COMMENT AND ANALYSIS

MERGER REVIEW OF BROADCASTING BUSINESSES: AN EVALUATION OF THE COMPETITION BUREAU PROPOSAL

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Introduction

Since the 1988 revision of the *Competition Act*, which among other things established a reviewable practice of anti-competitive mergers, the Canadian Radio-television and Telecommunications Commission ("CRTC") and the Competition Bureau have exercised parallel jurisdictions in relation to acquisitions of control of licensed broadcasting undertakings.

The Competition Bureau, in a May 2002 presentation to the Standing Committee on Canadian Heritage in the Study of the State of the Canadian Broadcasting System, put forward certain principles designed to carve out discrete issue areas for both the Competition Bureau and the CRTC in relation to acquisitions of control of broadcasting undertakings, including horizontal and vertical mergers among broadcasting undertakings.

After a review of the current approach of the Competition Bureau to mergers of broadcasting undertakings and of the CRTC to acquisitions of control of broadcasting undertakings, we will examine the Competition Bureau's May 2002 proposals in terms of clarity, feasibility, and their implications for transparent and efficient public policy administration, including the implementation of the policy objectives of the *Broadcasting Act* and the effective exercise of the CRTC's other regulatory powers.

By way of summary, it would appear that the Bureau's proposals would establish an unclear and unstable jurisdictional boundary between the Competition Tribunal and the CRTC which would very likely (1) increase friction between the two bodies; (2) increase boundary management litigation; (3) not increase the overall efficiency and predictability of broadcasting undertaking merger reviews; and (4) undermine achievement of the objectives of the *Broadcasting Act*.

If we assume that with the May 2002 proposals the Competition Bureau has put its best foot forward in terms of both a conceptual jurisdictional boundary and the rationale for such a split jurisdiction, it is arguable that the Competition Bureau has probably done more to support the CRTC having exclusive jurisdiction over acquisitions of control of broadcasting undertakings (by way of amendment of the *Competition Act* to exclude such transactions from the merger provisions), than it has done to support the Bureau having an identifiable exclusive "issue area" in relation to such transactions.

Competition Bureau Merger Review of Broadcasting Undertakings

Over the first decade of the new merger law, the Bureau's activities with respect to broadcasting mergers remained largely unnoticed and there was no apparent evidence of substantial disputes between the Bureau and the CRTC.

In late 1999, the Bureau and the CRTC jointly published a background document entitled *CRTC/Competition Bureau Interface*, which sought to clarify these bodies' respective regulatory jurisdictions. With respect to broadcasting mergers, this document stated:

> Under the *Broadcasting Act*, prior approval of the Commission is required for changes of control or ownership of licensed undertakings. Whereas the Bureau's examination of mergers relates exclusively to competitive effects, the Commission's consideration involves a broader set of objectives under the Act. This may encompass consideration of competition issues in order to further the objectives of the Act. The Bureau's concern in radio and television broadcast markets relates primarily to the impact on advertising markets and, with respect to broadcast distribution undertakings, to the choices and prices available to consumers. The Commission's concerns include those of the Bureau except that its consideration of advertising markets relates to the broadcasters' ability to fulfill the objectives of the Act.
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> It is generally Government and Commission policy to encourage competition in broadcasting, particularly in the distribution of broadcasting services.
>
> ***Modus Operandi:***
>
> Consequently, with respect to merger review:
>
> - there is parallel jurisdiction.
> - any transaction must comply with the legislation administered by both organizations.
> - the merger and related pre-notification requirements of the *Competition Act* apply to telecommunications and broadcasting mergers.
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> . . .
>
> - review by the Commission under the *Broadcasting Act* applies to changes in ownership or control of licensees under the Act.

It would appear that, at that time, both bodies were comfortable administering parallel merger review authority (although the CRTC's review, as discussed below, involves an express prior approval requirement and the *Competition Act* does not).

In late 2000, the Bureau applied to the Tribunal for a consent order regarding the sale of TQS (a Quebec television network) by Quebecor (a large Quebec-based publication and media business) in relation to Quebecor's acquisition of Videotron (a large Quebec-based cable TV and broadcasting conglomerate). The stated purpose of the requested order was to maintain competition in the sale of French-language television advertising time in Quebec.

In January 2001, the Tribunal ordered Quebecor to sell TQS if the CRTC approved the acquisition of the Quebec-based TVA Network (as part of the larger Videotron acquisition). Subsequently, in March 2001, Quebecor announced that it was divesting itself of the TQS Network, and the Bureau announced it would not oppose the remainder of the Quebecor/Videotron transaction.

In December 2001, the Bureau applied to the Competition Tribunal to prevent the acquisition by Astral Media Inc. of eight Quebec radio stations owned and operated by Telemedia and the 50% interest held by Telemedia in Radiomedia. Astral Media and Telemedia responded with an application to the Federal Court challenging the Bureau's jurisdiction.

In April 2002, the acquisitions were approved by the CRTC. The Commission's decision expressly addressed the impact of the merger on competition in local radio markets, among other matters. The Commission found that the resulting concentration of ownership was acceptable in all markets except Quebec City. The Commission directed Astral Media to divest one station in that market as a condition of approval.

On September 3, 2002, the Bureau announced that it had reached an agreement with Astral Media and Telemedia resolving its competition concerns with the acquisitions. The agreement was filed as a Consent Agreement with the Competition Tribunal. As a result of this agreement, the challenge to the applicability of the *Competition Act* merger provisions to broadcasting undertaking acquisitions did not proceed.

The Consent Agreement goes further than the CRTC's decision by requiring the parties to divest their AM radio stations in six French language markets (Montreal, Quebec, Gatineau-Ottawa, Sherbrooke, Trois-Riviéres and Chicoutimi-Jonquiére) as a network, to adopt a code of practice to avoid anti-competitive advertising practices, and to require their FM stations to continue to compete for local advertising in four markets (Gatineau-Ottawa, Sherbrooke, Trois-Riviéres and Chicoutimi-Jonquiére) for up to 42 months pending new entry.

After thirteen years of parallel merger review, this would appear to be the first instance of a differing result between the reviews of the Bureau and the CRTC. By virtue of this Consent Agreement it is apparent that, at least in one contested case, the merging parties could ultimately live with parallel Bureau/CRTC merger review jurisdictions, even where the result was a broader remedy than that which the expert regulator, the CRTC, had chosen.

CRTC Merger Jurisdiction

The CRTC's prior approval is required for both an acquisition of control or of a substantial interest, directly or indirectly, in a licensed broadcasting undertaking. The Commission has in the past refused to approve a number of acquisitions on competition/concentration of ownership grounds.

For example, in addition to the conditional approval of the Astral Media/Telemedia merger noted above, the Commission approved the acquisition by CTV of NetStar (the holding company for TSN, the largest English market sports channel) subject to the condition that CTV divest its controlling interest in SportsNet, a newer English market cable-based specialty sports channel (Decision CRTC 2000.86).

The following is the conclusion of the Commission's lengthy analysis of the concentration of ownership issue:

> The Commission notes statements made by the applicant that the merger would be advantageous because TSN and SportsNet would more likely remain complementary to each other in the programming that they present, as intended when they were licensed. The Commission also agrees that the merger would provide benefits to amateur sports via the benefits that the applicant proposed as well as increased scheduling opportunities for amateur sports events. However, when the Commission granted the SportsNet license to CTV in 1996, it simultaneously denied TSN's application for a regional sports service. This has the effect of ensuring that one player would not dominate both national and regional sports programming on specialty services. The Commission considers that the separate ownership of national and regional sports specialty services remains in the public interest, especially since CTV is already involved in sports broadcasting on over-the-air television, and may eventually have increased opportunities for sports broadcasting in the pay and pay-per-view sector.
>
> In order to address the Commission's concerns related to CTV's potential ability to dominate in the field of sports programming and its potential unfavourable consequences for other broadcasters, the Commission, by majority, requires, as a condition of approval, that the CTV file an application for Commission approval to divest its interests in SportsNet within one year of today's date. If an application for divestiture cannot be filed within one year, CTV is required to place its interest in SportsNet in trust until such an application is filed and a decision is issued by the Commission. As well, by majority, the Commission requires, as a condition of approval, that CTV confirm, within one year, that it no longer manages SportsNet directly or indirectly, and no longer votes the shares of other shareholders through a voting trust agreement or otherwise.

There is no Competition Bureau publication indicating that the Bureau had elected to challenge this merger under the *Competition Act*.

The CRTC has not published detailed guidance on when acquisitions may become problematic on concentration grounds. However, the Commission's Commercial Radio Policy statement does note that radio station acquisitions will be examined in part in relation to their impact on local programming diversity and local advertising competition. Providing a more definitive policy would be tricky as the Commission is a quasi-judicial tribunal and must be mindful of fettering its discretion to decide individual applications. Competition is also only one of many factors the Commission must address in such cases.

In addition, for an acquisition of a programming undertaking (i.e. television, radio, specialty television, but not cable television), the Commission requires the applicant to demonstrate that the acquisition will produce "significant and unequivocal benefits" to the Canadian broadcasting system (now by convention defined as special benefits having a value of approximately 10% of the value of the acquisition spread over the term of the target's license).

As can be seen from the following excerpts from the CRTC's explanation of the "benefits test" (Public Notice CRTC 1989-109, Elements Assessed by the Commission in Considering Applications for the Transfer of Ownership or Control of Broadcasting Undertakings), this policy derives from the CRTC's basic statutory mandate to regulate the broadcasting sector to increase the amount of Canadian broadcasting content above the level that would be expected solely through the operation of market forces:

> An applicant is expected to propose a specific package of significant and unequivocal benefits that will yield measurable improvements to the communities served by the broadcasting undertaking and to the Canadian broadcasting system. The Commission must be satisfied that the proposed benefits package is commensurate with the size and nature of the transaction and takes into account the responsibilities to be assumed, the characteristics and viability of the broadcasting undertakings in question and the scale of programming, management, financial and technical resources available to the purchaser.
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> The Commission assesses each application on its own merits and does not use any benchmark or formula with respect to the type or amount of benefits proposed.
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> Only those initiatives that would not be realized without approval of the proposed transfer are viewed as benefits. In order to be accepted as a benefit, the proposed expenditure must be incremental. Expenditures that would normally be considered ongoing normal responsibilities of the existing licensee will not be accepted as benefits unless that licensee, because of financial circumstances, could not implement the initiative or reasonably planned to delay such an improvement beyond the time frame proposed by the purchaser. Commitments by prospective purchasers to assume existing obligations of licensees are not generally accepted as benefits, except where continuation of the service itself is in doubt. Moreover, the Commission does not generally accept as a benefit any proposed initiative that is dependent upon approval of a separate application yet to be considered by the Commission.

In a 1993 revision of this policy (Public Notice CRTC 1993-88), the Commission defined four categories of relevant benefits (tangible, intangible, local and system-wide) as follows:

> Tangible benefits fall into three broad categories: operating expenditures, such as in the areas of additional staff or programming improvements; capital expenditures for technical improvements; and grants and contribution to Canadian talent or program development.
>
> Intangible benefits include the experience and resources of the purchaser, local ownership, entry of new players and the promise to maintain or improve a struggling service.
>
> The Commission maintains a case-by-case approach, assessing each application on its merits and taking into account both the tangible and intangible benefits proposed. The Commission may accept a package consisting solely of intangible benefits in cases where the survival of the service is at stake.
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> The Commission considers local benefits to be very important. At the same time, it recognizes the value of investing in system-wide benefits, such as research and development, particularly in light of the rapid pace of change in the broadcasting and cable environments. The Commission will assess proposals regarding local and system-wide benefits on a case-by-case basis, taking the particular circumstance of the application into account.

In addition, from time-to-time, the Commission has issued special policies on mergers in the broadcasting sector. From the late 1990's to 2001, the Commission had established an effective freeze on further acquisitions of analogue specialty television services by cable television businesses, based partly on concerns over possible anti-competitive cable carrier discrimination between affiliated and unaffiliated specialty services. The CRTC has now elected to rely instead on section 9 of the Broadcasting Distribution Regulations which prohibits distributors from giving undue preference to any person, including itself.

The Competition Bureau's May 2002 Proposal

In his May 7, 2002 presentation to the Standing Committee on Canadian Heritage, the Commissioner of Competition recommended that the CRTC's mandate be clarified to:

(a) specify that the CRTC has a responsibility to preserve a diversity of voices within the broadcasting system; and

(b) focus, at the same time, the CRTC review of broadcasting transactions solely on the impact that the mergers would have on core cultural values and diversity of voices.

With respect to (a), the Commissioner acknowledged that the impact of media concentration on the diversity of voices is not within the scope of the *Competition Act* as follows:

> Diversity of voices is not an issue of economic competition and, consequently, does not fall within the purview of the Bureau's mandate. Canadian culture is squarely based on a democratic government which in turn needs diversity of voices to live up to its ideals. We therefore view the maintenance of diversity of voices a natural adjunct to the CRTC's mandate to maintain and enhance Canadian culture.

With respect to (b), after noting the parallel jurisdictions and stressing that "we favour a clear division of responsibilities and jurisdictions", the Commissioner explained his proposed merger review boundary as follows :

> The *Competition Act* provides certain criteria for analysis that the Bureau applies in all merger reviews, including those which involve media companies. We would continue to review the commercial implications of broadcasting transactions and their competitive effects on market power.
>
> The CRTC should not review broadcasting transactions from the perspective of commercial viability. The CRTC's review should be focused solely on the impact the proposed merger would have on the attainment of core cultural objectives: the production and distribution of Canadian content and according to us, its logical corollary, the maintenance of a diversity of voices.

That is, the CRTC would have exclusive jurisdiction with respect to acquisitions of control of broadcasting undertakings in so far as an acquisition affected preservation of a "diversity of voices", whereas the Competition Tribunal (and by default the Competition Bureau) would have exclusive jurisdiction over such transactions with respect to their "commercial implications" and their "competitive effects on market power".

The more lengthy Bureau brief to the Standing Committee develops the thesis that the current broadcasting regulatory model of creating economic rents through restricting competition which are then channelled to producing otherwise unprofitable Canadian content will be seriously undermined by technological developments in the near term. The Bureau's brief proposes as a remedy greater reliance on market forces and less detailed regulation, but unfortunately without explaining what regulatory controls should be given up, where, and when, other than positing that a "diversity of voices" should be the overriding objective and this objective should be achieved in a fashion consistent with the right to freedom of expression guaranteed by the *Charter* (such an express statutory linkage is obviously unnecessary in any event):

> The important value of diversity of voices must be considered in the context of an increasingly concentrated media environment. Many observers have openly expressed concern that media concentration adversely affects the marketplace of ideas. While matters such as the editorial policy of a national newspaper chain or the impact of media concentration on the diversity of voices are not within the scope of the *Competition Act*, they do raise serious issues that need to be addressed in an open and democratic society.
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> The CRTC's mandate should clearly state that it has a responsibility to preserve a diversity of voices within Canada's broadcasting system and its regulations should be consistent with, and foster the freedom of expression guaranteed by the *Charter of Rights and Freedoms*. Freedom of expression encompasses the principle of an open marketplace of ideas and serves to maintain and strengthen democracy. Diversity of voices is not an issue of economic competition and, consequently, does not fall within the purview of the Bureau's mandate. However, it is a natural adjunct to the CRTC's mandate to maintain and enhance Canadian culture.
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> Clearly, some regulations may be needed to prevent one or a few strong players from dominating content. The CRTC should develop objective measures of content-domination and impose regulations based on such objective measures in cases where it is satisfied that such domination is actually occurring.

The brief does not provide any elaboration on, or additional justification for, the proposed diversity of voices/ market power merger jurisdiction boundary.

Evaluation of the Competition Bureau's Proposal

As the Competition Bureau itself recognizes, the purpose of the *Broadcasting Act* is to create a mix of cultural products ("voices") for Canadians through the broadcasting system by means of a range of regulatory constraints administered by the CRTC (and largely left up to the CRTC's expert discretion) that would likely not be supplied by broadcasters absent extensive direct regulation.

As confirmation of the very broad regulatory discretion granted to the CRTC to achieve Parliament's policy objectives, section 5 of the *Broadcasting Act* states that the Commission shall regulate and supervise all aspects of the Canadian broadcasting system with a view to implementing the Act's broadcasting policy. Any legislation intended to remove, in some fashion, jurisdiction over acquisitions of broadcasting undertakings would necessarily need to address the ongoing appropriateness of this statutory job description. At the very least, an amendment of section 5 would be required to prevent its application to the carved-out jurisdiction, and to remove an otherwise obvious source of statutory conflict and a basis for litigation.

The list of broadcasting policy objectives in the *Broadcasting Act* is long and somewhat self-contradictory, but the policy can be summarized as: maximize the amount and diversity of Canadian-originated broadcasting in all its dimensions – cultural, entertainment, editorial for all age and cultural groups with special emphasis on the founding cultures, and maximize the availability of this broadcast content throughout Canada at reasonable cost (the reason for treating cable services as a public utility much like telephone service).

The principal interwoven means to achieve these goals employed by the CRTC include:

(a) entry controls to produce economic rents to support policy objectives (licensing of both programming and distribution businesses);

(b) conditions of license to restrict competition among Canadian broadcasters (for example by controlling the music mix on radio stations) and competition from non-Canadian products (including individual programs, songs, non-Canadian stations, and networks available over cable and satellite TV), and to direct economic rents towards producing Canadian broadcast products (by means of Canadian content quotas for broadcasters, or in the case of cable-TV services, public utility obligations to extend services to otherwise unprofitable areas and to increase channel carriage capacity); and

(c) increasing broadcasting advertising revenue by simultaneous substitution of the Canadian signal carrying United States programs in place of the "imported" United States network signal.

