A note about Commerce Act s.36 issues

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There has been dissatisfaction with section 36 of the Commerce Act (CA) expressed by the Commerce Commission (CC) [1] and some others in various forums. The concerns relate to the way the Courts have interpreted and applied this section using a counterfactual test. Section 36 relates to unilateral actions by firms. It would seem that the disaffected parties want to extend the ambit of the test to encapsulate the sort of approach that is applied in tests of a "Substantial Lessening of Competition" (SLC) to multilateral actions. To consider the ramifications it is necessary to very briefly set out the framework. Brevity requires a little poetic license in expression; and not dealing with some issues. In particular, it does not consider the way the Courts in fact reach decisions on these issues (how they interpret the CA and the s.36 counterfactual), although it is very important and evolving.

1) The Framework
   a) the CA has the overarching objective of the long term benefit of consumers: which in law and economics is typically interpreted as dynamic efficiency;
   b) competition is a (very common) tool to achieve the CA goal. However, it is well known that competition as measured by the number of firms can be excessive: for example, lessen investment, quality, and product variety;
   c) The place of competition in the CA is revealed by the fact that the CA allows there to be a substantial lessening of competition (SLC) if economic efficiency is improved by the conduct (as assessed by a cost-benefit analysis: i.e. the public benefit test);
   d) Competition is a useful process not an overarching objective.

2) Relevant key prohibitions under the CA
   a) Unilateral Actions (s.36): A dominant firm shall not take actions with the purpose of driving another firm from the market or preventing a firm's entry or limiting a firm's competitive conduct. The present test for this (in addition to purpose) is: a) does the firm have substantial market power, if yes then b) would the firm behave the same way in a workably competitive market?

[1] For example, as reported by the National Business Review January 29 2014..

b) Multilateral Actions
    i) s.27: A contract or arrangement that engenders an SLC is prohibited;
    ii) s.47: a merger that is likely to result in an SLC is prohibited.

3) The Tests
    a) All the tests use some counterfactual. In New Zealand, assessments of breach are based upon a counterfactual to answer the question; what would be the outcome if the conduct in question did, or did not take place?
    b) All the tests typically use hypothetical counterfactuals: these are conjectures (that may be in the form of a model) as to the market outcome in the alternative. The degree of realism varies across the facts of cases, but because they all involve conjecture about the future, behaviour and outcomes (with or without conduct or arrangement) they are hypothetical and as such necessarily embody assumptions.
    c) The counterfactual test of s.36 differs from those used in multilateral conduct tests
        i) It asks if the conduct would be observed in a workably competitive market. Thus it is contemporaneous, and not forward looking; although it may be used to infer ongoing market performance;
        ii) In some settings (industries) the workably competitive market of the s.36 counterfactual can be very abstract;
        iii) In other settings it can be very concrete indeed, and directly observable to a close approximation. Where the conduct can be directly observed in like industries in other jurisdictions it can be very well specified and directly informative (often at least as much as the speculation about the future that is part of the SLC tests).

4) Unilateral vs Multilateral: generic issues to the proposed change
    a) Conduct relevant to s.27 and s.47 is revealed in instruments (arrangements/contracts and merger terms). These instruments reveal actions taken or about to be taken. They can be the focus of an SLC investigation (without them generally there would be no SLC investigation (this is a bit strong: as for example understandings can be in violation of multilateral arrangements))
    b) Conduct under s.36 is unilateral. Signals that s.36 may be violated arise from the behavior of the firm going about its own business. The range of unilateral actions that could be taken is, of course infinite, and include conduct that might be tested at the behest of the CC and/or competitors (as a practical matter the list might include a squeeze, raising rivals costs predation etc etc.)
    c) The SLC test as applied to s.27 and s.47 cases evaluates competition effects by

applying a counterfactual analysis against what would happen without the agreement. If a SLC is found there will be a breach (unless the parties have applied in advance for an authorisation and the Commission finds that there is a net public benefit). In this way these sections contribute to the overarching goal of the CA.

d) Under present legislation a breach of s.36 is a per se breach of the CA; there is no need to establish an effect on competition.

e) To elaborate it is useful to consider a (hypothetical) alternative commerce act in which it is supposed that the SLC was a general test of breach. Then if the unilateral test on its present s.36 terms and the counterfactual test remained it could be viewed as if it had the effect of an SLC. On this interpretation, finding a breach of s.36 would not entail first finding an SLC, instead, it would be as if an SLC was implied by a s.36 breach.[2] Again on this interpretation, s.36 narrows unilateral (and the assumed consequent SLC) breaching actions to those having the intent of eliminating a firm from the market, limiting the competitive ability of a firm or preventing entry. Apart from these breaching behaviours a firm large or small could carry out the range of myriad other actions that go to running a business.

f) The present CA provides "workable" confidence to dominant firms that comes in two forms: a) as far as "own" actions are concerned these firms need not be concerned about breach so long as they do not act with intent to remove/prevent entry/limit competitive conduct of others; and b) that they can check on whether their actions may breach s.36 by asking would the relevant action be seen in a workably competitive market?

