COMPETITION & REGULATION TIMES

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BETTER THE DEVIL YOU OWN

Most of New Zealand's electricity distribution industry is owned by "energy trusts", yet the trusts' potential for resolving natural-monopoly problems seems to be largely unappreciated, according to recent research by Professors Lewis Evans and Neil Quigley.[1]

In a trust where consumers both own the assets and retain dividends (in this case, customer rebates), the interests of consumers and efficiency coincide. Such a trust resolves a key aspect of the natural monopoly problem by removing the incentive for the owners to generate monopoly profits at the expense of consumers.[2]

Consumers are at risk from a "natural monopoly" because (given current technology and cost structures), there is limited potential for duplication of, and competition against, the existing facility. Examples are the cables that provide telephone services to households and the lines that transmit electricity. *to page 2*

THE COSTS OF

TELECOMMUNICATIONS REGULATION

There is ample evidence that consumers have benefited from the new entry, technological change and improved levels of service that have been associated with New Zealand's light-handed regulatory regime for telecommunications.[1]

Moreover, the telecommunications industry is subject to much more technological change and has more scope for network bypass than the electricity industry, and is free from some intrinsic problems that inhibit the operation of competitive market structures in electricity.[2]

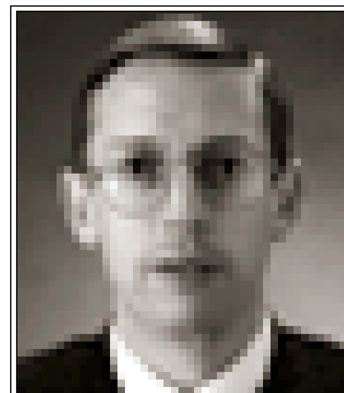
Despite this, the report of the Ministerial Inquiry into Telecommunications represents a major departure from the relatively light-handed recommendations of the Ministerial Inquiry into the Electricity Industry.

The report of the Telecommunications Inquiry suggests that, after the progress of the last decade, consumers will now gain from the introduction of heavy regulation and centralised planning in the telecommunications market. It proposes that an appropriately staffed Electronic Communications Commission be established, and that the Commissioner have the responsibility to act as backup to commercial negotiation in a wide range of industry activities. The Commissioner would also have the ability to mandate or force certain practices and, in these cases, to be the "last-resort" price-setter for mandated activities.

The model proposed is adopted from Australia, where "essential facilities", if "declared", become subject to a mandatory access regime. Thus, if the local loop owned by Telecom was declared, Telecom would be required to supply local loop services to anyone requesting them. If there is a dispute as to the price at which these services are supplied, the Commissioner is to be the final arbiter.

The report does not make a plausible case for the introduction of heavy regulation, because it does not systematically evaluate the relative efficiency of New Zealand telecommunications. The standard arguments about the welfare gains from the regulation of natural monopoly

GUEST EDITORIAL



NEIL QUIGLEY

are not advanced, and in any event are not now applicable to the telecommunications industry as a whole. Neither does the report provide any credible evidence that enforcement of the Commerce Act is ineffective as a mechanism for addressing any genuine competition problems in telecommunications markets.

The most alarming aspect of the report is its failure to consider the high cost of introducing a heavy regulatory regime in telecommunications. Regulatory promotion of the private interests of new entrants to the telecommunications market will not provide benefits to the *to page 4*

from page 1

In modern telecommunications the natural monopoly problem is greatly reduced by the range of new ways that lines can be bypassed - cellphones, cable and satellites, for example. This is less the case for electricity lines, where in New Zealand we find a number of lines trusts: 27 at last count.

Consumer trusts provide a close approximation to economic efficiency in the presence of a natural monopoly. This is because they provide incentives for efficient decision-making on pricing, investment and divestment. (They may be less productive over time because they do not possess tradable shares, but in the case of a genuine natural monopoly there is no perfect solution to this.)

The key to consumer trusts' resolving the monopoly issues is that the effective final price to their consumers is not what they pay for electricity, but rather that price less rebated profits. (The more closely profits are rebated to consumers according to the amount that they consume, the more effective this is at counteracting the risks of monopoly.)

A consumer trust structure also helps ensure the optimal level of capital investment, since consumers care about future services. The elected trustees are charged with making decisions that are in the interests of consumers as a whole. If, in addition, the trust is established in perpetuity, this requires that the trustees consider the interests of all future, as well as present, consumers.

Only when decisions and property rights are vested with consumers will a natural monopoly make efficient decisions about the acquisition and retention of assets. Only consumers have the incentives to correctly assess the efficiency of capital investment decisions. Consumers will not asset strip.

It is important that consumer trusts are not confused with trusts held by local bodies. Local-body trusts divert funds to other purposes and thereby use the trust as a vehicle for local taxation. This reduces the beneficial effect on the monopoly problem of bundling trust income and prices to consumers.

In fact, when local-body trusts apply all the trust income to projects, their behaviour is the same as that of a profit-maximising private monopoly, but they do not have the discipline of potential take-over that such a firm normally faces. Further, the trustees of consumer trusts are directly accountable to consumers for the performance of the industry. This is in marked contrast with local-body trusts, because their trustees are chosen through a local-body political process. Local-body trusts are economically inefficient and contrary to consumers' interests, compared to consumer trusts and corporations with traded shares.

In many circumstances, consumer trusts provide a superior alternative to heavy-handed price-control regulation. There are a wide variety of information, incentive and efficiency problems associated with regulation such as cpi-x. This form of regulation does not solve the quality or productive efficiency issues, and it is a very clumsy way to address natural monopoly even if applied to profit-maximising entities such as listed corporations and local-body trusts whose objectives are known.

The application of cpi-x to consumer trusts is additionally fraught because the trusts' objectives are already aligned with those of consumers. Price regulation will interfere with this and yield various possible adverse outcomes. By imposing costs on the regulated firm, trust and consumers, price regulation is likely to lead to unintended quality and performance outcomes as trustees focus more on the regulator than on their consumer-beneficiaries, and as the regulator shares with the trustees responsibility for the company's performance.

It is difficult to conceive how a centrally located regulator could solve any regional natural monopoly problem better than consumer trusts. Their only chance would be to force the trusts to become listed corporations prior to applying the regulatory schema.

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1 *Prof Lewis Evans is Executive Director of the New Zealand Institute for the Study of Competition and Regulation. Prof Neil Quigley is Dean of the Faculty of Commerce and Administration at Victoria University of Wellington.*

2 *Certain inefficiencies may remain in this structure, some of which are resolvable in other ways. For example, the tendency of management to gold-plate assets and to retain free cash within the firm may be controlled to some degree by benchmarking and rules on the proportion of the net income that must be paid as dividends. But productive efficiency generated by the threat of take-over is not present because trusts do not have tradable shares. With all forms of trust there may be concerns about the productive efficiency of management arising from the absence of competitive pressure.*

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E-TAIL THERAPY: COOL,

BUT NOT QUITE THE **REAL THING**

Bronwyn Howell[1] uses a virtual crystal ball to look into the future of shopping.

As I upload my e-grocery list for this week I'm wondering if this electronic shopping phenomenon will eventually take over.

