CANADIAN COMPETITION RECORD

THE *CANADA PIPE* CASE

CANADA PIPE – TRIBUNAL FINDS EXCLUSIVITY REBATE BY DOMINANT FIRM NOT ANTI-COMPETITIVE

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Introduction

Canada Pipe[2] is the first contested abuse of dominance case that the Competition Bureau has lost. It is the first finding by the Competition Tribunal in its almost 20 year history of interpreting the *Competition Act* that a practice of exclusive dealing by a dominant firm was not anti-competitive.[3]

The Tribunal found that although Canada Pipe Company Limited ("Canada Pipe") was a dominant firm (it had an 80-90% market share), its loyalty discount program was not anti-competitive and did not substantially lessen competition.

In its decision, the Tribunal made reference to a number of features that, in the Tribunal's view, distinguished Canada Pipe's exclusivity program from exclusive arrangements the Tribunal had found to be anti-competitive in previous cases. Specifically, the Tribunal found that while Canada Pipe's stocking distributor program gave distributors an economic incentive to deal with Canada Pipe exclusively, it was not coercive (distributors could exit the program at certain times without penalty, and were not impeded from purchasing selectively from Canada Pipe at undiscounted list prices). The Tribunal also found that Canada Pipe's exclusivity program did not prevent entry (although in fact only limited entry had occurred, the Tribunal found it was too early to conclude that such entry was viable, and the Tribunal indicated a finding of viability was key to ascertaining the effectiveness of new entry). The Tribunal also accepted that there was a valid, efficiency-enhancing business rationale for the exclusivity arrangements, in that they resulted in increased sales volume for Canada Pipe, reducing its unit costs and allowing it to profitably stock less frequently used products.

Although *Canada Pipe* can be factually distinguished from cases in which the Tribunal has found an abuse of dominance to have occurred, some of the distinctions drawn by the Tribunal are arguably relatively minor. It may be too early to predict whether *Canada Pipe* reflects a significant shift in the Tribunal's analysis of abuse of dominance cases, or is simply the result of applying its traditional analysis to a different set of facts. Furthermore, the impact of the decision on future cases will likely depend in part on the outcome of the Commissioner's appeal, which was commenced on March 7, 2005 and has yet to be heard.

In our view, it is unlikely that the decision in *Canada Pipe* reflects any reduction in the Tribunal's level of concern regarding anti-competitive practices by dominant firms. It is likely that the Tribunal will continue to prohibit exclusivity practices of dominant firms where they are found to have the requisite exclusionary purpose and anti-competitive effect. This would be consistent with the Tribunal's previous decisions and with the approach to dominance cases taken in many (but not all) U.S. cases.

Regardless of the outcome of the appeal or the interpretation given to the decision in future cases, the decision in *Canada Pipe* clearly demonstrates the Tribunal's willingness to consider the competitive impact of exclusive dealing practices engaged in by dominant firms, rather than following a structural approach under which competitively restrictive conduct by a dominant firm is condemned as anti-competitive – as appears to have been the case in the European Community (see below).

Summary of Decision

Background

The products at issue in Canada Pipe were cast iron drain, waste and vent ("DWV") pipes, fittings and mechanical joint couplings. At the time of the Commissioner's application to the Tribunal, Canada Pipe manufactured pipe and fittings in Canada and imported couplings manufactured by its U.S. affiliates. Vandem Industries ("Vandem") was the only other Canadian manufacturer of DWV pipe and fittings; Vandem also imported couplings.[4] Other sellers of DWV products in Canada imported pipe, fittings and couplings primarily from the United States and Asia.

Prior to 1997, cast iron ("DWV") pipe and fittings were manufactured in Canada by four foundries belonging to Dave Gooding or companies controlled by him, including Bibby Ste-Croix Foundries Inc. ("Bibby"). In 1997, Canada Pipe purchased two of those foundries, one of which was subsequently closed. As part of the sale and purchase agreement, the vendors and shareholders of Bibby agreed, for a period of seven years, not to engage in the manufacture, sale or distribution of cast iron DWV products or any similar business in Canada.

In the same year, two former officers of Bibby founded Vandem. Vandem concluded an agreement with a foundry in Ontario to begin producing cast iron pipe, and began importing cast iron fittings and mechanical joint couplings.

In 1998, Canada Pipe acquired Cremco Supply Ltd. ("Cremco"), a Canadian manufacturer of couplings and an importer of other DWV products. As part of the sale and purchase agreement, the vendors and shareholders of Cremco agreed, for a period of seven years, not to engage in the manufacture, sale or distribution of cast iron DWV products or any similar business in Canada. The same year, Bibby purchased BMI Canada Inc.'s imported cast iron DWV fittings inventory. BMI Canada Inc. then withdrew from the relevant markets.[5]

The Tribunal found that the total value of cast iron DWV product sales in Canada was approximately $30 million per year.[6] The Tribunal concluded that since pipe, fittings and couplings could be bought separately from different suppliers and that pricing differed for each of them, there were in fact three distinct product markets rather than

a single unified cast iron DWV product market. Similarly, as different market forces operated in different parts of the country, the Tribunal found there were six distinct geographic markets in Canada, for a total of 18 relevant markets (three product markets in each of six geographic markets). The Tribunal found that Canada Pipe controlled between 80% and 90% of the market for cast iron DWV products (the Tribunal did not make explicit findings regarding market share in each of the 18 relevant markets). Vandem's share was approximately 10%. Importers, including Sierra Distributors and New Centurion, accounted for approximately 5% of Canadian sales.

On October 31, 2002, the Commissioner of Competition applied to the Competition Tribunal for an order under the exclusive dealing (s. 77) and abuse of dominant position (s. 79) provisions of the *Competition Act*. The Commissioner alleged that Canada Pipe's stocking distributor program (described below) created, enhanced and preserved Canada Pipe's market power. The Commissioner also challenged certain acquisitions by Canada Pipe of competitors, and restrictive non-compete covenants in the acquisition agreements, under the abuse of dominance provision.[7]

The Tribunal's Decision

Dominance

As noted above, Canada Pipe accounted for 80% to 90% of the sales of cast iron DWV products in certain markets. Unsurprisingly, the Tribunal found that Canada Pipe could and did exercise market power in the three relevant product markets (cast iron pipes, fittings and mechanical joint couplings) and six geographic regions (British Columbia, Alberta, Saskatchewan and Manitoba, Ontario, Quebec, and Atlantic Canada). Canada Pipe had high margins and significant ability to vary prices across regions.

However, entry (by Vandem and importers) had occurred and had had an impact on prices, particularly in British Columbia, Alberta and Ontario. Prices for Canada Pipe's products were lower in British Columbia than in Quebec even though the products were manufactured in Quebec. The Tribunal noted that entry had been limited and its viability had yet to be determined.[8] Distributors and contractors had weak countervailing power. The limited real growth potential of the market may have discouraged more significant entry.

Anti-Competitive Acts

<u>Acquisitions and Restrictive Covenants</u>

Prior to 1998 Canada Pipe had made a number of acquisitions, some of which included restrictive covenants. Since 1998, although new players had entered the market and others had increased their sales, Canada Pipe had made no further acquisitions. The Tribunal found that Canada Pipe's acquisitions did not constitute a practice of anti-competitive acts; indeed, they could be seen as "a rational move... in a mature industry".[9] Furthermore, the acquisitions occurred more than three years before the Commissioner applied for an order and the limitation provided in section 79 applied.[10]

The Tribunal stated that restrictive covenants are a normal part of business. Agreements to sell a business usually contain such clauses, and the Commissioner had not shown that the restrictive covenants were unreasonable.

The Stocking Distributor Program

The main practice at issue in the proceedings was Canada Pipe's stocking distributor program. The stocking distributor program was a preferential rebate program whereby distributors of Canada Pipe's products obtained significant rebates and discounts in return for stocking Canada Pipe's products exclusively. Participants received discounts off Canada Pipe's list prices as well as quarterly and yearly rebates.[11] Apart from a minimum purchase requirement, the percentage discounts and rebates did not vary with the volume purchased. There were no signed contracts for the program and distributors could join or exit at any time. The discounts were applied at the time of purchase, provided the distributor had committed to being part of the program, and rebates were applied for each completed calendar quarter or year. Except for losing the rebates for the year and quarter to date, there were no penalties for opting out of the program.

As Canada Pipe was the only full-line supplier in Canada, it was not feasible for a distributor to avoid dealing in Canada Pipe's products entirely – a customer who did not want to participate in the stocking distributor program could buy some products from other sources but would need to purchase less frequently used items from Canada Pipe at undiscounted prices. There was evidence that it was relatively easy to source 80-90% of the most commonly used products from other suppliers and that Canada Pipe would be most likely to supply the others.

The Commissioner's expert concluded that as a result of the discounts and rebates available to participants in the stocking distributor program, unless a customer was prepared to give 2/3 of its business to a competitor who was offering prices at 50% of Canada Pipe's list prices it was more economical for the customer to purchase exclusively from Canada Pipe. The Commissioner argued that Canada Pipe's stocking distributor program was anti-competitive because once distributors were part of the program it was so costly to withdraw (and partially source their products from other suppliers) that Canada Pipe's competitors were unable to entice distributors to deal with them.

The Tribunal found that the terms of the stocking distributor program were "not onerous". At the beginning of every calendar year, distributors were free to terminate the arrangement without any loss or financial penalty. Every quarter, distributors could opt out at a cost of the rebate for the year to date. Distributors could reinstate the program the following quarter. The terms were known and transparent. Competitors knew when distributors might be interested in switching, and the conditions of exit were easy to manage. There were no penalties or liquidated damages. The program did not pose a significant legal obstacle to switching suppliers.

The Tribunal also accepted one of Canada Pipe's business justifications for the program – that it needed to sell a certain volume in all three product categories to maintain full production of all product lines. Canada Pipe had argued that the exclusivity arrangements allowed it to produce a high volume of product, reducing its unit costs and enabling it to sell low-volume products at reasonable prices. The Tribunal found that the availability of less frequently used products served the interests of distributors and contractors, whether or not they participated in the program, and ultimately benefited the consumer.

Crucially, the Commissioner failed to persuade the Tribunal that switching costs were a sufficient deterrent to prevent distributors from changing suppliers. Although the stocking distributor program was an attractive program for a distributor, it did not prevent a distributor from considering other options or from purchasing elsewhere if it was more advantageous to do so. The Tribunal found that the stocking distributor program had had an impact on competitors but had not prevented entry or expansion. The rebate structure in the program was an inducement to exclusive dealing but the program did not have an exclusionary effect.

Ultimately the Tribunal found that the program bore "none of the characteristics that were found offensive in *Nielsen, NutraSweet* or *Laidlaw*."[12] Its terms were clear, its duration was short, non-performance by the distributor did not result in penalty clauses or liquidated damages, it did not have an exclusionary effect as was evident from the fact that it had not prevented entry or competition (at least in some regions), and furthermore Canada Pipe demonstrated that it had a valid business justification.

Accordingly, the Tribunal concluded that the stocking distributor program did not substantially lessen or prevent competition.

Exclusive Dealing

Both parties dealt with section 77 only summarily. The Tribunal concluded that the stocking distributor program was a practice of exclusive dealing. However, the Commissioner failed to persuade the Tribunal that it impeded or was likely to impede entry of a new competitor or have any other exclusionary effect, or that it had lessened competition substantially.

Was *Canada Pipe* Correctly Decided?

As indicated above, the Commissioner has appealed the Tribunal's decision, and predicting the outcome of the Commissioner's appeal is beyond the scope of this article. However, on the basis of the Tribunal's findings of fact, it appears that the Tribunal's decision not to prohibit Canada Pipe's stocking distributor program was a reasonable one as a matter of economic theory.

Entry

An exclusionary act by a dominant firm is welfare decreasing if it results in the exit or contraction of, or prevents the entry or expansion of, a more efficient rival. The Tribunal's findings regarding the characteristics of the cast iron DWV product market, and the design of the stocking distributor program, suggest that it would not likely have had that effect.

