IN THE WEST, COMPETITION LAW GOVERNS THE RISING KINGS OF THE ECONOMY

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I. INTRODUCTION

The primary goal of *most* nations' governments is simple: to maximize social welfare. Developed nations attempt to achieve this through economic efficiency, and in the West, by implementing a "free market" economy.

Perfectly competitive markets will lead to a "Pareto Efficiency" (i.e. maximum social welfare). But a perfectly competitive market can scarcely be found, if it exists at all. In most industries, perfect competition is stifled by asymmetric information between firms at all levels. Varying scales, productive capabilities, and efficiency levels also adversely affects the competitive balance in any industry. Most developed capitalistic economies have some form of government intervention policy aimed to increase economic efficiency by promoting competition. In Canada, this policy is reflected in *The Canadian Competition Act*. Other nations have similar acts, the United Kingdom for instance, has the *Competition Act* (1998) along with the *Enterprise Act* (2002), each of which are aimed at controlling firms that abuse dominant market positions.[2]

All forms of these pro-competition government regulatory Acts share certain similarities. In general, they aim to: (1) prevent collusion between firms; (2) increase information symmetry; (3) prevent predatory pricing tactics and price fixing; and (4) reduce concentration of market power.

After defining economic competition and the goals of the Canadian Competition Act, this report analyses three landmark case studies: (1) the 1998 proposed bank mergers (the Bank of Montreal and the Royal Bank of Canada, and the Canadian Imperial Bank of Commerce and the Toronto Dominion Bank); (2) the 1999 proposed merger between Air

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[2] UK Enterprise Act 2002

Canada and Canadian Airlines; and, (3) the 2000 proposed merger between Superior Propane and ICG Propane.

II. MAXIMUM ECONOMIC EFFICIENCY REQUIRES PERFECT COMPETITION

If maximum social welfare is a function of market efficiency, then good government should seek to reduce or eliminate market inefficiencies. Pareto Efficiency, or maximized social welfare, is an important concept in economic theory and practice. To better understand the concept, “perfectly competitive markets” should be defined.

A perfectly competitive market has three main characteristics: (1) many buyers and sellers exist in the market; (2) goods and services offered by the various sellers are generally the same; and, (3) firms can freely enter or exit the market (i.e. low barriers to entry).[3] A perfectly competitive market has two important types of efficiencies. The first is productive, which means goods and services are produced at the lowest possible cost. The second is allocative, which means price is set at the marginal cost. Monopolies lead to allocative inefficiencies, for instance, price is set much higher than marginal cost.[4] The purpose of Competition Law is to prevent, correct, or regulate these inefficiencies to achieve maximum economic efficiency.

A. How Governments Effect Economic Efficiency

The Canadian Competition Act is designed to increase economic efficiency, by promoting competition. The Act regulates four broad practices effecting market competitiveness: (1) anti-competitive acts and unfair business practices of existing

[3] *Principles of MicroEconomics,* 1st Canadian Edition, Mankiw, Kneebone, Mckenzie, and Rowe, Page 288
[4] *MicroEconomics,* 11th Canadian Edition, Christopher T.S. Ragan and Richard G. Lipsey, Page 305

monopolies; (2) unethical marketing and advertising practices; (3) anti-competitive acts, such as collusion, price fixing, and partitioning markets amongst firms; and, (4) mergers that would lead to high market concentration.[5] The Canadian parliament passed the Act in 1986.

B. The Role Of The Competition Bureau And The Competition Tribunal

The Competition Bureau's responsibility is to administer the Competition Act. The Bureau is an independent law enforcement agency. In prospective large mergers, the firms must notify and seek permission from the Competition Bureau.

