In Confidence

Office of the Minister of Commerce and Consumer Affairs
Chair, Cabinet Economic Development Committee

Release of Discussion Document: Review of Section 36 of the Commerce Act and Other Matters

Proposal

1 This paper seeks agreement to the release of a discussion document that addresses three issues in Part 2 of the Commerce Act 1986 (the Act). The discussion document:

1.1 proposes changes to section 36 of the Act: section 36 regulates anti-competitive conduct by firms with a substantial degree of market power;

1.2 proposes the repeal of intellectual property (IP) provisions from the Act; and

1.3 seeks views on a minor, technical issue regarding the treatment of covenants under the Act.

Executive summary

2 Section 36 of the Act prevents firms with market power from abusing that power to suppress competition. The courts' interpretation of section 36 requires a complex counterfactual test that means firms can get away with some forms of anti-competitive behaviour. It is also very difficult for the Commerce Commission (and private litigants) to enforce section 36 in all but the most egregious cases.

3 The attached discussion document proposes changing section 36 to align it with recent changes to the Australian law. This would also bring New Zealand's law in line with the generally accepted approach in other developed economies. The proposal may prove controversial with large, dominant firms and their legal advisors.

4 The discussion document also proposes repealing the provisions in the Act that shield some IP arrangements from competition law scrutiny. The current provisions are outdated, unclear, and poorly understood.

5 The discussion document canvasses some drafting improvements to the treatment of covenants. These would ensure that any cartel agreements included in a covenant are prohibited. This is a minor, technical proposal.

Comment

Purpose of the Commerce Act and competition policy

6 The Commerce Act seeks to promote competition between firms for the benefit of consumers. It does so by prohibiting firms from engaging in a range of anti-competitive conduct. Competition is a key driver of productivity and innovation. It can lead to lower prices, higher quality goods and services, and more choice for consumers.

Competition policy work programme

7 The government currently has a busy work programme in respect of competition policy. In particular:

7.1 The Commerce (Criminalisation of Cartels) Amendment Bill is currently awaiting second reading. The Bill will criminalise hard-core cartel conduct (such as price-fixing).

7.2 The Commerce Amendment Bill is currently before the Transport and Infrastructure Select Committee. The Bill will allow the Commerce Commission to conduct 'competition studies' to promote competition in various sectors, strengthen the regulatory regime for airports, and improve the Commerce Commission's enforcement powers. It is due to be reported back from Select Committee by 2 November 2018, although I expect it to report back before the end of September.

8 In addition to this work, there are three other aspects of the Commerce Act that I am seeking to review, which are the subject of the attached discussion document. The focus of the review is on section 36, which relates to anti-competitive unilateral conduct. I have also included the Act's IP provisions within the review's scope, partly because section 36 has a bespoke IP provision. The treatment of covenants is a minor issue but an important one to consult on, as the issue is connected to the current Commerce (Criminalisation of Cartels) Amendment Bill.

What does section 36 do and what is anti-competitive unilateral conduct?

9 Anti-competitive unilateral conduct is when a firm with substantial market power impedes existing or potential competitors from competing and thus causes harm to consumers.

10 Section 36 is intended to prevent anti-competitive unilateral conduct. At present, section 36 of the Act prohibits a firm with substantial market power from taking advantage of that power for an anti-competitive exclusionary purpose.

11 Below are some examples of the behaviour that section 36 is intended to prohibit:

11.1 **Exclusive dealing:** where a powerful business has contracts with retailers, distributors, or suppliers that require or induce them to only to sell that business' products or only supply that business. This may be harmful if the arrangement denies a competitor access to an important supply or distribution channel.

11.2 **Refusal to supply:** This occurs where a vertically-integrated business refuses to supply a competitor with an input, such as a raw material, or to give access to infrastructure (such as port services) that the competitor needs to compete in downstream (e.g. retail) markets.

