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The Effects of Smallness and Remoteness on Competition Law- The Case of New Zealand

*Michal S. Gal**

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Abstract

The economic characteristics of an economy- most notably its size, its openness to trade and its remoteness from its trading partners, greatly affect the competitiveness and performance of its markets by reducing internal and external competitive pressures. Accordingly, small, insulated economies should devise appropriate policies that offset at least some of these effects. This paper analyzes some of the effects of smallness and remoteness on optimal competition law. The first part provides a basis for the discussion by surveying the basic economic effects of small market size. The second part builds upon these observations to analyze some of the major effects of small size on optimal competition law. In particular, a dichotomy is suggested between cases in which small size affects the *content* of the rules and those in which small size only *strengthens* the need for the adoption of a certain rule. The article exemplifies these general principles by focusing on New Zealand's competition law in an attempt to seek whether, and to what extent, such law is actually attuned to the effects of small, open, remote markets.

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INTRODUCTION

Competition is the corner-stone of laissez-faire societies. The free market economy is based on the assumption that the market's invisible hand is generally a far more powerful guardian of social welfare than any other form of regulation. Competition not only promotes economic efficiency, but also non-purely economic goals such as the dispersion of economic opportunity, limitation of undue influences on the political system and the strengthening of individual freedoms. Competition law is the main legal tool that ensures that competition takes its course, whenever possible.

Yet for competition to achieve these goals, certain market conditions must exist, including a sufficiently large number of actual or potential competitors that create significant competitive constraints. Where such conditions do not exist, or they are limited, competition might not work effectively. Accordingly, competition law should be fitted to the specific market conditions of each country in which it is applied.

Leading economists, including Nobel Laureate Michael Spence, have long recognized the effects of the small size of a domestic market on the economic characteristics and performance of markets. They concluded that the fundamental structural traits of small economies are so pronounced that small economies belong to a “different class of market economies.”¹ In light of this conclusion, this article attempts to deal with the question of how this “different class of market economies” impacts on competition law. In particular- does New Zealand competition law deal effectively with the special characteristics of its economy resulting from small size and remoteness from major markets.

The first part of the article provides a basis for this discussion by surveying the basic economic effects of small market size. The second part builds upon these observations to analyze some of the major effects of small size on optimal competition law. In particular, a dichotomy is suggested between cases in which small size affects the *content* of the rules and those cases in which small size only *strengthens* the case for the adoption of a certain rule. The article exemplifies the applicability of these general principles by focusing on New Zealand's competition law in an attempt to seek whether, and to what extent, such law is actually attuned to the effects of small, remote markets.

Although the examples focus on New Zealand, they are also of much relevance to other small and remote jurisdictions, such as Australia, as well. Despite its much larger population, Australia also exhibits traits of a small economy, as many of its markets are highly concentrated. This is due to the concentration of population in several dispersed centers over a large land mass, which often creates concentrated regional markets. In addition, New Zealand and Australian competition laws are similar in many respects, so

¹ Richard E. Caves, Michael E. Porter, A. Michael Spence and John T. Scott, *Competition in the Open Economy- A Model Applied to Canada* (Cambridge, Mass.: Harvard University Press, 1980), p. 5.

that the interpretation and application of one often provides important insights for the other.

PART I: THE SPECIAL ECONOMIC TRAITS OF SMALL MARKET ECONOMIES

What makes small economies a "special case of market economies"? This part seeks to answer this question. It defines what constitutes a small market economy and presents its key economic characteristics. As these characteristics have been surveyed in length elsewhere, I will only briefly survey them herewith.²

1. WHAT CONSTITUTES A SMALL MARKET ECONOMY?

Let us first define what constitutes a "small market economy." For the definition to be meaningful for competition law, it should focus on what is significant for it: market conduct and performance. The suggested definition, therefore, is as follows: a small economy is an independent sovereign jurisdiction that can support only a small number of competitors in most of its industries, when catering to demand. This definition captures the fundamental trait of smallness- the highly concentrated nature of most of its markets.

The definition is arbitrary in the sense that there is no "magic number" that distinguishes a small economy from a large one. Jurisdictions can be placed on a continuum in accordance to their size. Some jurisdictions are very small, such as Faro Islands (with a population of approximately 40,000) and Malta (350,000). New Zealand is also a small economy, but is much larger given a population of approximately 4 million. Of course, the smaller the economy the more concentrated its industries are likely to be and *vice versa*. Yet all small economies are characterized by monopolistic or oligopolistic structures in most of their industries.

Market size is influenced by three main factors: population size, the height of trade barriers and population dispersion.³ Small population size decreases domestic demand and reduces the number of firms that can efficiently serve the market. Population dispersion over a large geographic size is also an important factor, as it may create several small local markets within a geographically large jurisdiction, as in the case of Australia.

The size of an economy is also influenced by the height of its artificial and natural trade barriers. Primarily, the relevance of the jurisdiction in economic analysis is dependent on the international trade environment in which it is placed. Liechtenstein, Andorra and

² Michal S. Gal, *Competition Policy for Small Market Economies* (Harvard University Press, 2003). See also Michal S. Gal, "Size Does Matter: General Policy Prescriptions for Optimal Competition Rules in Small Economies," (2001) 73 *University of Southern California Law Review* 1468.

³ Of course, this list is not exclusive. Nonetheless, the three factors suggested above have the most significant influence on concentration levels in most industrially developed economies.

Monaco, for example, are so economically integrated with their larger neighboring states that they can be economically regarded as part of their markets. In these jurisdictions a high degree of trade negates a conclusion of smallness, based on population size alone. New Zealand is an island economy which is quite remote from major world markets and even its main trading partner, Australia. In fact, as Evans and Hughes show, New Zealand has the most remote position of all OECD countries.⁴ Such remoteness creates natural barriers to trade by increasing transportation costs and reducing the timeliness of supply, thereby decreasing the competitive pressure that foreign firms can exert on domestic markets.⁵ It is noteworthy that most of New Zealand's barriers to trade are natural, rather than government-made. There is very limited reliance on tariffs, quotas or other artificial trade barriers in its trade policy. Yet even such a high degree of openness to trade cannot erase the effects of its remoteness and small size.

It should be emphasized that to be considered small, not all the industries should be highly concentrated. Some industries, such as retail services, are highly competitive even in small economies. Conversely, firms located in small economies might even dominate world markets. In these cases the size of the domestic market does not constrain the scale and scope of production of such firms. Nonetheless, when such firms are the exception rather than the rule, the jurisdiction should still be defined as small.

2. SPECIAL ECONOMIC CHARACTERISTICS OF SMALL MARKET ECONOMIES⁶

Economic research has shown that there are three main economic characteristics of small economies: high industrial concentration levels, high entry barriers, and inefficient levels of production. These characteristics result from the basic handicap of small economies: the large size of minimum efficient scales of production (MES) relative to demand. Naturally, no two small economies are alike. Nonetheless, some regularities in economic phenomena can be found in all small economies.

Small economies are characterized by *high industrial concentration levels* in many of their industries. Industrial concentration signifies the concentration of an industry as determined by the number and size of firms operating in it. One of the main factors that leads to industrial concentration is the size of a unit of production that is just sufficiently large to achieve lowest average costs of production relative to demand. This can be illustrated by a simplified example. Suppose a firm has to produce at least 10,000 units

⁴ Lewis Evans and Patrick Hughes "Competition Policy in Small Distant Open Economies: Some Lessons from the Economics Literature," New Zealand Treasury Working Paper 03/31 (December 2003), p. 1.

⁵ International Monetary Fund, "Sources of Economic Growth in New Zealand: A Comparative Analysis" IMF Country Report No. 04/127 (International Monetary Fund: Washington, 2004). A study conducted by the Australian Treasury also confirms that distance from major trade markets affects the productivity of domestic markets. Bryn Battersby, "Does Distance Matter? The Effect of Geographic Isolation on Productivity Levels" Australian Treasury Working Paper 2006-03, April 2006.

⁶ This chapter is largely based on Gal, *supra*, Chapter 1.

in order to achieve lowest costs, and domestic demand is 20,000, then the market can economically support only two efficient sized firms. If market demand is only 10,000, then the market can support only one efficient sized firm.⁷ The smaller market demand, the fewer production units can operate in the market, and the higher the level of industrial concentration.

