

Paula Rebstock's Speech Notes
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Competition and the Role of the Commerce Commission

Aon Lunch With Paula Rebstock, Commerce Commission Chair
Wellington Chamber of Commerce

Introduction

1. Good afternoon everyone and thank you Charles for your introduction. I am delighted to be here today. I look forward to hearing your comments and questions at the end of my presentation.
2. In talking about the role of the Commerce Commission I have to begin by saying the Commission is unashamedly pro-market, because of the benefits competition brings. A free market economy is the best way to allocate a country's precious resources, and can deliver lower prices, innovative products and more choice.
3. American economist Kenneth Train has observed that: "Competition, in theory if not always in practice, is nothing short of a miracle." In a competitive market, each firm tries to make as much profit as possible, and each consumer acts in their own interest, yet the result is maximum benefit for society. New Zealand's competition law is based on the premise that competition offers the right incentives to guide private actions towards the public good.
4. Today I am going to talk about the benefits of competition: for businesses, consumers and the New Zealand economy. I'll look at some of the threats to competition that the Commission has dealt with in recent years. And I'll discuss the role of competition policy. I hope to convince you that robust competition is the best way to deliver the benefits of a market economy, and that competition authorities like the Commerce Commission must play their role to ensure that competition can flourish.

The benefits of competition

5. Competition is the basic underpinning of a market economy. Indeed, it is such a basic fact of economic life that it is easy to take for granted. But consider for a moment how elegant the process of competition is, at least in principle. Firms compete on their merits to attract the customer's dollar. Those that best meet customer demand—in terms of price, quality and service—are rewarded with higher sales and profits. They attract investment and thrive. Those that don't are starved of business and go under, freeing up

resources for the use of more efficient operators.

6. And a competitive market is, to a large extent, self-regulating. The market itself offers both carrots and sticks to encourage the best from everyone.
7. The most obvious benefit of competition is the pressure it exerts to lower prices and raise quality, because customers 'vote' with their dollar for the best and lowest cost offerings. Competition also encourages productivity by creating incentives to work smarter, and enabling company performance to be measured against the performance of competitors. Encouraging innovation is another direct benefit of competition, as companies try to out-think each other, and take up new technologies quickly, before their competitors.
8. As well as increasing the incentive for firms to invest in their own expansion, a competition-focused economy is likely to be more attractive to foreign direct investment. An economy where competition rules are adequately enforced is more attractive to prospective investors, because it is one in which businesses are likely to succeed or fail on their merits.

Competition law and consumer law

9. To deliver these benefits, competition needs to be facilitated through robust legal frameworks. As I'm sure you all know, the Commerce Act is the Act designed to preserve competitive markets in New Zealand.
10. But there are two other Acts that also promote competition in New Zealand: the Fair Trading Act and CCCFA. Some see these Acts as consumer protection, but to the Commission their role is to help protect the competitive process.
11. Consumers help to drive competition through their choices. And consumers can only send the right signals to firms if their choices are founded on accurate information. They depend on companies to provide much of that information, but companies cannot always be relied on for accuracy.
12. Several high profile cases in the last year show how misleading behaviour by firms disempowers consumers, disadvantages competitors, and thereby undermines the competitive process. Banks and airlines had no incentive to lower fees while those fees remained hidden from consumers. Carter Holt Harvey was not pressured to deliver timber that met the grade as long as falsely labeled below-grade timber was attracting the same premium price. And who can forget Teresa Gattung's¹ statement in 2006 about pricing information in the telecommunications industry: "Think about pricing. What has every telco in the world done in the past? It's used confusion as its chief marketing tool. And that's fine."

¹ Teresa Gattung Statement

13. It is hardly surprising that consumers become cynical about the information they receive, even when dealing with New Zealand's biggest companies. To play their part in the competitive process, consumers must be able to trust the information they get, which is why the Commerce Commission places a high priority on enforcing the Fair Trading and CCCFA Acts.

