

Contracting, Incentives for Breach, and the Impact of Competition Law

By

Lewis T Evans and Neil C Quigley

Victoria University of Wellington
and
New Zealand Institute for the Study of Competition and Regulation

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1 Introduction

The economic performance of the New Zealand economy is influenced by the legal environment for contracting. In general, production and investment will be optimised by a legal environment that minimises the transactions costs associated with writing and enforcing contracts.

Until the regulatory reforms of the late 1980s and 1990s, heavy-handed regulation and government ownership were pervasive in New Zealand. Under this regime, the bulk of large-scale infrastructure investment was undertaken by the public sector; long-term contracts between private sector entities were uncommon, and the scope for opportunistic action was limited by regulatory proscription of activity. The efficiency implications of the legal framework for contracting in New Zealand have been enhanced by the deregulation and privatisation of economic activity in the period since 1984 (Evans, Grimes and Wilkinson, 1996) has enhanced the importance of contracting for the performance of the economy as a whole. Considerable infrastructure management and investment is now in private hands, and the terms of private contractual agreements together with competition law provide the principal restrictions on the actions of market participants.

Under New Zealand law, no provision of a contract may be enforced where it is in breach of the Commerce Act (s. 27(4)). Further, as Dammerly (1999) has indicated, the courts in New Zealand have taken the view that pending a decision on the substantive question of legality under the Commerce Act, a contract provision that is plausibly claimed to be in breach of the Act cannot be enforced. From the perspective of economics, the efficiency of this decision depends very much on the incentives of the party that has sought refuge in an appeal to competition law.

In this paper we provide an economic perspective on the application of competition law to contracts. In Section 2 we set out an economic framework for the analysis of contracts. In section 3 we provide an outline of a contract and relational framework between two firms. This contract contains certain of the key features of the Clear vs Telecom case analysed by Dammerly. We do not examine all of the relevant facts of that case: rather we use key features as a relevant example. We set out and analyse the

allocation of risk-bearing implied by the structure and pricing regime in the contract. We point out the implications of not treating a contract as a coherent bundle of rights and obligations, and thereby treating provisions as distinct elements. In Section 4 we consider the interface between contract and competition law for the contract set out in Section 3. We analyse the decision problem facing an entrant who has the option of appealing to competition law and is disadvantaged by the outcome of a contract with a dominant incumbent. We argue that the entrant will have inefficiently strong incentives to appeal to competition law. In addition, we show that the option for the entrant to appeal to competition law will have a pervasive influence on the terms and conditions of the contract, and will produce a marked reduction in the efficiency of the contracting process. In Section 5 we consider contractual and judicial means of addressing this incentive problem.

2 Contracts

The terms and conditions agreed by parties to a contract establish their legally enforceable rights and responsibilities. From the perspective of economics, contracts provide a transactions cost-minimising means of establishing constraints within which rational individuals maximise the pursuit of their goals consistent with the interests of other parties to the contract.

The literature in economics (see Katz, 1998 and Shavell, 1998) views contracts as a means of limiting opportunism by constraining behaviour. As Posner (1992: 91) has observed,

“...the fundamental function of contract law ... is to deter people from behaving opportunistically toward their contracting parties, in order to encourage the optimal timing of economic activity and ...obviate costly self-protective measures.”

Because the potential for opportunism is pervasive, all contracts establish explicit or implicit constraints on the actions of parties.¹

¹ Section 27(2) of the Commerce Act provides that contracts that have or may have the effect of substantially lessening competition are In the context of the view that all contracts provide constraints

Contracts typically contain a balance of incentive payments and provisions for monitoring that minimise transactions costs. Normally, the more reliance placed on incentives, the lower are monitoring costs. Contracts allocate property rights in specifying what components of any contract are held or owned by any party at any time. Because it is not possible to control the realisation of states of the world, contracts allocate risk both explicitly and implicitly. Risks are allocated between parties in a manner that, *ceteris paribus*, has parties that are more willing and able to carry risk assuming more risk relative to other parties. The terms of the contract will embody compensation for the risk explicitly and implicitly assumed by each party.

