Quantifying Efficiency Gains in a Competition Case:

Sustaining a Section 96 Efficiency Defence

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Toronto

Presented at National Conference, Canada's Changing Competition Regime
February 26 – 27, 2003 – The Old Mill, Toronto

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1.0 INTRODUCTION

Under the Canadian Competition Act[1] (the Act), if the Commissioner of Competition (hereinafter "the Commissioner") considers a merger or proposed merger anti-competitive, the Commissioner may challenge the merger and apply to the Competition Tribunal (hereinafter "the Tribunal") for an order to dissolve the merger, or, in the case of a proposed merger, the order may stop the merger, in its planning stages. If a challenged merger is shown to be "likely to prevent or lessen competition substantially", the Competition Tribunal may, pursuant to section 92, issue the sought after order.

However, using the so-called "efficiencies defense" set out in section 96 of the *Competition Act,* parties to an anti-competition merger may prevent the issuance of such an order. Under the efficiencies defense, the Tribunal shall not order a dissolution or divestiture if it can be demonstrated the merger is expected to yield substantial gains in efficiency that will outweigh its anticipated anti-competitive "effects."[2] Thus, section 96 calls for a trade-off analysis in which beneficial, merger-driven efficiencies are weighed against the harmful effects of increased market concentration. Section 96 sets out the "efficiencies defense" as follows:

> "96. (1) The Tribunal shall not make an order under section 92 if it finds that the merger or proposed merger in respect of which the application is made has brought about or is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition that will result from the merger or proposed merger and that the gains in efficiency would not likely be attained if the order were made.
>
> (2) In considering whether a merger or proposed merger is likely to bring about gains in efficiency described in subsection (1), the Tribunal shall consider whether such gains will result in
>
> (a) a significant increase in the real value of exports; or
>
> (b) a significant substitution of domestic products for imported products.
>
> (3) For the purpose of this section, the Tribunal shall not find that a merger or proposed merger has brought about or is likely to bring about gains in efficiency by reason only of a redistribution of income between two or more persons."[3]

The first merger in Canadian history in which the section 96 efficiencies defense was successfully used was the merger of Superior Propane Inc. and ICG Propane Inc. In *The Commissioner of Competition v. Superior Propane Inc.*[4] *(Superior Propane 1)*, the Competition Tribunal allowed the defence and adopted the total surplus standard in interpreting the "effects" that must be considered under section 96. The Commissioner appealed *Superior Propane 1* to the Federal Court of Appeal

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1 R.S. C. 1985, c. C-34, as amended (hereafter "the Act").

2 *Ibid*., at s. 96.

3 *Ibid.*

4 The Commissioner of Competition v. Superior Propane Inc., 2000 Comp. Trib. 15.

(*Superior Propane 2*[5]). The Federal Court of Appeal agreed that the efficiencies defense was proper, which meant the merger should not be dissolved, but the Federal Court of Appeal rejected the Tribunal's interpretation of section 96 and remitted the matter back to the Competition Tribunal (*Superior Propone* 3[6]) with instructions that the Tribunal consider all the distributional effects, not just the dead-weight losses. Following the Tribunal's subsequent redetermination, the Commissioner once again appealed to the Federal Court of Appeal but the appeal was dismissed.

1.1 Purpose and Structure of this Paper

The primary purpose of this paper is to discuss how "gains in efficiency" are quantified for purposes of sustaining a section 96 efficiencies defence. Both the statutory and practical requirements of claiming the efficiencies defense will be examined. As well, since we were part of the merging companies' team of experts in the Superior Propane cases[7], we will analyze the efficiencies quantification in that merger.

Before discussing the quantification of efficiencies, we begin with a brief explanation of the economic background behind the section 96 efficiencies defense. We then discuss the section 96 balancing test that requires comparison of the potential anti-competitive "effects" of a merger and the expected efficiency gains that would be realized if the merger is permitted. Section 4 of this paper takes an in-depth look at the four alternative approaches for analyzing the possible effects of a merger, concluding with a discussion of the current state of the law regarding which approach will be applied by Canadian anti-trust authorities.

Sections 5 and 6 are the heart of this paper. Section 5 begins with a discussion of the types of efficiency gains to be considered in applying the section 96 balancing test, as well as restrictions limiting recognizable efficiencies. Then we move to the burden of proving efficiencies and an in-depth discussion of valuation issues regarding efficiencies and the quality and nature of evidence supporting an efficiencies defense.

Section 6 features a case study-type analysis of the Superior Propane set of cases, including analysis of the conclusions set out in the Cole-Kearney expert report that was presented in support of application of the efficiencies defense.

And finally, in Section 7 we offer concluding remarks about how to substantiate efficiency claims and the role of the expert evidence in doing so.

5 Canada (Commissioner of Competition) v. Superior Propane Inc., 2001 FCA 104.

6 The Commissioner of Competition v. Superior Propane Inc., 2000 Comp. Trib. 16

7 As explained in Section 6.2 of this paper, we co-authored the Cole-Kearney Report along with A.T. Kearney Ltd. a management consulting firm.

2.0 THE ECONOMICS UNDERLYING SECTION 96 OF THE ACT

Mergers tend to increase industry concentration, giving the merging parties greater market power, and possibly resulting in anti-competitive pricing. The potentially harmful effects of anti-competitive pricing are discussed in the following subsections.

2.1 Consumer Surplus and Wealth Transfer

A price increase resulting from an anti-competitive merger transfers wealth from the consumers of the affected goods and services to the producers of these products. When a consumer purchases a product, that consumer has a subjective (dollar) valuation that she ascribes to that good or service.[8] The difference between this subjective valuation and the purchase price is the *net* value the consumer realizes from her consumption of the product.

When the consumer's perception of value is higher than the actual price paid, the *net value* is positive. Economists refer to this positive *net value* as the "consumer surplus." After a post-merger price increase, consumers who continue to purchase the firm's product lose a portion of the consumer surplus they used to realize because the difference between the consumers' subjective valuation of the product and its price is smaller. Thus, the lost consumer surplus is equal to the difference between the pre- and post-merger price of the product.

In aggregate, the total loss in consumer surplus engendered by an anti-competitive pricing scheme is simply the sum of these individual losses over each unit that the merged firm *continues to sell* after the price increase.[9] This aggregate lost value, or *wealth*, is now captured by the producer of the product (the merged firm) who realizes this difference through additional per unit revenues. Consequently, economists dub this consumer-to-producer reallocation of value as the "wealth transfer".[10] Since policy makers generally have no reason to believe a dollar in the hands of producers will be used for a more socially beneficial purpose than a dollar in the hands of consumers,[11] economists frequently regard this wealth transfer as a neutral impact on market power-enhancing mergers.[12]

8 Note that this valuation must be greater than, or equal to, the price she paid for it. Another way of looking at it is that the price must be equal to or below her valuation – her "willingness to pay" – or the consumer simply will not purchase the good or service in question since, by doing so, she would realize a net loss.

