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**NATURAL MONOPOLY REGULATION
IN
NEW ZEALAND**

By

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Introduction

I have been asked to speak to you today about New Zealand's approach to competition regulation, with particular reference to the regulation of natural monopolies. In doing so I propose to discuss:

- The role of the Commerce Commission;
- New Zealand's 'light handed' regulatory approach, with specific reference to natural monopoly/utility regulation;
- Outcomes of New Zealand's 'light handed' regulatory approach; and to
- Highlight some of the points of departure of New Zealand's regime from that of Australia's regulatory regime.

The Role of the Commerce Commission

The Commerce Commission is an enforcement agency established under the Commerce Act 1986. Its primary role is to bring about awareness, acceptance and compliance with the Commerce and Fair Trading Acts.

The Fair Trading Act promotes fair trading by prohibiting misleading and deceptive trading conduct. The Commerce Act aims "to promote competition in markets within New Zealand" by:

- attacking anti-competitive behaviour whether by groups of competing firms or by dominant firms;
- assessing business acquisitions to prevent the acquisition or strengthening of a dominant position in a market; and
- imposing price control in circumstances of restricted competition.

The Commerce Act provides the rules for New Zealand businesses facing an open competitive economy, and has broad coverage. It applies to almost all markets, irrespective of the industry or corporate form involved, whether firms are publicly or privately owned, and whether utilities or not.

As an enforcement agency, the Commission has a range of enforcement tools available to it which include education, administrative settlement, and prosecution through the courts. Private court action is also able to be taken under most parts of the Act.¹ Only the courts can make findings on whether or not there has been a breach of the Commerce Act and impose penalties.

It is also important to note that the Commission, as an enforcement body, has no role as an arbiter or mediator of disputes involving practices which may breach the Act. The Commission is also not an industry-specific regulator, or a market designer. It does not have predetermined ideas about the numbers or relative strengths of competitors that should be in particular markets.

Anti-Competitive Behaviour

In “promoting competition” through attacking anti-competitive behaviour, the Commerce Act prohibits restrictive trade practices (RTPs) which adversely affect competition. Restrictive trade practices which contravene the Act include:

- Arrangements, contracts and understandings between competitors that substantially lessen competition in a market (section 27);
- Arrangements between competitors that reduce the competitiveness of another rival (section 29);
- Price fixing (section 30);
- A company, dominant in a market, using its position to prevent competition in either that market or another market (section 36).

The Commission enforces the RTP provisions of the Act by court action or through administrative settlements. The penalties for a breach contained in the legislation are significant (up to \$5 million for an organisation and up to \$500,000 for an individual).

However, the Commission would like to see the Courts imposing much higher penalties for breaches of the Act.²

An RTP resulting in a loss of competition can be authorised by the Commission provided it can be shown that the public benefits exceed the detriments stemming from the loss of competition. Authorisation gives protection to the trade practice from legal action under the Commerce Act.

Given the characteristics of natural monopolies, section 36 of the Commerce Act is of particular relevance. Section 36, which is based on section 46 of the Australian Trade Practices Act 1974, prohibits a person who has a dominant position in a market from using that market 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.

Section 36 is not directed against the existence of monopolies, but at the conduct of the monopoly; that is, the misuse of its market power. The section does not prevent a dominant firm from using its market power for purposes other than restricting competition. For example, the charging of prices above the competitive level is not, in itself, prohibited by the Commerce Act.

Behaviour which may constitute an abuse of a dominant position and therefore breach section 36 of the Act includes:

- charging below cost³ for a good or service for the purpose of eliminating competition;
- restricting the supply of a good or service;
- requiring customers to deal exclusively with it;
- refusing to deal with suppliers who sell to competitors.

With the exception of behaviour which falls within section 36, restrictive trade practices are authorisable on application to the Commission, the test being whether detriments to competition are outweighed by benefits to the public, derived from the practice.