Regulation

14. Not every firm in New Zealand faces competitive pressure, so the Commission regulates sectors where natural monopolies exist, including telecommunications, electricity transmission and distribution, and gas distribution, as well as the dairy sector. The regimes in each case are different, but the aim of regulation is consistent: to deliver the outcomes that would occur if the companies faced competition – efficient prices and investment, and innovative products and services.
15. Successful infrastructure businesses are critical to New Zealand's economic success. Their role is to provide world-class services to underpin the rest of the economy. Those services should be of a quality that reflects consumer demand, and they should be priced to reflect the cost of supply, including a reasonable return on investment.
16. New Zealand's regulatory regimes must let monopoly businesses make sufficient returns to support ongoing investment. But those companies must also be accountable for ensuring that their investment is efficient and well planned. They must also ensure that any investment they have planned - and charged customers for - does actually occur.
17. Regulating monopolies will always be a balancing act. However, it is important to remember that monopolies are regulated in all other developed countries, and how New Zealand regulates these industries will have important consequences for our international competitiveness.

Key Issues – energy regulation

18. Regulation of the energy sector is governed by Parts 4 and 5 of the Commerce Act, which are included in the Government's current review of that Act. As you would expect, the Commission has been engaging with the Ministry of Economic Development on the review and providing our perspective on the proposals.
19. While the Commission has made a large number of decisions lately in the energy sector, I would like to focus on three that are significant to this region.

20. Last year the Commission announced its intention to declare control of Vector's electricity distribution services after an investigation revealed inefficient disparities in Vector's charges between different customer classes. In the Wellington region alone we found that price decreases in each of two consecutive years were necessary to remove the overcharging. The estimated required annual reductions included 3.4% for residential customers, 17.2% for small commercial customers, 24.6% for large commercial customers and 24.5% for small industrial customers. At the time Vector was earning a 6.8% average return from its Auckland customers, it was earning an average return of 13.3% from its Wellington customers (including a return of nearly 30% from small industrial customers).
21. Subsequently, Vector has offered the Commission an administrative settlement, whereby Vector rebalanced its prices from April this year. The Commission's preliminary view is that the settlement meets the objectives of the regulatory regime, but we will be consulting with interested parties over the next several months before reaching a final view.
22. The second matter of direct relevance to you concerns Transpower, the national grid operator. Following Transpower's announcement of its intention to increase prices by 19.1% on December 2005, followed by further on average increases of 13% per annum for the next five years the Commission announced its intention to control Transpower. In March last year the Transpower Board agreed to suspend the 19% price increase and enter into administrative settlement discussions with the Commission. After lengthy discussions the Commission has received a settlement offer that the Commission proposes to accept. If accepted, the current Transpower regulatory thresholds would be replaced by a new transmission threshold, a capital expenditure threshold and a system operator service threshold.
23. As currently proposed the 19% price increase for 2006/07 would be reduced to 10.2% and would be funded against the Economic Valuation Accounts. The 2007/08 forecast price increase of 13% would be reduced to 8.1%, and would also be applied against the EV accounts, rather than charged directly to consumers.
24. The document released last week sets out the terms of that offer and we are now seeking views from interested parties on it before reaching a final decision.
25. The final energy matter I want to briefly mention relates to the Commission's proposal to reduce the gas distribution prices of Powerco by a further 42% in April 2008, in addition to the 2005 reduction of 9%. This amount would claw back the additional overcharging that has occurred since 2005. Naturally we expect vigorous submissions from Powerco on our preliminary views.

26. The critical issues to be addressed include the lack of supporting information in Powerco's capex and opex proposals, the justification for the valuation of their assets and the need to treat revaluation gains as income for the purpose of setting prices.
27. The process from here is to allow written submissions, followed by a public conference, before the Commission makes a final decision in February 2008.

Key issues – telecommunications regulation

28. You will be aware of the major changes underway in New Zealand's telecommunications sector. The amendments made to the Telecommunications Act late last year mean that implementation of local loop unbundling and the separation of Telecom are major workstreams for the Commerce Commission this year.
29. The new Telecommunications Commissioner, Dr Ross Patterson, joined the Commission in July this year. The Commission is very pleased to have a Commissioner of his calibre join us at this critical time for the telecommunications industry.
30. Priorities in this calendar year include two major planks of regulation: setting terms and conditions for key broadband services, and finalising our mobile services investigation.
31. In addition we will continue to monitor market conditions and of course will oversee the implementation of the recently announced Telecom separation package.

