NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION TO MINISTRY OF COMMERCE

PENALTIES, REMEDIES AND COURT PROCESSES UNDER THE COMMERCE ACT 1986

MARCH 1998

1 INTRODUCTION

This submission is made by the New Zealand Business Roundtable (NZBR), an organisation of the 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 national interests.

The NZBR has taken a close interest in Commerce Act issues over the years because of the Commerce Act's pervasive influence on economic activity in New Zealand.

The Ministry of Commerce's current review focuses on enforcement of the Act. Its report *Penalties, Remedies and Court Processes Under the Commerce Act 1986: A Discussion Document* (the Discussion Document) examines what penalties and remedies should apply to Commerce Act breaches in principle. It compares these with existing practice, and draws the conclusion that penalties and enforcement are not sufficient to deter anti-competitive behaviour.

This submission comments on the Discussion Document. The NZBR does not believe that the Discussion Document makes a convincing case for increasing penalties for breaches of the Commerce Act.

This submission begins in section 2 by restating the NZBR's view that the priority for reform is implementation of the decisions reached during the 1992/93 review of the Commerce Act and the completion of the review of thresholds. Section 3 focuses on the Discussion Document. Concluding comments are presented in section 4.

2 UNFINISHED BUSINESS

The NZBR supported the government's 1991-93 review of the Commerce Act and considered that the outcome of the review was generally satisfactory. We welcomed the primacy the review gave to economic efficiency (measured in terms of total producer and consumer surplus) as the basis for government intervention under the Commerce Act. We were in favour of the review's conclusion that no weighting should be given to income distribution considerations ("Government's policy is to value resources equally regardless of whether they are in the hands of consumers or producers").[1] In our view, most, if not all of the recommendations of the review would have improved the Commerce Act. We did not consider the review dealt adequately with the labour market and producer boards.

In the follow-up phase of this exercise we supported the review of the different thresholds applying in the Act to acquisitions and restrictive trade practices. Our view was that the

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1 *Commerce Act Review: Decisions*, paper attached to letter from Ministry of Commerce to Roger Kerr, 4 March 1993 (copy attached as an annex).

same threshold should apply to both acquisitions and commercial practices and that the assessment of harm should focus on 'market power' rather than 'dominance' or 'lessening of competition'. We were disappointed that the Ministry of Commerce took no action after the release of its discussion document on the threshold issue.

The NZBR notes with concern that the government has not implemented the decisions reached during the 1992/93 review and that it did not reach a decision on the threshold issue. We believe that it is important that both the regulatory authorities and the private sector are able to operate within the best and clearest set of rules possible. The enactment of the review decisions and adoption of consistent thresholds would be most helpful in that regard.

In our view, implementation of these changes would have a much more significant and positive impact on economic efficiency than any of the proposals contained in the current paper. We urge the government to give them priority.

3 DISCUSSION DOCUMENT

3.1 Overview

The Discussion Document fails to make a convincing case for increasing penalties for breaches of the Commerce Act. It overstates the costs of monopoly behaviour by implicitly assuming that income transfers are detriments to consumers. It does not give due recognition to the difficulty of determining whether or not actions breach the Act and underestimates the costs that might be imposed by increasing penalties for breaching the Act.

The paper suggests that problems exist by constructing theoretical worst case scenarios which are unlikely to prevail in practice. The paper does not provide evidence that businesses are deliberately flouting the provisions of the Act or that breaches remain undetected for extended periods. On the contrary, there is strong evidence that businesses take a risk averse approach to Commerce Act matters, seeking clearance or authorisation of mergers or restrictive trade practices prior to their implementation if doubts exist as to their legality.

3.2 Objective of the Commerce Act

The Discussion Document notes that "the underlying objective of the Commerce Act is economic efficiency, with the protection of competitive processes being the means to achieve it." The paper notes that giving competition laws multiple objectives can undermine the efficiency objective and observes that fairness should not be part of the substantive provisions of the law.

The NZBR strongly supports the view that economic efficiency should be the primary objective of the Commerce Act. An objective of efficiency maximisation focuses on ensuring that the mix of goods most preferred by consumers is produced at minimum cost. The efficiency approach aims to maximise the size of the economic cake.