12 Prohibitions against anti-competitive unilateral conduct do not prohibit a firm from holding a monopoly position in a market or charging high prices. These are addressed by other means (e.g. by reducing barriers to market entry to support competition), or, in cases where market entry is not likely (such as for electricity distribution or fixed-line broadband), by directly regulating businesses' revenues.

13 The prohibition must allow the incumbent firm to compete on its merits, but it should also stop it from unduly impeding the uptake of new innovations or entry by a new, more

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efficient supplier. This is a difficult balance. Misuse of market power is widely regarded internationally as one of the most complex areas of competition law.

What consideration has there previously been of section 36?

14 On 17 November 2015, the Ministry of Business, Innovation and Employment (MBIE) released an issues paper (the “Issues Paper”) seeking views on three main subjects: anti-competitive unilateral conduct, alternative enforcement mechanisms (e.g. the cease and desist regime); and market studies. In total, 39 submissions were received.

15 MBIE concluded that there are three problems with section 36, following analysis of these submissions, engagement with stakeholders and further desktop research:

15.1 there is a high risk that the current legal test is leading to the wrong answers (failing to deter conduct that undermines the long-term benefit of consumers);

15.2 it is costly and complex to enforce (it is resource-intensive and time-consuming to try and define the possible hypothetical market that might be adopted by a court under the counterfactual test); and

15.3 it is somewhat unpredictable (it is difficult to know in advance which hypothetical market the court will adopt under the counterfactual test).

16 Cabinet considered the review on 9 June 2017 and invited the Minister of Commerce and Consumer Affairs to report back to Cabinet by end of June 2018 on whether it is appropriate to proceed to a section 36 options paper [CAB-17-MIN-0274].

What has happened in Australia with the unilateral conduct prohibition?

17 Between 2014 and 2015, Australia carried out a comprehensive review of its competition laws and policies (the Harper Review). This review included the prohibition in section 46 of the Australian Competition and Consumer Act 2010 (the equivalent to New Zealand’s section 36). In its final report, the Harper Review recommended replacing its existing prohibition with a new provision prohibiting firms with substantial market power from engaging in conduct that has the purpose, effect or likely effect of substantial lessening competition. New legislation in line with the Harper Review recommendations came into force on 6 November 2017.

What are the intellectual property provisions in the Act and why do they exist?

18 The Act contains three provisions that restrict the application of the Act to certain conduct relating to IP (such as copyright or patents). The scope of the provisions is unclear and has not been tested in the courts. However, they potentially mean that in some circumstances, a firm may not be prohibited from acting anti-competitively in relation to its IP (such as by imposing particular conditions on the use of its IP or refusing to licence its IP at all).

19 The main IP exemption, section 45, appears to have its origins in Germany’s 1958 competition legislation and dates from an era when competition law and IP protections were seen as being incompatible with each other. This is because IP rights in effect grant a limited monopoly to the rights holder. As the thinking went, there was little point in granting IP rights if these would regularly and immediately fall foul of competition law. Partial exemptions from competition law for IP were consequently introduced in some jurisdictions as a way to address this conflict.

20 Over time, this view has changed and it is generally accepted that:

20.1 IP is essentially comparable to any other form of property;

20.2 IP is not presumed to create market power in the competition law context; and

20.3 IP licensing is generally pro-competitive.

21 For these reasons, many jurisdictions have moved to a neutral approach that treats IP rights as no different from any other commercial right. This sometimes means forbidding IP owners from exercising some of their rights if to do so would be anti-competitive.

22 Australia's competition law has a similar provision to New Zealand's section 45. The provision has been subject to seven separate reviews since 1999 that have recommended its repeal or significant narrowing, including the Harper Review. The Australian Government has recently committed to repealing the exemption.

What are covenants and how are they treated in the Act?

23 The Act defines covenants as relating to land. A covenant on land generally restricts the way in which that land can be used. For example, a supermarket may place a covenant on the sale of its surplus land to prevent that land from being used for a competing supermarket. Depending on the context, such as the availability of other suitable land for use as a supermarket, this covenant might impede competition.

