NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION TO THE COMMERCE COMMITTEE ON THE COMMERCE AMENDMENT BILL

JULY 1999

1.0 Introduction

1.1 This submission on the Commerce Amendment Bill (the Bill) is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The NZBR has taken a close interest in Commerce Act issues because of the pervasive influence of the Act on commercial decision making in New Zealand.

1.3 In this submission we comment on the provisions in the Bill which propose the following changes to the Commerce Act:

- Amending section 30 so that bid rigging, market allocation and output limitation agreements are also deemed to substantially lessen competition.

- Inserting a new section 59A to enable the Commission to authorise restrictive trade practices that an applicant is already engaged in.

- Increasing penalties for breaches of Part II of the Commerce Act (restrictive trade practices, including provisions relating to the use of a dominant position in a market).

1.4 We oppose extending the reach of section 30 to include bid rigging, market allocation and output limitation agreements. We oppose the proposed increase in penalties for breaches of Part II of the Act. We support the proposed amendment that would allow the Commission to authorise restrictive trade practices that are already in place.

1.5 Section 2 of this submission discusses the proposal to extend the reach of section 30. Section 3 briefly examines the case for allowing the Commission to authorise existing restrictive trade practices. Section 4 discusses the proposals for increasing penalties for breaches of Part II of the Act. Concluding comments are presented in section 5.

2.0 Extending section 30

2.1 A variety of business arrangements are adopted by companies because they minimise the sum of transaction costs (costs of obtaining information, contracting, and so on) and production costs. The design of contracts can be complex and creative. Innovations in arrangements can be expected over time. Non-standard and complex contracts are often used to cope with the transaction costs that would arise with standard contracts. Where such

arrangements are mistakenly condemned by antitrust policies, the costs are potentially high.

2.2 The Commerce Amendment Bill proposes extending section 30 to capture 'hard core' cartel activity. We have three concerns with this proposal:

- Officials have not provided any convincing evidence that 'hard core' cartel behaviour is an actual problem in the New Zealand market. Policy should be based on real rather than theoretical problems.
- Not all bid rigging, market allocation and output limitation agreements are motivated by anti-competitive objectives, nor do they always have adverse efficiency effects in practice.
- The provisions will capture practices that they are not intended to capture and will distort decisions undesirably.

2.3 Officials have asserted, rather than demonstrated that there is a problem with 'hard core' cartels in New Zealand. There is little or no evidence that the provisions in the Commerce Act are not already adequate for dealing with anti-competitive agreements in relation to bid rigging, market allocation and output limitation agreements.

2.4 The proposed changes to the Act presume that price fixing, bid rigging, market allocation and output limitation agreements are always harmful when this is not necessarily the case. As with other arrangements, these practices are beneficial in some situations:

- Collective bargaining in the labour market is a form of price fixing. There is no reason to presume that it is typically an inefficient practice in open and competitive labour markets. Such a practice could be caught by the proposed changes if the application of the Commerce Act were extended to the labour market, as we believe it should be.
- Price fixing can reduce search costs for consumers. It may also be a way of managing an externality such as safety or after-sales service (since, once prices are fixed, firms will compete on quality).
- In an industry in which there are economies of scale, there may be no competitive equilibrium. Coordination of prices or market allocation may help achieve a stable market in the presence of economies of scale.[1]

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[1] Bittlingmayer, G, 'Decreasing Average Cost and Competition: A New Look at the Addyston Pipe Case', *Journal of Law and Economics*, vol XXV, October 1982.

2.5 Deeming these practices to be anti-competitive forces businesses using them to seek an authorisation even if there is no anti-competitive effect. The result is to increase the costs of doing business.

2.6 Of even more concern is the risk that the proposed extension of section 30 will capture harmless or efficiency-enhancing practices even though this is apparently not the intention of the provisions.[2]

2.7 For example, the allocation of territories by franchise operations is common. Allocation of territories can serve a number of pro-efficiency purposes. It can allow individual businesses to achieve economies of scale; it can encourage franchisees to deliver a high quality of service; it may allow the franchiser to promote the brand and can provide incentives for the franchisers and franchisees to invest in their reputations.

