Survey on Competition Law in Small Economies

(Special Project for the 2009 ICN Annual Conference)

Response of the New Zealand Commerce Commission
Wellington, 22 October 2008

Note on the structure of comments in this response: While the questionnaire was not structured in the way we have presented our observations, we concluded that our views could be expressed more clearly by separating the questions raised in the document. We identified 18 questions, and organised them under the document's five headings of the analytical framework, the notion of a "small economy", anticompetitive agreements, abuse of dominance and mergers.

1. Analytical Framework

Q 1 - Does the size of the economy affect the application of competition law, and if so how?

A small economy such as New Zealand does have characteristics that affect the application of competition law. For example although we consider that the analytical framework which should be used to assess market power should be the same in small or isolated economies as in larger economies, market factors may result in more limited competition and/or higher barriers to entry. This could result in a greater incidence of dominance/substantial market power findings. The implications of the size of the economy for the application of competition law are discussed more fully below, in the responses to the other questions in the Survey.

New Zealand is regarded as a small economy in terms of both its GDP (NZ$177.5 billion nominal for the financial year ending 31 March 2008) and its domestic market of 4.3 million people (October 2008). It is geographically isolated in relation to the world's major trading nations. Remoteness naturally affects transport and transaction costs of international trade, and in some cases this could have implications for the application of competition law.

New Zealand is an open economy in which exports and foreign procurement markets are significant factors for the country's economic performance and for the conduct of domestic competition law. New Zealand's competition law, as defined in the Commerce Act 1986, applies to New Zealand markets, and is not defined with respect to New Zealand (as opposed to foreign) entities or consumers.

The main competition consequences of the particular characteristics of the New Zealand economy are fourfold:

- Many of New Zealand's markets are highly concentrated. Consequently, the main policy response is to facilitate competition through minimising barriers to entry to markets. This requires competition policy, broadly defined, to focus on ensuring minimal barriers to trade of goods and services, and to the movement of labour and investment, both within and beyond the national borders. In addition, competition laws should generally avoid 'rules of thumb' based on market concentration, that is, the application of these laws should be based on a full competition assessment on the facts, balancing anticompetitive and pro-competitive factors.

- In a few markets, competition might not allow firms to achieve minimum efficient scale. Consequently, competition policy and law should focus on the goal of ensuring the efficient operation of markets, and must recognise that in some case, this may be better achieved by means other than competition.

- New Zealand's economy depends to a considerable extent on trade. Much of the anticompetitive harm to New Zealand markets has an international dimension, being either anticompetitive conduct occurring offshore or arrangements in which at least some of the parties to the conduct are overseas-based. This raises complex jurisdictional issues for the enforcement of competition law, and the New Zealand Commerce Commission (the Commission) is increasingly seeking to respond to these challenges through cooperation with overseas competition regulators. As a result of its leniency policy, the Commission has become aware of more international cartels that are impacting on New Zealand markets. In particular the Commission has received applications for immunity from a number of international parties who are subject to high profile cartel investigations in other jurisdictions. Typically, these parties file applications in New Zealand out of their concern that the Commission would start an investigation to follow up what had been discovered elsewhere, and would take enforcement action against them.

- Given our small size, New Zealand's competition institutions (including its policy, judicial and enforcement bodies) might also struggle to achieve minimum efficient scale. Consequently, New Zealand looks to draw on international experience and case law where relevant and to use its available resources to best effect. For example the Commission has functions both as the generic competition enforcement body and as the industry-specific regulator for a small number of regulated sectors, so as to draw on the pool of competition expertise.

2. <u>The Notion of a "Small Economy"</u>

We note that, in the context of international relations, many attempts to define a 'small state' have found formulating an objective definition of 'smallness' to be an elusive task. For example, a 1964 study by the Institute of Commonwealth Studies concluded that it is not possible "to decide what smallness means with any precision. It is a comparative and not an absolute idea. Whatever scales of magnitude are employed seem arbitrary and it is

difficult to pick out of them where smallness begins or ends." While this assessment was made over four decades ago, subsequent attempts at definition do not appear to have advanced the conclusion significantly.

While some writers have quantified their definitions of a small state, all who have done so appear to have acknowledged that their definitions were arbitrary. For example, Vital (1973) proposed upper population limits of ten to twenty million "in the case of economically advanced countries and …20 to 30 million in the case of under-developed countries". Olson, McLellan and Sonderman (1983) had a comparable level in mind when they suggested that a small market was one of under 10 to 20 million people.

