OFFICE OF THE MINISTER
OF COMMERCE

The Chair
Cabinet Business Committee

Proposed Amendments to the Commerce Act in relation to cartels

Proposal

1. This paper reports back on the consultation on the exposure draft *Commerce (Cartels and Other Matters) Amendment Bill* (the exposure draft Bill) and makes final policy recommendations in relation to the issues raised and seeks introduction of the attached Bill.

Executive Summary

2. Effective competition underpins the productivity of individual firms and the public sector and as a result plays an important role in the overall economy. Competition law is just one instrument that the government can use to promote a competitive culture in New Zealand but it is a very important one because it applies to all sectors, except where specifically exempt. General competition law, as set out in the Commerce Act, is designed to incentivise competitive behaviour through prohibiting anticompetitive practices, including hard-core cartels.

3. As the OECD has previously noted:

> "Cartels harm consumers and have pernicious effects on economic efficiency. A successful cartel raises price above the competitive level and reduces output. Consumers (which include businesses and governments) choose either not to pay the higher price for some or all of the cartelised product that they desire, thus forgoing the product, or they pay the cartel price and thereby unknowingly transfer wealth to the cartel operators."[1]

4. At an individual firm level, ensuring that inputs are competitively priced allows firms to compete more effectively in domestic and international markets. From a public sector perspective, effective competition is also important because the public sector is a major purchaser of goods and services. Carefully designed procurement processes can be used by the public sector to achieve competitive outcomes that promote economic growth, while encouraging value for money over the long-term.

5. However, the competitive process only works well when acquirers and suppliers act and price independently and honestly.

6. The question of whether to introduce criminal sanctions arose out of the Single Economic Market (SEM) Outcomes Framework.[2] In 2009, Australia criminalised hard-core cartel conduct, so it was timely for the government to consider criminalising hard-core cartel behaviour in New Zealand.

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[1] OECD, *Hard Core Cartels: Recent Progress and Challenges Ahead,* 2003, p 8.
[2] Trans-Tasman Outcomes Framework under the Single Economic Market agenda jointly announced by the Australian and New Zealand Prime Ministers in 2009.

7. Responses to a discussion document on cartel criminalisation[3] identified problems with the current legislative regime. In particular, there was uncertainty over the scope of the prohibition and whether it prohibited legitimate, pro-competitive conduct. Submissions on the discussion document suggested that if the scope of the prohibited conduct was ill-defined, then introducing criminal sanctions could exacerbate existing problems in that it would have a chilling effect and increase compliance costs.

8. Given this uncertainty, Cabinet decided to develop an exposure draft Bill to test whether it would be possible to clarify the law. The exposure draft Bill was released in June 2011 and submissions were sought on whether the Bill adequately supported pro-competitive business arrangements.

9. Having considered submissions, there is broad support for reforms to the civil regime; including amendments to the prohibition and exemptions and the introduction of a clearance regime. In particular, there was support for:

    - The prohibition, which specifically prohibits price fixing, restricting output, market allocation and bid rigging.

    - The collaborative activity exemption, which is a broad principle based exemption that examines the substance of the collaborative activity, not the form.

      Together the prohibition and exemptions clarify the law and minimise the risk of overreach, which exists in the current law.

    - The clearance regime, which allows businesses to manage any residual risk prior to entering into a collaborative activity.

10. The main issue of contention is whether criminalisation is the best way to increase deterrence.

11. Additional measures that have been identified to mitigate the downside of criminalisation include:

    - Inviting the Commerce Commission to develop prosecution guidelines that outline when they would take a criminal prosecution.

    - Inviting the Commerce Commission to undertake further advocacy work to promote better understanding of the prohibitions in the Commerce Act, particularly the cartel prohibition and exemptions.

12. In response to concerns about the transition to a new regime and the potential for the introduction of criminal sanctions to exacerbate the risk of any chilling effect, I am proposing to sequence the introduction of the new regime so that the prohibition, exemptions and the clearance regime come into force on the day that the Act receives Royal assent but delay the commencement of criminal sanctions to give the new regime time to bed-in.

13. Overall the amendments to the Commerce Act are part of a coherent package of reforms that carefully balance competing concerns. Criminal sanctions are a significant change. Consequently it has been important to provide greater certainty to businesses. Given the safeguards that have been built into the new regime and the sequencing of the commencement of criminal sanctions, the benefits of criminalisation should be fully realised and any downsides of criminalisation substantially mitigated.

[3] Ministry of Economic Development, *Cartel Criminalisation: Discussion Document,* January 2010.

Background

Hard-core cartels create harm

14. Hard-core cartels are formed when rival firms agree to not compete with each other by fixing prices, restricting outputs, allocating markets or rigging bids. Cartels allow firms to raise their prices above the competitive level without fear of losing customers to rivals. This increases the profits of the participants but it does not create a countervailing benefit to consumers through more efficient business operations. Cartels are difficult to detect because they are generally conducted in secret and the participants often go to great lengths to hide their activity.