2.8 Many of the franchise operations, such as those that provide home services, are small and operate in competitive markets. The new provisions in the Act would force them to seek authorisation of their agreements even if there were no lessening of competition. Because of the cost of obtaining authorisations these businesses may be deterred from using such agreements even if they have no anti-competitive impact. They may be forced to adopt alternative, less satisfactory arrangements. For some small franchise operators, the cost of obtaining an authorisation could drive them out of business.

2.9 The constraint on bid rigging may also affect harmless practices. Companies and individuals bidding for contract work commonly enter agreements with potential competitors to submit a joint bid. Consortia may offer a mix of skills required to undertake a project, thereby reducing transaction costs. Competitors may also cooperate where a project is large relative to their resources. Cooperation allows the parties to share risks and to pool resources when they would not have the resources to handle a project individually. In some cases potential competitors would be considered as joint venture parties. Section 31 exempts joint ventures from the provisions of section 30. However, there are a number of requirements in section 31 that need to be satisfied. These may not always be satisfied when parties are involved in a joint bid.

2.10 In the paragraphs above, we have provided examples of arrangements which, although efficiency-enhancing, could be affected by the proposed amendments to section 30. Licensing agreements and other arrangements

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[2] Office of the Minister of Enterprise and Commerce, *Paper 2 – Reforming Penalties and Offences*, undated paper for Cabinet Economic Committee, notes at paragraph 21 that the prohibition on agreements would "not relate to arrangements between suppliers and re-sellers, for example franchise agreements".

between suppliers and distributors may also be caught by the provisions. Our conclusion is that the proposed amendment to section 30 of the Act is ill-considered. It appears likely to impose substantial net costs.

3.0 Allowing the Commission to authorise existing restrictive trade practices

3.1 Allowing the Commission to authorise pre-existing restrictive trade practices appears sensible. It would allow companies to correct a position that might have been created by an oversight, or to obtain greater comfort as to the legality of practices if circumstances change.

4.0 Increasing penalties for breaches of Part II of the Act

4.1 We oppose the proposed increases in penalties for the following reasons:

- There is little evidence that businesses deliberately flout the Commerce Act or that breaches remain undetected for extended periods.
- The proposed increases in the penalties do not give due recognition to the difficulty of determining whether or not actions breach the Act. There is often substantial uncertainty over whether particular actions breach the Act.
- The proposed increases will impose costs by deterring efficiency-enhancing behaviour.
- Underlying the proposed changes is the assumption that there exists a benchmark of 'perfect competition' which results in a particular allocation of the gains ('surplus') from a transaction between consumers and producers. The benchmark is flawed – perfect competition rarely, if ever, exists in practice – and it is wrong to assume that one particular distribution of surplus is 'right' and that others are illegal transfers of wealth.

4.2 We do not believe that there is a case for increasing the penalties for breaches of Part II of the Act. In our view there is little evidence that businesses are deliberately flouting the Act. On the contrary, businesses generally take a risk averse approach to Commerce Act matters, seeking clearance or authorisation of mergers and restrictive trade practices prior to their implementation if there is any doubt as to their legality.

4.3 If the potential gains from offending were large and the penalties insufficient, one might expect that firms would rationally choose to offend and re-offend repeatedly. Yet there is no evidence of such a problem.

4.4 Instead, observed behaviour is more consistent with the explanation that firms try not to contravene the Act and that breaches happen mainly because of genuine uncertainty as to whether or not behaviour is legal. Once uncertainty is clarified through Court action, businesses typically adjust their behaviour to stay within the law.

4.5 Firms make a considerable investment in their reputations for honesty and fair dealing. A finding that a business has breached the Commerce Act could have a substantial negative impact on its reputation, and on its custom. A focus on pecuniary penalties alone understates the impact of a finding that a business has breached the Commerce Act.

