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CONTRACTS THAT LESSEN COMPETITION:
WHAT IS SECTION 27 FOR, AND HOW HAS IT BEEN USED?

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I Introduction

In this paper we explore the application of competition law to contracts, in particular vertical contracts between a firm and its customers. We examine the competition policy goals which underpin the law's treatment of such contracts, and consider how well New Zealand's legislation and case law achieves those goals. We also examine some areas where New Zealand's law can learn from the successes – and failures – of United States case law.

Our conclusion is, in short, that the principles set out in the Commerce Act 1986 are sound, but that:

1. There have been a number of serious wrong turnings in the application of the Act;
2. There are some curious anomalies between the Act's approach to contracts which lessen competition, and its treatment of acquisitions and mergers with precisely the same economic effect; and
3. We would do well to learn from current United States experiences about certain types of challenges to contracting behaviour, including predatory pricing, exclusive dealing, price discrimination and tie-in sales.

II New Zealand Competition Law and Institutions: a Brief Overview

A Commerce Act 1986

New Zealand's generic competition law is set out in the Commerce Act. In common with the competition laws of most developed economies, the Act has as its focus three basic types of conduct that may harm competition:¹

1. Agreements which reduce competition:
2. Unilateral misuse of market power to prevent or hinder competition; and
3. Mergers and business acquisitions that reduce competition.

¹ We use the term "harm competition" to mean that the conduct results in higher prices to consumers. The term "harm to competition" is used interchangeably in this paper with "reduction in competition" and "lessening competition".
In outline, Part II of the Act prohibits entering into or giving effect to agreements that harm competition in any market (sections 27-35), and unilateral use of market power to harm competition in any market (sections 36-42). Part III prohibits business acquisitions (including mergers) that harm competition. Part IV provides for the imposition of price controls on goods and services supplied in markets where competition is absent or very limited. Price control can be imposed by Order in Council (ie regulations), and is then administered by the Commerce Commission. 2 Part V enables market participants to obtain clearances from the Commerce Commission in respect of acquisitions which do not breach Part III (there is no comparable process for clearance of agreements or unilateral conduct), and authorisations in respect of agreements to which Part II applies or acquisitions to which Part III applies (but not unilateral conduct), where there is harm to competition but this harm is outweighed by other public benefits.

The focus of this paper is section 27 of the Act, which is closely modelled on, but not identical to, section 45 of the Australian Trade Practices Act 1974 (Cth). It provides:

27. Contracts, arrangements, or understandings substantially lessening competition prohibited—

1. No person shall enter into a contract or arrangement, or arrive at an understanding, containing a provision that has the purpose, or has or is likely to have the effect, of substantially lessening competition in a market.

2. No person shall give effect to a provision of a contract, arrangement, or understanding that has the purpose, or has or is likely to have the effect, of substantially lessening competition in a market.

3. Subsection (2) of this section applies in respect of a contract or arrangement entered into, or an understanding arrived at, whether before or after the commencement of this Act.

4. No provision of a contract, whether made before or after the commencement of this Act, that has the purpose, or has or is likely to have the effect, of substantially lessening competition in a market is enforceable.

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2 No goods or services have been subject to price control under Part IV since 1993, when price control in respect of natural gas was lifted. But Governments have been more willing to contemplate use of price control in recent years, its imposition in the electricity distribution sector is contemplated by the recently enacted Part 4A of the Commerce Act, and the Commerce Amendment Act 2001 made extensive changes to Part IV to provide for a more sophisticated and flexible price control regime, which is intended to address some of the concerns about Part IV which have contributed to its limited significance in practice.
B Relief in Respect of Breaches of the Act

The Act allows any person, without restrictions on standing, to apply to the High Court for an injunction to restrain conduct that would breach the prohibitions in the Act. Any person who suffers loss as a consequence of a breach of the Act may claim compensation for that loss from the wrongdoer, again in proceedings before the High Court.

The Commerce Commission also has standing to bring proceedings claiming a pecuniary penalty of up to $500,000 (for natural persons) or $5 million (for corporate defendants) in respect of any breach of Part II or Part III of the Act. These are civil penalties, rather than criminal sanctions. The Act does not provide for criminal sanctions in respect of breaches of Part II or Part III, but does impose criminal sanctions (in the form of relatively minor fines) for breach of any price controls established under Part IV.

Where assets or shares have been acquired in breach of Part III, there is limited provision for the making of a divestiture order, on the application of the Commission. The Commission must seek the order within two years of the acquisition. No other person has standing to seek such an order in respect of a completed acquisition.

The Act does not provide for multiple damages, or for the award of any other form of punitive damages in claims brought by persons other than the Commission.

Nor does the Act make any provision for relief in favour of persons other than parties to litigation in respect of breaches of Part II or Part III, for example by requiring a person who has acquired market power in breach of the Act, and raised prices, to compensate those who paid the higher prices. The only method of seeking disgorgement of such illegal gains expressly provided for in the Act is a claim by the Commission for a pecuniary penalty. This is all the more curious given the express provision for disgorgement orders and refunds to customers in respect of breaches of Part IV price controls. Some sort of representative action might be possible under the High Court Rules. But class actions as they are known in the United States are not a feature of the New Zealand legal landscape, and it is most unlikely that the courts would adopt such a procedure in the absence of express authority in legislation, or at least in the High Court Rules.

The Act makes provision for certain forms of ancillary relief, where a breach is established. Most relevantly for present purposes, the Act provides that where any provision of a contract is entered into in breach of the Act, or where giving effect to a provision of a contract would breach the Act, the Court has a broad discretion on the application of any party to the contract to vary the contract (in a manner consistent with the Act), cancel the contract, or order any party to make restitution or pay compensation to another party to the contract (section 89).
The normal New Zealand costs rules apply in Commerce Act litigation, including claims by the Commerce Commission for pecuniary penalties (see for example, Commerce Commission v Caltex\(^3\)). The successful party will normally recover its reasonable disbursements together with a reasonable contribution to legal costs, which under the current costs regime is likely to be in the region of two-thirds of actual and reasonable legal costs.

C The Institutions Responsible for Applying the Act

The institutions responsible for administering and applying the Act are:

1. The Commerce Commission, which is responsible for making decisions on applications for clearances of mergers, and applications for authorisations (on public benefit grounds) of acquisitions and agreements. The Commission plays a central role in any price control regime under Part IV, advising the Minister on whether or not to impose such controls, and administering the price control regime. The Commission also has a general enforcement role, with standing to seek remedies in respect of any breach of the Act, and the sole ability to bring proceedings seeking to impose penalties for past breaches. However, private enforcement has always been central to the effectiveness of the Act: the Commission simply is not resourced to investigate and follow up all alleged breaches, and can only afford to take enforcement action in a handful of cases each year;

2. The High Court, which hears appeals from decisions of the Commission on clearances and authorisations, and hears all claims for relief in respect of breaches of the Act – including claims for injunctions to prevent breaches, compensation for past breaches, and claims by the Commission for penalties. The High Court can (and regularly does) sit on certain Commerce Act cases with lay members selected for their expertise in “industry, commerce, economics, law, or accountancy” (section 77(2)). The contribution made by economists sitting with High Court Judges has been a significant feature of the New Zealand Commerce Act experience; and

3. The Court of Appeal, which hears appeals from decisions of the High Court. There is no provision for economists or other lay members to sit with the Court of Appeal on Commerce Act appeals. Decisions of the Court of Appeal on appeals relating to clearances and authorisations (where the Court is hearing a second appeal on matters which originated before the Commission) are final. Other decisions can be appealed to the Privy Council.

\(^3\) (2000) 9 TCLR 424.
III Some Basic Principles of Competition Policy

In this section of our paper we set out a few basic principles of competition policy which ought to guide legislators, and judges, in making decisions about how competition law should apply to contracting behaviour of firms. We do this because it is always a good discipline to be explicit about one's starting point, and also because there has been a tendency, both in New Zealand and the United States, to lose sight of these basic principles from time to time. As we shall see below, some recent New Zealand decisions are particularly vulnerable to this criticism.

A The Focus is on Competition as a Means to Efficiency

Our starting point is that competition policy is concerned with economic welfare. Coherent competition policy seeks to encourage competition in markets because competition is in general welfare enhancing. That is, competition generally creates incentives for market participants to behave in ways that enhance allocative efficiency, productive efficiency, and dynamic efficiency, and these in turn contribute to consumer welfare and producer welfare. In a small economy such as New Zealand's, which is reliant on exports, productive efficiency is particularly important.

The basic proposition, that competition policy seeks to encourage competition in markets, does however require further elaboration, and some qualification.

B Efficiency Does Not Necessarily Require Rivalry

The first point that needs to be made is that competition is not intrinsically desirable - it is only desirable insofar as it contributes to economic welfare in the relevant markets. Although this point is well understood by economists, it is less well understood by lawyers. Some lawyers have a tendency to use the term "competition" in the sense of rivalrous behaviour, and to see a reduction in the number of rivals in a market as an undesirable reduction in the level of competition in that market, regardless of the effect on economic welfare. We comment below on the confusion that this approach has produced, and suggest that a more helpful approach in assessing whether a particular contract (or other act) reduces competition and is undesirable may be to focus on the constraints on discretionary market behaviour with and without the contract/act, whether any effective constraints that exist or would otherwise come into existence are removed, and to consider the outcomes of competition. We also discuss the possibility that overall efficiency can be improved even if there is a lessening of competition (ie harm to consumers).

For now, however, we simply emphasise that competition policy is not always concerned to maximise the number of rivals in markets. To take but one example, there are markets which, because of economies of scale, are not efficiently served by many small firms. Consumers may enjoy lower prices when
a market is served by a smaller number of large providers than by a large number of small providers. Moreover it is possible that, in the presence of scale economies, overall economic welfare is higher when the market is served by one efficient firm even if the consequence is that consumers face higher prices from reduced competition.

Thus competition policy is not about the number of market participants as such, and has as its focus the protection of efficient competitive processes, rather than of:

1. particular competitors; or
2. a particular number of competitors; or
3. particular limits on market share; or
4. particular “ideal” market structures.

C Market Share is Not the Same as Market Power

A closely related point is that a high market share does not necessarily imply high market power. At the (theoretical) limit, in a perfectly contestable market, a supplier may have a market share of 100% but no market power. Any attempt to charge a monopoly price would result in aggressive entry by others seeking a share of the available rents, and a loss of market share, and would drive prices back down to competitive levels.

Perfectly contestable markets are of course rare if not non-existent. But the model is an important one for a small economy like New Zealand, where many products are imported and the number of importers is often very low. Entry into these markets is not costless or instantaneous – but, on the other hand, it may not be very expensive or very slow. The deadweight costs which result from any temporary exploitation of such short-term market power are likely to be small compared with the costs of legal intervention, and legal processes are likely to be much slower than market responses in addressing any short-term rent-seeking behaviour.

D Competition Law is Just One Aspect of Competition Policy

Competition policy is not the same thing as competition law. Competition policy finds its expression in a number of policy instruments, one of which is generic competition laws, which are intended to deter or prevent anti-competitive conduct by market participants. (Other New Zealand examples of policy instruments giving effect to competition policy are tariff removal and reductions, removal of non-tariff barriers to imports, the Trans-Tasman Mutual Recognition Act 1997, the Electricity Industry Reform Act 1998, steps taken to reduce barriers to entry in many sectors such as telecommunications, energy and transport, the recommendations of the recent electricity and telecommunications inquiries, and the electricity sector reforms provided for in the Electricity Amendment Act 2001.)

This clarification is important because it reminds us that while competition
law should always be consistent with competition policy, it is a fallacy to argue that because a particular outcome is desirable as a matter of competition policy, it is required by competition laws - or, as this argument is more commonly framed in the courts, that because a particular outcome is undesirable as a matter of competition policy, it must be contrary to competition law. It also reminds us that when considering possible reform of competition laws, it is not legitimate to leap from the desirability of particular outcomes as a matter of competition policy to the inclusion in competition laws of provisions designed to bring about those outcomes. The limits of law as a mechanism for achieving certain types of policy outcome, in terms of cost, delay, and institutional expertise, are always relevant to determining the proper scope of competition laws.

One very important facet of the New Zealand Commerce Act, which reflects an understanding on the part of legislators that law has significant limits as an instrument for pursuing competition policy, is its focus on deterring identifiable conduct that reduces the existing level of competition. This is discussed further below.

It is difficult to over-emphasise the importance of limits on institutional capacity in relation to the development of successful competition law. The theoretical possibility of harm to competition from a practice is not sufficient to justify the prohibition of that practice, unless we can be reasonably confident that we can in practice, without too many false positives and without excessive cost and delay, distinguish the goats from the sheep. If the evidence needed to draw such distinctions with reasonable confidence is likely to be unobtainable, or extraordinarily costly to obtain, or beyond the capacity of the court system to evaluate and apply, then it is preferable for the law to avoid the need to draw such distinctions. Nor is this an area where we can afford to draw simpler, over-inclusive distinctions which ensure the “goats” are caught by prohibiting a wider class of transaction - we would be undermining the very market activity which the Act seeks to promote, at considerable (and typically unquantifiable) cost. We cannot afford to prohibit sheep, or deter sheep farming, as a side effect of waging a costly and unpredictable war against a small number of goats!

E Conduct Which Reduces Competition May Be Efficient

Because competition is just one - albeit very significant - means to the achievement of economic efficiency, the Act recognises that there are circumstances in which pursuit of competition in a particular market will not be efficiency-enhancing, or otherwise in the public interest. This is the rationale for the provisions in Part V which allow the Commission to grant authorisations in respect of agreements which breach Part II or acquisitions which breach Part III, where any harm to competition is outweighed by other public benefits. The Commission's guidelines on assessment of public benefits make it clear
that the Commission's focus is on efficiency gains, despite the broad references to "benefit to the public". 4

The extent to which efficiency is relevant to the analysis of Part II of the Act is the subject of some debate. The case law appears to establish that efficiency is relevant under Part II at least to the extent that:

1. When considering the effect of an agreement or of particular conduct on competition, it does not follow that there is harm to competition simply because less efficient competitors may find it more difficult (or impossible) to compete; and

2. Where an agreement or other conduct has some pro-competitive and anti-competitive effects in the same market, these must be weighed against each other to determine their net effect.