Indeed, the Tribunal found that "the most striking argument against the alleged anti-competitive effect of the SDP" was that it had not prevented entry or expansion, at least in some regions.[13] Although entry may have been "difficult" (because, among other things, Canada Pipe was a known manufacturer that offered a complete line of products and the market was not growing), this was unrelated to the stocking distributor program. The Tribunal emphasized that, after the program was implemented, a manufacturer entered the market (the first such

entry in 30 years) and obtained a 10% market share within a period of four years. Importers had also increased their market share from 2.5% to 5%.

It could be argued that the entry and expansion that had occurred was too limited to effectively constrain Canada Pipe's market power. Indeed, the Tribunal noted that it remained to be seen whether the competitors who had entered were viable.[14] As discussed below, the combined share of Canada Pipe's competitors was close to LePage's share of transparent tape sales which the U.S. Third Circuit found had not "genuinely challenged 3M's monopoly".[15] However, there was other evidence (regarding the low cost of establishing an import business, and the availability of domestic foundry capacity that could be economically converted to cast iron DWV production) to support the Tribunal's conclusion that entry was feasible. There was also evidence that, where and when entry had occurred, it had resulted in lower prices.

The Nature of the Exclusivity Program

Exclusionary terms cannot be unilaterally imposed on buyers. They require acceptance by the buyer, and they will not be accepted unless the buyer is made better off (i.e., unless the cost to the buyer of complying with the exclusivity terms is outweighed by the consideration given by the seller in exchange for the agreement to comply with them).[16] It will not be profitable for a seller to compensate buyers for entering into exclusionary agreements unless either: (i) there are efficiencies to exclusive dealing; or (ii) there are contracting externalities that prevent buyers from reaching the efficient outcome.[17]

If exclusive dealing results in net, offsetting efficiency gains, it should not be prohibited (at least under a total welfare standard). The important question, therefore, is whether there are contracting externalities that would lead to an inefficient (anti-competitive) outcome.

Canada Pipe's expert identified two circumstances where externalities could result in an anti-competitive exclusive dealing arrangement: (i) an exclusive dealing contract with substantial penalties for a breach imposes an additional cost for switching to a new entrant or other competitor;[18] and (ii) if sufficient buyers sign exclusive dealing contracts so that the remaining business would be insufficient to support a competitor, this would allow the supplier to monopolize the market and raise the prices charged to non-exclusive customers.[19] The stocking distributor program did not have either of these characteristics.

With regard to penalties for breach, customers could exit the program at the beginning of any calendar year with no penalty or at the beginning of any quarter at a cost of 4% of the year-to-date purchases. There were no penalty clauses or liquidated damages. The main advantage of the program, the discount, was provided as soon as the distributor entered the program and was only unavailable from the moment the distributor chose to leave the program, i.e., it was not taken away retroactively.

With regard to the second circumstance, the stocking distributor program did not discriminate among buyers. The terms of the program were clear, transparent and available to all distributors.

Conclusion

Taking the Tribunal's conclusions about the feasibility of entry and the stocking distributor program's impact on prices at face value, it is difficult to see how customers (distributors) could have been negatively impacted by the program. In these circumstances, and given that there were no significant costs to exiting the program and it did not discriminate among buyers, the Tribunal's conclusion that the program was not anti-competitive is not surprising.

Is *Canada Pipe* Consistent with Previous Tribunal Decisions?

The Tribunal reviewed its decisions in previous cases where it had found an exclusionary practice to constitute an abuse of dominant position. As noted above, the Tribunal used strong language in concluding that Canada Pipe's stocking distributor program did not have any of the anti-competitive characteristics that were found to be offensive in *Nielsen, NutraSweet, Laidlaw* or *Tele-Direct*.[20]

- In *Nielsen* and *Laidlaw*, the Tribunal found binding contracts with heavy opt-out penalties to be anti-competitive, since would-be entrants were precluded from competing for locked-in customers.
- In *Nielsen*, the Tribunal found that, in the context of binding contracts with heavy opt-out penalties, exclusivity clauses were an additional barrier to competition which offered no economic advantage.
- In *NutraSweet*, the Tribunal found clauses that encouraged customer loyalty to have an exclusionary effect in the context of a comprehensive contract that included exclusive supply and use provisions, as well as other provisions designed to preclude competition, such as a meet-and-release clause.
- In *NutraSweet*, customers faced significant switching costs including changing labels and promotional campaigns, and customers were reluctant to lose the goodwill associated with the NutraSweet brand.
- In *Tele-Direct*, the Tribunal found that actions that ultimately harmed customers, by depriving them of a true choice, or harmed competitors because Tele-Direct was powerful enough to directly interfere in business relationships between competitors and suppliers, were anti-competitive.

It appears that it was of central importance to the Tribunal's decision that the stocking distributor program did not "appear to have an exclusionary effect or cause detriment to the consumer."[21] Indeed, the Tribunal found that the program "serves the interests of distributors and contractors, whether or not they belong to the SDP, and ultimately benefits the consumer."[22] It found that "although the SDP is an attractive program for a distributor, it does not prevent the distributor from considering other options, or from purchasing elsewhere if it is more advantageous to do so."[23]

In the Tribunal's view, one important factor that distinguished *Canada Pipe*'s loyalty program was that distributors who did not wish to purchase exclusively from Canada Pipe could still purchase selected products from it. In fact, the evidence was that they had no choice but to purchase some DWV products from Canada Pipe (at significantly higher prices) because they were not available from other suppliers. Although the magnitude of the

discounts and rebates appeared to provide a powerful incentive to deal exclusively with Canada Pipe, the Tribunal found that it had not in fact precluded some distributors from dealing with Canada Pipe on a non-exclusive basis. In the Tribunal's view, this was in contrast to the situation in *Nielsen, Laidlaw* and *NutraSweet*, where customers were contractually required to obtain products or services from the dominant supplier exclusively or not at all.

Of course, because there were some products that were currently only available from Canada Pipe, Canada Pipe could have tried to set the non-exclusive prices of those products high enough that no distributor would have had an incentive to leave the stocking distributor program. Assuming that the Tribunal was correct in its finding that Canada Pipe's non-exclusive prices were not already that high, it is not clear that it would have been profitable for Canada Pipe to pursue such a strategy. If Canada Pipe had significantly raised the price of any particular product, one or more of its competitors would likely have begun making or importing that product. It does not appear that Canada Pipe had any intellectual property rights or that there were other barriers to entry that would have prevented its competitors from supplying any particular DWV product; it was simply not economically feasible for them to supply every DWV product.

Accordingly, while some might argue that the magnitude and nature of the exclusivity discount in *Canada Pipe* resulted in a *de facto* exclusion of competitors, that was not the finding of the Tribunal. This appears to be the primary element that distinguished the loyalty program in *Canada Pipe* from loyalty programs which had been prohibited in previous Tribunal decisions. Although the stocking distributor program provided an attractive incentive for customers to deal exclusively with Canada Pipe, there were no binding contracts, heavy opt-out penalties (at least at certain times of the year), meet-or-release clauses, prohibitive switching costs (apart from the loss of the exclusivity discounts) or other factors that deprived customers of a "true choice". The Tribunal also accepted that Canada Pipe had a legitimate business justification for its exclusivity program.

Is *Canada Pipe* Consistent with Abuse of Dominance Cases in the United States?

Two recent decisions of the United States Court of Appeals for the Third Circuit have found exclusive dealing practices by dominant firms to be contrary to §2 of the Sherman Act. However, certain features of the exclusive dealing practices may explain the different results in those cases. It does not appear that U.S. courts consider loyalty discount programs by dominant firms to be *per se* Sherman Act violations, or that *Canada Pipe* is necessarily inconsistent with recent U.S. jurisprudence.

Dentsply

In *United States v. Dentsply Int'l Inc.*, the Department of Justice challenged an exclusive dealing practice under §2 of the Sherman Act.[24] Dentsply manufactured artificial teeth for use in dentures and other restorative appliances. It sold them to dental products dealers, who in turn supplied the teeth and various other materials to dental laboratories. Dentsply had a 75-80% market share on a revenue basis or 67% on a unit basis. There were about 12 other manufacturers, the largest of which had a 5% share. In 1993, Dentsply adopted a requirement

that its authorized dealers not add competing product lines to their offering (i.e., with the exception of pre-1993 grandfathered sales, Dentsply dealers were required to sell Dentsply products exclusively).

The District Court for the District of Delaware denied the injunctive relief sought by the government. The District Court found that direct distribution to dental laboratories was a viable method of distribution, and thus Dentsply's exclusive arrangements with dealers did not foreclose a substantial share of the market or present an unreasonable restraint on competition. The District Court found the government had failed to prove that Dentsply's actions had been or could be successful in preventing new or potential competitors from gaining a foothold in the market.

On appeal, the Court of Appeals for the Third Circuit reversed the decision and remanded the case to the District Court with directions to grant the injunctive relief requested. The Third Circuit court stated that the proper inquiry was not whether direct sales enabled a competitor to "survive" but rather whether direct selling "poses a real threat" to the defendant's monopoly.

Dentsply's exclusive dealing practice can be distinguished from Canada Pipe's stocking distributor program on the basis that, while Canada Pipe permitted distributors to purchase from Canada Pipe on a non-exclusive basis, with the exception of limited grandfathering, Dentsply's dealers were required to sell Dentsply products exclusively. As Dentsply operated on a purchase order basis, its distributor relationships were essentially terminable at will. There was evidence that Dentsply enforced the exclusivity requirement by threatening to terminate dealers who sold competing products. It appears that the coercive nature of the Dentsply program was an important distinguishing feature.

Furthermore, unlike in *Canada Pipe* where the Tribunal concluded that the evidence failed to establish that the purpose of the stocking distributor program was "predatory, exclusionary or disciplinary",[25] the Court of Appeals in *Dentsply* found not only that Dentsply intended to keep competition from gaining a toehold, but also that the exclusive arrangement impeded entry/expansion of rivals to the point where they did not pose a real threat to Dentsply's monopoly. While Canada Pipe's competitors had not obtained high market shares, and the Tribunal did not ultimately conclude that they were "viable", the Tribunal was apparently satisfied that their entry or expansion had resulted in lower prices (i.e., had mitigated Canada Pipe's market power) at least in certain parts of the country. Whether this analysis of the significance of the entry and expansion that had occurred reflects an important qualitative difference in the facts at issue, or different (conflicting) conclusions on similar facts, is perhaps open to debate.

3M

In *LePage's Inc. v. 3M* ("*3M*"), LePage's sued 3M alleging violations of §2 of the Sherman Act.[26] LePage's argued that 3M violated §2 by: (i) offering rebates to customers conditioned on purchases spanning six of 3M's product lines;[27] and (ii) entering into contracts that expressly or effectively required dealing virtually exclusively with 3M. The jury ruled in favour of LePage's. The District Court for the Eastern District of Pennsylvania subsequently granted 3M's motion for judgment as a matter of law as to the attempted maintenance of monopoly

power claim, but concluded that the jury could reasonably have found that 3M's exclusive dealing and bundled rebates could sustain a verdict under §2. On appeal, a panel of the Court of Appeals for the Third Circuit reversed the District Court's judgment on LePage's §2 claim by a divided vote. The Court granted LePage's motion for a rehearing en banc, and on rehearing a majority affirmed the District Court's judgment, i.e., affirming the jury verdict against 3M with respect to exclusive dealing and bundled rebates.[28]

The evidence was that 3M, which manufactured Scotch tape, had approximately 90% of the United States transparent tape market until the early 1990s. In about 1980, LePage's decided to sell "second brand" and private label transparent tape. By 1992, LePage's sold 88% of private label tape in the United States (which represented approximately 14% of total transparent tape sales).

3M introduced its bundled rebate programs in 1993. The Court found that 3M's rebates to some customers were as much as half of LePage's prior tape sales to that customer. By 1997, LePage's market share had fallen to 9.35% of total tape sales and it closed one of its two plants. At the time of trial, LePage's share had declined to 67% of the private label business. LePage's asserted that 3M used its monopoly over its Scotch tape brand to gain a competitive advantage in private label tape sales.

