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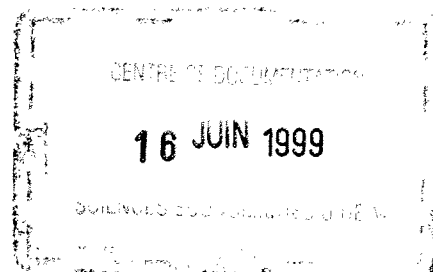
*M&A CASES : DEFINITION OF THE RELEVANT MARKET*

PAR  
GEORGES L. POLICAR

FACULTÉ DES ARTS ET DES SCIENCES  
DÉPARTMENT DE SCIENCES ÉCONOMIQUES

RAPPORT DE RECHERCHE PRÉSENTÉ À LA FACULTÉ DES ÉTUDES SUPÉRIEURES EN  
VUE DE L'OBTENTION DU GRADE DE MAÎTRE ÈS SCIENCES ÉCONOMIQUES (M.Sc.)

AVRIL 1999



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## Abstract

This Research Paper analyzes the approach of Canadian Courts and the Competition Tribunal with respect to the delineation of the relevant market in merger cases.

Canadian jurisprudence has made significant headway since the introduction into Canadian law of a civil scheme of regulating anti-competitiveness brought about the enactment in 1986 of the *Competition Act*.

We first examine the economic foundations of competition policy and implicitly, that of a merger policy. Then, we analyze the statutory definition of merger, the relevant market concept, market power paradigms, the *Merger Enforcement Guidelines* and Canadian jurisprudence. American jurisprudence is also examined since it is relevant to the development and interpretation of Canadian law. We conclude that Courts and the Competition Tribunal did in fact provide a framework of analysis for defining relevant markets. Moreover, this framework is fairly consistent with the approach adopted by the *Director of Investigation and Research* in the *Merger Enforcement Guidelines*.

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## Foreword

The completion of this Research Paper marks the end of a long journey. It has a special meaning for me since its content and substance combine my areas of study and professional interests: Law and Economics. *Its underlying significance though is the fulfillment of a duty, which should be shared by all, to pursue knowledge and enlightenment through reflection on the human condition.*

I would like to express my sincere thanks to Professor Jacques Robert for encouraging me to explore the field of antitrust and guiding my research in this area which has stimulated my interest and intellectual curiosity.

I take this opportunity also to pay special tribute to those people who have directly or indirectly contributed to this endeavour. My dear mother, Vesta, who has untiringly devoted her life to the education of her children and has always been a tremendous source of inspiration and guidance; my three brothers - Réginald, Emmanuel and Réal - for constantly being there for me; my father, Georges; and two special friends and former classmates, Nadine Moreau and Patricia Azevedo for their assistance and encouragement during my university studies.

*Altius, citius, fortius,*

Georges L. Policar

April 1999

## Introduction

With the era of globalizing markets, firms have to compete nationally and internationally. In order to survive, they often have to undergo significant restructuring. Merger is one form of corporate restructuring. Indeed, globalization or not, there are numerous reasons for firms to engage in mergers including synergies or efficiencies, growth, superior management, financial or tax considerations, advantages in marketing, complementarities in R&D, speculative and monopoly motives.

The merger provisions of the *Competition Act*<sup>1</sup> (the “*Act*”) provide for the regulation of the competitive effect of mergers. Indeed, the essential purpose of the *Act* is to maintain and encourage competition in Canada in order to promote the efficiency and adaptability of the Canadian economy. The *Act* also seeks to provide customers with competitive prices and product choices.<sup>2</sup> The *Clayton Act*<sup>3</sup> and the *Sherman Act*<sup>4</sup> in the United States aim at similar objectives. The merger provisions must be construed in accordance with the *Act*’s purpose.

These provisions are not concerned with all kinds of mergers, but only with those that prevent or lessen, or are likely to prevent or lessen, competition substantially. Therefore, the central concern is with respect to the exercise of market power by a single firm or a group of firms acting collectively. The proscribed degree of market power is defined in terms of price increase. Power over price is indeed a distinctive feature of firms evolving in imperfectly competitive market structures.

In Canada, like in the United States, merger analysis is conducted according to a two-step process. The first step is to define the relevant market. The second is to define the competitive effect of the merger within that market.

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<sup>1</sup> R.S.C. 1985, c. C-34. The complete title of the *Act* is *An Act to provide for the general regulation of trade and commerce in respect of conspiracies, trade practices and mergers affecting competition*. It may also be cited as the *Competition Act* (section 1 of the *Act*).

<sup>2</sup> Section 1.1 of the *Act*.

<sup>3</sup> 38 Stat. 730 (1914), 15 U.S.C. §§ 12-27.

<sup>4</sup> 26 Stat. 209 (1890), 15 U.S.C. §§ 1-7.

Our analysis will be limited to the first step. Indeed, developing and applying a market power paradigm conducive to the proper market definition in any given case underlies economic intricacies unfamiliar to the legal mind. In fact, the assessment of relevant markets in Canadian law has been characterized as “an intuitive and impressionistic exercise”<sup>5</sup>. Commentators chiefly argue that Canadian Courts and the Competition Tribunal have failed to provide a comprehensive framework as to how markets should be defined.

The main objective of this Research Paper is to analyze the soundness of Canadian competition law with respect to the delineation of the relevant market. However, a thorough understanding of the subject requires, first of all, the ascertainment of the rationale of competition policy and, implicitly, that of merger policy.

In Part I, we examine the economic foundations of antitrust. We start with an analysis of the role of the price mechanism as a coordination device in a free market economy, and show that it allocates efficiently society’s scarce resources under a perfectly competitive market structure. We then turn to imperfectly competitive market structures, and demonstrate that, in contrast with the competitive firm, the behavior of a firm exercising market power leads to a price that is too high, resulting in a *dead-weight* welfare loss to society as well as other harmful effects. We conclude that the potential social gains from an antitrust policy and, *a fortiori*, from a merger policy, are likely substantial. We then analyze the goals of the *Competition Act* as well as the *Clayton Act* and the *Sherman Act*.

Part II deals with the competitive effect of mergers. We first scrutinize the statutory definition of merger. We then analyze the definition of the relevant market. In so doing, we respectively focus on the concept of relevant market, market power paradigms, merger enforcement guidelines, and Canadian jurisprudence. American jurisprudence is considered to the extent that it is relevant to the development and interpretation of Canadian law. Indeed, the issue of market definition has not received in Canada the extensive treatment that it has in the U.S.

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<sup>5</sup> A. Neil Campbell, *Merger Law and Practice - The Regulation of Mergers Under the Competition Act* (Toronto: Carswell, 1997) at 55; and Paul S. Crampton, *Mergers and the Competition Act* (Toronto: Carswell, 1990) at 263.

We conclude that Canadian Courts and the Competition Tribunal did in fact provide a framework as to how markets are to be defined. Moreover, this framework does not significantly deviate from the underlying analytical process set out by the *Director of Investigation and Research* in the *Canadian Merger Enforcement Guidelines*<sup>6</sup>.

The Paper is based on the law as at December 31, 1998.

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<sup>6</sup> Director of Investigation and Research, *Merger Enforcement Guidelines* (Ottawa: Supply and Services Canada, 1991).



## Part I : The Law and Economics of Antitrust

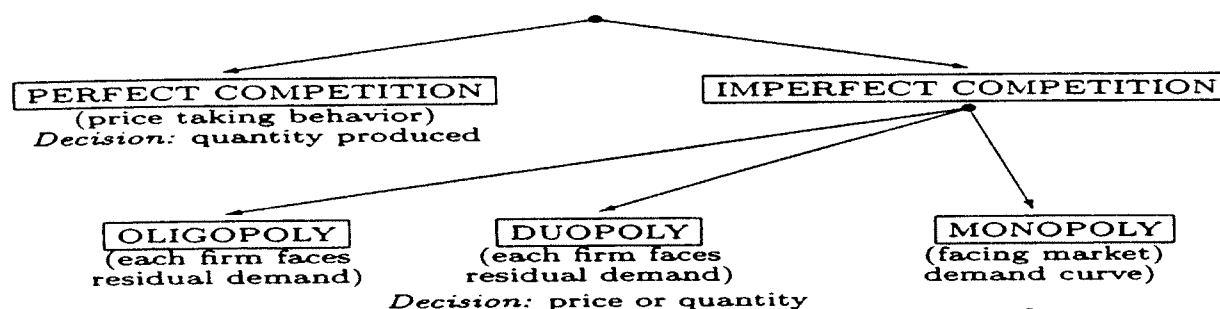
### 1. Economic Theory of Monopoly and the Case for Antitrust

#### 1.1 The Coordinating Function of the Price mechanism

Three coordination tasks underlie the dynamics of any economic system: output selection, production planning and distribution. The peculiar feature of a free-market economy resides in the role of the price mechanism as a coordination device. The accuracy of such a device results essentially from its natural integration of information and decisions pertaining to decentralized activities: prices are determined endogeneously; they are derived from the free and unfettered pursuit of self-interest. Therefore, in a free-market economy, prices vary so as to bring the quantity produced in line with the quantity demanded; inputs are assigned to the firms that can make the most productive use of them; goods are rationed on the basis of preferences and relative incomes.

A distinctive feature of the price mechanism, of paramount interest to economists, is that it allocates efficiently society's scarce resources if certain conditions are met. Economists refer to this set of conditions as a perfectly competitive market structure<sup>7</sup>. Figure 1 shows that market structures are classified according to two categories: perfectly competitive and imperfectly competitive.<sup>8</sup> Perfect competition is at one extreme while pure monopoly is at the other. In between are hybrid forms that share some characteristics of both perfect competition and monopoly.

Figure 1 : Market Structures



<sup>7</sup> Economists distinguish among different kinds of market structures mainly according to how many firms they include, whether the products of the different firms are identical or somewhat different and the persistence of entry barriers. For an historical development of the perfect competition model, see George J. Stigler, "Perfect Competition, Historically Contemplated" (1957) 65 *Journal of Political Economy* at 1-17.

Our Analysis will focus on these very extreme cases. Indeed, a perfectly competitive market yields the performance of an ideally functioning market whereas the pure monopoly results in a loss of welfare to society due to the monopolist's exercise of market power. The analysis of the pure monopoly case is applicable to the other kinds of imperfectly competitive market structures since when few firms compete, they might as well exercise market power.

In modern economic theory, a market is said to be perfectly competitive if the following conditions are met: numerous small firms and customers (*i.e.* the market has so many buyers and sellers that each one constitutes a negligible portion of the whole so that its decisions have no effect on price, firms and consumers are price takers), homogeneity of product (*i.e.* the product offered by any seller is identical to that supplied by any other seller, so that consumers do not care from which firm they buy), freedom of entry and exit (*i.e.* new firms desiring to enter the market face no impediments that the existing firms can avoid, there are no barriers preventing firms from clearing the market), perfect information (*i.e.* each agent is well informed about the available products and their prices).

According to Shy<sup>9</sup>, the assumption of competitive behavior is independent of how many firms and consumers there are in the market, it relates only to beliefs. Competitive behavior implies that agents think that their actions will not have any effect on the market price.

These are exacting requirements that are met infrequently. Demsetz points out that:

several economists... consider perfect competition a woefully inadequate model of competitive activity. Those dissatisfied with the model of perfect competition make several related points, but chief among these are that it gives excessive attention to only one kind of competition, price competition, and that perfect competition is too static to reflect the essence of competitive activity.<sup>10</sup>

Reviewing the treatment of competition by classical writers, Demsetz notes:

they took competition for granted, assuming it to be a pervasive restraint on the pursuit of self-interest... The problem central to their interests was the mastery of the nature and consequences of decentralization... The phenomenon on which they focus was the price system, for they realize that prices provided the linkage between decentralized activities.<sup>11</sup>

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<sup>8</sup> Oz Shy, *Industrial Organization - Theory and Applications* (MIT Press, 1996) at 61.

<sup>9</sup> *Ibid* at 63.

<sup>10</sup> Harold Demsetz, *Economic, Legal and Political Dimension of Competition*, vol. 4 (North-Holland Publishing Co. 1982) at 2.

<sup>11</sup> *Ibid* at 4-5.

Therefore, he concludes that the difficulties with competition partially come from the attempt to use the perfect competition model for a purpose for which it is not suited: analyzing competitive activity. According to Demsetz, it is the coordinating function of the price system in a perfectly decentralized economy that the model explicates, not competitive activity.

Hence, economists' interest in perfect competition does not lie in its descriptive realism. Indeed, the analysis of perfect competition shall be viewed as a reflection of the weakness of imperfectly competitive market structures.

### **1.2 The Perfectly Competitive Firm Profit-Maximization Problem**

Economic literature generally assumes that firms have one goal: profit-maximization.<sup>12</sup> Marginal analysis is the decision process that helps economists to determine what constitutes the optimal decision for a profit-maximizing firm.

Profit-maximization requires the firm to pick an output level that makes its marginal cost equal to its marginal revenue. The only feature that distinguishes the profit-maximizing equilibrium of the competitive firm from that of any other type of firm is its horizontal demand curve. Such feature essentially results from the assumption that there are numerous small firms and consumers or, according to Shy's terminology<sup>13</sup>, that agents do not believe that their actions have any effect on the market price.

Because it is a price taker, the equilibrium of a profit-maximizing firm in a perfectly competitive market must occur at an output level at which marginal cost is equal to price.

Therefore, in a perfectly competitive market, the optimal production decision is such that:

$$(1) P = MR = MC$$

---

<sup>12</sup> There is, however, a widespread feeling that, in practice, managers have other objectives (*e.g.* maximizing the firm's size and growth and the perquisites of the managerial position). Non-profit-maximization essentially results from the principal-agent problem. For a discussion for and against the profit-maximization hypothesis, see Jean Tirole, *The Theory of Industrial Organization* (MIT, 1988) at 60.

<sup>13</sup> Oz Shy, *supra*, note 8.

Where  $P$  is the price of the commodity produced by the competitive firm,  $MR$  is the marginal revenue derived from the sale of an additional unit and  $MC$  the marginal cost resulting from the production of an additional unit.

Equation (1) is referred to as the short run equilibrium of the competitive firm.<sup>14</sup> The long run competitive equilibrium is such that:

$$(2) P = MC = AC$$

Therefore, in the long run, every firm produces at the minimum point on its average cost curve. Thus, the output of competitive industries is produced at the lowest possible cost to society.

### 1.3 Social Welfare under Perfect Competition<sup>15</sup>

Efficiency in the choice of output quantities requires that, for each of the economy's output, the marginal cost ( $MC$ ) of the last unit produced be equal to the marginal utility ( $MU$ ) of the last unit consumed:

$$(3) MC = MU$$

We have shown that under perfect competition, the optimal output level is such that:

$$(4) MC = P$$

A necessary and sufficient condition to maximize the total net utility derived from the purchase of commodities is, for each commodity, to buy the quantity such that:

$$(5) MU = P$$

From (4) and (5), we have  $MC = MU$ . Therefore, equilibrium under perfect competition is efficient.

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<sup>14</sup> If  $P = MR = MC > AC$  (average cost), in the long run, the economic profit will attract new firms in the industry. In the long run, entry forces the price down until it is tangent to the long run average cost curve.

<sup>15</sup> This analysis is derived from Baumol and Blinder, *Economics - Principles and Policy* (Dryden Press, 1997) at 245ff. We limit the demonstration of competitive optimality to the output selection. For a demonstration of optimal allocation of inputs as well as optimal distribution, see Peter Asch, *Economic Theory and the Antitrust Dilemma* (Robert E. Krieger Publishing Co., 1984) at 18-24.

### 1.4 The Monopoly Profit-Maximization Problem<sup>16</sup>

Monopoly is an imperfectly competitive market structure. As previously noted, the analysis of the pure monopoly case applies to the other imperfectly competitive market structures since when few firms compete, they might as well exercise monopoly power.

