

2 June 2016

Hon Paul Goldsmith
Minister of Commerce
Parliament Buildings

Dear Minister

Targeted Commerce Act Review

1. We have now had the opportunity to review the submissions made by interested parties on the Targeted Commerce Act Review (the Review).
2. As would be expected, there are a range of submissions. Some, like us, support reform of section 36 of the Commerce Act (s 36) or at least further consideration of the issues (there are 13 submissions in this category); others are resistant to reform (18 fall in this category). Perhaps unsurprisingly, those resistant to reform are large businesses and the advisors that represent them.
3. We are writing because we want to ensure that you have the information necessary to make a well informed decision that promotes the best long term interests of New Zealand consumers.¹ Like you, we support reform that removes barriers to entry into New Zealand markets and ensures that competitive outcomes are achieved. The *Microsoft* litigation in both Europe and the United States, which focussed on Microsoft's conduct in excluding non-Microsoft software, illustrates the key role an effective unilateral market power prohibition plays in reducing barriers to entry and promoting innovation. This litigation enabled the continued development of a middleware market and cross-platform technologies and software.²
4. We consider that reform of s 36 is necessary to achieve those goals. As we outlined in our original submission, we believe reform is necessary because s 36 is not currently effective in promoting competition in New Zealand domestic markets for the long term interests of consumers. An effective unilateral conduct provision is especially important for a small economy with concentrated markets.³ Section 36 is

¹ And is therefore consistent with the purpose of the Commerce Act.

² See "Review of the Final Judgments by the United States and New York Group" *US v Microsoft Corporation* (30 August 2007), available at <https://www.justice.gov/atr/case/us-v-microsoft-corporation-browser-and-middleware> (last accessed 30 May 2016).

³ See Competition Policy Review Final Report (**Harper Review**) at 340; Michal Gal *Competition Policy for Small Market Economies* (Harvard University Press, Cambridge, 2003) at 93; Andy Gavil "Imagining a counterfactual section 36: Rebalancing New Zealand's competition law framework" (2015) 46 VUWLR 1043.

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not effective primarily because of the way the courts have interpreted the “taking advantage” part of s 36.

5. Our view is consistent with the views expressed in the Final Report of the Australian Competition Policy Review (Harper Review), which concluded:⁴

In the Panel’s view, the ‘take advantage’ limb of section 46 is not a useful test by which to distinguish competitive from anti-competitive unilateral conduct. The test has given rise to substantial difficulties of interpretation, revealed in the decided cases, undermining confidence in the effectiveness of the law.

6. A key theme that has been raised in the submissions on the Review is that the benefits of reform do not outweigh the costs. Submitters opposed to reform claim the Commission has not demonstrated a need for change, or that any benefits from change would outweigh the (alleged) uncertainty that any reform would entail for businesses with substantial market power.

7. Almost identical arguments against reform of Australia’s s 46 were made to the Harper Review Panel. Nevertheless, that Panel concluded as follows.⁵

The Panel’s proposed reform to section 46 is an important change, which will (like all regulatory change) involve some transitional costs, as firms become familiar with the prohibition and as courts develop jurisprudence on its application. In the Panel’s view, the change is justified as transitional costs should not be excessive and will be outweighed by benefits.

The Panel agrees with the [ACCC] that the uncertainty ‘should not be unduly significant as the change is to an existing test [equivalent to s 45] with which business are already familiar – that is, the substantial lessening of competition test used in other provisions of the CCA. This incorporates ‘standards and concepts ... at least well enough known as to be susceptible to practically workable ex ante analysis’ ...

Indeed, framing the offence by reference to the impact on competition in a market enables major businesses to advance pro-competitive justifications for their conduct, in the absence of an anti-competitive purpose.

