IAG SUBMISSION

TARGETED REVIEW OF THE COMMERCE ACT

9 February 2016

1. INTRODUCTION

1.1 This submission is a response by IAG New Zealand Group (IAG) to the Ministry of Business, Innovation and Employment (MBIE)'s 'Targeted Review of the Commerce Act 1986' (Targeted Review).

1.2 We support the maintenance of effective and efficient competition law that reflects the specific nature of New Zealand's domestic markets. As such we welcome the opportunity to provide our perspectives on the three topics raised:

- Anti-competitive exclusionary conduct;
- Alternative enforcement mechanisms; and
- Market studies.

1.3 We would welcome the opportunity to discuss the points we raise in this submission and look forward to working with the Government in progressing this review. IAG's contacts for matters relating to this submission are:

2. SUMMARY

Anti competitive exclusionary conduct

2.1 We do not believe that Section 36 of the Commerce Act (the Act) requires reform. The current policy of the section is to require a causal connection between the use of substantial market power and detriment to the competitive process. We believe this is necessary to ensure that prohibitions on exclusionary conduct are not applied arbitrarily, and that competition law protects competition rather than individual competitors.

2.2 We do not support any move away from counterfactual analysis to an "effects based" test. This would undermine the commercial certainty that is currently a feature of section 36 jurisprudence. Furthermore, we do not think it is practical to implement a clearance regime or other mechanism in order to provide the level of commercial certainty promoted by the current legal test.

2.3 The counterfactual test, as applied by the courts since 2010, does a very good job of distinguishing between benign and exclusionary conduct in most circumstances. The risk of 'false negatives' is low, and if necessary could be further reduced through more careful application of existing analytical approaches.

Alternative enforcement mechanisms

2.4 We are open to the consideration of alternative enforcement mechanisms under the Act. We broadly consider that the statutory framework is consistent with principles driven competition law. We would support the development of alternative enforcement mechanisms if those mechanisms can assist the Commerce Commission (the Commission) to apply that statutory framework more effectively.

Market studies

2.5 We do not see a strong case for the development of a market studies power. The Commission is primarily an enforcement agency with respect to generic competition law. A non enforcement power is unlikely to sit well with the Commission's established culture. If a generic market inquiry power is desirable, then it would sit more naturally with an established recommendatory body such as the Productivity Commission.

3. ANTI COMPETITIVE EXCLUSIONARY CONDUCT

3.1 The focus of our submission is the requirement for a causal connection between use of substantial market power and harm to competition in a market.

3.2 Under the current law, this requires application of the counterfactual test: a comparative analysis of the impugned conduct against a hypothetical scenario involving a workably competitive market in which there is no substantial market power.

3.3 In our view, this aspect of section 36 does not require reform. We would be concerned with any movement towards an "effects based" test. The current legal test is relatively certain, legally and economically robust, and reasonably effective in practice. Any movement away from counterfactual analysis to an "effects based" test would undermine these features of the current regime.

Current policy settings suit the New Zealand economic environment

3.4 Competition law in general and prohibitions on unilateral exclusionary conduct in particular are very difficult to get right. That said, our view is that the current policy approach underpinning section 36 (and the Commerce Act generally) is appropriate for the New Zealand economy.

3.5 New Zealand's economy is characterised by its small market size. This makes it difficult for many businesses to reach minimum efficient scale and can lead to the concentration of markets and businesses holding high market shares. This concentration can be a precursor to the creation of substantial market power.

3.6 In these circumstances it is vital that the accumulation of market power itself is not deemed to be anti-competitive. Accepting some degree of market power through high market share is appropriate for a small, remote economy. It allows all businesses to compete regardless of size and scale, and ensures that competitive market forces rather than the law determine business successes. Because small economies like New Zealand tend to have more concentrated markets, conduct that appears exclusionary may actually be competition operating effectively.

3.7 These features of New Zealand markets raise the stakes in terms of getting competition law right. And it is important that we do this so that the competition in our markets is not reduced through the misuse of market power.

3.8 However, we believe that high levels of legal uncertainty and law that either protects or restricts certain competitors will dampen the opportunities for the genuine competition that benefits consumers. Even in concentrated markets large and small businesses alike are required to compete, and this dynamic should be protected and promoted by competition law settings.

3.9 There are two aspects of the current policy approach in particular that we support. The first is that the policy is aimed at the protection of competition rather than individual competitors. This is clearly the most effective means of delivering long-term benefits to consumers, as the Targeted Review acknowledges. This has been the standard approach under the Commerce Act since its inception and it should continue.

