firms was between -1.9 and -3.9 (or approximately -3).[9]

An individual-firm demand elasticity of –3 in the pre-merger market implies that pre-merger prices are already 50% higher than marginal cost. A profit-maximizing firm sets price according to the following formula (called the Lerner relationship):

$$\frac{P-c}{P} \qquad \frac{1}{e}$$

where P is price, c is cost and e is the (absolute value of the) firm's own demand elasticity.[10] An estimate that e is 3 is *ipso facto* an estimate that P exceeds c by 50%.

One source of market power in the pre-merger market according to Professor Ward's evidence is the incorporation by each of the two major firms of the price response by its rival to changes in its own price. Professor Ward estimates that Superior responded to price increases by ICG by matching each one percent price increase with about a two-thirds of a percentage price increase. (Professor Ward assumes in his evidence that the response by ICG to Superior's price changes is symmetric.)[11] If zero market power were exercised in the pre-merger market, in contrast to Professor Ward's evidence, then prices would approximate marginal cost and each firm would be a "price-taker" rather than responding to price increases of its rivals.

Professor Ward's deadweight loss estimates are based on Figure 1, which is produced from his evidence[12]. In this figure, the downward-sloping demand curve represents consumers' reservation prices or willingness to pay for the next unit of a product. The reservation price is higher at lower quantities of the product. Referring to the figure, Professor Ward associates a price increase from P^1 to P^2 with a deadweight loss ("DWL") equal to the darkly shaded triangle and a transfer from consumers to shareholders equal to the lightly shaded rectangle. The Tribunal essentially adopts Professor Ward's estimates of the deadweight loss.

Figure 1 is an incorrect depiction of the deadweight loss resulting from a merger-induced price increase from P^1 to P^2 when P^1 exceeds marginal cost (i.e. when there is pre-merger market power), a condition recognized in Professor Ward's evidence. Deadweight loss is measured by a triangle bounded by the demand curve, price, and marginal cost. When P^1 exceeds marginal cost, a deadweight loss, depicted by the triangle DWL^1 in Figure 2, already exists in the pre-merger market. That is, relative to the hypothetical world where price equals unit cost (denoted by c in the diagram), the pre-merger market is characterized by a loss in total surplus equal to DWL^1. The deadweight loss associated with the merger is the <u>increase</u> in the size of the deadweight loss triangle above marginal cost as the market moves from P^1 to P^2. This increase is depicted in Figure 2 as the difference in the two triangles bordered by the demand curve and marginal cost, a trapezoid-shaped area. The correct merger-related deadweight loss so calculated exceeds the area of the triangular area adopted in Professor Ward's evidence (labeled "Ward's DWL" in Figure 2) by the area of the rectangle underneath this triangle (labeled "missing DWL").[13]

For a market elasticity of demand of –1.5 (the value on which the Tribunal focuses in its reading of Professor Ward's evidence), individual firm demand elasticities of –3, and a price increase of 9%, the actual deadweight loss that follows from Professor Ward's estimates is approximately 8.5 times the value that he reports.[14]

The magnitude of this error is clearly large. More importantly, the correction brings the difference between the estimate of deadweight loss implied by the Commissioner's expert evidence and the Tribunal's estimate of efficiencies well within the range of estimation error that is imposed by the limitations of data and econometric evidence in the case. While the Tribunal notes that the Commissioner did attempt to provide additional estimates of deadweight loss, the Commissioner did so based on information put forward only in final argument. The Commissioner did not address this correct total surplus test in properly submitted evidence. Because of this, the Tribunal excluded the revised estimates (451).

As the Tribunal noted (434), citing Trebilcock and Winter, estimates of "deadweight loss triangles" tend to be small relative to even modest efficiency gains. Deadweight loss triangles measure the surplus loss of a given price increase when one starts from a price equal to marginal cost. As we find here, however, the deadweight loss from a given price increase when one starts from a pre-merger price exceeding marginal cost can be very large.

