



**Review of the Competition Thresholds in the Commerce Act 1986 and
Related Issues**

A discussion document

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1 Executive summary

1. The purpose of the Commerce Act is to promote competition in markets in New Zealand. The Act has this focus as a means to facilitate gains in economic efficiency across the economy. Improvements in efficiency enable the economy to produce more output with the same level of resources and thereby enhance the welfare of New Zealanders.

2. To achieve its purpose, the Act has both structural and behavioural prohibitions. At the structural end, its merger provisions seek to prevent anti-competitive conduct on the assumption that market structure affects the ability, and the incentive, to engage in anti-competitive behaviour. Working in tandem with the merger provisions, the Act has two key behavioural provisions to prohibit the misuse of market power:

- section 36 - which regulates the use of a dominant position, held by a single firm, in a market; and
- section 27 - which prohibits anti-competitive agreements among firms (i.e. contracts, arrangements or understandings that substantially lessen competition).

3. Each of the three key prohibitions has an associated threshold. The three prohibitions, with their associated thresholds identified in bold, are:

- section 27 which prohibits contracts, arrangements, or understandings between competitors that have the effect, or likely effect of **substantially lessening competition** in a market;
- section 36 which prohibits the unilateral use of a **dominant position** in a market for exclusionary purposes; and
- section 47 which prohibits the acquisition or strengthening of a **dominant position** in a market.

As outlined in Section 3 of this discussion document, ideally the thresholds should be triggered whenever there is a concern about a potential abuse of market power. Concerns about the potential for abusing market power may not only arise as a consequence of single-firm dominance, but may also involve explicit multi-firm collusion and joint dominance based on tacit collusion.

4. This discussion document reviews concerns about the current competition thresholds, particularly those for mergers and unilateral action. Section 4 of this document outlines the concerns about the adequacy of these thresholds.

5. In terms of the threshold for mergers, it seems that the current threshold does not allow consideration of the potential harm that may result from joint dominance in a market or whether the resultant market structure will be conducive to collusion either explicit or tacit.

6. Tacit collusion can arise in some oligopolistic industries. As the word “tacit” implies, even in the absence of direct communications (which would constitute a breach of section 27), firms can misuse market power by moving their industry in the direction of greater co-

ordination. In such industries firms can co-ordinate their behaviour by doing little more than observing and anticipating the moves of their rivals. The effect of such oligopolistic co-ordination is parallel behaviour, such as parallel price movements, that approximates the results associated with explicit agreement to set prices, output levels, or other conditions of trade.

7. This is of concern because although section 27 allows market participants to address incidents of explicit collusion, the Act has no mechanism aimed at instances of tacit collusion that can arise in some oligopolistic industries. To give the Act such an ability, either section 27 could be amended to address significant instances of tacit collusion, or mergers could receive greater scrutiny as a means of preventing tacit collusion in the economy.

8. In response to this problem, Section 6 of this document outlines a possible proposal to broaden the range of mergers and acquisitions that are potentially subject to the prohibition. This could be achieved via adopting the Australian threshold, i.e. to substantially lessening competition. It also discusses a proposal that may streamline the clearance and authorisation process for mergers.

9. As discussed in Section 6, the key policy trade off associated with broadening the threshold for mergers and acquisitions will be whether the increased uncertainty and compliance and enforcement costs will be justified. In particular, it is likely that the broader threshold will increase the scrutiny of mergers occurring in the non-tradeable sector of the economy, as this sector is not subject to the pressures of international competition. The Australian experience suggests that although mergers and acquisitions will receive greater scrutiny the number of mergers actually opposed does not increase significantly.

10. Turning to section 36, the key issue is consideration of whether its scope has, through judicial interpretation, become narrower than when the Act came into effect. It discusses the judicial interpretation of the 'dominance', 'use' and 'purpose' tests.

11. Section 6 of this document outlines two options for possible change to the section 36 threshold, either:

- Option 1 – amend the definition of dominance in section 3(8); or
- Option 2 - adopt the Australian threshold i.e. change the threshold to 'substantial degree of power in a market'.

There is also discussion on the possibility of adding definitions of 'use' and 'purpose'.

12. Section 7 of this document sets out amendments proposed to the price control provisions of the Act. These proposals result from consideration of the need to allow for an up-to-date approach to price control for electricity line businesses and do not signal any change to the Government's approach to price control generally.

13. The Government, as part of its commitment to having an effective Commerce Act, wants to make decisions on the competition thresholds by the end of June. To inform its decision making, submissions are welcome on the proposals outlined in this document. Section 8 of this document outlines a list of questions that the Government is particularly interested to hear views on. The deadline for submissions is **14 May 1999**.

2 The current regime

1. Competition describes a process where rival sellers independently strive for the patronage of buyers in order to achieve a particular business objective such as increased profits, and/or increased market share. The “competition” itself takes place in terms of factors such as price, service, or quality. This process of competition forces sellers to offer consumers a greater choice of products and services at lower prices.
2. Where the competitive process operates and price signals are free from distortions this creates incentives for firms to re-deploy resources from lower to higher value uses. This gives rise to efficiency gains critical to economic growth and economic prosperity.
3. However, offering a lower price, or better quality or service, than a rival is not the only way to gain the patronage of buyers. In the face of the competitive process firms also have incentives to obtain control over factors, such as price, which are critical to determining business transactions. Control may arise by limiting competition through the erection of barriers to market entry, or by engaging in collusive arrangements with competitors to restrict prices and output. Such arrangements can result in efficiency losses that adversely affect industry performance, economic growth and the general standard of living.

The Act's three key prohibitions

4. The primary instrument employed to correct these market failures, or to safeguard competition, in New Zealand is the Commerce Act. To do this job the Act has three key prohibitions:

- section 27 which prohibits behaviour that has the purpose, effect or likely effect of substantially lessening competition in a market;
- section 36 which prohibits the use of a dominant position in a market for exclusionary purposes; and
- section 47 which prohibits business acquisitions that are likely to result in the acquisition of, or strengthening of, a dominant position in a market.

5. These three provisions of the Act are designed to promote competition indirectly through preventing certain changes in market structure (section 47) and directly through restrictions on particular conduct (sections 27 and 36).

Efficiency override

6. While the Act's objective is “to promote competition in markets”, this objective can be overridden, in certain circumstances, where efficiency advantages are considered to outweigh detriments from the loss of competition. In the case of mergers, companies may voluntarily apply to the Commerce Commission for an authorisation. An authorisation will be granted if the Commission is satisfied that the merger would be likely to result in a benefit to the public, which would outweigh any detriment from the loss of competition.

7. Similarly collective conduct that substantially lessens competition can also be authorised if there is a resulting net public benefit. However, no such authorisation is available for unilateral conduct that breaches section 36.

The competition thresholds

8. Each of the three key prohibitions has an associated threshold. The thresholds identify for scrutiny those changes in market structures and behaviours that are likely to result in significant economic harm, caused through the exercise of market power. The three thresholds are:

- section 27 prohibits behaviour that has the purpose, effect, or likely effect of **substantially lessening competition** in a market;
- section 36 prohibits the use of a **dominant position** in a market for exclusionary purposes; and
- section 47 prohibits the acquisition or strengthening of a **dominant position** in a market.

The relationship between sections 36 and 47

9. Sections 36 and 47 are interrelated. The current threshold level of dominance, in terms of market power, is the same in both sections of the Act. However, the relationship goes beyond that. The merger provisions seek to prevent certain changes in market structures that may be conducive to the abuse of market power. Section 36 is concerned with the behaviour of firms in a market and prohibits the use of a dominant position for exclusionary purposes.

10. Implicit in the Act, is a weighting in terms of the reliance placed on the use of structural prohibitions (i.e. merger control) versus that placed on behavioural prohibitions (i.e. mainly s 27 and s 36) to facilitate competition in New Zealand's markets. In New Zealand strong weighting is placed on behavioural rather than structural prohibitions for reasons set out in Section 3 of this document. However, in some cases it could be that reliance on merger control is more effective in achieving competitive outcomes. It is likely that detection and successful prosecution of section 36 offences will be a lot lower than 100 percent, as for example, some smaller firms are unlikely to have the resources to sustain a success challenge. There may also be concerns about the impact of litigation on the ongoing business relationship with the dominant firm.

11. In reviewing the thresholds it is critical to maintain an appropriate balance in the use of structural and behavioural controls. If, for example, the threshold for mergers is too narrow this means increased reliance on section 36 to control the conduct of dominant firms (and arguably on section 27 to control the explicit agreements of oligopolies). If there is greater reliance on the behavioural prohibitions, then these must be robust in order for the regime to be effective.

Interpretation of the current thresholds

Substantially lessening competition

12. In New Zealand there have been few cases involving the interpretation of the term “substantially lessening competition”. As a consequence any conclusions about the level of this threshold are necessarily tentative. The term “substantially lessening competition” does not set an absolute threshold. Instead it compares the state of the market after the specified behaviour, with the hypothetical state of the market in the absence of the behaviour. For example, the decision in the Australian case *Dandy Power Equipment Pty Ltd v Mercury Marine Pty Ltd*¹ in 1982 states:

To apply the concept of substantially lessening competition in a market, it is necessary to assess the nature and extent of the market, the probable nature and extent of competition which would exist therein but for the conduct in question, the way the market operates and the nature and extent of the contemplated lessening.

13. The need for such a comparative analysis was affirmed in subsequent cases in New Zealand, for example, *Tru Tone Ltd v Festival Records Retail Marketing Ltd* (1988)² and in *Auckland Regional Authority v Mutual Rental Cars (Auckland Airport) Ltd & Ors* (1988)³.

14. The expression ‘substantially lessens competition’ as used in the Act refers to a loss of competition that is more than trivial or minimal. For example, McGechan J in *Commerce Commission v Port Nelson Ltd* (1995)⁴ stated:

Accordingly reference to section 27(1) to ‘substantially lessening competition’ is taken as meaning “lessening competition in a way which is more than insubstantial or nominal. The mere ephemeral and minimal will not suffice. Inevitably that will involve some attention to relativity; and in the end be a question of judgement on a matter of degree.

15. The Act is intended to protect the competitive process, not individual competitors. Consequently, to demonstrate that there has been a section 27 breach of the Act, it is insufficient to show that the practice under investigation has adversely affected a competitor. It will be necessary to show that the practice substantially lessens competition in the market as a whole. This is evident from judgements such as in *ARA Mutual Rental Cars*.

Dominance

16. Interpretation of dominance has developed in two phases. In the first phase an economic approach to the concept of dominance was taken. In the second phase a “dictionary definition” approach was adopted.⁵

¹ (1982) ATPR 40 – 315.

² (1988) 2 TCLR 525, 539; 2NZBLC 103,081, 103,092-103,094; affirmed on appeal (1988) 2 TCLR 542, 552 (CA).

³ (1987) 2 NZLR 647, 671; (1987) 2 TCLR 141,166.

⁴ (1995) 6 TCLR 406; (1995) 5 NZBLC 103,762.

⁵ *Gault on Commercial Law*, Brookers, Wellington 1994 CA 3.20.

17. At the outset, New Zealand courts tended to rely on an economic test for ‘dominance’ as discussed in the European Commission’s decision from *Re Continental Can Co Inc* (1972)⁶. The key focus of this approach was on the entity’s power to behave independently without taking into account the actions of their competitors, purchasers, or suppliers. However, the bulk of the early New Zealand case law on dominance related to mergers and acquisitions. This body of law refined this economic approach to defining dominance.⁷ In *Re Magnum Corporation Ltd and New Zealand Breweries Ltd*⁸ the Commission stated:

...Being in a ‘dominant position’ is interpreted by the Commission, in essence, as having sufficient market power (economic strength) to enable the dominant party to behave to an appreciable extent in a discretionary manner without suffering detrimental effects in the relevant market(s).

18. The High Court cited with approval this view in *Lion Corp Ltd v CC* (1987)⁹. In 1991 the High Court in *Telecom Corp of NZ Ltd v CC*¹⁰ concluded:

- i that dominance is equivalent to “a high degree of market power”;
- ii dominance is a structural measure of the ability of a firm to exert market power: “Market structure sets real limits upon the market conduct that is possible”;
- iii the factors to be taken into account in determining the market structure “encompass all those features of a firms external competitive environment that constrain its production and selling policies, not just...market concentration”;
- iv the most important factor is barriers to entry; and
- v dominance, or “high market power”, is equivalent to a situation “when a person is in a position of economic strength such that it can behave to a large extent independently of that person’s competitors”.