9 As price rises, some marginal demanders of the product will no longer continue to buy the good since their subjective valuation will be below the post-merger price level. Thus, the number of units the merged entity sells will fall post-combination by the number of units no longer purchased by these consumers.

10 For example, see Williamson, Oliver, "Economies as an Antitrust Defense: The Welfare Effects" (1968), 58 Amer. Econ. Rev. 18 (hereinafter "Williamson"). See also the discussion of the competition Tribunal and the Federal Court throughout the *Superior Propane* litigation (*supra* notes 4-6).

11 Such a judgment requires knowledge of: 1) the distribution of income among producers, consumers, and society in general; and 2) society's preferences regarding that distribution. Given the vast informational requirements needed for such a determination, economists generally agree that such knowledge will rarely, if ever, be available to policy-makers and so there is no theoretical reason to prefer wealth in the hands of either consumers or producers.

12 For example see Williamson, *supra* note 9.

2.2 Deadweight Loss and Societal Gains

When a merged entity raises the price of one of its products post-merger, existing consumers with relative low valuations will no longer purchase the product since the price will now exceed the value they ascribe to it.[13] Thus, the consumer surplus these forced-out consumers previously attained through their purchases of the product is lost after the implementation of the post-merger price increase. This "deadweight loss" does not result in a corresponding gain to the producers of the product or to any other segment of society. This lost surplus simply no longer exists and constitutes a cost borne by the economy as a whole.[14]

With these effects in mind, economist Oliver Williamson introduced the concept of efficiencies into merger analysis.[15] Williamson's theory is that while anti-competitive mergers – or more specifically, the post-merger price increases anti-competitive mergers engender – invite deadweight losses, such combinations may also give rise to cost saving efficiencies that yield corresponding societal welfare gains. Williamson's argument is that if these savings are large enough, they may outweigh the resulting deadweight losses and therefore the economy realizes a net welfare *gain* equal to the excess of the efficiency gains over the deadweight losses. In light of this theory, Williamson argued that antitrust regulators should incorporate an efficiencies defense into their merger review framework. Under this defense, an anti-competitive combination would be permitted if the parties could demonstrate that anticipated merger-driven efficiencies were expected to outweigh deadweight losses resulting from the merger.

The Canadian Parliament incorporated such an efficiencies defense into its 1985 amendments to the Act.[16] These provisions now constitute section 96 of the Act.

3.0 THE TRADE-OFF: BALANCING EFFICIENCIES AGAINST "EFFECTS" UNDER SECTION 96

As noted, under subsection 96(1) of the Act, the Tribunal may not make an order that prohibits or otherwise limits an anti-competitive merger if it can be shown that the combination in question "... has brought about or is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition that will result from the merger."[17] In this trade-off analysis, therefore, the "gains in efficiency" are weighed against the "effects of any prevention or lessening of competition." Thus, there are two parts to this balancing test:

i. the expected efficiency gains, and

ii. the anti-competitive "effects".

Before discussing these two components, it is important to note the manner in which this balancing test is to be performed. Pursuant to subsection 96(1), the gains in efficiencies resulting from the merger must be both: (i) greater than the harmful effects of the merger, and (ii) the gains must offset the harmful effects of the merger.

According to the Competition Bureau's Merger Enforcement Guidelines (hereinafter "the MEGs"),[18] when the efficiency gains and "effects" under consideration can be quantified in similar units of measurement (e.g., dollars), the term "greater than" is to be given its intuitive, mathematical meaning. Furthermore, if the quantified gains are numerically greater than the corresponding quantified losses, the MEGs state that these gains are considered to have "offset" those losses.

In the case of non-quantifiable gains and losses – such as the effects of a post-merger change in management strategy – the MEGs recognize that a numerical comparison is impossible and therefore, "greater than" should not be applied in its mathematical sense. In these situations, according to *Superior Propane 1*, the Tribunal must perform a qualitative weighing process in which the non-quantifiable gains and losses are first balanced against each other and then against any net quantified gains.[19] Obviously, such a qualitative balancing procedure is inherently subjective and, therefore, difficult to accomplish in practice.[20]

4.0 "THE EFFECTS OF ANY PREVENTION OR LESSENING OF COMPETITION"

On one side of the balancing test, section 96 refers to "any effects". This wording is broad enough to support a broad range of possible interpretations. Because section 96's balancing test inextricably links the concept of "effects" to the quantification of efficiencies, we will briefly summarize the alternative interpretations that have been put forth in this debate concerning interpretation of the word "effects" and the current state of the law.

4.1 "Effects": The Many Candidate Interpretations of subsection 96(1)

Anti-competitive "effects", one side of the balancing test, includes deadweight losses associated with post-merger price increase. However, there is no general consensus regarding whether the wealth transfer, or some portion thereof, should also be considered an "effect" for the purposes of section 96. In the course of the Superior Propane litigation, the Tribunal examined four alternative interpretations of the "effects" phrase:

i. the *total surplus standard*,

ii. the *balancing weights approach*,

iii. the *consumer surplus standard*, and

iv. the *price standard*.[21]

13 In other words, consumers will not purchase products that are expected to yield a negative consumer surplus.

14 Given that "deadweight losses" are recognized by both policy makers and economists as a net welfare loss borne by society, the existence of these losses has been the traditional rationale for the regulation of market-power enhancing mergers. For a more complete discussion, see Tirole, Jean, The Theory of Industrial Organization, (Cambridge) MIT Press, 1998, at p. 65-68.

15 See Williamson, *supra* footnote 9.

16 At that time, the Act was still called by its original name – the *Combines Investigation Act*.

17 The Act, *supra* footnote 1.

18 Consumer and Corporate Affairs Canada, *Merger Enforcement Guidelines* (1991) (hereinafter the MEGs) at s. 5.4. It should be noted that the Tribunal is not legally bound by these Guidelines, they are simply the Bureau's interpretation of the Act and, as such, they were not drafted under a grant of statutory authority. However, in practice, the Tribunal has often followed the Guidelines. Many of the MEG passages cited in this paper have been followed by the Tribunal, which means that they carry precendential weight accorded any decision of the Tribunal.

19 *Superior Propane 1, supra* note 4 at para 459.

20 Indeed, this is the perhaps the Tribunal's primary motivation for its emphasis on quantifiable effects when evaluating an efficiencies claim.

21 See *Superior Propane 3, supra* note 7.

These four different interpretations of "effects", as it is used in subsection 96(1), are discussed below.

4.1.1 Total Surplus Standard

One interpretation of the expression anti-competitive "effects" as used in subsection 96(1) treats deadweight losses as the only relevant "effect" under subsection 96(1); the wealth transfer is considered to be "neutral".[22] This interpretation has become known as the *total surplus standard*, since it considers only economy-wide welfare effects (i.e., changes in net surplus) and is indifferent to how anti-competitive mergers may reallocate wealth among groups within society.

