The Commerce Act

Taking advantage of market power

This fact sheet explains what a substantial degree of market power is and when taking advantage of that power is illegal under section 36 of the Commerce Act. It is intended to give businesses a better understanding of the types of behaviour that risk breaking the law. It also outlines what situations and behaviour may not necessarily be illegal.

Some businesses have substantial market power. This in itself is not illegal. But, when a business has a substantial degree of market power and takes advantage of that power for an anti-competitive purpose, competition can be harmed. Competition delivers lower prices, better quality, more choice and greater innovation to New Zealand consumers.

Sometimes a business with market power can take advantage of its market power to drive a competitor out of business or to prevent a new competitor from starting up. This can reduce or eliminate competition from a market, harming consumers and the wider economy.

Section 36 of the Commerce Act makes it illegal for any business with a substantial degree of market power to take advantage of that power to deter or prevent rival businesses from competing effectively.

In this fact sheet we cover:

- What is illegal under section 36?
- What types of behaviour are illegal?
- What types of behaviour are not illegal?

What is illegal under section 36?

There are three elements to section 36. A business will breach the Commerce Act if it:

- has a substantial degree of market power
- takes advantage of that power

  and
- has an anti-competitive purpose.

What is a substantial degree of market power?

To decide whether a business has a substantial degree of market power, we first need to understand the market, or markets, in which the business operates.

Section 36 – key points

- A business will break the law if it has a substantial degree of market power, takes advantage of that power and has an anti-competitive purpose.
- It is not illegal for a business to have a substantial degree of market power. But taking advantage of that market power to harm competition is illegal.
- High prices in themselves are not illegal.
- There are many types of behaviour that are illegal under section 36. It is often hard to distinguish anti-competitive behaviour from aggressive, but legal, competitive behaviour.
- Aggressive rivalry by large businesses may not be illegal – large businesses also have a right to compete. But they are not allowed to take advantage of their market power to prevent others from competing effectively.
- A refusal to deal with or supply someone is not, in itself, illegal.

What is the relevant market?

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

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.

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**

Businesses may have power in one market but may use that power in a different (but usually related) market. This can still be illegal under section 36.

What is substantial market power?

Only businesses that have substantial market power can harm competition. A business has substantial market power when it can profitably hold prices above competitive levels for a sustained period of time. Such a price rise will only be profitable if the business does not face effective competition from rivals in the same market.

When assessing whether a business has substantial market power, we consider how much existing and potential competition the business faces. We also look at other factors such as how much power buyers have.

- **Market share and existing competition**
  Does the business have a high market share? How much existing competition is there? Do these competitors help keep prices down? High market share alone does not necessarily mean a business has market power.

A business has substantial market power when it can profitably hold prices above competitive levels for a sustained period of time.

- **Potential competition**
  How much potential competition is there? If the business were to increase prices or reduce quality, how long would it take for a new competitor to enter or an existing competitor to expand? Would any new entry or expansion help keep the business' prices down? Could customers import a similar product at a similar price directly from overseas?
- **Countervailing buyer power**
  How much power are customers able to exert on the business? Would customers be in a position to refuse to buy the goods or services from a supplier that increased prices or lowered quality? Could customers:
  - credibly threaten to switch to another supplier?
  - sponsor another company to enter, for example, by promising a long-term contract to the company if it entered?
  - enter the market themselves?

What does "taking advantage of" mean?

To decide if a business is taking advantage of its market power, we ask whether the business would have behaved the same way if it did not have substantial market power, but was otherwise in similar circumstances. This is how we test whether the behaviour is the direct result of the market power the business has. It is sometimes called the "counterfactual test".

In other words, a business with a substantial degree of market power can compete in the same way as a business which does not have market power. Applying this test in practice can be complex and is usually the element of section 36 that requires the most analysis.

What does "anti-competitive purpose" mean?

Behaviour is illegal under section 36 if it has one of the following anti-competitive purposes:

- to restrict the entry of another business into any market
- to prevent or deter a business from being able to compete effectively
- to eliminate a business from any market.

Even if a business has other legitimate reasons for certain behaviour, if it also has one of these anti-competitive purposes, the behaviour will breach section 36.

Section 36 does not, however, protect individual businesses from facing vigorous, or even aggressive, competition.