Other "non-market" aspects of the CRTC broadcast regulation include: cultural balance (including sexual and ethnic stereotype avoidance), increasing local content and programming (current affairs and entertainment, especially on radio), editorial balance in current affairs, limiting sexual and violent content to adult audiences in late night hours, limiting the use of children's programming as an advertising vehicle, and controlling the balance between advertising and non-advertising content.

In all entry-restricted regulated industries, it has been accepted that a necessary corollary to entry control is to control acquisitions of regulated businesses. Acquisitions control is seen as necessary to prevent shareholders from capitalizing and appropriating for themselves the economic rents created by regulation for policy purposes, and to ensure that the merged entity will fully adhere to the public policy commitments of the individual licenses established pre-merger. The CRTC's "benefits test" is primarily directed at the first concern, whereas the Commission's broad treatment of ownership concentration has been primarily directed at this second concern.

Seen in this context, maximizing diversity of Canadian cultural products and avoidance of excessive Canadian broadcasting industry concentration are inextricably related ends and means, as much as are maximizing diversity and controlling entry and broadcasting product design through licensing and license conditions.

It follows that broadcasting regulation can be expected to result in a higher industry concentration than would market forces, and that such higher concentration, while resulting in a less "efficient" industry, may well serve the objectives of broadcasting regulation if it supports the economic rent generation and allocation of rents to policy "goods" objectives of broadcasting regulation. One aspect of this rent generation is the ability to exercise market power in setting higher advertising fees than would be established in a competitive market. This is an important aspect of the Bureau's difference with the CRTC in the Astral Media case.

Whether we like it or not, the generation of economic rents through regulation in the broadcasting sector will create a wide range of price and supply distortions in the acquisition of inputs by that sector and also in the pricing of its

outputs. These distortions are not restricted to less competition in the pricing of advertising services, and hence higher advertising rates.

Arguably, the price paid by cable subscribers for specialty television services is as high as it is because of the Canadian content requirements of their licenses. Many such distortions will affect related unregulated markets. For example, the prices of creative and technical services will be bid up to levels higher than would exist in a competitive market, thus increasing the cost structure of film production and live entertainment.

Indeed, the connection between the regulatory policy objectives and merger regulation is probably far greater in broadcasting than in airlines where there is at present an express exemption from the *Competition Act* merger provisions for acquisitions approved by the Canadian Transportation Agency.

Seen in this context, the merger jurisdiction boundary proposed by the Bureau would become essentially meaningless. If enacted, it would be unenforceable, although the implementing legislation would probably be a litigation magnet for some time to come as businesses would shop for their preferred merger regulator (as arguably Astral Media initially felt compelled to do), and as regulators jockey for jurisdictional pre-eminence under the guise of jurisdictional and legislative "clarity and transparency".

It is apparent that any legislative amendment to implement the Bureau's proposal, if it used the vague terminology advanced by the Bureau, would not constrain either the Bureau or the CRTC from reviewing a broadcasting industry merger in a given case. Any broadcasting sector merger will palpably affect the "diversity of voices" policy objective, however simply or elaborately that objective is expressed legislatively. Equally, any such merger will potentially impact the overall efficiency of the broadcasting industry and affect "commercial relationships" within the broadcasting sector and between that sector and other sectors.

The CRTC and the Bureau are not likely to always agree on the extent to which increased efficiency is desirable or where resulting efficiency gains should go. The CRTC would want these gains to go to the Canadian content producers. The Bureau would assume (erroneously, perhaps, at least in the near term) that the market was sufficiently competitive that consumers should and would end up with these gains.

Perhaps not surprisingly, it would appear from the Astral Media case that the CRTC does have a higher tolerance for market concentration than does the Competition Bureau.

Conclusion

The Competition Bureau's May 2002 broadcasting merger jurisdictional proposals contribute more to an appreciation that, in directly regulated industries where price, product choice, and inter-firm competition are rigorously controlled to achieve non-market policy objectives, merger regulation is an essential component of the regulator's tool kit, and that sharing that power with another regulator will likely undermine achievement of the stated public policy objectives for that industry.

The Bureau's proposal therefore actually lends greater support to amending the *Competition Act* to exclude Competition Tribunal jurisdiction where a broadcasting undertaking acquisition is subject to prior CRTC approval than it does to excluding the CRTC's jurisdiction from certain aspects of broadcasting mergers.

While we can all agree that the *Competition Act* sets out useful business conduct rules for the economy as a whole, it is not clear that the Act, the Bureau's policies and practices, and the jurisprudence under it are necessarily well-suited, in whole or in part, to industries whose structure, products, and pricing practices are the result of a longstanding myriad of regulatory interventions, primarily designed by statutory direction to achieve a variety of cultural policy objectives. Rather than grabbing for some industry structure jurisdiction while the Canadian broadcasting sector remains extensively regulated, it might have been more helpful for the Competition Bureau to explain how and where market forces can now be relied on to achieve the cultural development objectives of Canadian broadcasting policy, and to wait until CRTC regulation has then been effectively removed from significant components of the industry before asserting some form of exclusive role in policing broadcasting sector mergers.

As part of any initiative to give the CRTC exclusive merger jurisdiction over the broadcasting sector, the government could also issue a policy direction to the Commission that required it to be particularly mindful of avoiding substantial anti-competitive effects on unregulated markets, such as the market for advertising services which has been an important aspect of the Bureau's own assessment of broadcasting mergers.

Notes

* Partner and student-at-law, respectively. The views expressed herein are those of the authors alone.

THE POLITICAL ECONOMY OF THE EFFICIENCY DEFENCE

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I know that unless people understand that everyone can benefit from our ideas, then no-one will.[2]

Iain Duncan Smith, Leader of the British Conservative Party

Author's Note: Long after this article was accepted by the *Record*, and just before this issue was sent to the printer, the Federal Court of Appeal dismissed the Commissioner's appeal in *Superior Propane* (see the Message from the Editors at (i)). Two judges who did not participate in the original judgment by the Court of Appeal, Richard, C.J. and Rothstein, J.A., issued a very narrow opinion, confined to a determination of whether the Competition Tribunal's redetermination judgment was inconsistent with the prior Court of Appeal determination. Dissenting in part was Létourneau, J.A., an original member of the panel. The second appellate panel concluded that the original panel's opinion could be broadly read to permit what the Tribunal did. Thus, the second panel did not have occasion to consider arguments such as the one set forth below - that the Tribunal's approach, considered afresh, is inconsistent with Parliament's intent and with assumptions about the way legislatures operate in democracies. Review by the Supreme Court of Canada would, of course, permit consideration of these points.

The ongoing litigation in the *Superior Propane* case has provided a wonderful vehicle for extensive commentary, in these pages,[3] the reports of the Federal Court of Appeal[4] and the Competition Tribunal,[5] and elsewhere,[6] about the proper interpretation of section 96 of the *Competition Act*, which provides that mergers found to be likely to lessen competition substantially will nonetheless not be blocked by the Tribunal when efficiency gains "will be greater than, and will offset, the effects" ("*surpasseront et neutraliseront les effets*") of the merger. On one side of the battle lines we find a panel of the Federal Court of Appeal and the Commissioner of Competition, with sideline support primarily from foreign commentators, who believe that the most significant economic effect of most competition-lessening mergers – the money paid by the vast majority of consumers willing to pay the higher post-merger price charged by the remaining firm(s) in the market – is a significant harm that must be weighed against any efficiency gains. On the other side we find the Tribunal majority aligned with virtually the entire weight of Canadian economic and legal commentary, expressing the view that the wealth transfer from consumers to producers is a socially neutral aspect of the transaction that deserves little or no consideration.

For the uninitiated, the dispute arises in the context of a merger between two of the leading distributors of natural gas in Canada. The Commissioner challenged the merger as likely to lessen competition substantially. The Competition Bureau's lawyers presented evidence that the merging parties were already pricing significantly higher than marginal cost, and that the average price increase following the merger would be an additional 9%. As a result, the Bureau's economic expert estimated that the merger would result in a loss in consumer surplus and increase in producer surplus on the order of $40 million annually (the wealth transfer), and a deadweight loss of approximately $3 million. However, the respondents persuaded the Tribunal that the merger-specific efficiencies

(primarily due to elimination of redundant distributional operations) totalled approximately $29 million annually. Thus, it is clear that, in performing the balancing of harms and benefits required by section 96, viewing the wealth transfer as socially neutral clearly results in a finding of legality, and counting the wealth transfer as a harm results in a finding of illegality.

I want to suggest that the debate rages on because the parties are talking past each other. Canadian economists and their economically-influenced fellow travellers among competition lawyers are disciples of modern welfare economics. Welfare economics seeks to analyze whether changes in society improve social well-being. Because modern microeconomics believes that it is impossible to make interpersonal comparisons of utility and because that belief makes it impossible to make tradeoffs as between one person's betterment and another's worsened position, welfare economics has largely confined its measure of the impact of social changes on social well-being to the "Pareto criterion" – a change improves social well-being if no one is worse off after the change and at least one person is better off. An alternative way of looking at this is to require that all change be consensual: the gainers must be able to compensate the losers so that they acquiesce in the change. But economists recognize that this is a demanding — indeed, almost impossible — criterion if for no other reason than that there are significant transaction costs to identifying and bargaining with the losers. As an alternative to the Pareto criterion, the "Kaldor-Hicks criterion" merely requires that the monetary value of the gains exceeds the monetary value of the losses, not that compensation actually be paid.[7] Because economists realize that actual redistribution can be incredibly complex, and call for moral and political as well as economic judgments, the actual redistribution is assumed or judged irrelevant to an economically rigorous competition policy. Eminent antitrust economist Donald McFetridge could not have put it more directly and succinctly, referring to a test that focuses on wealth redistribution from consumers: "The consumer surplus standard is acknowledged to have no basis in welfare economics."[8]

It may be difficult to reconcile welfare economics with the notion that Parliament would do such a foolish thing as enact legislation that promotes the interests of a majority of Canadians. However, whatever the merits of welfare economics for academic analysis, it conflicts with two more fundamental aspects of modern society: (1) a commitment to democratic structures based on the principle of one-person, one-vote, and (2) a recognition that society's rejection of *laissez faire* with regard to regulation of the economy means that, regarding many subjects, the one-person, one-vote regime of government will replace the one-dollar, one-vote regime of private markets. In short, my general thesis is that a commitment to democratic structures constitutes a rejection of the Kaldor-Hicks criterion as the ordinary measure of public policy: <u>that is, proposals that maximize total wealth but, because of distributional effects, actually make most Canadians worse off, should be presumed (though subject to rebuttal) to be unsound policy, and should be presumed (based on accepted principles of statutory interpretation that assume legislation is enacted in the public interest) not to have been enacted by the legislature</u>. As applied to the debate concerning section 96, this explains why Parliament should insist that the *Competition Act*'s goals include securing for consumers "competitive prices and product choices," and why it is unlikely that, as the Tribunal has claimed, Parliament intended that this purpose give way to the goal of promoting the "efficiency and adaptability of the Canadian economy" by ignoring the massive wealth transfer expected to result from a merger-to-monopoly.

In this essay, I apply the principles of democratic majority rule to the statutory interpretation of the *Competition Act*. The essay suggests that a politically-responsive Parliament would not enact an efficiency defence indifferent to a transfer of wealth from voters who primarily see themselves as consumers, a class that constitutes a voting majority, to voters who primarily see themselves as shareholders. The actual history of the 1986 enactment of the *Competition Act* supports the view that voters' elected representatives were willing to sacrifice consumer interests, but only to the extent that greater efficiencies allowed Canadian firms to compete more effectively in a global setting. Finally, the claim by the Competition Tribunal that a narrow efficiency defence simply represents the Americanization of Canadian law is rejected.

Consider first a pure and simple democracy, a society consisting of ten people, governed by majority vote. Suppose each of them earned $10, and the question presented was whether Adam and Betty should be able to engage in a practice that would give them each $50 of income, while consigning the remaining eight citizens to $5 each. The community will ordinarily reject the rule, even though it is Kaldor-Hicks optimal (by increasing total income from $100 to $140). At a strategic minimum, to defeat a proposal to prohibit the practice, Adam and Betty would ordinarily have to promise to pay out at least $6 to at least four other citizens.

There are important exceptions that remain true in complex as well as simple democracies. At least four are apparent. First, perhaps Chris, David, Elizabeth and Frank all perceive that, in the long-run, they are actually better off, even though the immediate effect is adverse, because they eventually expect to profit from a policy that permits the Adam/Betty practice. They could benefit in two discrete ways. Each of them might see that they too can embark on a business practice that will enrich them but would be prohibited by the anti-Adam/Betty proposal. Or they might believe that the benefits to Adam and Betty will "trickle down" to them, making them better off. (I note in passing the mixed record of trickle down approaches recorded in economic history.) Second, even if no one else is likely to benefit from permitting the particular practice that Adam and Betty propose, perhaps – either expressly or through a social norm – Adam and Betty commit to voting for other rules that are likely to provide an equal or greater benefit to at least four other citizens. Third, Adam and Betty might appeal to non-economic values of others in society, persuading them that Adam and Betty need the additional money more than the rest (perhaps Adam and Betty have larger families, more medical needs, were previously victimized by the others who now feel guilty). Fourth, Adam and Betty may have special skills, or are unusually mobile, and credibly threaten to leave this small society if they can't have their way, and the others might believe that keeping Adam and Betty around is worth the loss of income.

In a large society with anonymous voting, it is very difficult to reach a conclusion about the second and third exceptions, so these proposals may well fail even if they are both Kaldor-Hicks optimal and democratically optimal. It has been suggested that republican forms of government solve this problem by allowing representatives to bargain with each other.[9] Ideally, this bargaining is utility-enhancing for modern societies: Parliament can facilitate factional negotiations that permit redistribution when necessary, persuasion as to higher utility values when appropriate, and conditions for "repeat-game" bargaining to facilitate a commitment to a series of rules that, in the aggregate, are utility-enhancing. Thus, for example, legislatures might adopt a policy that redistributes wealth to provide a safety-net for poor citizens, because it satisfies the majority's taste for compassion. Likewise, Parliament might adopt a policy that prevents imports, because it satisfies the majority's taste for nationalism.

At the same time, public choice theory has shown that this process can be abused by rent-seeking. Adam and Betty ordinarily couldn't persuade a democracy of ten to have their way, but if we move into modern Canada with a proposal to enrich Adam and Betty by $100,000 a year, at a cost to every other Canadian of 66 cents, it is entirely possible that Adam and Betty could lobby the government to approve the change while no one else would bother to oppose the scheme (the so-called "collective action" problem).

Using the more complex model of a modern Parliament, now consider another simple plan, and policy proposal with the following features:

- the proposal increases total wealth;
- the proposal redistributes income to 20% of citizens and away from 80% of citizens;
- we can confidently predict that at least 55% of citizens will never be able to profit from the proposed policy; and
- there are no fairness or other non-economic claims that would lead a majority of the citizens to desire redistribution to the favoured 20%.

My thesis is that, absent the rent-seeking distortions where collective action problems are present, the legislature will not adopt the proposal, and they should not adopt the proposal.

Advocates of maximizing total wealth often call for policy makers and interpreters to enact Kaldor-Hicks optimal legislation now and deal with distributional issues separately; this is certainly a common refrain among a school of thought regarding competition policy. This approach is unlikely to resolve the conflict between Kaldor-Hicks optimality and democratic principles where the distributional effects are adverse to most citizens. The force of inertia in the legislative process means that asking the legislature *ex ante* to design a program that is both efficient and redistributive is very different from asking the legislature to pass subsequent redistributive proposals. The public choice theory of special interest influence suggests the ease with which opponents can block the redistribution bill.[10] Moreover, it is one thing for Parliament to pass legislation dealing with the general problem of wealth distribution. On the other hand, identifying specific individuals victimized by specific anticompetitive practices, and securing a wealth redistribution to those deemed worthy, is very different, very difficult and very costly.

