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THE PRICE OF CONTROL
Efficient Regulation of Monopoly Pricing

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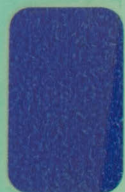

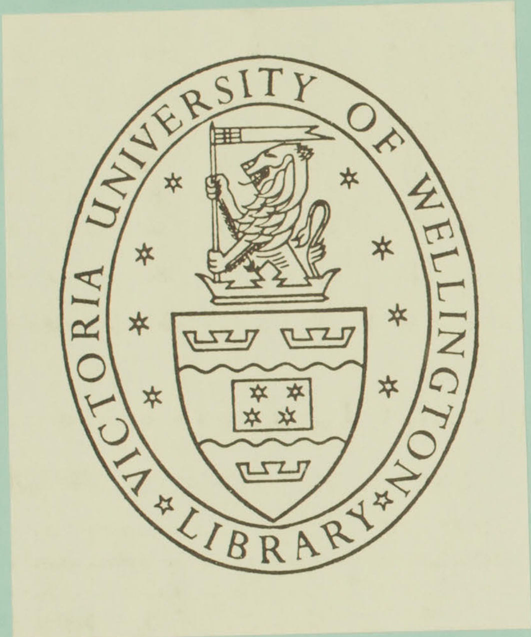
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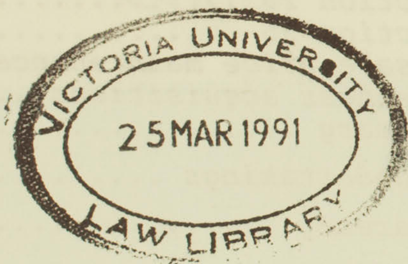
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INTRODUCTION

IN 301 A.D. THE EDICT OF DIOCLETIAN was promulgated,[1] fixing maximum prices for commodities, freight rates and wages. Its aim was to restore the Roman Empire which was "breaking up in misery and confusion, bankruptcy and anarchy" and those who defied the Edict were severely punished. Inflation and war were the causes of this economic disaster, along with the ambitions of powerful men. The Edict failed to restore the economy and the Roman Empire collapsed. It was 1600 years before such an elaborate price control scheme was again attempted.

The control of prices has been a matter of concern for as long as trade and markets have existed. Legislation to prevent monopolies and practices affecting the price of goods and food in Britain dates back to 1552.[2] In New Zealand statutory price control began early this century and has arisen directly from the economic climate. The New Zealand economy was heavily regulated and restricted after World War I. Controls diminished the market's flexibility so that it could not respond quickly to the changing needs of its own or the world markets. The introduction of tariffs and licences for the import and export of goods in 1938 also considerably isolated the New Zealand market by preventing competition from overseas companies. Monopolies became frequent and those who could import goods worked from positions of dominance. Direct price control was necessary to prevent the abuse of market power, especially for essential goods. Price control

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1. *H Michell, "The Edict of Diocletian: A Study of Price Fixing in the Roman Empire" The Canadian Journal of Economics and Political Science, Vol XIII No.1, February 1947 p1*
2. *J Collinge The Law Relating to the Control of Competition, Restrictive Trade Practices and Monopolies in New Zealand (1969) Sweet & Maxwell (N.Z.) Ltd, Chapter 2*

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was used to stabilise prices and the economy, and during times of war and high inflation it was most stringently applied.

In the last six years the pace of de-regulation in New Zealand has increased rapidly. Gone are many of the restrictive legislative provisions which prevented competition and protected monopolists. Gone too, are the controls that were needed to prevent the abuse of market power concentrated in those monopolies. Many previous monopolies now face competition and, in order to survive, are forced to become more efficient. Natural monopolies remain, however, where it is inefficient or impossible to duplicate the services provided. Regulation of these firms remains necessary but the move has been away from heavy-handed statutory regimes to "light-handed" regulation and more stringent disclosure requirements.

Until the mid 1970s the emphasis behind price control was stabilisation of prices in the face of high inflation and excess demand. This changed, however, and in line with the de-regulation and free market policies of the 1984 Labour Government, the policy behind anti-competitive laws became the promotion of competition. In Western economies competition is currently held to be the most efficient method of allocating resources. In a perfect market supply matches demand and the market regulates itself accordingly. Where prices are too high consumers either refuse to buy or turn to competitors who sell at lower prices. If a monopoly is charging high prices, potential competitors see the opportunities and enter the market, thus providing competition.

The market is not perfect; in some areas it fails. Natural monopolies will always exist and Government intervention may make it impossible for new

competitors to emerge. Those firms who have managed to gain market power may create entry barriers which prevent new participants entering the market. Legislative intervention is justified only when the market fails - when the market performance, from a consumer welfare point of view, is economically inefficient.

The need to control prices is exacerbated by New Zealand's ongoing inflation which pushes prices steadily higher. Although the New Zealand economy is now subject to fewer controls inflation is running at 7-8% for 1990.[3] The Reserve Bank of New Zealand has projected an inflation rate of 3-5% for next year,[4] and must reach the Government set target of 0-2% by the end of 1992.[5]

Legislation can be in two different forms. It may control an industry by statutorily dictating the maximum price at which the industry may sell its goods and otherwise intervening in the industry's management and decision making. Monopolists often benefit from regulation. Where the permitted rate of return of a monopoly is based on its capital investment monopolies may invest in over-capacity equipment and thus increase their guaranteed return at the expense of efficiency. Regulating bodies have no way of knowing whether the use of such equipment is efficient as their information comes from the monopolist.[6] Monopolists tend also to be inflexible and bureaucratic, dictating rather than responding to market demands.

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3. *Inflation rate for the March year is 7.2% to date: B. Hodgetts "Monetary Conditions and Policy" 53 No.2 RBNZ Bulletin 1990, p115*
4. *Reserve Bank of New Zealand Monetary Policy Statement, September 1990, p1*
5. *See the Policy Targets Agreement signed by the Minister of Finance and the Governor of the Reserve Bank on 2 March 1990*
6. *Jill Hills De-regulating Telecoms: Competition and Control in the United States, Japan and Britain (1986) Francis*

The alternative to control is legislation that may be more regulatory in nature. It determines a list of practices which are forbidden and sets behavioural guidelines and requirements. Within the limits imposed the industry is free to make its own decisions. Today, regulation is imposed where market power is concentrated and competition is insufficient to ensure maximum allocative efficiency. The legislation focuses on promoting competition and preventing it from being impaired. The emphasis on competition does have one danger, however. The ultimate aim is efficiency; competition is merely the means to that end and the goal of efficiency is sometimes lost from sight. While for the most part promoting competition promotes efficiency that is not always the case.

In New Zealand the control of prices has nearly come full circle. Initially prices were regulated by indirect methods, with control being imposed by statute only in this century. Since the early 1980s a policy of deregulation has been speedily implemented and the direct control of prices by statute has been drastically reduced as deregulation has led to increased competition and removed the need for direct control. With many goods the market itself now determines the behaviour of participants and there is less scope for unfair practices. Today only one product comes under the express statutory price control regime in the Commerce Act 1986 and it is unlikely that others will be added.

The power of statutory price control today lies in the threat of its application. It is not a very flexible or efficient method of control and alternative regulatory methods have arisen. Undertakings to limit price increases have been set out in Deeds or written into a company's articles. In some industries

mandatory public disclosure with an independent monitor and public scrutiny has been proposed. Behind these methods lies the constant threat that restrictive regulation may be imposed on an industry if the Government believes it is required. If there are political reasons for constraining a market a central body may be created which indirectly controls the industry. The success of these methods has yet to be determined in New Zealand.

Why have different ways of preventing abuse of market power? Each method endeavours to provide some restraint while retaining as much efficiency as possible. The needs of the market are not constant, however. Certain industries will, because of their structure and function and importance, require a much higher degree of regulation. The loss of efficiency caused by the regulatory mechanisms is far less than that lost by destructive market practices such as high prices, poor quality and a limited range of goods, over-capitalisation and other practices found in monopolistic industries. Other industries have constraints placed upon them in the market by, for example, a limited amount of competition or the pressures of participants in the markets vertically above or below them. "Light-handed" regulation is all that is required to ensure their efficient performance. It is necessary to determine the likelihood of poor economic behaviour in an industry and weigh it against the loss of efficiency a regulatory measure will bring.

This paper looks at methods of regulation and control of monopoly industries found in New Zealand; their success as a regulatory mechanism and their effects on allocative efficiency. The history of the statutory price control regime which, until recently, has been the major form of restraint on monopoly

industries is set out in Part I. Price control itself is discussed in Part II and alternative measures of control and regulation are examined in Part III.

PART I: HISTORY OF STATUTORY PRICE CONTROL

New Zealand initially hesitated to regulate an economy which was fairly strongly self-regulating - a carry-over from its early pioneering attitudes. Most early regulation was indirect, for example, early state owned enterprises were created to compete against the monopolies.[7] The aim was to provide competition to regulate the industry. However, the state owned enterprises emulated the monopolies and defeated the purpose of their creation.

The Monopoly Prevention Act 1908 was the first direct legislation relating to price control, but it covered too small a range of goods to be very effective.[8] The Commercial Trusts Act followed in 1910, deeming conspiracies to monopolise or control prices to be an offence if contrary to the "public interest". It too only affected a limited number of goods and there were few prosecutions. The landmark case of *R v Crown Milling Co Ltd*[9] was decided under this Act. The Crown Milling Company was formed as sole selling agent for the millowners, creating a partial monopoly which controlled the supply and price of flour for most of New Zealand. The Privy Council held this arrangement was not unlawful as it was not contrary to the public interest and the determination of the price of wheat was left in the hands of the industry. Flour later became a price controlled good.

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7. *A. Bollard "More Market: The Deregulation of Industry" published in A. Bollard & R. Buckle Economic Liberalisation in New Zealand (1987) Allen & Unwin, p26. See also below n8, p2*
8. *Y. van Roy Guidebook to New Zealand Competition Laws (1987) Commerce Clearing House, p2*
9. *[1925] NZLR 258, [1927] AC 394 (PC). This case illustrates the weakness of the statutory provisions - see above n8, p3*

During and as a result of World War I price controls were created under a succession of Acts on only a limited number of goods - and reluctantly.[10] Control was required because of the shortages but was only used where necessary. At the end of the war the Board of Trades Act 1919 was passed and regulations were promulgated to control the prices of selected goods[11] - demand was still greater than supply. It was also illegal to profiteer at "unreasonably high prices" if the sale might or did produce "more than a fair and reasonable rate of commercial profit".[12] The provisions were so vague that they lead to few convictions. The Prevention of Profiteering Act 1936 which followed was more precise - but again no prosecutions resulted under this Act.