Business Acquisitions

Section 47 of the Commerce Act prohibits business acquisitions if, as a result of the acquisition –

- A firm would acquire a dominant position in a market; or
- A firm's dominant position in a market would be strengthened

In this section, as in section 36, the meaning of “dominant position” is important and there has been considerable discussion in the courts about the meaning of the phrase, and how the presence or absence of dominance may be determined.

Section 3(9) of the Commerce Act defines a person as having a dominant position in a market if:

... that person as a supplier or acquirer ... of goods or services is ... in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in that market ...

In determining whether a person has such a dominant influence, regard is had to :

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

The Court of Appeal in *Port Nelson Ltd v Commerce Commission* [1996] 3 NZLR 554 approved the following dominance standard, which had earlier been adopted by the High Court:

... dominance involves more than “high” market power; more than mere ability to behave “largely” independently of competitors; and more than power to effect “appreciable” changes in terms of trading. It involves a high degree of market *control*.

If there is a risk of dominance arising from a business acquisition, a clearance or authorisation can be sought from the Commission, which if approved gives protection to the proposed acquisition from challenge under the Act by either the Commission or other parties. Business acquisitions, which do not give rise to dominance concerns can be given clearance by the Commission. The Commission will grant an authorisation if it is satisfied that the detriments arising from the dominance gained or strengthened as a result of the acquisition is outweighed by benefits to the public.

Section 47 does not apply to business acquisitions where there is a bare transfer of market dominance; that is, where dominance is transferred from one party to another without being strengthened in the process.

New Zealand’s ‘Light Handed’ Regulatory Regime

New Zealand’s approach to competition regulation, often described as ‘light handed’ regulation, has attracted considerable international attention. Many countries these days seem to be calling their regulatory regimes “light handed” including Australia. However, I would claim (without the slightest suggestion of bias) that New Zealand has the original and only truly “light handed” regime.

The concept of 'light handed' regulation emerged from the policy debate concerning the deregulation and privatisation of the state-owned telecommunications monopoly during the late 1980s. Following on from this, and as part of wider economic liberalisation policies, other utilities in New Zealand (which were generally statutory monopolies under state ownership) were also progressively reformed. Reforms included:

- The removal of statutory monopoly rights so as to expose utilities to competition;
- The corporatisation (and in some cases, privatisation) of numerous state trading departments, structuring them as limited liability companies with independent (primarily private sector) boards of directors and commercial objectives;
- Their restructuring to isolate the natural monopoly elements from the more contestable parts of the industries;
- The removal of social service obligations or their explicit funding by government rather than by cross-subsidy with profits earned by the business in non-contestable markets.

The 'light handed' approach, which has been in operation for about 10 years, followed a long period of heavy-handed industry-specific forms of regulation with high levels of trade protection, considerable regulation of the production sector, a major role for government in the provision of services, price control and many legislative monopolies. The overall thrust of the 'light handed' policy was, and is, to achieve efficiency and to encourage competition in New Zealand markets.

'Light handed' regulation provides an attractive, less economically distortionary alternative to heavier forms of regulation with the associated industry-specific regulatory bodies and higher compliance costs. For example, direct regulatory control imposed by an industry-specific regulator can generate its own inefficiencies including the costs of operating the regulatory body, the information supply costs imposed on the regulated firms, and the compliance costs arising from the distortions caused by imperfect regulation. The possibility of "regulatory capture" is often noted as another possible concern; that is, where the regulator is "captured" by the regulated with the monopoly firms influencing the regulator to their own advantage.

As I have stated, the 'light handed' regulatory regime in New Zealand has broad coverage, with the Commerce Act 1986 applying to most markets, irrespective of the industry involved. As such, utility regulation in New Zealand is approached in a characteristically straightforward manner, using the same set of competition principles used to regulate other industries, together with some additional light-handed elements.