Since the total surplus standard considers only deadweight losses and dismisses the wider range of "effects", this interpretation is far more likely to approve efficiency-enhancing, anti-competitive mergers, than alternative standards that give additional weight to the wealth transfer. Obviously, the greater the "effects" that receive consideration under section 96, the higher the corresponding efficiencies have to be to offset those "effects". Thus, the total surplus standard constitutes the least stringent interpretation of the efficiencies defense, providing the narrowest interpretation of "effects."

4.1.2 Balancing Weights Approach

The balancing weights approach considers deadweight losses plus a portion of the wealth transfer. This approach gives effect to redistributional concerns by expanding the definition of "effects" beyond deadweight losses to include that portion of the wealth transfer that is regressive[23] in nature, i.e., from relatively less wealthy consumers to relatively wealthy producers. The balancing weights approach accomplishes this by measuring the net welfare loss engendered by the regressive component of the wealth transfer and counting it as an "effect" for purposes of the section 96 balancing test.[24]

The balancing weights approach suffers from one major drawback: the informational requirements necessary to implement this standard are onerous. Under this approach, the Tribunal must not only have a great deal of insight into society's preferences regarding the appropriate allocation of wealth, but must also possess detailed information regarding the distribution of income between the relevant consumer and producer groups. Indeed, such impractical informational requirements were ultimately the Tribunal's rationale for its inability to properly apply the balancing weights standard in Superior Propane 3, the most recent decision.[25]

22 *Ibid.*, at para 95-101.

23 This approach was proposed by Professor Townley, the Commissioner's expert witness in *Superior Propane 1*. Prof. Townley reasoned that if wealth transfer was regressive, i.e., from relatively poor consumers to relatively wealthy producers, the redistribution of wealth will result in a decrease in overall welfare due to the operation of a well-accepted micro-economic principle, the diminishing marginal utility of wealth. In short, this theory holds that the wealthier the individual, the less each incremental increase in that individual's wealth impacts on his overall welfare and vice-a-versa. It follows from this conjecture that the transfer of a given dollar amount of wealth from the less wealthy to the more wealthy will result in a greater welfare loss to the less wealthy than welfare gain to the wealthy individual, resulting in a net welfare loss.

24 Specifically, the Balancing Weights Approach works as follows. One first derives "w" from the equation: ("Wealth transfer" + "Efficiency gains") – w ("Wealth transfer" + "Deadweight loss") = 0. The equation effectively compares the gain in producer surplus (first bracketed term), given by the wealth transfer plus the efficiency gains, with the weighted loss of consumer surplus (second bracketed term), which is comprised of the weighted sum of the wealth transfer and deadweight loss. The "break-even" weight, w, which is derived from this equation, gives the weight at which the efficiency gains just offset the lost surplus. At any heavier weight, the lost surplus outweighs the gained surplus and the efficiencies defense will not succeed. At any lower weight, the surplus gained outweighs that which is lost. Thus, the Tribunal's task is to determine whether the "break-even" w is correct in light of society's preferences regarding the appropriate distributions of income and the incomes of consumers relative to the wealth of producers. For further information, see *Superior Propane 3* at para 102-113, *supra* note 6.

25 *Superior Propane 3, supra* note 6 at para 338.

4.1.3 The Consumer Surplus Standard

The remaining two approaches – the *consumer surplus standard* and the *price standard* – are somewhat less relevant to the Canadian efficiencies defense, since the former was dismissed by the Competition Tribunal in *Superior Propane* #3 and the latter does not appear to have been seriously considered. However, for the sake of completeness, these standards are briefly discussed in this paper.

Proponents of the *consumer surplus standard* advocate treating the wealth transfer in its entirety as an "effect" under section 96. That is, this interpretation would only allow efficiency-enhancing, anti-competitive mergers to proceed where the expected efficiency gains are larger in magnitude than the sum of the deadweight loss *and* the post-merger wealth transfer.

4.1.4 The Price Standard

The *price standard* accords even greater significance to the wealth transfer by ascribing an infinite weight in the efficiencies/"effects" trade-off, in other words, if an efficiency-enhancing merger causes *any* wealth redistribution (i.e., transfer of wealth) away from consumers, the harmful effects of the merger are treated as automatically outweighing the counter-veiling efficiency gains. Since any post-merger increase in price effects wealth redistribution from consumers to producers, the price standard effectively requires the expected efficiency gains to be so large that post-merger prices will remain the same or fall below pre-merger levels despite the increase in market power.[26]

Contrasted with the *total surplus* and *balancing weights approaches*, the last two standards – *consumer surplus* and *price standards* – are far less permissive of efficiency-enhancing mergers. By treating the entire wealth transfer as an anti-competitive "effect", the *consumer surplus standard* requires the parties claiming the section 96 defense to prove the existence of a considerable quantum of efficiency gains. When compared to the *consumer surplus approach*, the *price standard* would likely result in an even more limited version of the efficiencies defense, since the proven efficiency gains must be so significant the merged entity will be expected to set its profit-maximizing price at or below pre-merger levels.

4.2 "Effects": The Current State of the Law

In *Superior Propane* 1[27], the majority of the Competition Tribunal endorsed the adoption of the *total surplus standard*. However, on appeal by the Commissioner[28], in *Superior Propane 2*, the Federal Appellate Court rejected the Tribunal's *total surpus standard* interpretation of section 96. The Federal Court concluded that a proper interpretation of subsection 96(1) should "include all the anti-competitive effects... having regard to all of the statutory purposes set out in section 1.1."[29] The Federal Court then remitted the matter of the efficiencies defense back to the Tribunal, with

26 Interestingly, the price standard is the balancing criterion that has been adopted by U.S. antitrust policy-makers in their enforcement guidelines. Section 4 of the U.S. Department of Justice's "Horizontal Merger Enforcement Guidelines state: "The Agency will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market. To make the requisite determination, the Agency considers whether cognizable efficiencies likely would be sufficient to reverse the merger's potential to harm consumers in the relevant market, e.g., by preventing price increases in that market." Thus, under the U.S. antitrust regime, efficiencies are a factor in the regulator's decision regarding whether to challenge a merger. It should be noted that there is no efficiencies defense in the U.S. today.

27 *Superior Propane 1, supra* note 4.

28 *Superior Propane 2, supra* note 5.

29 *Ibid.*, at para 92.

instructions to make a re-determination on this issue in accordance with the Court's holding. While the Federal Court did not go so far as to specify the standard that should be applied under section 96, the Court stated that the *balancing weights* approach proposed by Prof. Townley (described above) satisfied the Court's requirements.

