

CANADIAN COMPETITION RECORD

COMMENT AND ANALYSIS**DEALING WITH PREDATORY CONDUCT IN THE CANADIAN AIRLINE
INDUSTRY: A PROPOSAL¹**

By: Thomas W. Ross, UPS Foundation Professor of
Regulation and Competition Policy and
W.T. Stanbury, Professor Emeritus
Faculty of Commerce & Business Administration
University of British Columbia

1. Introduction

The main purposes of this paper are: (a) to review the Competition Bureau's new provisions to deal with predatory conduct in the airline industry, and (b) to put forward a new proposal in this context which we believe represents progress toward dealing with certain limitations in the new legislation. Predatory conduct is a notoriously difficult problem for antitrust/competition policy. Like most economists, we tend to be sceptical that it is a widespread problem and we are also sceptical about the ability of antitrust authorities to draft and enforce a law that is neither over nor under inclusive, that is reasonably clear to the firms subject to it, and that can be administered in a prompt and effective fashion.

At the same time, our research on the airline industry – particularly in light of Air Canada's takeover of Canadian Airlines Corporation in early January 2000 – tells us that predation is more likely to occur there than in most other industries and that the previous law (paragraph 50(1)(c) and sections 78-79 of the *Competition Act* prior to the amendments embodied in Bill C-26) was quite inadequate for the task (see Stanbury & Ross, 2001). At the same time, while we believe the amendments dealing with predatory conduct in Bill C-26 (effective July 5, 2000) and the new Regulations under section 78 (effective August 23, 2000) represent a significant improvement, we believe that further refinements are merited to ensure that "tough but fair competition" is not "chilled" and that air carriers will have a clearer idea of what they can and cannot do.

This paper is organized as follows. Section 2 sketches the problem of predation in the airline industry and the evolution of the economic analysis of predation. Section 3 outlines the Competition Bureau's new approach to dealing with predatory conduct in the airline industry and it includes our critique of the new provisions. Section 4 describes the first case brought under the new provisions, notably section 104.1. It dealt with complaints by the new CanJet Airlines against Air Canada.² In section 5 we outline our proposal, which we believe offers a somewhat clearer approach to predatory conduct in the domestic airline industry. Our brief conclusions are set out in section 6.

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2. Predation and the Airline Industry

It is important to recognize that predation in airline markets can take many forms. For example, incumbent carriers can use their superior size and financial strength to drive new entrants from the market with prices that impose significant losses on the entrants (and on themselves). Incumbents can also render entrants unprofitable by adding additional and excess capacity to the market through additional flights or larger aircraft, spreading the available business too thinly for profitable operation. While the period of predation is also costly for the predator, if the tactic is successful at eliminating the competitor, the predator may be able to recoup its losses by raising prices after the competitor has left the market.

Predation in one market or against one competitor can have the added benefit of discouraging other potential competitors from entering against the same incumbent in the same or even other markets. A “reputation for toughness” thus earned may be an element of competitive advantage that lasts for some time. Predation may also be used to discipline competitors that have been overly aggressive toward the dominant firm. Thus, again, the dominant firm may be able to raise prices in the future.

While we do not here review the modern economic theory of predation, we offer a few summary comments.³ Early work by economists attempting to understand predatory pricing suggested that it was unlikely to be the strategy of choice for a firm that could more profitably, for example, buy its rival.⁴ It was further argued that predation may not even work if, for example, the victim could just sit out the predatory period and re-enter when prices were inevitably raised. A very important contribution of these writers was their warning that it was very difficult to distinguish predation from good, aggressive competition and that tough rules against predatory pricing could serve to undermine the very thing they were intended to protect: competition.

Subsequent work by economists in the 1970s, 1980s and 1990s changed thinking about predation by advancing understanding in two directions. A number of careful case studies provided fairly convincing evidence that predatory strategies had been employed successfully in several industries.⁵ And economic theorists, using the tools of modern game theory, established that predatory actions could indeed be optimal strategies in models of incomplete or asymmetric information.⁶ For example, they have shown that under some conditions it is possible for incumbent firms to lose money through a predatory attack on one entrant but make it up later by discouraging other potential entrants. This is most likely when the incumbent operates in many markets – as is the case for large airlines – so that predation in one market can be paid for by higher profits in a number of others.

Despite these more recent developments, we believe most economists would still argue for considerable caution in the application of any rules against predation for fear of stifling legitimate competition. Clearly, what we do not want to do is to discourage good, vigorous competition by making firms “enforcement victims” of overly aggressive public authorities or of rivals looking to tilt the playing field to their advantage. This would create a greater problem than the one we are attempting to solve.

American courts have also been reluctant to find that aggressive pricing is predatory under the antitrust laws, and the success rate of plaintiff victims is low.⁷ This said, serious allegations of predation in the airline industries of

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Canada and the United States have been put forward in recent years. In the United States, for example, the Antitrust Division of the Department of Justice launched an action against American Airlines in 1999⁸ and the Department of Transportation signaled its concern by proposing a new way to evaluate predation claims in airline markets.⁹ In Canada, Canadian Airlines International alleged in 1992 that it had been the victim of predatory actions – low prices and excess capacity – by its financially much stronger rival Air Canada. (This case was dropped as part of the agreements to facilitate completion of the deal between AMR Corp. and CAI – see Stanbury & Ross, 2001).

As pointed out by the early critics of rules against predatory pricing, the practice can be very expensive for the predator. In order to drive out a rival, the predator must frequently incur even larger losses than those of its victim, simply because it is selling more units at a price below cost. In some cases, however, the predator can adopt a more “targeted” strategy that allows it to keep high prices on much of its output and charge low prices only where those prices are likely to steal business from the victim. An important example of such targeting can be the creation of a “fighting brand” – a new brand of the product that aims directly at the victim’s market.

With this in mind, Air Canada’s announced plan to launch a discount airline merits attention. While there may be a number of legitimate business reasons for Air Canada to establish a discount operation¹⁰, there is certainly some chance that the new subsidiary could be a mechanism by which Air Canada could predate against other discount carriers at lower cost to its own operations.

3. The Bureau’s New Approach¹¹

3.1 *Predatory Conduct in the Airline Industry:*

Many of the changes in the *Competition Act* made by Bill C-26 (effective July 5, 2000) deal with the complex problem of predatory conduct in the airline industry in light of Air Canada’s takeover of Canadian Airlines Corporation (“CAC”) in January 2000. As a result, Air Canada gained a dominant position in the largest markets (city-pairs) and a monopoly on 120 of the top 200 routes, according to the Competition Bureau.

The new Regulations made under subsection 78(2) of the *Competition Act* created the following new anti-competitive acts with respect to the domestic airline industry effective August 23, 2000:

- (a) operating capacity on a route or routes at fares that do not cover the avoidable cost of providing the service;
- (b) increasing capacity on a route or routes at fares that do not cover the avoidable cost of providing the service;
- (c) using a low-cost second-brand carrier in a manner that is described in paragraph (a) or (b);
- (d) pre-empting airport facilities or services that are required by another air carrier for the operation of its business, with the object of withholding the airport facilities or services from a market;

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- (e) to the extent not governed by regulations respecting take-off and landing slots made under any other Act, pre-empting take-off or landing slots that are required by another air carrier for the operation of its business, with the object of withholding take-off or landing slots from a market;
- (f) using commissions, incentives or other inducements to sell or purchase its flights for the purpose of disciplining or eliminating a competitor or impeding or preventing a competitor's entry into, or expansion in, a market;
- (g) using a loyalty marketing program for the purpose of disciplining or eliminating a competitor or impeding or preventing a competitor's entry into, or expansion in, a market; and
- (h) altering its schedules, networks, or infrastructure for the purpose of disciplining or eliminating a competitor or impeding or preventing a competitor's entry into, or expansion in, a market.¹²

It is important to appreciate the context in which the new anti-competitive acts exist: these must be acts done by a dominant air carrier (substantial or complete control of the relevant market) in the domestic market. There are high barriers to entry (or expansion) to become a large-network carrier like Air Canada. Therefore, predatory conduct may be economically rational because recoupment is possible in the absence of antitrust actions or where the authorities' response is so slow as to negate its effect.

In general, predatory conduct (a) is intended to weaken rivals (or potential rivals) directly; (b) requires the perpetrator to invest in losses or sub normal profits (in the expectation of future recoupment); (c) is not driven largely by market conditions, e.g., with a drop in demand, it makes sense for a firm to lower prices as low as short run variable cost to expand sales so long as it is covering the relevant marginal costs; and (d) is facilitated if the predator is financially stronger than its target.

Note that under the new provision in paragraph 78(1)(k), the predatory conduct by a domestic air carrier may be indirect, e.g., denying essential facilities to a rival which are routinely made available to others on commercial terms.¹³ Essential facilities include, but are not limited to, take-off and landing slots, interline arrangements, airport gates, maintenance services, and baggage handling infrastructure, equipment and services.¹⁴

Essential services are defined in section 2 of the new Regulations as those (a) that are required in order to provide a competitive air service; (b) that cannot reasonably or practicably be purchased, acquired, provided or replicated by another air carrier on its own behalf; (c) that are effectively controlled by the air carrier who denies access to them or refuses supply of them; and (d) that can be feasibly provided to another air carrier, having regard to operational or safety considerations, or legitimate business justifications of the air carrier referred to in (c).

3.2 Applying Sections 78 and 79

Ascertaining Predatory Conduct – The Information Problem: Obviously, the effect of the new provisions depends on the definition of predatory conduct. Here we focus on the first two items in the new Regulations under section 78 of the *Competition Act* (low fares and increases in capacity) which were listed in the section above.

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These types of anti-competitive conduct require a great deal of information. The Competition Bureau needs to know the following if the loss of revenues due to diversion (of sales from high fare classes to lower fare classes) is to be treated as a cost to the alleged predator airline or if price/cost comparisons are to be done by flight rather than seat:

- the fares for each class on each flight (and changes over time prior to each flight);
- the number of seats made available in each fare class over time for each flight (size of the “buckets”) – this is to assess diversion;
- the number of seats sold in each fare class;
- any change in aircraft seating capacity during the period in question (this alters capacity);
- the presence of seasonal and cyclical factors (and even specific holidays) – to recognize changes in demand;
- the level of and changes in “fences” for restricted fare classes;¹⁵
- the timing of fare cuts and/or increase in low-fare seats. Did it occur prior to entry? How far ahead?
- changes in frequent flyer plan (“FFP”) points during the period of alleged predation; and
- the incumbent carrier’s avoidable costs – these depend on the time period under consideration.

Avoidable Costs: The term “avoidable costs” is not defined in the *Competition Act* or its new Regulations, but the Competition Bureau’s *Draft Enforcement Guidelines on the Abuse of Dominance in the Airline Industry* (February 8, 2001) (the “Draft Guidelines”) state that avoidable costs refer to “all costs that could have been avoided by the dominant airline had it chosen not to offer the service in question” (p. 12). The Bureau will use the flight as its unit of capacity to compare revenues and costs. Its operative test is whether “the avoidable cost of the flight on a daily basis for a period of at least a month,” is less than the total revenue for that flight measured over the same period (p. 13). Thus, the Bureau incorporates all fare classes used on that flight over the month (p. 13). Therefore, although the Bureau does not specifically say so, its measure of revenue takes into account diversion to the extent that it occurs on the flight in question over the month the Bureau measures costs and revenues.

Note, however, that the Bureau will measure the revenues and avoidable costs for the flight on a daily basis (p. 14). “For a given flight the Bureau considers whether that flight’s average daily revenues over a month cover its avoidable costs, as well as the number of times that flight’s revenues did not cover its avoidable costs” (p. 14). Figure 1 illustrates how the Bureau is likely to categorize various costs as avoidable or not with respect to the airline’s decision to cancel or add a flight.

It should be noted that predatory behaviour can occur even if an airline does not alter its schedule at all. It can change fares, alter the size of the “buckets” for various fare classes, increase frequent flyer points, offer free limousine service, and/or reduce the fences for one or more discount fare categories. The Bureau states that it “does not consider that matching the dollar price of a competitor for travel on a specific flight is the same as

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charging the same real price for the same quality and quantity” (p. 12). We agree, but the problem lies in translating the concept into practice in the messy real world. For example, by how much should the Bureau adjust the stated fare when (a) triple frequent flyer points are offered, or (b) the stay-over-Saturday-night requirement is dropped from the three lowest fare categories? Predatory conduct (a violation of sections 78-79) is defined in the Regulations as (a) operating capacity at fares that do not cover avoidable costs, and (b) increasing capacity at fares that do not cover avoidable costs.

Baumol (1996, pp. 58-59) proposed that average avoidable cost (“AAC”) be substituted for average variable cost (“AVC”) in Areeda & Turner’s (1975) widely-cited approach to predatory pricing. AAC is defined by Bolton et al. (2000, p. 2271) as “the average per unit cost that the predator would have avoided during the period of below cost pricing had it not produced the predatory increment of sales.” AAC is a short run measure because it excludes any sunk costs incurred before the period of predation as these are inescapable. It does not require any allocation between fixed and variable costs which is often problematic (Bolton et al., 2000, p. 2272). AAC more closely approximates the full marginal cost of a particular good or service because it includes all costs (fixed costs or variable costs) that would have been avoided had the defendant not made the predatory sales (Bolton et al., 2000, p. 2272).

Which costs were avoidable if Air Canada did not match the lowest fare offered by CanJet following its entry into several routes on September 5, 2000? They would appear to include any increased advertising/marketing costs, increased fuel costs due to more passengers, travel commissions on increased passengers, the cost of additional FFP points awarded to increased passengers, and the costs of meals and (non alcoholic) beverages for additional passengers.

But this is not the only way to think about avoidable costs. We should not just talk about the costs they could avoid by keeping prices at the original level. We also need to talk about the costs Air Canada could avoid by not selling the output they are pricing so low, i.e., what costs could Air Canada avoid by not running the flight or flights in question. This is related to Baumol’s point about predation with multiple products that are sold together which we note below.

Should the estimated costs of diversion be included in avoidable costs? We address this issue below. Before doing so, it is useful to consider the broader context of a dominant incumbent carrier’s response to entry. Obviously, the measurement of avoidable costs is sensitive to the major carrier’s change in strategy. For example, if it involves adding flights or changing the size of aircraft on a route, then avoidable costs will be much larger than if the carrier simply lowers fares and allocates more seats to that fare class. In theory, when considering how it should respond to new entry (whether by a start-up or an existing carrier), Air Canada should compare the incremental costs and revenues of each alternative. That is, it should compare the incremental net benefits of various options, including doing nothing.

Under this approach, Air Canada (any incumbent) should also consider the intangible benefits and costs related to its actions (e.g., matching the entrants low fares) as well. Air Canada may wish to be seen as being responsive to price-sensitive travellers, and it may want to build a reputation as a “tough” competitor which consists of signals

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to entrants, and signals to potential entrants. This approach also requires that Air Canada consider the risk of provoking an investigation by the antitrust authorities. Such an investigation results in direct costs related to legal bills, the use of executive time (responding to the allegations), and the indirect costs of adverse publicity.

We suggest that a key issue is this: when the incumbent offers more low-fare seats (at a fare that matches the entrant), does it make itself worse off (in terms of expected net present value) than it would by adopting another strategy? This requires consideration of loss of revenue due to diversion. It also requires consideration of intangible costs and benefits. It also requires consideration of the longer term consequences.

The concept of avoidable costs offered by Bolton et al. (2000, p. 2271) implicitly requires that the incumbent compare its costs when it engages in the alleged predation to some alternative. But what is the counter-factual case to offering X seats at the lowest fare offered by the entrant? Is it offering the same number of seats at a higher fare? Is it offering fewer seats at the entrant's lowest fare? This is not clear from the definition.

Diversion: Diversion occurs when an airline changes the terms of its low-fare offerings (e.g., more seats, lower fares, even lower fares) and, as a result, sells fewer higher-priced tickets. Obviously, the greatest cost occurs when a full-fare (unrestricted Economy) passenger is able to switch to a deeply discounted fare. Thus, even a small amount of diversion can greatly increase the effective cost to a full-service carrier of offering deep discount fares.

With respect to the matter of diversion, there would appear to be several approaches. First, one could treat revenues diverted from higher yields as an avoidable cost for the purposes of performing an avoidable cost test. This is not really in the spirit of the definition of avoidable costs which typically includes only real social costs of production (diversion is really a transfer of surplus from producers to consumers). Second, one could treat revenues diverted as a deduction from the revenues earned and thereby adjust the definition of price for the purposes of the price-avoidable cost test. While producing the same sort of results as the first approach, this is cleaner and keeps us from mixing apples (revenues) and oranges (costs). One concern with either of these approaches is that a firm might fail a price-avoidable cost test with diversion, even with a price above its average total cost and even when the entrant is receiving a price greater than its average total cost. More generally, there is always something like diversion in predation cases in that marginal revenue ("MR") is less than price.¹⁶ Usually we do a price/cost test and not a MR/cost test. Would incorporating diversion mean that in all predation cases we should consider MR rather than price? It seems that part of the objections to the U.S. Department of Transportation approach was the difficulty of establishing the counterfactual – what could the incumbent have done differently given the information it had at the time it decided how to respond to entry? Under a third approach, evidence of diversion could be used to establish predatory intent, which would supplement an avoidable cost test. But it would not constitute part of that test.

