



COMMERCE COMMISSION

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**THE COMMISSION'S APPROACH ACROSS
ITS RESPONSIBILITIES**

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INTRODUCTION

1. In this paper I describe key aspects of the Commission's approach to its responsibilities under the Commerce Act 1986, the Telecommunications Act 2001 and the Dairy Industry Restructuring Act 2001, focusing on the Commission's adjudication role. There have been a number of developments in the regulatory environment, so it is timely to consider the Commission's approach to the following:

- The restrictive trade practice and business acquisition provisions (Parts II, III and V of the Commerce Act);
- The general control provisions as applied in the draft airports inquiry report (Part IV of the Commerce Act);
- The special control regime applying to large electricity lines companies (Part 4A of the Commerce Act);
- The regime applying to telecommunications (Parts 2 and 3 of the Telecommunications Act); and
- The constraints applied to the dairy industry (Part 2 of the Dairy Industry Restructuring Act).

2. The Commission is also responsible for enforcing the Fair Trading Act 1986. I do not cover the Commission's fair trading responsibilities in this paper.

3. The Commission seeks to ensure consistency across its responsibilities both in terms of its economic framework and its general approach. However, the statutory provisions applying to the different areas differ, and these differences are reflected in the Commission's approach.

4. This reports work-in-progress in many areas, with the Commission's approach potentially subject to change as further developmental work is undertaken, submissions are received from interested parties and we gain experience in the different areas.

RESTRICTIVE TRADE PRACTICES AND BUSINESS ACQUISITIONS

Statutory Provisions

5. The Commission decides applications for clearance of business acquisitions, as well as authorisation of restrictive trade practices ("agreements") and of business acquisitions that substantially lessen competition. It is also responsible for investigating conduct that may breach the restrictive trade practice and business acquisition provisions of the Commerce Act.

6. The Commerce Act prohibits the entering into or giving effect to contracts, arrangements or understandings that substantially lessen competition in a market; contain

exclusionary provisions; or have the purpose or likely effect of fixing prices between competitors (ss27 to 30).

7. The Act prohibits business acquisitions that would have or be likely to have the effect of substantially lessening competition in a market (s47).

8. The Commission may authorise an agreement or business acquisition if the public benefits outweigh the detriments from the lessening of competition (Part V). In the analysis of public benefits, the Commission must have regard to any efficiencies that result (s3A).

The Economic Framework

9. Parts II and III of the Commerce Act do not have their own purpose statements. The Commission is therefore guided by the purpose statement of Act which is “to promote competition in markets for the long-term benefit of consumers within New Zealand”. The Commission considers that an efficiency-based approach to the analysis of agreements and business acquisitions is consistent with the objectives of the Act.

10. The Commission views a lessening of competition as equivalent to a strengthening of market power. It focuses on the impact of a proposed transaction on the unilateral or coordinated exercise of market power. In assessing the impact on competition, it considers the constraints potentially imposed by domestic rivals, imports, potential entrants, and other competition factors.

11. The Commission uses a forward-looking, counterfactual approach to assess the competition effects of a business acquisition, comparing two future scenarios: with the acquisition and without.

12. The Commission also uses a counterfactual approach to measure the detriments and benefits in authorising both acquisitions and agreements. The Commission assesses the detriments and public benefits from business transactions in terms of their effect on allocative, productive and dynamic efficiency, using a competitive market model.

13. The Commission generally does not take into account income distribution between New Zealand consumers and producers, but may discount the interests of foreigners in certain circumstances.

CONTROL OF GOODS OR SERVICES

Statutory Provisions

14. Part IV of the Commerce Act provides for the imposition of control when particular conditions are met. Part V provides for the authorisation of prices, revenues and quality standards of controlled goods and services.

15. The Commission is responsible for advising the Minister on the need for control (either of its own volition, or at the direction of the Minister), and for administering any control regime imposed by the Minister.

16. The Minister may only recommend control if he/she is satisfied that competition in the relevant market is limited or likely to be lessened, and it is in the interests of acquirers or suppliers that control be imposed (s52).