19. However, in *Telecom Corp of NZ Ltd v Commerce Commission* (1992)¹¹, the Court of Appeal appeared to move away from assessing dominance on economic principles more towards a dictionary definition. The Court stressed the need to address the basic dominance test in terms of the “dominant influence” principles in the Act.¹² Cooke P stated:

It is a dangerous method of statutory interpretation to substitute words which the Legislature has not in fact chosen. Words can have overtones not quite caught by any paraphrase, and ‘dominant’ is one of them. But so far as any paraphrase can be helpful I think that words such as ‘a prevailing, commanding, ascendant, governing, primary, principal, or leading influence’ convey much the same idea.

⁶ (1972) CMLR D11.

⁷ *ibid* CA 3.21

⁸ (1986) 2 TCLR 177, 195-196; (1987) 1 NZBLC (Com) 104,073, 104,088.

⁹ 2 NZLR 682,690; (1987) 2 TCLR 202,206.

¹⁰ (1991) 4 TCLR 473, 509; (1991) 3 NZBLC 102,340, 102,368

¹¹ (1992) 3 NZLR 429.

¹² *Gault* op cit CA 3.22.

...One of the expressions used by the Administrative Division was 'high market power'. If by this the Court meant something less than any of the foregoing paraphrases, it set too low a test.

20. The current state of the dominance test was considered in both the High Court and Court of Appeal in the *Port Nelson* litigation¹³. In this case, the High Court accepted, in light of the Court of Appeal's decision in *Telecom*, that the test for dominance has evolved away from economic theory towards a definition based statutory interpretation approach. McGechan J stated:

The test for 'dominance' is not a matter of prevailing economic theory, to be identified outside the statute. Nevertheless, it remains a term used in the context of a competitive structure, and inevitably, economic concepts and terminology intrude. 'Dominance' includes a qualitative assessment of market power. It involves more than 'high' market power, more than mere ability to behave 'largely' independently of competitors...It involves a high degree of market control...There need not be a monopoly...Expression in terms of mastery is perhaps ...misaligned and needs to be read down. To be dominant the firm must be able to act, within the limits of commercial reality, without significant competitive or consumer constraints...the ability to dictate must be sustainable.

21. The Court of Appeal decision on *Port Nelson* supported Justice McGechan's view on dominance and denied that the 1992 *Telecom v Commerce Commission* judgement has changed the approach to assessing dominance. Gault J stated:

...the decision of this Court did not, in our view, shift the concept of dominant position away from that from which it had been derived....There is to be borne in mind the distinction between the concept (dominant position in a market) and the test for its existence (market share, vertical and horizontal constraints – which economists assess as elements of market power)¹⁴.

Commerce Commission's Merger Guidelines

22. The Commerce Commission, in its Merger Guidelines¹⁵, sets out the approach it takes to assessing "dominance" with respect to applications for mergers and acquisitions. The Guidelines define certain "safe harbours". These "safe harbours" reflect the Commission's view, of where a dominant position in a market is generally unlikely to be created or strengthened following a merger or acquisition. "Safe harbours" exist where:

- the merged entity (including any interconnected or associated persons) has less than in the order of a 40% share of the relevant market; or
- the merged entity (including any interconnected or associated persons) has less than in the order of a 60% share of the relevant market, and faces competition from at least one other market participant having no less than in the order of a 15% market share.

¹³ *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406 (HC); *Port Nelson Limited v Commerce Commission* (1996) 7 TCLR 217 (CA).

¹⁴ (1996) TTCLR 217.

¹⁵ "Business Acquisitions Guidelines", Commerce Commission 1996.

23. The Commission will not, except in unusual circumstances, seek to intervene in business acquisitions which, given the appropriate delineation of the relevant market and measurement of market shares, fall within these safe harbours.

24. In practice, a study of the Commission's decisions on business acquisitions, made over the period January 1991 to December 1996¹⁶, suggests that:

- in assessing dominance the most important factors are: market share, barriers to entry, the constraint provided by imports and the presence of other competitors; and
- dominance was found in markets only where the share of the parties exceeded 70%, and then only in some cases.

¹⁶ 'A Study of the Commerce Commission's Evaluation of Applications for Business Acquisition Clearances and Authorisations, 1991-1996', Commerce Commission, Occasional Paper No. 8 February 1998, p. 23.

3 Why have thresholds in the Act?

The role of the Act's thresholds

1. The purpose of the Commerce Act is to promote competition in markets in New Zealand. The Act has this focus as a means to facilitate gains in economic efficiency across the economy. Improvements in efficiency enable the economy to produce more output with the same level of resources and thereby enhance the welfare of New Zealanders.

2. To achieve its purpose, the Act relies on both structural prohibitions (section 47) and behavioural prohibitions (sections 27 and 36). In theory, structural prohibitions would not be required if the enforcement of behavioural prohibitions were perfect, as no market structure is in itself of harm for the economy. However, certain market structures are likely to soften competition and to be more conducive than others to anti-competitive conduct such as tacit collusion, which is difficult to detect and to prevent. Because it will be prohibitively costly and simply not practical to directly address behaviour that leads to, or follows from, a substantial lessening of competition in all cases, structural prohibitions can be viewed as a second-best solution to address competition concerns.

3. Given the Act's structural and behavioural prohibitions, judgements are required as to what mergers and other activities are likely to be harmful to the economy and which are beneficial. Such judgements can be difficult to make, as they demand predictions about competition and efficiency effects in markets that are constantly changing. As Brunt (1990) said:

Competition is a process rather than a situation. Dynamic processes of substitution are at work. Technological change in products and processes, whether small or large, is ongoing and there are changing tastes and shifting demographic and local factors to which business firms respond. Profits and losses move the system: it is the hope of supernormal profits and some respite from the 'perennial gale' that motivates firms' endeavours to discover and supply the kinds of good and services their customers want and to strive for cost-efficiency. Such a vision tells us that effective competition is fully compatible with the existence of strictly 'limited monopolies' resting upon some short run advantage or upon distinctive characteristics of product (including location). Where there is effective competition, it is the on going substitution process that ensures that any achievement of market power will be transitory.¹⁷

4. The thresholds in the Commerce Act are used to identify activities that are likely to result in significant economic harm. Harm in this context relates to the exercise of market power that results in efficiency losses.

5. The underlying rationale for including thresholds in the Act is to avoid not only administration, compliance and litigation costs imposed by the Act, but also other economic costs such as uncertainty due to such things as lack of statutory clarity and judicial error. Due to the presence of such costs, the use of competition law in an

¹⁷ Brunt, M. 'Market Definition Issues in Australian and New Zealand Trade Practices Litigation', *Australian Business Law Review*, 1990, Vol. 18, No.2, p 90.

economy will only be of benefit where the harm prevented is greater than the costs of scrutiny and prohibition. Hence, to minimise these costs, there are thresholds in the Act that have to be passed before activities are subject to further scrutiny.

Criteria for the Act's thresholds

6. For the thresholds to be effective, their focus must be sufficiently narrow to avoid interfering with transactions that will enhance efficiency, but not so narrow that potentially harmful behaviour escapes scrutiny. A threshold for mergers, for example, must capture for scrutiny only those acquisitions that threaten substantial economic harm by the creation of market power.

7. As well, the thresholds need to be clear about the types of behaviours and structures subject to scrutiny to provide certainty to market participants. Obscure thresholds could lead firms to engage in anti-competitive or efficiency reducing behaviour in the belief that it is permitted. Alternatively obscurity may cause some firms to forego efficiency enhancing behaviour because of the possible costs of defending the behaviour and the possibility that the behaviour will be prohibited.

8. Thus, for the thresholds to assist in achieving the purpose of the Commerce Act they must:

- capture for scrutiny those activities likely to impose efficiency losses;
- not deter or prevent efficiency enhancing behaviour; and
- minimise uncertainty and the costs of administration, compliance and enforcement.

4 Concerns with the current thresholds

1. As discussed in the previous section, the role of the thresholds is to identify for scrutiny those changes in market structures and behaviours that are likely to result in significant economic harm through the exercise of market power. This section examines whether the thresholds for mergers and acquisitions, and for the abuse of a dominant position are effective in achieving this role. Being effective requires that they meet the criteria outlined on page 12 and that they are capable of being applied to all sources of market power.

The threshold for mergers and acquisitions

2. New Zealand has a very narrow threshold for mergers in comparison with other OECD economies. It is likely that this threshold excludes from full scrutiny mergers that fall short of creating single firm dominance, but may nevertheless have efficiency reducing outcomes. Indeed, the threshold of single firm dominance has led the industrial economist Greer to conclude that:

...(the Act) assumes a competitive market structure in the absence of pure or near monopoly. Even mergers creating monopoly are allowed if it can be shown that the barriers to entry are low, or the merger's detriments will likely be outweighed by efficiencies¹⁸.

3. This focus on single-firm dominance ignores any potential harm that may result from joint dominance in a market. Consequently it prevents mergers being scrutinized in terms of whether the resultant market structure will be conducive to collusion, whether explicit, or tacit. Indeed, Hay (1996) argues that in terms of the Commission's "safe harbour" of 60% with at least one rival with 15%, such a firm would have more market power because it would anticipate some tacit collusion from its larger rivals.

4. An example of the limited ability of the merger provisions to take into account the potential harm that can result from joint dominance, is the Commerce Commission's decision on 12 February 1999 that gave TransAlta a clearance for its proposed acquisition of 40% of Contact Energy.

5. The Commission, bound by the threshold in the Act, noted in its decision that: *'the incentives for collusive behaviour may be strengthened by the proposed acquisition'*. However in paragraph 117 the Commission states:

...this exhibition of enhanced market power by a group of oligopolists would not be evidence of a dominant position having been acquired or strengthened...dominance under the Act refers to single firm dominance, and a dominant position in a market refers to a firm being able to exercise a "high degree of market control".

As well, the Commission, in paragraph 121-122 states:

¹⁸ Greer, D.F. 'New Zealand's Merger Policy: the Antipodean Alternative', *International Merger Law*, October 1990, p 4.

Clearly, a merger between Contact and TransAlta would be very likely to trigger antitrust concern in the United States. However, the threshold for anti-merger policy in that country under the Clayton Act is a “substantially lessening of competition”, which is a lower threshold than the dominance threshold under the Commerce Act...The Commission is bound by the Commerce Act and by court precedents on dominance set under that Act.

The problem of tacit collusion in oligopolistic industries

6. Tacit collusion can arise in some oligopolistic industries. As the word ‘tacit’ implies, even in the absence of direct communication, firms in some highly oligopolistic industries can misuse market power by moving their industry in the direction of greater coordination¹⁹. In such industries firms can co-ordinate their behaviour by doing little more than observing and anticipating the moves of their rivals. The effect of such oligopolistic coordination is parallel behaviour, such as parallel price movements, that approaches the results associated with explicit agreement to set prices, output levels, or other conditions of trade.

7. Co-ordination can occur in oligopolistic industries, as the decisions of firms are interdependent. Each firm recognises that the sale of its product depends on the prices that its rivals charge, and that its rivals will react to any change in price, or output, that it makes. Given this interdependence, firms recognise that their profits will be higher when co-ordinated policies are pursued than when each firm looks after its narrow self-interest.

8. This is because even though an individual firm could increase its profits in the short term by reducing its price, this price reduction may cause rivals to respond by similarly reducing their prices. This results in lower profits for all firms. Thus a preferable strategy might be for all firms to increase price where the drop in revenue from the lost sales, is less than the total rise in revenue achieved through the price increase.

9. In this way, even in the absence of any formal collusion among firms, tight oligopolistic industries can be expected to exhibit a tendency toward the maximisation of collective profits. Such behaviour can approach the pricing and output outcomes associated with pure monopoly²⁰, and thus impose significant efficiency losses throughout the economy.