Clearly, if we do not include diverted revenues in the price-cost test, it will be (much) harder to establish predation, but this may not be so bad. In the case of airlines, it would probably force us to consider the revenues and costs for a whole flight (or all the flights on a route). But would we necessarily want to condemn Air Canada if it

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competed with CanJet by giving everyone on its flights between Toronto and Moncton the same low fare, but the fare was high enough to cover all avoidable costs? If an entrant can't compete with that, who are we protecting? And why?

Baumol (1996, p. 70) argues that if the AAC test is used (as it should be) to determine whether an alleged predatory price constitutes a threat to efficient competitors, "then the opportunity-cost of owner supplied inputs should be included, but the revenues foregone as a result of the price cut should not." According to Baumol (1996), in the U.S., in at least two cases prior to 1994, the courts specifically rejected foregone revenues or profits as a type of opportunity cost that must be considered in a predation case.¹⁷

In summary terms, while diversion is an important consideration, the proper way to use data on diversion is something that merits further analysis.

Discussion: We could define any tactic as "predatory" where it is a profit-maximizing strategy for a firm only if there is a recoupment period. Of course, recoupment requires barriers to entry sufficiently high to permit supra-competitive prices following the application of the tactic (which weakens/eliminates a rival). Baumol (1996) points out that such an approach is too broad. It would include actions by a firm that reduce profits (incur losses) in the short run, but are expected to increase the net present value of the stream of profits. He refers to shutting down a factory to retool it to reduce costs and/or get ready to produce a new product, large expenditures on R&D, and entering a new market at low volume and so suffering losses until sales reach a certain level. What distinguishes the two cases? At least two things: first, the examples given by Baumol are not targeted on a specific competitor – although their effect may be, in time, to reduce one or more competitor's profits. So the matter of intent is quite different. Second, in a case of true predation, the tactic is rational only if the target is cowed or forced to exit (and then recoupment occurs).

It has been frequently noted that predation may be associated with an asymmetry in the financial strength of the large (dominant) incumbent and newer/smaller rivals.¹⁸ There is no doubt such asymmetry makes predation more attractive for the financially stronger firm. In the real world, all competitors do not face the same borrowing (and lending) rates. Also, in the real world temporary exit (and later re-entry) for the firm as a whole is often infeasible.¹⁹ Of course, entrants with only enough capital to survive on the assumption that all days will be sunny cannot be construed to be "serious" rivals. They could perish for changes in the total market (e.g. a recession) that have nothing to do with predatory conduct by a large incumbent.

It has been noted that none of the major air carriers have targeted Southwest Airlines, the epitome of the low-fare carriers. Why? Because Southwest is larger, serves more markets, and is financially strong (largely reflecting a higher rate of return).²⁰ Note also, however, that Southwest has worked hard to avoid going "head to head" with large incumbents in their hubs, for example, by developing nearby airports such as Hobby Field in Dallas instead of Dallas-Ft. Worth airport, the main hub of American Airlines.

So what is different about the airline industry? In general, the following characteristics seem important. (1) Airlines have very low marginal costs in the very short run with respect to an otherwise empty seat – where a major

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carrier is committed to a schedule for, typically, three months. (2) There are huge opportunities (and incentives) for price discrimination (not checked by the law). This is called "yield management" and for full-service carriers the same flight may contain up to a dozen fare classes. (3) The inventory is highly perishable – if a seat is not sold, it cannot be stored, the aircraft flies with an empty seat. (4) There is very rapid diffusion of price changes because 80% of tickets are sold through travel agents who use a computer reservations system. Also, airlines are making greater use of their own websites to handle reservations. (5) Both large network and niche carriers have their particular advantages, but the latter have to be very careful to stay in their niche. (6) Demand is both highly seasonal and pro-cyclical. (7) The airline industry is highly dynamic requiring rapid responses to changes in the environment and by competitors. (8) Barriers to entry in Canada to create a national, large-network carrier to compete head-to-head with Air Canada are very high (but they are much lower for "niche entrants").

4. The CanJet Case

The first use of the new section 104.1 came on October 12, 2000, when the Commissioner of Competition made a temporary cease and desist order against Air Canada for its matching of the lowest fares offered by CanJet Airlines, a startup carrier which began operations on September 5, 2000.²¹ CanJet had immediately complained to the Bureau about Air Canada's response to its entry into certain routes.²² The Bureau's press release said, in part, the following:

Based on preliminary information gathered to date, the Bureau believes that Air Canada's pricing response to Canjet's entry into the market could be anti-competitive...

The cease and desist order specifies that, effective immediately, Air Canada must stop offering or selling special L14EASTS fares on 5 routes in Eastern Canada. These routes are: Halifax-Ottawa, Halifax-St. John's, Halifax-Montreal, Toronto-Windsor, and Ottawa-Windsor. The Bureau is satisfied that a temporary order is not warranted for two other routes which are part of Canjet's complaint. These are: Halifax-Toronto and Toronto-Winnipeg. L14EASTS are special discount air fares offered on the five Air Canada routes, which require 14 days advance booking.

The temporary order was to expire on October 31 but it was later extended twice for 30 days each to the end of 2000.

Air Canada immediately began a constitutional challenge of section 104.1. On October 31, 2000, the Commissioner extended his order to apply to three routes: Halifax-Ottawa, Halifax-Montreal, and Halifax-St. Johns.

On October 24, 2000, the *Globe and Mail* (B4) reported that CanJet had indicated it would be pulling out of the Windsor-Toronto route over the next five weeks because of low load factors (only 20%). In November, Air Canada CEO Robert Milton said that he welcomed the new competition, but that he feared that Air Canada would be held responsible for an inevitable shakeout in this new discount market (*Maclean's* (6 November 2000) 68-73).

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In his testimony (affidavit) before the Competition Tribunal, the owner of CanJet, Ken Rowe, said that “Air Canada’s strategic conduct has already largely, if not entirely, destroyed CanJet’s launch momentum.” Rowe listed the following anti-competitive tactics by Air Canada:

- hoarding counter space at airports, forcing CanJet into less desirable locations;
- restricting access to landing and takeoff slots at Pearson International Airport in Toronto;
- causing CanJet to be allocated gates distant from one another, delaying connecting passengers;
- interfering with airport arrival-departure screen displays so information relating to CanJet flights is missing; and
- refusing to share spare parts, contrary to industry practice. (*Financial Post* (11 November 2000) D3).

He also discussed Air Canada’s price and capacity response to CanJet’s entry on September 5, 2000: “By establishing a new discount fare to match CanJet’s fares, Air Canada forced CanJet to respond by substantially increasing its allocation of seats to the lowest fare category, which is the equivalent of a further price reduction.” CanJet said that it has a 60% load factor, but observers suggest that it is much lower.

Air Canada said CanJet’s allegations of “dirty tricks” by Air Canada were “factually untrue.” Its affidavit said that:

counter space allocation, slots, gates and many airport flight information displays are controlled by airport authorities, not Air Canada. Regarding the refusal to share spare parts, he said Air Canada’s policy is to not share parts with any competitors. (*Financial Post* (15 November 2000) C3)

Air Canada also told the Competition Tribunal that its deep discount fares on routes served by CanJet amounted to less than 2.5% of all seats on the contested routes. Further, Air Canada’s lawyer said all five routes continued to be profitable after the low fares were offered.

That is evidence, [Air Canada] lawyer Katherine Kay argued, the fares were not predatory and could not reasonably be expected to hurt CanJet enough to draw the wrath of the Bureau. In addition, Air Canada did not promote the fares with advertising or publicity, she said. “If that was the plan, to come out of the gate and crush CanJet, presumably they would have wanted to let people know about the new fares...” she said. (*Financial Post* (17 November 2000) C4)

Air Canada had appealed the Commissioner’s temporary cease and desist order. The Competition Tribunal (a single judicial member) upheld the Commissioner’s order late Friday night, November 24, 2000 (*Financial Post* (27 November 2000) C3). This decision was appealed by Air Canada.

On December 31, 2000, the Commissioner’s temporary cease and desist order against Air Canada expired, having been extended twice to the maximum of 80 days. At that time, the Bureau was still awaiting more

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information from Air Canada and indicated that it would decide in January 2001 if it would pursue the case under sections 78-79 of the *Competition Act*. (See *Vancouver Sun* (29 December 2000) C9).

On February 23, 2001, Air Canada agreed to drop its one-way unrestricted LAC fare on three routes (Halifax-Montreal, Halifax-Ottawa and Halifax-St. John's) after extensive negotiations with the Competition Bureau (*National Post* website (24 February 2001)).

On March 5, 2001, the Commissioner of Competition announced that he is seeking an order against Air Canada under sections 78-79 of the *Competition Act* with respect to its pricing and capacity actions vis-à-vis CanJet and WestJet on routes in eastern Canada (Competition Bureau, News Release (5 March 2001)).

5. Our Proposal

As discussed above, the challenge in designing policies to protect against predatory behaviour is in finding a mechanism that stops firms from truly predatory actions without discouraging tough, non-predatory competition. In our view, predation is rare enough and the dangers of competitive chill serious enough, that our proposal errs on the side of permitting actions that might strictly speaking be predatory in some cases. Our purpose with this proposal is to work toward an approach satisfying the following conditions: (i) it will be as clear as possible in that it will provide incumbents with as good information as possible regarding how aggressive a response is permissible without being interpreted as predatory; (ii) it will not chill legitimate competition – that is, it will permit incumbent firms to compete aggressively with entrants; and (iii) it can be administered quickly and at reasonable cost.

The main contribution of this proposal relative to current policy is to provide greater clarity with respect to what competitive responses will be considered as falling in a “safe harbour” and therefore be presumptively acceptable. Responses falling outside this safe harbour will be treated much as the Competition Bureau plans to do under the current provisions.

We see this as very much a work in progress that we offer to stimulate discussion.

5.1 Step 1: Market Power Screen

First, the authorities must confirm whether or not the market is conducive to predation. The key here is to determine whether predation can impose significant costs on a victim²³ and whether it will be possible for the predator to recoup its losses after the victim has left the market. Recoupment generally requires that there be significant barriers to entry. (Of course, a reputation for predatory behaviour is a barrier that the predator can cultivate itself.) This is essentially the first step laid out in the Bureau's current *Predatory Pricing Enforcement Guidelines* (relating to paragraph 50(1)(c)). Given the economics of the airline industry and Air Canada's strong position, it is likely that airline markets in which Air Canada was a dominant player would survive this screening and the analysis of alleged instances of predation would move to the second step.

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5.2 Step 2: Predatory or Defensive?

Are the price cuts predatory or defensive? The approach here may have to differ depending on whether the incumbent lowered fares after the entrant announced its fares, or the incumbent's lower fares were announced first (as a pre-emptive move). Consider the first case in which the entrant offered the lower fares. Here, the incumbent's new fares would be compared to those that existed prior to the new entry and any fare reductions would be viewed as purely defensive if the incumbent only matched fares and otherwise did not change its offerings (i.e., did not add capacity or change its schedule on the routes in question).

There is a question here as to what we should permit in terms of adjustment of the "buckets" or number of seats at each fare. Consider two possibilities: (i) the incumbent could be permitted to lower price to match the price of the entrant but only offer as many seats at that price as it previously offered at its (previous) lowest price; or, (ii) we could permit the incumbent to sell as many seats of its current capacity at the lowest price. We favour this second approach because it is administratively much simpler, and because in our view successful predation against an efficient entrant in the airline industry will require a matching of fares and a significant increase in capacity.²⁴ That said, we fully acknowledge that this approach will allow a dominant carrier to lower its best fares and, by reducing fences and changing the size of buckets, to increase its quantity sold at those lower fares significantly. We believe, however, that without adding additional flights or larger-capacity aircraft, this is unlikely to be enough to eliminate an efficient entrant. And we also recognize that for an incumbent to turn over seats it could sell at high prices to time-sensitive travellers and to place them in this low price bucket would represent a costly diversion of business.²⁵

5.3 Step 3: Determining Predatory Intentions

Our approach to the matter of intent is as follows: (i) if the incumbent cuts price below that of entrant, its flights would be assessed to see if they cover avoidable costs. If they do not, predation would be presumed. The presumption may be rebuttable under some circumstances (to be specified); (ii) if the incumbent only matches the entrant's price but adds frequency, the additional flights will be examined to see if their revenues cover avoidable costs. If they do not, we have a rebuttable presumption of predation; and (iii) if the incumbent matches the price of the entrant but adjusts its schedule to bracket the entrant's flights, the revenues of the bracketing flights will be compared to their avoidable costs. If they do not cover their avoidable costs, we again have a rebuttable presumption of predation.²⁶

5.4 Step 4: Rebutting a Presumption of Predation

The incumbent can attempt to rebut the presumption of predation by demonstrating that its behaviour was consistent with profit maximization even if the entrant is not chased from the market. We would suggest that arguing that extra capacity was actually necessary because of expectations of greatly increased demand at lower prices would almost bind the incumbent to maintain that capacity after exit by the entrant. It would certainly be hard to make that argument a second time after removing capacity prior to an earlier entrant's departure.

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In support of the presumption, the Crown might provide other evidence that this behaviour can only be profitable by driving out the rival, e.g., data on diversion, other evidence of predation (e.g., memos describing predatory plans and intent).

5.5 Administration of this Approach

We recognize that this system could permit incumbents to price below costs as long as they only match the entrant's price. And the incumbent will have other advantages like frequent flyer points and airport lounges. But the entrant will (or should) have the advantage of lower costs. Allowing incumbents to match price (without review of their costs) as long as they do not add capacity or bracket the entrant's flights is a very easily administered rule that could provide entrants with some space. If they come in with a significantly lower fare and stimulate demand, entrants should be able to pick up much of that. And the fact that it will be hard to cut the fares further and make the entrant bleed as profusely means that it would take longer to drive the entrant out, maybe making predation an unattractive strategy.

We think this approach has the advantage of giving the incumbents the freedom to compete that they may claim to be their "right". Indeed, a case can be made that even if it is only one of many features of a service that customers care about, the "price" is somewhat special. Some customers will demand the lowest price irrespective of other service attributes and to prevent the incumbent from matching the entrant's lower fares is to exclude it from the competition for those customers and to risk imposing on it a reputation of not being responsive to competition.

We do not here wade into the debate about the appropriate definition of "avoidable cost". We expect that the Competition Tribunal will provide some guidance here as it considers the Commissioner's current request for an order against Air Canada, but we recognize that this is a topic which may require further analysis.

6. Conclusions

Predatory behaviour is a notoriously difficult area in which to craft socially beneficial rules for firm behaviour. A law that is too soft on predators risks sacrificing long-run competition for the limited benefits of a short price war. On the other hand, a law that is too aggressive risks discouraging tough non-predatory competition, just the sort of behaviour competition policy is designed to protect. In part because many (maybe even most) economists view true predation as rare, there is a case to be made that the optimal policy is no policy. While acknowledging that one must be cautious, we disagree. We believe that in some industries the conditions necessary for predation actually exist – and for a number of reasons given above we believe the airline industry in Canada is now one of those industries. Some of these reasons have to do with the economics of airline markets generally. These have given rise to concerns about predation in other jurisdictions. Other reasons relate to circumstances unique to the Canadian marketplace, notably the presence of an unregulated dominant carrier.

Recent changes to the Canadian policy toward predation in airline markets in the form of new legislation and regulations will undoubtedly be helpful, but in this paper we have provided some views as to how this new

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approach might be improved. The key is to provide the incumbent carrier with greater guidance as to how it may respond to entry without running the risk of being found to have engaged in predatory behaviour. In short, we would permit incumbents to respond in such a way as to hold on to their current volume of business and, while a more aggressive response might still be permissible, it would be subject to a more thorough review.

We recognize that our proposal is not a complete policy toward predation in airline markets. For example, we have not provided our own definition of avoidable cost, we have not defined when flights are close enough to each other to constitute "bracketing" and we have not spelled out an approach to "pre-emptive" predation. On these and other issues we continue to work and we hope others will as well.