17. There are no goods or services controlled under Part IV of the Commerce Act at present. The Commission was last involved in price control in the late 1980s and early 1990s when prices for natural gas, flour, wheat and milk were controlled.

18. The Commission's July 2001 report on airfield activities at Auckland, Wellington and Christchurch international airports, the "Draft Airports Study"¹ is its first examination of whether control should be imposed under Part IV of the Act. It presents the Commission's preliminary views which could change in the final report.

The Economic Framework

19. The control provisions of Part IV of the Commerce Act are focused on the interests of acquirers or suppliers. Economic efficiency and income distribution are therefore both important considerations.

20. In considering whether competition is limited, the Commission focused on the potential for companies to exert market power in defined markets. The Commission's approach to defining markets and analysing market power was the same as that used under Parts II and III of the Commerce Act.

21. However, the Commission's view is that the "limited competition" threshold of Part IV is lower than the "lessening of competition" threshold in Parts II and III. The "lessened" threshold in Part IV, which was not used in the Commission's analysis, appears to be an even lower threshold.

22. In assessing whether control would benefit acquirers (suppliers were not relevant) the Commission used a forward-looking counterfactual approach in which it compared two future hypothetical scenarios: one with price control and one without control. Its approach is analogous to that used for Parts II and III of the Commerce Act.

23. To determine the "with control" scenario, the Commission estimated the potential efficiency losses and income transfers in the "without control" scenario compared to the Commission's theoretical model of workable competition. The Commission then deducted from this estimate, the potential direct and indirect costs of control that would fall on acquirers.

¹ Commerce Commission, *Draft Report: Price Control Study of Airfield Activities at Auckland, Wellington, and Christchurch International Airports*, July 2001.

24. In assessing the potential efficiency benefits to acquirers of control, the Commission considered the effects on allocative, productive and dynamic efficiency.

25. In its draft report in deciding whether to recommend control, the Commission conducted a net benefit analysis that focused on economic efficiency. This analysis is analogous to the net benefit test used for trade practices and business acquisitions.

26. The statute is framed in terms of the interests of acquirers, so the transfer of rents between the airports and acquirers is arguably relevant but the distribution of income between New Zealanders and foreigners is not. This approach, if adopted, would contrast with the approach adopted for agreements and business acquisitions, where income distribution is not considered other than to discount the interests of foreigners in some circumstances.

27. The views expressed in the Draft Airports Study were the Commission's preliminary views. These views are potentially subject to change in the final report.

ELECTRICITY DISTRIBUTION AND TRANSMISSION INDUSTRY

Statutory Provisions

28. Part 4A of the Commerce Act introduces a special statutory scheme for the targeted control of large electricity lines businesses in markets directly related to electricity distribution and transmission. Electricity is the only industry subject to a special control regime under the Commerce Act. The Commission, not the Minister, may impose control.

29. The Commission's role is to design thresholds for the declaration of control, determine whether control should be declared (and to declare control), and to administer any control regime. (The Commission's other responsibilities under Part 4A are not considered here.) The Commission's proposed approach was outlined in the March 2002 Discussion Paper.²

30. The Commission was guided by the purpose statement in Part 4A (subpart 1). This states that the purpose is to promote the efficient operation of electricity distribution and transmission markets through targeted control for the long-term benefit of consumers by ensuring suppliers:

- (a) are limited in their ability to extract excessive profits;
- (b) face strong incentives to improve efficiency and provide the quality consumers demand; and

² Commerce Commission, *Regulation of Electricity Lines Businesses: Discussion Paper*, 21 March 2002.

- (c) share the benefits of efficiency gains with consumers (s57E).

The Economic Framework

31. The focus of the legislation is on the long-term benefit of consumers. Economic efficiency was the Commission's primary consideration. Income distribution was considered relevant to the objectives of limiting excess profits and ensuring the sharing of efficiency gains with consumers. No distinction was drawn between New Zealanders and foreigners.

32. The legislation assumes that competition in the relevant markets is limited so the Commission did not need to undertake such analysis.