Collusion is not inevitable in oligopolistic industries

10. Concentrated industries may be more conducive to co-ordination, but this does not mean that oligopolies will always behave anti-competitively. Aside from competition from rivals, competition can come from a variety of other sources including imports, substitute products, countervailing power, and potential competitors.²¹

11. What determines whether tacit collusion will be prevalent in an oligopolistic industry or not, depends on the product and its market. It has been known for a long time that under certain structural conditions co-ordinating firms have incentives to deviate.²² Often

¹⁹ Scherer and Ross *Industrial Market Structure and Economic Performance*, (Boston: Houghton Mifflin, 1990) p 235.

²⁰ *ibid* p 226.

²¹ ‘*Merger Regulation: A review of the draft merger guidelines administered by the ACCC*’, (Canberra: Australian Industry Commission 1996) p 37.

²² Stigler, *A Theory of Oligopoly*, 72 *Journal of Political Economy* 44 (1964).

a firm can increase the quantity it sells dramatically by undercutting the cooperative price slightly. Even though the firm must accept a lower price to achieve this result, it may find the temptation irresistible when the lower price remains in excess of cost.

12. In terms of what some of these structural conditions are, generally it has been found that coordination will be less likely to be successful the greater the degree that:

- the product supplied is heterogeneous, complex or changing;
- the industry is dependent on large and infrequent orders;
- there are depressed business conditions²³;
- firms can increase sales by winning several contracts with large buyers, or by signing long-term contracts with buyers;
- captive production, or non price competition (e.g. advertising and servicing), allows firms to increase sales secretly²⁴;
- entry entails low sunk costs; and
- an anti-competitive price rise would be defeated by new competition, or deterred by the prospect of new competition²⁵.

How prevalent is tacit collusion in the economy?

13. In the absence of large numbers of industry studies it is difficult to know how prevalent tacit collusion is in the New Zealand economy, and the magnitude of the efficiency loss imposed. However, there is some industry specific research that tends to suggest that tacit collusion may occur in some markets, at least in ones for homogenous products.

Retail petrol market

14. The International Energy Agency (IEA), in its May 1997, report suggested that there was evidence of tacit collusion in the retail petrol market. This report raised concerns about the degree of market concentration, and price levels relative to other countries which highlighted significant concerns about the strength of competition in that market. The IEA concluded that there were: '*...grounds for suspecting oligopolistic pricing behaviour by the four oil companies that dominate the industry*²⁶.

15. The NZIER (1996)²⁷ provided earlier evidence that supported the conclusions of the IEA. From their study the NZIER concluded that the market for petrol in New Zealand was not a competitive one resulting in harm to both consumer welfare and industry efficiency. Comparisons of New Zealand retail petrol prices and the landed price of imported petrol showed an increase of about 1 cent per litre per year between 1990 and mid-1996 (since then the trend has been falling). According to the NZIER, for every 1-cent per litre increase in the price of petrol, the oil companies' combined revenue increased by approximately \$27 million per annum.

²³ Scherer and Ross p 315.

²⁴ Baker, J.B. 'Two Sherman Act Section 1 Dilemmas: parallel pricing, the oligopoly problem and contemporary economic theory', *The Antitrust Bulletin* Spring 1993 pp. 151-152.

²⁵ *ibid* p 181.

²⁶ IEA, *Energy Policies of IEA Countries: New Zealand 1997 Review* (Paris: OECD 1997) p 9.

²⁷ *Petrol Prices: An Investigation into Petrol Prices in New Zealand*, NZIER, Report to the Ministry of Commerce.

16. With the entry of an independent retailer (Challenge) into this market, in April 1998, and the announced intentions of other independents to enter the market, the retail price of petrol decreased significantly in the areas where new entry occurred.

17. The indication that a fifth participant was essential to securing reductions in the retail price of petrol, illustrates the desirability of having a threshold for mergers and acquisitions broader than dominance. Around the time that the petroleum wholesaling industry was deregulated two companies were formed to compete in the retail market. In 1986 the Top Group was formed and acquired 21 retail stations in the North Island, including 8 in Auckland and 7 in Wellington. At about the same time Solo, a group of 13 retail outlets under single ownership also entered into a long supply contract with BP. Both Top Group and Solo provided some prospect of increased rivalry possibly by the import of refined products.²⁸ However on 20 August 1988 Top Group was sold to BP.

Overseas research on the prevalence of tacit collusion

18. Research from other economies illustrates the prevalence and harm of coordinated behaviour in oligopolistic industries. In the United States during the 1920's and 1930's, the three tobacco companies selling 90% of industry output, maintained virtually identical list prices and discounts for 20 years. During the same period there were many instances in which the defendants' prices had featured lockstep increases even during the Great Depression when the companies' costs had fallen. Courts in the United States found no economic justification for the suspect pattern of behaviour, and thus inferred an agreement from the pattern of behaviour²⁹.

19. Again from the United States, between 1962 and 1970 the three largest breakfast cereal manufacturers (who controlled around 76% of total sales) increased their wholesale prices per pound by 14 cents – much more than the differential any single company could sustain through individual pricing action. Price leadership facilitated the joint movement to higher prices³⁰. Industrial economist FM Scherer in commenting on this case said:

My analysis revealed that Kellogg's upward price leadership was usually followed by major rivals General Mills and General Foods. One of the case's many frustrations was the failure to have accepted into evidence documents revealing that Kellogg's price analysts made their recommendations assuming that rivals would follow Kellogg's price lead and therefore that market shares would be preserved³¹.

20. Greer (1989), cites a number of studies that illustrate the occurrence of coordinated behaviour, including:

- Moore (1986) estimated that when other variables are held constant, airline fares in highly concentrated city-pair markets (with fewer than five carriers) are 20% to 40% higher than fares in unconcentrated markets (with five or more carriers);

²⁸ Miller, R.A, *Price Setting and Deregulation: the Flour Milling and Petrol Wholesaling Industries*, (Wellington: NZIER) p.51.

²⁹ Kovacic, W.E. 'The Identification and Proof of Horizontal Agreements', *The Antitrust Bulletin/Spring 1993*, p 32.

³⁰ Scherer and Ross, p 257

³¹ In Willig, R.D., 'From 'Merger Analysis, Industrial Organisation Theory, and Merger Guidelines', *Brookings Papers: Microeconomics 1991*, p 324.

- Fraas and Greer (1977) from an analysis of 606 cases of illegal price fixing in the U.S., found that the highest frequencies of cartel activity occur in markets with approximately four to 10 firms. Below four firms, cartel activity is relatively low because tacit collusion or single firm dominance is controlling; and
- Gribbon and Utton (1986) found that over the period 1960-1981 in the United Kingdom, 18 out of 21 “concentrated oligopoly” industries (i.e. where the two leading firms shared 50% or more of a market) priced non-competitively.

The Australian experience

21. The possibility that the dominance threshold is resulting in too little scrutiny of mergers is borne out by the Australian experience. When Australia was considering moving from a dominance test, to a substantially lessening of competition test, the then Trade Practices Commission (TPC)³² pointed to a number of mergers, that although permitted by the dominance threshold, raised efficiency concerns. In their view these mergers did not receive proper scrutiny. They included the following mergers.

- Coles/Myer – this merger resulted in a substantial increase in concentration in the market for retailing, and caused the removal of a significant competitor from that market and possibly prevented entry in the shorter term by another competitor.
- Ansett/East-West – this resulted in a reduction in competition particularly on major eastern trunk routes and price competition in NSW largely disappeared.
- ICI/Berger-British Paints – following the merger prices of architectural paint went up approximately 35% and prices of automotive paint rose substantially.
- Amcor/VisyBoard/Smorgons – Amcor and Visy Board acquired the Smorgons fibreboard container operation. Since the merger, fibreboard container prices increased substantially.
- Ampol/Solo – Solo was an aggressive price competitor in petrol retailing and had a major impact on the Australian retail market. The merger was followed by a sharp rise in petrol prices.

22. The TPC believed that each of these mergers should have gone down the authorisation track, so that all the relevant efficiency considerations could have been properly examined.

Section 27 addresses explicit collusion only

23. The potential for tacit collusion in the economy is of concern from a competition law perspective, because the Act has no mechanism to respond to it. The threshold for mergers does not allow consideration of joint dominance, and section 27 responds to instances of explicit collusion only.

24. In terms of section 27, case law to date suggests that for any liability to arise from section 27, communication between parties, or at least a conscious mutual commitment, is

³² Now the Australian Competition and Consumer Commission.

a necessary condition. This test is derived from the leading United Kingdom case – *British Basic Slag Limited* where Cross J said:

*All that is required to constitute an arrangement not enforceable in law is that the parties to it shall have communicated with each other in some way, and that as a result of the communication each has intentionally aroused in the other an expectation that he will act in a certain way.*³³

The need for communication of the terms of the arrangement between the parties was endorsed by the UK Court of Appeal. The same standard has been held to apply in New Zealand as well as in Australia.³⁴

25. However, in *Auckland Regional Authority v Mutual Rental Cars (Auckland Airport) Ltd* (1988), Barker J said:

*An arrangement or understanding comes into existence as a result of some communication between the parties; the communication can however occur by written or spoken word the one to the other or by one observing and interpreting the other's behaviour.*³⁵

Although this reference to communication by 'observing and interpreting' suggests that section 27 could be used to remedy tacit collusion, it has never been applied by the New Zealand courts to such conduct.³⁶ The few New Zealand and Australian cases³⁷ that have considered the meaning of an 'arrangement or understanding' in an oligopoly context, have concluded that collusion is not an inevitable result of an oligopolistic market structure, and should not be inferred merely from parallel conduct which produces apparently anti-competitive outcomes.³⁸ In other words outcomes which in economic terms can only be explained by collusion, would probably be held to be insufficient to satisfy the evidential requirements of an 'arrangement or understanding'.³⁹

Should section 27 be amended to address tacit collusion?

26. The competition jurisdiction in the European Union allows behavioural remedies to be used to address tacit collusion. The competition jurisdiction in the United States also allows this but to a more limited extent. The question for those with a stake in the New Zealand jurisdiction, is whether section 27 should address tacit collusion as well as explicit collusion.

27. The major risk of making such an amendment is the negative impact that this would have on commercial activity and thus economic growth. Co-ordinated behaviour is not inevitable in oligopolistic markets. It is only likely to occur in the presence of certain factors, such as markets for homogeneous products. Where it is observed, uniform conduct may reflect a set of identical business responses, by a group of similarly situated competitors, to the same economic conditions. Indeed, price uniformity may be the

³³ Cited in Berkahn, M. 'Shared Monopolies and Tacit Collusion: Applying Competition Law to the Petrol Industry', *New Zealand Business Law Quarterly* Vol. 4 May 1998 p 103.

³⁴ *ibid*

³⁵ Berkahn *op cit* p.104

³⁶ *ibid*.

³⁷ *Lion Corp Ltd v Commerce Commission (this was a merger decision)*, *Trade Practices Commission v Email Ltd*.

³⁸ Berkahn *op cit* p.104

³⁹ *ibid*

outcome of fierce competition between few sellers. Oil wholesalers argued this was the case in the petroleum industry. In practice it will be difficult to determine whether price uniformity has resulted from competition, or from tacit collusion. Conscious parallel behaviour should not, therefore, be treated as illegal in itself. At most it should be treated as circumstantial evidence of anti-competitive behaviour.

Implications for merger policy

28. The concern then is not that oligopolistic markets will inevitably result in anti-competitive outcomes, it is that these markets may facilitate collusion both explicit and tacit. The Act has a behavioural mechanism that allows instances of explicit collusion to be addressed. However, no such mechanism exists for tacit collusion. Yet this type of collusion can result in significantly inefficient outcomes. Another option for addressing tacit collusion, rather than amending section 27, would be to broaden the range of acquisitions that are potentially subject to the merger/acquisition prohibition. This may allow for merger scrutiny in terms of whether or not members of a resultant highly concentrated market are likely to compete or coordinate.

29. Such scrutiny would be consistent with what occurs in most other competition jurisdictions. The European Commission, at least since the *Nestle* decision in 1992, has shown a willingness to control oligopolies by interpreting its merger regulations to include situations of joint dominance.⁴⁰ In *Nestle* the Commission concluded that many of the classic conditions facilitating oligopolistic coordination were present, and that:

*The maintenance or development of whatever competition there remains in that market therefore requires particular protection. Any structural operation restricting even more the scope for competition in such a situation has to be judged severely.*⁴¹

Does a small economy need a very permissive merger threshold?