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Figure 1

**Competition Bureau's Categorization of Costs in Determining
Predatory Conduct in the Airline Industry**

Cost Category	Examples	Discussion
Outright Avoidable	<ul style="list-style-type: none"> • Travel Agent Commissions • Fuel and Oil Expenses • Navigation Fees • Landing Fees • Aircraft Costs 	The airline would no longer incur the cost for these items in the event that it cancelled a flight. Similarly, if a flight was added these costs would need to be incurred.
Avoidable through redeployment	<ul style="list-style-type: none"> • Flight crew labour • Cabin crew labour • Aircraft costs 	These costs are avoidable in the sense that upon cancelling a flight, the airline would likely redeploy the aircraft and crew to an alternative route. Similarly, if a flight was added the airline would likely redeploy the needed aircraft and crew from another route.
Potentially Avoidable	<ul style="list-style-type: none"> • Maintenance labour • Ticketing agent labour • Baggage handler labour • Reservation labour 	To the extent that these costs are specific to a flight and could be either avoided outright, or avoidable through redeployment of labour to another route, they would be considered avoidable.
Unavoidable	<ul style="list-style-type: none"> • Executive salaries • Building expenses • General overhead 	These costs are not specific to a flight and thus are unavoidable in the event that a flight is added or cancelled.

Source: Competition Bureau, *Draft Enforcement Guidelines on the Abuse of Dominance in the Airline Industry* (Ottawa: February 8, 2001) at 15.

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Notes

¹ This paper extends work done for the Canada Transportation Act Review Panel reported in Ross and Stanbury (2001). The authors are very grateful for the Panel's support as well as for the comments of many colleagues contributing to the Review. They also wish to thank Jennifer Ng and Raul Pacheco-Vega for excellent research assistance and Cynthia Hendricks for skilful word processing services. The usual caveat applies, of course.

² We note that effective May 1, 2001, the operations of Canada 3000 and CanJet were merged. It is not clear at this time what this will do to this matter involving allegations of predatory pricing by Air Canada against CanJet. At the writing of this article the actions against Air Canada by the Commissioner of Competition (described in section 4 below) were proceeding.

³ A nice review of the economics literature and the U.S. legal history of predation is contained in Bolton, Brodley and Riordan (2000).

⁴ The classic reference is McGee (1958).

⁵ See, for example, Yamey (1972), Burns (1986), Von Hohenbalken and West (1986), Weiman and Levin (1994) and Morton (1997).

⁶ For a discussion of these theories, see Milgrom and Roberts (1990).

⁷ The most important recent case is *Brooke Group Ltd. v. Brown and Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

⁸ *United States v. AMR Corporation*, Civil Action No. 99-1180-JIM, District Court of Kansas, complaint filed May 13, 1999. On April 27, 2001, Judge J. Thomas Marten granted American Airline's motion for summary judgment. On June 26, 2001, the U.S. Department of Justice indicated that it would appeal the federal judge's dismissal of the suit.

⁹ U.S. Department of Transportation (1998).

¹⁰ For example, Air Canada may simply be trying to segment its market and charge lower prices to consumers with higher elasticities of demand. It may also be an attempt to lower costs on some operations by setting up an alternative lower-wage labour force. As a result of its intended acquisition of a significant interest in Roots Air (announced May 3, 2001), Air Canada may have the vehicle it needs to launch a discount carrier.

¹¹ We do not discuss the new section 104.1 of the Competition Act, which was part of Bill C-26. It gives the Commissioner of Competition the power to issue temporary cease and desist orders (initially for 20 days, but extendable to a total of 80 days) against a domestic airline if certain conditions are met. These include the Commissioner's perception that, in the absence of the temporary order, "(i) injury to competition that cannot adequately be remedied by the [Competition] Tribunal is likely to occur, or (ii) a person is likely to be eliminated as a competitor, suffer a significant loss of market share, suffer a significant loss of revenue or suffer other harm that cannot be adequately remedied by the Tribunal." This new provision was immediately the subject of a constitutional challenge by Air Canada. when it became subject to the first cease and desist order issued on October 12, 2000. See section 4 below.

¹² See *Canada Gazette* Part II, Vol. 134, No. 18, SOR12000-324, August 30, 2000, at 2049-2054.

¹³ In March 2001 RootsAir, prior to its start-up on March 26, formerly complained to the Bureau about delays in gaining access to Air Canada's Aeroplan. As we shall see in section 4, CanJet has alleged that Air Canada was making it difficult for it to obtain necessary facilities at certain airports.

¹⁴ *Supra* note 12 at 2050.

¹⁵ This was a critical aspect of Air Canada's alleged predation against Canadian Airlines International in 1991-1992. (Note that Stanbury provided expert advice to CAI on this case.)

¹⁶ And not just in predation cases. The gap between price and marginal revenue is a measure of revenues foregone on the sale of earlier units through the sale of extra units. Any time a firm prices below its short-run monopoly level, which it may do for many pro-competitive reasons, it will appear predatory under these tests.

¹⁷ See *Continental Airlines v. American Airlines Inc.* (1993) 824 F. Supp. 689 (SD Texas); and *IBM Peripheral EDP Devices Antitrust Litigation* (1978) 459 F. Supp 626 (N.D. Calif).

¹⁸ The matter of asymmetry goes beyond financial strength. It could involve asymmetry with respect to information (perceptions of "toughness" and/or the predator's costs), and with respect to the relative costs of incumbents versus the entrant (prey).

¹⁹ While in some industries it might be possible for a victim to temporarily suspend production and "wait out" the predator – even buying up supplies from the predator at prices below cost – this is not an attractive option in markets in which consumers want assurance that the seller will be in continuous operation. For example, in the airline industry (and perhaps

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many other service industries) consumers are unlikely to be attracted to a carrier that too easily suspends operations temporarily on a route because of aggressive competition.

²⁰ On the importance of Southwest in lowering fares in the U.S., see Morrison (2000).

²¹ Here is a very brief history of CanJet. The organizers of CanJet (the IMP International Group Inc.) indicated in June 2000 that they were getting ready to start a low-fare operation based in the Maritimes and modelled on Southwest Airlines (*Financial Post* (6 June 2000) C1, C8). Two weeks later CanJet said it would start service August 1 with two B-737s serving Toronto, Ottawa, Halifax, Windsor (*Financial Post* (24 June 2000) B6). Start-up was delayed until September 5, 2000, at which time Air Canada immediately matched its lowest fares. In late September, with the addition of three more aircraft, CanJet added service to Montreal, Winnipeg and St. John's. Its unrestricted, one-way, everyday fare for Toronto-Montreal and Montreal-Halifax was \$99.

On February 14, 2001, CanJet announced that it was "introducing new, even lower fares in direct response to another round of what CanJet believes is further predatory fare action this week by Air Canada" (CanJet, Press Release (14 February 2001)). The new fares were \$99 for all flights between Toronto and Winnipeg, \$79 for Toronto-Halifax, Halifax-Ottawa and Halifax-St. John's, and \$69 for Halifax-Montreal.

In mid-February 2001, CanJet announced that it was deferring further expansion and was filing more complaints with the Competition Bureau about the alleged predatory conduct of Air Canada (*National Post* website (15 February 2001)). CanJet did not add three B-737s to its fleet of six as planned.

Ken Rowe, whose IMP Group International Inc. owns CanJet, said in mid-March 2001 that the new airline should be profitable by the summer, but that it could be sold before then (*National Post* website (13 March 2001)). Industry sources said that CanJet had approached prospective buyers. They also suggested that CanJet had been losing over \$2 million per month, but Rowe's letter to CanJet's 450 employees did not address this point. A day earlier, RootsAir announced that it had no interest in acquiring CanJet (*National Post* website (12 March 2001)). On March 28, 2001, CanJet and Canada 3000 announced plans to merge by May 1, subject to regulatory approvals. IMP Group International Inc., owner of CanJet, was to receive 900,000 shares of Canada 3000 Inc. (*Globe and Mail* website (28 March 2001)). The Department of Transport did not challenge the merger under the authority given to it under Bill C-26 effective in July 2000.

²² A useful chronology can be found in the Competition Bureau's News Release, "Competition Bureau Continues Air Canada Inquiry" (28 December 2000).

²³ As described earlier, in some cases a victim can simply shut down (or produce for inventory) and wait out the predator, returning to the market when the predator raises its prices. This would not appear to be an attractive alternative for entrants into the airline industry, however.

²⁴ Recall, also, that each seat that the incumbent sells of its existing capacity at a low price is a seat that is unavailable for sale at a higher price, if there is no change in the size of the aircraft or change in the frequency of service on the route(s) in question. It can therefore carry a high opportunity cost for a predator, which would further serve to deter predation. The key here is that by limiting the incumbent's ability to add capacity (without an avoidable cost review), we protect the ability of the entrant to capture a significant share of the larger market stimulated by its lower prices.

²⁵ The case in which the incumbent has moved pre-emptively to lower fares (in anticipation of the entry of a new player) is more difficult and we think deserves further study. If it moves before entry but after the entry and the entrant's prices have been announced, the process we describe here may have to be little modified. However, if the entrant's prices have not been announced (or if the announcement lacks complete credibility) the "price-matching" safe harbour just described is not relevant. Thus, it may be the case that any significant price reduction would have to be assessed according to the avoidable cost test. Another possibility would be to let it set prices at any level it wants as long as it does not increase capacity relative to a period before the entry became expected. The rest of this proposal will assume that the entry has occurred and that the behaviour under review is the incumbent's response to that actual entry.

²⁶ Clearly, this part of the proposal is incomplete in that we do not define "bracketing". This will take further analysis and we would appreciate receiving input from our colleagues more familiar than we with the operational (specifically, scheduling) side of the airline business.

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THE INTERNATIONALISATION OF ANTITRUST: THE NEED FOR A GLOBAL COMPETITION FORUM

By: J. William Rowley, Q.C. and Omar K. Wakil
McMillan Binch, Toronto

The Need for a Global Forum*

The last ten months have witnessed a remarkable change in thinking amongst antitrust authorities as to the nature and the manner of addressing issues arising from the near geometric growth over the last decade in the number of national antitrust regimes. What is new (and notable, given previously held views to the contrary in the U.S. agencies) is the now widely held view that the time has come for a multilateral initiative to complement existing bilateral agreements and institutional arrangements to address necessary convergence of multiplying processes.

In this context, the endorsement of the concept of a Global Competition Forum¹ (or GCF) in February at a multinational meeting at Ditchley Park, outside Oxford in the United Kingdom, constitutes a quantum forward leap. The Ditchley meeting, convened and hosted by the International Bar Association (IBA), with support from Fordham University and the American Bar Association's Antitrust Section, saw more than 40 of the world's senior competition law officials and professionals, acting in an individual capacity, discuss the concept and role of such a multilateral Forum.² The resulting consensus set the stage for the formal launch of the initiative as early as year-end.

More recently, however, the disturbing question has arisen as to whether the momentum gained at Ditchley has been put at risk by the length of the change of leadership process at the U.S. Antitrust Division, and the seeming insistence by leading antitrust agencies that they alone should manage the GCF's design and planning (not surprisingly, the agencies' incentives and time frame for moving forward are different from those who bear the principal burden imposed by the present patchwork approach). Given the serious and increasing marketplace costs imposed by multiple and divergent antitrust regimes, international business community leaders need to take immediate responsibility to catalyze action and reform. The questions to be addressed by the GCF are sufficiently pressing that the formal launch of the Forum should not be delayed.

The Nature of the Problem

In conjunction with economic liberalisation, nations have come to recognise competition as a powerful tool for spurring innovation and economic growth, and the importance of a legal framework to safeguard market force disciplines. In the result, competition laws have been enacted rapidly over the past decade; many incorporating some form of merger notification requirement and most with provisions on cartels and abuses of dominance. There are now over 80 different laws, with two dozen more in the making, most with differing procedural and substantive standards. The proliferation of these new regimes, coupled with an increasingly globalised economy, presents a serious challenge to all those affected, including regulators and the business community.

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Merger Control

Today's multiplicity of merger control regimes means mergers are often subject to review by numerous agencies in a variety of jurisdictions. Obtaining regulatory clearance on multi-jurisdictional transactions is increasingly complex, expensive and time-consuming because of different substantive and procedural standards. The burden can be particularly heavy if the number of reviewing jurisdictions is large or if they have seriously inconsistent procedural requirements. Transnational mergers also raise a host of substantive issues, such as the possibility of inconsistent remedies – *General Electric/Honeywell* being the most recent example³ – or the treatment of confidential information in the course of exchanges between competition authorities.

A few examples of the differences in the world's merger control regimes illustrate the extent of the problem. Some countries, such as Brazil and Russia, have merger notification thresholds based on worldwide assets or turnover. Tests like these, which look only to the worldwide assets or revenues of the merger parties, have the clear potential to subject many international transactions to merger notification obligations in countries around the world in which the parties have minimal activity. Logic would suggest that a merger have at least local effects before an obligation to notify is triggered. But where there is no specific domestic reference, a filing may be required when the nexus between merger and market is minimal.

In many jurisdictions the filing timeframe, or triggering event, is also far from clear and numerous countries require filings to be submitted very quickly after a transaction emerges. In more than two dozen jurisdictions, filings may be required within seven to 15 days of signing or announcing a merger agreement. In some cases high fines may be the consequence of a late filing. In Argentina, failure to file a required report can result in fines of up to US\$1 million per day; in Brazil, more than 20% of the filings made in 2000 were ruled to be late, with fines imposed averaging over US\$80,000.

Although some deadlines are flexible, many statutory requirements can be totally unrealistic for transactions which emerge quickly (even if completion may be far distant). In both hostile and confidential situations, the problem is exacerbated, with lawyers often unable to get deep enough into an organization to get the information needed to complete worldwide filings on a timely basis.

Many regimes call for notifications that require detailed substantive "competitive effects" analyses to be made at an early stage of the transaction (unlike the U.S. Hart-Scott-Rodino merger filing, which largely requires the parties to submit pre-existing documents). This is true in a host of other jurisdictions that require filings to be submitted soon after the signing or announcement of a merger agreement or the launch of a bid.

Numerous jurisdictions also require merger parties to supply quantities of data that are often difficult, time-consuming and expensive to obtain yet add little real insight into the relevant substantive issues. Many notification forms, for instance, require transaction documents to be translated into the local language. These sorts of requirements frequently make it necessary for parties involved in multi-jurisdictional transactions to translate hundreds of pages into dozens of languages.

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Some jurisdictions require documents such as balance sheets to be notarised or apostilled and legalised before submission. Many others require merger parties to establish the existence of the merger parties by submitting documents such as articles of incorporation (which sometimes need to be translated and usually need to be notarised or apostilled and legalised). In Mexico, for example, merger parties are frequently asked to provide translated copies of the bylaws of all of their subsidiaries. The notoriously burdensome Argentine form F1 requires merger parties to provide detailed information about sales of overlapping products broken down by local customs code categorisation (which itself is often extremely difficult to determine).⁴

Many jurisdictions appear to be 'cashing-in' on merger filings by charging high filing fees. In Canada the fee is presently \$25,000; relatively modest by international standards. Since February the U.S. has employed a sliding scale fee, with the fee for large mergers being an astonishing US\$280,000. Although the new U.S. fee has significantly increased transaction costs for large mergers with a U.S. dimension, the real worry is that the trend of introducing filing fees or increasing existing fees elsewhere in the world will impose a high and inappropriate "merger tax" as new countries bring competition laws on-line.

To date, insufficient work has been done to measure the costs of reviews under multiple notification regimes. This is set to change.

Last September, the IBA, with support from the American Bar Association (ABA), launched a year-long global study to analyse and quantify the direct and indirect costs of compliance with the ever multiplying systems of merger notification and review. The IBA and ABA, as sponsors, have retained experts in the fields of economics (LECG LLC), polling (Pollara) and valuation (Low Rosen Taylor Soriano) to design and implement a worldwide survey to measure and report on the mushrooming costs of merger review for multi-jurisdictional mergers. Results are hoped to be published by year-end.

Cartel Enforcement

The need for greater international interaction is also acute in connection with the detection and enforcement of anti-cartel laws, and the resolution of cases when cartel activity has been revealed.

One significant hurdle that continues to confront antitrust authorities in Canada, the U.S. and elsewhere is that only a limited number of jurisdictions have legal systems that enable them to allow foreign antitrust authorities access to confidential law enforcement or statutorily protected information, or to exercise compulsory powers to obtain evidence for use in another jurisdiction's antitrust actions.⁵

Another hurdle was pointed out by Douglas Melamed, then acting head of the U.S. Department of Justice's Antitrust Division, at last year's Fordham conference. Melamed noted that the most effective means of combating cartels involves a combination of tough laws and

a sound, non-discretionary leniency program because that combination maximises the likelihood that one of the cartel participants will voluntarily come forward with evidence of the cartel. But the efficacy of [a] leniency program can be significantly impaired if other countries with anti-

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cartel laws lack a robust leniency program, because firms might fear that voluntarily coming forward in the U.S. will subject them to increased risk of prosecution abroad.⁶

Alexander Schaub, Europe's DG Competition chief, summed up the current state of affairs well in mid-March when he observed that "the transnational character of today's competition cases clashes with the traditionally territorial scope of domestic antitrust rules."⁷

Formal Co-operation Agreements and Forums

At present, international co-operation amongst antitrust authorities occurs formally through a multiplicity of bilateral co-operation agreements and arrangements, most notably the series of bilateral agreements between countries such as Australia, Canada, Israel, Japan, the U.S. and E.U.⁸ Informal co-operation and contacts between agencies also obviously occurs on a daily, case-by-case basis as part of, for example, a merger review or cartel investigation.