A pure monopoly is an industry in which there is only one supplier of a product for which there are no close substitutes. Barriers to entry and cost advantages are the two basic reasons underlying the existence of monopoly.

The essence of the economic concept of monopoly resides in the monopolist power over price. This power derives from the fact that, unlike the competitive firm, the monopolist is the sole seller of a product. Assuming that the price consumers are willing to pay tends to rise as the quantity offered shrinks, the monopolist's demand curve is decreasing. We also assume that cost is increasing with output. Differentiability is assumed.

The best known monopoly distortion results from the monopoly pricing behavior. To focus on this distortion, we assume that the monopolist's products are given and that their existence and quality are known to customers.

Let  $q = D(p)$  be the demand for the good produced by the monopoly, with inverse demand function  $p = P(q)$ . Let  $C(q)$  be the cost of producing  $q$  units of this good. A profit-maximizing monopoly chooses the monopoly price  $p^m$  so as to  $\text{Max}_p ( pD(p) - C(D(p)) )$ .

The first-order condition for this problem is:

$$p^m - C'(D(p^m)) = -D(p^m)/D'(p^m)$$

or

$$(6) \frac{p^m - C'}{p^m} = \frac{1}{E} \text{ where } C' \text{ denotes the marginal cost and } E = -D'p^m/D \text{ denotes the demand}$$

elasticity at the monopoly price  $p^m$ . We ignore the second-order condition maximization. Equation (6) indicates that the relative *markup*, the ratio between the profit margin and the price,

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<sup>16</sup> This analysis is derived from Tirole, *supra*, note 12, at 66ff.

is inversely proportional to the demand elasticity. The monopoly sells at a price greater than the socially optimal price, which is marginal cost. Indeed, since  $D > 0$  and  $D' < 0$ , then  $E > 0$ . Therefore,  $p^m$  has to be greater than  $C'$  which is the competitive price.

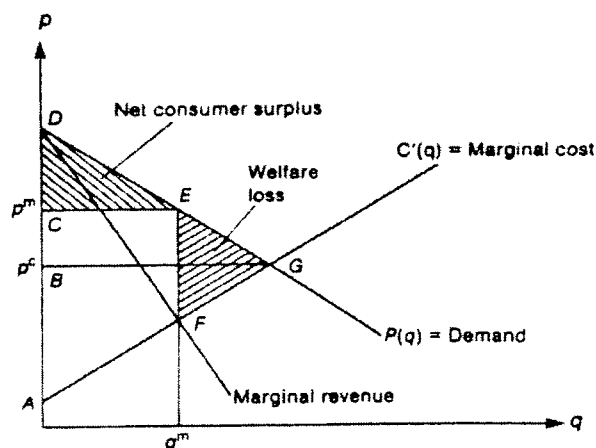
We established that efficiency in resource allocation requires that the marginal utility (MU) of each commodity be equal to its marginal cost (MC). Also, perfect competition guarantees that:  $MU = P$  and  $MC = P$  so that  $MU = MC$ . Under monopoly, consumers continue to maximize their own welfare by setting  $MU = P$ . Therefore, we have:

$$MU = p^m \text{ but } MC < p^m \text{ so that } MC < MU$$

Because  $MU > MC$ , too small a share of society's scarce resources is being used to produce the monopolized commodity. Monopoly breeds inefficiency in resource allocation by producing too little output and charging too high a price.

From a normative point of view, the appropriate measure of distortion is the loss of social welfare. Social welfare is the sum of consumer surplus and firms' profits. To measure the loss, we compare the social welfare at the monopoly price (DEFAD in Figure 2) versus the competitive price (DGAD). Therefore, the *dead-weight* welfare loss is equal to the area of the triangle EFG. This represents the loss in value to those consumers who at the competitive price would buy the product, but at the monopoly price are deflected to substitutes.

**Figure 2 : Monopoly and Social Welfare**



The *dead-weight* loss is only one of the harmful effects of monopoly. Posner<sup>17</sup> argues that the cost to society associated with the existence of monopoly is much higher than the *dead-weight* loss. Following Tullock<sup>18</sup>, he argues that the pursuit of monopoly rent is in itself a competitive activity that would continue until, at the margin, the expected gains of monopoly were just equal to the costs incurred in becoming a monopolist. Hence, he concludes that all monopoly rent should be counted in the costs of monopoly. Therefore, the actual *dead-weight* loss is represented by CEGFAC in Figure 2.

Analyzing the two main assumptions leading to Posner's conclusions, namely rent dissipation and socially wasteful dissipation, Tirole<sup>19</sup> concludes that we should refrain from drawing any general conclusion about which fraction of the monopoly profit should be counted as a welfare loss. According to Tirole, only a careful description of the rent-seeking game can allow us to give an order of magnitude for this fraction. As rent-seeking games vary considerably in practice, we are obliged to analyze the issue case by case.

Monopoly power can also have perverse effects on the supply side. In particular, a monopolist may produce at a higher cost than would a competitive firm. Such inefficiency, or *X-inefficiency* (a major element of *X-inefficiency* is motivation, it is not the only element, and hence, the terms *motivation inefficiency* or *incentive inefficiency* are not employed) results from the delegation problem analyzed in the theory of the firm.<sup>20</sup> Due to intricacies underlying principal-agent relationships, the agent is likely to engage in *X-inefficiency*.

Shareholders can use the performance of firms with related technologies (or demands) as a yardstick to control the performance of their firm. This yardstick competition, when applicable, may explain why competitive firms' managers are better controlled than monopolies' managers. Therefore, the latter are more likely to engage in *X-inefficiency*.

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<sup>17</sup> Richard A. Posner, *Antitrust Law: An Economic Perspective* (Chicago: University of Chicago Press, 1976).

<sup>18</sup> G. Tullock, "The Welfare Costs of Tariffs, Monopolies and Theft" (1967) 5 *Western Economic Journal* at 224-232.

<sup>19</sup> Tirole, *supra*, note 12.

<sup>20</sup> See Harvey Leibenstein, "Allocative Efficiency vs. 'X-Efficiency'" (June 1966) 56 *American Economic Review* at 392-415.

The foregoing analysis enables one to conclude, at least tentatively, that the potential social gains from an effective antitrust policy and therefore, from a merger policy, are likely to be substantial. This point has been obscured by a series of studies that attempt to measure the social cost of monopoly in the American economy and find that it was very slight. Harberger<sup>21</sup> estimated a total welfare loss not exceeding .1 percent of the gross national product. Several empirical studies yielded figures in the same general range.<sup>22</sup>

Harberger's estimate gave rise to much controversy about both data and methodology. Scherer<sup>23</sup> concludes that this estimate was biased downward. In particular, Harberger assumed unit demand elasticity, which creates downward bias in the estimation of welfare losses. In addition, the estimate ignores the tendency of competition for a monopoly position to transform expected monopoly profits into costs and thereby push down rates of return in monopolized industries toward the competitive level.<sup>24</sup>

Including some other distortions, such as those associated with rent-seeking, Cowling and Mueller<sup>25</sup> and Jenny and Weber<sup>26</sup> found losses in the range of 4 to 7 percent of the gross national product. Scherer concludes that these estimates are exaggerated. Applying some multiplicative correction factors to Harberger's results, he finds that the *dead-weight* loss attributable to monopolistic resource misallocation in the U.S. lies somewhere between .5 and 2 percent of the gross national product.

However, according to Posner, such studies cannot be used to measure the potential social gains from having antitrust laws mainly because they measure the costs of monopoly given the existence of those laws, not the costs of monopoly that could be expected in the absence of such laws. In a sense, they measure the degree to which the antitrust laws have failed.

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<sup>21</sup> Arnold C. Harberger, "Monopoly and Resource Allocation", (May 1954) 44 *American Economic Review* at 77-87.

<sup>22</sup> For a listing of those studies, see F. M. Scherer, *Industrial Market Structure and Economic Performance*, 3<sup>rd</sup> ed. (Houghton Mifflin Co., 1990) at 663, note 4.

<sup>23</sup> *Ibid.* at 667.

<sup>24</sup> Posner, *supra*, note 17..

<sup>25</sup> K. Cowling & D. Mueller, "The Social Costs of Monopoly Power" (1978) 88 *Economic Journal* at 724-748.

<sup>26</sup> F. Jenny & K. Weber, "Aggregate Welfare Loss Due to Monopoly Power in the French Economy: Some Tentative Estimates" (1983) 32 *Journal of Industrial Economics* at 113-130.



## 2. Goals of Competition Policy

Antitrust policy cannot be made rational until we are able to give a firm answer to one question: what is the point of the law - what are its goals? Everything else follows from the answer we give. Is the antitrust judge to be guided by one value or by several? If by several, how is he to decide cases where a conflict in values arises? Only when the question of goals has been settled is it possible to frame a coherent body of substantive rules.<sup>27</sup>

Policy goals underlie the proscribed degree of market power. Therefore, they play a more significant role at the second step of merger analysis (*i.e.* the assessment of the competitive effect of the merger or proposed merger within the relevant market). Nevertheless, market power depends heavily on the defined market. In fact, the relevant market can even be, consciously or not, enlarged or narrowed in order to suit policy goals. Consequently, a proper knowledge of the underlying policy allows to provide for the effect of policy objectives with respect to the relevant market delineation.

### 2.1 Canadian Competition Policy

#### A - Overview of the *Competition Act*<sup>28</sup>

The *Competition Act* provides for the general regulation of trade and commerce in respect of conspiracies, trade practices and mergers affecting competition. The *Act* is divided into ten parts: Purpose and Interpretation (Part I), Investigation and Research (Part II), Administration (Part III), Special Remedies (Part IV), (Part V)<sup>29</sup>, Offenses in Relation to Competition (Part VI), Other Offenses (Part VII), Matters Reviewable by Tribunal (Part VIII), Notifiable Transactions (Part IX) and General (Part X).

The *Director of Investigation and Research* (the “Director”) is the public official responsible for enforcing the *Act*. Parts I to III of the *Act* provide the framework for his enforcement activities. The Director is a Governor-in-Council appointee<sup>30</sup> who heads the Competition Bureau<sup>31</sup>.

<sup>27</sup> Robert H. Bork, *The Antitrust Paradox* (New York: Basic Books, 1978) at 50.

<sup>28</sup> R.S.C. 1985, c. C-34.

<sup>29</sup> Part V has been repealed by R.S.C. 1985, c. 19 (2<sup>nd</sup> Supp.), s.19.

<sup>30</sup> *Competition Act, supra*, note 28, subsect.2(1) and 7(1).

The Bureau's internal structure is divided into branches: the Criminal Matters Branch investigates criminal offenses relating to anti-competitive behavior; the Marketing Practices Branch is responsible for the investigation of criminal offenses relating to misleading advertising and other deceptive marketing practices; the Civil Matters Branch investigates competition cases reviewable by the Competition Tribunal and is responsible for the Director's appearances and interventions before regulatory boards and tribunals; the Economics and International Affairs Branch co-ordinates the Bureau's work in the area of international cooperation and liaison with other government departments and provides economic advice to other branches; the Compliance and Operations Branch is responsible for the Bureau's enforcement policy; the Mergers Branch is responsible for the review of merger transactions.

The Director must commence an "inquiry" into potential breaches of the *Act* after a request from the Minister of Industry (to whom he reports) or a complaint by six Canadian residents, he may also do so on his own motion.<sup>32</sup>

The *Act* contains both criminal and civil provisions.

Criminal offenses<sup>33</sup> include conspiracy, bid-rigging, discriminatory and predatory pricing, price maintenance and misleading advertising or deceptive marketing practices.<sup>34</sup> While such matters are initially investigated by the Director, prosecutions are brought by the Department of Justice officials. Penalties include fines or imprisonment, or both.

The Civil Matters Reviewable by Tribunal<sup>35</sup> consist of certain types of conduct which are not illegal *per se*. The Competition Tribunal, on the Director's application, determines on a case-

<sup>31</sup> The *Act* vests power in the Director rather than the Bureau.

<sup>32</sup> *Competition Act, supra*, note 28, ss. 9-10.

<sup>33</sup> Part VI of the *Act*.

<sup>34</sup> *Competition Act, supra*, note 28, ss. 45-61.

<sup>35</sup> Part VIII of the *Act*. The Tribunal's enabling legislation is the *Competition Tribunal Act*, R.S.C. 1985, c. 19 (2<sup>nd</sup> Supp.), Part I. The Tribunal consists of not more than four members to be appointed from among the judges of the Federal Court and not more than eight lay members appointed by the Minister of Industry on the recommendation of an advisory council composed of members knowledgeable in economics, industry, commerce or public affairs, individuals chosen from business communities, the legal community, consumer groups and labor (section 3 of the *Comp. Trib. Act*). The Tribunal has exclusive jurisdiction to hear and determine all applications made under Part VIII of the *Competition Act* (section 8 of the *Comp. Trib. Act*). In any proceedings before the Tribunal, questions of law shall be determined by the judicial members and questions of fact or mixed law and fact shall be determined by all

by-case basis whether anti-competitive results have occurred or are likely to occur. Reviewable matters include mergers, abuse of dominant position, refusal to deal, consignment selling, exclusive dealing, tied selling, market restriction and delivered pricing.

## **B - Purpose of the *Competition Act***

Section 1.1 of the *Act* establishes its purpose :

The purpose of this Act is to maintain and encourage competition in Canada in order to promote the efficiency and adaptability of the Canadian economy, in order to expand opportunities for Canadian participation in world markets while at the same time recognizing the role of foreign competition in Canada, in order to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the Canadian economy and in order to provide consumers with competitive prices and product choices.

The purpose of the Act is to maintain and encourage competition in Canada. However, it is generally recognized that competition is not a goal in itself but a means towards maximization of economic welfare. There is less consensus about whether consumer or total welfare should be maximized. If maximization of consumer welfare is the paramount concern, then a merger which allows market power to be exercised will have two unacceptable consequences: the *dead-weight* loss to society as output is restricted, and an expropriation of consumer surplus by the merging parties. Unless real efficiency gains passed through to consumers are expected to outweigh both these effects, the merger would be categorized as anti-competitive.<sup>36</sup> Conversely, redistributive effects are neutral under a total welfare maximization approach; efficiency gains then need only offset the *dead-weight* loss arising from an output restriction. The efficiency gains defense introduced in the 1986 *Competition Act* suggests that Parliament accepted total welfare maximization as the overriding goal of Canadian merger policy even though consumer welfare may be the predominant concern of other components of the legislation.<sup>37</sup>

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members (see, *infra*, note 87 for a more detailed analysis of this jurisdictional question). The Tribunal's expertise lies in economics and commerce. Indeed, the definition of the relevant market in a given case falls squarely within the Tribunal's area of expertise (see *Southam v. Director of Investigation and Research* [1997] 1 S.C.R. 748 at 772ff.

<sup>36</sup> This has basically been the approach taken in the U.S. where the efficiency gains are not a defense to anti-competitive merger but are relevant if they would prevent a price increase; see A.N. Campbell and M.J. Trebilcock, "A Comparative Analysis of Merger Law : the United States and the European Community" (1992) 15 *World Competition* (no. 3) 5 at 20-21; United States Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines* (Washington : April 1992), ¶ 4, avoids any direct comment on this issue.

<sup>37</sup> Campbell, *Merger Law and Practice, supra*, note 5, at 10.

Distributive conflicts are inherent to most competition policy issues. However, it is not easy to make categorical generalizations about distributional questions; it is not clear either that competition policy is a particularly effective instrument for pursuing redistributive goals.<sup>38</sup> Notwithstanding the reference to opportunities for small business in the purpose clause of the *Act*, it is generally assumed that distributional concerns are not an important consideration in the Canadian merger control regime.<sup>39</sup> In this regard Brenner & Brenner conclude that the purpose of the *Act* is to embrace competition in the “common business sense”<sup>40</sup> and that the singling out of big firms for special scrutiny stems from both the framework provided by classical economic analysis and the fear of concentration of power which underlies the origins of antitrust laws in the United States and the more recent Canadian experience.

