New Zealand Business Roundtable

SUBMISSION

on the

Ministry of Economic Development Exposure Draft *Cartel Criminalisation*

July 2011

1. Introduction

1.1 This submission on the Ministry of Economic Development Exposure Draft *Cartel Criminalisation* is made by the New Zealand Business Roundtable, an organisation comprising primarily chief executives of major business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall national interests.

1.2 The Business Roundtable supports well-conceived law regulating cartel conduct. However, for the reasons explained in our March 2010 submission on the earlier Ministry of Economic Development discussion document, we are opposed to criminalisation. There is little engagement in the exposure draft with many of the points we made earlier. They are not repeated in this submission and we ask that the Ministry review them.

1.3 We commend the process that MED has followed in releasing an exposure draft on criminalisation, with an accompanying draft Regulatory Impact Statement. Earlier we were concerned that a decision to criminalise looked like being a fait accompli. Because our focus is on the fundamental case for criminalisation we limit our comments in this submission largely to the analysis in the RIS. Some points of a legal nature were made in our earlier submission.

2. Background

2.1 This exercise needs to be viewed in the context of the New Zealand economy's serious difficulties and the state of regulation that is affecting its performance. In our view, and that of many other observers, the drastic slump in productivity growth during the last government's term of office owes much to the rapid growth of ill-conceived regulation. The OECD has documented New Zealand's slide in the rankings for the quality of product market regulation. Its analysis does not cover factor markets – capital, labour and land. There are major problems in these areas too. In our view addressing regulatory problems in all these areas is a far higher priority than considering new regulation in the form of criminalisation of cartels.

2.2 MED has consistently resisted these private sector perspectives on business regulation. It keeps insisting that "New Zealand has a high quality regulatory environment." Among government departments it is responsible for by far the largest stock of regulation affecting businesses. It has been an enthusiastic promoter of new regulation, some of which has been of appalling quality, such as the initial financial advisers legislation. It is opposed to new regulatory disciplines in the form of the Regulatory Standards Bill. We see the criminalisation proposals as another example of poor quality regulatory analysis by MED and its itch to extend its regulatory reach. Until there is a major improvement in MED's overall understanding of regulatory issues, an upgrading of its regulatory analysis and a willingness to listen to private sector views, we think New Zealand will continue to suffer from regulatory overload.

3. The draft Regulatory Impact Statement: cost benefit estimates

3.1 The essence of an RIS is cost benefit analysis. The essence of cost benefit analysis is a quantification of costs and benefits. There is no such quantification in the draft RIS and ministers were given a poor basis for making policy judgments.

3.2 In our view skilled analysts should be able to come up with information that would give decision makers a feel for the costs and benefits of criminalisation. We demonstrated the potential for such analysis in the discussion on Transpower in our earlier submission. The MED documents contain some estimates which would be at least a starting point for an adequate RIS.

3.3 What decision makers need to know in considering criminalisation is, on the benefit side, the possible number of cartel cases in New Zealand, the welfare losses that might be associated with them, and the marginal effect of criminalisation as an additional deterrent of cartel conduct.

3.4 In terms of numbers, the information presented in the RIS suggests they are small. It reports that over the past 16 years only four price fixing agreements have gone through the courts, only four cases of proceedings have been issued and 26 warnings have been given. On these figures we are talking about just over two identified cases a year, many of which are minor. We very much doubt that many other cases have gone undetected.

3.5 The RIS contains sketchy information on the welfare losses associated with particular cartel cases. For the three domestic and trans-Tasman cartels cited, the annual overcharge is around $250,000, $2 million and $600,000 respectively (a total of $2.85 million). The RIS also reports that empirical studies find that deadweight losses are on average 10% to 20% of the overcharge. On this basis the total annual welfare loss from these three cartel cases is in the range of $285,000 to $570,000. Such welfare losses are not large. These cases were determined on the basis of existing civil law provisions. The issue for policy is the marginal additional efficiency gains that might arise from criminalisation. In the context of a $200 billion economy, these might be vanishingly small.

3.6 We acknowledge that the efficiency losses from international cartels could be larger (perhaps $4-8 million in the air cargo case using the same calculations, but we read this figure to apply to the impact of the global cartel, not just its impact in New Zealand). However, international cartels are often detected in other jurisdictions and the marginal deterrence effect of criminalisation might again be minor. We also acknowledge the limited data available on New Zealand cases. Nevertheless, as the Transpower example showed, it is entirely possible to analyse cases of cartel conduct that MED considers plausible on a hypothetical basis and give ministers a feel for the

magnitude of deadweight losses that might be avoided with criminalisation. On the basis of the above estimates, the numbers look small.

3.7 Rough estimates of benefits should then be compared with costs. In the first instance these include current enforcement expenditure by the Commerce Commission which was put at around $3 million per annum in the 2010 discussion document. This figure alone might swamp potential benefits. To it should be added the resource costs in the private sector of handling Commission inquiries: estimates of these costs should be possible. Estimates should also be possible of the costs of criminal actions: we are informed that jury trials could last as long as six months. Next is the cost to the private sector of complying with a criminal regime. We are informed that in Australia following criminalisation there has been, as would be expected, a lot more resources devoted to internal compliance procedures, reporting to board audit and compliance committees, board discussions and the like. It should be possible through surveys to obtain information of this kind.