Returning to the theme of competitive markets....

Threats to competition

32. Given the benefits that competition brings, surely everyone would want to be part of this environment. Or to put it another way, if competition is so great, why do we need the Commerce Commission?
33. The fact is that firms have a love-hate relationship with competition. On one hand, it keeps them sharp and encourages them to achieve their full potential. On the other hand, it's damn hard work. It is hardly surprising that the lean and hungry competitive firm will sometimes look with envy at the lazy cartel member.
34. There are many threats to competition. Today I will look at four: the market behaviour threat of cartels, the market structure threats of anti-competitive alliances and so-called 'national champions', and the market information threat of misleading behaviour.

Cartels

35. When it comes to anti-competitive behaviour, cartels are generally considered the most egregious. It is worth remembering that the victims of cartels are nearly always, in the first instance, other businesses. While end consumers will eventually suffer, the immediate impact is on downstream businesses that rely on the cartel members for vital inputs.
36. Cartels are alive and well in NZ, which is why cartel enforcement is a priority for the Commission this year. The cases we're seeing cover an amazing range of industry sectors. Cartels are happening in big markets and small and no quarter of the economy seems to be spared. Cases we are currently investigating are affecting the critical energy and transportation infrastructure sectors, and the health sector. They are affecting building costs, and office supplies, packaging, and inputs into basic industrial processes. They are affecting markets with annual turnover as high as \$500 million and as low as two or three million dollars a year.
37. These cartels are being led by New Zealanders in some cases and in others initiated by overseas companies with clear impact on New Zealand markets. In some cases, New Zealand companies who are involved are not even aware of price-fixing being led overseas, and which are flowing through local subsidiaries.
38. These cartels are hindering the performance of New Zealand exporters by inflating the cost of key inputs, placing a drag on the competitiveness of New Zealand companies. And they are impacting domestic New Zealand industry by distorting cost structures to the ultimate detriment of consumers. Despite all of this diversity of shapes and sizes, one thing is a constant throughout our investigations – New Zealand businesses are on the front line in terms of who is victimised by the conduct.
39. Of course, the public learned last year that cartel activity in New Zealand is not a theoretical problem, when the Courts imposed more than five million dollars in penalties on companies involved in a wood chemicals cartel, including the highest ever penalty for breaching the Commerce Act. For a case that has so far cost the New Zealand taxpayer \$1.3 million to investigate and prosecute, you would have to say that the prosecution has delivered value for money. The case continues with the Commission's action against the final defendant company, NuFarm, yet to be resolved.

40. As well as the civil penalties, two individuals from the wood chemicals cartel received criminal convictions for hiding information from the Commission. In one instance, an executive hid papers under his floorboards, moving them to his neighbour's basement when the investigation closed in. You may laugh, but this is not unusual; in another case, papers that the company had failed to provide in response to a statutory notice were found behind a box of Christmas decorations. The secretive nature of cartels makes them difficult and expensive to investigate, and we welcomed these criminal convictions as evidence that the Court will look seriously on any attempt to hinder Commission investigations.
41. The Commission is discovering an increasing number of cartels to prosecute. This is partly due to increased investigative expertise, and partly due to the Commission's Leniency Policy, which offers immunity from Commerce Commission prosecution for the first cartel member who blows the whistle on their co-conspirators.
42. At the moment we have around ten high priority competition cases, of which seven could be characterised as "hard core" cartels. We would normally expect to initiate one or two competition cases per year, but as a result of the behaviour coming to our attention, we expect to take four to six cases in each of the next two years. After that we expect the level to stabilise at a level somewhat higher than it has been in the past.