Broadly, the main elements of this 'light handed' regulation are the following:

- In some utility industries, the contestable and non-contestable/natural monopoly businesses within the utility have been separated, either by separate ownership or by the accounting "ring fencing" of the two businesses (for example, the separation of Trans

Power, the natural monopoly electricity transmission system, from the electricity generator).

- Reliance on general competition law, as expressed in the Commerce Act 1986. As I have just outlined, under section 36 of the Act dominant firms must not use their dominant position in a market to restrict entry, prevent or deter competitive conduct, or eliminate competitors. Utilities should also not engage in trade practices which substantially lessen competition, or in business acquisitions, which lead to the acquisition or strengthening of a dominant position.
- Industry specific information disclosure regulations require the annual disclosure of accounting and other information by incumbent operators of “essential facilities” with market power. These regulations are designed to make transparent the operations of companies possessing market power, and to encourage self-regulation.
- Stronger action is possible, given sufficient justification, through the provision for the introduction of price control by the government, as provided for in Part IV of the Commerce Act, or other forms of regulation.

The application of ‘light handed’ regulation to utilities or “vertically integrated natural monopolies” (which includes telecommunications, electricity and natural gas reticulation) starts with the recognition that not all parts of an incumbent’s business are natural monopolies. The central aim is to encourage competition in those related markets where entry is possible, and to ensure that entrants into those markets are not deterred by the market power of the integrated incumbent in the essential facilities services market.

The main regulatory problems posed by these utilities arise where access to the incumbent’s essential facility network is necessary for new entrants to compete in the provision of upstream or downstream services. These utilities have an obvious incentive to preserve their monopoly power and profit by hindering access, either by an outright refusal to supply, or by setting an access price and terms high enough to render entry unattractive.

There is also a group of utilities organised around natural monopoly facilities, which are not vertically integrated. These include electricity transmission, ports and airports. Such utilities may have the horizontal market power to extract excess profits from the sale of the final good or service.

To date, the Commerce Commission has had to resolve three main competition issues involving utilities:

- Business acquisitions;

- The price and other terms of access to network facilities; and
- Complaints of monopoly pricing.

In briefly looking at one of these, that of access issues, I would point out that complaints about access to a utilities network can range from an outright refusal to negotiate, to issues about the appropriate access price and terms. For example, important case law has resulted from a dispute over the attempts by Clear Communications (the entrant) to negotiate an interconnection agreement with Telecom (the incumbent) to use Telecom's local loops in order to provide a local telephone service.

Telecom put forward the Baumol-Willig rule as the way of setting the interconnection price. That rule states that monopolists are entitled to provide services to competitors at the same price they implicitly charge themselves, including, if any, monopoly profits. The Privy Council sanctioned this rule in 1994. However, critics of the rule have argued that it has undermined the effectiveness of section 36 and the government has issued a policy statement that it did not consider the Baumol-Willig rule to constitute a satisfactory form of access pricing.

A number of interconnection agreements have been negotiated to date (for example, between Telecom and Clear, BellSouth, and Saturn Communications), and it is significant to note that the interconnection terms are more favourable than Baumol-Willig prices.

The Commission has also received complaints from those involved in the supply and distribution of electricity, alleging inability by one company to gain access to another's network.

Price Control

The threat of price control is an important and necessary part of the 'light-handed' regulatory regime. Part IV of the Commerce Act provides for the introduction of price control by the Government in circumstances where:

- goods or services are, or will be, supplied or acquired in a market where either limited competition exists or competition is likely to be lessened; and
- it is necessary or desirable for the prices of those goods or services to be controlled in the interests of consumers.

The Commission can recommend the imposition of price control or, alternatively, may be asked by the Government to report on the necessity or desirability of such a step. While there are no goods or services subject to price control at the present time, the Minister of Commerce has asked the Commission to report on the desirability of price control relating to international airport, airfield services charges.

Once a good or service is declared as a controlled good or service, a supplier of that good or service may apply to the Commission for an authorised price. It is an offence to supply at any price more onerous than the authorised price. If a supplier does not apply for a price to be authorised, the Commission can initiate the price authorisation process itself. The Commission may authorise a “maximum, actual, or minimum price, as the case may require”. The Commission can also accept price undertakings as an alternative to setting an authorised price.