It may be helpful to elaborate on the simple economics of why pre-merger market power makes such a difference, without reference to triangles, rectangles or trapezoids. Consider, for example, a market in which 100 consumers each purchase one unit of the product in the pre-merger market. Suppose that price is initially equal to a marginal cost of $10, then increases by 10% to $11. A loss in total surplus, or deadweight loss, arises with the departure from the market of consumers whose willingness to pay is between $10 and $11. Suppose that the size of this departing group is 10, or 10% of initial purchasers.[15] The loss in total surplus associated with each of these consumers is equal to the difference between the consumer's willingness to pay and the marginal cost. This loss is on average only 50 cents for each departing consumer, for a total loss in surplus of about $5 or only 0.5% of initial revenue. The key to the small size of the deadweight loss is that the consumers departing from the market are those whose value for the product was only slightly above the cost of producing the product. Total gains from trade in a market (total surplus) is the difference between the social value of the product (the aggregate of consumers' value for the product) and the social cost of producing the product. Where the consumers discouraged from purchasing by a price increase are those whose value is only slightly above cost, the loss in total surplus associated with the price increase will be small.

Now consider a second example. Marginal cost is still $10; however, the initial price is $20. The percentage price increase is still 10% (now from $20 to $22); continue to assume that there are initially 100 consumers and that 10 of these are discouraged from buying by the price increase. In this second example, the average departing consumer will value the product at $21. The loss in total surplus represented by the average departing consumer is the difference in this value and marginal cost of $10, which is $11. This is a large number. As a consequence of the initial gap between price and marginal cost, the departing consumers are no longer consumers whose value for the product is only marginally above the cost of production. As a result, each of the departing consumers represents the loss of substantial gains to trade. The total loss of surplus in this second example is $100 or 5.0% of initial revenue, 10 times the percentage loss found in the first example.

It is useful as well to address a question that may be raised in the minds of some readers. Are we suggesting that a merger to a given post-merger price, or a merger of a given market to monopoly, involves a small deadweight loss when the market is initially competitive but a large deadweight loss when market power is exercised pre-merger? We may appear to be suggesting that "pre-merger market power raises the deadweight loss associated with a merger to monopoly in a given market". Yet this could not be true, since the monopolization of a market that is already part way along the path towards monopoly pricing clearly cannot involve greater social loss than the monopolization of a market with initially competitive pricing.

The resolution to the apparent paradox is in the phrasing of the question. Monopolization of a market - given a demand schedule and costs - involves greater deadweight loss if the market is initially competitive than if market power is already being exercised. This proposition holds constant the demand schedule and costs. However, the deadweight loss associated with a given price increase is larger when there is pre-merger market power than when there is not. This proposition holds constant the magnitude of the price increase attributed to the merger. The effect on deadweight loss of pre-merger market power, in other words, depends on what is being held constant. In the *Superior Propane* merger, the price increase of about 9% estimated by Professor Ward involves a much greater deadweight loss when its calculation correctly incorporates Professor Ward's own estimate of pre-merger market power. On the other hand, relative to a competitive market the existence of pre-merger market power (assuming, for our purposes, that it exists) reduces the deadweight loss attributable to the merger.[16]

Efficiency Calculations

We move now to the other side of the efficiencies / deadweight loss comparison. The Tribunal and the Commissioner err on this side of the comparison as well in their calculations of the cost savings associated with the merger. Cost savings can be categorized into savings in fixed costs and savings in variable costs. The savings in variable costs must be applied to the post-merger output quantity (Q^2 in Figure 2), not the pre-merger quantity (Q^1). The Tribunal adjusts downwards the respondents' claims for efficiencies (380) for various reasons, but these reasons do not include a reduction in volume sold as a result of a price increase. In its trade-off analysis, however, the Tribunal assumes price increases in the range of 7.0% to 11.0% in the various segments of the propane market (453) and adopts the Commissioner's assumed elasticity of demand of –1.5 (455, 458, 463). The volume decrease implied by a demand elasticity of –1.5 and a price increase of approximately 9% is –13.5%. The Tribunal's analysis, in other words, assumes approximately this decrease in volume. To the extent that the respondents' claimed cost savings (for example in categories such as reductions in the size of delivery fleet, the number of drivers and propane supply (see 380)) depend upon volume, the claimed cost savings should have been reduced further in both the Tribunal's estimates and the Commissioner's submissions.

