



**NEW ZEALAND INSTITUTE FOR THE STUDY
OF COMPETITION AND REGULATION INC.**

**The Efficiencies Defense in Merger Analysis
in Canada and the US**

Frank Mathewson

**Professor (Economics), Director of the Institute for Policy Analysis (University of
Toronto), and Senior Consultant, Charles River Associates**

Whatever the statutory differences or language differences in Guidelines between Canada and the US, the application of competition rules and procedures is remarkably similar in the two countries. Recent adjustments to the role of efficiencies in merger analysis in the two countries reveal a potential departure from this claim. The Canadian Competition Bureau (the agency responsible for the implementation of competition policy in Canada) has moved from a clear and focused position on the role of efficiencies in merger analysis to one that is much less certain and focused. For its part, the US agencies (Department of Justice and the Federal Trade Commission) have moved from a more ambiguous or undefined position on the role of efficiencies in merger analysis to one that is more certain and focused.

The background for this claim on the role of efficiencies is as follows. I begin with Canada. Canada's *Competition Act* (the "Act") gives explicit statutory recognition to efficiencies, in both the introductory section (section 1.1) and the merger section (section 96). This latter section prohibits the Canadian Competition Tribunal from making an order against a merger if the proposed merger would bring about gains in efficiency that are greater than, and would offset, any prevention or lessening of competition, provided that these gains would not likely be attained without the merger. A merger involving a substantial lessening of competition that might otherwise require a remedy or even be prohibited might be permitted to proceed if the efficiency gain is large enough.

Most observers, including most economists, believe that the appropriate metric for balancing these offsetting effects is the standard of total surplus. Surplus to the

shareholders of the merging parties is the profits earned by the merged entity. Surplus to consumers is the value that they attach to consuming the product relative to the price that they pay. Total surplus is the sum of these two surpluses. A merger would pass muster if this sum were positive.

The following is illustrative. Suppose that competitive prices prevail before a merger. Suppose further that each consumer buys only one unit of the product. Then the loss of consumer surplus from a merger that increases prices above competitive levels is the surplus lost by consumers priced out of the market. Notice that a merger that results in a price increase transfers some surplus from consumers who continue to buy the product to the shareholders of the merged entity. These consumers willingly pay the higher price for the good and this transfer is counted as neutral as the merger does not eliminate this surplus from the economy. The lost surplus comes from those consumers who now no longer purchase the product when they formerly did at the pre-merger competitive price. It is this loss that must be balanced against any efficiencies that uniquely result from the merger.

The confusion on the application of this metric comes from a series of announcements from the Canadian Competition Bureau.

- (i) The 1991 Canadian Merger Enforcement Guidelines state that when a merger produces a price increase, as I outline above, the merger brings about a neutral redistribution effect and a negative resource allocation effect. The efficiency gains need to be balanced against the negative resource allocation effects. The guidelines recognize that when a dollar is

transferred from a buyer to a seller, there can be no determination who is more deserving or in whose hands this dollar has greater value.

- (ii) In one 1992 case (the *Hillsdown* case), the Competition Tribunal (the Canadian administrative law tribunal that hears competition cases) questioned (in an *obiter*) the metric that should be applied to this trade-off in merger analysis. In response, the then head of the Competition Bureau maintained an allegiance to the approach set out in the Merger Enforcement Guidelines.
- (iii) In September 1999, the current head of the Bureau stated that no merger to monopoly could ever bring about gains in efficiency sufficient to offset the effects of the merger on competition.
- (iv) Recently, the Bureau has stated that a merger that creates a substantial lessening of competition but would pass under the total surplus standard would be passed to the Competition Tribunal to determine the appropriate welfare metric to assess the merger.
- (v) More recently, the chief economist of the Bureau proposes a two-stage test. At stage 1, if buyers of the relevant products are similar and the quantity that they purchase is virtually independent of the income levels of the buyers, then the conventional surplus metric will apply. If this is not so, then at stage 2, the Bureau will seek to assess whether the transfers arising from the merger can be considered to be neutral.

These statements are confusing and raise a number of concerns. For example, a merger to monopoly with sufficiently large cost savings unique to the merger could

produce a reduction in price. Would such a merger be challenged? Consider the strategy of referring cases to the Tribunal based on calculation of the surplus measure. The practical realities are that Tribunal cases are time intensive and expensive for the parties. Referring cases to the Tribunal for a clarification of the surplus metric may encourage parties to abandon efficiency-enhancing mergers and thus the strategy may be tantamount to blocking the proposed merger. This would be equivalent to rejecting the metric. This raises another question: what special tools and analysis lie in the hands of the members of the Competition Tribunal (panels are drawn from members of the Federal Court (judiciary members) and other appointed lay members) that would permit them to opine on matters of income or wealth redistribution? Distribution matters are traditionally left to Parliament to determine (through social assistance plans or other initiatives).