The merger that is the subject of the *Superior Propane* litigation illustrates these points. On the macro level, although an increasing number of Canadians invest in stock directly or through pension and mutual funds or insurance companies, most Canadian citizens function in the economy primarily as consumers, not as shareholders of corporations that sell goods and services. Nor are Canadian voters likely to have non-economic reasons for wanting to enrich shareholders as a class. Nor, as a general matter, are Canadians generally of the view that legislation that favours a particular wealthy minority will "trickle down" to benefit ordinary Canadians. Thus, a competition-lessening merger is ordinarily unlikely to benefit most Canadians, and a general policy facilitating wealth transfers from consumers to producers is likely to harm most Canadians, even if the merger increases total wealth. At the same time, the harm of the merger of Superior and ICG is not felt across the board. Although some have suggested that the appropriate policy response to price concerns is direct government price controls,[11] Canadians

have generally and wisely disfavoured such an approach as unwieldy. Thus, it is unlikely that Parliament intended that the Tribunal approve the Superior/ICG merger, and the approach that makes sense in the context of democratic politics would be to assume that Parliament intended the *Competition Act*'s merger provisions to prevent consumer exploitation. If merging parties want, they are free to seek exemptions from Parliament in special legislation that is coupled with specific redistribution proposals (like special tax credits for poor and rural Canadians who depend on the product and are most likely to be exploited).[12]

Applying traditional welfare economics, the Competition Tribunal and its defenders agonize over how to evaluate the "harm" caused by the estimated price increase of $40 million annually as a result of the Superior/ICG merger. This lead the Tribunal to impose a burden on the Commissioner to demonstrate that a wealth transfer was socially adverse, from the framework of welfare economics, even though the burden they imposed would be almost impossible to meet.[13] In an effort to "speak the language" of welfare economics in the initial proceedings, the Bureau submitted an analysis by Professor Peter Townley, suggesting that a sophisticated approach to welfare economics would include an analysis of the distributional effects of a merger. Where, for example, poorer individuals obtain greater value for each dollar spent than wealthier individuals, a redistribution of wealth from the poor to the rich would not be neutral but welfare decreasing. The Bureau used this analysis to argue that the *Superior Propane* merger was not welfare-enhancing because most of the victimized consumers were poor Canadians or small- and medium-sized businesses, and these individuals were likely to be hurt more by losing $40 million than the shareholders would benefit by gaining $40 million. As a matter of political economy, an approach that follows Prof. Townley's analysis has been criticized for asking the Tribunal either to make moral or political decisions about the desirability of certain types of redistribution, or to determine how much value each individual associates with each dollar gained or lost.[14]

But this criticism misses the main point of the Court of Appeal's holding, which was effectively disregarded by the Tribunal on remand, that the exploitation of consumers *qua* consumers is a harm that must be offset by efficiency gains for section 96 to save a competition-lessening merger from condemnation. The main point can be concisely stated as follows: <u>the Competition Act protects consumers against price exploitation not because consumers are poor, or more worthy in a moral sense, but because Parliament properly recognized that in the Canadian democracy there are more consumers than shareholders, and thus for any competition legislation to gain democratic support, it must – absent potentially offsetting justifications – prohibit such mergers.</u> This is why it makes perfect sense to attribute to Parliament a <u>political/utilitarian</u> motive of acting in the best interests of the greatest number of Canadians, even though such a motive is not necessarily consistent with any criterion in the field of academic economics,[15] and even though Tribunal members Nadon, J. and Dr. Schwartz seem unwilling to acknowledge the basic political observation that voters would not view the use of economic power to transfer wealth as socially neutral.[16] The Court of Appeal recognized this, even if the Tribunal audaciously disagreed.[17]

Once the *Competition Act* is viewed as a democratic expression of the aspirations of most Canadians, as opposed to an exercise in academic economic analysis, several flaws in the recent decision of the Tribunal on redetermination become apparent:

• The Tribunal's decision fails to explain why – absent clear evidence of special-interest capture – Parliament would want to permit a consumer-exploiting merger to go forward simply because cost savings will pass through to the benefit of corporate shareholders, many of whom might not even be Canadian.[18]

• Ignoring the traditional Canadian approach of interpreting statutes in a purposive manner by identifying the mischief that Parliament sought to correct, the Tribunal fails to reconcile the almost exclusive focus in legislative debates on permitting efficient mergers to increase Canadian productivity in a world market and denying the supremacy of efficiency values to consumer protection.

• The Tribunal seems to contradict itself when it writes that competitive prices are not desirable because they are low or fair to consumers, but then suggests other means of ensuring low and fair prices that risk substantial and widespread bureaucracy and inefficiency.[19] It is precisely because a competitive market is the best way to ensure low and fair prices to consumers that competition law protects consumers. The Tribunal's suggestion that as a matter of Canadian policy, redistributional concerns with mergers that simultaneously increase price and lower costs should be dealt with through a price review board is unsatisfactory for precisely the reason the Tribunal has identified: price controls are bureaucratic and unwieldy.[20] Nor would general redistribution policies, such as welfare payments or a more progressive tax system, properly remedy the harm to a discrete class of consumers exploited by a specific merger-to-monopoly. Thus, although it may be true that "Parliament has more effective tools than competition policy to deal with distributive concerns"[21] if one is concerned with the overall distribution of wealth in Canadian society, what is at issue here are the concerns about a specific unjust distribution of wealth caused by a specific anti-competitive merger, a very different matter for which commentators have not suggested any more effective policy responses.

The foregoing analysis suggests why it is unlikely that a Parliament elected by and presumably responsive to a majority of Canadian voters would enact an efficiency defence to a competition law that would not consider wealth transfers as a social harm to be weighed against efficiency gains. A review of the actual legislative history of the *Competition Act* confirms that the MPs considering the legislation in 1986 actually behaved as the foregoing analysis would expect.

It is, of course, easier to criticize the Tribunal than to develop a coherent alternative interpretation of the *Competition Act*, a process made more difficult because of the somewhat tortuous process whereby the Bureau was hamstrung by policies of former officials that adopted the anti-consumer, wealth-transfers-are-neutral approach.[22] Moreover, a simple alternative based on the principles of political economy sketched above is clearly contrary to reality: if Parliament was solely interested in protecting the majority of Canadians-qua-consumers, they wouldn't have enacted an efficiency defence in the first place! Thus, a more sophisticated response is necessary, but one that explains why Parliament would not want to adopt an anti-consumer standard.

Referring back to the simple model of democratic decisionmaking, there is no evidence that in enacting the efficiency defence Parliament also enacted "side-payments" to a sufficient number of Canadians with minimal stock holdings so that a majority was really better off. Nor is there any evidence that a majority of Canadians expected to become sufficiently wealthy that their primary economic role in society would be that of a shareholder

rather than a consumer. (Note mass investments in stock were less common in 1986 than today.) Nor is there evidence that business groups pushing for the efficiency defence had an explicit or implicit political bargain to support other legislation that would benefit consumers.[23] Nor did advocates of the efficiency defence elaborate a theory of "trickle down economics" that demonstrated that a majority of Canadians would benefit from increased wealth in the hands of shareholders. Why, then, would Canadian voters favour any proposal that would result in their paying more for goods and services because of a competition-lessening merger?

The answer is apparent from a review of the legislative history: the primary purpose of the efficiency defence was to strengthen Canadian firms in international competition, not to allow firms to increase price, save costs, and retain all the benefits for themselves. Even the Tribunal conceded that Parliament intended the efficiency defence as a tool to strengthen Canadian firms and increase their productivity "in the face of aggressive international competition" for the purpose of "promoting national economic development."[24] Thus, in a key part of legislative history upon which the Tribunal relies, when the committee rejected an amendment by opposition critic André Ouellet to make competitive prices and consumer choice the overriding goals of the statute, Parliamentary Secretary Bill Domm explained that the draft language he preferred did not "overlook consumers" but rather was designed to "encourage competition, and particularly participation in world markets."[25] This is also reflected in the statute, which focuses specifically on the increased ability of firms to compete internationally.[26] Indeed, Domm's statement that the language that emerged as section 96 was designed to implement a policy to promote efficiencies but emphasizing that this was "not an absolute override but rather a balancing defence of the benefits against the costs,"[27] clearly suggests that Domm, responding to Ouellet's criticisms, was including higher prices to consumers, and not solely deadweight loss, as among the "costs" to be weighed.

Unlike the notion that Canadians are willing to pay more simply to enrich shareholders, the willingness of a majority of Canadians to trade-off slightly higher consumer prices for proven efficiencies likely to result in greater international competitiveness makes eminent sense. Canadians also see themselves as workers, and logically prefer a strong economy with lots of jobs. In an increasingly globalized economy, Canadians also see the benefits, both as workers and as consumers, to having Canadian companies among major international players.

Placing the consideration of the enactment of the *Competition Act* in its proper historical context provides further support for the conclusion that Parliament did not intend an efficiency defence to ignore harms caused by higher prices. As an interpretive technique, the Tribunal held that any correct interpretation of the *Competition Act* must result in a significant number of mergers that would be found illegal under section 92 but saved by section 96.[28] Such an approach assumes that, in enacting sections 92 and 96, Parliament clearly understood how the Tribunal would apply section 92, and therefore intended section 96 to exempt a clearly-defined set of otherwise-unlawful mergers. It is not clear, however, that Parliament possessed 20-20 vision in foreseeing that the Tribunal and the Commissioner would necessarily apply section 92 in the sophisticated and rigorous way that it has been applied. For example, Parliament was sufficiently concerned about this to specify in subsection 92(2) that market shares would not be determinative in the section 92 analysis, an approach so widely rejected in modern competition policy that today it is superfluous. Parliament may have also been concerned that the Tribunal would fail in its section 92 analysis to account for the pro-competitive effect that efficiencies would have in reducing the likelihood

of coordinated interaction among the remaining firms. Indeed, an interpretation that the section 96 defence was intended simply to ensure that the Tribunal barred only those mergers that truly lessened competition is consistent with the French version of the statute, that uses the verb *neutraliser* in lieu of the English word "offset." The Tribunal acknowledged that the parliamentary drafters designed section 96 to be the principal locus of analysis of efficiencies. If Parliament thought the section 92 analysis might lack serious consideration of those efficiencies that would indeed neutralize the harm, then section 96 was originally designed to have a larger role than it plays now when those considerations are incorporated in the Commissioner's *prima facie* case.

Enacting this law two years before the Canada-U.S. Free Trade Agreement, Parliament may also have assumed that mergers necessary to allow Canadian firms to compete on an efficient scale with their American counterparts would not be permitted under section 92 because existing trade barriers would preclude consideration of U.S. firms in the relevant market. But this original understanding must be construed today in light of NAFTA. Although the Tribunal correctly notes that NAFTA permits Canada to focus solely on efficiencies occurring within Canadian markets, NAFTA precludes discrimination between Canadian or foreign shareholders in the application of competition law. Thus, even if the Tribunal's claim that Parliament was neutral as to whether $40 million per year should be in the pockets of moderate-income Canadians and small business on the one hand, or the shareholders of Superior on the other, in a post-NAFTA world the law would also have to be neutral as between Canadian consumers and foreign shareholders. Parliament could hardly have intended such a result.

Another interpretation, which is consistent in theory with democratic principles (although drawing no actual support from the legislative history) was first set forth in *Hillsdown*.[29] Justice Reed suggested that the efficiency defence will often operate to permit mergers where the certainty of achieving benefits is high, but the likelihood of lessening competition (while sufficient to warrant a finding under section 92) is more uncertain.

Eminent Canadian economists have made the fair point that the claim that the total surplus approach will rarely permit mergers to be blocked is overstated, in that mergers between firms that are already pricing above competitive levels are likely to result in a higher amount of deadweight loss than the Tribunal found in its first decision in *Superior Propane*.[30] Indeed, Professor McFetridge suggests (without citation, although I am not privy to the internal deliberations of the Bureau so have no basis to question this) that the Commissioner's objection to the total surplus standard was because such a standard was "too easy to meet."[31] Still, defenders of total surplus have yet to provide a persuasive explanation – given the current distribution of shareholder wealth in Canadian society – for why a majority of Canadians would view the distributional effects as "neutral."

Having rejected the likelihood that Canadian voters would prefer an efficiency defence that did not require the Tribunal to find that resource savings outweighed a wealth transfer from consumers to shareholders, another possibility is that Parliament acted in a manner contrary to the interests of ordinary Canadians. Perhaps the most politically defensible argument in favour of the Tribunal's position is that the *Competition Act* represents a fig-leaf designed by business interests to appear to be pro-consumer but that, in actuality, reflects free reign for shareholder interests. Indeed, media reports provide some support for that claim, as a matter of political history.[32] Whether one takes a more traditional textual approach to statutory interpretation, or a more modern approach that looks to

the public purposes that underlie legislative design, Canadian courts have yet to adopt an interpretive approach that effectuates secret special interest deals.[33]

Finally, the Tribunal rejected any effort to narrow the efficiency defence in a manner consistent with the interests of most ordinary Canadians, by virtually implying that any such effort was part of some typically overreaching plot by Americans to force their northern neighbour to do things our way.[34] On the contrary, an approach which fully counts wealth transfers as a harm, but weighs them against a variety of efficiency benefits, is especially adapted for the Canadian economy and differs in significant ways from the treatment of efficiencies in merger analysis in the United States.

Efficiencies are considered twice in Canadian merger analysis. First, a demonstration of lower costs may indicate that the merged parties are unlikely to engage in secret or tacit collusion with their remaining rivals, so that the merger will not have a competition lessening effect proscribed by section 92.[35] Second, the lower costs may justify a merger under section 96 even if there are competition lessening effects. In contrast, efficiencies are only considered in the United States if they sufficiently counteract (might I dare suggest to bilingual Canadians that they *neutraliseront*) the competitive harm, so that there is no substantial lessening of competition.

The landmark case of *United States* v. *Philadelphia National Bank*[36] illustrates another significant difference between the American practice and the narrower definition of section 96 now advocated by the Commissioner. The Antitrust Division of the Justice Department objected to a merger between two large Philadelphia banks, whose combined market share in Philadelphia exceeded 30%. The Comptroller of the Currency (who, unlike the Canadian Minister of Finance, does not have the final say) approved the merger despite the Antitrust Division's objections, on two grounds. First, the merger would allow Philadelphia corporations to obtain large-scale financing from a source other than the New York "money center" banks, thus increasing competition in that sector of the market. Second, the presence of such a bank in Philadelphia would attract additional corporate investment in Philadelphia. When the merger was challenged under the *Clayton Act*, the U.S. Supreme Court rejected both of these defences. In contrast, section 96 clearly contemplates that the Tribunal will weigh efficiency benefits in one sector of the Canadian economy against any harm (including wealth transfer) caused by the merger in other geographic or product markets. Secondly, the ancillary economic benefits that would result from increased efficiency are also benefits that may be presented by the merging parties.

The legislative history of section 96 supports the proposition that the principal rationale for the efficiency defence was the ability of firms in the relatively smaller Canadian market to merge to achieve economies of scale so that they might more effectively compete – either against larger American or other foreign concerns in the domestic market, or to obtain economic benefits for all Canadians through increased exports obtainable through merger-specific efficiencies. These concerns are not considered in the United States once it is clear that consumers will suffer from higher prices.

None of the six differences between Canada and the United States identified by the Tribunal[37] suggests that the Commissioner's uniquely Canadian interpretation is erroneous:

(1) market structure considerations are no longer sufficient to condemn a merger in either country;

(2) contrary to the U.S. Guidelines, the Commissioner's interpretation does not require blocking all mergers where significant consumer surplus is still eroded, notwithstanding efficiencies;

(3) contrary to U.S. judicial precedent, the Commissioner's interpretation does not require efficiencies to offset harms in a single market, but allows efficiencies in one market to offset harms in another;

(4) although a larger and less concentrated market means that undue concentrations of power might not be necessary to achieve scale economies in the U.S., the Commissioner's approach permits full consideration of scale economies as an efficiency to be weighed against demonstrable harm;

(5) historic consideration for small businesses in the U.S. no longer plays a major part in U.S. merger policy; and

(6) the Commissioner's interpretation fully incorporates the Canadian interest in permitting the creation of "entities that may possibly compete more effectively with large foreign enterprises at home and abroad," but simply requires the Tribunal to balance the benefits from global competition against the full harm to consumers, so that Canadians do not have to pay higher prices with, as appears to be the case here, virtually no benefit to Canadian international competitiveness.

When firms with substantial Canadian assets merge, they are subject to a statute, the *Competition Act*. This law was not imposed upon Canadians by Her Majesty or her representative acting upon sage counsel by brilliant economic advisors, but rather upon the consent of the House of Commons, elected by Canadian voters. As such, courts should interpret the law in a manner that it was likely intended by Parliament – to benefit the Canadian public. Although it is clear that most Canadians interact in the economy generally as consumers, the record is clear that Parliament sought legislation that would not only protect consumers, but also would allow Canadian businesses the flexibility to increase efficiency through merger or acquisition, so that these firms could increase exports or otherwise compete more effectively in the global marketplace. But there is no evidence that Parliament was unconcerned about the higher prices likely to result from competition-lessening mergers; indeed, the evidence is to the contrary.

It is facially ironic that the current leader of the British Tories would candidly acknowledge that no matter how convinced we are of how our ideas will benefit society, modern concepts of government responsible to electoral majorities require that at least most citizens be convinced that we are right. But the irony is only facial, because Iain Duncan Smith's intellectual predecessor, Sir Edmund Burke, amply demonstrated that democracy was not only inconsistent with traditional (if now outmoded) conceptions of a good society, but that democracy is inconsistent with maximizing societal wealth when power is given to the poor masses.[38] The specific goals that modern welfare economists advocate for a good society – maximizing total wealth – differ from Burke's, but at an abstract level both advocate a goal different than the utilitarian maximization of the interests of the majority. And, indeed, total wealth might well be maximized if Her Majesty governed Canada through a modern Privy Council consisting solely of sage economic advisers. However, as long as Canada remains governed by the principle of government responsible to an elected House of Commons, the distributional effects of economic behaviour, of income, as well as the creation of wealth, remain critical to the enactment and interpretation of Canadian public policy.

Notes

[1] The author is Professor of Law at the University of Illinois, and teaches courses in Antitrust, Statutory Interpretation, Comparative Canadian Law, and Comparative Competition Law. After initially writing about this subject, see *infra* note 6, the author has been consulted by the Competition Bureau in regard to the *Superior Propane* litigation discussed herein. The author wishes to thank Peter Carstensen, Tom Ginsburg, John Lopatka, Thomas Ross, Bruce Smith, Peter Townley, Michael Trebilcock, Tom Ulen and participants in a workshop at the University of Illinois Institute for Government and Public Affairs for helpful comments, although the usual suspects among them remain unpersuaded.

