Should s.36 of the Commerce Act be amended to include an effects test?

By Henry Ergas

28 April 1998

Should s.36 of the Commerce Act be amended to include an effects test?

Comments on a paper by P Leonard of Gilbert & Tobin delivered at a Conference on Telecommunications and the Commerce Act sponsored by TUANZ.

By Henry Ergas

Wellington, 28 April 1998.

Let me say at the outset that I am very pleased to comment on this paper. It deals with an important issue in a thoughtful and thought-provoking way. Having said that, I believe that it is seriously flawed. My purpose here is to set those flaws out.

In essence, the paper proposes that s36 be modified through an "effects test" – that is, a test that assesses whether the conduct alleged to be in breach will have the effect or likely effect of substantially lessening competition.

The authors recognise that it is not easy to define or identify anti-competitive effects. They also acknowledge that there is a concern that the resulting uncertainty might deter firms from engaging in actions that while they harm competitors do not harm competition. So as to address these concerns, the authors propose that the effects test be given a particular definition, set out at some length in their paper.

I interpret this definition as involving two core elements:

The first element is a substantial modification to the definition of what is meant by making use of market power. Under current standards, we say that a firm *makes use* of market power when it acts in a way in which it could or would not if it did not have that market power. In contrast, the authors say that conduct should be held to make use of market power even if that conduct would be engaged in by a firm that faced vigorous competition. Rather, the test should be whether the conduct is likely to have harmful effects on competitors that it would not have absent the market power at issue. This, it will be seen, would substantially expand the scope of conduct that would fall within the reach of the statutory provision.

The second element is the test of what conduct, having fallen within the reach of the provision, would be found to be a breach. Here the authors propose that conduct be

held to be in breach if it could not be matched by an efficient competitor. So as to clarify what this means, the authors set out a number of examples, including bundling, foreclosure and so on.

Do these changes do the trick? Would they really reduce uncertainty without imposing substantial economic costs? It is my view that they do not.

Let me begin with the first leg of the authors' test. The authors phrase it as follows:

> "Whether the defendant would have been unlikely to act in the same way and thereby cause the same damage to an efficient competitor if it were operating in a competitive market." (Page 16).

Now, what does implementing this test require? You would need to know what the defendant would or could have done if it were in a hypothetical competitive market. You would also need to know what the plaintiff would look like were it a hypothetical competitor in that hypothetical market. And then you would need to assess the hypothetical damage done to the now hypothetical plaintiff by the hypothetical defendant in that hypothetical market. By then, you would be at least three removes from reality, and yet your task would have just begun.

This suggests that the test the authors propose is riddled with uncertainty. The question then is where these uncertainties might lead – and, in particular, what the risks are of conduct which is no more than competition on the merits being caught within the expanded reach of the statutory prohibition.

It is my view that these risks are substantial. Consider an incumbent which scales up capacity so as to secure further economies of scale or scope. If that incumbent has a high market share, it is possible that the resulting cost savings would deter the entry or expansion of competitors. It is equally possible that this effect – the alleged 'harm' – would not occur in a hypothetical alternative market structure, since -- by definition -- there is virtually no conduct a firm can enter into in a competitive market that will cause any injury to an efficient rival. As a result, application of the rule the authors propose would, or at least might well, imply that a dominant firm that sought to exploit economies of scale or scope would come within the reach of the statutory prohibition. Yet, as the High Court found in the Sky case, it seems eminently desirable that firms, including incumbent suppliers, should strive as vigorously as they can to bring costs down.

In short, the first leg of the authors' proposals is seriously deficient. Does looking at the second improve the view?

In essence, the authors propose that the effects standard be operationalised through an imputation test, that is, a comparison between the defendant's conduct and that open to an efficient competitor. These tests are well-established in the literature, and they are one of the rare areas where there is a consensus among economists. That consensus centres on two points:

A. The first is that imputation is a test and not a *per se* rule. It may establish a presumption; but it is readily shown that there are circumstances in which a practice which fails the test is socially beneficial.