Conclusions

Superior Propane both clarifies and relaxes the restrictions imposed by Canadian competition law on mergers that generate efficiencies, notwithstanding the limitations on the efficiency defence of pre-merger market power. As discussed, the efficiency defence following *Hillsdown* and recent statements from the Competition Bureau

rested on shaky ground. *Superior Propane* explicitly allows mergers that lead to substantial lessening of competition providing the mergers generate sufficient efficiencies to meet the total surplus test – and, as the Tribunal recognizes, relatively small cost efficiencies may be enough to offset a substantial lessening of competition. Prior to *Superior Propane*, competition lawyers would have properly advised clients not to pursue mergers that involved an obvious and substantial lessening of competition. After *Superior Propane*, such advice is too conservative for mergers involving significant efficiencies.

Will *Superior Propane* open the floodgates for mergers in Canada? The number of contentious mergers brought forward may well increase, but as this paper shows the now-expanded efficiencies defence is still limited by the correct incorporation of pre-merger market power in merger analysis. More significantly, even a substantial increase in the percentage of contentious mergers will not represent a flood of new mergers in Canada. In a recent period in Canada, less than 2% of mergers raised an issue under the *Competition Act*.[17] The overwhelming majority of mergers appear driven by legitimate business concerns such as efficiencies and product development, not by a desire for market power.

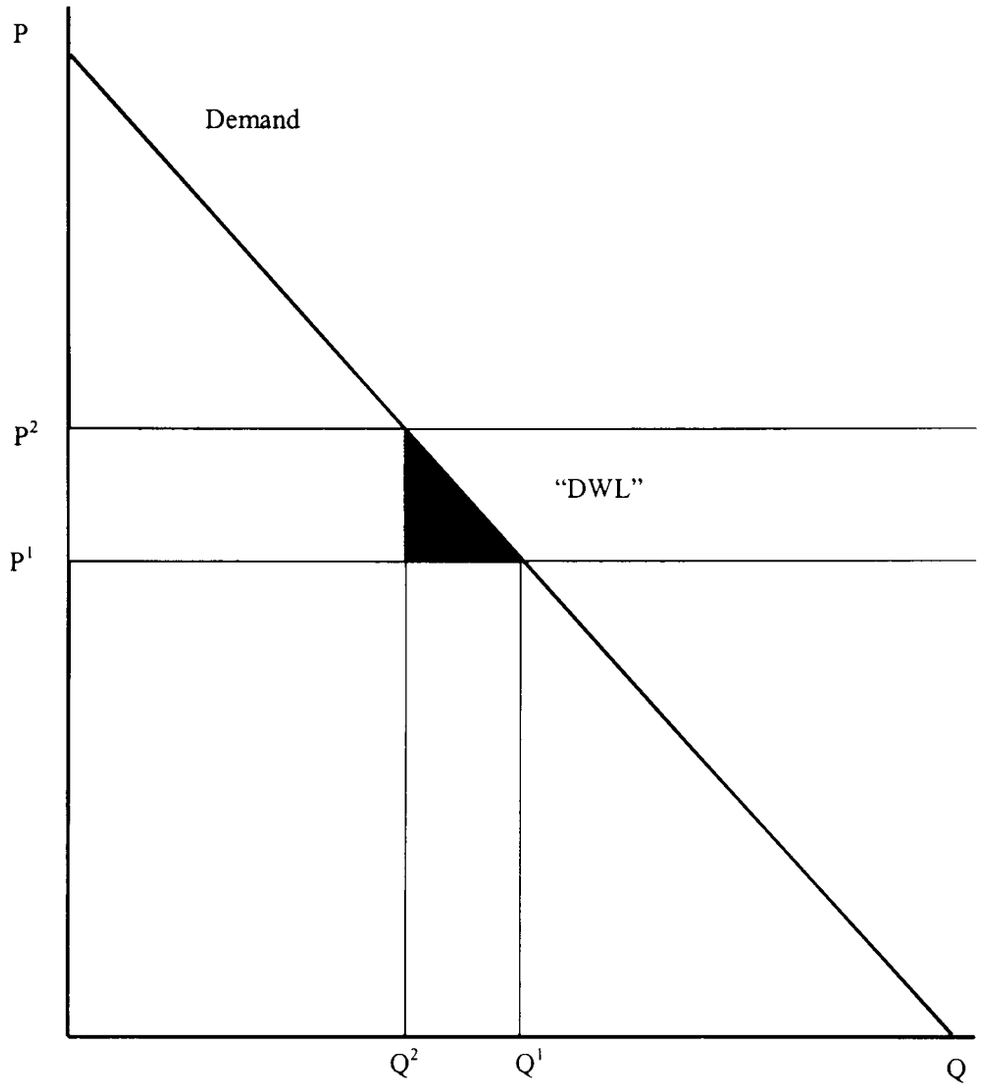

Figure 1: Professor Ward's Estimation of Deadweight Loss as Price Increases from P^1 to P^2