30. In a small economy, high domestic market concentration will be a pervasive feature. Concentration levels in New Zealand are very high by international standards. This is due mainly to the need for industries to achieve minimum viable scale, as well as to achieve economies of scale. In contrast, in a large economy a firm with a much smaller market share can attain economies of scale.

31. Given the size of New Zealand's economy, and the high merger threshold, it is not surprising that relatively few mergers and acquisitions have been prohibited. Of the 211 applications received for business acquisitions, over the period January 1991 to December 1996, only 15 were declined.

32. However, simply being a small economy does not necessarily imply the need for a very permissive threshold for mergers. For example, scale economies can be achieved through exporting.

33. Khemani (1991) states that a broader threshold is desirable for a small economy. Khemani points out that an erroneous assessment of the economic effects of a merger by the competition authority is likely to have a relatively greater impact in a small, rather than in a large, economy. This is because in a small economy an overly permissive policy may

⁴⁰ Berkahn op cit p. 102

⁴¹ *ibid.*

entrench monopolistic and oligopolistic elements in the market. In such markets, although the merger itself may generate efficiencies, these efficiencies may be eroded over time through the incentives to reduce output and increase price, and/or through organisational inefficiencies.

34. Khemani also points to the Canadian Bureau of Competition Policy's experience where the long time periods required to realise efficiencies from mergers in highly concentrated markets, impose significant costs on that economy. In Canada most of the efficiency claims advanced by merging parties are of the genre of increased plant or product-specific economies of scale. To realise such economies proposals typically involve the rationalisation of product lines, plant closures, and increased specialisation. However, in monopolistic or oligopolistic markets where competitive rivalry is lacking, the time periods required to realise the "claimed" potential efficiencies can be long, and the foregone costs of the potential efficiencies, high. Although merging parties advance efficiency claims, these efficiencies are not weighed, in and of themselves, against the substantial lessening of competition arising from the merger.

The section 36 threshold

35. Consistent with a light handed regulatory regime, the Commerce Act places primacy on the use of its behavioural remedies, rather than its structural ones, to promote competition in markets in New Zealand. This balance is reflected in, by OECD standards, our permissive merger regime. However, because market conduct can be heavily dependent on market structure, a permissive merger regime demands the safety net of robust behavioural prohibitions. A concern is that section 36 is not effective in prohibiting anti-competitive behaviour.

The scheme of section 36

36. Section 36 of the Commerce Act prohibits a person in a dominant position from using that position for an anti-competitive purpose. What constitutes a purpose of an anti-competitive nature is specified in section 36(1)(a), (b) and (c). Section 36(1) states:

"No person who has a dominant position in a market shall use that position for the purpose of –

- (1) Restricting the entry of any person into that or any other market; or
- (2) Preventing or deterring any person from engaging in competitive conduct in that or in any other market; or
- (3) Eliminating any person from that or any other market."

37. Unlike most other restrictive trade practices prohibited under Part II of the Commerce Act, section 36 is largely interpreted as a single firm only threshold. The policy rationale behind section 36 is to prohibit the misuse of market power by the unilateral anti-competitive conduct of a dominant firm. In order to contravene section 36, three key components must be proven. These components are:

- **Dominant position** in a market;
- **Use** of that dominant position; and
- A **purpose** of restricting, preventing, deterring, or eliminating competition.

In order to identify the potential for improving the effectiveness of section 36, each of the fundamental components to the section is considered in turn.

Dominant Position in a Market

38. Section 3(8) of the Act specifies factors to be considered when determining whether a person⁴² has a “dominant position” in a market. To have a dominant position in a market, persons must be in a position to exercise a “dominant influence” over the production, acquisition, supply or price of goods or services in a market. Therefore, a prerequisite to being dominant is that a person needs to be a supplier or acquirer of goods, or services. Section 3(8) of the Act specifies the necessary considerations to determine whether a person is in a position to exercise a dominant influence over the production, acquisition, supply or price of goods or services in a market. These include:

- the share of the market, the technical knowledge, the access to materials or capital of that person or that person together with any interconnected body corporate;
- the extent to which that person is constrained by the conduct of competitors or potential competitors in that market;
- the extent to which that person is constrained by the conduct of suppliers or acquirers of goods or services in that market.

39. In essence, these components reflect considerations of the barriers to entry and market share, elasticity of supply and elasticity of demand. Taken individually, these ‘tests’ ask valuable questions in terms of the current market environment; the possibility, sustainability and timeliness of new entry to the market; and the extent to which suppliers and consumers individually and collectively can act as viable constraints on the behaviour of a dominant player. The Courts in a number of ways have interpreted these components of ‘dominant influence’ under section 36.

Case law on dominance

40. As discussed in Section 2 of this document, the case law on ‘dominance’ has developed in two phases. In the first phase an economic approach to the concept of dominance was taken. In the second phase a “dictionary definition” approach was adopted. To summarise the economic approach tended define ‘dominance’ in circumstances where a person can act to a large extent independently of its customers, with an ability to give effect to “an appreciable change in the price and other aspects of supply”.⁴³

41. The second phase occurred when the Court of Appeal in *Telecom Corporation of New Zealand Limited v Commerce Commission*⁴⁴ signalled a shift away from an economic approach to a more dictionary definition based methodology. As is mentioned in Section 2, the current state of the dominance test was considered in both the High Court and Court of Appeal in the *Port Nelson* litigation⁴⁵. In this case, the High Court accepted, in light of the Court of Appeal’s decision in *Telecom* – ‘that the test for dominance was no longer a matter of prevailing economic theory’ (McGechan J).

⁴² A person under the Act is defined as including a local authority and any association of persons whether incorporated or not.

⁴³ *Re Magnum Corp Ltd and Dominion Breweries Ltd* (1986) 2 TCLR 177, 195-196; (1987) 1 NZBLC (Com) 104,073, 104,088. Approved in *Lion Corp Ltd v Commerce Commission* (1987) 2 NZLR 682, 690; (1987) 2 TCLR 202, 206.

⁴⁴ [1992] 3 NZLR 429; (1992) 4 TCLR 648; 4 NZBLC 102,724.

⁴⁵ *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406 (HC); *Port Nelson Limited v Commerce Commission* (1996) 7 TCLR 217 (CA).

42. While the Court of Appeal appears to support the view that a non-technical dictionary definition approach is not the established test for dominance, there is some ambiguity in this area. It would appear from a specific comment from the judiciary, that if there is ambiguity this should be addressed by Parliament. Gault J in the same judgement stated:

The decision in Telecom v CC has been criticised as setting too high a level of market power so as to limit the value of the section as an effective regulator of abusive anti-competitive conduct. In this respect it must be noted that the Commerce Act was amended in 1994 without any change being made to ss3 (8) or 36; compare the change to the corresponding Australian s 46 of the Trade Practices Act in 1986 from “in a position substantially to control a market” to “a substantial degree of power in a market”.

Policy implications

43. The case law in this area appears to have set a high threshold for dominance under section 36. This is largely interpreted as a single firm only threshold, despite the fact that section 3(8) arguably supports a lower threshold⁴⁶. The addition of a plain English definition along side the economic definition appearing in the Act both raises the threshold for triggering section 36 attention and, arguably, creates uncertainty about the respective weighting the courts will apply from case to case.

Use of a Dominant Position

44. Under section 36, it is evidentially necessary to consider whether there has been **use** of a dominant position for one of the purposes specified in section 36(1)(a) to (c). Given that no case in New Zealand to date has turned solely on the issue of use of a dominant position, little jurisprudence exists on this concept. To test this component however, the New Zealand courts have predominantly adopted a view consistent with the Australian High Court’s decision in *Queensland Wire Industries Pty Ltd v BHP Co Ltd*⁴⁷. In this case, the Court decided that the Australian equivalent of “taking advantage of” equated to “use”, and that this component was to be viewed as a causal link between dominance and purpose, where purpose was the important issue for consideration.

45. The Court in *Natwest Australia Bank Ltd v Boral Gerrard Strapping Systems Pt Ltd* supported this perception of ‘use’ as a link between dominance and purpose⁴⁸. Here the Court expressed ‘use’ as a type of causal connection between the dominant position and the conduct at issue. In this case, the Court went on to state that:

“the connection may be demonstrated by showing a reliance by the contravener upon its market power to insulate it from the sanctions that competition would ordinarily visit upon its conduct.”

46. However, in the case of *Telecom Corp of NZ Ltd v Clear Communications Ltd*⁴⁹, the Privy Council took an opposite view of ‘use’. In this case, the Privy Council indicated that the concept of ‘use’ was of greater importance than purpose, and decided that it is possible to infer purpose from the use of a dominant position, but not the converse. The Privy Council developed a “use test” whereby a firm does not use its market dominance if

⁴⁶ As noted by Gault J in the Court of Appeal decision *Port Nelson Ltd v Commerce Commission*

⁴⁷ (1989) 167 CLR 177

⁴⁸ (1992) ATPR 41-196, 40,644.

⁴⁹ (1995) 1 NZLR 385; (1994) 6 TCLR 138; 5 NZBLC 103,552.

it acts in a way that a non-dominant firm in a contestable market would act. The Privy Council stated:

In Their Lordships' view it cannot be said that a person in a dominant market position 'uses' that position for the purposes of section 36 unless he acts in a way which a person not in a dominant position but otherwise in the same circumstances would have acted.

47. This change in focus has however, not been adopted in subsequent decisions by New Zealand courts in the *Port Nelson* cases. Here, the courts reverted back to the *Queensland Wire* rationale of 'use' constituting a neutral causal connection between dominance and the purpose of the conduct in question. In the Ministry's view, this interpretation is the original intent of Parliament.

Purpose of restricting, deterring, preventing or eliminating competition

48. The final component in showing that a dominant firm has breached section 36 is to prove purpose. The current definition applied to purpose under the Act (section 2(5)(b)) requires that the anti-competitive purpose or reason was the "substantial" purpose of the dominant firm. A substantial purpose is considered to be material in nature. In addition, the courts have also favoured defining 'purpose' in terms of an element of "object or aim" by the dominant party as opposed to mere intention⁵⁰. Therefore, intention to do an act which is known will have anti-competitive consequences is not sufficient to show purpose under the Act.

49. It is also clear from current case law that the 'effect' of the action of the dominant party is not relevant to this section⁵¹. While the courts have not required direct evidence of 'purpose', in the case of section 27 actions the court considers objective aspects such as the wording of the provisions, the terms of the arrangement and the circumstances leading to the arrangement to infer 'purpose'. However, in the case of section 36 actions, the only behaviour from which the court can infer 'purpose' is the conduct of the dominant party itself. This usually involves an inference that a party intends the natural and probable consequences of acts committed by them. However, this inference is usually rebuttable on ascertaining the subjective intention of the person concerned. Accordingly, imputing an anti-competitive 'purpose' to a dominant party under section 36 requires a relatively high threshold of evidence.

50. Much of the jurisprudence on 'purpose' revolves around whether a subjective or objective test should be applied when showing 'purpose' under section 36. There has been no real consensus on this issue. In *Union Shipping*⁵² the court stated

Proof of purpose, in the nature of these cases will often turn upon inferences drawn from actions and circumstances, with a sprinkling of internal memoranda and correspondence. Protestations of inner thoughts which do not reconcile with objective likelihoods are unlikely to carry much weight. In many cases, (...) both objective and subjective standards are met.

⁵⁰ *Union Shipping* (1990) 2 NZLR 662.

⁵¹ *New Zealand Private Hospitals Association – Auckland Branch (inc) v Northern Regional Health Authority* 7/12/94, Blanchard J, HC Auckland CP 440/94.

⁵² (1990) 2 NZLR 662, 707

51. Further, in *Port Nelson v the Commerce Commission* (1996)⁵³, the Court of Appeal cast doubt on the need to decide whether an objective or subjective approach is intended. Gault J stated

...we heard argument as to whether the proscribed purposes are to be ascertained subjectively or objectively (...) Much has been written on this distinction which is generally unimportant in practice.

52. Accordingly, while the courts have tended to devote much time to the issue of whether 'purpose' under section 36 connotes a subjective or objective test, the most recent case law suggests this debate is of little value.