However what Part II and Part III do not allow is the balancing of harm to competition in one market against efficiency gains in another, and it is not clear whether Part II allows the balancing of harm to competition from one provision in a contract against efficiency gains resulting from other provisions in the contract, or from entry into the contract as a whole. Such balancing exercises, drawing on wider efficiency considerations - or for that matter on other policy goals - are permitted under the Act when considering an application for authorisation, but probably not otherwise.

F The Act Does Not Seek to Eliminate Existing Market Power

Another very important principle is that the Commerce Act is intended to deter conduct (including mergers and acquisitions), which has the effect of reducing competition in New Zealand. It is not intended to force the break up of existing (legitimately acquired) monopolies, or to require market participants to take active steps to surrender, or constrain themselves from exercising, legitimately acquired market power. That is, it is not a "trust-busting" statute designed to unravel existing market power in New Zealand, or market power acquired without breaching any of the provisions of the Act (for example by building strong brands, or through product innovation). This is apparent in the restriction of "break-up" or sell-down remedies to acquisitions in breach of Part III. This limit on the Act's scope was explicitly noted by the Government of the day when the Act was introduced. 5

In other words, the Act is directed against conduct which removes existing competitive constraints on market participants, or which prevents the emergence of constraints that would otherwise have developed. It does not require market

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4 Section 3A, which requires the Commission to have regard to efficiencies when assessing public benefit, also seems to assume that the concept has other facets. It is not clear what they might be, however, and in practice the Commission gives little or no weight to benefits that cannot be couched in efficiency terms.

5 See New Zealand Parliamentary Debates vol 463 pp 4683, 4690; vol 468 pp 8590, 8593; vol 469 pp 507, 512, 515, 675, 676.
participants to create, or voluntarily subject themselves to, new constraints that would not otherwise have arisen. Nor does it seek to prevent the infliction of harm on existing competitors – or even their elimination from the market – as a consequence of legitimate competitive conduct (i.e., out-competing them).

G  Big Firms Should Also be Able to Compete Vigorously

It is important, especially in a small and highly concentrated economy that big players are able to compete vigorously as well as small players. Law is a clumsy tool for deterring unilateral conduct by firms, and needs to be used with caution to avoid deterring conduct which is aggressively competitive, rather than anti-competitive. This was the rationale for limiting the provisions addressed to unilateral conduct to large firms only, and focussing on the business rationale for the conduct in question (which as discussed below, we consider should be interpreted as a focus on reasonable foreseeability of harm to competition), rather than its effects as assessed with the benefit of hindsight, or with the benefit of information not reasonably available to the firm at the time. We return to the distinction between unilateral conduct, and agreements between market participants, below.

H  Competition Policy is Concerned with Deadweight Costs, Not Transfers

From the focus on efficiency described above flows an emphasis on deadweight losses, rather than transfers from one class of market participant to another. Competition policy (and competition law) should be concerned with conduct that results in significant deadweight losses, and should not be used as tools in the debate about who captures rents in a market, or how any surplus is allocated as between suppliers and purchasers. One implication of this approach is that a lessening of competition that results in consumers facing higher prices can be offset by a gain in productive efficiency, so that overall economic welfare increases.

There are three basic reasons for taking what seems to some commentators to be an unappealingly agnostic approach to the incidence of gains and losses:

1. First, and most importantly, any attempt to intervene in the allocation of the economic surplus derived from a market will result in price signals that send inappropriate messages to market participants in the long run, and make it more likely that continued regulatory intervention will be required in contexts where the marketplace would otherwise have produced more efficient outcomes. Consider, for example, an application for authorisation of a merger of the only two importers into New Zealand of some product. Let us assume

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6 This has been recognised by the courts on a number of occasions, including by the High Court of Australia in *Queensland Wire Industries Pty Ltd v BHP* (1989) 167 CLR 177 and by the Privy Council in *Telecom Corporation of NZ Ltd v Clear Communications Ltd* [1995] 1 NZLR 385.
that the merger will create new market power, at least in the short
term – perhaps it would be likely to take a year or two for significant
new entry to occur. Let us also assume that the merger will reduce
the merged entity’s costs (eg through reduced unit shipping costs),
with the result that there will be savings that exceed any deadweight
loss even in the first few years. Some would argue that there needs to
be some assurance that these savings will be passed on to consumers,
as otherwise they may face price increases at the same time that the
firm enjoys cost savings. But this misses the point that the best long-
term assurance of consumer welfare is either further entry, or the
merged firm pricing at a level which is so low that further entry is
uneconomic, rather than the Commission attempting to fix prices in
a market where entry will soon protect consumers;

2 It would be exceptionally difficult to impose any appropriate
conditions on the merger that did not require continuing and extensive
intervention by the Commission. For example, an immediate price
drop might be promised – but what if prices rose again subsequently?
Would the Commission need to review such an increase, to check
whether it represented a response to changed market circumstances,
or was simply a reallocation of gains from trade? If costs fell, would
further reductions in price be required to preserve a particular
allocation of rents, or would the firm be allowed to take advantage
of cost reductions to reallocate rents? Good practical sense underlies
the Act’s prohibition on the Commission accepting behavioural
undertakings of this kind, and becoming enmeshed in such issues;
and

3 Even if such intervention could be devised and appropriately targeted
to ensure that savings were passed on to consumers, this would have
a significant effect on the incentives for firms and their managers to
seek out new ways of reducing costs through acquisitions and mergers.
If the firm cannot retain such gains, it has no incentive to seek them
out and incur the (often significant) costs of implementing a merger.
Trying to “share” the gains to preserve such incentives inevitably
attenuates those incentives, and is an even less implementable
prescription for any agency unfortunate enough to be charged with
such a task.

Some commentators have pointed out that where a transaction results in
a significant transfer from consumers to suppliers, rent-seeking behaviour by
suppliers may dissipate some or all of this transfer. So the deadweight costs we
are concerned with include the deadweight costs of such rent-seeking conduct.7

7 Relevant deadweight costs also include any expenditures customers make to avoid the market
power.
But it is a fallacy to leap from this observation to the conclusion that all transfers should be counted as deadweight losses, and that competition law should be as hostile to transfers as it is to the deadweight loss caused by supra-competitive pricing in a market. The potential for rent-seeking behaviour of this kind varies from market to market, and from transaction to transaction: while it is right to be vigilant to identify any costs of this kind that may result from a particular deal, it is wrong to adopt a blanket assumption that all transfers will be dissipated in this way. Specifically, as long as the marginal cost of obtaining rents rises, transfers will not generally be completely dissipated. This is exactly the same principle that says that, in equilibrium, the marginal entrant earns zero profits, but this is not necessarily the position of all firms.

I No Increase in Market Power – No Competition Policy Concern

Although it should be so obvious that it goes without saying, the focus on efficiency and on deadweight losses referred to above means that there is no competition policy concern whatsoever if there is no deadweight loss. Where conduct (such as a merger, or an agreement) has no effect at all on what market participants are able to charge, or are likely to charge – ie has no effect on the degree of market power any person can exercise in that market – there is no competition policy concern. And if there is no competition policy concern, competition law should not bite.

The courts have in some contexts observed that competition law is concerned to prevent market participants being able to “charge more, or give less”. But in other contexts this truism seems to be lost sight of – as we shall see when we come to some of the cases on section 27, including Health Waikato\(^8\) and Port Nelson.\(^9\)

II Substance Over Form

Finally, sound competition policy focuses on the economic effect of particular transactions, rather than their form. If the policy concern in respect of two transactions is identical, one would expect that absent compelling reasons to the contrary:

1. The transactions should be subject to the same substantive test for legality;
2. Any legal review should involve a similar process; and
3. Similar remedies and relief should be available, in the event of a breach.

As we shall see below, this is not in fact the case in New Zealand. In particular, where vertical integration can be achieved either through merger or

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8 Health Waikato Ltd/Midland Health v Commerce Commission, Decision No. 275, 1 Aug 1995.
through contracting, New Zealand law applies similar tests (though this is a recent development), but follows very different procedures, and provides for remedies that differ both in nature and in the timeframe over which they are available.

IV When Should Competition Policy be Concerned with Contracts?

In this section, we first provide a general overview of contracts, explaining why interfering in contracts as an antitrust remedy long after the contracts have been signed carries with it significant costs. We describe four simple principles that antitrust authorities should use in order to reduce uncertainty about property rights. We next discuss the antitrust concerns associated with horizontal and then vertical contracts.

A Introduction – General Economic Analysis of Contracts

As Coase\textsuperscript{10} pointed out long ago, contractual relations between firms are a substitute for activities within a firm. Coase and subsequent researchers have analysed in detail the advantages of contracts with their associated transaction costs in comparison with the advantage of performing tasks within the firm. And, of course, contracts themselves come in myriad forms ranging from very short-term contracts for standardised goods to elaborate long-term contracts for highly specialised goods. The recognition that these different ways of transacting are substitutes for each other, though imperfect ones, leads to a simple but important policy conclusion. Any focused antitrust attack on one type of transaction will lead to an inevitable substitution in the way in which firms organise their business dealings. Since firms presumably choose the most efficient method of organising transactions, any such substitution is one cost of an antitrust policy that tilts the balance.

Antitrust policy is usually not neutral to the form of transaction, at least in New Zealand and the United States. There seems to be a belief that, \textit{ex post}, there is likely to be a higher cost to breaking up a firm than there is to breaking a long-term contract, and that the latter cost is likely to be higher than the cost of breaking a short-term contract. By cost, we do not mean the financial cost to the parties from altering the terms of trade. Instead, we mean the increased transaction cost from having to either carry on with a dismembered firm, or from having to negotiate and enforce alternative contracts to carry on business. Although we have never seen a study documenting such relative costs, the ranking we have just given sounds sensible. However, \textit{ex post} costs are only part of the story, and one must recognise that there are \textit{ex ante} benefits of being able to reliably enter into business transactions without having to worry

about future government interference. Indeed, what researchers in contracting have taught us is that it is precisely in situations where very specialised investments must be made that the party making the investment and the party relying on the output of the investment would want assurances far into the future to protect themselves from possible opportunistic behaviour. For example, a long-term contract specifying the price (or price formula) for a highly specialised input would protect a buyer who relies on the specialised input from being taken advantage of in the short run, and similarly protects the seller from being stuck with an unsaleable product. Any erosion of reliability of subsequent property rights in the enforceability of the contract would diminish the incentive for either the buyer (who wants assurance of supply at a reasonable price) or seller (who wants assurance of sale of his otherwise unsaleable (specialised) product) to engage in the transaction. The cost of the erosion of subsequent property rights in a contract must include the general disincentive to make investments in specialised assets, since one response to weak property rights is to forego the investment. That is the ex ante cost of an antitrust policy that can interfere with long-term contracts.\(^{11}\)

The presumption implicit in much antitrust enforcement would seem to be that the sum of the ex post and predicted ex ante cost consequences (on other transactions) from interference with contracts between firms is less than the corresponding cost of interference with the activities within a firm as in a divestiture order to break up a merged firm. Again, we are aware of no quantitative evidence to support the supposition. However, there is an antitrust concern that we have rarely seen analysed that suggests that the preference for intervening in contracts instead of in the internal activities of firms has perhaps been over-emphasised. When two firms merge, all subsequent decisions about the use of the combined firm’s assets are coordinated and ultimately controlled by one decision maker. In contrast, with contractual relations between two firms, there at least remains the possibility that subsequent decisions about use of the two firms’ assets will be made by competing decision makers. Therefore, if one is concerned with preserving the possibility for future competition, contracts not combining internal firm activities should be favoured over a full-blown merger. Hence, antitrust authorities that create a disincentive to use long-term contracts are favouring mergers that could result in less competition in the future.

The point about the cost of uncertainty in the enforceability of contracts, caused by fears of antitrust intervention, raises a more general point, also made by Coase.\(^ {12}\) It is that the assignment of property rights is essential in order to achieve efficiency. An antitrust authority that is guided by the latest whim in economic theory creates an environment in which businesses will not know

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12 Supra n 10.
how to plan their future, with an inevitable decline in efficiency. That is why it is important for an antitrust authority to have very clear general principles and guidelines, and for exceptions to those principles and guidelines to be rare. Although it would be presumptuous to claim that we can outline such principles in a way that will generate a uniform consensus, we take a stab at doing so because it is the only way to provide a basis to implement a consistent antitrust policy.

1. As we said in section III above, the overarching principle for antitrust should be efficiency, the maximisation of consumer plus producer surplus. From this principle, the next three follow.

2. A firm should be permitted to reap the rewards of any market power that it creates by dint of having a new or improved product. That includes the ability to price above marginal cost, to price discriminate, and to design and produce the product as it sees fit.

3. A firm should be permitted to transfer its market power, through outright sale to another firm, provided the transfer to that other firm will not lead to an increase in market power.

4. Firms should be able to use outside distributors as they see fit, provided any foreclosure of other firms from distributors does not cause a harm that outweighs the benefit from the distribution scheme.

The rationale for the first principle is that the goal of antitrust enforcement is to improve the welfare of the nation's citizens. Efficiency gains through cost savings are just as important as equivalent gains to consumers achieved through price reduction in creating benefits to society.  

The second principle is based on the assumption that competition in innovation and in the achievement of cost savings requires that the successful firm be rewarded for its efforts. Removing that profit incentive would shut off the commercial reward from the development of new ideas, and thereby reduce the incentive to discover such ideas. Researchers have attributed the tremendous gains in living standards in the last few hundred years to the creation of new products, and most researchers find that the social rate of return to innovation exceeds the private rate. If anything, this result suggests that we give more, not less, incentive to innovating firms to reap profits from their ideas. This approach is reflected in intellectual property laws, for example, where market power is created and protected by law to incentivise certain types of innovation.