Consider next the two-stage test. There are serious measurement issues of determining when demands for products are income neutral. Even if such a determination could be made, if the conventional welfare metric is to be avoided, should a different welfare metric apply to merger cases where products are income neutral (say pharmaceutical products for severe illnesses) from those where products are income sensitive (high-end performance automobiles)? The end result, I submit, is that the clear and unambiguous welfare metric set out in the Canadian statute and defined in the Merger Enforcement Guidelines has been set aside for a series of unclear and ambiguous statements.

On April 8, 1997, US agencies revised Section 4 (on efficiencies) of the 1992 US Horizontal Merger Guidelines. This revised section points out that competition drives firms to achieve efficiencies. In assessing proposed mergers, only those efficiencies that

can be realized through the merger (merger-specific efficiencies) will be considered by the respective enforcement agency. This is similar in spirit to the Canadian guidelines. Both the US and Canadian Guidelines place a clear measurement burden on the merging parties. Efficiencies are difficult to verify and quantify as much of the data and information required to perform such an assessment rest with the merging parties. Only verifiable efficiency claims will be entertained. The US Guidelines use the term *cognizable efficiencies* to refer to merger-specific efficiencies that have been verified and do not arise from any anticompetitive reduction in output or service that might flow from the proposed merger. The US Guidelines spell out that the agency reviewing the merger will ask whether these cognizable efficiencies are sufficient to reverse any anticompetitive effect: are these efficiencies sufficiently large to cause consumer prices not to fall? Notice that this is a more demanding hurdle than the one set out in the Canadian guidelines where prices can rise provided efficiencies are larger in magnitude than the corresponding lost consumer surplus. In the US, the efficiencies must be sufficient to guarantee no price increase.

Commissioner Pitofsky of the US Federal Trade Commission claims (“Efficiencies in Defense of Mergers: Two Years Later”, (1999) 7 *George Mason Law Review*, 485) that the US Guidelines were revised for the benefit of the lower courts, who were uncomfortable in merger cases with the exclusion of efficiencies in accordance with earlier US Supreme Court doctrine. Commissioner Pitofsky states that the revision served 4 main objectives:

- (i) The revisions tied efficiencies directly into the competitive effects analysis;

- (ii) The revisions made clear that any efficiency claim must be attributed uniquely to the merger at hand and the revisions committed the respective agency to evaluate claimed efficiencies against other practical alternatives;
- (iii) The revisions state that the agencies will require proof of greater efficiencies as the likely anticompetitive effects of any proposed merger increase;
- (iv) The revisions define which efficiencies matter – cognizable efficiencies.

Commissioner Pitofsky assesses a set of recent US merger cases in light of the 1997 revisions. For example, he points to the *Staples* case (Staples, the second largest office supply superstore chain in the US, proposed to acquire Office Depot, the largest office supply superstore chain.) The district court decided that office supply superstores constitute a separate relevant product market and that the two merging parties had high market share. The court then examined the efficiency claims of the parties, including the claim that the merged entity could bargain more assiduously with its suppliers for better prices. The inference here is that the revisions in the Guidelines legitimized the district court's exercise of evaluating the efficiency claims of the parties. The court rejected the efficiency claims as (i) overstated relative to efficiency claims made in internal document unrelated to the litigation, and (ii) increased buying power was likely to flow to both parties even if they did not merge as both were expanding rapidly. (Increased buying power alone without the savings of resources is not an efficiency; it is a pecuniary effect where one party secures a larger share of the gains from trade because of an enhanced threat point in its bargaining position. Both the Canadian and US Guidelines recognize this distinction.)

Efficiencies (and synergies) will always arise in any merger review as they form the pro-competitive rationale to drive mergers. The merging parties somehow hope to do something better after the merger. Efficiencies become more critical when the merger gives rise to a substantial lessening of competition. The issue then becomes one of evaluating the anticompetitive against the procompetitive effects. There is considerable agreement among economists on the application of a welfare metric that balances losses and gains with dollars treated as equals. On this matter, Canada has moved from a clear and unambiguous policy that embraces this welfare standard to one that is clouded and uncertain. The US has moved to include efficiencies in the equation, although the US price standard (that the net effect of a merger is that consumer prices cannot rise) is a more stringent hurdle that rules out some otherwise allocatively efficient mergers.