At the beginning of World War II selective control was replaced by comprehensive controls issued under emergency regulations. The fear of shortage and future price increases lead to the belief that there was no alternative to control, although there were many arguments against the wisdom and viability of such a course.[13] Control prevented the excess demand created by shortages from damaging the post-war economy until that demand had been worked off. Post-war Germany in particular had a low tolerance for excess demand and faced economic disintegration. Price control, supplemented with rationing, was fairly effective in staving off disaster in Germany, whereas in the United States the rapid removal of its wartime controls resulted in high levels of inflation in the 1950s.[14]

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10. *C. Cliffe "Price Control and Profitability Assessment Under the Commerce Act 1975" (1984) 2 Cant Law Review 133, footnote 2*
11. *Above n8, p198*
12. *Section 32. See above n2*
13. *J.K. Galbraith A Theory of Price Control: The Classic Account (1980) Harvard University Press, p5*
14. *Above n13, p38*

In New Zealand the Control of Prices Act 1947 consolidated the wartime powers of price control and re-enacted profiteering offences similar to those in the 1919 Act[15]. The 1947 Act remained in force until 1975. As New Zealand was not a manufacturing country the aim of price control was to promote price stability and protect consumers rather than to improve or direct the development of industrial efficiency.[16] The 1947 Act prohibited price increases above "the price of goods and services of substantially the same nature and quality ruling at the 1st September 1939" without permission.[17] The focus was on the prices, rather than whether the industry was abusing its market powers. The aim was stabilisation of prices; efficiency was not an issue.

From the 1950s the National Government exempted such an increasing number of goods and services from control that a Positive Price list of controlled goods was created; other goods were subject only to market control. The 1947 Act had also created a Price Tribunal, which was responsible for the administration of the system and whose consent was required before the prices of any Positive List goods could be raised. However, the method of control proved unpopular, causing delays and expense to controlled industries. It also reduced competition and resulted in the movement of investments away from controlled industries.[18]

With fewer controls on prices it became evident that other trade practices legislation was necessary.

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15. *Above n2, p46*
16. *Above n10, p134*
17. *Above n2, p55*
18. *J. Collinge The Law Relating to Restrictive Trade Practices and Monopolies, Mergers and Takeovers in New Zealand (1982) 2e Butterworths, p332*

The Trade Practices Act 1958 was passed to control the economy and promote stability by preventing de-controlled industries setting up their own anti-competitive rules - as in the *Crown Milling* situation. The restriction of anti-competitive activities was designed to increase the scope and importance of industry - and strengthen competition - so that the market would self-regulate. The philosophy was free enterprise.

Throughout the 1960s the Positive List contained only key inputs - fertilisers, subsidised basic foods (such as bread), imported items handled by monopolies (fruit, sugar) and drugs.[19] The Trade Practices and Prices Commission was created under the 1958 Act to take over the old Price Tribunal's function.

The economic recession in the late 1970s was accompanied by increasing external and internal deficits and declining terms of overseas trade.[20] Inflation in the seventies and eighties was also persistently high and controls were required on goods to prevent the prices increasing at higher than inflation rates. The trend towards de-control was reversed. In 1972 the Stabilisation of Prices Regulations were introduced,[21] reorganising the Positive List into two categories, A and B, and re-introducing "blanket" price controls.[22] The price of Category A goods could not be increased without the Commission's approval. In 1975, as a result of continuing inflation, general dissatisfaction with the

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19. *J. Ayto & A. Bollard "New Zealand Distributive Trades: Pricing, Regulation and Structural Change" NZ Institute of Economic Research (Inc) Research Paper 34, 1987, p66*
20. *Above n10, p135*
21. *Promulgated under the Economic Stabilisation Act 1948*
22. *Above n8, p198*

bulk of regulations and a greater demand for competition policy, the Commerce Act 1975 was passed, consolidating the provisions of the 1947 and 1958 Acts.

The Commerce Act 1975

Under the 1975 Act the Secretary of Trade and Industry took over the role of approving price increases for Category A goods. For the first time a right of appeal[23] was provided - to the Commerce Commission. It was only once an appellate process existed that the methodology of determining prices became an issue. In 1977 Category A goods again became a Positive List of controlled goods. A new policy of de-regulation led to a slow decrease in the number of controlled goods.

De-control, the process whereby goods and services ceased to have fixed statutory prices, was more rapidly implemented once the Labour Government came into power in 1984. By 1986 only nine[24] items were still controlled, mostly in industries undergoing restructuring in some form.[25] Such de-control was only possible because of the de-regulation across the industry. Control was no longer required where import protection and tariffs were removed sufficiently to allow in overseas competition, or local industries were open to local competitors through de-regulation.

The 1975 Act introduced legislation designed to promote competition, a move away from the earlier focus on stabilisation. The 1975 Act's long title declared its policy:

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23. *Other than those which could be brought under the limited and limiting writs system*
24. *Butter, cement, drugs, bran and pollard, flour, steel, natural gas, and milk - Report of the Commerce Commission for the year ended 31 March 1987*
25. *Above n19, p74*

> *An Act to promote the interests of consumers and the effective and efficient development of industry and commerce through the encouragement of competition, to prevent mischiefs that may result from monopolies, mergers, and takeovers and from trade practices ... and to provide for the regulation, where necessary, of the prices of goods and services.*

The legislation aimed to stimulate competition by eliminating anti-competitive practices and promoting improved efficiency and productivity. Prices would be regulated only where necessary.[26] Competition was considered to be the most satisfactory method of achieving what was in the best public interest.

Section 98 of the 1975 Act contained the statutory criteria for determining applications for price increases. Some of the criteria conflicted, for example, maintaining stable internal price levels and achieving full employment (paragraph a). It was noted of the criteria that[27]

> *[t]hey provide only the framework for determining a justified price. Their effectiveness is dependent on the manner in which they are interpreted and applied.*

And this is where the problem lay: in applying the criteria the Commission's emphasis was on keeping prices low rather than promoting allocative efficiency. Low prices were considered to be in the best public interest. The Secretary and the Commission were strongly influenced by the policies under earlier Acts - in the 1976 *Bakers Association*[28] Case the

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26. *Above n10, p136*
27. *Above n10, p137*
28. *New Zealand Association of Bakers (Inc) v Secretary of Trade and Industry (1976) 1 NZAR, transcript D13. See above n10, p151*

Commission followed past decisions made under different economic conditions. In 1981 the Director of the Commerce Division of the Department of Trade and Industry said in evidence in the *Brewers Association* Case[29] that he thought "the passing of the Commerce Act did not really change the administration of price control from either the 1974 or the 1973 regulations." The Commission accepted and entrenched this attitude, despite the fact that the Act's expressed objectives included effective and efficient development of industry through competition, and the criteria had never been fully argued before a pricing body.[30]

In practice the profitability criterion dominated all others.[31] The Secretary and Commission generally applied the return on shareholders' funds test set out in section 98(1)(c).[32] Prices were fixed to cover costs and allow a reasonable return on capital.[33] "Reasonable" was determined by considering the average rate of return earned by companies listed in the Reserve Bank of New Zealand industry statistics.[34] These statistics, while independent, were recognised as not being terribly accurate,[35] nor were there any other independent figures available to take their place.[36]

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29. *Brewers Association of N.Z. (Inc) v Secretary of Trade and Industry Decision No.54A, 6 November 1981, paras 61-72*
30. *Above n10, p144*
31. *Above n10, p141*
32. *The two other tests based on assets employed or annual sales were rarely used*
33. *I McKay "Stabilisation of Wages and Prices" Wellington District Law Society Seminar Series 1977*
34. *Above n10, p158*
35. *Interview with Mr C.G. Pottinger, 28 August 1990*
36. *Report of the Commerce Commission Following an Inquiry into the Question of Removal of Cement From the Positive List of Controlled Goods and Services 1981 and an Inquiry into Certain Matters Relating to Price Control and Pricing Practices and the Manufacturing and Distribution of Cement, March 1986, para 147*

The Secretary authorised rates that were not "notably out of line with that earned by the general run of companies".[37] Prices were set by the Secretary either on an industry average price or on a price based on the performance of one or a few firms. These prices prevented firms using their market power to earn excess profits at the consumers' expense, but permitted sufficient profit for the firm to maintain financial stability and economic viability.[38] If a firm made too much profit price increases were disallowed. In an early appeal a substantial return on investment was considered by the Department to be "wholly inconsistent with Category A price control".[39] Excess profit was seen as contrary to the policy of the Act, even if it was because the firm had performed particularly well and had streamlined its procedures. The Department's policies were a disincentive towards efficiency.

The shareholders' funds method was criticised[40] because it failed to specify the components that should be included as assets and liabilities in determining profitability. Adjustments were made to the figures to negate the effects of tax incentives, asset revaluations and the elimination of other export trade assets and funds (and their income) but these adjustments were so arbitrary that they did not reflect the firm's true position. In *Bakers Association*[41] the Secretary stated that he would not permit any major departure from historic cost accounting because this would be a major policy decision and he saw no reason to make any policy change.[42] The Commission also

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37. *Golden Bay Cement Co Ltd v Secretary of Trade and Industry (1982) 3 NZAR 76 - Above n10, p158*
38. *Section 98(1)(ca) - See Above n10, p139*
39. *Akrad Radio Corporation Ltd v Secretary of Trade and Industry (1977) 1 NZAR para 23 - Above n10, p141*
40. *Above n10. This method was also criticised in Re an Application by the Natural Gas Corporation of New Zealand Limited Commerce Commission Decision No. 207, 31 July 1987*
41. *Above n28*

refused to accept any changes because of the long practice of the Price Tribunal in applying the historical cost method.[43]

The 1976 amendment introduced a replacement cost valuation test.[44] It directed the Secretary or Commission to have regard to the replacement cost of current or fixed assets if they considered it necessary to the preservation of "the financial stability and economic viability" of the business. This provision should have enabled the Secretary and Commission to use this test in the place of the section 98(1)(c) tests, but it was so narrowly construed that it was only used to rescue firms "going to the wall".[45] Once again the Secretary and Commission failed take advantage of an opportunity to modify and improve the policy behind price control.

The market and economic conditions changed but price control increases continued to be determined under inadequate, archaic policies.[46] The focus was on limiting price increases so that the firm's profit margin remained "reasonable" - it was *profit* control rather than *price* control.