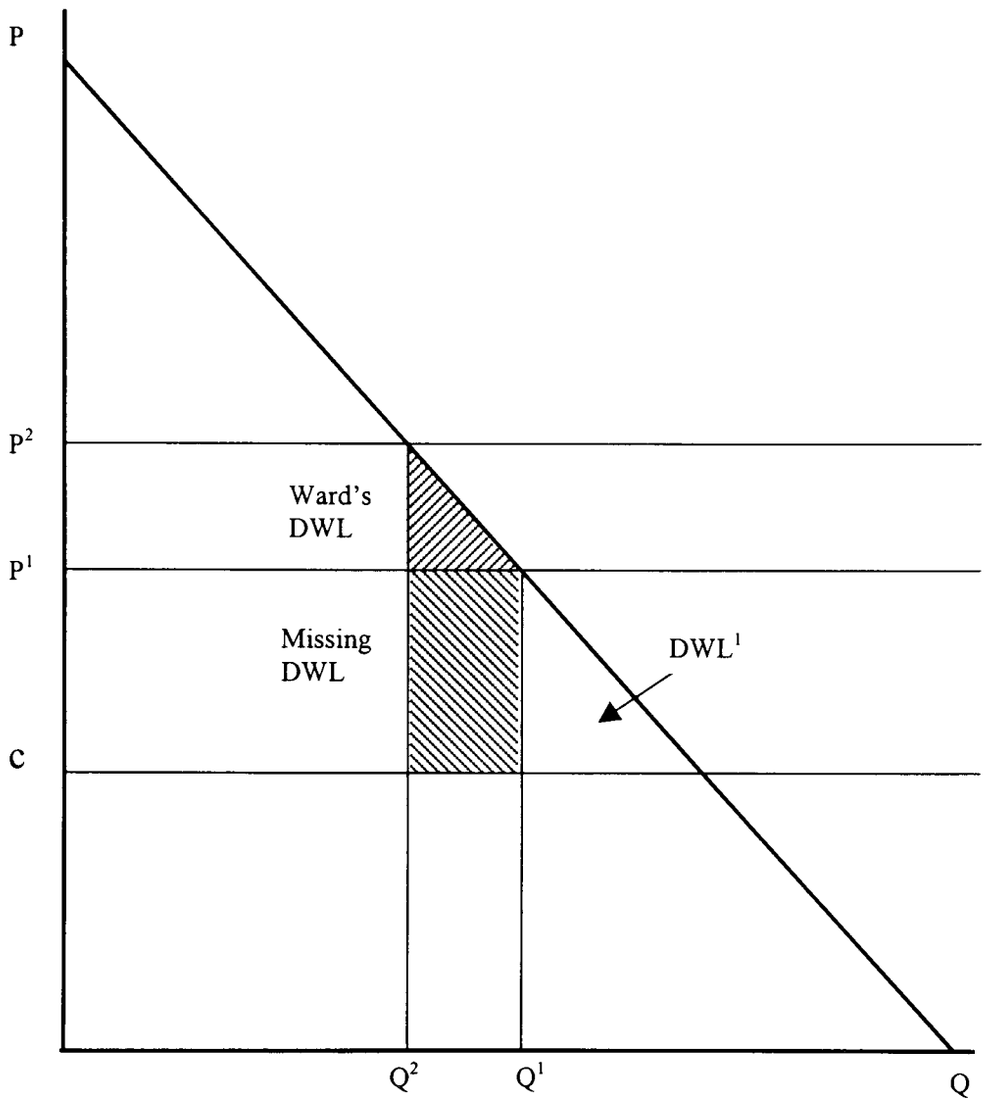

Figure 2: Correct Estimation of Deadweight Loss as Price Increases from P^1 to P^2