Multilateral discussions of competition policy matters ordinarily occur as part of a member states' participation in organizations such as the OECD, WTO or United Nations Conference on Trade and Development (UNCTAD). The question naturally arises as to whether one of these institutions might provide an appropriate home to global work on the identified issues.

Bilateral Agreements

Bilateral co-operation occurs both formally and informally between domestic enforcement officials and their overseas colleagues. Bilateral co-operation agreements were initially primarily intended to avoid conflicts resulting from the extra-territorial enforcement of U.S. antitrust laws. Most modern antitrust co-operation agreements contain provisions permitting the active co-operation between authorities.⁹

Although bilateral agreements are vital to effective international antitrust enforcement, they are primarily designed to facilitate co-operation between enforcers on a case-by-case basis. They allow for custom-tailored solutions to specific cross-border antitrust issues whilst permitting differences in markets, legal traditions and other aspects to be accommodated.¹⁰ These agreements have the beneficial side effect of allowing enforcers to learn from each other, permitting over time conversions in the thinking and approach of antitrust authorities to shared problems. They are not, however, designed to develop policy changes or reform domestic regimes.

Multilateral Contact

Multilateral discussions between enforcement agencies occur on a number of fronts, primarily under the auspices of the OECD and WTO, although other agencies, such as UNCTAD, also play a vital role.

OECD

The OECD has undertaken substantial substantive work on competition primarily since the formation in 1987 of the Committee on Competition Law and Policy (CLP). It has made a number of important recommendations, most notably the 1995 Recommendation Concerning Co-operation Between Member Countries on Anticompetitive

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Practices Affecting International Trade; the 1998 Recommendation Concerning Effective Action Against Hard Core Cartels; and the 1999 notification framework for transnational mergers.¹¹ These recommendations, as well as the CLP's other work, such as its country reports on national antitrust regimes and authorities, have led to a number of significant reforms.

The 1995 co-operation recommendation has helped inform the thinking of those drafting the numerous bilateral agreements adopted by numerous jurisdictions. Similarly, country reports on Denmark, Greece and other jurisdictions have resulted in significant domestic reform. In Denmark, for instance, the existing merger control regime was radically overhauled following a critical OECD report; in Greece, significant personnel changes at the antitrust authority were announced after the OECD questioned the effectiveness of the agency.¹²

However, the OECD has its weaknesses – most notably a very limited membership drawn from the world's principal industrialized economies. Although efforts are now under way to involve competition authorities from developing and transition countries, the OECD cannot pretend to offer a world forum for debate. More importantly, the OECD membership excludes or provides only limited access to non-national groups (such as businesses, the professions and consumers) that need to be part of multilateral antitrust policy reform.¹³

WTO

The WTO's working group on trade and competition law was established during the 1996 Ministerial Conference in Singapore, where the WTO set up two working groups to consider the relationships between trade and investment and competition policies "in order to identify any areas that may merit further consideration in the WTO framework."¹⁴

The WTO brings to the competition policy table a very broad membership and a very successful track record on negotiating trade agreements. It also brings the support of several key institutions, including the European Union, which has long called for WTO involvement in international antitrust reform. Mario Monti has recently emphasised that the EU favours a WTO Agreement on Competition which "would rest on a commitment by member countries to establish and enforce domestic competition laws."¹⁵ According to Commissioner Monti, "these laws should be based on "core principles" of non-discrimination, transparency, and due process reflecting a consensus between WTO members."¹⁶

Although an Agreement on Competition along the lines suggested by Commissioner Monti is seen by many to have obvious merit, its probability of success is highly uncertain given the strongly held views by some to the contrary. Nor, in any event, would an Agreement on Competition be likely to result in quick solutions to the urgent problems associated with proliferation as it will take years, if not decades, to develop.

Finally, as a trade-related and trade-focused organization, the WTO's treatment of antitrust matters risks being treated as ancillary to its primary focus. The WTO itself has noted that "[w]ork in the WTO on investment and competition policy has largely taken the form of responses to specific trade policy issues, rather than a look at the broad picture."¹⁷ At this stage, the working groups' tasks are "analytical and exploratory." Thus, although the WTO may ultimately adopt rules relating to antitrust (even this is unclear), they are likely to be a long time in

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coming and are not likely to address all issues of concern to the international antitrust community. (In this context, it is noteworthy that Commissioner Monti has repeatedly emphasised the need for a GCF and that its work would not duplicate that of the WTO – or for that matter, the OECD or UNCTAD.)

UNCTAD

UNCTAD's role in the field of competition law and policy dates from the early 1970s, when developing countries (in particular) called for work on restrictive business practices.¹⁸ This ultimately led to the adoption in 1980 by the U.N. General Assembly of a multilateral code of conduct on such practices that took the form of a recommendation to states.¹⁹ The implementation of the recommendation is monitored and reviewed by the following institutional bodies:

- The Intergovernmental Group of Experts on Competition Law and Policy, which provides an annual forum for multilateral consultations, discussions and exchange of views between states on matters related to the recommendation. (It also undertakes and disseminates periodically studies and research on competition policy issues.)
- The U.N. Review Conferences, which meet at five-year intervals, which most recently reaffirmed by way of resolution the validity of the recommendation and called for its implementation by states.

UNCTAD is also heavily involved in providing technical assistance to countries seeking to formulate and enforce competition and consumer protection laws and policies. To date, more than 50 developing countries and countries with economies in transition have received UNCTAD's technical assistance in this regard.²⁰ UNCTAD also helps competition authorities create a "competition culture" by educating the public and private sectors of countries with developing and transitional economies; and by promoting competition advocacy activities of public authorities.

Rather like the OECD, UNCTAD also suffers in the views of some from a sense of imbalance. If the OECD is thought to be the home of the major industrialised countries, UNCTAD is said to be the champion of developing countries.

Against this background, many Ditchley participants felt that great value could be added if an institution could be created which bridged the gap in a flexible non-bureaucratic manner.

One thing is clear from this brief tour d'horizon of co-operation – there are currently a variety of bilateral and multilateral mechanisms and forums which provide the opportunity for competition law enforcers to co-operate on individual cases and meet and talk about competition policy issues. However, what all of these forums lack is the participation of a full complement of those with a legitimate interest in the development of competition policy.

Stakeholders include businesses whose transactions and practices the agencies review (and which have a unique insight into the system cost now being imposed by multiple oversight through diverse processes); consumers whose interests competition laws are designed to protect; the legal profession, which deals with antitrust laws on a daily basis; and countries with developing and transitional economies that are in the process of formulating and enforcing new antitrust laws.

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These and other stakeholders need not (and should not) participate in every aspect of the work of a Global Competition Forum – giving business a key role in reforming cartel enforcement techniques might be like giving the fox the keys to the hen house in the words of one commentator. But a global initiative which distinguishes itself from existing institutions by adopting a mindset of inclusiveness has the potential to add real value by providing a meeting place for all stakeholders to have their views heard and taken into consideration on those issues that directly affect them.

ICPAC and the Development of the GCF

Concerns about the proliferation of merger control regimes and the difficulty in enforcing cartel laws in the international context, as well as the shortcomings of existing bilateral agreements and multilateral forums, were recognised in the Report of the International Competition Policy Advisory Committee (the “ICPAC Report”).²¹ The ICPAC Report, released in February 2000, recommended the formation of a “Global Competition Initiative” (or GCI) to foster dialogue directed toward greater convergence of competition law and analysis, common understandings, and a common culture.

Two elements of such an initiative were seen as fundamental. First, membership in the forum was envisioned to be inclusive with representation of government officials, private firms, non-governmental organizations and others. Second, the formation of the GCI would not and should not preclude the continued use of existing international organizations and venues such as the WTO, the OECD, and UNCTAD to address competition policy topics. Indeed, the proposed initiative was seen to be complimentary to these institutions.

Somewhat surprisingly, ICPAC’s recommendation to create a GCI initially received a muted reception, perhaps because of the United States’ historic commitment to bilateral co-operative efforts. But all of this changed when Joel Klein endorsed in Brussels the establishment of a new global approach at last September’s 10th Anniversary Conference for the EC’s Merger Task Force.²² Klein’s directional thinking appears to have been taken up by both of his interim successors, Douglas Melamed and John Nannes.²³ And although the official views of Charles James (newly confirmed head of the Antitrust Division of the U.S. Department of Justice) and Tim Muris (now Chairman of the Federal Trade Commission) have not been made known, it is understood that each (as well as the Attorney General) are keenly supportive of the need for a multilateral approach to the global issues which now confront us.

There is no doubt of the European position: Competition Commissioner Mario Monti has repeatedly emphasised the need for a multilateral, multi-jurisdictional approach and his strong support for the initiative and Alex Schaub has been an active participant in the ongoing work of the post-Ditchley GCF informal planning group.

The Global Competition Forum as Envisaged at Ditchley

As a result of these public expressions of support in Brussels, the Ditchley Park meeting addressed as its central question the need for such a forum for dialogue, for sharing experience and expertise, and – insofar as possible –

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for building consensus among competition professionals around the world. The purpose of the meeting was to explore ideas, not to reach formal conclusions on the exact structure or content of a GCF.

During the course of two and half days, both in plenary sessions and working groups, 43 participants representing 23 countries, 20 competition authorities and nine other international institutions considered three separate sets of issues: merger control in the 21st century; competition policy and competition advocacy in developing countries; and structural and process issues that face a new global initiative.

The discussions provided an opportunity to consider a variety of fundamental features of the competition forum including its governing purpose, organizational design and activities. A remarkable degree of consensus emerged on these key issues, as discussed below in greater detail.²⁴

GCF Purpose

It was envisioned that the core purpose of the GCF should be to draw together diverse combinations of competition professionals to consider transnational competition problems in open and non-binding discussions. Mario Monti has since said that the “end-objective” of the GCF “should be to achieve a maximum of convergence and consensus between participants through dialogue, and exchange of experiences on enforcement policy and practice.”²⁵ It was also seen to be essential that the global initiative add practical value to the work of existing institutions and not duplicate existing activities: in particular the remit of the Forum would not duplicate competition work of the WTO, the OECD or UNCTAD.

The overall objectives of the Forum and the importance of the need to add value to existing work received strong support at the Ditchley Park meeting. Importantly, the nine international organizations that attended the conference were, in the words of Ky Ewing, “not trying simply to protect their turf, but agreeing that the new Initiative would be a useful addition.”²⁶

GCF Organizational Design

Although there was general agreement that competition authorities should constitute its core stakeholders, it was thought that the Forum must be an inclusive organization in which the legal community, academics, and business interests would be appropriately represented. The GCF should not simply be an “antitrust regulators club” with limited membership.

Mario Monti recently confirmed this consensus when he noted that the Global Forum “should be first and foremost a competition authority forum, but would draw together all interested parties – both public (for example, other international organizations) and private (for example, business, professional, consumer and academic bodies), who could all be appropriately associated with the forum, as participants and “facilitators”. Such a combination of participants was seen to be a unique feature of the GCF; one which could add real value relative to existing organizations.

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Indeed, the work to date of institutions such as the OECD, WTO and UNCTAD is seen to have suffered from the lack of sufficient input from those most directly affected by the proliferation of national competition laws. In the case of merger control, for example, this would clearly include members of the international business community who have the knowledge of the cost imposed by the current morass of conflicting processes.²⁷

Participants also saw it as crucial that the new initiative be able to attract broad and active participation from countries with new and developing competition regimes. The Ditchley Park meeting itself took an important first step in this direction in bringing together participants from Japan, Australia, Brazil, Argentina, Mexico, South Africa, Israel, Hungary, Turkey and Poland and a host of other countries. It is clear, however, that every effort will have to be made to make subsequent events even more inclusive.

Another idea floated at the conference, and more recently discussed at the informal planning group which formed at Ditchley, was a "main event" of an annual conference, perhaps coupled with peripheral or regional workshops and mandated task forces. The workshops and taskforces could consider specific issues and might involve a more limited range of participants tailored to address the particular subject under consideration. The annual meetings themselves could be held at the fringes of other international meetings that currently attract participants from countries with developed, developing and transitional economies, such as the annual Fordham conference in New York and the biannual *Bundeskartellamt* conference in Berlin.

Finally, it seemed clear that the GCF should not be a bricks-and-mortar organization or employ a new bureaucracy. One possibility might be to guide ongoing activities through a secretariat staffed by interim secondment from sponsoring agencies (perhaps with a very limited number of people employed on a more permanent basis).

GCF Activities

Participants were open-minded about the precise activities of the GCF and the topics that it should address. Initial topics might include multijurisdictional merger review, multijurisdictional cartel enforcement, and challenges associated with co-operation and information exchanges among competition authorities.

Several participants emphasised that resolving procedural issues involved in multi-national merger review (e.g., divergent notification thresholds, timing and filing requirements) required urgent attention, but discussion was not limited to procedural issues. Participants also recognised that merger control was only one of numerous subjects worthy of international consideration. It was also thought that the Forum should make a particular effort to focus on competition issues of concern to developing countries and those countries with fledgling competition law regimes.

The Forum could also play a role in legal education and in identifying the forms of assistance of benefit to jurisdictions. With many developing countries in the process of establishing competition law frameworks, the advent of the Forum is all the more timely given the importance of ensuring, to the extent possible, the adoption of commonly agreed principles.

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Has Momentum Been Lost?

One of the great difficulties about a good idea is often its implementation. In the case of the GCF this may be proving to be the case.

As Ditchley wound down it seemed clear there would eventually need to be some form of a Steering Committee to oversee the Forum's formal birth and ongoing management. In the meantime, a small number of participants were asked to serve as an informal interim Planning Group to address start up questions, including the identification of potential candidates to serve on such a Steering Committee, once formed, and the time and place of a more inclusive "formal" launch meeting towards the end of the year.²⁸ Although the Planning Group has met a number of times by teleconferences and once in person, at the *Bundeskartellamt* conference in Berlin in May, it has not yet spoken publicly of its thoughts and deliberations. This should change as soon as possible.

Prescription for the Informal Planning Group

Although it is clear that the GCF requires broadly based support at both the agency and other stakeholder level, it is equally apparent that it will have no chance of succeeding without the wholehearted endorsement (and shared views as to appropriate objectives) from the European and United States agencies.

If this is right, an early public buy-in to the initiative by Messrs. James and Muris would do much to reassure those who are concerned with momentum.

In the meantime, the informal Planning Group might consider how to encourage input to its deliberations. Transparency would also yield benefits.

The following action points would seem worth consideration by the Planning Group:

- Establishment and publication of a time frame for initial design completion and launch stages of the project.
- As to the launch itself, every effort should be made to move to a "Ditchley Two" later this year – on the fringes of the Fordham might work well. In any event, it would be wrong to delay the next public step forward. The cost of lost momentum will be too high, and there is much to be gained from participatory discussion.
- The early, and preferably centralised, publication of papers defining/refining thinking on the GCF's scope, objective, mandate, governance and make-up. Comment from any interested party should be sought and encouraged.
- Funding needs and alternatives should be aired. Agency officials might be surprised at the potential interest in the private sector to assist a global initiative of this sort.
- Obvious areas for post-start-up "Working Group" activity should be identified. Three candidate topics suggest themselves - "Merger Best Practices and Process Convergence," "Cartel Enforcement" and "Co-operation and Information Exchanges." It is not too early to invite all who have an interest to become "members" of those working groups they would like. It is also not too early to invite such volunteers to

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prepare papers, comments or other input as they consider useful. Ultimately, the working groups will need to establish their priorities and agenda, but they are unlikely to be ill served by having ready-made material from which to draw.

- Finally, the IBA has volunteered to facilitate further meetings and provide such other services as may be necessary to move the initiative from concept to reality. The International Chamber of Commerce and the American Bar Association have also offered their support, and made known their keen interest in being involved in the process in the future. Given these offers, and the existing infrastructure of these organisations, further thought might be given as to whether they could be asked to help move matters forward. This could start with distributing minutes or materials which refine the Planning Group's thinking. None of these organisations will have any interest in challenging the core leadership role the competition agencies wish to and should take in the GCF. However, they do have important administrative back-up and a vital interest stake in seeing that the work of the Forum is begun and provided with necessary support.

With the seeds of the GCF now well planted, its emergence, future health and growth can only benefit from as much sunlight as possible.