From the perspective of economics, all provisions of *legal* contracts should be enforced irrespective of the *ex post facto* distribution of gains associated with completion of the contract, and this maxim is applicable in all market situations. This is because contracts explicitly or implicitly allocate risk among the parties, and provide expected returns to each party that are consistent with information available to the parties at the time that the contract is signed. Greater *ex ante* investment in information relevant to the contract by either party will improve the efficiency of the contracting process. No increase in efficiency can be obtained by reinterpreting contracts in the light of information obtained during the term of the contract or after its completion, though such information may improve the efficiency of subsequent contracts.

The requirement that all provisions of legal contracts be enforced whatever the *ex post facto* distribution of gains from them has the greatest impact on dynamic efficiency; that is, the efficiency of ongoing economic interaction in society. Contracts stipulate actions and outcomes on which investment in information, assets and actions specific to the contract may be undertaken. Because these investments are based on the terms of the contract, a lower level of investment will result if there is uncertainty about the enforceability of the contract.

If an asset can be converted to alternative uses at negligible cost, then it will be able to earn a return on its replacement value, irrespective of the withdrawal of one use. Assets

on behaviour, one might argue that many contracts are, or could be held to be, in breach of the Commerce Act.

specific to the contract are vulnerable to hold-up², particularly where this takes the form of negotiation of a lower price for the use of the asset after it is in place than would have been agreed before the investment was made. Specific assets increase the transactions costs of contracting³ by requiring either credible contracts or vertical/horizontal integration as a means of avoiding hold-up. Although contracts reduce transactions costs in many contexts, it is for specific assets that the enforceability of all contractual provisions is most important. It follows that it is in respect of investment in specific assets that a failure for the courts to enforce the *ex ante* bargain enshrined in the contract will result in the greatest reduction in dynamic efficiency.

Where a buyer of a service has only one seller with whom they may deal, the seller may be in a position to impose a wide range of terms on the seller – in effect to offer a “take it or leave it” offer. It does not follow, however, that the buyer would be indifferent to the terms of the contract offered, or that the contract represented “the only option” for the buyer. As Posner (1992: 115) points out:

...since a monopolized product will be priced higher than it would be under competition, prospective buyers will invest more, rather than less, in search; and one form of consumer search is careful reading of the contract. It is also false to conclude that it will not pay the consumer to read the contract if he knows the monopoly seller will not bargain (haggle) with him, for he must still decide whether to buy the product or do without.

In other words, the existence of a monopoly seller may result in more rather than less contract-specific investment in information by the purchaser, and that information will include an assessment of alternative applications of the funds being used in the transaction with the monopolist.

² One of the recurring economic themes of repeated transactions is the benefit to be obtained by the opportunity to make a commitment (Fudenberg and Tirole (1991, s.3.2.3)). The seemingly paradoxical result that commitment that necessarily constrains opportunism has value arises because it affects other parties' opportunities. The credibility of any commitment is termed “time consistency” in economics, where it means that incentives are such that terms of a contract will not be violated. Time consistency has had much currency in economic public policy literature, where a time consistent policy is one that the government has incentives to stick to the policy (for macroeconomics see Mankiw, 1988).

³ See Williamson (1979).

In situations such as that considered by Posner, competition statutes have a prime effect on the operation of contracts. If there is a dominant firm in the market, competition statutes may require the firm to act as if the market were more competitive, and the courts may view failure to strike a contract as evidence of anti-competitive behaviour. Thus, competition law may constrain the contracts that firms, particularly dominant firms, may offer and accede to.

The application of competition law to contracts is justified by the social costs that result from contracts whose terms are shaped by or facilitate the exercise of market power. It is economically efficient for competition law to make such contracts unenforceable, and more generally, to provide a framework within which the costs and benefits to society may be assessed.⁴ To use competition law to rule a contract unenforceable requires that there is some departure from efficiency that is correctable under competition law.