The answer probably depends on whether "e-tail therapy" can be made at least as therapeutic as the live alternative. It all depends on how important the social side of shopping really is to us, and according to the surveys, shopping is one of our favourite leisure-time pursuits.

But first, the upside of virtual shopping.

Already, supermarkets like Woolworths encourage people to push cyber-trolleys and browse their on-line shelves for everyday necessities, which are delivered by courier at a time convenient to the customer.

For customers it's flexible, convenient, 24-hour-a-day shopping, but some powerful economies lie behind it, too. Cybermarkets don't need to maintain vast carparks or ambient walk-in environments. Spacious aisles, accessible shelves and cheerful check-out staff can give way to warehouses and robotic packers.

Further, the location of the warehouse is not dictated by proximity to customers' places of work and residence, but by a trade-off between cheap ground rents and proximity to distribution channels (that is, urban arterial roads).

Currently, Woolworths charges a fee for home delivery. But it seems possible that once a critical mass of cyber-shoppers is reached, the combination of cheap warehousing and optimised courier deliveries will be lower than the high costs of maintaining walk-in stores.

Indeed, we may end up paying a premium for the luxury of shopping in person.

So is the traditional supermarket on its last legs?

One failing of cybermarkets is that they do not yet offer a product in the social exchange market. The position of one's fingers over the mouse cannot convey the same signals as the alignment of the bananas in one's trolley.

Some retailers seem to understand this, like those who attach cafés to book shops, garden centres and homeware stores. Amazon.com's on-line ordering provides a certain thrill but, once the novelty wears off, can a dialogue box match a blueberry muffin, a latte and the chance for social interaction? (And how else can we explain that the public outlets for the Internet have grown up around cafés?)

"THE POSITION OF ONE'S FINGERS OVER THE MOUSE CANNOT CONVEY THE SAME SIGNALS AS THE ALIGNMENT OF THE BANANAS IN ONE'S TROLLEY."

There is something else that personal shopping provides for which we may be prepared to pay a premium: virtual supermarkets do not offer a satisfactory substitute for the ability to smell, touch and visually examine produce.

Already, supermarkets entice us with the smell of bread from their bakeries, the firmness and colour of fruit and vegetables, and the appearance of the actual piece of meat or fish on offer. We may not care about which box of brand-x soap powder we buy, but we do care about which kiwifruit or chicken breast we place in our supermarket trolley.

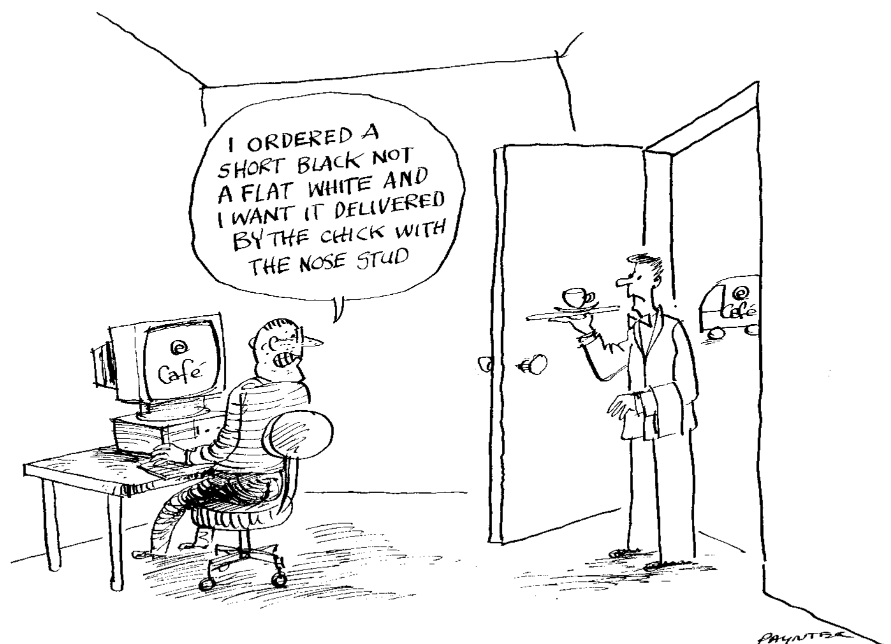
If that is right, the growth of cyber-supermarkets could prompt the re-emergence of the local fruiterer, baker and butcher. Already specialist sensory-stimulating stores like bakeries, not seen for years, are making a comeback in our shopping precincts.

Is this the way of the future, or merely a short-term trend while we await the development of cyber-sensory technology?

For a possible answer, check the recent financial reports from Amazon.com. The world's biggest electronic retailer has begun laying off staff - and to date has only made losses.

Has the Internet shopping bubble imploded without making a cybercent in profit?

1 *With help from serious e-shopper Rob Smillie.*



GUEST EDITORIAL from page 1

economy as a whole. Further, the proposed regulations would change the direction and reduce the speed of technological innovation in the New Zealand telecommunications market in ways that may substantially reduce consumer welfare.

Role of the Commissioner

The proposed Commissioner would have the right to determine the acceptability of a range of contracts within the industry.

The report suggests that three types of contracts will emerge: those that are unrestricted and not the business of the Commissioner; those that are subject to a range of criteria concerned with access; and those that are subject to these criteria plus the Commissioner's pricing principles.

The behaviour of competitors will be affected by this stratification. It will change the nature of competition by making the role of the Commissioner part of the strategic interaction in telecommunications markets. The strategic game that all companies play in securing competitive advantage will now include getting the Commissioner "on side" with contracts, for example by seeking to have an activity shifted up the hierarchy of Commissioner involvement.

An industry body to set standards

The Commissioner is also proposed as the final arbiter in respect of standards that will be set by an industry body that has statutory recognition. Statutory recognition of industry-specific standard-setting bodies is rarely efficiency-enhancing. Such bodies are more likely to reduce competition by encouraging co-operation across a broader front and by setting standards that protect the incumbents by discouraging new entrants.[3]

Contracts

The ability for any party to request a review of contracts by appeal to the Commissioner, and the proposal for determinations on price to have public input beyond the parties to the contract, undermine the ability of contracts to provide certainty to their signatories.[4] Certainty enables investments to be planned and risks to be managed. Without certainty, commitment to ongoing relationships and to the investments in the tangible and intangible assets necessary for those relationships will be reduced.

Mandated access

A natural outcome of the regime adopted in Australia and proposed for New Zealand telecommunications is that it inhibits investment in infrastructure and thereby reduces effective competition. By encouraging mandated use of a single wholesale network it reduces the incentive and increases the risk to any firm building their own network. Retail-firm competition increases at the expense of wholesale network competition and, despite price setting by the regulator, higher prices and poorer quality networks are the likely result for consumers.[5]

It is a central failing of the report that despite making much of static (allocative) inefficiencies that may exist at any point in time, it does not recognise that there is a trade-off between static and dynamic efficiency. A focus on static efficiency may not provide a framework within which the (dynamically) efficient investment decisions that are required for consumer benefits in the future will actually be made.[6]

> “THE MOST ALARMING ASPECT OF THE REPORT IS ITS FAILURE TO CONSIDER THE HIGH COST OF INTRODUCING A HEAVY REGULATORY REGIME IN TELECOMMUNICATIONS.”