The most detrimental effect of this approach was the failure to give any recognition to efficiency and the resulting lack of incentive to improve. Greater efficiency would lead to higher profits - but little or no price increase would then be permitted. Inefficient firms with small profits could survive because their prices would be statutorily increased, whereas in a competitive market they would have to absorb some costs

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42. *Above n10, p148*
43. *Above n10, p148*
44. *Section 98(2)*
45. *Above n27. See also above n10, p151*
46. *Above n10, and n4*

and become efficient to succeed.[47] Despite its mention in section 98(1)(a) and in the general objectives in section 2, efficiency was not a factor that the Secretary or Commission generally considered in determining statutory price increases.[48]

By 1986 Government policies had changed to promote a free market economy and widespread competition. The Commission accepted that the philosophies and policies it was applying were no longer appropriate and a new approach was finally taken under the Commerce Act 1986.[49]

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47. *Above n33*
48. *Above n10, p167*
49. *Above n8, p198*

PART II: STATUTORY PRICE CONTROL: THE COMMERCE ACT 1986

Introduction

> *The Labour government's general rationale for its competition law is to "[minimise] the social costs associated with collusive practices and use of market power for anti competitive purposes ... thus encouraging economic efficiency".*[50]

The present Act aims "to promote competition in markets within New Zealand".[51] Among the many changes to the legislation are modified price control provisions which, in the de-regulated market, are only to be used as a last resort.[52] Political controls are likely to be the most effective deterrent for State Owned Enterprises but any abuse of power can also be restricted by statutory price control if necessary.[53]

Ideally, price control should force firms to operate as they would in a competitive market. This is impossible; a more realistic "second best goal" is[54]

> *[t]he production of maximum output at lowest price consistent with (a) technically efficient use of inputs, and (b) permitting the firm to earn a reasonable rate of return to investment.*

Today natural gas remains the only controlled good under the Commerce Act 1986 (the Act).[55] The Order is

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50. *K.M. Vautier "Competition Policy and Competition Law in New Zealand" published in A. Bollard & R. Buckle Economic Liberalisation in New Zealand (1987) Allen & Unwin, p53*
51. *Long title to the Commerce Act 1986*
52. *Above n50, p59*
53. *Chairman of the Commission, Commerce Commission Press Statements, 16 September 1986, 23 October 1986*
54. *Bello, "The Firm, Investment, Rate of Return and the Monopolies Commission (1977) 4 Jrnl of Business Finance and Accounting, p242. Quoted above n10, p138*
55. *See the Controlled Goods (Natural Gas) Order 1986*

due to expire on 31 December 1990, but as yet there is insufficient competition for the industry to be de-controlled. The natural gas industry "is characterised by a high degree of Government intervention at all functional levels of the market."[56] All natural gas mined is sold to the Government who on-sells it to Petroleum Corporation of New Zealand (Petrocorp), its wholly owned subsidiary Natural Gas Corporation of New Zealand (NGC), and Electricorp. NGC on-sells the bulk (64%) of its gas to franchisees who have exclusive supply areas.

Declaration of Price Control

Part IV contains the provisions for placing goods under price control. Under section 53 goods shall only be controlled if the competition in the market is limited or is likely to be lessened, and it is necessary or desirable in the interests of users, consumers, or suppliers. The Minister of Trade and Industry may recommend that prices be controlled, and the Governor-General may then make an Order-in-Council following that recommendation.

The Order-in-Council may specify[57] whether the Order will apply to goods only -

(a) Within specified regions, areas, or localities in New Zealand;
(b) In different quantities, qualities, grades, or classes;
(c) For the use of different persons or classes of persons.

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56. *Re an application by the Natural Gas Corporation New Zealand Limited for an authorisation of prices of controlled goods and services, Decision No. 207 of the Commerce Commission Decision, 31 July 1987, p6*
57. *Section 53(4)*

The Commerce Commission may also make recommendations to the Minister and the Minister may in fact require that the Commission do so. Once goods and services have become controlled, section 55 restricts their supply unless the Commission has authorised a price under Part V of the Act and the supply complies with those provisions. If section 55 is contravened a maximum fine of $30,000 for body corporates and $10,000 for others is sanctioned.[58] The Commission may also obtain an injunction and contracts may be varied or cancelled.[59]

A supplier of controlled goods or services may apply to the Commission for authorisation of a maximum, actual, or minimum price for those goods. The Commission "shall authorise prices in such manner as it thinks fit" and may also include provisions that it "thinks necessary or desirable for the proper administration of the authorisation, or to ensure compliance with its provisions".[60] The reasons for the Commission's decision must be given in writing.

The procedure for price clearance applications is the same as for all applications for authorisation under the Act.[61] The provisions for giving public notice are different, however. The Commission may by its own motion authorise prices by notice in the Gazette and shall do so at its own discretion.[62] Authorised prices must be published but as the Commission thinks fit, although amendments to authorisations must be gazetted.

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58. *Section 86*
59. *Sections 87(a), 89*
60. *Sections 70(4), (5)*
61. *Section 60*
62. *Sections 70(3), (4)*

If the Commission requires further information to enable it to exercise its powers under Part IV of the Act that information must be furnished.[63] Its powers for gathering information are widely expressed.

A provisional price may be authorised under section 71 while an authorised price is being determined. There is no time limit on provisional prices, nor may they be appealed from.[64] If the actual price subsequently determined is lower, refunds may be made.

The Commission has no power to receive complaints from consumers and act on them under Part IV. However, where any type of consumer complaint is received the Commission may look at whether there is sufficient evidence for the Commission to make a recommendation to the Minister under section 53 of the Act. The Minister will have the final say as to whether price control is imposed. Recently the Commission received over 150 consumer complaints about Telecom's price and quality of services.[65] Commission investigators met with Telecom's senior management and received written responses from Telecom under fifty categories of complaints. Telecom's explanations were that standard charges have been introduced to previously free services and the reduction in cross-subsidisation had increased prices for some services. Telecom accepted that computer malfunctions had caused some account errors and that staff training on handling complaints had been inadequate. The standard contract was also

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63. *Section 70(7)*
64. *<u>Northern Roller Milling Co Limited</u> v <u>The Commerce Commission</u> [1990] NZAR 112, 116. Welgas Holdings Limited criticised this in their Submission (No.35) on the Commerce Amendment Bill. The Amendment Act (1990, No.41) made no changes on these points*
65. *Press Statement from the Commerce Commission, 18 July 1990. 130 complaints were investigated*

being revised.[66] Although there was some substance to the complaints, the Commission decided that that Telecom's behaviour did not substantially lessen or prevent competition and that there were no compelling reasons to warrant a formal investigation into suitability of price control for Telecom.[67] "Price control", said the Commission Chairperson, "may distort market price signals normally present in that market, outweighing any benefits to consumers from price control."[68]

The statutory criteria

The new Act made considerable changes to the statutory criteria previously considered under section 98, so much so that it could be inferred that "Parliament intended a major departure in the approach to be adopted by the Commission."[69]

In 1985, at the time the Commerce Bill was being debated, the Commission was enquiring into the cement industry[70] and it discussed the approach it would take to the new criteria once they passed into law. In determining prices, efficient firms would be permitted to make adequate profits, thus giving them incentives to be efficient, but users and consumers would be protected from costs being automatically passed onto the consumer if they would have been absorbed in a competitive industry.[71]

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66. *Letter to the writer from the Commerce Commission dated 21 September 1990. The standard contract has also been re-written with many changes based on the Report by the Ombudsman Nadja Tollemache on an Investigation into the Standard "Contract for Telecom Services" used by Telecom Corporation of New Zealand Limited 17 November 1989*
67. *Above n65*
68. *Above n66*
69. *Auckland Bulk Gas Users Group v The Commerce Commission (1989) 2 NZBLC 103,723, 103,733*
70. *Above n36. See also above n8, p202*
71. *Above n36, paras 69 and 181*

The first Commerce Commission decision on price control under the new Act was the application by the Natural Gas Division of Petrocorp,[72] Decision 174. The crucial issue for the industry was the methodology of determining the price to be applied (discussed later). Incredibly, the Commission referred to the old criteria and applied the old methods, considering essentially the same matters in determining the rate of return as it considered under the 1975 Act. It also drew on precedents set under that earlier Act.[73]

As NGC was dissatisfied the Commission agreed to re-examine the issue, which it did in Decision 207. This decision represented a complete change in policy from its precedents. The historical method of cost accounting was finally discredited and a new methodology, representing a considerable improvement, was put in its place. The decision was appealed but the High Court upheld it, noting that:-[74]

> *[i]t is fair to say that under the new Act there is a new regime and a regard to new considerations without any obligation to keep to the past and, indeed, an indication that new methods and considerations are to be applied.*

Section 73

There are considerably fewer statutory criteria to be considered in determining the price for goods under the 1986 Act. Section 98 has been replaced by the much broader provisions in section 73:

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72. *<u>Re an application by the Natural Gas Division of the Petroleum Corporation of New Zealand</u> for an authorisation of prices of controlled goods or services, Decision No. 174 of the Commerce Commission Decision, 11 September 1986. The Natural Gas Division later became the Natural Gas Corporation of New Zealand Ltd (NGC)*

73. *Above n72, para 87*

74. *Above n72, p103,733*

73. In exercising its powers under sections 70 and 72 of the Act, the Commission shall have regard to -

(a) The extent to which competition is limited or is likely to be lessened in respect of the controlled goods or services:

(b) The necessity or desirability of safeguarding the interests of users, or consumers or, as the case may be, of suppliers:

(c) The promotion of efficiency in the production and supply or acquisition of the controlled goods or services.

In these criteria the change in policy can clearly be seen. The old emphasis on a firm's profitability now has no statutory expression. No statutory methodology is provided, nor is there a detailed list of factors which must be considered. Many of the old criteria will still be pertinent but the focus in the Act has changed to promote competition and market efficiency, while protecting the vulnerable groups in the industry.

The Commerce Commission applied the section 73 criteria in Decision 207 and the points raised are summarised below.

(a) Competition

Price control recommendations can only be made where competition in a market is limited or is likely to be lessened.[75] In order to determine the extent of competition it is necessary to determine the "relevant market". Markets at several functional levels were identified, all of which are highly regulated. Both the prospecting and mining of natural gas require a licence[76] which is granted at the discretion of the Minister of Energy. All gas is sold to the Crown and

75. *Section 53*
76. *Section 4 of the Petroleum Act 1937*

sales of reticulated gas are made only to NGC. Retail sales are regulated in franchise areas under the Gas Act 1982. Only franchise holders may supply gas and the Minister of Energy may grant only one franchise in any one area.[77] There is a chain of monopolies through all market levels to consumers and end users.[78]

Eighty percent of NGC's natural gas is used by industrial consumers. Natural gas has limited substitutability in the industrial and commercial user markets because it is much cheaper than other energy sources and requires substantial capital commitment in setting up the equipment for industrial use. CNG users retain the choice between petrol and CNG. Domestic consumers may choose between electricity and gas, however, once gas appliances have been fitted the choice is narrowed for the life of the appliance. The Commission concluded that competition in the wholesale and commercial retail markets was very limited.[79]

(b) Safeguarding the interests of users, consumers and suppliers

Where competition is limited there is a greater need for protection:[80]

> *If competition is workable or effective then the unimpeded operation of the market will safeguard customers' interests to a greater or lesser degree. In a market where effective competition is absent price control can be effective in safeguarding customers' interests.*

The Commission's concern was to safeguard the indirect interest of customers by controlling the

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77. *Section 21 of the Petroleum Act 1937.*
78. *Above n72, p3*
79. *Above n57, paras 19, 20*
80. *Above n56, para 21*

wholesale price of natural gas and, in the retail market, to protect the more vulnerable industrial and commercial users who would face high costs if they were to convert to other energy forms. The Commission noted that it was necessary to ensure that these users did not subsidise other customers. Having identified the need to safeguard users, consumers and suppliers the Commission showed that it had satisfied section 53(2)(b) of the Act and was thus able to make a recommendation that prices be controlled.