[2] "A Better Way for Britain" (18 July 2002) available at http://www.conservatives.com/news/article.cfm?obj_id=34918 & speeches=1

[3] See, e.g., M. Sanderson, "Competition Tribunal's Redetermination Decision in *Superior Propane*: Continued Lessons on the Value of the Total Surplus Standard" (2002) 21:1 Can. Comp. Rec. 1 and F. Mathewson & R. Winter, "The Analysis of Efficiencies in *Superior Propane*: Correct Criterion Incorrectly Applied" (2000) 20:2 Can. Comp. Rec. 88 ("total surplus" approach that properly measures deadweight loss – especially where pre-merger prices were above the competitive level – would not automatically approve mergers-to-monopoly where demand is inelastic); R.J. Holsten, "*The Commissioner of Competition* v. *Superior Propane* – The Tribunal Strikes Back" (2002) 21:1 Can. Comp. Rec. 26 (criticizing the Bureau's failure to present the strongest case for economic harm and for appealing the initial decision); R.W. Lusk, "Balancing Competition and Efficiencies – An Impossible Dream" (2002) 21:1 Can. Comp. Rec. 33 (criticizing the Tribunal's lack of fidelity with the appellate court's decision and for imposing too much of a burden on the Commissioner to demonstrate adverse effects); D.G. McFetridge, "Efficiencies Standards: Take Your Pick" (2002) 21:1 Can. Comp. Rec. 45 (defending the total surplus standard as not being too lenient on merging parties); M. Barutciski & B.A. Facey, "*Superior Propane*: An Overview of the First Efficiency Case" (2000) 20:2 Can. Comp. Rec. 36 (generally praising the Tribunal's initial decision and faulting the Commissioner for deviating from the *Merger Enforcement Guidelines*); J.L. Gudofsky & P. Gay, "Long Live the *Merger Enforcement Guidelines*? A Review of the *Superior Propane* Decision" (2000) 20:2 Can. Comp. Rec. 46 (generally praising the initial Tribunal analysis of efficiencies, although raising insightful questions for further analysis); M. Trebilcock & R.A. Winter, "The State of Efficiencies in Canadian Merger Policy" (1999-2000) 19:4 Can. Comp. Rec. 106 (criticizing the Commissioner for non-economic considerations of wealth transfer). Of the two articles from these pages critical of a total surplus approach, one, D. Tadmor, "Comments on the *Superior Propane* Case" (2001-2002) 20:4 Can. Comp. Rec. 77 (criticizing the Tribunal's failure to consider harms on a local basis, dynamic costs, and loss of consumer choice), is from the former General Director of the Israel Antitrust Authority. The one Canadian author critical of the Tribunal's total surplus approach is J. S. Tyhurst, "The *Superior Propane* Decision: Common Sense Overcomes Geometry, or How the Federal Court of Appeal Squared the Triangle" (2001) 20:3 Can. Comp. Rec. 8.

[4] *Canada (Commissioner of Competition)* v. *Superior Propane Inc.*, [2001] 3 F.C. 185, 11 C.P.R. (4th) 289 (F.C.A.) [hereinafter *Propane Appeal* cited to C.P.R.].

[5] *Canada (Commissioner of Competition)* v. *Superior Propane Inc.*, [2002] C.C.T.D. No. 10, 18 C.P.R. (4th) 417 (Comp. Trib.) [hereinafter *Propane (Redetermination Decision)*]; [2000] C.C.T.D. No. 15, 7 C.P.R. (4th) 385 (Comp. Trib.) [hereinafter *Propane (Initial Decision)*].

[6] See, e.g., B.A. Facey et al., "An Efficiency Defense That Maximizes Welfare: The Canadian Competition Tribunal Gets It Right" Fall 2000 Antitrust 70; A.A. Fisher, R. Lande & S.F. Ross, "Legalizing Merger to Monopoly and Higher Prices: The Canadian Competition Tribunal Gets It Wrong," Fall 2000 Antitrust 71; M. Sanderson, "Efficiency Analysis in Canadian Merger Cases" (1997) 65 Antitrust L.J. 623; S.F. Ross, "Did the Canadian Parliament Really Permit Mergers that Exploit Canadian Consumers So the World Can Be More Efficient?" (1997) 65 Antitrust L.J. 641; D.G. McFetridge, "The Prospects for the Efficiency Defence," (1996) 26 Can. Bus. L.J. 321; P.S. Crampton, "Alternative Approaches to Competition Law: Consumers' Surplus, Total Surplus, Total Welfare and Non-Efficiency Goals" (1994) 17 World Comp. 55; P.S. Crampton, *Mergers and the Competition Act* (Toronto: Carswell, 1990) at 495-554.

[7] R.D. Cooter & T.S. Ulen, *Law and Economics*, 3d ed. (Reading, Mass.: Addison Wesley Longman, 1999) at 35-40.

[8] McFetridge, *supra* note 3 at 55. See also Barutciski & Facey, *supra* note 3 at 36 (initial Tribunal decision adopting total surplus standard gave Canada "the most economically sophisticated merger law in the world").

[9] See, e.g. R.C. Cooter, *The Strategic Constitution* (Princeton, N.J.: Princeton Univ. Press, 2000) c. 3.

[10] It is true that this argument has somewhat more force in the United States, where weak party discipline, strong legislative committees, a bicameral legislature and a separate executive present myriad "veto-gates" that special interests can close to prevent legislation from passing. It is much easier for a determined minister to enact legislation in Canada. At the same time, the influence of special interests on the Canadian legislative process is well-documented. See, e.g., F. Thompson & W.T. Stanbury, "The Political Economy of Interest Groups in the Legislative Process in Canada" (Montréal: Inst. of Research on Public Policy, May 1979); R.J. Jackson & D. Jackson, *Politics in Canada* 4th ed. (Scarborough, Ontario: Prentice Hall Canada, 1986).

[11] See *Propane* (*Redetermination Decision*), *supra* note 5 at para. 205.

[12] Although some suggest the specifics haven't worked and alternatives would be preferred, an example of this is separate legislation that permitted Air Canada to acquire Canadian Airlines with a variety of special regulatory provisions to mitigate the harm caused by the creation of a dominant air carrier in many air travel city-pair markets. See *An Act to amend the Canada Transportation Act, the Competition Act, the Competition Tribunal Act and the Air Canada Public Participation Act and to Amend Another Act in Consequence*, R.S.C. 2002 c.16. I suggest that these regulatory provisions would have been more difficult to achieve if, for example, the merger had already been approved and the provisions were simply in response to the adverse consequences of the merger.
[13] See, e.g., Member Lloyd's dissent in *Propane* (*Redetermination Decision*), *supra* note 5 at paras. 425-27, and Lusk, *supra* note 3.
[14] Professor Townley's affidavit (August 1999, at 6), argues that a complete welfare economics approach would require the latter assessment. Available at http://www.ct.tc.gc.ca/english/cases/propane/propane.html, document 115. Mathewson & Winter, *supra* note 3 at 90, observe that a policy that blocked a merger between two closely-held corporations owned by wealthy Canadian families but that would allow the same merger to go forward if both firms were acquired by a teachers' pension fund is poor policy and, because of the effect on share ownership, would render economic analysis hopelessly complex.
[15] *Cf. Propane* (*Redetermination Decision*), *supra* note 5 at para. 93 (citing Prof. Townley to this effect). At the same time, economists do recognize that a rule of democracy that allows the preferences of the median voter to govern will not usually be consistent with a Kaldor-Hicks efficient result. Cooter, *supra* note 9 at 32-33.
[16] *Propane (Redetermination Decision)*, *supra* note 5 at para. 185.
[17] *Propane Appeal*, *supra* note 4 at 326, citing J.F. Brodley, "The Economic Goals of Antitrust: Efficiency, Consumer Welfare, and Technological Progress (1987), 62 N.Y.U.L. Rev. 1020 at 1035-36. Although the Tribunal professed an inability to understand why Professor Brodley's article was relevant, since it does not directly address Canadian competition law, the Court of Appeal understood the Canadian application of Brodley's point – his observations about why democracies must enact competition policies that benefit most of its citizens are directly applicable to the construction of a Canadian statute.
[18] Note that the Tribunal addresses NAFTA concerns by limiting its focus to Canadian resources, but NAFTA would not permit the Tribunal to differentiate between Superior Propane, for example, and a global multi-national who also saved money through more efficient resource application in Canada.
[19] *Propane (Redetermination Decision)*, *supra* note 5 at para. 204.
[20] *Ibid.* paras. 206-07.
[21] Gudofsky & Gay, *supra* note 3 at 73.
[22] See, e.g., Competition Bureau, *Merger Enforcement Guidelines*, section 5.5 and footnote 57; H.I. Wetston, "Developments and Emerging Challenges in Canadian Competition Law" 1992 Fordham Corp. L. Inst. 195 (Barry E. Hawk, ed., 1993).
[23] I consider below the possibility that section 96 is a pro-business provision inserted in Bill C-91, which otherwise was a very pro-consumer proposal, as a secret *quid pro quo* to prevent business groups, possessing disproportionate political influence, from otherwise defeating the measure. Suffice it to say now that there is no explicit evidence of such a bargain.
[24] *Propane (Redetermination Decision)*, *supra* note 5 at para. 81.
[25] *Ibid.* at para. 62.
[26] *Competition Act*, section 96(2).
[27] *Propane (Redetermination Decision)*, *supra* note 5 at para. 69.
[28] *Ibid.* at para. 83.
[29] *Canadian (Director of Investigation & Research)* v. *Hillsdown Holdings (Canada) Ltd.* (1992), 41 C.P.R. (3d) 289 (Comp. Trib.).
[30] See Sanderson, *supra* note 3, Mathewson & Winter, *supra* note 3, McFetridge, *supra* note 3 (citing economic studies demonstrating this point).
[31] McFetridge, *supra* note 3 at 47.
[32] A. Fotheringham, "Why lobbyists should keep their mouths shut," *Maclean's* (28 December 1998) 116 (major business lobbyist bragged to a reporter that business suggestions were the driving force behind competition legislation, with author Peter Newman concluding that it "was the only time in the history of capitalism that any country allowed its anti-monopoly legislation to be written by the very people it was meant to police").
[33] *Cf. Haida Nation* v. *B.C.* (*Minister of Forests*), (1997) 45 B.C.L.R. (3d) 80, 153 D.L.R. (4th) 1 (B.C.C.A.) (court upholds language barring forest licenses on land subject to native land claims, notwithstanding argument that the Social Credit government that enacted the British Columbia statute would never have intended such a result). For an argument, applicable to Canada, for why courts properly limit themselves to interpreting a statute based on the legislation's publicly stated purposes, see J.R. Macey, "Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model" (1986) 86 Colum. L. Rev. 223 at 227.

[34] *Propane (Redetermination Decision), supra* note 5 at para. 155.

[35] In this regard, I confess to not understanding the Tribunal's point, *ibid.* at para. 137, that "efficiencies are to be considered only under section 96 and not under section 92."

[36] 374 U.S. 321 (1963).

[37] *Propane (Redetermination Decision) supra* note 5 at paras. 131-49.

[38] E. Burke, *Reflections on Revolution in France* (Harmondsworth, England: Penguin Books Ltd, Conor Cruise O'Brien, ed., 1968) at 228-40.

DRAFT "ENFORCEMENT GUIDELINES FOR ILLEGAL TRADE PRACTICES: UNREASONABLY LOW PRICING POLICIES" – THE WAY AHEAD

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Introduction

On March 8, 2002, the Competition Bureau released the draft *Enforcement Guidelines for Illegal Trade Practices: Unreasonably Low Pricing Policies* ("Draft Guidelines") for public comment which signaled a renewed approach to predatory pricing. The Draft Guidelines have received a mixed response from the public. Several commentators support the new proposals whereas others have noted concerns, particularly with respect to the treatment of recoupment. This paper describes the development of the economics, law and enforcement policy on predation in Canada. It concludes with a brief overview of options that are being considered for revised Draft Guidelines that will be issued by the Bureau in the coming months.

Economics of Predation

Robert Bork stated that predatory pricing occurs where a firm deliberately pursues business practices that would not be profit-maximizing except for the expectation that (1) rivals will be driven from the market, leaving the predator with sufficient market share to command monopoly profits, or (2) rivals will be chastened sufficiently to abandon competitive behaviour the predator finds threatening or inconvenient.[1] The classic form of predation involves an actual or near monopolist selling at below cost prices in the short run, thus incurring losses, in order to eliminate competitors (typically a new entrant), and subsequently recouping losses by charging higher, non-competitive prices in the market. Short run profits are sacrificed but the economy is harmed in the long run as the resulting high prices decrease output and exclude some consumers from the market. Predation is also usually associated with having "deep pockets" or "the long purse," that is, greater financial wherewithal to withstand losses than rivals.

A great deal has been written on whether predation is plausible, notably by Easterbrook and McGee.[2] Theories of predation contain assumptions that have been challenged by the Chicago School of economic analysis. Predation is implausible it is posited because the monopolist or near monopolist will incur comparatively greater losses than its intended victim and, therefore, the more logical course would be to enter into a merger to avoid losses. Imperfect access to capital and financing by targets of predation is the second assumption that has been attacked by the Chicago School. Again, because losses will be more onerous for the predator, all the target has to do is stop operations and finance fixed costs for the period of predation, then resume operations when prices recover. Another problem with firms pursuing a predator strategy is that consumers must be complicit with the strategy. Critics of predation argue that consumers usually understand that it is against their long term interest to permit the market to be monopolized in the future, and counterstrategies, such as long term contracts between consumers and targets, can defeat the goal of monopolization. Finally, the predator's goal of recoupment will only be successful if

there are high barriers to entry or expansion. In addition to the inherent uncertainty of recouping losses, the Chicago School generally only sees barriers created by government to be of sufficient effect to limit entry into profitable markets.

Not surprisingly, there are competing schools of thought. The "New Learning" does not concede that capital markets are always perfect or that barriers to entry are low in every market. There are antitrust laws governing mergers. Asymmetry of information, multi-product or multi-market firms and game theory based on leveraging reputation can also explain why predation is plausible in certain circumstances. Firms in a competitive game do not know the costs of their rivals with certainty. However, firms may take prices as signals of their competitor's costs. Predation can be less costly than a merger and, thus, be a rational response if it creates a reputation of having lower costs or a reputation of "toughness" to discipline actual or potential rivals.[3] Obviously, the viability of this strategy is directly related to the firm's size and market share as well as the number of product and geographic markets in which the firm participates. In these circumstances, it may be viable for a firm with "deep pockets" to finance predation internally. In contrast, the target of the predation may not have the "commercial muscle" to convince its bankers or shareholders to finance losses. As well, on-going financing of new entrants is usually contingent on meeting certain financial objectives ultimately related to profitability. The result is that the target either exits or raises prices.

Academics have also written extensively about rules to distinguish predation from beneficial competition. Easterbrook recommended that only consumers should be able to bring complaints of predation.[4] However, the latter would result in under-enforcement because the Competition Bureau relies almost exclusively on information provided by alleged targets to detect predatory behaviour. Other suggestions such as requiring a firm to go out of business before taking action would be tantamount to a rule that only dead men can object to murder.

Much of the literature on predation focuses on how to distinguish predatory pricing from aggressive competition. The well-known Areeda-Turner test focuses on price-cost relationships to detect predatory pricing.[5] In theory, only prices below marginal cost should be condemned as predatory since the sale of each additional unit only adds to losses and makes no contribution to fixed costs. In practice, the accounting concept of average variable costs, that is, costs that vary directly with production, is used as a proxy for marginal costs.

Where prices are above average variable costs but less than average total costs, determining predation becomes more complex. More factors need to be taken into account because over a longer time period more costs are variable. We also know that firms experience distress, sell perishable products, enter new markets or develop new products, face new competitors, or participate in network industries. All of the above can be business justifications for below-cost pricing.

The debate on whether predation exists and whether such behaviour should be addressed by competition law has largely been resolved in the affirmative.[6] Nonetheless, most economists concede that predation is rare, and enforcement policies should protect competitive markets rather than protect competitors from competition itself.

Canadian Law and Jurisprudence

Section 50 of the *Competition Act* was introduced into Canada's competition law in 1935 following the *Report of the Royal Commission on Price Spreads and Mass Buying*. At the time, Parliament was concerned about the survival of small and medium sized businesses.[7] The provisions have been untouched by amendments despite several recommendations and one recent attempt to decriminalize the price discrimination and discriminatory promotional allowances provisions in paragraph 50(1)(a) and section 51, respectively.[8]

The provisions addressing predation provide:

> 50.(1) Illegal Trade Practices – Every one engaged in a business who
>
> ...
>
> (b) engages in a policy of selling products in any area of Canada at prices lower than those exacted by him elsewhere in Canada, having the effect or tendency of substantially lessening competition or eliminating a competitor in such part of Canada, or designed to have such effect, or
>
> (c) engages in a policy of selling products at prices unreasonably low, having the effect or tendency of substantially lessening competition or eliminating a competitor, or designed to have that effect,
>
> is guilty of an indictable offence and liable to imprisonment for a term not exceeding two years.