The limits of regulatory judgement

The social benefit from competition is not measured by price alone. Since the future path of technological change is uncertain, society benefits from the "genetic diversity" that is associated with network competition. Such competition is absent under regulatory planning, since regulators prefer single pre-determined paths of technical progress.

When things go wrong in regulated markets, the regulators never blame their regulatory systems, and invariably seek solutions in extended regulation. The superficial attraction of these solutions rests more on the difficulty of quantifying the costs of regulation than on their likely effectiveness.

The essence of competitive decision-making is that it allows for alternative estimates of the price and the associated profitability of investment. In dynamic markets with heterogeneous products and rapid technical change, it is a practical impossibility for a regulator to set a competitive price for any product or facility.

Yet the report advocates just such central planning, in that the Commissioner will determine prices for key contracts in the industry. Consequently, decisions of the Commissioner will also determine investment in new and existing networks and in maintenance.

The Internet

Being preoccupied with the concerns of an earlier era, the report places insufficient emphasis on competition issues posed by the burgeoning use of the Internet. Internet and data usage of networks is rapidly rivalling the use of these networks for phone calls and aspects of the governance of the Internet deserve consideration.

Conclusion

The report of the Telecommunications Inquiry would take us down a path that places the welfare of competitors ahead of the long-term welfare of consumers. It is ironic that this should be the case for an industry that is delivering benefits to New Zealand consumers that are at least equivalent to those received by consumers of telecommunications services in other countries. This leading position cannot be claimed by most other New Zealand industries, or activities for that matter.

PROF NEIL QUIGLEY, DEAN OF FACULTY OF COMMERCE AND ADMINISTRATION, VICTORIA UNIVERSITY OF WELLINGTON.

1 *See, for example, Boles de Boer, David; Lewis Evans and Bronwyn Howell, "The State of e-New Zealand" at www.iscr.org.nz under "research".*

2 *In particular: electricity decays instantly; when transmitted between two points it takes all routes that are available; and the electricity grid has to be managed so that it is continuously in balance.*

3 *For a direct analogy, see my work on the Canadian Payments Association: Quigley, N C. "Public Policy and the Canadian Payments System: Risk, Regulation and Competition" in Mintz, J M; and J E Pesando (eds.). Putting Consumers First: Reforming the Canadian Financial Services Industry (C D Howe Institute, Toronto) pp41-72.*

4 *Evans, L T; and N C Quigley. "Contracting, Incentives for Breach and the Impact of Competition Law". World Competition. June 2000.*

5 *Boles de Boer, David; Christina Enright and Lewis Evans, "The New Zealand and Australian Internet Service Provider Markets", Info, October 2000, and www.iscr.org.nz under "research".*

6 *Evans, L T; N C Quigley and J Zhang, "Dynamic Efficiency and Price Control", available at www.iscr.org.nz under "research".*

TELECOM'S "KIWI SHARE": DO CONSUMERS STILL NEED IT?

The Kiwi Share imposed on Telecom New Zealand Ltd when it was privatised in 1990 was to some extent a political construct. The Government was planning to sell New Zealand's largest company, and the consumer protections in the Kiwi Share helped make that more palatable, writes Prof Lewis Evans, Executive Director of ISCR.

And, at least on the surface, there was economic sense behind the Kiwi Share, too. After all, some of Telecom's core business at that time was a natural monopoly, and there was no history of competition for most of its other services in the New Zealand market.

But now, a decade on, what is the place of the Kiwi Share?

It attempts a mixture of functions. Since 1990 the Kiwi Share has:

- limited any rise in household access charges for telephones to the rate of inflation
- enforced the presence of a free local calling option
- required that rural household access charges are the same as those of urban households.

The economics behind the limit on the access charge is straightforward: it is an example of dealing with market power through cpi-x price regulation (with "x" in this case being zero).

The purpose of a mandatory free local calling option is less clear. Apart from dealing with a political "hot button", there are three possible motivations.

First, the free-call option could be construed as part of the cpi-x regulation, since it ensures that only one element of the tariff - the regulated access charge - can change.

Second, it could be designed to improve the economic performance of the local calling market by ensuring greater penetration of telephones. The rationale would be that it benefits all users when there are more people on the network. This explanation seems implausible, however, since even in 1990 roughly 96% of households had telephones. Also, it is the combined cost of access and usage that determines telephone penetration.

(With hindsight it can be argued, however, that free local calling has assisted penetration of the Internet. The OECD has identified just such a connection, and New Zealand ranks very highly in Internet penetration compared to other countries. This has beneficial effects on the Internet network, as e-mail is of more use the more persons and firms that use it.)

The third possible explanation of ensuring free local calls is that the government was cross-subsidising from households that make few calls to those that make a large number (or relatively long) local calls. This would favour large households, particularly those with children.

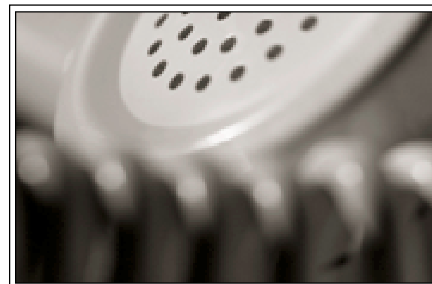
Whatever the motivation or the benefits identified with hindsight, it is not obvious that regulation is needed to enforce the free-calling option. Suppliers often offer zero usage charges as a choice where there is wide variation in usage: note, for example, the "all you can eat" Internet charges for a flat monthly access fee.

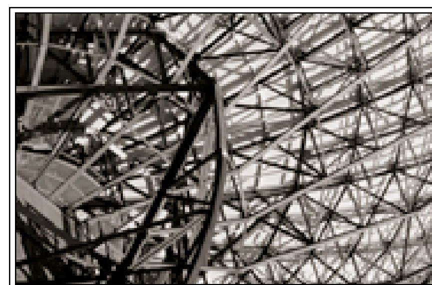
Finally, what do we make of the "universal service" obligation that requires Telecom to offer urban and rural customers the same terms and conditions?

The costs of telecommunication networks are very sensitive to customer density: cities are much cheaper to serve than sparsely populated areas. The Kiwi Share therefore ensures a cross-subsidy to rural consumers at the expense of urban telephone subscribers - although the actual amount of the cross-subsidy is controversial. Business telephone users may also be subsidising rural residents.

The purpose of universal service is difficult to define. It is not a subsidy of the less well off by the wealthy: is it likely that high-country farm owners are less well off than low-income households in suburbs? Even if it were true that the average rural household is less well off than the average urban household, there would be significant anomalies within that generality. And anyway, the social welfare system has made telephony benefits available and targets low-income households more directly, more efficiently, and without discrimination on the basis of location.

There must be some other basis for universal service. It is sometimes motivated by "ubiquity", whereby the government deems every person or household to have the same right to have the same access to telephones. Whether this merely recasts the equity or network externality motivations in other terms is never clear, but it is used to justify cross-subsidies between groups of households.





This issue is more topical now than it was in 1990. Telecom's so-called natural monopoly in local telephony is being rapidly whittled away by technology and competition. Competition will make universal service in its present form unsustainable: the profitable sectors are the first to be attacked by competition, and the money available for cross subsidies disappears. (Note, for example, that urban, not rural, subscribers are targeted by the new entrant Telstra-Saturn.)