Political values are also often advanced as a potential goal for competition policy. The proponents chiefly argue that heavy concentration of economic power undermines various populist and egalitarian democratic values as a result of the exertion of undue influence on the political process by those holding concentrated economic power. However, Canadians’ fear of business and power concentration was initially not as great as Americans’.<sup>41</sup> Referring to Gorecki and Stanbury, Brenner and Brenner<sup>42</sup> argue that the fear of power concentration arrived in Canada only with the merger boom of the 1970’s and early 1980’s, and this is what may have had an effect on the framers of the *Competition Act*. In addition, it has been pointed out that the connection between concentrated economic power and political influence is obscure and not conclusively demonstrated. Even if a clear connection is assumed, it is not obvious that competition policy is the appropriate instrument for mitigating this influence. The Competition Tribunal has confirmed that political goals will not be accorded much weight in merger reviews

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<sup>38</sup> See generally J.B. Dunlop, D. McQueen and M.J. Trebilcock, *Canadian Competition Policy - A Legal and Economic Analysis* (Toronto : Canada Law Book Inc, 1987) at 64-66.

<sup>39</sup> See A.N. Campbell, *supra*, note 5, at 11-12.

<sup>40</sup> *i.e* the conscious vying against each other for the patronage of customers, using price as well as non-price strategies; see Gabrielle A. Brenner and Reuven Brenner, *Mergers and the Competition Act*, Université de Montréal, Département de Sciences Économiques, cahier 1687, 1987, at 6-7.

<sup>41</sup> Paul K. Gorecki and W. T. Stanbury, *The objectives of Canadian Competition Policy - 1888-1983* (Toronto: The Institute for Research and Public Policy, 1984) at 13.

<sup>42</sup> G.A. Brenner and R. Brenner, *supra*, note 40, at 6.

because it is charged with adjudicating the economic merits of particular transactions, not the “furtherance of a variety of public policies howsoever worthy those may be”<sup>43</sup>.

Some process goals also underlie the enforcement of the Canadian competition policy. These goals are reflected to some extent in the institutional and procedural design of the Canadian merger review regime.<sup>44</sup>

Hence, the *Competition Act* aims at economic, political, distributive and process goals. However, economic goals are predominant.

## 2.2 American Antitrust Policy

### A - Overview of American Antitrust Laws

American antitrust law is especially set forth in two distinct enactments: the *Sherman Act*<sup>45</sup> and the *Clayton Act*<sup>46</sup>. The Antitrust Division of the Department of Justice (the “DOJ”) and the Bureau of Competition of the Federal Trade Commission<sup>47</sup> (the “FTC”) are in charge of monitoring merger activities under the *Sherman Act* and the *Clayton Act*. Given the DOJ’s exclusive jurisdiction over criminal matters, it is solely responsible for issues that arise pursuant to the *Sherman Act*. However, it shares concurrent jurisdiction with the FTC over merger related

<sup>43</sup> *Canada (Director of Investigation and Research) v. Air Canada (Request for Leave to Intervene)* (1988), 32 Admin. L.R. 157 (Competition Trib.), at 164 ; rev’d (1988), 33 Admin.L.R. 229 (Fed. C.A); aff’d (1989) 1 S.C.R. 236.

<sup>44</sup> See A.N. Campbell, *supra*, note 5, c. 10-11, 13.

<sup>45</sup> 26 Stat. 209 (1890), 15 U.S.C. §§ 1-7. The historical context played a key role in the enactment of the principal antitrust statutes. Indeed, all were products of periods characterized by sentiment favoring economic or political decentralization. The *Sherman Act* was passed during the Populist Era. When he introduced the bill, Senator Sherman stated that:

The popular mind is agitated with problems that may disturb social order, and among them all none is more threatening than the inequality of condition of wealth and opportunity that has grown within a single generation out of the concentration of capital into vast combinations to control production and trade and to break down competition. see 21 CONG. REC. 2460 (1890)

<sup>46</sup> 38 Stat. 730 (1914), 15 U.S.C. §§ 12-27. The Act is entitled *An Act to Supplement Existing Laws Against Restraint and Monopoly and For Other Purposes*. It is commonly known as the *Clayton Act*.

<sup>47</sup> The Federal Trade Commission’s enabling legislation is the *Federal Trade Commission Act*, 15 U.S.C. §§ 41-58. The Act delegated broad powers to it:

- (i) authority to enforce section 5 of the *Federal Trade Commission Act*, which prohibits “unfair methods of competition (...) and unfair or deceptive acts or practices in or affecting commerce”; and
- (ii) authority to investigate and report on economic problems and corporate activity, particularly with respect to antitrust laws.

matters arising under the *Clayton Act*<sup>48</sup>. In addition to enforcement by the DOJ and FTC, the law also provides for private actions.<sup>49</sup>

The main substantive provisions of the *Sherman Act* are sections 1 and 2:

1. Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among several States, or with foreign nations, is hereby declared to be illegal...
2. Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among several States, or with foreign nations shall be deemed guilty of a felony...

Section 1 focuses on the duality of actions among firms. More precisely, the essence of an offence under section 1 is the act of joining together to conspire to limit competition. Therefore, the main concern is to find an agreement among firms.

Section 2 is concerned with the single-firm conduct that misuses its power by taking exclusionary actions (predatory pricing, refusal to deal...).

The principal provision of the *Clayton Act* affecting merger is section 7. Its operative paragraph states that:

No person engaged in commerce or in any activity affecting commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another person engaged also in commerce or in any activity affecting commerce where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create monopoly.<sup>50</sup>

## **B - Goals of American Antitrust Policy<sup>51</sup>**

There is general agreement that the central objective of the antitrust laws is to protect the competitive enterprise system. There is debate, however, as to why we extend such protection and as to whether the antitrust laws have additional objectives.

<sup>48</sup> The *Clayton Act* is a non-criminal statute.

<sup>49</sup> See generally: ABA, *The Private Enforcement of Section 7 of the Clayton Act*, Monograph 1 (1977).

<sup>50</sup> Section 7's initial choice of language left a gaping loophole: it banned only stock acquisitions - the principal large scale consolidation method at the time. By shifting to the outright purchase of the competitor's assets, companies could escape the law's reach. The *Celler-Kefauver Act* amended section 7 of the *Clayton Act* by removing the asset acquisition loophole (see Crampton, *supra*, note 5, pp. 69-70). Section 7 was introduced in the 1914 enactment of the *Clayton Act* following dissatisfaction with the merger provisions of the *Sherman Act*.

<sup>51</sup> This section is mainly derived from ABA Antitrust Section, Monograph 12, *Horizontal Mergers: Law and Policy*, (1986) at 5ff.

The views expressed by commentators fall along a spectrum. One pole is represented by the view that the sole purpose of the antitrust laws is to maximize economic efficiency. According to this view, there is no legal foundation for reflecting social, political, or other non-efficiency criteria.

The opposite pole is represented by the view that the antitrust laws are based on multiple values, some of which cannot be reduced to an economic model or quantified easily. Non-economic values can be defined roughly as falling into two categories: “political values” which include the preservation of the Jeffersonian vision of small business, deconcentration of economic power to prevent undemocratic political influence, preservation of private control over business enterprises, and protection of individual freedom in social and political matters; and “social values” which include equitable distribution of wealth, protection of fair treatment in economic dealings, and preservation of local ownership of business.

There is no question that a wide range of economic, social and political considerations is discussed in the legislative debates surrounding the passage of the antitrust laws. Nonetheless, there is dispute as to the inferences that may properly be drawn from the debates as to Congress’s ultimate intent.

*Brown Shoe Co. v. United States*<sup>52</sup> is the first Supreme Court case decided under amended section 7. Reviewing the legislative history of amended section 7, the Court found that Congress had sought to protect a range of economic, social, and political objectives.

The pursuit of non-economic goals was then fueled by the increasing popularity of the structure-conduct-performance paradigm<sup>53</sup>.

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<sup>52</sup> 370 U.S. 294 (1962).

<sup>53</sup> This model was initially developed by Edward S. Mason at Harvard in the 1930’s. The empirical economics literature advocating this theory was pioneered by Joe S. Bain in his 1951 (J.S. Bain, “Relation of Profit Rate to Industry Concentration; American Manufacturing, 1936-1940” (August 1951), 65, No. 3 *Quarterly Journal of Economics* at 293-332) and 1956 (J.S. Bain, *Barriers to New Competition* (Cambridge, Mass.: Harvard University Press, 1956)) studies in which he found statistically significant differences between the average profit rates on equity in industries where the eight firm concentration ratio was equal to or greater than 70% and those where this same ratio was less than 70%. Bain’s results were confirmed in subsequent studies (see P.A. Pautler, “A Review of the

As the 1970's unfolded, several developments in economic thinking seriously challenged the underpinnings of the philosophy upon which the Supreme Court's decisions and the DOJ's *Merger Guidelines* were based.<sup>54</sup> The most dramatic development was the evolution and swift rise to influence of the Chicago School<sup>55</sup> of economic analysis.

The *General Dynamics*<sup>56</sup> case marked a departure from the structuralist approach and signaled a change in the Supreme Court's antitrust philosophy.

The release of the Justice Department's *1982 Merger Guidelines*<sup>57</sup> represented a significant step in the evolution of merger policy. The *Guidelines* reflected a strong welfare

Economic Basis for a Broad Based Horizontal Merger Policy" (1983) 28 *Antitrust Bulletin* 571 at 590-591). In short, the structure-conduct-performance paradigm contemplates that performance in particular industries or markets depends upon the conduct of sellers and buyers with respect to such matters as pricing policies and practices, product line and advertising strategies, overt and tacit inter-firm cooperation, R&D commitments... In turn, conduct depends upon the structure of the relevant market, embracing such features as the number and size distribution of sellers and buyers, the degree of physical or subjective differentiation prevailing among competing sellers' products, the presence or absence of barriers to entry of new firms... On the basis of that model, Bok, who thought that "...there was every reason to believe that Congress preferred the non-economic advantages of deconcentrated markets to limited reductions in the cost of operations...", proposed an approach for the assessment of the competitive effect of mergers (see Bok D., "Section 7 of the Clayton Act and the Merging of Law and Economics" (1986) 55 *Harv. L.R.* 226 at 318). The Supreme Court followed his approach in *U.S. v. Philadelphia National Bank* 374 U.S. 321 (1963) and subsequent cases: *U.S. v. Aluminium Company of America* 377 U.S. 271 (1964) and *U.S. v. Continental Can Company* 378 U.S. 441 (1964). The structuralist approach was carried further in *U.S. v. Von's Grocery* 384 U.S. 270 (1966) and *U.S. v. Pabst Brewing Co.* 384 U.S. 546 (1966) and culminated by the publication of the 1968 *Merger Guidelines* of the Department of Justice (4 *Trade Reg. Rep.* (CCH) § 13, 101).

<sup>54</sup> See ABA, Antitrust Section, *Horizontal Mergers: Law and Policy*, Monograph 12, *supra*, note 51, at 39ff.

<sup>55</sup> In general, the Chicago School views antitrust law as justifiable only to maximize efficiency, and not to promote a variety of other socio-political goals that can be advanced by other policy instruments that are more appropriate in this regard. Viewed from this perspective, the sole objective of antitrust is to prevent the dead-weight loss that is caused when output is restricted to a point where price exceeds the marginal cost. This view was led by Brozen and Demsetz, who argued that the earlier studies by Bain were sensitive to sample, might not be stable over time, and might depend on the size distribution of firms within an industry.

<sup>56</sup> *U.S. v. General Dynamics*, 415 U.S. 486 (1974). The ruling of this case coincided with the shifting composition of the judiciary which, particularly for the Supreme Court, was bringing more non-populist jurists to the bench. Fox observed :

A shift in the course of antitrust followed changes in the composition of the Supreme Court. Chief Justice Warren, Justices Black, Harlan, and Fortas, and later Justice Douglas, retired. President Nixon appointed Harry A. Blackman, Warren E. Burger, William H. Rehnquist, and Lewis F. Powell... Chief Justice Warren and Justices Black and Douglas (had been) particularly prominent in their articulation of power-dispersion as the primary goal of antitrust. Fox, E., «The Modernization of Antitrust : A New Equilibrium» (1981), 66 *Cornell L.R.* 1140, at 1143, note 8.

Thereafter, the government has lost a series of cases: e.g. *U.S. v. Marine Bancorporation*, 418 U.S. 602 (1974); *U.S. v. Connecticut Nat'l Bank*, 418 U.S. 656 (1974); *U.S. v. Citizens and Southern National Bank*, 422 U.S. 86 (1975).

<sup>57</sup> 4 *Trade Reg. Rep.* (CCH) 13, 102.



economics orientation, aimed at the maximization of allocative efficiency.<sup>58</sup> On the same day that the Justice Department released its *1982 Merger Guidelines*, the FTC released a *Statement on Horizontal Mergers*<sup>59</sup>. The values underlying the two documents appear to be similar.<sup>60</sup>

The revision of the *Guidelines* in 1984 reflected the same underlying values and objectives as the *1982 Guidelines*.<sup>61</sup>

In 1992, the Department of Justice and the Federal Trade Commission issued new, joint *1992 Horizontal Merger Guidelines*<sup>62</sup>. In concept, structure and content, the *1992 Guidelines* resemble the *1984 Guidelines*. Like that of the *1984 Guidelines*, the “unifying theme” of the *1992 Guidelines* is that “mergers should not be permitted to create or enhance market power or to facilitate its exercise”.<sup>63</sup>

To the extent that U.S merger jurisprudence is concerned with efficiency, it can be of precedential value to the assessment of the competitive effect of mergers under the *Competition Act*.<sup>64</sup> Indeed, basic principles of statutory interpretation are to the effect that an Act shall be construed in accordance with its purpose.<sup>65</sup>

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<sup>58</sup> The revision process of the 1968 version of the Guidelines was commenced by William Baxter, appointed head of the Antitrust Division of the Justice Department by the Reagan Administration which was very sympathetic to the Chicago School.

<sup>59</sup> See *4 Trade Reg. Rep. (CCH)* § 13, 200.

<sup>60</sup> ABA Antitrust Section, Monograph No. 12, *Horizontal Mergers: Law and Policy*, *supra* note 51, at 47.

<sup>61</sup> *Ibid.* at 49.

<sup>62</sup> See ABA Antitrust Section, *The 1992 Horizontal Merger Guidelines: Commentary and Text*, (1992).

<sup>63</sup> *Ibid.* at 2-3.

<sup>64</sup> For example, in *Canada (Director of Investigation and Research) v. Southam* (1995) 63 C.P.R. 1, Robertson J., writing for the Federal Court of Appeal, draws heavily on American Jurisprudence in order to set out the principles underlying the delineation of the relevant market.

<sup>65</sup> E.g. *Quebec Statutory Interpretation Act*, R.S.Q., c. I-16, s. 41.

## Part II : Competitive Effect of Mergers

### 1. Statutory Definition of Merger

Mergers are usually classified into three general categories: a merger is *horizontal* when firms in the same industry, producing identical or similar products and selling in the same geographical market, merge; *vertical* when a firm producing an intermediate good (or factor of production) merges with a firm producing the final good that uses this intermediate good, or when two companies who have a potential buyer-seller relationship prior to a merger merge; *conglomerate*<sup>66</sup> when firms producing less related products merge.

According to section 91 of the *Competition Act*, “merger” means the acquisition or establishment, direct or indirect, by one or more persons, whether by purchase or lease of shares or assets, by amalgamation or by combination or otherwise, of control over or significant interest in the whole or a part of a business of a competitor, supplier, customer or other person.