15. Cartel activity impedes New Zealand's economic performance in three ways:

    a. By raising the price above the competitive level, a cartel reduces demand for the good or service and hence production of the good or service. As a result, resources are not deployed where they will be of maximum benefit.

    b. A successful cartel also protects its participants from the risk that they will lose market share in response to competition from another firm. This protects inefficient firms and creates a drag on productivity improvements.

    c. The lack of competition creates less incentive for the cartel members to innovate by reducing costs or improving the quality of their product in order to retain their market share. Cartelised businesses may also attract greater levels of investment because they are more profitable than they would be in a competitive environment. This would create distortions in investment.

16. In addition to its economic harm, the higher prices imposed by cartels result in a transfer of wealth from consumers to the cartel. The transfer is on the basis of a secretive agreement that consumers are not aware of and as a result has been likened to theft or fraud. However, unlike theft or fraud where the harm resulting from the offending is generally limited to a discrete group of people, the harm created by cartels affects the whole economy.

17. Currently cartel conduct is prohibited under section 30 of the Commerce Act, which is an outcomes based prohibition. In other words, it prohibits conduct that has the effect of fixing prices.

18. Since the Commerce Act came into force, the Commerce Commission has investigated numerous alleged cartels. Many investigations are settled before they go to court or the Commission exercises its prosecutorial discretion and elects to warn alleged offenders rather than instituting proceedings.

19. New Zealand courts have found against 16 different cartels and imposed civil pecuniary penalties. These penalties have generally been in the order of $100,000 to $500,000. However, the penalty provisions in the Act where amended in 2001 to provide for higher penalties. More recently the courts appear to have been willing to impose higher penalties. For instance, in the air cargo proceedings, a penalty of $6.5 million was imposed on Qantas, $6 million on Cargolux and $1.5 million on British Airways.[4] The penalties in the freight forwarding proceedings have also been between $2.5 and $1.1 million.[5]

20. There have been a number of proceedings against domestic cartels. These have been in a range of different sectors, including animal remedies and ophthalmology. Currently there are two trans-Tasman cartels before the courts: wood chemicals and cardboard. The widely publicised air cargo and freight forwarding cartels are also examples of international cartels that have affected New Zealand.

International movement towards criminalising hard-core cartel behaviour

21. There has been growing international recognition of the extent of cartel activity, with many cartels operating in multiple countries. In response, a number of our key trading partners, such as the United States, the United Kingdom, Canada, Australia, Japan and Korea, have criminalised cartel conduct. All the developed common law countries have criminalised cartel conduct. The OECD recommends cartel criminalisation where this is consistent with social and legal norms.[6]

22. This raises the question of whether the current legislation provides sufficient disincentives for cartel activity and allows New Zealand to participate in co-ordinated international criminal action against hard-core cartels.

23. In order to reduce barriers to trans-Tasman trade, the Government has committed to a high-level outcome under the SEM Outcomes Framework of ensuring that firms will face the same consequences for the same anti-competitive conduct [ERD Min (09) 10/1]. In 2009, Australia criminalised hard-core cartel conduct, so it was timely for the Government to consider criminalising in New Zealand.

The policy process identified problems with the existing regime

24. Currently, the Commerce Act deters cartel conduct through a prohibition that focuses on the conduct's effect on price. Market allocation, output restrictions and bid rigging are only prohibited if it can be shown that the conduct had a price effect. There are a range of exemptions, including a joint venture exemption. The Act also provides a range of penalties, including civil pecuniary penalties. The Commerce Commission detects and investigates cartel behaviour through the use of its leniency policy, which encourages those involved in cartel behaviour to notify the Commission in return for leniency.

[4] The air cargo proceedings are still before the court, however, settlements have been reached with Qantas and British Airways.
[5] Geologistics $2.5million, EGL $1.5 million, BAX$1.4 million, Schenker $1.1 million and Panalpina $2.7 million.
[6] OECD, *Hard Core Cartels: Recent Progress and Challenges Ahead*, 2003.

25. In January 2010 a discussion document was released for consultation and sought views on whether New Zealand should criminalise hard-core cartel conduct.[7] It noted that increased deterrence could be achieved by:

    - Undertaking additional enforcement activity.
    - Increasing the level of financial penalties or other forms of penalty.
    - Introducing a criminal offence for hard-core cartel conduct.

26. While some submissions suggested that the current penalty regime provides an adequate deterrent effect, penalties are problematic in that optimum penalties are difficult to calculate. There are generally discounts available for cooperation and imposing the maximum fine may be enough to bankrupt some firms, which is undesirable from a competition perspective. In New Zealand, the judiciary has never imposed maximum fines, which suggests there is unlikely to be any significant benefit from increasing penalties for firms above their current level.