In a competitive industry, what criterion should a government use to design universal service? Because of its transfers between households, universal service essentially entails taxes and subsidies. The optimally designed universal-service system would have taxes and subsidies that have minimal effects on investment and usage, except where change is to be induced deliberately.

Such taxes and subsidies would be forward-looking, because past decisions (investments, for example) are sunk and cannot be affected. They would also be confined to the telecommunications industry in order to minimise effects elsewhere, although more efficient taxes may exist elsewhere in the economy.

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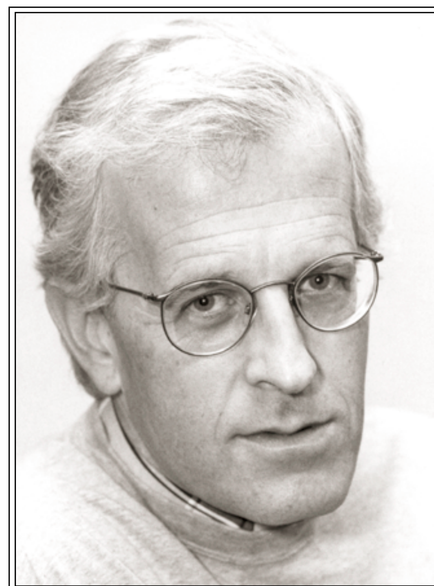
GUEST ARTICLE

NORTH AMERICA'S

VALUES-LADEN MERGERS POLICY[1]

Businesses in the United States and Canada are facing new uncertainties as they adjust to changes in how economic efficiency is taken into account when regulators consider merger proposals, Prof Frank Mathewson[2] writes from Canada.



FRANK MATHEWSON

Efficiencies and synergies are prominent in any review of a proposed merger, since they can be the reason for merging in the first place: the parties hope somehow to do something better after the merger.

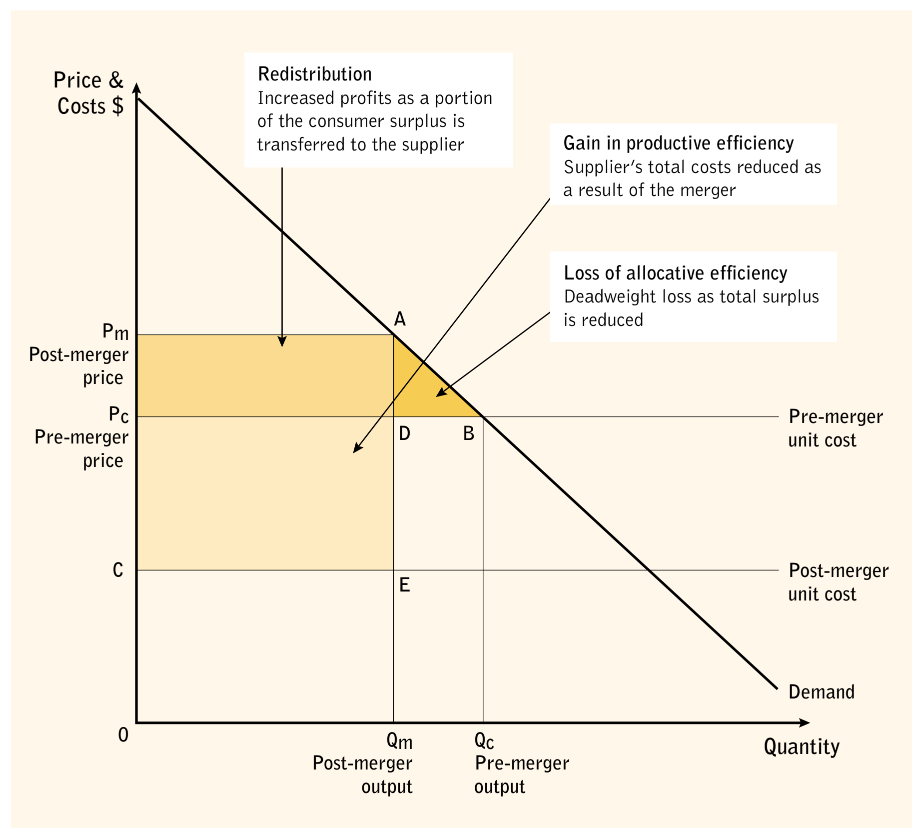
Efficiencies become critical when the merger also leads to a substantial lessening of competition. Do the pro-efficiency gains outweigh the anti-competitive losses? If yes, should competition authorities permit the merger to proceed? A "yes" answer to this last question constitutes the "efficiency defence".

There is considerable agreement among economists on how to measure the gains and losses when assessing an efficiency defence. They apply a "welfare metric" that balances losses and gains to compare the "total surplus" before and after the merger.

Surplus to the shareholders of the merging parties is the profits earned by the merged entity. Surplus to consumers is the value that they attach to consuming the product relative to the price that they pay. Total surplus is the sum of these two surpluses. A merger would pass muster if the post-merger sum were larger than the pre-merger sum.

Crucial to the analysis is that, when a dollar is transferred from a buyer to a seller, no value judgement is made on who is more "deserving" or in whose hands this dollar has greater value. The size of the cake is the key; how it is divided is not relevant to determining total surplus.

Suppose that a merger reduces competition and increases prices (as in the illustration,[3] where the post-merger price rises through reduced competition, and post-merger costs fall through efficiency).[4]



In this case, the lost surplus and reduced allocative efficiency are represented by the value that would otherwise have been received by consumers who are now priced out of the market (the triangle ABD). This is the "deadweight loss" from the merger.

This loss is balanced against any efficiencies that uniquely result from the merger. In the diagram, the added efficiency gained by the merged companies is the rectangle P_CDEC.

Notice that the higher price transfers some surplus from consumers who continue to buy the product to the shareholders of the merged entity (the rectangle P_MADP_C shifts from consumers to the producers). These consumers willingly pay the higher price for the good; the economic analysis counts this transfer of surplus as neutral because the surplus remains in the economy.

In the example shown in the diagram, the gain to producers outweighs the losses to consumers, and the values-neutral economist would approve the merger.

The Canadian Competition Bureau, which is responsible for implementing competition policy in Canada, has moved from a clear and focused position along these lines to one that is much less certain.

Canada's law says the Competition Tribunal must approve a merger if it brings about gains in efficiency that are greater than, and offset, any prevention or lessening of competition, provided that these gains are not likely to be attained without the merger.

In other words, a merger that substantially

lessens competition that might otherwise require a remedy or even be prohibited can be permitted if the efficiency gain is large enough.

But a series of announcements from the Canadian Competition Bureau has confused this relatively simple picture.

In September 1999, the current head of the Bureau (the Commissioner) stated that no merger to monopoly could ever bring about gains in efficiency sufficient to offset the reduced competition. (Under this presumption, the merger illustrated in the diagram would be disallowed, despite passing the "total surplus" test.)

Recently, the Bureau has stated that a non-monopoly merger that substantially lessens competition but that passes the "total surplus" standard will be passed to the Competition Tribunal to determine the appropriate welfare metric to assess the merger. In other words, the Tribunal is to make value judgements about the income redistribution that results from the merger.