The part of the second principle dealing with price discrimination is based on both theory and pragmatism. As a matter of economic theory, the welfare effect of price discrimination is ambiguous. The reason for the ambiguity is that price discrimination can allow a firm to set a low price for some group of

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13 An interesting issue is whether efficiency should be discounted if some of the owners of the firm are not citizens of New Zealand. Since we believe that overall efficiency is a desirable goal (stock ownership can change), our initial disposition would be to ignore the foreign ownership issue.
customers who would not have otherwise purchased the product and thereby lead to an increase in output and consumer surplus. It does not always lead to such an output expansion. It depends. Even if theoretically one believed that courts and regulatory agencies were able to do the appropriate calculations to figure out whether price discrimination raises or lowers output, the policy maker would be faced with the question of whether to prevent price discrimination and, if so, how to do so. If it did decide to ban price discrimination, then all types of very common pricing would become subject to antitrust scrutiny. For example, it is very common for firms to offer volume discounts, senior citizen discounts, buyer loyalty plans, or cheap weekend rates. All those would become illegal if price discrimination were declared illegal. The enforcement of such a policy would be a nightmare. Fortunately for New Zealand, the Commerce Act contains no specific prohibition of price discrimination. The Australian provision was not followed in 1986, and indeed was subsequently repealed in Australia in accordance with the recommendations of the Hilmer Committee.\textsuperscript{14} But attempts to use section 27 to attack price discrimination, especially in the context of "bundled" products, mean that these warnings cannot be ignored.

The justification for the part of the second principle dealing with product design is straightforward. The reason why a firm, not the government, should decide how to design and produce its product is because governments have no comparative advantage in designing products, and inefficient product designs could impose large costs on society.

The third principle follows directly from the second. If a firm is permitted to do something (such as set the monopoly price for its product), then transfer of that right to a third party raises no antitrust concerns, provided that third party does not itself already have a significant presence in the market. It does not matter who exercises market power, if the degree of market power is unchanged.

The fourth principle recognises that even a dominant firm cannot use its power to control distribution in a way to adversely affect competition unless certain conditions, such as large-scale economies, prevail. In the absence of those special conditions, there need be no scrutiny given to the distribution policy of even dominant firms. We return to this in our discussion of the \textit{Fisher \& Paykel case},\textsuperscript{15} below.

There are two implications that follow from application of these four general principles. First, any antitrust policy must balance the costs and benefits in all affected markets. Suppose for example two firms merge and, as a result, the firms are able to achieve large efficiencies in product 1 and market power in product 2. If there are economies of scope in producing the products together


\textsuperscript{15} \textit{Fisher \& Paykel Ltd v Commerce Commission} (1990) 3 NZBLC 101, 655.
so that the efficiencies are merger specific, then the gains in the market for product 1 must be balanced against the harm in the market for product 2. To claim that every consumer has, under the antitrust laws, a right not to be harmed goes too far. Such a policy would prevent welfare enhancing (in the aggregate) mergers.

The second implication is that, in the absence of a regulated industry, a firm should have no duty to deal with others. In some industries, a case can be made for regulatory intervention including imposing an obligation to deal in certain circumstances, at prices and on terms set by or under the supervision of a regulator. But determining whether intervention of this kind is required, and designing an appropriate regulatory regime, raises complex and sophisticated policy issues. Administering such a regime requires a mix of industry, economic and accounting expertise and resources. The courts simply are not in a position to assess the costs and benefits of imposing (and specifying the parameters of) a duty to deal, or to administer such a duty in a meaningful way. There is no basis for expecting intervention by a body that lacks the skills and resources needed to administer an appropriate regulatory regime, such as a court, to deliver benefits that outweigh its costs.

Let us now turn to a discussion of how the use of horizontal and vertical contracts can and cannot harm competition.

B. **Horizontal Contracts – Contracts Amongst Rivals**

Contracts among rivals immediately raise the spectre of a cartel and, for that reason, antitrust authorities generally frown upon them. There is a widespread consensus that cartels are bad because they can restrict output and thereby raise prices with no offsetting benefits. For the same reason, mergers that lead to the creation of substantial additional market power so that the result of the merger is reduced output and elevated prices are also widely frowned upon.

But suppose that there is no market power possible in an industry, should antitrust authorities allow a contract between the firms that allow the firms to coordinate output? Before one answers no for fear of creating a cartel, we need to remind ourselves that, in every country whose antitrust laws we have examined, a merger of the two firms would be lawful. If a merger is lawful, how could a contractual agreement (which we have already seen is less restrictive and less concentrating than a merger) be attacked? We can think of only one reason. A merger may be more detectable, especially where there are filing requirements, than a contract between competing firms. Since contracts between firms can have an anticompetitive effect (as can mergers), greater penalties associated with concealed contracts used to cartelise may be justified, although

not outright prohibition of such contracts. Just as mergers create efficiencies, so can contracts between competitors.

The most difficult antitrust issues regarding horizontal contracts come when efficiency requires collective action among firms that in the aggregate have market power. One example of such a situation would be agreement on standards for a product. Such standards may require every firm in the industry to adhere to the standards. The danger in such a situation is the obvious one, that firms can use the collective nature of the agreement as an opportunity to collude or exclude new entrants. A particularly difficult situation arises when a collection of firms form, for efficiency reasons, a closed joint venture to develop a new product. The venture is closed to create property rights in the success of the product. But the difficult judgment call is whether such a joint venture is the only way to create incentives for the desired research and development. If so, we would allow it, but only after exploring whether industry participation was necessary for efficiency.

Probably the clearest lesson for antitrust enforcement regarding the use of horizontal contracts is that the penalties for explicit collusion must be significant to deter the activity, since the gains to the cartel members could be large. Moreover, criminal penalties can and should be used to heighten the deterrent effect for hard-core cartels, to address the risk of under-deterrence of firms and executives who would be unable to pay a pecuniary penalty set at an appropriate level to achieve deterrence. Too often, governments uncover significant price fixing cartels, but fail to fine or punish the perpetrators with the result that there continues to be a strong economic incentive to form secret cartels.

C Vertical Contracts
Contracts between a firm and its customers are often described as vertical contracts because the contracts are between firms at different stages of production. Vertical contracting can encompass a wide range of behaviour. Vertical mergers, predatory pricing, tie-in sales and various exclusionary conditions (eg exclusive dealing and territorial restrictions) could all fall into this general category since they all involve details of dealings between firms at different stages of production.

In order for a vertical contract to harm competition as distinct from some

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17 One approach which addresses concerns about concealed contracts may be to require certain contracts to be notified to the competition authority at the time they are entered into, failing which a more stringent standard is applied – compare section 44(1)(g), which provides that Part II does not apply to contracts which relate solely to export markets, if those contracts are entered into one year after the Commission is notified of the agreement.

disappointed competitor, it is necessary that the vertical contract somehow create or maintain market power in a way not possible without the contract but consistent with the freedom of a firm with market power to price its product as it sees fit. For example, a monopolist who sells a product at the monopoly price should not be subject to attack, otherwise there would be no incentive to ever create new products so as to become a monopolist. But this then means that it would be illogical to attack a contract in which the monopolist receives a payment from one distributor for the right to sell the product exclusively on the grounds that, had the monopolist sold to more than one distributor, there would have been more competition. Indeed, there seems to be widespread confusion between the fact that vertical arrangements can be used to extract monopoly profits, which should be unobjectionable, and the fact that vertical arrangements can sometimes be used to create more market power than would otherwise exist.

Economists have contributed to this confusion by failing to distinguish a theoretical possibility from an empirical practicality for actions in the latter category. We describe some of the ways vertical contracting can harm competition below, but before we do so we examine a situation where vertical contracts raise no antitrust issue.

In the absence of market power, vertical contracting should raise no antitrust issues. Most such vertical contracts, even if they are of long duration, would fall into the category of efficient contracting designed to allow each firm to plan its operations without having to worry about opportunistic behaviour. The key, of course, is the assumption of no market power - which typically should be assessed ex ante. In other words, if Firm A chooses Firm B from many possible suppliers, then Firm A has benefited from ex ante competition. Subsequent to signing the contract, Firm A may be locked into Firm B and lack ready alternatives (especially in the short run). If Firm B tries to take advantage of Firm A, then Firm A may have a breach of contract case against Firm B (or else Firm A may sue the poor contractual terms it negotiated), but it should not have any antitrust case. Firm A may suffer as a result of Firm B's actions, but that alone has no competitive consequences on price or output in a world with no market power. Although one could say that Firm B has short-run power ex post over Firm A, any such power is a consequence of Firm's A's negotiations, and should not be turned into an antitrust violation. Moreover, any breach would have no effect on market pricing as a result of the lack of market power. One immediate application of this logic is that it is improper generally to treat cases involving after-market repair and service as antitrust violations when competition exists ex ante. This logic also exposes the flaw in the Commerce Commission's decision in Health Waikato, and more generally the flaw in arguments that there are competition concerns where funders such as purchasers of public health services or Transit New Zealand enter into long-term contracts with service providers, following a competitive process.
Much more interesting and difficult issues arise when a firm with market power enters into various vertical contracts that are alleged to maintain that power. One way to unravel what is a sensible antitrust claim from a nonsensical claim is to examine whether the alleged behaviour increases the market power of the firm relative to what it could achieve if it is unfettered in the pricing of its product — a freedom that any unregulated monopolist should have, for reasons already explained, and does have under New Zealand law. So, to return to the after-market example, in general, a firm with market power in the initial sale should not be subject to antitrust attack if it refuses to sell (monopolised) repair parts to outside vendors. The reason is that, as long as the price of repair parts can be set at any level, the alleged competition from many outside repair vendors with the initial monopolist’s repair service is illusory. The ability of outside vendors to compete is completely dependent on the monopolist’s pricing, so these vendors cannot constrain the monopolist’s pricing of repair services. Hence, if the monopolist chooses not to supply outside vendors, it is likely to be for other reasons related to efficiency.¹⁹

Vertical distribution arrangements that create exclusivity — either territorial or in selling a particular brand of product — can raise antitrust concerns because they can theoretically foreclose rivals from obtaining distribution services. The offsetting concern is that it is well known that exclusive distribution practices are common and can be efficient. The efficiency rationale derives from the fact that free riding in distribution can be controlled by exclusivity. The problem with antitrust concerns in this area is that they are usually raised by rivals who complain that they have difficulty competing. But that difficulty could of course simply result from tough competition, which should be encouraged. It is precisely because rivals have an interest in thwarting tough competition that antitrust authorities should treat claims based on exclusivity cautiously. The key necessary element required for a valid antitrust claim is that there be such scale economies in distribution that it is not possible for rivals to obtain efficient distribution in light of the exclusive arrangements of the dominant firm. This is a necessary but not sufficient condition because, even if competition is harmed, efficiency overall may be improved by the exclusionary arrangement even after one accounts for the competitive harm. Unfortunately, our experience has been that it is difficult to measure the harm to competition versus the gain in efficiency quantitatively with the data available in most cases.

Another vertical contracting practice subject to antitrust challenge is tie-in sales. In a tie-in sale, the sale of one product (A) is conditioned on the sale of another (B). There seems to be a concern that there is “foreclosure” of the market for the tied product B and that somehow consumers of product B are harmed. Despite being revealed over 40 years ago as wrong (the idea is due to

Aaron Director, and was elaborated by Bowman, this argument still seems to have much appeal. The simple point is that a monopolist of A would always do better by extracting profits from A through a higher price, rather than tying some competitively produced product B, in the case in which A and B are used in fixed proportions. In the variable proportion case, the argument reduces to whether a monopolist is free to price discriminate. If it is – as we have argued it should be – there again is no antitrust issue. These observations should take care of the bulk of tie-in cases.

It is possible to construct theories of tie-in sales in which rivals in A are harmed by a dominant firm's use of a tie-in, but these explanations require not only market power, but also scale economies and certain dynamic interdependencies. Moreover, any attack on tie-in sales should recognise that most tie-in sales (and every product can be regarded as a bundle of tied characteristics) are motivated by efficiency, and any interference with efficient product design could have large costs. That means that, even in those rare cases where tie-in sales are used to harm competition, one must not condemn the practice unless the tie-in can be undone without materially altering the product. That can be a difficult judgment to reach, and one that lawyers and economists may have little training to make. It suggests a much more cautious approach to undoing tie-ins achieved through product design as compared to tie-ins achieved solely through contract.

A subtlety that arises in analysing tie-in sales concerns the distinction between extracting profits in a monopolised market versus creating a monopoly in a different market. The use of existing market power to extract rents in one market should not be confused with an attempt to extract rents from consumers who would not otherwise have had to deal with the monopolist, by reducing competition in another market. Note, moreover, that simply reducing competition in another market is not enough, if every consumer in that other market had to deal with the monopolist anyway. An example may assist. Suppose there is an island which has one hotel, with a restaurant, and there are several other restaurants on the island. The island has a number of permanent residents. If the hotel requires all its guests to eat in the hotel restaurant, and there is insufficient custom to support the other restaurants without the patronage of some hotel guests, the closure of the other restaurants following the adoption of this policy by the hotel compels the permanent residents to also eat in the hotel restaurant, reducing the competition to supply them with

22 The example is due to R Gertner, and is based on Whinston (1990) supra n 21.
meals, and giving the hotel a new ability to extract rents from the permanent residents which it did not previously have. If on the other hand there were no permanent residents, so the only customers for meals were hotel guests, the same policy would not cause any competition concern. Since the hotel could have extracted the same rents from the guests in the room charges in any event, there is no additional harm to consumers.

It might be argued that the harm to consumers where there are no permanent residents lies in the reduction in choice that results from there being only one restaurant – that is, in a reduction in non-price competition. But if hotel guests value this variety, then they will be willing to pay more for a holiday that provides that variety – and the hotel will be able to capture this in higher room charges (restaurants, which are competing with each other, will not be able to capture any rents). In other words it would be irrational for the hotel to pursue this strategy, if consumers would be better off with more restaurants. An allegation that consumers are harmed by the hotel’s policy is an allegation that the hotel management is acting irrationally, and failing to maximise its profits. This is not inconceivable – but:

- We should be more sceptical about claims of harm in such contexts than a superficial analysis might suggest;
- There is no reason to use competition law to prevent harms of this kind, i.e. to address conduct of firms in situations where there is no incentive to harm competition.

The final topic on vertical contracts that we discuss is price predation. Since a price is negotiated with a customer, predatory pricing is attackable as a vertical contract if it harms competition. The trouble with predation claims is the same as claims based on exclusionary conduct: a rival is complaining about the success of another rival. In the case of price predation, the concern is with too low a price – precisely a situation that benefits consumers and harms rivals. The idea is that, after driving out all one’s rivals, the remaining firm will raise price and reap the rewards of its new found market power. There has been so much study of this alleged problem that it is clear that it has caused a significant loss to the economy by diverting scholars from devoting attention to more pressing problems! The bottom line is that there is very little evidence that this strategy is followed with any frequency, and the number of cases in which it has been documented is small.