Indeed, studies of New Zealand's economy have indicated high levels of industrial concentration. Ratnayake showed that New Zealand manufacturing industries are more concentrated than those of most other countries.⁸ His analysis supports the hypothesis that economies of scale are a major source of concentration. The other determinants of industry concentration are entry barriers, the size of industry, import competition and foreign ownership of industry.

Apart from high concentration levels, smallness of an economy also creates *high entry barriers into its industries*. The main entry barrier is created by scale economies, by the need to produce at levels that cater to a large portion of demand in order to achieve minimum costs. Additional entry barriers can be created by a supply constraint on factors of production. Small population size necessarily constrains the availability of labor, especially skilled labor. Moreover, most, although certainly not all, of the small economies are also small in geographic size. Small geographical size often implies a limited and a less diversified supply of natural, non-reproducible resources, as in the case of New Zealand. In addition, oftentimes small economies also have a small business elite which implies limited competition in the ownership market.

Beyond high concentration levels and high entry barriers, another cause of small economies' inefficiencies is the problem of *sub-optimal levels of production*. A recurring observation in studies of manufacturing industries in small economies is that a considerably larger fraction of all output is produced in sub-optimal volumes and sub-optimal plants, much lower than pure MES considerations would suggest. To illustrate, in the example used above in which demand is 20,000 and costs are minimized at 10,000 units, we might find two firms producing 9,000 units each. Such small-scale operation can have a significant impact on the efficiency of firms if penalties for such operation are significant.

There are numerous reasons for the persistence of sub-optimal plants. Yet economic research has shown that the most influential factor is the high levels of interdependence between firms in concentrated markets. Simply put, the lower the number of firms operating in a market and the higher the barriers to entry, the greater the influence of firms on each other. Firms recognize this by seeking cooperative policies that are more profitable to them than when each firm aggressively seeks a larger market share. Of course, collusive behavior does not necessarily justify sub-optimal production.

⁷ This example assumes, of course, homogenous products.

⁸ Ratnayake (1999), cited in Evans and Hughes, *supra*, footnote 2.

However, the relatively large size of production MES may blunt incentives to adopt efficiency-enhancing measures and creates, in many situations, output levels which are sub-optimal but yet profit-maximizing for the firms.

Indeed, a study conducted by Arnold, Boles de Boer and Evans⁹ concluded that New Zealand, relative to other countries included in the study, generally has the highest total cost to revenue (with smaller firms having a relatively higher ratio than larger firms) and significant diseconomies of scale. These characteristics are those that might reasonably be expected in one of the world's smallest and most geographically isolated developed economies.

Accordingly, the small size of an economy coupled with its distance from its trading partners places a handicap on its economic performance. The small number of competitors in many domestic markets means that competition is likely to be limited with the existence of disproportionately more natural monopolies, dominant firms, and oligopolies than in large economies. Their presence can be expected to have an adverse impact on prices of many goods and services, with knock-on effects where they are also inputs in production. Thus, small economies suffer both from the inability to realize some scale economies and from the lack of competitive conditions in many of their industries.

Market forces alone cannot achieve efficiency in small markets that operate, mainly, by private ordering and that are characterized by high concentration levels and high barriers to entry. In the absence of appropriate regulation, market forces will not, in many cases, sustain a desirable degree and form of competitive discipline among firms in the economy. Even openness to trade is limited in its effect when trade barriers are such that domestic players are not significantly affected by world markets. When this proves to be the case, competition law has an important role in placing pro-efficiency pressures on domestic producers. This was acknowledged in New Zealand in the parliamentary debates preceding the enactment of the Act:

"[B]ecause the economy is small it is more important that [competition] rules exist, so that the consumer is not gouged and left to the mercy of a few suppliers who have rigged prices."¹⁰

Thus, the next part of the article focuses on the effects of small size on competition law.

II. THE EFFECTS OF SMALL SIZE ON COMPETITION LAW¹¹

⁹ Arnold, T, D Boles de Boer and Lewis Evans, "The Structure of New Zealand Industry and its Implications for Competition Law," in M Berry and L. Evans eds. *New Zealand Competition Law at the Turn of the Century* (Wellington: Victoria University of Wellington Press, 2003), Chapter 1.

¹⁰ (1985) 463 N.Z. Parliamentary Debates 4686.

¹¹ Gal, *supra*, chapters 3-6.

1. THE BASIC DILEMMA

These economic characteristics of small economies create a basic dilemma between productive efficiency and competitive conditions. If a given number of firms can operate efficiently in the market, *productive efficiency* requires that the market contain only this given number of firms, all operating at efficient productive levels. Otherwise, firms will operate at diseconomies of scale which would increase their costs, reduce their ability to compete with foreign firms, reduce their international competitiveness and most likely also harm consumers.

At the same time, productive efficiency imperatives often cause industrial concentration in a small market to be high enough to allow some market power to be realized. Higher levels of concentration can also cause income distributions created by increased market power, it can dampen entrepreneurial vigor, and create the social and political malaise that follow from excessive concentration of economic power. Such outcomes might be especially problematic if they enhance the existing distribution of wealth and do not allow new entrepreneurs to enter the market easily. This dilemma affects almost every area of competition policy.

These salient characteristics have important policy implications as they require small economies to devise appropriate policies that offset at least some of the adverse effects of their small size. Accordingly, the law has to be designed to deal effectively with the unique obstacles to competition that are inherent in an economy, including those that stem from small size. New Zealand's government acknowledged this in stating that "the size of the New Zealand economy has to be taken into account when making decisions and considering whether an action is anti-competitive."¹² Given that the market's invisible hand has a much weaker self-correcting tendency, the costs of improper design and application of competition laws might be greater in both the short and the long run.

To be sure, many of the principles and doctrines that apply to large jurisdictions apply equally to small ones. The main goal of competition law- to increase social welfare, and its main tool- competition, are similar. Yet the comparative prevalence of concentrated market structures in a small economy creates a set of trade-offs that may require a different set of rules to regulate market conduct. The economic paradigms on which the competition policies of large economies are based do not necessarily apply to small economies. The main factor that creates the need to tailor competition law to economic size is that competition laws often consist of "fit-all" formulations. Such formulations are designed to achieve the stated goals in each category of cases to which they apply, while recognizing that some false positives and some false negatives may occur at the margin. The marginal cases of large economies constitute, however, the mainstream cases for small economies. The effect of small size is similar to that of a magnifying glass: special market phenomena become more significant as extremes become the rule.

¹² Parliament discussion of Commerce Amendment Bill (27 February 2001), p. 2972.

This requires small economies to change the focus of their competition laws to regulate their markets efficiently.

I suggest two types of effects of small size. First are cases in which small size simply strengthens the need for the adoption of a certain rule. Such a rule would also benefit a large economy- but its adoption is much more important in a small one. The second are cases in which small size changes the content of the rule itself.

2. FIRST CATEGORY: SMALLNESS STRENGTHENS NEED FOR ADOPTION

Example I: Goals of competition law

While there seems to currently exist a world-wide consensus that efficiency should be the primary goal of competition law, the dilemma between efficiency and other social goals, such as distributive justice, is much more pronounced in small economies than in large ones.

In a small economy it is vital that the goals of competition policy be clearly, consciously, and unambiguously defined, and that economic efficiency be given primacy over other goals, at least in most settings.¹³ Goals signal to market participants as well as to regulators how the law should be interpreted and implemented. While goals should always be clear, the special characteristics of small economies increase this need. The reason is that in small economies striking a balance between competing goals raises particularly difficult trade-offs that may create high degrees of uncertainty.

The reason is that in small economies protecting other goals, such as distributive justice and better business opportunities, by way of enabling small competitors to stay in the market regardless of their efficiency, comes at a higher price. In large economies social values are achieved in many cases by a competition law that prevents conduct that significantly limits competition. Competition law thus generally simultaneously achieves the goals of efficiency and more egalitarian income distribution. In a small economy, on the other hand, economies of scale reduce, by definition, the number of firms necessary to supply any given demand and may reduce or altogether eliminate competition in the affected market. The price to be paid by a small economy for enhancing distributive justice goals is thus much higher and involves keeping in the market inefficient firms, and on-going regulation of the market. Accordingly, economic and social objectives may substantially diverge when efficiency dictates displacement of small firms by larger business units.