33. The Commission drew on the properties of competitive markets in developing thresholds. It proposed comparing the performance and behaviour of the line businesses to thresholds established on the basis of the theoretical model of competition.

34. The Commission proposed four possible thresholds (efficiency, profit, sharing and quality) based on the purpose statement of Part 4A.

35. The Commission has not developed in any detail the approach it would adopt to assessing whether to impose control.

TELECOMMUNICATIONS INDUSTRY

Statutory Provisions

36. The Telecommunications Act 2001, which governs the regulation of the telecommunications industry, requires the Commission to:

- Promote negotiation of agreements between access providers and seekers;
- Make determinations in respect of designated services and specified services having regard to the purpose of the Telecommunications Act, and the standard access and pricing principles listed in Schedule 1;
- Recommend to the Minister of Communications the addition, amendment, or omission of designated and specified services;
- Approve Telecommunications Access Codes, if satisfied they meet the requirements of the Telecommunications Act;
- Validate the cost incurred for the supply of declared TSO (telecommunications service obligation) instruments and determine the allocation payable by all liable persons (Part III of the Act); and
- Report to the Minister within two years on whether Telecom's local and fixed public data network should be unbundled.

37. Section 18 of the Telecommunications Act states that the purpose of the relevant part of the Act is to promote competition in telecommunications markets for the long-term benefit of end-users of telecommunications services by regulating and providing for the regulation of the supply of certain telecommunications services.

The Economic Framework

38. The relevant provisions of the Act are focused on the interests of end-users of telecommunications services. The statute requires the Commission to adopt an efficiency-based approach. The Commission considers that dynamic efficiency is of particular importance given the dynamic nature of the telecommunications industry.³

39. An important aspect of the Commission's role is dispute resolution concerning access services, where the parties have been unable to reach agreement after making reasonable efforts to do so.

40. As yet, the Commission has not developed the approach it will use to determine whether regulation of the telecommunications industry should be extended or reduced.

41. When making determinations as to TSOs, the Commission aims to minimise distortions to the competitive process or to efficient investment and to minimise the impact on demand by non-TSO customers or for non-TSO services.

DAIRY INDUSTRY

Statutory Provisions

42. The Commission has a regulatory and enforcement role in the dairy industry under Part 2 of the Dairy Industry Restructuring Act 2001 ("DIR Act"). Its responsibilities under the Act include:

- Considering applications from parties in dispute with Fonterra concerning exit and/or entry of shareholders, or any regulations made under the DIR Act, such as those relating to the supply and pricing of raw milk to independent processors, and making determinations to resolve such disputes; and
- Conducting investigations into those aspects of the behaviour of Fonterra that appear to breach the conditions for entry and exit of shareholders, or any regulations made under the Act.⁴

³ Commerce Commission, *A Guide to the Role of the Commerce Commission in Making Access Determinations under the Telecommunications Act*, 28 May 2002.

⁴ Commerce Commission, "Dairy Industry Restructuring Act 2001: The Commission's Role", *Compliance*, Issue 22, December 2001, p 1.

43. The purpose of the provisions is to promote the efficient operation of dairy markets in New Zealand (s70).

44. The Commission's role under Part 2 of the DIR Act is restricted to specific provisions and does not extend to general disputes between Fonterra and its shareholders. The Commission is able to use all of its information gathering powers under the Commerce Act to assist it in exercising its role under the DIR Act.

The Commission's Economic Framework

45. The Act assumes that Fonterra may have a substantial amount of market power in domestic dairy markets. The provisions of the Act attempt to mitigate the risks of the exercise of that market power. The DIR Act facilitates contestability in the New Zealand raw milk market and provides for access to other dairy goods or services supplied by Fonterra to be regulated if necessary.

46. The Commission's role is largely one of dispute resolution on the basis of criteria specified in the Act. It is likely that economic efficiency will be an important consideration in the Commission's decision-making.

47. The Commission has not yet been required to make a determination under the DIR Act. However, the Commission intends drawing on its experience in conducting investigations and making adjudication decisions under other legislation when undertaking its role under the DIR Act.