Some writers, such as Nolan (1995), have used the concept of a fourth category: the "micro-state". This category has been defined in a number of cases as comprising very small states with a population of not more than one million. Examples of the use of this definition are the United Nations Institute for Training and Research (1971) and the Commonwealth Consultative Group (1985). A number of writers have followed the lead of these organisations in identifying micro-states.

For purposes of the ICN Survey, an "economy" in the context of competition law refers to a distinct legal jurisdiction, defined by borders and governed by legal institutions empowered to enact and enforce competition law regime. The "smallness" of the economy depends on the framework in which the country operates.

The paper identifies the following possible criteria;

- Size of the economy, in terms of GDP;
- Size of the territory, in which the economy "takes place" and its geographical location;
- Population in absolute terms, or population compared to neighbouring economies;
- Legal, cultural, social and historical differences compared to the neighbouring economies;
- Comparative importance or size of the undertakings, or of the number of global players which have their seat in the territory of a small economy;
- Degree of regional economic integration, including entry barriers, dependence on international trade, economic ties with neighbouring countries.

Q 2 - Are the criteria for defining a small economy adequate in your view?

Most of the criteria listed in the paper are clearly central to attempts to define a small economy. However, it is not evident how many of them would need to be satisfied for an economy to be clearly within the 'small' category. That is, if an economy met only one criterion, and no others, would that be sufficient? Are all of the criteria of equal importance? That is, if meeting more than one of the criteria is required, what weighting is to be given to each? In relation to population numbers, would any distinction be made about the extent to which the population participated in the market economy?

In relation to the criterion of "legal, cultural, social and historical difference compared to neighbouring countries", it is not immediately clear how this would help to define the "smallness of an economy".

The size of the economy in terms of GDP and its degree of openness seem particularly important. They are likely to have the most impact on determining the sizes of many individual markets, which then may have implications for the extent of competition. Per capita purchasing power based on GDP per capita may also be a relevant criterion.

Q 3 - How do you define your economy ("large" or "small")? By which standards?

A recent classification lists 221 sovereign states and self-governing independent territories in the world. In terms of population, New Zealand ranks 122nd. That is, there are 99 smaller entities in the world. However, while interesting, this statistic does not seem to provide a basis for a useful comparison of where the boundaries of smallness should be set in relation to New Zealand. Further, in the context of competition policy, it is likely than many of the smaller states do not have a competition law.

We feel that is probably most useful to compare New Zealand with other members of the OECD. On this basis New Zealand is clearly a small economy.

- Size of the economy, in terms of GDP;

New Zealand is among the 5 smallest economies in the OECD ranking of 30 countries, with a GDP of around US$110 billion (NZ$177 billion).

- Size of the territory, in which the economy "takes place" and its geographical location;

A global comparison suggests that the land area of states seems to have little relationship to their population size or to their national income. New Zealand's land area (268,680 square kilometres) is not exceptionally small if compared to countries in Europe. For example, the land area is a little larger than the United Kingdom, about three-quarters that of Germany and about half that of France.

However, New Zealand is geographically isolated. In contrast, the borders of countries in Europe, Asia and Africa are usually contiguous with those of one or more neighbours. New Zealand is a long distance from the major trading markets in Europe, Asia and North America. It is small in comparison with its nearest neighbour, Australia. While New Zealand and Australia have many close links, the two countries are over 2,000 kilometres apart at the closest point.

- Population in absolute terms, or population compared to neighbouring economies;

New Zealand's population is small in absolute terms (4.3 million) compared with that of most members of the OECD, and is relatively small compared to Australia.

- Comparative importance or size of the undertakings, or of the number of global players which have their seat in the territory of a small economy.

A number of multi-national companies have branch representation in New Zealand. However, most of New Zealand's major industries and financial institutions have their headquarters in Australia. With the exception of the dairy industry (Fonterra), few New Zealand companies can be considered to be global players. New Zealand has a much narrower natural resource base than Australia.

- Degree of regional economic integration, including entry barriers, dependence on international trade, economic ties with neighbouring countries.

New Zealand has an open economy. Openness here refers to the ease with which goods and services, information, capital and other factors of production can flow between the domestic economy and the rest of the world. New Zealand also has low entry barriers. However, while New Zealand has low barriers to trade, total trade as a portion of GDP of New Zealand is lower than that of other small OECD countries.

New Zealand has a high level of regional economic co-operation and has signed free trade agreements and agreements on closer economic ties with a number of countries.

For many products and services, New Zealand relies on supplies from Australia because of the absence of a domestic industry in those sectors. Markets in Australia and New Zealand are significantly integrated. Benefits flow from the Trans-Tasman Mutual Recognition Agreement and the Australian/New Zealand Closer Economic Relationship Agreement. Goods, services and even labour can move with ease between the two countries. In most cases, products produced in Australia can enter New Zealand duty-free.