The complexity associated with assessing society's interest in the efficiency of contracts is most apparent in respect of the concept of dynamic efficiency. Dynamic efficiency is provided when the legal and institutional framework in society provides the lowest costs and distortions to economic interaction in order that economic efficiency is optimised over time. It follows that inefficiency at one point in time need not be dynamically inefficient or imply that there is an alternative contract that will provide a better outcome for society as a whole. For example, rents earned by a dominant incumbent firm may not be dynamically inefficient: if those rents attract entry that increases output and stimulates technological innovation, then contracts in the market may be consistent with dynamic efficiency and maximising the present value of social welfare. Similarly, patents (which can be viewed as legal sanction to write exclusion contracts), provide a monopoly at one point in time, but competition in the process of developing patentable innovations. The institution of patents is designed to enhance dynamic efficiency, at the potential cost of static efficiency. Thus, actions aimed at static efficiency problems are consistent with improvements in social welfare only where they improve or do not reduce dynamic efficiency. Static efficiency problems must be perceived as very likely to persist into the future if there is to be any case for the application of competition statutes.

⁴ Shavell (1998, 441-442) discusses the implications for efficiency of various measures of damages.

3. The Contractual Framework

Description of the Contract

The contract that we consider in this paper is signed at time period T , and has the following features:

1. The contract is between two firms: Aco, a dominant firm in a network industry, and Bco, a new entrant to that industry. These two firms compete in offering a homogeneous product to households. Their networks have a large element of specificity.
2. Aco and Bco have a long running dispute about the terms on which Bco can utilise part of Aco's network for the delivery of services.
3. Aco and Bco agree on a contract that:
 - Settles all disputes arising from the past relationship between the two firms.
 - Establishes terms, including a pricing regime, under which Bco may use the Aco network for the delivery of services ("the terms of interconnection"). In particular, the pricing regime provides for payment of no access fee and a constant per minute charge for time on the network with no volume or duration discounts.
 - Applies for a fixed term of five years.

In time period $T+1$, Aco expands its use of a new off-peak charging regime for its households. This pricing regime was used on a trial basis in time period $T-1$, and this was public information at time T . The pricing regime in the contract between Aco and Bco makes it difficult for Bco to match the prices Aco is offering to households. At $T+2$, Bco ceases to pay Aco for the interconnection services that it is consuming, and the courts find that payments may be withheld pending a decision on the substantive issue of whether provisions of the contract breach the Commerce Act.

Analysis of Risk-Bearing in the Contract

The interconnection contract represents but one element of the class of two-part tariff interconnection contracts. This class includes the following three special cases:

1. A volume usage charge with the fixed connection fee set at zero. This is the interconnection pricing regime of the contract between Aco and Bco.
2. A volume usage charge and a fixed connection fee.
3. No volume usage charge and a fixed connection fee.

The choice between the three pricing structures, and the choice of the level of access and usage fee, will influence the expected return and other aspects of the agreement that each party requires to sign the contract. This is because the three pricing structures provide for different allocations of risk-bearing between the two parties to the contract.

To examine in more detail the implications of the choice of pricing structure for the allocation of risk, we will consider two types of uncertainty about the future⁵: uncertainty about states of the world and uncertainty about the strategies of parties to the contract; including final pricing and bypass.⁶

1. A contract with no fixed connection fee and a volume usage charge means that Bco does not carry any of the risk associated with the ability to obtain market share and the scale of its operation. Whatever the scale of Bco's business, it pays a flat per minute usage charge, and neither higher-than-expected or lower-than-expected volumes of business change the per minute rate. Conversely, this means that in terms of this contract Bco does not have access to any volume discounting that other forms of two-part tariffs would provide.

This contract with no fixed connection fee and a volume usage charge allocates to the purchaser (Bco) the risk that either Aco or another supplier might adopt a pricing strategy that made the volume usage charge disadvantageous. While this risk is to some extent endogenous to the contractual relationship (Aco is a party to the contract), any disadvantage to Bco could be exogenous in that a third party might adopt such a pricing strategy. That is, outside the Aco-Bco contract, the contracts market, that we shall term the spot market, poses risk to Bco of pricing strategies that are costly to Bco because of the usage charge structure.

⁵ The inability to contract over all contingencies and quantities that are verifiable invariably means that contracts are incomplete.

The usage-charge-only tariff places the risk of the investment in specific assets (network assets) that bypass Aco's specific assets squarely with Aco. Bco reduces its full unit payment to Aco for each unit switched to any network established by Bco. In addition, the usage charge means that demand risk stemming from business cycle fluctuations is absorbed largely by Aco.