4.6 The proposed changes to the Act focus on 'hard core' cartel practices, on the basis that higher penalties are necessary because these arrangements are relatively difficult to detect. However, the assumption that cartels are difficult to detect, or that they can operate successfully for an extended period before they are detected, is not generally correct. The weight of theoretical and empirical evidence is that cartels are inherently unstable, and usually short-lived. They are unlikely to be effective except in very unusual situations.[3]

4.7 As well, the problems of detecting breaches of the Commerce Act do not generally arise because the behaviour is hidden, but rather because of the inherent difficulty of determining whether particular actions are legal or illegal. The difficulty of distinguishing legal from illegal business activity (in terms of the Commerce Act) is often severe. Many arrangements that reduce competition (allocative efficiency) result in cost savings (productive efficiency improvements). Determining whether there is a positive or negative impact on efficiency involves trading off the different effects. Identifying and quantifying the different impacts is very difficult and in many cases subjective. Reasonable people can come to different conclusions.

4.8 The changes proposed are also aimed at network industries because, it is claimed, the time taken to resolve disputes provides a strong incentive for an incumbent to continue litigation. However, it seems more likely that the time taken for the courts to decide cases is due to the difficulty of determining whether particular actions breach the Act. In *Telecom v Clear*, one of the most contentious cases heard by the courts, the issue involved was the pricing of access to Telecom New Zealand's network. In that case, the Privy Council overturned decisions made by New Zealand's Court of Appeal (which had itself overturned the decision of the High Court). This case

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[3] See, for example, Viscusi, W, Vernon, J and Harrington, J, *Economics of Regulation and Antitrust*, 2nd edition, MIT Press, Cambridge, 1995.

indicates that even expert judges can disagree over the legality or illegality of certain practices. The problem facing those in business is even more difficult.

4.9 It is also likely that inefficiency within the court system contributes to the delays in court decision-making. If this is a problem, it should be addressed directly. However, we do not support empowering the Commerce Commission to issue cease and desist orders as a solution to problems with court processes.

4.10 The proposals in the Bill also fail to recognise the incentives of competitors and new entrants (who may have a small market share in New Zealand but are not necessarily small companies) to engage in litigation and to prolong disputes in an attempt to disadvantage dominant incumbents. In part such action may be designed to encourage government intervention in favour of the new entrant. Strengthening the penalties in the Act and encouraging private litigation will serve to increase the anti-competitive use of the Act.

4.11 Because of the difficulty of determining whether or not behaviour breaches the Act, increasing the penalties may have perverse effects. While increasing the penalties may further deter undesirable behaviour, in our view the greater risk is that high penalties will deter desirable behaviour.

4.12 Increasing the penalties faced by individuals and preventing companies from indemnifying them is likely to exacerbate this effect. Individual managers are likely to be more risk averse than companies. They will therefore take a relatively conservative stance in relation to behaviour that could be deemed anti-competitive. Individual managers would generally only obtain a small share, if any, of any gain from anti-competitive behaviour. The same managers are likely to be held responsible if the firm is found to have breached the Act. The adverse consequences in terms of their personal reputation and future career prospects could be relatively large. The overall result is that managers are likely to reject borderline efficiency-enhancing arrangements under the current provisions of the Act. Any increase in the penalties imposed on individuals is likely to increase this effect. Again, although an increase in the penalties may have the positive effect of deterring some anti-competitive behaviour, it appears more likely on balance to have a negative impact on efficiency.

4.13 The penalty provisions in the Act apply to advisors (such as accountants, lawyers and investment bankers) as well as to the companies undertaking the disputed actions. The removal of the ability of employers to indemnify their employees will increase the reluctance of advisors to become involved in Commerce Act work, or to work on developing innovative contractual arrangements that might be found to breach the Commerce Act.