There are similarities between the conduct at issue in *3M* and *Canada Pipe*. Similar to Canada Pipe's stocking distributor program, 3M offered discounts to customers for buying a wide range of products exclusively (or nearly exclusively) from 3M, including several products which LePage's did not make. However, there are also several significant differences in the factual findings that may explain why 3M's conduct was found to be unlawful while Canada Pipe's conduct was not prohibited.[29] First, there was evidence that 3M entered the private label tape market for the purpose of eliminating competing private label suppliers, and that it planned to recoup its forsaken profits by abandoning the private label segment and selling more higher-priced Scotch tape once its competitors had been eliminated. The District Court stated the following:

> The jury could reasonably infer that 3M's planned elimination of the lower priced private label tape, as well as the lower priced Highland brand, would channel consumer selection to the higher priced Scotch brand and lead to higher profits for 3M. Indeed, Defendant concedes that "3M could later recoup the profits it has forsaken on Scotch tape and private label tape by selling more higher priced Scotch tape...if there would be no competition by others in the private label tape segment when 3M abandoned that part of the market to sell only higher-priced Scotch tape."[30]

LePage's expert testified that the price of Scotch tape had increased since 1994, after 3M instituted its rebate program. By 1996, 3M had begun to offer incentives to some customers to increase purchases of Scotch tape over 3M's second-tier brand. 3M internal memoranda indicated 3M's interest in raising prices.

Second, the District Court found that there was "substantial evidence at trial that significant entry barriers prevent competitors from entering the...tape market in the United States." Indeed, while the leading competitors' market shares were roughly equal in the *3M* and *Canada Pipe* cases (9.35% for LePage's and approximately

10% for Vandem), the evidence that LePage's share had declined (from approximately 14%) following the introduction of the bundled rebate program may have been significant. Conversely, in *Canada Pipe*, the Tribunal found that while entry was difficult, the stocking distributor program had not prevented the entry or expansion of competitors in some parts of the country.

Even if the stocking distributor program resulted in the exit of some of Canada Pipe's current competitors, if there were no material barriers to entry Canada Pipe could not expect to recoup forsaken profits (because subsequent price increases would lead to new entry). Put another way, if the Tribunal was correct in its finding regarding entry, there would have been no incentive for Canada Pipe to implement the stocking distributor program unless the program was profitable whether or not it resulted in the exit of competitors.

Third, it appears that 3M had at least three different types of rebate programs (Executive Growth Fund, Partnership Growth Fund and Brand Mix Rebates) which it offered to certain retailers at different times. Within each program, it appears that the volume targets and rebate magnitudes were customer-specific. Conversely, Canada Pipe's stocking distributor program was available to all distributors on identical terms. As indicated above, one way in which a supplier can exclude a more efficient potential competitor is by entering into exclusivity arrangements in exchange for low prices with some customers but not others. If economies of scale are important (as they apparently were in *Canada Pipe* and *3M*), the incumbent will be able to deter entry by locking up a sufficient number of customers, and may be able to recoup its losses by charging monopoly prices to the remaining customers. This may have been a valid concern in *3M*, but would not have been a concern under the terms of Canada Pipe's stocking distributor program.[31]

Finally, it appears that 3M's stated business justification for the exclusivity arrangement was relatively weak (and was rejected by the Court):

> Although 3M alludes to its customers' desire to have single invoices and single shipments in defense of its bundled rebates, 3M cites to no testimony or evidence in the 55 volume appendix that would support any actual economic efficiencies in having single invoices and/or single shipments. It is highly unlikely that 3M shipped transparent tape along with retail auto products or home improvement products to customers such as Staples or that, if it did, the savings stemming from the joint shipment approaches the millions of dollars 3M returned to customers in bundled rebates.
>
> There is considerable evidence in the record that 3M entered the private-label market only to "kill it."[32]

In contrast, the Tribunal accepted Canada Pipe's justification that the exclusivity arrangement allowed it to maintain a high sales volume, reducing unit costs and making it economically feasible to stock a full range of products.[33]

Is *Canada Pipe* Consistent with Abuse of Dominance Cases in the European Union?

European competition law has traditionally been seen as more hostile toward fidelity or loyalty discounts than U.S. or Canadian law. In particular, European courts have traditionally found loyalty discounts by dominant firms (other than straight line volume discounts) to be anti-competitive and to contravene Article 82 unless they reflect lower costs resulting from the exclusivity arrangement. This approach, reflected in recent decisions of the Court of First Instance in *Michelin II* and *British Airways*, is clearly inconsistent with the Tribunal's decision in *Canada Pipe*.

Michelin II

In *Michelin II*,[34] the Commission of the European Communities held that Manufacture française des pneumatiques Michelin ("Michelin France") abused its dominant position in the markets for new replacement tires and retread tires for trucks and buses through a system of rebates, discounts and other financial benefits the main objective of which was to tie resellers to Michelin France and to maintain its market share. The Commission imposed a fine of €19.76 million and ordered Michelin France to refrain from repeating any of the alleged abusive conduct or adopting any measure having equivalent effect. Michelin France's application to the Court of First Instance was dismissed on September 30, 2003.

Michelin II concerned two sets of rebate structures. From 1980 to 1996, Michelin France provided three categories of general rebates to dealers: (i) quantity rebates, expressed as a percentage of the dealer's purchases of Michelin tires, with the percentage rate increasing according to the quantity purchased; (ii) a "service bonus" based on quality of service to the dealer's customers; and (iii) a "progress bonus" based on the dealer's year-over-year increase in new tire sales. After 1997, Michelin France adopted a new rebate structure with four categories of rebates: (i) invoice rebates based on the volume of purchases in the previous one, two or three years; (ii) an achieved-target bonus for dealers who achieved an agreed-upon value of purchases; (iii) end-of-year rebates designed to adjust the invoice rebate to reflect actual purchases; and (iv) a multi-product rebate for dealers who achieved sales targets for more than one tire category.

In its decision, the Court of First Instance reviewed prior case law and confirmed that an exclusive dealing arrangement by a dominant firm is considered a *per se* abuse of dominance:

> With more particular regard to the granting of rebates by an undertaking in a dominant position, it is apparent from a consistent line of decisions that a loyalty rebate, which is granted in return for an undertaking by the customer to obtain his stock exclusively or almost exclusively from an undertaking in a dominant position, is contrary to Article 82 EC. Such a rebate is designed through the grant of financial advantage, to prevent customers from obtaining their supplies from competing producers.[35]

Quantity rebate systems linked solely to the volume of purchases made are generally considered not to have this foreclosure effect. However, the Court confirmed that even volume discounts may be considered abusive in some circumstances:

> It follows that a rebate system in which the rate of the discount increases according to the volume purchased will not infringe Article 82 EC unless the criteria and rules for granting the rebate reveal that the system is not based on an economically justified countervailing advantage but tends, following the example of a loyalty and target rebate, to prevent customers from obtaining their supplies from competitors.
>
> In determining whether a quantity rebate system is abusive, it will therefore be necessary to consider all the circumstances, particularly the criteria and rules governing the grant of the rebate, and to investigate whether, in providing an advantage not based on any economic service justifying it, the rebates tend to remove or restrict the buyer's freedom to choose his sources of supply, to bar competitors from access to the market, to apply dissimilar conditions to equivalent transactions with other trading parties or to strengthen the dominant position by distorting competition.[36]

The Court upheld the Commission's decision that Michelin France's quantity rebates were "loyalty-inducing" and therefore constituted an abuse of dominance, in part because the higher discount rate for achieving a particular sales volume was applied to the dealer's entire purchase volume, rather than just the incremental purchases above that threshold volume. The Court also found that the one-year reference period for calculating the rebate rate was too long and that Michelin France had failed to demonstrate a valid economic justification for the quantity rebate scheme. The Court also dismissed Michelin France's other grounds for appeal.

British Airways

In July 1999, the Commission of the European Communities held that, by applying certain marketing agreements and a system of performance rewards to air travel agents established in the United Kingdom, British Airways plc ("BA") abused its dominant position in the United Kingdom market for air travel agency services, and imposed a fine of €6.8 million.[37] BA's application to the Court of First Instance for an annulment of the Commission's decision was dismissed.[38] The case has been appealed to the European Court of Justice.

BA had concluded agreements with UK travel agents entitling them to a basic standard commission on their sales of BA air tickets. In addition, BA concluded agreements with travel agents which provided for the payment of additional incentives based on the extent to which a travel agent: (i) increased the value of its sales of BA tickets from one year to the next; (ii) increased BA's share of the agent's worldwide sales; and/or (iii) increased the value of its sales of BA tickets in a particular calendar month compared to that achieved during the corresponding month in the previous year.

The common feature of the commission schemes at issue was that meeting the targets for sales growth led to an increase in the commission paid on all tickets sold by the agent, not just on the incremental sales above the target level. This meant that when a travel agent was close to one of the thresholds for an increase in commission rate, selling relatively few extra BA tickets could have a large effect on the agent's commission income. Conversely,

a competitor who wished to give a travel agent an incentive to divert some sales from BA to the competing airline would have to pay a much higher rate of commission than BA to compensate for this effect.

The Court of First Instance confirmed its finding in previous cases that applying dissimilar conditions to equivalent transactions with different trading parties, thereby placing one or more of the trading parties at a competitive disadvantage, may constitute an abuse of dominance. It held that the performance reward schemes at issue could result in different rates of commission being applied to two travel agents who sold an identical volume or value of BA tickets in a particular year, if their BA ticket sales in the previous year (and hence their rate of growth) were different.[39]

Furthermore, as in *Michelin II*, the Court of First Instance reiterated that "consistent case-law shows that a fidelity rebate, granted in consideration of an undertaking by the customer to take supplies exclusively or almost exclusively from a dominant undertaking, is contrary to Article 82 EC. Such a rebate has the effect, through the granting of financial advantages, of preventing customers from obtaining supplies from rival producers."[40]

Conclusion

As indicated above, European courts have consistently held that an exclusivity arrangement by a dominant firm is a *per se* abuse of dominance. Under such an analysis, Canada Pipe's stocking distributor program would clearly be considered anti-competitive under EC law.

The European Community approach to exclusivity and other loyalty rebates has been criticized. For example, a recent report prepared for the UK Office of Fair Trading describes several pro-competitive motivations for fidelity rebates, and argues that the EC's *per se* prohibition is not justified on economic grounds.[41] A recent OECD paper reached a similar conclusion.[42]

Recently there have been some indications that the European Union is re-assessing its approach to Article 82. If recent changes to European competition law are any indication, any changes to Article 82 may result in greater convergence with U.S. law. However, it is not clear that Canada Pipe's stocking distributor program would be sanctioned under EU law any time in the near future.

The Tribunal's decision in *Canada Pipe* is arguably more consistent with the U.S. jurisprudence. While previous Canadian and U.S. decisions have prohibited exclusive dealing arrangements by dominant firms which resulted in market foreclosure, the Tribunal found that Canada Pipe's stocking distributor program did not appear to have an exclusionary effect or cause detriment to the consumer. While it may be too early to predict whether *Canada Pipe* reflects a significant shift in the Tribunal's analysis of abuse of dominance cases, the decision in *Canada Pipe* clearly demonstrates the Tribunal's willingness to consider the real competitive impact of exclusive dealing practices engaged in by dominant firms, rather than following a structural approach under which competitively restrictive conduct by a dominant firm is condemned as anti-competitive.

