CN RAIL ACQUIRES H&R TRANSPORT - COMPETITION ANALYSIS

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Canada's Competition Bureau has released a position statement regarding the acquisition by Canadian National Railway Company ("CN") of intermodal shipping assets of H&R Transport Limited ("H&R"). The Transaction is the Bureau's first reported experience with its draft Model Mergers Timing Agreement, released in July 2019. The case demonstrates the application of Canada's efficiencies defence, the Bureau's attention to deals falling beneath notification thresholds, and its use of additional investigative tools.

Bureau's Investigative Process and Use of Timing Agreement

The position statement indicates that the Transaction was not notifiable under Part IX of the *Competition Act*. Accordingly, CN and H&R were not required to submit pre-merger notifications to the Bureau and the statutory waiting periods would not have applied to prevent completion. It appears that the Bureau learned of the Transaction through CN's news release, underscoring the Bureau's continued effort to identify and review small transactions that may raise competition concerns.[1] Indeed, parties argued the *Tervita* case[2] all the way to Supreme Court of Canada, which was an investigation of a transaction that was not notifiable under the Act. (Please see our bulletin on the *Tervita* case.)

In a complex review involving a notifiable transaction that raises competition concerns, the Bureau would generally issue Supplementary Information Requests ("SIR") at the end of the initial 30-day waiting period in order to obtain additional information, documents and data for in-depth review. The *Competition Act* permits parties to complete a transaction 30 days after the parties certify their compliance with a SIR, unless the Bureau takes enforcement action by filing an application to the Competition Tribunal to block or otherwise seek remedies in respect of the transaction. However, 30 days are sometimes insufficient for the Bureau to fully process and analyze the materials it receives from the parties and make a decision whether to take enforcement action, particularly when the parties also advance an efficiencies defence. In these situations, the Bureau may seek agreement from the parties to delay closing beyond the end of the waiting period for an agreed period while the Bureau completes its review. The Bureau intended that its model timing agreement would provide a template for the kinds of commitments it may seek and provide in connection with transactions it reviews.

Since the Transaction was not notifiable, the Bureau would not have faced its usual timing pressure and it is therefore unclear why the Bureau required a timing agreement. One might speculate as to the reasons. In any event, the parties agreed on timing, but the position statement is silent on their rationale.

The position statement indicates that the timing agreement used in the Transaction required that CN and H&R each present a representative to the Bureau for examination under oath in regards to their efficiencies claims. This is consistent with the Bureau's model timing agreement. We note that the Bureau also can seek a court order under section 11(1) of the Act to examine parties' representatives under oath. The use of oral examinations in merger reviews has been relatively infrequent historically. With oral examination under oath being included in the model timing agreement and as confirmed by the experience of this Transaction, the Bureau has signaled an increased willingness to use this investigative tool for complex merger reviews, especially in cases where the parties advance an efficiencies claim.

CN announced the Transaction on May 9, 2019, and approximately 10 weeks later on July 19, 2019, the Bureau and the parties had entered into a timing agreement. The parties supplied the information required by the Bureau and the Bureau completed its analysis of the Transaction, including review of claimed transaction efficiencies, within a further four-month period.[3] In light of the Bureau's timing guidance, this was a reasonably expeditious review for a transaction that the Bureau determined likely would lessen competition substantially but that it justified on the basis of the efficiencies defence.[4]

Market Definition and Anti-Competitive Effects

In its examination of the competitive effects of the Transaction, the Bureau focused on full truckload refrigerated intermodal services (truck/rail combination) finding competitive overlap measured by the volume of container shipments through rail terminal locations, broken down by specific origin-destination (O-D) rail terminal pairs. The Bureau concluded the Transaction likely would lessen competition substantially across eight O-D pairs in the provision of these services to customers. The Bureau nevertheless concluded that likely efficiency gains from the Transaction were greater than and would offset the likely anti-competitive effects.

The Bureau's focus on distinct O-D pairs highlights its long-standing practice of O-D pair analysis for market definition purposes in relation to transportation markets. Each such O-D pair in essence represents a separate market for transportation services.