8. Some submissions to the Review also claim that section 27 of the Commerce Act (s 27) already has a substantial lessening of competition test that would ensure that any problems with s 36 are already capable of enforcement via the Commerce Act.
9. In short, the submissions disclose a view that there is no problem with the enforcement of s 36. While that might be so from a large firm perspective (which we can understand given the permissive nature of s 36), it is not the case from an enforcement and NZ Inc perspective.

⁴ Harper Review Final Report, at 338.

⁵ Harper Review Final Report, at 341.

10. For a start, there are inherent inconsistencies in the submissions opposing reform. These submitters criticise the Commission for not describing the cases it could not take under the current s 36; yet, the submitters do not attempt to describe what pro-competitive conduct they could not undertake with a reformed s 36. This is even more startling given the implication from these submissions that s 27 is already a perfect substitute for s 36. If this were the case, there would seem to be little incremental uncertainty for a firm if s 36 was reformed to mirror s 27. In any event, as the Harper Review Panel endorsed, any uncertainty from a change to a substantial lessening of competition test should not be unduly significant given its presence in the remainder of the legislation.
11. What then of the benefits of reform? It is difficult to examine all the cases we have considered (or screened out) and say with certainty whether the matter would have led to successful enforcement action if an alternative s 36 was in place. Much like the hypothetical counterfactual test, such a hypothetical analysis would be fraught.
12. Nevertheless, we have set out three examples below to illustrate the practical problems associated with s 36. We emphasise that in providing these examples we are not suggesting that these cases would have been decided differently under a differently constituted s 36. We are not, as the Commission did not do that analysis. We provide these examples merely to counter the claim that there are no issues with s 36, and that s 27 acts as a perfect safety net to any claims that would not be captured by s 36.
13. It also suffices to say that unilateral market power cases are significant and the benefits of an effective regime will not always be evident in the number of cases taken. New Zealand's economy and the Commerce Act is based on the premise that scarce resources are best allocated, and cost efficiency and innovation best promoted, in competitive markets. There are substantial and meaningful benefits from competition. Effectively deterring unilateral conduct that by its very nature can seriously undermine this competition and the benefits consumers derive from it is crucial to ensuring New Zealand performs to its economic potential.
14. Submitters say that reform will 'chill' competitive conduct. There is simply no evidence to support that proposition,⁶ and we do not accept that competitive conduct in overseas markets with an 'effects test' has been chilled. Rather, we consider that a properly functioning unilateral conduct test will deter anti-competitive conduct.

⁶ See Gavil, above n3, at 1062 quoting Jonathan Baker "Beyond Schumpeter vs. Arrow: How Antitrust Fosters Innovation" (2007) 74 Antitrust LJ 575 at 587:

...the economic literature does not support an *a priori* assumption that monopoly will best promote innovation. "As a general rule, competition does not just lead firms to produce more and charge less; it encourages them to innovate, as well. Competition supplies a powerful motive for innovation".

Practical examples of the issues with counterfactual analysis

15. As set out in our original submission, the counterfactual test put forward by the courts means that conduct by a firm with substantial market power that has the effect or likely effect of substantially lessening competition may not be prohibited even though New Zealand consumers will more than likely be worse off.
16. The test is, therefore, at odds with an underlying foundation of competition law that what matters is the impact of a firm's conduct on competition, because of the benefits that competition brings to an economy. The test focuses on the wrong question and so risks the wrong result, and creates a safe harbour for certain types of conduct that may harm competition. Again, this point was addressed by the Harper Review Panel who commented:⁷

Business conduct should not be immunised merely because it is often undertaken by firms without market power. Conduct such as exclusive dealing, loss-leader pricing and cross subsidisation may all be undertaken by firms without market power without raising competition concerns, while the same conduct undertaken by a firm with market power might raise competition concerns.