2. A network interconnection contract that has both an access fee and a user charge shares risk in that it allocates some of the state-of-the-world risk to the purchaser, as opposed to the party that supplies the network services who is paid through a lower usage charge.
3. A contract with a fixed connection fee and no volume usage charge provides strong incentives for the purchaser to increase business volume, and allocates to the supplier the risk that they will be able to do so. In this case Aco bears the risk that the volume of Bco's business will be larger than the expected volume on which the fixed connection fee was set. Under this contract Bco carries the risk that the state of the world will involve a downturn in demand for interconnection services. Bco also carries the risk that Aco will adopt a competitive strategy that limits Bco's market share. The risk of alternative final-pricing strategies is shared as compared to case 1. The risk of bypass to Aco is reduced and the incentive for Bco to bypass is also reduced.

Two other aspects of risk deserve attention. First, our contract requires the delivery of interconnection services for a fixed period and at a fixed price. This provision of the contract allocates to the purchaser the risk of a fall in the spot market price of interconnection services, while the supplier bears the risk of a rise in the spot market price.⁷ Second, our contract establishes a price for a five-year period. This is a long term given the rate and uncertainty of technological change and new entry to the modern telecommunications market. Under the contract between Aco and Bco, the

⁶ We make no claim to evaluate here all the relevant aspects of any actual interconnection contract. The properties of interconnection contracts and their relationship to economic efficiency is a vast topic. We do not consider, for example, any implications, under the contract, of Aco using Bco's network.

⁷ By a rise in the spot price we mean a rise relative to expectations. The terms of the interconnection contract will have been influenced by each parties' expectation of future spot prices. In telecommunications these might well have been expected to decline over the period of the contract.

latter firm bears all of the risk that over the five years of the contract technical change or new competition will drive down the spot price of interconnection faster than expected. Where the industry is characterised by rapid technical change this provision would be disadvantageous to Bco, and the more so because if the spot price falls surprisingly quickly it may not be in Aco's interest to renegotiate. This provision and the relatively long term of the contract would strengthen Bco's incentive to bypass Aco's network in this event.

To summarise, Bco accepted a contract that assigned to Aco much of the risk associated with the level of business generated by Bco and the bypass of Aco by Bco. It assigned to Bco all of the risk that the spot market price of interconnection access might fall more quickly than expected, and also the risk that new pricing regimes such as off-peak discounting might become important in the market. In terms of its contract with Aco, Bco bears this risk whether it is Aco or a third party provider that adopts the new pricing regime. Over the long period of the contract, both assignments of risk seem counter intuitive, since Bco should be best placed to assume some risk associated with its volume growth, and since Aco should be best able to bear at least some of the risk of the emergence of new pricing strategies (especially those that it develops itself). Nonetheless, the economist presumes that these allocations of risk were recognised at the time that the contract was written.

Interpreting the Contract As A Whole

We have seen that the final allocation of risk between Aco and Bco under the contract is complex. Moreover, the allocation of risk in the contract as a whole is influenced by a number of different features and provisions of the contract. Consequently, contracts must be considered and interpreted as a whole.

Contracts are the outcome of a negotiated acceptance of a bundle of obligations. To set aside any aspect of the bundle without the agreement of both parties would affect the willingness of parties to accept the residual components of the contract and the benefit of the contract to them. We illustrate this with two aspects of the contract. The importance of this conclusion lies in the effect on future contracts. If it becomes accepted that provisions of a contract can be set aside, contracts will be designed to

allow for this contingency. If relevant parts can be identified *ex ante*, contracts may be written that approximate the collection of a set of almost self-contained subcontracts. This would reduce efficiency by reducing possible contractual trade-offs and thereby the set of available contracts. The reduced set of acceptable contracts may in fact reduce the incentive to enter contracts and thereby influence investment.

The first example of the importance of treating the contract as a whole applies to the settlement of past disputes included in the contract. Aco and Bco have simultaneously agreed on a settlement of outstanding issues relating to their past business interactions and terms governing aspects of their future relationship. The settlement must therefore be viewed as an integral part of the contract. This is true because if the terms of the settlement were more generous to either Aco or Bco, then that party would be prepared to accept less favourable terms in respect of the contract for their future relationship.