Efficiency also better enables firms to compete in global markets, or to compete more effectively with foreign firms in their domestic markets. If firms are prevented from

¹³ For a similar conclusion see Lewis Evans, "The Efficiency Test Under Competition Law and Regulation: In the Small Distant Open Economy that is New Zealand," 38(2) *New Zealand Economic Papers* 241 (2004).

reaching levels of production that enable them to reduce their costs, then they would not survive once the market is open to foreign competition, or it would cost the state a high price to subsidize them in order for them to stay alive. An interesting example involves Caribbean rum producers. The Caribbean domestic market for rum is very competitive. At the same time, high distribution and marketing costs in potential foreign markets create significant obstacles to the export of rum. A joint venture among rum producers that enables them to realize scale economies in distribution and marketing abroad and to export rum would increase total welfare if the revenues from sales in other markets are significant. It might also enable firms to achieve scale economies in domestic markets, thereby reducing domestic costs.

Finally, the importance of economic efficiency as a primary objective becomes highlighted in a small economy in which interdependencies in the interests of various stakeholders are likely to be more significantly affected by a particular market transaction. If competition law is influenced by non-economic considerations, the risk of costly interest-group-affected industrial policy in the guise of competition law becomes high.

Accordingly, in small economies social goals should be given little weight in formulating competition law. This is not to say that when not purely economic considerations exist, such as producing a certain product within the jurisdictional borders for security reasons, they should be disregarded. Yet these considerations should be limited in their scope and specifically set out in the appropriate legislation. In addition, competition law should not completely disregard distributional issues. If the increase in efficiency is only passed on to the firm owners and there is no public benefit from it, in the form of lower prices for consumers, higher level of technical knowledge to domestic workers, etc., then the case for allowing the conduct is much weaker.

This concern was recognized in New Zealand in the authorization provisions. In the past, the Commerce Commission's Guidelines to the Analysis of Public Benefits and Detriments provided that when considering "public benefits" the "public" is the public of New Zealand and that benefits to foreigners are to be counted only to the extent that they also involve benefits to New Zealanders.¹⁴ The Guidelines, however, are no longer used, as they have yet to be updated to reflect recent changes in the merger provisions.

Currently, the leading authority is the *Amps-A* decision, in which the High Court stated:

"We reject any view that profits earned by overseas investment in this country are necessarily to be regarded as a drain on New Zealand...[I]mprovements in international efficiency create gains from trade and investment which, from a long-run perspective, benefit the New Zealand public. On the other hand, if there are circumstances in which the exercise of market power gives rise to

¹⁴ Commerce Commission, Guidelines on Public Benefits and Detriments (1994).

functionless monopoly rents, supra-normal profits that arise neither from cost savings nor innovation, and which accrue to overseas shareholders, we think it right to regard these as exploitation of the New Zealand community and to be counted as a detriment to the public."¹⁵

The width of this test focuses on the interpretation of "functionless monopoly rents". The courts seems to suggest that the phrase refers to rents that have no long or short term benefit to New Zealand consumers, such as the stimulation of new competition and innovation. Accordingly, it will rarely apply unless barriers to entry into the relevant market are extremely high.¹⁶ Notwithstanding international reciprocity considerations, the general approach which focuses on the overall effects of a conduct on the domestic market is a sound one, as it enables the economy to take into account broad welfare considerations, whilst not being afraid that in so doing it will benefit foreigners at the expense of domestic producers and consumers.

The importance of economic efficiency as a goal of competition law was specifically recognized by New Zealand. Section 1A of the Commerce Act states that the goal of the Act is "to promote competition in markets for the long-term benefit of consumers within New Zealand." The provision, according to the Explanatory Note, clarifies that although the Act seeks to promote competition, competition is not an end in itself but a means to promote the long-term benefit of consumers. There is a presumption that the goal of benefits to consumers will be achieved through the promotion of competition. However, this presumption may be rebutted if the long-term benefit to consumers is likely to be achieved through efficiency gains that outweigh any anti-competitive detriment.¹⁷

In addition, section 3A of the Act states that "Where the Commission is required under this Act to determine whether or not, or the extent to which, conduct will result, or will be likely to result, in a benefit to the public, the Commission shall have regard to any efficiencies that the Commission considers will result, or will be likely to result, from that conduct." The provision was added to the Act to ensure that economic efficiencies were regarded as benefits to the public, but it was left to the Commission to determine what weight to give them in any particular case.¹⁸

The key question is to what extent could efficiencies be considered as offsetting potential anti-competitive conduct- does New Zealand competition law enhance consumer welfare, total welfare or a combination of both? Are there different circumstances in which each standard achieves precedence over the other? The importance of this issue becomes highlighted due to two seemingly clashing factors. On the one hand, it might be argued that the wording of the goals provision suggests that not all efficiencies will be considered, as efficiencies have to be passed-on to

¹⁵ *Telecom Corp of NZ Ltd v Commerce Commission* (1991) 3 NZBLC 102,340, at p. 531, p. 102,386.

¹⁶ Evans and Hughes, *supra*.

¹⁷ Commission report, 296-2, p.6.

¹⁸ Gault on Commercial Law, Chapter 3; *Telecom, supra*, at p. 528; p 102,383.

consumers, as required under the consumer welfare standard.¹⁹ On the other hand, the "public benefit" test was interpreted very widely. In *Telecom*,²⁰ for example, the High Court cited with approval the following passage from *Re Queensland Co-op Milling Association*²¹ regarding the meaning of public benefit: "we would not wish to rule out of consideration any argument coming within the widest possible conception of public benefit. This we see as anything of value to the community generally, any contribution to the aims pursued by the society including as one of its principal elements (in the context of trade practices legislation) the achievement of the economic goals of efficiency and progress." The question thus becomes which standard takes precedence, and when.

To better understand the issue, it is useful to briefly review the debates prior to the enactment of the goals provision. In the early 90's the New Zealand Government decided that what was important was the overall increase in economic welfare through increased efficiency and that the distribution of that welfare was to be considered irrelevant.²² The reason was that benefits accruing to a few will usually be diffused to the broader population to the extent the company is taxed or spends more and thereby generates subsequent rounds of spending.

In the late 90's the new government stressed the importance of the interests of consumers. The Commerce Committee stated²³ that an efficiency analysis should be consistent with long-term consumer welfare. Where a proposed course of action will limit competition, it might still be possible to have that course of action legitimised through authorisation if the benefits to *consumers* (generally through improved efficiencies) outweigh the detriments. Economic efficiencies must be considered as benefits to the public, but this consideration must now be within the context of the overall purpose of promoting competition for the long-term benefit of consumers within New Zealand. This view is consistent with the consumer welfare standard.

The Minister, however, seemed to be taking a wider view in stating that "The focus on competition in the purpose statement also does not preclude wider public benefit issues being taken into account where appropriate. It simply clarifies that there should be a presumption in favour of competition, and competition must prevail unless the efficiencies of other public benefits are shown to exceed the detriments from the lessening of competition."²⁴ This statement seems to give total welfare considerations

¹⁹ The following paragraphs benefited from the discussion in Rex Adhar, "Consumers, Redistribution Of Income And The Purpose Of Competition Law" *E.C.L.R.* 2002, 23(7), 341.

²⁰ *Telecom*, *supra*; *Re New Zealand Co-operative Dairy Co Ltd/Auckland Co-operative Milk Producers Ltd* (1988) 1 N.Z.B.L.C. (Com.) 104, 320, pp. 104, 358.

²¹ *Milling Assn Ltd; Re Defiance Holdings Ltd* (1976) 25 FLR 169; 8 ALR 481; ATPR 40-012

²² Commerce Commission, Guidelines on Public Detriments and Benefits (1994).

²³ Commerce Committee Report (296-2), p. 7.

²⁴ Consideration by Parliament of the Report of the Commerce Committee (Hansard, 27 February 2001).

precedence at least in those cases which apply a public benefits test. As elaborated below, this seems to be the approach adopted by the courts.