Notes

* A version of this paper was originally presented on June 19, 2001, at the *Canadian Competition Policy: Preparing for the Future* conference, sponsored by the Richard Ivey School of Business, Industry Canada and the Competition Bureau.

¹ European regulators have recently shown a marked preference for the term Global Competition Forum rather than the term Global Competition Initiative favoured by the authors of the ICPAC Report. We have used both terms interchangeably in this paper.

² Participants in the Ditchley conference were from Australia, Belgium, Brazil, Canada, the European Union, Finland, France, Germany, Hungary, Israel, Italy, Mexico, the Netherlands, South Africa, Spain, Switzerland, the United Kingdom, the United States and Turkey.

³ See "GE All But Walks Away From Bid From Honeywell" *Globe and Mail* (15 June 2001) B1 as well as "Split Between US and EU on Antitrust Issues Grows" and "Honeywell in Limbo" at B8. See also "GE Deal Almost Killed by EU" *Globe and Mail* (12 June 2001) B14; "GE Calls Up the Big Guns as EU Merger Talks Falter" *Globe and Mail* (14 June 2001) B13; and "GE Says EU Offer 'Final'" *Globe and Mail* (18 June 2001) B8.

⁴ Section 5(g) of the Form requires parties to "[i]nform the total Argentine exports and imports of each of the Involved Products and the Substitute Products, annually for the three last years, indicating FOB and CIF values, and the correspondent volume (in measure units). Present the information by customs duties nomenclator's position (number and description), by enterprise (in case of imports) and by origin and destination, as applicable. Attach the documentation that proves the figures that are informed, for example, INDEC listings."

⁵ International Competition Policy Advisory Committee to the Attorney General and Assistant Attorney General for Antitrust, *Final Report* (Washington DC: US Government Printing Office, 2000) at 183 (hereinafter "ICPAC Report"). Co-operation between antitrust enforcers in cartel matters often occurs under the auspices of a Mutual Legal Assistance Treaty in criminal matters ("MLAT"), which may permit assistance in criminal antitrust matters, including assistance in compelling production of materials and obtaining access to confidential investigative information from other antitrust authorities. (Co-operation under bilateral antitrust agreements is usually limited in scope and typically does not permit authorities to compel production of information from overseas corporations or individuals, or to access confidential information held by other competition authorities.)

⁶ See A.D. Melamed, "Promoting Sound Antitrust Enforcement in the Global Economy" (Address to the Fordham Corporate Law Institute 27th Annual Conference on International Antitrust Law and Policy, New York, New York, 19 October 2000).

⁷ See *The Global Competition Forum: How It Should be Organised and Operated*, Dr. Alexander Schaub, Director General for Competition, European Policy Centre, Brussels, 14 March 2001, available online through <http://europa.eu.int/>.

⁸ See generally, ICPAC Report at 181.

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⁹ In the Canadian context, co-operation between the Competition Bureau and the U.S. agencies occurs regularly and is formally conducted primarily through two international accords: the 1984 *Mutual Legal Assistance Treaty* and the 1995 *Agreement Regarding the Application of Competition and Deceptive Marketing Practices Laws*. Co-operation between the Bureau and European enforcement officials of the European Commission is also significant and is likely to increase following the implementation of a co-operation agreement between Canada and the European Union in 1999. For commentary regarding the Canada-EU agreement, see O.K. Wakil, J.F. Clifford and N. Johnson, "Canada and the European Union Enter into a New Era of Antitrust Enforcement Cooperation" (February 2000) *Antitrust Report* 20.

¹⁰ K. von Finckenstein, Q.C., "International Antitrust Co-operation: Bilateralism or Multilateralism?" (Address to the ABA Section of Antitrust Law / CBA National Competition Law Section Conference *International Antitrust Issues: Pacific Rim and Beyond*, Vancouver, 31 May 2001).

¹¹ See generally, <http://www.oecd.org/daf/clp/>.

¹² These country reports are available online through <http://www.oecd.org/daf/clp/>.

¹³ A new OECD Global Forum on Competition will hold its first meeting in Paris during the week of October 15, 2001. This new program, which is designed to bring together on a regular basis high-level officials from the 30 OECD Members (plus the European Union), the 5 Observers to the OECD Committee on CLP – Argentina, Brazil, Israel, Lithuania, and Russia – and up to 20 additional non-Members, represents an important initiative to broaden the OECD's scope of activity. If the OECD were prepared to provide for proper representation of others with an interest in the debate, it cannot be excluded that it might have the potential to provide the most appropriate home for the new GCF.

¹⁴ See World Trade Organisation, *Annual Report 1997* at 79. See generally, <http://www.wto.org/>.

¹⁵ See M. Monti, "The EU Views on Global Competition Forum," ABA Meetings (19 March 2001) at 5.

¹⁶ *Ibid.* Commissioner Monti also emphasised that "[i]n calling for a WTO global competition agreement, it is time to shatter the myth that we are seeking to erode the sovereignty of national authorities. On the contrary, strong national enforcement agencies are indispensable to the success of a framework agreement. The EU is not proposing a harmonisation of substantive competition laws nor that individual decisions of national competition authorities be subject to dispute settlement under the WTO."

¹⁷ See <http://www.wto.org/>.

¹⁸ The following outline of UNCTAD's competition law activities draws on information available on UNCTAD's website, <http://www.unctad.org/>.

¹⁹ The *Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices* (Resolution 35/63 of 5 December 1980) (the "UN RBP Set"). The main objectives of the UN RBP Set are: to ensure that RBPs do not "impede or negate the realisation of the benefits that should arise from the liberalisation of tariff and non-tariff barriers affecting world trade, particularly those affecting the trade and development of developing countries"; to promote competition and innovation, and to control concentration of economic power, in order to improve efficiency in international trade and to accelerate development; to protect and promote social welfare in general and, in particular, the interests of consumers. The UN RBP Set calls for the prohibition of anti-competitive practices among rival enterprises (cartels) at national, import, export and international levels. It proscribes the acquisition and/or abuse of dominant positions of market power and invites states to adopt and effectively enforce competition legislation and to cooperate with each other in this field. It also calls upon the international community and UNCTAD in particular to provide technical assistance, advisory and training services to developing countries and countries with economies in transition on competition law and policy. Last but not least, it provides for "preferential or differential" treatment for development purposes.

For additional information about the UN RBP Set and UNCTAD's competition law activities generally, see <http://www.unctad.org/>.

²⁰ In this connection, UNCTAD also publishes and updates a Model Law on Competition (TD/RBP/CONF.5/7); see <http://www.unctad.org/>.

²¹ ICPAC Report at 281 ff.

²² See J.I. Klein, "Time for a Global Competition Initiative?" (EC Merger Control 10th Anniversary Conference, Brussels, Belgium, 14 September 2000). See also "US Endorses a Global Approach to Antitrust" *Wall Street Journal* (15 September 2000) A15.

²³ *Supra* note 6 at 13-19.

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²⁴ Our overview of the Ditchley Park meeting draws on the official report of the meeting, *The Initiative for a Global Competition Forum*, prepared by Merit E. Janow and available through the International Bar Association's website, <http://www.ibanet.org/>.

²⁵ See "Transatlantic Co-operation and Multilateral Initiatives in Competition Policy" (Speech at a conference, organised by the European Voice, entitled "US-EU relations at the Dawn of a New Era: Bridging The Transatlantic Business Divide" 20 March 2001).

²⁶ See "Global Competition Forum Launched" *Global Competition Review* (April/May 2001) at 5.

²⁷ A first task of this group will be to attempt to persuade legislators and agencies in a small number of key jurisdictions to adopt (or at least to pilot test) a voluntary "common process" system with co-ordinated time limits and filing requirements. A non-mandatory "lead agency" protocol similar in principle to the work sharing arrangements contemplated by the ICPAC Report might also be explored. If the initial phase is successful, it would form a powerful model for extension to numerous other jurisdictions involved in reviewing mergers. See also: J.W. Rowley, Q.C. and A. Neil Campbell, "Multi-jurisdictional Merger Review – Is it Time for a Common Form Filing Treaty?" in *Policy Directions for Global Merger Review, A Special Report by the Global Forum for Competition and Trade Policy*, *Global Competition Review*, April 1999.

²⁸ Members of the interim Planning Group are Dr. Pascual Garcia – Mexico, Frederic Jenny – France, David Lewis – South Africa, John Nannes – USA, Alexander Schaub – EU, David Tadmor – Israel and Konrad von Finckenstein, Q.C. – Canada.

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THE INTELLECTUAL PROPERTY ENFORCEMENT GUIDELINES AND THE TREATMENT OF INNOVATION: ASSESSMENT AND COMPARISON WITH THE U.S. APPROACH

By: Chantale LaCasse and Brian Rivard*

Introduction

In September 2000, the Commissioner of Competition released the final version of the *Intellectual Property Enforcement Guidelines* ("IPEGs").¹ The IPEGs articulate the Competition Bureau's enforcement policy regarding the application of the *Competition Act* to conduct that involves intellectual property ("IP"). In particular, as stated in the Preface, the IPEGs state how the Bureau:

- approaches the interface between competition policy and intellectual property rights;
- determines the circumstances under which conduct involving intellectual property could contravene the Act; and
- distinguishes between circumstances that should be examined under the general provisions of the Act and those that warrant a special remedy under section 32.

Although there had been a number of speeches by Bureau officials that, in a very broad way, described the Bureau's approach to the intellectual property and competition law interface,² the IPEGs represent the first complete official statement by the Bureau on these matters.

The IPEGs follow by five years the U.S. Department of Justice and the Federal Trade Commission's release of the *Antitrust Guidelines for the Licensing of Intellectual Property* ("U.S. Guidelines").³ Competition authorities in Japan and in the European Community have also recently implemented guidelines or regulations pertaining to the treatment of intellectual property rights under competition legislation.⁴ In all of these jurisdictions, the issuance of guidelines reflects at least in part a need to articulate the role of competition law in fostering innovation and technological change,⁵ and to present the competition authority's method of analysis in these matters. The U.S. Guidelines, in particular, introduced the concept of an innovation market. This concept is specifically aimed at capturing effects on innovation that cannot be identified using the analysis of traditional antitrust markets. As is evident from the following assessment given by former Industry Minister John Manley in 1999, the impetus for the release of intellectual property enforcement guidelines in Canada arose from the same need:

Ensuring a high rate of innovation and productivity improvement is at the core of the challenges facing the Canadian economy as we approach the next century. ... The application of competition policy vis-a-vis intellectual property rights and innovation poses particularly complex challenges for policy makers and administrators. While competition policy has traditionally focused on maintaining rivalry and maximizing efficiency primarily in a static sense, increasingly, scholars and administrators recognize the need for consideration of the dynamic effects of framework policies on innovation and the diffusion of new technology. The purpose of this volume is to assess and reflect on the application of competition policy toward intellectual property in Canada, to help ensure an appropriate balance between the provision of incentives for innovation and the maintenance of vigorous inter-firm rivalry in markets for goods and services.⁶

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In this paper, we place both the U.S. Guidelines and the IPEGs in the context of the enforcement history that preceded their release. We provide a critical assessment of the approach to innovation and dynamic efficiency issues presented in the IPEGs and we compare it to the approach to innovation in the U.S. Guidelines. The use of innovation markets, which is a cornerstone of the enforcement approach put forward by the U.S. Guidelines, is explicitly ruled out in the enforcement approach taken by the Bureau in the IPEGs. We argue that while there may be many good theoretical and practical reasons for not adopting the innovation market approach in Canada, the IPEGs offer very little in the way of replacement. In this respect, the IPEGs fall short of providing the level of guidance on the competition law treatment of innovation and dynamic efficiency effects that might have otherwise been expected.

Context

In the early 1990s, the Federal Trade Commission and the U.S. government contested a number of mergers in markets in which innovation played a crucial part. The acquisition of Genentech by Roche Holdings is a case in point.⁷ Roche Holdings, in addition to manufacturing pharmaceuticals, conducted research in biotechnology. Genentech was a leading biotechnology firm. The complaint alleged that the transaction would substantially lessen potential competition in three distinct markets. In the market for vitamin C, Roche was holding a dominant position while Genentech (in partnership with another biotechnology firm, Lubrizol) had just patented a new process for producing the vitamin. In the market for human growth hormone, the roles of the two firms were reversed: Genentech was dominant in the U.S. market and Roche had successfully conducted trials for an alternative therapy. In the third market – the market for CD4-based therapeutics for the treatment of HIV infection – the situation was different. Both firms were engaged in research for the development of these therapies but no product yet existed. It was alleged in this market as well that the acquisition would result in a lessening of potential competition. The challenge to the acquisition resulted in a consent order. Roche divested its human growth hormone business, Genentech divested its interest in the new vitamin C process and Roche was required to license its CD4-based therapeutic patents for a period of ten years.

The intervention in the market for CD4-based therapeutics can be reasonably construed as aiming to preserve independent research tracks for a potentially crucial medical therapy.⁸ However, as pointed out by Commissioner Deborah K. Owen who dissented from the findings in the case, the requirements of the potential competition doctrine had not been met in this market. Strictly speaking, for there to be a lessening of potential competition, at least one firm must be currently producing as another stands ready to enter. The market for the product must already exist. Since no CD4-based therapeutics product had been sold, the requirements for the doctrine had not been met.

To the extent that intervention to maintain the level of innovation efforts was justified, such intervention seemed to require an expansion of the then-current antitrust doctrines, or the development of new methodology targeted specifically at analyzing the effects of conduct on innovation. In the *Roche Holdings* case, the potential competition doctrine needed to be extended to apply to future markets.⁹ There were a number of other challenges to mergers in the early 1990s that preceded the release of the U.S. Guidelines for which the effects on innovation were at the

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core of the concern. These challenges sometimes attempted to adapt the potential competition doctrine to fit the case, sometimes presented a novel research and development market and sometimes did both.¹⁰ The theories presented in these cases were refined as time went on and, to a large extent, were consolidated in the U.S. Guidelines. The novel definition of a relevant market around research and development efforts became the innovation market.

In the U.S. Guidelines, the new procedure to assess the effects of mergers on innovation is taken to apply to other conduct in which intellectual property can be prominent. The introductory remarks in the U.S. Guidelines emphasize the importance of elaborating clear enforcement principles that deal with the intersection of antitrust and intellectual property laws. It is widely held that continued improvement in the quality of life and the pace of economic growth owes a great deal to high-tech industries. A reasonable goal for enforcement authorities is to remove any uncertainty in their policies that could have a chilling effect on business in these industries.

Indeed, uncertainty regarding the application of antitrust policy to conduct involving intellectual property can dampen incentives to innovation. If, in certain circumstances, it is mistakenly perceived that remedies will directly interfere with intellectual property rights, potential intellectual property rights owners will not expect to be able to appropriate the full rents of their innovative efforts. The incentive to innovate is weakened with the reduction in the expected rents. The same is true if firms avoid entering into potentially lucrative contracts or transactions for fear of over-zealous scrutiny.

Dispelling the uncertainty surrounding enforcement policy is also very much an explicit goal of the IPEGs. As Corley & Facey¹¹ note, there are good reasons to believe that Canadian businesses indeed face uncertainty regarding the application of competition law to intellectual property. First, there have been only a limited number of cases involving the application of the Act to intellectual property rights.¹² This is probably not a reflection of differences in the goals or the diligence of the enforcement agencies in the two countries. Most likely, the U.S. sees comparatively more cases that involve intellectual property rights in general, and cases that involve patents in particular, because of more active research and development in the private sector. In particular, its pharmaceutical and biotechnology industries are in relative terms larger and more active in research.¹³

Second, of the small set of cases that have been litigated in Canada, one decision by the Competition Tribunal has served to put into question long-held assumptions about how the Act was to be applied to intellectual property. Warner Music Canada Ltd. held the copyrights to a large body of musical recordings, making it effectively the only firm capable of providing music club services to Canadian consumers. BMG Direct Ltd. requested from Warner Music Canada Ltd. a license to its copyrights and was refused. BMG was thus prevented from competing effectively in the market. The Director of Investigation and Research (now the Commissioner) brought a case against Warner under section 75, the refusal to deal provisions. The Tribunal accepted Warner's argument that "licenses" were not products under the meaning of this section, and thus that the section could not be used to force Warner to supply BMG. By excluding licenses from being products, the decision put into question how the Act would apply to intellectual property.

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The Competition Bureau began work on the IPEGs shortly after the *Warner* decision. The IPEGs are meant to fill a gap and to dispel some of the uncertainty surrounding the application of competition law to intellectual property. To a large extent, they lead enforcement policy rather than consolidate enforcement history as the U.S. Guidelines had done. The IPEGs are nevertheless careful to show how their enforcement principles are consistent with the precedents that do exist in Canadian law.

The first draft of the IPEGs was released in June 1999. A second and carefully revised draft was released in April 2000 after a round of public consultation. The final version of the IPEGs, on which this paper is based, was issued in September of 2000. The modifications from the second draft to the final version are small in number, but at times affect the substance of the enforcement position put forth by the IPEGs. We note some of these instances below when describing the text of the IPEGs.