The Bureau also took a narrow approach to the means of transportation in determining markets. It concluded that the demand for intermodal services is distinct from the demand for over-the-road truck transportation.[5] The Bureau concluded that for market definition purposes trucking is a less viable substitute for rail transportation, even in relation to the same O-D pair, providing less effective competition to rail services as distance increases.

In assessing the anti-competitive effects of the Transaction, the Bureau considered the limited number of competing suppliers in Canada, particularly in relation to the upstream rail services portion of these intermodal services (CP is the only other such provider). In Canada, the rail service market is dominated by two Class I railways (CN and CP), who exert market power over customers in the provision of rail services over large parts of their respective networks. The *Canada Transportation Act* includes remedies intended to counteract, at least in part, if not always effectively, that market power.

The Bureau took into account the high barriers to entry and noted that CN and CP are vertically integrated suppliers able to charge unregulated rail rates to their downstream competitors. In other words, the vertical integration of CN and CP with truckers to form a supply chain allows CN and CP to charge unregulated rates to others, such as wholesalers of trucking services, who would compete at a disadvantage to the integrated intermodal supply formed by their respective mergers.

For both customers and those competing with these integrated suppliers of intermodal services, then, the Bureau found a substantial lessening of competition due to the Transaction.

In some cases, the *Canada Transportation Act* provides limited recourse against the market power imbalance between rail carriers and customers and, to a lesser extent, between international intermodal carriers with CN and CP as upstream rail service providers. The statute permits a shipper to challenge a railway's rates and conditions of service through final offer arbitration (FOA).[6] However, domestic intermodal traffic such as that considered by the Bureau in connection with the Transaction is ineligible for FOA.[7] The exclusion dates back to the inception of the FOA remedy in 1988 based on an expectation that containerized traffic would have access to competitive options from multiple carriers and modes. In other words, the proponents of that expectation adopted a broader view of the market than the Bureau found when it assessed the relevant markets.

Efficiencies Analysis

Although it found that the Transaction likely would lessen competition substantially, the Bureau cleared the Transaction on the basis that the gains in efficiencies that the Transaction are likely to generate would be greater than and offset the Transaction's likely anti-competitive effects. The position statement represents only the fourth time that the Bureau has publicly acknowledged clearing a transaction based on the efficiencies defence.[8] To assess the applicability of the efficiencies defence, the Bureau engages in a trade-off analysis, comparing the amount of eligible efficiency gains the parties likely would achieve from the transaction against the amount of the anti-competitive effects likely to result from the transaction.

Where a transaction is likely to have an anti-competitive effect in multiple markets, the Bureau had previously indicated that it may conduct the trade-off analysis on a market-by-market basis where it is possible to do so.[9] For example, in the Bureau's review of Superior Plus's acquisition of Canwest Propane,[10] the Bureau concluded that the transaction was likely to have anti-competitive effects in 22 local geographic markets. The Bureau then conducted the efficiencies trade-off analysis for each of the 22 markets to determine which were likely to see efficiency gains resulting from the transaction that outweighed the anti-competitive effects of the transaction. In that case, the Bureau concluded that the efficiency gains in 12 of the 22 markets would not be greater than and offset the anti-competitive effects from the transaction. Consequently, the Bureau required divestitures in those 12 markets.

While it is not entirely clear from the Bureau's position statement, it appears that in the H&R transaction the Bureau did not conduct the trade-off analysis on a market-by-market basis. The Bureau indicated that it considered efficiencies related to "elimination of overhead costs, the elimination of duplicative facilities, and the elimination of duplicative IT systems and software licenses." Elimination of overhead costs and duplicative IT system and software licenses are not likely to be divisible to individual geographic markets. That is, they are classic network industry overhead centres that are not attributable to particular traffic on O-D pairs. Further, the eight O-D pairs all originated in either Toronto or Montreal, with end destinations in either Winnipeg, Saskatoon, Calgary, or Vancouver. Therefore, eliminating duplicative facilities might affect multiple O-D pairs, making division of efficiencies among each individual market difficult. If correct, we would expect that the Bureau could not practically conduct a market-by-market trade-off analysis.