In *Superior Propane 3*, the Competition Tribunal's recent re-determination of the efficiencies defense[30], the Tribunal once again allowed the merger to proceed under the auspices of the section 96 defense, albeit for slightly different reasons. Per the Federal Court's recommendation, the Tribunal was compelled to include a treatment of the wealth transfer in its balancing analysis, and attempted to implement Prof. Townley's balancing weights approach. However, in *Superior Propane 3*, the Tribunal asserted it simply did not have sufficient information in evidence to make any comprehensive determination regarding the distribution of incomes between the affected producer and consumer groups.[31] In *Superior Propane 3*, the Tribunal concluded that a small portion of the wealth transfer (approximately 10%) would be regressive in nature, but under any "reasonable weighting scheme" the efficiencies more than offset the "effects" under the *balancing weights approach*.[32]

5.0 TYPES OF EFFICIENCIES UNDER SECTION 96 AND QUANTIFYING EFFICIENCIES

Having examined the "effects" branch of the balancing test, we now move to the focal point of this article – the quantification of efficiency gains under section 96.

5.1 Types of Efficiencies Recognized Under Subsection 96(1)

The MEGs identify two broad categories of efficiency gains under section 96:[33]

(i) Productive efficiencies; and

(ii) Dynamic efficiencies.

5.1.1 Productive Efficiencies

According to the MEGs, "[P]roductive efficiencies result from real long run savings in resources which permit firms to produce more or better quality output from the same amount of inputs."[34] In other words, these efficiencies arise where the merged firm is more cost-effective in delivering the same output than were the predecessor firms.

Productive efficiencies are often the main focus of analysis because "they can be quantifiably measured, objectively ascertained and supported by engineering, accounting and other data."[35]

30 *Superior Propane 3, supra* note 6.

31 *Ibid*. at para. 338

32 *Superior Propane 3, supra* note 6 at para 371.

33 MEGs, *supra* note 17 at Appendix II.

34 *Ibid*

35 MEGs, *supra* note 17 at Appendix II.

The most common type of productive efficiency gains are achieved through "economies of scale", "economies of scope" and through specialization. For example:

- "Economies of scale" arise through long run reductions in average variable cost resulting from increased production volumes. Such "economies of scale" can generally be achieved on either a product-specific or plant-specific basis.[36]
- "Economies of scope" are achieved in multi-product plants where the cost of producing more than one product or service at a given level of output is reduced by producing them together rather than separately.
- "Specialization efficiencies" often arise at the plant level thanks to labour specialization, the elimination of duplicate processes, reduced down time, and lower spare parts in inventory costs.[37]

In the multi-plant situation, productive efficiency savings may result from plant specialization, the rationalization of various administrative and management activities, and the rationalization of research and development.[38] On a firm-wide level, cost savings may be achieved through the elimination of redundant management positions, advertising initiatives, and distribution networks, or through the transfer of superior production techniques, managerial know-how, and intellectual property rights.[39]

5.1.2 Dynamic Efficiencies

In contrast to productive efficiency gains, the MEGs state that dynamic efficiencies are cost savings achieved through the "optimal introduction of new products, the development of more efficient productive processes, and the improvement of product quality and service"[40] over time. That is, dynamic efficiencies are the positive effects of the innovative and productivity-enhancing activities that businesses undertake as their operations evolve.

Due to the speculative nature of these gains, dynamic efficiencies are easily distinguished from the relatively tangible productive efficiencies examined above. Given their speculative character[41], "dynamic efficiencies are ordinarily extremely difficult to measure"[42] and, as a result, are usually accorded a qualitative weighting in the section 96 analysis.

Dynamic efficiencies are often accorded much less significance than productive efficiencies because they are inherently less easily quantified and are therefore subjective. However, this is not to say dynamic efficiencies are unimportant. While the MEGs express a clear preference for quantifiable productive efficiencies, the MEGs acknowledge that dynamic efficiencies are "crucial to both the general evolution of competition and the international competitiveness of Canadian industries."[43]

36 *Ibid*

37 *Ibid*

38 *Ibid.*

39 *Ibid.*

40 *Ibid.*

41 Indeed, the very point of innovation is that no one will envision it until it has occurred.

42 MEGs, *supra* note 17 at Appendix II.

43 MEGs, *supra* note 17 at Appendix II.

5.2 Restrictions Limiting Recognizable Efficiencies Under Section 96

If proving the existence of efficiency gains before the Competition Tribunal were simply a matter of identifying and measuring potential merger-driven cost savings, successfully claiming an efficiencies defense under the Act would be a much easier task. There are two substantial restrictions on the scope of efficiencies that may be considered under subsection 96(1). In effect, they are savings or efficiencies which are to be excluded:

i. savings which would likely be achieved through non-merger alternatives; and

ii. the gains must be real and not merely pecuniary in nature.

With respect to the first restriction, subsection 96(1) explicitly requires that "the gains in efficiency would not likely be attained if the order were made."[44] The "order" refers to the order sought by the Commissioner or any order the Tribunal may make under subsection 92(1), to prevent the merging parties from effecting a substantial lessening of competition. Pursuant to this restriction, if the claimed efficiencies would *likely* be attained through less anti-competitive means (such as a joint venture or a merger with a third party) and therefore would be achieved even if the order were made, then these efficiencies should not be attributable to the merger under review.[45] The party claiming the efficiencies defense must prove, on a balance of probabilities, that the claimed cost savings represent a benefit of the proposed merger. Efficiencies that were already underway pre-merger, or that would most likely have been achieved without the merger, can not be claimed as efficiencies.[46]

The Tribunal will not require that parties claiming an efficiencies defense prove the claimed cost savings *could not* be achieved in the absence of the contemplated merger, nor must they prove the efficiencies are *merger-specific*. To do so would impose too stringent of a standard of proof. Instead, the parties are only required to demonstrate that the efficiencies in question are not likely to be achieved through non-merger alternatives.[47] In demonstrating this, the parties may refer to the "market realities" of the industry in question. According to the MEGs, "[i]f the common industry practice is such that the alternative in question would not likely be resorted to if the order were made, the efficiencies in question will ordinarily be included in the balancing process."[48]

The second limitation, imposed by section 96 requires that claimed efficiencies constitute real resource savings rather than mere pecuniary gains. Pursuant to subsection 96(3) of the Act, "the Tribunal shall not find that a merger or proposed merger has brought about or is likely to bring about gains in efficiency by reason only of a redistribution of income between two or more persons."[49] "Gains in efficiency" must therefore constitute a genuine improvement in societal welfare, not a mere gain by one party at the expense of another. The efficiencies in question must yield real savings of productive resources that would then be free to be employed elsewhere in the economy. In contrast, cost savings resulting from a "redistribution of income between two or more persons" do not constitute real efficiency gains, since they amount to mere re-allocations of wealth among members of society – that is, they do not liberate productive resources. Such redistributions of wealth are deemed "pecuniary" and, as such they fall under S.96(3) and are not considered when determining efficiencies described in S.96(1).

