

# 2011 CBA Competition Law Spring Forum

## *Network Industries and Canadian Competition Law*

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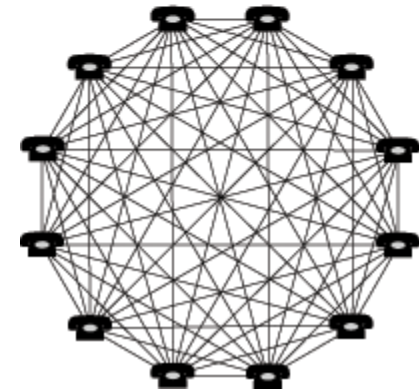
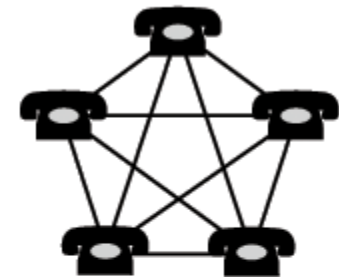
# Overview of Network Effects

What are network effects?

- Demand-side economies of scale
- Intrinsic value v. network value/externality

Types of networks and network effects

- Actual v. virtual
  - Actual: e.g., telephone systems, ATMs, airlines, railways
  - Virtual: e.g., computer software, VCRs, QWERTY keyboard, social media
- 1 sided, 2 sided



# Network Effects in Competition Law



- Network effects appear in:
  - Merger cases involving companies in industries where networks are important to being able to compete
  - Non-merger matters (often abuse of dominance cases) where firm(s) with significant market presence may control access to key network inputs needed to compete
    - Essential facilities doctrine?
- Landmark antitrust cases internationally involving network effects include:
  - *AT&T*
  - *Microsoft*

# Network Effects in Competition Law

- Remedy issue often viewed as a choice between 2 models:
  - *inter-network competition model*
    - preserve competition at the network or system level (i.e., prevent merger or require divestitures/break-up)
  - *monopoly/access model*
    - forego network based competition in favour of allowing efficiencies associated with network and focus remedies on access to the network (i.e., facilitate competition in secondary or complementary markets)

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# Network Effects in Canadian Merger Review

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# Mergers - Contested

## *Gemini II* (1992-93)



- Gemini computer reservation system (CRS) was originally created by merger of CRSs of Air Canada and Canadian Airlines subject to Tribunal consent order (*Gemini I*).
- Canadian, in financial distress, sought to survive through a transaction with American Airlines conditional upon transferring its CRS business from Gemini to American's Sabre CRS – which required variation of Gemini consent order. Bureau sought variation; Air Canada opposed.
- Tribunal granted variation under s.106 and ordered merger remedy pursuant to s.92.
- Tribunal found likely SLC (in absence of variation) based on merger review framework under ss.92-93: "The possible failure of Canadian is analogous, for purposes of competition analysis to an Air Canada/Canadian merger."

# Mergers - Contested

## *Gemini II*



- Tribunal found significant barriers due to network effects:

". . . airlines have taken great pains to structure themselves into networks, simply so that they are not limited to providing point-to-point service between a restricted number of city-pairs. **The value of the network, considered as a whole, is greater than the sum of its parts.** . . . there are significant marketing advantages to large airlines. Passengers perceive greater value when they do not have to worry about transferring their luggage, when they wait a shorter time between flights because flights are co-ordinated and when it is easier to accumulate and use frequent flyer points because of a large number of destinations. The airlines benefit from cost sharing at transfer points, but most importantly they benefit from the passengers they receive from the other airlines on the network. . . . The importance of being part of a network or at least sharing designator codes extends to the way that flights are displayed on CRSs."



# Mergers - Contested

## *Other Cases*



- ***RBC/BMO and TD/CIBC (1998)***

- Minister of Finance, with input from Competition Bureau, blocked proposed bank mergers in 1998.

- Bureau's letters to the banks and Minister of Finance discussed competition concerns in various financial sectors.

- branch banking: importance of having a bank branch network and an ABM network (or greater access to Interac network) highlighted as barriers to entry into branch banking

- credit cards networks: concerns raised in respect of intra-network competition as well as potentially inter-network competition (e.g., impact on MasterCard if BMO were to switch to issuing Visa)

- ***Superior Propane (2000-02)***

- Merger involved combining two propane distribution networks, although no significant Tribunal discussion of network effects.