(c) Efficiency

The efficiency of an industry now receives detailed consideration in the determination of prices and the Commission may require the implementation of efficiency measures or incentives. Consideration of the issue was divided into two areas: the efficient allocation of resources and technical efficiency.

Economically, the efficient allocation of resources requires that the selling prices give the right signals to customers. This is difficult for the Commission to control as the financial returns from gas sales go to several different areas of the gas industry: exploration and mining costs, the payment of Government royalties and levies, and returns to the wholesalers and retailers.[81] The Commission's role, therefore, is to approve prices which reflect the very low risk to wholesalers and retailers and enables the benefits of low costs to be passed on to the consumer. It was suggested by the Commission that NGC implement schemes to improve efficiency in the industry, such as providing tariff differentials to encourage consumers to use gas in off-peak times.

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81. *Above n56, para 25*

Technical efficiency was assessed in terms of the day-to-day cost of operations and the efficient use of assets. The Commission refused to evaluate past investment decisions and considered it best to limit itself to assessing "whether appropriate systems are in place and that incentives exist to discourage inefficiencies."[82] The gas industry has considerable capital assets and major inefficiencies occur where there is inadequate control of capital expenditure. Management incentives may also be used to control inefficiency. The Commission warned against the incentives being related solely to maximisation of sales revenues or profit and suggested Petrocorp consider the establishment of incentives aimed at cost control.[83]

The emphasis placed by the Commission on the efficiency issue is in line with general market policies which focus on and aim towards successful and efficient business practices. Since Decision 207 price control has certainly become a more effective method of monopoly control because monopolists must run their operations with greater proficiency and absorb more of their production costs. Ultimately the consumer benefits because price increases no longer have such a large inefficiency component.

Determining the price

Under previous legislation the methodology used to set the price of a controlled good was one of the statutory criteria to be considered.[84] Under the new Act no methodology is given, leaving the Commission free to determine the most suitable formulation. The method used to determine the price is very important

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82. *Above n56, para 29*
83. *Above n56, paras 30-31*
84. *Section 98(1)(c)*

because if it is unsound or encourages inefficient practices the viability of the whole statutory price control regime is affected.

The price determined depends largely on the profit made by firms in the industry. Until 1987 profitability of price controlled firms was assessed by granting a pre-tax return on shareholders equity or assets, based on comparable earnings in the rest of the economy,[85] although there had been criticism of these methods since an appeal authority was first provided under the 1975 Act.

It took 12 years for the Commission to fully examine and hear argument on this issue, but in the 1987 application for price authorisation for NGC, Decision 207, the old methodology was examined and the Commission said:[86]

> *Among the many criticisms of either or both of these approaches are their failure to measure market power and resource allocation needs, their deleterious effects on profitability, investment and output and their failure to deal with the essential problem of preventing the firm from earning excess profits in the future.*

Decision 207 was made after NGC began appeal proceedings against Decision 174, where the Commerce Commission had applied the historical cost accounting methods in line with precedent decisions. Rather than continue with the appeal NGC proposed that a Working Party be set up to examine methodologies of price determination. The Commission agreed, and delayed the application of Decision 174.

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85. *Above n56, p16*
86. *Above n56, p16*

The Working Party's objectives were "to reach agreement on an appropriate framework and methodology for setting prices consistent with the provisions of the Commerce Act 1986."[87] The Party comprised four members, two each from the Commission and Petrocorp. Both parties agreed to be bound by the working party's findings. The Working Party recommended that a new pricing methodology be adopted and this was accepted by NGC and the Commission. The working party's findings were adopted by the Commission in Decision 207.

The consultation for determining the suitable method to apply to price applications was made with the monopoly group itself, NGC. Given that the purpose of controlling prices is to prevent monopoly pricing was it an appropriate body to consult with? The Working Party did not invite submissions from the gas industry; of all the interested parties only NGC's viewpoint was considered by the Working Party. Before making its decision the Commission did seek and receive comments from the Auckland Bulk Gas Users Group (ABGUG). AGBUG objected to the use of the formula chosen on the grounds that its application to retail gas companies and utilities would almost double the return allowed.[88] ABGUG also considered that the formula did not meet the section 73 requirements in that it did not take account of the need to safeguard consumers and users' interests and did not promote efficiency.[89] The Commission was not persuaded to alter its views, however,[90] and ABGUG appealed. As earlier stated, the High Court upheld the Commission's decision.

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87. *Report of the Commerce Commission/Petroleum Corporation of NZ Ltd Working Party on Price Control* 5 February 1987, p1
88. *Letter from Mr C.G. Pottinger of Buddle Findlay (solicitor to ABGUG), to the Commerce Commission, 12 May 1987.*
89. *R.A. Morin Utilities' Cost of Capital (1984) Public Utility Reports, p194*
90. *Above n72, p103,728*

The new formula

For a business to be economically viable its return should at least equal the cost of capital.[91] The issue before the Working Party was to find a method of ascertaining the cost of capital and to this end it examined and reported on the various proposals put before it. The High Court neatly summarised the methods looked at in the Report:[92]

> *The first of these was the asset revaluation model which purports to revalue the company's assets to current replacement costs less accumulated real depreciation and an appropriate real rate of return is then applied to that. That was rejected because of the difficulties in the use of replacement rather than historical cost data and the difficulty of ascertaining or fixing a real rate of return. The second was the discounted cash flow (DCF) or economic rate of return which is based upon the profit rate on capital as defined as that rate of compound discount (or interest) which equates the present value of net cash flows to the capital outlay used to generate those cash flows. While this was acknowledged to be a theoretically correct model, the working party felt that it would be difficult to verify the assumptions underlying the estimates of the various factors, particularly in New Zealand. The third method was the accounting rate of return which was defined as the net income before interest and tax/fixed and working capital (capital employed). This requires a calculation to find the weighted average cost of capital or WACC, which is done using the formula:*

$$WACC = \frac{Re}{(1-t)} \times \frac{E}{K} + Rd \times \frac{D}{K}$$

91. *Above n72, p103,726. Cost of capital was defined as the weighted average cost to business of acquiring funds, both debt and equity*
92. *Above n72, p103,726-7*

Where Re = cost of equity capital
Rd = cost of debt (before tax)
t = effective company tax rate
D = debt capital
E = Equity capital
K = capital employed

It was the working party's view that the calculation of the cost of equity capital appeared to be a particular difficulty since the NGC had no tradable equity. Recourse was then made to the capital asset pricing model (CAPM) which purports to determine the market price for risk and the appropriate measure of risk for a single asset. ... The risk premium has two components, the diversifiable risk which an asset contributes to a portfolio of assets and the non-diversifiable risk which relates to the economy as a whole and which is inescapable.

The first two methods were rejected because the information required for the calculations is not readily available in an accurate enough form in New Zealand. The WACC/CAPM formula was chosen because it is a sensible, logically rigorous theory and appropriate for the information available in the New Zealand market.[93]

Several criticisms have been leveled at the WACC/CAPM formula:

1. The CAPM model applies the expected return to the book value of shareholders funds, which is rarely the same as the market capitalisation of the firm's shares;[94]

2. The model is based on risk factors and as the gas industry comprises a monopoly at the wholesale level and has a captive market a relatively low commercial risk is involved.[95] As there is such a

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93. *Above n72, p103,738*
94. *Above n72, p103,735*
95. *Above n72, 103,728*

low risk profits should be lower than those of industries faced with competition and therefore exposed to higher risk. If the profit is the same or higher than that of companies which operate in a competitive environment the interests of consumers and users are unlikely to be safeguarded, nor will there be any incentive for efficiency. It would be better if the rate of return finally determined was checked against those of companies with similar debt-equity loadings and a reduction made if the controlled firms' profits were the same or higher.

3. The model is based on various assumptions which may not obtain in an industry. General assumptions are that capital markets are competitive and efficient with freely available information and that investors are profit-maximisers who pursue monetary self-interests. More specifically, investors are expected to hold diversified portfolios and are assumed to have no transaction costs or other limitations on capital transactions.[96] Investors may not act according to these assumptions. It should be noted, however, that all models must be based on some general assumptions and the fundamental nature of the CAPM model has withstood some relaxing of these assumptions.[97]

4. While the CAPM model is appropriate for companies such as NGC there are difficulties in applying it to bodies which have little or no commercial equity, such as local authorities.[98]

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96. *Above n89, p194*
97. *Above n89, p207*
98. *Internal Commerce Commission Memorandum to Price Control Division, from David Taylor and Geoff Connor (Commission members of the Working Party) dated 8 May 1987, p1*

Despite these criticisms the WACC/CAPM formula is an improvement over the methodologies of the past. The old methodology based on the percentage of shareholders' funds was arbitrary, inaccurate, gave no regard to efficiency and appeared to be too concerned with limiting a firm's profits. The new method seems to be suitable for the New Zealand market, is based on sound principles and, in conjunction with the section 73 factors, takes into consideration all the elements to promote competition and efficiency at all levels of a market. The major criticisms are that the prices are based on risk in a situation where virtually no risk exists and that, although new model may suit parts of the gas industry, it by no means suits all of it. The users, ABGUG, would have preferred a more flexible approach such as applying the different components from the different tests according to the structure and requirements of the industry at different market levels.

The formula may be less viable in other industries. The Commission did indicate that it intended to move to a cost of capital methodology for price control where applicable, although it recognised that there may be short term practical difficulties in some areas.[99] The method was never applied to any other industry as by 1 April 1988 only the natural gas industry remained under price control. Although the Court looked specifically at the WACC/CAPM in relation to the gas industry it made several general comments on the formula's suitability[100] which indicates that it

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99. *<u>Re an Application by the Dominion Federation of Milk Vendors Incorporated</u> for an increase in the rates of allowances for the delivery of milk, Commerce Commission Decision No 193, 8 April 1987, para 48. The new method was never applied to the milk industry as milk ceased to come under price control once the Milk Act 1988 came into force*

100. *The High Court described it as a "sensible theory, logically*

would be accepted by the High Court in other cases, were they to arise. If statutory price control does become a more widespread method of control again, however, the WACC/CAPM formula may be challenged by other industries.

Statutory price control is of less importance now that it applies only to one product. It remains merely as a threat to many large corporations. As a method of control it is inflexible and expensive; applications take a great deal of time and paperwork and are usually not brought more than once a year. It also discourages investment and innovation in controlled industries and acts as a disincentive for potential competitors.[101] Although efficiency is now given greater consideration price controlled firms remain less efficient than those working in a competitive environment where there is a greater need to absorb costs in order to survive. For these reasons price control is not popular and is retained more as a final sanction or last resort. Competition, where it can be effectively introduced, is a much more efficient constraint.

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rigorous and consistent with accepted and acceptable economic thinking". Above n72, p103,738

101. *Commerce Commission Press Statement 16 September 1986*

PART III: THE ALTERNATIVES

Price control or regulation in any form today is no longer the issue it was. The removal of controls, reduction in tariffs and relaxation of licence restrictions has led to increased competition in many industries, both from abroad and locally. Market forces now constrain the behaviour of many industries previously under statutory price control. The market is also anxious to encourage the free market business policies prevalent today and to avoid regulatory restraints. Today, too, businesses wish to project "clean" corporate images of public responsibility. They are less likely to excite consumer concern by abusing their dominant positions.