3.8 Probably the most important and difficult cost to estimate is the chilling effect on pro-competitive collaborative behaviour that is acknowledged as a major risk of criminalisation. Again, however, hypothetical cases could be analysed. The interchange case involving banks and card issuers shows how difficult it can be to draw the line between efficient collaborative arrangements and anti-competitive behaviour. Many believe the action taken by the Commission was ill-conceived. If collective fee-setting were deterred for fear of attracting criminal action, what might be the welfare losses associated with alternative arrangements? Similar issues could arise with bidding consortia for infrastructure projects, international freight consortia or syndicated loans by banks. It is also not sufficient to assert that regulators will come to the 'right' (efficient) answers in all such cases. Even a change of regulator might result in different decisions: the current Commerce Commission might take a different view on the interchange fee issue than its predecessor, for example. On the 'chilling effect' issue, we think MED has a responsibility to ministers and the business sector to do some proper research to establish possible costs. These could be much larger in relation to the size of the economy in New Zealand than in a bigger economy like the United States.

3.9 Other elements of a cost benefit analysis, such as the costs of imprisonment, are mentioned in the RIS. In some cases we question whether an objective account is being presented to ministers. For example, the RIS acknowledges that costs will be higher with criminal cases, but argues that "as there are likely to be only a very small number of prosecutions in any given year, the magnitude of this additional cost is unlikely to be significant." Yet MED (and other departments) have made an issue over court costs associated with the Regulatory Standards Bill, where we consider cases would be few and far between and would of course not involve criminal actions. This looks like biased advocacy to us.

4. The draft Regulatory Impact Statement: methodology

4.1 The methodology of the RIS does not, in our view, conform with Cabinet Manual requirements. We hope it would not be accepted as adequate by the Treasury.

4.2 On problem definition, paragraph 19 is hypothetical and none of the hypotheses is tested. For example, it is stated that "A lack of detection of cartels via leniency may be an indicator that New Zealand's penalty regime is not a sufficient deterrent to cartel behaviour." Another hypothesis may be that there is not a lot of cartel behaviour going on. Policy should not be based on such loose speculations. There is no solid evidence presented that the current civil penalties are sub-optimal, nor is there any recognition that the present leniency regime is recent and that it may be too early to draw conclusions about its effectiveness.

4.3 In the absence of any identified substantive problem, the RIS falls back on arguments of international harmonisation which do not appear strong. OECD efforts to promote a 'regulatory cartel' among its members should be viewed cautiously (like OECD pressures for tax harmonisation). There are advantages in regulatory competition and New Zealand should strive for the highest quality policy settings, not necessarily the OECD norm. Harmonisation with Australia is also mentioned, but without any indication to ministers that Australia's criminalisation legislation is widely regarded as a mess and indeed has not been followed in the MED proposals. In the United Kingdom, a cartel offence was introduced in the Enterprise Act 2002. This has proved to be a damp squib: there have been just two prosecutions since 2002, one of which collapsed spectacularly because the leniency applicant and the Office of Fair Trading failed to disclose all relevant information to the defendants. We strongly doubt that international considerations should be a major driver of New Zealand's regime.

4.4 In respect of objectives (para 27), the two that are postulated pre-justify the recommended path. The first objective of promoting deterrence asserts without evidence that there is a real problem. The objective of promoting international regulatory conformity is not based on evidence that present arrangements are unsatisfactory or unworkable. Pre-justification is inconsistent with the Cabinet Manual requirements.

4.5 Elsewhere in the RIS there is a concern that firms might collude to raise prices "compared to competitive prices". However, "competitive prices" are not observable. No two economists chosen at random could be expected to agree on what a competitive cost structure would be, let alone a competitive price. It follows that no businessperson could be sure whether the price that would allow them to recoup common costs, joint costs and variable costs would be determined to be a competitive price or an uncompetitive price. In our view the only potential basis for concern is that the cartel might achieve supernormal profits for a sustained period. This is a

matter of price relative to incurred costs, not of price relative to a "competitive price". If there would be either no buyers or suppliers at the "competitive price" it is not a useful benchmark. The "sustained period" aspect also requires consideration of entry barriers facing those who are not part of the cartel, and the availability of cartel-busting strategies by customers or suppliers.

4.6 As Professor Lew Evans of Victoria University of Wellington has pointed out, the great difficulty in this area is that there are many examples where cooperation and even collusion on price are welfare-enhancing. Some of these occur where price is less important in contracts than the freedom to innovate and respond to changed circumstances in dimensions other than price. Examples include evolving digital services and innovative manufacture: the very features of a modern growing economy. We would go so far as to question a per se prohibition on price fixing. We see the judgments involved in this area as extremely difficult, prone to error, and unsuited to criminalisation.

5. Conclusion

5.1 This submission has focused on the Regulatory Impact Statement presented by the Ministry of Economic Development. We have not gone into a number of legal and other issues that were noted in our 2010 submission and elaborated on by other submitters. The RIS contains a summary of arguments against criminalisation (in paras 82-86) which we endorse.

5.2 In our view the RIS is inadequate and does not constitute a basis for recommending criminalisation to ministers. It needs to be comprehensively redone. There is no good reason why many elements of the cost benefits analysis could not be quantified using actual or hypothetical estimates. If MED lacks the capability to undertake this work it should be contracted out to a competent economic consultancy firm. New Zealand should not embark on yet more regulation of the business sector without a much more clear-cut demonstration that doing so would yield benefits that exceed the costs.