For this, the chief economist of the Bureau proposes a two-stage test. At Stage 1, if buyers of the relevant products are similar and the quantity that they purchase is virtually independent of their income levels, then the conventional total surplus standard will apply. If this is not so, then at Stage 2 the Bureau will seek to assess whether the transfers arising from the merger can be considered to be neutral.

These statements are confusing and raise a number of concerns. For example, a merger to monopoly with sufficient cost savings unique to the merger *could* produce a reduction in price (a combination of enhanced market power plus a sufficient cost reduction can produce, on balance, a price reduction). Would such a merger be challenged?

Further, consider firms' strategy in deciding whether to refer such cases to the Tribunal. These cases are time-intensive and expensive. The prospect of an additional hearing so the Tribunal can rule on income-distribution issues may lead parties to abandon efficiency-enhancing mergers. This would be tantamount to blocking the proposed merger without a hearing.

This raises another question. What special tools and analysis lie in the hands of the members of the Competition Tribunal (judges of the Federal Court and appointed lay members) that permit them to opine on matters of redistribution? Income and wealth distribution is traditionally left to Parliament to determine.

Next, consider the two-stage test. There are serious difficulties in determining whether demands for products are income-neutral. Even if this could be determined, why should a different standard apply to mergers where products are income-neutral (say pharmaceutical products for severe illnesses) from those where products are income-sensitive (high-performance automobiles)? If standards are to vary, what should they be, who should set them, and what guarantees consistency through time with different Tribunal panels?

The end result is that the clear and unambiguous welfare metric in the Canadian statute has been set aside for a series of unclear and ambiguous statements.

"THE CLEAR AND UNAMBIGUOUS WELFARE METRIC IN THE CANADIAN STATUTE HAS BEEN SET ASIDE FOR A SERIES OF UNCLEAR AND AMBIGUOUS STATEMENTS"

On 30 August 2000, the Canadian Competition Tribunal rendered a decision on a contested merger (*The Commissioner of Competition v. Superior Propane Inc., 2000* Comp.Trib 15). While the majority adopted the total surplus standard, the decision was not unanimous. The majority ruled in favour of the merger, finding that the proposal would yield annual efficiencies of approximately $29.2 million for 10 years, with a maximum annual deadweight loss of $3 million over the same period.

The majority rejected the suggestion that distributional consideration should have any weight in the trade-off analysis, or that different values could be attached to dollars gained by shareholders and lost by consumers. The majority also rejected the Commissioner's position that, as a matter of law, efficiencies could never save a merger to monopoly.

One member of the Tribunal dissented. This member found that the parties to the proposed merger failed to meet the required burden of proof, as they had not presented convincing evidence that the claimed efficiencies would be realised and that wealth transfers should not be excluded from the trade-off analysis.

Meanwhile, a different move is being made in the United States. In April 1997, the US agencies revised their Horizontal Merger Guidelines. The revised section points out that competition drives firms to achieve efficiencies. The Guidelines spell out that the agency reviewing the merger will ask whether the measurable and verifiable ("cognizable") efficiencies are big enough to reverse any anti-competitive effect: in other words, are the efficiencies so large that consumer prices will not rise?

Notice that this is a more demanding hurdle than the one set out in the Canadian guidelines, where prices can rise provided efficiencies are larger in magnitude than the corresponding lost consumer surplus. In the US, the efficiencies must be sufficient to guarantee no price increase, whatever the effect on total surplus and thus total welfare.

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1 A fuller version of this article is available on the NZISCR website at www.iscr.org.nz under "research".

2 Frank Mathewson is Professor (Economics), Director of the Institute for Policy Analysis (University of Toronto), and Senior Consultant, Charles River Associates.

3 The diagram is adapted from Williamson, O E (1977), "Economies as an Antitrust Defence: The Welfare Tradeoffs", American Economic Review, vol. 58, pp 18-36, as reproduced by Dr Michael Pickford (February 1998), "The Evaluation of Public Benefit and Detriment Under the Commerce Act", Occasional Paper 7, New Zealand Commerce Commission.

4 The diagram makes a number of simplifying assumptions, according to Pickford (ibid.), including that the market contains two firms producing a standardised good; both firms have the same, constant unit costs of production; there are substantial barriers to entry and no imports; and the price is competitive before the firms merge.

Prof Frank Mathewson will be in New Zealand for NZISCR's conference "Competition Law at the Turn of the Century" in Wellington in November. For details, see page 11.

A NEW ZEALAND PERSPECTIVE ON THE EFFICIENCIES DEFENCE[1]

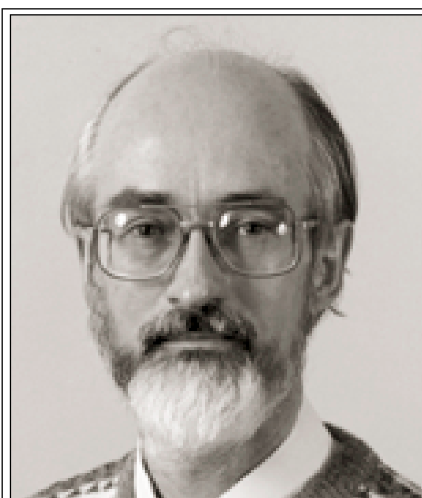
New Zealand's current competition laws, like Canada's, are comparatively new. The Commerce Act (the "Act") and Canada's Competition Act were both passed in 1986. New Zealand's law recognises the "efficiencies defence" described by Prof Mathewson in his article (pages 6 and 7), but applies it in a special context, write Mark Berry and Michael Pickford.[2]

Where a merger is likely to result in a position of market dominance, the parties may apply to the Commerce Commission (the "Commission") under section 67 for authorisation prior to implementation. As part of the authorisation procedure, the Commission then identifies and weighs the detriments likely from achieving dominance, and balances those against the public benefits likely from the merger as a whole.

Thus, there are striking similarities between the New Zealand position, section 96 of the Canadian Competition Act and the US governmental guidelines described in Prof Mathewson's paper. New Zealand's approach, however, is more tolerant toward mergers claiming efficiencies than is apparently the case in Canada. Indeed, seven mergers have been authorised on public benefit grounds.

The Commission, mindful of the wording of the Act, considers that a public benefit is any gain, and a detriment is any loss, to the public of New Zealand, with an emphasis on gains and losses being measured in terms of economic efficiency. Since 1990, it has been explicit in the statute that efficiencies must be taken into account in assessing public benefits. If the Commission is satisfied that the benefits outweigh the detriments, the proposed merger will be authorised.

In the early 1990s, the treatment of changes in the distribution of income was contentious. This has been resolved in favour of neutrality: a gain by one group at the expense of another is viewed as being not directly relevant to efficiency. However, it is recognised that income transfers caused by monopoly pricing do provide margins that could be absorbed by production inefficiencies. For example, there may be rent-seeking by managers and others in the merged entity, leading to the dissipation of rents through inflated costs. Similarly, because of the New Zealand focus, profits repatriated overseas (less local taxes paid) are apt to be regarded as a welfare loss unless offset by subsequent actions by those investors which advantage New Zealand.