Price authorisations are subject to appeal to the High Court.

The broad criteria the Commission must take into account in setting an authorised price are set out in the Act (section 73):

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

It probably goes without saying that for the threat of the imposition of price control to be credible; the Government needs to be prepared to use the price control provisions of the Act when the situation demands it.

Outcomes of New Zealand’s ‘Light Handed’ Regulatory Regime

It is argued by some that New Zealand’s approach involves regulation that is too light handed with the result that firms with market power operate without sufficient restraint, and to the detriment of their customers and of efficient production. However, the Commerce Commission considers that the policy, while still being developed and refined, has had some important successes for the economy in terms of improved efficiency and increased competition.

Of course, it would also be fair to say that the policy has encountered some as yet unresolved difficulties.

In relation to the telecommunications industry, Telecom had its statutory monopoly right over the provision of telecommunication network services removed in 1989. In line with the country’s ‘light handed’ regime, there is very little in the way of industry specific forms of regulation apart from specific information disclosure requirements, and no specific telecommunications regulatory body.

The Telecommunications (Disclosure) Regulations 1990 require Telecom to provide details of its local access related services, including interconnection agreements, any substantial discounts offered, and financial accounts for activities related to local access.

The Commerce Commission believes that the telecommunications industry has made positive gains since deregulation, not least in terms of its competitiveness. There has been significant new entry, a general downward trend in prices, a wide range of new products and services have been introduced, and the industry has become more customer-orientated with improvements in service quality. Perhaps the major outstanding issues are those of number portability, local loop access arrangements and issues related to industry convergence.

A number of recent studies reflect reasonably favourably on the New Zealand approach in comparison with overseas alternatives. For example:

- Professor Henry Ergas (1996) concluded that, in relation to telecommunications, the New Zealand regime compared favourably with the more heavy handed Australian regime; and
- Economists De Boer and Evans (1996) favourably compared Telecom's productivity improvements with those of British Telecom following privatisation.

Turning to the electricity industry, deregulation within the 'light handed' regulatory framework has seen some benefits, particularly for industrial and large commercial users, and technological advances and service improvements. However, there is considerable debate as to the level which these benefits have filtered through to residential and small customers.

Again, the information disclosure requirements (specifically, the Electricity (Information Disclosure) Regulations 1994) play an important role in encouraging self-regulation in the industry by facilitating the comparison of prices, costs, and other performance indicators across power companies. Local electricity supply companies must publicly disclose separate accounting information on their generation, distribution and other activities such as retailing. The information includes prices, line charges to all consumers, and other key contractual conditions. Consumers' bills were also unbundled so as to reveal the separate line and energy components.

However, there are some shortcomings in the present information disclosure regime. For example, the ability to make inter-company performance comparisons is hindered by the diversity of power companies, and the flexibility within the regulations for companies to define their businesses and to allocate assets and costs between them.

Electricity Reforms

These, and related concerns, are being addressed in the Government's recently announced electricity reforms, which I will just touch on today. Broadly, the reforms are aimed at providing more competitive prices and a choice of electricity suppliers for smaller customers. However, some argue that the reforms are a backward step towards direct intervention by the Government, and will not remedy the distortions that exist in the industry.

The package of reforms include:

- the reform of the Government's major generation business, with ECNZ to be split into three separate generation companies which, along with Contract Energy, will be permitted to compete in the retail energy market. These generation companies will remain in state ownership;
- ownership of electricity lines and businesses is to be split from the competitive activities of electricity retailing and generation. Electricity supply companies have a choice on how they implement ownership separation. They can set up a separate trust by 1 April 1999 to own and run whichever business they do not wish to keep; or sell whichever business they do not wish to keep by 31 December 2003. Companies choosing the second option will have to set up separate companies in the meantime and run them as if they had separate owners, including having separate boards and management.
- other reforms include stronger/enhanced information disclosure requirements, and a requirement that the industry adopt within twelve months low cost arrangements to enable smaller consumers to change retailers.