Decisions at time T will be affected by expectations of the future. For example, the settlement may differ according to whether or not there is to be a contract. Given that there is a contract, the settlement will have been affected by the terms of the forward-looking contract, even if the contract does not incorporate transfers between parties explicitly relating to the relationship before T (i.e. it does not explicitly incorporate aspects of the settlement). The effect of expectations about the future on the settlement may simply occur via their effect on the bargaining position of each party. This will generally differ according to whether the agreement at T is “one-shot” (i.e. marks a termination) or part of a “repeated game” (e.g. one agreement in a series of agreements/activities associated with a relationship running into the indefinite future).⁸ To set aside or interpret only the settlement or the agreement relating to ongoing business is to attempt to interpret only part of the contract.

The second example of the importance of treating the contract in its totality concerns the allocation of risk bearing that is fixed in the contract. Recall that under the contract, Aco bears much of the risk associated with the level of business and bypass. Bco carried the

⁸ There is a growing literature in which game theory is used to analyse the implications for contracts of opportunism (Schmidt (1998, 432)) in repeated relationships (Salanié (1997, ch.7)).

risk that the spot market price of interconnection might fall more quickly than expected, and of the evolution of new pricing regimes by any market participant. This outcome resulted from the parties' assessments of the future and their willingness to carry risk as embodied in the contracting process. To set aside the payment of the usage charge, even for a period of time, is to quite alter the allocation of risk between the two parties. The expectation of this possibility of *ex post* re-allocation of risk by treating contracts provision by provision must raise the transactions costs of any contract.

In sum, setting aside some provisions of a contract may alter the balance of rights, obligations, risk and expected return that was negotiated in the contract as a whole. In this case it would be inefficient to enforce the residual of any contract having set aside any part of it.

4. The Interplay of Contract and Competition Law

Breach of Contract

No matter how much the parties to a contract invest in *ex ante* consideration of implications of contractual terms in future (uncertain) states of the world, there exists the possibility that one party will wish to be relieved of certain of the obligations set out in the contract.⁹ In these circumstances a party will have at least four options.

- (1) Absorb the losses resulting from the fulfillment of the contract.
- (2) Negotiate with the other party to obtain satisfactory terms on which they may be relieved of the obligations set out in the contract.
- (3) Unilaterally breach provisions of the contract, accepting any penalties for breach of contract that might be set out in liquidated damages clauses in the contract or that might be applied by the court.
- (4) Unilateral breach and seek legal means of having relevant provisions invalidated, such as claims that they breach competition law.

⁹ Re-negotiation is typically required to yield *ex post* efficient outcomes in any state of the world. But it reduces the protection of specific investments, and thereby dynamic efficiency.

Options (1) and (2) are probably most common in practice. If the term of the contract is relatively short, the costs of re-negotiation during the term of the contract may be greater than the losses associated with fulfillment of the contract. If the contract is longer term, then the costs of contract fulfillment may be large enough to make re-negotiation appropriate. The party that has benefited from the state of the world may re-negotiate for several reasons. First, default on the contract may be costly for both parties (as where both parties have made contract-specific investments), and the party that has benefited from the changed circumstances may benefit more from the re-negotiation than from compensation payable on default. This will especially be the case where compensation is not forward-looking. Second, the contract may represent part of a longer term or wider business relationship. In both cases the party that has benefited from the outcome of the states of the world may have incentives to make concessions in re-negotiation rather than enforce the contract.

If, however, re-negotiation is not mutually advantageous, the disadvantaged party will be prepared to bear the costs of breaching provisions of the contract whenever this is cheaper than completing the contract. Further, the disadvantaged firm will be willing to invest in legal means of having the provisions invalidated, including appeals to competition law, up to the point of expected costs of liquidated damages and/or court-imposed costs for breach of contract. In this case, one of options (3) and (4) will be adopted. Because firms will assess and choose between these two options based on the expected payoff each provides, the two options are (from the perspective of economics) closely linked.