"Purpose test" versus "effects test"

53. In order to lessen the high threshold attached to 'purpose' under section 36, some commentators have suggested the inclusion of an "effects test". An "effects test" would assess whether the conduct alleged to be in breach will have the effect, or likely effect, of restricting, deterring, preventing or limiting competition. There are two key factors that caution against inclusion in section 36 of an "effects test". First, such a test would substantially expand the scope of conduct that would fall within the reach of section 36. For example, a dominant firm that sought to scale up capacity to achieve economies of scale and scope would come within the reach of section 36 should an effects test be implemented⁵⁴. This would increase uncertainty and tend to deter efficient commercial activity.

54. Second, such a test could increase the risk of judicial error because of the difficulties associated in determining whether or not conduct is in breach of the Act. A ruling would require knowledge of:

- What the defendant would, or could, have done if it were in a hypothetical competitive market;
- What the plaintiff would look like if it were a competitor in that hypothetical market; and
- The damage done to the plaintiff by the defendant in the hypothetical market⁵⁵.

55. All these factors require assumptions and estimations about firms' structures and behaviour that would be difficult to predict with reasonable levels of certainty.

56. Conversely, it is argued that the "purpose test" inadequately distinguishes between anti-competitive conduct and strong competitive conduct, and that the adoption of a rigorous "effects test" would mitigate this problem. On balance however, the Ministry considers that an "effects test" would not assist in promoting competition in our markets.

Definition of Purpose

57. Section 46(7) of the Australian Trade Practices Act 1974 provides a clear statutory test for purpose. It provides that a court may determine that a firm has a relevant 'purpose' even if the existence of that 'purpose' has been ascertained only by inference from that firm's conduct, or the conduct of any other person, or from other relevant

⁵³ (1996) 7 TCLR 217

⁵⁴ Ergas, H 'Should section 36 of the Commerce Act be amended to include an effects test', Comments on a paper delivered at the TUANZ Conference on Telecommunications 1998.

⁵⁵ *ibid*

circumstances. No commensurate provision currently exists in New Zealand's Commerce Act.

58. Despite the fact that our Act does not contain an express provision of this nature, the courts have indicated that they will infer 'purpose' from the conduct of the dominant person and the particular circumstances surrounding it. This approach of inferring purpose from the dominant parties conduct is illustrated in *Union Shipping*:

Proof of purpose, in the nature of these cases will often turn upon inferences drawn from actions and circumstances, with a sprinkling of internal memoranda and correspondence.

59. By adopting a similar statutory test for 'purpose' as that embraced in Australia, it is possible that we would simply be codifying an existing test currently used by the courts in this area. Greater clarity and the potential ability to utilise Australian precedents on the issue could also result.

Judicial interpretation has raised the threshold

60. The courts' interpretation of these concepts since the Act's enactment in 1986 has led to a rather narrow and restrictive interpretation and application of the section than when the Act came into effect. In particular the use of a plain English definition of 'dominance' implies a higher threshold than originally intended. There may be a need to redefine 'dominance' in a way that focuses directly on market power and the factors that influence the extent of a firm's market power. Such factors may include market share, elasticity of supply and elasticity of demand.

A widened section 27

61. It is generally accepted that Parliament intended the focus of section 27 and section 36 to be on different types of behaviour. Section 27 was designed to focus on collective anti-competitive behaviour and section 36 on unilateral behaviour. However, since *Port Nelson*, the scope of section 27 may have expanded into the domain of section 36.

62. Although judicial interpretation has narrowed the scope of section 36, the Court of Appeal may have deliberately widened the scope of section 27 as a means of redress. It is generally accepted that the decision in *Port Nelson* widened the scope of section 27 allowing it to be used to challenge behaviour of dominant firms. This section typically applies to agreements between competitors for the purpose of substantially lessening competition. However, even though this was not the situation in the *Port Nelson* case, the Court of Appeal held that it was sufficient if only one of the parties to the contract had an anti-competitive purpose. This means that section 27 can now be used to challenge unilateral conduct – previously the domain of section 36.

Policy implication

63. Although the judiciary may have found a solution to the problem of a weakened section 36, at least in the case of *Port Nelson*, it is unclear how successful that remedy would be over the full range of anti-competitive behaviour that can be engaged in by a dominant firm. Some section 36 conduct may not be caught by section 27 as there may be no contract, arrangement, or understanding.

64. In any case it is a second best approach to resolving the problem. This is because until the precedent is well entrenched, use of section 27 to resolve “section 36 type problems” will raise the level of uncertainty for market participants. The cost to participants of managing that uncertainty may be substantial. As well, if use of section 27 proves to be less comprehensive in its coverage than section 36 in the form intended by Parliament, the economy as a whole will suffer through the foregone benefits that a greater level of competitive rivalry would have secured.

65. Moreover, it could be argued that Parliament implicitly decided to place greater reliance on the Act’s behavioural prohibitions than on its structural ones in Part III. This balance only works when the behaviour prohibitions are robust. When the regime is ‘out of balance’, as it appears to be now, we run the risk of allowing the creation of substantial market power without equipping market participants with the full range of tools to respond to abuses of that power.

Should section 36 prohibit monopoly pricing?

66. Some commentators have suggested that monopoly pricing should be considered to be an abuse of a dominant position in addition to what is provided by Part IV of the Act. Currently, section 36 does not prohibit the charging of a ‘monopoly’ price. This is because section 36 prohibits dominant firms from using a dominant position for the purpose of restricting competition; it does not prohibit such firms from using market power for purposes that are not anti-competitive.

67. Where monopoly power is ‘transitory’, there are a number of factors that suggest that prohibiting monopoly pricing would be detrimental to competition and efficiency, these are that:

- monopoly pricing in itself does not impair the opportunities of rivals, rather high prices encourage the entry and expansion of rivals. That is, the existence of monopoly prices creates the incentives for other firms to enter the market. Entrants typically bring innovative products and processes and stimulate the former monopoly incumbent to improve the efficiency of its operations;
- prohibiting monopoly pricing denies monopoly profits to firms whose monopoly power was acquired through having superior skill, product and business acumen. Thus restricting monopoly pricing would eliminate the primary incentive for firms to exhibit such behaviour in the market. For instance, it would deprive shareholders of the returns commensurate with the level of risk taken by the firm, and the firm’s management and employees would forego the higher earnings and salaries that would have reflected the success of their endeavours;
- over time it would discourage the firm’s on-going innovative and cost-reducing efforts by eliminating the reward.

68. However, where an industry has natural monopoly characteristics, or otherwise has non-transitory high market power, monopoly pricing will not attract rivalry. Rather, in such industries monopoly pricing can be used to achieve anti-competitive purposes. One example of this potential is the interconnection price that can be charged by a dominant firm for competitors to gain access to an essential facility.

69. In 1994 the Privy Council sanctioned the use of the Baumol-Willig rule for pricing interconnection services in telecommunications markets. This rule states that monopolists are entitled to provide services to competitors at the same price they implicitly charge themselves, including any monopoly profits. In response to the Privy Council decision, the Government issued a media release in 1996 that stated:

....developments since the Privy Council decision demonstrate that the major telecommunications industry players do not support the Baumol-Willig rule as a satisfactory basis for interconnection pricing. The Government considers that the ...rule has the potential to lessen competition, thereby limiting the rate of introduction of new products and services and lessening the benefits to users.

70. This begs the question as to whether section 36 and the courts should be used to regulate interconnection prices where they contain elements of monopoly pricing. There are several factors that suggest that this would be an ill-advised strategy.

71. First, requiring the courts to rule on access price assumes that the courts are able to determine what a “reasonable” non-monopoly price is. This is a difficult, if not impossible task to impose on the courts. To set such a price the courts would require knowledge of all cost, demand, and technological variables and all of these are subject to constant change.

72. Second, even if courts could determine what constitutes a reasonable price, enforcing such a price would involve the courts in ongoing supervision. Our current judicial system does not contemplate the courts taking such a role in commercial affairs.

73. As well, apart from enforcement, there is an issue that a reasonable price fixed today may through economic conditions become the unreasonable price tomorrow. As the President of the Court of Appeal commented in the litigation between Clear and Telecom:

It may be regrettable that the Court cannot resolve the matter, perhaps painting with a broad brush, but the Act rightly does not contemplate this. We are not a price fixing authority.

74. The Government’s general approach in response to this issue is through, some or all of, the following:

- the use of meaningful information disclosure;
- the use of price control and the threat of price control;
- ensuring the Commerce Act is consistently able to facilitate competition in markets across the economy; and
- ensuring that the wider body of regulation is consistent with achieving an open economy which facilitates a high level of innovation and technological change.

5 Thresholds in other jurisdictions

1. In considering strategies to respond to the problems identified in Section 4, it is useful to examine what methods are employed in other competition jurisdictions to respond to the same issues. This section reviews how the jurisdictions of Australia, Canada, Germany and the United States respond to mergers and acquisitions, and to the abuse of market/monopoly powers. These countries are reviewed as the first two are relatively small economies like New Zealand. The German jurisdiction provides an example of one of the most stringent regimes in the world. The United States is included as its jurisdiction is typically regarded as being at the forefront of competition law.

Australia

Mergers and acquisitions

2. Australia applies a competition test to the consideration of proposals for mergers and acquisitions. The threshold is one of 'substantial lessening of competition' and is contained within section 50 of the Australian Trade Practices Act 1974. This provision states that a merger or acquisition that would have the effect, or be likely to have the effect, of substantial lessening of competition is prohibited.

3. Section 50(3) sets out the matters which must be taken into account in determining whether the acquisition would have the effect, or likely effect, of substantially lessening competition:

- the actual and potential level of import competition on the market;
- the height of the barriers to entry to the market;
- the level of concentration in the market;
- the degree of countervailing power in the market;
- the likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices or profit margins;
- the extent to which substitutes are available in the market or are likely to be available in the market;
- the dynamic characteristics of the market, including growth, innovation and product differentiation;
- the likelihood that the acquisition would result in the removal from the market of a vigorous and effective competitor; and
- the nature and extent of vertical integration.

4. As in New Zealand, authorisation is available for mergers and acquisitions that are likely to result in a benefit to the public which would outweigh the detriment from the loss of competition.

Abuse of market power

5. Section 46 of the Trade Practices Act covers the use of dominance in the Australian context. However, instead of requiring dominance for the threshold test in Australia, the Trade Practices Act requires "a substantial degree of market power."

6. The Australian case law on section 46 tends to suggest that the market power required by this threshold is less than that required to “dominate” a market. The concept of a substantial degree of market power has similarly been defined as being “large or weighty”. Accordingly, the courts have tended to define this threshold of “substantial” market power as an element less than control and less than the power to determine the prices of a substantial part of the market. Further, in addition to monopolies, section 46 applies to major participants in an oligopolistic market⁵⁶. Accordingly, the Australian threshold is interpreted at a lower level than the single firm only threshold which tends to apply in New Zealand.

Canada

Mergers and acquisitions

7. The Canadian jurisdiction also applies a “substantially lessening of competition” to mergers and acquisitions. Under section 92 of the Canadian Competition Act 1986, the following factors are considered in determining whether there has been a substantial lessening of competition:

- the extent to which foreign products, or foreign competitors, provide, or are likely to provide, effective competition to the businesses of the parties to the merger or proposed merger;
- whether the business, or a part of the business, of a party to the merger or proposed merger has failed, or is likely to fail;
- the extent to which acceptable substitutes for products supplied by the parties to the merger, or proposed merger, are or are likely to be available;
- the extent to which effective competition remains, or would remain, in a market that is or would be affected by the merger or proposed merger;
- any likelihood that the merger or proposed merger will, or would, result in the removal of a vigorous and effective competitor;
- the nature and extent of change and innovation in a relevant market; and
- any other factor that is relevant to competition in a market that is, or would, be affected by the merger or proposed merger.

8. Mergers will not be challenged where the post-merger market share of the merged entity would be less than 35 percent. Similarly mergers will not be challenged where the exercise of market power by two or more firms in the relevant market will be greater than in the absence of the merger where:

- the post-merger share of the market accounted for by the four largest firms in the market would be less than 65%, or
- the post-merger market share of the merged entity would be less than 10%.