In light of the rarity of successful predation, significant restraint should be shown by competition agencies and courts in penalising low prices. The New Zealand Commerce Act seeks to encourage such restraint by limiting section 36 so that it applies only to firms with a substantial degree of market power, and only where it is shown that they acted for the proscribed purpose. The Port Nelson decision cuts across this policy, assessing low prices charged by a firm to its customers by reference to an “effects” test. We return to this topic below.
V Contracts and the Commerce Act 1986

A The Elements of Section 27

In this section of our paper, we comment briefly on each limb of the test contemplated by section 27, then look at the relationship between section 27 and other provisions in the Act.

B Contracts, Arrangements and Understandings

Section 27 is intended to apply not only to express legally enforceable contracts, but also to other express arrangements, and also to less formal “understandings”. The ambit of section 27 was considered in Auckland Regional Authority v Mutual Rental Cars (Auckland Airport Ltd),\(^{23}\) where it was emphasised that even arrangements and understandings require a degree of mutuality between the alleged participants, although this may need to be inferred from observed conduct. Indeed an understanding could arise without any direct verbal communication, where the conduct of one person communicates an intention to act in a certain way to another, were that second person to act in a particular way, and the second person then acts on that implicit message.

The comments of the Privy Council in Apple Fields Ltd v NZ Apple and Pear Marketing Board were to similar effect, emphasising that although arrangements may be informal, there must be some “meeting of minds . . . not amounting to a formal contract, but leading to an agreed course of action”.\(^{24}\)

C Focus on Particular Provisions

Section 27 applies not to contracts as a whole, but separately to each provision of a contract. This is reinforced by section 89, which provides that:

1 The fact that a contract contains a provision which was entered into in breach of section 27, or giving effect to which would breach section 27, does not affect the enforceability of any other provision of that contract; and

2 Nothing in the Illegal Contracts Act 1970 (which renders a contract unenforceable as a whole, if any provision is illegal) applies to contracts entered into in contravention of the Commerce Act, or to contracts which contain a provision, giving effect to which, would breach section 27.

This distinction has had a significant effect on the way in which cases concerning contracts are approached by the Commission and the courts. In particular:

\(^{23}\) [1987] 2 NZLR 647.
1 Where a provision of a contract has the effect of reducing competition in a market, the pro-competitive effect of other provisions in that contract will not prevent that provision from breaching section 27; and

2 Before a provision that raises competition concerns can be authorised, the Commission asks whether that provision gives rise to benefits that outweigh any detriments that it is likely to cause. The benefits from other provisions, or from the contract as a whole, can be taken into account (on this approach) only if the provision in question is necessary for the other provisions, or the contract, to be entered into. The Commission tends to ask whether the contract would still be entered into if the offending provision were deleted or modified to reduce its effect on the market – and if the answer is in the affirmative, it attributes no benefits to the provision and denies authorisation. We return to this issue below, in our discussion of the Health Waikato decision.

D Relevance of Other Contracts etc

However, the focus on separate provisions does not mean that the combined effect of several provisions in a contract, or of several contracts, can be ignored. Section 3(5) provides:

(5) For the purposes of section 27 of this Act, a provision of a contract, arrangement, or understanding shall be deemed to have or to be likely to have the effect of substantially lessening competition in a market if that provision and—

(a) The other provisions of that contract, arrangement, or understanding; or

(b) The provisions of any other contract, arrangement, or understanding to which that person or any interconnected body corporate is a party—

Taken together, have or are likely to have the effect of substantially lessening competition in that market.

On a first reading, this provision appears to do no more than state the obvious – the effect of any provision of a contract on competition in a market can only be assessed taking into account the combined effect of that provision and all the other factors influencing competition in that market. This is after all the thrust of another limb of section 3, namely section 3(3) which provides:

(3) For the purposes of this Act, the effect on competition in a market shall be determined by reference to all factors that affect competition in that market including competition from goods or services supplied or likely to be supplied by persons not resident or not carrying on business in New Zealand.

However section 3(5) can produce some real practical conundrums, where
the combined effect of several provisions in separate contracts is a substantial lessening of competition in breach of section 27, with the result that each and every one of those contracts is treated as breaching section 27.

Suppose, for example, that there are two producers of steel in a market, P and Q, and that in 1998 X agreed to purchase for a fixed price the entire output of P’s steel factory. If X now agrees to purchase all the steel produced by Q and hence becomes the sole supplier of steel, the effect of that agreement is undoubtedly to lessen competition—even though that would not be the case if the earlier agreement with P had not been entered into. So that agreement contravenes section 27. More problematically, however, the effect of section 3(5) appears to be that the agreement with P also now breaches section 27, since when taken together with the agreement with Q, it has the prohibited effect. Only one contract needs to fall in order to avoid any adverse effect on competition—but the Act does not answer the question of which contract is rendered unenforceable, and which remains in effect.

E Purpose or Effect, or Likely Effect

The references in section 27 to the purpose of a provision are somewhat cryptic. Some clarification is provided by section 2(5), which provides that a provision has a particular purpose if the provision was included in the contract for that purpose (among others), and that purpose was a substantial purpose.

It has been held by the Court of Appeal that it is sufficient for only one party to have the relevant purpose. That is, one party may propose a provision in order to secure an anti-competitive outcome, and the other party may be indifferent to this purpose, or be willing to accede to the provision for some other reason—but the purpose of the former party will suffice for the provision to be regarded as having that purpose.

The Court of Appeal has also confirmed that there is little practical importance in the much-rehearsed debate about whether it is subjective purpose or objective purpose that is in issue, since in practice it is very rare to find clear declarations of subjective purpose. The normal position is that the court has

25 This is the very conclusion reached in Shell (Petroleum Mining) Co Ltd v Kapuni Gas Contractors Ltd (1997) 1 TCLR 465 (discussed in more detail below) – the Kapuni gas contract entered into in 1967 was held to breach section 27 because its effect in the 1990s, when combined with the Main contracts entered into in 1973 (and modified subsequently) was to lessen competition in certain markets.

26 Port Nelson, supra n 9.

27 Supra n 9. The Australian and New Zealand cases on the subjective/objective distinction are conveniently summarised in Gault on Commercial Law para 27.11 (though as at the date of this paper, the discussion had not been updated to take into account the Court of Appeal decision in Port Nelson). Section 36B now provides that, for the purposes of sections 36 and 36A, purpose may be inferred from conduct or from any other relevant circumstances. No corresponding provision applies to section 27, but this is unlikely to lead to any difference in approach in practice.
before it evidence which sheds some light on the business rationale for entering into the relevant contract, and perhaps even the relevant provision, and the key question is whether this business rationale involves a lessening of competition. It matters little whether the court describes what it then does as assessing the intention that party must have had (an “objective” test), or as drawing inferences from this material about subjective intentions at the time.

In essence, it seems to us that the mix of subjective and objective factors described by the court in *Port Nelson* is very close to a test of reasonable foreseeability of harm to competition, based on the information available to the firm at the time. Nor should this be a surprise: competition policy is not interested in mental states, or moral guilt. But it is concerned with liability rules that create appropriate incentives for firms to avoid harm to competition, without deterring aggressive competitive conduct. A reasonable foreseeability test seems likely to achieve this balance.

If reasonable foreseeability is an appropriate standard for imposing liability *ex post*, why does section 27 also impose liability for entering into (or giving effect to) a contract that has the effect or likely effect of lessening competition? The key seems to us to lie in the availability of an authorisation to enter into the contract *ex ante*. In the context of an application for authorisation of a contract, it is appropriate for the regulator to inquire into the likely effects of a proposed course of action using all evidence available to it, and decline to permit the contract in the future if it is likely to have anti-competitive effects (unless those effects are outweighed by benefits resulting from entry into the contract, as discussed below). The effects test in section 27 is best understood as requiring liability to be assessed after the event by mirroring this *ex ante* test and asking whether, at the time the contract was entered into, it had the effect or would have been seen by a regulator (with access to extensive information about the market, including information not available to the firm) as likely to have the effect of lessening competition. That is, liability under section 27 cannot be established simply by showing, with the benefit of hindsight, that there has been harm to competition: the test is not an effects test in this crude sense. It differs from the reasonable foreseeability test described above, and is a more stringent test, because it looks not only to the information available to the firm, but to all information about the relevant markets available at the time. The justification for taking this stricter approach appears to be to avoid the perverse incentives that firms would face if the approach taken in the context

28 Similarly, where it is alleged that giving effect to a contract breached section 27 because a change in circumstances had led to the contract having the effect of lessening competition, even though the contract did not harm competition at the time it was entered into, the question should be whether at the time of the alleged breach (the “giving effect” to the provision) the contract had the effect or would have been seen by a regulator (with access to extensive information about the market, including information not available to the firm) as likely to have the effect of lessening competition.
of an authorisation application was more stringent than that which would be applied in subsequent proceedings. To ensure that firms do not gain strategic benefits from not seeking an authorisation, the same "effects" test used in authorisation proceedings is also applied in ex post liability proceedings.\(^{29}\)

The question of whether a provision has a particular effect is not one which has attracted statutory or judicial elaboration, apart from the confirmation in section 3(5) (discussed above) that effects must be assessed in the light of all other provisions in the same contract, and in other contracts entered into by a party to that contract. It is essentially a question of fact, though some complex questions of causation can arise.

The courts have however had to grapple with the question of when an effect is "likely". The prevailing view in New Zealand today is that "likely" in this context does not import probability, but rather some lower test. The distinction drawn by the Court of Appeal in Port Nelson was that the occurrence of the effects must be "above mere possibility but not so high as more likely than not and is best expressed as a real and substantial risk that the stated consequence will happen."\(^{30}\)

F Time at Which "Effects" Test is Applied

Section 2(3) makes it clear that the section 27 test continues to apply to each provision of a contract throughout the life of that contract. It provides:

(3) Where any provision of this Act is expressed to render a provision of a contract or a covenant unenforceable if the provision of the contract or the covenant has or is likely to have a particular effect, that provision of this Act applies in relation to the provision of the contract or the covenant at any time when the provision of the contract or the covenant has or is likely to have that effect, notwithstanding that—

(a) At an earlier time the provision of the contract or the covenant did not have that effect or was not regarded as likely to have that effect; or

(b) The provision of the contract or the covenant will not or may not have that effect at a later time.

The result is that a contract, which is entirely unobjectionable and lawful at the time it is entered into, may become unenforceable, and giving effect to it may become unlawful, at some later date. The uncertainty this creates is exacerbated by the unavailability of clearances in respect of contracts, and the Commission's practice of refusing to grant authorisations unless the provision is seen as likely to lessen competition at the time it is entered into. The

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29 This approach does entail some costs to firms, as in order to seek an authorisation they are forced to reveal contracting strategies. But this cost probably is not as acute as having to reveal entire pricing strategies, discussed further in this paper at "Comparison with section 36 (unilateral conduct)".

30 Port Nelson, supra n 9, 562–3.
Commission’s approach to authorisation applications is discussed in more detail below.

G When is Competition “LesseeRed” in a Market?

The focus of section 27 is the lessening (or likely lessening) of competition in a market. Section 3(2) extends the concept of lessening of competition somewhat, to include the hindering or prevention of competition. Case law in Australia and in New Zealand offers a range of glosses on these terms.\(^{31}\) It is clear that it must be the process of competition that is harmed, and that it is not enough for the effectiveness of a particular competitor to be reduced. The basic approach endorsed by most of the cases is to ask what the market would be likely to look like with the provision, and without the provision, and to inquire whether competition in the market is less in the “with” scenario than in the “without” scenario.

Rather surprisingly, however, none of the cases adopts what appears to us to be the most useful test for identifying a lessening of competition. That test is derived from the observation we made above that the concern of the Act is to deter conduct that harms (efficient) competition. Competition is harmed if and only if there is an increase in market power (ie if and only if a competitive constraint is removed or its development impeded).\(^{32}\) This occurs as the result of an agreement if and only if the agreement removes (or prevents the emergence of) a competitive constraint in the relevant market. Thus the test is, quite simply, whether the agreement removes any constraint on the exercise of market power in the relevant market that would have existed but for the agreement, or prevents the emergence of a constraint that would have come into existence but for the agreement. Put a slightly different way, is any market participant’s ability to charge more, or give less, enhanced by the agreement in question?

Some commentators have suggested that market power is not relevant to the section 27 inquiry, or has only very limited relevance.\(^{33}\) It is undoubtedly true that very little market power is required before section 27 will apply. The section 27 threshold is very different from either the former “dominance” threshold in sections 36 and 47, or the new threshold for section 36 introduced in 2001 of “a substantial degree of power in a market”. But it does not follow that market power is irrelevant to determining which agreements do lessen competition in breach of section 27. It would make no sense at all from a competition policy perspective for section 27 to apply to agreements which relate to a market where there is no market power, or which do not alter the

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\(^{31}\) For a useful summary, see Gault on Commercial Law para 27.16.

\(^{32}\) Of course, this is not the end of the inquiry. As our earlier discussion explained, we would allow harm to competition (ie an increase in prices) to occur if it were offset by a gain in efficiency. Part V, in relation to authorisations, is concerned with this balancing exercise.

\(^{33}\) For a summary of the argument, and references to the relevant commentators, see Gault on Commercial Law para 27.16.
degree of market power that can be exercised. Absent an increase in market power, there simply is no increase in deadweight loss caused by the agreement, and thus no competition policy concern.

H When is a Lessening “Substantial”?  

Section 2(1A) provides that “substantial”, for the purposes of section 27 and certain other provisions, means “real or of substance”. If section 27 is to serve the Act’s basic policy goals, it must apply if and only if the agreement in question increases market power (and thus lessens competition) to an extent that is real or of substance, and not merely to an extent that is negligible or trivial.