# Mergers - Consent

## *Gemini I (1989)*



- Bureau originally sought dissolution of merger of computer reservation systems (CRSs) of Air Canada and Canadian Airlines
- Bureau subsequently decided not to oppose merger subject to entering a consent order providing for access and other remedial provisions (CRS rules) to address competition concerns.
- Competition concern was about barriers to entry into CRS and airline markets, as well as impact on travel agents.
- "blend of structural and behaviour remedies" (CO Impact Statement)
  - structural: direct access links to Gemini
  - behavioural:
    - CRS markets – Air Canada and Canadian to provide timely, non-discriminatory information to other CRSs; and to participate in other CRSs on commercially reasonable terms
    - airline markets – provisions to address display bias, potential collusion
  - contemplation that CRS regulation would be introduced

# Mergers - Consent



## *Air Canada/Canadian Airlines (1999)*

- Bureau identified similar airline network effects concerns as identified in *Gemini II*, but allowed merger on failing firm grounds, subject to undertakings through CTA.
- Undertakings sought to address network effect barriers by requiring Air Canada to:
  - enter into interline and joint fares agreements with competitors
  - allow access to Aeroplan to competitors
  - surrender of take-off/landing slots and airport facilities (e.g. gates)
  - potentially divest Canadian Regional Airlines
- *Competition Act*/regulations were also amended (amendments subsequently repealed in 2009) to augment abuse provisions to prohibit Air Canada from:
  - pre-empting airport facilities or slots
  - using frequent flyer programs to impeded competitors
  - altering networks, schedules to impede competitors

# Mergers – Consent

## *CN/BC Rail (2004)*



- Transaction raised competition concerns in 2 areas:
  - Rail interline transportation of commodities between BC rail territory and various markets throughout North America.
    - Concern that post-merger, CN could raise the cost of connection at Vancouver, reducing options for connecting points.
  - Rail transportation of grain from the Peace River area.
- Remedies:
  - CN provided several commitments, including on open gateway rates, transit times, car allocations and Peace River service.
  - Remedies are regulatory-type in nature, including provisions on arbitration and possible monitor.
- Network effects were not discussed directly in the consent agreement or Bureau backgrounder, although remedy focused on fair access for shippers to rail network.

# Mergers – Consent

## *TSX/Bourse de Montréal (2009)*



- Merger of Canada's two largest financial trading exchanges.
- Bureau found a barrier to entry due to network effects associated with the value of liquidity:
  - "exchanges with a greater number of buyers and sellers more readily trade liquid instruments, attracting additional buyers and sellers".
  - "network effects act as a barrier to entry into the industry for the trading of financial instruments since, in order to achieve liquidity, entry must be made on a large scale with the ability to quickly attract buyers and sellers".
- Among reasons for allowing merger, Bureau concluded Alpha (alternative trading system) was likely to overcome the network effect barrier and be an effective competitor.

# Mergers – Consent

## *Other Cases*



- Other consent merger cases involving networks, but no significant discussion of network effects, include:
  - ***Rogers/Microcell (2005)***
  - ***BGM/Chum (2007)***



# Non-Merger Cases – Contested



- Some early contested abuse cases involved network industries, although without significant Tribunal discussion of network effects.
  - ***Yellow Pages/CANYPS (1994)***
  - ***Nielsen (1996)***
- ***B-Filer Inc. v. The Bank of Nova Scotia (2005)***
  - Harm alleged included impeding critical mass of customers needed for the "network effects" required for successful business.
  - Application denied; networks effects not addressed by Tribunal.
- ***Commissioner v. Visa, MasterCard (2011 - ongoing)***
  - s.76 price maintenance case with respect to prices paid by merchants for credit card network services in Canada.



# Non-Merger Cases Contested (in part)



- ***Commissioner v. Air Canada (2001-04)***  
**(Abuse of Dominance Predation Case)**
  - Commissioner alleged similar network effect barriers as in *Gemini II* and *Air Canada/Canadian Airlines* merger:
    - Air Canada had several advantages over competing low cost carriers, including connections throughout its own and Star Alliance network.
    - New entrants faced high barriers that included a lack of "feed traffic" and a lack of access to certain airport facilities, including gates, loading bridges, ticket counters and baggage systems.
  - Dominance/SLC issues not addressed by Tribunal (Commissioner decided in 2004 not to pursue case)
  - Avoidable cost test for predation was addressed by Tribunal (contested litigation 2001-03)
    - network effects relevant to measuring revenues and avoidable costs.