Notes

[1] 2000 Comp. Trib. 15 [hereinafter *Superior Propane*. Numbers in parentheses refer to paragraph numbers in the decision.]
[2] The surplus gained by a consumer from purchasing a unit of a product is the excess of the consumer's value of the product over the price paid. For example, if a consumer would pay at a maximum $10 for a unit of a product, but is able to purchase the unit at $7, the consumer earns a surplus of $3. "Consumer surplus" is the sum of such surpluses across consumers and represents the dollar value of the consumers' gains from trade in the market. Adding seller profits yields the total surplus, or total gains to trade in the market.
[3] MEGs, footnote 57.
[4] (1992) 41 C.P.R. (3d) 289 [hereinafter *Hillsdown*].
[5] Mr. Wetston stated that he was "of the view that, from an enforcement perspective, it is preferable not to depart at this time from the approach adopted in the *Merger Enforcement Guidelines*," Howard Wetston, "Developments and Emerging Challenges in Canadian Competition Law," Speech at the Fordham Corporate Law Institute, New York, October 22, 1992, at 9.
[6] Gwillym Allen, speech to conference attendees at "Meet the Competition Bureau", Toronto, May 3, 1999, published at http://strategis.ic.gc.ca/SSG/ct01548e.html (date accessed: February 7, 2000), at 5.
[7] The "deadweight loss" associated with a price above marginal cost is the loss in total surplus in the market relative to the case where price equals marginal cost. In other words, the deadweight loss associated with a price increase is that portion of the additional expenditure by buyers that does not represent simply a transfer to sellers. A merger that increases price will increase the deadweight loss in a market to the extent that demand is elastic (responsive to price).
[8] *Hillsdown*, Section VI B.
[9] Evidence of Professor Michael Ward, at 29. An individual-firm elasticity of demand of -3 means that a 1% price increase results in a 3% decline in quantity purchased from the firm. A market elasticity of demand of say -1.5, means that if prices by all firms in a market rose by 1% the market quantity purchased would fall by 1.5%.
[10] Note that the relevant demand elasticity is the individual-firm elasticity of demand, not the market elasticity of demand.
[11] Evidence of Professor Ward, at 26 and 27.
[12] Evidence of Professor Ward, at 33.
[13] The impact of pre-merger market power on deadweight loss in merger analysis is well understood in the economics literature. For a particularly clear exposition, see Donald G. McFetridge, "Prospects for the Efficiency Defence," 1996 *Canadian Business Journal* 26 (1996) at 321-357.
[14] The following approximate calculations support the figure of 8.5. Refer to Figure 2. With the market demand elasticity of -1.5, we have Q2 = Q1 [1-1.5(.09)]. The area of the triangle marked "Ward's DWL" is then given by (1/2)(P2 – P1)(Q1 – Q2) = (1/2)(.09P1)(.135Q1) = .006 P1Q1, or 0.6% of initial sales, consistent with the value reported in Table 8 (p.34) of Professor Ward's evidence. The area of the rectangle underneath "Ward's DWL" is (P1-c)(Q1-Q2) = .33P1*.135Q1 = 0.045 P1Q1. Adding the two areas yields a merger-related deadweight loss of 0.051P1Q1, or 5.1% of initial sales. This is 8.5 times 0.6% of initial sales.
[15] Equivalently, suppose that the elasticity of demand is –1.0.
[16] We emphasize that we are commenting on the internal logical consistency of the evidence filed on behalf of the Commissioner and the aspects of the Tribunal's decision that follow this evidence. In particular, we do not comment here on the validity of Professor Ward's estimates of pre-merger market power. Note that since the respondents did not allege pre-merger market power, none of our comments applies to their evidence.
[17] Between 1986 and 1994, the Competition Bureau examined roughly 22% of publicly reported mergers and only about 1.6% of reported mergers raised an issue under the *Competition Act*. (Donald G. McFetridge, "Merger Enforcement under the *Competition Act*: The First Ten Years," *Review of Industrial Organization*, Vol. 13, Nos. 1-2 (April 1998) 25-56. The statistics are to the end of the 1993-1994 budget year and exclude the half year for 1986.)

CANADIAN COMPETITION RECORD

HIGHLIGHTS

FEATURE ARTICLES

VOL. 20, NO. 3 SUMMER 2001