4.14 Managers and advisors will not generally be willing to bear the risk of the proposed penalties. In addition to increasing the conservative nature of their

approach to contracting arrangements, they will seek other means of protecting themselves from adverse Commerce Act decisions. One option would be to buy indemnity insurance (if it is available), an option that may be less efficient than indemnification by the individual's employer. This could increase the transaction costs of liability protection and waste resources. If managers and advisors cannot obtain protection through such means, they will be increasingly reluctant to work for companies such as Telecom New Zealand and other network companies that face the greatest Commerce Act risks. Since the market for managers is international, the network companies will be forced to pay higher compensation to attract managers. Consumers are likely to end up bearing the increased costs.

4.15 The proposal that penalties could be based on 10 percent of the total turnover of a firm is completely inconsistent with an approach that seeks to relate penalties to the expected value of the gain from a breach of the Commerce Act. This approach discriminates against larger firms since it exposes them to the risk that a relatively unimportant breach of the Act could result in disproportionately high penalties. A penalty based on 10 percent of a firm's turnover could eliminate the profits of a low margin business.

4.16 As noted in paragraph 4.1, the benchmark underlying the proposed changes to the Commerce Act penalties is flawed. It is wrong to assume that one particular distribution of surplus is 'right' and that others are illegal transfers of wealth. The perfect competition model, which appears to be the benchmark adopted by officials, does not provide a suitable benchmark. Perfect competition rarely, if ever, prevails in real markets.

4.17 The efficiency detriment from monopoly behaviour is the loss of welfare that results when consumers facing monopoly prices choose to buy substitute products that are more expensive to produce than the monopolist's products or are of lower quality. The result is a waste of resources (allocative inefficiency).

4.18 Monopoly profits that simply transfer income from consumers to producers are not a detriment judged by an efficiency standard. The Commerce Commission's guidelines note that distribution is irrelevant to the analysis of public benefits and detriments under the Act.[4]

4.19 However, underlying the proposed amendments to the Commerce Act is an assumption that a change in the share of 'surplus' between consumers and producers is wrong, and that it must be deterred by higher penalties. However, consumers only buy goods from producers if the benefit they receive exceeds the price they pay. Their decision to buy is voluntary and

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[4] Commerce Commission, *Guidelines to the Analysis of Public Benefits and Detriments*, October 1994 (revised December 1997).

any payments made to the supplier are the result of consumers' own choices. If efficiency is the objective of the Commerce Act, then these transfers are legal. An approach that bases penalties on the transfer of wealth between consumers and producers – a transfer that is not illegal – is suspect.

4.20 The suggestion that in contemplating injunctions, judges must consider the impact on consumers risks undue weighting being given to the distribution of the gains from transactions (between consumers and producers) rather than to the efficiency implications of particular arrangements.

5.0 Summary

5.1 With the exception of the proposed new section 59A of the Commerce Act, the Commerce Amendment Act should be withdrawn. Officials have not presented a convincing case for extending the reach of section 30. Neither have they made a convincing case for increasing the penalties that apply under the Act.

5.2 There is little or no evidence that bid rigging, market allocation or output limitation agreements are a particular problem in the New Zealand market or that the current provisions of the Act are not adequate for dealing with situations where such practices are detrimental.

5.3 There is little or no evidence that companies breach the Act because of inadequate penalties or that judges are constrained by the penalties available.

5.4 While the proposals might increase the deterrence of anti-competitive behaviour, they will also deter efficiency-enhancing behaviour. The costs of the latter are likely to outweigh the benefits of the former.

5.5 We also note that the provisions are likely to affect a number of practices such as market allocation by franchises that are not anti-competitive at all. The result would be to substantially increase the costs to businesses operating in competitive markets for no positive offsetting benefit.

5.6 In our view officials have failed to demonstrate that there is a problem, that the proposed changes to the Commerce Act are the best way of dealing with the supposed problem, or that the benefits of the proposed changes outweigh the likely costs. The relevant amendments should not proceed.