I Prior Approval of Contracts (Authorisations; No Clearances)  

Section 27 does not apply to a contract in respect of which an authorisation has been obtained, or which is conditional on an authorisation being sought (subject to certain procedural requirements, in the latter case – see section 59, replacing the former section 35). The procedure for seeking an authorisation in respect of a provision of a contract is set out in sections 58–65. An authorisation to enter into a contract must be sought before the contract is entered into, except where the contract is conditional on authorisation and the other requirements of section 59 are satisfied, to ensure that entry into the contract is not a breach of section 27. Section 59A, introduced in 2001, also provides for authorisations to enter into a contract to be granted after the contract has been entered into. However section 59B provides that contraventions that occurred before an authorisation under section 59A remain contraventions despite the authorisation. The combined effect of these provisions is not entirely clear, but appears to be that:

- Entry into a provision that contravenes section 27, and acts done to give effect to the provision pre-authorisation, remain contraventions of the Act, in respect of which aggrieved parties can seek relief;
- A provision which contravenes section 27 remains unenforceable unless and until an authorisation is finally granted;
- From the time an authorisation is granted, the provision is enforceable, and giving effect to it is not a breach of section 27;
- In determining an authorisation application of this kind, the Commission can take into account past benefits and detriments that resulted from the provision, not just prospective benefits and detriments. If this is correct (it is not made explicit anywhere in the Act), this represents a significant departure from the position before the 2001 amendment, and aligns New Zealand more closely with the Australian approach.

The Commission is required to prepare a draft determination, and is in most cases required to hold a conference to hear submissions in relation to the draft determination before it delivers its final determination in respect of the application.
An application for an authorisation will be entertained by the Commission only if it considers that the provision in respect of which authorisation is sought is likely to cause a lessening of competition – though that lessening need not be substantial.\textsuperscript{34} If there is no competition concern, the Commission will decline an authorisation – and there is no provision for obtaining a clearance in respect of contracts. So the Act does not provide any method for obtaining a formal determination that there is no breach of section 27, which prevents subsequent challenges to the contract. The anomalous result of this approach is that parties to a contract that will result in a benefit to the public may be better off if the contract gives rise to a competition concern at the time it is entered into than they would be if it did not give rise to any such concern. If there is a competition concern, they can apply for and obtain an authorisation, protecting the contract from subsequent Commerce Act challenges (unless the authorisation is revisited under section 65, as discussed below). No such protection is available for contracts that, at the time they are entered into, do not harm competition, however beneficial they may be to the public.

Moreover section 65 provides that authorisations can be varied or withdrawn, where \textit{inter alia} there has been a material change of circumstances. This provision has never been invoked by the Commission to vary or cancel an authorisation against the wishes of the original applicant. But the corresponding Australian provision has been used in this way,\textsuperscript{35} raising serious questions about the degree of certainty that can be achieved by contracting parties even where an authorisation is sought and obtained.

The Act provides that an authorisation may only be granted if the Commission is satisfied that the benefits to the public from the provision in question outweigh any lessening of competition that is likely to result from that provision. The Commission's well established approach to this test is to identify likely “with” and “without” scenarios, and to ask:

1. Whether there will be less competition in the market with the provision than without the provision; and
2. Whether any benefits will be obtained by the public in the “with” scenario that would not be obtained in the “without” scenario, and whether those benefits outweigh any reduction in competition as between the two scenarios.

This approach seems to be a helpful way of structuring the inquiry, provided that “less competition” is understood as meaning higher prices, and does little more than to flesh out the approach implicit in the Act. But the

\textsuperscript{34} Section 61(6A), and see, for example, Commerce Commission Decision No 356 (17 May 1999).

\textsuperscript{35} See, for example, Re Alliance Petroleum Australia Pty Ltd & Ors (AGL Cooper Basin Natural Gas Supply arrangements) Australian Competition Tribunal 2 (14 October 1997).
manner in which “without” scenarios are developed is more controversial – this is explored in more detail in our discussion of the Health Waikato decision in section VI below.

J Remedies for Breach of Section 27

Section 27 renders offending provisions unenforceable, without the need for any action to be taken by a party to the contract. In theory, at least, a party to a contract can simply assert that a provision is unenforceable by virtue of section 27, and cease to give effect to it. If the other party brings proceedings to enforce the provision, whether by way of a claim for specific performance or for damages for breach, section 27 could be relied on as a defence. However in all but the clearest of cases, there can be genuine disagreement about whether section 27 applies, and about the extent of its application to a contract. The value implications of a claim of unenforceability (especially where only one party’s obligations are said to breach section 27, with other provisions remaining enforceable) also make disputes likely in many cases.

As noted above, the courts can grant an injunction to restrain a person from breaching the Act, which in this context means an injunction to prevent a party to the contract from giving effect to the offending provision, or seeking to enforce it. The courts have also been willing to grant declarations as to the enforceability of a particular provision.36 And where giving effect to a provision has caused loss, compensation is recoverable by the injured person, whether or not that person is a party to the contract.37

The Commission is also able to seek a pecuniary penalty in respect of a breach of section 27, and has done so on a number of occasions, in particular in relation to price-fixing agreements and similar arrangements.38

Where section 27 affects only one party’s obligations, or affects part of a contract but not other parts, the commercial balance of the contract may be significantly affected. This can be addressed under section 89, which as noted above allows the court to cancel or vary the contract, or award compensation or restitution.

36 See ARA v Mutual Rental Cars (Auckland Airport) Ltd [1987] 2 NZLR 647, and the discussion on availability of declarations in Gault on Commercial Law para CA89.05.

37 The issue of who has standing to sue is one we note only in passing. The choice of who can sue can greatly influence the enforcement of the law. In New Zealand, unlike the United States, class actions of consumers are not permitted. This increases the incentive of firms to engage in antitrust violations. However, unlike the United States, indirect purchasers can sue (eg consumers who purchase in stores subject to an anticompetitive harm). This gives rise to double counting of penalties and over-enforcement of the law. Finally, in merger cases, it seems to us that (contrary to the position in New Zealand) rivals should not generally have standing to sue because in a typical merger case that harms competition, rivals benefit from the anticompetitive price increase. Rival opposition to a merger often indicates that the rival fears efficient competition – the precise opposite of an anticompetitive effect. See Brunswick Corp v Pueblo Bowl-O-Mat Inc 429 US 477 (1977).

38 See, for example, Commerce Commission v Caltex New Zealand Ltd (2000) 9 TCLR 366.
Some doubt was expressed by the High Court in *Kapuni* about the appropriateness of awarding compensation in respect of rights which were rendered unenforceable by section 27, on the grounds that the term “compensation” carried with it a suggestion of being deprived of legitimately owned property. With respect, this approach would deprive the court of a very useful tool for ensuring that where some provisions of a contract are rendered unenforceable through no fault of either party, pursuit of competition policy goals does not have the side effect of reallocating wealth in a manner which is unpredictable ex ante, but which creates significant incentives for opportunism ex post. Ex ante incentives to invest in specialised assets are undermined if the continuing application of section 27 is not coupled with protection of contractual quasi-rents, as opposed to rents from prohibited market power.

The court did go on to say, in the *Kapuni* case, that it had sought to vary the contract to achieve a competitive outcome “while still maintaining a reasonable balance between the parties’ economic interests. We therefore decline to award compensation in the circumstances of this case.” Thus the question of whether compensation is available in a case where rebalancing through a variation is not possible appears to remain open.

We should emphasise that the compensation awarded to a party to a contract which is rendered unenforceable by section 27 should include the competitive value of the resources contracted for, but should not include any element of compensation for lost rents from the very market power which section 27 is designed to defeat. The compensation should relate to any losses excluding such rents. Suppose we have a case where two contracts to which A is a party, operate together to give A market power in a relevant market, for example, where A is a distributor and has the exclusive right to buy as much of the output as A specifies of the only two steel producers in a market. Both contracts were entered into some years ago when there were many steel producers, and steel prices have risen steeply. The price in the first contract is now very favourable to A, and the price in the second is also low (but somewhat higher). To remove the competition concern caused by the common control of the two contracts, either:

1. A should be permitted to transfer one of those contracts to someone else, who would pay A only what the contractual entitlements are worth in the context where the purchaser will then have to compete with A in the steel market. This would give A only the present value

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39 *Shell (Petroleum Mining) Co Ltd v Kapuni Gas Contractors Ltd* (1997) 7 NZLR 463, 536. David Goddard appeared as counsel for Natural Gas Corporation of New Zealand Ltd (NGC), one of the defendants in these proceedings, and Dennis Carlton appeared as an expert witness called by NGC.

40 Ibid, 536.
of the difference between a market price emerging from competition between the two and the contract price for the steel covered by the contract (ie A would not get any rents derived from market power that violates section 27). Note that transferring either contract would solve the problem – it need not be the later contract. And once the contract was assigned to an independent third party, its provisions would no longer be affected by section 27, and it would again be entirely enforceable; or

2 If one of the contracts is cancelled by the Court under section 89, so that A loses the opportunity to sell the rights under it at a price that reflects its value excluding monopoly rents, that cancellation effects a transfer from A to the producer of the value that A could have realised in a sale to a third party. There is no competition policy justification for this windfall. It could be avoided by requiring the producer to compensate A, at least where it is the producer who seeks this remedy and who opposes a sale of the contractual rights to a third party. Compensation on this basis is unobjectionable from a competition policy standpoint, and reflects the loss to A of property in the form of contract rights that could have been sold for value to a third party. Where it is not the contractual provision that is inherently unobjectionable, and its enforceability depends on who holds the contract rights, it seems wrong and unnecessary to treat the “property” represented by these rights as tainted by illegality. If they are not so tainted that they cannot be sold to a third party and become enforceable once more, they are not so tainted that their value should be expropriated without compensation. Nor would a lump sum payment of this kind have any effect on subsequent competition in the relevant markets – it would be a sunk cost.

K Comparison with Section 36 (Unilateral Conduct)

Section 36 of the Act is concerned with unilateral misuse of market power for the purpose of preventing or reducing competition in a market. That is, in crude terms, it is concerned with attempts to use market power in one market to preserve or extend that market power, or to obtain market power in other markets. It is not, of course, concerned with monopoly pricing: Part II is not designed to prevent a person with lawfully acquired market power from obtaining rents from the use of that market power to set prices above marginal cost.

The most significant differences between sections 36 and 27 are that:

1 Section 27 applies to all firms, while section 36 applies only to firms which have a substantial degree of power in a market (a threshold that, before amendment in 2001, was set even higher at “dominance” in a market); and
Section 36 applies only where the firm with substantial market power acts for the purpose of preventing or restricting or deterring competition. It is not enough for the firm’s unilateral actions to have that effect, absent the proscribed purpose.

Extending section 36 to include an “effects” test (ie to impose liability where unilateral conduct has the effect or likely effect of harming competition) has been proposed on several occasions, but has always been rejected on the grounds that this would deter desirable competitive conduct by large firms, in particular aggressive competition which might have the effect of driving competitors out of business, and which might subsequently be held to have harmed competition. An effects test in the context of unilateral misuse of market power was also considered and rejected in Australia by the Hilmer committee.41

It seems to us that liability under section 36 should require both the effect and likely effect of harm to (efficient) competition, and an element of foreseeability of harm to competition (described in the Act, perhaps somewhat unhelpfully, as “purpose”) in the sense that the firm either expected this effect, or should reasonably have expected it. Rejecting liability based solely on anti-competitive effects makes sense, especially when one bears in mind the limits of law as an instrument for achieving competition policy:

1 Section 36 is addressed to market participants, and is intended to deter them ex ante from embarking on certain anti-competitive courses of conduct by exposing them to the risk of liability, should they do so. It is not intended to create a risk that a firm will be found to have incurred liability for engaging in acts that it did not anticipate would harm efficient competition, and that a reasonable person would not have expected to have that effect based on the information reasonably available to that firm. Nor is it intended to require firms to conduct the sort of minute inquiry assisted by discovery and expert evidence that a court can undertake in order to assess what the effect of a contract has been, or is likely to be. If firms knew that they might incur liability for making life difficult for competitors, and that whether or not they were liable could not reasonably readily be ascertained by them, action which might have such effects would also be deterred;

2 It follows that the risk of over-deterrence from a rule imposing liability for unilateral acts that have the effect of harming competition, as assessed by a court with greater information (including information about the operations of competitors which was not available to the firm in question), after the event, is considerable. The cost of deterring aggressive competition is potentially very significant. An “effects”

41 Australian Independent Committee of Inquiry, National Competition Policy, August 1993, 6 (the Hilmer Report).
rule applied to unilateral conduct with the benefit of hindsight could deter many acts by large firms which make life difficult for competitors, but which are efficient, and thus desirable from a competition policy standpoint. The risk of liability under competition laws, coupled with difficulty in predicting likely outcomes and the delays involved in obtaining a final determination, would inevitably cause firms to pause before engaging in vigorous but legitimate competitive activity; and

3 It seems unlikely that any sensible regulatory mechanism could be devised for ex ante approval of unilateral decisions – the problems of delay, confidentiality of commercial strategies, and regulatory expertise seem insuperable. So firms would have to act first and risk being sued later – and less efficient competitors would have every incentive to sue to deter vigorous competition, and to try to share in legitimately acquired rents.

For all these reasons, the Act adopts a deliberate policy of restraint in relation to unilateral acts by market participants. The language of “purpose” used in the Act may not be the best way to capture the element of reasonable foreseeability of harm required for imposition of liability. But at least it distinguishes those cases which do require something more than mere effects, as assessed with the benefit of hindsight or with the benefit of information that was not known to the firm at the time – and as noted above in discussing section 27 the “purpose” requirement can be, and in practice often is, read to mean something much more like a foreseeability test than a “guilty intent” test.\footnote{It also seems somewhat odd to impose liability where harm to competition was foreseeable at the time of the acts complained of, but did not in fact occur. Yet this appears to be the effect of the decision in Port Nelson, discussed in more detail below.}

Because the Act provides for different approaches when assessing liability for unilateral conduct and when assessing liability for entering into an agreement, or the continuing enforceability of agreements, it is very important to distinguish clearly between the effect on competition of an agreement or series of agreements entered into by a firm, and the effect on competition of a unilaterally adopted policy on pricing of a product. This distinction is particularly acute where sales of the product occur in a spot market, or involve contracts of very short duration. Any pricing policy necessarily results in contracts with customers, which contain terms – price terms – fixed by reference to that policy. But neither any single contract containing such prices, nor the aggregate of contracts entered into in the past with prices set by reference to that policy, can be described as having any effect (that is real or of substance) on competition in the market (so long as the contracts have been performed, or will be performed within a time frame so short that any impact on competition}
is trivial, or relate to fixed (resaleable) quantities of outputs. At any given point in time, the contracts already entered into are irrelevant to future competition: they will have no prospective effect on the market. Consider the position where a supplier announces that it will perform its existing (very short-term) contracts, but that henceforth it will price on a different basis: that supplier’s past and current contracts cannot be said to have any effect on competition from that point onwards. Likewise, even if there is no change in policy, it is the prevailing pricing policy pursuant to which the firm sets future prices, which will affect competition one way or another, and not any contracts of the kind described above (i.e. very short-term, or for a fixed resaleable quantity) entered into up to the time at which the inquiry falls to be made. Adopting a policy on how to price for a product is precisely the sort of unilateral conduct that should be assessed under section 36. It cannot and should not be assessed under section 27, with the benefit of hindsight and of access to information (including information about competitors’ operations) that was not reasonably available to the firm when determining its pricing policy. We return to this theme in our discussion of the Port Nelson decision.