MIKE PICKFORD

MARK BERRY

Since the *Air New Zealand/Ansett* decision of 1996, the Commission, in response to the observations of Richardson J in *Telecom v Commerce Commission*, has attempted to quantify benefits and detriments where feasible, rather than rely on intuition in balancing them.

In order to assess benefits and detriments, it is critical to establish an appropriate "counterfactual"; that is, a comparison has to be made between two hypothetical future situations, one with and one without the merger, with the differences between them being attributed to the impact of the merger.

Time scales of up to five years ahead have been used in assessing benefits and detriments. Applicants' claims for benefits often look forward a few years following the merger; the Commission tends to assume that detriments will follow similar trends.

In assessing the magnitude of the potential detriments, the Commission normally considers three potential losses of efficiency, namely allocative, productive and dynamic inefficiencies.

With **allocative inefficiency**, the aim is to quantify the size of the "deadweight loss triangle" (see the diagram that accompanies Prof Mathewson's article). That depends on the price elasticity of market demand and of supply (that is, how buyers and suppliers respond to price changes), the anticipated size of the price rise post-merger, and the size of the market measured by the total outlay. A model is constructed that is intended to reflect the structure of the market in question as far as information permits.

Productive inefficiency is considered likely when a firm acquires a dominant position in a market, because it lacks the competitive pressures to remain efficient. Organisational slack may creep into its operations, salaries and benefits may become inflated, and costs in general may increase, because satisfactory profit is achieved even at less than full efficiency.

In assessing such potential losses to the economy, the Commission focuses upon those costs of the merged entity that are likely to be susceptible to inefficiency. For example, the costs of bought-in raw materials are less likely to be affected by market power than those related to the entity's own manufacturing and distribution operations.

Applicants often argue various reasons why their industry would be less prone to productive inefficiency - such as an export orientation, the constraints posed by a co-operative form of organisation, or peripheral competition from other products that are not quite close enough substitutes to be included in the original market definition.

Dynamic inefficiency considers whether the merged entity's adoption of superior new technology (reducing costs) and improved products (better meeting consumer wants) may be retarded by the merger. In assessing the possible losses from reduced dynamic efficiency, the Commission takes into account the degree of intrinsic dynamism in the industry as a whole. This includes advances in technology and in products, the sources of that dynamism (whether internally or externally generated), the frequency of product innovation, and the level of research intensity (sums spent on R&D). The Commission recognises that predictions on dynamic efficiency losses are notoriously difficult to make, and hence allows a relatively wide range of possible outcomes.

The onus is upon the applicants to establish that their proposed mergers will generate a net public benefit, and hence much space in applications is generally devoted to laying out benefit claims, usually supported by the work of independent economic experts. Experience suggests that these benefit claims are likely to be over-stated, the difficulties of obtaining them understated, and the scope for making similar gains in the absence of the proposal sometimes overlooked. While the Commission is prepared to entertain a wide variety of benefit claims, it has always taken a sceptical stance towards claims. To be acceptable, claims must be plausible, generally supported by detailed evidence, and with a demonstrable nexus between the benefits claimed and the proposed merger.

The Commission has expressed scepticism where substantial benefits are claimed to appear immediately, when it is evident that they could only be achieved gradually and at some cost and effort. Claimed benefits often overlook the difficulties that many mergers experience in trying to integrate the disparate activities of two firms with different cultures, especially where one firm is being acquired rather than being an equal merger partner. There may be too many issues for management to deal with simultaneously.

Also, the benefits must be "real" rather than "pecuniary" ones. That is, they must lead to savings in inputs used, rather than merely reflect the superior buying power of the merged entity.

In summary, significant complexities and uncertainties surround the efficiencies defence in New Zealand. Nonetheless, in accordance with the spirit of the Commerce Act, authorisation of an otherwise unlawful merger on efficiency grounds is a distinct possibility in New Zealand.

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1 *A fuller version of this article is available on the NZISCR website at www.iscr.org.nz under "research".*

2 *Mark Berry is Deputy Chairman of the Commerce Commission and a research principal at NZISCR. Michael Pickford is Chief Economist of the Commerce Commission.*

KIWI SHARE, from page 5

Finally, because the existence of taxes and subsidies commonly create misrepresentation of positions and costs, it has been suggested that the efficient way to implement universal service is to get firms to bid for the right to supply it.

What, then, does the Telecommunications Inquiry propose for the Kiwi Share? Its key recommendations are to retain two of the three elements of the Kiwi Share, and continue to enforce them only on Telecom. Thus the cpi-x price cap and the free-local calling option would remain, but rural and urban access charges would be decoupled (enabling the monthly rental for urban households to be lower than for rural customers).

A central feature of this proposal is that it retains the universal service requirement - because rural charges are still subject to cpi-x price controls - and continues to impose the requirement only on the incumbent, Telecom. Yet if universal service requirements were the outcome of efficiently designed transfers through taxes and subsidies, it would be neutral as to which firms carry the obligations.

Investment in and maintenance of rural networks will be affected where price is less than cost. Even if rural consumers are willing to pay for upgrades, Telecom is unable to charge for them, and given competition elsewhere in telecommunications it will be difficult to cross-subsidise them, even if its shareholders are philanthropic. A price cap imposed only on Telecom renders its development, and even maintenance, of the existing rural network uneconomic.

New Zealand's relatively high uptake of the Internet also occurs in rural areas, but rural consumers have complained about services. This is not a peculiarly New Zealand issue: the problem already occurs in sparsely populated portions of the United States. A Public Utility Commissioner told me in July that in Montana the telecommunications service of small towns is deteriorating and outages resulting from low investment in infrastructure are quite common under price regulation.

The report of the Telecommunications Inquiry does not lay down a forward-looking universal service framework. It is correct when it says that Telecom's buyers knew about the Kiwi Share and could take account of it, but that is hardly relevant to setting a framework for the future of the telecommunications industry. The past is history and unchangeable.

Of much greater importance looking forward is the effect on any company of changing the regulatory rules now and in the future. The threat of major regulatory change creates uncertainty that inhibits investment and maintenance. Carrying out the threat strengthens the uncertainty, since regulators and regulatory policies will come and go in the future. The report pays scant regard to this factor.

The Inquiry advocates retaining the free local calling option. As discussed above, there appears to be little basis for mandating such an option - and indeed it is contrary in principle to the Government's express wish that in electricity fixed charges should be low relative to usage charges.