Yet even if no wide public benefit test is applied, the Act applies a very wide consumer welfare standard which recognizes "deferred" or "long-term" consumer interests. This test is quite different from the one employed, for example, in the U.S., which focuses on the direct benefits to consumers. The rationale behind this wide interpretation is that some monopoly power and retention of monopoly profits is justified to maintain producers' incentives to improve production and innovate. Competition law will subordinate the immediate welfare of consumers, by way of lower prices or higher quality, to the long-run productivity of the entire economy.²⁵ This approach also recognizes that productivity growth is the most important determinant of long-term consumer welfare and a nation's standard of living. This approach is a sound one. As Porter notes, a preoccupation with short-term consumer welfare and price-cost margins overlooks the fundamental benefit of competition which is to drive productivity growth through innovation.²⁶

Example II: Merger review

There is no better area of law to exemplify the effects of small size on competition law than merger review. As noted above, competition policy in small economies must reconcile the technical constraints that productive efficiency places on the number of competitors with the undesirability of certain types of industry behavior created by high degrees of concentration for allocative and dynamic efficiency.

In small economies, large firm or plant size may be required in order to achieve efficient scales of production. One key implication of this fact is that high levels of concentration may be a necessary evil in order to achieve efficiency. Accordingly, competition law should be sympathetic to the enhancement of output by individual firms, through either internal growth or mergers, which allows for the exhaustion of economies of scale that were not exhausted by previous market structures, and could not be exhausted in less anticompetitive ways.

The drawback of such a policy is that high levels of concentration might result in higher industrial concentration or absolute monopoly control. Accordingly, competition law should strive to strike a balance between structural efficiency and competitive vigor so that firms operate at efficient scales and pass at least some of the benefits of greater efficiency on to consumers. This is well illustrated by horizontal merger review.

²⁵ See, e.g., *Verizon Communications Inc., Petitioner v. Law offices of Curtis v. Trinko, LLP.*, 540 U.S. 398, 124 S. Ct. 872 (2004).

²⁶ Michael Porter, "Competition and Antitrust: Toward a Productivity-based Approach to Evaluating Mergers and Joint Ventures" (2001) 46 *Antitrust Bull.* 919, at 934-935.

By definition, a horizontal merger reduces the number of competitors in the market, and the resulting entity ordinarily has a larger market share than either of the merging parties had before the merger. This, in turn, may substantially lessen competition. At the same time, a merger may enhance efficiency by allowing firms to attain scale economies that were previously unattainable—either because of firm interdependence or the absolute size of firms. The benefits of reduced costs may even be passed on to consumers if the cost advantage is great enough that the new price is lower than the pre-merger price.

Large economies tend to use structural variables as the main guide in determining the likely competitive consequences of mergers. Thus, many large economies adopted an approach that signified the absolute value of competition over increased total efficiency. The underlying assumption was that there was no need for high concentration levels to achieve efficiency. Such an assumption holds true in most industries in large economies. Moreover, an erroneous assessment of the economic effects of a merger is likely to have a relatively small impact on a large economy compared to a small one.

Such a policy would necessarily have detrimental results for small economies, in which concentration is a necessary evil in order to realize scale economies. Therefore, prohibiting all mergers that increase concentration above relatively low thresholds would be economically harmful. An overly aggressive or rigid stance toward mergers may prevent desirable efficiency-enhancing mergers from taking place. A small economy should, instead, adopt a merger policy that is more accommodating to efficiency defenses, and that relies less on rigid structural variables.

The main policy vehicle for achieving this goal is the adoption of an approach that balances the potential pro-competitive and anticompetitive effects of a proposed merger. Given that efficiencies vary widely from one industry to another, such that no general presumptions can be made based on market structure alone, this requires a case by case analysis of the potential efficiencies. The adopted rules should enable the merging parties to prove their claim of efficiencies realistically. This requires that legal presumptions, burdens of proof, and the balancing rule be reasonably specified.

Does New Zealand case law follow these guidelines? As elaborated below, currently, after several changes in its laws, the answer is generally positive.

A. Tests for Illegality

The small size of the market influences the merger illegality test to be adopted. Two major tests can be identified. The first prohibits mergers that will or are likely to prevent or lessen competition in the market substantially.²⁷ This test generally centers on unilateral exercise of market power or on implicit or explicit cooperative conduct. The

²⁷ For example, section 96 of the Canadian *Competition Act 1986*; Section 50 of the Australian *Trade Practices Act 1974*; Section 21 of the Israeli *Restrictive Trade Practices Act 1988*.

second illegality test prohibits mergers that create or strengthen a dominant position in the relevant market and thus is generally interpreted to center on the unilateral exercise of market power.

The behavioral lessening of competition test is more suitable for small economies than the structural creation or strengthening of dominance test. In a small economy, a larger percentage of mergers would tend to create a dominant firm. Yet these mergers do not necessarily lessen competition. Moreover, mergers that do not create a dominant position may nonetheless lessen competition significantly. Most importantly, the dominance test might not prevent coordinated interaction of firms as a method of exercising market power, which is a major concern in small economies. Another situation that might not be caught under a strict application of the dominance approach is when in the post-merger situation there are at least two relatively evenly matched participants in the market. This can be exemplified by the Australian Amcor case. There, Amcor and Visy Board each bought 50% of the only remaining Australian corrugated fireboard manufacturer, Smorgon. This did not lead to dominance by either company as they each increased their market shares proportionally, but it did substantially lessen competition.²⁸

The practical implications of the differences between the two standards are exemplified by the case of *Progressive Enterprises*.²⁹ On May 26, 2001 New Zealand amended its *Commerce Act*. The new law changed the merger illegality threshold from the “creation or strengthening of a dominant position” to “substantial lessening of competition.”

On 25 May 2001, the day before the new test came into force, *Progressive Enterprises*, a company operating three supermarket chains, applied for clearance in respect of a proposed acquisition of Woolworths supermarkets. The Commission approved the merger under the old market dominance test. New Zealand case law interpreted dominance as involving “a high degree of market control.”³⁰ The Commission concluded that the proposed merger did not meet this high standard, as the merger would result in a combined entity accounting for around 42% of the relevant market. Also, the merged entity would face competition from the Foodstuffs companies, which collectively account for a market share of about 58%.³¹

²⁸ For this and other cases that substantially lessen competition but do not fall under the dominance test see Allan Fels, “The ACCC Attitude to Mergers” (Presentation given at the Institute of Public Affairs Seminar, Melbourne, 24 July 1998). *Amcor Ltd. v. Visy Board Pty Ltd.*, 18 IPR 621.

²⁹ *Progressive Enterprises Ltd. and Woolworths (New Zealand) Ltd.* (New Zealand Commerce Commission Decision 438, unpublished, 13 July 2001).

³⁰ *Commerce Commission v. Port Nelson Ltd.* (1995) 5 NZBLC 103, 762 (HC) at 103,787. Approved by the New Zealand Court of Appeal in *Commerce Commission v. Port Nelson Ltd.* (1996) 5 NZBLC 104,142, 104,161.

³¹ *Progressive Enterprises Ltd. and Woolworths (New Zealand) Ltd.* (Commerce Commission Decision 438, unpublished, 13 July 2001), p. 13.

Foodstuffs challenged the decision. The High Court dismissed the challenge but the New Zealand Court of Appeal allowed the appeal and declared that the Commission was required to assess the application under the new substantial lessening of competition test.³² The merger was then resubmitted to the Commission to be decided under the lessening of competition standard.³³ The Commission stated that lessening of competition and a strengthening of market power should be taken as being equivalent. It then acknowledged that the new test is a broader test than the dominance test.³⁴ It then found that as a result of the merger the supermarket retail market would be highly concentrated with two firms of almost equal size, limited product differentiation and price transparency. Thus it would facilitate “leader-follower” tacit collusion. Consequently, it prohibited the merger.³⁵ The merger eventually took place, as the Privy Council overruled the Court of Appeal and decided that the dominance test applied. The different decisions demonstrate the importance of the standard for regulating mergers.³⁶

The Commission has stated that for the substantial lessening of competition test to apply, competition must be lessened in a considerable and sustainable way.³⁷ A lessening of competition and the creation, enhancement or facilitation of the exercise of market power may be taken as being equivalent. The analysis is based on a comparison of a factual scenario- the merger is allowed to go through- with a counterfactual- the merger is prohibited. This type of analysis is a sound one- as it takes into account the already existing limited competition conditions in the market as a given and does not compare it to a hypothetical perfectly competitive market.