L Comparison with Part III (Mergers)

Section 47 prohibits acquisitions of shares or the assets of a business, where the acquisition will substantially lessen competition in a market. This test was introduced in 2001, replacing the original 1986 test of whether the acquisition would result in a firm acquiring or strengthening dominance in a market.

As noted above, a firm can seek a clearance in respect of a merger, confirming that it does not breach section 47, or can seek an authorisation where section 47 applies, but the public benefits from the merger outweigh the detriments. If a clearance or authorisation is obtained, and the merger proceeds within twelve months of clearance, it cannot be unwound or challenged before the courts even if there is a change in circumstances, which results in the merger having, with the benefit of hindsight, substantially lessened competition. In other words, the test is applied only once, at the time of the merger: if it is satisfied, the merger cannot subsequently be challenged under the Commerce Act.

The significant differences in the Act’s treatment of acquisitions and contracts result in a strong, and unjustified, bias towards structuring transactions as acquisitions wherever possible. Consider the choice facing a firm that proposes to build a gas-fired electricity generation plant between purchase of the only gas field that can supply the site, and signing a 30 year exclusive supply contract with the field owner (vertical integration by one means or another is essential, to prevent opportunistic attempts by the field owner to capture quasi-rents once the station has been constructed). If the purchase option is chosen, and the acquisition proceeds without any application for a clearance or authorisation, the risk of a challenge is slight (at least if the generator has no
other gas field interests). The purchase need not be announced until completed, and at that point only the Commerce Commission could seek to unravel it. To avoid any risk at all, a clearance could be sought, and if obtained, would ensure that no one could later seek to force divestiture of the field. A clearance would be obtained if the purchase would not substantially lessen competition in any market, for example if there would be a mere transfer of market power (as might be the case, subject to market definition issues, if there was no other producing field).

On the other hand, if a long-term contract is signed:

1. The test that would be applied is whether the contract is likely to have the effect of substantially lessening competition in a market. This is on its face the same as the current section 47 test;

2. If an authorisation is sought and the Commission does not identify any likely lessening of competition, an authorisation will be refused;

3. If no authorisation is granted because the Commission does not perceive any likely lessening of competition at the time the contract is entered into, and market circumstances subsequently change, provisions of the contract may become unenforceable. The allocations of property rights on the basis of which the parties made their initial investments are likely to be significantly disturbed; and

4. If on the other hand the Commission believes that the generation plant would be likely to be built even if the term of the contract were shorter, perhaps because the capital cost could be amortised over a shorter period and recovered from electricity consumers in higher prices, the decision in *Health Waikato* discussed below suggests that it follows that there is a lessening of competition as a result of the 30 year term, and that authorisation should be refused unless the benefits from the 30 year term outweigh these anti-competitive detriments. This would be an odd outcome – but it is a real risk, on the basis of current case law. Note that there is no comparable risk if the field is simply purchased – the Commission does not seek to review the terms of outright purchases, for example by suggesting that a lease would be more appropriate.

Similar problems confront a manufacturer of appliances making the choice between opening its own outlets, or entering into exclusive supply arrangements with independent retailers. The former route raises no Commerce Act risks of any substance: the latter, as demonstrated by *Fisher & Paykel* (discussed below), gives rise to a potential section 27 exposure.
VI The NZ case-law under section 27 – some themes

This section of our paper reviews five significant section 27 cases from a competition policy standpoint, asking whether the outcomes and reasoning are consistent with the Act’s economic objectives. Where this is not the case, we consider whether responsibility for the departure lies with the drafting of the Act – that is, does it need to be amended to achieve its basic goals – or whether it would, on the language of the Act, be open to the courts to take a more appropriate approach.

A ARA v Mutual Rental Cars

One of the first cases decided under section 27 concerned rental car concessions at Auckland Airport. The Auckland Regional Authority (ARA), which operated the airport, was concerned to maximise revenue from concessions to operate rental car facilities at the airport. It sought tenders for the concessions on either a “two only” or “three only” basis, and received a number of tenders, including tenders on both bases from Avis and Hertz. After considering the tenders, the ARA granted concessions to Avis and Hertz alone, for initial periods of three years which could be extended for a further three years at their option. It was held in subsequent litigation that although the concession agreements did not expressly prohibit the grant of further concessions, there was a collateral contract between the ARA and each concession holder to that effect.

Budget Rental Cars subsequently entered the rental car market in New Zealand, and sought a concession at the airport. It engaged in litigation on a range of grounds to seek to compel the ARA to abandon the “two only” approach. Budget asserted that when the Commerce Act came into force, it rendered the collateral contracts requiring this approach unenforceable and unlawful. The ARA sought declarations from the court to clarify the legal position. Hertz was willing to depart from the “two only” approach, with an adjustment to the terms of its concession (including price). Avis was not. Claims and cross-claims were also filed between Budget and Avis. At the time of the hearing, Budget was operating from premises three kilometres from the airport – a Budget representative greeted customers in the terminal, and Budget’s customers were transported by Budget between the airport and the Budget premises.

The Court rejected Budget’s argument that there was any arrangement or understanding between Avis and Hertz in relation to the concessions, finding that the only relevant contracts, arrangements or understandings were between ARA and Avis, and ARA and Hertz. Thus Budget’s claim that there was an exclusionary agreement of the kind addressed in section 29 of the Commerce Act failed on the facts.\footnote{1987 NZLR 647.}

The primary remaining allegations made by Budget were that:

\footnote{Ibid, 664–5.}
ARA was in breach of section 36 in using its market power, in respect of provision of facilities at the airport, to reduce competition in a market for rental car services at the airport; and

The collateral contracts between ARA and each concession holder preventing the letting of further concessions breached section 27, as they substantially lessened competition in a market for provision of rental car services at the airport.

One question that was – or should have been – at the heart of this case was whether these vertical contracts gave Avis and Hertz additional market power that they would not have enjoyed, had there been additional concessions at the airport.

Plainly the ARA was using its market power to extract rents from Avis and Hertz – but this is not prohibited by the Commerce Act. In particular, it is very clear that charging a monopoly price is not a breach of section 36, and that contracts do not breach section 27 merely because they specify a price that includes an element of monopoly rent. So the use of market power to extract the highest available return was, from both policy and legal perspectives, irrelevant. Nor did the contracts alter the ARA’s market power in any way – that stemmed from its ownership and control of the facilities.

So the only harm to competition that was even in theory possible as a consequence of these dealings was a removal of constraints that would otherwise have affected Avis and Hertz in the market in which they supplied rental vehicles.

Avis argued that there was no separate market for rental vehicle services provided at the airport, but rather that there was a national market for the provision of rental vehicles. The evidence was that all the national rental car operators charged uniform rates throughout the country, and did not practise price discrimination based on the location of the particular rental outlet. There was no separate airport promotion, although Hertz and Avis publicity material clearly outlined the convenience of an airport location.

The Court did not agree. It found breaches of sections 27 and 36, on the basis that there was a separate market for the provision of rental vehicles from the airport itself, and that:

The collateral contracts had the effect and purpose of lessening competition in that market; and

The purpose of ARA in entering into the collateral contracts was to exclude competitors of Avis and Hertz from this market, albeit as a means to the end of maximising revenue.45

The Court described at some length the advantages to a rental car company of having a booth at the airport, and concluded that this gave it a “competitive edge” over those who did not. And it found that as a matter of commercial common sense, there is no acceptable substitute (at least for business travellers)

for being able to collect a car at the airport itself. All this is true – but beside the point. Harm to competitors has been identified – but not harm to consumers. A consumer could obtain a car of the same quality and at the same price from Avis or Hertz at the airport as they could anywhere else. There was no evidence of prices being lower at other airports in New Zealand or overseas where more concessions were let: at least for New Zealand, the reverse seems to have been established. Nor was there any evidence for other critical indicia of the contracts creating market power, such as evidence that if Budget had a concession at the airport, this would force Avis or Hertz to charge less at the airport, or evidence that more cars would be rented from the airport if Budget had a booth in the airport (if quantities would not increase, there would be no welfare gains).

The origin of the Court’s error can be detected in the following statement:

The test of competition is not concerned with the economic fate of individual competitors [true] but with the level of rivalrous behaviour in the market [false]. (square-bracketed comments added)

The contracts plainly reduced rivalry at the airport. But there was no evidence at all of increased market power (ie an ability, due to the exclusion of other providers, to charge more or give less to customers at the airport). Indeed there was unchallenged evidence to the contrary.

In concluding that there was a distinct “Auckland airport rental car” market the Court seems to have been strongly influenced by expert evidence which pointed out that there was little substitution between rental cars supplied at the airport, and cars supplied in the central city. It was said, in support of this analysis, that Budget was unlikely to be able to attract business away from the airport operations of Avis and Hertz by offering lower prices in town. Once again, while accepting that these descriptions of market conduct are likely to be accurate, they tell us very little about the relevant markets and competitive constraints. The evidence on uniform national pricing, despite differing costs of operation in different centres, the lack of substitutability from the demand side between a car in one place and a car in another, and absence of barriers to entry into the car rental market away from specialised facilities like airports, together point strongly away from separate geographical markets. Rather, they tend to suggest that the product being supplied by Avis, Hertz and Budget may have been described too simplistically (perhaps “nationally networked car rental services”, supplied in a national market, might be more appropriate).

More interesting from a competition policy perspective was a statement in a Hertz strategic paper that “because Budget was excluded from Auckland airport for three years and from Christchurch airport for five years, it was precluded from attacking the domestic business market.” If this was true, then

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46 Ibid. 674.
47 Ibid. 671.
there may have been a competition concern in relation to that wider market. If the court had explored the implications of this statement, it would have been asking the right question, which was whether prices were likely to drop nationally if Budget could compete more effectively in the provision of nationally available rental services. (And this question would have underscored the importance of the evidence in relation to Budget’s exclusion from Christchurch airport, which hardly featured in the Court’s reasoning.) Unfortunately, having gone down a different path, the Court did not explore this issue further.

The first key lesson to be learned from this case is that one should always start by asking why the contracts that are attacked are said to harm consumers. How will consumers benefit – in terms of better products or lower prices – if the contracts go? If there is no reason to believe that without the contracts prices will fall, and quantities supplied increase, then the contracts do not harm competition. If the Court had focused on this question – and it would probably have been assisted in doing so if Avis had called expert economic evidence, which it failed to do, and if it had sat with a lay member, which it did not – then the appropriate inquiries could have been made. The Court may have stumbled on the right answer – who knows? But this is not how competition cases should be decided.

The second key lesson is that one should not confuse the use of existing market power to extract rents in one market – which ARA was seeking to do, and was entitled to do – with an attempt to extract rents from consumers who would not otherwise have had to deal with the monopolist, by reducing competition in another market. Simply reducing competition in another market is not enough, if every consumer in that other market had to deal with the monopolist anyway, as discussed above in relation to tie-in sales.

B Fisher & Paykel

In Fisher & Paykel the High Court was called on to consider an exclusive dealership clause which Fisher & Paykel, the leading manufacturer and wholesaler of whiteware in New Zealand, had for many years included in the distribution agreements it entered into with all retailers selling its whiteware products. The clause required dealers not to stock or sell the whiteware of any other distributor. The distribution agreement was terminable by either party on ninety days’ notice.

Before the abolition of import licensing and the reduction or removal of tariffs on whiteware, a process that began in 1987, Fisher & Paykel had been essentially the sole supplier of such products in New Zealand. Competition in the whiteware market developed swiftly after that date, primarily with imports from Australia. But Fisher & Paykel remained the major player, with roughly an 80% market share at the time of the hearing. Fisher & Paykel had 204

48 Supra n 15.
franchised whiteware dealers who sold through 450 outlets, out of the
approximately 800 to 850 outlets in New Zealand retailing whiteware.

When the Commerce Act came into force, Fisher & Paykel applied to the
Commission for an authorisation of the clause, arguing either that it did not
lessen competition, or that if it did lessen competition, it gave rise to public
benefits that outweighed any detriments. The Commission held, by a majority,
that the clause did lessen competition, and that it did not give rise to benefits,
which outweighed the resulting detriments. The dissenting member of the
Commission considered that the clause did not lessen competition, so that no
authorisation was needed. 49 Fisher & Paykel appealed to the High Court. Its
appeal was heard with a claim by its main competitor, Eimate Ltd and by Eimate's
New Zealand subsidiary Simpson Appliances that the provisions breached
section 27. Fisher & Paykel counterclaimed for declarations that the clause did
not breach section 27.

The High Court held that the exclusive dealership clause did not breach
section 27. Thus the question of public benefits did not arise – though the
Court indicated that if it had to decide the question, it would have found that
the benefits were not sufficient to outweigh any detriments (an odd conclusion,
if there were no detriments!). It followed that no authorisation would be granted,
but the court did make declarations that the clause did not breach section 27. 50

The result is consistent with the approach we have outlined above. Fisher
& Paykel was allowed to contract for a result that it could also have achieved
by vertically integrating into distribution. Arrangements of this kind with dealers
could only raise competition concerns under the very limited circumstances
described in section IV: there would need to be an effective foreclosure of
competitors from distribution, which could only occur in very special conditions
which were not shown to be present in this case.

The Court identified this issue in the reasons it gave for its conclusions: 51

1 In the absence of artificial barriers to entry, an EDC can have positive
pro-competitive effects in a market for the reasons outlined by
Professor Klein, provided that a significant component, in this case,
retail space, has not been foreclosed.