Paragraph 50(1)(b) (geographic price discrimination) and paragraph 50(1)(c) (predatory pricing) address two types of harm to competition:

1. effect, tendency or design of substantially lessening competition; and

2. effect, tendency or design of eliminating a competitor.

The competitive effects test of "substantially lessening competition" is sufficiently close to the test of prevent or lessen competition substantially found in the merger and abuse of dominance provisions of the *Competition Act* that it falls within the mainstream concerns about market power. However, the same cannot always be said of the eliminating a competitor element of the offence. This presents a longstanding conundrum for antitrust enforcers. The *Competition Act* seeks to protect competition and not individual competitors, yet in certain markets the presence of individual competitors can be vitally important to maintaining and encouraging a competitive market.

Carnation is the only significant case under paragraph 50(1)(b).[9] The company was charged with geographic price discrimination as it charged lower prices for condensed milk in British Columbia than it did in Alberta to counter a new competitor in the British Columbia market. The Court ruled that the pricing conduct was not illegal, that it is permissible to react to new competition by cutting prices. There have been few cases under that provision since the *Carnation* decision.[10]

There have been four significant cases under paragraph 50(1)(c): *Producers Dairy,*[11] *Hoffman LaRoche,*[12] *Consumers Glass*[13] and *Boehringer/Bristol Myers Squibb*[14]

In *Producers Dairy*, the court found that two days of low pricing activity was not of a sufficient duration to constitute a policy. Similar complaints would not likely merit more than a few minutes consideration at the Bureau today.

In *Hoffman LaRoche*, the accused was convicted of selling valium at a zero price to hospitals in response to the entry of a new competitor. The court found that the give-away program had no adverse impact on competition and that the target firm was not seriously impeded in its ability to compete, but convicted on the basis that the policy was designed to substantially lessen competition. The trial decision provides considerable insight into the meaning of "unreasonable". The court ruled that above cost prices can never be unreasonable, but rejected a purely price/cost approach for determining whether prices are unreasonable. Rather, all relevant factors need to be considered by courts, such as the duration of the below cost prices and the business objectives underlying the policy.

The company was fined $50,000, far less than the Crown's recommendation of $1 million. The court noted that Hoffman LaRoche's policy did not ultimately succeed in excluding competitors and cost the company more than $1 million. The court also commented on the rarity of predatory pricing in the economy compared to conspiracy and price fixing, on the defensive nature of Hoffman LaRoche's policy, that a penalty for intention to harm should be less severe than actual harm, as well as other well-established factors in delivering its sentence.[15]

In *Consumers Glass*, Portion, a wholly-owned subsidiary of Consumers Glass that manufactured disposable cup lids, cut prices below average total costs in response to the entry of a new competitor formed by former employees. The company was acquitted on the basis that, at a time of industry over capacity, the company was minimizing losses by selling at above average variable cost. The court essentially endorsed the Areeda-Turner test although it did consider the underlying intent of Portion's business objectives in determining that Portion's prices were not unreasonable.[16]

Boehringer/Bristol Myers Squibb was a private prosecution under section 36 of the *Competition Act*. The case is notable for affirming that price matching, even if it is below cost, is not unreasonable.

Predatory pricing can also be the subject of an application to the Competition Tribunal under the civil abuse of dominance provisions. The recent Enforcement Guidelines on these provisions contain a section on predation.[17] The Bureau has incorporated, and the Competition Tribunal has considered, allegations of predatory conduct in two abuse cases: *Nutrasweet* and *Teledirect*.

In *NutraSweet*, the Competition Tribunal dismissed the Commissioner's allegation that the NutraSweet Company was selling at prices below "acquisition cost" which is identified as an anti-competitive act in paragraph 78(1)(i). The Tribunal held that the Commissioner did not present a consistent or coherent case as to the proper measurement of cost, and then went on to endorse the Areeda-Turner rule, pricing below average variable cost, as the appropriate standard for determining predation.

The other case where the Competition Tribunal addressed predatory conduct was *Teledirect*, where the Tribunal rejected the argument that Teledirect's responses to entry initiatives were predatory. In the judgement, the Tribunal expressed concerns about drawing proper distinctions between pro and anti-competitive pricing behaviour and expressed concerns about the law being used to discourage aggressive competition. In both cases, the Tribunal concluded that evidence of probable recoupment is an essential element to support an allegation of predation.[18]

While there have been a very limited number of cases, an over-arching set of principles to establish predation has developed, including below cost pricing without business justification and post-predation recoupment through the exercise of market power.

1992 Predatory Pricing Enforcement Guidelines

In the early 1990s, the Bureau issued two enforcement guidelines on criminal provisions addressing pricing which continue in effect today.[19] Prior to the publication of the 1992 *Predatory Pricing Enforcement Guidelines* (the "1992 Guidelines"), the Bureau's examination of predatory pricing complaints focused on the complicated and time-consuming analysis of price-cost relationships as opposed to the likely competitive effects of the low pricing behaviour. The result was a significant number of inquiries but few referrals to the Attorney General or prosecutions before the courts.

The 1992 Guidelines follow the classic model of predation. They were heavily influenced by the jurisprudence arising out of the U.S. courts in *Matsuhita Electric Industrial Co.* v. *Zenith Radio Corp.*[20] and the paper by Joskow and Klevorick, "A Framework for Analyzing Predatory Pricing Policy", which proposed a two stage process for analyzing predation.[21] In *Matsuhita*, the U.S. Supreme Court commented on the rarity and general implausibility of predation.[22]

The two stage analysis introduced in the 1992 Guidelines radically changed the Bureau's approach to predation. In stage one, market power on the part of the predator must be established using high market share and barriers to entry as well as the ability to recoup losses as indicators. Only if the market power requirement is satisfied would the Bureau move to the second stage and examine the relationship between price and costs. The costs tests in the 1992 Guidelines are taken from *Consumers Glass*, in which the tests were, in turn, based on Areeda-Turner.

Prices below average variable costs were deemed to be unreasonable, while prices between average variable and average total costs would fall into the "grey range". In the "grey range," the Bureau would delve into the surrounding circumstances such as industry conditions, business objectives underlying the below cost prices and whether the firm passed over opportunities to increase prices. In both situations, there would have to be a "policy" of selling at below cost prices and an absence of a legitimate business justification for the activity as required by the jurisprudence.

Equally important as the analytical approach contained therein, the Preface to the 1992 Guidelines states that predation is rare and the Bureau's enforcement policy should not chill price competition.

The 1992 Guidelines focus on complaints that are likely to have the effect or tendency of substantially lessening competition. They provide minimal commentary on how complaints about the elimination of a competitor would be addressed other than to suggest that market power must be evident before the Bureau would act.[23] Similarly, the discussion in the 1992 Guidelines on the nature of evidence that would be required for the Bureau to investigate a complaint where the target firm alleges that below cost pricing is intended to have an anti-competitive effect concludes with market power, i.e. a substantial lessening of competition, being the ultimate determinate of whether the Bureau will pursue the complaint.

The 1992 Guidelines provide a narrow treatment to section 50(1)(c) that is informed by one school of economic thought. Nonetheless, the 1992 Guidelines have been criticized for not going further by shutting off pricing policies designed to eliminate a competitor as a basis for inquiry.[24]

VanDuzer Report and the Standing Committee on Industry Report

In 1997, MP Dan McTeague introduced a private member's Bill, Bill C-235, designed to combat the anti-competitive effects of predatory pricing.[25] The Bill was considered by the Standing Committee on Industry, but it was not passed. Rather, the Committee embarked on a study of the pricing provisions of the *Competition Act*. In response, the Bureau retained Anthony VanDuzer and Gilles Paquet of the University of Ottawa to undertake an independent study of the pricing provisions of the Act and related enforcement practices of the Bureau. The Report, commonly referred to as the VanDuzer Report, was issued in October 1999.[26]

The VanDuzer Report covers section 50 (price discrimination, geographic price discrimination and predatory pricing), section 51 (discriminatory promotional allowances) and section 61 (price maintenance). As well, the VanDuzer Report addresses the potential application of the abuse of dominant position provisions to pricing practices largely as a prescriptive measure. The adequacy of the law, the Bureau's interpretation of the sections and its enforcement guidelines, as well as the Bureau's enforcement track record and practices, are described and analyzed in detail.

The VanDuzer Report provides a statistical breakdown of the Bureau's enforcement effort. Since the publication of the 1992 Guidelines, the only formal action taken by the Bureau or the Attorney General consists of nine complaints which were resolved by way of Alternative Case Resolutions. The absence of prosecutions or formal inquiries was not condemned. In fact, the VanDuzer Report noted that the Bureau's focus on cartel enforcement was reasonable in an era of resource pressures. The situation has not changed since the publication of the VanDuzer Report.[27]

The Report's recommendations regarding predatory pricing are noted below.

- The current criminal provision is vague, potentially overbroad and limited in remedial options. The case law does not provide a complete methodology for accessing illegality. Consequently, the provision should be repealed and treated as an anti-competitive act under civil abuse of dominant position before the Competition Tribunal, an adjudicative body expert in competition law and economics.

- Revised notions of market power using strategic behaviour and a different approach to remedial orders would have to be developed under the abuse of dominance provisions given the Competition Tribunal's reluctance both to accept dominance where market shares are less than 50% and to directly intervene in pricing decisions of firms.

- The authors advocate revisions to the 1992 Guidelines. The requirement to establish sufficient market power held by the predator to recoup losses under a criminal law burden of proof is too onerous. The Guidelines effectively remove intent-based predation claims from consideration. Consequently, they adopt an interpretation that is narrower than the statute or case law. Finally, the 1992 Guidelines do not address newer theories of predation, issues arising out of the new information based economy or how predation could be addressed under the abuse of dominance provisions.

- The Bureau should contest more predation cases. The 1992 Guidelines and the Bureau's case selection criteria mitigate against initiating predation cases.

In April 2002, the Standing Committee on Industry issued a report entitled *A Plan to Modernize Canada's Competition Regime* (the "Committee Report").[28] The Committee Report is the outcome of a complex series of events involving both private member's bills and government initiated proposals to amend the *Competition Act.*[29] The Committee Report is comprehensive with a list of 29 recommendations.

On the subject of predation, the Standing Committee on Industry endorses the VanDuzer Report recommendation to repeal paragraphs 50(1)(b) and 50(1)(c) and include predatory pricing as an anti-competitive act within the abuse of dominance provisions. Identical recommendations are made for the price discrimination and discriminatory promotional allowances provisions of the Act. The Bureau's argument that a criminal sanction deters the most egregious form of predation was not accepted.

The Committee Report also recommends that the government repeal the "dominance test" in paragraph 79(1)(a) of the abuse of dominance provisions and grant the Competition Tribunal the power to impose administrative penalties and damages as well as permit private access under section 79.

In its response to the Committee Report tabled in the House of Commons on October 1, 2002, the government undertakes to consult on decriminalizing sections 50 and 51 in the next initiative to amend the *Competition Act.*

Draft Enforcement Guidelines for Illegal Trade Practices: Unreasonably Low Pricing Policies

The Draft *Enforcement Guidelines for Illegal Trade Practices: Unreasonably Low Pricing Policies* (the "Draft Guidelines") attempt to respond to the recommendations in the VanDuzer Report albeit largely within the continued context of criminal law. They follow the release of the Draft *Enforcement Guidelines on the Abuse of Dominance in the Airline Industry* in February 2001. The document is more comprehensive than the 1992 Guidelines as it addresses geographic price discrimination set out in paragraph 50(1)(b), and provides more guidance on enforcement process and potential inquiry outcomes. The Draft Guidelines contain three fundamental proposed changes:

1. recoupment would not be used as the primary case screening factor at the initial complaint evaluation stage,

2. the concept of avoidable cost, as opposed to average variable and average total cost, is used as the cost standard to determine "unreasonableness", and

3. a new concept, predation resulting from market expansion, is incorporated.

The 1992 Guidelines set a high enforcement threshold for the Bureau. By establishing recoupment as the primary screening criterion, potentially valid predatory pricing complaints may not have been addressed. As noted in the VanDuzer Report, the burden of establishing that the alleged predator has market power sufficient to recoup losses is too onerous for both Bureau enforcement officers and economists, as well as the complainants at the early stage of an investigation. The likelihood of recoupment requires a sophisticated analysis of the potential reactions of competitors and potential entrants, as well as consumers. Without recourse to formal investigatory powers it may be almost impossible to establish a likelihood of recoupment which relies on a sophisticated theory of competitive harm, such as establishing an industry standard or increased interdependent market power.[30] Where the alleged predator has a market share of at least 35% in a market characterized by high barriers to entry, it is perverse that the Bureau would not continue an investigation. Recoupment should be viewed as a rebuttable presumption under such market conditions.[31]

The change to using avoidable cost stems from dissatisfaction with the Areeda-Turner test among economists.[32] Classifying variable and fixed costs items and the relevant time period for the analysis can be difficult.[33] In the long run, all costs are variable, and fixed cost investment decisions are variable costs before they are actually committed. Boulton, Brodley and Riordan describe avoidable cost as "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".[34] In practice, average variable costs will likely account for the greatest proportion of cost items under the avoidable cost test with only incremental fixed costs being added to the equation.[35]

In any event, below cost pricing is not *per se* illegal in Canada. Only a policy of selling at unreasonably low prices will attract liability, and unreasonably low prices can only be established after examining all of the surrounding circumstances to determine whether there is a business justification for the behaviour.

The section in the Draft Guidelines on predation resulting from market expansion responds to a common source of complaint from small and medium size businesses: the extension of dominance into new markets through the use of predation.

Consultation Results

The Bureau undertook public consultations for three months and received nine submissions which can be viewed on the Bureau's website. A critical analysis was also published in a prior issue of the *Record*.[36] Compared to previous draft guidelines issued by the Bureau, the document did not attract a great deal of public interest.[37]

The proposed change addressing recoupment generated the most comments. The Canadian Bar Association, among others, argued that removing recoupment as the primary screening factor could have a chilling effect on legitimate price competition. The Draft Guidelines clearly did not succeed in communicating the Bureau's desire to expand the role of recoupment beyond the classic form of predation described under "Economics of Predation" above. In any proceeding before the courts or the Competition Tribunal, the Attorney General and the Bureau would be faced with arguments that the absence of recoupment goes against the weight of academic and judicial thinking over the past two decades.

Hunter and Brown criticized the inclusion of reputational effects, a new element in the treatment of barriers to entry, on the grounds that it does not reflect the jurisprudence.[38] The last major case in Canada, *Consumers Glass*, was decided in 1981 and the concept has yet to be argued in a Canadian case. Reputational effects in predation cases have been before the courts in the United States albeit with mixed results.[39]

At the same time, the law indicates that unreasonably low pricing policies with the effect, tendency or design of eliminating a competitor are illegal. Here, recoupment may not be required. Intentionally or not, the Canadian Bar Association, among others, are arguing that elimination of a competitor alone should not be the basis for a predation case.

With the exception of Hunter and Brown, the use of avoidable costs was accepted as an appropriate cost standard to determine predation.[40] However, several commentators indicated that the description of the time period used for calculating avoidable costs is imprecise, and the section should provide more practical guidance on the treatment of specific cost items. Also, several submissions noted that the Competition Tribunal would be conducting a hearing on avoidable costs as part of the Bureau's application alleging that Air Canada abused its dominant position in air carrier services by selling at prices below avoidable costs in seven city pair markets, and the Bureau should await the outcome of this proceeding.

The addition of predation resulting from market expansion attracted little in the way of negative comment and was supported by most commentators.

Finally, there is the view that the Draft Guidelines are too ambiguous with respect to market power considerations generally, and fail to precisely articulate the Bureau's enforcement process with the consequent risk of chilling legitimate price competition. Fettering aggressive but legal price competition is a concern the Bureau takes very seriously even though the "chilling effect" may be difficult to verify. On the other hand, the Association Québecoise des Indépendants du Pétrole and the Canadian Federation of Independent Grocers argue that the document does not go far enough to address all forms of predatory conduct.

Proposals for Further Consultation

At the time of writing, revised Draft Guidelines for further consultation have not received the approval of the Bureau Policy Committee. Therefore, the discussion below should be seen as an exploration of ways to address market power issues as opposed to definitive statements on the contents of revised Draft Guidelines.

Antitrust enforcers are often faced with a dilemma about whether there is really a distinction between a substantial lessening of competition and the elimination of a competitor, particularly if the target is a disruptive or innovative competitor and there are pre-existing concerns about market power in the relevant market. The Bureau is currently looking at ways to establish separate criteria for dealing with the substantial lessening of competition and competitor elimination branches so that policy guidance on both parts of the law can be addressed.

To show a substantial lessening of competition, probable recoupment would be a necessary condition along with the minimum 35% market share guideline and high barriers to entry. However, in addition to the traditional "in-market" recoupment of lost profits, recoupment in other markets, preserving market position, establishing a standard or a reputation for predation, among others, could be included as forms of recoupment.

An analysis of the likelihood of recoupment could also include evaluating the reactions of customers. When customers are able to take steps to ensure their long term interest in a competitive market, recoupment is less likely. Typically predation is less likely where firms face a few sophisticated buyers. The likelihood that recoupment would be successful increases where there is a large number of customers or where there is a "free rider" problem. The latter can occur where each customer wishes to maximize their interests by buying from the predator at the low price, while at the same time assuming that other customers will support the target firm to maintain the long-term competitiveness of the market. The resulting lack of support for the target firm will render it unable to survive the period of below cost prices.