A business with a substantial degree of market power can compete in the same way as a business which does not have market power.

What types of behaviour may be illegal under section 36?

A range of behaviours may be illegal under section 36. Some of these types of behaviour are described below. In each case, we would need to carefully analyse the behaviour to assess whether:

- the business has a substantial degree of market power and if so, whether the business is acting in a way that is inconsistent with how it would act in a competitive market
- there are plausible business reasons for the behaviour
- there is any evidence to indicate the business is using its market power for an anti-competitive purpose – to either stop a competitor from entering a market, make it harder for the competitor to compete effectively or force the competitor out of the market altogether.

The behaviour may also raise issues under other sections of the Commerce Act, particularly section 27, which covers anti-competitive agreements.

Predatory pricing

Predatory pricing is where a business lowers its prices for a sustained period of time to drive a competitor or competitors out of the market. For such behaviour to be illegal, a business must be pricing below an appropriate measure of cost. The business must also have the ability to recover its losses by increasing its prices later, without having to worry about others entering the market.

A business with a substantial degree of market power has the same right to compete as any other business. Where predatory pricing is alleged, it may be legitimate for the business with substantial market power to match a competitor's low price, even if it is below cost. This point is illustrated in the following case.

EXAMPLE – predatory pricing or competitive price matching?

New Wool Products started manufacturing a wool insulation product in competition with INZCO's Pink Batts. In response, INZCO developed a similar wool product and introduced a 2-for-1 deal for retailers in markets where New Wool Products was operating. We prosecuted INZCO on the basis it had used its market power to undertake a predatory pricing campaign against its competitor. However, the Privy Council ultimately ruled that INZCO had not breached the Commerce Act. You can read the full case study at **www.comcom.govt.nz/s36-case-study-1**

Refusal to supply

A refusal to supply can occur when a business operates at more than one level of the supply chain. Typically a business refuses to supply a competitor with an input, such as a raw material, or to give access to infrastructure, such as port services. The competitor needs the input or infrastructure to be able to compete in downstream markets, where the business refusing to supply also operates.

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.

We may be concerned about a refusal to supply if:

- the product or service, or a close substitute, is not available cost-effectively from other businesses

  and
- it does not make economic sense for the competitor to build its own infrastructure or to produce the input product or service itself.

However, in many cases, a refusal to deal, or to supply, may not, in itself, be illegal under the Commerce Act.

In general, any person in trade is able to decide who it does business with. This includes a supplier having the right to decide how many resellers it will appoint and their geographic distribution. The supplier will probably consider commercial factors such as:

- what is the right number of outlets in a given area?
- what is the cost to supply each outlet compared to the likely return?
- what is the credit worthiness of potential resellers?

A supplier may decide not to supply a particular reseller and providing that that decision is made on sound commercial grounds, such as those above, there is not likely to be an issue under the Commerce Act.

A refusal to deal or supply may also raise issues under other sections, including section 27 (agreements that substantially lessen competition), and section 37 (resale price maintenance). You can read more in our fact sheets *Agreements that substantially lessen competition* and *Resale price maintenance at* **www.comcom.govt.nz/fact-sheets-3**

EXAMPLE – assessing a refusal to supply

An outdoors gear supplier became the New Zealand agent for a brand of ski boots and decided not to supply the boots to a retailer who had stocked the boots for many years. The retailer complained to us. We concluded that the supplier did not have a substantial degree of market power and therefore could not have taken advantage of that market power. You can read the full case study at **www.comcom.govt.nz/s36-case-study-2**

High access pricing

High access pricing can also occur when a business operates at more than one level of the supply chain. Typically a business charges a competitor high prices for an input or access to the infrastructure needed to compete in downstream markets where the supplying business also operates.

We may be concerned if:

- the business charges its competitor high prices relative to the selling price of the downstream product or service
- the product or service, or a close substitute, is not available cost-effectively from other businesses

  and
- it does not make economic sense for the competitor to build its own infrastructure or to produce the input product or service itself.

This is sometimes referred to as a price or margin squeeze. This is where a downstream competitor can't survive as the price they are paying for the input is too high compared to the price customers are being charged.