2 No significant retail space has been foreclosed; rather, the
establishment of retail outlets by the new entrants has been no more
difficult than could be expected, given the history of import and
tariff protection in this country up to 1985.

More disturbing however was the emphasis the Court placed on the short
notice period for terminating the distribution agreements. 52 In our view the

50 Fisher & Paykel, supra n 15, 101,686.
51 Ibid, 101,687.
52 Ibid, 101,687.
notice period was entirely irrelevant, given the other findings of the Court. The short point was that vertical integration into retailing by contracting, whether for short or long terms, could not create new market power for Fisher & Paykel.

Thus while welcoming the result reached, we would caution strongly against drawing from the judgment any condemnation of long-term exclusive distribution contracts, or for that matter of other forms of long-term vertical integration by contract. They do not increase market power, in the absence of foreclosure, so do not lessen competition. Nor, very importantly, should the case be relied on to support arguments that length of term matters, where foreclosure is absent.

C Health Waikato\(^\text{53}\)

In 1995 an authorisation was sought for a proposed contract between the Midland Health Regional Health Authority (the RHA), the purchaser of publicly funded health services for the region, and Health Waikato (a major provider of health services, and operator of various hospitals, in the region) for the provision of mental health services. Health Waikato proposed to build a new mental health facility. To recover the costs of this investment, it sought from the RHA a ten year contract for use of the facility, and first rights to negotiate for provision of services in the facility. The Commerce Commission decided that the contract lessened competition in the markets for in-patient mental health facilities, and certain mental health services. It declined to authorise the contract. The Commission suggested that the parties could enter into a contract for use of the facilities for five years, during which the cost of the facility would be paid in full by the RHA, without there being a Commerce Act problem. Because the Commission saw a shorter contract as likely, if authorisation for a longer one were refused, it decided both that the longer contract lessened competition in various markets (presumably, as compared with a shorter one – the benchmark used by the Commission in this part of its decision is less than clear) and that all the public benefits derived from the longer contract would be derived from a shorter one – so none of these benefits could be attributed to the longer contract and weighed against its anti-competitive effect.

On the face of it, the outcome was a strange one – the buyer of the services (ie the taxpayer, through the RHA) is being made to pay the full cost of the facility over a shorter term, in the hope that five years down the track increased competition will constrain what Health Waikato can charge from that point onwards. Yet after five years the RHA would not own the facility, or have any rights to a reduced price for access to it. The price per annum would (inevitably) be higher over the shorter term – Health Waikato was insisting that it not be exposed to opportunistic behaviour by the RHA before it had recovered its

\(^{53}\) Supra n 8.
specialised investment, which was only protected for the contract term. Health Waikato was (unsurprisingly) indifferent to a shorter term with a correspondingly increased price.

It was the RHA which wanted to pay for the specialised investment over a term closer to its economic life – otherwise it was taking on the risk of hold up by the facility owner, if competition did not eventuate. And even if competition to supply the facility did occur in five years time, any owner of new specialised facilities would need to recover the cost of developing those facilities in bidding to supply the RHA – so Health Waikato would be able, even under competition, to charge for use of the facilities (up to the level of its competitors’ development costs) despite the full cost of the facilities having already been paid by the RHA. Put another way, if you are going to pay the full cost of a facility, you will normally seek to contract for the use of the facility for its economic life. In a normal commercial setting, a proposal (whether from the supplier or from a regulator) that you had to pay for the entire facility over half of its economic life would lead either to the contract being abandoned, or to vertical integration – the purchaser of services would build the facility itself, contracting only for services at the facility, and paying for the facility once only. The Commission’s suggestion of a shorter term seemed plausible only because of artificial non-market constraints on the parties. The RHA had to buy these services (it could not abandon the transaction), and it was not allowed to build its own hospitals, so it could not vertically integrate to avoid hold-up. The outcome was a far cry from the “market” approach to provision of health services, which the then prevailing legislation required.

Once again, if the Commission had simply started by asking whether the proposed contracts harmed consumers, the right approach would have been much clearer. (There is the added complexity that the “consumer” role is shared by the actual users of the services and the RHA as purchaser. This is probably best conceptualised by thinking of the RHA as an agent for users, buying services on their behalf.) The short point is that consumers lost from the shorter term – they paid more during the first five years than they otherwise would have, and were then exposed to paying a price for the facility in the second five years that would be constrained only by the possibility of someone else building another (duplicative) facility, and recovering the cost of doing so in the contract price. This is not much of a constraint. It should have troubled the Commission that it was in effect trying to “protect” the RHA – the consumer, or perhaps the consumers’ agent – from a contract which it wanted to enter into, and that it was doing so by requiring it to enter into arrangements that would almost inevitably result in the RHA paying more over the ten year period.
D Kapuni^{54}

The relevant aspect of the Kapuni case for present purposes was the argument by the field owners, Shell and Todd, that section 27 rendered unenforceable a long-term contract under which they had agreed to sell all the gas in the field to the Crown. The Crown’s rights had since been assigned to National Gas Corporation (NGC), and then to Kapuni Gas Contracts Ltd (KGCL), a wholly owned subsidiary of Fletcher Challenge Ltd, which was also a 33% shareholder in NGC. Kapuni Gas Contracts Ltd on-sold the gas to petrochemical companies, and to NGC (which was entitled to any gas purchased by KGCL and not sold to the petrochemical plants). The only other significant gas field at the time of the trial was the Maui field, gas from which was committed under long-term contracts to NGC, Methanex (one of the petrochemical companies), and Contact (an electricity generator). The Maui field was discovered, and the Maui contracts entered into, some years after the Kapuni contract was entered into. Diagrams of gas flows in New Zealand at the time, and of the contractual relationships in relation to Kapuni gas, appear in Appendix 1.

The argument for the plaintiffs was that the combined effect of the Kapuni and Maui contracts was to commit all gas other than gas used for electricity generation or petrochemical production to NGC, giving NGC substantial market power in the wholesale and retail reticulated gas markets. This had plainly been the case in the recent past – the difficult question for the Court was whether changes in the electricity and petrochemical industries were likely to result in that gas competing with NGC’s gas in the near future.

The Court found that the market for reticulated gas was distinct from the market(s) for petrochemical gas, and gas for electricity generation. From this finding it followed inevitably that the combined effect of the contracts between the plaintiffs and KGCL and between KGCL and NGC in relation to Kapuni gas, and between NGC and the Crown in relation to Maui gas, was to lessen competition in the reticulated gas market.\(^55\) As noted earlier in this paper, the Court concluded that this meant that the Kapuni contract was unenforceable under section 27, even though it was entered into before the Act came into force, and even though it was the combined effect of that contract and subsequent contracts that gave rise to a competition concern.

The most interesting aspect of the Kapuni decision relates to remedies. The Court varied the Kapuni gas contract, by releasing half the gas in the field from the contract and allowing the plaintiffs to sell it in competition with NGC. The Court relied, in doing so, on an undertaking given by NGC in connection with the tender proposal to treat Kapuni gas for any person at a reasonable price, and on undertakings from the plaintiffs not to sell any gas

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54 Supra n 39.
55 Ibid.
they were awarded for electricity generation or to petrochemical plants. This is pretty significant intervention in a market, by any standards.

The defendants had argued that if there was a section 27 problem in respect of some of their contract entitlements, they should be allowed to tender out those entitlements. This should ensure that they retained the benefit of the price negotiated in a contract entered into long before the Commerce Act was enacted, without receiving any rents from market power created by the interaction of that contract and the subsequent Maui contracts. A sale of the entitlements would restore competition just as effectively as returning the gas to the field owners by setting aside the contract – indeed they would be likely bidders. It was pointed out that there was a strong analogy with the position of a defendant who was held to have acquired assets in breach of Part III – the remedy there is to require the assets to be sold, not to confiscate them or return them without any payment to the vendor! Indeed the only respect in which the analogy did not hold is that the Kapuni defendants were less culpable than our hypothetical Part III defendant, who acquired its assets in breach of the Act – they had acquired the contractual rights entirely lawfully, and the Commerce Act then supervened.

Alternatively, if a tender was not allowed for any reason, and the contract was cancelled in whole or in part, it was argued that compensation should be paid for the loss of the right to the value such a tender would generate (ie the present value of the difference between the price for gas that would emerge under the competition, which section 27 is designed to protect, and the contract price).

The Court rejected a tender, on the grounds that it was too complex and would require too much supervision from the Court. Certainly the tender terms, in part because of the need for treatment of the gas, were not the simplest. But this leaves open the possibility that such a remedy would be allowed in a simpler case. And of course if the rights had been tendered out at any time before the trial, so that KGCL (or possibly just NGC) no longer had rights to any gas under the Kapuni contract, there would have been no section 27 problem and no basis for making any orders under section 89.

The Court also rejected the defendants’ alternative argument that they should be awarded compensation, on the basis outlined above. This is the weakest aspect of the Court’s reasoning. It is best explained by the Court’s statement that compensation was not needed because the contract had been varied in a manner designed to preserve the commercial balance between the parties.

The Court’s preference for an interventionist approach to solving the

56 Ibid. 537.
57 Ibid. 535.
58 Ibid. 536.
competition problems identified, rather than a market approach (through a tender) seems at odds with the basic thrust of the Act. It relied on precisely the sort of behavioural undertakings to "bring about" competition that the Commerce Commission is prohibited from accepting in merger cases, in order to avoid the Commission becoming the de facto regulator of an industry. Instead, the Court assumed that role – or passed it on to arbitrators in certain respects.

The outcome in Kapuni can perhaps be put down to the novelty of the arguments, and the complexity of the contractual environment. Let us hope that in simpler cases, such as the steel example referred to earlier in this paper, a market-based solution will be preferred, and expropriation (and the perverse incentives it creates) avoided.

E Port Nelson

We commented above that the very important distinction between unilateral conduct, which is subject to the section 36 test, and agreements, which are tested against section 27, had been blurred by the courts in Port Nelson. These proceedings arose out of the response of the Nelson port company (which owned and operated the port, and provided a range of services including stevedoring, tug services and pilotage) to supply of pilotage services by some of its former employees, in competition with the port company. The company, which was held to be dominant in several markets, including markets for the supply of wharf services and pilotage and tug services:

1 Refused to supply its tugs to ships unless its own pilots were used (the tug tie);
2 Set very low prices for pilotage for smaller ships, the field in which it faced competition from the new pilot service. It did this by setting prices based on tonnage, with a low minimum price applicable to all smaller ships; and
3 Offered a discount to purchasers of all its services including pilotage – a 5% discount across the cost of all services, which in some cases was greater than its price for pilotage.

The Commerce Commission argued that these actions breached sections 27 and 36. The section 27 argument was founded on section 3(5), and asserted that although no one contract with a port user affected competition, taken together those contracts had both the purpose and effect of lessening competition in the relevant markets.

At first instance the tug tie was held to be a breach of section 36, and the low minimum pilotage price for smaller ships and the discount were held to breach section 27. The Court held that the minimum price and the discount had the purpose of lessening competition, and that at the time they had been

59 Supra n 9.
60 Ibid. 103,821.
entered into with customers they had been likely to have the effect of lessening competition, even though they had not in practice done so. The Court rejected the argument that the minimum price and discount breached section 36.

The port company appealed from the findings of breach, and the Commission cross-appealed on various issues, in particular from the findings that the minimum price and discount did not breach section 36. The port company’s appeal failed. The Court also rejected (giving very brief reasons) the Commission’s cross-appeal, but with indications that had it not found the breaches of section 27 to be made out, it might have looked more sympathetically on these arguments, which in the event it was not practically necessary to consider.

The competition policy concern in relation to this judgment is that the port company’s practice of charging low prices was held to be unlawful by reference to an “effects” test, rather than being measured solely against the narrower section 36 “purpose” test. That is, the Court imposed liability because it was satisfied, after hearing all the evidence, that the contracts were likely to harm competition when they were entered into – when it should have asked only whether the port company knew that harm to competition was likely if it entered into such contracts, or ought reasonably to have expected that such harm was likely based on the information reasonably available to it. Low pricing which makes it difficult for a competitor to compete – which is an integral facet of competition, but which can also characterise predatory pricing – is the focal example of unilateral conduct which should not lightly be discouraged, and which should be tested by reference to the more circumscribed section 36 test. It is the classic example that is always given for rejecting an “effects” test in section 36. The Port Nelson decision runs counter to a series of rejections of an extension of section 36 along such lines, in both Australia and New Zealand.

If the approach to section 27 in Port Nelson is followed, the policy rationale for rejecting an “effects” test in section 36 is largely defeated – large firms considering a price drop will need to ask whether their low prices, which will be included in their contracts with customers, might later be held by a court to have had the effect of lessening competition (even though a reasonable inquiry undertaken by the firm at that time would not indicate that this effect is likely) and so breach section 27. From a policy perspective, this outcome is extremely unsatisfactory.

61 Ibid, 103,802 and 103,812. It seems somewhat odd to penalise conduct that we know, with the benefit of hindsight, did not harm competition. An examination of whether harm is likely is inevitable if it is future harm to competition that is sought to be prevented. But where all the relevant events lie in the past, and it is established that competition has not been harmed, imposing liability could only be justified by arguments based on relative costs of monitoring and enforcement, and effective deterrence. This issue merits further study.

62 Ibid, 103,826.

63 Supra n 4.

64 Ibid, 580.
Were the courts compelled to reach this conclusion – is it the drafting of the statute which has compromised its policy objectives? This does not seem to be the case. The economic principles outlined earlier in this paper can readily be applied to the interpretation of section 27. The contracts entered into by Port Nelson with its customers were one-off short-term contracts. At any given point in time, the contracts already entered into were irrelevant to future competition: they had no prospective effect on the market. Suppose, for example, that Port Nelson had announced that it would perform its existing contracts but that henceforth it would increase its minimum prices and would abandon the discount structure. What effect on competition would the existing contracts have? None – and certainly none that was real or of substance. The new pilot service struggled to compete because the port company had adopted a particular pricing policy. Taking a forward looking approach, as competition analysis requires, it is that pricing policy and not the existing contracts for piloting of particular ships that will affect competition (i.e. affect prices in the market). In the language of the section, the existing contracts have no effect at all on competition in the market – it is the pricing policy of the port company, and the offers made pursuant to that policy, which will determine how competitive the market is in the future. Adopting such a policy is precisely the sort of unilateral conduct that should be assessed under section 36. It cannot be assessed under section 27 – and should not be.