Q4 - How do you define the size of your neighbouring economies or major trading partners?

In comparison with New Zealand, Australia is a large economy in terms of GDP, GDP per capita and territory. Australia's population is five times larger, its GDP is about seven times greater and its land area is over 28 times larger.

Australia is New Zealand's major trading partner followed by the USA, Japan and China.

3. <u>Anticompetitive Agreements</u>

As in other small countries, competing enterprises in New Zealand generally know a good deal about each other. Managers and employees often move from one competitor to another within the same sector and at times keep in touch with their previous

employer(s). The business elite in New Zealand is also small, and businesspeople often have many links outside business activities, including through their leisure interests. Information sharing and networking mechanisms understandably can play a role in facilitating collusion.

Views have been expressed in some quarters in New Zealand, and internationally, that some conduct that might be labeled as price-fixing should not be pursued by the Commission on the grounds that it in fact constitutes well-intentioned joint bidding deals. The basis of such arguments is that joint ventures between competitors in small economies could sometimes enhance competition, especially in a concentrated market where a number of small companies might need to submit joint bids in order to compete effectively with a large and dominant company. Notwithstanding this argument, the Commission takes the same approach to domestic cartels as to international cartels.

Q 5 - How, if at all, should such elements be taken into account?

The 'cosiness' of small economies may facilitate a higher level of cartel behaviour, all else being the same. Where the number of suppliers in a market is small, it is easier to maintain collusive arrangements. When people know each other well, there is less need for detailed and difficult-to-manage contractual arrangements. When the Commission was no longer confined to limiting the boundaries of relevant markets to national borders, the likelihood of this happening was reduced. Furthermore, most cartel cases have lately been operating outside New Zealand where these domestic factors should play a limited role.

Q 6 - What is the importance of open borders in this context?

Open borders, such as in New Zealand, typically increase the number of competitors in domestic markets, that is, overseas firms can become competitors by exporting to New Zealand. This can help domestic markets for tradable goods to be more competitive than would otherwise be the case, but at the same time, overseas cartel activity can be 'imported' into the country. Most of the cartels cases currently under investigation by the Commission in New Zealand involve large international companies, where establishing jurisdiction becomes an important issue. Also see the response above to Q 5.

Q 7 - Is there evidence for more oligopolies in small economies?

If so, what type of competition policy is best suited to cope with the implications that oligopolies have on competition?

Some major business sectors in New Zealand, including airlines, grocery retailing and telecommunications, have oligopolistic market structures. We are not aware of evidence for/of the existence of relatively more oligopolies in New Zealand than elsewhere.

However, we note that much of competition policy is in fact concerned with dealing with oligopolistic markets.

The economic argument here appears to be based on the presumption that small economies can support fewer firms. Domestic demand may be small compared to the minimum efficient scale. The argument follows that small economies have less competitive markets and face more and "different" types of anticompetitive conduct. Evans and Hughes suggest that:

> "*In small economies it will generally be that competition concerns arise in oligopoly or near monopoly industries where again dynamic efficiency considerations are important: for example, for New Zealand dynamic efficiency must be the competition law criterion if exploration for gas and oil are enabled. Thus, it may be that for small economies that already emphasise dynamic efficiency little adjustment may be needed. Across industries there already would be case-specific analysis focusing on the removal of institutional barriers to entry".*[1]

We agree that the focus of competition law should be on measures that do not inhibit but rather enhance dynamic performance. Achieving this might be a particular challenge for New Zealand with its small isolated domestic market. This is because domestic demand—and therefore domestic opportunity—is limited and firms in many markets are more mobile in the modern world. This combination enhances the argument for a competition law that enables dynamic efficiency and thereby the long term interest of New Zealand consumers.

In New Zealand the Commerce Act includes a provision for an anticompetitive agreement to be 'authorised' by the Commerce Commission if it can be shown that such an agreement would lead to a net public benefit, that is, if the benefits from the agreement exceed the detriments from the lessening of competition. This presumably reflects the belief that some types of anti-competitive agreements might in some circumstances be socially desirable.

Q 8 - Could the enhanced risk of collusion and anti-competitive conduct justify harsher sanctions or a different focus of the competition laws?

One could argue generally that cartel sanctions are not large enough to deter cartel behaviour, given the difficulty of uncovering such behaviour. In particular, the maximum fines allowed under the Commerce Act are relatively low. However, we do not believe that the enhanced risk of collusion and anti-competitive conduct alleged to be present in the domestic markets of small economies, justify harsher sanctions.