27. In contrast, criminal sanctions would change the incentives on individuals.

28. Submissions raised concerns that it would be difficult to express in legislation what constitutes hard-core cartel conduct. If ill-defined, criminal sanctions may:

    - deter pro-competitive behaviour because people would be more risk averse if there was uncertainty around the scope of the prohibition or exemptions; and
    - increase the costs of doing business because people would be more likely to seek specialist advice where there was a risk that the activity they are considering engaging in may be in breach. Furthermore, they could be personally liable, and if liable, may be subject to criminal sanctions.

29. In response to concerns, Cabinet agreed to develop an exposure draft Bill on cartel criminalisation to test whether it was possible to define the prohibition and exemptions with sufficient clarity, such that any downsides of criminalisation would be remedied or at least mitigated [EGI Min (10) 25/3 refers].

30. This Cabinet Paper reports back on the consultation on the exposure draft Bill and makes final policy recommendations, principally to criminalise hard-core cartel conduct.

Consultation on the exposure draft Bill

31. Sixteen written submissions were received. In addition, officials held a number of workshops with competition law specialists, corporate counsel, economists and other business representatives. Submissions were complimentary about the process, in particular the decision to develop and consult on an exposure draft Bill prior to making final policy decisions.

32. Responses to the exposure draft Bill differed from those received on the discussion document. There were a range of views, including:

    - Those that had previously supported the introduction of criminal sanctions, maintained their support.

[7] Ministry of Economic Development, *Cartel Criminalisation: Discussion Document,* January 2010.

- Some submitters, who had previously opposed criminalising, had reconsidered their position based on the legislative framework set out in the exposure draft Bill and accepted that there could be benefit in criminalising.

- Others remained reluctant to endorse criminalisation but viewed it as inevitable and as a result were willing to engage so that the final regime would be workable. These submitters expressed general support for the design of the prohibition, exemptions and clearance regime, however, they continued to raise the same concerns: that the case for criminalisation has not been made and introducing criminal sanctions could chill legitimate pro-competitive activity.

33. One cause for concern was that even within large, seemingly well-resourced businesses; sales people, mid-level managers and senior managers may already be reluctant to engage in pro-competitive, efficiency enhancing conduct with competitors because of the risk that it might be in breach of the Commerce Act.

34. Where submissions addressed the design of the regime, most were of the opinion that it would be a significant improvement on the current price fixing prohibition and joint venture exemption set out in the Commerce Act. Australian competition specialists, Brent Fisse and Caron Beaton-Wells commented that the exposure draft Bill is a substantial improvement on the Australian regime and avoids the overreach and undue complexity of the Australian provisions.[8]

Key features of the regime

35. There are a number of key features of the regime. These include:

- A parallel civil prohibition and criminal offence [EGI Min (10) 25/3, paragraph 7.1 refers].

- A prohibition that defines the form of the conduct that is illegal (fixing prices, restricting output, allocating markets and rigging bids) rather than the outcome (the effect on price) [EGI Min (10) 25/3, paragraph 7.3.1 refers].

- The exemptions, particularly the collaborative activity exemption, which would replace the joint venture exemption in the current regime.

- The mental element of the criminal offence, which is 'intent'. For instance, intent to fix prices, allocate markets, restrict output or rig bids.

- The introduction of a clearance regime for collaborative activities.

- For an individual, the maximum penalty for a cartel offence will be a term of imprisonment of seven years and for a body corporate it will be the same as the current maximum pecuniary penalty [EGI Min (10) 25/3, paragraphs 7.17 and 7.18 refer].

36. I would like to draw your attention to three elements of the regime, which have a number of safeguards built into them to promote certainty and confidence in the new regime:

- the collaborative activity exemption;

[8] Beaton-Wells, C, Fisse, F, *Submission for the Ministry of Economic Development (NZ),* 1 August 2011, p2.

- the clearance regime; and
- the criminal offence.

Collaborative activity exemption

37. Given the broad scope of the prohibition, the exemptions are essential to the workability of the proposed regime.

38. In developing the exposure draft Bill both an ancillary restraints exemption and joint venture exemption were considered.[9] However, subsequent to the decisions on these policy parameters[10], a third option of an exemption for collaborative activity was developed and adopted for the purposes of the exposure draft Bill. It is intended to be sufficiently broad to cover both joint ventures and ancillary restraints.

39. The exemption for collaborative activity focuses on substance over form. It asks whether collaborative activity has a legitimate collaborative purpose (i.e. does not have a dominant purpose that is anticompetitive) and whether the cartel provision is reasonably necessary to achieve that purpose.

40. In general the exemption has been well received by businesses and competition law specialists. BusinessNZ stated that "the breadth of the exemption should create greater certainty for businesses that are proposing to enter into collaborative efficiency-enhancing arrangements". At the workshops, competition law specialists indicated that businesses should be able to satisfy themselves that contemplated conduct does not come within the prohibition.

41. To the extent that concerns have been raised, it relates to the exemption being new and as a result there is uncertainty over how the Commission will interpret and approach the new exemption. More specifically, there is a concern that the 'reasonably necessary' limb of the exemption allows the Commission to second-guess commercial judgements made by the parties.