But businesses seek to maximise their profits. It is easier to raise prices than to put in place economic measures which reduce costs. If the business is a monopoly and provides vital or necessary goods and services the prices charged can be very high.

Competition will limit the extent to which prices can be increased. Where monopolies have previously existed, however, competition may not necessarily be sufficient. They may be replaced by oligopolies which can restrict competition and prevent the action and reaction of market forces. With large firms potential competitors also have to be large to affect policies and behaviour in the market. In an oligopolistic market lowering prices is not an effective competitive weapon as it is too easily followed by competitors, with the advantage gained being quickly lost. Other market tools are used to attract customers, such as "gimmicky" advertising and competitions with attractive prizes - as has happened in the de-regulated fuel industry. Consumers are forced to accept higher prices

because there is no alternative. Such pricing practices are not conducive to efficiency in the industry.

Competition is not possible where natural monopolies exist. Natural monopolies occur where the duplication of a good or service is either impossible (as in a limited resource) or not sufficiently economically viable to make it an efficient option (for example railway lines). Whoever has ownership of the natural monopoly has control and the potential for monopoly pricing and inefficiency exists.

In these situations some form of restraint may be necessary to prevent anti-competitive and inefficient practices from occurring. In the following sections of this paper some alternative measures of control are discussed and their effectiveness considered.

The Commerce Act 1986 promotes competition by making various anti-competitive practices illegal. Although it refers to efficiency only in the Part IV statutory price control regime already discussed, it indirectly promotes efficiency through its encouragement of competition and by allowing anti-competitive practices to be authorised where it is in the public benefit to do so. One such public benefit that has been recognised by the Commission is efficiency.

As the Commerce Act has a limited effect on industries where there is little or no competition other regulatory devices have arisen in New Zealand. Some corporations have been required to give undertakings which restrict the rate of price increases and ensure that certain services are retained. Light-handed regulation requiring full disclosure or transparency by monopolies is now imposed by statute in

certain industries and monitors with statutory powers to receive the information, investigate complaints and report on their findings have been proposed. If the Commerce Act, the undertakings or the light handed regulation are insufficient more specific and restrictive regulation may be applied. The threat of regulation in itself is a deterrent.

Some industries are too important to remain without controls. The financial sector is one example as the failure of a financial institution can, if unchecked, cause an economic catastrophe. The financial sector is controlled by a central bank, the Reserve Bank of New Zealand. Government monetary policies are also implemented through the central bank, thus affecting the money market.

The alternatives are discussed in detail.

A. *The Commerce Act 1986 - other provisions*

The Commerce Act 1986 (the Act) provides a statutory regime designed to promote competition by, among other things, discouraging anti-competitive trade practices. While these provisions will be of some effect in controlling monopoly/dominant firm pricing practices they were not designed to control situations where competition cannot or does not exist. Instead their goal is to promote competition itself where possible and prevent monopolies arising where their existence is against the public interest. Where that is not possible other methods of control such as the Part IV price control regime are provided.

The Act assists in preventing dominant or large firms using their power to affect competitors in other markets. Where de-regulation has opened a previously

restricted industry to competition the Act seeks to ensure that existing firms do not create entry barriers to preserve their favourable position.

Firms may not enter into contracts, arrangements or understandings which substantially lessen competition or contain exclusionary provisions.[102] It is also illegal to specify the price at which goods must be on-sold and to refuse to supply unless the supplier agrees to such resale price maintenance. If the Commerce Commission considers they are of public benefit, however, all these practices may be authorised and, since the Act was amended earlier this year, whenever the Commission must consider public benefit it must have regard to any efficiencies which may result.[103] Where firms intend to use a dominant position to restrict, prevent, or eliminate competitors they are in breach of section 36 of the Act and their actions cannot be authorised.

The Act also permits scrutiny of proposals which may result in the concentration of power in the marketplace. Companies may, by merging or taking over a competitor, avoid the need for anti-competitive trade practices which would otherwise be illegal.[104] If companies instead of agreeing to fix prices merge with each other they are not automatically breaching the Act: it is an offence only if it results in the acquisition or strengthening of a dominant position.[105]

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102. *Sections 27 and 29. Covenants which substantially lessen competition are also illegal; see section 28*

103. *Section 4 of the Commerce Amendment Act 1990 No. 41 adds section 3A to the principal Act*

104. *J.G. Collinge & B.R. Clarke Law of Marketing in Australia and New Zealand (1989) 2e, Butterworths, p109*

105. *New section 47 as inserted by section 18 of the Amendment Act. The new business acquisition provisions will not come into force until 1 January 1991*

Under sections 80(a) and 84(a) it is also illegal to aid, abet or counsel, or induce or attempt to induce another person to contravene the provisions in Part II or Part III of the Act.

The Act's provisions will be looked at in more detail.

Section 27

Contracts, arrangements or understandings (agreements) which contain provisions that have the purpose, effect or the likely effect of substantially lessening competition are illegal under section 27 of the Act. Where competition exists there may be the temptation for various competitors to agree among themselves to, for example, supply goods or services only at an agreed price or to allocate districts in which each competitor will operate. If the arrangement is sufficiently widespread competition will be significantly lessened because those who are parties to the arrangement are not competing with each other, and the benefits of having competing parties are lost.

Contracts, arrangements and understandings which are caught by section 27 may be authorised[106] by the Commerce Commission if the Commission is satisfied that the application of the provision[107]

> *will in all circumstances result, or be likely to result, in a benefit to the public which would outweigh the lessening in competition that would result, or would be likely to result or is deemed to result therefrom.*

Once a provision has been authorised it becomes lawful.

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106. *Section 58*
107. *Section 61(6)*

Where there is no competition section 27 is not so effective; agreements are less likely to be entered into as there are no competitors. But monopolists who enter into agreements with suppliers or buyers at other functional levels of an industry may be caught by section 27. Arrangements may be made between the monopolist and certain groups of suppliers or buyers to trade with those groups only or to make provisions which fix, control or maintain prices within the group. The latter provisions are, in fact, deemed to substantially lessen competition under section 30 of the Act, which makes it easier to show that section 27 has been breached. Where a monopolist enters agreements separately with several suppliers and the cumulative effect of all the separate agreements is to substantially lessen competition, each one is individually deemed to substantially lessen competition under section 3(5). This deeming provision is important where there is no collective agreement but many individual agreements between monopolists and different suppliers, each of which alone is not sufficient to substantially lessen competition. Thus the actions of monopolists in charging monopoly rents will not come within the section, but where they attempt to enter restrictive agreements with suppliers in other markets in order to limit competition in those markets they are in breach of the Act. It is the inclusion of the suppliers that makes the agreements illegal.

Under section 3(2) the phrase "lessening of competition" has been extended to include references to the hindering or preventing of competition. Where de-regulation and de-control have removed entry barriers to previously monopolistic industries monopolies cannot enter agreements which would prevent competitors from entering the market without breaching section 27. For

example, monopolists could not make exclusive dealing arrangements with suppliers to ensure that potential competitors could not distribute their products.

Section 29

Section 29 makes the entering into of exclusionary provisions illegal. These are defined as provisions in a contract, arrangement or understanding entered into by two or more *competitors* which prevent, restrict or limit the supply or acquisition of goods and services.[108] The restriction must be imposed by the parties to the contract and (since the 1990 amendment) on the parties' competitors. There is no requirement to prove that the provision substantially lessens competition; it is enough to show that the agreement merely exists. Unilateral decisions by monopolists are not caught. A monopolist agreeing to supply only one supplier will also not be caught under this section as two or more competitors must be party to the agreement. Arrangements such as exclusive dealing clauses between the monopolist and some suppliers will breach the section as the victims are competing suppliers. The section will also catch arrangements where the monopolist will only supply at a fixed price and two or more customers have agreed to it. The monopolist will not supply to other customers who do not agree to the fixed price. The monopolist is caught, not because it is a monopoly, but because the agreement involves competing parties.

Exclusionary provisions may also be authorised if the Commission is satisfied that the provision will result or be likely to result in such a benefit to the public, in all the circumstances, that it should be permitted.[109]

In most situations the monopolist will be making

unilateral decisions on the prices it will charge and sections 27 and 29 will be of no effect. Their main effect will be to prevent monopolists from dominating and influencing the pricing behaviour of suppliers through some form of price discrimination or supply restriction. They have no impact on the monopolist who, by charging monopoly rents, forces customers to put their prices up to meet their costs.

Section 36

Section 36 prohibits the use of a dominant position in any market for the purpose of -

(a) restricting the entry of any person in that or any other market; or
(b) Preventing or deterring any person from engaging in competitive conduct in that or any other market; or
(c) eliminating any person from that or any other market.

Actions in breach of this section cannot be authorised.

Section 36 is generally considered to be the most effective provision with which to restrain monopolies. Potential competitors in an industry have recourse against any dominant firms which abuse their position with the intention of reducing competition. But competition must still be a possibility. Domestic users of utilities such as electricity, gas and telephones, who are not competitors, have no redress under this section.

The section is made wider, however, by catching firms who are dominant in one market and behave predatorily in *any* market. This means that monopolies

108. *Section 29*
109. *Section 61(7)*

may still be restrained if they act with the intention of restricting, preventing or eliminating competitors in *another* market. A monopoly which intends to supply certain firms only or uses discriminatory or predatory pricing for the purpose of eliminating customers will be in breach of section 36 regardless of whether it actually competes in that market. Retail suppliers who buy from a monopoly can use the section to challenge pricing practices which affect the competition in the supply market. Monopolies at the top of a supply chain who intend to restrict competition in the retail market vertically below them may be restrained under section 36.

Dominant firms that wish to enter and compete in another market may supply goods at a very low price to drive out competitors, cross-subsidising from the profits made in the market where it dominates. The other market could be in a different region, as in *Victorian Egg Marketing Board v Parkwood Eggs Pty Limited*,[110] where it was alleged that eggs were sold in the neighbouring state at a predatory price in order to drive out competitors. Alternatively, the other market could be at a different functional level, for example, where a monopolistic manufacturer decides to break into the suppliers' market of its goods; or a dominant firm may decide to market a different product related to its industry. In *Tytel Pty Ltd v Australian Telecommunciations Commission*[111] ATC used its dominant position as a statutory body exempt from customs duty to introduce a new type of telephone at a much cheaper price than its competitor. Such cross-subsidisation, if done with the intention of eliminating or damaging a competitor, is illegal under section 36.

110. *(1978) ATPR 40-081*
111. *(1986) ATPR 40-711*

A major problem with section 36 is that it must be proved that the firm *intended* to use its dominant position to restrict, prevent or eliminate competitors, and such proof may be very difficult to obtain.[112] Unless the purpose is expressly stated (unlikely) it may not be possible to prove that a firm's actions were intended to harm competition, although often it can be inferred from the firm's conduct.