Yet it seems that the High Court has cast the net too widely. In *Air New Zealand*³⁸ the Court held that an inquiry should not be limited "to the existence of market power in the factual." In my opinion, this test is too wide. If a high degree of market power does not exist in the factual, then there is no reason to suspect that it will "significantly lessen competition." The illegality standard should, instead, be applied to capture only those cases in which the merger creates significant market power or increases the existing market power significantly, as the Commission seems to have suggested.

Most recently, in *New Zealand Bus*, the High Court analyzed the meaning of the “substantial lessening of competition” standard.³⁹ The merger created a merged entity

³² *Foodstuffs (Auckland) Ltd. v. Commerce Commission and Progressive Enterprises Ltd.* (CA163/01) (Court of Appeal of New Zealand, unpublished, 19 September 2001).

³³ *Progressive Enterprises Ltd. and Woolworths (New Zealand) Ltd.* (New Zealand Commerce Commission, unpublished, 14 December 2001).

³⁴ *Ibid.*, para. 79-84.

³⁵ *Ibid.*, para. 222-6.

³⁶ Privy Council decision, (2002) 7 NZBLC 103,692, (2002) 10 TCLR 356.

³⁷ Mergers and Acquisitions Guidelines, Commerce Commission, *December 2003*, www.comcom.govt.nz, para. 2.6.

³⁸ *Air New Zealand and Anor v Commerce Commission and ors* HC AK CIV 2003 404 6590 (17 September 2004).

³⁹ *Commerce Commission v. New Zealand Bus Ltd.* (CIV 2006-485-585, 29 June 2006).

with 97% of the subsidized contracts for public transportation in value. Yet the parties to the merger argued that it would not substantially lessen competition in the market, since even in the pre-merger period they rarely competed. The court found that such limited competition was a result of an understanding among the merging parties to not compete, and not a direct result of natural market conditions. The Court rightly accepted the Commission's argument that should the merger be prohibited, the smaller company would be sold to another bus company, which would then use its existing routes and facilities as a springboard for competition. This conclusion was based on a market analysis which indicated that there exist high entry barriers into the market, so that entry could only be done by way of acquisition.

The *New Zealand Bus* case is also interesting since it demonstrates the importance of casting the merger net wide enough to capture all external changes in market structure that might harm competition significantly. As noted above, even in the pre-merger situation there was almost no competition in the market. This resulted from the fact that one competitor held more than a quarter of the market shares of his main competitor, and thus their economic interests were intertwined beyond pure oligopolistic coordination incentives. If the merger provisions had been applied correctly in the past, such acquisition of shares in a rival company would have been prohibited from its incipency, as it carries the potential to substantially limit competition in the market.

B. Balancing approach

As noted above, a balancing approach is more suitable for small economies than an absolute value of competition approach. This is because it enables the benefits from increased concentration to be balanced against the detriments to competition. It recognizes that a merger should be permitted if the improvements in efficiency resulting from a merger are greater than and offset its anti-competitive effects.

From New Zealand case law and commentary, it seems that efficiency arguments play an important role in merger analysis.⁴⁰ New Zealand's merger regime has two tiers of control. Section 47 of the Commerce Act sets the illegality standard to prohibit mergers that "substantially lessen competition". Efficiencies are relevant under it only to the extent that they impact on the level of competition in the market. Yet parties to a proposed merger are provided with the option of seeking formal authorization of the merger by the Commission.⁴¹ The Commission is mandated to grant an authorization if the merger would lead to a public benefit that outweighs the lessening in competition. Those dissatisfied with a Commission decision may appeal it to the High Court.

⁴⁰ See also Michael J. Trebilcock, "The Great Efficiencies Debate in Canadian Merger Policy" 10 *New Zealand Business Law Quarterly* 298 (2004), at p. 318.

⁴¹ *Commerce Act 1986*, Section 67.

For authorization to be granted, the applicant must establish public benefits that outweigh the anti-competitive detriment of the proposed merger. Public benefit was interpreted, essentially, as an efficiency defense. Efficiency is the principal factor that the Commission and, on appeal, the courts take into consideration under the Act. The Commission's Merger Guidelines⁴² note that detriments include losses of economic efficiency, and of incentives to innovate and to avoid waste. Benefits include tangible benefits, such as scale and scope economies, better use of existing capacity, cost reductions due to reduced labor costs, greater specialization in production, lower working capital and reduced transaction costs. They also include intangible benefits, such as environmental and health improvements.

Until 1991 the New Zealand public benefit test was applied to require that the benefits accrued to a reasonable cross-section of the public. Since 1991 the courts have established that the public benefits must be net gains in economic or social terms.⁴³ The distribution of gains and losses is thus irrelevant to their inclusion in the process of weighting benefits and detriments.⁴⁴

The plaintiffs argued that this approach seems to be at odds with the section 1A of the Act, which specifically provides that the goal of the law is to enhance long-term benefits for consumers. The court replied by stating that "We are satisfied that the introduction of s 1A should not disturb the Commission's established practice of treating as neutral any wealth transfers between New Zealand consumers and producers. Determinations of authorization applications...are properly concerned with balancing any efficiency detriments associated with breaches of the statutory competition standard, against any efficiency gains that may result from the business acquisition or contractual arrangement in question. It is the balancing of these real resource impacts on the economy that best serves the long-term interests of consumers."⁴⁵ The court also clarified that "[t]his issue is confined to wealth transfers within New Zealand. Transfers between New Zealand and other countries are not necessarily regarded as welfare neutral."⁴⁶

The approach towards public benefits can be exemplified by the case of *Air New Zealand*, in which both the Commission as well as the High Court adopted a very wide approach, which took into account public benefits relating to all aspects of the proposal such as increase of tourism in New Zealand and online benefits for consumers,⁴⁷ with an emphasis on gains and losses being measured in terms of economic efficiency. Those benefits that could not be easily quantified were taken into account intuitively. This

⁴² Commerce Commission, Mergers and Acquisitions Guidelines.

⁴³ *Telecom Corporation of NZ Ltd. V. Commerce Commission* [1992] NZLR 193.

⁴⁴ *Air New Zealand*, *supra*, para. 238.

⁴⁵ *Ibid.*, para. 241.

⁴⁶ *Ibid.*, para. 242.

⁴⁷ See also *Goodman Fielder Ltd/Wattie Industries Ltd (1987) 1 NZBLC (Com) 104,108, at p 104,147; Qantas Airways Ltd/Air NZ Ltd CC Decision No 511 (23/10/03) at para. 897.*

approach is a sound one, as it gives proper regard to all the aspects of a merger that can affect New Zealand interests.

C. Analysis of competitive conditions

New Zealand's case law also generally exhibits a healthy approach of analyzing the dynamics of a market's competitive conditions such as the height of entry and expansion barriers and countervailing market power rather than adopting a static analysis. Such an approach is highly suitable for merger analysis, especially in a small economy. The reason is that in a small economy a static analysis may quite frequently lead to a conclusion of lessening of competition, whereas a more dynamic one, which takes account of the likelihood of potential competition, will allow mergers that do not actually harm competition in the long-run to go through. The same is true, of course, for joint ventures as well.

The New Zealand approach can be exemplified by two relatively recent cases. In *New Zealand Diagnostics* the Commission declined clearance to a joint venture of two firms to provide joint diagnostic laboratory services in six District Health Board ("DHB") districts.⁴⁸ The relevant DHBs advised the Commission of the benefits of single provider contracts. Accordingly, the Commission recognized that in the near future competition will be *for* the market, rather than *in* the market.