An efficiency standard would regard as legal those monopoly practices that generated benefits (such as achievements of economies of scale) that outweighed the costs in terms of misallocated resources. Under an efficiency standard competition is valued to the extent that it achieves an efficient outcome ñ it is not valued as an end in itself. An efficiency approach puts equal weights on consumer and producer interests rather than arbitrarily favouring one over the other.

Although income distribution is an important factor in determining economic welfare, we do not believe this is appropriately pursued through antitrust policy. The Commerce Act is not a transparent means of achieving income distribution objectives. Income distribution objectives can be achieved more effectively through other mechanisms such as the tax and transfer system.

Despite the Discussion Document initially accepting that efficiency is the primary objective of the Act (with competition the means to achieving efficiency), it adopts quite a different approach throughout. In particular, the Document is dominated by an implicit or explicit concern about the income transfer impacts of monopoly pricing.

The paper introduces income transfer concerns by quoting Charles Rule: "the people who take your money this way [by price fixing] are thieves".[2] It also notes that "a non-economic argument is that the producer monopoly profit is a coerced transfer of wealth from consumers to producers and should be taken into consideration on the grounds that it does not improve social welfare". It observes "this reduction in consumer surplus is gained by producers. There is debate about whether that consequence, ie the 'producer monopoly profit', should be treated as a detriment".[3]

The Discussion Document does not explicitly support the suggestion that monopoly profits should be illegal but its approach and language throughout suggests strong sympathy for this position.

However, it is absolutely clear that the efficiency detriment from monopoly behaviour is the loss of welfare that results when consumers, in the face of monopoly prices, choose to buy substitute products that are more expensive to produce than the monopolist's product or are of lower quality. For a given level of consumer satisfaction, resources are wasted (this is termed allocative inefficiency).

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2 Ministry of Commerce, (1998) *Penalties, Remedies and Court Processes Under the Commerce Act 1986: A Discussion Document*, January 1998, p 6.

3 *Ibid*, p 7.

A higher monopoly producer profit is not a detriment judged from the efficiency standard if it merely reallocates income from consumers to producers. Transactions generate benefits to consumers and producers measured by the sum of consumers' surplus and producers' surplus.[4] Economists sometimes draw on a theoretical economic model (the perfect competition model) to provide a benchmark for an 'acceptable' division of the benefits from transactions ñ this is implicitly the standard adopted in the Discussion Document. But where there are substantial fixed or common costs, a producer may have to price above marginal cost to cover total costs. Other models (such as the contestability model that recognises that prices sometimes need to be set above marginal cost to allow total costs to be recovered) provide different benchmarks. Economics provides no way of determining whether one income distribution is superior to another since the choice involves value judgments that differ between individuals.

The argument that any monopoly profit is a coerced transfer between producers and consumers ñ or theft ñ is also incorrect. Consumers only buy goods from producers if the benefits to them exceed the price they pay. Their decision to buy is entirely voluntary and any payments made to the supplier are a result of consumers' own choices.

It is worth noting that, in principle, a price-discriminating monopolist can capture all of the consumer and producer surplus but produce output at the socially optimal level. In that situation there is no allocative efficiency loss.

3.3 Economic approach to determining remedies

The Discussion Document outlines the economic approach to determining optimal sanctions. We agree in principle with this approach which assumes that the primary purpose of penalties is to deter undesired behaviour and that companies rationally respond to the expected penalties.

The economic approach suggests that potential offenders will be deterred by penalties set so that the expected cost of violating the law is equal to the harm imposed on society by the activity, including any wealth transfers. The lower the probability that offences will not be detected, the higher should be the optimal penalty.

The economic approach could, in principle, be applied simply if the monopoly profit[5] was a detriment. In that case, the optimal penalty would be based on the sum of the monopoly

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4 Consumers' surplus is measured as the benefit each consumer receives from the good net of the price paid for the good. Producers' surplus is measured as the benefits the producer receives from producing the good, net of the costs of making it.

5 In principle, economists are concerned about the efficiency implications of setting prices above marginal costs. However, where common costs are important or there are economies of scale, prices must be set above marginal costs if total costs are to be covered (otherwise the firm will go out of business). Monopoly profits are only generated if prices are set above the level sufficient to cover average costs. Generally the position of

profit and the deadweight losses generated by monopoly pricing as suggested in the Discussion Document. Such a penalty would ensure that monopoly behaviour only took place if there were efficiency gains (such as cost savings) greater than the deadweight losses that resulted from monopoly pricing. This approach would also be correct if all of the monopoly profits were wasted in rent-seeking behaviour.