To be caught under section 36 the firm must be dominant in a market. Dominance will in some cases depend on how the market is defined. In a large, widely defined market a firm is less likely to be considered dominant and section 36 will not apply to it. For monopoly industries, especially natural monopolies, the market is clearly delineated and dominance is not often an issue.

Many natural monopolies provide essential goods and services and, according to the Ministry of Commerce, the Act is to be relied on to guarantee access these essential facilities.[113] The question arises as to whether the provisions of the Act, and principally section 36, are sufficient to ensure that access is guaranteed. Access to essential facilities can be protected under the provisions in section 36, although to be fully effective its scope would have to

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112. *For example, in New Zealand Magic Millions Ltd & Anor v Wrightsons Bloodstock Ltd (1990) 3 NZBLC 101,501 Wrightsons changed the date of its sales to coincide with that of Magic Millions ostensibly because its original date clashed with the Commonwealth Games. Proof that Wrightsons' intention was to harm Magic Millions was only obtained because Wrightsons admitted that it would not change its dates in following years*

113. *"Guarantee of Access to Essential Facilities" - A discussion paper by the Competition Policy and Business Law Division, Ministry of Commerce, December 1989, p1*

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be developed.[114] The American essential facilities doctrine would, if adopted in New Zealand, sufficiently broaden section 36 to guarantee access.

The doctrine was expressed in *Hecht v Pro-Football Inc*[115] as follows

> *... "where facilities cannot be practicably duplicated by would-be competitors, those in possession of them must allow them to be shared on fair terms. It is illegal restraint of trade to foreclose the scarce facility." ... To be "essential" a facility need not be indispensable; it is sufficient if duplication of the facility would be economically infeasible and if denial of its use inflicts a severe handicap on potential market entrants. Necessarily, this principle must be carefully delimited; the antitrust laws do not require that an essential facility be shared if such sharing would be impractical or would inhibit the defendant's ability to serve its customers adequately.*

The doctrine was accepted by the High Court in *ARA v Auckland Mutual Rental Cars (Auckland Airport) Ltd and Others.*[116] However, in a more recent case, *Union Shipping New Zealand Ltd v Port Nelson Ltd*[117] the High Court hesitated to incorporate the doctrine because of its basis in American law, its still controversial status in the American jurisdiction, and the fact that the full Federal Court of Australia[118] had sharply criticised it. The doctrine is by no means settled law in New Zealand. Consideration needs to be given to issues such as which facilities are "essential" and what constitutes a "facility". The limits to the doctrine require judicial examination; at what point does the owner's behaviour change from being acceptably

114. *Above n113, p15*
115. *570 F 2d 982 (1977), p992*
116. *[1987] 2 NZLR 647, 680*
117. *(1990) 3 NZBLC 101,618, 101,643*
118. *Queensland Wire Industries Pty Ltd v The Broken Hill Proprietary Co Ltd (1989) 83 ALR 577*

competitive to illegal restraint of trade? The future of the doctrine in New Zealand depends on the resolution of these issues and whether it will be accepted by the Court of Appeal.

Resale Price Maintenance Agreements

A supplier who refuses to supply goods unless the resale price is maintained at not less than a specified price is in breach of sections 37 or 38 of the Act. The provisions cover both the entering into agreements containing resale price maintenance agreements (RPMs) and the refusal to supply (constructive or otherwise) unless the RPM is agreed to. There is no requirement that the RPM lessen competition; any RPM is illegal under the Act. The Act has been amended so that RPMs may now be authorised by the Commerce Commission.[119]

The RPM provisions protect suppliers from monopolies or dominant firms who endeavour to control the resale price of their goods. Although the firms can sell to their suppliers at any price they choose they may not control the price at which such goods are on-sold. Large firms may supply recommended prices which, if genuine, are not considered to be RPMs.[120] The RPM provisions help restrain monopolists from interfering with and restricting competition in supply markets.

Business acquisitions

The new merger and takeover provisions in Part III (now entitled "Business Acquisitions") mirror the Australian system. These provisions were changed

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119. *New sections 58, 58A and 58B as inserted by section 19 of the Commerce Amendment Act 1990. See also the amendments to sections 59 and 61*
120. *Section 39*

considerably under the Amendment Act; previously if certain thresholds[121] were exceeded mergers and takeovers had to be cleared or authorised by the Commerce Commission. Clearance or authorisation is no longer mandatory, but if the acquisition results in the creation of strengthening of a dominant position it is illegal. The test for "dominant position" has changed under the Amendment Act,[122] resulting in uncertainty as to its interpretation.

It is in the hands of the businesses to determine whether the acquisition will breach the Act and whether clearance or authorisation should be sought. If none is obtained and there is an acquisition or strengthening of a dominant position the Commission or any other person may bring an action to prevent that acquisition. The firm may face high pecuniary penalties,[123] divestiture of assets, and the merger may be unravelled. The latter, however, is a very expensive and difficult process.

A potential business acquisition that will breach the Act may be authorised if the Commission is satisfied that it will result "in such a benefit to the public that it should be permitted."[124] Public benefit is not defined in the Act but the new section 3A now requires that the Commission have regard to efficiency when considering public benefit. The Commission, who stated that "there appears to be no limitation as to

121. *Where a substantial portion of voting stock, capital or assets in a business is acquired - section 47 - and the aggregate value of assets exceeds those set out in the First Schedule*

122. *Section 3 of the Amendment Act amends section 3(8) of the principal Act to exclude its application to sections 66 and 67 and inserts a new definition of "dominant position" relating solely to section 47 and 48 of the principal Act (section 3(9) of the Amendment Act)*

123. *Section 80 has been amended to raise the penalties to $500,000 for individual and $5,000,000 for body corporates*

124. *Section 67(3)(b)*

the nature of public benefit which may be claimed,"[125] had already recognised that increased efficiency, among other things, is a benefit which should be considered. It also stated, however, that as competition protects consumer interests the Commission would have to be convinced that the benefits of the increased efficiency would be passed on to consumers[126] and that the benefits would outweigh the detrimental effects of lessening competition. Now that efficiency has received specific statutory recognition the Commission may give it greater weight. Large firms can produce and market goods far more cheaply than a host of small firms where some resources must be duplicated. Large firms have greater bargaining power with overseas industries and greater opportunities and funding for research and development. The positive benefits of large scale enterprises may outweigh the benefits of competition, especially if the consumers also benefit.

Firms may be reluctant to seek clearance or authorisation because of the delays in receiving a response, exacerbated by the fact that the Commerce Commission now has no deadlines to meet. If the Commission does not respond within ten working days of an application the clearance is deemed to be declined under section 66.

The lack of a mandatory authorisation or clearance for large business acquisitions removes one protective step from the process of creating large, powerful and potentially dominant firms. However, it is usually clear beforehand whether an acquisition will affect or create dominance and firms will be wary of proceeding without first seeking clearance from the Commission. Much of the Commission's resources have been applied to

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125. *Re Weddel Crown Corporation Limited & Ors* (1987) 1 NZBLC (Com) 104,200, p104,213, para 25(i)

126. *Re Proposal by Goodman Fielder Limited* (1987) 6 NZAR 446

the investigation of mergers and takeovers which have subsequently been cleared. Now that fewer acquisitions will require mandatory attention these resources may be used in the enforcement of restraint of trade provisions.

The increase in the penalties has ensured that the new provisions have considerable force. Of great significance is the new provision that the Commission *or any other person* may now apply for an injunction to be granted if Part III of the Act is being contravened.[127] Affected parties are likely to respond more quickly to a proposed business acquisition than the Commission (who must now seek information on business acquisitions rather than have the information brought to it). Potentially illegal acquisitions will be closely scrutinised by those affected and under this provision action can be taken to prevent the acquisition from proceeding until it has been examined by the Court.

Companies today are also anxious to maintain a "clean" corporate image. If an acquisition is likely to be illegal they will seek clearance or avoid potentially illegal acquisitions rather than face the high pecuniary penalties and moral opprobrium attached to a public court hearing.

Summary

The Act's objective is to promote competition and, where competition is limited or lessened, to provide a statutory price control regime if it is desirable. The Act works to restrict the creation or strengthening of dominance unless there are public benefits which outweigh the detriments. The high pecuniary penalties

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127. *Section 30 of the Amendment Act amends section 84 of the Act*

will act as a significant deterrent to the instigators of potentially illegal proposals and, if they proceed regardless, any person may apply for an injunction against them.

The Act has only a limited amount of control over monopoly industries. Under section 27 and 29 monopolies are restricted from entering agreements which will affect competition or contain exclusionary provisions. Unilateral actions are not caught, nor are agreements which do not affect competition, unless they contain exclusionary provisions. Along with the RPM sections these provisions restrain monopolies from directly controlling and limiting competition in the markets they service.

Unilateral actions by dominant firms that are intended to harm competition in any market are prohibited but proving that purpose is a difficult hurdle to overcome. Section 36 is not yet fully developed judicially and at present access to essential facilities cannot be guaranteed under its provisions. The adoption in New Zealand of the essential facilities doctrine would sufficiently broaden the scope of the legislation to guarantee access, but this doctrine has not been fully determined and its acceptance in New Zealand is still uncertain.

The ultimate aim is to increase and promote efficiency. The Act promotes competition which, in most cases is the most effective means of ensuring efficiency. Where competition does not result in efficiency maximisation and it is in the public benefit to lessen competition the Act permits restrictive practices to be authorised. Sometimes competition is not the most desirable method of achieving efficiency. One large firm may be more cost efficient than several small firms, it may be better able to

compete in international markets and will be better able to fund research and development.

The Act's provisions (apart from Part IV) are of limited use as a method of price control against monopolies because generally they have little application where there is little or no competition. They are designed to enhance existing and potential competition rather than to take its place where it cannot or does not exist. Despite the fact that monopoly control is not their primary purpose they do have a limited success in curbing monopoly excesses and their existence may, in some cases, provide sufficient restraint to obviate the need for more specific and exacting price control measures.

B. *Price undertakings*

Price undertakings are promises made by a firm that it will not increase its prices above an agreed level. Other forms of undertakings are often also given, such as the promise to continue to provide certain services.

The Labour Government, in the process of corporatising and privatising many public utilities and previous government run monopolies, has in some cases required that some form of undertakings be built in to control prices and to ensure the continuation of specified services. The undertakings usually apply to social services which the government has stipulated must continue. When New Zealand Post was corporatised it executed a Deed with the Crown which guarantees the frequency and extent of deliveries in New Zealand.[128]

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128. *Deed between The Minister of Commerce and New Zealand Post Limited dated 7 September 1989*

The price of postage is also regulated under the Deed. Basic letter post rates are set at 40c per letter and increases are linked to CPI.[129] The Deed is a contract and is binding on the parties. It can, however, be varied if both parties agree.

The Deed supplements the Postal Services Act 1987. This Act restricts the price at which other carriers can circulate mail, thus reducing the competition that New Zealand Post faces at present. Under the Deed the Crown has promised to relax the statutory limits over other carriers by lowering the minimum price from $1.75 (current) to 80c by 1 October 1991. This will increase the potential for effective domestic competition over the next one to two years. The Postal Amendment Bill[130] contains the provisions as promised in the Deed but it has yet to be passed.

