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Efficiencies Analysis in Canada

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EFFICIENCIES ANALYSIS IN CANADA

Seminar: Economic Analysis
in Horizontal and Non-Horizontal Mergers
APEC 2019 – Chile

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- The views and opinions expressed in this presentation are entirely those of the speaker and do not necessarily represent any policies or positions of the Commissioner of Competition, the Competition Bureau or the Department of Justice of Canada. Any mistakes and omissions are entirely those of the presenter.

Agenda

- What is the efficiencies defence in Canada?
  - Key principles evolved from policy and jurisprudence

- Application of the efficiencies defence in practice
  - Case examples

Role of Efficiencies

- Legislative/policy debate going back as far as 1969
  - Moved from 'public interest' test to a **focus on economic goals.**
  - Recognition that mergers can produce efficiencies and anti-competitive effects.

- Part of the purpose clause of the *Competition Act* (1986)
  - **"…to promote the efficiency and adaptability of the Canadian economy…"**

- *Competition Act* provides an explicit efficiencies exception/defence to an anti-competitive merger
  - **Trade-off analysis**
  - Different from the '**integrated analysis**' applied in most other jurisdictions

- A thorough assessment of efficiency claims is unnecessary in the vast majority of Bureau reviews.

Explicit Provision in the *Competition Act*

Exception where gains in efficiency

s.96.(1)

The Tribunal shall not make an order prohibiting a merger or proposed merger (under s.92) if it finds that the merger or proposed merger

"has <u>brought about or is likely to bring about</u> gains in efficiency that will be <u>greater than, and will offset</u>, the effects of any prevention or lessening of competition … and that the gains in efficiency would <u>not likely be attained if the **order** were made</u>. (emphasis added)

Factors to be considered

s.96(2)

"In considering whether a merger or proposed merger is likely to bring about gains in efficiency …. consider whether such gains will result in (a) a significant increase in the real value of exports; or (b) a significant substitution of domestic products for imported products."

s. 96(3)

"For purposes of this section, the Tribunal shall not find that a merger or proposed merger has brought about or is likely to bring about gains in efficiency by reason only of a redistribution of income between two or more persons."

Visualizing the Trade-off

Gains in efficiency not likely to be attained if an order is made.

(cost of making an order)

Effects of any prevention or lessening of competition likely to result from merger

(cost of <u>not</u> making an order)

Merging Parties' burden to show

Commissioner's burden to show

Merging Parties' burden to demonstrate that the left side will be **greater than, and will offset,** the right side.

Who Bears the Burden

Commissioner's burden:

- To show the effects of any prevention or lessening of competition likely to result from the merger

Merging Parties' burden:

- To show the nature, magnitude, likelihood and timeliness of the gains in efficiency arising from the merger
- To show that gains in efficiency will be greater than and will offset the anti-competitive effects, both quantitatively and qualitatively

Screening for Cognizable Efficiencies

- Must not likely be attained if an order were made
  - An order may apply to the merger in its entirety or to limited parts of the merger
- Must be "likely" to be brought out by the merger
- Must relate to certain categories of efficiencies
  - Primarily productive efficiencies; could also be dynamic efficiencies
- Must accrue to the Canadian economy
- Must not be brought about by reason of a redistribution of income between two or more persons (s. 96(3))