This approach to section 27 also resolves the issue touched on by the Court of Appeal that on the Commission’s interpretation of section 27, each customer of Port Nelson who entered into a contract at a low price, or which provided for a discount, breached the Commerce Act and was liable to a penalty. The Court acknowledged that this followed from section 27(1), which prohibits entering into contracts with the effect of lessening competition.65 It might be suggested that this concern could be resolved through discretionary setting of penalties: customers would not be penalised for acting innocently in accepting the prices offered to them. But it seems unsatisfactory to interpret a statute as rendering unlawful conduct by a person who has no reason to suspect that he or she is doing anything wrong, and who could not reasonably discover the breach. It is far more satisfactory to conclude that Port Nelson may have been breaching section 36 in making the offer of the low price, but that the customers did no wrong, since the contracts did not breach section 27.

Whether Port Nelson was in breach of section 36 on all three counts remains an open question, despite the High Court’s conclusion to the contrary in respect of two of the three allegations. As noted above, the Court of Appeal seems to have had some sympathy for the view that there may have been section

36 breaches. But the use of section 27 in that case was unprecedented, inconsistent with the language of the provision, and disastrous from a policy perspective. The decision is plainly wrong, and should not be followed.

VII What Can New Zealand Learn from United States Antitrust Enforcement?

A Horizontal

The current United States antitrust policy on horizontal contracts seems pretty reasonable for the most part. Mergers that create significant market power are attacked immediately. Although they have the power to do so, sensibly, the United States agencies in charge of merger enforcement recently have generally refrained from attacking mergers long after they have closed. This is obviously important for establishing clear property rights in operating a business. Current United States antitrust policy toward horizontal contracts regarding pricing or output also seems sensible. Basically, cartel-like agreements among firms with collective market power are illegal. Moreover, especially recently, the United States Department of Justice has been successful in obtaining significant penalties and criminal sanctions against price fixers. We have listed in Appendix 2 the recent fines and criminal penalties in the United States and New Zealand for price fixing cases. The table illustrates that United States penalties have dramatically increased recently and, even on a per dollar of Gross National Product (GNP) basis, dwarf those in New Zealand. (In the United States, the perpetrators of a conspiracy are also subject to private antitrust suits which themselves can generate significant penalties.)

The United States has been flexible enough to recognise that exceptions to the hostility toward horizontal agreements should be relaxed when unique efficiencies are at stake. So, for example, in the *BMI* case, the Court recognised that a collective of songwriters who fixed royalty rates so simplified certain transactions that it was allowed. This efficiency defence was needed to overcome the presumption of an adverse effect from collective action when there is market power. It remains a curiosity of United States antitrust law that contracts between rival firms with no market power can still create a presumption of illegality.

One area of misguided United States antitrust enforcement regarding horizontal "agreements" has been the attempt to prosecute oligopolies for not behaving more competitively. Through a long string of cases, the government has unsuccessfully tried to attack tacit collusion, "shared monopoly" and

67 Joint ventures raise special issues related to exclusion – supra n18.
"facilitating practices". The underlying problem with all these cases is that there is no obvious remedy – telling firms to ignore their rivals’ reactions is not sensible and so antitrust enforcement here is likely to be a waste of time.

B Vertical

Turning to the vertical arena, the results for United States antitrust policy are much more mixed. It is here that antitrust authorities should be especially sceptical, since the harms to competition are usually alleged by rivals. United States policies on predation cases and exclusivity in distribution have been economically sensible. The same cannot be said for their policies regarding resale price maintenance, after-markets, tie-in sales, and price discrimination.

United States case law on price predation is an example to be followed. In two recent cases, Matsushita and Brown and Williamson, the Supreme Court found that the economic facts that make predation an unlikely strategy – losses from the low prices and inability to recoup through elevated prices – must be recognised and, if present, should end the case. A much more difficult issue arises in predation cases when there may be room for only one firm. Although it may be hard to establish that only one efficient firm can survive, it is a realistic possibility, that as far as we know, no antitrust authority has dealt with. A possible example of this could be airline travel between two cities. Suppose the two cities are served by one airline, a new entrant comes in and a price war ensues. The entrant finally leaves, and prices rise. Should that be considered predation? No case has dealt with the issue and the proposed guidelines on price predation in the airline industry issued by the United States Department of Transportation have also ignored the matter. Yet, under most standard theories of predation, this case would be classified as predation even though, as a logical matter, the implicit premise of a predation case – namely that, absent the predation, there would be competition – is false.

United States treatment of exclusivity in distribution is pretty sensible. It uses a rule of reason to balance the efficiencies that might result from any exclusivity against possible harm to competition from making distribution more difficult for rivals. Although a sensible rule to state, it is quite difficult to actually perform a quantitative balancing in specific cases.

In contrast to its generally sensible rule on evaluating non-price vertical restrictions, the Supreme Court has taken the position that resale price maintenance, under which a manufacturer tells the retailer what price to charge,

68 See, for example, Theatre Enterprises v Paramount Distributing Corp 346 US 537 (1954); FTC v Kellogg et al, Docket No 8883, 99 FTC Reporter 8 (1982); E I Du Pont De Nemours & Co v FTC, 729 F 2d 128 (2nd Circuit, 1984).
is per se illegal. This doctrine is in tension with the so-called Colgate doctrine under which a firm can choose with whom to do business. It often requires an army of lawyers to make sure that, when a firm cuts off a retailer who discounts, it is exercising its Colgate rights and not violating the per se restrictions on enforcing resale price maintenance.

United States case law on after-markets is not an example to follow. In Kodak, the Supreme Court ruled that ex ante competition was not a sufficient defence to throw out an antitrust claim that Kodak suppressed competition in after-markets by refusing to supply repair parts to independent dealers. As we have explained, there is little convincing economic logic to justify such a claim. Indeed, it is difficult to think of an effective remedy absent price regulation of Kodak’s spare parts, a remedy that a court is in no position to administer.

Tie-in doctrine in the United States is another example of antitrust policy that sets a poor example. The current treatment of tie-ins is based on notions of foreclosure of competition, “forcing”, and whether there are one or two products involved. There is simply no coherent economic basis for current tie-in law. Perhaps the Supreme Court recognised this when they said: “It is far too late in the history of our antitrust jurisprudence to question the proposition that certain tying arrangements pose an unacceptable risk of stifling competition and therefore are unreasonable 'per se’.”

Finally, there is one law, the Robinson Patman Act, which forbids price discrimination where the effect is to lessen competition. The Act was passed to protect small grocers from competition on the part of A&P, a large grocery chain, which received large volume discounts. This special interest legislation inhibits competition by requiring that discounts be passed along to equally situated rivals. The result is that suppliers do not give discounts, and that harms consumers. Luckily, the Act has been relatively moribund in recent decades, though the Federal Trade Commission unfortunately increased its enforcement somewhat in the 1990s.

The United States antitrust laws have not been as clear as they might in

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75 The Court ruled that there were economic theories that a factual inquiry could or could not support that would create competitive harm. Hence, the Court ordered the case to trial (which Kodak lost).
76 Jefferson Parish Hospital District No 2 v Hyde 466 US 2, 16 (1984). There are coherent theories of antitrust harm from tie-ins: see, for example, Whinston (1990) supra n 21, Carlton and Waldman 2002 supra n 21. We hasten to add that the theoretical possibility of harm must be followed with an empirical validation before the theory should be considered applicable. In any case, even these theories could not justify the full extent of the United States hostility to tie-ins.
protecting the property of a monopolist. In two cases, *Berkey*\(^77\) and *Olympia*,\(^78\) the courts made clear that one rival does not have an obligation to help a rival. But, in two other rulings, *Aspen*\(^79\) and *Kodak*,\(^80\) the Supreme Court seemed to place an obligation on a monopolist to deal (supposedly at "reasonable" prices — good luck!) unless legitimate competitive reasons for the refusal existed. Our own view is that clear property rights, even for a monopolist, are the best spur to competition and innovation, and that forced use of another's property should not be an antitrust concern. Forced use inevitably entails the court setting, or supervising, prices — and quality, and product definition, and so on — which courts are singularly ill-equipped to do in terms of resources, expertise and process.

The New Zealand courts have commented on the difficulty — perhaps impossibility — of compelling (and thus regulating) supply, a task that is imposed on them by the current approach to section 36. It seems to us that in the rare cases where intervention to compel supply is justified, that intervention should be implemented more transparently by better equipped agencies, following an appropriate process which assesses the benefits and costs of such intervention. If such intervention is not justified, no one — and particularly not the courts — should embark on that course under the guise of applying section 36. The Commerce Act should not operate in this way — but the case law may be too entrenched on both sides of the Tasman for this argument to be much more than a lament for the coherence that might have been!

United States antitrust laws have also not been as clear as they might in distinguishing breach of contract cases from antitrust cases. Since antitrust cases command treble damages as penalties in the United States, there is an incentive to turn a breach of contract case into an antitrust case. Several cases involving disputes between franchisers and franchisees have been successfully brought,\(^81\) though improperly so from an economic perspective, as antitrust cases. As we explained earlier, typically a mere breach of contract is unlikely to alter competition in the market, even though it may harm an individual firm, in the absence of market power.\(^82\)

\(^77\) *Berkey Photo Inc v Eastman Kodak Company* 603 F2d 263 (2d Cir 1979) cert denied 444 US 1109 (1980).
\(^78\) *Olympia Equipment Leasing Co v Western Union Telegraph Co* 797 F 2d 370 (7th Cir 1986) cert denied 480 US 934 (1987).
\(^80\) Supra n 74.
\(^82\) Even with market power, a breach of contract between a monopolist and an input supplier could affect, say, a monopolist's marginal cost curve, but the harm to the monopolist could be recovered in a breach of contract action and, if expected, should not affect the monopolist's pricing. For a breach to give rise to an antitrust claim, the breach would, for example, have had to have an effect on market structure and, as a result, on prices.
VIII Some Suggestions for Reform

Our discussion above suggests the following prescriptions for New Zealand's legislators and judges:

1. Courts need to be conscious of their limitations in trying to intervene to enhance competition. In particular, they have neither the resources nor the skills to act as regulators;

2. Concerns about applying section 27 to long-term contracts that create long run relationships akin to those within a firm could be mitigated by:
   (a) Making provision for clearances in respect of contracts, to enable parties to obtain a formal determination that there is no competition concern, and prevent future challenges to the contract under section 27. This would ensure that parties to a contract that does not raise competition concerns are not worse off than parties to a contract that does raise competition concerns, so is eligible for an authorisation. This would also address the unjustified distinction the Act currently draws between vertical integration by contract, and vertical integration by merger or acquisition; and
   (b) Removing the ability to revisit authorisations in relation to contracts, where circumstances change;

3. Courts should be wary of equating competition and rivalry, and a reduction in the number of rivals with a reduction in competition. Courts should always begin by asking how the impugned contract harms consumers – who is paying more, or getting less? If no consumer is shown to be harmed in this way, there is no competition concern;

4. Vertical contracts entered into by firms with market power should not be attacked simply because they harm competitors, where they do not harm competition (i.e. do not result in an increase in prices to consumers). There is no additional harm to competition simply because a firm that already has market power enters into a vertical contract under which it receives rents from its existing market power;

5. Section 27 should not be used to deprive a resource owner of the competitive value of the resource (i.e. the value that remains after the section 27 concern has been resolved). Remedies should be designed to avoid this, where a breach of section 27 is identified.

6. A careful distinction between the effects of past contracts and the effects of a firm's decision on its future pricing policy is essential to avoid applying an effects-based liability test to unilateral conduct, where such a test is inappropriate, and risks deterring vigorous competition. An effects test is appropriate when considering whether to grant an authorisation to enter into a contract ex ante; the
Commission should consider the likely effects of the contract, taking into account all information which the Commission can obtain at the time. And given the ability of the parties to seek an authorisation ex ante, it makes sense to adopt a liability test for entry into a contract which mirrors the approach on an authorisation application and looks to the likely effects of the contract at that time, drawing on all information about the market that was then available. This ensures that there are no perverse incentives for a firm to refrain from seeking an authorisation, in the hope that a less stringent test would be applied in any subsequent liability proceedings. What is clear, though, is that an effects test of any kind is inappropriate, and has been rejected by policymakers, in the context of liability for unilateral market conduct such as setting future prices (where the risk of deterring pro-competitive conduct is much greater, and clearances and authorisations are not available). Section 27 should not be applied to such conduct, as this imports an effects-based liability test, and risks deterring vigorous competition. The appropriate test in relation to unilateral conduct such as setting future prices is the “purpose” test provided for in section 36, which focuses on whether the firm should reasonably have foreseen harm to competition based on the information available to it at the time; and

New Zealand can learn the following lessons from the successes and failures of United States policy on vertical contracts:

(a) Exclusionary distribution arrangements in the presence of economies of scale can sometimes harm competition, and merit scrutiny;

(b) It is unwise to impose a duty to deal administered by the courts – this is essentially a regulatory task, and should be undertaken by a properly resourced regulator, if there is a case for regulation. If there is not, the courts should not try to fill a perceived gap;

(c) It is unwise to attack price predation vigorously, as this will chill competition, and predators rarely succeed;

(d) It is unwise to attack tie-in sales generally. There are special circumstances in which tie-ins can harm competition. But intervening in how firms design and market products carries significant risks;

(e) Price discrimination should not be treated as breaching competition law, whether practised directly by the monopolist or indirectly through distributors.
Appendix I: Gas Flows in New Zealand Pre-Kapuni

Maui    Kapuni    TAWN    McKee    Other    Kupe

Crown    KGCL

Contact    Methanex    NGC    BOP

NGC Gas Cos    Other utilities    Southdown

Maui    Kapuni    McKee

Crown

NGC

NGC Gas Cos    Other utilities    Southdown
## Appendix II: Antitrust Penalties: United States vs New Zealand

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</table>

### Sources
- (Note: Figures for 1999–2001 represent upgraded New Zealand System of National Accounts and thus are not directly comparable to those for 1990–98.
- US GDP: [www.bea.doc.gov/bea/dn/npaweb/TableViewFixed.asp](http://www.bea.doc.gov/bea/dn/npaweb/TableViewFixed.asp)
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