Exclusive dealing

A business may have contracts with retailers or distributors that allow them to only sell its products. A business may also have contracts with a supplier under which the supplier agrees to supply only to that business. These types of arrangements can benefit competition. For example, they can encourage investment by retailers and distributors in advertising and after-sales services.

However, it would be illegal if a business was using its substantial market power through an exclusive dealing arrangement for an anti-competitive purpose, such as denying competitors access to an input or an important distribution channel.

We would look at the extent to which an exclusive dealing arrangement did in fact deny access to a competitor. We would consider, for example, whether a particular input was in short supply and whether alternative sources of supply were available.

Tying

Tying involves a business only selling a product if the customer purchases it together with another product. In other words, product A is only available if the buyer also agrees to buy product B. Selling products together in this way is often good for both consumers and suppliers but, sometimes, tying can harm competition. For example, if a competing supplier of product B can't supply product A, it may not be able to compete effectively with the business that is tying the two products together.

EXAMPLE – where tying harms competition

The Hermitage at Aoraki/Mount Cook decided to tie the purchase of hotel accommodation with the supply of evening meals through a compulsory "Dinner, Bed and Breakfast" rate. We found that the deal limited competition and restricted consumer choice. You can read the full case study at **www.comcom.govt.nz/s36-case-study-3**

When a business with substantial market power offers conditional discounts for an anti-competitive purpose, a competitor can be prevented from competing effectively.

Conditional discounts

Conditional discounts involve a business offering customers a discount if they meet a certain condition. For example, customers may be required to purchase a certain proportion of their stock or certain volumes from the business to qualify for the discount. Conditional discounts can be a form of competitive pricing. They may result in economies of scale for sellers and lower buyers' costs for providing goods or services to customers. For example, volume discounts are a common business practice that can benefit consumers.

However, when a business with substantial market power offers conditional discounts for an anti-competitive purpose, a competitor can be prevented from competing effectively. For example, a competitor may not be able to get access to a sufficient share of customers to achieve the scale it needs to compete effectively.

What types of behaviour are not illegal under section 36?

We receive many complaints alleging businesses are taking advantage of market power for an anti-competitive purpose. However, many of these complaints don't meet the requirements of section 36. Below are examples of behaviour that are not illegal under the Commerce Act.

Simply having a substantial degree of market power

It is not illegal for a business to have a substantial degree of market power. Businesses often obtain market power through being more efficient or innovative than their competitors. If obtained this way, market power can be seen as a reward for competing successfully.

Powerful businesses competing aggressively

A business with a substantial degree of market power has the same right to compete as any other business. Distinguishing between illegal anti-competitive behaviour and aggressive but legal competition can be difficult and is done on a case-by-case basis.

High prices

A business is generally free to offer goods or services at any price it chooses. High prices in themselves are not illegal. Imposing high prices, such as high access prices to competitors, will only be illegal if a business is taking advantage of its market power for an anti-competitive purpose.

Enforcement of intellectual property

It is not illegal to enforce a statutory intellectual property right, such as enforcing copyright, patent, registered design or trademarks. These intellectual property rights are set out under section 45(2) of the Commerce Act.

A business with a substantial degree of market power has the same right to compete as any other business.

Markets where there is little or no competition

In some markets, there may be little or no competition and little prospect of future competition. In these markets the Commerce Commission may conduct a price control inquiry, either at the request of the Minister or on its own initiative. The outcome of such an inquiry may be that the Minister directs the Commission to regulate the price or quality of those goods or services for the long-term benefit of consumers.

The Commission already regulates certain markets under either Part 4 of the Commerce Act or under specific legislation, including electricity lines services, gas pipeline services, airport services, telecommunications and the dairy industry services. You can read more in our fact sheet *Regulation of goods and services* at **www.comcom.govt.nz/the-commerce-act-regulation-of-goods-and-services**

Section 27 – agreements with suppliers and customers

Sometimes a business with substantial market power may enter into contracts or other agreements with suppliers or customers with the purpose of tying the market up and forcing another competitor out. This type of behaviour may also be illegal under section 27 of the Commerce Act, which makes it illegal to include provisions in agreements that have the purpose, effect or likely effect of substantially lessening competition in a market. You can read more in our fact sheet *Agreements that substantially lessen competition* at **www.comcom.govt.nz/slc-agreements**

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/market-power-fact-sheet**
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.

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