Breach of Contract or Appeal to Competition Law

The factors affecting the choice between options (3) and (4) are summarised in the following representation.¹⁰ The disaffected party to the contract will choose the lowest cost option of either

Unilateral Breach(B) or Breach and invoke Competition Law(C)

¹⁰ We recognise that anticipated future costs and benefits (as well as the likelihood) of an ongoing relationship between the parties will also affect the decision. We abstract from this problematic issue by presuming that the possibility of, and the nature of, any future relationship will be unaffected by the choice between the different approaches to breaching the contract. We have also assumed that a direct breach of the contract draws compensation payments.

The costs associated with these two options are:

The cost of a unilateral breach is the expected (E) compensation plus the legal costs () of obtaining it. The expected gain from appealing to competition law depends upon the probability of winning under competition law (pr). It consists of the legal costs of the competition law action () plus payment of compensation should it fail less any possible award should it win, both adjusted for the probability of winning. Note that it is the costs of the disaffected party that enter the calculation; no other agent's costs are included. Note also, that if future relationships are not affected, any award or compensation will simply be transfer payments: they only influence resource use, and hence economic efficiency to the extent that they affect decisions taken in the future. The resource costs are the legal costs. The total of these will include that of the party being breached against as well as that of the court system; and all these would have to be assessed to evaluate the economic efficiency of the choice of the disaffected party.

The party will choose competition law if

which illustrates that there can exist a very strong incentive to apply competition law even if the case is weak: that is, even if the probability of success is low. For any level of legal costs, the higher is the expected compensation and anticipated award the lower will be the probability of success that will make it worthwhile for a party to a contract to challenge it under competition law. This finding is enhanced by the fact that the determination of undesirable situations/behaviours under competition law is very inexact. The complexity of assessments of efficiency increase the potential for "type 2" errors to be made¹¹; that is, to find a breach of competition law when in fact there is no departure from the public interest.

¹¹ For any given "type 1" error probability.

This way of thinking about the payoff to alternative feasible actions where breach of contract is desired by one party also indicates that parties to a contract may have stronger incentives to challenge the provisions of the contract than do outside parties. Private third parties may challenge a contract where they are disadvantaged by a breach of competition law. If the court finds that a breach of competition law has occurred, the third party may be awarded damages and will in addition benefit from the absence of the anti-competitive behaviour in that market in the future. Parties to a contract who challenge it under competition law may also obtain the benefits of damages and altered market circumstances in the future. In addition, however, if the party to the contract has been disadvantaged by exogenous events during the term of the contract, this party will also benefit from the removal of the costs associated with continuing to meet the terms of the contract.

Impact of Competition Law on Contract Design

There is no unambiguous definition of contractual provisions that are in breach of the Commerce Act. In most cases, it is a time consuming and expensive process to ascertain whether the Commerce Act has in fact been violated. The ambiguity and expense of ascertaining compliance with competition law is increased by the particular words used in the New Zealand Commerce Act.

Section 27 (1) of the Commerce Act states that

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

The underlined phrase also appears in sections 27 (2) and 27 (4) of the Act. This phrase lowers the standard, and alters the nature, of proof. It appears to provide for the possibility that a provision of a contract that is likely to have the effect of substantially lessening competition at some time during the term of the contract represents a breach of the Act. Goddard (1997, 457) suggests that contracts that facilitate long term vertical or horizontal relationships should be treated as merger decisions: thus, if a contract is acceptable under competition statutes at the time it is written then these statutes should

have no future application to the contract. This argument also follows from the view that no aspect of the realisation of exogenous events during the contract should be viewed as relevant to the interpretation of the competitive implications of the contract. Thus, to suggest that the Commerce Act could be breached by provisions of the contract that may substantially lessen competition given some realisation of events that were uncertain at the time that the contract was signed is not consistent with economic efficiency. It would be extremely costly for parties to consider whether the different provisions in the contract might be regarded as a breach of the Commerce Act under future strategies and future states of the world. This would, in turn, significantly increase the costs of signing long-term contracts, and might result in parties being unwilling to sign efficient long-term contractual agreements.