42. Having considered the submissions, my view is that the collaborative activity exemption should make it clear that pro-competitive and efficiency enhancing activities are not prohibited but rather encouraged under the Commerce Act, however, I acknowledge that the test is new for New Zealand and initially there may be some uncertainty over how it will be applied.

The clearance regime

43. The Bill introduces a clearance regime to help businesses manage any residual risk that their proposed collaborative activity might be in breach. Currently the Commerce Act provides a clearance regime for mergers. The clearance regime allows parties proposing to acquire assets or shares to test with the Commission whether the acquisition would raise competition concerns. There is no equivalent regime for

[9] A joint venture is an association of persons formed to pursue a particular business objective for mutual profit. The term 'joint venture' does not have a settled legal meaning in New Zealand, reflecting the fact that it covers a wide variety of arrangements. Depending on their purpose or effect, joint ventures can be a legitimate form of business activity that have pro-competitive, efficiency enhancing effects. However, joint ventures often include restraints on competition between the parties. The US and Canada have developed an ancillary restraint defence to exempt those restraints which are ancillary to a lawful purpose and reasonably necessary to accomplish that purpose.

[10] EGI Min (10) 25/3, paragraphs 7.7 and 7.8 refer.

collaborative arrangements despite them having pro-competitive, efficiency enhancing benefits that are similar to mergers.

44. Clearance provides confirmation that the collaborative activity is okay, in that it would not contravene the per se prohibition[11] against cartel conduct, nor would it contravene the rule of reason prohibition[12] in section 27. Section 27 prohibits arrangements that have the purpose, effect or likely effect of substantially lessening competition in a market.

45. Consequently there are two limbs to the proposed clearance test. The first limb relates to the collaborative activity exemption and allows a person to apply to the Commission to seek confirmation that the activity is a legitimate collaborative activity. For the most part, it is envisaged that this would be a straightforward process whereby the applicant would set out the scope of the collaborative activity in the application for clearance and justify why the cartel provision is reasonably necessary. The Commission's role would be to verify the elements of the application. The second limb mirrors the test used in merger clearances and tests whether the collaborative activity raises competition concerns.

46. The Commission's practice is to publish detailed written reasons for its decisions. By having the Commission turn its mind to the key elements of the collaborative activity exemption in deciding whether or not to give clearance, over time this analysis would form a non-binding body of precedent.

47. The clearance regime has also been well received. BusinessNZ submitted that the clearance regime provides a positive option for businesses to take up and allows businesses to manage uncertainty.

Criminal offence provision

48. The introduction of criminal sanctions is still a major issue of contention.

49. Section 82B of the Bill provides for criminal liability. It sets out the additional element of intention needed to prove the offence and the criminal penalty regime. The offence would need to be proved to a higher standard – beyond reasonable doubt. For bodies corporate, the maximum penalty is the same as the maximum pecuniary penalty. For individuals, the maximum penalty is a term of imprisonment not exceeding seven years.[13]

50. As previously indicated, among those that support criminalisation, the likely increased detection and deterrence effects were cited as the main reason to introduce criminal sanctions. Supporters see criminalisation as a suitable punishment given the level of harm caused by cartels. Some also believe that there would be value in aligning New Zealand's approach with other jurisdictions.

[11] Per se prohibitions prohibit certain types of conduct, without any assessment of the impact of that conduct on competition. Per se rules provide greater certainty and predictability for businesses and avoid courts having to undertake detailed inquiries into the economic effects of a practice.

[12] Rule of reason prohibitions involve an examination of the effect of the conduct on competition in a market. Such a prohibition never prohibits pro-competitive or competitively neutral conduct but they do not create bright line rules and as a result do not enable a quick assessment of whether conduct is legitimate.

[13] This is less than our trading partners. Canada has a maximum term of imprisonment of 14 years and Australia 10 years.

51. Those who oppose criminalisation argue that there is a lack of evidence of a problem to justify criminal penalties for cartels as well as a lack of evidence to suggest that criminalisation would improve either the detection or deterrence of cartels. They suggest that the current penalties are effective. Thus criminalisation would offer little benefit while imposing substantial costs on businesses and the Commerce Commission.

52. A prominent commentator and proponent of criminalisation, made the following points:

- The starting point should be that hard-core cartel behaviour must be criminalised. The nature of the conduct is serious widespread fraud affecting many businesses and individuals.

- From an ethics perspective, business should be demanding criminalisation. Purchasers of goods and services, most often businesses, are irretrievably harmed.

- The nature of the hard-core cartel conduct is often strongly indicative of criminal behaviour. Executives go to some lengths to conceal their behaviour.