Notes

[1] Peter Franklyn is a partner and Steve Sansom is an associate in the Competition & Antitrust Law Group of Osler, Hoskin & Harcourt LLP.
[2] *Canada (Commissioner of Competition) v. Canada Pipe Co. Ltd.* (2005 Comp. Trib. 3).
[3] The Tribunal had previously found exclusive dealing by a dominant firm to be anti-competitive in three cases decided under s. 79 of the *Competition Act*, R.S.C. 1985, c. C-34: *Canada (Director of Investigation and Research) v. NutraSweet Co.* (1990), 32 C.P.R. (3d) 1 ("*NutraSweet*"); *Canada (Director of Investigation and Research) v. Laidlaw Waste Systems Ltd.* (1992), 40 C.P.R. (3d) 289 ("*Laidlaw*") and *Canada (Director of Investigation and Research) v. D & B Companies of Canada Ltd.* (1995) 64 C.P.R. (3d) 216 ("*Nielsen*"). In a previous application under s. 31.4 of the *Combines Investigation Act*, R.S.C. 1970, c. C-23, the predecessor legislation to the *Competition Act*, the Restrictive Trade Practices Tribunal had found that exclusive dealing by a "major supplier" was not anti-competitive because there was evidence of entry and expansion by competitors: *Director of Investigation and Research v. Bombardier Ltd.* (1980), 53 C.P.R. (2d) 47.
[4] A small amount of DWV mechanical joint couplings was manufactured in Canada by Rollee Industrial Products (1987) Ltd.
[5] Although not referred to in the Tribunal's reasons for decision, the seven year restrictive covenants pertaining to the two Gooding foundries not purchased by Canada Pipe have now expired and the vendors of Bibby and Cremco are no longer prohibited from engaging in the business. It is possible that this was a factor in the Tribunal's findings regarding the possibility of future entry.
[6] Pipes and fittings can be manufactured in a variety of materials, including cast iron, plastic, copper, asbestos cement, stainless steel and glass. Mechanical joint couplings can be made of cast iron, rubber (neoprene) or stainless steel. Cast iron products represented only 11% of DWV product sales in Canada. There was evidence that the use of different materials was partly constrained by building and plumbing codes, and the Tribunal found that the relevant markets were limited to cast iron products.
[7] Prior to the hearing of the application there were a number of procedural motions, including a constitutional challenge to the *Competition Tribunal Rules* and several motions by Canada Pipe for additional disclosure from the Commissioner. A discussion of the procedural aspects of *Canada Pipe* is beyond the scope of this article. The hearing commenced on March 1, 2004 and was heard over 30 sitting days between March 1 and September 2, 2004. The Tribunal issued its reasons for decision on February 3, 2005.
[8] While Vandem had captured 10% of sales in Canada and had become profitable in the four years since its entry, a representative of Vandem testified that Vandem needed a 15% market share to remain viable. The Tribunal questioned the credibility of the evidence given by representatives of Vandem, and stated that "given the paucity of financial information on Vandem's circumstances, the Tribunal has no way of knowing whether Vandem is or will be viable."
[9] *Canada Pipe*, para. 196.
[10] Pursuant to s. 79(6) of the *Competition Act*, no application may be made under s. 79 in respect of a practice of anti-competitive acts more than three years after the practice has ceased.
[11] The Tribunal's decision (at paragraph 44) includes the following examples of the magnitude of the exclusivity discounts and rebates:

> The multiplier for pipe, for example, could be .55 for a stocking distributor, and .94 for a non-stocking distributor. Thus, at the time of purchase, the stocking distributor would pay 55 percent of the list price for pipe, while the non-stocking distributor would pay 94 percent of the list price. If the stocking distributor remained on the program for a full quarter, it would also receive a quarterly rebate. In 2002, for instance, the rebate was 7 percent on pipe, 15 percent on fittings and 9 percent on MJ couplings. Further, if it remains on the program for an entire calendar year, it receives the yearly rebate, which in 2002 was 4 percent on all products.

[12] *Canada Pipe*, para. 256.
[13] *Canada Pipe*, para. 261.
[14] In discussing barriers to entry, the Tribunal correctly pointed out (at para. 152) that "entry must be shown to be both effective and viable." Interestingly, in discussing the impact of the stocking distributor program the Tribunal noted that although entry in this case was "clearly effective...its viability remains to be determined" (at para. 265).
[15] *LePage's v. 3M*, 324 F.3d 141 (3d Cir. 2003) at 163.

[16] For example, if Product A is only available from one seller, and that seller insists that as a condition of purchasing Product A the buyer purchase Product B (for which there are other sources of supply) exclusively from the same seller, the buyer will only agree to do so if the benefit of obtaining Product A exceeds the cost of obtaining Product B exclusively from that seller. In particular, even if Product A is a critical input into the buyer's production process and is unavailable from other sources, the buyer will still not agree to the exclusivity provision if the cost of the exclusivity arrangement is greater than the loss that would result from ceasing production.
[17] J. Church, "The Economics of Exclusionary Agreements and Abuse of Dominant Position in Canada", (2003), Canadian Bar Association Annual Fall Conference on Competition Law.
[18] Aghion, P., and P. Bolton, "Contracts as Barrier to Entry", (1987), 77 *American Economic Review* 388.
[19] Rasmusen, E.B., J.M. Ramseyer and J.S. Wiley Jr., "Naked Exclusion", (1991) 81 *American Economic Review* 1137.
[20] *Canada (Director of Investigation and Research) v. Tele-Direct (Publications) Inc.* (1997), 73 C.P.R. (3d) 1 ("*Tele-Direct*") was an abuse of dominance case but did not involve allegations of exclusive dealing.
[21] *Canada Pipe*, para. 191.
[22] *Canada Pipe*, para. 212.
[23] *Canada Pipe*, para. 237.
[24] 2005 U.S. App. Lexis 3219 (2005); rev'g 277 F. Supp. 2d 387 (D. Del., 2003).
[25] *Canada Pipe*, para. 237.
[26] 324 F.3d 141 (2003); aff'g 2000 U.S. Dist. Lexis 3087.
[27] Health Care Products, Home Care Products, Home Improvement Products, Stationery Products (including transparent tape and Post-It Notes), Retail Auto Products and Leisure Time.
[28] 324 F.3d 141 (3d Cir. 2003).
[29] Strictly speaking, the Court of Appeals did not find that 3M's conduct was unlawful; it merely found that the jury verdict to that effect was not unreasonable.
[30] 2000 U.S. Dist. Lexis 3087 at 7.
[31] It could also be argued that *3M* is distinguishable because while LePage's was legally prohibited from selling Scotch brand tape, Vandem and importers could have manufactured/sold any of the products that were the subject of Canada Pipe's stocking distributor program. However, there was evidence that it was not economically feasible for any of Canada Pipe's competitors to offer a full line of products without significantly increasing their sales volumes.
[32] 324 F.3d 141 (2003) at 164.
[33] Arguably, *Canada Pipe* is also distinguishable from a previous Third Circuit decision, *SmithKline Corp. v. Eli Lilly & Co.*, 575 F.2d 1056 (3d Cir. 1978). Lilly instituted a rebate program that provided a 3% bonus rebate for hospitals that purchased specified quantities of any three of Lilly's five cephalosporins, two of which were protected by patents. In its discussion of *Lilly* in *3M*, the Court stated that "the gravamen of Lilly's §2 violation was that Lilly linked a product on which it faced competition with products on which it faced no competition." The effect was that "in order to offer a rebate of the same net dollar amount as Lilly's, SmithKline had to offer purchasers of Ancef rebates of some 16% to hospitals of average size, and 35% to larger volume hospitals." While the magnitude of the rebate in *Lilly* appears to have been smaller than the rebate in *Canada Pipe*, as indicated above it does not appear that any Canada Pipe products were protected by patents and thus it potentially faced competition on any of them.
[34] Commission Decision 2000/405/EC, Court of First Instance Case T-203/01.
[35] *Michelin II*, CFI para. 56 (references omitted).
[36] *Michelin II*, CFI paras. 59-60 (references omitted).
[37] Virgin/British Airways, Commission Decision 2000/74/EC of 14 July 1999.
[38] Virgin/British Airways, CFI Case T-219/99.
[39] In 2001, the United States Court of Appeals for the Second Circuit dismissed an appeal by Virgin from summary judgment in a case alleging similar facts: *Virgin Atlantic Airways Limited v. British Airways plc*, 257 F.3d 256.
[40] Virgin/British Airways, CFI Case T-219/99, para. 244.
[41] RBB Economics, "Selective price cuts and fidelity rebates", July 2005, pp. 19, 102-66.
[42] Organization for Economic Co-operation and Development, "Loyalty and Fidelity Discounts and Rebates", Proceedings of a Competition Policy Roundtable, February 2003.

CANADIAN COMPETITION RECORD

DOES CANADA PIPE *REALLY* HAVE MARKET POWER?

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The Competition Tribunal recently dismissed the Commissioner of Competition's application under sections 77 and 79 of the *Competition Act* in the *Canada Pipe* case.[1] This decision is currently under appeal by the Commissioner. The Tribunal found that Canada Pipe's Bibby Ste. Croix division ("Bibby") has market power in three narrow product markets in each of six (regional) geographic markets, but it dismissed the Commissioner's claims that Bibby's Stocking Distributor Program ("SDP") is anti-competitive and that it substantially lessened competition. In this paper we discuss the Tribunal's findings on market definition and market power.

Loyalty programs and other arrangements that encourage exclusivity are efficient if used by firms in competitive markets: if they were not efficient, they would not survive the pressures of competition. These same arrangements may be anti-competitive when employed by firms in uncompetitive markets, since they can entrench or extend market power. An assessment of market power is therefore an important element in any abuse of dominance case, and the Tribunal has since the *NutraSweet* case interpreted section 79's "control" element to mean "market power."

In every abuse of dominance case heard by the Tribunal so far, including *Canada Pipe*, the Respondent was found to have market power. *Canada Pipe* is unusual in that it is the only case in which the Tribunal concluded that the Respondent's practices were not anti-competitive and did not substantially lessen competition. That the Tribunal made these findings notwithstanding that it also concluded that Bibby has market power and that its loyalty program is effective in inducing distributors to be loyal (and not buy from competing manufacturers) indicates that it did not act reflexively but rather carefully considered the effects of Bibby's practices.

In the next section of this paper, we discuss the Tribunal's finding on product market definition and its related finding that Bibby possessed market power. The following section describes the Commissioner's market power case, which we conclude was not established by the data and economic analysis that were presented to the Tribunal.

Product Market Definition

In her Application, the Commissioner claimed that there were three relevant product markets, namely the supply of cast iron drain, waste and vent ("DWV") pipe, fittings and mechanical joint ("MJ") couplings.[2] DWV products made of other materials, such as plastic, were excluded from the Commissioner's product market because "[c]ast iron has unique characteristics and end-uses for which there are no practical substitutes."[3] Various national, provincial, and municipal building codes mandate that for some applications – in particular for buildings that are, in the Commissioner's words, "of a certain height and occupancy" – DWV systems must be made of materials that are non-combustible and meet certain smoke spread requirements. The central issue with respect to market definition during the hearing was whether plastic DWV products are substitutes for cast

iron DWV products in applications covered by building codes. If the product markets included plastics, then Bibby's market share would be too low, at about 10%, to sustain a conclusion that it had market power. The Commissioner argued that product market definition in this case is not necessary because there is direct evidence of "market control".[4] The Commissioner nevertheless submitted evidence relating to product markets.

The Tribunal's Determination of the Product Markets

The Tribunal noted that "plastics seem to offer a number of advantages to the construction industry and appear to be increasingly used", but nevertheless found that cast iron plays a distinct role in the DWV industry.[5] It accepted the Commissioner's submissions on product market, finding markets for cast iron DWV pipe, fittings and couplings to the exclusion of DWV products made of plastics and other materials.

The evidence cited by the Tribunal in support of its conclusions consisted almost exclusively of testimony from witnesses to the effect that <u>for certain DWV applications</u>, plastics and other materials could not be substituted for cast iron.[6] For example, a distributor of plumbing supply products testified that "I think there's still some trepidation in the marketplace about using PVC products on high-rise-type projects or major institutional commercial-type projects";[7] the Tribunal found that "the evidence of some contractors was that they opt for cast iron for certain applications"; and upon a review of the evidence of an expert witness for the Commissioner, who is a building code consultant, the Tribunal concluded that "in high-rise buildings, cast iron offers the advantage of meeting all requirements for fire and life safety purposes, and that only non-combustible materials, essentially cast iron, can be used in vertical shafts."[8] The Tribunal's analyses of "End Use"[9] and "Physical and Technical Characteristics"[10] were similarly limited to the advantages of cast iron in "certain applications". With respect to "Substitutability", the Tribunal concluded that "[o]n the evidence, the Tribunal is satisfied that <u>for certain applications</u>, cast iron has no economic substitute".[11] [emphasis added]

Lack of Substitutability in "Certain" Applications Does Not Imply Market Power

Even if we take as given the conclusion that cast iron DWV is a preferred material for some buyers, it does not follow that even a sole producer (a monopoly) of cast iron DWV products possesses market power.[12] Whether or not the sole producer has market power can only be determined through careful empirical investigation. The first question to ask is whether the seller can price discriminate by charging higher prices to "captive" buyers – in this case, buyers who prefer cast iron to other materials. If so, then the seller may be able to exercise market power over these buyers. If price discrimination is not feasible, and the seller must charge the same price to all buyers – including both captive and non-captive buyers – then the market power question turns largely on the relative importance of the captive segment to the seller. To elaborate on this point, we describe below a set of hypothetical market structures and their implications for market power. For the purposes of our discussion, we make the simplifying assumption that a seller faces two sets of buyers, one consisting of captive customers with no close substitutes for the seller's output, and one consisting of non-captive customers who have many close substitutes and choose among products mainly on the basis of price. Our conclusions apply to a much wider range of circumstances, for example where there are many different types of buyers with varying preferences with respect to substitutability.