While the Commission recognized the DHB's rationale for single provider contracts, it rejected the joint venture since it would reduce competition without offsetting benefits. The Commission noted that, in the absence of the proposed merger, either of the merging parties would be able to provide competitive constraints in future bidding rounds. However, if the two largest private pathology providers were able to tender jointly, it would fall on the remaining potential competitors to provide competitive constraints by virtue of their ability to enter the market. Yet they could not provide a sufficient competitive constraint. In sum, while the Commission recognized the importance of scale economies that justified the provision of services by only one laboratory in each district, it also recognized the importance of competition *for* the market in order to restrain the bids by firms for serving the market. The decision is based on the dynamics of competition in the long run- the effects of an elimination of a major competitor on competition for the market.

The second example of a competitive impact test that does not solely concentrate on high degrees of increased concentration involves the case of *Southern Cross*, in which the Court of Appeal reaffirmed the importance of the potential for new entry and expansion of small firms as a competitive constraint.⁴⁹ There, a majority of the Court held that a merger that would create a merged entity which would likely have 70-80% of

⁴⁸ *New Zealand Diagnostic Group Ltd. and Sonic Healthcare (New Zealand) Ltd.* (Commerce Commission decision no. 559, 29 September 2005).

⁴⁹ *Commerce Commission v Southern Cross Medical Care Society* (2001) 10 TCLR 269.

the relevant market would still not likely result in the merged entity acquiring or strengthening a dominant position in the market, due to relatively low barriers to entry.

It is important to note that while a dynamic analysis of market conditions is much more appropriate than a static one, care should be taken to ensure that the analysis is applied in a way which ensures that competitive forces are in fact not significantly lessened. In *Southern Cross*, for example, the Court cited *Queensland Wire* for the proposition that "[t]he conventional view is that economies of scale may constitute a barrier to entry only when 'the minimum size for an efficient firm is very large, relative to the size of the market.'" If this statement were to be read to imply that the required level of economies of scale must approach that of a natural monopoly before there can be a barrier to entry, then this would be highly problematic, as it will not prevent competition-reducing mergers in oligopolistic markets. Assume that minimum efficient scale is 30% and the economic penalty for operating at lower sizes is very high so that entry barriers at lower levels of operation are significant. Only three efficient-sized firms can operate in the market, and due to their interdependence they would have strong incentives to coordinate their conduct. If such scale economies were not conceived as entry barriers, then one of the main problems of small, concentrated markets would not be addressed by merger law.⁵⁰

Example III: Cooperative Agreements Among Rivals

The small size of an economy also exacerbates some of the issues involved in the regulation of cooperative agreements among rivals, such as specialization agreements or joint ventures and strategic alliances for shared production or distribution.

Such agreements raise trade restraint concerns, especially the facilitation or enhancement of cooperation among competitors in already concentrated markets as well as spill-over effects into other markets in which the firms operate. At the same time, cooperative agreements may enable a group of firms to carry on an activity on a more efficient scale; to reduce information or transaction costs; to engage in expensive or high risk innovative projects; or to eliminate free rider problems. Absent such agreements, many firms in small economies would incur high costs because they cannot reach scale economies on their own. Cooperation is thus essential for certain activities.

The potential pro-competitive effects of cooperative agreements require the rejection of a *per se* rule under which all arrangements that restrict competition are prohibited. Instead, small economies should adopt a rule that balances the pro and anti-competitive effects of cooperative conduct, and allows arrangements in which the pro-competitive benefits outweigh the restrictions on competition.

⁵⁰ Chris Noonan, "Navigating Barriers to Entry and Expansion Under the Southern Cross" (2003) 9 *NZBLQ* 66.

There are several ways in which New Zealand's competition law recognizes and embraces the importance of certain joint ventures, although some problems still remain. First is the interpretation of the general prohibition on anti-competitive arrangements. Joint ventures may be caught under section 27 which prohibits any contract, arrangement or understanding which has the purpose or the likely effect of significantly reducing trade, unless it was granted authorization by the Commission. Section 27 was interpreted as a net approach, which balances pro-competitive and anticompetitive effects.⁵¹ In so doing, the Commission and the courts can have regard to any efficiencies that are pro-competitive.⁵² In *Clear Communications*, for example, the Court stated that "the achievement of economies of scale and scope, that in itself can simply be viewed as an element in a long run dynamic, competitive process." It also stated that "if [a firm's] purpose is to expand its business into complementary products, achieving in the process economies of scale and scope, it cannot be said to be pursuing an anti-competitive purpose." This wide interpretation solves the main problem created by the cumbersome authorization process in that it lets through those ventures that have overall pro-competitive effects.

Second, the Act applies a rule of reason analysis to ancillary trade restrictions which may increase competition. Section 30 prohibits certain kinds of agreements *per se*. Contracts, arrangements or understandings which have the purpose, effect, or likely effect of fixing, controlling, or maintaining the price of goods or services, or any discount allowance, rebate, or credit are deemed to lessen competition, and the defendant cannot seek to prove otherwise. However, recognizing that certain joint ventures may require such provisions for the achievement of pro-competitive purposes, New Zealand has included several specific exemptions in its law. For example, Section 33 exempts joint buying and selling activities from *per se* illegality if the price fixing agreement relates to the price for goods or services to be acquired collectively by the parties or the joint advertising of the price for the sale of goods or services collectively acquired. These rules recognize that some types of price fixing arrangements might enable small entities to compete effectively with larger groups that would not be possible unless they cooperate with other businesses. Such provisions remain subject to the general competition test, yet they are not assumed to be anti-competitive *per se*.

The importance of applying a rule of reason analysis to such restrictions can be exemplified by the Australian case of *Pharma-Buy*.⁵³ The Trade Practices Commission granted clearance to a buying and promotion scheme involving 40 pharmacies in Melbourne. The group comprised a small portion of the relevant market, and outlets were geographically dispersed, so that participants were unable to significantly

⁵¹ *Fisher & Paykel Ltd* (No 2) (1987) 1 NZBLC (Com) 104,377, 104,395.

⁵² *Shell (Petroleum Mining) Co Ltd v Kapuni Gas Contracts Ltd* (1997) 7 TCLR 463, 528-531; *Clear Communications Ltd v Sky Network Television Ltd* 1/8/97.

⁵³ *E. F. Found Pty Ltd. & William Hodge Pty Ltd.*, (C4272)(Australian Trade Practices Commission, unpublished, 11 July 1975). See also *Eastern Express Pty Ltd. v. General Newspapers Pty Ltd.* [1992] 106 ALR 297.

influence price in the market. The Commission based its decision on the fact that the effect of the promotion was to enable this small group of outlets to compete more effectively against other, more substantial, outlets.

Contrast this rule with the U.S. case of *Topco*.⁵⁴ *Topco* involved a cooperative association of small and medium-sized retailers that desired to cooperate to obtain high quality merchandise under private labels to compete more effectively with larger national and regional chains. *Topco* required exclusivity through trademark licenses specifying the territory in which each member could sell such trademarked goods. The District Court applied a rule of reason analysis and found that such restrictions were required to allow small retailers to compete effectively with larger ones, to prevent members from free riding on other members' efforts to promote the trademark. The Supreme Court reversed, applying a *per se* rule to territorial restraints.⁵⁵ Application of a similar rule in small economies could be harmful, as small competitors would be prohibited from using certain competitive methods, in which the competitive benefits strongly outweigh potential harmful conduct, to challenge dominant firms.

Lastly, Sections 61(6) and (7) of the Act provide that the Commission should not grant authorisation unless it is satisfied that the practice will be likely to result in a benefit to the public which would outweigh the lessening of competition which would result therefrom.⁵⁶ The balancing test enables the Commission to take into account efficiency considerations as well as other benefits that might accrue as a result of the joint venture.⁵⁷ Yet, as noted above, the authorization process is costly, lengthy and cumbersome, so that it is more important to cast the net less widely so that most pro-competitive agreements will not require authorization in the first place.