Section 91 defines merger in a very broad fashion. Caught within the definition are not only share and asset acquisitions, but also other types of agreements whereby a “significant interest in” the whole or part of a business of a competitor, supplier, customer or other person is obtained. The definition in the *Act* encompasses all purchasers (“one or more persons”). It also clearly covers horizontal<sup>67</sup>, vertical<sup>68</sup> and conglomerate<sup>69</sup> mergers. However, only those mergers which fall within the parameters of section 92 (*i.e.* a merger or proposed merger which prevents or lessens, or is likely to prevent or lessen, competition substantially) are challengeable by the Director before the Tribunal.

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<sup>66</sup> Conglomerate mergers are classified into three subclasses : *product extension* (the acquiring and acquired firms are functionally related in production or distribution), *market extension* (the firms produce the same products but sell them in different geographic markets) and *other conglomerate* (the firms are essentially unrelated in the products they produce and distribute).

<sup>67</sup> The inclusion of horizontal mergers stems from the reference, in section 91, to the “business of a competitor”.

<sup>68</sup> The inclusion of vertical mergers stems from the reference, in section 91, to the “business of a ... supplier (or) customer”.

## 2. Assessment of Competitive Effects of Mergers

It is generally accepted that a merger must be examined in terms of its likely effect on competition within a relevant market. Indeed, in Canada as well as in the U.S., merger analysis is a two-step process. The first is to define the relevant market. The second is to determine the competitive effect of the merger within the defined market. Our analysis will be limited to the first step.

### 2.1 The *Relevant Market* Concept

Subsection 92(1) of the *Act* requires, for the Tribunal to intervene, that the Director demonstrates that a merger or proposed merger prevents or lessens, or is likely to prevent or lessen, competition substantially:

- (a) in a trade, industry or profession
- (b) among the sources from which a trade, industry or profession obtains a product,
- (c) among the sources from which a trade, industry or profession disposes of a product, or
- (d) otherwise than as described in paragraphs (a) to (c)

According to Crampton<sup>70</sup>, given the fact that section 93 contemplates an evaluation of the nature of “any barriers to entry into a *market*”, “the extent to which effective competition remains or would remain in a *market* that is or would be affected by the merger or proposed merger”, “the nature and extent of change and innovation in a *relevant market*”, and “any other factor that is relevant to competition in a *market* that is or would be affected by the merger or proposed merger”, it would appear that Parliament intended that competition must be shown to be likely to be prevented or lessened substantially in an antitrust, or competition law market, and not in relation to a “class or species of business”, a “line of commerce” or other notional entity. Antitrust, or competition law, markets are commonly referred to as relevant market<sup>71</sup>.

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<sup>69</sup> The inclusion of conglomerate mergers flows from the reference, in section 91, to “other persons” in the list of potential vendors.

<sup>70</sup> P.S. Crampton, *Mergers and the Competition Act*, *supra*, note 5, at 263-264.

<sup>71</sup> The relevant market concept differs importantly from the “classical” concept of an economic market. The economic market concept encompasses the complete set of suppliers and demanders whose trading establishes the price of a good. However, it has no specific connection to the purposes of antitrust analysis. Relevant antitrust

The relevant market is an artificial creation with two dimensions: product and geographic.<sup>72</sup> It is constructed because of the need of a framework within which to assess the process of competition. It is a means of determining the competition law issue of market power.<sup>73</sup> Market power is recognized as the ability to profitably raise prices above competitive level without losing a significant portion of business to rival firms or firms that may become rivals as a result of the price increase. It may be exercised by a single dominant firm or by a group of firms acting collectively. For purposes of assessing the likelihood that a merger will facilitate the collective exercise of market power through tacit or explicit collusion, market definition has been characterized as essential, because “it is necessary to determine which sellers have to coordinate their actions...”<sup>74</sup>. For purposes of assessing the likelihood that a merger will create or enhance single-firm market power, market definition has been characterized as “an analytical construct enabling us to compensate for our inability to measure market power directly”<sup>75</sup>. Since it is not possible to measure market power directly, it is necessary to infer market power through the use of proxies such as market shares and concentration ratios. Such proxies require that we first define the relevant market.<sup>76</sup> As Posner observed:

The importance attached to defining a market in which to appraise the competitive effects of a challenged merger is one more example of the law's failure to have developed a genuinely economic approach to the problem of monopoly.<sup>77</sup>

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markets can be smaller or larger than the corresponding classical economic markets. An antitrust market would be smaller, for example, if there is a substantial competitive fringe that does not constrain prices but is willing to sell at the market determined price. An antitrust market would be larger, where due to an absence of entry barriers, firms outside the industry would enter quickly in response to a significant price increase.

Similarly, businessmen often refer to “markets” that differ significantly from competition law markets.

<sup>72</sup> The product dimension of the relevant market provides for the identification of products which represent realistic substitution possibilities for the merging parties' products. The geographic dimension provides for the determination of the areas to which customers can turn in case of an exercise of market power by the merging parties. In addition to product and geographic dimensions it is sometimes suggested that market definition involves a temporal aspect, but the Federal Court of Appeal has noted that this is largely a theoretical concern: see *Canada (Director of Investigation & Research) v. Southam (Reasons for Judgment on the Appeal of the Director)* (1995) 63 C.P.R. (3d) 1, 21 B.L.R. (2d) 1 (Fed. C.A.); [1997] 1 S.C.R. 748.

<sup>73</sup> The Federal Court of Appeal has noted that “market definition is vital to merger analysis and Parliament's concern over the exercise of market power”; see *Canada (Director of Investigation and Research) v. Southam* (1995) 63 C.P.R. (3d) 1, at 40.

<sup>74</sup> Werden, “A closer Analysis of Antitrust Markets”, 62 *Wash. U.L.Q.* 647, 651 n. 26 (1985); Werden, “Market Delineation and the Justice Department's Merger Guidelines”, 1983 *Duke L.J.* 514, 517 n. 14.

<sup>75</sup> Baker & Blumenthal, “The 1982 Guidelines and Preexisting Law”, (1983) 71 *Calif.L. Rev.* 311 at 323.

<sup>76</sup> However, pursuant to subsection 92(2) of the *Competition Act*, the Tribunal shall not find that a merger or proposed merger prevents or lessens, or is likely to prevent or lessen, competition solely on the basis of evidence of concentration or market share.

<sup>77</sup> Posner, *supra*, note 17, at 125.

If the elasticity of demand and supply facing the parties to a merger, or a group of sellers, could be directly measured, “(...) it would be redundant to ask whether the merging parties or group constituted an economically meaningful market”<sup>78</sup>.

In the United States, the need to determine the relevant market was discovered early in the history of antitrust litigation. *Standard Oil*<sup>79</sup>, a landmark *Sherman Act*<sup>80</sup> case, construed the language of section 2, similar to that of section 7 of the *Clayton Act*<sup>81</sup>, to have:

both a geographical and distributive significance; that is, it includes any portion of the United States and any one of the classes of things forming a part of interstate or foreign commerce.<sup>82</sup>

The importance of preparing a well articulated argument in support of one’s view of the relevant market in the context of a competition law case cannot be overstated. Indeed, the party who manages to convince the court of his view of this matter generally wins the case, because as the purported market is enlarged, the relative significance of the merging parties within that market usually decreases. Conversely, as a market is defined more narrowly, the competitive significance of challenged conduct typically increases. However, as long as there is recognition that restraints on the exercise of market power may come from outside as well as inside the relevant market, market boundaries need not be traced precisely.<sup>83</sup>

Unfortunately, there has been a great deal of confusion about how markets ought to be defined for antitrust purposes.<sup>84</sup>

The *Competition Act* provides no methodological guidance as to how markets should be defined. Similarly, in the United States, Congress neither gave clear instruction as to the

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<sup>78</sup> *Ibid.*

<sup>79</sup> *Standard Oil Co. v. United States*, 221 U.S. 1, 61 (1911).

<sup>80</sup> 209 Stat. (1890), 15 U.S.C. §§ 1-7. American Courts have used *Sherman* and *Clayton Act* cases interchangeably as authority for appropriate market definition methodology; see ABA Antitrust Section, Monograph No. 7, *Merger Standards Under U.S. Antitrust Laws* (1981), p. 26.

<sup>81</sup> 38 Stat. 730 (1914), 15 U.S.C. §§ 12-27.

<sup>82</sup> ABA Antitrust Section, Monograph 7, *Merger Standards Under U.S. Antitrust Laws* (1981) at 25. As to section 7 of the *Clayton Act*, because it is violated only by transactions that may substantially lessen competition in any line of commerce in any section of the country, an acquisition must be examined in terms of its likely impact upon competition within a relevant market that has both a product and a geographic dimension. See, e.g., *Brown Shoe Co. v. United States*, 370 U.S. 294, 324 (1962). The Supreme Court has held that “determination of the relevant market is a necessary predicate to a finding of a violation of the Clayton Act”. See *United States v. E.I. du Pont de Nemours & Co.*, 353 U.S. 586, 593 (1957).

<sup>83</sup> This conclusion stems as a corollary of two general principles enunciated in *Canada (Director of Investigation and Research) v. Hillsdown Holdings (Canada) Ltd. (Reasons and Order)* (1992) 41 C.P.R. (3d) 289 (Competition Trb.), at 297: market definition is merely a means to facilitate the assessment of market power; market boundaries are neither precise nor static.

methodology to be followed in defining the product market<sup>85</sup> nor provided definitive guidelines for determining the geographic market<sup>86</sup>. It remains on the Judiciary to provide a framework of analysis for the delineation of the relevant market.

The Federal Court of Appeal (Canada) has noted that the analytical framework and tests to be used are questions of law.<sup>87</sup> However, unlike the *Director* who adopted the hypothetical monopolist paradigm in his *Merger Enforcement Guidelines*<sup>88</sup>, neither the Courts nor the Competition Tribunal have yet adopted a particular market power paradigm. In this regard,

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<sup>84</sup> T. Dunfee, S. Stern, S. & F. Sturdivant, "Bounding Markets in Merger Cases: Identifying Relevant Competitors" (1983) 78 *Northwestern Univ. L.R.* 733 at 734.

<sup>85</sup> In *United States v. Bethlehem Steel Corp.*, 168 F. Supp. 576 (S.D.N.Y. 1958), the district Court undertook a thorough review of the congressional reports and debates. The Court held that the relevant product market should be defined with the overall intent of Congress in mind. However, the Court found that no specific methodology to be followed in determining the precise bounds of the product market was suggested by the legislative history of the 1950 Amendments to the *Clayton Act*. In *Brown Shoe v. United States*, *supra*, note 52; the Supreme Court found that Congress did not adopt or reject any specific methodology for defining the products bounds of a market, but had indicated merely that mergers would have to be viewed functionally in evaluating them under amended section 7.

<sup>86</sup> The Senate Committee Report noted in general terms that the section of the country relevant in determining the propriety of a transaction under the 1950 Amendment of section 7 would vary with the industry involved. Therefore, no uniform definition could be fashioned in terms of miles, population or other measures. (S. REP. No. 1775, 81<sup>st</sup> Cong., 2<sup>nd</sup> Sess. 5-6 (1959)).

<sup>87</sup> *i.e.* the meaning of the notion of "relevant market" is a question of law. That is to say, while the limits of a market in a particular case will be a function of both the unique factual situation at hand and the weight that is placed on certain factors by the Competition Tribunal (*i.e.* a question of fact or mixed law and fact), the issue of what must be considered, and the legitimacy of various criteria, are questions of law. In *Canada (Director of Investigation & Research) v. Southam*, *supra*, note 73, at 40 the Federal Court of Appeal notes that :

Market definition is a legal construct, not an economic one. It must be recognized that although the term "relevant market" is referred to in subsection 93(g) of the Act, it remains undefined as is the case in comparable legislation found in other jurisdictions; e.g. s. 7 of the *Clayton Act*, 15 U.S.C. 18 (U.S.C.A. 1993). The omission is not an oversight on the part of Parliament but an implied recognition of the fact that the term is and has always been a judicial construct informed by economic principles and now guided by the practical experience of those familiar with the operation of markets - lay members of the Tribunal.

The distinction between questions of law and questions of fact for purposes of antitrust analysis is an important one. Indeed, subsection 12(1) of the *Competition Act* contemplates a tripartite classification of questions before the Tribunal into questions of law, questions of fact, and questions of mixed law and fact. The judicial members of the Competition Tribunal have exclusive jurisdiction to determine questions of law. Briefly stated, questions of law are questions about what the correct legal test is; questions of fact are questions about what actually took place between the parties; and questions of mixed law and fact are questions about whether the facts satisfy the legal tests. (see *Canada (DIR) v. Southam* [1997] 1 S.C.R. 748 at 766-767)

Also, pursuant to subsection 13(2) of the *Competition Tribunal Act*, an appeal on a question of fact cannot be brought without leave of the Federal Court of Appeal.

Finally, curial deference is owed by appellate courts to the factual conclusions and mixed law and fact conclusions of the Competition Tribunal (this stems from the general rule that appellate courts should be reluctant to venture into a re-examination of the factual conclusions of the trial judge, especially in complex matters such as those handled by the Competition Tribunal).

<sup>88</sup> DIR, *Merger Enforcement Guidelines*, *supra*, note 6.

commentators argue that they have failed to provide a comprehensive framework and consider their approach as intuitive and impressionistic.<sup>89</sup>

## 2.2 Market Power Paradigms

There are five major approaches or paradigms for identifying relevant markets in merger cases<sup>90</sup>: substitutability, cross-elasticity, price relationship, hypothetical monopolist, and product shipments<sup>91</sup>.

### A - The Substitutability Paradigm<sup>92</sup>

The substitutability approach distinguishes between close and distant substitutes<sup>93</sup> based on a qualitative (as opposed to quantitative) assessment of the commercial realities faced by buyers and sellers. It is derived from the practical indicia approach to submarkets developed by the United States Supreme Court in the *Brown Shoe* case<sup>94</sup>:

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<sup>89</sup> See Campbell, *Merger Law and Practice*, *supra*, note 5, at 55 and Crampton, *Mergers and the Competition Act*, *supra*, note 5, at 263.

<sup>90</sup> In *Canada (DIR) v. Hilldown Holdings*, *supra*, note 83, at 301, the Competition Tribunal notes that determining the geographic dimensions of the relevant market is similar to determining the product dimensions. In the United States, the landmark *Brown Shoe Co. v. United States*, *supra*, note 52, at 336 decision of the U.S. Supreme Court held that “(t)he criteria to be used in determining the appropriate geographic market are essentially similar to those used to determine the relevant product market”. Therefore, our analysis of the market power paradigms will mainly focus on the product dimensions of the relevant market. However, we will sometimes underline certain specific distinctions characteristic of the geographic dimensions.

<sup>91</sup> This approach is applicable only to the geographic market definition.

<sup>92</sup> One shall keep in mind that although substitutability is the central issue in determining the existence of market power, the substitutability paradigm is but an approach towards defining the relevant market. In other words, one shall distinguish the substitutability concept from the substitutability paradigm.

<sup>93</sup> Economists say that goods become closer substitutes as their prices become increasingly interdependent with prices of other goods. Close substitutes are distinguished from distant substitutes, the prices of which are generally not strongly correlated or linked. However, it is important to note that substitutability can be assessed by reference to various other factors such as end use, industry and consumer opinion, industry and consumer conduct, particular physical characteristics of the products and characteristics of production processes. Close demand and supply substitutes are to be included in the relevant market, whereas all other demand and supply substitutes would be excluded as being too distant to effectively constrain the conduct of the parties or parties to the merger.

With respect to the substitutability paradigm, the geographic dimensions of the relevant market should be determined according to the extent to which buyers located at increasing distances from the plants of the merging parties would be willing to substitute another source of supply for the product of the merging firms; or sellers located at increasing distances from the plants of the merging parties would be willing to divert supply to serve the needs of the merging parties’ customers. in response to a substantial and non-transitory price increase or other exercise of market power by the merging parties.