- The concern that criminalising hard-core conduct risks chilling pro-competitive behaviour is overstated. The US has always prosecuted hard-core cartel conduct criminally and there is no evidence that it has chilled pro-competitive behaviour.[14]

53. In another article a partner in one of New Zealand's large commercial firms questioned whether the proposed regime was "a well-designed sledgehammer to crack a nut". The article noted that while the stated objectives of promoting deterrence and improving international cooperation in cartel enforcement are worthwhile, it remains possible for effectively designed legislation to represent bad policy if the need for legislative change or incremental gains from that change are minimal.[15]

54. Implicit in the range of views is a range of different values. Some may see cartel behaviour as being harmful in the same way that a monopolist causes harm. It is a transaction with a willing buyer albeit at the cartelised price. Persons that hold these views may be less likely to see cartel behaviour as worthy of criminal sanctions. At the other end of the spectrum, there are those that consider cartel behaviour as morally wrong and unambiguously harmful. These people are more likely to see such conduct as deserving of criminal sanctions.

55. In considering whether to create a criminal offence, the Legislative Advisory Committee Guidelines suggest that regard should be had to the following questions:

- Will the conduct in question, if permitted or allowed to continue unchecked cause substantial harm to individual or public interests?

- Is the conduct that is to be categorised as a criminal office able to be defined with precision?

[14] Taylor, P, *Tarantulas, drug dealing, fraud, and cartels,* NZ Lawyer, 15 July 2011, p 14.
[15] Ladd S, Milne, C, *Cartel criminalisation – a well-designed sledgehammer to crack a nut?,* NZ Lawyer, 29 July 2011, p 12.

- Would public opinion support the use of the criminal law, or is the conduct in question likely to be regarded as trivial by the general public?[16]

56. In my view the first and second factors are met. In relation to the first factor, as set out above, hard-core cartels cause harm, both to individuals and to the economy. It is impossible to know the size of the harm because cartels by their very nature are secret but there is no reason to think that cartels do not operate in New Zealand given that our markets are concentrated. In relation to the second factor, feedback on the exposure draft Bill suggests that it has clarified the law and minimises the overreach and undue complexity of the Australian provisions. A number of people have said that if New Zealand was to criminalise hard-core cartel conduct, the approach set out in the exposure draft Bill would be the way to do it.

57. Other factors that are likely to be important include:

- Encouraging those with prosecutorial discretion to only prosecute cases of serious offending.

- Undertaking advocacy work to promote better understanding of the offence.

- Finally, criminalising, in and of itself, sends a message that the government considers cartel behaviour to be worthy of criminal sanctions.

58. In response to business concerns that the regime is new and consequently that the introduction of criminal sanction may exacerbate the risk of chilling pro-competitive behaviour, I also propose to:

- Invite the Commerce Commission to develop prosecution guidelines that outline when they would take a criminal prosecution.

- Invite the Commerce Commission to undertake further advocacy work to promote better understanding of the prohibitions in the Commerce Act, particularly the cartel prohibition.

- Sequence the introduction of the new regime so that the prohibition, exemptions and the clearance regime come into force the day after the Act receives Royal assent but the commencement of criminal sanctions is delayed.

59. Sequencing the introduction of the new regime would allow the new civil regime to bed-in and in doing so reduce the risks and cost of criminalisation. More specifically:

- It allows businesses and their advisors to become familiar with and develop confidence in the new regime before the introduction of criminal sanctions. This should further mitigate the risk that criminal sanctions would chill pro-competitive behaviour.

- It allows the Commission to develop the capability required to investigate criminal behaviour but also to signal its approach to the collaborative activity exemption through its assessment of clearances applications.

60. Sequencing would be achieved by specifying a commencement date for criminal sanctions in the Bill. Section 2 of the Bill provides that criminal sanctions will commence two years after the date on which the Act receives Royal assent.

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[16] *Legislative Advisory Committee Guidelines: Guidelines on Process and Content of Legislation*, 2001 edition, p 144.

Recommendation to criminalise cartel behaviour

61. The incremental costs and benefits associated with the introduction of criminal sanctions are set out in the following table. They are discussed in more detail in the Regulatory Impact Statement.

For	Against
The main benefits are: 1. Increased deterrence due to severe sanctions and associated stigma. 2. Increased detection from benefits received as a result of leniency. 3. An improved ability to cooperate and detect cartel conduct. 4. Advancing the SEM Outcomes Framework. ***Improved deterrence*** Severity of criminal sanctions would likely lead to increased deterrence especially from the social stigma and possible restriction of an individual's freedom. ***Improved ability to detect*** Increased sanctions would improve the effectiveness of the leniency regime by increasing the value to the individual applying for leniency. ***Improved ability to cooperate*** This is particularly important for global cartels where information is more likely to be shared with countries that have criminal regimes. Criminal sanctions also allow for the use of mechanisms such as extradition. ***SEM Outcomes Framework*** SEM objectives may be advanced by ensuring that competition laws in Australia and New Zealand establish comparable standards of behaviour and sanctions for illegal conduct.	The main costs are: 1. Increased costs for the regulator. 2. Increased court and incarceration costs. 3. Any incremental costs of businesses. ***Regulator costs*** • Costs associated with developing capability to investigate criminal offences. • Increased costs to carry out advocacy work, including the development of guidelines. ***Court and incarceration costs*** These costs are unlikely to be significant. ***Business costs*** Submissions suggested that costs would also result from: • deterring pro-competitive behaviour; and • the increased costs of doing business due to threat of criminal sanctions. As discussed above, the regime has been carefully designed to mitigate these costs.