17. The recognition that some conduct may be benign when undertaken by a firm without market power but be harmful if the firm has market power is accepted throughout the world, with the exception of New Zealand (and Australia, although reform may be pending).
18. The Commission's Winstone Wallboards and Sky Television investigations are good examples of situations where s 36 has effectively provided a safe harbour for conduct by large firms without regard to anti-competitive effect.
- 18.1 Winstone was a case that considered loyalty rebates. While there were a number of reasons why we ultimately concluded Winstone's rebates were unlikely to substantially lessen competition (under s 27) by foreclosing competitors, the pertinent point is that the s 36 conclusion was driven solely by the counterfactual test regardless of competitive impact. We concluded a firm without market power was likely to offer loyalty rebates of the type offered by Winstone because loyalty rebates are common in competitive markets (indeed many of the merchants offered them). We reached this conclusion applying the counterfactual test without ever having to examine the impact of the conduct.
- 18.2 Similar comments can be made about our Sky TV investigation where we assessed whether Sky's content contracts amounted to Sky taking advantage of any substantial market power it had. This required us to ask whether Sky would have entered into similar contracts if it did not have substantial market power. If it would have, then Sky's contracts could not be in breach of s 36 even if those contracts had an anti-competitive effect. The counterfactual

⁷ Harper Review Final Report, at 339.

test, therefore, provided a safe harbour regardless of any anti-competitive effect that may have existed, such as raising barriers to entry.

19. We acknowledge that s 27 was in issue in both of those cases, a point we will come back to below. But in any event, it would have been an odd result had we concluded there was a substantial lessening of competition under s 27 in either of those cases, but concluded that we could not have proceeded under s 36 even though both cases were about whether there had been unilateral abuses of market power, rather than about conspiracies to reduce competition.⁸
20. A third example that illustrates how the counterfactual test ignores competitive impacts is the Commission's early 2000s investigation into whether Air New Zealand used its substantial market power to deter Origin Pacific from introducing a direct Hamilton to Christchurch service. This case also shows that the claim that the counterfactual test is highly certain is somewhat illusory.
21. The backstory is that in 2003 Origin Pacific announced a new Hamilton-Christchurch service, and a connecting Tauranga-Hamilton service. Eight days after Origin had announced its service, Air New Zealand announced it too would commence a direct Hamilton-Christchurch service. To do so, Air New Zealand had to redeploy one of its 66 seat ATR-72 aircraft from its existing direct Wellington-Hamilton service, reducing its service levels on that route.
22. The Commission concluded that Air New Zealand had not taken advantage of its substantial market power, and therefore had not breached s 36. But the process to get there was tortuous. Rather than focussing on harm to competition and the commercial realities Air New Zealand faced at the time in responding to the Origin move by redeploying an aircraft from the Hamilton-Wellington route, the Commission had to hypothesise how Air New Zealand would have acted if it faced competition on the Hamilton-Wellington route. That is, how would Air New Zealand have acted if it could not count on recapturing passengers that would not be able to fly due to Air New Zealand's reduced Hamilton-Wellington capacity (spilled passengers).

⁸ The recent *Cement Australia (ACCC v Cement Australia Pty Ltd [2013] FCA 909 (10 September 2013))* case and the *Rural Press (Rural Press Ltd v ACCC [2003] HCA 75)* case illustrate this odd result.

- In *Cement Australia* the trial judge held that there was a substantial lessening of competition and that the particular exclusive contracts were entered into with the purpose of substantially lessening competition, but *Cement Australia* had not taken advantage of its substantial market power.
- *Rural Press* involved an agreement between two rival publishers (*Rural Press* and *Waikerie*) that *Waikerie* would withdraw its competing publication from *Rural Press*'s area. That agreement followed *Rural Press* threatening to enter *Waikerie*'s own area if *Waikerie* did not withdraw. The High Court found unanimously (as the Federal and Full Federal Courts had found previously) that *Rural Press* and *Waikerie* had reached an agreement to substantially lessen competition. However, they found that *Rural Press* had not taken advantage of its substantial market power in threatening *Waikerie* in order to engineer the anti-competitive agreement.