The Seller Can Price Discriminate Between Different Classes of Buyers

In this case the sole supplier could charge two prices, a high price to the captive buyers and a lower one in the non-captive segment of the market. If the captive buyers were truly captive, in that they had no close substitutes for the sole seller's product, then the relevant market could be defined to include only sales to these captive customers. The Competition Bureau and the U.S. antitrust enforcement agencies both acknowledge that relevant markets may include only certain classes of buyers, if sellers can price discriminate.[13]

The Tribunal heard no evidence that Bibby prices in this way – all customers are offered the same schedule of prices. Moreover, the structure of the market strongly discourages price discrimination. The cast iron DWV products used in code-restricted applications are identical to the products used in other applications, so that Bibby cannot price discriminate by simply charging higher prices for products that are used in code-restricted applications. In order to price discriminate, therefore, Bibby would have to know when it sold a given shipment whether it will be used in a code-restricted application. But this is not possible: Bibby sells its products exclusively to distributors, who re-sell these products to builders, who can (and do) use these products in both code-restricted applications (where we maintain the assumption that buyers favour cast iron DWV) and in non code-restricted applications (where the market is highly competitive between cast iron, plastic, and other DWV materials). There is obviously no way for Bibby to target builders who plan to use a given purchase in a code-restricted application.

Furthermore, even if Bibby could target captive buyers, any attempt to do so would be defeated by arbitrage: the distributors who obtained product at the lower price would offer it for resale to captive buyers at a price below the discriminatory high price being charged by Bibby. In fact, some evidence was presented at the Tribunal hearing that DWV distributors shipped product across regional boundaries in response to higher prices available in other regions (regional arbitrage).[14]

The Seller Cannot Price Discriminate Between Different Classes of Buyers

When, as in *Canada Pipe*, the seller cannot identify buyers with different demands or is unable to prevent arbitrage, then whether or not the seller has market power depends largely on the relative importance of the captive segment to the seller.

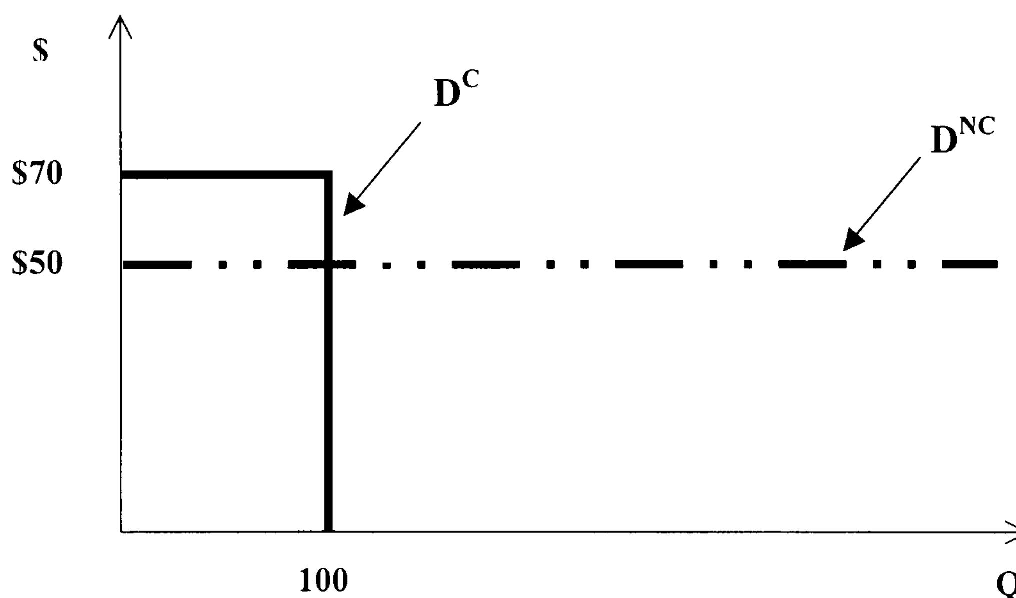
If the seller can earn profits on non-captive buyers – this would be the case if, for example, the seller's marginal cost increased with output, or if its product was slightly differentiated from other products – and it has few captive buyers, then its profit-maximizing price would be constrained by the competition for non-captive buyers. Since captive buyers comprise a small share of its profit base, the seller's profit from exploiting their willingness to pay a high price would be more than offset by its reduction in profits from the loss of sales to non-captive buyers. We elaborate on this point in the example below.

Example

Widgets are made of many materials, but only Silly Putty Widgets, Inc., ("SPW") makes its widgets from silly putty. All other widget manufacturers, of which there are many, make their widgets from other materials. SPW accounts for only 10% of widget industry sales, but 100% of widgets made of silly putty. There are a number of consumers who strongly prefer silly putty widgets to those made of other materials, and they will not switch to these other materials even if silly putty widgets are much more expensive than other widgets. These captive buyers have perfectly inelastic demand for silly putty widgets: at any price up to $70, they will purchase one hundred in total. The demand of captive buyers is represented by D^C in Figure 1.

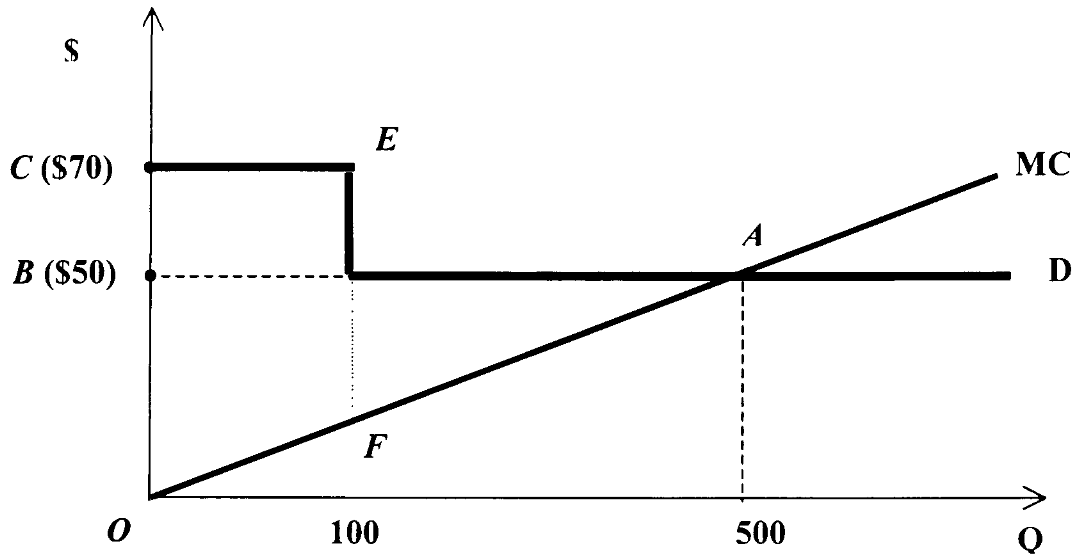
All other buyers care only about price, and therefore buy only the cheapest widgets, regardless of material. Since there are many widget manufacturers, the broader widget market is competitive, with an equilibrium price of $50. SPW can sell as many widgets as it wants to these non-captive buyers, as long as its price does not exceed $50. The demand for SPW's output from these customers is represented by D^{NC} in Figure 1.

Figure 1 - Demand for SPW's Widgets from Captive and Non-Captive Buyers



SPW cannot price discriminate among captive and non-captive buyers and must therefore charge a single price to all customers. The demand for SPW's output from both captive and non-captive customers is represented by the bolded line in Figure 2 (labeled D), which coincides with D^C for output less than 100, and with D^{NC} for output in excess of 100. SPW's marginal cost curve is labeled MC.

Figure 2 - SPW's Demand and Cost Curves



If SPW sets its price at $50, it will sell to both captive and non-captive customers. Its profit maximizing quantity at $50 is 500, since at this volume its marginal cost is equal to price.[15] Total profit at $50 is $12,500, which is represented by the area BAO.

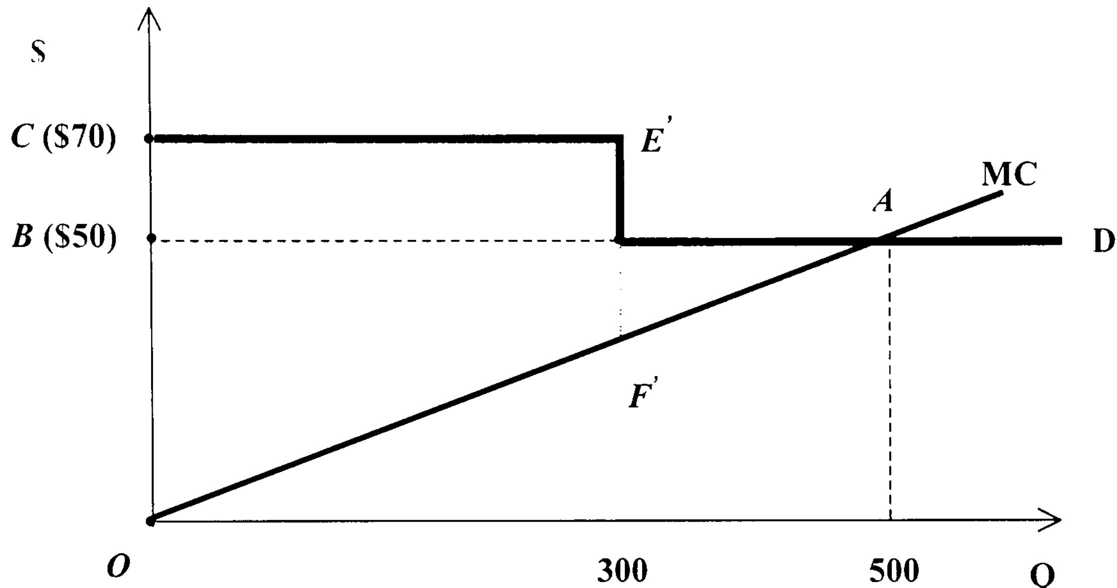
Captive buyers are willing to pay up to $70 for silly putty widgets. If SPW tried to extract more rents from this market segment, it could increase price to $70, and earn an additional $20 for each of the 100 units purchased by captive customers. However, at this higher price, it would lose all of its non-captive customers. At $70, SPW would sell 100 units, all to captive buyers, for a profit of $6,500, which is represented by the area *CEFO*.[16] SPW will clearly choose to price at $50, since this yields higher profits.

Notice that even though SPW has a significant number of captive buyers, its price is capped by the prices charged by other widget manufacturers. Since its price is equal to marginal cost, SPW's price is "competitive". Further, whether or not there is a competing supplier of silly putty widgets is irrelevant to SPW. Since SPW's price is determined by the demand of non-captive buyers, entry by another silly putty widget manufacturer will not affect SPW's price or profits.

Suppose now that the number of captive buyers is 300. SPW's demand curve is now represented by D' in Figure 3. With this demand curve for its output, SPW's profit maximizing strategy is to set a price of $70: although SPW's profit from selling to both captive and non-captive buyers is unchanged at $12,500, its profit from selling only to captive buyers at a higher price has increased to $16,500. In this case, entry by another silly putty widget producer <u>would</u> harm SPW. Such entry would reduce SPW's profit, because the entrant would bid against SPW for the business of buyers who prefer their widgets to be made of silly putty. The equilibrium price

would depend on the costs of the entrant and the nature of competition between SPW and the entrant, but would certainly be less than $70, and consequently SPW's profit would fall below $16,500.[17]

Figure 3



In both cases a significant number of buyers are captive to SPW, but when demand by captive buyers is relatively low (Figure 2), SPW does not have market power. Its price is constrained by the existence of producers of widgets made of other materials, and its price is equal to marginal cost. Furthermore, SPW has no incentive to exclude (through the use of a loyalty program, for example) another supplier of silly putty widgets, since entry by such a supplier will not reduce its profits. When demand by captive buyers is relatively high (Figure 3), SPW does have market power, and entry would erode this market power and lead to lower prices for silly putty widgets. SPW therefore has an incentive to exclude a competing silly putty widget manufacturer.

