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Intelligence MEMOS

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From: John Rook and Larry Schwartz
To: Competition Policy Observers
Re: COMPETITION BUREAU DRAFT GUIDELINES: IS EFFICIENCY ON LIFE-SUPPORT?

Recently, Jeanne Pratt, now interim Commissioner of Competition, trumpeted the positive impact of recent amendments to the *Competition Act* that make it more difficult to clear mergers. Prior to these amendments, market share and concentration were two of the factors considered in making this assessment; now they are pre-eminent.

The recent amendments also removed the s.96 efficiency defence to an anti-competitive merger. Combined with the renewed emphasis on market share and concentration evidence, the early assessments for a role for efficiency in merger review have been quite negative.

Last fall, the Bureau released its 90-page proposed Merger Enforcement Guidelines (MEGs) and initiated a public consultation which is ongoing.

1 The new structural presumption

As part of the market-power inquiry under s.92(1), the *Competition Act* continues to require the finding of a substantial lessening or prevention of competition in order to stop a merger.

However, s.92(2) of the Act now instructs the Competition Tribunal, the adjudicator of cases, to find a lessening or prevention of competition solely from evidence demonstrating a significant increase in market shares and concentration. If the post-merger market share exceeds 30 percent and concentration as measured by the Herfindahl-Hirschman Index (HHI) exceeds 1,800, the merger is presumptively anti-competitive.

Although not a statutory requirement in US antitrust law, a similar presumption has long been a feature of the its Merger Guidelines. The **1984 guidelines** (pdf p.15) say that if the increase in the HHI exceeds 100 and the post-merger HHI substantially exceeds 1,800, only in extraordinary cases will pro-competitive factors including efficiencies establish that the merger is not likely substantially to lessen competition.

Moreover, those guidelines required merging parties to offer evidence of significant net efficiencies with "clear and convincing evidence" (pdf p.16) to rebut that presumption. This latter requirement was **dropped** from the 1992 US Horizontal Merger Guidelines in order that efficiency evidence not be held to a higher standard of proof than evidence demonstrating a likely anticompetitive effect.

2 What does the absence of s.96 mean?

With the s.96 efficiency defence to an anti-competitive merger gone, the practical effect is to shift consideration of merger efficiencies to s.93(h) which continues to enable the Tribunal to consider "any other factor" it deems relevant to the question whether the merger is anti-competitive.

This enables merging parties to present evidence on the merger's pro-competitive effects including efficiencies, but the draft MEGs provides little guidance on how the Bureau will evaluate such evidence. All that can be said for certain is that the statute does not rule out a so-called "trade-off," whether as previously defined in s.96 or something else; efficiencies could be a consideration under s.93(h) but not a defence.

The draft MEGs identify the "pro-competitive benefits" that mergers may present and also discuss certain conditions under which the Bureau will consider those benefits. At p.71, it insists that such benefits must be "verifiable and likely to occur" and rivalry-enhancing.

The further requirement that pro-competitive benefits must be "specific to the merger" is unclear. Under the previous s.96 in *Hillsdown* and *Propane*, the Tribunal had held that only the efficiencies that would not be achieved absent the merger (i.e. if the order were made) could be included in the trade-off. Does the absence of s.96 now indicate that proven pro-competitive benefits will not be considered if they can be achieved in another, presumably less anti-competitive, way?

Regarding efficiencies in particular, the draft MEGs further acknowledge that

> "Some mergers may result in a more effective use of productive resources, or "efficiency," where they lead to certain types of cost-savings, or benefit consumers by combining complementary assets or products." (s.286, p.71)

But they also state that

> "…when a merger otherwise presents significant competition concerns, even gains that are supported by rigorous evidence are unlikely to change our conclusions regarding harm to competition." (s.288, p.71)"

The Bureau's view is that proven merger efficiencies will not count when the merger presents "significant competition concerns" but does not elaborate. Unlike the US merger guidelines since 1992, this position indicates clearly that the Bureau will hold efficiency evidence to a higher standard than evidence of concentration or market share.

3 What is the standard for efficiency gains?

Prior to its removal, s.96 had required that proven efficiencies must "exceed and offset" the effects of an anti-competitive merger. However, the draft guidelines do not discuss how large proven efficiencies must be to be considered a positive factor under s.93(h).

The obvious starting point for merging parties is to demonstrate that proven efficiencies exceed the efficiency (or "deadweight") loss arising from the merged firm's exercise of market power. Such evidence would support the conclusion that efficiencies are a positive factor in that inquiry. The Bureau's draft MEGs make no mention of either the deadweight loss or of the wealth transfer that were central foci in previous MEGs. Perhaps because the draft mentions the "effect on competition" nine times, this could indicates that the Bureau now accepts that the former is the merger's effect "on competition" whereas the latter, being an effect on the distribution of income, is not.

If so, then under the draft MEGs, merging parties will be able to argue that proven efficiency claims need only exceed the proven deadweight loss to be considered a positive factor under s.93(h). It follows that the larger this positive factor is, the more likely it is that the Tribunal would find that the merger does not create an SLC/SPC.

They should also insist that their efficiency estimates be reviewed under the same evidentiary standards that apply to the Bureau's market share and concentration evidence.

4 A Chilling Effect on Mergers?

However, as few merger proponents will be willing to litigate the Bureau's assessment at the Tribunal, the structural presumption in s.92 will often trump a more nuanced consideration of the pro-competitive factors under s.93.

All of which suggests that the recent amendments to the *Competition Act* will have a chilling effect on merger activity, particularly among large, older companies seeking to become more effective competitors by restructuring via merger.

The statutory structural presumption, the removal of the s.96 efficiency defence and the unanswered questions in the draft MEGs have made it more difficult for merging parties to invoke merger efficiencies in Canada than in the United States. This is troubling because the Canadian economy remains a small, open economy compared to the United States.

Note however that the "purpose clause" in s.1.1 of the *Competition Act* was not amended and continues to require that competition be maintained and encouraged in order to achieve all the listed objectives including the efficiency and adaptability of the Canadian economy. So the statutory structural presumption in merger review must be used with some care and applied together with s.93(h).

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