The fact that undertakings control only a small part of a firm's overall operation may result in high price increases in other, less political, areas of business. For example, the domestic basic postage rate has been held at 40 cents per letter since September 1989 whereas international postage charges have increased by 20-30% for standard airmail letters since the beginning of 1989.[131] While these increases could have arisen because services were previously priced too cheaply and are now no longer cross-subsidised, they could also be as a result of profit maximisation in unrestricted areas of service.

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129. *Above n128*
130. *194-2 as at 5 December 1989*
131. *For example a standard airmail letter to Australia increased from 80c to $1.00; to North America and Asia from $1.05 to $1.50; and to South America, Europe, Africa and the Middle East from $1.30 to $1.80. These increases are 20%, 30% and 28% respectively: New Zealand Post, Schedules of Rates and*

The sale of Telecom provides a more topical example of undertakings. Article 11 of the Articles of Association[132] provides for the retention by the Government of the "Kiwi" share. This share has attached special voting rights which prohibit changes to certain articles unless the Crown agrees to those changes. The Kiwi shareholder has the right to attend general shareholders' meetings and speak on any matter relating to the Kiwi share rights, but there are no rights to vote at these meetings. The Crown may also convert the Kiwi Share into an ordinary share.[133]

Article 11 contains undertakings given by Telecom that are "set in concrete".[134] In article 11.4 Telecom promises:

1. Free local calls for residential customers. But it reserves the right to provide optional tariff packages[135] which will have a charge attached;

2. Telecom will charge a standard residential rental for ordinary residential service which will not be increased in real terms *provided that overall profitability is not unreasonably impaired*;

3. A standard residential rental for all users, including those in rural areas and ordinary residential services will remain as widely available as it is at present.

Conditions, Sheet 34, Guide Issue 1 and Sheet 31, Guide Issue 6;4/90

132. *See Appendix*
133. *Article 11.2*
134. *Minister of State Owned Enterprises, Richard Prebble, quoted in The Evening Post, Wednesday, May 16, 1990, p3*
135. *Where, for example, a user can choose to pay a low fixed "entry" fee (low rental) and high usage charges (toll charges) or choose a high fixed entry fee and low usage charge depending on usage. S.J. Brown & D.S. Sibley The Theory of Public Utility Pricing (1986) Cambridge University Press, p2*

These undertakings cover only a small part of Telecom's services - those that, apparently, have been abused overseas.[136] Telecom is free to provide and price other services according to its own business practices.

How effective are these undertakings?

The Articles of Association bind a company as if they were executed under Deed.[137] Thus the undertakings are binding on Telecom. If Telecom were to breach them article 11.4 expressly states that only the Kiwi Shareholder (that is, the Crown) may enforce these rights. Other actions remain; customers may be able to sue under section 9 of the Fair Trading Act on the grounds of misrepresentation, especially in the light of the extensive media publication surrounding the undertakings. Consumers may lobby politicians to endeavour to persuade them to enforce the undertakings if consumer services are not provided as promised.

The undertakings can be changed with the Government's permission. And although the Minister of State Owned Enterprises, Mr Prebble, has promised that he will not change them[138] he cannot bind future Ministers. Now that Telecom has been sold only time will tell whether or not the concrete in which the undertakings are set will remain firm:[139]

> *Overseas experience of telecommunications privatisation shows public service standards tend to fall by the wayside despite political promises beforehand. British Telecom only*

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136. *Comment by Richard Prebble, National Business Review, Thursday, May 17, 1990, p3*
137. *Section 34 of the Companies Act 1955*
138. *The Evening Post, Wednesday, May 16, 1990, p3*
139. *Editorial, National Business Review, Wednesday, April 11, 1990, p24*

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> *moved to improve its service after a huge post-privatisation outcry about sloppy standards. ... The Americans experienced price hikes for local services and erratically maintained public telephone facilities following the break up of AT & T's domestic monopoly.*

Telecom has also left itself a loophole - if the overall profitability is not unreasonably impaired. This could decrease the effectiveness of the undertakings. What would constitute unreasonable impairment of profitability? Would any lessening in profit be sufficient, or would it need to be substantial? Telecom's profit last year was $240 million, a return on shareholders' funds of 10%.[140] In comparison, Fletcher Challenge achieved an 18.7% return on shareholders' funds.[141] Telecom may consider its profits unreasonably impaired - and escape from its undertakings - if it cannot maintain or better its return.

The undertakings also refer to a standard residential rental. At the moment rentals are not standard throughout New Zealand as some subscribers are still on older and more expensive switchboards. Telecom hopes to have replaced all its switchboards within the next two years and at that time the rental for basic residential telephone services will be the same for all domestic users. New technology has become increasingly available but it takes longer to reach the small towns and rural customers than for city dwellers. There may not always be a "standard" residential rental - what happens to the undertakings in that case? And what is the "ordinary residential telephone service"? Telecom plans to introduce additional optional services which will be charged for,

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140. *Telecom Corporation of New Zealand Limited, Annual Report for 1989, p2*
141. *Fletcher Challenge Limited Annual Report for 1989, p1*

for example, the optional tariff packages. These may become so widespread as to be ordinary - but what of those who don't want the services or live in areas where they are not available? With such loose definitions and an "out" where profits are unreasonably impaired these undertakings, "set in concrete", are virtually ineffective, except for their public relations value:[142]

> *And lest anyone should doubt, "Publicly given undertakings" (and Telecom has been required to give rather a lot) "are considered to be highly effective as regulators of Telecom's behaviour". If the Labour Party's publicly given undertaking not to sell Telecom is anything to go by, they are quite worthless.*

The main advantage of these well publicised undertakings is that Telecom has publicly promised to provide socially necessary services to its consumers at a reasonable price. It will face strong criticism and public disapproval if it seeks to deviate from the undertakings. Some of its moves to date have already proved unpopular where, for example, it has tightened its policies to make its operations more efficient. Previously free services are now charged for and consumers have, naturally, been unhappy. Telecom also made a Statement of Corporate Intent[143] in which it stated that it "will be socially responsible and a good employer." Telecom is anxious to project a friendly, helpful, corporate image. It also has stringent statutory disclosure requirements[144] and will find it very difficult to explain and justify any excessive pricing behaviour.

One factor which may exercise some control over Telecom's behaviour is the American situation. Public

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142. *Editorial, The Dominion, Monday, March 19, 1990*
143. *In April 1988*
144. *Under the Telecommunications Act 1990*

utility owners in the United States are seeking a less regulated industry. New Zealand is an example of a de-regulated economy in which public utilities have been privatised. There would be a great deal of political embarrassment if the American owned New Zealand Telecom was found to have taken advantage of the de-regulated industry to over-charge and under-serve its customers. Telecom may be more careful in New Zealand in order to convince the United States politicians that de-regulation does work.

The telecommunications industry is no longer constrained as a statutory monopoly.[145] Telecom operates in a wide market which includes the provision of equipment as well as the network and networking services. Competition already exists in the production of equipment, and cellular telephone companies provide alternative network services. In addition, the Alternative Telephone Company (ATC) is setting up a wide range of services in competition with Telecom. It will provide separate inter-city transmission lines using fibre optics and digital microwave networks, which will link with Telecom's local wiring systems (the local loop). Telecom and ATC have signed an agreement under which ATC has access to the local loop and the Government will be closely monitoring this arrangement.[146] To this end regulations[147] have been passed under the Telecommunications Act 1990 requiring full disclosure by Telecom on its operations. Because there is competition, further regulation is not considered necessary.

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145. *See the Telecommunications Amendment Act 1988 which came into force this year. The definition of "network operator" was extended to include any person declared to be a network operator by Order-in-Council. To date six companies have been so declared: see regulations 1989/228, 299, 300 & 1990/76, 92, & 114*
146. *Interview with Neil Tuckwell, General Manager Corporate, ATC, 5 September 1990*
147. *Telecommunications (Disclosure) Regulations 1990, No 120*

Whether such competition will be sufficient depends on the efficacy of the monitoring regulations and the ability of competitors to enter the market. If alternative network systems have to be developed entry costs are high and may constrain potential competitors. If competitors are able to use existing networking systems (as ATC will do) at reasonable rates, linking their equipment into the Telecom-owned local loops, competition will develop and an economically efficient industry will result. As owner of the loop Telecom remains in a dominant position for this facility and, unless it is monitored, the potential for abuse remains. It is interesting to note that Telecom's response to the potential competition has been to warn phone users that telephone rentals may increase more rapidly to compensate for its decreasing share of the market.[148]

Apart from actions for misrepresentation consumers will have no legal redress in the event that the undertakings are breached. All they can do is seek to persuade their political representatives to bring pressure on the Government to enforce breaches or to prevent changes being made. The effectiveness or otherwise of undertakings will depend on their wording and on the likelihood that the parties will agree to their change or to their enforcement.

C. *Transparency*

Transparency is the new catchword for the compulsory disclosure of information. Currently this is the most favoured method of control by two major groups of monopoly utility users: The Major

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148. *The Evening Post, Wednesday, May 9, 1990 p5. This is hardly in line with its Statement of Corporate Intent.*

Electricity Users Group (MEUG)[149] and the Auckland Manufacturers Association (AMA),[150] which includes among its members the Auckland Bulk Gas Users Group (ABGUG) and the Industrial Users Group. These groups together represent the majority of gas users in the North Island. These groups believe that full and detailed disclosure of information by monopoly groups will be a major form of control by laying corporations open to scrutiny and public and political pressure. AMA adds the proviso that price control should be retained until *extensive* full disclosure provisions have been put in place and have been shown to be effective.[151]

The most important objectives for an industry are the encouragement of economic efficiency, the management of risks associated with structural change and the enhancement of competition.[152] MEUG strongly advocates transparency to enable the monitoring and control of the electricity industry after its de-regulation, to ensure that these objectives remain paramount:[153]

> *Unrestrained, any enterprise with a monopoly or dominant market position will maximise monopoly rents. ... A monopoly can compensate for inefficiencies through the ability to extract excess profit, if its behaviour is not restrained.*

The requirement to release information and the ability to monitor the operation of a company is a powerful inducement for responsible market behaviour and has constrained dominant market behaviour in other markets.[154] Consumers are able to judge for themselves

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149. *Major Electricity Users Group* *Light Handed Regulation in a Restructured Electricity Industry* *February 1990*
150. *Submission by AMA to the Ministry of Commerce on the Review of Price Control on Natural Gas Wholesaling, 30 August 1990*
151. *Above n150, p47*
152. *Above n149, p3*
153. *Above n149, p3*

the performance of the entity and if it is exploiting its dominant position and/or operating inefficiently public or political pressure can be applied. Recourse to the Commerce Commission or the Courts is also available. "Information is everything."[155]

In the last ten years there has been a general move in New Zealand towards open access to information. This was reflected in the Official Information Act 1982 which requires that information be released in certain circumstances. With the creation of state owned enterprises transparency and accountability became statutory duties in the State Owned Enterprises Act 1986 (the SOE Act). The subsequent corporatisation and sale of SOEs has resulted in disclosure requirements being expressed in industry specific legislation. The Finance Act 1990 removes Telecom from the Official Information Act 1982, the SOE Act,[156] and the Ombudsmen Act 1975, placing it on the same footing as any other company. However, public disclosure is required under the Telecommunications Amendment Act 1990 which authorises regulations requiring the Corporation to make publicly available financial statements in relation to the supply of telecommunication goods and services. The information must include prices, terms and conditions and the Corporation shall also supply to the Secretary of Commerce information[157]

> *for the purpose of ascertaining the scope of information required to be made available to the public to facilitate effective competition in the supply of telecommunication goods and services.*

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154. *Above n149, p4*
155. *C.E.H. Twiss, Director of Legal Services for British Gas. See Above n149, p4*
156. *Sections 22-30 of the SOE Act continue to apply. These are procedural provisions relation to the Minister's shareholding*
157. *Section 5D*

The Postal Services Amendment Bill seeks to bring into law similar provisions in new sections 18 and 19. New section 18 requires an annual report to be furnished pursuant to section 15(1)(a) of the State Owned Enterprises Act 1986 and section 19 requires that the Corporation provide information to enable the Secretary of Commerce to -

> *(a) Monitor the efficiency and quality of service provided by the Corporation; and*
>
> *(b) Monitor the Corporation's compliance with any agreement entered into between the Crown and the Corporation in relation to prices, frequency, and quality of services.*

The provisions for both Telecom and the Post Office are very widely drafted to enable sufficient transparency to be achieved for effective monitoring.