The problem is that if efficiency is the primary objective of the Commerce Act then monopoly profits are not 'illegal gains' or 'harm to consumers'. Consider the case of a perfectly price-discriminating monopolist who raises prices but does not cause any deadweight losses. If efficiency is the standard, then the monopolist has not breached the Commerce Act. Yet under the proposed approach the monopolist would face penalties based on the monopoly profit. An approach that penalises legal behaviour or bases penalties on income transfers that are not illegal is suspect. The dilemma is that only if the penalties do include income transfers will they provide incentives to avoid the deadweight losses associated with monopoly behaviour.

The Discussion Document suggests that penalties should be high because of the difficulty of detecting breaches of the Commerce Act. However, 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. Increasing penalties in these circumstances would have perverse effects.

The Discussion Document notes that high penalties could significantly deter legal borderline behaviour if the likelihood of punishing illegal activity is not much greater than the probability of punishing legal behaviour. The paper does not comment on whether this is indeed likely to be the case for antitrust cases. Polinsky and Shavell, two of the most prominent authors on the economics of crime, note that "the occurrence of legal error seems inevitable".[6]

In our view the difficulty of distinguishing legal from illegal business activity (in terms of the Commerce Act) is often severe, resulting in genuine uncertainty as to whether or not actions breach the Act. Many arrangements that adversely affect allocative efficiency result in productive efficiency improvements. Determining whether there is a positive or negative impact on efficiency overall 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. The lack of clarity as to the objectives of the Act increases the difficulty of determining whether business arrangements breach the Act.

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the average cost curve is not known so it is very difficult to determine whether a firm is setting monopoly prices.

[6] Polinsky, A Michael and Shavell, Steven, (1989) "Legal Errors, Litigation, and the Incentive to Obey the Law", 5, *Journal of Law, Economics and Organisation*, p 99.

Increasing the penalties may further deter undesirable behaviour, but in our view the greater risk is that desirable conduct would be further discouraged and that this negative impact would outweigh any potential gains.

As well, an increase in penalties can have complex impacts beyond just deterring breaches of the Act. In a study of US price-fixing and bid-rigging cases, Edward Snyder estimates the deterrent effect of increasing penalties.[7] He considers the changes in behaviour since 1974 when the US congress increased the penalties for criminal anti-trust offences from misdemeanour to felony level. This meant that the maximum fine increased from $50,000 to $1 million, and the maximum prison sentence from one year to three years.

Snyder examines two questions: "First, how do the courts react to statutory changes in penalties? Second, does the threat of higher penalties significantly reduce the number and severity of offences committed?" Snyder notes two main deleterious effects of increased penalties. The first is that offenders will increase their spending to reduce the probability of prosecution and conviction. The second is due to legal error. Snyder identifies a number of possible effects of legal error. First, non-offenders may spend resources to reduce the probability of prosecution and conviction. Second, firms are likely "to consider the role of legal error in choosing among business practices and may avoid efficiency-enhancing practices that may be construed as violations".[8] Third, the courts may react to the higher maximum penalties by requiring a higher standard of proof, assuming they react to legislative change. The combination of these effects may make it harder to convict those not deterred by the higher penalties.

Snyder finds evidence of a decline in the number of successful prosecutions, after taking account of more relaxed enforcement during the Reagan presidency. He concludes[9] that when higher penalties apply, defendants are more likely not to plead guilty, and that the higher penalties have reduced the probability of conviction in cases that are litigated.[10]

Snyder suggests that the results are inconsistent with the possibility that the sole effect of higher penalties is to influence the decision to commit an offence, ie to deter offending.[11] The Discussion Document also ignores the scope for the Commerce Act to be used anti-competitively. An increase in penalties may encourage greater use of the Act for anti-competitive purposes. Baumol and Ordover comment on the US antitrust environment as follows:

> " whenever a competitor is too successful or too efficient, whenever his competition threatens to become sufficiently effective to disturb the quiet and

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7 Snyder, Edward A, (1990) "The effect of higher criminal penalties on anti-trust enforcement", *Journal of Law and Economics,* 33, pp 439-462.

