COMMERCE COMMISSION NEW ZEALAND

The Commerce Act

Agreements that substantially lessen competition

This document should be read in view of amendments to the Commerce Act made in August 2017. The Commission will update the document in the near future to reflect changes made under the Act.

This fact sheet explains how and when an agreement may be illegal under section 27 of the Commerce Act. It is designed to give businesses an understanding of when agreements they have with competitors, suppliers or customers may substantially lessen competition in a market.

Agreements between businesses are an essential part of how markets work. But some agreements harm competition, which can mean higher prices, less choice and lower quality for consumers. Such agreements may be illegal under section 27 of the Commerce Act.

Section 27 covers many types of agreements, including formal and informal agreements, agreements between competitors, and agreements between suppliers and customers. It is illegal both to reach an anti-competitive agreement and to put such an agreement into effect. Even attempting to come to such an agreement can break the law. It also doesn't matter whether an agreement is deliberately anti-competitive – if it substantially lessens competition, it will be illegal.

Some anti-competitive agreements may also be illegal under other sections of the Commerce Act. These include:

- section 29, which makes agreements between competitors to exclude rivals illegal, unless the agreement does not substantially lessen competition
- section 30, which makes price fixing agreements between competitors illegal (you can read more in our fact sheet *Price fixing and cartels* at www.comcom.govt.nz/price-fixing-and-cartels-fact-sheet).

What is illegal under section 27?

Under section 27 it is illegal to "enter into a **contract** or **arrangement**, or arrive at an **understanding**, containing a provision that has the **purpose**, or has or is likely to have the **effect**, of **substantially lessening competition in a market**."

Section 27 also prohibits **giving effect** to such a contract, arrangement or understanding. In other words, both entering into and giving effect to such an agreement is illegal.

It doesn't matter whether an agreement is deliberately anti-competitive – if it substantially lessens competition, it will be illegal.

What do these terms mean?

Contract, arrangement or understanding

- A **contract** is a formal agreement between two or more parties that is enforceable under the law. It can be oral or written.
- An **arrangement** or **understanding** is something less formal than a contract. It requires a consensus that leads to an agreed course of action. This includes situations where the parties have agreed that only one of them will act or not act in a certain way. Even a "nod and a wink" between parties can be evidence of reaching an understanding.

In this fact sheet, the term "agreement" covers the terms contract, arrangement and understanding.

Purpose, effect or likely effect

- The **purpose** is the intention or aim of the part of the agreement alleged to be anti-competitive. The purpose does not need to be the only or main purpose – it need only be a substantial purpose. We primarily assess purpose by looking at what happened, or was likely to happen, in the market as a result of the agreement. What each party intended when entering the agreement can also be relevant.
- The **effect** is the actual result of the agreement.
- The **likely effect** is the likely future effect of the agreement. An effect is "likely" if there is a real and substantial risk that it will occur.

A substantial lessening of competition in one or more markets

What is a market?

Before we can assess whether an agreement substantially lessens competition in a given market, we first need to work out what that market is.

A market includes only those products or services that are seen as close substitutes. We look at the extent to which consumers and suppliers will substitute products for each other in the face of a price increase.

EXAMPLE

To decide if butter and margarine are in the same market, we look at whether they are substitutes for each other. We would ask, if there was a small increase in the price of butter:

- would buyers switch from butter to margarine?

  or
- would margarine producers switch to producing butter?

If enough customers switched to margarine so that the price increase was not profitable for butter producers, we would consider butter and margarine to be substitutes for each other and in the same market.

Likewise, if enough margarine producers decided it was profitable for them to switch to producing butter instead, we would also consider butter and margarine to be substitutes and in the same market.

An arrangement or understanding is something less formal than a contract. It requires a consensus that leads to an agreed course of action.

We define markets in a common sense way that fits with how the public or the industry views the market. Sometimes defining the market is a more technical exercise. You can read more about how we define a market at **www.comcom.govt.nz/mergers-and-acquisitions-guidelines-consultation**

What is a lessening of competition?

A lessening of competition is the same as an increase in market power for one or more businesses in a market. An agreement that increases the market power of one or more businesses will also lessen competition in that market.

Having more market power means a business can make decisions or act more independently of its competitors. A business with more market power can charge more or give less in terms of quality or service, without having to closely consider the possible reactions of its competitors, or the possibility of losing its customers to those competitors.

Often the businesses that have entered an anti-competitive agreement have been competing in the relevant market up until the point that they reach that agreement. When such competitors or potential competitors enter into an agreement not to compete, in effect, they are starting to behave like a single business, increasing their market power.

For vertical (supplier/customer) agreements to be illegal under section 27, the agreement must increase the market power of at least one of the businesses at one or more levels of the supply chain.