Still, the Act might cast the net too widely and prevent or condemn welfare-enhancing collaborative agreements. The main obstacle is the scope of the *per se* prohibition on price fixing. A narrow, literal interpretation of the Section 30 prohibition would capture pro-competitive arrangements and thus reduce social welfare. The tools surveyed above do not sufficiently remedy this problem: the exemptions are too narrow and the authorization process often inefficient. One way that was suggested to solve this problem is to simply abolish the prohibition and apply a rule of reason analysis in all cases.⁵⁸ In my opinion, this solution should be rejected. There is much merit and economic sense in creating a bright line prohibition for arrangements that experience has taught us that there is very limited or no chance that they will be found to be pro-competitive. At the same

⁵⁴ *U.S. v. Topco Ass'n* 405 U.S. 596, 607-8, 92 S. Ct. 1126 (1972). Several lower courts have nonetheless applied a rule of reason when horizontal market division was found to be ancillary to a joint venture. See, e.g., *General Leaseways Inc. v. National Truck Leasing Ass'n*, 744 F. 2d 588 (7th Cir. 1984).

⁵⁵ *Ibid.*, 607-11.

⁵⁶ Gault, *supra*, CA61.04

⁵⁷ Contrast this with the narrower wording of the Australian equivalent: s 90(6) and (7) *Trade Practices Act 1974*.

⁵⁸ *Ibid.*

time, as price-fixing arrangements might sometimes be an integral part of pro-competitive arrangements, it is important to devise efficient tools that would enable the competition institutions to differentiate harmful and beneficial agreements. While there is no optimal tool, the U.S. doctrine of ancillary restraints coupled with the quick look approach might provide a relatively workable solution.⁵⁹ Under U.S. law a provision is considered ancillary if it is necessary in order to achieve the legitimate pro-competitive objective of the agreement and its harm to competition is proportional to the public benefit achieved from it. The “quick look” doctrine is essentially a screening device that enables the court to identify those restraints which are worthy of closer scrutiny. The doctrine enables the court to determine the likely effect of the restraint when “an observer with even a rudimentary understanding of economics could conclude that the arrangements in question would have an anticompetitive effect on customers and markets”.⁶⁰ The EU tool of block exemptions that define groups of cases in which the *per se* prohibition does not apply might also be of use.

It should be emphasized that the rule of reason or balancing approaches advocated above require the establishment of competent institutions- competition authority and courts- that will be able to do the "fitting" of the law which is required in individual cases and to set clear rules that will promote certainty. Otherwise, they might create more harm than benefit.⁶¹

Example IV: The Relative Importance of Conduct Regulation

A policy that is more lenient towards mergers and the internal growth of firms that lead to more efficient market structures must be accompanied by legal rules minimizing the harmful effect of more concentrated market structures.

One method to achieve this goal is to apply strict rules to collusive anti-competitive behavior. Such a policy may help to induce oligopolists to operate at higher levels of output and lower prices than they would have in the absence of legal consequences.

Similarly, a strict policy should be adopted towards exclusionary practices with no offsetting benefits, when practiced by monopolies. Given the prevalence of dominant firms in small economies and the relative inability of market forces to erode them, a small economy cannot afford to leave the regulation of monopoly power to market forces alone. Competition law must focus particularly on deterring the creation and

⁵⁹ See, e.g., Andrew Harpham, Donald Robertson and Philip L Williams, "The Competition Law Analysis of Collaborative Structures" forthcoming, *Australian Business Law Journal* (2006), proposing such a solution in the Australian context.

⁶⁰ *California Dental Association v FTC* 526 US 756, 770 (1999).

⁶¹ See, e.g., Michal S. Gal, "The Ecology of Antitrust: Preconditions for Antitrust Enforcement in Developing Countries" in *Competition, Competitiveness and Development: Lessons from Developing Countries* (UN, 2004), 22. Can be found at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=665181

maintenance of artificial barriers to entry. New entrants must have the opportunity to enter a market without handicaps other than those arising from the first-mover advantages enjoyed by existing competitors.

An interrelated method involves setting deterrent penalties. Such penalties increase the costs of breach and increase the incentives of market players to comply with the law. Accordingly, the *Commerce Act* was amended in 2001 to increase pecuniary penalties. The amended Act also provides courts with the power to award exemplary damages. It also increases personal liability for breaches of the law and preventing firms from indemnifying decision makers for such penalties. These are important steps in increasing awareness and incentives to follow the law.

Second Category: Cases in which Size Affects Content

Apart from the effects of small size on enhancing the need for more efficient and effective competition rules, size may also affect the content of the law. Let me try to drive this point home by using three examples.

Example I: Substantive Criteria for Analyzing Anti-Competitive Effects

Competition law is sometimes based on general assumptions regarding market behavior instead of applying rules that require the regulator to analyze each case anew. In some cases, the assumptions on which such rules are based are generally efficient in large economies, but would not create such results in small ones. The reason is that the marginal cases of large economies are oftentimes the main cases for small ones. Accordingly, assumptions and the rules that are based on them might in some cases need to be changed.

This can be easily exemplified by Merger illegality standards. Most economies tend to use structural variables as the main guide in determining the likely competitive consequences of mergers. These variables usually focus on the level of concentration in the market as measured by the sum of the market shares of the three or four largest firms, by the firms' turnover, or by the HHI index, which sums of the squared market shares of all firms operating in the relevant market.

These parameters must be fine-tuned for a small economy. For example, the EC turnover rates that serve to screen anti-competitive mergers are much too high for New Zealand firms. The HHI levels adopted by the U.S. antitrust authorities also illustrate the importance of fine-tuning legal presumptions to economic size. Although HHI levels are only a prima facie indicator of the anticompetitive effects of a merger, they create presumptions of illegality, absent a clear showing to the contrary. The U.S. HHI levels create such a presumption, for example, in a merger between the two smaller firms in a market with six businesses, four holding 20% market shares and two holding 10%. This choice of index may be suitable to the nature of U.S. markets, in which it might be

presumed that absent clear showings to the contrary, firms in markets that meet this threshold have already exhausted their scale economies. Yet such a presumption does not hold true in small economies. Objection to the merger of the two smaller firms that will reduce competitors from six to five will usually prohibit firms from achieving efficient scales.

This is not to say that small economies should reject the use of legal presumptions altogether. Such presumptions are important as they enhance predictability and reduce the need for a costly case-by-case analysis. At the same time, small economies need to fine-tune these presumptions to their markets by adopting, for example, much higher concentration thresholds than those adopted in the U.S.

The New Zealand Commerce Commission seems to have acted in accordance with this view. Its Mergers and Acquisitions Guidelines specify two safe harbours. Any merger that falls within these safe harbours is presumed not to substantially lessen competition. Such harbours include two situations: (a) where a three-firm concentration ratio in the relevant market is below 70 percent and the market share of the combined entity is less than in the order of a 40 percent share; or (b) the three-firm concentration ratio in the relevant market is above 70 percent and the market share of the combined entity is less than in the order of 20 percent.⁶²

The adoption of such wide safety zones in small economies recognizes that in many concentrated markets mergers may well produce efficiencies that outweigh anti-competitive harm. Mergers that fall within these limitations are ultimately adjudged to be competitive and are approved without the need to consider their efficiency benefits. Such a policy eliminates the problems and the costs inherent in a case-by-case analysis of anti-competitive effects and efficiencies. Yet, to be efficient, safety-zones must be correctly defined so as to capture most of the scale economy problems, but nothing more. This is problematic, because efficiencies and industry-specific characteristics that affect market power differ significantly from one case to another. Nonetheless, small economies often set safe harbours that assume a relatively high degree of scale economies, yet capture the main problems created by mergers- a strong, dominant competitor or conditions which are highly likely to create coordinated effects.

Another example for rules of thumb that are influenced by market size involves the definition of dominance. As I show in my book, in small economies lower market shares generally indicate a higher degree of market power.⁶³ This is due to a higher degree of inelasticity of supply. Until quite recently this was not acknowledged in New Zealand. Rather, the threshold was “dominant position in a market.”⁶⁴ The law was, however, amended in 2001 in line with the Australian law which requires ‘high market control’.

⁶² Mergers and acquisitions guidelines, *supra*.

⁶³ Gal, *supra*, chapter 3.

⁶⁴ *Telecom Corp of NZ Ltd v CC* [1992] 3 NZLR 429; (1992) 4 TCLR 648; 4 NZBLC 102,724 (CA) and *Port Nelson Ltd v CC* [1996] 3 NZLR 554; (1996) 7 TCLR 217; 5 NZBLC 104,142 (CA).