The general conclusion to be drawn from the above example is that where a seller supplies two or more groups of buyers with differing substitution possibilities but cannot "segment" them sufficiently to price discriminate, the outcome is sensitive to the precise market conditions. At one extreme is the case where the more competitive segment is perfectly competitive, so that the seller cannot influence the price to those competitive buyers and must choose whether to supply everything at the competitive price or sell only to the captive buyers. An important sub-case is where demand from the captive buyers is perfectly inelastic (up to some reservation price). In this case if the seller decides to sell only to the captive buyers, the price will automatically be the reservation price of those buyers. In a more general case, the strategy of the seller depends on the respective elasticities in the two markets, and the size of demand in the two markets. Without a detailed assessment of these indicators, it is impossible to tell whether the seller has market power or not, even if it has the ability to charge monopoly prices to captive buyers without reducing their demand.

Application to Canada Pipe

The Tribunal's conclusion that Bibby possessed market power rests heavily on its identification of a narrow product market consisting of cast iron DWV products. The evidence cited by the Tribunal in support of its product market finding consisted almost entirely of testimony from market participants to the effect that some participants prefer cast iron DWV products over plastic and other materials in certain applications. In terms of our example, this is analogous to finding that SPW has market power because some buyers prefer silly putty widgets to widgets made of other materials. Just as in the example – where whether or not SPW has market power depends on the nature of the demand and cost curves (in the example, we showed that whether or not SPW has market power depended largely on how large the population of captive buyers is) – whether or not Bibby has market power, given that some buyers prefer cast iron in some applications, depends on how many such buyers there are, the nature of Bibby's costs, and other market circumstances. The Tribunal did not cite any evidence related to these factors. We conclude that there was insufficient evidence for a conclusion that the market is limited to cast iron DWV products.

Market Power

Although the Commissioner presented some indirect, or structural, evidence of market power, her case that Bibby has market power rested largely on what she and her economics expert referred to as "direct" evidence. The Tribunal concluded that Bibby has market power in all eighteen markets (three product markets in each of six geographic markets). We deal first with the Tribunal's conclusions with respect to direct evidence of market power.

Direct Evidence of Market Power

The Tribunal explained that "[m]arket power is the ability to set prices above competitive levels for a considerable period."[18] Notice that this definition has two components: 1) the ability to set prices above competitive levels; and 2) the ability to do so for a considerable period. What length of time is considerable is not defined, but the Bureau's *Enforcement Guidelines on the Abuse of Dominance Provisions* ("EGADs") explain that the Bureau "normally regards a 'considerable' period of time for the purposes of establishing market power to be one year."[19]

The Commissioner's case relied on the testimony of her economics expert. The expert's conclusion that Bibby has market power was based on the following three observations: 1) Bibby's margins were "high" in at least some of the 18 regional and product markets; 2) Bibby's prices were substantially above import prices; and 3) Bibby's prices were low where it faced competition.

The Tribunal did not appear to find the evidence supporting any of these analyses entirely convincing, but it nevertheless concluded that Bibby had market power. The reported margins varied from region to region, and the Tribunal acknowledged that the margin analysis provides "little evidence of market power in Ontario...Alberta, and BC, which together make up 75 percent of Bibby's sales of cast iron DWV products in Canada."[20] It noted

that "margins are high and remain high in 25 percent of the market (Quebec and the Maritimes)."[21] The Tribunal also noted that the Commissioner's expert had failed to provide a proper benchmark of "competitive" margins. Furthermore, although this was not noted by the Tribunal, the expert conducted his margin analysis for fittings on the basis of three types of fittings which accounted for, at most, only 14% of Bibby's annual revenues from the sale of fittings.[22] In light of these findings, and since no evidence was presented on Bibby's margins on couplings, the margin evidence could, at the very most, support a conclusion that Bibby had market power in six out of the eighteen markets (pipe and fittings in the Prairies, Quebec and the Maritimes).

Even in these six markets, the implications of the margin data are unclear. Recall that the Tribunal's definition of market power is the ability to raise (and maintain) price above the competitive level for a considerable period. A standard definition of competitive pricing involves prices equal to marginal cost. The margin data presented to the Tribunal involved accounting measures of average cost, not economic measures of marginal cost. Thus, variations in such margin data cannot be taken as indicative of a presence or absence of market power for a myriad of reasons. Accounting cost often underestimates opportunity cost, mainly because fixed costs (including the costs of capital) may not be included in the costs recorded in a company's accounts. If accounting costs do underestimate opportunity costs, then positive accounting margins may be associated with zero or even negative economic margins.[23] The Commissioner and her expert did not perform a detailed analysis of the cost data, and therefore could not determine whether the costs used in the margin analysis were an appropriate proxy for economic costs. This was acknowledged by the expert, and noted by the Tribunal, which wrote that the Commissioner's expert "made his calculations based on limited data provided by Bibby, but cannot say how those costs were established by Bibby nor what they include. Moreover, he adds, even high margins do not necessarily lead to a conclusion of high economic profits, because the extra revenues (beyond marginal costs) might be necessary to cover fixed costs. Further, the Tribunal has no data on Bibby's ratio of fixed costs to variable costs."[24]

Second, leaving aside the problems of using accounting data to infer economic costs, if marginal cost exceeds average cost, then a margin that is perceived as "high" when computed based on average cost, may actually be competitive if data on marginal costs were utilized in the calculation.[25] The reported margins were certainly derived from an average cost calculation and not a marginal one. Consider again Figure 2, reproduced as Figure 4 below with the addition of a line representing SPW's average variable cost at 500 units, which is implied by its marginal cost curve. SPW's total variable cost is $12,500 at 500 units, so its average variable cost is $25 ($12,500/500). Its margin, calculated as price minus cost divided by price, is 50% (=[50-25]/50); this margin is positive and perhaps economically significant, even though price is equal to marginal cost, which represents perfectly competitive pricing.

Figure 4 - SPW's Marginal Cost and Average Variable Cost Curves

Despite these limitations on the margins analysis, the Tribunal concluded that high accounting margins implied market power. This is in contrast to the Tribunal's findings in *Tele-Direct*.[26] In that case, the Commissioner also provided direct evidence of market power, but rather than simply showing that Tele-Direct's price-cost margins were high, he showed that its accounting profits were high. In *Canada Pipe*, the Commissioner provided no evidence of Bibby's overall profitability: she simply provided data that allegedly showed that Bibby was earning high margins on some product lines. Based on the available evidence, even Bibby's overall accounting profits may have been much lower than the margin analysis would indicate. This would be the case, for example, if Bibby had significant unallocated fixed costs, so that high margins on some products would contribute to covering overhead while other products made little or no contribution. In such a situation, Bibby's economic profits may indicate competition even though it earned high margins on some products, because its overall economic profits may be zero or close to zero.

In *Tele-Direct*, the Tribunal found additional direct evidence of market power, including the payments made by Tele-Direct to telcos (which supported the Commissioner's submission that Tele-Direct was earning positive economic profits), price discrimination, and dissatisfied customers. Even with this apparently stronger evidence, for the *Tele-Direct* Tribunal the direct evidence played a supporting, rather than central role: "[t]he direct evidence of market power advanced by the Director along with Tele-Direct's pricing policies affirm our previous conclusion based on the indirect approach that Tele-Direct has market power in telephone directory advertising."[27]

The only direct evidence of Bibby's market power in Ontario and B.C. presented by the Commissioner's expert related to Bibby's responses to entry of imports in B.C. and entry by a domestic competitor in Ontario. The expert presented a multiple regression model that purported to show that Bibby lowered its prices in B.C. and

Alberta in response to an increase in imports. This was interpreted by the Commissioner to imply that in B.C. and Alberta "prices were supra-competitive to begin with."[28] The Tribunal accepted some criticisms offered by the respondent's expert of this data analysis, and concluded that "[t]he issue was left unresolved."[29] Ironically, in *Tele-Direct*, the Commissioner appeared to make the opposite argument, when he submitted that Tele-Direct's lack of a competitive reaction to the entry of smaller directories "confirmed that they are of little importance in constraining Tele-Direct's market power."[30]

Data and conceptual problems notwithstanding, the Tribunal seems to have accepted the Commissioner's premise that entry that has the effect of reducing an allegedly dominant firm's prices is somehow indicative of market power. The Commissioner's reasoning appears to be that since entry had the effect of reducing Bibby's prices, and the new (lower) price levels were at least "competitive" (i.e. the new prices at least covered Bibby's variable costs), then Bibby's prices <u>before</u> entry must have been supra-competitive (i.e. they must have exceeded Bibby's marginal cost). Since prices were above competitive levels, then, according to this line of argument, they indicate that Bibby has market power.

Again, the *Tele-Direct* Tribunal responded to a similar conceptual issue in a strikingly different way. In *Tele-Direct*, the Tribunal explained that:

> ...market power is generally considered to mean an ability to set prices above competitive levels and to maintain them at that level for a significant period of time <u>without erosion by new entry or expansion of existing firms</u>.[31] [emphasis added]

For the *Canada Pipe* Tribunal, application of this definition should have meant that <u>if</u> entry occurred <u>and</u> Bibby's prices fell because of this entry,[32] then Bibby <u>does not have market power</u>, because this would have meant that Bibby could not maintain prices above competitive levels "without erosion by new entry". In other words, the correct conclusion to draw from the Commissioner's submission on the effects of entry would have been that Bibby does <u>not</u> have market power. The Tribunal did seem to indicate that it could see this logic, when it wrote that it "cannot conclude that for Vandem, the SDP was a barrier to entry. Entry was effective, as shown by the competitive prices in Ontario, which followed Vandem's entry."[33]

Indirect Evidence of Market Power

The Commissioner's indirect case on market power consisted primarily of evidence that purported to show that Bibby had a high market share and that barriers to entry were high. The market share data can be dealt with very quickly – since the economic expert for the Commissioner was instructed by the Commissioner to merely <u>assume</u> a product market, then the process of calculating market shares within that assumed product market has no more validity than that of the assumption itself. Moreover, the Tribunal's only reference to market share is the following: "Evidence shows that Bibby controls between 80 and 90% of the market in cast iron DWV products."[34] There is no reference to Bibby's market share in any of the three product markets or in any of the six geographic markets accepted by the Tribunal.

Barriers to Entry

In its barriers to entry analysis, the Tribunal considered sunk costs, cost of entry, incumbent advantage, and the SDP.[35] The Tribunal found that there was no convincing evidence of sunk costs; that the costs of entry were not prohibitive, and in fact were minimal; that the SDP was not a barrier to entry; and that actual entry has occurred. The Tribunal noted that there is "significant evidence that it is possible to enter the market successfully."[36]

Surprisingly, the Tribunal concluded that "entry is limited as shown by Bibby maintaining a considerable market share"[37] and that "Bibby does control a substantial part of the cast iron DWV products market."[38] In other words, despite finding little, if any, evidence of actual barriers to entry, the Tribunal concluded that, because Bibby maintains a high market share, it must have market power.

High market share, however, is a necessary, but not a sufficient condition for market power. The Bureau's EGADs emphasize this point:

> ...high market share is not in itself sufficient to prove market power. Without barriers to entry, any attempt by a firm with high market share to exercise market power is likely to be met with entry or expansion of existing firms such that the firm with the high market share loses enough customers to its rivals that it is not profitable to attempt to raise prices above competitive levels.[39]

In other words, a high market share cannot be proof that barriers to entry are high. A firm with high market share will not be able to exercise market power by raising price if an attempt to do so will be met with competitive entry. Barriers to entry must therefore be analyzed separately from market share to determine whether there is a likelihood that market power could be exercised. If high market share proved market power, as the Tribunal seemed to imply in *Canada Pipe*, then there would be no need to conduct a separate barriers to entry analysis at all.

The appropriate logic is summed up in the *Tele-Direct* decision, where the Tribunal, after considering various factors relating to barriers to entry, concluded that "[t]he condition of easy entry required to overcome the presumption of market power arising from Tele-Direct's extremely large market share is not satisfied."[40] This clearly implies that the fact of a large market share cannot be used as the basis for concluding that barriers to entry are prohibitive.