23. In doing so the Commission had to ignore Air New Zealand's commercial realities and the impact on the market of the conduct, and ask a purely hypothetical question. The Commission's conclusion on this hypothetical analysis turned on a single adjustment to an assumption about seating capacity in this hypothetical scenario. This change was made late in the investigation. That this change was made so late and was so significant to the outcome tends to belie the purported certainty of the counterfactual test. It seems a strange result that (the Commission's view of) Air New Zealand's compliance with s 36 should turn on assumptions about abstract scenarios to the exclusion of actual evidence of Air New Zealand's position.
24. In our view, this example shows how ill-suited the counterfactual test is. The conclusion swung on a change in one assumption. But regardless of which way that assumption went, in either scenario an examination of competitive harm was sidelined. As a result the case could have led to a false negative or a false positive depending on assumptions used in a hypothetical analysis.
25. Moreover, this case shows that the assertion that s 36 should remain because it is more certain for business than a substantial lessening of competition test is misplaced. Business is already exposed to significant risks around how the Commission and the courts will undertake the hypothetical analysis required by the taking advantage test.

Section 27 is not a perfect substitute for a properly functioning unilateral market power section

26. Section 27 does not solve all the issues with s 36, particularly when conduct is unilateral at its core. There are, of course, some types of conduct that simply cannot be caught under s 27 (eg, refusal to deal cases like the *Universal Music*⁹ case in Australia). The Air New Zealand/Origin and Winstone investigations also illustrate that even where there is an agreement between firms, s 27 is an inadequate safety net.
27. The Commerce Act does allow the Commission to assess whether an agreement entered into by a firm, combined with all other agreements that firm is a party to, breaches s 27.
28. However, in the Air New Zealand/Origin investigation, the Commission was assessing the conduct of Air New Zealand in announcing its new service and redeploying an aircraft. It would not have been possible to adequately capture the conduct by attempting to aggregate all of Air New Zealand's ticket sales to customers on the Hamilton-Christchurch route for the purposes of a s 27 case.
29. The Winstone case illustrates the complications that can arise relying solely on s 27.

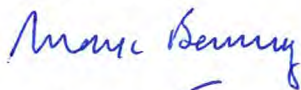
⁹ *Universal Music Australia Pty Ltd v ACCC* [2003] FCAFC 193.

- 29.1 Section 27 is directed towards agreements between parties, not unilateral conduct. Our Winstone investigation concerned Winstone's loyalty rebates with large merchants and whether Winstone was inducing merchants not to use alternative plasterboard suppliers through a lump sum (rather than a per unit) loyalty rebate that the merchants would retain rather than pass through to end consumers.
- 29.2 The rebate provisions in the merchant agreements said nothing about whether merchants would retain the rebates or not. They were silent on this.
- 29.3 For a s 27 case to succeed, would we have had to prove that each merchant had agreed with Winstone to retain the rebate? Arguably, this is a more difficult and wide ranging case than if the question was just whether Winstone's conduct in structuring and paying the rebates as it did had the purpose, effect or likely effect of substantially lessening competition.
30. This is not to suggest that s 27 cannot be useful in some cases. Merely, that for truly unilateral conduct s 27 either will not be adequate to capture the conduct, or can create complications because it adds the requirement of needing to show an agreement or set of agreements.

Concluding comments

31. We acknowledge that the issue of reforming s 36 is controversial. The divided opinions on the Issues Paper illustrate this. But it is important to get this right. Certainly, if a decision is to be made that the benefits of reform do not outweigh the costs of increased uncertainty for business from reform (which we do not accept), then that is a trade-off that should only be made after a full and robust consideration of the competing arguments.
32. We have highlighted in this letter only some of the areas where we take a different view to other submitters. There are many others, and we would like the opportunity to submit in response to those.
33. We therefore encourage you to continue to examine these important issues whether through an Options Paper, or via a cross submission stage.

Yours sincerely



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