62. Overall the amendments to the Commerce Act are part of a coherent package of reforms that carefully balance competing concerns. Criminal sanctions are a significant change. Consequently it has been important to provide greater certainty to businesses. Given the safeguards that have been built into the new regime and the sequencing of the commencement of criminal sanctions, the benefits of criminalisation should be fully realised and any downsides of criminalisation substantially mitigated.

Consultation

63. The Commerce Commission, Treasury, Ministry of Justice, Ministry of Foreign Affairs and Trade, Crown Law, Ministry of Transport, Ministry of Agriculture and Forestry and the Department of Prime Minister and Cabinet have been consulted on the proposals in this paper.

64. Treasury have indicated that they have concerns about introducing criminal sanctions. More particularly:

> "Treasury supports moves to clarify the laws around cartel behaviour, such as the changes proposed in option 2 of the attached RIS. The proposed clearance regime for pro-competitive behaviour would reduce uncertainty for businesses entering into pro-competitive arrangements with competitors. However, criminalisation of cartels is not required for these changes to be made. It is also unclear that there would be additional benefits from criminalisation, over and above the benefits from clarifying the laws around cartels, that would justify the increased costs on businesses, courts and the Commerce Commission.
>
> "Our reasons for this are:
>
> - It is not clear that New Zealand has levels of cartel behaviour that warrant criminalisation. Only 16 price fixing judgements have been issued by the New Zealand courts over the past 25 years and the maximum civil penalties have never been imposed.
>
> - The impact of criminalisation is uncertain. Given the civil penalties already available, criminalisation is unlikely to significantly increase either the deterrence or detection of cartel behaviour. Without a significant improvements in cartel detection or deterrence, the main benefit from criminalisation appears to be greater alignment of pro-competitive regulation with other jurisdictions. However, increased international cooperation can be achieved through other means.
>
> - Any marginal benefits from criminalisation are likely to be significantly outweighed by the costs faced by businesses who would have to ensure they are complying with the law. Despite the proposed clearance regime for collaborative arrangements, there is likely to be some chilling of pro-competitive behaviour. The Commerce Commission and the Courts would also face increased costs, as a higher standard of proof would be required to pursue criminal cases.
>
> "On balance, it is difficult to see how the likely benefits of cartel criminalisation in terms of international cooperation would exceed the likely costs imposed on businesses, the Commerce Commission, and the Courts. The benefits from clarifying the laws around cartel behaviour can be achieved without the introduction of criminal penalties. Treasury also notes that the majority of written submissions did not support cartel criminalisation."

Fiscal Implications

65. I anticipate that there may be an initial increase in costs resulting from the introduction of the new civil regime, particularly the new collaborative activity exemption and clearance regime. These include:

- One-off set-up costs to enable the Commission to develop collaborative activity guidelines. The Commission estimates that the guidelines would cost around $50,000.

- Costs associated with continued advocacy and assessing clearance applications.

66. Clearance applications are accompanied by a clearance fee, however, the fee does not represent the average cost of a clearance. The Commission has advised that the average cost of a clearance is approximately $40,000. Following a review of the application fee, which is currently set at $2,000 (excl GST), Cabinet agreed that the fee be increased to $7,000 excluding GST [EDC Min (05) 8/3.1-3.5 refers]. This would also apply to applications for collaborative activity clearances. It is not possible to estimate the number of clearance applications, however, I expect that any initial surge would ease as businesses become familiar and develop confidence in the new regime.

67. The introduction of criminal sanctions may also involve some additional incremental cost to enable the Commission to build capability in criminal investigation and procedure and to develop appropriate guidelines. The Commission already has existing evidence rooms so it is unlikely that it will need to undertake additional capital investments. I estimate that the guidelines would cost around $50,000 and I understand that the Commission is already investing in building capability in criminal procedure.

68. The increased costs to the Commission associated with the introduction of the new regime should be able to be met from reprioritisation in the Vote, if not within the existing appropriation.

69. Cartel prosecutions, whether criminal or civil, are complex and lengthy. The incremental cost to the Court of taking a criminal prosecution is unlikely to be substantial. At this stage I estimate that the costs would be similar, or not so different as to warrant funding changes for Vote Courts.

70. Similarly, I am not anticipating an increase in imprisonment rates such that it would have a significant impact of Vote Corrections and therefore do not propose funding changes.

Human Rights

71. The Bill appears to be consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Regulatory Impact Analysis

72. A Regulatory Impact Statement has been prepared and is attached to this Cabinet paper at **Appendix 2**.

Quality of the Impact Analysis

73. Treasury's Regulatory Impact Analysis Team (RIAT) has reviewed the attached RIS. Its assessment is set out below:

"The Regulatory Impact Analysis (RIA) requirements apply to the proposal in this paper and a Regulatory Impact Statement (RIS) has been prepared and is attached.

