Is the Commerce Act 1986 fit for purpose?

A blueprint for a new Commerce Act

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Introduction

As New Zealand's experiment with deregulation limps unsteadily into its fourth decade, documented cases of regulatory failure accumulate: leaky homes (Dyer,2019), Pike River (Macfie 2013; Royal Commission on the Pike River Coal Mine Tragedy, 2012), electricity excess profits (Bertram 2013; Bertram and Twaddle 2005; Wolak 2009; Poletti, 2018), finance company collapses (Lee 2019), workplace injuries and deaths (Armstrong 2014).

A common theme running through these failures is that the weakening of regulatory legal requirements in the 1980s and 1990s, under the rubric "light-handed regulation", was accompanied by a hollowing-out of the public sector's regulatory capability. That was never a necessary combination.

One can imagine a strong state staying its regulatory hand, yet managing to deter abuses of market power by the credible threat of firm regulatory action. But the particular set of ideas which drove New Zealand's deregulation was motivated as much by a quest to weaken the state as it was by a quest to reduce formal regulatory restraints on business.

The irony is that unless regulation itself is abandoned entirely (which admittedly was probably the dream of some), the state always retains responsibility for exercising control over markets and imposing limits on market behaviour. Unless the state possesses genuinely capable regulators with the necessary resources and mandate, a programme of "light-handed regulation" will fail to protect consumers and the public from undesired hazards and predation.

Light-handed regulation, in short, could have been credible and effective only if practised by a strong state with clear regulatory objectives and with genuine residual power to regulate effectively whenever non-compliance arose – what Myrdal (1968) called a "hard state". A weak state with unclear objectives and lacking strong barriers to capture of its policy and regulatory processes by rent-seeking elites– what Myrdal called a "soft state" – is apt to fail at regulation, whether "light-handed" or "heavy-handed", and under either scenario will be prone to misdirected regulatory effort. The coupling of light-handed regulation and a soft state was and is a sure recipe for regulatory failure.

This argument is summarised in the 2x2 matrix below:

	Hard state	Soft state
Light handed regulation	Works provided there is a credible heavy-handed backstop	Fails comprehensively
Heavy handed regulation	Works	Likely to fail

Experience with New Zealand's Commerce Act 1986 provides a good case study of such a combination of weak regulation and a weak regulator.

Background theory of the state

Writing in 1651, Thomas Hobbes argued the inescapable need for some governing authority to exercise sovereign power to restrain the predatory "natural passions" of humankind (Hobbes 1968 Part II Chapter 17, pp.223-224):

> … the Lawes of Nature (as *Justice, Equity, Modesty, Mercy, and* (in summe) *doing to others, as wee would be done to,*) of themselves, without the terrour of some Power, to cause them to be observed, are contrary to our natural passions, that carry us to Partiality, Pride, Revenge and the like. And <u>**Covenants, without the Sword, are but Words, and of no strength to secure a man at all. Therefore … if there be no Power erected, or not great enough for our security**</u>, every man will and may lawfully rely on his own strength and art, for caution against all other men. [Emphasis added.]

The Golden Rule (what Hobbes called "Lawes of Nature") could not, he argued, prevail in a "state of nature" where no individual had any protection against others apart from his or her own ability to resist predation. In the state of nature, brute force would determine the distribution of wealth and income and nobody could trust anyone else not to act in a self-serving way.

Hobbes therefore argued for a strong sovereign authority that would restrain predatory behaviour, by establishing and enforcing rules to restrain unbridled greed and self-aggrandisement and to impose norms of civilised behaviour. Economic historians such as North (1990, 1991) similarly emphasise the importance of strong, well-designed "rules of the game" for the historical development of markets under the shelter of constructed institutions such as property rights and sanctity of contract. The first of these means that some specified individual or group holds a legitimate exclusive claim over certain resources and the ability to gain from utilisation or sale of those resources. The second means that promises can be made and kept with certainty as to the outcome. Modern capitalism could not have developed without these basic institutional pillars.

But while necessary, rights of property and contract could never suffice in themselves to ensure Hobbes's "justice, equity, modesty, mercy". Other restraints on human greed, backed by credible enforcement, are equally needed. The presence or absence of such restraints has been the focus of much comparative cross-country research into the causes of economic success or failure. Acemoglu and Robinson, to take just one example, argue for the positive effect of "inclusive" institutions, in contrast to "extractive economic institutions" that are "structured to extract resources from the many by the few" (2012 p.430).

A century after Hobbes, Adam Smith pointed out in his critique of mercantilism (1776) that if the institutions of power were captured by vested interests and used to advance their private agenda, then the regulatory apparatus of government could itself become an instrument of oppression and a constraint in the wealth of a nation (Buchanan et al 1980; Tullock 1989). Hence alongside Smith's belief that competitive markets could harness human self-interest to serve the common good went his clear recognition of the need for a "statesman" to implement a set of "duties of the sovereign". Among those duties was "administration of justice", defined by Smith as "the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it" (Smith 1976 Book IV Chapter ix). That meant an effective prohibition on the use of either political influence or outright coercion to secure economic benefit for a favoured group at the expense of the general population.

Rosenberg (1960 p.559) comments that

> A neglected theme running through virtually all of the *Wealth of Nations* is Smith's attempt to define, in very specific terms, the details of the institutional structure which will best harmonize the individual's pursuit of his selfish interests with the broader interests of society. … Smith was obsessed with the urge to go beyond the ordinary market-structure definition of competition and to evaluate the effectiveness of different institutional forms in *enforcing* this identity.
>
> "The ideal institutional order for Smith is one which places the individual under just the proper amount of psychic tension. The individual applies himself with maximum industry and efficiency when the reward for effort is neither too low (slaves, apprentices) nor too great (monopolists, large landowners)**.**

Hobbes' appeal to the Golden Rule (doing to others as we would be done to) is a recurring theme in political philosophy, notably in the use by Rawls (1971) of the conceptual device of a "veil of ignorance" that strips away from the individual all the particular powers, assets and attributes that the individual will actually enjoy, and then forces them to choose amongst possible social arrangements. Rawls argues that placed in that position, the rational individual will opt to insure against the worst possible outcome – hence will choose the institutions that best protect the most vulnerable, weakest members of society.