The Treatment of Innovation

Intellectual property rights are distinct from other property rights because they are protected by statute. Strong property rights can provide the correct incentives for investment in innovation and creative endeavours despite the fact that intellectual property is typically easy to copy or to steal. It is only by excluding others from its use that the intellectual property rights owner can directly profit from the property. The rents that can thus be captured serve as the basic reward for investing in the development of intellectual property.

In a market in which innovation is important, antitrust enforcement can centre on static or on dynamic efficiency concerns. A concern arises over static efficiency when identifiable conduct leads to market power being created or enhanced. The use of this market power leads to a loss in welfare resulting from market quantities deviating from competitive levels. It is possible that the market power used by the firms is at least partly tied to their intellectual property rights, or that the conduct directly concerns trade or licensing of the intellectual property rights. A concern arises over dynamic efficiency when the conduct under scrutiny can damage the incentives of the firm or other firms in the market to innovate.¹⁴ The loss of welfare is then due to products or processes not being developed as rapidly as would otherwise have been the case, or not being developed at all.

Antitrust enforcement in spheres where intellectual property rights are important must proceed carefully since it risks weakening the system of economic incentives put in place by intellectual property statutes to invest in innovation. The analysis of anti-competitive behaviour and the analysis of any remedy proposed must take into account dynamic efficiency considerations to address this concern. Further, dynamic efficiency considerations are at the heart of cases for which intervention aims to preserve innovation incentives. As mentioned above, a number of U.S. merger cases from the early 1990s fit this categorization.

U.S. authorities took the position that to address these dynamic efficiency considerations, a new conceptual apparatus was required. The U.S. Guidelines, in elaborating the concept of the "innovation market," present such a new analysis. The Competition Bureau, in contrast, takes the position that traditional antitrust analysis is already equipped with the tools and the concepts necessary to take innovation effects into account. Traditional analysis sometimes requires careful reinterpretation in situations involving intellectual property, but its solid and

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long-standing foundations can still be counted upon to underlie the analysis of cases in the “new economy.” Intellectual property is, first and foremost, simply property. In what follows, we elaborate on the differences in the treatment of innovation in the two enforcement guidelines.

The Treatment of Innovation in the U.S. Guidelines

The U.S. Guidelines state that the aim of antitrust laws is to “promote innovation and consumer welfare by prohibiting certain actions that may harm competition with respect to either existing or new ways of serving consumers.”¹⁵ Prominent among the antitrust concerns for which the U.S. Guidelines provide principles of analysis is the possibility that “a licensing arrangement may have competitive effects on innovation that cannot be adequately addressed through”¹⁶ the traditional analysis of markets. For such circumstances, as well as other circumstances such as the acquisition of intellectual property through a merger, the U.S. Guidelines provide the new innovation market approach. The goal of the U.S. Guidelines to integrate dynamic efficiency concerns in the antitrust analysis of intellectual property is made clear by the fact that the innovation market approach concerns itself directly with capturing the effects of conduct on the incentives to develop new products and processes.

Three types of markets could be affected by arrangements involving intellectual property:

- a goods market, in which the relevant product is a final or intermediate good made using the intellectual property as an input or a good that is used as an input, along with the intellectual property;
- a technology market, in which the rights to use the intellectual property are licensed or traded; and,
- an innovation market which “consists of the research and development directed to particular new or improved goods or processes, and the close substitutes for that research and development.”¹⁷

The approach to the delineation of goods markets and technology markets is rooted in the traditional approach to market definition used in various agencies’ publications and guidelines, such as the *Horizontal Merger Guidelines* jointly published by the Federal Trade Commission and the U.S. Department of Justice.¹⁸ An innovation market, however, is conceptually different from the other two types of markets. In goods or technology markets, market power relates to the ability of firms to decrease output and increase price for a significant period of time. In an innovation market, market power relates to the firms’ ability to decrease research inputs (i.e., spending on research and development) and thereby retard the pace of innovation. One must take care, however, not to oversimplify the distinction. The innovation market is defined with respect to inputs, but the ultimate goal of the approach is to capture the effects of conduct on consumer welfare in existing or future goods or technology markets. By retarding the pace of innovation, new products or more efficient production processes for existing products are not introduced in a timely fashion. Thus, the effects of market power in an innovation market eventually are felt in downstream goods and technology markets and result in a loss of welfare to consumers.

Gilbert & Sunshine¹⁹ were among the first to articulate the merits of supplementing the traditional antitrust analysis with the innovation market approach. We follow their general line of argumentation in summarizing the logic of the innovation market approach and in presenting its potential contribution to antitrust analysis.

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A basic premise of the approach is that innovation and technological change play a crucial role in generating economic growth. Domestic and global economies will continue to grow only if they continue to produce new products that consumers value or lower cost technologies that produce existing products at lower cost. Technological change and economic growth are vital for continued social well-being. A second premise is that the competitive dynamics of the market place spur innovation and technological change. Firms seek new processes to decrease their costs, they develop new products to differentiate themselves in the eyes of consumers, all in an effort to gain an edge over their competitors. The greater are the efforts in research, the greater are the expected rewards (namely profits from new products and processes). Thus, firms that count on innovation to gain an edge over their competition spend more on research and development. Conversely, when there is little competition, it can be in a firm's interest to choose low levels of spending in research and development to keep costs low. The lack of competition means that the firm can simply continue to reap profits from current products without expending significant effort on developing future products. When there are few firms in a position to conduct research in the field, the reduction in research and development spending by even one firm can reduce the overall pace of innovation in the market.

Against the backdrop of this vision of the innovation process in the marketplace, it can be argued that when antitrust analysis uses only traditional market delineation, it may not capture all welfare consequences of decreased innovation efforts. This point is most clearly argued in Gilbert & Sunshine through an example.²⁰ In this example, two firms produce an intermediate good, aluminium ingots. This intermediate good is used in the production of two final goods, cable and lawn furniture. The two firms are duopolists in the world market for cable. Each firm is a monopolist in a distinct geographic market for lawn furniture. There are sufficient barriers to entry in the two separate geographic markets for lawn furniture so that the two firms are neither actual nor potential competitors in a given geographic market.

Gilbert & Sunshine consider the possibility of a merger between the two firms. Each of the firms is engaged in R&D aimed at reducing the cost of ingot. It is assumed that if the merger proceeds, the innovation will not occur or it will occur at a much later date. Two effects of the merger can be identified. First, as a result of the elimination of competition between the duopolists in the cable market, the profit-maximizing price for cable would be higher than would have prevailed absent the merger. This effect would be routinely identified by traditional analysis. Second, because the innovation does not occur, the input cost reductions in aluminium ingot do not materialize, and thus the profit-maximizing price in each of the lawn furniture markets is higher than would have prevailed absent the merger. This effect would be ignored by traditional analysis because the firms under scrutiny are neither current nor potential competitors in each of the lawn furniture markets.

The example illustrates how an analysis that, in the traditional way, limits itself to examining structural effects in a downstream market in which the merging firms are either actual or potential competitors could fail to capture some of the adverse effects of the loss of innovation.²¹ Given the importance of innovation on economic growth and given the potential for a merger or any other arrangements involving intellectual property to alter the incentives to innovate, it can be argued that a more direct examination of innovation incentives in merger review is required, and the innovation market approach is offered as a means to do just that.

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A five-step analytical procedure is developed to render the innovation market approach operational.²² First, a relevant innovation product is delineated by identifying the overlapping R&D activities of the firms under scrutiny. For an R&D activity to be included, it must be established that the outcome of this activity would have a significant impact on one or more relevant downstream product (goods or technology) markets. Second, firms engaged in R&D activities that are substitutes for the R&D activities of the parties under scrutiny are identified and included in a relevant innovation market. This is akin to using the hypothetical monopolist approach in traditional analysis to define the relevant market: a relevant innovation market is one that identifies the set of R&D activities for which a hypothetical monopolist would profit from a small but significant and non-transitory reduction in R&D spending.²³ In a third step, the agencies evaluate actual and potential competition from downstream firms as a check on the willingness of firms that have market power in an innovation market to reduce R&D spending. Innovation can provide an edge in downstream goods and technology markets that allows a firm to increase its share in these markets and thereby increase its profit. If the expected loss of competitive opportunities in downstream markets from the reduced R&D exceeds any savings from reducing R&D spending, then even a firm with market power in an innovation market would have no incentive to reduce its R&D effort (and thus the conduct under scrutiny cannot adversely affect the incentives to innovate). Assuming that firms could be willing to decrease their R&D spending, the agencies then proceed to a fourth step which consists of assessing the increase in concentration in R&D activities, and in evaluating the competitive effects on R&D activities stemming from the arrangement or transaction. The agencies determine whether the share of the innovation market held by the firms under scrutiny is sufficient to affect the total level of R&D expenditure in the market. Factors other than those analysed in step 3 but that could affect the likelihood that the transaction or arrangement adversely impacts R&D expenditure, such as the quality of the firms' R&D activity and its expected success rate, are also taken into account at this time. Finally, the agencies evaluate potential R&D efficiencies. Such efficiencies occur if the merger eliminates duplication in R&D effort, combines complementary R&D inputs and activities, or achieves unexploited economies of scale. These efficiencies enhance the likelihood or the value of innovation.

With this practical procedure, the innovation market approach purports to provide the practical analytical tools necessary to promote dynamic efficiency of the economy. However, the critics of the innovation market approach have been vocal in arguing that the approach does not live up to this promise. Both the theoretical foundations and practical applicability of the approach have been attacked. We summarize here the main criticisms.²⁴

One important premise of the approach is that increased concentration leads to a reduction in innovation activity.²⁵ Yet, there is no well articulated economic theory or empirical results that support this premise unambiguously. Indeed, the theoretical debate on whether competition or monopoly is the market structure most conducive to innovation is long-standing and it remains unresolved.²⁶ On one side of the debate are those who point to the incentives of firms to find and implement cost-reducing innovation in a competitive setting. On the other side of the debate are those who emphasize that innovation is a risky and expensive business, and that firms with market power are more likely to be willing to bear the risk of innovative activity and are more able to obtain the required financing. Empirical work in the area has not lent credence more to one side than the other.

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The innovation market approach does not add new arguments or further clarification to the debate on the optimal market structure for innovation. Rather, it takes the fact that competition is the market structure most likely to maximize social welfare as a rebuttable presumption: given that there is no conclusive evidence that concentration stimulates innovation, it should be assumed that it does not, and that competition should be encouraged. Critics of the innovation market approach adopt the opposite view: given that there is no conclusive evidence that concentration retards innovation, “[s]ince any mistakes could inhibit or deter innovation rather than further it, ... antitrust should refrain from acting in order to avoid costly mistakes.”²⁷

The innovation market approach also rests on the assumption that more innovation is better: more innovation automatically leads to welfare gains because innovation either lowers costs for existing products or leads to the introduction of new products. This would be true if firms bore the complete burden of the improvements. However, if advances are financed through increased prices for current products, it is not possible to state unambiguously that innovation always leads to welfare gains. Consumers may like improved products, but they may prefer to pass on an improvement if the improvement means paying higher prices for the current version of the product. As with any other non-price attribute of products, more of the attribute has an ambiguous effect on welfare if more of the desired attribute comes paired with higher prices.

Ultimately, whether innovation can be systematically linked to welfare gains is an empirical issue.²⁸ Even if such a link were to be strongly established, it is worth noting that the innovation market approach does not seek to control the pace of innovation directly. Rather, it tries to ensure that innovation spending is at competitive levels. But ensuring high levels of R&D spending is not the same as ensuring high levels of innovation. For example, if research spending is high because there are two firms engaged in research instead of one, not all extra funds can be thought to contribute to increasing the pace of innovation. Inevitably, if both firms are in the same innovation market, their research programs are to some extent substitutes, and so there will be duplication in the research conducted. Indeed, in the extreme case of a patent race, where only one firm can win the prize, a reduction in R&D spending that eliminates one of two identical research programs without reducing the likely realization of the innovation would be socially efficient. Maintaining a certain level of research spending does not necessarily ensure that a socially optimal level of innovation will be achieved.

A practical criticism against the innovation market approach is that innovation market concerns can be adequately addressed through the application of the potential competition doctrine and thus that the approach adds nothing new to the existing tools of antitrust enforcement.²⁹ Indeed, when exerting market power in innovation markets coincides with the use of market power in a product or technology market, traditional antitrust analysis could be sufficient to capture the welfare effects of the conduct or transaction under review. For instance, if the ability to reduce research spending in an innovation market were directly linked to the acquisition by an incumbent of a potential competitor, the potential competition doctrine alone could be used to assess the likely anti-competitive effects. This was the case in Wright’s disputed acquisition of Orthomet.³⁰ Wright manufactured finger implants and was engaged in R&D to improve the product. Orthomet was working to make operational finger implants designed by the Mayo Foundation but was not present on the product market at the time of the acquisition. While the complaint alleged both the elimination of potential competition in the market for finger implants and the

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elimination of actual competition in the innovation market for the next generation implants, the elimination of the potential competition seems also to capture the lessening of actual competition in the innovation market.

But there are circumstances in which the innovation market approach potentially identifies welfare effects that would have been missed by the usual antitrust analysis. One such set of circumstances materializes when anti-competitive effects of the conduct or transaction are expected to occur in a market for a product that does not yet exist. When no firm is marketing a product, then as previously noted, the potential competition doctrine does not strictly apply.³¹ The antitrust concern can then revolve around the potential elimination of complementary and competing lines of research, or of the concentration of intellectual property rights in the hands of one firm possibly precluding other firms from entering the innovation market. Further, the example given by Gilbert & Sunshine is a genuine set of circumstances for which the traditional analysis falls short. Rapp cites empirical work to support the claim that such circumstances are rare so that, in most instances, the conventional analysis of product and technology markets will suffice. However, this fails to establish that the innovation market approach does not add value to the conventional analysis, even if the circumstances in which it does are rare.

To date, the innovation market approach has been applied in a number of consent orders obtained by the Department of Justice and the Federal Trade Commission, but there have been no litigated cases. The courts have not pronounced themselves on the innovation market approach and the general acceptance of the innovation market approach in U.S. law remains unsettled. The "judgement" rendered by the scholarly economic debate, however, is clearer. The approach suffers both from serious theoretical limitations and from practical difficulties. The innovation market approach should only be applied in those specific cases for which the facts clearly warrant intervention (e.g., when regulatory barriers clearly deter efficient entry or when firms' specific assets are clearly difficult to replicate). In the vast majority of cases, focusing on output and price effects in downstream goods and technology markets would identify the detrimental effects of the conduct or transaction without having recourse to the innovation market approach.

Even if it must be considered flawed, the inclusion of the innovation market approach in the U.S. Guidelines has helped to further the understanding of the analysis of innovation incentives and dynamic efficiency in an antitrust enforcement context. The introduction of new analytic approaches, even if these approaches prove to be useful only in limited circumstances, do achieve the guidelines' goal of providing guidance and practical advice on how the agencies consider innovation incentives.

The Treatment of Innovation in the IPEGs

In releasing the IPEGs, Canada follows the lead of the United States and of several members of the European Union. The goal at the forefront of the IPEGs is one of providing clarification on the Bureau's enforcement policy.

The Bureau has received an increasing number of requests for information on its treatment of IP under the *Competition Act*. This document, the Intellectual Property Enforcement Guidelines, sets out how the Competition Bureau views the interface between IP law and competition law. It also explains the analytical framework the Bureau uses to assess conduct involving IP.³²

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This need for clarification arises principally from the fact that Canadian case law is sparse. Furthermore, the latest decision of the Competition Tribunal in *Warner* served to intensify – rather than dispel – the uncertainty surrounding the application of the Act to intellectual property.