One effect of the words used in Section 27 (1), (2) and (4) of the Commerce Act is to provide parties to a contract with an option exercisable during the term of the contract. This option to claim that provisions of a contract breach the Commerce Act could be exercised in the event that either party viewed the realisation of outcomes from the contract to be disadvantageous. It is at least plausible that at the time that Aco and Bco signed their contract they both recognised that contract provisions may be breached through an appeal to competition law. What would be the implications for efficiency if we assumed that Aco's and Bco's advisers had studied the Commerce Act and recognised this potential at the time that the contract was signed?

Opportunities to claim violations of the Commerce Act are not symmetrical between the two parties to the contract that we have described. It is less credible for a dominant firm to claim that a contract reflects the exercise of market power by a small entrant than vice versa. We would expect this asymmetry to be reflected in the provisions of the contract.

The ability of Bco to use the Commerce Act to breach the contract will, *ceterus paribus*, reduce the extent to which Bco invests in information relating to the contract. This will reduce the efficiency of the contract, since efficiency is enhanced by increases in the information available to either party to the contract. It will also mean that Bco will be willing to sign a contract for a longer period, even though its reduced investment in information would normally suggest a shorter contractual period. The option to use

competition law as a means of breach provides Bco with protection from outcomes that might make a long-term contract disadvantageous to it. This will have implications for the design of the contract. In particular, we would expect the terms of the contract to provide Aco with some compensation for the ability of Bco to limit its downside risk in this way.

If only Bco may credibly use a claimed violation of the Commerce Act as a means of breaching a contract provision whose *ex post* realisation is disadvantageous for it, Aco will respond in several ways. First, it is likely that Aco will make a larger specific investment in information relating to the outcome of the contract. In the absence of an option to breach provisions of the contract, it will be in Aco's interests to investigate the range and probability associated with outcomes that it would regard as disadvantageous.

Second, Aco's optimal response to Bco's option for breach will include shortening the length of contract. A shorter contract restricts the period over which there will be uncertainty about the realisation of contingent events. As compared to longer contracts, changes in market circumstances can be managed at contract renewal rather than within the parameters of an established contract. A short term will limit both the value and the credibility of attempts to use competition law to resile from the contract. It will reduce the magnitude of any damages or penalties payable if any provision is deemed to violate the Commerce Act, and reduce the magnitude of any losses suffered from honouring it. Thus, a short term will reduce the incentive for Bco to use competition law to breach the contract. In general, this is likely to have the effect of inhibiting dynamic efficiency by reducing the period of commitment required for investment in specific assets.

Third, Aco's preference for a short-term contract, its specific investment in information relating to provisions of the contract, and its lack of an option to breach a provision all suggest that Aco will require a higher expected return to sign a given contract. That is, the terms of the contract will have to be more favourable to Aco to compensate for the option that the Commerce Act provides for Bco to challenge contract provisions once the outcomes are realised.

More generous terms for Aco create a further problem: they increase the likelihood that in evaluating the contract the Commerce Commission or the High Court will take the view that the contract breaches the Commerce Act. These bodies should consider the fact that the option for Bco to claim a breach of the Commerce Act after the contract has been signed makes it more likely that the terms of the contract will look advantageous to Aco. This balance of advantage in the contract will, however, reflect efficient contracting, not the exercise of market power.

Where the courts are willing to rule a provision unenforceable until there is a substantive decision on the case, the incentives for Bco are amplified. A claim of breach of the Commerce Act may result in the plaintiff being able to reduce or suspend payments, making the defendant an involuntary creditor of the plaintiff, and with court delays this situation may persist for a substantial period of time. If the claims of Bco are motivated in part by adverse changes in market circumstances that influence its financial viability, then the Commerce Act option will be particularly attractive.

Our analysis suggests that the option for Bco to utilise the Commerce Act to breach provisions of the contract will result in the two parties having different views about the optimal length of the contract. In particular, Bco will prefer a long-term contract, but without the option to appeal to the Commerce Act a shorter contract allowing for regular renegotiation of terms might be preferred. The option available to Bco will also influence the distribution of expected returns associated with the contract, and provide an asymmetry in the incentives for Aco and Bco to invest in information relevant to the negotiation of the contract. More generally the potential to appeal to the Commerce Act increases the costs associated with writing long-term contracts, and hence reduces dynamic efficiency in the economy as a whole.