9. The Canadian legislation requires notification of major mergers to the Canadian Bureau of Competition Policy before they may be consummated. Companies are obliged to notify the Bureau of a proposed merger when two thresholds are met. These are:

⁵⁶ “Second Reading Speech: “Trade Practices Revision Bill”, *Hansard*, House of Representatives, 19 March 1986.

- the parties must have total assets in Canada or gross annual revenues from sales in, from or into, Canada of over \$400 million (\$ Canadian); and
- the value of assets to be acquired or gross revenue from sales generated by those assets must exceed \$35 million. (Note in the case of a corporate amalgamation, the threshold is \$70 million).

10. The Canadian model also allows for authorisation of mergers that would otherwise breach the Act where the merger is likely to bring about efficiency gains that outweigh any detriment from the loss of competition. Within that analysis the Canadian legislation prevents a redistribution of income between two or more persons from being considered as an efficiency gain.

Abuse of market power

11. The Canadian legislation prohibits the use of a dominant position to substantially lessen competition. The restrictions are contained within sections 78 and 79 of the Competition Act. For the restrictions to apply, one or more persons must substantially control a class of business in Canada. They must have engaged in, or currently be engaging in, anti-competitive acts having the effect of preventing or lessening competition substantially. Consideration is given to whether or not the anti-competitive activity is the result of a business's superior competitive performance.

12. The test in the legislation is whether “one or more persons substantially or completely control of a market”. That test allows for consideration of situations of joint dominance.

Germany

Mergers

13. The German treatment of mergers is probably the most strict in the OECD. The German restrictions contain a double definition for dominance in the consideration of mergers – market domination and paramount market position. Mergers that create or strengthen either position are prohibited.

14. The German legislation contains rebuttable presumptions of dominance. Dominance is presumed if the following market share thresholds are exceeded:

- for single-firm dominance – a market share of at least one third;
- for oligopolistic dominance – three or fewer undertakings reaching a combined market share of 50%, or five or fewer undertakings reaching a combined market share of two thirds.

Although the Bundeskartellamt can initially use the statutory presumptions, it subsequently has to actually determine that its own findings and the arguments put forward by the parties confirm rather than rebut the presumption.

Abuse of market power

15. As in the other three competition jurisdictions, in Germany the conduct of dominant and powerful enterprises is not per se subject to statutory control. Certain practices are prohibited only where the enterprise abuses its market power. Under German law, market-dominating enterprises must not unfairly hinder other enterprises nor, in the absence of facts justifying such differentiation, treat other enterprises differently. The same definitions of dominance that apply for merger control, also apply here.

United States of America

Mergers and acquisitions

16. The Clayton Act is the general merger statute that covers combinations including joint ventures and open market acquisitions. The test under section 7 of the Clayton Act, is whether the transaction is likely to harm competition, or tend to create a monopoly. The law is prospective, and allows for the prevention of a merger in the showing of likely future effects. It is not necessary to prove actual, historic effect or non-competitive conditions.

17. The statutory test for mergers is phrased explicitly in terms of competitive effect. The Department of Justice's Merger Guidelines revolve around a market definition protocol, which is based on demand substitution incentives and behaviour as proxies for cross-elasticity of demand. A critical component is the long-term significance of entry. The guidelines also specify the methods used to identify and characterise market participants, presumptions about the structural measures, and set standards for evaluating likely competitive effects of entry.

18. The U.S. jurisdiction also has a pre-merger notification process. The reporting requirement for this is sales or assets of about \$U.S.15 million.

Abuse of market power

19. Unlike the jurisdictions of Australia or Canada, the U.S. jurisdiction refers directly to the concept of monopolisation to deal with unilateral misuse of market powers. Section 2 of the Sherman Act prohibits the abuse of monopolisation or dominance. This section states:

“Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among several States, or with foreign nations, shall be deemed guilty of a felony, and on conviction thereof, shall be punished by fine not exceeding ten million dollars if a corporation, or, if any other person, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.”

What this section prohibits is conduct that, by unfair means, achieves or maintains a monopoly, principally by excluding other efficient competitors. Implicit in section 2 of the Sherman Act, is the possibility of more than one company sharing a monopoly position, although it is more commonly used in the context of single firm monopoly.

6 Proposals for Reforms

1. This section outlines a set of proposals that could be adopted in response to the concerns outlined in Section 4. Suggested proposals for the threshold for mergers and acquisitions are presented first. This is followed by suggested proposals for section 36.

Broadening the threshold for mergers and acquisitions

2. As discussed in Section 4, it is likely that the current thresholds for mergers, by ignoring the potential for joint dominance, prevents sufficient scrutiny of mergers that fall short of creating single firm dominance, but may nevertheless result in efficiency losses. In particular, mergers are not scrutinised in terms of whether they facilitate tacit collusion in tight oligopolistic industries. A merger creating such an industry can facilitate the change from firms competing to firms colluding. This loss of competitive rivalry then translates into losses in industry efficiency and consumer welfare.

Proposal - adopt a competition test for mergers and acquisitions

3. One way to allow the Act to respond to the problems associated with joint dominance would be to allow for fuller scrutiny of merger and acquisition proposals. To achieve this, the merger threshold, which has the role of identifying what level of market power is likely to be harmful to the economy, would need to be broadened to focus directly on the impact on competition. To achieve this the Australian threshold for mergers could be adopted. This would mean replacing the current prohibition with:

*No person shall acquire assets of a business or shares if the acquisition would have the effect, or be likely to have the effect, of **substantially lessening competition** in a market for goods and services*

Benefits of adopting the Australian threshold

Merger scrutiny will encompass joint dominance

4. Adoption of a competition test for mergers would clearly recognise that single firm dominance is not an essential precondition to the abuse of market power. Single firms acting in concert with a limited number of others, can abuse market power and impose significant efficiency losses. Having the Australian threshold would allow mergers to be scrutinised in terms of the competition and efficiency effects of joint dominance. That is, mergers could be scrutinised in terms of whether the resultant market structure would facilitate collusion, both explicit and tacit. Australian experience suggests that this is unlikely to mean in practice a large increase in the number of illegal mergers. Rather it will mean that the market characteristics that are conducive to illegal collusion, such as few players and product homogeneity, will also need to be considered in merger analysis.

Greater scrutiny of mergers in the non-tradeable sector

5. A competition test for mergers will subject a number of mergers that previously escaped scrutiny to authorisation and its efficiency test. In particular, the broader threshold should provide greater scrutiny of mergers occurring in the non-tradeable sector (for example many of the industries in the services sector) of the economy. This will be beneficial, as mergers within this sector, are likely to pose the greatest risk in terms of inefficient outcomes, as the non-tradeable sector is not subject to the pressures of international competition that the tradeable sector is exposed to.

6. Changing the threshold for mergers is unlikely to have any particular regional impact. The Act is generic and applies across all sectors of the New Zealand economy. Competition concerns can arise in regions heavily based on the primary sector as much as they can in regions heavily based on the manufacturing and services sectors. When considering matters under the Commerce Act it is generally necessary to define which market or markets are likely to be affected. An important component of market definition is the geographic extent of the market. For example, a market may cover the whole country, or smaller regions or districts. Geographic definition starts at the location of the merging firm and extends out to cover all markets likely to be affected by anti-competitive behaviour on the part of the merging entity. There is no reason why changing the merger threshold will focus geographic market definition on any one region of New Zealand in particular.

7. Greater scrutiny of merger proposals will also be of benefit in recently deregulated industries. In these industries the dominance threshold can offer little guarantee against an inefficient outcome. These losses may be so significant that they erode the efficiencies gained through deregulation.

8. The advantage of greater scrutiny of mergers occurring in these sectors was a key reason why the Australians changed their threshold. As Brunt at the time commented:

In terms of likely impact, more mergers will be examined by the Trade Practices Commission; and more will be sent to authorisation. Some, relatively few mergers, in industries sheltered from international competition, will be stopped. But they will be very important mergers, strategically located with the economy. The new law will be vitally important for the functioning of the deregulated and privatised utilities – industries such as telecommunications, energy and transport. And there are other industries that had an easy ride through the dominance law – such as media, aviation, areas of retailing – that will now come under closer scrutiny.⁵⁷

Sharper focus for the Commerce Act

9. Having a competition test for mergers would also provide a sharper focus for the Commerce Act on promoting competition and efficiency. Currently the Act has a very narrow merger threshold on the basis that high market concentration is needed to allow firms to realise sufficient economies of scale. Such economies are particularly important to assist firms to be competitive on the world market. At the same time the Act also provides the authorisation procedure as a way to balance the efficiencies of any merger against any anti-competitive effects.

⁵⁷ Brunt M, 'Australian and New Zealand Competition Law and Policy', paper given at the 19th Annual Fordham Corporate Law Institute International Antitrust Law and Policy, October 22-23 1992, p 192.

10. In this sense the job of examining efficiencies is done first in a very blunt way that ignores the competition effects (i.e. through the merger threshold), and then in a merger-specific way through authorisation. This approach could weaken the ability of the Act to promote efficiency. As mentioned earlier, in monopolistic or oligopolistic markets where competitive rivalry is lacking, the time periods required to realise the “claimed” potential efficiencies from merger can be long, and the foregone costs of the potential efficiencies high.

11. A preferable approach is to examine the competition effects first, and then balance any loss of competition against the efficiency gains. In our view, the competitive process in our economy will be better served by a competition test for mergers working in tandem with the authorisation procedure.

Consistency in the treatment of mergers and restrictive trade practices

12. Having a ‘substantially lessening competition’ threshold for mergers, would remove the current inconsistency in the treatment of restrictive business practices, which fall outside of section 36, and mergers. Anti-competitive outcomes can be the same whether achieved through contract (arrangement or understanding) or through merger. The only real difference is one of form. For example, if two firms agree to engage in conduct that substantially lessens competition this would contravene the Act. Yet if the two firms merge to achieve the same result, then as long as the merger does not result in dominance, or increased dominance, the anti-competitive outcome will not breach the Act.

13. If anything the law should be tougher on mergers because it is the most enduring form of agreement between firms. If firms merge then the opportunity for competition between them is gone forever.

14. The current inconsistency could be creating some incentive for firms to merge to gain the outcomes that they are prohibited from achieving under ss27 – 29 of the Act.

Consistency with other jurisdictions

15. If New Zealand adopted a competition test for mergers it would bring us more in line with the approach taken by almost all OECD countries. In particular it would make our Act consistent with the Australian law. This would minimise the risks of business uncertainty, as Australian jurisprudence would have persuasive effect in the New Zealand courts. It would also simplify the regulatory environment for those businesses operating in both countries.

The costs of broadening the threshold

16. Although using a broader threshold is likely to be of net benefit to the economy, a broader threshold will impose some costs on the economy. This will reflect the increased number of mergers scrutinised and potentially prohibited.

Increase merger scrutiny will increase compliance costs and administration costs

17. Since changing its threshold from ‘dominance’ to ‘substantially lessening competition’ in January 1993, Australia tended to experience an increase in the number of mergers scrutinised. It has also experienced a slight increase in the number of mergers opposed in

the first three years of the changed threshold. These results are given in the table immediately below⁵⁸. The statistics do not cover the number of proposals that are not proceeded with because the parties consider they will be in breach of the Act without referring them to the ACCC. So these statistics may underestimate the number of merger proposals prevented by the Act.

Australian mergers examined and opposed

Financial year	No. of mergers examined	No. of mergers opposed
1996/97	149	7
1995/96	120	12
1994/95	118	12
1993/94	78	6
1992/93	86	5

18. Over the first two years of the changed threshold, the amount of time devoted to investigations was significantly greater under the new competition test. Under the dominance test the TPC considered and cleared the vast majority of mergers within one week. However, in 1996 its successor the ACCC indicated that for the few mergers that raised very substantial issues that were likely to breach the Act, six to eight weeks were needed to provide a response. In matters that appear to breach the merger threshold, the ACCC will usually be able to complete its consideration within one month. In cases where it is satisfied that merger thresholds are not breached, the ACCC can usually inform the parties that no action will be taken in 10 to 15 days⁵⁹.

19. We need to be wary in interpreting the Australian experience, as Australia does not have a clearance process, it just has authorisation. However, what can be said is that the number of applications seeking clearance and then requiring authorisation will increase.