The IPEGs support the belief that innovation and creative endeavours are the motor of the modern economy. The difference in the treatment of innovation between the U.S. Guidelines and the IPEGs is foreshadowed by the place that competition laws are given in the promotion of innovation. The U.S. Guidelines envision antitrust laws as directly aiming to promote innovation. The IPEGs, in contrast, assign to the intellectual property laws the burden of fostering innovation and creative endeavours: “Adequate protection of intellectual property (IP) plays an important role in stimulating new technology development, artistic expression and knowledge dissemination, all of which are vital to the knowledge-based economy.”³³ In the IPEGs, competition laws are given a more modest and supporting role. Competition laws are consistent with intellectual property laws because they promote efficiency and welfare, and they can help protect the incentives to innovation created by intellectual property laws:

Applying the *Competition Act* to conduct associated with IP may prevent anti-competitive conduct that impedes the efficient production and diffusion of goods and technologies and the creation of new products. The promotion of a competitive marketplace through the application of competition laws is consistent with the objectives underlying IP laws.³⁴

The IPEGs appear more ambitious in their scope than the U.S. Guidelines. The U.S. Guidelines focus on licensing agreements and pinpoint a list of particular antitrust concerns that are to be addressed. The IPEGs aim to present general principles of interpretation and analysis that apply to all competition matters that could involve intellectual property: “The Guidelines discuss the circumstances in which the Bureau, under the *Competition Act*, would seek to restrain anti-competitive conduct associated with the exercise of IP rights in order to maintain competitive markets.”³⁵ The IPEGs are less ambitious in the methodology that they propose to deal with intellectual property issues. While both the U.S. Guidelines and the IPEGs uphold the principle that standard antitrust analysis applies to conduct involving intellectual property, the U.S. Guidelines supplement this standard analysis with the innovation market approach to deal with dynamic efficiency concerns. The IPEGs do not adopt the U.S. concept of an innovation market. Given the weaknesses in the theoretical foundations of the innovation market analysis pointed out by its critics, it seems wise of the Canadian authorities not to have incorporated the approach. The IPEGs adopt instead the position that standard antitrust analysis is also adequate to address dynamic efficiency concerns. We will argue that, unfortunately, the IPEGs provide little guidance on why and how this is the case.

Unlike the U.S. Guidelines, the IPEGs specify the practical procedure by which “standard antitrust analysis” is applied to conduct involving intellectual property. After clearly identifying the conduct or transaction to be scrutinized, the analysis begins with the definition of a relevant market. The IPEGs’ description of the possible relevant markets does not include the notion of an innovation market: “the Bureau is likely to define the relevant market based on one of the following: the intangible knowledge or know-how that constitutes the IP, processes that are based on the IP rights, or the final or intermediate good resulting from, or incorporating, the IP.”³⁶ Markets based on a final or intermediate good incorporating the IP correspond exactly to the goods market in the U.S. Guidelines. Although stated very differently, a relevant market defined around know-how or processes associated with the IP is in essence equivalent to the notion of a technology market in the U.S. Guidelines.

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The IPEGs' rejection of the innovation market approach does not come only from omitting the innovation market in the list of potentially relevant markets. It is made explicitly, and as such merits a separate paragraph in the IPEGs: "The Bureau does not define markets based on research and development activity or innovation efforts alone. The Bureau usually concentrates on price or output effects."³⁷ This characterization refers to the (perhaps too simple) distinction between innovation markets and other markets based on the effect of market power. In an innovation market, market power translates into an ability to control inputs. In other markets, market power refers to the ability to control output and price.

After the definition of the relevant market, the IPEGs describe the steps remaining in the standard analysis as follows: "determining if the firm(s) under scrutiny possess market power [...]; determining if the transaction or conduct would unduly or substantially lessen or prevent competition in the relevant market(s); and considering, when appropriate, any relevant efficiency rationales."³⁸ This procedure to examine potentially anti-competitive conduct is a synthesis of the analytic approach presented at length in the *Merger Enforcement Guidelines*.³⁹ The IPEGs state the belief that this standard analysis is versatile enough to apply across all types of markets and all types of intellectual property: "this approach applies to all industries and all types of business transactions and conduct, and is sufficiently flexible to accommodate differences among the many forms of IP protection as well as between IP and other types of property."⁴⁰ Intellectual property, in the IPEGs, is property first and foremost.

While the IPEGs take care to re-interpret the definition of relevant markets when intellectual property is involved, the IPEGs provide little clarification on how the standard analysis can address the dynamic efficiency concerns that conduct involving intellectual property can raise. Two sections of the IPEGs do provide a general indication of the likely approach to innovation and dynamic efficiency issues under the general provisions of the Act, but necessary details indicating how to tailor the remainder of the standard analysis are scant.⁴¹

The first section of the IPEGs concerned with dynamic efficiency issues considers directly innovation incentives. It states that "(c)onduct that directly reduces the innovation effort of the firms under scrutiny or restricts or prevents the innovation efforts of others may be anti-competitive."⁴² This is further clarified in a second statement found in the description of potential anti-competitive effects: "a transaction or conduct that reduces innovation activity could be anti-competitive if it prevents future competition in a prospective product or process market."⁴³ It thus appears that the IPEGs do not consider a reduction in innovative activity, in and of itself, to represent a substantial or undue lessening of competition. Rather, the evidence of a reduction in innovation is to be treated as a specific anti-competitive effect of some conduct under review. For a finding of a substantial or undue lessening of competition, further evidence is needed that the reduction in innovation activity leads to an enhanced ability by the firms under scrutiny to exercise market power in a well defined goods or technology market.⁴⁴ This is a sensible approach. However, no additional guidance is provided on the type of evidence that would be sufficient to link a reduction in innovation spending to the ability by firms to exercise market power in a relevant market. In particular, none of the hypothetical examples contained in Part 7 of the IPEGs illustrates a situation in which a particular conduct reduces the innovation efforts of a firm or group of firms with the effect that a substantial lessening of competition in a well defined goods or technology market results.

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A second portion of the IPEGs is directly concerned with dynamic efficiency. In discussing the treatment of "Efficiency Considerations" under the standard analysis, the IPEGs state that:

there may be instances when creating or increasing market power is justified because of the efficiencies created. Indeed, this principle is consistent with the protection afforded by IP laws, which foster dynamic efficiency and competition by facilitating the creation of valuable works or processes that result in long-term increases in product selection, quality, output and productivity. In providing incentives for investment, IP laws grant exclusivity to the protected works that may result in temporary market power. Consequently, the Bureau considers both the short-term and long-term efficiency implications of conduct on a transaction when analyzing efficiencies in cases involving IP.⁴⁵

This statement is consistent with the supporting role that the IPEGs set out for competition law in the promotion of innovation. It suggests that the analysis in the IPEGs assumes that in general, protection under the intellectual property laws provides neither too little nor too much market power, and that any short-term harm due to a conduct or transaction should be balanced against potential long-term benefits from improved innovation incentives. How this balance is to be struck in practice is not obvious. For the Bureau's intention to consider both short-term and long-term efficiencies to have practical value, it would be necessary for the IPEGs to develop the framework required for such an analysis to proceed. Further, the type of evidence that the Bureau would require when considering the effects of conduct involving intellectual property on dynamic efficiency would need to be discussed. The presentation of the analysis in the IPEGs does not provide guidance on these points. Part 7 of the IPEGs includes hypothetical examples that are on point but the analysis presented is not sufficient to fill in the gaps left in the presentation of the analysis. Hypothetical examples 3.2, 3.3 and 5 acknowledge that efficiency benefits could offset the lessening of competition of a business practice but they do not specify the types of efficiency benefits or business justifications that could offset the harm of the conduct. Example 4 presents a situation in which exclusivity provisions could be required to justify investments necessary to achieve economies of scale even though such provisions lead to a lessening of competition. However, no guidance is provided as to the type of evidence that would be required to establish such a claim in practice.

Against the backdrop of Minister Manley's message in the Preface to the Industry Canada Research volume (quoted in the opening paragraphs of this paper), it seems incongruous that the IPEGs take the standard analysis, without any additional analytical framework, to be sufficient for addressing dynamic efficiency concerns. Indeed, the need for enforcement guidelines, in Canada and elsewhere, arises from the belief that the standard analysis is (at worst) inadequate to address dynamic efficiency concerns, or (at best) that it is adequate but that the way in which the standard analysis is to apply to such circumstances needs to be specified. The IPEGs' view, however, is entirely consistent with critics of the innovation market approach who have argued that a new form of analysis is unnecessary. These critics believe that an expanded application of the U.S. potential competition doctrine in current or future goods markets is suitable to capture the innovation effects of transactions and other conduct involving intellectual property.⁴⁶ Although the U.S. potential competition doctrine is not identified by name, some of the language in the IPEGs suggests that the doctrine is an integral part of the Bureau's standard analysis. In particular, the IPEGs state that the Bureau may seek to challenge an arrangement under one of the general provisions of the Act, "[i]f an owner licenses, transfers or sells the IP to a firm or group of firms that would have

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been actual or potential competitors without the arrangement, and if this arrangement creates, enhances or maintains market power.”⁴⁷

While the Bureau appears to concur with many critics of the innovation market in concluding that expanded application of the potential competition doctrine is adequate, it does not provide within the IPEGs a formal elaboration of how such a doctrine would be applied in the specific circumstances where innovation effects are most important. The contribution of the IPEGs does not rest with its framework for analysis of innovation incentives and dynamic efficiency issues. Instead, their main contribution lies in their clear articulation of the Bureau’s central enforcement principle. The Bureau’s central enforcement principle is that the general provisions of the Act, (which do not include section 32), can only be invoked when the conduct involves ‘something more’ than the mere exercise of a right defined by intellectual property statutes. The mere exercise of an intellectual property right is “the owner’s right to unilaterally exclude others from using the IP. The Bureau views an IP owner’s use or non-use of the IP also as being the mere exercise of the IP right.”⁴⁸ The conduct involves ‘something more’ than the mere exercise of the intellectual property right and falls within the general provisions of the Act when “IP rights form the basis of arrangements between independent entities, whether in the form of a transfer, licensing arrangement or agreement to use or enforce IP rights, and when the alleged competitive harm stems from such an arrangement and not just from the mere exercise of the IP right and nothing else.”⁴⁹

The IPEGs draw the distinction between the mere exercise of the intellectual property right and ‘something more’ by appealing to the difference between acts taken by the intellectual property owner alone, and acts involving parties other than the intellectual property owner. The mere exercise of the intellectual property right is referred to as the unilateral exercise of this right.⁵⁰ Thus, the unilateral exercise of the right includes not only circumstances in which the owner alone decides whether to use the IP, but also circumstances in which, for instance, the owner refuses to license the intellectual property to another party. The exercise of the right is then unilateral in the sense that the agreement of another party need not be secured – rather than in the sense that no other party is involved or affected by the exercise of the right. There is ‘something more’ if the intellectual property owner “sells, transfers or licenses the intellectual property”⁵¹ to another independent entity or to independent entities. These are situations in which the exercise of the right does require the agreement of at least one other party.

Section 79, the abuse of dominance provision of the Act, states specifically that the mere exercise of an intellectual property right cannot be considered anti-competitive. In removing the mere exercise of intellectual property rights from the ambit of the general provisions of the Act for situations in which the competitive harm comes exclusively from the mere exercise of the right, the IPEGs unify the approach used by all general provisions of the Act. The condition that the competitive harm stem exclusively from the mere exercise of the right is important. In particular, it implies that the right to refuse to license, which is a mere exercise of the intellectual property right, will only be examined under the general provisions of the Act when the competitive harm stems from something more than the refusal itself. In most practical cases, it may well be difficult to distinguish whether competitive harm arises exclusively from the refusal or from some other practice.⁵²

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The main enforcement principle of the IPEGs, by removing the mere exercise of intellectual property rights from the ambit of the general provisions, again reflects a view that the intellectual property laws are the main instruments to promote innovation. Antitrust enforcement should not weaken basic property rights because doing so would damage the incentives that intellectual property laws create for innovation and creative endeavours. However, with the use of section 32, which is in the special remedies section of the Act, the IPEGs do open the possibility that the Act can be used to “fine-tune” the intellectual property laws. Section 32 deals specifically with anti-competitive conduct involving intellectual property rights. It requires that the conduct be shown to lead to undue restraint of trade or lessened competition. The remedies available include modifying the rights held by the intellectual property owner, revoking those rights, or requiring licensing. Thus, section 32 could allow competition laws to correct perceived deficiencies in the ability of intellectual property laws, in specific circumstances, to promote innovation. Section 32 has no counterpart in U.S. law and as such provides a distinct and additional means of enforcement.

The IPEGs are clear that the use of section 32 is intended to be very limited. Intervention under this section would only be contemplated when the conduct involves the unilateral exercise of an intellectual property right and when the competitive harm stems only from the unilateral exercise of the right.⁵³ Furthermore, the example and the analysis presented in the IPEGs only consider the case of a refusal to license, suggesting that this would most likely be the conduct under review.

The analysis that would establish that enforcement should be undertaken under section 32 proceeds in two steps. The first step must establish that the mere refusal to license intellectual property results in a substantial lessening of competition in a relevant market. The relevant market must be “different or significantly larger than the subject matter of the IP.”⁵⁴ This condition precludes the possibility that intervention under section 32 would merely establish competition in the development of a technology by duplicating the intellectual property for other firms through low cost licensing arrangements. The IPEGs state that the condition for the first step would be satisfied only when “i) the holder of the IP is dominant in the relevant market, and ii) the IP is an essential input or resource for firms participating in the relevant market – that is, the refusal to allow others to use the IP prevents other firms from effectively competing in the relevant market.”⁵⁵ Evidence is thus required that the refusal is a significant factor in restricting competition by firms that could add new value to the economy. This would be the case, for instance, if these firms would enter the market by introducing differentiated or improved versions of the intellectual property or if the intellectual property becomes an essential component in the production of some downstream product. This last clause (essential component) seems akin to the type of situations that the essential facilities doctrine in the U.S. is intended to capture.⁵⁶

In the second step of the analysis for section 32, “the Bureau must establish that invoking a special remedy against the IP right holder would not adversely alter the incentives to invest in research and development in the economy.”⁵⁷ This requires the Bureau to conduct an explicit examination of the incentives to innovate once the remedy is in place.⁵⁸ As our discussion of the U.S. innovation market approach indicates, there are numerous conceptual and practical difficulties associated with evaluating innovation incentives in a given market. These difficulties are made more daunting by the fact that the analysis under section 32 requires an assessment of

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whether a special remedy would “adversely alter the incentives to invest in research and development in the economy” [emphasis added]. The potential danger here is that by requiring the licensing of a product to potential competitors, the Bureau would be undermining one of the crucial aspects of the statutory right of an IP holder: the right to exclude others from the use and commercialization of their ideas and innovations. The Bureau thus needs to assess whether intervening in such a way in the case of a specific holder of an intellectual property right would provide a signal to other innovators that their protection under intellectual property statutes can be weakened after it has been granted. For other innovators to find intervention appropriate, clear criteria would have to be set that could establish that the intellectual property right holder under scrutiny had been granted “too broad” a level of protection. The remedy could then be seen to realign the level of protection with public interest. If the factors invoked by the Bureau (and the courts granting the remedy) are construed as arbitrary by other innovators, intervention would create uncertainty. Before deciding to proceed with spending on research and development, potential innovators would weigh the risk that the Bureau could step in and weaken their statutory protection. This risk reduces the expected rewards to innovation and thereby reduces the incentives to innovate in the economy.

Ensuring that the second step is satisfied requires assessing the effect and true economic cost of the possible chill on the incentives for future innovation of a given intervention under section 32. This seems, to say the least, difficult to accomplish in practice. The IPEGs do provide for an easier test to satisfy the second step. However, this easier test does not seem wholly consistent with the intent of the analysis under section 32. The IPEGs state that “This [second] step is satisfied if the refusal to license the IP is stifling further innovation” explaining that “if the refusal is stifling further innovation then the Bureau would conclude that incentives to invest in research and development have been harmed by the refusal and a special remedy would help realign these incentives with the public interest in greater competition.”⁵⁹

Taken literally, this passage of the IPEGs states that to establish that the incentives to innovate in the whole economy would be realigned by invoking a special remedy under section 32, it is sufficient to show that the refusal to license the IP was stifling innovation (presumably, in a relevant market). Certainly, the burden imposed before intervention is justified is much easier to meet if it must simply be established that some harm to innovation has occurred in some market. But it is hard to see how from the fact that a conduct harms innovation at a point in time in a given market, it must readily follow that intervention will not harm the incentives to innovate of other firms, in other markets in the economy, at any other point in the future. This easier test does not logically seem to be sufficient to establish that the second step of the analysis under section 32 is satisfied.

The IPEGs provide an example (Example 8) that illustrates how the two-step analysis under section 32 would be applied. It does not however, confront directly the difficulties that exist in evaluating innovation incentives. In this example, ABACUS and two other firms initially develop competing electronic spreadsheet software. ABACUS becomes the dominant provider of electronic spreadsheet software because of network effects. Its large installed base of customers become locked into the words and layout of the ABACUS menu command hierarchy making it costly for these customers to switch to alternative spreadsheet formats. A new company, CALCULATOR, later develops an improved spreadsheet product that it starts to market at a lower price than the ABACUS

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product. Despite the benefits of the new product, CALCULATOR runs into financial difficulty and approaches ABACUS asking for a license to use its words and layout menu command hierarchy. ABACUS refuses to provide CALCULATOR with a license. As a result, numerous other firms announce that they are discontinuing their spreadsheet development programs.