Qantas / Air New Zealand strategic alliance

43. Cartels are a threat to competition that arises from the behaviour of firms. Other threats can come from the structure of markets, which is why the Commission is responsible for considering the competition effects of mergers and acquisitions. While generally the Commission will not allow anti-competitive mergers, it is able to approve mergers, acquisitions or other arrangements that might reduce competition, if the benefits to the public outweigh the harm to competition.
44. It was on this basis that we considered an application from Qantas and Air New Zealand in 2002. The airlines applied to the Commission for authorisation to form a strategic alliance, consisting of equity holdings and joint decisions on output and pricing.
45. They predicted a host of benefits for New Zealanders, including greater efficiencies, more frequent flights to more destinations, and an increase in domestic tourism. On closer examination, however, this last benefit in particular proved to have a somewhat shaky basis: the airlines were predicting more New Zealanders would holiday at home because the cost of international airfares would make overseas holidays unaffordable. Not something many New Zealanders would see as a public benefit.

46. The airlines also forecast dire consequences if the alliance didn't go ahead. They asserted that: "the Australasian markets cannot support more than one FSA [full service airline] network." They spoke of a "war of attrition" that could send Air New Zealand in particular into a "death spiral," leading it to withdraw from most if not all international routes and become a virtually domestic airline.
47. As it turns out, the alliance was not authorised, and those dire predictions have not come true. The Australasian market can clearly support more than one Full Service Airline – and in recent years the number of competing operators has increased.
48. And contrary to predictions, Air New Zealand has expanded elements of its network, is reported to be the only airline to offer routes that circle the globe, and announced new international destinations as recently as this year, when it added Vancouver to its list.

National champions

49. Let me move on to another threat to competition. Philip Lowe², Director General for Competition of the European Commission, once quipped "they're illegal, they're immoral and they're fat". Former Chair of the UK Competition Commission Paul Geroski³ suggested, they are "... more likely to become national basket cases than national breadwinners".
50. These gentlemen were referring to national champions, which as you can imagine are not very popular with competition regulators. Let me be clear, I am definitely not talking about situations where, entirely through their own skill and determination, firms pull ahead of their rivals and excel either internationally or domestically to become market leaders. Instead, I am referring to firms that receive extra support to become the dominant or only player in a market.
51. From time to time in New Zealand we hear similar arguments, indeed the Qantas / Air New Zealand alliance proposal relied in part on national champion claims. But in the Commission's view, these so-called champions are likely in the long run to have a negative impact on the economy.

² Philip Lowe

³ Dr Paul Geroski

52. We see numerous examples overseas where governments have provided support, and that this support can take many forms. It might be a call for competition authorities to look the other way when a particular firm, or firms in a particular industry, wish to engage in a bit of price-fixing or other anti-competitive behaviour.
53. Or it could be through government support for a merger between domestic firms in order to create a more powerful one, perhaps expressly opposing the acquisition of one of those firms by a foreign company. This was the case in Spain when a merger was proposed between the dominant gas and electricity suppliers, Gas Natural and Endesa.
54. When it came to light that Endesa preferred the bid of a German energy company, E.ons, over Gas Natural's bid, the Spanish government⁴ said that Spain would "do everything in our power to ensure that Spain's energy companies remain Spanish" and went as far as saying that Endesa was "unpatriotic" and "went to Germany to sell itself".
55. In the end, the Spanish government decided to approve the merger between the two Spanish companies, despite the Spanish competition authority recommending that it be blocked due to significant competition concerns. From a competition perspective, nationalistic feelings were put ahead of the national interest.
56. There is already provision in New Zealand law to authorise anti-competitive behaviour if the public benefits outweigh the detriments. In other words, if a national champion was truly in the national interest, it could be allowed for under the Commerce Act. But when vested interests are set aside, this is rarely the case.

Misleading behaviour - Ribena

57. The final example I would like to give of threats to competition is the threat posed by misleading behaviour. It is also an excellent example of the deterrent effect of enforcement action.
58. The prosecution of GlaxoSmithKline for false and misleading claims about the vitamin C content of Ribena attracted an unprecedented level of public and media interest, in New Zealand, and around the world.
59. While the Commission shared the public's concerns about the impact on consumers, we were also concerned about the impact of these false and misleading claims on competition.