<sup>94</sup> *Brown Shoe Co. v. United States*, *supra*, note 52, at 325.

The outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it. However, within this broad market, well-defined submarkets may exist which, in themselves, constitute product markets for antitrust purposes. (...) The boundaries of such a submarket may be determined by examining such practical indicia as industry or public recognition of the submarket as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors.

This approach takes into consideration both demand<sup>95</sup> and supply<sup>96</sup> substitutes. Its qualitative character has won it the favor of Courts. Indeed, considering that direct measures of cross-elasticities are rarely available, Courts have naturally tended to measure substitutability through indirect indicia, such as the ones outlined in the *Brown Shoe* case. Crampton<sup>97</sup> notes that this approach comes closest to occupying the middle ground between the intuitive approach typically favored by the Courts and the various theoretical frameworks suggested by economists.

Even though this approach can easily be understood and applied, it allows arbitrariness.<sup>98</sup> It may also lead to an erroneous conclusion in the particular case of a product with multiple imperfect substitutes, none of which is closed to the merged parties' product, but their combined effect prevent the exercise of market power by the merged parties.

## **B - The Cross-Elasticity Paradigm**

The cross-elasticity paradigm is a quantitative approach. Pursuant to this approach, a product market is composed of a group of products for which cross-elasticity of demand and cross-elasticity of supply are high. Cross-elasticity of demand and cross-elasticity of supply are the most common economic measures of the degree of substitutability between two goods or sources of supply.

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<sup>95</sup> *i.e.* products to which consumers might turn in response to a price increase or other exercise of market power as a result of the merger.

<sup>96</sup> *i.e.* producers who could easily alter their production process in order to produce close substitutes of the merged parties' product in response to an increase in price or other exercise of market power.

<sup>97</sup> Crampton, *Mergers and the Competition Act*, *supra*, note 5, at 266-267.

<sup>98</sup> *i.e.* to the extent that close and distant substitutes are distinguished, with respect to the product market dimension, by an arbitrary drawn line at some point along the continuum of linkage between the price of a given product and the prices of all other products and services; and, with respect to the geographic dimension, by an arbitrary drawn line at the frontier beyond which buyers of the products of (i) the merging parties, (ii) firms located in close proximity to the merging parties, and (iii) distant firms that could ship "close" product substitutes into the area of operation of the merging parties and the above-mentioned firms, would not travel to purchase "close" product substitutes in response to a significant and non-transitory increase in price or other exercise of market power by the merging parties. See Crampton, *ibid.*, at 267, 311-312.



Demand elasticity refers to the effect which a change in the price of one product has on the demand of another. It measures the rate at which consumers increase or decrease their consumption of one product in response to the price change of another. Given that :

$$E_{yx} = \frac{\% \text{ change in the quantity of X}}{\% \text{ change in the price of Y}}$$

where  $E_{yx}$  is the cross-elasticity of demand between products X and Y. X and Y are said to be substitutes if  $E_{yx}$  is positive and complements if negative. Cross-elasticity is computed with respect to other products in the market until the product dimensions of the market have been defined.

Supply elasticity focuses on the ability of existing firms to alter their production facilities to produce a product which competes with that produced by the merging parties in response to a price increase or other exercise of market power.<sup>99</sup>

Crampton<sup>100</sup> notes that several important limitations have become apparent with respect to the application of cross-elasticity measures to competition law. First, one must gather empirical data regarding the variation of quantities demanded or supplied as a result of changes in the price of other goods (which is extremely difficult in the best of circumstances). Second, these measures assume that the price of the good that is being examined, together with all other factors which are capable of influencing demand / supply for this good, remain constant. Third, apart from these practical difficulties that are associated with measuring cross-elasticities in the “real world”, there are no magic values of cross-elasticity measures which divide close substitutes from distant substitutes (the choice of where to locate the dividing line is completely arbitrary). Finally,

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<sup>99</sup> It would appear that supply elasticity does not directly affect the question of whether one product is a substitute for another. Its primary purpose is to identify all of the firms that are within the relevant market. Consequently, this factor takes on greater significance when consideration is given to the matter of market shares or concentration and whether the merger is likely to lessen competition substantially.

<sup>100</sup> Crampton, *supra*, note 5, at 277.

several weaknesses in the correspondence between cross-elasticity and substitutability have been identified.<sup>101</sup>

The difficulties that would be associated with employing cross-elasticity as a *bona fide* framework of analysis would be great.<sup>102</sup>

### C - The Price Relationships Paradigm

The price relationships approach focuses on historical price movements. According to this approach, two products are included in the same market when their relative prices maintain a stable ratio.<sup>103</sup>

Crampton<sup>104</sup> notes that although price relationships have been widely recognized to be an important factor in the definition of competition law markets, they do not appear to have been accepted as a framework of analysis. He attributes that to the fact that there are significant theoretical and practical shortcomings with this approach. Among these, price relationships between products provide little information about the elasticities of supply of different producers<sup>105</sup>; correlation between the prices of different products can be more related to the fact that the products in question use similar inputs, or face similar demand forces, than to any price interdependency between them. On the practical side, there are usually significant difficulties associated with obtaining reliable price data.<sup>106</sup>

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<sup>101</sup> See K. Boyer, "Industry Boundaries" in Calvani, T. and Siegfried, J., *Economic Analysis and Antitrust Law* (Toronto: Little, Brown and Co., 1979) 88, at 94 - 95.

<sup>102</sup> The limitations on the Competition Bureau are such that it has never had the necessary statistical data to actually compute cross-elasticities or own-price elasticities, and statistics have seldom been provided from external sources. See P. Crampton, «Relevant Market Analysis in Recent Merger Branch Divisions», in R.S. Khemani and W.T. Stanburry, *Canadian Competition Law and Policy at the Centenary*, (Halifax: The Institute for Research on Public Policy, 1991) at p. 246.

<sup>103</sup> G. Stigler & R. Sherwin, "The Extent of the Market" (Oct. 1985) 28 *Jour. L & Econ.* 555, at 566.

<sup>104</sup> Crampton, *Mergers and the Competition Act*, *supra*, note 5, at 279-280.

<sup>105</sup> See D. T. Scheffman & P. T. Spiller, "Geographic Market Definition Under the U.S. Department of Justice Merger Guidelines" (April 1987) 30 *Journ. L. & Econ.* 123, at 129.

<sup>106</sup> R. Harris & T. Jorde, "Market Definition in the Merger Guidelines: Implications for Antitrust Enforcement" (1983) 71 *Cal. L. R.* 464, at 473; K. Elzinga & T. Hogarty., "The Problem of Geographic Market Delineation in Antimerger Suits" (1973) 28 *Antitrust Bull.* 45, at 49; G. Werden., "Market Delineation and the Justice Department's Merger Guidelines" (1983) *Duke L.J.* 514.

## D - The Hypothetical Monopolist Paradigm

The hypothetical monopolist paradigm appears to have its roots in Boyer's "ideal collusive group"<sup>107</sup>.

Under the hypothetical monopolist paradigm one asks what would happen if a hypothetical monopolist seller of a group of products imposed a "significant and non-transitory" price increase<sup>108</sup>. In the event that a sufficient number of buyers were to shift to other products such that the monopolist would find the price increase unprofitable then that group of products is deemed too narrow to constitute a market. Accordingly, the market is expanded to embrace the next best substitute. The analysis is repeated until one is able to identify the smallest group of products for which the hypothetical monopolist could profitably impose a price increase. The geographic market is determined in an analogous manner.

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<sup>107</sup> Boyer proposes to define an industry from the point of view of a single firm: to a firm, its industry is the smallest group of sellers such that, were all members of the group to collude, bringing additional members into the collusive group would give the firm only minimal short term advantage. In a sense, a firm sees its industry as the ideal collusive group.

The notions of substitution on both the supply side and the demand side are subsumed in the definition. The criterion suggested would likely place producers of goods which are not substitutes in a different industry, since those producers are not likely to constrain the decision making of industry members, and thus their addition to the group would not be a significant advantage.

Similarly, if a firm does not currently produce a good substitute to the industry's products, but could in the short term, the existence of such a firm would constrain the business behavior of the industry members and there should be a definite interest in including this firm in any collusive scheme. The length of time considered to be "short" will arbitrarily separate industry members from potential entrants. If the run is long enough, there will be no potential entrants, only members of the industry. See Boyer, *supra*, note 101, at 92.

<sup>108</sup> Typically, the literature refers to a 5% threshold increase in price sustained over a period of one year. Invariably, the 5% threshold can be adjusted, depending on the nature of the industry. The hypothesized price increase has significant policy implications by virtue of the fact that the percentage increase is directly related to the potential market power that is to be tolerated before merger enforcement is invoked. At the same time, it has been suggested that any threshold level is necessarily arbitrary and based on intuition. See Werden, *supra*, note 106, at 550 and ABA Antitrust Section, Monograph No. 12, *Horizontal Merger: Law and Policy* (1986), at 118, citing Elzinga and Hogarty, "The Problem of Geographic Market Delineation in Antimerger Suits" (1973) 18 *Antitrust Bull.* 45, at 74. In addition, whether current market prices or future prices which would expect to prevail in the absence of the merger are used in the determination of the base price before the postulated price increase, the based price is still susceptible to the so-called "cellophane trap" phenomenon. In *United States v. E.I. Du Pont de Nemours & Co.* (1956), 351 U.S. 377, the Court held that flexible wrapping materials rather than cellophane wrap was the relevant product market. The Court interpreted Du Pont's inability to profitably raise prices as an absence of market power. The trap is that such evidence is equally compatible with the possibility that market power exists but is already being exercised by a dominant firm. See Crampton, *Mergers and the Competition Act*, *supra*, note 5, at 283-284.

Crampton<sup>109</sup> notes that the methodology underlying this approach is simple and goes directly to the heart of the matter: if the only seller of a given product in a given area would not be able to exercise market power, as measured by its inability to profitably impose a “small but significant and non-transitory” price increase, then reducing the number of sellers cannot pose a problem.

This approach has been criticized for offering little guidance regarding its practical implementation.<sup>110</sup> Campbell<sup>111</sup> notes that the hypothetical monopolist methodology brings up a number of technical issues including price and response time parameters, measurement of selling prices and the treatment of price inelastic segments within a market. He adds that, at the end of the day, it is the analytical factors used to evaluate likely buyers and sellers responses to price increases which are critical, and those turn out to have much in common with the non-quantitative substitutability approach. Nevertheless, the hypothetical monopolist paradigm has been lauded for setting out a workable theoretical framework as an alternative to the alleged *ad hoc* approach of the Courts.

### **E - The Product Shipments Paradigm**

This approach was developed within the geographic market context. It defines a market through the application of two tests: “Little Out From Inside” (LOFI), and “Little In From Outside” (LIFO). The LOFI test asks:

What is the smallest geographic region required to account for nearly all shipments from a given producing area? This question concerned the “supply side” and ensured that significant “exports” to other regions were taken into account. The ratio associated with LOFI is the sales of sellers located in the producing area to customers in that same area divided by the total sales of these firms to all destinations.<sup>112</sup>

<sup>109</sup> *Ibid.* at 281.

<sup>110</sup> For instance, In *Canada (DIR) v. Southam*, *supra*, note 73, at 58, the Federal Court of Appeal referred to the use of the hypothetical monopolist approach by the Director and U.S. enforcement agencies. While not explicitly approving or disapproving its use, the Court noted that:

Apparently, the value of the paradigm does not lie in its practical application. Its true function is to ensure that the task of market delineation does not lose sight of the principal concern - the ability of the merging firms to profitably impose price increases.

<sup>111</sup> Campbell, *Merger Law and Practice*, *supra*, note 5, at 59-60.

<sup>112</sup> Elzinga & Hogarty, “The Problem of Geographic Market Definition Revisited: The Case of Coal”, (1978) 23 *Antitrust Bull.* 1, at 2. This paradigm was initially proposed by Elzinga and Hogarty in response to what they perceived to be obvious errors made by the U.S. Department of Justice in delineating the geographic market in *United States v. Pabst Brewing Co.*, 384 U.S. 546 (1966), by relying uniquely on LIFO, and in *United States v. Philadelphia National Bank*, 374 U.S. 321 (1963), by relying uniquely on LOFI. See ABA Antitrust Division, Monograph No.12, *Horizontal Mergers: Law and Policy* (1986), at 97-98.

The LIFO test asks:

Of total purchases within the region identified by the LOFI test do nearly all emanate from within that region itself? This question dealt with the "demand side" and guaranteed that significant "imports" from other regions would not be overlooked. The ratio associated with LIFO is the sales of firms in the producing area to customers located in that area divided by the total purchases these customers make from all sellers wherever located.<sup>113</sup>

One of the weaknesses of this approach is that it does not measure elasticities. Therefore, it conveys little information as to market's susceptibility to the exercise of market power. It may be that a group of products or a geographic area has been historically insulated because prices have remained competitive, but that purchasers could readily turn to alternatives if faced with even a small price increase. In such an instance, the paradigm would lead the fact finder to define a market in which market power was not present.<sup>114</sup>

### 2.3 Merger Enforcement Guidelines

In 1992, the *Director of Investigation and Research* issued the first Canadian *Merger Guidelines*<sup>115</sup>. The *Guidelines* describe the enforcement policy of the Director under the *Competition Act*. They are designed to achieve several purposes. Obviously, they promote a better understanding of the Director's merger enforcement policy. They also provide a single unifying framework for evaluating the likely impact of merger on competition. Moreover, they facilitate business planning by articulating the approach used by the Bureau of Competition Policy in reviewing merger transactions.

In certain respects, the Canadian *Guidelines* build upon the 1982 and 1984 *United States Department of Justice Merger Guidelines*<sup>116</sup> which, in turn, were drafted having regard to the

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<sup>113</sup> Elzinga & Hogarty, *supra*, note 112.

<sup>114</sup> ABA, *supra*, note 112, at 101.

<sup>115</sup> DIR, *Merger Enforcement Guidelines*, *supra*, note 6. The Guidelines supersede all previous statements made by the Director or other officials of the Bureau of Competition Policy. However, they are not binding on the Competition Tribunal, the Courts of Justice or on how discretion will be exercised by the Bureau in particular cases.

<sup>116</sup> The 1982 *Guidelines* are reproduced in *Federal Register*, vol. 47, No. 126, (June 30, 1982), at 28, 493-502; the 1984 *Guidelines* are reproduced in *BNA Antitrust & Trade Reg. Rep.*, No. 1169, Special Supplement. On April 2, 1992, the Department of Justice and the Federal Trade Commission issued new joint *1992 Merger Guidelines*. In concept, structure and content, the *1992 Guidelines* resemble the 1984 *Guidelines*. See ABA Antitrust Section, *The 1992 Merger Guidelines: Commentary and Text* (1992), at 2.

extensive United States jurisprudence surrounding the interpretation of section 7 of the *Clayton Act*.

Indeed, both Canadian and American Guidelines expressly adopt the hypothetical monopolist paradigm.

According to the Canadian Guidelines, a relevant market is conceptually defined in terms of the smallest group of products and smallest geographic area in relation to which sellers, if acting as a single firm (a “hypothetical monopolist”) that was the only seller of those products in that area, could profitably impose and sustain a significant and non-transitory price increase<sup>117</sup> above levels that would likely exist in the absence of the merger.<sup>118</sup>

The assessment of whether a significant and non-transitory price increase would likely be made unprofitable involves an examination of likely responses from sources of product and geographic competition, on both the demand and supply sides of the market. On the demand side, it is necessary to evaluate the extent to which:

- (i) buyers would likely switch to substitute products; and,
- (ii) buyers would likely switch to the same product sold in other areas.