The Regulatory Impact Analysis Team (RIAT) has reviewed the RIS prepared by the Ministry of Economic Development and associated supporting material, and considers that the information and analysis summarised in the RIS meets the quality assurance criteria.

Because of the hidden nature of cartels, and the difficultly of accurately determining the costs they impose on the economy, a more precise cost benefit analysis is not feasible. This makes it difficult to precisely determine the incremental impact of criminalisation in deterring cartel conduct, and so whether it is a proportionate response to the problems posed by cartel conduct.

The effectiveness of criminalisation in deterring cartel conduct will also rely mainly on the effectiveness of the enforcement activities undertaken by the regulator."

Consistency with Government Statement on Regulation

74. I have considered the analysis and advice of my officials, as summarised in the attached Regulatory Impact Statement and I am satisfied that, aside from the risks, uncertainties and caveats already noted in this Cabinet paper, the regulatory proposals recommended in this paper:

- are required in the public interest;
- will deliver the highest net benefits of the practical options available; and
- are consistent with our commitments in the Government Statement on Regulation.

Compliance

75. The Bill complies with the:

- principles of the Treaty of Waitangi;
- rights and freedoms contained in the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993;
- principles and guidelines set out in the Privacy Act 1993;
- relevant international standards and obligations; and
- LAC Guidelines: Guidelines on Process and Content of Legislation as discussed at paragraph 55 above.

Associated regulations

76. The Commerce Act (Fees) Regulations will be amended to include fees relating to the new clearance regime.

Commencement of legislation

77. The Bill will come into force the day after it receives Royal assent. To allow the amendments to bed-in prior to the introduction of criminal sanctions, the criminal regime will commence two years after the commencement of the rest of the Act.

Parliamentary Stages

78. It is proposed that the Bill be introduced into the House of Representatives in the middle of October and referred to the Commerce Select Committee for public consultation. The Bill holds a priority 4 on the 2011 legislative programme.

Publicity

79. I propose to issue a press release once the Bill has been introduced into the House. The Ministry of Economic Development will also post a copy of this paper on its website.

Recommendations

80. The Minister of Commerce recommends that the Committee:

1 Note the report on the consultation on the exposure draft Commerce (Cartels and Other Matters) Amendment Bill.

2 Note that, following consultation, a number of amendments have been made to the Bill. These are set out at Appendix 1.

3 Note that the Commerce (Cartels and Other Matters) Amendment Bill holds priority 4 on the legislation programme.

4 Note that the Bill amends the Commerce Act in relation to cartels and introduces criminal sanctions for hard-core cartel conduct.

5 Approve for introduction the Commerce (Cartels and Other Matters) Amendment Bill, subject to the final approval of the government caucus.

6 Agree that the Bill be introduced and referred to the Commerce Select Committee for consideration.

7 Invite the Commerce Commission to:

7.1 develop prosecution guidelines that outline when they would take a criminal prosecution;

7.2 develop guidelines on their approach to collaborative activities; and

7.3 undertake further advocacy work to promote better understanding of the prohibitions in the Commerce Act, particularly the cartel prohibition and exemptions.

Hon Simon Power
Minister of Commerce

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Appendix 1

Amendments following consultation on the exposure draft Bill

81. Following consultation on the exposure draft Bill, a number of amendments have been made. The main amendments include:

Design of the prohibition and exemptions

- *Repealing section 29*

82. One consequence of the proposed changes to the prohibition is that some conduct that is currently prohibited under section 29 would also be prohibited under section 30. This is because conduct that has the purpose of restricting output or allocating markets may also have exclusionary purposes.

83. Submissions suggested that section 29 is redundant, serves no on-going useful purpose and should be repealed. This is because any exclusionary provisions that have the purpose, effect or likely effect of substantially lessening competition will also be prohibited under section 27.

84. The overlap between the provisions creates uncertainty and undue expense for parties to proceedings under the Act. It should be repealed.

- *Including an exemption for vertical supply arrangements*

85. A vertical supply arrangement occurs where a vertically integrated company sells goods to a person who is a competitor at another level of the supply chain. Such arrangements are common place and are generally considered to enhance consumer welfare. Unless they have an anticompetitive purpose they should be exempt from the per se prohibition.

86. The explanatory materials to the exposure draft Bill sought comment on whether the prohibition would apply to vertical supply agreements or whether they would come within the collaborative activity exemption. Submissions suggested that while some vertical supply arrangements would come within the collaborative activity exemption, for others it may be difficult to show that the arrangement was collaborative or that the cartel provision was reasonably necessary for the collaborative purpose.

87. Other jurisdictions do not provide a specific exemption for vertical supply arrangements because it is difficult to distinguish legitimate conduct. For instance, in Canada the Competition Bureau's *Competitor Collaboration Guidelines* note that such arrangements can be pro-competitive and are not deserving of condemnation without an inquiry into their actual competitive effects.[17] As a result, the guidelines indicate that the Bureau will not assess such arrangements under the per se prohibition.[18]

88. The Bill exempts supply agreements between the supplier and customer where the cartel provision does not have the dominant purpose of lessening competition. Such agreements would still be subject to the rule of reason prohibition in section 27 and would be prohibited where they had the purpose, effect or likely effect of substantially lessening competition in a market.