Conclusions

In this brief review, we have discussed the economic data and analysis that the Tribunal considered in reaching its conclusion that Bibby possessed market power within the properly defined product and geographic markets. However, our conclusion is that the data presented by the Commissioner and her experts do not support a finding of market power.

Notes

* Andy Baziliauskas is a Principal with CRA International and Roger Ware is a Professor of Economics at Queens University and a Director, LECG Canada. LECG provided expert economic consulting for Canada Pipe in this case. Roger Ware filed an expert report and testified before the Competition Tribunal on behalf of Canada Pipe. Andy Baziliauskas consulted at all stages of the case and filed an affidavit in earlier proceedings.

[1] *Commissioner of Competition v. Canada Pipe*, 2005 Comp. Trib. 3 (February 3, 2005) CT-2002-006 (unreported) [*Canada Pipe*].

[2] *Ibid.*, Commissioner's Notice of Application at para. 50. A typical DWV installation will include a variety of sizes and shapes of each of pipe, fittings, and couplings.

[3] *Ibid.* at para. 52.

[4] *Canada Pipe*, *supra* note 1 at para. 54.

[5] *Ibid.* at para. 112.

[6] The only evidence cited by the Tribunal on indicators other than substitutability between cast iron and other materials in "certain" applications is related to differences in price levels and Bibby's responses to entry into the DWV industry. The Tribunal did not find this evidence convincing.

[7] *Canada Pipe*, *supra* note 1 at para. 73.

[8] *Ibid.* at para. 82.

[9] *Ibid.* at para. 91.

[10] *Ibid.* at para. 94.

[11] *Ibid.* at para. 102.

[12] In the Canadian market besides Canada Pipe, there is a second significant Canadian manufacturer (Vandem), plus many imported sources of cast iron DWV materials.

[13] Paragraph 3.9. of the *Merger Enforcement Guidelines* states that:

> In some circumstances, sellers may identify and charge different prices to targeted sets of buyers. Sellers may price discriminate when certain buyers cannot effectively switch to other products or geographic locations and cannot engage in arbitrage with other buyers by taking advantage of price differences. When price discrimination is feasible, it may be appropriate to define relevant markets with reference to the characteristics of the classes of buyers or to the particular locations of the targeted buyers.

Section 1.0 of the *Horizontal Merger Guidelines* issued by the U.S. antitrust enforcement agencies explains that:

> where a hypothetical monopolist likely would discriminate in prices charged to different groups of buyers, distinguished, for example, by their uses or locations, the Agency may delineate different relevant markets corresponding to each such buyer group. Competition for sales to each such group may be affected differently by a particular merger and markets are delineated by evaluating the demand response of each such buyer group. A relevant market of this kind is described by a collection of products for sale to a given group of buyers.

[14] *Canada Pipe*, *supra* note 1, Testimony of R. Byrne, Vol. 4 at 860 and 865; Testimony of M. Corriveau, Vol. 10 at 2058.

[15] Any unit sold in excess of 500 will cost more to produce than the price, $50, and if SPW sold fewer than 500 units, additional units cost less than $50 to produce, so it would not be maximizing profits.

[16] Marginal cost at quantity Q is assumed to be (1/10)Q.

[17] SPW's profit from serving only captive customers would also be relatively higher if its marginal cost curve was steeper.

[18] *Canada Pipe*, *supra* note 1 at para. 122.

[19] At 13-14.

[20] *Canada Pipe*, *supra* note 1 at para. 128.

[21] *Ibid.*

[22] *Canada Pipe*, *supra* note 1, Expert Affidavit of Thomas W. Ross, February 19, 2004, Appendix 3 at 2.

[23] For more comprehensive discussions of the difficulty of inferring market power from accounting data, see George J. Benston, "Accounting Numbers and Economic Values" (Spring 1982) 27 Antitrust Bulletin 161; Franklin M. Fisher & John J. McGowan, "On the Misuse of Accounting Rates of Return to Infer Monopoly Profits" (March 1983) 73 American Economic Review 82; and Franklin M. Fisher, "The Misuse of Accounting Rates of Return: Reply" (June 1984) 74 American Economic Review 509.

[24] *Canada Pipe*, *supra* note 1 at para. 129.
[25] Margins were calculated as price minus cost divided by price.
[26] *Commissioner of Competition v. Tele-Direct (Publications) Inc.* (1997), 73 C.P.R. (3d) 1 (Comp. Trib.)
[27] *Ibid.* at 145.
[28] *Canada Pipe*, *supra* note 1 at para. 135.
[29] *Ibid.*
[30] *Tele-Direct*, *supra* note 26 at 114.
[31] *Ibid.* at 110.
[32] We noted above that the question of the effect of entry on Bibby's prices was deemed by the Tribunal to be "unresolved".
[33] *Canada Pipe*, *supra* note 1 at para. 148.
[34] *Ibid.* at para. 140.
[35] *Ibid.* at para. 138.
[36] *Ibid.* at para. 156.
[37] *Ibid.* at para. 156.
[38] *Ibid.* at para. 161.
[39] EGADs at 15.
[40] *Tele-Direct*, *supra* note 26 at 130.

PUTTING THE NEW TRIBUNAL RULES TO THE TEST – LESSONS FROM THE *CANADA PIPE* PROCEEDINGS

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Introduction

In February 2002, the *Competition Tribunal Rules*[1] (the "Rules") were substantially amended so as to expedite and streamline non-merger proceedings before the Competition Tribunal. The most significant amendment was the change from a relevance-based standard of disclosure, under which parties were required to disclose all relevant documents, to a reliance-based standard of disclosure under which parties must disclose only those documents upon which they intend to rely. This change to the Rules has undeniably shifted the landscape of litigation before the Tribunal in favour of the Commissioner of Competition. When one reads the new Rules in conjunction with the investigative provisions of the *Competition Act*, it is clear that the Commissioner now has available to her a number of procedural and strategic advantages in non-merger proceedings before the Tribunal. For that reason, such matters no longer proceed on anything close to a level playing field.

The Tribunal's recent decision in *Canada Pipe*[2] is the first contested abuse of dominance case to be tried under the Rules after the 2002 amendments (the "Revised Rules"). With the benefit of hindsight, we can look to these proceedings for practical examples of how the Revised Rules operate and affect a Respondent's rights to procedural fairness in contested non-merger cases before the Tribunal. Although not necessarily evident from the overall result, the procedural challenges and resulting decisions during the *Canada Pipe* proceedings clearly demonstrate how the Revised Rules can seriously impair a Respondent's ability to respond effectively to the Commissioner's case and present a proper and complete defence.

In order to understand how the Revised Rules have fared in their first outing before the Tribunal, it is important to understand the underlying rationale for and goals of the 2002 amendments. The ultimate goal of these amendments was to streamline and expedite non-merger proceedings before the Tribunal. In a 2003 paper, Justice Sandra Simpson (the Acting Chairperson of the Tribunal at the time) noted the ways in which this streamlining was to be achieved, including: the elimination of discovery; increased use of pre-filed written evidence; reduced reliance on oral testimony; and active Tribunal case management.[3] However, based on the *Canada Pipe* proceedings, it is evident that the Revised Rules have achieved only one of these objectives, namely the virtual elimination of rights of discovery. Furthermore, it is evident that the elimination of discovery and significant reduction of the Commissioner's disclosure obligations in the pursuit of expedited proceedings has come at the expense of procedural fairness. In this paper, we review the intended goals of the Revised Rules as well as their actual effects as evidenced in the *Canada Pipe* proceedings.

The Revised Rules: Unrealized Goals and Faulty Assumptions

No Reduced Reliance on Oral Testimony

As noted by Justice Simpson, one of the intended results of the Revised Rules was an increased reliance on written evidence and a corresponding decrease in reliance on oral testimony.[4] However, from a practical perspective, with the absence of any safeguards to prevent or curb the Commissioner's reliance upon oral evidence, the Revised Rules create a strategic incentive for the Commissioner to disclose as few documents as possible and instead rely on *viva voce* testimony. The Commissioner yielded to this incentive in the *Canada Pipe* proceedings where she relied heavily on the oral testimony of her lay and expert witnesses rather than the documents that she and Canada Pipe chose to produce.

While there are no apparent negative consequences to the Commissioner should she choose to rely upon oral testimony rather than documentary evidence, such a strategy puts a Respondent at a severe disadvantage. As a practical matter, the Revised Rules provide a Respondent with little, if any, advance notice of the content of the testimony of a witness called by the Commissioner. Although will-say statements are intended to provide such advance notice, in actual practice, they are often so broadly drafted as to provide virtually no meaningful disclosure of a witness's testimony before that person enters the witness box during the course of the hearing. While the Tribunal held in *Canada Pipe* that a witness could not testify to matters that were not referred to in his or her will-say statement, it proceeded to interpret the will-say statements quite broadly.[5] In effect, the Tribunal held that as long as a particular subject matter was referred to or listed in a will-say statement, the witness should be permitted to testify about that subject matter. This is so even if the will-say statement does not set out or describe the stance of the person's evidence concerning that subject. As a result, a significant portion of the oral testimony challenged by Canada Pipe was nonetheless admitted by the Tribunal even though Canada Pipe had no meaningful advance notice of the substance of the evidence of many of the Commissioner's witnesses.

The adverse effect upon a Respondent of a lack of sufficient notice of a witness's testimony could presumably be addressed by asking the Tribunal to order discovery of a particular witness. Under the Revised Rules, discovery of a witness may be granted "if warranted by the circumstances".[6] However, in *Canada Pipe*, the Respondent's request for discovery of the principal complainant was denied on the basis that "discovery of a non-party is exceptional" and the Tribunal's view that this witness's will-say statement provided sufficient notice of his testimony.[7] If discovery is to be ordered only in exceptional cases, then, in most cases, the Respondent will be left with only the limited disclosure provided by the Commissioner in her witness will-say statements.

Furthermore, the unfairness to a Respondent that arises from the inability to predict a witness's testimony is now compounded by the absence of any requirement to disclose all relevant documents. Disclosure of all relevant documents (rather than merely those documents selected by the Commissioner to bolster her case) can provide background and context with respect to the content of a witness's testimony, and can enable a Respondent to test in a meaningful manner evidence the Commissioner relies upon in seeking a remedy.

Documents Are Necessary to Test Oral Evidence

Access to all relevant documents is critical to a Respondent not only for building a full defence but also to ensure that a Respondent can properly test a witness's evidence on cross-examination. Effective cross-examination also puts the Tribunal in a better position to assess a witness's evidence, and to reach reliable conclusions in respect of important but contentious issues of fact and mixed fact and law.

The importance of having relevant documents to test a witness's evidence was amply illustrated in the *Canada Pipe* proceedings. To demonstrate the alleged impact of Canada Pipe's loyalty-based rebate program, senior executives of the principal complainant testified to its alleged financial difficulties. However, the Commissioner did not disclose any financial statements from the complainant. In fact, the very few documents disclosed by the Commissioner that related to the complainant suggested that the complainant was a viable competitor. As such, Canada Pipe learned of the complainant's alleged financial difficulties for the first time when representatives of the complainant took the stand during the course of the hearing. Although Canada Pipe objected to this evidence on the basis that it was not covered in the witness's will-say, it was allowed by the Tribunal based on a very generous reading of the will-say statement. In this instance, the Commissioner's lack of disclosure prevented Canada Pipe from effectively cross-examining the complainant on its alleged financial difficulties.

By contrast, in the very few cases where the Commissioner made documents available to Canada Pipe, they were instrumental in testing this same witness's evidence on other points. This witness testified, for example, that the complainant's sales were principally made in the U.S. and not Canada because it was having difficulty selling in Canada due to Canada Pipe's fidelity-based "Stocking Distributor Program". The few documents disclosed by the Commissioner relating to the complainant revealed that this statement was flatly inconsistent with these very documents. If those documents had not been produced, there is no doubt that the evidence of this witness in respect of this important issue would have gone unchallenged, and that the Tribunal could have decided the case based upon an incorrect factual premise.