To illustrate this concept, let us look at an example:

- Consider a horizontal merger in which the combining parties are expected to obtain post-merger price discounts from their suppliers. If these cost savings are a consequence of the merged entity's new-found bargaining power, then such gains will be considered "pecuniary", since they are simply transfers of wealth between the merged entity and its suppliers. However, if these discounts are rooted in actual economies of scale that the suppliers can now realize due to the merged entity's increased order flows, then these gains will be considered true efficiencies for the purposes of subsection 96(1).

5.3 Merging Parties Have the Onus of Proof

The merging parties have the onus of proving the existence of claimed efficiency gains beyond a balance of the probabilities[50], which according to many commentators, is an exceedingly difficult task.[51] An assessment of efficiency gains under section 96 requires parties asserting an efficiencies defense to determine the capabilities of each of the merging parties to reduce costs in the absence of the transaction and analyze how the combination would result in cost savings that would not be attainable through alternate means.

5.4 Present Value Versus Nominal Dollar Weightings

"Effects" are likely to be realized shortly after the merger is completed, since profit maximizing firms will be eager to exercise newly realized market power as soon as possible. The task of determining the precise timing and durability of these "effects" is typically left to economist experts since various market and competitive factors will influence timing and the risk of "effects" realization.

When balancing "effects" against efficiencies, should net present values or nominal values be used? Net present values (NPVs) are preferable. Determining the net present value of efficiencies requires genuine appreciation of the business plan of the merged entity including, most particularly, timing and the risk related to successful integration and likelihood of realization of the synergies. (The timing and risk relating to efficiencies, unlike effects, need not be left to economists).

Care should be taken not to double count risk of achieving either effects or efficiencies. Consequently, a good practical guide will be to reduce them both by the same factor for the time value of money, not risk. Prior to so doing, the nominal dollar efficiencies and effects should be risk or probability adjusted. That is to say, if there is ninety percent certainty that $100 can be saved per annum through productive efficiencies resulting from the merger, the amount claimed before discounting for the cost of money should be $90.

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44 The Act, *supra* note 1 at s. 96(1).

45 Note that in the event that only some fraction of a claimed efficiency gain meets this test, the fraction that does not satisfy this requirement will not be counted towards the merger. For example, if it can be shown that of the claimed cost savings expected to result from the post-merger rationalization of distribution networks could be achieved through third party contracting initiatives, then only the remaining will be attributed to the merger.

46 MEGs, *supra* note 17 at Appendix II.

47 It is worth noting that previously there was some argument regarding whether the efficiencies must merely be *unlikely* to be realized if the order is made or, under a much more stringent test, could never be attained if the order were made (in other words, that the efficiencies are *unique* to the merger). In *Canada (Director of Investigation and Research) v. Hillsdown Holdings (Canada) Ltd.*, 41 C.P.R. (3d) 289, this debate was settled when the Tribunal ruled that the appropriate test is the *likely* standard.

48 MEGs, *supra* note 17 at Appendix II.

49 The Act, *supra* note 1 at s. 96(3).

50 This was established in the *Hillsdown Holdings* matter (*supra* note 47) where the Tribunal held that the party making out the efficiencies defense under section 96 (i.e., the respondents to an alleged violation of s. 92) has the burden of proof with respect to the efficiency gains.

51 For example, see Kattan, Joseph, *"Efficiencies and Merger Analysis"*, 62 (2) Antitrust Law Journal 1994 (hereinafter "Kattan"), Winter at pg 513.

5.4.1 Risk Considerations

In assessing the risk of achieving the efficiencies, whether determining probability of realization separately or including it in an appropriate discount rate, the following factors should be considered:

1. Whether the efficiencies are internally focused and reflect savings in controllable costs and whether they result from redundancies and duplications arising out of the merger rather than from changing the operating paradigm. Efficiency gains predominantly a function of internal organization and cost factors are more predictable than revenue or demand oriented gains.
2. The anticipated time period over which the efficiencies will be implemented and the period over which they will be enjoyed.
3. The likelihood that the aggregate efficiencies can be successfully implemented as planned.
4. Effectiveness of the merged firm's management to execute the merger integration.
5. Complexity of steps needed to be taken to obtain synergy opportunities.
6. Similarity of the merging businesses.
7. Degree of business focus and commitment of the merged business to realizing the overall business plan and specifically the integration plan and related synergies.
8. Sufficiency of financial strength of the merged firm to fund restructuring requirements.
9. Likely impact of reaction of outside forces (customers/competitors/suppliers).
10. Other factors bearing on the achievability of the synergies.

While each case is different, generally, cost-side efficiencies are more easily achieved than revenue-based synergies. Therefore, the probability of achieving cost-side efficiencies should be higher than the probability of achieving revenue-based synergies.

5.4.2 Discount Rate Considerations

In the determination of NPV, if the discount rate is to incorporate the risk of achieving the efficiencies it should reflect all of the above risk related factors.

In addition, when determining NPV, the following should also be considered:

- market rates of return for comparable opportunities; and
- the market-based risk free rate (the rate of return that can be earned on a risk free investment, such as a Government of Canada Treasury Bond) plus a risk premium (the incremental amount required beyond the risk free rate of return to provide for the possibility that the efficiencies will vary from their predicted levels and/or timing).

The discount rate should not reflect:

- the assumption there is a higher likelihood the merged entity will be able to exercise market power over a sustained period to substantially raise prices and enjoy a lower equity risk than the merging parties faced prior to the merger;
- the business risks facing the merging parties prior to the merger that are not applicable to the merged entity;
- a discount for risk or conservatism that has already been built into the nominal dollar estimates. Failing to take into account such a built-in discount happens frequently, resulting in an error that penalizes the cash flows twice.

If cost side efficiencies are insulated from many of the general business risks facing the merged entity's equity holders, the risk premium should be less than that appropriate to an equity rate of return. The relevant rate is likely higher than the cost of debt and lower than the cost of equity.

Section 5.7.1 of the MEGs refer to the Treasury Board of Canada's guideline rates as set out in its Benefit-Cost Analysis Guide (the Guide). The Treasury Board rates are, according to the Guide, intended to reflect an opportunity cost in the private sector for the use of funds spent by the Government of Canada on its programs. The MEGs recommend use of the Treasury Board rate as an appropriate discount rate.

The MEGs also recommend[52] that a sensitivity analysis done regarding the assumption of a discount rate include rates, such as a "cost of capital" or "industry hurdle rate", specific to the industry in question.

Before using the Treasury Board rate, the following should be taken into account:

- the rate does not take into account the specifics of any particular matter;
- the rate was last amended in July 1998 and has remained in draft form to date, to the best of our knowledge; and
- use of the rate may well result in unnecessary discounting for risk or, in fact, double counting because a party claiming the efficiency defense may base its calculations on extensive due diligence and conservative assumptions as to the realization and achievability of the efficiencies (ie the risk in the discount rate needs to be properly matched with the risk inherent in the synergy cash flows).