3.10 The second aspect is the requirement that unlawful exclusionary conduct can only be established for the purposes of section 36 if there is a demonstrable causal connection between the use of market power and competitive harm. This approach ensures: that the presence of substantial market power (which will be common in concentrated markets) is not itself a breach of competition law; that a reduction in competition is not itself a breach of completion law; and that the normal competitive activity of a business with market power is not itself a breach of competition law.

3.11 It also supplies the basis for differentiating between harmful and competitive conduct in an objective, principled way.

Reform would create unnecessary risk and uncertainty

3.12 The most likely reform initiative is a move towards a more explicit 'effects based' test. IAG is strongly against this type of reform for a number of reasons.

3.13 First, an effects based test does away with the causal connection between market power and reduced competition in a market. The removal of this causal connection means that an effects based test may involve analysis that is less cogent in economic terms. This creates an unacceptable risk of 'false positives': normal competitive activity of a business with market power being deemed unlawful.

3.14 Second, an effects based test will have a chilling effect. Any move towards an effects-based test, and away from counterfactual analysis, risks large businesses being punished for unintended and unforeseeable consequences from conduct that was innocent at the time a business decision was made. This will create acute uncertainty for the business community and result in more conservative decision making. The likely effect will be a reduction in the intensity with which large businesses compete - a poor outcome for consumers who benefit from increased competition and one that the law should look to avoid.

3.15 Third, the analysis of effect already exists. The 'counterfactual test' is a misnomer to the extent it implies that it does not include the economic analysis of market effects. When applied appropriately, counterfactual analysis involves direct consideration of the economic effects of the use of substantial market power. Therefore it is difficult to see what the benefits of a more explicit requirement for effects based analysis might be.

3.16 Last, an effects based test is likely to upend the currently settled policy position over the purpose of prohibitions on exclusionary conduct. The temptation to protect smaller businesses from conduct that is perceived to be unfair may be great, and a flexible effects test could see the law applied in inconsistent or unintended ways. Policy coherency should be criteria against which reform proposals should be assessed. The high level of discretion that effects tests leave to the courts potentially compromises that coherency.

3.17 The issues with a move towards an effects based test are not easily addressed. The development of statutory defences or regulator authorisation would likely be unworkable in practice.

3.18 Businesses in competitive markets constantly make decisions that have the potential to affect their competitors. In an increasingly digital marketplace, in market offers can be amended and updated in real time. This is great for consumers as competitors try to be first to market and respond to competitive pressures, but it is manifestly not the

type of environment that supports formal regulatory approvals. Businesses need to act with confidence, and the current law allows them to do that in most circumstances.

3.19 In any case, such additional mechanisms leave the legal and business environment more complicated. Prohibitions on exclusionary conduct should be simple to apply so that large businesses and smaller competitors know the boundaries of lawful conduct with confidence. Statutory defences, regulator authorisation and the like are unnecessary under the current law, and would only serve to complicate business decision-making.

The current drafting and interpretation of section 36 is workably effective

3.20 Because the current section 36 deals with economic effects, any dissatisfaction with the way it operates in practice likely points to a need for better or more consistent application of standard analysis rather than presenting a case for reform. In our view the current section 36 actually works very well in most circumstances.

3.21 Missing from the current reform debate are examples of where the current law delivers clearly unsatisfactory results. It is not sufficient to point to cases where the Commission was unsuccessful. It must be shown that the reason for that lack of success is inherent to the test that the Commission is required to apply. In both *Carter Holt Harvey* and *0867* cases there was simply insufficient evidence to establish unlawful exclusionary conduct. It is not credible to suggest that counterfactual analysis alone drove the results in these cases. Both would be likely to have reached the same result if an effects based test was applied.

3.22 That said, we are alive to concerns that counterfactual analysis can be somewhat abstract or opaque. This can be the result where counterfactual analysis is applied poorly so that the analysis does little to reveal the workings of economic markets. Where counterfactual analysis is underpinned by cogent economic theory and sound evidence the prospect of poor results is greatly reduced. This may raise important institutional questions about the type of evidence the regulator is able to present to the court, and the capability of the courts themselves to deal with that evidence appropriately. These questions can be addressed pragmatically without the need for far-reaching reform.

3.23 In fact, the more recent section 36 cases have shown that the courts have a desire to undertake comparative counterfactual analysis in an economically robust way. Both the *Datatails* case in the Court of Appeal and the *Zespri* case in the High Court demonstrate the merits of cogent counterfactual analysis in the area of economic law. If these trends are allowed to continue, with the courts taking the economic evidence carefully and seriously, then many of the perceived concerns with section 36 evaporate.

3.24 Application of counterfactual analysis can certainly be improved, but it mostly works well. In that context, it is difficult to see the need for statutory reform. The current law establishes a formal framework that conforms closely to fundamental economic principles of fair competition, and the application of that framework in practice continues to improve. If non statutory methods such as judicial training or reorganisation within the Commission are available to speed up the fine-tuning of counterfactual analysis, these could be adopted. In our view this would be much preferable to an approach that involved reinventing jurisprudence based on new statutory drafting.