When notified, the Competition Bureau performs an economic analysis that: (1) defines the relevant market (e.g. is "propane" in the propane market or the fuel market?); (2) identifies the current "market power" structure; (3) determines how the market power would change as a result of the prospective merger; and, (4) weighs the projected change in market power and projected market efficiency gains (i.e. if the merger is approved, will consumer costs be reduced, and profits increased?). In cases where a merger may have a detrimental effect on Canada's overall social welfare, the Director of the Competition Bureau sends the case to the Competition Tribunal for adjudication.[6]

C. The Tribunal And Its Application Of The Competition Act

The Competition Tribunal has the responsibility to apply the Act. Section 96 of the Competition Act is dedicated to mergers, and states clearly that a merger shall be permitted if "economic efficiency" will result. Section 2.1 of Part 2, The Anti-Competitive Threshold, defines the Tribunal's responsibilities with respect to mergers:

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[5] Class Notes: Competition Act + Mergers, Dr. A.G. Nimarko
[6] *MicroEconomics,* 11th Canadian Edition, Christopher T.S. Ragan and Richard G. Lipsey, Page 303

2.1. As set out in Section 91(1) of the Act, the Tribunal may make an order when it finds that a merger "prevents or lessens, or is likely to prevent of lessen, competition substantially." A substantial prevention or lessening of competion results only from mergers that are likely to create, maintain, or enhance the ability of the merged entity, unilaterlaly, or in coordination with other firms, to exercise market power.[7]

The Tribunal must decide whether a prospective merger will increase or decrease market concentration. The Tribunal weighs a variety of factors including the competitive balance of the defined market, the subsequent quality of product, consumer choice, and most importantly price.

III. GOVERNING CONCENTRATED ECONOMIC POWER

Lord Acton, an English politician, famously said, "Power tends to corrupt, and absolute power corrupts absolutely." At around the end of the 20th century the Tribunal ruled on three prospective mergers, which fundamentally illustrates how Canada governs the potential of concentrated economic power.

A. Two "Big Five" Proposed Bank Mergers

In 1998 the Royal Bank of Canada and the Bank of Montreal proposed to merge. In the same year the Canadian Imperial Bank of Commerce and the Toronto Dominion Bank proposed to merge. These two proposals lead to the most exhaustive merger review process ever carried out in Canada. The review period totalled ten months.[8] Finally, on

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[7] *Competition in the Canadian Small and Medium Sized Business Financing Market*, December 2003, Canadian Bankers Association, http://www.fin.gc.ca/consultresp/mergersRespns_7e.html#Executive%20Summar

[8] Annual Report 98/99 – Reviewing Mergers, Department of Finance Canada

December 14, 1998, then Finance Minister Paul Martin announced that the bank mergers would *not* be permitted.[9]

The Canadian domestic financial services market is dominated by "the Big Five." The Big Five are the five largest financial institutions in Canada, the Royal Bank of Canada, the Toronto-Dominion Bank, the Bank of Nova Scotia, the Bank of Montreal, and the Canadian Imperial Bank of Commerce. The Big Five are more properly defined as international financial conglomerates. In fact, 44% of RBC's Banking branch—the core of Canada's largest financial institutions activities—serves non-Canadian clients.[10] According to Bloomberg in 2011, all five banks were ranked amongst the world's top 20 strongest $100 billion dollar asset banks.[11]

The two proposed mergers would have allowed Canada's banks to spread enormous fixed costs over a much larger client base. With billions of dollars already being generated on the global market, the mergers would promote scale efficiency, which would better enable the banks to compete internationally. However, the issue was whether *Canadians* would benefit or suffer from increased domestic concentration?

The banks argued that concentration would have little to no effect on competition. The banks claimed that the three most fundamental elements of competition would still exist: choice, price, and access. With over 1,300 credit unions and 58 foreign and domestic banks to choose from, the banks claimed the Canadian bank market would

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[9] In cases of Chartered Bank mergers, the federal minister of finance, makes the final decision.
[10] *MicroEconomics,* 11th Canadian Edition, Christopher T.S. Ragan and Richard G. Lipsey, Page 304
[11] www.wikipedia.com/bankingincanada

remain highly competitive.[12] Studies conducted by several banks as well as by analysts such as PriceWaterHouseCoopers indicated that retail bank prices and loan approval rates are much more favourable for small businesses and the consumer in Canada than in the United States.[13]

Unfortunately for the banks, the Tribunal found otherwise. Finance Minister Paul Martin—citing strong evidence presented by the Competition Bureau—deemed that the mergers risked: (1) excessive market concentration and market power leading to increased barriers to entry, higher prices, and reduced services; (2) a large reduction in competition; and, (3) reduced policy flexibility for the government to address potential future financial matters.[14] The Minister claimed that the decision was based on the best interests of Canadian consumers and small businesses and that no merger would be allowed until a strong and competitive financial services sector policy framework could be implemented:

> "The government will not consider any merger among major banks until the new policy framework is in place. But even then, new proposals will first have to demonstrate, in the light of the circumstances of the day, that they do not unduly

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[12] *Competition in the Canadian Small and Medium Sized Business Financing Market*, December 2003, Canadian Bankers Association, http://www.fin.gc.ca/consultresp/mergersRespns_7e.html#Executive%20Summar
[13] Id.
[14] Response of Superior Propane Inc. and ICG Propane Inc. (Document # 20) SUPERSEDED by Document # 62 1999-01-29, http://www.ct-tc.gc.ca/english/CaseDetails.asp?x=219&CaseID=202#274

concentrate economic power, significantly reduce competition or restrict our flexibility to address prudential concerns."[15]

The Canadian Federation of Independent Business, in a letter to parliament, agreed with the Tribunal's decision, stating that Canada already had one of the most concentrated banking systems in the world.[16] The Tribunal held that competition would be reduced through a merger, which would only serve to further concentrate the market.

B. Justified Monopoly For Canada's Airlines

In 1992, Canadian Airlines received a merger proposal from Air Canada. The deal later broke based on concerns of excessive debt loads, on both sides, but was a strong indicator that both airlines were in significant financial trouble. Seven years later, in August 1999, Canadian Airlines accepted Air Canada's merger proposal, forming Canada's single dominant airline.

In the early 1990's both Canadian Airlines and Air Canada reported losses of $208 million and $448 million respectively.[17] The majority of these losses were due to sunk costs (costs that have already been incurred and cannot be recoverd). By 1999, with both airlines riddled in debt, both Canadian Airlines and Air Canada considered a merger as the only viable way to achieve long-term financial stability—the Competition Bureau agreed.

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[15] Finance Minister, Paul Martin, December 14, 1998, Response of Superior Propane Inc. and ICG Propane Inc. (Document # 20) SUPERSEDED by Document # 62 1999-01-29, http://www.ct-tc.gc.ca/english/CaseDetails.asp?x=219&CaseID=202#274
[16] Competition in the Public Interest: Large Bank mergers in Canada, the Standing Senate Committee on Banking, Trade and Commerce, Sixth Report, December 2002, www.parl.gc.ca
[17] Principles of MicroEconomics, 1st Canadian Edition, Mankiw, Kneebone, Mckenzie, and Rowe, Page 295

The primary concern in opposition was that the merger would effectively create a monopoly in Canada's domestic airline industry. Opponents argued that the monopoly would cause massive layoffs, potential price increases, a likely reduction in domestic ownership, and a proposed reduction in services. However, after a review by the Competition Bureau, the Commissioner of Competition agreed that the merger—despite creating an effective monopoly—was warranted and necessary for the survival of a Canadian controlled airline company. But the Competition Bureau's acceptance would come with several stipulations aimed at protecting the public's interest.

The Competition Bureau established five main provisions, which targeted pricing, competition, Canadian ownership and control, services to small communities, and fair treatment of employees. The provisions addressed both domestic and international competition issues, including domestic restrictions on pricing tactics such as discounts in certain markets. International provisions included a new competitive framework aimed at enabling international competitors full access to all Canadian airline markets.[18]

Although both airlines were in financial ruin prior to 1999, the merge did little to turn the crisis around. In the wake of the 2001 terror attacks, which negatively effected airline revenue, Air Canada's post-merger debt load became crippling, and on April 1, 2003, Air Canada filed for bankruptcy protection. The company still faces financial difficulties, and remains billions of dollars in debt.[19]

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[18] Minister of Transport Prepared to Approve the Air Canada Transaction to Purchase Canadian Airlines – Secures Commitments to Protect Public Interest, Transport Canada, media room, news release, http://www.tc.gc.ca/mediaroom/releases/nat/1999/99_h113e.htm

[19] Www.cbc.ca/news/background/aircanada/history

C. Merging Natural Gas

On December 7, 1998, Superior Propane formally applied to the Competition Tribunal for the right to acquire ICG Propane Inc. A hearing was set for September 9, 1999. Numerous expert witnesses were drawn on both sides to perform economic analysis on the market consequences of the acquisition. On January 31, 2003, after several appeals, the decision to allow the merger was granted. The primary motivation for the acquisition was economic efficiency.