24 In 2017, when the Act's price fixing prohibitions were repealed and replaced with new cartel prohibitions, covenants were inadvertently excluded from the new prohibitions. This was an oversight, rather than any change in the policy position. The impact of this is that covenants which create or implement a cartel will not automatically be prohibited in the same way that standard cartel agreements are. This loophole could apply in a case where, for example, two parties to a land agreement who are competitors impose restrictions regarding the use of land, with the aim of sharing or carving-up markets. While the loophole is small, it should be closed.

The discussion document

25 I propose to release the attached discussion document to seek feedback on: a re-design of section 36, a repeal of the Act's provisions relating to intellectual property, and changes to the treatment of covenants.

26 Given the subject matter, the discussion document is most likely to be read by those with some competition law expertise. However, the document contains a non-technical executive summary, and a one-page summary of the issues will be released alongside the discussion document for the benefit of non-experts.

Scope of the discussion document

27 The paper proposes that the primary objective for any change to the Act should be "to promote competition in markets for the long-term benefit of consumers within New Zealand", which is the purpose of the Act. The paper sets out four criteria for assessing any possible changes:

27.1 minimise the risk of wrong answers that stop pro-competitive behaviour (Type I errors – false positives);

27.2 minimise the risk of wrong answers that allow anti-competitive behaviour (Type II errors – false negatives);

27.3 provide businesses with predictability for procompetitive decision making and reasonable compliance costs; and

27.4 minimise the cost and complexity of enforcing cases in order to penalise and deter anti-competitive behaviour.

28 For each issue, the discussion document provides background and outlines the problems with the status quo. It canvasses the options for addressing the problems. The document considers the impacts, costs, and benefits of the option(s) over the status quo.

Section 36

29 The paper presents a preferred option to change section 36 and align it with the key elements of the equivalent Australian provision. The Australians went through a rigorous, independent process to design their new provision and we can benefit from their efforts. This also fits well with the general scheme of the Act, which is based on the Australian legislation. It would ensure that developments in the Australian case law would be relevant to New Zealand.

30 The paper also proposes extending the general authorisation provisions of the Act to section 36. Authorisations allow the Commerce Commission to 'approve' conduct that lessens competition, where that conduct has other benefits that outweigh these costs.

31 The paper also seeks views on section 36A of the Act. As part of the Closer Economic Relations review in 1988, the Australian and New Zealand governments agreed to remove protections against dumping (the situation where a business sells its goods at a cheaper price in a foreign country than its home country) for goods traded across the Tasman. Instead, reliance was placed on generic competition law to protect against conduct such as predatory pricing (which can be a factor in dumping). To enable this, section 36A was inserted in to the Act to enable consideration of market power in Australia or a Trans-Tasman market. The Australian legislation was amended with a reciprocal provision: their section 46A. Any changes to section 36A would only be made in consultation with the Australian government.

Intellectual property provisions

32 The IP chapter proposes repealing the IP-related provisions in the Act. There is a strong presumption that there should not be any exemptions to the Act unless there is a compelling reason for the exemption.

Covenants

33 The covenants chapter presents two options for addressing the issue identified above:

33.1 reinstating a separate prohibition for covenants involving cartel provisions; or

33.2 redefining contracts to include covenants (preferred).

Proposed process

34 As noted above, the government has a busy competition work programme. To reduce any risk of 'reform fatigue' among the business or competition law community, I propose to hold the release of the discussion document until early 2019 unless there is a good reason to release the document earlier.

35 When the document is released, I propose that public consultation last for a period of seven weeks. After consideration of the submissions and advice from officials, I will report back to Cabinet with any proposals for legislative change by late 2019.

Consultation

36 The Treasury, Ministry of Foreign Affairs and Trade, Ministry for Primary Industries, Ministry of Transport and the Commerce Commission have been consulted on the contents of this paper. The Department of Prime Minister and Cabinet, the Electricity Authority and the Productivity Commission have been informed.