4. ALTERNATIVE ENFORCEMENT MECHANISMS

4.1 We broadly welcome the consideration of alternative enforcement mechanisms under the Act.

4.2 In line with our views on section 36, set out above, we consider that the statutory framework is broadly consistent with principles driven competition law. In some cases, however, application of the law in a coherent and effective way may be able to be improved. We would support the development of alternative enforcement mechanisms if those mechanisms can assist the Commission to apply that statutory framework more effectively in practice.

4.3 There may be a number of benefits associated with greater use of alternative enforcement mechanisms, including:

- The capability to address lower level offending relatively quickly and cost effectively;
- The possibility of a staged approach to enforcement action, with the ability to escalate acting as an effective deterrent; and
- The ability to develop a consistent body of administrative practice that can bring increased certainty to the business community without the need for the development of court based jurisprudence.

4.4 There are also risks associated with such mechanisms, particularly around the maintenance of due process and other procedural protections. These are broadly referred to as the requirements of natural justice in the Targeted Review. IAG supports all steps to ensure procedural fairness and due process, and this must be a key consideration for the development of any alternative mechanisms.

4.5 The Targeted Review raises a number of preliminary options for consideration. At this stage we do not have strong views on whether current mechanisms are working effectively, or if there is a case for further development and refinement. What we do support is careful consideration of the available alternatives to ensure that the Commerce Act is fit for purpose.

4.6 The one proposal where we may have concerns is with opening up the cease and desist regime to private parties. There may be the potential for the abuse of these mechanisms by competitors if the cease and desist regime was opened up in that way. If this option is opened up for serious consideration, we suggest that protections against the abuse by private parties of enforcement mechanisms are also explored.

4.7 Regardless, there is nothing to prevent the Commission from acting informally, as it already does, by making press releases, issuing “please explain” letters and formal warnings, publishing formal investigation reports, and generally keeping a watching brief on markets where there is reason to have some concern.

5. MARKET STUDIES

5.1 We do not see a strong case for giving the Commerce Commission the power to undertake market studies.

Inconsistent with current role

5.2 While the Commission does have a degree of expertise with respect to competitive markets, it is primarily an enforcement agency. Its principal role is to monitor the conduct of individual market participants and take action to deter or punish anti competitive conduct where evidence of it is discovered. This enforcement role does not sit naturally with a generic market inquiry power that requires the examination of market structure and outcomes.

5.3 In practice the prevailing culture within an established enforcement body may make it difficult to inquire into market performance in an objective and neutral way. Similarly, that culture may be at odds with the relatively non intrusive approach typically taken to market studies. This could easily impact how fully and confidently market participants engage in any study.

5.4 We acknowledge that use of market study powers by competition agencies is relatively uncontroversial in other jurisdictions. However, it should be noted that these powers are often conferred contemporaneously with the establishment of the competition authority. A non punitive, investigatory culture is part of the DNA of the competition agency from Day 1. That is not the case here, and retro-fitting an inquiry power to a general competition enforcement function may not work successfully.

More than competition

5.5 We believe that investigation of the performance of a market must take a wider view than just competition. Regulation, trade barriers, security of raw material, access to capital, availability of skills, infrastructure and a host of other factors are important to assessing performance. Indeed a sole focus on competition may be at odds with important structural and regulatory factors that are central to the sound functioning of a market and maximising its contribution to the overall wellbeing of the country.

5.6 The Targeted Review usefully points out that signs that a market may not be working well should not be conflated with unlawful conduct by one or more market participants. Taking this wider view would address this risk.

Others are better placed

5.7 We believe there are other government agencies that are better placed to exercise these powers and take the broader consideration into account.

5.8 In the financial sector, for example, the Financial Markets Authority already has extensive disclosure powers. These have been used consistently, and provide an accurate reflection of the state of the market. While the focus is not on competition per se, these inquiries are required to come to a view on how effectively markets function in practice. This will almost always include an assessment of competitive dynamics, at least implicitly.

5.9 The Productivity Commission is also well placed to address non enforcement based competition inquiries into specific markets. Such inquires already fall within the Productivity Commission's mandate, although it may require a specific Ministerial direction before any inquiry can be conducted. The Productivity Commission has the advantage of being a credible recommendatory body with a broad audience that can act on its findings and recommendations. The Commerce Commission is part of the audience for these reports, and in most cases that should be sufficient to promote understanding of competitive dynamics in specific markets.

5.10 Moreover, given the range of investigatory powers already held by the Commission, the Productivity Commission and other agencies, there does not appear to be a gap that is required to be filled by a new market studies power.