B. The second is that imputation tests, when they are used, should be framed in terms of the lower of the costs of the plaintiff or the defendant. Put in lay terms, this means that a price is presumptively lawful if it is no lower than the sum of the avoidable costs necessarily incurred to supply the market at issue. I note that the economic expert most frequently used by Optus – that is, by the firm Gilbert & Tobin represent – has expressed this matter particularly forcefully, arguing that it is short-run marginal cost that should be used in defining this price floor. Somewhat surprisingly, this economist's views are not cited.

The paper departs significantly from this consensus – without acknowledging that it does so. Consider the following paragraph:

> "This is not to suggest that inefficient competitors are to be sheltered or protected. However, advantages enjoyed by the incumbent .. must be given proper account. Sunk costs, diversified product range (resulting in joint and common costs representing large part of the cost base), significant economies of scale and decreasing average costs, enable the incumbent to structure pricing to prevent "normal" business justifiable levels of subsidisation by competitors, and thus prevent competitors from earning their cost of capital" (at page 15).

I frankly do not know quite what the last line of this text means: what, one might well ask, are "normal" business justifiable levels of subsidisation? But what the

authors are trying to do is clear enough – it is to change the benchmark being used to assess whether conduct could or could not be matched by an efficient competitor. In effect, what the authors propose is that the test be framed in terms of a hypothetical *entrant* which may or may not be fully able to achieve the economies of scale and/or scope. This entrant's costs may well be higher than those of the incumbent -- indeed, that is the nub of the paragraph I have just cited. What then would be the result of the test the authors propose? It would be to force the incumbent to keep a price umbrella over its competitors.

Seen in operational terms, this test is hardly simple to apply or to comply with. It would require the incumbent to ask itself not what its costs are – but rather what the costs are of its current or likely competitors. Of course, firms routinely analyse their rivals' costs; but it is surely a different matter to make those judgements, with all the errors they inevitably involve, the basis for legal liability.

But even if the test were operational, it would seem profoundly undesirable. It seems difficult to believe that it would not blunt the incentives to compete, not solely on price but also by implementing new and improved ways of doing things. Indeed, I know of no economist who has advocated a rule of this type.

It is therefore my view that the approach the authors propose to implementing an effects test would do more harm than good. What they say in trying to spell out the conduct they would proscribe only increases my discomfort.

It is, for example, extraordinary to suggest – as the authors do at page 23 – that there be a presumption against conduct merely because it "increase rivals' costs". What this means is far from clear; what it implies is that an incumbent that increases its advertising outlays, hence placing competitors in a situation where they would need to follow, would be presumed to be in breach of the Act.

Even more extraordinary is the suggested prohibition on responding to competition through geographically targeted discounts, even when the resulting prices are substantially above costs. This is a blatant attempt to increase the cost an incumbent would bear in responding to entry. Again, it is interesting to note that Professor George Hay, a senior economist who has been a consultant to Gilbert & Tobin, has written extensively and perceptively on why discounts of this kind are not anti-competitive – and yet his work on this issue is not cited. So too have Areeda and Turner – and here too, though extensively referred to elsewhere in the paper, they are not cited.

In short, the papers' proposals are at best unclear and at worse dangerous. Are these risks worth taking? In my view, they are not.

This is partly because the proposals are poorly thought through -- even if one wanted to change the Commerce Act, one would be ill-advised to do it this way. But it is also because the paper does not provide any convincing evidence that change is needed -- it merely takes it as a premise that the present arrangements are broken and hence need to be mended. This premise is a questionable one, both in terms of the effectiveness of the Commerce Act and in terms of the outcomes the current arrangements have delivered to consumers.

As regards the effectiveness of the Commerce Act, it is my view that the authors misunderstand the situation in New Zealand.

Thus, they mis-state the substance and implications of the Privy Council's decision in Clear, notably with respect to the use test and its relation to purpose. In the discussion of bundling at page 20, they reason that under the Privy Council test bundling is always exempt because it might be found in a competitive market. However, it is quite clear that the test of use involved in that decision is contextual and objective – with the question being whether bundling would be employed in this manner by a firm not in a dominant position *but otherwise in the same circumstances*. This was made clear by the Privy Council itself and has since been confirmed in a number of subsequent decisions, including Port Nelson and Purebred Jersey Society v Jersey Breeders Association.