All of this brings me directly to twenty-first-century New Zealand and the design of institutional architecture in this country. My central proposition in this paper will be that if forced to undertake Rawls's "veil of ignorance" experiment, no rational person would choose the regulatory arrangements that were established here in the 1980s and 1990s. If this argument succeeds, then how, standing behind Rawls's veil, might we sketch a possible blueprint for a new Commerce Act?

Three central themes embodied in the Commerce Act 1986, have been (i) tolerance of monopolistic price-gouging, (ii) an idealised notion of competition that leaves the victims of anticompetitive conduct without remedy, and (iii) absence of concern about wealth transfers arising from exploitation of market power, whether those transfers are from consumers to producers, or from small firms to large ones. The next three sections consider how the Commerce Act 1986 addresses (or fails to address) these issues.

Regulating monopolistic price-gouging

Protection of the weak against the strong is the essential task of Hobbes's Leviathan. It is also a central theme in the English common law as codified by a contemporary of Hobbes, Lord Chief Justice Sir Matthew Hale. In a work entitled "De Portibus Maris" Hale set out what has since been known as the "doctrine of prime necessity" or "essential facilities doctrine", a clear example of a situation in which the power of the state ought to be used to check the behaviour of a monopolist.

In Hale's port example, the owner of the only wharf and crane in a port that is relied on by many users to undertake their trading business is legally constrained to charge only reasonable rates for use of the facility, because it is "affected with a public purpose". The common law overrode the individual monopolist's right to charge a profit-maximising or even prohibitive amount, because doing so would damage the general welfare and the ability of competitors to use the port on reasonable terms. Hale puts it thus (1787 pp.77-78):

> There cannot be taken arbitrary and excessive duties for cranage, wharfage, pesage &c., neither can they be enhanced to an immoderate rate, but the duties must be reasonable and moderate …. For now the wharf and crane and other conveniences are affected with a publick interest, and they cease to be *juris private* only…. But in that case the king may limit by his charter and license him [the wharf owner] to take reasonable tolls, though it be a new port or wharf, and made publick; because he is to be at the charge to maintain and repair it, and find those conveniences that are fit for it, as cranes and weights.

Notice that there are three quite clear and distinct elements here: protection of buyers of the service against extortion (price-gouging[1]); recognition of the justification for the owner of the monopoly facility to recover reasonable costs of operation, maintenance and repair

[1] Price-gouging can be broadly defined as "charging services or pricing goods at unreasonably high prices". While often used to refer to short-run opportunistic exploitation of crisis situations such as the COVID pandemic in 2020, the term can also be used to describe the pricing behaviour of a coercive monopoly that uses its market power to hold prices above the competitive level. The term is used here in the second, long-term sense.

(but no more); and protection of the process of competition by ensuring open access to all comers on equal terms. This section looks at the first two of these. The next section takes up the third.

From English common law, Hale's doctrine passed into US law (Hamilton 1930) where among other things it provided the basis for the Sherman Act 1890 with its famous section 2:

> Every person who shall monopolize[2], or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding $10,000,000 if a corporation, or, if any other person, $350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

Lande (1982 p.70 fn 20) remarks that

> the Sherman Act was passed for a number of purposes: preventing monopolistic transfers of wealth from consumers to trusts, encouraging corporate productive efficiency in order that consumers would receive these benefits as well, reducing the social and political power of large aggregations of capital, and providing opportunities for small entrepreneurs. Congress' more minor goals were not, however, meant to interfere significantly with the right of purchasers to buy competitively priced goods.

Under the Sherman Act and the subsequent Clayton Act, Hales' doctrine limiting monopoly prices to reasonable costs became the subject of extensive litigation over monopoly pricing in the USA, culminating in a 1944 Supreme Court ruling on how a monopoly firm's fixed assets should be valued in calculating those reasonable costs (Troxel 1947 Chapters 10-17; *Federal Power Commission v. Hope Natural Gas Co* 320 U.S. 591 (1944)). Central to the *Hope* decision was the proposition that regulated utility rates should be set on the basis of the historic cost of prudently-incurred investment. Investors in a monopoly business had the right to receive a "return on and of" what they had actually spent to set up the business, but no more. The resulting pricing formula corresponds to Adam Smith's "natural price" (Smith 1976 Book I Chapter 7) and Alfred Marshall's "normal price" (Marshall 1936 Book V Chapter 3 section 4).

In New Zealand prior to 1986, the *Hope* rule on how a regulator ought to set the reasonable price for a monopoly utility underpinned the price-control procedures for private monopolies. Section 54 of the Commerce Act 1975 commenced with the provision "(1) Every person commits an offence against this Act who whether as principal or agent, and whether by himself or his agent, sells or agrees or offers to sell any goods or services at a

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2 The clearly intended meaning of "monopolizing" was seeking and/or using market power to raise prices unduly; the Sherman Act was triggered largely by the practices of railroad companies in charging for freight out of the agricultural Midwest.

price which is unreasonably high." The section then went on to lay out in detail the procedures to be followed by a Court in assessing when a price was unreasonably high.

Recovery of operating costs, plus anything up to and including a fair return on and of capital expenditure actually undertaken to install fixed assets ("original" or "historic" cost), was the standard basis for price setting by courts and tribunals administering New Zealand's Positive List of controlled private-sector prices under the Commerce Act 1975. The same upper limit on prices was observed by the publicly-owned monopoly utilities such as New Zealand Electricity Division, the regional Electricity Supply Authorities, the Harbour Boards, airport authorities, and the NZ Post Office as owner of the telecommunications system. (The difference between regulated private businesses and those state-owned utilities was that the latter opted not to recover a full commercial return on the historic cost of their fixed assets, in order to hold down the price of what were in those days considered essential services.)