[1] Evans, L. and Hughes, P. (2003) "Competition Policy in Small Distant Open Economies: Some Lessons from the Economics Literature", New Zealand Treasury Working Paper 03/31.

Q9 - Vertical constraints are often linked to imports in small economies.

We have not been able to identify any examples that support this statement.

Q 10 - Does this require or justify a different analysis of vertical restraints, especially of resale price maintenance and of parallel import bans, in small economies?

Moreover, could the fact that the risk of foreclosure is higher justify a different analysis?

We have no reason to believe that a different type of analysis is required. In the United States, for example, under the "rule of reason" approach to vertical restraints, the courts give more weight to the potential benefits of such contracts. However, in New Zealand public benefits may be considered only in the context of authorization – see response under question 7 above. This approach does not appear to be based on the smallness of the New Zealand economy.

4. Abuse of Dominance

Q 11 - Does this mean that a specific regime should apply to the conduct of dominant undertakings in a small economy?

Or does this make no difference? Is there a different approach towards collective dominance issues?

It is often argued that economies of scale or of scope, combined with small markets, lead to more dominant firms in small economies. While plausible, there is not much evidence in New Zealand to support this hypothesis. It may be that such industries do not locate themselves in small economies because they provide too small a domestic base. Where such industries have been promoted by government support in the past in small economies, moves towards market liberalisation may have led to their demise (e.g. car assembly in New Zealand).

Another example is the dairy industry where the size of the New Zealand economy may have influenced the way that the dairy industry is regulated. The Dairy Industry Restructuring Act 2001 allowed the amalgamation of the majority of New Zealand's dairy producers into Fonterra, a single company controlling approximately 95 percent of milk processing in New Zealand, making it a significant international player. However, a key goal of this regulatory regime is to promote the efficient and competitive operation of domestic dairy markets, which is achieved through the imposition on Fonterra of certain obligation relating to raw milk supply and the entry and exit of suppliers.

Justification for a having a different regime to apply to dominant firms in small economies seems to be absent in New Zealand.

The aim should be to prevent abusive conduct towards competitors. The difficulty in doing this in New Zealand is the widely experienced one of determining what "abusive" conduct is. The Commission has commenced a project to review the effectiveness of section 36 of the Commerce Act (which prohibits "taking advantage of market power") in dealing with anti-competitive unilateral conduct. The following factors are relevant to the New Zealand review:

- Most competition law regimes have general prohibitions against firms with market power, (so called dominant firms) abusing or using this power in a way that may harm competition. This reflects the view that powerful firms should be prevented from exclusionary behaviour, such as predation, that harms the competitive process. Our understanding is that many countries have found the provisions on unilateral conduct in their legislation difficult to apply.

  The 2001 amendment of the wording of the section in the Act; from "dominant" and "use" to "substantial market power" and "taking advantage of", was not helpful as it does not appear to have led to a change in the way the section is applied.

- The Court's interpretation of section 36 is based on the view that a firm with market power is entitled to compete (i.e. protect its market position) in the same ways that any other competitor in the market could do. This reflects the view that, if a firm with market power was not permitted to compete, this would result in "soft competition" that would thwart the competitive process - the very thing competition law seeks to encourage. The New Zealand courts apply a "counterfactual test" in assessing whether a firm with market power has breached section 36. This reflects the decision of the Privy Council in the 1994 Telecom case[2] which stated that:

  > *"...it cannot be said that a person uses that position for the purposes of section 36 unless he acts in a way which a person not in a dominant position but otherwise in the same circumstances would have acted."*

5. <u>Mergers</u>

Q 12 - Are there any differences for small economies with respect to the substance of the merger control regime?

No, this is not the case of New Zealand. For example, the Commission's merger guidelines are similar to those of larger countries. However in clearing mergers, the Commission might tend to allow somewhat larger market shares than what a number of other competition authorities do.

[2] Telecom Corporation of New Zealand v Clear Communications Ltd [1995] 1 NZLR 385

The guidelines specify "safe harbours" to give guidance as to which business acquisitions are unlikely to substantially lessen competition, and hence to contravene the Commerce Act. Safe harbours provide a screening device for the purposes of administrative convenience, and are not intended as a replacement for case-by-case analysis.

The Commission is of the view that an acquisition is unlikely to substantially lessen competition in a market where, after the proposed acquisition, either of the following situations exist:

- the three-firm concentration ratio in the relevant market is below 70 percent and the market share of the combined entity is less than in the order of a 40 percent share; or

- the three-firm concentration ratio in the relevant market is above 70 percent and the market share of the combined entity is less than in the order of 20 percent.