20. It is also likely that New Zealand experience of a broader threshold would be similar to that of Australia's. More mergers will be scrutinised but, given authorisation, only slightly more will be opposed.

21. The increased number of mergers scrutinised by the Commission will impose an increase in administration costs for the Commission and an increase in compliance costs for firms. The compliance costs for firms include the cost of applying for clearances and authorisations, and any additional costs if the Commission's decisions are challenged. Currently the application fee for clearance of a merger is \$2,250, and \$22,500 (both GST inclusive) for an authorisation. Added to these fees are the other costs firms bear in making their applications, which involve executive time and the cost of legal and economic advice. If an authorisation is subsequently required, travel and accommodation costs may also be incurred in attending any Commission conference.

Increase in uncertainty for business

22. Altering the threshold for mergers could also create a degree of business uncertainty, to the extent that participants would be unclear of the legal consequences of proposed mergers, particularly in the first years of the new threshold. However, as the 'substantial

⁵⁸ Statistics from - 'The ACCC's approach to mergers a statistical summary', Australian Competition and Consumer Commission, January 1998, p 4.

⁵⁹ *ibid* p 11.

lessening of competition' test applies elsewhere in the Act, and in Australia in relation to mergers and acquisitions, any uncertainty should be minimal. Merger decisions from the ACCC and from the Australian courts will provide useful guidance for the business community, and any residual uncertainty could be addressed by the Commerce Commission issuing revised merger guidelines.

Adopting section 50(3) of the Trade Practices Act

23. Another way to reduce uncertainty would be to adopt section 50(3) of the Trade Practices Act. Section 50(3) sets out the matters which must be taken into account in determining whether the acquisition would have the effect, or likely effect, of substantially lessening competition:

- the actual and potential level of import competition on the market;
- the height of the barriers to entry to the market;
- the level of concentration in the market;
- the degree of countervailing power in the market;
- the likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices or profit margins;
- the extent to which substitutes are available in the market or are likely to be available in the market;
- the dynamic characteristics of the market, including growth, innovation and product differentiation;
- the likelihood that the acquisition would result in the removal from the market of a vigorous and effective competitor; and
- the nature and extent of vertical integration.

24. One difficulty with providing such guidance in the statute is that it would force the Commerce Commission to consider every matter in section 50(3) in making its decisions even when they all may not be directly relevant. There is also a degree of overlap between the matters listed in the Australian section. Alternatively the Commission could revise its Merger Guidelines to define clearly what the relevant dimensions of market power are in its consideration of merger/acquisition proposals.

Streamline the clearance process

25. One way in which the increased compliance costs could be minimised, if the merger threshold was broadened, would be to try and streamline the clearance process. This could be done with or without a change to the threshold. If achievable, streamlining would better target the Commission's attention on those proposals that will substantially lessen competition, or create or strengthen dominance.

26. The current pre-merger notification regime distinguishes between applications depending upon whether a clearance or authorisation is sought. Clearance requires the Commission to consider whether the acquisition would create or strengthen a dominant position. Authorisation requires the Commission to consider whether the acquisition would be of net benefit to the economy. The time limits for each are 10 and 60 days respectively, with scope for extensions through agreement between the Commission and the applicant.

27. The potential problem with this is that there is a wide variation between the amount of time and effort needed to consider different clearance applications. The most complex

clearance proposals can require almost as much analysis as most authorisation applications. The consequences are that:

- for straightforward clearance applications the Commission seeks too much information in its standard forms, the 10 day limit is too long, and the application fee of \$2,250 is too high; and
- for more complex clearance applications the 10-day limit is too short, and the application fee is too low. This may encourage some applicants to seek a clearance where an authorisation application (fee \$22,500) is more appropriate.

28. An alternative would be a “short form-long form” system that distinguished applications by the amount of analysis needed, and not whether clearance or authorisation is being sought. A possible recipe, which is an adaptation of the Canadian regime, is as follows:

- i the applicant has the choice of completing the Commission’s “short” or “long” form;
- ii if the applicant submits the “long” form application, the Commission has 60 working days to consider whether to approve the application either on the grounds that it is not anti-competitive, or meets the public benefit test;
- iii the “short” form requires only the most fundamental information about the proposal;
- iv with “short” form applications, the Commission has the option of:
 - allowing five working days from the date of registration to lapse, in which case the proposal is deemed to be approved. Or at any time within the five days, the Commission could confirm in writing that the proposal has been approved; or
 - seeking further information from the applicant within the five working days, and extending the review period for up to another 10 days from the date of receipt of the additional information; or
 - inviting the applicant to complete the “long” form. If the applicant declines the invitation the proposal is deemed to be not approved. If the applicant agrees, the clock starts at zero and the Commission has 60 working days to consider whether to approve the application either on the grounds that it is not anti-competitive or meets the public benefit test.

29. This system could lower both the Commission’s administration costs and compliance costs for firms. It could also provide a more efficient distribution of the costs of merger scrutiny between market participants. These advantages suggest that if the clearance process could be streamlined along the lines of the Canadian regime, this would be preferable to the status quo.

Improving the threshold for Section 36

30. As discussed in Section 4, the key issue associated with the current section 36 is that judicial interpretation has narrowed its scope over time. This has reduced the section's effectiveness in prohibiting and deterring unilateral misuses of market power. Two options are presented in response:

- Option 1 - amendment of the definition of dominance in section 3(8) and the addition of definitions of 'use' and 'purpose'; or
- Option 2 - apply the Australian threshold to section 36 and the Australian definition of 'purpose'.

These options are not mutually exclusive and some hybrid between the two could also be an option.

Option 1 – Amendment of dominance, use and purpose

31. Option 1 would seek to restore section 36 to the scope originally intended by Parliament in 1986. This could be achieved by:

- *amending the definition of 'dominant position' in section 3(8);*
- *clarifying 'use' to mean a neutral causal connection between dominance and the purpose; and/or*
- *adding a statutory test for 'purpose' similar to section 46(7) of the Australian Trade Practices Act, that will allow for the inference of purpose from the dominant firm's conduct.*

Advantages of Option 1

32. The key advantage of Option 1 is that it would lower the threshold for section 36 only to the level originally intended by Parliament. Once case law is well established, this will mean that it will be able to prohibit and deter the dominant firms from misusing market power, with a lower risk that efficiency enhancing conduct is deterred (i.e. as compared with Option 2).

33. A new definition of 'dominant' in section 3(8) could focus directly on the concept of the misuse of market power. This would provide a more accurate characterisation of the market failure that section 36 is designed to address. This would refocus the interpretation of section 36 back on to the ability of a firm to behave to an appreciable extent in a discretionary manner without suffering detrimental effect.

34. In several respects Option 1 represents a codification of developing section 36 case law. Codification will create greater clarity in the interpretation of section 36 of the Act and thus greater certainty for market participants. This certainty will be achieved at a lower cost overall, i.e. by the passage of legislation, rather than through the more expensive alternative of private and public sector litigation.

Costs of Option 1

35. Although a redefined threshold for section 36 is likely to be of net benefit, it is acknowledged that an amended section 36 will impose costs on the economy. The key costs of addressing the issues associated with section 36 via Option 1 include:

- an increase in the level of legal uncertainty and thus some uncertainty to business. Although the courts are likely to be familiar with the general concepts, such as misuse of market power, the defining lines provided by the new legislation will take time and resources to develop;
- an increase in compliance costs for firms, at least in the first few years of the redefined section 36, as firms seek greater amounts of legal advice as a means to manage the increased uncertainty they face; and
- a slight deterrence of efficiency enhancing conduct for the largest firms in the economy until the uncertainty surrounding the new section is sufficiently dissipated.

Option 2 – Adopting the Australian threshold for section 36

36. The current problems with section 36 could be resolved by replacing the threshold for section 36 with one that refers directly to market power and adding a definition of purpose. This could be achieved by adopting the ‘substantial degree of power in a market’ threshold used in section 46 of the Australian Trade Practices Act. This would incorporate the Australian ‘take advantage of’ in replace of our section’s ‘use’. A definition of purpose would be provided via adoption of section 46(7). This would mean that the current threshold for section 36 would be replaced with:

A person who has a substantial degree of power in a market shall not take advantage of that power for the purpose of:

- *restricting the entry of any person into that, or any other market; or*
- *preventing or deterring any person from engaging in competitive conduct in that, or in any other market; or*
- *eliminating any person from that or any other market.*

37. The Australian section 46(7) would be picked up into our Act and this section states:

Without in any way limiting the manner in which the purpose of a person may be established for the purposes of any other provision of this Act, a corporation may be taken to have taken advantage of its power for a purpose referred to in sub-section (1) notwithstanding that after all the evidence has been considered the existence of that purpose is ascertainable only by inference from the conduct of the corporation or of any other person or from other relevant circumstances.

38. Adopting the Australian threshold will have the effect of lowering the threshold for section 36. A firm having a 'substantial degree of market power' will have a lesser degree of market power than a firm in a 'dominant position'.

Advantages of Option 2

39. There would be a number of advantages in resolving the issues concerning section 36, by adopting the Australian threshold. First, the Australian threshold has the advantage that it focuses directly on the concept of market power. As with Option 1, this would provide a more accurate characterisation of the market failure that section 36 is designed to address and should provide a better focus for judicial interpretation.

40. Second, as the Australian threshold of a 'substantial degree of market power' is a lower threshold than a 'dominant position in a market', this may make it easier for market participants to remedy instances of unilateral abuses of market behaviour. In this way it will be more effective in promoting competition in the economy.

41. Adopting the Australian threshold, would also give the Act the potential to respond to issues of joint dominance. Only one firm can be dominant at any given time within a particular market. However, there may be several firms in a market that have substantial market power, and who are able to jointly exercise that power for the purpose of restricting entry, preventing or deterring competitive conduct, or eliminating competitors.

42. The Australian threshold would also have the advantage of removing any concern about differences in the current thresholds in relation to the use of market power within trans-Tasman markets.

43. It is interesting to note parenthetically, that in the view of Brunt⁶⁰ New Zealand did not intend to achieve a higher threshold than the Australian statute. As she observes:

...it is a relic of a time when the Australian section 46 was couched in terms of a "position substantially to control a market", and is an interesting example of the manner in which the New Zealand statutory design may be caught in the coat-tails of Australian shifts of policy.

Costs of Option 2

44. The costs of addressing the issues associated with section 36 with adoption of the Australian threshold, will differ to some extent to those associated with Option 1. Specifically, Option 2 will not be associated with the same level of legal uncertainty as Option 1 will, as the business community will be able to look to Australian case law as a guide to likely interpretation by the New Zealand courts. The costs of Option 2 arise from lowering the threshold for section 36, which is likely to:

- increase compliance costs for business as a greater range of conduct would be expected to be caught;
- increase the Commission's costs of enforcing the Act and the costs of enforcement generally as there will be an increase the range of conduct subject to section 36; and
- increase the risk that efficiency enhancing conduct is either deterred or prohibited.

⁶⁰ Brunt M, 'Australian and New Zealand Competition Law and Policy', paper given at the 19th Annual Fordham Corporate Law Institute International Antitrust Law and Policy, October 22-23 1992.

7 Price Control

Introduction

1. The Government has signalled that it may implement price control on the electricity lines businesses if they do not reduce costs and prices. In examining requirements for the new electricity sector price control provisions, a small number of areas have been identified where the existing Commerce Act provisions may be deficient. It is proposed that change be made to the Commerce Act provisions on price control, relating to all sectors (not just electricity). The proposed amendments are outlined below. It is emphasised that these proposals do **not** signal any change to the Government's approach to price control generally. The changes discussed below will merely bring the Commerce Act provisions into line with current approaches to price control overseas and have been driven by the need to allow for an up-to-date approach to price control for electricity lines.

The proposals

Current approach to price control

2. Under the Commerce Act in its current form, once an Order-in-Council has been promulgated under section 53 of the Act declaring that the prices for goods or services be controlled, the responsibility for imposing price control passes to the Commerce Commission.

3. Section 70(1) of the Commerce Act provides that the Commission may "*authorise a maximum, actual or minimum price*". Section 70(4) says that the Commission shall "*authorise prices in such manner as it thinks fit*". Section 71 allows the Commission to authorise a provisional price and section 72(1) allows the Commission, instead of authorising a price, to "*obtain or accept a written undertaking from the supplier of those goods or services in relation to the price*".