5.5 Quality and Nature of Evidence to Support Efficiencies

To successfully substantiate the expected efficiency gains claimed, the MEGs call for an "objective verification of particular sources of efficiencies gains"[53] through accounting statements, appropriate consultants' studies and similar documents. This evidence should "describe the precise nature and magnitude of each type of efficiency gain that it is expected will be brought about by the merger."[54] In *Canada (Director of Investigation and Research) v. Canadian Pacific*,[55] the Tribunal held that these

52 MEGs, *supra* note 17, section 5.7.1

53 MEGs, *supra* note 17 at Appendix II.

54 Ibid.

55 *Canada (Director of Investigation & Research) v. Canadian Pacific Ltd.* (1997), 73 C.P.R. (3rd) 573 (Comp. Trib.).

documents must also contain particulars regarding the integration plan by which the merging parties propose to achieve these efficiencies.[56]

Not only is the onus of proof on the party claiming the efficiency defense, but experience shows that "most purported synergies are like the colorful petals of the Venus flytrap – dangerous deceivers."[57] Consequently, evidence in support of the efficiencies should have the following qualities:

1. The evidence must make common sense.
2. The evidence must be supported by "a detailed business plan which expresses … the commitment and accountability of … management".[58] The efficiencies evidence must not be "only a theoretical exercise that may never be implemented by management".[59]
3. Evidence not initially developed for the competition hearing, but rather in support of the business plan or the integration plan, will be far more credible than such evidence developed solely to support an efficiencies defense.
4. Evidence in respect of the efficiencies defense should be consistent with, and supported by, the various business plans of the merged firm, including: the integration plan, the human resource plan, the capital expenditure plan, systems and IT plans, marketing and communications plans, etc.
5. The evidence must have a practical orientation and not be unduly complex.
6. The evidence must demonstrate a holistic understanding of the business.
7. Evidence concerning the specific merger in question should include information about how the particular merger stacks up against benchmark criteria that has been established to predict whether a merger will be successful in achieving anticipated synergies and efficiencies. Appendix 1 contains information about the benchmarks that have been developed in this area.
8. Evidence concerning efficiencies should be ranked from the highest dollar value to lowest dollar value.
9. Evidence concerning the annualized ranking of efficiencies should be set out in a format that permits discounted cash flow analysis and present value determinations to be done easily.

56 It has been noted elsewhere that courts tend to the view after-the-fact testimony of economic and business consultants rather critically, given the tendency for these agents to submit overstated efficiency assessments that are blatantly in the interest of their clients. In the same vein, courts are thought to prefer studies undertaken or commissioned by management prior to the decision to merger, since such reports are perceived to be free from the one-sided bias that often characterizes evidence prepared solely for the purposes of litigation. (See Kattan, *supra* note 55) However, this natural reluctance of the courts does not, and should not, stand in the way of credible efficiency assessments drafted by expert witnesses, especially since most companies do not slavishly document every step of the decision making process and therefore may not be able to produce a paper trail of efficiencies that pre-date the announcement of the merger. For such parties, expert testimony is the only credible means of establishing efficiencies before an adjudicative body and, as a result, such evidence should face a healthy degree of skepticism rather than outright antagonism.

57 Sirower, Mark L. The Synergy Trap: How companies lose the acquisition game, (New York) The Free Press, A Division of Simon & Schuster Inc., 1997, *p. 5*.

58 *Superior Propane 1, supra* note 4 at para 490.

59 *Ibid*, at para 492.

5.6 Coordination of Experts and Client Information

Experts can best assist counsel mounting an efficiencies defense by preparing a combination of *pro-forma* business models and reviewing pertinent and extensive cost and value analysis. To avoid "reinventing the wheel", experts should work with the client's information and, through extensive discussion with management, distill the information appropriate to support an efficiencies defense.

The expertise required to present evidence sufficient to support an efficiencies defense includes the following: business and financial analysis, merger integration analysis, operations and logistics, marketing and human resource planning. Because an efficiencies claim is highly detailed, it may be necessary to retain separate industry experts and litigation consultants. Rarely will one litigation-support expert have sufficient industry knowledge. Similarly, it is unlikely that an industry expert will have the necessarily litigation presentation or analytical skills. To make the evidence come alive and not be purely theoretical, it is critical experts have actual advisory and consulting experience in the areas most germane to the case.

5.7 Efficiencies Based on Pass Through of Supplier-Based Real Savings

To substantiate certain efficiencies that might otherwise be considered pecuniary in nature, it will often be necessary to investigate the business of suppliers of the merged entity. To demonstrate that savings from a supplier are not merely pecuniary, the fact that the supplier is going to realize real productive efficiencies, which will lead to falling prices, must be shown. Significant time, energy and cooperation will be required by numerous parties to put forth acceptable evidence in this respect. Confidentiality and other matters will have to be addressed on a timely basis to satisfy not only the merged entity but also its suppliers' and their competitive concerns.

The balance of this article focuses on a discussion of the efficiencies and the nature of the evidence provided in the *Superior Propane* series of cases.

6.0 THE *SUPERIOR PROPANE* LITIGATION: A CASE STUDY IN THE QUANTIFICATION OF EFFICIENCY GAINS

In this section we examine the analysis of productive efficiencies in the Superior Propane cases to demonstrate various characteristics of the efficiencies relevant to a successful section 96 defense.

Before addressing the detailed productive efficiencies involved in Superior Propane, some background information regarding the merger is useful.

6.1 Background to *Superior Propane*

Superior Propane Inc. (Superior) was engaged primarily in the retailing and wholesaling of propane, the sale of propane-fueled appliances/equipment and related services across Canada. ICG Propane Inc. (ICG), Superior's largest competitor, sold and distributed propane and related services across Canada, with the exceptions of PEI, Newfoundland, and Nova Scotia. At the time of the proposed merger, these two companies were the only suppliers of propane and propane-related products that served end-users on a nation-wide basis. Together, they held a significant percentage of the market share in these industries. According to the Commissioner's expert witness, Professor West, of the 74 local markets Superior and ICG served in 1997, in 32 markets the combined market share of the two companies was great than 80% and in 66 markets their combined market share was greater than 60%.[60]

On December 7, 1998, Superior acquired all the shares of ICG with the intention of combining the two entities. Following the acquisition, the Commissioner brought an application pursuant to section 92 of the Act seeking an order dissolving the Superior-ICG merger, or any other remedy that would prevent the "substantial lessening of competition" expected to result from this proposed combination.[61] The Commissioner's position was that a merger between these two companies (the Respondents) would create a dominant national propane marketer and, in some cases, a dominant local propane marketer vested with a considerable degree of market power. Neil Finkelstein[62], counsel for the Respondents, argued the merger should not be dissolved because the efficiencies defense of section 96 should apply.

In *Superior Propane 1*, the Tribunal unanimously agreed with the Commissioner that the proposed merger was likely to substantially lessen competition in the market for retail propane. But, the Tribunal accepted the Respondents' efficiencies defense and did not issue an order (pursuant to section 92) dissolving or otherwise obstructing the Superior-ICG combination.