⁴ Spanish Government Statement: Endesa

60. Considering an increasingly health conscious public, health claims can give products a substantial competitive edge. There is strong anecdotal evidence that customers chose Ribena, and in particular chose to buy it for their children, because they believed its vitamin C content made it a healthy choice. And GlaxoSmithKline's 'blackcurrants versus oranges' comparison can be read as a direct attempt to gain a competitive advantage over orange-based fruit drinks.
61. Misleading claims harm competitors and the competitive process, and it is for this reason that competition authorities like the Commission devote considerable effort to detecting and deterring misleading behaviour by firms.
62. The strategic focus under the Fair Trading Act is on:
- Hidden fees, terms and conditions with the emphasis on ensuring that all material information is disclosed in the advertising of new communications products and services (particularly broadband and premium texting services) and on ensuring that all costs are included in price advertising;
 - Misleading product descriptions and labels with a focus on products aimed at improving health through nutrition; and
 - The general retail industry, with a focus on bait advertising and misleading consumers about their rights.
63. With respect to the enforcement of the CCCF Act, we will continue to:
- Take litigation to send the strongest possible message to credit providers about the need to comply with the disclosure provisions; and
 - Seek to establish precedents with respect to the reasonableness of fees and credit-related insurance provisions.

Deterrence

64. I would like to finish today by considering how competition agencies like the Commission achieve their outcomes and deliver maximum benefit for the taxpayer's investment.
65. Competition enforcement is, by its very nature, episodic. No competition authority can hope to discover every anti-competitive or misleading act that occurs. We simply cannot be everywhere at once. And in fact, a competition agency can generally only pursue a limited proportion even of those breaches that do come to its attention. So we need to carefully select those cases that will have the greatest impact.

66. In making these selections, the Commission considers the direct impact of the behaviour; and is likely to select cases for prosecution where there is clearly significant harm being caused, for example, where the impact on competition is particularly severe, or where a large number of consumers are affected.
67. But considering that the Commission can, necessarily, only pursue a relatively small number of cases each year, we must also consider the message these actions send to the wider business community, for it is through this deterrent effect that the impact of our actions can be multiplied. We must ensure that we communicate not only the outcomes of our actions, but the reasoning behind them, so that businesses can better understand the behaviour that is likely to attract enforcement action.
68. The Ribena case is a good example of the deterrent effect. While the fine imposed on GlaxoSmithKline was less than \$300,000, the effect on the company's reputation and the Ribena brand has been immeasurable. A number of commentators have noted that the case has a message relevant to businesses across the board: to quote the *National Business Review's* somewhat undiplomatic headline: "Careless Kiwi companies should learn from Ribena fiasco."
69. As an enforcement agency with limited resources we rely on the fact that our actions send clear messages, and that many businesses will choose to learn from the mistakes of others, rather than make their own.
70. Of course deterrent affects are difficult to measure and the cost / benefit equations will always be open to debate. So let's look at a more straightforward, if rough, comparison of the cost of enforcement, and the return in fines, refunds, and costs paid to the Commission under the Fair Trading Act.
71. In the fifteen months from January 2006 to March 2007, in the Fair Trading area alone, the Commerce Commission has obtained approximately \$30 million in refunds, penalties and costs, of which nearly \$24 million was refunds returned directly to consumers. Over the same period, the cost of Fair Trading enforcement has been around \$7.5 million.
72. And of course this does not account for the positive effects of this enforcement through all the other mechanisms I have discussed today. Even in the simplest terms, competition agencies generally deliver a high return on the public's investment.

Conclusion

73. In conclusion, let me repeat that the Commerce Commission is unashamedly pro-market, because we believe that competition is the best way to allocate our scarce resources. Consumers and businesses do need protection, but they should be protected *through* market forces, not protected *from* them. To deliver the benefits of a market economy, markets must be dynamic, and the Commission's role is to deter anti-competitive actions that would threaten the dynamic functioning of the New Zealand economy. Where competition is limited due to natural monopolies, the role of the Commission is to regulate to ensure consumers face the prices and quality that would result if markets were competitive.

74. The desired result is a robust marketplace where firms that innovate and meet their customers' needs have the competitive edge. There is no question that a competitive market is a tough testing ground. However, exposure to competition is still the best guarantee that businesses will perform at a high level and deliver the quality of life that New Zealanders expect.

THANK YOU