4. Broadly speaking, therefore, the existing provisions of the Act allow the Commission to specify a price for goods or services. That is the approach that the Commission took when it last administered price control (the early 1990's).

5. The Government has no role in deciding the form of price control to be used by the Commission, if, in the future, price control is imposed on any goods or services. It does, however, have a role in ensuring that the relevant Commerce Act provisions **allow** the Commission to apply whichever form of price control it deems most appropriate within the framework provided by the Act. The current narrow provisions described above would not allow this.

Newer approaches to price control

6. The CPI-X (or price cap) approach was developed in the UK in the 1980s. Since then it has been more widely adopted and is generally considered to work reasonably well in comparison with other methods of price control in its objective of

introducing a proxy for competition on companies which operate in markets where competition is limited.

7. CPI-X involves the regulator (in this case the Commerce Commission) developing a formula for capping the average prices or total revenue for a firm so that price or revenue increases in one year do not exceed the percentage increase in the Consumer Price Index, minus (or plus) X. X is set by the regulator as a number which will impose a productivity incentive on the regulated firm, while at the same time allowing it to make an adequate rate of return if it meets the productivity level set. The regulator can also set any other parameters deemed necessary (such as service quality, or allowing the company to pass on to consumers increased costs that the regulator considers are outside the control of the firm).

8. Sliding scale or profit sharing has been suggested as an approach which might be useful as an alternative to CPI-X. However, it has not generally been taken up. Using this approach, the regulator would set a profit-sharing rule which divided excess profits between customers and shareholders by allowing dividend or rate-of-return increases only if prices were simultaneously cut.

9. Price control by itself does nothing to encourage the provision of acceptable quality goods or services. It is entirely possible, in a market where competition is limited, that a company would attempt to recover the revenue it had been forced to forgo under price control by reducing the quality of the goods or services it provided. This issue is particularly important in a CPI - X regime where one obvious way to recoup the revenue foregone by the imposition of the regime is to simply lower the quality (and therefore the cost to the regulated company) of the service it provides. Since the regulated company is, under the New Zealand regime, operating in a market where competition is limited or likely to be lessened, it is highly likely that the users of the company's goods or services will not have alternative sources of supply. The regulator may, therefore, wish to include in the price control an approach mandating a requirement that goods or services sold be of a specified quality.

Proposed amendments to provide for new price control approaches

10. It is proposed that sections 70 – 74 in Part V of the Commerce Act be amended by adding to the existing provisions for authorising prices, provisions which would allow for the following:

- a) the use by the Commerce Commission of a formula approach to determine allowed revenue or prices;
- b) relating prices or revenue allowed to forecast movements in the CPI;
- c) inclusion in the formula of:
 - (i) any productivity incentive factor which the Commission may set from time to time;
 - (ii) a correction factor to reflect under or over recovery; and
 - (iii) any other adjustment factors as the Commission may determine from time to time;

- d) requiring a company to price its goods or services in accordance with a schedule which links the rate of return achieved by the company with the price the company may charge for the provision of goods or services (in order to permit sliding - scale price control);
- e) clarifying that the Commission may set any service quality requirements and any requirements for verifying service quality it deems necessary.

11. Sections 52 -57 in Part IV of the Commerce Act (Declaration of Price Control) and sections 86 - 87 in Part I (Control of Prices) include references to the price for controlled goods or services. It is proposed that these sections be amended consequentially, to allow for the adoption of a formula approach instead of the specification of a price and to reflect that revenue rather than price may be controlled.

Additional amendments

Advice from Commerce Commission on price control criteria

12. Section 54 of the Commerce Act provides that the Minister for Enterprise and Commerce can ask the Commerce Commission to report on whether price control should be imposed. However, the Commerce Act in its current form does not provide for the Minister to obtain advice from the Commission on the thresholds or criteria for the application of price control. It is considered that such advice could be helpful. Therefore it is proposed to add such a provision to Part IV of the Commerce Act. The Government's agreement in principle to add such a provision was announced by the Minister for Enterprise and Commerce in April 1998, as part of a package of announcements on electricity sector reform.

Amendment to price control criteria

13. The existing section 73 in Part V of the Commerce Act is:

73. Considerations to be observed by Commission – In exercising its powers under section 70 and section 72 of this Act, the Commission shall have regard to –

- a) *The extent to which competition is limited or is likely to be lessened in respect of the controlled goods or services;*
- b) *The necessity or desirability of safeguarding the interests of users, or consumers or, as the case may be, of suppliers;*
- c) *The promotion of efficiency in the production and supply or acquisition of the controlled goods or services.*

14. Sections 70 and 72 relate to the mechanics of imposing price control. When this section comes into play, the decision to impose price control has already been taken by the Government under section 53 of the Act. Under section 53 the Minister shall not make a recommendation that goods or services shall be placed under price control unless the Minister is satisfied that:

- a) *Goods or services to which the recommendation relates are or will be supplied or acquired in a market in which competition is limited or is likely to be lessened; and*
- b) *It is necessary or desirable for the prices of those goods or services to be controlled in accordance with this Act in the interests of users, or consumers, or, as the case may be, of suppliers.*

15. It is considered redundant for the Commission to take section 73 a) and b) into account, as the Minister would already have considered these criteria under section 53. It is suggested that the only criterion which should be considered by the Commission in deciding on price control methodology is that contained in section 73 c). It is therefore proposed that sections 73 a) and b) be deleted from the Act.

Right to appeal Commerce Commission price control decision

16. Section 91 of the Act provides a right of appeal to the High Court against any determination of the Commission and section 92 of the Act sets out the persons who may appeal Commerce Commission determinations. Section 92 (a) allows an appeal against a decision by the Commission in connection with an application for an authorisation of a restrictive trade practice. Section 92 (b) allows the recipient of such an authorisation to appeal a Commission decision to revoke or vary such an authorisation. Section 92 (c) allows appeals concerning Commission decisions on business acquisitions.

17. Sections 92 (d) and (e) permit appeals against price control authorisations (that is the mechanics used by the Commission to arrive at a particular price) under section 70 of the Act. The bodies subject to price control and substantial consumers or purchasers have the right to appeal. The substantive decision to impose price control will have already been made by the Minister for Enterprise and Commerce under section 53. There is no right of appeal against decisions made under section 53.

18. Thus appeals under sections 92 (a) - (c) are against substantive Commission decisions to grant or decline applications for clearances or authorisations. Appeals under section 92 (d) - (e) however, must be confined to the technicalities of the approach taken by the Commission in setting a controlled price.

19. In hearing an appeal under section 92 (d) (*Auckland Bulk Gas Users v. Commerce Commission* [1990] 1 NZLR 448) the Court commented that, *in a case of price control and complicated detailed accountancy matters, ... it is important that the Court should give full regard to the decision of the Commission. It is not for this Court to overturn the Commission if it simply disagrees or thinks some other figure or figures or some other formulas might be preferred unless it appears that the Commission has gone wrong in principle or law or policy.*

20. In *Welgas Holdings Ltd v. Commerce Commission* ([1990] 1 NZLR 484) there were three issues. The first concerned an issue of natural justice and therefore is outside the existing appeal right. The second concerned whether the Commission had been correct in taking account of take-or-pay liabilities. The Court decided the Commission's decision was reasonable in the circumstances.

21. A third appeal related to the use by the Commission of a tax factor within the Capital Asset Pricing Model it employed. The Court considered the issue in some detail;

independent experts gave evidence for each side of the argument. The Court noted that the Commission was *palpably better placed to make decisions than an appeal Court working fairly closely to the adversarial mode*. The Court found in favour of the Commission.

22. In *Mercury Energy Ltd v. Transpower NZ Ltd* (High Court 18 December 1998) the Court noted:

Whilst the Court is not unaccustomed to dealing with matters of complex economic theory, pricing methodologies and the like, and whilst it has mechanisms available to assist it in deciding those questions, it was common ground that the setting of pricing principles would be a protracted matter of considerable complexity, ill-suited to the adversarial process and one which would require to be regularly if not continuously repeated.

Options

23. The Courts generally have therefore taken the view that the Commission's price control calculations and methodology are not appropriate matters to be appealed to the Courts. There is therefore an issue as to whether sections 91 and 92 are effective in their existing form. There would appear to be three options relating to these sections.

24. First, the appeal rights can remain in their existing form. In this case, companies would continue to be able to appeal the Commission's methodology.

25. Second, the right of appeal from price control determinations could be removed by repealing sections 92 (d) and (e). The right of judicial review would remain. Thus, if there were any assertions that the processes followed by the Commission were deficient, then judicial review would be the appropriate avenue for such challenges. Section 91 of the Act would also need to be amended to reflect the fact that there is no longer a right of appeal against any determination made by the Commission under section 70 of the Act.

26. The third option would be to restrict the appeal rights relating to price control determinations to issues of law. Under this option, decisions of the Commission would only be appealable if, in arriving at its decision, the Commission made an error of law. This option could be achieved by appropriately amending section 91 of the Act.

Penalties provisions

27. Sections 86 and 87 contain the penalties and remedies for contraventions of price control orders. Under section 86 (1) fines of \$10,000 can be levied for a contravention of section 55 by a person other than a body corporate and \$30,000 in the case of a body corporate. Currently, penalties for contraventions of Parts II and III of the Act are \$500,000 for persons and \$5,000,000 for bodies corporate.

28. On 11 February 1999 the Minister for Enterprise and Commerce announced amendments to the penalties and remedies sections of the Commerce Act to combat anti-competitive behaviour. The changes include:

- ♣ A maximum penalty of up to three times the value of the illegal gain or ten per cent of the firm's annual turnover.

- ♣ prohibiting firms from indemnifying their agents for any breaches of the Act, making these individuals accountable;
- ♣ giving the courts the discretion to ban offenders from directing or managing a body corporate for up to five years.

29. It is suggested that it is appropriate for the price control penalties also be amended in line with the changes outlined above.

30. If the Commission, as part of the price control regime, were to impose service quality standards, the normal penalty provisions in the Act would apply for any contravention. Additionally it will be appropriate to allow the Commission to set service quality standards which apply for individual consumers. In this case the penalty for not meeting the standard would be a rebate off the customer's bill (e.g. a rebate of \$20 for every hour over 4 if a company fails to restore power to a customer within 4 hours where the fault is within the control of the supplier). Some customer contracts already contain a similar provision. The penalties provisions of the Act will need to be amended to allow for such an approach.

8 Submissions called for

The Ministry is seeking written submissions from interested parties on the proposals outlined in Sections 6 and 7 of this document. The purpose of the submissions will be to inform decisions that the Government may take on the thresholds in sections 36 and 47 of the Commerce Act. The deadline for submissions is **14 May 1999**.

Questions for submitters

The Government is particularly interested to hear views on the following questions:

1. Is the current threshold for mergers and acquisitions appropriate? Is so why? If not, what threshold should apply and why?
2. Should applications for mergers and business acquisitions be scrutinized in terms of whether or not the resultant market structure would be conducive to collusion, either explicit or tacit?
3. Would replacement of the current merger threshold with the Australian threshold (i.e. substantially lessening competition) be of benefit to the New Zealand economy?
4. Do you have any comments on whether the clearance process for merger applications can, and should, be streamlined?
5. Is section 36 effective in helping to ensure competition is promoted in markets in New Zealand? If not – why not?
6. What would be the best strategy to resolve the issues associated with section 36:
 - (a) amending the definition of ‘dominance’, ‘use’ and ‘purpose’; or
 - (b) adopting the Australian threshold; or
 - (c) some other approach?
7. Do you have any comments on the proposal for amending the price control regime?
8. Are there any other changes that would make the Commerce Act more effective in promoting competition?

Contact details

Submissions should arrive no later than **14 May 1999** and should be directed to:

Competition Team
Competition and Enterprise Branch
Ministry of Commerce
PO Box 1473
WELLINGTON

Fax: (64 4) 499 1791

Email: gayelene.wright@moc.govt.nz

Delivery address: Level 9, Ministry of Commerce Building, 33 Bowen Street.

Confidential submissions should be clearly marked 'Confidential' and should be accompanied by a non-confidential copy with reasons given for any deletions.

The Ministry will maintain a public file of all non-confidential submissions.