The new definition does not require the firm to be the only one operating in its market but it does require that it be able to dictate the terms of its trading on a sustainable basis. This definition is much more suitable for a small economy, and is one more example of the need to often apply a pragmatic rather than a doctrinaire approach.

Example II: Remedial issues

The concentrated nature of an economy also raises a structural consideration that is almost absent in large economies. In using its remedial powers, a competition authority in a small economy should take into account, when attempting to restore competition in the market, the effect of its remedy on the current market equilibrium. Otherwise, it might create a situation which is counter-productive to competition.

This will happen if several conditions are met: the remedy necessarily leads to the exit of a competitor from the market; the market can support only a small number of firms; entry barriers are high, and the assets of the exiting firm may not be utilized by a new firm (for example, where reputation is an important factor in the consumer's decision) or the process of establishing a competitor in the market is lengthy. In such situations, it is important to exercise caution with regard to the viability of competitors, if their viability is crucial for competition.

Take, for example, a market situation in which the relevant market can support only two firms, the number of competitors that actually exist in the market. Assume that one firm is found to engage in anti-competitive behavior, and that the authority does not exercise enough caution in its decision such that the firm has to exit the market due to a significant comparative disadvantage created by the remedy. If a new entrant faces high barriers to entry, this change in market structure may affect pricing, as there is only one firm remaining.

Example III: International firms

Lowered barriers to international trade create competition law issues that go well beyond national frontiers. Whereas in the past competition law issues were largely contained within national borders, today's business is increasingly global. Firms in one country may engage in a conduct that affects other jurisdictions. Small size affects also the regulation of conduct with extra-territorial effects.

Small size exacerbates the importance of issues of extra-territoriality. The large proportion of foreign-produced products that are traded in a small economy and the reduced ability of domestic market forces to effectively regulate foreign importers, often imply that the anti-competitive conduct of dominant foreign importers will have strong negative effects on small jurisdictions, without significant offsetting efficiencies. This section uses the example of mergers that have extra-territorial effects to identify the

problems faced by small economies and to examine the legal tools available to them to combat anti-competitive conduct by foreign firms that affects them significantly.

Extra-territorial mergers can be divided into four main groups in accordance with their welfare effects. The first type reduces the welfare of both their home jurisdiction and other jurisdictions in which they trade. To illustrate, assume that two firms holding a dominant position in world markets merge and that the merger does not achieve significant efficiencies. The second type of merger has no negative effect on the welfare of all jurisdictions in which the merging parties trade. In both categories the decision of the home jurisdiction will generally coincide with the interests of the foreign jurisdiction.

The difficult cases arise in the third and fourth types of extra-territorial mergers, as different jurisdictions may reach conflicting decisions and have divergent interests. In the third type the proposed merger has positive or neutral welfare effects on the home jurisdiction, and negative effects on all or some foreign jurisdictions. This may occur, for example, when the merging firms face strong competition in their domestic market but face limited competition in other markets. The fourth type creates opposite mixed effects: it creates negative welfare effects in the home jurisdiction and positive effects in a foreign jurisdiction.

Most jurisdictions adopt a concept of inbound extraterritoriality, which enables them to apply their own competition policy to regulate offshore conduct with significant domestic anti-competitive effects. Accordingly, Section 4(1) of New Zealand's Commerce Act applies its provisions to any conduct which affects domestic markets. Inbound extraterritoriality is, however, a limited tool in small economies. Small economies usually cannot prevent a merger with anti-competitive effects from occurring by unilateral action only, as they face severe challenges to effective prosecution. The main problem is that small economies can rarely make a credible threat to prohibit a merger of foreign firms. Given that trade in the small economy is usually only a small part of the foreign firm's total world operation, were it to place significant restrictions on the merger, the foreign firm would, most likely, choose to exit it and trade only in other jurisdictions. As the negative welfare effects of the exit of the foreign firm from the small economy may well be greater than from the continued operation of the merged entity within its borders, a small economy usually has no incentive to prevent it from trading within its borders if it merged. The foreign firm, acknowledging this effect, will not take into account, in its merging decision, the effect of its decision on the small economy. In addition, the small economy may lack the resources and relevant information to block the merger. The New Zealand High Court has recognized these problems, in *British American Tobacco*, stating that The Commerce Act... extends to those transactions although whether... the Commission can do anything effective about it remains a matter for doubt."⁶⁵

⁶⁵ *CC v British American Tobacco Holdings (NZ) Ltd* (2002) 7 NZBLC 103,546.

So what can be done? First, to join forces with other jurisdictions to create a credible threat to a merger that reduces welfare in all of them. If a sufficient number of jurisdictions join forces to prevent such a merger, then this might create economic incentives for firms to abandon attempts to merge. This is one of the main reasons why regional agreements, such as the Caribbean Single Market Agreement, are of such importance.

Second, and more realistic, is to take changes in the market structures of their large importers as a given and to attempt to regulate the merged entities with the existing regulatory tools that relate to the actions and structure of these foreign firms within their domestic markets. This implies that regulatory measures play a more significant role in the competition policy of small economies than large ones.

The Australian case of *Rothmans/British American Tobacco*⁶⁶ provides an interesting example. The proposed merger did not create competition concerns in the major jurisdictions in which the firms operated and thus was not blocked. It created, however, significant competition concerns in Australia, as the market share of the merged companies would have been around 65% with only one major competitor left in the cigarette market. The competition authority agreed to approve the merger only after the merged parties agreed to divest cigarette brands and production and distribution facilities equal to 17% of the Australian market. The brands and facilities located in Australia were then acquired by a major international tobacco organization that did not previously trade in the Australian market. The merger thus went ahead while competition in the domestic market was preserved.⁶⁷ New Zealand also has powers of divestiture in Section 85 of the Commerce Act, which it might use to achieve similar results. Conduct concessions can also be applied in order to reduce the effects of extra-territorial mergers.⁶⁸

It is interesting to note that the fact that large economies such as the EU and the US have not focused on total welfare in their merger review but rather employ a consumer welfare standard has generally served small economies well. The reason is that this standard places a higher limitation on the merging firms, and thus indirectly reduces their concentration also in the foreign markets in which they operate.

CONCLUSION

Despite substantial differences in optimal competition policy for small and large economies, many small economies give no systematic weight to considerations of the

⁶⁶*Rothmans/British American Tobacco* (ACCC, unpublished, 3 June 1999).

⁶⁷ See also the case of *Smith Snackfood/Frito Lay* (ACCC, unpublished, 1997) in which divestiture of local production facilities was key to approving the merger.

⁶⁸ See Gal, *supra*, chapter 6.

size of the economy in their competition policy. Rather, many small jurisdictions adopt or rely upon the statutes and established case law of large jurisdictions.

This approach has many recognizable advantages, such as a ready basis for the law and a large body of comprehensive case law and commentary. In addition to these learning externalities, it also generates network externalities. As more decisions that apply the law to various factual settings begin to accumulate, legal certainty is increased. European Union and U.S. competition law, being the most widely used competition laws, are thus worth to other jurisdictions more than their face value as judged by the clarity and comprehensibility of their provisions and current case law. It also reduces the resources necessary to create a competition law tailored to a jurisdiction's special characteristics.

Yet the adoption of the laws of a large jurisdiction have important pitfalls. This paper elaborated on the inappropriateness of a one-size-fits-all approach and the necessity of adapting competition policy to the economic circumstances and institutional endowments of individual countries. The challenge is thus to adapt the doctrines established in a large market to a smaller market. This caution was reflected by the in *Brambles* by the High Court, which stated that care must be taken to ensure that the analysis in foreign case law is appropriate to New Zealand.⁶⁹

It seems that New Zealand is generally taking the effects of its small size and distance from its trading parties into account. There is much recognition of the special characteristics of its small, remote markets. its competition law is often quite permissive with regard to the realization of scale economies which are necessary to increase productive and dynamic efficiency. While finding the golden route between productive and dynamic efficiency and competitiveness is not easy, many of New Zealand's recent applications of its competition law seems to be not far off the mark.

⁶⁹ *Brambles*, *supra*, para. 69.