In 1986, however, at the same time as the State-Owned Enterprises Act pushed public utilities toward profit-driven corporatisation and privatisation, the old Commerce Act with its clear focus on consumer protection was swept away by the new Commerce Act 1986. The 1986 Act (i) made monopoly profiteering (price-gouging) legal except where the Minister of Commerce takes a political decision to regulate prices by means of an Order in Council under Part IV; and (ii) stripped away the old common-law right of redress for victims of price-gouging.

The Commerce Commission has crisply summed up the position as follows, referring to the profits of the unregulated electricity generators (Commerce Commission 2009 p.6 paragraph v):

> The exercise of market power to earn market power rents is not … a contravention of the Commerce Act, but is a lawful, rational exploitation of the ability and incentives available to the generators.

The Commission's website is equally clear: "Charging high prices to consumers is not illegal under section 36 of the Commerce Act"[3].

Two hundred years of common-law protection against profiteering was simply "ousted" by the 1986 Act. The "doctrine of prime necessity" (or "essential facilities doctrine"), derived from Hales, previously enabled the courts to determine the reasonableness of charges by the monopolist owner of an essential infrastructure facility without which other parties could not operate. But the decision of the Privy Council in *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385 established that the Commerce Act 1986 had removed this protection for parties seeking access to telecommunication networks.

Subsequent decisions of the Court of Appeal in *Vector Ltd v Transpower New Zealand Ltd* [1999] 3 NZLR 646, *Metrowater v Gladwin* (2000) 6 NZBLC 102, and *Pacifica Shipping Ltd v*

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[3] https://comcom.govt.nz/business/avoiding-anti-competitive-behaviour/taking-advantage-of-market-power accessed 12 April 2020.

Centreport Ltd [2003] 1 NZLR 433 made this clear equally for the case of electricity transmission lines, water pipelines, and wharf charges respectively.

As Tipping J said in delivering the Court of Appeal's decision in *Pacifica Shipping Ltd v Centreport Ltd* at paragraph 15

> The essence of the decision in *Vector* was that the doctrine of prime necessity was excluded by the Commerce Act. This conclusion was held to be reinforced by the State-Owned Enterprises Act 1986. The reason the doctrine is excluded is that the only price control available under current New Zealand law is that provided for in Part IV of the Commerce Act, and such control is available only when the conditions set out in Part IV are satisfied.

So since 1986, any decision to regulate a profiteering monopolist has to be a political, not a judicial, one, made by the Minister of the day subject to lobbying financed by the monopoly profits that have flowed from previous failure to regulate. The 1986 Act shifted the job of identifying monopoly abuse from courts and tribunals to the Minister of Commerce. Procedures for deciding whether to invoke Part IV remain informal, rules of evidence are not applied, and under-resourced government agencies advising the Minister, often with inadequate in-house skills, are vulnerable to intense lobbying away from either public gaze or the discipline of a judicial forum. Each Minister will judge differently, and there is no body of clear precedents or case law built up. As Governments and Ministers change, so does the probability of regulation, which makes delay a winning strategy for any monopolist faced with an activist Minister. It's easy to get the impression that the regulatory machinery in Part IV of the Commerce Act was deliberately set up to fail. Indeed it is difficult to see any other explanation for the framing of the legislation.

The Commerce Commission's power even to investigate (let alone prevent) possible price-gouging and excessive profits (which it had possessed under the 1975 Commerce Act) was stripped away in 1986, and was restored only in October 2018 when a new Part 3A was added to the Commerce Act, over vocal opposition from the Act Party[4]. The first study, on oligopolistic pricing of petrol, was released in late 2019 and drew the predictable instant response from the business lobby: "BusinessNZ Chief Executive Kirk Hope said the business sector would be concerned at the risk of commercial returns being expropriated by regulatory action, reducing incentives to invest in the New Zealand economy" (*Business Desk* 5 December 2019). ("The business sector" referred to here is clearly big business. Many small business owners in New Zealand would be delighted to

[4] "The Commerce Commission has been asking for this power for years. It can now go after any industry it doesn't like on the suspicion that it is uncompetitive. They have the power to demand all of the industry players' internal information, then decide if they are making too much money or not based on theoretical calculations and models that may or may not reflect the practical realities faced by business. The real problem with New Zealand's economy is a lack of scale to support more competitors. We live in a small, sparsely-populated country with fewer than five million people." (Seymour 2018).

see more constraints placed on the behaviour of large companies further up the food chain.)

As of mid-2020 just four industries have their prices regulated under Part IV: electricity networks, gas pipelines, telecommunications networks, and (less directly) airports. The regulatory proceedings are complex and highly technical, which renders them largely inaccessible to outsiders. The principled simplicity of Adam Smith's natural price, and the *Hope* principle of allowing no more than fair return on and of the original cost of fixed assets, lie buried under a mountain of submissions, litigation, impenetrable spreadsheets, and arbitrary asset valuations and revaluations.

In the case of electricity networks, the weakest consumers – households – are currently paying hundreds of millions of dollars each year in excess of what could have been allowable under either US regulatory rules or New Zealand's previous price-setting rules under the Commerce Act 1975 (Bertram and Terry 2000; Bertram and Twaddle 2005; Bertram 2006, 2013, 2016, 2018a, 2018b, 2019). The history of how this came about is straightforward.

First, by the Energy Companies Act 1992 Parliament compelled the publicly-owned networks to transform themselves into profit-maximising corporations and opened the way to their privatisation. Then, starting in 1994, these natural monopolies were left unregulated for a decade and allowed (indeed, encouraged) to raise their prices to the monopoly-profit-maximising level, familiar from first-year economics textbooks. At the same time they were allowed (again urged, even compelled, by officials) to raise the book value of their fixed assets from historic cost to replacement cost, and then on to "fair value" (that is, the discounted present value of expected monopoly profits)[5]. Those new asset values were declared legitimate in 2000 by a ministerial inquiry headed by former Minister of Commerce David Caygill, architect of the Commerce Act 1986 (Caygill et al 2000). They were subsequently adopted from 2002 on by the Commerce Commission as "deemed historic cost" values, and have been hard-wired into the Commission's regulatory process from 2008 on.