Adopting the *total surplus standard*, the majority of the Tribunal in *Superior Propane 1* found that the Respondents had successfully made out the section 96 efficiencies defense, since the $29.21 million in admissible efficiency gains were clearly "greater than and offset" the quantified, per year deadweight loss of $3 million established by the Commissioner.[63]

60 *Superior Propane 1, supra* note 4 at para 111.

61 *Ibid.,* at para 1.

62 Neil Finkelstein is currently a senior litigation partner with Blake, Cassels & Graydon LLP, Toronto, Canada

63 *Ibid.*, at para 463-69.

Superior Propane 1 was the first case in Canada to uphold a merger where the efficiencies outweighed the significant lessening of competition. That is to say, the efficiencies outweighed the effects.

6.2 The "Cole-Kearney" Report and the Commissioner's Rebuttal

As previously noted, Superior had the burden of proof with respect to the efficiencies component of the section 96 defense. Therefore, Superior retained a group of experts[64] to prepare a report detailing the expected merger-related efficiency gains. This Report, dubbed the "Cole-Kearney" Report after the experts that prepared it, this report contained an in-depth quantification of the anticipated efficiency gains flowing from the Superior-ICG combination.

The Cole-Kearney report asserted that post-merger efficiency gains would likely be realized in three areas of the merged-entity's operations:

i. corporate center,

ii. customer support, and

iii. field operations.

The Respondents did not compare the efficiencies to the effects because the efficiencies so clearly where "greater than and offset" the deadweight loss, and no present value calculations were needed. In rebuttal, the Commissioner elected not to lead evidence regarding the quantum of these efficiencies, but instead reviewed the underlying assumptions and methodologies of the expert's report.

In Superior Propane 1, the Tribunal found:

- The vast majority of Superior's claim was genuine and should not be reduced;
- Certain specific items were reduced and, taking into account these reductions, the Superior-ICG merger was expected to yield annual efficiency gains of $29.21 million.[65]

The vast majority of the efficiencies derived from the merger stemmed from planned reductions in personnel, facility requirements, and other items, due to the elimination of redundancies between the operations of Superior and ICG. The experts estimated that these expected efficiency gains would yield a cumulative ten-year, nominal[66] cost savings of approximately $401 million (or around $40 million in nominal, per-year net efficiencies).[67]

The following discussion sets out the types of efficiencies identified in the Cole-Kearney Report, the restrictions placed on these claimed efficiencies as a result of application of section 96, and the methodologies employed by the experts to quantify these cost savings.

64 A.T. Kearney Ltd., a management consultancy firm, and Cole Valuation Partners Limited, a business valuation and litigation support firm.

65 *Superior Propane 1, supra* 4 at para 383.

66 i.e., the un-discounted sum of the efficiency gains.

67 The Cole-Kearney Report at 2.

6.3 Types of Efficiency Gains Recognized by Superior

The vast majority of Superior's claimed efficiencies identified in the Cole-Kearney Report were expected to result from long-run reductions in costs (elimination of inter-firm redundancies) that would allow the merged entity to produce more, or better quality, outputs from the same amount of inputs. Likewise, the non-redundancy driven efficiencies claimed by the Respondents, such as cost savings obtainable through the realization of economies of scale and the adoption of more efficient information systems, also resulted from similar long-run cost reductions. Thus, these efficiency gains were clearly productive in nature.

The Report did not address the issue of dynamic efficiencies, since such efficiencies were considered too speculative.[68]

6.4 The Section 96 Restrictions as Applied in *Superior Propane*

6.4.1 Restriction 1: Gains Not Likely to be Achieved if the Order is Made

As noted, subsection 96(1) of the Act requires that if efficiencies similar to those being claimed could be achieved through less anti-competitive means (i.e., initiatives that do not incur similar deleterious "effects"), the cost savings in question will not constitute "efficiency gains". This restriction requires the merging parties to analyze reasonable strategic merger alternatives and assess whether the specific cost savings in question would likely be achieved through these alternatives.

Since the redundancies expected as a result of the Superior-ICG merger would not have been created by any other merger or similar combination in the propane industry, the Report concluded "[n]o other combination of firms creates a comparable opportunity for the elimination of duplicative costs, redundant personnel, systems and assets."[69] In support of this conclusion, the experts examined possible joint ventures, specialization agreements, licensing and other strategic initiatives. This examination showed that not all of the efficiencies claimed were driven by the elimination of redundancies. The research showed that certain cost savings were likely to be realized in the absence of the Superior-ICG merger and so such cost savings were not included in determination of the efficiency gains. To assure the Tribunal that the efficiencies claimed were only those which could be realized through the merger, it was important to thoroughly investigate and highlight these costs in the Report. For example, the Report identified $35.66 million in savings in the area of administration that ICG expected to derive independent of the merger. Since these gains were "likely to be obtained if the order were made", they were excluded from the overall efficiency gains expected to result from the merger.

Superior asserted that the merger would likely save $660,000 in avoided public company costs, since ICG would no longer proceed with its tentative plans to take the firm public after its combination with Superior. At trial, the Commissioner criticized this claim on the basis that ICG could have been acquired by another company, which would mean these costs would have bee avoided in a less anti-competitive manner. In light of the Commissioner's arguments, the Tribunal in *Superior Propane 1* concluded that the evidence on record did not establish that ICG would likely go public if a divestiture order were made. Consequently, the Tribunal refused to accept these claimed efficiency gains because they were not merger-specific.[70]

[68] This was supported by the dissenting opinion of Ms. Lloyd. See *Superior Propane 1, supra* note 4 at para 509.

[69] The Cole-Kearney Report at pp 2.

[70] *Superior 1, supra* note 4, para. 352

6.4.2 Restriction 2: Gains Must Constitute Real Savings of Economic Resources

As noted, to be recognized as "efficiency gains" under section 96, claimed efficiencies must constitute real savings of economic resources. Pecuniary savings resulting from a redistribution of income between private entities do not meet this requirement.

The Cole-Kearney Report concluded Superior would have a cumulative ten-year efficiency gain of $26.07 million, due to the planned rationalization of the firms' purchasing activities. Specifically, the Report concluded the merged entity would be able to obtain significant supplier price discounts after the merger was completed[71] because the firm's suppliers would be willing to grant such price concessions, since they would be able to realize significant economies of scale from the merged entity's increased order volumes.