The Revised Rules Do Not Result In Expedited Proceedings

Given the original aim of the Revised Rules, the Tribunal also appears to have assumed that moving from a relevance-based standard to a reliance-based standard would necessarily result in expedited proceedings. As evident from the lengthy procedural disputes in *Canada Pipe*, however, the lower level of disclosure afforded by the Revised Rules almost inevitably will lead to arguments between the parties concerning the nature and scope of the disclosure the Commissioner should be required to make. Dealing with such arguments is time-consuming and detracts from the efficient functioning of the Tribunal.

In fact, in the *Canada Pipe* proceedings, 16 months elapsed between the date the Notice of Application was filed and the date the hearing commenced. This is at least twice as long as any other contested abuse of dominance case heard before the Tribunal under the old Rules. Arguably, some aspects of future procedural disputes may be avoided because of the jurisprudence developed in *Canada Pipe*. However, given that the disclosure ordered in each case will be fact specific, similar procedural disputes are just as likely to occur in

future cases, particularly where, as in *Canada Pipe*, the stakes for the Respondent are extremely significant. Furthermore, with the proposed introduction of extraordinary administrative monetary penalties through Bill C-19, the likelihood of future procedural disputes concerning the appropriate levels of disclosure in contested abuse of dominance proceedings is virtually guaranteed. In fact, if Bill C-19 proceeds as proposed and significant administrative monetary penalties are available under section 79, there will undoubtedly be a challenge to the constitutionality of the amendments and Revised Rules as section 79 will arguably become a penal provision thereby allowing a Respondent to avail itself of its rights to *Stinchcombe*[8] level disclosure under the Canadian *Charter of Rights and Freedoms*.

The Respondent Does Not Have Access to All Necessary Documents

Another assumption which appears to have motivated the 2002 amendments is that a Respondent will itself have access to most of the necessary documents and thus will have sufficient information available to it to prove its case. As Justice Simpson explained in her paper:

> [The Committee observed that] respondents may often have much of the relevant information in their possession before an application is filed. For instance, a respondent would usually have specific information related to the industry in which it operates, including the pre-existing level of competition in the market, the names of industry participants and their market shares and the nature of the product and geographic markets.[9]

However, this assumption will not be applicable in most abuse of dominance cases for a number of reasons. First and foremost, a Respondent's view of the relevant markets and corresponding market shares is rarely shared by the Commissioner. In most cases, Respondents seek to define markets broadly and the Commissioner seeks to define markets narrowly. Thus, while a Respondent may have some information to support its views of the relevant market, in most cases, the Respondent will not have sufficiently complete or detailed information to enable it to put forward a complete and well-documented case, including economic analysis, concerning the relevant markets and the resulting market shares. Secondly, abuse of dominance cases must consider and address whether competition has been substantially lessened or prevented as a result of the Respondent's practices. Under the Revised Rules, a Respondent is assumed to have information concerning the effect of its practices on competition. However, this assumption is unrealistic given that Respondents would rarely have access to detailed and competitively sensitive information about the financial status and business affairs of their competitors.

The Commissioner, on the other hand, has the ability to gather obviously relevant information of this nature. Indeed, it would be extraordinary for the Commissioner not to have done so before commencing an abuse of dominance case. In *Canada Pipe*, the Tribunal acknowledged that the Commissioner clearly had documents relevant to the issues in this case which she chose not to disclose.[10] However, the Tribunal nonetheless refused to order the Commissioner to disclose these documents. In our view, the serious implications associated with allowing the Commissioner to collect relevant documents and then effectively conceal them from the Respondent and the Tribunal were evident from the *Canada Pipe* proceedings.

In *Canada Pipe*, the Commissioner had documents in her possession that clearly went to one of the most contentious issues in this case, the manner in which the relevant product market should be defined.[11] In the course of the Bureau's investigation of the drain, waste and vent ("DWV") industry, the Commissioner obtained section 11 orders against at least 19 industry participants, as well as Canada Pipe. Pursuant to the orders, industry participants were asked questions that were clearly germane to the issue of the relevant product market. For instance, one question asked industry participants for their views on substitutes to Canada Pipe's cast iron DWV products (e.g., copper, plastic, asbestos cement). The bulk of the materials the Bureau received pursuant to these orders were never produced. Of the few responses to this question that were disclosed, a number listed DWV products made from materials other than cast iron as potential substitutes.

Given that product market was a crucial issue in this case, access to all of the documents provided by third parties to the Commissioner on this point would have allowed Canada Pipe to prepare a more complete defence and given the Tribunal a broader and potentially much more accurate picture of the competitive landscape. Given that, unlike the Commissioner, Canada Pipe does not itself have the power to compel third parties and competitors to produce documentation or information, Canada Pipe was completely reliant on the Commissioner to use properly her investigative and other powers to obtain relevant information, and to disclose that information on a timely basis. The Commissioner took no steps, however, to gather certain types of information that were directly relevant to the definition of the relevant product market as asserted by Canada Pipe. By way of example, section 11 orders were not obtained against the producers or suppliers of the various products that Canada Pipe maintained were important components of the relevant product market, such as plastic, copper or asbestos pipe. In addition, many of the documents and much of the information obtained by the Bureau from industry participants were never produced. Furthermore, Canada Pipe's attempts to obtain such disclosure from either the Commissioner or the section 11 order recipients were rejected by the Tribunal.[12]

Similarly, in order to conduct an economic analysis of the cross-elasticities and pricing correlations of the various DWV products made from materials other than cast iron (including products the Commissioner argued should not be included in the relevant product market), analysis of detailed pricing and purchasing information relating to these other products would have been required. This information was not available to Canada Pipe. Nor would such similar information likely be available to any Respondent in any other abuse of dominance proceeding. Although the Commissioner apparently did not collect such information in this case, she was in a position to do so. Even if she had, she would have had no corresponding obligation to disclose the information if it were not favourable to her case.

Ultimately, the Tribunal accepted the Commissioner's view of the relevant product market and held that the relevant product market included only cast iron DWV products. The Tribunal reached this conclusion based on a patently inadequate factual record. It is clear that the Tribunal considered the lack of sufficient evidence to demonstrate the relationship between prices of DWV products made from cast iron and DWV products made from plastic to be a key determinant of this issue. However, it is difficult to conceive of how Canada Pipe could ever have collected detailed information about the prices of its competitors' products in the absence of compulsory powers of production or disclosure. We are left to question whether the Tribunal would have reached a similar

conclusion with the benefit of full disclosure from the Commissioner or discovery of other DWV product manufacturers.

The Commissioner's Position Is Unfairly Enhanced by the Revised Rules

Whatever the intended aims of the Revised Rules, the clear result has been to create an uneven playing field that favours the Commissioner and deprives the Tribunal of a complete or even reliable factual record. Under the Revised Rules, the Respondent and the Tribunal no longer have the benefit of all relevant information the Commissioner has collected during the course of an investigation. Instead, the Respondent must rely on documents the Commissioner chooses to disclose in support of her case, documents that are available publicly, or documents the Respondent can gather from third parties voluntarily.

The limited levels of disclosure imposed by the Revised Rules do not, however, negatively impact the Commissioner's ability to collect information necessary to put forward her case. The Commissioner can still utilize her right to discovery through the use of section 11 orders to compel oral discovery or documentary disclosure. In fact, the Commissioner's right to use section 11 orders continues even after a hearing has commenced. By contrast, the Respondent has no comparable investigatory powers that can act as surrogate discovery tools.

The result must necessarily be a systematic bias in favour of the Commissioner's challenges to trade practices under the non-merger provisions of the *Competition Act*, such that companies operating in Canada will be subject to orders under the abuse of dominance, tied selling, exclusive dealing and refusal to deal provisions where a full factual record would not justify such an order. General awareness of such bias will likely deter many Canadian businesses from engaging in conduct not intended to be deterred by the *Competition Act*, with potentially adverse consequences for the efficiency of such businesses and the Canadian economy as a whole.

Conclusions: Where Do We Go from Here?

In our view, given the far-reaching and ongoing implications that an application to the Tribunal under the abuse of dominance provisions can have upon a Respondent's business, there is simply no justification for differentiating between the Commissioner's disclosure obligations in merger and non-merger proceedings. As evidenced in *Canada Pipe*, a Respondent's ability to respond adequately and present a proper defence is severely limited by the Revised Rules.

As a result, we believe the Tribunal's Rules should be amended to impose upon the Commissioner the obligation to disclose all relevant documents the Commissioner has gathered during the course of an investigation. The circumstances in which the Commissioner should be permitted to invoke "public interest privilege" to shield relevant documents from production should be curtailed, and should be limited to those very rare cases where production would expose the party from whom the documents were obtained to an appreciable risk of harm or economic reprisal. The Commissioner should be required to meet this test for non-disclosure on a case-by-case basis, using proper evidence to do so.

If the Tribunal is to endure as an important and respected adjudicative body, it is imperative that its processes and procedures be fair and balanced, and that they do not favour one party at the direct expense of the other. Rights to substantive and procedural fairness cannot be sacrificed on the alter of expediency.

Furthermore, the Tribunal itself has a vested interest in ensuring that the decisions it reaches are well grounded in a complete and accurate evidentiary record. If the Tribunal reaches factual conclusions that industry participants (or others) know are either highly questionable or simply wrong, and does so based on an inadequate record, the credibility of the Tribunal will be undermined and calls for legislative reform to the Rules and structure of the Tribunal will mount. In addition, and perhaps most importantly, the Tribunal will risk issuing decisions that have the effect of impairing legal certainty and economic efficiency, and achieve the opposite of the intended goals of the *Competition Act* and the establishment of the Tribunal as a body with economic expertise.

Notes

* Kent Thomson and Anita Banicevic are partners at Davies Ward Phillips & Vineberg LLP and were part of the litigation team that represented Canada Pipe Company Ltd. in this matter. The authors would like to thank their partner, Charles Tingley, for his comments and assistance.

1 SOR/94-290, as amended. The reform package was promulgated by SOR/2002-62.

2 *Commissioner of Competition v. Canada Pipe*, 2005 Comp. Trib. 3 (February 3, 2005) CT-2002-006 (unreported) [*Canada Pipe*]. The *Canada Pipe* decision is available on the Tribunal's website at: http://www.ct-tc.gc.ca/english/CaseDetails.asp?x=68&CaseID=163#216. On March 7, 2005, the Commissioner of Competition announced that she had appealed the Tribunal's decision to Canada's Federal Court of Appeal on the grounds that the Tribunal allegedly erred in its determination that Canada Pipe's loyalty-based rebate program is not an anti-competitive act and has not resulted in any substantial lessening or prevention of competition. Canada Pipe has cross-appealed in respect of the issues of market definition and market power.

3 Hon. Justice S.J. Simpson, "Objectives of the Amendments to the Competition Tribunal's Rules Relating to Reviewable Matters Other than Mergers" (Paper presented at Canada's Changing Competition Regime, 26-27 February 2003).

4 *Ibid.* at 2.

5 *The Commissioner of Competition v. Canada Pipe Company Ltd.*, CT-2002-006, Transcript dated March 12, 2004, volume 10 at pages 1904-1906.

6 See Rule 21(2)(d).

7 *Commissioner of Competition v. Canada Pipe Company*, 2004 Comp. Trib. 2 (January 23, 2004) CT-2002-006 at para 58 [*Canada Pipe Motion Reasons*].

8 *R. v Stinchcombe*, [1991] 3 S.C.R. 326. In this case, the Supreme Court of Canada held that in criminal cases, the accused has a constitutional right to full and complete disclosure of the Crown's case. Thus, the Crown has a legal obligation to disclose all relevant information in its possession.

9 Simpson, *supra* note 3.

10 *Canada Pipe Motion Reasons, supra* note 6 at para 48.

11 While Canada Pipe argued that the relevant product market must include drain, waste and vent products made from materials other than cast iron, including plastic, copper, asbestos cement and stainless steel, the Commissioner argued that the relevant product market included only cast iron drain, waste and vent products.

12 Canada Pipe attempted to obtain further disclosure from the Commissioner under Rule 21 but its motion was dismissed by the Tribunal. Canada Pipe also tried to obtain further disclosure from some of the section 11 order recipients (who were called to testify by the Commissioner at the hearing) through the use of *subpoenas duces tecum*; however, the subpoenas were quashed by the Tribunal at the request of the Commissioner.