Throughout this inexorable process of locking-in monopoly profits at the expense of those with the least power in the market – residential consumers – there was hardly a chink through which the case for protecting the weak against the strong could be heard, let alone taken seriously. With their common-law rights ousted, the well-being of consumers was at the mercy of a political and administrative establishment in thrall to the big companies' lobbyists and consultants.

One final stage of big industry's capture of the regulatory apparatus remained to be worked through. In 2008, Parliament passed the Commerce Amendment Act to codify the price-setting methodology to be used by the Commerce Commission as regulator. For the first time in two decades the words "excess profits" appeared in a New Zealand law,

[5] This process was hidden behind the impenetrable technocratic façade of the so-called Optimised Deprival Valuation methodology (ODV) under which accountants, engineers and lawyers made fortunes during the 1990s.

but submerged under a mass of competing concerns about promoting investment and "efficiency". The new section 52A(1) read

> The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—
> (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
> (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
> (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
> (d) are limited in their ability to extract excessive profits.

Making sense of this semantic morass lies beyond the scope of this paper. Just one point will suffice. Completely unregulated monopolists are always, as a matter of common sense as well as elementary economic theory, "limited in their ability to extract excessive profits". That is why "profit maximisation" is the central feature of economic theories of the firm. Monopolistic price-gouging is fully consistent with section 52A(1) of the amended Commerce Act. Parliament in 2008 succeeded only in codifying price-gouging into law. Both Labour and National Parties supported the legislation. Only the Maori Party stood against it, correctly perceiving that it offered no real protection for consumers.

At the same time, the 2008 Act brought the courts back into price regulation by providing for a right of appeal on the merits against Commerce Commission decisions. The appeal right is set out in sections 52Z and 52ZA of the amended Act. It was the result of sustained lobbying by, and tailored to the interests of, the regulated industries. It is limited to parties that have participated in hearings on the decision to be appealed, immediately ruling out ordinary consumers, who entirely lack the resources or the representatives to participate continuously in Commerce Commission hearings. (In any case the costs of appeal to the High Court are far beyond the means of any individual consumer or consumer organisation.) Hence the only hope for protection of consumers would have lain with the Commerce Commission itself – but the appeals process is basically a means by which deep-pocketed monopoly interests can hold the Commission itself to ransom, given their ability to squeeze the Commission's limited budget to the tune of many millions of dollars.

No sooner had the Commission adopted the monopoly asset valuations written into network company books during the wild-west decade 1994-2004 than large regulated monopolies in airports, gas pipelines and electricity networks mounted a joint appeal against the Commission's "Input Methodologies" under the 2008 legislation, with the large electricity networks arguing (among numerous other complaints) that their inflated asset valuations were too *low*. The list of lawyers appearing for the appellants reads as a who's who of New Zealand's top legal talent. The arguments which they laid before the Court resurrected all the specious theories spawned in US litigation between the discredited 1898 *Smyth v Ames* decision (171 U.S. 361) and the 1944 *Hope* decision. Presumably aware of this, the High Court asked what had happened to the original, historic-cost asset valuations of the electricity network assets, and heard that (*Wellington International Airport and Ors v Commerce Commission,* [2013] NZHC 3289 at paragraph 428):

> The MED and subsequently the Commission took an ODV approach for two basic reasons:
> (a) because of a lack of reliable historic cost information, and
> (b) because they considered that an ODV approach mimics outcomes in competitive markets

That alleged lack of "reliable" information on historic cost came at the end of a decade and a half of intensely-prescriptive "information disclosure" which had been the promised crown jewel of light-handed regulation. Detailed financial statements had been published annually in the *Gazette* until 2008, with strongly supportive audit statements by New Zealand's top accountancy firms. Those accounts contained continuously-tracked historic cost asset values grounded in the pre-1994 books of the electricity networks. The proposition that they were not "reliable" and hence could be set aside does not qualify to be described even as a fig leaf.

The Ministry and the Commission, basically, sold consumers down the river. Having done so, the Commission has since 2013 proudly defended the network asset valuations as its "line in the sand" that cannot be revisited[6]. The effect is to put a floor under network prices at the monopoly level established as of 2004[7].

In 2019 yet another ministerial inquiry, having relied on the Commission to reassure it that there were no excess profits, meekly reported that all was well (Dean et al 2019). The lesson for regulated monopolists was clear: regulatory capture works under New Zealand's prevailing law, and the Commerce Commission can be broken by the credible threat of costly litigation. That litigation trump card applies not only to price regulation. it has worked even more powerfully to entrench anti-competitive conduct, the subject of the next section.

The Courts now tend to take for granted that the weakly-amended Part 4 of the Commerce Act provides a secure guarantee against profiteering. Mallon J, for example, in *Commerce Commission v First Gas Ltd* [2019] NZHC 231, says without qualification at paragraph 6

> Transmission and distribution networks are regulated by price-quality regulations imposed by the Commission under Part 4 of the Commerce Act. The effect of this is to prevent gas pipeline businesses from earning excessive returns.

6 See *Wellington International Airport and Ors v Commerce Commission,* [2013] NZHC 3289 paragraphs 269-271, 472-478, 635-649, 764-776, 981-983.

7 Network owners have since 2018 been given the option of applying to the Commission for "accelerated depreciation" which allows them to charge customers now to pay for anticipated future write-downs of unsustainable asset values. The decision went through with minimal fanfare on a shortened timeframe. No consumers made submissions. I doubt that any consumer had any idea of what was being proposed.

If only we could be certain that were true. The history of the gas industry following privatisation of Natural Gas Corporation in 1987-88 is not encouraging[8] .

The Ministry for Business, Innovation and Employment recently issued a discussion paper containing the statement (2019 p.5) "While monopoly pricing reduces consumer welfare, it generally does not harm the competitive process (if anything, it can attract competitors)." The continuing primacy of the so-called "competitive process" over consumer wellbeing could hardly be more clearly stated.