The analysis of this example in the IPEGs states that “the Bureau would likely seek a special remedy that would allow other spreadsheet firms to gain access to the words and layout of ABACUS’ menu hierarchy”.⁶⁰ The fact that the refusal to license to CALCULATOR led to the discontinuation of additional research in the area is evidence that the ability of the dominant firm ABACUS to impose incompatibility in its menu hierarchy harms innovation. The market power that ABACUS holds seems to be a result of the costs that consumers must bear to learn the software rather than a result of it having a superior product. The IPEGs assess that in all likelihood, the menu hierarchy was somewhat arbitrary and involved little innovative expense.

The example leaves interesting questions unanswered. It is not clear whether the firms that initially entered the market recognized the possibility that network effects would lead to “tipping”, i.e., to one firm dominating the market. If the firms did recognize this possibility, it is conceivable that the profits from being dominant in the market were in fact the prize that encouraged firms to make the initially costly investments to develop an electronic spreadsheet. It would be interesting to learn how the Bureau would take this into consideration when evaluating whether the remedy is likely to create a chill on the incentives to innovate in the economy. Furthermore, as the example states, “[t]o establish whether ABACUS’s refusal created an undue restraint of trade or lessened competition, the Bureau would determine whether the refusal adversely affected competition in a relevant market that was different or significantly larger than the subject matter of ABACUS’s IP rights or the products or services which result directly from the exercise of such IP rights.”⁶¹ However, the example does not clearly spell out why the defined market, “ABACUS-compatible spreadsheets,” differs or is significantly larger than its IP. Future innovators are likely to view this distinction as being arbitrary. In addition, it is not clear how firms in other sectors of the economy would interpret the Bureau’s finding that ABACUS’ choice of its words and layout hierarchy was “arbitrary.” It may be difficult for firms to reconcile how certain aspects of their intellectual property are arbitrary but nevertheless contribute significantly to their success and potential dominance in a market. Using the seemingly arbitrary nature of firms’ choices to justify intervention could introduce uncertainty that would discourage future innovation unless the criteria used to determine when certain aspects of the intellectual property are arbitrary were made plain.

Conclusion

Following the *Warner* decision, there was a clear need for the Bureau to state its position on how the Act would be applied to situations involving the refusal to license an intellectual property right to a competitor. The *Warner* case created an uncertainty regarding the Bureau’s view of when refusals to license could be deemed anti-competitive and hence when such refusals warrant closer scrutiny. In setting out their central enforcement principle, the IPEGs clarify the Bureau’s position in this respect. The IPEGs also provide guidance by officially taking the position that in enforcing the Act, the Bureau views intellectual property statutes and competition laws

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as complementary. Both spheres together aim to promote dynamic efficiency. The Bureau's conception of the interface between intellectual property protection and antitrust matters conforms to that of other jurisdictions such as the U.S.

The IPEGs, however, fall short. They do not provide clarity on how the Bureau's traditional or "standard analytic approach" can be adapted to deal with the dynamic efficiency issues often associated with intellectual property. The IPEGs reject the innovation market approach that has been adopted by the U.S. Guidelines out of a recognition that the traditional approach to antitrust analysis can often fail to capture the dynamic efficiency effects of conduct. On the one hand, the IPEGs recognize that dynamic efficiency analysis is important, but on the other, they fail to indicate with any specificity an approach that would replace the innovation market approach for this purpose. Bringing clarity to the competition law treatment of innovation incentives and dynamic efficiency issues was, as Minister Manley indicated, one of the prominent reasons for releasing guidelines. In this regard, the IPEGs do not provide the expected guidance.

Notes

* Respectively Senior Consultant, National Economic Research Associates, Inc. and Senior Analyst, Surveillance Market Assessment & Compliance, The Independent Electricity Operator. Both authors contributed to the preparation of the first draft of the Intellectual Property Enforcement Guidelines released on June 11, 1999. Chantale LaCasse contributed as a member of a panel of outside experts and Brian Rivard contributed as a Senior Economist at the Competition Bureau.

¹ Competition Bureau, Industry Canada, Government of Canada, September 2000.

² For example, see Patricia Smith, "The Competition Policy/Intellectual Property Law Interface: Current Thinking Within the Competition Bureau" (Remarks to The Canadian Institute Conference on Competition Law and Competitive Business Practices, Toronto, 12 June 1998); Gilles Ménard, "Abuse of Dominance: Some Reflections of Recent Cases and Emerging Issues" (Remarks to The Canadian Institute Conference on Competition Law and Competitive Business Practices, Toronto, 10 May 1996); and George N. Addy, "Competition Policy and Intellectual Property Rights: Complementary Framework Policies for a Dynamic Market" (Address to the XXXVIth World Congress of the AIPPI, Montreal, 29 June 1995).

³ Jointly issued by the U.S. Department of Justice and the Federal Trade Commission, April 6, 1995.

⁴ See Japan, Fair Trade Commission (1989), *Guidelines for the Regulation of Unfair Trade Practices With Respect to Patent and Know-How Licensing Agreements* and European Commission, *Block Exemption Regarding Technology Transfer*, Brussels, January 31, 1996.

⁵ See R.D. Anderson, S.D. Khosla & M.F. Ronayne, "The Competition Policy Treatment of Intellectual Property Rights in Canada: Retrospect and Prospect," in R.S. Khemani & W.T. Stanbury, eds., *Canadian Competition Law and Policy at the Centenary* (Halifax: Institute for Research on Public Policy, 1991) 532.

⁶ R.D. Anderson & N.T. Gallini, eds., *Competition Policy and Intellectual Property Rights in the Knowledge-Based Economy* (Calgary: University of Calgary Press for the Industry Canada Research Series, 1998). This volume was intended to provide the academic working blocks from which the Canadian guidelines would be drafted.

⁷ *Roche Holdings Ltd.*, 113 F.T.C. 1086 (1990).

⁸ This is the interpretation of the case given in the Prepared Remarks of Susan DeSanti before the conference: Antitrust for High-Tech Companies, Business Development Associates, San Francisco, February 1996.

⁹ The *Roche Holdings* case is used here for illustration purposes since it can be easily seen how the potential competition doctrine alone was insufficient to argue the state's case. In addition to the International Guidelines of 1988, there were other cases that were more instrumental in shaping the 1995 U.S. Guidelines. For an excellent discussion, see W.K. Tom & J.A. Newberg, "Antitrust and Intellectual Property: From Separate Spheres to Unified Field" (1997) 66 Antitrust Law Journal 167.

¹⁰ In *Wright Medical Technology Inc.*, file no. 951-0015 (Dec. 1994), the complaint used both the potential competition doctrine and the research and development market. Other cases brought before the release of the U.S. Guidelines in which innovation was a central concern include *United States v. General Motors Corp.*, Civ. No. 93-530 (1993), *Monsanto Co.*, Docket No. C-3458 (Sept. 1993), *United States v. Flow International Corp. and Ingersoll-Rand Co.*, Civ. No. 94-73120 (April

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1994), *Sensormatic Electronics Corp.*, File No. 941-0126 (Jan. 1995) and *American Home Product*, F.T.C. C-3557 (February 1995).

¹¹ R.F.D. Corley & B.A. Facey, "Intellectual Property Under the *Competition Act*: The Draft IP Guidelines in Perspective" (2000) 20:1 *Can. Comp. Rec.* 5.

¹² *R. v. Canadian General Electric* (9 March 1979), (Ont. Prov. Ct.) [unreported]; *Canada (Director of Investigation and Research) v. Southam Inc.* (1992), 47 C.P.R. (3d) 240; *Canada (Director of Investigation and Research) v. NutraSweet Co.* (1990), 32 C.P.R. (3d) 1; *Canada (Director of Investigation and Research) v. Tele-Direct (Publications) Inc.* (1997), 73 C.P.R. (3d) 1; *Director of Investigation and Research v. Bank of Montreal* (1996), 68 C.P.R. (3d) 527; *Director of Investigation and Research v. AGT Directory Limited*, [1974] C.C.T.D. No. 24, Trib. Dec. No. CT 9402/19; *Director of Investigation and Research v. Chrysler Canada Ltd.* (1989), 27 C.P.R. (3d) 1 (Comp. Trib.); *Director of Investigation and Research v. Xerox Canada Inc.* (1990), 33 C.P.R. (3d) 83; *Canada (Director of Investigation and Research) v. Warner Music Canada Ltd.* (1997), 78 C.P.R. (3d) 321; *R. v. Union Carbide Canada Limited*, Exchequer Court of Canada, Court No. B-1979; *R. v. Union Carbide Canada Limited*, Court No. B03495; *Molnycke AB v. Kimberly-Clark of Canada Limited* (1991), 36 C.P.R. (3d) 493.

¹³ In her 1996 Remarks (*supra* note 8) DeSanti notes that the Federal Trade Commission had only once brought a case involving innovation in an industry other than pharmaceuticals or biotechnology. She is referring to *Sensormatic Electronics Corp.*, C-3572 (April 1995).

¹⁴ The position taken by both the U.S. and Canadian Guidelines that intellectual property laws and antitrust laws are complementary depends on the ability of antitrust analysis to be extended beyond short-run, static efficiency considerations. For a discussion of this point, see N.T. Gallini & M. Trebilcock, "Intellectual Property Rights and Competition Policy: A Framework for Analysis of Economic and Legal Issues" in *Competition Policy and Intellectual Property Rights in the Knowledge-Based Economy* (Calgary: University of Calgary Press, 1998) 17.

¹⁵ U.S. Guidelines, *supra* note 3 at 2.

¹⁶ *Ibid.* at 10.

¹⁷ *Ibid.* at 11.

¹⁸ April 2, 1992 (revised: April 8, 1997).

¹⁹ R.J. Gilbert & S.C. Sunshine, "Incorporating Dynamic Efficiency Concerns in Merger Analysis: The Use of Innovation Markets" (1994) 63:1 *Antitrust Law Journal* 569.

²⁰ *Ibid.* at 581-585.

²¹ They also describe how analysis of product rather than process innovation is similar where R&D directed to new or improved products is likely to have spillover benefits in markets in which firms do not presently compete.

²² This procedure is developed in Gilbert & Sunshine (1994) with a particular attention to the analysis of mergers (*supra* note 19 at 595-597). The U.S. Guidelines do not provide a detailed description of how the innovation market approach can be practically applied, although some examples of the required analysis are given.

²³ The U.S. Guidelines (*supra* note 3 at 11) require that "the Agencies will delineate an innovation market only when the capabilities to engage in the relevant research and development can be associated with specialized assets or characteristics of specific firms." This requirement ensures that there is a concrete criterion to judge whether firms are engaged in substitute R&D activity.

²⁴ The most notable critique of the innovation market approach is R.T. Rapp, "The Misapplication of the Innovation Market Approach to Merger Analysis" (1995) 64 *Antitrust Law Journal* 19 at 37-46. Our discussion overlaps some of Rapp's discussion. Other critiques include: G.A. Hay, "Innovations in Antitrust Enforcement" (1995) 64 *Antitrust L.J.* 7; R.J. Hoerner, "Innovation Markets: New Wine in Old Bottles?" (1995) 64 *Antitrust L.J.* 49; and S. Addanki "Should Antitrust Enforcers Rely on Potential Competition Analysis or the Concept of Innovation Markets?" (Testimony before the Federal Trade Commission Hearings on Global and Innovation-Based Competition, 25 October 1995).

²⁵ See the U.S. Federal Trade Commission, *Anticipating the 21st Century: Competition Policy in the New High-Tech, Global Marketplace* (May 1996), c. 6 at 10.

²⁶ The debate famously pits the vision of Schumpeter against the work of Arrow. For a summary of the issues, see F.M. Scherer, "Schumpeter and Plausible Capitalism" (September 1992) XXX *Journal of Economic Literature* at 1416-1433.

²⁷ *Ibid.* at 17.

²⁸ It has also been argued that if innovation is systematically linked to welfare gains, the probability that those gains will not be realized because R&D activities are monopolized is low. See, in particular, S. Addanki, *supra* note 24.

²⁹ Rapp, *supra* note 24 at 37 and Hay, *supra* note 24. For a detailed discussion of the U.S. Potential Competition Doctrine, see

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U.S. Federal Trade Commission, *supra* note 25, c. 7 at 23.

³⁰ *Wright Medical Technology Inc.*, C-3564 (March 1995).

³¹ See the contested acquisition of American Cyanamid by American Home Products, *American Home Products Corporation*, C-3557 (February 1995) and the contested merger of Ciba-Geigy and Sandoz, *Ciba-Geigy Ltd.*, C-3725 (March 1997).

³² IPEGs, *supra* note 1, at 1.

³³ *Ibid.* at 1.

³⁴ *Ibid.* at 5.

³⁵ *Ibid.* at 1.

³⁶ *Ibid.* at 11.

³⁷ *Ibid.* at 11.

³⁸ *Ibid.* at 6.

³⁹ Director of Investigation and Research (Minister of Supply and Services Canada, 1991).

⁴⁰ IPEGs, *supra* note 1 at 6.

⁴¹ In the presentation of section 32, some additional analytical considerations are presented that are directly tailored to intellectual property. This is discussed below.

⁴² IPEGs, *supra* note 1 at 11.

⁴³ *Ibid.* at 13.

⁴⁴ In this regard, the IPEGs' approach to innovation activity is less interventionist than the U.S. approach under the innovation market analysis. Indeed, with the innovation market approach, evidence that a transaction or conduct results in a reduction of innovative activity can be, in and of itself, sufficient for the agencies to challenge the transaction or conduct.

⁴⁵ IPEGs, *supra* note 1 at 13-14.

⁴⁶ See Rapp (1995), *supra* note 24, and Hay (1995) *supra* note 24. The U.S. Federal Trade Commission has provided a description of how such an approach might apply and when it would likely fail to capture the type of innovation effects identified by the proponents of the innovation market analysis (see U.S. Federal Trade Commission, *supra* note 25 c.7).

⁴⁷ IPEGs, *supra* note 1 at 7. The footnote to this text states that the analysis would use either a goods or technology market. Other language includes (at 6) "a transaction or conduct that reduces innovation activity could be anti-competitive if it prevents future competition in a prospective product or process market."

⁴⁸ *Ibid.* at 7.

⁴⁹ *Ibid.* at 7.

⁵⁰ *Ibid.*, see, for instance, section 4.2.1 at 7.

⁵¹ *Ibid.* at 7.

⁵² The previous draft of the IPEGs provided an example (example 7.1) that purported to illustrate the distinction. In the example, a firm initially licenses technical specifications to encourage software producers to develop products for its hardware. Although the firm had promised to continue licensing its technical specifications, it decides at a certain point to renege on its promise. The previous draft argued that the competitive harm in this example stemmed from the breach of the firm's promise rather than from the refusal *per se*. Interestingly, this example was dropped from the final version of the IPEGs. No explanation for its removal was given, therefore it is unclear whether the Bureau would consider reviewing such conduct under the general provisions.

⁵³ See Corley and Facey (2000) *supra* note 11 for a more detailed presentation of section 32.

⁵⁴ IPEGs, *supra* note 1 at 9.

⁵⁵ *Ibid.* at 9 [emphasis added].

⁵⁶ There is no specific "essential facility" provision for tangible private property under the Act. Instead, essential facility cases involving private property would most likely be dealt with under section 75 or section 79 of the Act. In this respect, the treatment given to intellectual property seems to be explicitly different from the treatment given to other property. Defendants facing scrutiny for a refusal involving private property could then argue that their private property encompasses an intellectual property right so as to be investigated under section 32. (In particular, one wonders whether such an argument could have been made in *Director of Investigation and Research v. Bank of Montreal* (1996), 68 C.P.R. (3d) 527 (Comp. Trib.) or *Director of Investigation and Research v. D & B Co. of Canada* (1995), 64 C.P.R. (3d) 216 (Comp. Trib.). This would be a preferred defence strategy if the burden of proof under section 32 were believed to be higher than under section 75 or 79.

⁵⁷ IPEGs, *supra* note 1 at 9.

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⁵⁸ In the previous version of the IPEGs, it was stated that step two was "satisfied by the presence of at least one of the following two factors:

iii) the cost to the innovator to create the IP was insignificant, or

iv) the refusal to license the IP is stifling further innovation" (see paragraph 42, Draft Two). The reference to the innovator's cost to create the IP was particularly troubling. In those circumstances in which it is possible to determine that the actual costs to the innovator of creating the intellectual property were low, it may not follow that the protection of the intellectual property statutes was unnecessary for the innovation to occur. Indeed, it is possible that the costs were anticipated to be large even though once the innovation process was complete, the realized cost to the innovator was small. It is generally difficult to assess what were an innovator's *ex ante* expectations of the costs and benefits of an innovation. As a result, it is impossible to determine whether the investment in the intellectual property would have taken place were it not for the benefits associated with the statutory protection of the *intellectual* property rights. It was wise of the Bureau to have eliminated this factor from the section 32 analysis.

⁵⁹ IPEGs, *supra* note 1 at 9.

⁶⁰ *Ibid.* at 26.

⁶¹ *Ibid.* at 25.

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