Financial implications

37 Overall, the changes in costs and savings to the Commerce Commission are too small to warrant any changes to their funding. At this stage, I am not anticipating any financial implications from possible changes.

Human rights

38 The proposals in the discussion document are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Legislative implications

39 The preferred option in the discussion document would require amendment of the Act. After consultation, I will report back to Cabinet seeking policy decisions. At that time I will have more detail on the appropriate legislative vehicle and priority.

Regulatory impact analysis

40 The Treasury's Regulatory Impact Analysis Panel has reviewed the attached discussion document prepared by MBIE. The Panel has focussed on the discussion of section 36 of the Act as this is a significant regulatory issue.

41 The discussion document sets out analysis of the problem, identification of options and analysis of the preferred option in a clear and concise way for a technical audience. In-depth analysis has only been undertaken on the preferred option, which is to adopt and adapt an effects test based on Australian law. This was done on the basis that a rigorous and independent process was undertaken by the Australian Government prior to adopting an effects based test. Because preliminary consultation was undertaken when the Issues Paper was released in 2015, the consultation questions are seeking new evidence or additional stakeholder views on the problem definition, preferred option and alternative options.

42 The Treasury expects the process for implementation and monitoring any amendments to section 36 to be included in the regulatory impact analysis provided to Cabinet following the consultation process.

Publicity

43 I plan to release the attached discussion document to the public with a press release. In addition, MBIE will email interested stakeholders. The discussion document will be published on MBIE's website.

44 The question of whether or not to amend section 36 of the Act has already been the subject of consultation and a cross-submissions process. Those submissions revealed strongly held views on both sides of the issue. The processes in Australia to amend their equivalent provisions were the subject of vocal debate and lobbying.

45 Opponents of reform are likely to say that there is not enough evidence of a problem to proceed with a discussion document. I disagree and consider that there is enough evidence from the Issues Paper consultation and cross-submission process to conclude that there is an issue with section 36. It is worth moving to a discussion of options.

46 This paper is seeking to move the discussion from **whether** to amend section 36, to **how** to amend. I am still anticipating a reasonable level of debate and discussion. That said, the discussion is reasonably technical and unlikely to raise much concern beyond interested stakeholders.

47 I am not expecting the issues of the IP provisions or the treatment of covenants to be particularly controversial.

Recommendations

The Minister of Commerce and Consumer Affairs recommends that the Committee:

1 **note** that on 6 June 2017, Cabinet invited the Minister of Commerce and Consumer Affairs (the Minister) to report back to the Economic Growth and Infrastructure Committee by 30 June 2018 with:

  1.1 any further evidence of harm occurring [from the current formulation of section 36];

  1.2 the costs and benefits of alternatives to the current formulation of section 36;

  1.3 any further developments in Australia on the misuse of market power and the changes Australia is making to its law in this area;

  1.4 recommendations as to whether to proceed to an options paper; [CAB-17-MIN-0274];

2 **note** that the attached discussion document proposes changing section 36 to align it with the key elements of the equivalent Australian provision;

3 **note** that the discussion document proposes repealing the intellectual property provisions from the Commerce Act 1986;

4 **note** that the discussion document proposes redefining contracts in the Commerce Act 1986 to include covenants;

5 **agree** to the release of the discussion document entitled "Review of Section 36 of the Commerce Act and Other Matters", subject to any minor or technical amendments that may be required;

6 **invite** the Minister to report back to the Cabinet Economic Development Committee by 30 November 2019 with the outcomes of consultation and any proposed policy changes;

Communication

7 **note** that the Minister will release the discussion document with a press release;

8 **note** that the Ministry of Business, Innovation and Employment will publish a copy of this paper on its website.

Authorised for lodgement

Hon Kris Faafoi
Minister of Commerce and Consumer Affairs