[17] Canadian Competition Bureau, *Competitor Collaboration Guidelines,* 2009, section 2.3.3.
[18] See footnotes 11 and 12 above for an explanation of per se and rule of reason prohibitions.

- *Repealing the per se prohibition in relation to covenants and relying on the substantive competition prohibition in section 28*

89. The exposure draft Bill did not amend section 34 of the Commerce Act, which sets out a per se prohibition in relation to covenants. The explanatory material to the exposure draft Bill noted that in Australia covenants are regulated under a rule of reason prohibition not a per se prohibition. This means that they are not subject to criminal sanctions. This Bill takes the same approach and repeals section 34.

The criminal offence

- *Clarifying the mental element*

90. The exposure draft Bill provided for a parallel criminal offence and civil prohibition. The only distinguishing feature of the criminal regime was that the criminal offence required knowledge that it contained a cartel provision at the time the person entered into or gave effect to a contract, arrangement or understanding.

91. A number of submissions commented on the mental element. They considered that intention would better differentiate civil and criminal liability.

92. Having considered submissions, it is appropriate to amend the mental element. The criminal offence should require intent to fix prices, allocate markets, restrict output and rig bids.

Other matters

- *Sequencing the introduction of the new regime*

93. As set out above, to further ensure that the benefits of criminalisation are realised and the costs are mitigated, the introduction of the new regime will be sequenced. The prohibition, exemptions and the clearance regime come into force on the day after the Act receives Royal assent but the commencement of criminal sanctions is delayed for two years from the date of commencement.

- *Amending the jurisdictional rules*

94. To enable effective enforcement, Cabinet considered that the jurisdictional rules applying to criminal conspiracies should apply to the cartel offence and the civil prohibition [EGI Min (10) 25/3, paragraph 7.27.1 refers].

95. Given the implications for New Zealand's relationships with our trading partners, I wanted to satisfy myself that this course of action was appropriate. Having reflected on this further, I am satisfied that it is appropriate to align with the conspiracy rules under the Crimes Act. In particular, where any part of a prohibited act occurs in New Zealand then the whole of that act is deemed to have occurred in New Zealand. This is justifiable where the activity has a real or substantial connection with New Zealand because it gives effect to the purpose of the Act.

96. In relation to offshore mergers, Cabinet initially agreed to repeal section 4(3) of the Act and adopt, with appropriate adaptions, section 50(A) of the Australian Competition and Consumer Act 2010. The new regime is set out in section 47A to 47D of the Bill. However, last year the Supreme Court in *Poynter*[19] found that section 4 is an exhaustive list of circumstances in which the Act applies to conduct outside New Zealand. As a result, I am of the view that there would be risk in repealing section 4(3).

- *Amending the penalties for obstruction*

97. Currently the Cabinet decision provides that the penalties in the Act for obstruction should be increased to:

    - a short term of imprisonment for individuals, with a maximum term of 18 months; and

    - a maximum fine of $1,000,000 for bodies corporate.

    [EGI Min (10) 25/3, paragraph 7.25 refers].

98. The purpose of the amendments was to align the penalties with comparable legislation, such as the Serious Fraud Office Act 1990 in New Zealand and the Competition and Consumer Act 2010 in Australia.

99. There were a number of submissions on this issue. Many were of the view that it would create substantial costs to businesses in complying with compulsory notices issued under the Commission's information gathering powers. It may incentivise businesses to take costly steps to avoid the possibility of non-compliance. This could include challenging the lawfulness of notices that are not adequately specified or seeking additional time to ensure the accuracy of information provided. This would create delays to the Commission's processes.

100. At this stage, the penalties do not seem to be impeding the Commission's processes so I do not propose to introduce criminal sanctions. Instead I proposed to update the penalties so that they reflect similar penalties in other business law statutes. For individuals I recommend that the penalty be increased to $100,000 and for everyone else $300,000.

- *Minor amendment to penalties*

101. Current sanctions are a fine set at the greater of either:

    - $10,000,000; or

    - three times the value of the commercial gain, if it can be ascertained; or

    - if it cannot be ascertained, 10% of the turnover of the body corporate and any interconnected bodies corporate.

102. The turnover limb is unclear as it does not specify the time period over which to calculate the penalty. The Bill clarifies this limb by linking it to turnover in the accounting periods that the offending took place.

[19] *Poynter v Commerce Commission* [2010] NZSC 38, at paragraphs [15] to [17].

- *Ensuring that the Commerce Act applies to entities other than bodies corporate and individuals*

103. Currently it is not clear that penalties can be applied to entities other than bodies corporate and individuals. I propose to amend the legislation to ensure that penalties apply to entities other than bodies corporate and individuals.