Superior was successfully able to show that the merger would lead to around $300 million dollars in economic gains, and would have no detrimental effects on the market. Superior showed that other fuel sources, in particular natural gas, accounted for approximately 98% of the market share and therefore the propane merger would not substantially lessen market competitiveness. Superior's report also claimed that the propane industry had historically been easy to enter, and that the merger would not raise any significant barriers.[20] The Commissioner of the Competition Tribunal called on numerous experts who reached varying conclusions. However, there was an expert consensus that the merger may: (1) lead to higher domestic propane prices; and, (2) increase barriers to entry in the industry.

Experts and leading economists working on behalf of the propane companies claimed that the findings of the Commissioners' experts were based not on empirical evidence, but rather solely on theoretical economics. Mr. Gustavo E. Bamberger, arguing on behalf of Superior, discounted the claim that an increased market share would lead to higher prices, indicating that there is no consistent correlation between market share and

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[20] *Expert Rebuttal Affidavit of D. Carlton and G. Bamberger* d. 14.09.99 1999-12-03, http://www.ct-tc.gc.ca/english/CaseDetails.asp?x=219&CaseID=202#274

market prices. Bamberger stated in his testimony: “even a monopolist has incentive to pass along some portion of cost savings because it increases its sales (and profits) by doing so.”[21] Mr. Dennis W. Carlton, a second lead economic expert for Superior, performed a detailed economic analysis and concluded that: (1) there is no economic evidence to support the claim that retail propane prices depend on the number of “national” suppliers in Canada; (2) there is no systematic evidence that shows propane prices are constrained by either ICG or other independent retailers; and, (3) based on evidence from a prior Superior acquisition, the merger would not substantially lessen competition.[22] Mr. Carlton’s claims were substantiated by empirical evidence showing that entry and expansion had already taken place within the industry, and that Superior’s prices were constrained by independent competition.

The Commissioner argued that the merger would lead to a concentrated market, creating significant barriers to entry. He also argued that domestic market prices would subsequently rise. However, the Commissioners’ claims were not supported by concrete evidence. Whereas, on the other hand, economic analysis had showed that merger efficiencies would lead to $29 million in profit, and only $8.6 million in anti-competitive effects.[23] The Tribunal concluded that economic efficiencies justified ruling in favor of Superior.

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[21] *Competition in the Canadian Small and Medium Sized Business Financing Market*, December 2003, Canadian Bankers Association, http://www.fin.gc.ca/consultresp/mergersRespns_7e.html#Executive%20Summar
[22] *Id.*
[23] *Merger Enforcement Guidelines, Part 2 – The Anti-Competitive Threshold, Overview*, Section 2.1, The Canadian Competition Act

IV. CONCLUSION

The Canadian Competition Act has greatly impacted many domestic industries and has played an integral role in shaping Canada's economic framework since 1992.

In Superior Propane and ICG Propane Inc., economic efficiencies outweighed market concentration, and the Competition Tribunal accepted the merger. In the case of the "Big Five" bank mergers, domestic market concentration outweighed the importance of scale efficiencies and global competitiveness, and the Competition Tribunal rejected the merger. In each case, the Competition Bureau analysed whether the mergers would ultimately benefit Canadians. The Competition Bureau weighed factors such as market concentration, barriers to entry, and price.

The primary goal of Canada's government should be to maximize the social welfare of its citizenry. Canada attempts to achieve this through economic efficiency, by implementing a "free market" economy. Perfect economic efficiency can only be achieved through perfectly competitive markets. But market imperfections, like asymmetric information and unethical business practices, are inevitable.

In an increasingly complex and global economy, anti-competitive law and the governmental agencies that apply it, such as the Canadian Competition Bureau, will play a vital role in achieving the illusive and indefinable so-called Pareto Efficiency, maximum social welfare.