Rather, the real significance of the Privy Council judgement is that it established use as an economic criterion that is independent of the purpose test. It clearly established that where use is found, purpose follows inexorably. Accordingly, the purpose test does not, and cannot, make life difficult for plaintiffs.

The authors also overlook the significance of Port Nelson. Not only did that case confirm that – in contrast to the United States – the possibility of recoupment is not needed for a finding of predation; it also substantially eliminated the distinction between unilateral and concerted action. By thus extending liability under s.27, it has imported to unilateral action the lower threshold of market power used in Australia. No less significantly, it allows Courts to base a finding of liability on any of effect, likely effect, objective purpose or subjective purpose.

The view that the Commerce Act lacks teeth is therefore a curious one. Indeed, I note that the success rate of s36 claims is far higher than that of its TPA counterpart. It

might be unfair to say that New Zealand Courts are now free and easy with findings of breach – but it would be even less accurate to cast them, as this paper seems to do, as shy and retiring violets of the mountain.

So much for the Act itself; how about the outcomes regulation by the Act has brought to New Zealand consumers?

I accept that there are substantial difficulties with international comparisons – though aficionados of this field will find it strange to hear these difficulties being rehearsed by Gilbert & Tobin, who regularly speak of "world best practice regulation". Yet the facts of the matter are clear – and they are that New Zealand consumers of telecommunications services have secured benefits which are large both absolutely and relatively to experience overseas.

The contrast with Australia is especially interesting. Given the audience, I won't say that a picture is worth a thousand words – rather, at current compression, the ratio seems to be more like 1 to 150. But there is surely something to be learned from the comparison the slide sets out.

I accept that we made so many mistakes in Australia that it is difficult to know quite what each contributed to the disappointing outcomes observed. To put it slightly differently, it is indeed true that science does not allow us to say whether the patient died from being beaten or being deprived of food. But it would be a curious twist indeed to say, as Peter Leonard did yesterday, that we therefore have no basis for thinking that beating and starvation are not good for telecommunications consumers or other living creatures.

Rather, it seems to me that the lesson of the Australian experience is that most bad things come together – and that there is a reason for this. It may be that as the regulator you start out just to give competitors a bit of a leg up: to help them through what is undoubtedly a difficult process. And then you find yourself being dragged into ever deeper waters, as the full armoury of regulatory powers gets used to create and share rents. And what do you get for your effort? Not vibrant challengers but premature geriatrics, whose main skill lies in threatening to pull out if they do not get what they want. The FCC Staff showed a lot of wisdom in saying that:

> "A firm does not have to possess a large market share to exercise economic power. The OCC's (Other Common Carriers -- the competitors to AT&T) do not possess large market shares, but they can certainly exercise power by threatening to make government

> officials who have inflicted large costs on consumers to promote competition look bad. They can do this by threatening to fail. A small market share and low profits can be assets in such an extortion campaign. They make the threat of failure more compelling and thus make it more likely that government officials will yield to extortionate demands. And as is always the case with extortionists, giving in merely encourages additional blackmail attempts".

In Australia, we frequently look to New Zealand for lessons; this, I submit, is an area where New Zealand could learn from Australia about the mistakes that can be made. I could hardly claim not to have contributed to some of those mistakes; but that only makes it more important to face up to the outcomes. Those outcomes cast further substantial doubt on this paper's policy advice.

In conclusion, the patient has not been shown to be ill -- but strong medicine is recommended. The fact that those to whom similar treatments have been prescribed have died, is taken to be irrelevant. The likelihood of distress from the resulting uncertainty is brushed aside. There is only one thing of which the friends and relatives can be certain – and that is that whatever the outcome, the doctor will send his bill. Were I a New Zealander, this is not a bargain into which I would lightly enter.