On the supply side, it is necessary to evaluate the extent to which:

- (iii) new entry would likely occur through the construction of facilities<sup>119</sup>, or as a result of sellers of other products adapting existing facilities to commence production of the product or a substitute; and,
- (iv) sellers of the product or a of substitute who are located in distant areas would likely divert their product into the area in question.

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<sup>117</sup> The *Bureau* considers a 5 percent price increase to be significant, and a one year period to be non-transitory. However, a different price increase or time period may be employed when the Director is satisfied that the application of the 5 percent or the one year threshold would not reflect market realities. In general, the based price that is employed in postulating a significant and non-transitory price increase is whatever is ordinarily considered to be the price (absent the merger) of the product at the stage of the industry being examined.

<sup>118</sup> The following analysis is derived from “Part 3 - Market Definition” in the *Merger Enforcement Guidelines - Director of Investigation and Research, supra*, note 6, at 7ff.

<sup>119</sup> This particular supply response is considered subsequent to market definition, in the assessment of ease of entry in order to determine the likelihood of substantial prevention or lessening of competition. It is therefore beyond the scope of our analysis which is limited to the market definition stage.

More specifically, the Canadian *Guidelines* state, for both product and geographic market, some evaluative criteria which will be given particular weight in the assessment of the nature and magnitude of likely supply and demand responses to a future price increase in particular cases.<sup>120</sup>

For the product dimension, the criteria are the following:<sup>121</sup>

**3.2.2.1 Views, Strategies, Behavior and Identity of Buyers** - The views, strategies and behavior are often among the most important sources of information considered in the assessment of whether buyers will likely switch to another product in the event of the postulated significant and non-transitory price increase. What buyers state they are likely to do, what they have done in the past, and their strategic business plans, often provide a reliable indication of whether the postulated price increase is likely to be imposed and sustained. Where buyers have not substituted product B for product A in the past, and indicate that they would not likely do so in the event of the price increase, it may be inappropriate to conclude, on the basis of hypothetical considerations, that these products compete in the same relevant market. The same can be true where two products are sold to buyers that have distinct characteristics. e.g., where product A is sold to consumers and product B is sold to businesses.

**3.2.2.2 Trade Views, Strategies and Behavior** - Helpful information regarding historical and likely future developments in the relevant market is often provided by third parties knowledgeable about the industry, such as persons who supply sellers of the relevant product. Similarly, industry surveys often provide data that assists the analysis. Another source of useful information is the past behavior of the merging parties, or others who sell the relevant product, in relation to other products that are alleged to provide a significant constraining influence. For example, modifications to product design or packaging that follow similar developments made to a second product may suggest that the two products are in the same relevant market.

**3.2.2.3 End Use** - The extent to which two products are functionally interchangeable in end use is an important source of information regarding whether substitution between them is likely to occur. Indeed, functional interchangeability is generally a necessary, but not sufficient, condition that must be met for two products to warrant inclusion in the same relevant market. Products that are purchased for similar end uses may be in the same relevant market notwithstanding the fact that they have very different physical characteristics, e.g., matches and disposable lighters.

Two products are more likely to be found to be in separate relevant markets as the difference between their prices increases or as their individual end uses are, or are perceived to be, more unique. For example, premium products such as gold plated lighters, luxury cars and writing instruments may be found to be in separate relevant markets from discount lighters, compact cars and disposable pens, respectively, notwithstanding that the premium and discount products have the same end uses.

**3.2.2.4 Physical and Technical Characteristics** - Although two products with unique physical or technical characteristics *may* be found to be in the same relevant market on the basis of functional interchangeability, such products are often found to be in separate relevant markets. In general, the greater is the value that buyers place on the actual or perceived unique physical or technical characteristics of a product, the more likely it is that the product will be found to be in a distinct relevant market. Product warranties, post-sales service, order turnaround time, etc., are all included in the bundle of characteristics that make up a product.

**3.2.2.5 Switching Costs** - Notwithstanding that two products may be functionally interchangeable, it is important to assess the extent to which the transaction costs which buyers would have to incur in order to retool, repackage, adapt their marketing, breach a supply contract, learn new procedures, etc., are likely to be sufficient to render switching unlikely in response to a significant and non-transitory price increase. In addition, account is taken of the extent to which failure of the product to satisfy expectations or to perform as expected would impose significant costs on the buyer, and of whether the risks associated with incurring these costs is likely to render switching unlikely in response to a significant and non-transitory price increase. Such costs could include damage to the buyer's

<sup>120</sup> The purpose of these evaluative criteria is to provide indirect evidence of substitutability considering that direct evidence, in the form of statistical measures of cross-elasticities of demand and supply, is rarely available.

<sup>121</sup> Given the central role played by the *Guidelines* in the enforcement policy of the Director, we have chosen to reproduce those criteria in their entirety.

reputation as a reseller, or the expense of shutting down an entire production line as a result of failure of a product that is a component in this line.

It is also important to consider whether buyers place such a premium on sourcing a full line of products that sellers of only one of these products would not be able to constrain a significant and non-transitory price increase imposed by the full line supplier in relation to that product alone.

**3.2.2.6 Price Relationships and Relative Price Levels** - The absence of a strong correlation in price movements between two products over a significant period of time immediately prior to a merger generally suggests that the products are not in the same relevant market. Conversely, a high correlation in the price movements of products A and B is often indicative of significant competition between these products. However, the correlation may be attributable to price changes in common inputs, inflation, pricing policies of multi-product firms, or other variables that cannot be said to suggest the presence of a high degree of substitutability. Accordingly, it will be generally necessary to determine whether the parallel price movements can be explained by one or more of these reasons, before this source of information will be considered indicative of significant competition between A and B.

Similarly, a determination will be made of the extent to which historical price responses suggests that sellers of product B are likely to constrain the postulated significant and non-transitory price increase in relation to product A. (...)

**3.2.2.7 Cost of Adapting or Constructing Production Processes, Distribution and Marketing** - In assessing the extent to which sources of potential competition exercise a constraining influence on the prices of products sold within the relevant market, account must be taken of sellers who do not actually produce the relevant product, but who have facilities that could be adapted to produce the relevant product. Where it can be established that such a seller would likely adapt its existing facilities to produce the relevant product in sufficient quantities to constrain a significant and non-transitory price increase in the relevant market, this source of competition will generally be included within the relevant market. (footnote omitted) However, potential competition from sellers who could produce the relevant product by adapting facilities that are actually producing another product will not be assessed at the market definition stage of the assessment of the merger where:

- (i) such a seller would likely encounter significant difficulty distributing or marketing the relevant product; or,
- (ii) new production or distribution facilities would be required to produce and sell on a significant scale.

In these circumstances, this source of competition will instead be considered subsequent to the delineation of the relevant market, in assessment of the likelihood of future entry pursuant to section 93 (d) of the Act. (...)

A similar approach is taken where a vertically integrated seller that produces a product entirely for its own internal use as an input into, or component of a downstream product, clearly exercises a constraining influence on the relevant market. The product of these sellers will generally be included within the relevant market unless:

- (i) these sellers would likely encounter significant difficulty diverting production away from their downstream need, or marketing the product in the relevant market; or,
- (ii) they would likely have to make a substantial investment to expand their existing production facilities to produce and sell on a significant scale.

(...)

**3.2.2.8 Existence of Second Hand, Reconditioned or Leased Products** - Where the availability of second hand, reconditioned, refurbished, recycled or leased products would constrain the significant and non-transitory price increase from being profitably imposed, this will be taken into account in the market definition stage (...).

For the geographic dimension, the criteria are the following:

**3.3.2.1 Views, Strategies and Behavior of Buyers** - The discussion in part 3.2.2.1 of the importance of information relating to the views, strategies, past behavior and identity of buyers is equally applicable to the geographic scope of relevant markets. Moreover, it is important to assess the extent to which considerations relating to convenience influence what buyers are likely to do in the event of the postulated significant and non-transitory price increase. This is particularly so in the case of service industries, the products of which often cannot be arbitrated.

**3.3.2.2 Trade Views, Strategies and Behavior** - Helpful information regarding historical and likely future developments in the relevant market is often provided by third parties who are knowledgeable



about the industry, such as persons who supply the sellers of the relevant product. Similarly, industry surveys often provide data that assists the analysis. An additional source of useful information is the extent to which persons who sell the relevant product in one area respond to changes in the price, packaging, servicing, etc., of the relevant product in a second area. The extent to which distant sellers are taken into account in business plans, marketing strategies and other documentation can be a further source of important information.

**3.3.2.3 Switching Costs** - See section 3.2.2.5 above and 3.3.2.4 below.

**3.3.2.4 Transportation Costs** - Transportation costs ordinarily play a central role in the delineation of the geographic scope of relevant markets. In general, where the price in a distant area, plus the cost that would be incurred to transport the product to the relevant geographic area, exceeds the price in the latter area plus the postulated significant and non-transitory price increase, the products of sellers located in the distant area will not be included in the relevant market. (footnote omitted)

Where prices in a distant area have historically exceeded prices in the relevant geographic area by more than transportation costs, this is usually a good indication that the two areas are in separate relevant markets, for reasons that go beyond transportation costs. However, it may not be conclusive, because the postulated significant and non-transitory price increase in the relevant market may elevate prices to a level above the distant price plus transportation costs. In this case, and absent evidence suggesting other reasons why the distant supplier would not likely commence sales in the relevant market, it will generally be assumed that the supplier would likely do so.

Where prices in a distant area have been historically lower than prices in the relevant geographic area by an amount which exceeds transportation costs, this is usually a good indication that the distant area is in a separate relevant market, for reasons that go beyond transportation costs. However, it may be that these additional reasons, together with transportation costs, would not be sufficient to prevent distant suppliers from constraining the further increase in the price differential that would be brought about by the postulated significant and non-transitory price increase. Where this would likely be the case, the relevant market would have to be expanded to account for this source of competition.

**3.3.2.5 Local Set-up Costs** - In assessing the extent to which sellers of the relevant product in a second area are likely to respond to the postulated significant and non-transitory price increase in the relevant geographic area, it is necessary to evaluate the extent to which they would face non-recoverable local set-up costs, e.g., warehouse requirements, a direct-store-delivery network, marketing costs, the need to hire local salespersons, and the costs associated with obtaining local regulatory approval. (...)

**3.3.2.6 Particular Characteristics of the Product** - In assessing whether distant suppliers are likely to divert the relevant product to the relevant geographic area in response to the postulated significant and non-transitory price increase, it is important to examine whether the particular product would not likely be transported into the relevant market because of fragility, perishability, etc.

**3.3.2.7 Price Relationships and Relative Price Levels** - The absence of a strong correlation in price movements of the relevant product in two distinct geographic areas over a significant period of time immediately prior to a merger generally suggests that the two regions are not in the same relevant market. Conversely, a high correlation in the price movements of the relevant product in two different areas is often indicative of significant competition between these products. However, the correlation may be attributable to price changes in common input, inflation, pricing policies of multi-market firms, or other variables that cannot be said to suggest the presence of a high degree of substitutability. Accordingly, parallel price movements will generally be examined to determine whether they can be explained by one or more of these reasons, before they are considered to be indicative of significant competition between sellers in the two areas.

In addition, an attempt will be made to determine the extent to which historical price responses accurately convey whether sellers in the second area are likely to constrain the future significant and non-transitory price increase in the area where the merging parties compete. The value of information on price movements and price levels is often undermined by difficulty in ascertaining the price at which sales are actually transacted.

**3.3.2.8 Shipment Patterns** - Significant shipments of the relevant product from a second area into the area in relation to which a significant and non-transitory price increase is being postulated generally suggest that the second area is in the relevant market. However, past trading patterns can be a poor indicator of the extent to which supply sources in the second area are likely to be able to constrain the ability of sellers in the first area to profitably increase prices. Information demonstrating significant shipments from the first area into the second, in and of itself, provides little information regarding the extent to which sellers in the first area are likely to be prevented from being able to profitably increase prices. The absence of significant shipments between two areas suggests that they are not in the same relevant market, yet cannot be relied upon as conclusively demonstrating this fact, because shipments from the second area into the first may commence in response to the postulated

significant and non-transitory price increase. Sellers in the respective areas may have prevented buyers in their area from switching in the other area by keeping prices just below the level at which such switching would have occur.

**3.3.2.9 Foreign Competition** - In general, the principles articulated above will be applied in assessing both domestic and international sources of competition. (...)

Although the *Director* expressly adopted the hypothetical monopolist paradigm, one can reasonably think that the above mentioned criteria will play a central role in its enforcement policy.<sup>122</sup> Indeed, the *Director* recognizes that direct evidence, in the form of statistical measures of cross-elasticities of demand and supply, is rarely available. Therefore, he turns to indirect evidence of substitutability. This is tantamount, to a certain extent, to saying that the hypothetical monopolist paradigm will be applied but, in fact, applying the practical indicia approach (*i.e.* the substitutability approach). This being said, it is not difficult to reconcile the apparent differences of approach between the *Guidelines* and the jurisprudence of Canadian Courts and the Competition Tribunal.

## 2.4 Canadian Jurisprudence

The issue of market definition in Canadian jurisprudence has not received the extensive treatment that it has in the United States. Before 1986, Canadian competition law, and merger law in particular, was largely based on the criminal provisions of the former *Combines Investigation Act*<sup>123</sup>. Consequently, the issue of market definition was never pursued in terms of the economic and social policies generally associated with a civil scheme<sup>124</sup> of regulating anti-competitiveness. Thus, the old criminal cases dealing with market definition are of little assistance in fashioning a modern market definition under Part VIII of the *Competition Act*.

Four of the old criminal cases which touch on market definition are note-worthy as they demonstrate that market definition was not a well-developed concept in Canadian law. All of these cases, however, do focus on the central concept of product market definition: substitutability. Yet, none offer a framework for determining how substitutability is to be assessed.

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<sup>122</sup> See Campbell, *Merger Law and Practice*, *supra*, note 5, at 59-60.

<sup>123</sup> R.S.C. 1952, c. 34.

*R v. J. W. Mills & Sons Ltd.*<sup>125</sup> is perhaps the most significant one.<sup>126</sup> That case turned on paragraphs 32 (1) (a) and (c) of the *Combines Investigation Act*<sup>127</sup> involving conspiracies to prevent or lessen competition. The accused were in the “import pool” business. They shipped goods that arrived in Vancouver from the Orient by ship to other points in Canada by use of a special category of railway car called “pool cars”. The accused argued, *inter alia*, that the Crown had not proved beyond a reasonable doubt a relevant market in which the impugned behavior had the necessary element of “undueness”. Gibson J. concluded otherwise after setting out the balancing process underlying market definition as well as the most comprehensive list of market factors ever presented in a reported Canadian case:

(...) speaking generally, it is of importance to bear in mind that the term “market” is a relative concept. In one sense, there is only one market in an economy since, to some extent, all products and services are substitutes for each other in competing for the customer’s dollar.

In another sense, almost every firm has its own market since, in most industries, each firm’s product is differentiated, to some extent, from that of all other firms.

Defining the relevant market in any particular case, therefore, requires a balance consideration of a number of characteristics or dimensions to meet the analytical needs of the specific matter under consideration.

At one extremity, an ill-defined definition of competition is that every service, article, or commodity, which competes for the consumer’s dollar is in competition with every other service, article, or commodity.

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<sup>124</sup> According to section 92 of the *Competition Act*, the necessity of proving that a merger or proposed merger is likely to prevent or lessen competition would seem to simply import the civil burden of proof, that is, a balance of probabilities or a preponderance of evidence.

<sup>125</sup> (1968) 2 Ex. C.R. 275.

<sup>126</sup> The other three cases are *R v. Hoffman-La Roche Ltd.* (1980) 109 D.L.R. (3d) 5 (Ont. H.C.), aff’d (1982), 125 D.L.R. (3d) 609; *R v. Canadian Coat and Apron Supply Ltd.* (1967) 2 Ex. C.R. 53; and *R. v. Canadian General Electric Company Ltd.* (1976) 15 O.R. (2d) 360 (H.C.).