What is the supply chain?

The supply chain refers to all steps in the production, distribution and sale of a product. It includes buying raw materials, manufacturing or importing, wholesaling, distributing, retailing and customer service. Each of these steps in the supply chain is described as being downstream of the ones before it.

How much is a substantial lessening of competition?

When considering whether an anti-competitive agreement breaches section 27, we must decide whether there is a lessening of competition in a market, and if so, whether it is substantial. This means that the reduction in competition resulting from the agreement must be real or of substance, which will be reflected in higher prices or lower quality or service.

To assess whether the lessening of competition is substantial, we look at how competitive the market would be with the agreement in place and compare that to how competitive it would be without the agreement. This is sometimes referred to as the counterfactual analysis.

To assess the impact of the agreement on competition in the market, we look at the following factors:

- existing competition
- potential competition
- countervailing buyer power.

If the difference between the level of competition in the market with and without the agreement is considered to be substantial, the agreement will be illegal.

Existing competition
We assess the effect of the agreement on existing competition by looking at the number, market share and behaviour of businesses in the market, particularly those that are not party to the agreement.

For example, the greater the number of competitors in the market, the more competitive the market is likely to be, particularly if a significant number of competitors or those with significant market share are not party to the agreement. If the combined effect of these factors mean the market is competitive, it is less likely that there will be a substantial lessening of competition as a result of the agreement.

Potential competition
We also assess the effect of the agreement on potential competition by looking at what it would take for a competitor to enter the market or to expand in that market in the face of the agreement. We look at a range of factors including:

- how hard it would be for a competitor to enter the market (including how much of the cost of entering couldn't be recovered)
- how long it would take a competitor to enter or expand in the market
- what scale of entry would be needed to become a significant competitor in the market and provide real competitive constraint.

In markets where entry or expansion is difficult, an agreement will be more likely to cause a substantial lessening of competition.

Countervailing buyer power
Countervailing buyer power is the ability of customers to resist unfavourable terms or high prices. Countervailing power depends on a customer's size, importance to the supplier, and whether the customer has other credible options for supply available to them, such as the ability to import a similar product directly from overseas, or to supply themselves.

EXAMPLE – the southern ophthalmologists

A group of South Island-based ophthalmologists came to an arrangement to not provide the necessary support for two Australian ophthalmologists who were in negotiations with Southland Health to clear a surgery backlog. The High Court ruled the Ophthalmological Society and five ophthalmologists had breached section 27 of the Commerce Act. You can read the full case study at **www.comcom.govt.nz/s27-case-study-1**

When is a substantial lessening of competition more likely?

A substantial lessening of competition is more likely to occur in markets where the agreement:

- prevents or makes it more difficult for a potential competitor to enter the market
- makes it more difficult for an exisiting competitor to expand.

In markets where it is already difficult to enter or expand, an anti-competitive agreement will make it even more difficult. Therefore, such an agreement will be more likely to substantially lessen competition.

Are there any exemptions from section 27?

Some kinds of agreements are exempt from section 27, such as partnership agreements, agreements between interconnected bodies corporate, and agreements to comply with standards. These are explained, along with a number of other important exemptions, in our fact sheet *Exemptions under the Commerce Act* at **www.comcom.govt.nz/exemptions-under-the-commerce-act-fact-sheet**

Some agreements between competitors may be exempt from the price-fixing rules under section 30 of the Commerce Act, but remain subject to the test under section 27 if they substantially lessen competition in a market.

Authorisations

Under the Commerce Act, the Commission can authorise an anti-competitive agreement where it is satisfied that the benefits to the public outweigh the harm of the agreement. You can read more about authorisations at **www.comcom.govt.nz/authorisations**

This fact sheet is a guide only and reflects the Commission's view. The publication is not intended to be definitive and should not be used instead of legal advice. It is businesses' responsibility to remain up to date with legislation. Only the courts can make a ruling on breaches of the Commerce Act.

Penalties

If the courts find an individual or body corporate has breached the Commerce Act, penalties can be heavy:

- for an individual, a maximum of $500,000; or
- for a body corporate, the greater of:
  - $10 million, or
  - three times the commercial gain, or, if this cannot be easily established, 10% of turnover.

Every separate breach of the Act (even if done by the same person) may incur a penalty.

To check for updates to this fact sheet visit: **www.comcom.govt.nz/slc-agreements**
This fact sheet is part of a series looking at the Commerce Act and anti-competitive practices.
Other fact sheets can be downloaded from **www.comcom.govt.nz/business-competition**

Contact Us

Contact the Commerce Commission with information about possible breaches of the Commerce Act.

Phone: 0800 943 600
Write : Contact Centre, PO Box 2351, Wellington 6140
Email : contact@comcom.govt.nz