5) View of Disaffected Parties:

a) In general terms the CC seems to propose that s.36 should be evaluated as an SLC directly. This would have the effect of opening a wide class of unilateral firm decisions to scrutiny by the CC and by competitors in an area where good (dynamically efficient) market performance is likely to require vigorous unilateral decisions by large firms (and those that would be large);

b) The proposal would have the effect reducing large firms' security in making unilateral decisions, a) because the set of behaviours that would potentially draw an SLC would be more extensive, and uncertain: particularly if the processes of establishing an SLC placed little weight on the existing s.36 counterfactual test; and b) there would be no definitive check on whether their actions may breach s.36 by asking would the relevant action be seen in a workably competitive market?

[2] It is not quite this simple, since it is possible for a breach of s.36 to not produce an SLC.

c) In response to this uncertainty: one suggestion is that if SLC test was available for the unilateral market power test, behavioural rules could be specified that gave the firms certainty for a class of legal unilateral actions. However, safe harbour rules that were definitive would be extremely hard to construct for unilateral actions (think of the world-wide debate about approaches to, and measurement of predation). They would likely err on the side of chilling competition and create uncertainty.

6) Other jurisdictions

a) There is not space to review these: a PhD student (Kay Winkler: in a paper now published in the European Competition Law Review) studied the application of predatory pricing in different jurisdictions. He showed that there are differences in approach among the EU, US, Aus and NZ and that the NZ/Aus approach used the counterfactual test of the approach as one way of predicting the outcome of the conduct (whereas the EU and US used other approaches).

b) The general approach of the EU does stand out, as it has an approach that means that large firms have some sort of duty of care to competition (small firms) in the market (e.g. large firms that price below some measure of cost are automatically in breach). In the EU the efficiency defense is potentially available if convincingly argued by the firm at its initiative.

7) The 0867 Case

a) This s.36 case sets the scene and is illustrative. The CC followed it to the New Zealand Supreme Court; seeking to apply its view of a different or wider test than the counterfactual test. In my view it was asking the court to find Telecom in breach where it had unilaterally carried out a dynamically efficient act.[3]

b) Any argument that Telecom's conduct was dynamically inefficient would have to be based around the result that the free ISPs that Telecom (through Clear) was cross subsidizing were (essentially) eliminated from the market. The case that this was a breach of s.36 would have had to explain why the elimination of "me too" ISP firms adversely affected dynamic efficiency (a study existed that showed that for ISPs it would be most unlikely[4]) and how any "benefit" of "many ISPs" covered the extra resource costs incurred at the relevant time and looking to the future.

c) The pursuit of this case raises questions, that include about the breadth of the test in unilateral conduct that the CC would like to apply; the CC's pursuit of competition

[3] I was engaged by Telecom to evidence on the 0867 case, and I had supervised an ISCR paper on the topic before this engagement.

[4] Boles de Boer, Enright, and Evans, "The ISP Markets of Australia and New Zealand", INFO: the journal of policy, regulation and strategy for telecommunications, information and media, 2000.

(measured in numbers of players) as well as the role of an efficiencies defense of s.36, even if efficiency was arguable.

8) In sum
   a) Competition is a tool not the universal driver of welfare: the SLC test is part of the tool.
   b) The present s.36 test finds a breach of the CA on a narrower range of conduct than would an SLC approach, and the CC would seem to like to broaden it.
   c) The narrower range of conduct provides large firms with some certainty regarding legal unilateral decision-making and conduct.
   d) The existing s.36 counterfactual test is a check on unilateral conduct. It is abstract in some settings, but in others it is concrete and at least as informative as many counterfactuals relating to the general SLC tests of s.27 and s.47.
   e) On what is proposed and the CC's 0867 actions the sort of change contemplated portends an increase in CC activity on unilateral actions.
   f) The extended direct use of an SLC and rules for safe harbour applied to dominant firms looks a lot like the EU approach to unilateral actions.
   g) Has the efficiency case for change been established?