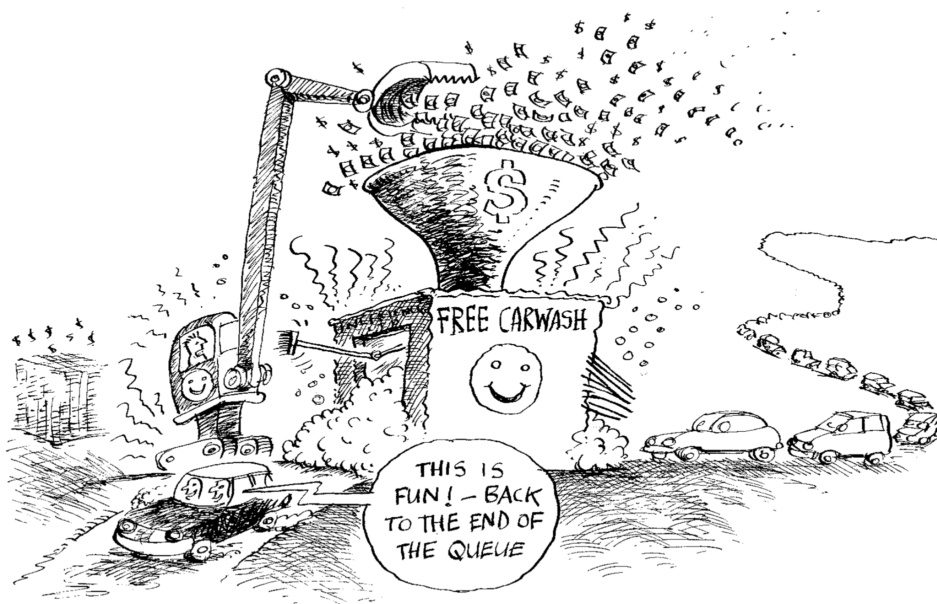
But there may be some merit in zero-price usage charges for local telephony access because of external benefits that attend expanding the network of active Internet users. Again, however, if the outcome is beneficial why restrict the obligation to Telecom? Also, given the huge volume of use generated by the Internet, it is likely that "all you can eat" pricing may be applied to local usage in any event.

Because competitors are bundling services in packages and because the terms of the restriction are unclear - is the Kiwi Share tariff still applicable if Telecom leases its lines out? - the competition effects of imposing this restriction on Telecom alone are difficult to assess.

The report of the Inquiry does not proscribe universal service for the distant future. This is understandable given the rapidly changing products of electronic communication. But the purposes of its universal service proposals are not provided, and the proposals do neglect getting current investment incentives right in order to create a bright future in electronic communications for all citizens.

SHOULD COLLUSION BE ILLEGAL
WHEN IT IMPROVES ECONOMIC EFFICIENCY?

Economic efficiency was increased by collusion relating to the removal of a free car wash offer in Auckland, argue Professors Lewis Evans and Neil Quigley.[1] They suggest that punishing collusion that increases economic efficiency calls into question the deeming provisions of section 30 of the Commerce Act, and the validity of a process that considers harm when assessing the penalty, but not when deciding liability.



Beginning in 1994, the offer of a free car wash with a $20 purchase of petrol became widely used as a promotion to increase petrol sales and increase acceptance of the use of car washes at service stations in Auckland and in other parts of New Zealand. At the end of May 1996, Caltex, Mobil and Shell simultaneously ceased to offer free car washes in the Auckland area.

The Commerce Commission claimed that the oil companies had reached an agreement to remove the free car wash offer and that this was a breach of s.30 of the Commerce Act 1986. In October 1999 the High Court upheld the Commerce Commission's claims against Caltex, Mobil and Shell, and in February 2000 it levied penalties of $450,000, $350,000 and $375,000 respectively on these three companies.

This case has a number of intriguing features:

- The High Court took the view that the free car wash was part of the consideration received by motorists purchasing $20 worth of petrol, which has interesting implications for many similar marketing promotions in other markets. The Court further found that an agreement to remove free car washes constituted an arrangement to fix prices, even though there was no arrangement relating to the prices that would be set after the free car wash offer was removed.
- The arrangement itself resulted from a number of very informal conversations between middle-management employees of the three oil companies. These conversations were, in the words of the High Court, sufficient to establish an understanding that constituted collusion on price, since they established that the three oil companies "knew that the others were moving to remove their free car washes at the time each gave their direction to do so".
- The Court held that the defendants' attempts to show that no harm was caused (in terms of the Commerce Act, that efficiency was not reduced by their actions) were irrelevant, since s.30 of the Commerce Act deems any price-fixing arrangements to be illegal.

Efficiency and the Commerce Act

The view of the Ministry of Commerce is that " ... the underlying objective of the Commerce Act is economic efficiency, with the protection of competitive processes being the means to achieve it."[2] The Ministry has also expressed the view that penalties set must reflect the harm that was caused. From the perspective of economics, efficiency must have been reduced for harm to have resulted from the removal of free car washes.

Explicit in the finding of the High Court is a recognition that efficiency may not have been reduced by the actions of the oil companies. Salmon J said: "There is also much to be said in my view for the submission on behalf of the defendants that the removal of the offer increased efficiency in the use of resources...Thus [in some respects the] .... objectives of the Commerce Act were met, but the fact remains that as a result of the deeming provision of s.30 of the Act, the action that was taken must in legal terms be said to have lessened competition."[3]

More important still, the evidence suggests that collusion to remove free car washes may actually have increased economic efficiency. The fact that the Commerce Act deems behaviour that may improve economic efficiency illegal raises fundamental questions about the internal consistency of the Commerce Act and the value of deeming provisions more generally.

Efficiency was enhanced by the removal of free car washes

Low prices are not necessarily efficient. The marginal cost of providing a basic car wash is in the range from 50c to $1.00, so the offer of a free car wash meant that:

- variable costs (electricity, water, soap) were not covered
- the costs of the car wash were subsidised from other aspects of the service station operations (petrol or shop sales).

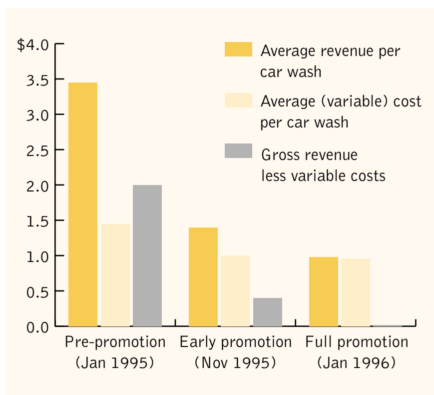
Equally, the car wash promotion produced inefficient allocations of resources and inefficient behaviour by consumers because:

- more car washes were consumed than would have been the case had the car washes been priced at their marginal cost

- consumers who would have benefited from (and been willing to pay for) better washes chose the free car wash option because of the subsidy associated with the price of that option.

Consequently, when the oil companies made their cheapest car washes free, many people traded down to free washes. The number of car washes consumed increased dramatically, and the allocation of resources to car washes was not that which would have been associated with the efficient pricing of car washes. In addition, with a requirement to provide free car washes, the oil companies did not have the same incentives to invest in new car wash technology that would have applied if all washes were priced at or above marginal cost.

When the free-wash offer ended, normal consumption patterns (and, in the longer run, normal investment patterns) returned. The hidden cross-subsidies ended. People who didn't value car washes stopped wasting soap, water and electricity. People who valued high-quality car washes started enjoying them again.



The efficiency of per se rules

Rules that identify particular behaviours as being per se illegal, such as the deeming provisions of s.30 of the Commerce Act, have the effect of limiting the range of evidence that may be considered by the Court. In particular, per se rules preclude consideration of "rule of reason" arguments about the public benefits and detriments of a behaviour. The literature in law and economics suggests that per se rules may reduce transactions costs by reducing the scope of investigations, avoiding the need for (imperfect) judicial decision-making and providing certainty on questions of legality. Per se rules may also be efficient where the behaviours deemed illegal are thought to have high social costs and few countervailing benefits, especially where actions are difficult to detect. But where it is credible that co-operation between firms may lead to more superior markets, the efficiency of per se rules must be questioned.