CONCLUSIONS

48. The Commission seeks to apply a consistent economic framework and approach across its responsibilities where this is possible. However, the statutory provisions applying to the different areas differ, and these differences are reflected in the Commission's approach. A summary of the Commission's approach to its different responsibilities is provided in Table 1 at the end of this paper.

49. The Commission interprets the competition concerns in the Commerce Act (Parts II, III, IV and 4A), and the relevant provisions of the Telecommunications Act and DIR Act as concerns with the potential exercise of market power.

50. The Commission's approach to its responsibilities under the Commerce Act, the Telecommunications Act and the DIR Act, draws on considerations of economic efficiency (allocative, productive and dynamic efficiency).

51. Income distribution considerations differ in importance across the Commission's responsibilities. Income distribution is relatively unimportant in the Commission's analysis under Parts II and III of the Commerce Act; the Telecommunications Act; and the DIR Act. Income distribution is an important factor in the control provisions of the Commerce Act (Part IV), where the focus is on the interests of acquirers and suppliers. Income distribution is relevant to the objectives of limiting excess profits and ensuring

the benefits of efficiency gains are shared with consumers under Part 4A of the Commerce Act.

52. The Commission uses a model of competition in assessing whether competition is lessened under Parts II and III of the Act and in assessing the detriments and benefits of transactions. It uses a model of competition for calculating the potential benefits of control (compared with the status quo) under Part IV. In developing thresholds under Part 4A, it has regard to properties of competitive markets. The competitive market model informs the Commission's approach to telecommunications regulation. The Commission recognises the reality of "imperfect competition" and the importance of dynamic efficiency, particularly in the telecommunications industry.

Table 1: Summary of Commerce Commission’s Approach to its Responsibilities

Responsibility	Features	Competition threshold	Commission’s approach	Efficiency	Income distribution
Parts II, III and V of the Commerce Act 1986	<ul style="list-style-type: none"> • Agreements and acquisitions • Long-term benefit of consumers 	<ul style="list-style-type: none"> • Substantial lessening of competition • Market power focus 	<ul style="list-style-type: none"> • With and without transaction counterfactual analysis • Competition model used to assess detriments and benefits 	<ul style="list-style-type: none"> • Primary focus 	<ul style="list-style-type: none"> • Not significant – may discount foreigners’ interests in some circumstances
Part IV of the Commerce Act 1986	<ul style="list-style-type: none"> • General control regime • Interests of acquirers and suppliers 	<ul style="list-style-type: none"> • Limited or lessened competition • Lower threshold than “substantial lessening” • Market power focus 	<ul style="list-style-type: none"> • With and without control counterfactual analysis • Competition model used to derive potential benefits of control 	<ul style="list-style-type: none"> • Important 	<ul style="list-style-type: none"> • Important – may be at expense of efficiency • Normal returns based on CAPM model
Part 4A of the Commerce Act 1986	<ul style="list-style-type: none"> • Special regime of targeted control of electricity lines businesses • Long-term benefit of consumers 	<ul style="list-style-type: none"> • Assumed regulation needed • Commission to develop thresholds • Market power focus 	<ul style="list-style-type: none"> • Model of competition used to establish thresholds for assessing behaviour of lines companies 	<ul style="list-style-type: none"> • Important 	<ul style="list-style-type: none"> • Moderately important • Normal returns based on CAPM model
Telecommunications Act 2001	<ul style="list-style-type: none"> • Dispute resolution • TSO • Long-term benefit of end-users 	<ul style="list-style-type: none"> • Assumed regulation needed • Market power focus 	<ul style="list-style-type: none"> • Model of competition informs analysis 	<ul style="list-style-type: none"> • Primary focus with emphasis on dynamic efficiency 	<ul style="list-style-type: none"> • Not relevant
Dairy Industry Restructuring Act 2001	<ul style="list-style-type: none"> • Dispute resolution 	<ul style="list-style-type: none"> • Assumed that Fonterra may have substantial market power 	<ul style="list-style-type: none"> • Likely to draw on experience in other areas 	<ul style="list-style-type: none"> • Important 	<ul style="list-style-type: none"> • Not relevant