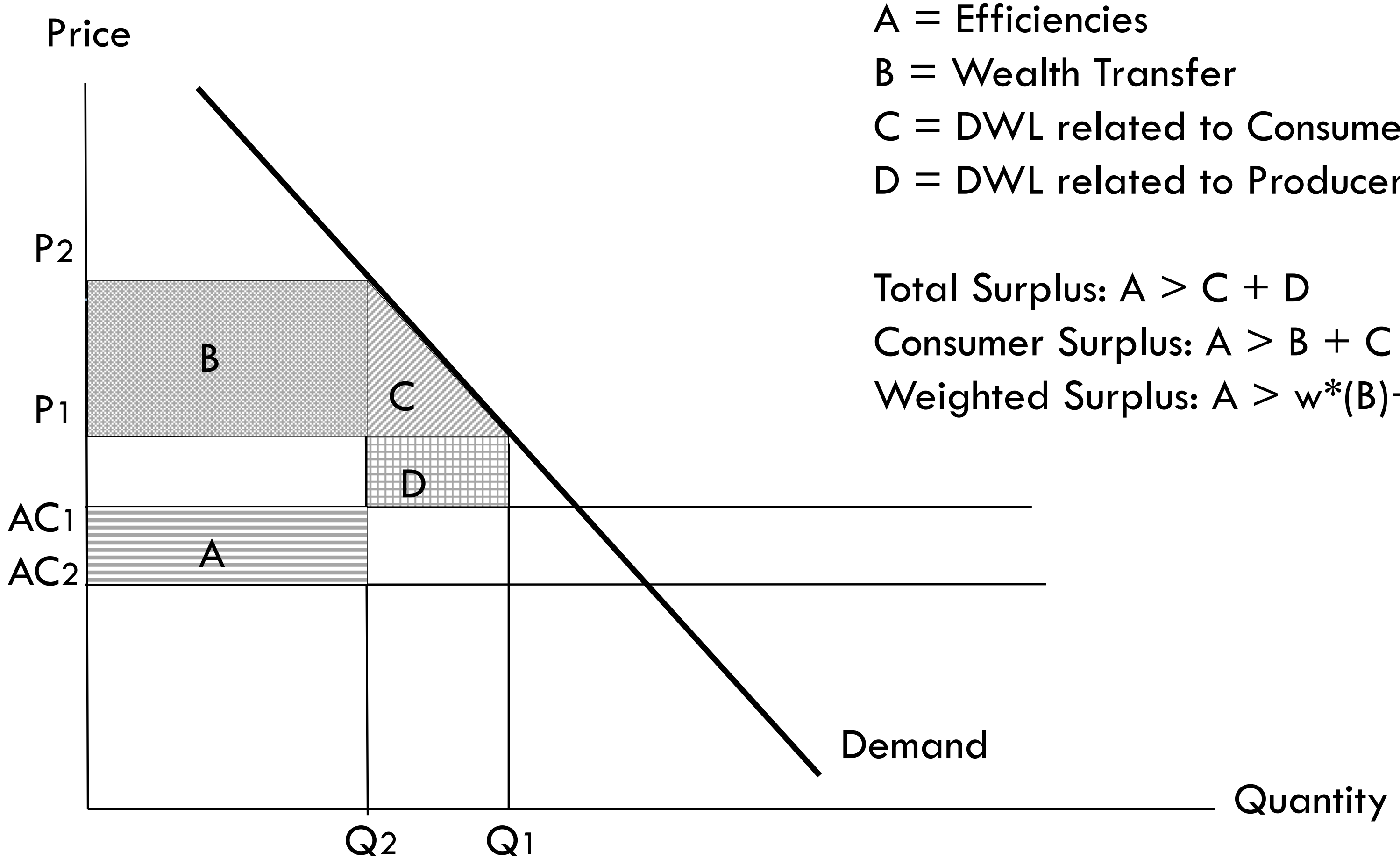
Identifying Anti-competitive effects

- Anti-competitive effects arise when a merger likely results in a substantial lessening or prevention of competition(s.92)
  - includes price effects and non-price effects (both quantitative and qualitative)
- **Price effects:**
  - Deadweight Loss (DWL)
    - Arises because some customers stop purchasing the good and/or switch to inferior/less desirable substitutes
    - Loss of allocative efficiency = anti-competitive effect
  - Wealth Transfer (WT)
    - Arises because some customers are willing to pay the higher price without altering their consumption
    - Redistributive effect may or may not be an anti-competitive effect, depending on the "welfare standard"

Welfare Standards

- **Price standard:** $\Delta p \leq 0$
- **Consumer surplus standard (CSS)**
  - E > WT + DWL
  - Treats the entire WT as an anti-competitive effect (no credit to producer)
- **Total surplus standard (TSS)**
  - E > DWL
  - Ignores the WT (i.e., implicitly assumes equal weighting on surplus of consumers and producers, where WT nets out)
- **Weighted surplus standard (WSS) – current approach in Canada**
  - E > w*(WT)+ DWL
  - Allows for differential weighting of consumer surplus vis-à-vis producer surplus, proportionate to socio-economic differences, where w≤ 1

Simplified Trade-off Diagram



A = Efficiencies
B = Wealth Transfer
C = DWL related to Consumers
D = DWL related to Producers

Total Surplus: A > C + D
Consumer Surplus: A > B + C
Weighted Surplus: A > w*(B)+C+D

Application of the Efficiencies Defence

- Validation and analysis of efficiency claims conducted by Bureau officers and economists as well as experts
  - May be considered by the Competition Tribunal in a contested proceeding
  - May be considered by the Commissioner without going to Competition Tribunal