Establishing probable recoupment may be too onerous to practically deal with complaints of predator elimination at the onset of an investigation. Measuring profitability of both the alleged predator and the target is a method the Bureau has used recently in the examination of pricing complaints dealing with the elimination of a competitor. Where both the alleged predator and target competitor are unprofitable in the relevant market, below cost pricing is more likely to have anti-competitive effects. If the alleged predator is unprofitable in a properly defined relevant market, predation could be one explanation. If the target is also unprofitable as a result of below cost prices, it is possible that the low pricing policy may have the tendency or design of eliminating the competitor. Under this scenario, we would also examine whether the structural characteristics of the market are conducive to the post-predation exercise of market power.

Simply waiting for firms to go out of business before the Bureau would start an investigation would lead to under enforcement for obvious reasons. Alleged targets of predatory conduct approach the Bureau when they are distressed and have hope of relief, not for post mortems. The Bureau would evaluate the target's ability to be an effective competitor during a period of below cost prices. Of course, there are many explanations for unprofitability that the Bureau would have to carefully ferret out before proceeding to analyzing price-cost relationships.

Another market power indicator that could be refined in revised Draft Guidelines is the treatment of market shares and concentration. The Draft Guidelines set out a threshold of 35% or where the predator's market share is considerably greater than its rivals. Commentators have understandably asked for guidance on how far below the 35% threshold the Bureau would venture. For instance, adding a requirement that the predator's market share is at least twice that of the target and/or the predator holds strategic advantages over its rivals would provide more

guidance on the type of market conditions that are consistent with plausible theories of predation as opposed to aggressive competition where the alleged predator's market share is less than 35%. Examples of strategic advantages would include global firm size, reputational advantages, control over strategic assets or other advantages associated with vertical integration.

Conclusion

The debate on predatory pricing in Canada is proving to be very interesting. Concerns expressed to the Bureau and members of Parliament about the retail gasoline, grocery and airlines industries and the role of small and medium sized businesses have lead to in-depth studies, new legislation and recommendations for sweeping legislative changes. The Bureau is revising its enforcement policies on predation and important litigation on predatory conduct is currently before the Competition Tribunal.

The Bureau will complete its commitment to update the 1992 Guidelines. The debate on decriminalization will not conclude overnight. In the meantime, the 1992 Guidelines will continue in force until new guidelines are finalized.

The Draft Guidelines failed to articulate modern economic concepts as clearly as most stakeholders expected, and the Bureau will be issuing a revised document for further consultations which will address the concerns expressed about market power and other issues. The revised document may return to the two-stage examination process in the 1992 Guidelines where market power criteria, including probable recoupment or profitability tests, have to be established before the analysis moves to the second stage examination of price-cost relationships and possible business justifications for the below cost pricing policy. The revised document will likely retain the avoidable cost and predation resulting from market expansion concepts in the Draft Guidelines. Finally, an appendix of hypothetical case examples and another summarizing the major cases will also be added.

Notes

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[1] R.H. Bork, *The Antitrust Paradox: A Policy at War with Itself* (Toronto: Toronto Free Press, 1993).

[2] J. McGee, "Predatory Price Cutting: the Standard Oil (N.J.) Case" (1958) 1 Journal of Law & Economics 137 and F.H. Easterbrook, "Predatory Strategies and Counter Strategies" (1981) 48 University of Chicago Law Review 263.

[3] B. Yamey, "Predatory Price Cutting: Notes and Comments" (1972) 15 J. of Law & Economics 129 and J. Milgrom & J. Roberts, "Predation, Reputation and Entry Deterrence", (1982) 27 Journal of Economic Theory 280.

[4] *Supra* note 2.

[5] P. Areeda & D.F. Turner, "Predatory Pricing and Related Practices under Section 2 of the Sherman Act" (1975) 88 Harvard Law Review 697. Other proposed rules for detecting predation include selling below long run average cost with intent to lessen competition, D.F. Greer "A Critique of Areeda and Turner's Standard for Predatory Practices" (1979), 24 Antitrust Bulletin, 223 and R. Posner, *Antitrust Law: An Economic Perspective* (Chicago: University of Chicago Press, 1976); a combined structural factors- price-cost test, P.L. Joskow & A.K. Klevorick, "A Framework for Analyzing Predatory Pricing Policy" (1979), 89 Yale Law Journal 213; post-entry pricing and output decisions by an incumbent firm, W.J. Baumol, "Quasi-Permanence Of Price Reductions: A Policy for Prevention of Predatory Pricing" (1979) 89 Yale Law Journal 1 and O.E. Williamson, "Predatory Pricing: A Strategic and Welfare Analysis" (1977) 87

Yale Law Journal 284; a "total circumstances" test was proposed by F.M. Scherer "Predatory Pricing and the Sherman Act: A Comment" (1976), 89 Harvard Law Review 869; and, finally, a combined structural factors-exit inducing test was proposed by J.A. Ordover & R.D. Willig, "An Economic Definition of Predation: Pricing and Product Innovation" (1981) Yale Law Journal 8.

[6] M. Trebilcock et al., *The Law and Economics of Canadian Competition Policy*, Chapter 5 (Toronto: University of Toronto Press, 2002) contains an excellent summary of various economic points of view on predation.

[7] For a description of Parliament's consideration, see Chapter 5 of *The Objectives of Canadian Competition Policy 1888-1983* by W.T. Stanbury & P.K. Gorecki (The Institute for Public Policy, 1984) and *Competition Policy in Canada, The First Hundred Years* (Bureau of Competition Policy, Consumer and Corporate Affairs, 1989) at 12-13.

[8] 1969 Report of Economic Council. Also see R.J. Patton, "A Business perspective on the Application of Criminal law to Pricing Practices under the Competition Act", published in Papers of the Canadian Bar Association Fall Conference on Competition Law, 2000. The 1996 *Report of the Consultative Panel on Amendments to the Competition Act* recommended the repeal of paragraph 50(1)(a) and section 51. However, this recommendation was not ultimately included in Bill C-20 which was passed by Parliament and came into force March 18, 1999.

[9] *R.* v. *Carnation Co.* (1968) 58 C.P.R. 112 (C.A. Alta).

[10] In *R.* v. *Perrault Driving Schools* the accused was convicted by a jury and sentenced to a year of imprisonment for conspiracy and geographic price discrimination in the Eastern Townships of Quebec. There are also two unreported cases, *R.* v. *Howard et. al.* (1958) South Burnaby, B.C. Police Court Government No. 50-1 and *R.* v. *Fairmount Plating (Alta.) Ltd.* (1977) Alta. Supreme Court Trial Division Government No. 255-1. In both cases the accused were acquitted basically on the grounds that the pricing behaviour involved meeting the competition. In *R.* v. *Canada Safeway Ltd.* (1973), 12 C.P.R. (2d) 3 (Alta. Trial Div.), the matter was settled by way of a prohibition order.

[11] *R.* v. *Producers Dairy Ltd.* (1966), C.P.R. (2d) 265.

[12] *R.* v. *Hoffman LaRoche* (1980), 28 O.R. (2d) 164 affirmed (1981), 33 O.R. (2d) 694 (C.A.).

[13] *R.* v. *Consumers Glass Co.* (1981), 33 O.R. (2d) 228.

[14] *Boehringer Ingelheim (Canada) Inc.* v. *Bristol-Myers Squibb Canada Inc.*, (1998) C.P.R. (3d) 51 (Ontario Court of Justice - General Division).

[15] *R.* v. *Hoffman LaRoche* (1980), Supreme Court of Ontario, Reasons for Sentence, No. 252.

[16] This conclusion is noted by D.F. McFetridge & S. Wong in "Predatory Pricing in Canada: The Law and the Economics" (1985), 63 Canadian Bar Review 4 at 698.

[17] *Enforcement Guidelines on Abuse of Dominant Position*, Industry Canada, July 2001.

[18] *Director of Investigation and Research* v. *Tele-Direct Publications Inc.* CT 94/03. The judgement specifically endorses recoupment as an essential element of predation. "The essence of an allegation of predatory pricing is that the firm foregoes short-run revenues by cutting prices, driving out rivals, and thus providing itself with an opportunity to recoup more than its short-term losses through higher profits earned in the longer term in the absence of competition." (at 293). Also see *Director of Investigation and Research* v. *The NutraSweet Company* CT 89/2 at 73-78.

[19] In 1992 and 1993, the Bureau issued the *Predatory Pricing Enforcement Guidelines* and the *Price Discrimination Enforcement Guidelines*, respectively.

[20] *Matsuhita Electric Industrial Co.* v. *Zenith Radio Corp.* 475 U.S. 574 (1986).

[21] *Supra* note 5.

[22] The U.S. Supreme Court affirmed the necessity of a "dangerous probability of recoupment" in its decision in *Brooke Group Ltd.* v. *Brown & Williamson Tobacco Corp.* 509 U.S. 209 (1993).

[23] *Supra* note 19 at 13.

[24] See "Is the Price Right? Comments on the Predatory Pricing Enforcement Guidelines and Price Discrimination Guidelines of the Bureau of Competition Policy" by L.A.W. Hunter & S. Hutton (1993) McGill Law Journal 830. *Supra* note 6, Trebilcock et al. endorse the 1992 Guidelines as consistent with sound economic principles and jurisprudence, and advocate removing the elimination of a competitor branch from the statute.

[25] Bill C-235 passed first reading in October 1997 and was then referred to the Standing Committee on Industry.

[26] J.A. VanDuzer & G. Paquet, Anticompetitive Pricing Practices and the Competition Act: Theory, Law and Practice (University of Ottawa, 22 October 1999, available on the Bureau's website).

[27] For a description of Alternative Case Resolutions see the *Conformity Continuum Bulletin*, Competition Bureau available at www.competition.ic.gc.ca. Prosecutions of predatory pricing by the Antitrust Division of the United States Department of Justice are also quite rare. The *Americans Airlines* case currently before the appeal courts is the first predatory pricing case taken by the Antitrust

Division in two decades. See *Predatory Pricing and State Below Cost Sales Statutes in the United States: An Analysis*, a study prepared for the Competition Bureau by Terry Calvani, a former Commissioner of the U.S. Federal Trade Commission, which is also available on the Bureau's website. Private suits are more common in the United States, but since the *Brooke Group* v. *Brown & Williamson* decision in 1993, few predatory pricing cases have survived summary judgement. See P. Boulton, J.F. Brodley & M.H. Riordan, "Predatory Pricing; Strategic Theory and Legal Policy" (2000) 88 Georgetown Law Review.

[28] *A Plan to Modernize Canada's Competition Regime*, Report of the Standing Committee on Industry Science and Technology, April 2002, House of Commons Canada.

[29] *Ibid.* See the Foreword by the Committee's Chair.

[30] The latter theory was advanced in *Brooke Group* v. *Brown & Williamson*. The U.S. Supreme Court rejected the argument on the grounds that conditions leading to an expectation of an increase in interdependent market power that would result in recoupment were not evident. The Court did not reject the theory that predation could be harmful if it leads to increased interdependence.

[31] The 35% market share and high barriers to entry indicators of market power are used in the *Merger Enforcement Guidelines, Enforcement Guidelines on Abuse of Dominant Position* and the 1992 Guidelines. The Draft Guidelines use the language " .. a market share of more than 35%, or if its market share is considerably greater than its rivals..." Footnote 8 of the 1992 Guidelines identifies where a firm with less than a 35% market share could affect pricing.

[32] See Boulton, Brodley & Riordan, *supra* note 27. In "Paradigm Shift: The Competition Bureau's Draft 'Enforcement Guidelines for Illegal Trade Practices: Unreasonably Low Pricing Policies' " by L.A.W. Hunter & J. Brown (2002) 21:1 Can. Comp. Rec. 86, the authors claim the Bureau is proposing the use of avoidable costs to be consistent with arguments the Bureau is using in its current litigation with Air Canada. They also allege the Bureau is adding more fixed cost items to the cost standard in an effort to make it easier to establish predation.

[33] For example, see discussion of *Nutrasweet* and *Teledirect* above. Also see G.J. Dorman, "Implementing Price/Cost Tests for Predation: Practical Issues" Antitrust Report May 2002. The latter addresses issues of calculating costs in the airline industry.

[34] *Supra* note 27 at 2271

[35] For example, if a ready mix concrete or waste disposal firm acquires additional specialized trucks to engage in a predatory campaign, the non-sunk costs of the equipment would be included in the calculation of avoidable cost.

[36] Hunter & Brown, *supra* note 32.

[37] For example, 46 submissions were received on the draft *Intellectual Property Enforcement Guidelines* in the first round of consultations and 19 submissions in the second round on the revised draft of the document. Possibly the low response rate results from the potentially divisive nature of the issue where business associations include members from both the large and small businesses communities.

[38] *Supra* note 32 at 98.

[39] The U.S. government's argument of "reputation for predation" was rejected at the court of first instance in *U.S.* v. *AMR Corporation et. al.* , D. Kansas, 99-1180 JTM, April 30, 2001. Reputational effects, however, were accepted in *Advo, Inc.* v. *Philadelphia Newspapers, Inc.* 51 F.3d. 1196 (3rd Circuit 1995) and were incorporated in a U.S. Department of Transportation Proposal under the Clinton Administration entitled "Proposal – Unfair Exclusionary Conduct in the Airline Transportation Industry Policy", Trade Regulation Reporter ¶ 50,163, May 1998.

[40] In a footnote to their paper, Hunter & Brown indicate that Stikeman Elliott is counsel to Air Canada in the current litigation before the Competition Tribunal under section 79, abuse of dominant position.

EFFICIENCY STANDARDS: THEY ALSO SERVE WHO ONLY SIT AND WEIGH(T)[1]

By: Peter G.C. Townley[2]

Author's Note: The following paper responds to a number of articles published in this journal concerning the attributes of the author's balancing weights approach and other efficiency defence standards. In its January 31, 2003 decision in the *Superior Propane* case (see the Message from the Editors at (i)), the Federal Court of Appeal accepted the Competition Tribunal's application of the balancing weights approach, although noting (at para. 21) that the Tribunal "did not adopt the precise model of Professor Townley." As the author was an expert witness in *Superior Propane*, he is not in a position to discuss how the balancing weights approach was interpreted and applied in *Superior Propane* until the litigation in that case comes to an end.

Introduction

Zalmanowitz (2001: 17) suggests, "Perhaps the ultimate question that arises out of *Superior Propane* is what kind of efficiency defence is best for Canada? – a question that Parliament may have to re-visit after the *Superior Propane* litigation comes to an end." Many have not exhibited Mr Zalmanowitz' patience; the re-examination process has already begun, perhaps due to the importance of the issue and to the uncertainty as to when *Superior Propane* will end.

For example, earlier this year, the House of Commons Standing Committee on Industry, Science and Technology made Recommendation 28:[3]

> That the Government of Canada immediately establish an independent task force of experts to study the role that efficiencies should play in all civilly reviewable sections of the *Competition Act* ...

On October 1, 2002, the Government responded to the Committee Report and stated as follows regarding Recommendation 28:

> The Government believes that it may be helpful to the ongoing debate of this issue to examine the treatment of efficiencies in merger cases in other jurisdictions. Therefore, it will commission a study on the treatment of efficiencies in merger review internationally and submit the findings of this benchmarking exercise to a parliamentary committee.

And, although discussion and possible amendments involving efficiencies need not be limited to section 96 of the *Competition Act*, MP Dan McTeague's private member's bill C-249 proposes amendments to it.[4]

Surely this type of review is overdue. Regarding section 96, Sanderson (1997: 625) notes: "The efficiency exception is broadly framed, and so, it may be argued, supports various interpretations ranging from a pure consumer welfare standard to a total welfare approach." If, in 1986, it was apparent that Parliament's intent was not clear, one wonders why clarification was not sought then.[5] Moreover, it does not help the matter that section 1.1, the "purpose clause" (like it or not), embraces potentially conflicting objectives without providing adequate guidance – within it, section 96 or any other section – as to how they might be resolved. Perhaps the warning bells set off by

Justice Reed's *obiter* observations, concerns and questions expressed in *Hillsdown* were not loud enough. In any case, if members of the antitrust community were waiting for jurisprudence to settle the matter, they now have Justice Evans' Federal Court of Appeal ruling in *Superior Propane*.

This journal, especially, has published much discussion concerning the merits of preferred efficiency standards and the deficiencies of others. Indeed, all the usual suspects have been rounded up – the balancing weights approach and the total surplus, consumer surplus and price standards[6] – and participants include Fisher et al. (2000), Gudofsky & Gay (2000), Lusk (2002), Mathewson & Winter (2000), Sanderson (2002), Trebilcock &Winter (1999-2000), Tyhurst (2001), Ware (2001) and Wong (2000).

Still, for good reason, witnesses in the *Superior Propane* case have, until recently, remained silent. That changed for the better, I think, with McFetridge (2002).[7] My view is that the balancing weights vs. total surplus debate, at least as it applies to the *Superior Propane* case, has been dealt with by the Federal Court of Appeal, so any discussion now limited to the relative merits of efficiency standards will have no bearing on the final outcome of that case. Further, whereas the focus in *Superior Propane* regarding efficiency standards is on what is and what was meant, a fuller discussion of what should be in advance of the parliamentary process suggested by Mr. Zalmanowitz would be, on balance, in the public interest.