Protecting the process of competition?

Up until 1986, New Zealand law (in the form of the Commerce Act 1975) had spelled out explicitly several types of anti-competitive conduct that were prohibited, including price collusion (s.27) resale price maintenance (s.28), tied bundling (s.50), and refusal to deal (s.23). In addition there was provision in Part III of the Act for monopolists' market conduct in general to be investigated, and penalties or remedies imposed. But this explicitly prescriptive approach was dumped overboard in 1986 in favour of a light-handed approach.

Considering the rhetoric at the time of its introduction, it could have been expected that the Commerce Act 1986 would stand or fall on the effectiveness of its provisions against anti-competitive conduct. In practice it fell. To understand why, one has to bear in mind that the drafting of the legislation was heavily influenced by Chicago School writers such as Stigler (1971), Posner (1976) and Bork (1978).

A standard refrain in the antitrust literature is that the goal is "protection of the process of competition, not of competitors"[9]. The obvious difficulty with this proposition is that protecting the process of competition by stopping a dominant firm from trampling on its competitors must inescapably be of benefit to, and provide a degree of protection to, those competitors, just as controls on price gouging will benefit consumers. Regulation that delivers no benefit to anyone is difficult to justify.

In the hands of Chicago adherents the rule "protect competition, not competitors" became the argument that any regulatory intervention that benefits any competitor or competitors at the expense of an incumbent firm is a distortion, rather than removal of a distortion, of the optimal market outcome. Regulation they viewed as simply the outcome of political struggles, through which rent-seeking interest groups competed to capture government policy.[10] Stigler (1971 p.3), for example, argued that "regulation is acquired by the industry and is designed and operated primarily for its benefit".

8 For the history see Gas Industry Company 2017 pp.2-5; on the monopoly profit-taking in the 1990s that finally led to Part 4 regulation see ACIL 2001; Bertram 1999 and 2004; and Bertram et al 2001.

9 The expression turned up originally in *Brown Shoe v.US*, 370 US 294 (1962). For a quick summary of arguments for and against see Kaiser (2009) section 8.

10 The Chicago approach is well characterised and critiqued in Hovenkamp (2019) and Hovenkamp and Morton (2020). For a (heavily-qualified) defence of Bork see Crane (2014).

Whatever real-world firms were doing could, in Chicago terms, be characterised as just the normal process of competition at work. That in turn meant that virtually any conduct by a firm with power in a market could be defended.

Section 36 of the Commerce Act 1986 was where this approach to conduct in a market came to roost. As originally worded that section read:

36. Use of dominant position in a market–(1) No person who has a dominant position in a market shall use that position for the purpose of–

(a) Restricting the entry of any person into that or any other market; or

(b) Preventing or deterring any person from engaging in competitive conduct in that or any
other market; or

(c) Eliminating any person from that or any other market.

Once the courts finished interpreting what Parliament had said, that key section provided cover for what courts elsewhere in the world would quickly recognise as anti-competitive conduct. Space does not permit a detailed review of the cases here (but see, e.g., Coull 1998, Curtin 2016, Farmer 1994, Berry 2006, Sumpter 2012, Ahdar 2009, Bertram 2006).

The test was threefold: (i) market dominance had to be proved, accompanied by (ii) "use" of that dominance, and (iii) use had to be for an anti-competitive purpose, as distinct from merely a desire to compete vigorously as any firm is supposed to do. This imposed a burden of proof that simply overwhelmed attempts by private parties and the Commerce Commission to rein in conduct that was transparently anti-competitive in its effects but could not be proven to flow from an anti-competitive purpose[11].

In *Telecom Corporation of New Zealand* Ltd *v Clear Communications* Ltd [*1995*] *1 NZLR* 385 a clear-cut example of what the textbooks call "raising rivals' costs" was found entirely legal under the 1986 wording. The Privy Council framed the issue as a counterfactual test: "In their Lordships' view it cannot be said that a person in a dominant market position 'uses' that position for the purposes of s36 if he acts in a way which a person not in a dominant position but otherwise in the same circumstances would have acted"; and further "a monopolist is entitled, like everyone else, to compete with its competitors: if it is not permitted to do so it would be holding an umbrella over inefficient competitors".

The same counterfactual test was crucial in a further Privy Council decision, *Carter Holt Harvey v Commerce Commission* [2006] 1 NZLR 145, which cleared CHH of what (on any common sense view of the facts – see Bertram 2006) amounted to predatory pricing and exclusionary bundling, on the basis that CHH was merely competing vigorously. That outcome would surely have been different under s.50 of the old Commerce Act 1975.

Rather than clearing up the morass of s.36, Parliament in a 2001 amendment just fiddled with the wording:

A person that has a substantial degree of power in a market must not take

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11 The same problem of identifying "purpose" overhangs sections 28 and 29 of the Commerce Act (Berry 2006 pp.610-613), but in those sections there is reference also to effect.

> advantage of that power for the purpose of—
> (a) restricting the entry of a person into that or any other market; or
> (b) preventing or deterring a person from engaging in competitive conduct in that or any other market; or
> (c) eliminating a person from that or any other market.

But replacing "dominant position" with "substantial degree of market power" and replacing "use" by "take advantage of" did not fix the basic problem. The way section 36 of the Commerce Act 1986 is framed means a virtually complete absence of any check on predatory and anti-competitive behaviour so long as the courts stay with the counterfactual test – and that test is presumably what Parliament intended, given that Parliament has not removed it in the 34 years since the legislation was passed. In a nutshell, the law still says that all firms, even those with market power, are permitted to act in what they judge to be their commercial best interests, regardless of the effect. What their purpose may be remains a matter of mere conjecture. Only in 2019 did an official proposal emerge to change "purpose" into "effect" (MBIE 2019). Whether that change, if eventually enacted, can make a real difference remains to be tested in the courts.

Meantime "New Zealand is the only country with modern competition law that requires an anti-competitive purpose and does not consider the effects of the conduct" (MinterEllisonRuddWatts 2019).