# Non-Merger Cases - Consent

## *Interac* (1996)



- 9 largest financial institutions (FIs) in Canada created Interac, the dominant shared network in Canada for:
  - ATM (shared cash dispensing) services; and
  - POS (direct payment) services.
- Bureau alleged that the respondents (Interac and the 9 FIs) were dominant in, and engaged in anti-competitive practices that substantially lessened competition in, 2 markets:
  - intermediate market for shared electronic network services; and
  - retail market for shared electronic financial services.

# Non-Merger Cases - Consent

## *Interac*



- Bureau opposed several Interac rules as anti-competitive, including:
  - exclusionary by-laws that limited access to the Interac network by non-members and made becoming a member difficult;
  - access fees that discriminated against smaller entrants and discourage entry of larger entrants (which in effect limited the sponsored members who purchased shared electronic network services);
  - restrictions on who was able to connect indirectly to the Interac network; and
  - governance rules that limited role of non-charter members on board.

# Non-Merger Cases - Consent

## *Interac*



- In Consent Order Impact Statement, the Bureau:
  - "acknowledges that in many respects the Interac network creates efficiencies that could not be realized without certain standardized rules or some degree of coordination among Members"
- Consent Order remedies sought to address:
  - Access to network: "A more openly accessible network provides the potential for significant entry of new Members who may connect either directly or indirectly, and as Acquirers or Issuers."
  - Governance: Enhanced representation on the Board to foster competitive pricing, improved service offerings and innovation.
  - New services: more flexible rules to introduce new and innovative services.
  - Fees/pricing: rules to eliminate constraint on competitive pricing.

# Non-Merger Cases - Consent

## *Interac*



Bureau's remedial approach:

- "there was considerable discussion on whether the appropriate remedy should be to divest or split Interac into at least two competing national networks. A major consideration was whether the welfare gains achieved through inter-network competition would outweigh the losses of efficiency that could result from the divestiture. In the final analysis, the Director's view was that the intra-member competition that would result following the implementation of the draft consent order and the new possibilities that were created through the use of the Interac network software, to promote bilateral and multilateral new shared services, was the minimum required to restore competition in these markets."

(Bureau speech, G. Ménard, 1996)

# Non-Merger Cases – Consent

## *CREA (2010)*



Commissioner's Notice of Application contains several claims about network effects in alleging that CREA has market power:


- "there are no reasonable substitutes for the MLS system because of network effects".
- "It is the presence of networks effects that gives MLS its distinct value and results in the MLS system being a key input in the provision of residential real estate brokerage services. As well, the presence of network effects is a significant barrier to entry to creating a rival listing service."
- "Network effects exist where the value of a service to a given user increases with the number of other users. In this case, the value of the MLS system to listing brokers (and thus their clients) increases as the number of potential homebuyers and cooperating brokers using the MLS system increases. Likewise, the value of the MLS system to home buyers and cooperating brokers increases as the number of listings increases."

# Non-Merger Cases – Consent

## *CREA*



- CREA's Response denied the Commissioner's allegations generally and specifically denied the allegation that CREA had market power.
- Commissioner's Reply re-iterated claim that CREA had market power, but with no reference to network effects.
- Matter settled through consent agreement without addressing validity of network effects claims. No reference to network or network effects in consent agreement.



# Network Effects in Competition Bureau Guidelines

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# Bureau Guidelines

- The Draft Abuse of Dominance Guidelines (2009):
  - recognize network effects as a potential barrier to entry and describe a network industry as "one where the value to one person of being connected to the network increases as more people join the network."
  - Anti-competitive acts: In considering whether an act is anti-competitive, the Guidelines note that "in some cases demand-enhancing activities may include conduct necessary to remain viable in a declining industry, or alternately, in an industry characterized by network effects (developing a definitive standard, for example)."
  - Exclusive dealing: "In certain circumstances, exclusive dealing may support a viability argument, such as in a declining industry that can only support one firm, or a network industry seeking a single efficient standard."
- Network effects also discussed in the Information Bulletin on the Abuse of Dominance Provisions as Applied to the Telecommunications Industry (2008) and Intellectual Property Enforcement Guidelines (2000).