Professor McFetridge intimates, perhaps tongue-in-cheek, that theologians are required to make balancing weights operational. If true, then they are also needed to pick through the price, consumer surplus and total surplus standards, because all entail ethical judgments with respect to the distributional impacts of mergers. Still, economists can take the identification and analysis of the inevitable efficiency-equity trade-offs quite a way ... yet stop short of preaching.[8]

Preliminaries

No debate would be necessary if perfect information regarding individuals' dollar gains and losses, social marginal utilities of income and the socially optimal method of aggregation were available, and if the objective were to allow welfare-increasing mergers and not to allow welfare-decreasing ones. A simple computer programme would suffice. However, as some of this information is private and/or unknowable, we are faced with formidable measurement and aggregation problems. The problem of how to assess a situation where some people would gain at the expense of others is neither new nor specific to mergers.

One way to deal with this problem is to apply the "Pareto Improvement Criterion": allow the act only if it makes at least one person better off and no person worse off. Application of this criterion involves no measurement of gains and losses and avoids interpersonal comparisons of utility. In merger analysis, its specific form is the price standard.

Another way is to apply the "Potential Pareto Improvement Criterion". In its simplest form, an act satisfies this criterion if the gains of gainers exceed the losses of losers such that the gainers could, hypothetically, compensate losers and still remain better off. Its merger-specific form is the total surplus standard. As compensation need be hypothetical only, satisfaction of the general criterion is neither necessary nor sufficient to conclude that the act

would result in a social gain. To make that step, either the distributional impacts of the act cannot be adverse or some other mechanism – in the background or linked to the act – must be operating to neutralize adverse distributional impacts. If distributional impacts are deemed adverse, and no accompanying mechanism exists to mitigate or prevent them, no conclusion regarding social well-being can be drawn from satisfaction or non-satisfaction of this criterion.

Whereas the price standard and total surplus standard are two extreme ways of dealing with ignorance, the balancing weights approach is simply a way, using whatever merger-specific information is available, to permit a judgment as to which of the two extreme standards is most likely to yield the correct answer: allow mergers in the public interest and stop those that would diminish it.

Although some have declared – without supporting argument – that the balancing weights approach is "unworkable", the economics of it have not been challenged in any fundamental way. On the other hand, while the total surplus standard is clearly workable, this is achieved at considerable sacrifice of economic legitimacy. Moreover, it does not appear to be appreciated that arguments against the balancing weights approach are not arguments for total surplus but, rather, for any arbitrary rule including the price standard, which has a much stronger foundation in welfare economics.

The focus of this paper is the balancing weights vs. total surplus debate, although I go beyond it in order to address other issues that may be fundamental to the resolution of Mr. Zalmanowitz' "ultimate question." As a value judgment is involved in the choice or application of all efficiency standards, one of these issues involves which body, Parliament or the Competition Tribunal, is to make it. That is, is it possible for Parliament to establish an ethical framework for the Tribunal to apply? The answer is important if only because one body has case-specific information available to it whereas the other does not.

To give the discussion a more precise context, I suggest the following:

- that only the monopoly (selling), not the monopsony (buying), case be considered;
- that various cases involving price discrimination be set aside;
- that a merger's impact on dynamic efficiency be considered neutral for our purposes;
- that we be mostly concerned with efficiency-enhancing, price-increasing mergers;
- that the merger in question would cause a substantial lessening of competition per section 92;
- that "price" means "effective price", thus accounting for complications such as merger-induced quality changes;
- that we call those who gain from such mergers "shareholders", "gainers", "producers" or simply "winners", and those who would lose "losers" or "consumers";[9]
- that we set aside the net export and small-medium firm considerations of section 1.1; and

- that the terminology used to describe various standards and their descriptions be drawn from either McFetridge (2002) or Townley (1999), thus avoiding confusion of terms: pure price standard vs. modified price standard, total surplus vs. total welfare vs. aggregate welfare, using "consumer surplus standard" when one really means either it, the total surplus standard or the price standard *et cetera*.

Total Surplus and Distributional Impacts - Assuming the Problem Away

McFetridge (2002: 45) states: "The good news is that the total surplus interpretation of section 96 which had come to be the Tribunal's preferred interpretation may yet survive as the default standard where evidence of adverse distributive effects or the weight to be attached to them is inconclusive." This is, of course, what application of the balancing weights approach dictates in the circumstances noted. The difference between the methods arises when a merger would have adverse distributional impacts. As McFetridge continues, "The assumption that redistributive effects are neutral is the essence of the total surplus standard."[10] That is, whereas the balancing weights approach is an attempt, albeit with imperfect information, to account for such adverse impacts, the essence of the total surplus standard is to assume away their existence and/or importance.

That there exists resistance to incorporating or even checking for distributional concerns in merger analysis is somewhat surprising. It is true that total surplus is consistent with the third postulate of Harberger (1971): deduct consumers' losses measured by the change in consumer surplus from producers' gains as measured by the increase in producer surplus, and there is your answer.[11] However, seven years later Professor Harberger advised how to proceed using a set of distributional weights in the event that an efficiency-equity trade-off were necessary. He states (1978: S113-4):

> One sure way to avoid paying an exaggerated price in terms of lost efficiency for the redistributive benefits that a weighting scheme would bring into account is simply to require that policies and projects should pass both tests – the pure efficiency test imposed by traditional applied welfare economics plus the weighted test that emerges when the welfare gains and losses of different groups are multiplied by designated weights before the balance is struck. [emphasis added]

Except for recognizing that a full set of distributional weights is likely not available, the method Harberger describes is equivalent to the second and third steps of the balancing weights approach described in Townley (1999). The similarity of methods is no small thing.

In its simplest form, when only highly aggregated information concerning winners and losers is available, balancing weights requires the ratio of gains to losses to be calculated. (This number must be greater than one if the merger satisfies the total surplus standard.) Assume, in a specific merger case, that this ratio is $1.x$. The question for decision makers is this: do you have evidence that would cause you to believe that the distributional impacts of this merger would be so egregious that the losses of losers should be accorded a premium in excess of x%. If you do not have such evidence, allow the merger; if you do, reject it. To make this method operational requires information regarding the relative income characteristics of winners and losers (including concentration and how they may overlap) and, perhaps, nationality.[12] If more disaggregated information is available, it can be incorporated.[13] Ultimately, a value judgment is required.

Mathewson & Winter (2000: 90) note that "carrying the welfare-weights approach to its full conclusion means that mergers such as the IntraWest acquisition of Whistler Mountain (which combined the adjacent Blackcomb and Whistler mountain ski area) could be accepted in spite of the prediction of negative cost efficiencies and a positive deadweight loss because the merger produced a favourable redistribution of wealth from very wealthy consumers (on average) to less wealthy shareholders." Although such a merger[14] would both fail Harberger's suggested method and be ruled out by the second step of the balancing weights approach,[15] their point is that there is a logical inconsistency in the latter (and my point is that the same is true of Harberger's). As failure to satisfy the Potential Pareto Improvement Criterion (or any of its derivatives such as total surplus) constitutes neither a necessary nor sufficient condition that the merger is welfare-decreasing or -increasing, it is possible that positive distributional impacts might outweigh negative efficiency consequences such that a merger could be, overall, welfare-enhancing.

From a pure welfare economics perspective, the Mathewson-Winter observation is absolutely correct. Although I am willing to drop the second step in the balancing weights approach, the one that would disallow efficiency-decreasing mergers, there may be resistance to this. For example, my interpretation of recent rulings is that whereas efficiencies do not trump the other objectives of section 1.1, they are to be treated as the most important one. Not allowing efficiency-decreasing mergers may be seen as a safeguard in this regard, perhaps akin to avoiding Harberger's "exaggerated price."

Nevertheless, removing this (TS > 0) condition may not have much impact. It is likely that the frequency of efficiency-increasing mergers is higher than that of efficiency-reducing ones if only because, *ceteris paribus*, the former are potentially more profitable than the latter. This is only to say that the incentive to merge for the profits reaped from the exercise of market power plus efficiencies is greater than the incentive to merge for these profits minus inefficiencies.

The text of Part 5[16] of the 1991 *Merger Enforcement Guidelines* effectively assumed away equity issues: "Where a merger results in a price increase, it brings about both a neutral redistribution effect[57] and a negative resource allocation effect on the sum of producer and consumer surplus (total surplus) within Canada" [emphasis added]. However, the accompanying footnote 57 reads: "When a dollar is transferred from a buyer to a seller, it cannot be determined *a priori* who is more deserving, or in whose hands it has a greater value."

Whereas the footnote is true but hollow – if we know nothing, then we know nothing – the text is inane. If it is impossible to determine how the parties affected by a merger value dollars – their marginal utilities of income (or wealth) – then, obviously, it is impossible to determine that they value them identically. If there is not enough information to say they are different, there is not enough to say they are the same. *A priori*, there is no basis for concluding that the redistribution is neutral or is not neutral. That this "conclusion" of neutrality is used to justify the total surplus standard is quite bizarre.

It is not unusual to make assumptions in order to make problems tractable. However, good methodology requires either that the reasonableness of assumptions be assessed or that the conclusion reached be robust with respect to alternative assumptions. It is rather muddled thinking that leads to "there are no adverse distributional impacts because we are using total surplus". Total surplus entails a value judgment in the form of the assumption that

transfers are neutral (that social marginal utilities of income are equal). It is not value-free. Moreover, when transfers are not neutral, total surplus breaks down as an indicator of aggregate well-being.

"Feel Good" Economics

Attempts have been made to make this problem seem minor or non-existent. Ware (2001: 4) puts a Bork-like spin on the matter:

> The Federal Court of Appeal's decision states continually that a merger involving a price increase implies a transfer of wealth from "consumers to producers". It is an unfortunate expression in this context that appears to take a position on behalf of defenseless consumers and against exploitative producers. In reality, there is no such thing as a transfer from consumers to producers. All income flows to "consumers" in the end. Shareholders are consumers. All price increases involve a transfer of wealth among consumers – this is the correct statement. Such a statement of course appears quite inoffensive and neutral. [emphasis in last line added]

Settling for the appearance of neutrality would not seem consistent with Canada's being "the most economically sophisticated merger law in the world."[17] Although Professor Ware's comments go beyond semantics, would anyone really be indifferent between being a winning-producer-consumer and a losing-consumer-consumer? The impact of a transfer on aggregate well-being is the issue, and a name change only masks the reality that some transfers between human beings are bound to be offensive and non-neutral.

Simons (1948: 123) has strong views in this vein:

> All the grosser mistakes in economic policy, if not most manifestations of democratic corruption, arise from focusing upon the interests of people as producers rather than upon their interests as consumers, that is, from acting on behalf of producer minorities rather than on behalf of the whole community as sellers of services and buyers of products. One gets the right answers usually by regarding simply the interests of consumers, since we are all consumers; and the answers reached by this approach are presumably the correct ones for laborers as a whole.

Moreover, whereas all shareholders may be consumers, not all consumers are shareholders. If we are to worry about consumers, and as consumption is the sole rationale for economic activity (according to no less an authority than Adam Smith[18]), then it is the price standard, not the total surplus standard, that should be adopted.

Indeed, proponents of the price standard have at least three strong arguments going for them *vis-à-vis* the total surplus standard and the consumer surplus standard:

- a merger that satisfies this standard unambiguously enhances the well-being of Canadians, whereas the other two do not carry this guarantee;
- of the three, the price standard requires the least information (and measurement); and
- given the requirement of "national treatment", it would not allow mergers for the benefit of foreign shareholders to the detriment of Canadian consumers, whereas the other two would – total surplus to the greater degree.[19]

GDP as a Measure of Economic Well-Being

Sanderson (1997: 627) offers an argument in support of total surplus somewhat related to Professor Ware's:

> In contrast, a consumer-oriented approach advocates treating consumers as more deserving of the wealth transfer than shareholders. Yet, when viewed in a general equilibrium context, this money is recirculated within the economy in any event, no matter who initially, or last, held it. Hence, it does not matter whose pocket the money flows through.

Part of the confusion may arise from the implicit equating of aggregate well-being and GDP. A transfer between two Canadians will have no impact on measured GDP. However, to conclude from this that aggregate well-being (social welfare) is unchanged does not follow.[20] Any notion that somehow a transfer will roll around the economy and eventually come to rest in the originator's pocket – even for a nanosecond – and thus effect compensation is quite interesting, but unfounded.[21] As no compensatory mechanism exists, a transfer between two people involves an increase in the lifetime utility of one person and a decrease in lifetime utility of the other. Determining whether or not a policy or act that creates winners and losers is in the public interest – increases social welfare – is not as easy as counting up dollar gains and losses.

There is a broader issue. A feature common to the total surplus standard, the consumer surplus standard and the balancing weights approach is that they would allow uncompensated transfers; gainers actually gain and losers actually lose. This is not a feature of other civil legislation. Take expropriation laws, for example. If a government expropriates a farmer's land, for instance, the affair does not end there. We do not identify the expropriation as a transfer and deem it unworthy of attention. We do not say that the government represents people, and the farmer is a person, so the transfer is between people, and they are all consumers, so put this way the "statement of course appears quite inoffensive and neutral." We do not say that this land will be used, so "when viewed in a general equilibrium context" the fruits of this use will eventually make it back into the pockets of the dispossessed farmer.

Rather, in non-totalitarian societies we demand that the farmer be compensated, either by an agreed purchase price or by application of expropriation legislation. As there is no external mechanism to effect compensation, it must be dealt with within the actual expropriation legislation. The relevance of this to merger laws, *mutatis mutandis*, is obvious.

The farmer of the example has, and exercises, his property rights, but do consumers have a right to competitive (or pre-merger) prices? Fisher *et al.* (2000) think they do:

> Any merger likely to raise prices would in effect constitute theft of some consumers' property without giving them anything in return. In a democracy, each person, wealthy or poor, has the right not to have his property stolen, no matter how poor the thieves are.

If Parliament were to accept this view, presumably the price standard would be adopted.

Usher (1983: 2)[22] uses different language, preferring "the word 'predation' to the word 'theft' because the former is technical while the latter is legal." Theft or predation, property right or not, my sense is that, as a society, we are willing to allow some individuals to be disadvantaged to the benefit of others in specific circumstances. Delineating

these "specific circumstances", which entails establishment of an ethical framework, is or should be part of efficiency defence standard design.

A Mathematical Problem Requiring an Ethical Assumption

The essential problem is that when wealth is transferred even just between two people, it is impossible to determine if their joint well-being increases, decreases or remains the same without additional information regarding their social marginal utilities of income. As this information is likely unknowable, an assumption entailing a value judgment is required. This is a mathematical problem of aggregation in need of an assumption if it is to be resolved. As winners and losers are involved, this assumption will have an ethical dimension.

As noted above, the total surplus standard is an application of the Potential Pareto Improvement Criterion ("PPIC"). That compensation of losers need only be hypothetical is where the PPIC – and by extension the total surplus standard – is of dubious usefulness as a stand-alone indicator of welfare change. That it enjoys the widespread support of antitrust economists is surprising given its treatment in mainstream journals and textbooks. For example, Blackorby & Donaldson (1990: 472) state:

> The ethical judgments implied by the compensating-variation [PPIC] test are not defensible. It treats increases in income as equally socially valuable no matter who receives them. Social judgments revealed by government policy and the overwhelming majority of individual judgments are not consistent with this indifference toward inequality.[23]

The problem vanishes if compensation is actually paid. If it is, the Pareto Improvement Criterion is satisfied because, after compensation, no person would be left worse-off and at least one person would be better-off. Without actual compensation, however, total surplus can only deal – and is only meant to deal – with allocative and technological efficiencies.

The cost-benefit analysis equivalent of total surplus is often applied in public sector project evaluation, but this does not mean that distributional impacts are ignored. In many cases it may be simply that reasons exist to believe that such impacts are mitigated by another mechanism working in tandem. For example, suppose the Government of Canada decides to increase the nation's defence capability. It may be argued that such a policy favours the wealthy because they have more to protect. Assume this is true. If the necessary funds were to be raised through a progressive income tax, it is also true that the wealthy will pay relatively more than others for the benefits they receive. Many would judge the distributional impacts of the project to be mitigated by this method of finance.

There is more to it. Although it may appear that the PPIC is being applied in project evaluation, usually mixed in are acts involving actual compensation. For example, if a defence project involves expansion of the nation's air defences, planes are bought and these transactions are, presumably, mutually advantageous (generating a Pareto Improvement, not just a potential one). If land is required for a highway, compensation is paid. If a bridge over water has the potential to harm marine stocks and thus the livelihoods of those who harvest them, contingency funds are set aside in order to mitigate those damages should they occur. If roadway expansion would increase noise pollution, sound barriers are erected. At the end of the day, it may be more difficult to find instances when losses are not compensated, avoided or mitigated than when they are.

Still, if it is likely that a stand-alone project will have adverse (net) distributional impacts, appropriate distributional weights can be applied.[24] The point is that if no other mechanism or instrument exists to mitigate distributional impacts when necessary, they have to be accounted for within the stand-alone policy (or test) itself in order to give it economic legitimacy. If not, applications of the PPIC (such as total surplus) do not yield economically meaningful answers.

The question of whether another mechanism is or could be coupled with total surplus, such that both the efficiency and equity aspects of mergers would be accounted for, is discussed below. One mechanism that is touted as a solution may actually exacerbate the problem. The other mechanism described might work, but other costs associated with it may be excessive and, for this reason and others, it has not found support in the antitrust community.