The Commerce Commission website puts it this way: "a business with a substantial degree of market power can compete in the same way as a business which does not have market power"[12]. A former Commission member has commented that the Act "comes close to giving firms with market power a free pass on pretty much anything that isn't the most obvious of rorts". (Donal Curtin, quoted by Underhill 2016).

In 2016 the manifest inadequacy of s.36 was highlighted at a Commerce Commission conference by Gavil (2016 p.1046, emphasis added):

> Like a magician's trick, focusing the investigation and litigation of a case **of** dominant firm conduct on the potential efficiencies realised by other, non-dominant firms draws attention away from the proper focus of the inquiry: the dominant firm and the effects of *its* conduct…
>
> By focusing the analysis on whether a firm lacking substantial market power would have engaged in the same conduct, the counterfactual test substitutes a hypothetical inquiry into the conduct's possible efficiencies when practised by a nondominant firm for the more important question of its actual or probable effects, both pro and anticompetitive, when practised by a specific dominant firm in a market with observable characteristics. It trades an inquiry into actual or probable harms, efficiencies and motivations in a real world market for a hypothetical inquiry that reveals only whether *some* efficiency *might* justify the conduct by *some other firm lacking* market power. It does not pose the more relevant and illuminating efficiency-related question: whether the dominant firm's conduct had a significant anticompetitive effect, taking into account evidence of efficiencies, if any. Reliance

12 https://comcom.govt.nz/business/avoiding-anti-competitive-behaviour/taking-advantage-of-market-power accessed 15 April 2020.

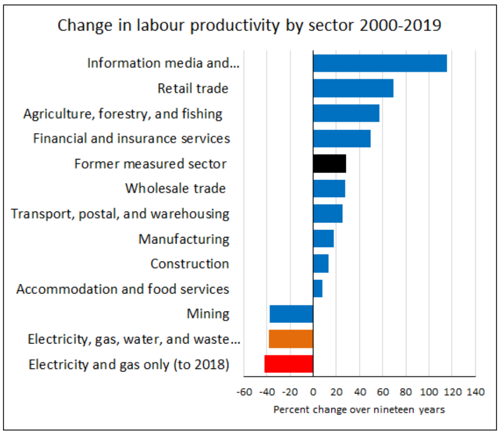
on the counterfactual test, therefore, is very likely to produce "false negatives"; that is, it will fail to condemn conduct that warrants prohibition**, precisely because it fails to attribute any significance to the dominant firm's market power.**

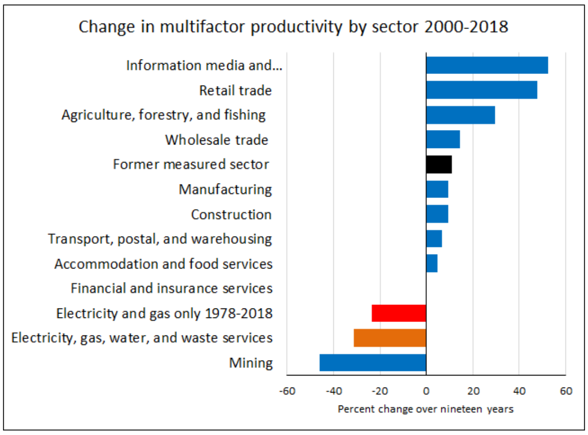
The inadequacies of s.36 have been obvious for decades now, yet Governments of all political stripes have been profoundly reluctant to fix it.[13] The minor semantic changes of 2001 were not effective in curbing abuse of market power. Critical commentary on s.36 and the outcomes of litigation under it steadily accumulated, but the counter-arguments from big-business advocates prevailed in the determination of policy and legislative changes, and officials in the Ministry for Business, Innovation and Employment have continued to give pride of place to the "efficiency" defence of monopoly.

One such clear statement of the dynamic-efficiencies argument is in MBIE 2015 p.15:

> Striving to acquire market power is what encourages innovation, and firms should not be punished when they achieve it. Nor, having acquired market power, should they be prevented from innovating further. Consumers benefit from increased productivity and innovation.

So, has productivity and innovation actually benefited in practice as MBIE claim? Of the sectors in the New Zealand economy with which this author is familiar, the outstanding case study of "striving to acquire market power" and then using it is the electricity sector. Having been left either completely unregulated (in the case of generation and retail) or ineffectually "regulated" (transmission and distribution) for over three decades, the sector's total factor productivity in 2019 was 16% below 1986. Its capital productivity was down 35%.





As the charts above show, since 1999-2000 when the current electricity industry structure was bedded in by the Bradford reforms, the sector's labour productivity has fallen 43%, capital productivity has fallen 17%, and total factor productivity has fallen 22% (Statistics New Zealand 2020, plus additional data provided to the author by Statistics New Zealand in

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13 Perhaps the clearest evidence of that reluctance is the way public anger at the anticompetitive, but fully legal, conduct of the monopoly Telecom NZ in the 1990s eventually led the Clark Government to regulate the sector via the Telecommunications Act 2001, rather than to fix the gaping s.36 loophole. That Act eccentrically outlawed the so-called Baumol-Willig pricing rule, use of which would, ironically, have been perfectly acceptable had Telecom's pricing been properly regulated.

February 2020). Across the twelve sectors of the New Zealand economy for which productivity data are available covering the period 2000-2019, electricity/gas and mining compete for the prize for the greatest productivity collapse. Meantime electricity sector profits boomed as price-gouging of residential consumers roared on. As a poster child for the MBIE/Chicago School's "efficiency" propositions, electricity is unimpressive to say the least. Surprisingly, even though the New Zealand Productivity Commission has been in existence for a decade now, it has initiated no inquiry into that sector.

Wealth distribution: benefits and detriments

Part 5 of the Commerce Act 1986 empowers the Commerce Commission to grant or withhold authorisation for mergers or restrictive practices that would otherwise be prohibited as anti-competitive. Section 67 (3)(a) provides that "if it is satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted [the Commission may] grant an authorisation for the acquisition". But how is "benefit to the public" to be judged? No definition is provided in the Act.