Moreover, the position statement indicated that the Bureau postulated a full block of the Transaction as the only effective remedial order that could address the competition concerns. This is likely an important reason why the Bureau chose not to conduct a market-by-market trade-off analysis. In the Superior Plus/Canwest transaction, the Bureau considered the appropriate remedies to be "something other than a full block" and both the anti-competitive effects and efficiencies were divisible due to the nature of the assets and geographic markets. There, a market-by-market trade-off analysis was possible.

Not surprisingly, the Bureau will vary the manner in which it conducts the trade-off analysis, depending on the particular industry, nature of transportation, assets and types of efficiency gains involved. Some transactions that do not entail gains or effects in individual markets or are not easily divisible to individual markets may be systemically more likely to succeed in advancing an efficiencies defence than transactions that entail more easily divisible effects and gains. Moreover, transactions for which a full block is the only effective remedial order may also be systematically more likely to succeed in advancing an efficiencies defence than transactions for which the Bureau can address the competitive concerns through partial remedial orders such as asset divestitures.

We note, in any event, that a market-by-market approach to trade-off analysis has been subject to criticism in the Canadian competition law bar as it is inconsistent with the Competition Tribunal's established jurisprudence in *Superior Propane*, which stated:

> [S]ection 96 of the Act applies to the transaction in its entirety. There is no requirement that gains in efficiency in one market or area exceed and offset the effects in that market or area. Rather, the tests of "greater than" and "offset" in section 96 require a comparison of the aggregate gains in efficiency with the aggregate of the effects of lessening or prevention of competition across all markets and areas. Accordingly, the Act clearly contemplates that some markets or areas may experience gains in efficiency that exceed the effects therein, while others may not.[11]

Conclusions

The CN/H&R Transaction is notable for a number of reasons. It is a further demonstration of the Bureau's willingness to identify and review non-notifiable transactions, and challenge those that are anti-competitive. Assessing competitive effects on the basis of O-D pairs is a continuation of the Bureau's historical approach to market definition in transportation markets. The Transaction is a new addition to a short list of transactions that the Bureau has announced would succeed on the basis of an efficiencies defence and it provides a useful illustration of the Bureau's approach to conducting the trade-off analysis.

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[1] The Bureau announced on September 17, 2019 that its Merger Intelligence and Notification Unit would be broadening its focus with active intelligence gathering on non-notifiable merger transactions that may raise competition concerns. Please see *Competition Bureau enhances information-gathering efforts on non-notifiable mergers*.
[2] *Tervita Corp. v. Canada* (*Commissioner of Competition*), 2015 SCC 3.
[3] The position statement indicates that on November 18, 2019 the Bureau informed representatives of the parties that it had decided to discontinue its investigation of the Transaction.
[4] The Bureau's draft model timing agreement contemplates up to 110 days for review after both parties comply with the requirements of a SIR.
[5] It also concluded that demand for containerized "truckload" shipments (for which shipments are charged a per-container flat rate) is distinct from that of "less-than truckload" shipments (for which shipments are charged on a per-pound basis).
[6] FOA is a confidential process available under the CTA. McMillan's Transportation Group regularly represents shippers who submit to FOA before arbitrators appointed by the Canadian Transportation Agency.
[7] Under subsection 159(1) of the CTA, FOA applies to the movement of containers by rail only if that movement precedes or follows marine transportation of the container from or to a Canadian port served by only one railway company.

[8] The three previous transactions were the *Superior Plus/Canexus* (2016), *Chemtrade/Canexus* (2017) and Calm Air/First Air (2017). Notably, the *Tervita* and *Superior Propane* cases were transactions challenged by the Bureau but ultimately cleared by the Competition Tribunal or courts on the basis of the efficiencies defence.
[9] Competition Bureau, *A practical guide to efficiencies analysis in merger reviews*, public consultation version.
[10] Competition Bureau, "*Competition Bureau statement regarding Superior Plus LP's proposed acquisition of Canwest Propane from Gibson Energy ULC*".
[11] *Canada (Commissioner of Competition) v. Superior Propane Inc*, 2002 Comp. Trib. 16, at para 140.

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.