In *Hoffman-La Roche*, the defendant, who was accused of predatory pricing by distributing the drug Valium to hospitals free of charge, argued that the market in which the firms competed consisted of all purchasers of their products (e.g. pharmacies, physicians) and not just hospitals. The Trial Judge held that the hospital market was the relevant market. On appeal, it was alleged that the Trial Judge had failed to recognize the availability of substitute products when circumscribing the relevant market. The argument was rejected on the ground that substitutability was an irrelevant factor in view of the fact that the accused had provided Valium free to hospitals for the purpose of eliminating a competitor.

In *R v. Canadian Coat and Apron Supply Ltd.*, the accused, who were in the business of applying “linen towels” and controlled 85% to 90% of the market, were charged under subsection 32 (1) of the *Combines Investigation Act* R.S.C. 1952, c. 34 for conspiring to fix prices. They argued unsuccessfully that the product market should be expanded to include paper towels and other substitute products. The argument was rejected on the basis of customer preference for linen towels.

In *R v. Canadian General Electric Co.*, the three largest manufacturers of “large lamps” controlling 95% of the Canadian market, were found guilty of conspiracy to lessen competition in the market contrary to para. 32 (1)(c) of the *Combines Investigation Act*. The Court found that large lamps, a class of light bulbs, were the relevant market based largely on industry perception and functional interchangeability.

<sup>127</sup> R.S.C. 1952, c. 34.

At the other extremity, is the narrower scope definition, which confines the market to services, articles, or commodities which have uniform quality and service.

In analyzing any individual case these extremes should be avoided and instead there should be weighed the various factors that determine the degrees of competition and the dimensions or boundaries of the competitive situation. For this purpose the dimensions or boundaries of a relevant market must be determined having in mind the purpose for what it is intended. For example, two products may be in the same market in one case and not in another.

And many characteristics or dimensions may be considered in defining the relevant market. All are not of the same order. And, in any particular case, usually, not all of the many characteristics or dimensions will have to be considered. In some instances, the definition may turn on only one characteristic or dimension or two (...). However, in order to make a correct choice of the appropriate characteristics or dimensions, it may be necessary to review several types before selecting the proper one or ones.

Hereunder are noted some pertinent characteristics or dimensions that may be considered in defining a relevant market, but this list is not exhaustive. The classification may also be arranged in various ways.

(a) Product Substitutability

(The term economists use for this is "cross-elasticity of demand". The terms "substitutability" and "cross-elasticity" are synonymous. As an example, the demands for two products have a high cross-elasticity if a change in the price of one results in a large measure, in purchasers substituting it for the other. How to measure the degree of cross-elasticity in any given case is usually difficult).

(b) Actual and potential competition.

(The problem sometimes in competition analysis is whether to confine the "relevant market" to existing competition or to consider potential (sometimes called "poised") competition as well).

(c) Geographical area.

(The geographic dimensions of a market is frequently an important factor in competition analysis - e.g., should the relevant market be analyzed on a national basis, a regional or a local area).

(d) Physical characteristics of products and services.

(Selecting products that have the same physical characteristics, or services that have the same features, is the simplest basis for defining a relevant market. But in some cases, for example, it may be correct legally to consider products with fairly dissimilar characteristics or services with somewhat dissimilar elements, as in the same market).

(e) End uses of products.

(The factor of end uses is closely related to physical characteristics in defining the relevant market. For example, if a product has different end uses in the hands of buyers, the definition of the relevant market may not be based solely on physical specifications. Also, for example, consideration of differences in uses is particularly important in studying market for services).

(f) Relative prices of goods or services.

(The prices of goods or services may define the relevant market).

(g) Integration and stages of manufacture.

(Because of differences between the activities of competitors, problems of integration arise. In determining the relevant market, the problem is what products at what stage of manufacture to include or exclude).

(h) Methods of production or origin.

(Methods of production and the product resulting, and origin of material, as e.g., whether or not imported, are often important factors to consider when defining the relevant market).

Gibson J.'s final reasoning and conclusion focused on lack of substitutability.

The most extensive Canadian case on the market definition issue is probably *Canada (Director of Investigation & Research) v. Southam*<sup>128</sup>. Indeed, it is the first, and remains the only

<sup>128</sup> (1992) 43 C.P.R. (3d) 161 (Comp. Trib.); (1995) 63 C.P.R. (3d) 1; [1997] 1 S.C.R. 748.

contested merger case under section 92 of the *Competition Act* to reach the Federal Court of Appeal. It was also appealed to the Supreme Court of Canada.

In this case, Southam (a diversified Canadian company whose principal business is newspapers publishing) acquired a direct or indirect controlling interest in 13 community newspapers in the Lower Mainland Vancouver area. The Director applied to the Competition Tribunal for an order that Southam divest itself of two community newspapers and one real estate advertising publication. The Director alleged that the acquisition of the two particular community newspapers, along with Southam's prior ownership of the only two daily newspapers published in the Lower Mainland Vancouver area, was likely to lessen or substantially prevent competition in the supply of print retail advertising services in various markets throughout the area, contrary to section 92 of the *Competition Act*. The Director also alleged that Southam's acquisition of the real estate advertising publication and of one particular community newspaper would lessen or prevent competition with respect to print real estate advertising services in the North Shore area of Vancouver. The parties are agreed as to the geographic dimension of the market. It is the product dimension which has proven problematic. The Competition Tribunal held that the acquisition of the two community newspapers and the ownership of the two daily newspapers did not violate section 92 (the "First Holding"), and that the acquisition of the real estate advertising publication and of the one particular community newspaper did violate section 92 (the "Second Holding").<sup>129</sup>

In order to make headway with respect to the issue of market definition in Canada, Robertson J., writing for the Federal Court of Appeal, provided an analysis which covered the market power paradigms, American jurisprudence, Canadian jurisprudence, and the merger enforcement guidelines in both Canada and the United States.<sup>130</sup>

With respect to Canadian jurisprudence, the learned judge notes that the only significant treatment of market definition under the *Competition Act* is found in the decisions of the

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<sup>129</sup> Our analysis will be limited to the "First Holding" since it contains the Federal Court of Appeal's analysis of the relevant market issue.

<sup>130</sup> We have already covered the market power paradigms as well as the merger enforcement guidelines. The American jurisprudence will be covered to the extent that it is relevant to the market definition issue in Canadian law.

Competition Tribunal in *Canada (Director of Investigation & Research) v. Hillsdown Holdings (Canada) Ltd.*<sup>131</sup> and, to a lesser extent, in *Canada (Director of Investigation and Research) v. Chrysler Canada Ltd.*<sup>132</sup> He deals first with the latter case.

In this case, the Director sought an order under section 75 of the *Competition Act* requiring the respondent to accept the complainant as a customer. The complainant carried on the business of exporting parts for Chrysler automobiles to markets outside of North America. One of the issues before the Competition Tribunal was whether the product market consisted of Chrysler auto parts sold in Canada, Chrysler auto parts sold in the United States or auto parts in general. In defining the terms “product” and “market”, the Tribunal specifically noted that the approach to market definition under section 75 was not to be equated with that involving mergers where the ultimate test is whether there will be a substantial lessening of competition. In cases involving paragraph 75 (1)(a), the ultimate test concerned the effect on the business of the person who is denied supplies. The Tribunal concluded that as the complainant’s customers specified genuine Chrysler parts and would not accept substitutes, the product in question was Chrysler auto parts. Moreover, since the price paid for Chrysler parts in Canada was lower than that paid in the United States, the market was defined as Chrysler auto parts sold in Canada.

In *Hillsdown*, the Competition Tribunal considered the merger of the two largest meat rendering companies in Southern Ontario. The Tribunal noted that the purpose of determining the product and geographic dimensions of the relevant market is to allow for identification of the competitors to the merged firm.

Geographic market definition was the central issue in this case. The tribunal noted that determining the geographic dimensions of the relevant market is similar to determining the product dimensions. One asks whether there is a geographic area within which the merged firm either alone or in concert with others is likely to have market power. This requires identifying some area such that the merged firm has an advantage based on geographic considerations over firms not inside that area. The Tribunal added that this advantage frequently results from

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<sup>131</sup> (1992) 41 C.P.R. (3d) 289.

<sup>132</sup> (1989), 27 C.P.R. (3d) 1.

transportation costs but often other factors may also be relevant, such as differing labor costs in the two areas or governmental restrictions and regulations. According to the Tribunal:

An assessment of geographic boundaries requires an assessment as to whether a significant number of consumers within the alleged area are willing to turn to suppliers outside of that area to obtain (...) services and whether there are suppliers outside the proposed boundary who could supply consumers within that area (...), as effective competitors to the merged firms (indicators of demand elasticity and supply elasticity respectively). It is clear that such switching or "substitutability" is more likely to occur on the edges of the defined geographic boundaries (...). As is the case in the product market dimensions, a useful starting point for their definition is the existing pattern or patterns of competition which existed pre-merger.<sup>133</sup>

The Tribunal discussed the geographic market issue by reference to three factors: distance, borders and consumer preference. The geographic market was ultimately held to be the area within approximately 250 miles of the merging parties' plants. Nevertheless, the Tribunal noted an underlying uncertainty with respect to the geographic dimensions arising because of the inherent ambiguity with respect to where market boundaries begin and end.

With respect to the product dimensions of the market, the Tribunal had little difficulty in accepting the Director's argument that the product market was the provision of rendering services for certain red meat materials. However, the Tribunal did specify that in determining the product dimensions of the market, the first step is to identify the product or products with respect to which, prior to the merger, the two firms were competitors. The second step is to ask whether there are any close substitutes to that product or products to which consumers could easily switch if prices were raised (an indication of demand elasticity). If two products appear to be close substitutes when both are sold at marginal cost, then the two should be included in the same product market.

In its conclusion, the Tribunal emphasized that market boundaries cannot and will not be precise in many instances. They can only be approximations. As long as market shares statistics are not taken as the only indicators of the existence of market power, the exact location of those boundaries becomes less important. Restraints on a merged firm's market power can come from both inside and outside the market as defined.

Product market definition was the central issue in *Southam*. Reviewing the Competition Tribunal's approach to market definition in the *Hillsdown* case, the Federal Court of Appeal

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<sup>133</sup> *DIR v. Hillsdown*, *supra*, note 131, at 301.

noted that the Competition Tribunal appeared to assume that the merging firms were, prior to the merger, competitors with respect to rendering services, thereby eliminating the first step of its stated approach. According to the Court, it is apparent that the Tribunal was not concerned with whether the services actually offered by the firms were close substitutes having regard to such factors as price and quality. Robertson J. added that if the reasoning in *Hillsdown* were applied in *Southam*, the Director's appeal would have to be allowed as both the Pacific Dailies and the community newspapers offer the same service: retail print advertising. However, the learned judge specified that to date, the Competition Tribunal had not been asked to articulate any framework under the "first step", to determine whether the products of two merging firms are in the same market. That is the very issue before the Federal Court in the *Southam* case.

Before analyzing whether the Tribunal erred in its application of the stated approach to product market definition by requiring the Director to adduce statistical or anecdotal evidence of price sensitivity on the part of the advertisers to the exclusion of other evidence of substitutability, Robertson J. first elaborates on the distinction between direct and indirect evidence of substitutability.

According to the learned judge, products can be said to be in the same market if they are close substitutes. In turn, products are close substitutes if buyers are willing to switch from one product to another in response to a relative change in price, *i.e.* if there is buyer price sensitivity. Direct evidence of substitutability includes both statistical evidence of buyer price sensitivity and anecdotal evidence, such as the testimony of buyers on past or hypothetical responses to price changes. However, since direct evidence may be difficult to obtain, it is also possible to measure substitutability and thereby infer price sensitivity through indirect means. Such indirect evidence focuses on certain practical indicia, such as functional interchangeability and industry views/behavior, to show that products are close substitutes.

To the extent that it is possible to adduce statistical evidence of high demand elasticity, such evidence is virtually conclusive that two products are in the same product market. Evidence of price sensitivity can also come in anecdotal form which is a less conclusive, although still a persuasive factor tending to show that products are substitutes. However, direct evidence of price



sensitivity is not a condition precedent for finding that two products are in the same market. On this point, the learned judge refers to the U.S. Supreme Court decision in *Continental Can Co.*<sup>134</sup> He adds that there are simply too many factors other than price which can affect a buyer's choice and which can explain a low demand elasticity at any point in time.

Turning to the Director's argument, Robertson J. found that the Tribunal erred by requiring the Director to adduce statistical or anecdotal evidence of high price sensitivity, and ignoring the significance of certain indirect evidence of substitutability which it was required to consider as a matter of law. In the Court's opinion, the Tribunal ignored relevant evidence with respect to two important matters: functional interchangeability and inter-industry competition.

According to the learned judge, functional interchangeability is a vital feature of substitutability and therefore an indispensable component of product market definition. It is not simply one of many criteria to be considered but a central part of the framework. Robertson J. goes further by stating that functional interchangeability will generally be regarded as a necessary but not sufficient condition to be met before products are placed in the same market. He adds that unlike buyer and trade behavior, functional interchangeability is a "purely objective factor (...) which focuses on use or purpose"<sup>135</sup>.

Robertson J. also found that inter-industry competition between the Pacific Dailies and the community newspapers was evidenced by constant striving to attract many of the same advertisers.

Therefore, he concluded that the Pacific Dailies and the community newspapers are in the same product market.

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<sup>134</sup> 378 U.S. 441 (1964). In the *Continental Can* case, there was vigorous competition between the metal and glass container industries for the business of various manufacturers. The evidence, however, disclosed a low demand elasticity. Nonetheless, the United States Supreme Court was prepared to conclude that the two products were in the same product market because of inter-industry competition. It shall be noted that the Federal Court of Appeal, in *Southam*, canvasses three of the seminal United States Supreme Court decisions which, in its opinion, reflect the general framework on which market analysis is undertaken in the U.S.. The first of these decisions is *United States v. Du Pont de Nemours & Co.*, 351 U.S. 377 (1956), where the Supreme Court articulated the product market tests of "cross-elasticity of demand" and "reasonable interchangeability of use". The second case is *Brown Shoe v. United States*, 370 U.S. 294 (1962), which has been described as the Rosetta Stone of market definition. In this case, the Supreme Court developed the submarket as well as the practical indicia approach. The third case is *Continental Can*.

Southam appealed the Federal Court of Appeal's findings before the Supreme Court.<sup>135</sup> The Supreme Court concluded that the Competition Tribunal neither failed to consider functional interchangeability nor inter-industry competition, and so did not err in law.

In particular, with respect to functional interchangeability, the highest Court notes that the Federal Court of Appeal's most general objection was the weight that the Tribunal assigned to the criterion of functional interchangeability. However, according to the Supreme Court, failure to accord adequate weight to certain factors does not imply that the Tribunal erred in law. The Court notes that the problem with such a suggestion is that it is inimical to the very notion of a balancing test. A balancing test is a legal rule whose application should be subtle and flexible, but not mechanical. The Court adds that it would be dangerous in the extreme to accord certain kinds of evidence decisive weight and that a test would be stilted and impossible of application if it purported to assign fixed weights to certain factors. In the Court's opinion, these sorts of things are not readily quantifiable and should not be considered as matters of law. They should instead be left initially at least to determination by the Tribunal. The most that can be said, as a matter of law, is that the Tribunal should consider each factor; but the according of weight to the factors should be left to the Tribunal. Indeed, the very purpose of a multi-factored test, such as the one that the Tribunal used to determine the dimensions of the relevant market, is to permit triers of fact to do justice in diverse particular cases. The Court goes further by adding that as a general rule, in cases like the one at bar, the aims and objective of the statute may not be served by assigning principal and overriding importance to any one factor. In the Court's opinion, it cannot be said, as a matter of law, that evidence of functional interchangeability should weigh more

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<sup>135</sup> (1995) 63 C.P.R. (3d) 1, at 64.