The same problem arose with a 2001 amendment to the Act's purpose statement which now states "the purpose of this Act is to promote competition in markets for the long-term benefit of consumers within New Zealand". Not only is there no definition of "competition" (Land et al 2010 p.98), but no indication is given of what constitutes a "benefit".

Suppose that merging two firms to form a monopoly enables production costs to be reduced, which is a gain in the efficiency of production, while at the same time conferring increased market power (hence ability to raise the price and increase profit). The key question surely should be: who gets the benefit of these two effects? If all the cost reduction were to be passed through to consumers as a lower price, then consumers would gain but the firm's owners gain nothing. That outcome would be a clear gain if "benefit" is equated to consumer benefit – this is commonly described as the "consumer surplus standard". If all the gain from lower costs and a monopoly price goes to the shareholders of the merged firm, then consumers are left worse off but – Chicago School advocates say - society as a whole benefits from the increased surplus in production. That is the "total surplus standard".

The fundamental issue here is distribution. The consumer surplus standard would allow only those mergers that leave consumers better off – a test recognisably related to Rawls' proposition that the interests of the worst-off must be paramount. The total surplus standard allows market power to be exercised and the firm's profits increased, even if no benefits flow to consumers.

A classic plank in the Chicago School position has always been that efficiencies on their own are sufficient justification for a merger, regardless of what happens to the welfare of consumers. The issue was framed by Williamson (1968)[14] but it was Bork (1978) who produced the most extreme statement of the so-called "efficiencies defence for mergers".

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[14] Williamson, however, never said that distribution of benefits did not matter. On the contrary, his 1968 paper noted that "while economies would remain a defense, any undesirable income distribution effects associated with market power would be counted against the merger rather than enter neutrally as the

> Bork did not use the term “consumer welfare” in the same way that most people use it today. For Bork, “consumer welfare” referred to the sum of the welfare, or surplus, enjoyed by both consumers and producers. Bork referred to consumer welfare as “merely another term for the wealth of the nation.” A large part of the welfare that emerges from Bork’s model accrues to producers rather than consumers. (Hovenkamp 2019 p.65).

By leaving undefined what was meant by “benefit to the public”, the Commerce Act 1986 opened the way for business lobbyists such as the Business Round Table, allied with Chicago School adherents among local academics, officials and lawyers, to capture the regulatory process at the expense of consumers. That capture involved embedding the total surplus standard into the Commerce Commission’s authorisation procedures (Easton 1989; Ministry of Commerce 1991; Pickford 1993; Bertram 2004a, 2004b) culminating by 1994 in wholehearted adoption by the Government of the day (without any referral to Parliament) and by the Commission, of the total surplus standard (Commerce Commission 1997). Thereafter, wealth transfers from consumers to monopolist producers were treated as of no consequence in merger cases.

Bertram (2004a) commented that

> The common thread through the public debates of 1988-93 was a relentless lobbying drive by proponents of the Chicago School, headed by Treasury and the Business Round Table, to narrow down the “public benefits test’ in a direction that would exclude consideration of any issues other than the three categories of economic efficiency (allocative, productive and dynamic). The lobbying campaign failed to achieve its goal of unambiguous statutory wording that would mandate the total surplus standard, but achieved its main objective by administrative means when Cabinet approved, and the Commerce Commission adopted, an interpretation of the public benefit test which excluded social, environmental, or so-called “distributional” considerations from Commerce Commission decision-making on mergers and trade practices. An arguable view is that this amounted to a neoliberal hijacking of the statute.

The argument for allowing mergers on efficiency grounds has always been that in a very small open economy such as New Zealand, optimally-sized firms will tend to be large relative to the local market, and hence to have market power. Achieving that optimal scale ought not, the argument goes, be checked by any requirement to make consumer welfare paramount (Evans 2004). But if there are genuine efficiency gains, it is not clear why a requirement to share them with consumers, to the point where consumers are better off after the merger than before, cannot be mandated as a condition of the merger (Lande 1982).

I have always held that (Bertram (2004b pp.269 and 273):

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naïve model implies”, and in a 1977 paper he argued for explicitly putting different weights on the gains of different parties affected by a merger. I discussed this literature in Bertram 2004a pp.40-49.

> there is nothing in economic theory pointing to any conclusion that society does not care about transfers, and there is therefore no principled basis on which economists could advise New Zealand regulatory agencies to ignore transfers…
>
> To allow society's income distribution to be determined by the exercise of market power rather than by agreed and democratically-sanctioned processes is corrosive of the fabric of civil society.

One final leg of the Chicago School position is its strong advocacy of the notion that any regulatory check on a monopoly's profit is a "taking" which should automatically be compensated. For an extreme statement of the case for New Zealand see Evans and Quigley (2011). For a firm (and in my view convincing) rebuttal see Huang (2011). My review of the argument is in Bertram (2010). A sustained campaign by the Act Party to write the extreme takings position into New Zealand law was, fortunately, unsuccessful.

An end to "pie in the sky"

The promise that deregulating large industry would unleash dynamic gains so great that after trickling down, they would leave everyone better off, is what may be called, following folksinger Woody Guthrie, the "pie in the sky" thesis. In his recent book-length critique of the Chicago School theorists in the US context, Baker remarks (2019 p.2):

> Bork and the Chicagoans … expected that relaxing antitrust rules would enable firms to achieve greater efficiencies. Firms would lower costs, possibly passing some of the savings through to lower prices. They would also improve their products and services, and innovate more quickly and extensively, boosting economic growth. .. [T]he Chicagoans were making a wager. The bet was that these efficiencies would more than compensate for any increased risk of firms exercising market power. If it worked, consumers would obtain long-term welfare benefits over and above any losses associated with anticompetitive practices.
>
> We now know that the Chicagoans lost their bet. Since the implementation of antitrust deregulation, market power has widened, without accompanying long-term gains in consumer welfare. Instead, economic dynamism and the rate of productivity growth have been declining. The harms from the exercise of market power have extended beyond the buyers and suppliers directly affected to include skewed economic growth and a skewed distribution of wealth. Whatever efficiency gains the Chicago-inspired changes may have achieved have not compensated for the market-power effects of the antitrust deregulation they sought.