- Claims are substantiated by documents prepared in the ordinary course of business
  - **Financial information**: plant and firm-level accounting statements, internal studies, strategic plans, integration plans, management consultant studies and other data and information from operations-level personnel
  - **Other information**: efficiencies realized from previous mergers involving similar assets; pre-merger info on product and process innovation; information related to economies of scale (MES), and economies of scope

Examples where Efficiencies Mattered

- Two contested cases where Competition Tribunal/Courts accepted the efficiencies defence
  - Propane, Tervita

- Recent examples where the Commissioner approved a merger on the basis of efficiencies (without applying to the Competition Tribunal)
  - Superior/Canexus (2016), Superior/Canwest (2017)

How to Measure Effects

- The trade-off requires a quantification of anti-competitive effects (Supreme Court in *Tervita*)
  - Estimates of demand elasticity (where data can be reasonably obtained)
    - Rough estimates based on internal documents, experts, market witnesses, natural experiments
  - Merger simulation models
  - Open to Competition Tribunal to accord qualitative weight

How to Measure Efficiencies

- **What counts:**
  - Most typically, savings in fixed costs and variable costs – e.g. reductions in overhead; rationalization/optimization of facilities and logistics
  - Elimination of double marginalization (in vertical cases)

- **What doesn't count:**
  - Cost savings that are redistributive in nature (e.g. savings from increased bargaining leverage with suppliers)
  - Cost savings that would have been achieved through alternative means
  - Cost savings that would not be affected by a remedial order
  - Cost savings that do not accrue to the Canadian economy
  - Cost savings resulting from a reduction in output, service, quality or product choice

- Must also deduct the costs of implementing the merger and achieving the efficiencies

Case Example: Superior/Canwest (2017)

Competitive Effects Analysis

Market Definition

Relevant Product Market: **retail sale of bulk propane**

- 3 categories of customers (residential, commercial and institutional, oilfield)

Relevant Geographic Market: **local**

- location of customers; topography/road access; distance between retail sites, delivery areas based on analysis of customer delivery data

High barriers to entry and little to no effective remaining competitors

SLC in 22 of 25 relevant markets of overlap

Quantification of effects: Bertrand model of competition with Logit demand

- Differentiated suppliers competing by setting price
- Pre-merger data used to calculate each firm's profit maximizing P and Q, both pre- and post-merger
- Results used to estimate likely anti-competitive effects

What Effects Counted:

• Loss of allocative efficiency i.e. deadweight loss arising from a reduction in output when price is increased	+	Socially adverse portion of the wealth transfer from lower-income residents and from government entities to bulk propane retailers

Case Example (continued)

- QUESTIONS:
- What remedy (remedial order) would effectively address the competitive harm arising from an SLC?
- Are there cognizable gains in efficiency that would be lost if that remedy is implemented?
- Do the cognizable gains in efficiency significantly outweigh and offset the competitive harm?

Case Example (continued)

Efficiencies Analysis
Timely and detailed information allowed Bureau to validate the claimed efficiencies outside of a litigated Tribunal process
Scope of remedy: local market divestitures (without a full block) could address the competitive harm • Unique trade-off at local level was possible in this case because both the efficiencies and the anti-competitive effects were highly divisible due to nature of assets and geographic market

Productive Efficiencies considered:
• Cost savings arising from rationalization of facilities and logistics given overlap between merging parties' locations and delivery routes
• Cost savings arising from head office rationalization
    • Some head office efficiencies may be lost as a result of the remedy that involves only a small portion of the acquired assets;
    • However, head office costs that would be incurred by a buyer involved in the remedy were not considered to be lost efficiencies because they were not considered to be lost as a result of the order

Case Example (continued)

- Local market trade-off:
  - Comparing the likely efficiencies from the proposed transaction in each of the 22 local markets to the likely anti-competitive effects in each of those 22 markets
- Conclusion:
  - Remedy not required in 10 markets where E were likely to clearly and significantly outweigh the A-C effects
  - Remedy required in 12 markets where E would not be likely to clearly and significantly outweigh the A-C effects
    - Divestiture of retail propane sites and associated assets, including customer contracts
    - Modification (waiver) of contract terms which impede customers switching in certain markets (e.g. automatic renewal, exclusive supply or minimum volume requirements, equipment removal, termination fees)
    - Consent Agreement detailing the remedy was registered with Competition Tribunal