<sup>136</sup> The question raised by the appeal is whether the Federal Court of Appeal erred in concluding that it owed no deference to the Tribunal's findings about the dimensions of the relevant market and in subsequently substituting for that finding one of its own. Such a question ultimately falls under administrative law. Indeed, it ultimately comes down to a question about the standard of review that an appellate court should apply in statutory appeal of administrative tribunals' decisions. Therefore, the Supreme Court unfortunately did not discuss at length the issue of relevant market definition.

Considering, on the one hand, the Competition Tribunal's expertise in economics and commerce and, on the other hand, the absence of a privative clause in the Tribunal's enabling legislation, the Supreme Court concluded that a standard more deferential than correctness but less deferential than "not patently unreasonable" is required. This standard is whether the decision of the Tribunal is unreasonable, *i.e.* the Tribunal should be held to a standard of reasonableness *simpliciter* (such standard simply instructs reviewing courts to accord considerable weight to the views of tribunals about matters with respect to which they have significant expertise).

heavily in the balance than other kind of evidence. Instead, an appellate court should ask whether the Tribunal's attention to functional interchangeability was reasonable.

The Supreme Court then elaborates on the role of "purpose" in determining whether two products should be included in the same market. The Court notes that a balancing process underlies the determination of whether two products can be included in the same market on the basis of the same purpose. The Court specifies that it is the correct or relevant purpose that must be found, which is to say the broadest purpose that is consistent with a high cross-elasticity of demand. The Court adds that the relevant purpose is a function of the psychology of consumption or preference. Linking this concept to functional interchangeability, the Court states that more is needed to establish functional interchangeability than citation of common purpose.

The Court also disagrees with the Federal Court of Appeal regarding the supposedly objective character of functional interchangeability.

Unfortunately, the Supreme Court essentially limited its discussion to the alleged Tribunal's ignorance of functional interchangeability and inter-industry competition. It did not address the determination of the relevant market as a question of law since it considered that the parties agree about the law:

On the surface, it appears that the parties agree about the law: both say that, in determining the dimensions of the relevant market, the Tribunal must consider indirect evidence of cross-elasticity of demand. No one quarrels with the Tribunal's understanding of the kinds of indirect evidence it should consider.<sup>137</sup>

In fact, it seems that the Supreme Court did not feel the need to elaborate on the state of the law with respect to the relevant market definition. Speaking for the Court, Iacobucci J. states:

I notice that the Tribunal seems to have been preoccupied with the definition of the relevant market. It is possible that members may occasionally have lost sight of the ultimate inquiry, which is whether the acquisition of the community newspapers by Southam substantially lessened competition. But again, I cannot say that the Tribunal's approach was unreasonable. Definition of the relevant market is indeed a necessary step in the inquiry; and the fact that the Tribunal dwelled on it is perhaps understandable if, as seems to have been the case, the bounds of the relevant market were not clear.<sup>138</sup>

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<sup>137</sup> [1997] 1 S.C.R. 748, at 768.

<sup>138</sup> *Idem.* at 788.

However, the Court did notice that determination of cross-elasticity of demand is in theory the truest *indicium* of the dimensions of a product market and that indirect evidence is useful only as a surrogate for cross-elasticity of demand. In this regard, except for the refusal to allow particular weighting to certain criteria in the balancing process, the Supreme Court's approach is consistent with the Federal Court of Appeal's approach.

In *R. v. Clarke Transport Canada Inc. and al.*<sup>139</sup>, a conspiracy case under section 45 of the *Competition Act*, five corporations were charged with conspiring to lessen competition unduly in the supply of pool car freight forwarding services. After determining that market power is one of the components necessary to establish undueness, Moldaver J. stated that it is imperative to first determine the relevant market when attempting to determine the degree of market power.

Moldaver J's analysis of the relevant market is extensively based on Robertson J's analysis in the *Southam* case. In his judgement, Moldaver J. states:

I have spent a considerable amount of time on the Southam decision because in my opinion, where the definition of relevant market turns on the issue of product substitutability, Robertson J. has correctly defined both the process to be followed and the factors to be considered.

Thus, it would appear that, in the current state of the law, *Southam* is the leading case with respect to product market definition. Indeed, like *Brown Shoe v. United States*<sup>140</sup> in American jurisprudence, it can be considered as the Rosetta Stone of product market definition.<sup>141</sup>

As to the geographic market delineation, *Hillsdown* is the only reported case since the enforcement of the *Competition Act* dealing significantly with the subject. The Competition Tribunal relied primarily on the substitutability approach along with a product shipment analysis in order to define the relevant market.

According to recent Courts' and Tribunal's decisions, it appears that the substitutability paradigm plays a central role in the definition of the relevant, product as well as geographic,

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<sup>139</sup> (1995) 64 C.P. R. 289.

<sup>140</sup> *Supra*, note 52; ABA Antitrust Law Section, Monograph No. 12, *Horizontal Mergers: Law and Policy* (1986), at 71.

<sup>141</sup> This qualification is especially appropriate when one considers that the practical indicia approach (*i.e.* the indirect evidence of substitutability approach) was developed in the *Brown Shoe* case.

market delineation. Even though other paradigms have been considered, they have been severely criticized.

Indeed, in *Southam*, the Federal Court of Appeal referred to the use of the hypothetical monopolist paradigm by the Director and the U.S. enforcement agencies. While not explicitly approving or disapproving its use, the Court noted that:

Apparently, the value of the paradigm does not lie in its practical application. Its true function is to ensure that the task of market delineation does not lose sight of the principal concern - the ability of the merging firm to profitably impose price increases.<sup>142</sup>

In *Canada (Director of Investigation and Research) v. Laidlaw Waste Systems (Reasons for Order)*, the Competition Tribunal dismissed the hypothetical monopolist approach as being a “conceptual test”.<sup>143</sup>

The Federal Court of Appeal observes that the hypothetical monopolist and the cross-elasticity paradigms are the two *theoretical* frameworks most commonly employed to explain the concept of relevant market.<sup>144</sup> However, the real issue is whether either paradigm is of any practical significance when it comes to the task of delineating the boundaries of the product market. After underlying the major criticisms of both paradigms, the Court observed that the most obvious limitation on the applicability of either approach is the unavailability of direct (*i.e.* statistical) evidence. With respect to the cross-elasticity paradigm, it adds that it is widely acknowledged that the statistical data necessary to compute cross-elasticity is rarely, if ever, available.<sup>145</sup>

In fact, a thorough analysis of the reasoning in the *Southam* case at the Competition Tribunal level, the Federal Court and Supreme Court levels certainly displays that the Courts as well as the Tribunal did in fact provide a comprehensive framework for the definition of the relevant market in merger cases:

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<sup>142</sup> *Supra*, note 135, at 58.

<sup>143</sup> (1992) 40 C.P.R. (3d) 289 (Competition Tribunal), at 317.

<sup>144</sup> *DIR v. Southam*, *supra*, note 135, at 44-45.

<sup>145</sup> *Idem*, at 45.

- 1) **Sound statistical evidence of high demand elasticity will first be considered, such evidence will be virtually conclusive, regardless of the paradigm adopted<sup>146</sup>, as to the dimensions of the relevant market.**
  
- 2) **In the absence of or insufficient sound statistical evidence, anecdotal evidence of price sensitivity will be considered. However, this form of evidence is less conclusive.**
  
- 3) **In the absence of statistical and anecdotal evidence (*i.e.* direct evidence<sup>147</sup>), indirect evidence of price sensitivity (*i.e.* the practical indicia approach) such as functional interchangeability and industry views/behavior will be considered. The indirect evidence will be considered through a subtle and flexible balancing process which do not accord decisive or fixed weight to certain kinds of evidence.**

This framework implies that the substitutability paradigm will likely be applied in most of the Courts' and Tribunal's rulings given the usual unavailability of direct evidence.

Considering the foregoing framework, as far as the post *Southam* ruling era is concerned, I shall respectfully dissent with those who share the opinion that market definition by Canadian Courts is nothing but an impressionistic exercise.<sup>148</sup> In this regard, one commentator refers to Robichaud J.'s statement in *K.C. Irving*<sup>149</sup>:

I believe myself on safe ground by stating that our Canadian decisions have consistently refused to be diverted by economics on theoretical arguments about when a market begins and ends and find the existence of a market from the particular facts of a case.

However, one may also construe Robichaud J.'s statement as meaning that economic theory must be filtered through the legal mind. As Gibson J. stated in *R v. Mills & Sons Ltd.*<sup>150</sup>:

Defining the relevant market in any particular case (...) requires a balanced consideration of a number of characteristics or dimensions to meet the analytical need of the specific matter under consideration.

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<sup>146</sup> The availability of statistical evidence generally implies the adoption of the cross-elasticity, hypothetical monopolist, price relationships or product shipments (geographic market). Unlike these approaches, the substitutability paradigm is based on a *qualitative* assessment of substitutability.

<sup>147</sup> There is some confusion as to whether anecdotal evidence is direct or indirect. See *DIR v. Southam*, *supra*, note 135, at 61.

<sup>148</sup> See Crampton, *supra*, note 5, p. 263 ; and Campbell, *supra*, note 5, at 55.

<sup>149</sup> (1974) 16 C.C.C. (2d) 49 (N.B.Q.B.), at 79.

<sup>150</sup> *Supra*, note 125.

This balancing process is inherent in the exercise of the judicial function. Therefore, judges are privileged to determine, *as a matter of law*, what is a relevant market. The fact that Parliament intended the notion of relevant market to be a question of law certainly supports this argument.<sup>151</sup> However, judges are not necessarily cognizant of economic theory or the realities of the market place. In their factual determinations of the relevant market, they shall be assisted by people who are knowledgeable of such theory and realities. Parliament recognized those needs by creating the Competition Tribunal which is a specialized Tribunal (composed of judges and lay members knowledgeable of economics and business realities) to deal exclusively with what the *Competition Act* calls «Reviewable Matters», mergers being a reviewable matter.<sup>152</sup>

In fact, the non-cartesian aspect underlying this balancing process may be necessary. As Sullivan<sup>153</sup> pointed out:

economic relationships are seldom so simple that a relevant market can be defined with exactitude and confidence. There is not for any product a single, real market waiting to be discovered.

Indeed, distinguishing between pro-competitive merger and anti-competitive mergers is by nature an inexact task. The use of a flexible balancing process may reflect faith in the Courts to resolve difficult question in the best manner and to reach an appropriate result in any given case. In this regard, merger law is far from unique. Flexible balancing processes pervade judicial determinations, especially in Tort Law where the concepts of “reasonable person in the circumstances” and “proximate cause” constantly need to be determined.

Nevertheless, the state of the law on relevant market definition remains, to a certain extent, especially for the lay person, a confusing one. One important source of confusion is certainly this dichotomy between, on the one hand, the adoption of a particular paradigm which is a legal question and, on the other hand, the application of the paradigm in a given case which is a factual or mixed law and fact question. The confusion stems from the fact that one must first adopt a paradigm as a matter of law, and then make factual determinations on the basis of indirect evidence which often includes the consideration of the other paradigms (*i.e.* the so called practical indicia approach). This paradox is illustrated by Crampton’s statement regarding the assessment of the factual determination of the product market dimensions:

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<sup>151</sup> See *supra*, note 87.

<sup>152</sup> See *supra*, note 35.

Regardless of which particular relevant market paradigm one adopts as a matter of law, a consideration of the cross-elasticity of demand and supply, the extent of substitutability, and price correlation between particular goods and the extent to which they are reasonably interchangeable can be immensely helpful in assessing, as a matter of fact, the actual bounds of a market, because each of these approaches to evaluating the relationship between products can yield an approximation of the nature of the demand and supply constraints faced by the merging parties.<sup>154</sup>

In fact, it seems that regardless of the framework adopted as a matter of law, the substitutability paradigm will somehow be applied as a matter of fact.

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<sup>153</sup> L. Sullivan, *Handbook of the Law of Antitrust* (1977) § 12, at 41.

<sup>154</sup> Crampton, *Mergers and the Competition Act*, *supra*, note 5, at 293.



## Conclusion

The merger provisions of the *Competition Act* aim at the prevention of anti-competitive mergers. A merger will be so considered if it allows the merging firms to exercise market power. Market power is generally measured in terms of power over price; more precisely, it is the ability of a firm or a group of firms to raise prices above competitive level without losing a significant portion of their business to rival firms or firms that may become rivals as a result of the price increase.

Defining the relevant market is a condition precedent to the assessment of the market power or the likely market power brought about by a merger. Indeed, the delineation of the relevant market is a means to the end of identifying the significant market forces that constrain or are likely to constrain the merged entities. The product dimension of the relevant market provides for the identification of products which represent realistic substitution possibilities for the merging parties' products. The geographic dimension provides for the determination of the areas to which customers can turn to in case of an exercise of market power by the merging parties.

Substitutability, cross-elasticity, price relationships, hypothetical monopolist and product shipments are the five major paradigms or approaches used to circumscribe the relevant market.

While the *Director of Investigation and Research* has embraced the hypothetical monopolist paradigm, the Courts and the Competition Tribunal have not yet adopted a particular paradigm. In this regard, commentators argue that they have failed to provide a comprehensive framework and consider their approach as intuitive and impressionistic.<sup>155</sup>

Undoubtedly, Canadian jurisprudence with respect to product market definition has not received the extensive treatment of its American counterpart. Nonetheless, it has made significant headway since the introduction in Canadian law of a civil scheme of regulating anti-competitiveness brought about the enactment of the *Competition Act* in 1986.

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<sup>155</sup> Campbell, *Merger Law Practice*, *supra*, note 5, at 55; and Crampton, *Mergers and the Competition Act*, *supra*, note 5, at 263.

In particular, a careful reading of the *Southam* case displays the framework followed by the Supreme Court of Canada, the Federal Court of Appeal as well as the Competition Tribunal when defining the relevant market:

- 1) Sound statistical evidence of high demand elasticity will be first considered, such evidence will be virtually conclusive as to the dimensions of the relevant market.
- 2) In the absence of or insufficient sound statistical evidence, anecdotal evidence of price sensitivity will be considered. However, this form of evidence is less conclusive.
- 3) In the absence of statistical or anecdotal evidence (*i.e.* direct evidence), indirect evidence of price sensitivity such as functional interchangeability, physical characteristics and industry views/behavior will be considered. The indirect evidence will be considered through a subtle and flexible balancing process which does not accord decisive or fixed weight to certain kinds of evidence.

Although this framework was developed in the product market context, it is applicable, *mutatis mutandi*, to the geographic market context. Indeed, one commentator notes that, as a matter of law, it is important to recognize that a coherent framework within which to assess relevant markets is necessary, and that it would be inconsistent, to say the very least, to adopt two different frameworks for the analysis of the product and geographic dimensions of markets.<sup>156</sup>

At first glance, the apparent distinction between the Director's approach and the one favored by the Courts and the Competition Tribunal seems to cast some uncertainty in merger law practice. However, it is reassuring that the former Director asserted that the relatively non-technical approach of the Tribunal "does not significantly deviate from the underlying analytical process set out in the *Merger Enforcement Guidelines*".<sup>157</sup> Indeed, the *Guidelines* recognize that direct evidence, in the form of statistical measures of cross-elasticities of demand and supply is rarely available and, therefore, give particular weight to factors typically considered by Courts and the Competition Tribunal in their application of the practical indicia approach.

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<sup>156</sup> Crampton, *Idem*, at 311.

<sup>157</sup> Campbell, *Merger Law Practice*, *supra*, note 5, at 55.

This reconciliation naturally follows when we consider that, regardless of the approach adopted, determining whether market power can be exercised ultimately comes down to an assessment of the extent of substitutability between the products of the merging entities and those of their rivals or potential rivals as well as the extent of substitutability between areas in which such products are distributed.

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