In particular, a per se rule such as the deeming provision of s.30:

- does not increase certainty for firms. In fact, per se illegality simply shifts uncertainty from judicial decision-making to the question of whether the Commerce Commission will choose to bring an action against companies for particular types of behaviour
- does not increase dynamic efficiency in markets, if efficient decision-making requires some form of co-operation between market participants
- does not reduce litigation costs. In the car wash case, the deeming provisions did not preclude the parties to the proceeding employing a range of experts including economists; it simply meant that their views about the efficiency of the actions taken were not relevant until the penalty-setting phase of the hearing
- removes efficiency from the Court's consideration of liability but not from the Court's determination of the penalty. Only if companies do not care about convictions but do care about pecuniary penalties are the incentives facing firms improved by deeming actions illegal and then subsequently considering efficiency when assessing penalties.

Conclusion

The car wash case has highlighted an internal inconsistency in the provisions of the Commerce Act. The aim of the Act is to promote economic efficiency, but s.30 may deem to be illegal actions that improve efficiency. It may also result in efficiency being considered in relation to the setting of penalties, even though it was not considered when liability was being determined. Both the evidence from the car wash case and the views expressed by the Court raise serious doubts about the efficiency of limitations on rule of reason arguments in competition matters.

1 *Evans and Quigley advised counsel for Caltex on their submission relating to the setting of penalties in this case, but none of their views should be attributed to Caltex or their counsel.*

2 *Ministry of Commerce 1998.*

3 *Salmon J CL 33/97, 15 February 2000 at 10.*

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domainnameportabilityissue.co.nz

Proposed changes to the governance of the Internet in New Zealand might give undue power to Internet Service Providers (ISPs) and may fall foul of the Commerce Act, a study by ISCR[1] has found. At the heart of the issue are proposed changes to the governance of the Domain Name Register that may threaten the portability of domain names. At present, the Domain Name Register is maintained by the nonprofit Internet Society of New Zealand (ISOCNZ) through its subsidiary Domainz. It is the exclusive New Zealand agent for assigning internationally compatible domain names.

Currently, there is no portability problem. The property right to your domain name is granted by Domainz to you and is entirely separate from and portable between ISPs. For example, the Jones Corporation Ltd can keep "jonescorp.co.nz" for as long as it likes, no matter how many times it changes ISPs. Domainz, because it is independent, has no commercial interest in who Jonescorp's ISP is, and thus has no reason to block Jonescorp's transfer between ISPs.

Contrast this with the controversial number-portability issue in telephony. You must change phone numbers if you change telephone providers. The Commerce Commission has identified that the absence of number portability creates an unacceptable barrier to entry.

But under the shared registry system proposed for the Domain Name Register, in which ISPs can register names on behalf of Internet users, a "domain name portability problem" becomes a distinct possibility. To guard against this occurring, a satisfactory governance structure binding the activities of all potential registration agents must be put in place.

How does this portability problem arise? The shared registry proposes that agents (ISPs) would take control of registering domain names. At the moment, the only function ISPs have in the registration process is to provide the IP address of their server to the Register in order to match the user's domain name with the ISP's server. Under the shared registry proposal, however, ISPs would control both access to domain names and access to the Internet.

Currently, Domainz grants the property right

to the domain name holder (jonescorp.co.nz), under a shared register. But in future an ISP agent may place conditions around the property right to the domain name, unless this is controlled by strict governance arrangements. For example, an ISP might withhold the use of jonescorp.co.nz if Jones decided to switch ISPs. This creates the domain name portability problem.

In the case of domain names, the costs may not just be limited to the inconvenience of reprinting stationery and amending numbers in a directory. Domain names are often an intrinsic part of a company's branding.

Why would an ISP want to maintain a hold on its customers by making it difficult for them to switch to a competitor? ISPs make their money from the amount of Internet traffic passing through their servers. To make more money, they must either increase the traffic, or lever more value out of the traffic they already have.

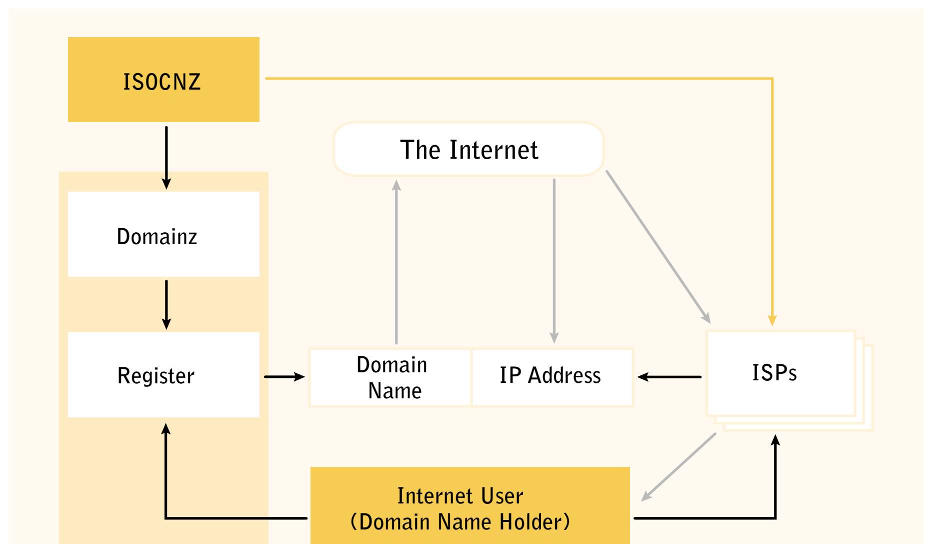
One potential way to increase revenue is to require a transfer fee from the user for releasing their domain name to another ISP. Hence, access to the Internet can be subject to hold-up through a conflict of interest between the ISP as a registration agent and the ISP as an Internet access agent.

Under the current single, independent registry system, there is no commercial interest in restricting the transfer of domain names between ISPs.

This is not to deny that the proposal to combine registration and access would have some benefits. The "seamless service" may reduce transactions costs. Furthermore, competition among ISP agents might also drive down the price of registering a domain name. However, these potential efficiency gains could be lost unless there are constraints on ISP behaviour to prevent the opportunity for hold-up of the kind outlined above.

If ISOCNZ adopts the shared registry proposal, it must also ensure that its governance structure will address this issue. If not, the efficiency benefits of the shared registry will not be realised.

1 Boles de Boer, David; Lewis Evans and Bronwyn Howell, "Governance of the Internet: emerging issues", New Zealand Institute for the Study of Competition and Regulation Inc, July 2000. Available under "research" at www.iscr.org.nz



The two dark yellow boxes in this diagram are principals. The other boxes represent agents working on behalf of the principals. Under the proposal to combine Internet registration and access, ISPs assume the Register function (via the yellow line) as agents of ISOCNZ, eliminating the two functions in the box at left. This is potentially more efficient, but may create conflicts of interest for ISPs, as they become agents to both principals.