5 Means of Addressing the Incentive Problems

We have argued that for Aco and Bco there are asymmetries in both the incentives to appeal to competition law and the credibility of any such appeal. In this section we consider some means by which these asymmetries may be addressed.

1. First, we note that it is not possible for the two parties to agree that the Commerce Act will not apply to their contract: Private contracts cannot override the Commerce Act. An alternative to contracting out would be for the Commerce Commission to be able to review and authorise contracts as a whole *ex ante*.¹²
2. The Commerce Commission could indicate that it would take action against both parties to a contract if either party succeeded in a private Commerce Act action against the contract.
3. The Commerce Act could be amended so as to be less expansive in its definition of contractual terms that could be held to be a breach of the Act.
4. Recognising the incentives for parties disadvantaged by the outcomes of contracts to make spurious claims of breach of the Commerce Act, the High Court could adopt a strong test for the consideration of such appeals.
5. When there is evidence that the *ex post* realisation of gains in the contract has given the complainant a private interest in resiling from contract provisions, this strong test might include enforcement of the provisions of the contract until there is a decision on the substantive issue.
6. Where any provision is found illegal, the whole contract becomes unenforceable. This will ensure that contracting tradeoffs that determine the balance of parties' interests across provisions are considered more thoroughly in any consideration of a challenge of any specific provision. Section 89(2) of the Commerce Act presents this opportunity to the Court now.

We view all of these courses of action as worthy of consideration in the sense that they have the potential to enhance efficiency by improving incentives, reducing the scope for opportunism, and lowering the costs of writing contracts.

¹² Presently this can only be done for prospective contractual arrangements tested against one or more specific subsections of the Commerce Act.

6. Conclusion

The purpose of competition law is to promote economic efficiency of which a large component is dynamic efficiency. Impediments to efficiency should be addressed by the application of competition law only insofar as these impediments are expected to persist into the future. Because enforceable contracts are critical to dynamic efficiency, it is properly a function of the administration of competition law to bolster the enforceability of contracts.

Parties to contracts in New Zealand have a “Commerce Act option” to claim that provisions of the contract breach competition law. Because it will not normally be credible for a dominant incumbent to claim that an entrant used its market power to insert inefficient provisions into a contract, the Commerce Act option introduces an asymmetry into the contracting process. This asymmetry will increase the transactions costs of contracting. It will also influence the term of the contract that is preferred by the different parties, the distribution of expected returns between the two parties, and the willingness of the two parties to make investments in information relevant to the negotiation of the contract. As a consequence, we have argued that the Commerce Act option will reduce the dynamic efficiency in the economy as a whole.

In interpreting any claimed violation, courts should consider that an entrant who is disadvantaged by changes in states of the world will have a strong incentive to claim that provisions in the contract violates the Commerce Act. This will be true even where there is a low probability of a judgement in their favour (that is, where the case is weak). An action brought on this basis has no grounding in economic efficiency. In addition, where both parties anticipate that the entrant has the option of breaching provisions by appealing to the Commerce Act:

- Entrants will rationally make lower sunk investment in information relating to the contract and, despite this low investment, prefer a long-term contract.
- The incentives for the dominant firm are to write a short-term contract and to make a substantial sunk investment in information relevant to the writing of the contract.

- To compensate for the Commerce Act option, the entrant will have been willing to offer and the dominant incumbent will require, a higher expected return over the term of the contract.

The incentives and actions of the plaintiff in the contracting process must be considered in forming a view about the credibility of any claimed breach of the Commerce Act. In cases conforming to the scenario for Aco and Bco analysed in this paper, the incentives for the entrant, Bco, to make spurious claims of breach of the Commerce Act are high. Consequently, we consider that pending a substantive decision on the case, the contract provisions should be enforced. These factors suggest to us that a determination that the Commerce Act had been breached should only be made where the breach is plain. Marginal breaches would be too difficult to distinguish from an efficient contract given the incentives created and balance of returns necessary to compensate for the Commerce Act option. We have also suggested that the Commerce Commission should consider taking action against both parties to a contract if either party succeeded in a private Commerce Act action against the contract. Implementation of these suggestions would, in our view, mitigate the efficiency losses that currently result from the potential for appeals under the Commerce Act to be used as a means of breaching efficient contracts.

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