8 *Op. cit.*, p 440.

9 He uses a bivariate probit analysis to account for the selection of cases to go to trial instead of being settled.

10 *Ibid*, p 452.

11 *Ibid*, p 456.

> easy life his rival is leading, the latter will be tempted to sue on the grounds that the competition is 'unfair'. Every successful enterprise comes to expect almost as a routine phenomenon that it will sooner or later find itself the defendant in a multiplicity of cases " .[12]

In the United States, for example, Microsoft has gained a large market share by providing products that meet consumers' needs. Its competitors (and others) are now using antitrust actions to attack its market position.

3.4 'League table of offences'

The Document singles out 'hard core cartels' as being at the top of a 'league table of offences' because price fixing, bid rigging agreements and the like are "obviously illegal under s27" and also that they are presumed to be difficult to detect.

However, cartel behaviour is not different in kind from other behaviour that might breach the Commerce Act. The efficiency concern is the deadweight loss from reducing output and any efficiency losses that might arise from rent-seeking behaviour. As with other arrangements, there are some situations in which price fixing brings offsetting benefits. For example, price fixing can reduce search costs for consumers. It may also be a way of managing an externality such as safety (since once prices are fixed, firms will compete on quality) or to allow the sharing of resources to achieve economies of scale.[13] Antitrust policy should not arbitrarily discriminate against price coordination across independent firms relative to the alternative of horizontal integration which would result in prices being determined within a single firm.

The assumption that cartels are difficult to detect, and can operate successfully for decades before they are detected, is based on a small number of cases which are not representative of the main conclusions of theoretical and empirical research. The weight of evidence indicates that price fixing cartels are inherently unstable and usually short-lived. It is possible to build theoretical models of collusive behaviour in which cartel members have incentives to stick to the agreed prices and outputs. However, these models are most useful for identifying the numerous impediments to effective cartelisation:

Collusion may attract entry ñ markets are powerful at breaking down barriers. Government regulation is one way that a cartel might be protected from competition;

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12 Baumol, William J and Ordover, Janusz A, (1985) "Use of Anti-trust to Subvert Competition", *Journal of Law and Economics*, p. 247-270.

13 Gans, J and Officer, R R, (1997) *The Economic Theory of Damages for Price Fixing Violations*, draft report, p 3.

The division of any monopoly profits between members of a cartel will be arbitrary and uncertain. As the number of firms in a cartel increases, collusion becomes more difficult. The extra gain from cheating on the agreement as the number of firms increases more than offsets the extra pain of the punishment from cheating;

Agreeing on the cartel price is difficult, especially when the firms are of different sizes or have different cost structures;[14]

Individual firms have difficulty constraining their sales staff from increasing sales at the expense of other cartel members;

Detecting cheating by cartel members can be difficult, which increases the difficulty of sustaining the cartel. Low prices may represent a breakdown of the cartel, or a shift in demand for the good.

If the product is differentiated on quality, it is easier for a cartel member to cheat without detection by altering the quality of the product than if it is homogeneous.

Because of these factors, cartelisation is generally difficult. If a cartel is established, internal pressures are more likely to destroy it than external efforts. Thus the Discussion Document's focus on cartels overstates the potential problems they create and the potential benefits from antitrust action or penalties.

The Document suggests that because the gains to price fixing are so large, pecuniary penalties may not be sufficient to deter such behaviour. It also draws an analogy between price fixing and theft or fraud to support the recommendation that criminal sanctions should apply to cases of price fixing and other 'hard core' cartel behaviour.

These conclusions cannot be supported. They are based on the mistaken introduction of income distribution considerations into the calculation of the harm arising from price fixing and other cartel behaviour. The income transfers (which are not illegal) substantially inflate the estimate of the damages from price fixing. Changes in the allocation of the gains from trade are different in nature to theft since they are the outcome of voluntary transactions between suppliers and consumers.

3.5 Pecuniary penalties applied in New Zealand

There is no evidence produced to support the proposition that breaches of the Act are occurring because the penalties imposed under the Act are too low. If the potential gains from offending are as large and difficult to detect as is suggested by the Discussion Document, and the penalties so low, one might expect that firms would rationally choose to offend and to reoffend repeatedly. Yet there is no evidence of such a problem.