Hovenkamp and Morton (2020 p.40) bluntly describe the Chicago School attack on antitrust as "one of the most complete cases of regulatory capture in economic history". Their abstract concludes:

> What kept Chicago alive was the financial support of firms and others who stood to profit from less intervention. Properly designed antitrust enforcement is a public good. Its beneficiaries — consumers — are individually small, numerous, scattered, and diverse. Those who stand to profit from nonintervention were fewer in number, individually much more powerful, and much more united in their message. As a result, the Chicago School

> went from being a model of enlightened economic policy to a powerful tool of regulatory capture.

They describe the capture of research, policy and advocacy as follows (2020 p.9):

> Economic theory demonstrates that funding for antitrust research will naturally be lopsided; there is no equivalent financial incentive to fund interventionist policy work because the benefits of antitrust enforcement accrue to consumers, who are very diffuse[15], not particular companies or institutions. Antitrust enforcement turns monopoly markets into competitive ones, corporate profit into consumer surplus, and is therefore a public good. As with any public good, it tends to be underprovided.

And p.10:

> The Chicagoans embraced economics when it would achieve their anti-enforcement ends, but largely ignored its advances in theory and empirical technique after 1970 because those tools sometimes proved that anticompetitive conduct had occurred, and that enforcement was needed. The movement created what might be called "Opportunistic Economics" by using economic analysis when it delivered the desired answer, and ignoring it when it did not.

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15 This is the classic argument advanced in Olsen Logic of Collective Action argument]

A blueprint for change that makes the interests of each New Zealander central to competition policy

Radical change to our competition law, not captured tinkering around the edges, is necessary. In thinking about how to replace the Commerce Act 1986 with something more in line with what Hobbes, Smith and Rawls had in mind, it pays to look in two directions. First, one needs to look back at what was thrown away to clear space for the new Act, and to ask how many babies were thrown away in the indiscriminate dumping of bathwater. That means revisiting the Commerce Act 1975, with its blunt prohibition of profiteering, its quick-response provisions for inquiring into possible cases of abuse of market power, and its specific penalties.

Then one needs to look outwards, at legislation and practices in other countries, and analyses in the global literature on competition law. Here are to be found forms of words, and concrete measures, that may be able to be rolled into new law for New Zealand.

There are some bottom lines that need to be drawn, going to the earlier discussion of Hobbes' image of the Covenant and the Sword. Protection of the weak against the strong requires both of those. New Zealand's 1986 transformation of its competition law has offered neither.

As a first step, the interests of New Zealand consumers need to be placed at the centre of the law as the overriding goal to which other goals are subsidiary. This would follow the recommendations of many legal scholars (see, for example Baker 2019; Hovenkamp and Morton 2020).

Second, the taking of excess profits needs to be declared illegal, reviving the crisp clarity of the Sherman Act and of s.54 of the Commerce Act 1975, and tossing overboard the meaningless "limited in their ability to extract excessive profits" of the 2008 Commerce Amendment Act. Excess profit in turn needs to be defined as any return that yields more than some limit over a normal profit, except where clear evidence can be presented to justify a greater return. That would put the burden of proof where it belongs – on the profit-taker – instead of on the aggrieved party as at present.[16]

(This shift would not involve abandoning altogether the notion that some activities may have such beneficial external effects that a high rate of return is justified. In particular, there is an obvious issue around intangible assets such as intellectual property which do not carry an objectively-determined value, relative to which profits might be judged excessive or acceptable.)

Third, forms of anticompetitive conduct that are proscribed need to be specified and some criteria laid down for detecting them. This involves a more away from the Commerce Act 1986's reliance on a generic. poorly-specified principle in section 36 which is full of

[16] The Commerce Act 1975 specified a threshold of 20% above normal price beyond which a Commerce Commission inquiry could be triggered, potentially followed up by price control.

loopholes through which possessors of market power and their lawyers have driven their triumphal chariots.

Fourth, the Sword must be empowered to enforce the Covenant more stringently than has been possible for either the courts or the Commerce Commission over the past three decades. That means that once the statutory framework has been fixed, a more effective and acvtivist Commerce Commission needs to be explicitly furnished with a litigation budget that will always at least match whatever big business throws into key court cases, making the full resources of the state available to underwrite legal action against deep-pocketed monopolists[17]. The ability of the powerful to intimidate the organs of governmental authority simply by using their ill-gotten gains to fund drawn-out, wasteful proceedings in the courts of the land has to end. Cases must be genuinely decided on the merits, not on the relative wealth of the parties.

Finally, who exactly will reliably stand on the side of, and in defence of, the weak and the poor, to face down the possessors and exploiters of market power? Reliance on then Commerce Commission and the Ministry, as these are currently constituted, means an ongoing risk that the regulatory apparatus will simply be captured by the powerful. Some advocate is needed, with standing to appear before Commission and Court hearings and that has the analytical resources to make heavyweight submissions on legislative and regulatory policy proposals from a consumer perspective. Existing consumer organisations have neither the muscle nor the intellectual grunt required. New Zealand's universities have largely ceased to provide a haven for academics not attuned to the ideology and demands of big business. There is space here for creative thinking.

From behind Rawls's veil, that looks like a reasonable, albeit demanding, menu for policy innovations to arrest New Zealand's ongoing slide from twentieth-century mixed capitalist economy, towards a new feudalism with entrenched dynastic wealth drawn from market power and a dominant rentier class.

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[17] The Commerce Commission Litigation Fund is an annual Budget item, which sets a pre-determined amount for the forthcoming year. It is supplemented by the Commission's own retained Litigation Reserve. But ultimately the availability of really big litigation funding remains a political decision by the Government of the day. How to balance the need for credible deterrence of corporate litigiousness against the risks of freeing any governmental agency freed from day-to-day budgetary restraint is admittedly a tough issue.

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