The figures are indicative only. The Commission may decline clearance, or may intervene, in acquisitions involving lower levels of market concentration. Similarly, acquisitions falling outside the safe harbours will not necessarily be prohibited by the Act, especially in cases where entry barriers are low. Such acquisitions usually require more detailed analysis involving consideration of a range of additional competition factors to determine whether the acquisition is likely to lead to a substantial lessening of competition.

Q 13 - Are there different justifications for having a merger control regime in small economies?

In principle, no, if the objective is to prevent a substantial lessening of competition in a market affected by a merger. However, one difference in NZ is that, in addition to clearance, there is a provision for authorisation of a merger (comparable to the process for applications for anticompetitive arrangements discussed above), in circumstances where the public benefits from a merger are assessed as outweighing the detriment from the substantial lessening of competition. This provision presumably reflects the view that in a small economy, there may be situations where allowing a lessening of competition may produce a greater efficiency gain than preserving competition.

Q 14 - Should there be different guidelines for geographic market definition?

We could not identify any reasons for applying different guidelines to define the relevant geographic market.

The geographical dimension of mergers is defined in the Merger and Acquisition Guidelines of the Commission. In general, a geographic market for goods will have the following characteristics;

- that no more than a relatively small proportion of production of the good within the area will be sold outside the area;
- that no more than a relatively small proportion of the good sold within the area will be supplied from outside the area; and
- that these proportions would not change significantly in response to a SSNIP by a hypothetical monopoly producer in the area.

In many markets, New Zealand buyers purchase products from both domestic and overseas suppliers. When imported products are close substitutes for domestic products, the overseas suppliers are part of the relevant market. In such circumstances, the Commission may define a "national market" and then consider the extent to which overseas suppliers or importers exercise a competitive constraint on the participants in the domestic market.

Q 15 - How might the size of the economy affect the application of legal presumptions?

In New Zealand there is no evidence of a link.

Q 16 - Which types of remedies are best suited for small economies?

The New Zealand Commerce Act provides for a voluntary notification regime for proposed acquisitions, under which parties contemplating an acquisition may submit an application for clearance or authorisation if they are in doubt as to whether their proposed acquisition might contravene section 47 of the Act.

Under section 66 of the Act, the Commission may grant clearances for acquisitions where it is satisfied that the proposed acquisition would not have, or would not be likely to have, the effect of substantially lessening competition in a market. Under section 67, the Commission may grant an authorisation for an acquisition that would result in a substantial lessening of competition, if the public benefits resulting from the acquisition are found to outweigh the detriments caused by the substantial lessening of competition.

If parties however choose to proceed with an acquisition without seeking prior clearance or authorisation and the Commission considers the acquisition would contravene section 47 of the Act, it might seek an injunction to prevent the acquisition going ahead. If the Commission becomes aware of a completed acquisition that it considers may contravene the Act, it might apply to the High Court to seek a declaration of a breach and various remedies, including injunctive relief, penalties and divestment. The Commission might also apply to the Cease and Desist Commissioners for an order. Parties undertaking acquisitions that appear to breach section 47 are also open to challenge in the courts from third parties.

In New Zealand the Commission has the ability to accept structural changes, including disinvestment when clearing a merger. The legislation does not allow the Commission to accept behaviour changes for clearing a merger.

The procedures of dealing with mergers in New Zealand (as described above) are regarded as well-suited for small economies. It avoids unnecessary reporting of mergers, reduces the burden on the Commission to consider proposed mergers with no competition implications and particularly it prevents the cost of monitoring and regulating businesses after they have merged.

Q 17 - On the level of the procedural regime, what are the appropriate criteria triggering an intervention or an inquiry into a merger project: turnover thresholds; structural criteria, such as the degree of organisational integration (existence of branches or subsidiaries) of one or both of the merging companies; effect on competition?

The Act considers mergers on a case by case basis to determine if it will have the "effect of substantially lessening competition in a market."

See also the answer to Q 12 above.

Q18- Should there be a mandatory or a voluntary notification regime, with or without a prohibition to proceed without clearance?

NZ has a voluntary pre-notification regime. Enterprises contemplating a merger may apply for a 'clearance' which is granted if competition would not be substantially lessened. Alternatively, they might seek authorisation if competition is likely to be harmed but there may be public benefits. If enterprises choose to proceed without a clearance, the Commission can seek to strike down the acquisition through the Courts if it considers that competition has been substantially lessened.

New Zealand believes that a mandatory regime would create unnecessary additional work, both for the business community and the Commission. The Commission's limited resources can be applied more constructively in other areas.

See also the answer to Q16 above.