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[14] Viscusi, W Kip, Vernon, John M and Harrington, Joseph E, (1995) *Economics of Regulation and Anti-trust*, 2nd edition, MIT Press, p 119.

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 adjust their behaviour to stay within the law.

The Discussion Document uses a theoretical scenario to draw the conclusion that "the maximum penalty limits under the Act are too low to deal with the worst case scenario".[15] Of course this begs the question of why industries do not deliberately contravene the Act if the benefits are so great and the Commerce Act penalties so low. More importantly, policy recommendations should be based on actual rather than theoretical problems.

Most New Zealand firms are likely to regard the current maximum penalties as significant. The Discussion Document suggests that the penalties are small relative to total turnover of a firm. However, a more relevant consideration is the effect on firm profits. The maximum penalties are in the order of 0.5 to 15 percent of net operating profits for the twenty largest listed New Zealand companies and range up to 60 percent of net profits for the top 50 companies. The maximum penalties would therefore have a substantial impact on the profitability of large New Zealand companies.

The Document suggests that judges are not using penalties to deter anti-competitive behaviour. However, judges are charged with interpreting the law and imposing appropriate penalties. They are in the best position to judge the trade-offs important in a particular case. The penalties judges have awarded in Commerce Act cases suggest that the maximum penalties are more than adequate to deal with the cases that come to court. If judges were imposing maximum penalties in most cases, there would at least be some evidence of a problem.

3.6 The role of damages

The Document considers whether damages awards should aim to compensate the consumer 'victim' for losses arising out of the anti-competitive conduct. However, the use of market power to increase the price above marginal cost does not involve any arbitrary removal of property. Some consumers will decide not to buy the good, and will spend their money elsewhere. Others will decide to buy at the higher price but will only do so if the benefits from the transaction outweigh the costs. The transfer of consumer surplus to the producer does not affect efficiency. Antitrust actions should not be based on an arbitrary view of how the gains from trade should be distributed.

It is worth noting also that an increase in damages awards may also result in greater use of the Commerce Act for anti-competitive purposes.

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15 *Ibid*, p 3.

3.7 Injunctions and other orders

The Document takes a simplistic view of the role of injunctions in competition law. The preliminary conclusion drawn is that "the interests of consumers have not rated highly compared with other factors. This means, in effect, that the Court's approach to injunctions is not serving the deterrence objective as well as it might". The Document takes little account of the possibility that antitrust remedies in general and injunctions in particular may be used as anti-competitive devices by rival companies, especially inefficient rival companies. The implicit assumption is that the plaintiff has a valid case.

In addition, the Document's emphasis on restoring the "harm suffered by the victims during the course of the legal proceedings" focuses on the transfer of consumer surplus to producers instead of on the allocative inefficiency caused by the exercise of market power. Consumers voluntarily chose to buy the good at the higher price because the benefits to them exceed the costs. We disagree with the conclusion that the Court's reluctance to grant interim injunctions has worked to the detriment of the interests of consumers.[16] The interests of consumers are best served by creating an environment in which the most efficient firms operate and seek new ways to produce the goods valued most highly by consumers. The liberal use of injunctions can have the opposite effect. Competitors have an incentive to oppose attempts by rival firms to reduce prices or improve services.

3.8 Court processes

The Discussion Document examines possible changes to court processes to improve enforcement of the Act. In our view, these considerations should be part of a broader review of changes to court processes rather than being considered in isolation.

4 SUMMARY

The Discussion Document does not make a convincing case for increasing penalties that apply under the Commerce Act. It presents no evidence that firms are breaching the Act because of inadequate penalties. There is also no evidence that judges are being constrained by the penalties available.

We do not accept that 'hard core cartels' should be subject to special treatment or that criminal sanctions should apply to price-fixing or other cartel behaviour. The Discussion Document's recommendations appear to be driven to a large extent by a view that income transfers constitute harm. This approach is inconsistent with the Document's acceptance that the primary objective of the Commerce Act is efficiency.

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16 *Ibid*, p 45.

We consider that priority in future reforms of the Commerce Act should be given to the issues discussed in section 2 of this submission.