As the achievement of economies of scale are examples of real resource savings, Superior argued the requirements of subsection 96(3) had been satisfied. The Commissioner disagreed, arguing that in the absence of any detailed information regarding the operations of the firm's suppliers, these anticipated economies of scale could not be substantiated. The Commissioner asserted that the claimed procurement gains could just as likely result from the merged entity's increased bargaining power vis-à-vis its suppliers. Such bargaining power-based savings are the result of a redistribution of wealth from the suppliers to the merged entity and so, the Commissioner reasoned, the procurement gains are likely to be pecuniary in nature. In Superior Propane 1 the Tribunal agreed with the Commissioner and concluded there was insufficient evidence to support Superior' contention that the claimed procurement savings were true economic efficiencies for the purposes of section 96.[72]

Concerning the property tax savings[73], Superior argued that an anticipated post-merger reduction in property taxes should be recognized as a savings of real economic resources, since the merging firms were expected to consume fewer local government services as a single entity.[74] While the Tribunal accepted Superior's argument in theory, the Tribunal was not convinced the merged entity would consume fewer of these resources and/or that local government would produce less of them as a result. The Tribunal commented that an invoice from local government demonstrating that the merged entity would consume fewer such goods and services would be sufficient to ground any resultant tax-related efficiencies as real resource savings. But, since Superior did not adduce such evidence, the property tax saving could not be substantiated in this manner and this part of the claim was rejected by the Tribunal.[75]

[71] These estimates were largely predicated on the expert's experience through negotiating transport contracts for other clients.

[72] *Superior Propane 1, supra* note 4 at para 346-348.

[73] Note that property tax savings were not included in the claimed efficiencies specified in the Cole-Kearney Report.

[74] This argument is contrary to the policy set forth in the MEGs, which state that property tax savings represent redistributions of income from taxpayers to the firm and, therefore, are considered merely pecuniary. See the MEGs, *supra* note 17 at s. 5.3.

[75] *Superior Propane 1, supra* note 4 at para 374-376.

6.5 Efficiency Gains are to be Net of the Cost of Realization

When quantifying efficiencies for the purposes a section 96 claim, any costs incurred to achieve the claimed efficiency gains should be deducted from the estimated nominal savings, yielding a "net" figure.[76] As a result, the Cole-Kearney Report specified many downward adjustments made to the expected quantum of efficiencies to reflect such costs. For example, since many of the efficiency gains claimed by Superior stemmed from the anticipated elimination of redundant personnel, severance costs were deducted from the efficiency estimates. In other words, severance was treated as a cost of achieving the personnel-related efficiencies, since these positions could not be eliminated without incurring sizeable severance payouts.[77]

The Commissioner criticized Superior's efficiency quantification on the grounds that pre-merger planning costs should have been deducted as a cost of achieving the anticipated efficiencies. These costs included the merger-related planning costs incurred by management, as well as the costs incurred to prepare the expert report. Despite the Commissioner's urging, the Tribunal ultimately refused this criticism on the grounds that such pre-merger costs have already been incurred and do not depend on whether the merger is implemented. The Tribunal concluded that conceptually these are "sunk" costs and therefore, should not be considered when evaluating the costs of achieving merger-driven efficiencies.[78]

6.6 Efficiencies Pertaining To Senior Management Compensation

The *Superior Propane* series of cases raised the question of how to treat senior management compensation and the incremental cost thereof to realize the efficiencies. Clearly, taking on new senior management is an incremental cost and ought to reduce efficiencies otherwise determined. However, can there be an incremental cost associated with senior management in place prior to the merger who will remain with the merged entity if management was already effectively working at capacity? While the scope of their work will obviously expand as a result of the merger, presumably management will work no more hours post-merger than before the merger. Their jobs may be different but there would be no greater economic cost to the economy pre- and post-merger. As a result, therefore, any materially greater compensation earned by such individuals as a result of the merger must be considered purely pecuniary.

In Superior's case there was a profit-sharing agreement by which certain managers would receive millions of dollars more per annum as a result of the increased profitability of the merged firm over the predecessor companies. While their increased compensation was deductible for tax purposes and categorized on the merged firm's income statement as compensation, it was, in fact, a form of profit sharing. As a result, the Cole-Kearney Report concluded no materially greater resources were being consumed, and Superior argued that this incremental compensation was only pecuniary, i.e., not a real cost.

[76] The MEGs, *supra* note 17 at s. 5.7.2.

[77] For instance, see the quantification of efficiency savings resulting from the elimination of redundant management positions. The Cole-Kearney Report at Appendix A1.

[78] *Superior Propane 1, supra* note 4 at para 378. It is also worth noting that the Tribunal was also of the opinion that if these "pre-merger planning" costs were not sunk (if, for example, the efficiency quantification experts' fees were contingent on the completion of the merger), then these would properly be deducted as a cost of achieving the efficiencies.

Superior argued that if the Tribunal found additional managerial resources were in fact being expended, a reasonable cost for those additional managerial resources should be a cost of achieving the efficiencies. The Tribunal wrongly, in our view, did not accept these arguments but rather based the additional managerial costs to achieve the efficiencies on the profit-sharing incentive plan. The Tribunal therefore excessively reduced the efficiencies.

6.7 Efficiencies had a High Probability of Realization

To rebut the skepticism surrounding the achievement of synergies and the onus put on Superior under section 96, Superior was able to demonstrate a high probability of realizing the efficiencies. The calculations made common sense, but the plan of integration was also benchmarked against objective criteria for success. Clear strengths of the evidence included:

- significant previous experience by management in acquiring and successfully integrating companies;
- one firm clearly was the acquirer and most of its business models survived;
- there was a close match between product lines and markets, which could greatly facilitate smooth integration;
- Superior had a single-minded focus on one business;
- there was modest leverage in the post-merger entity and financial strength in both the balance sheet and ongoing cash flow;
- there was a clear statement of vision and strategy communicated to all stakeholders, including employees, customers and suppliers;
- post-merger leadership was clearly identified; and
- numerous early wins/integration successes soon after the merger closed that created positive momentum during the initial phases of the integration.

6.8 Efficiencies Quantification: Presentation of Evidence

Neil Finkelstein, counsel for Superior designed the evidence so that there would be a comprehensive, independent study of the efficiencies. As a result, no rebuttal of Superior's evidence was likely to be successful without a comparably in-depth, independent study. As it turned out, the Commissioner undertook no such study but simply chose to rebut Superior's evidence.

Mr. Finkelstein was also guided by the principle "less is more" both in the preparation of experts as well as in presentation of witnesses. He directed that there would be one expert's report rather than a number of them and that a panel of experts would present it. He directed that one individual deliver the primary report, but panel members with specific expertise would deliver portions of the evidence-in-chief and would respond to more detailed cross-examination questions.

In the forty-eight day hearing, Mr. Finkelstein introduced four witness panels in three days and presented the full Report. Notwithstanding the fact that the Commissioner introduced eighty witness panels, no rebuttal of Superior's evidence was likely to be successful in our view without an in depth, independent study. The Commissioner undertook no such study.

7.0 CONCLUSION

A successful section 96 defense presents Canadian businesses with the opportunity to create real and enduring shareholder value through mergers that might otherwise be considered anti-competitive. As demonstrated by the successful efficiencies defense in Superior Propane, comparison of the effects versus efficiency gains depends on a combination of sound economics, common sense financial projections and credible merger integration plans.

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