The reforms also create new roles for the Commerce Commission, including the enforcement of the ownership separation rules and of the requirements that owners who have not yet complied with the ownership separation rules must operate at arms' length. The Commission is also empowered to issue exemptions from the involvement rule for specific investors.

The Electricity Industry Reform Act 1998, which gives effect to these reforms, was enacted by Parliament on 8 July 1998, but (apart from a number of specific provisions) does not come into force until 1 April 1999.

Differences between the Commerce Act 1986 and the Trade Practices Act 1974

While the Commerce Act is similar in several important respects to the Australian Trade Practices Act 1974, there are some important differences between the two statutory regimes, a number of which I will briefly outline today:

- I would first point out that the stated objectives of the two statutes are comparable: the Commerce Act aims to promote competition in markets in New Zealand and the Trade Practices Act aims to enhance the welfare of Australians through the promotion of competition and fair trading.
- Secondly, section 36 of the Commerce Act is similar to that of section 46 of the Trade Practices Act (on which it was based), but the two provisions are not identical. The most significant difference is the different threshold tests that apply: use of a “dominant position in a market” in New Zealand compared with taking advantage of “a substantial degree of power in a market” in Australia. “Dominance” connotes a greater degree of market power than is required by a “substantial degree of market power”.
- Thirdly, and similarly, different threshold tests apply in relation to mergers: the acquisition or strengthening of a “dominant position” in New Zealand compared with a substantial lessening of competition under the Australian legislation.
- As previously discussed, Part IV of the Commerce Act enables goods or services to be placed under direct price control; the “threat” of which is aimed at constraining the pricing behaviour of dominant firms. There is no counterpart in the Trade Practices Act, although the ACCC does have price surveillance functions under separate legislation, the Prices Surveillance Act 1983.
- With the exception of price fixing and resale price maintenance, the Commerce Act does not single out particular trade practices for attention in the way that the Trade Practices Act does. For example, the Australian legislation includes specific provisions dealing with price fixing, resale price maintenance, primary boycotts, secondary boycotts, and exclusive dealing
- Also, the Commerce Act does not contain any provisions matching the access regime provisions in Part IIIA of the Trade Practices Act, aimed at regulating access to “declared” essential facilities with natural monopoly characteristics. Nor does the Commerce Act contain any specific provisions relating to the telecommunications industry, as is now provided for in the Australian legislation (ie: Part XIC Trade Practices Act).
- The institutional arrangements to administer the Acts are similar in the two countries, with the Commerce Commission performing similar roles to the ACCC. However, in New Zealand, appeals are heard by the High Court, with the assistance of lay members, in contrast to the specialist Australian Trade Practices Tribunal with its federal court judge and lay assessors.

Conclusion

In concluding, I would like to reiterate that the Commission's role is somewhat different from that of most overseas regulatory bodies, including that of Australia's, in that the Commission enforces general competition law under a 'light handed' policy regime.

The area of utility regulation is particularly difficult to monitor and enforce due to the natural monopoly characteristics of networks which give rise to issues of dominance and access. The Commission's involvement with utility industries occurs only when an issue arises which is at risk of breaching the Commerce Act.

As earlier stated, the Commission is of the view that enforcement of this general legislation, together with information disclosure requirements and the threat of more heavy handed regulation through price control, has had important successes for the economy.

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¹ For example, only the Commission can apply to the Court under s 80 (pecuniary penalties for restrictive trade practices) and s 83 (pecuniary penalties for prohibited business acquisitions).

² In relation to restrictive trade practices, the Australian Trade Practices Act provides for penalties of up to a maximum of \$10 million for companies and \$500,000 for individuals.

³ Arguably below average variable cost, or average total cost, or at a level somewhere in-between.