Better Ways

One mantra chanted in support of total surplus and against balancing weights is that there are better ways than antitrust enforcement, such as taxes and transfers, to redistribute income. Hazledine (1994: 11) describes this justification of total surplus as "specious and probably disingenuous." Although Professor Hazledine is quite correct, it is the source of this misguided mantra that interests me. One reason for it may be a failure to distinguish intervention in otherwise competitive markets for efficiency objectives from intervention for distributional (equity) objectives. A second reason may be lack of appreciation that the existing tax-and-transfer system may actually exacerbate the distributional impacts of mergers.

Regarding the first, consider an otherwise competitive output market. If the government wishes to intervene because of some equity (distributional) objective, it will attempt to enforce a price lower than the equilibrium if it wishes to help consumers and to enforce one higher than what the equilibrium price would be if it wishes to aid producers. The former case usually involves price ceilings, while the latter often involves price supports maintained through some supply (mis)-management scheme. In both cases, less than what the competitive equilibrium output would have been is produced and consumed, and a deadweight loss results. So, if all this works according to plan, efficiency is sacrificed for equity.[25] Economists will point out that the same equity objectives could likely have been attained in a less distortionary manner (causing less deadweight loss) had the government employed a suitable mix of taxes and transfers instead.[26]

All of this is true, but how it relates to merger policy is confusing. Economists think governments should not intervene in otherwise well-functioning competitive markets in attempts to redistribute income. Why, then, would we advocate that merging firms intervene in otherwise well-functioning competitive markets in order to redistribute income to themselves? Antitrust laws, at least in part, prevent such redistribution.

Moreover, to chant the tax-and-transfer story as the saving grace of total surplus suggests that this system somehow results in the compensation of losers (thus satisfying the Pareto Improvement Criterion after compensation). Unfortunately, instead of ameliorating the distributional impacts of mergers, it is likely that the current tax-and-transfer system exacerbates them. If the merger is profitable, it is true that those who gain will pay higher taxes than otherwise, likely in the form of a mix of corporate and personal income taxes. Those who lose because of a

merger, however, should not expect compensation. First, direct taxes and transfers are income-based, and pure[27] consumers' nominal incomes have not changed.[28] They are not compensated by an increase in transfers because this system does not identify them as losers. Moreover, if the good in question is subject to indirect taxation (e.g., GST), consumers will take one hit because of the merger-induced increase in price and another because (*ad valorem*) taxes paid on the good will rise with the price.

By itself, the outcome of any PPIC-based test, like total surplus, has no normative content. As total surplus by itself does not yield meaningful answers with respect to the impacts of mergers on aggregate well-being, what is needed is something else – some other policy or mechanism – coupled with it.

In some circumstances, a potential companion policy to total surplus would be price regulation. If we were to allow mergers based on total surplus, but require the behavioural remedy that the prices of the goods or services involved not rise relative to pre-merger levels, there is the potential for such mergers to satisfy the Pareto Improvement Criterion; that is, consumers would be no worse-off and owners of the merging firms would still reap efficiencies. Moreover, as the post-merger quantity would be larger with price regulation (if effective) than without, any efficiencies arising from variable cost savings would be larger than otherwise (while fixed cost savings would not be affected). If it were possible to couple total surplus with price regulation in this manner, both the efficiency and equity concerns raised by mergers would be addressed.

However, there are costs of regulating to be considered. These would include, at least, the costs of monitoring and compliance. Also, a proper scheme could be quite complicated (and thus expensive) as one would wish to allow price movements caused by ordinary market forces but not those attributable to market power. No doubt these and other reasons account for the lack of popularity of behavioural remedies in general.

Still, the point remains that unless total surplus is coupled with some compensating mechanism, the basic problems of lack of normative content and how to treat adverse distributional impacts remain.

Balancing Weights in Practice

If we possessed all the information required to aggregate the utility impacts of a price-increasing, efficiency-enhancing merger, we would need neither the total surplus standard nor the balancing weights approach. However, we do not possess the information required to conduct this efficiency-equity trade-off perfectly. Whereas no effort is made to overcome this information problem when total surplus is applied, balancing weights presents a way – one of many possible ways – that causes decision makers to focus on the relevant aspects of this trade-off.

The ultimate decision requires a value judgment, and this will entail some view of vertical equity. The notion that the value of an extra dollar to a person diminishes as income increases is not new, and reflects only the assumption that a dollar lost by a poor person causes more pain than a dollar lost by a wealthy one.[29] An assumption is only an assumption, of course, but this one would appear to be more widely acceptable – and acted upon – than the alternatives. Marshall (1920: 108) puts it this way:

> This involves the consideration that a pound's worth of satisfaction to an ordinary poor man is a much greater thing than a pound's worth of satisfaction to an ordinary rich man . . . In earlier generations, many statesmen, and even some economists, neglected to make adequate allowance for considerations of this class, especially when constructing schemes of taxation; and their words or deeds seemed to imply a want of sympathy with the sufferings of the poor, though more often they were simply due to lack of thought.

Which distributional impacts might be "egregious" and who decides the matter, taking into account what information is available to the deciders, are both relevant issues. They are discussed below, after a few "technical" ones.

Mathewson & Winter (2000: 90) state:

> If redistributive effects were consistently accounted for, a merger that was unacceptable when wealthy Canadian families closely held the merging firms would suddenly become acceptable if a teacher's pension fund bought the shares. The incentives for share ownership by wealthy and less wealthy individuals would then be affected, the impact of merger policy on these incentives would become an issue for concern, and merger analysis could become hopelessly complex.

My understanding of this concern is that if a merger were in the offing, a less wealthy group might purchase shares from a wealthy group, distributional impacts would now be deemed to be not worrisome and the merger would, in effect, be judged solely on its efficiency merits. Perhaps. However, if the profits expected from the post-merger exercise of market power, in whole or part, were capitalized into the sale price of the shares, it would not be difficult to determine the actual distributive consequences of the merger. If the point is that mergers between widely held merging firms are less likely to raise equity concerns than closely held ones, this is true, the reason being that the overlap of winners and losers is more probable.

On the matter of overlap, when an individual is both a producer and consumer of the good the merging firms produce, Ware (2000: 6) raises this point:

> Paradoxically, however, this methodology [Balancing Weights] would then require the Tribunal to treat losses to consumers as a class differently from gains to shareholders as a class. A quirky implication is that a shareholder-consumer who gains a dollar as a shareholder and loses a dollar as a consumer would be deemed to be worse off.

Professor McFetridge (1999) raises the same issue, noting the "absurd implication that the same individual values a dollar paid out more highly than a dollar received." However, if this overlap were complete, presumably any differential weighting of consumers and shareholders would be deemed unreasonable. According to the balancing weights approach, the calculated weight is to be assessed regarding its "reasonableness". The number (x above) calculated, by itself, means nothing in the absence of further assessment with respect to the circumstances of the particular merger case. One does not calculate x, then flip a coin; further thought is required.

Somewhat ironically, the case Professors McFetridge and Ware identify is one where it would be quite unreasonable, presumably, to impute any premium to consumers' losses relative to shareholders' gains. Thus, in the circumstances they identify, if the merger satisfied the total surplus standard, it would <u>also</u> be allowed under the balancing weights approach. "Quirky", "absurd" results, just as when one conducts any proof by contradiction, have the merit of

pointing the analyst to the correct conclusion. Moreover, they point to a case where distributional impacts may cause concern: when winners and losers constitute more-or-less distinct groups based on income characteristics.

The Value Judgment

The balancing weights approach requires a value judgment, based on case-specific evidence, regarding the efficiency-equity trade-off that arises when an efficiency-enhancing merger would harm consumers. Although this approach has been criticized for requiring a value judgment, all other standards are conditioned on value judgments as well. For example, total surplus accords equal distributional weights and the price standard gives winners zero (or losers infinite) relative weight, both regardless of the actual circumstances of a particular merger. Consumer surplus lies between these extremes, but should not be seen as a reasonable compromise.[30]

Although Professor McFetridge calls for theologians to make such judgments, I would be reluctant to accord special status to an "expert" opinion proffered by a theologian, economist, lawyer, doctor, hockey player *et cetera* on the basis of that person's occupation. One reason economists give for abstaining from normative judgments is that, because there is no basis in economics for them, their value judgments are not to be judged as any more valid than any other person's – and I would add that no other person's should be judged to be more valid than that of an economist.[31] In my view, Justice Evans (at paragraph 116 of the Federal Court of Appeal ruling) understood my point exactly:

> Conversely, it is in my view far from a fatal objection to the balancing weights approach that its proponent at the hearing before the Tribunal, Professor Townley, testified that, as an economist, he was unable to determine what were the effects of the merger of Superior and ICG and whether the efficiencies likely to be produced thereby were greater than, and offset, them. I take his point simply to have been that he was called as a witness expert in economics and that the balancing exercise called for by section 96 required broader public policy judgments that were outside his area of expertise, but were for the Tribunal to make as it thought would best advance the public interest within the parameters of the Act.[32]

This is not to say that economists have no role. Presumably, information concerning the potential distributional impacts of a specific merger, as disaggregated as possible, would be of use to the Tribunal. Although one appreciates the reluctance of individuals to make value judgments that affect others, any assessment of the severity of distributional impacts (or lack thereof) based on the evidence at hand would yield a more informed decision than either the price standard or the total surplus standard. That these impacts cannot be assessed with mechanical precision and then perfectly traded off against efficiency impacts has drawn criticism, but surely more criticism might be directed at the other standards because they incorporate no assessment at all based on the available evidence.

Two Issues

Two issues emerge. The first has to do with predictability vs. the scope for error. The total surplus and price standards are more predictable and more easily litigated than the balancing weights approach. However, the price standard treats distributional impacts as egregious both when they, in fact, are and when they are not. Similarly,

the total surplus standard treats these impacts as negligible both when they are and when they are not. Therefore, application of the former comes with the likelihood of disallowing potentially welfare-enhancing mergers, while the latter involves the likelihood of allowing welfare-diminishing mergers. By accounting for the actual nature of the distributional impacts of a specific merger, the balancing weights approach lessens both of these probabilities and thus the cost of these errors. Because balancing weights is an "informed" approach, conditioned on case-specific information, it is more likely to treat distributional impacts as negligible when they are negligible, and to treat them as egregious when they are, in fact, egregious.

The second issue is related. Who makes the value judgment, the Tribunal or Parliament? As matters stand, whether allowed efficiencies are sufficient to overcome any adverse distributional impacts is left to members of the Tribunal, in the sense that they would apply their own values to the problem or values they perceive to be commonly held and in the public interest.

Some might claim, including members of the Tribunal, that it is up to Parliament to express its will, and that if there is a value judgment to be made it should be made by legislators. Gudofsky & Gay (2000: 77) offer a potential solution:

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

However, even if distributional impacts were listed in section 93 and/or 96, unless legislators were also able to articulate what constitutes the "public interest" and how to resolve the various conflicts that will inevitably arise, it is difficult to see how this would relieve members of the Tribunal of the necessity of making decisions with ethical dimensions and implications. Although Parliament could provide an ethical framework, setting out how it is to be applied by the Tribunal may not be possible.

If the Gudofsky-Gay solution were feasible, in that it provided the Tribunal with adequate direction to exercise an "equity exception", then the balancing weights approach would be operational. Parliament would have determined the ethical framework, and the Tribunal could apply it. Problem solved.

Nevertheless, for the sake of argument, assume that a solution along these lines were not possible or not advisable for whatever reasons. Parliament would, of course, set the ethical framework. However, if application of this framework could not be delegated, it would have to be mandated without knowledge of any specific case-related information or evidence. As the balancing weights approach requires the assessment of such evidence, Parliament would have reduced its options to the price standard, the consumer surplus standard and the total surplus standard.

The Federal Court of Appeal has already ruled on total surplus so, unless section 1.1 of the Act were to be amended, it is likely out of the running. I am aware of no support for the consumer surplus standard except that of

Fisher et al. (2000), and even their main arguments (including the issue of property rights) favour a price standard, which they advocate more strongly.[33]

Therefore, depending on whether or not a framework can be fashioned by Parliament for application by the Competition Tribunal, the efficiency defence debate could well come down to the price standard vs. the balancing weights approach. Of course, the debate must go beyond efficiency standards because there are other factors (e.g., dynamic efficiency and the other elements of section 1.1) to be considered. Mr. Zalmanowitz' "ultimate question" is complex, so one should not expect the assessment of it to be a simple exercise.

Notes

[1] With apologies to John Milton, Sonnet 19, "On His Blindness" (c. 1652).
[2] Professor of Economics at Acadia University and 2001-2002/2002-2003 T.D. MacDonald Chair in Industrial Economics at the Competition Bureau. The views expressed are not purported to be those of the Commissioner of Competition. The author thanks Gwill Allen, Marc Duhamel and Gernot Kofler for their insights.
[3] See Lastewka (2002) for the full report.
[4] See McTeague (2002). Conceivably, efficiency considerations could be treated in sections 92 and/or 93 of the Act, and section 96 could be rescinded. Indeed, it may be wise to put all sections related to mergers, including section 1.1, on the table.
[5] One wit has suggested that it should be possible today to "dig up" enough MPs from 1986 in order to put the question of intent to them.
[6] Descriptions of these four standards may be found in Townley (1999) for the case of mergers from no pre-existing market power to monopoly. Mathewson & Winter (2000) provide a description of the total surplus standard with pre-existing market power. See Hazledine (1998) for the case for having no efficiency defence.
[7] Professor McFetridge's rebuttal affidavit of my affidavit and my affidavit can be found on the Competition Tribunal's web site. See McFetridge (1999) and Townley (1999). Although the Tribunal did not post my "reply" affidavit, some of its elements appear below.
[8] Stigler's (1982) *The Economist as a Preacher* may provide interesting reading in this regard.
[9] Ware (2001) wishes everyone to be called a "consumer", as in "some consumers gain and other consumers lose". I address some of Professor Ware's concerns below.
[10] Professor McFetridge correctly identifies this as an assumption. Its seeming transformation to fact in the *Merger Enforcement Guidelines* is discussed below.
[11] Especially in the case of multiple price changes, estimation of compensating and/or equivalent variations is preferred to "change in consumer surplus".
[12] At paragraph 198 of the redetermination decision in *Superior Propane*, the Tribunal states: "Accordingly, the Tribunal agrees with counsel for the Commissioner that the portion of the transfer experienced by foreign consumers should be excluded in the section 96 analysis. However, the Tribunal does not agree that so doing is a matter of discretion." Presumably, foreign shareholders would be accorded symmetric treatment. This is an important issue for merger evaluation.
[13] Cowell & Gardiner (1999) is instructive in this regard and for estimation procedures and estimates of UK elasticities of marginal utilities of income.
[14] I assume, for the sake of discussion, that a substantial lessening of competition could be found in this case.
[15] The first step is to allow mergers that satisfy the price standard, and the second is to not allow a merger that does not satisfy the total surplus standard.
[16] No longer applicable, but still available at http://strategis.ic.gc.ca/SSG/ct01032e.html.
[17] Barutciski & Facey (2000: 36).
[18] See Adam Smith (1776, Book 4, Chapter 8): "Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to only so far as it may be necessary for promoting that of the consumer."
[19] As Ross (1997: 643) puts it: "...[I]t is unlikely that, in a democratic republic, elected policymakers would or should favor a policy that permits consumer-exploiting mergers because the result will maximize overall societal wealth through economic efficiency, especially in the context of a continental market where the economic harm may occur in Canada while the offsetting economic benefits will occur in the United States."

[20] Even first-year economics textbooks explain why GDP (or GNP) should not be equated with social welfare.
[21] This is akin to the "trickle-down" theory George Bush Sr. labelled "voodoo economics"
[22] See also Usher (1987).
[23] See Boadway & Bruce (1984) for a textbook treatment and Calabresi (1991) for a law journal one.
[24] See Townley (1998) regarding an evaluation procedure suitable for the inclusion of distributional weights and Treasury Board Secretariat (1998) for a discussion of the use of them in project evaluation.
[25] In some instances, however, the efficiency loss is incurred but either the equity goal is not achieved or, even, the distributional impacts are opposite to what the government intended; for example, when a black market forms in response to a price ceiling.
[26] For a fuller discussion of this see Raynauld *et al.* (1994), especially Chapters 8 and 9.
[27] Consumers who do not share in increased profits.
[28] Although a person's nominal income does not change, the increase in price(s) causes that income to yield less utility.
[29] As Cowell & Gardiner (1999) point out, these sorts of inter-personal comparisons require that individuals' utility scales be roughly the same. The Pareto Improvement Criterion – the price standard in the context of mergers – is a usual default if inter-personal comparisons of utility are to be avoided or are not feasible.
[30] The Pareto Improvement Criterion and the Potential Pareto Improvement Criterion, respectively, provide the welfare economics foundations for the price standard and the total surplus standard. Professor McFetridge and I agree that the consumer surplus standard has no foundation in welfare economics. Although McFetridge (2002) notes some of the weaknesses of this standard, a fuller critique of it may be found in Duhamel & Townley (2002).
[31] Any of these people could, of course, offer a personal opinion, not necessarily based on anything to do with their own circumstances.
[32] McFetridge (2002: 49) states that I "declined to provide any guidance as to how the reasonableness of the balancing weight should be determined, having no basis in economics for doing so." In fact, I directed the Tribunal to the Act for guidance.
[33] See also Lande (1989).

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