The Official Information Act 1982 may act against full disclosure.[158] Under section 9(2)(b)(ii) organisations subject to the Act do not have to release information that

> *would be likely unreasonably to prejudice the commercial position of the person who supplied or who is supplying the information.*

A refusal to supply information may be investigated by the Ombudsman, but refusals have been upheld where it has been found that the information would aid competition and cause commercial disadvantage to the supplier of information.[159] Natural monopolies,

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158. *Above n149, p11*
159. *See Office of the Ombudsman Ninth Compendium of Case Notes of the Ombudsmen Wellington, July 1989, Case Nos. 787 and 1127, p113 where the Ombudsman refused to release information on the level of gas reserves in a gas field because it was considered commercially sensitive. Its*

however, have no competition. Despite arguments that private companies cannot be forced into disclosing commercially sensitive information, there should be no barrier to information release, as it cannot be damaging if there is no competitor to take advantage of it. The Official Information Act should be exempted from application to information released by monopolistic industries.[160] Further, if a monitor is set up it may be given confidential information in order to make its report, but such information can be restricted from further publication.

Under the proposed scheme to restructure the electricity industry the national transmission grid will be separated from Electricorp and owned by a club of generators, distributors and some investors. Newcomers to the industry will be able to join the club. Distributors will no longer have exclusive areas of operation, which will permit competition in the supply market; local lines owned by distributors will be available to competitors at reasonable market rates.[161] The increased competition in the generation and distribution markets of the electricity industry will regulate the behaviour of the competitors.

The transmission grid, to which distributors must have access, is a natural monopoly and will not be duplicated. The owner of the transmission grid, Trans Power, is in a position of dominance and some form of regulation is necessary to provide incentives for cost minimisation and the proper exercise of market power.[162] The Electricity Task Force has recommended a

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release would disadvantage the operator in the highly competitive petroleum industry

160. *Above n149, p12*
161. *Above n113, p9*
162. *Report of the Electricity Task Force <u>Structure, Regulation and Ownership of the Electricity Industry</u> September 1989, p59*

light handed regulatory framework be implemented to provide transparency and monitoring functions.[163] Heavy regulation would only be introduced if where necessary.

Monitors

Disclosure by itself may not necessarily be enough. Information may be released in a misleading manner or in insufficient detail for "a meaningful and accurate appraisal of market behaviour and economic performance"[164] to be made. It may be necessary to appoint a monitor to receive and act on the information. A monitor would be able to investigate complaints, have the necessary skills to analyse information received and report its findings to the Government.

When Britain de-regulated its public utilities statutory monitoring bodies were created to protect consumers and promote competition. On privatisation of the gas industry a regulatory agency was created to protect consumers.[165] When British Telecom (BT) was sold the Government was aware that it would continue to dominate the market for the next few years. The Office of Telecommunications (OFTEL) was created by the Director General of Telecommunications[166] to monitor BT and its competitor, Mercury Communications Limited (Mercury), and to ensure "fair competition and fair prices."[167] The Director is head of OFTEL, which currently has approximately 100 employees.[168]

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163. *Above n162, p7*
164. *Above n149, p5*
165. *Office of the Director-General for Gas Supply - under the Gas Act 1986. Daintith & Willoughby <u>United Kingdom Oil and Gas Law</u> (1984) 2e Sweet & Maxwell, para 1-322. OFGAS operates in a similar manner to OFTEL described below. See below n171, p272*
166. *Under the Director's powers in the Telecommunications Act 1984*
167. *Above n6, p124*

OFTEL is an advisory body which examines any complaints made against British Telecom, and reports to the Minister of Trade and Industry on the advisability of commercial proposals and practices.[169] Its only direct power relates to the revision of the licences of BT and Mercury. Under these licences OFTEL operates a system of price control by placing an overall ceiling on the basic telephone-line rental and inland-call charges.[170] These represent 55% of BT's revenue.[171] Since 1983 these charges have been limited to the increase in the retail price index (RPI) less X percent, where X is currently fixed at 3 by the Government.[172] Individual services may increase at a rate more or less than RPI-X. The limits are to remain for five years - it is anticipated that competition should be sufficient by then for price ceilings to no longer be required.[173]

Indirectly OFTEL affects other areas of the market where the government follows its advice. The lack of power to enforce its recommendations has, however, led to BT ignoring the recommendations when they conflicted with BT's own interests.[174]

OFTEL also has a variety of competing objectives to apply. It is responsible for ensuring "such tele-communications services as satisfy all reasonable

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168. *C.D. Long* *Telecommunications Law and Practice* *(1988) Sweet & Maxwell, London, p11*
169. *Above n149, p131*
170. *M. Snow* *Marketplace Telecommunications: Regulation and Deregulation in Industrialised Democracies* *(1986) Longman, p164*
171. *D. Swann* *The Retreat of the State: Deregulation and Privatisation in the UK and US* *(1988) Harvester Wheatsheaf, p271*
172. *Above n170, p164*
173. *C.D. Long* *Telecommunications Law and Practice* *(1988) Sweet & Maxwell, London, p58*
174. *Above n6, p132*

demands for them",[175] and its duties include the provision of emergency services, public telephones, directory information, and maritime and rural services. It must also promote effective competition, efficiency, and research and development. Many of these duties conflict. OFTEL has been criticised by its predecessor on the grounds that it could not be responsible for both consumer interests and an adequate rate of return for BT.[176]

The RPI-X formula has been criticised on the grounds that it encourages firms to reduce costs by lowering the quality of their goods or services.[177] There are also difficulties in estimating productive efficiencies and technological progress, both of which are essential for determining X.[178] Studies[179] have shown that regulatory bodies tend to be unduly influenced by the industry which they regulate, especially where the regulators rely on the industry for information or together they determine the rules. The regulators are often assessed, too, on the performance of the industry - they develop a vested interest in its success.[180] The regulatory staff may also be influenced by private entertaining by the industry, the fear of budget cuts if the industry aggressively lobbies the Government, and the fact that any career advancement would mean a move into the industry.[181] Regulators may also use their position to favour their own political survival.

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175. *Above n6, p130*
176. *Above n6, p130*
177. *Above n162, p52*
178. *Above n162, p52*
179. *Above n6, p38*
180. *Above n6, p39*
181. *In Britain many regulators are civil servants. They are not supposed to enter an industry they have regulated for at least two years. These guidelines are regularly breached and may be one reason by there is a close relationship between bureaucrats and industry. Above n6, p40*

The restructuring proposals for New Zealand's electricity industry include the recommendation that a monitor be appointed.[182] The monitor MEUG proposes would be quite different from the monitoring bodies set up in the United Kingdom. Unlike OFTEL, it would not have any control over the fixing or approving of prices in the industry nor would it have the power to direct any part of the electricity industry.[183] It would be smaller, less bureaucratic and accessible to all groups who wish to obtain information and lay complaints. Other necessary pre-requisites would be independence from both political and industry associations, powers to obtain and publicise information, and knowledge of the industry to assess the information provided.[184] The monitor should be able to report to the Minister or Commerce Commission if it is not satisfied with any monopoly policies.

Such a monitor would still be vulnerable to pressure, albeit less so because it would not be involved in pricing or directing the industry. Its success would not be directly linked to that of the regulated industry. If its reports are acted on by the Government it will have a powerful effect on the industry.

Who should have the monitoring role? The Energy Division of the Ministry of Commerce was proposed[185] as a possible monitor, but concern was expressed by MEUG at the possibility of conflict between its monitoring duties and duties to advise the Government.[186] The Commerce Commission was also rejected by MEUG because,

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182. *Above n149 and above n162, p7*
183. *Above n149, p10*
184. *Above n149, p8*
185. *Public Submissions to the Electricity Task Force: See Above n162, p121*
186. *Above n149, p9*

with its price control functions, "it should be retained as the ultimate sanction" and its main focus is competition rather than the wider issues of economic efficiency and risk management.[187]

Transparency, with a monitor to receive and act on the disclosed information, creates a flexible and efficient method of regulation. There is little intervention in the industry unless restrictive practices are occurring. The compliance and administrative costs of compiling information reports and creating a monitor are not excessive, especially in the light of the benefits of such regulation. Problems could arise if the monitor has the power to make determinations relating to the operation of firms in the industry (as with OFTEL) and where, as a result, its success is directly linked to that of the industry. With suitable statutory backing, however, it is possible to have a monitor which retains its independence and has the power to receive complaints, investigate, and report its findings. If the advice of the monitor is taken by the Government the transparency/monitor proposal will be a successful and efficient form of regulation.

D. The threat of regulation

Industries which have been privatised and de-regulated live constantly with the threat that the Government may, if sufficiently pressured, introduce regulatory legislation. The Government cannot promise that it or its successors will not legislate at some future date; there will always be uncertainty.[188] As well as introducing industry specific legislation, the threat of imposing statutory price control under the

187. *Above n149, p9*
188. *Above n162, p52*

Commerce Act is also a significant deterrent against abuse of dominance in a market.[189] Regulation is less likely to be imposed under current political policies which indicate continuing support for a de-regulated and free market. The need to restrain in some situations is recognised, however, and if measures already in place fail the government may have no choice but to further regulate.

Firms may recognise the threat of regulation and modify their behaviour so as to avoid the costs and constraints of regulatory intervention. However, firms may also challenge the strength of the threat to see how far they may go before regulation is imposed.[190] The effectiveness of the threat will, therefore, depend on attitudes in the industry.

Regulation is more likely to be imposed on monopolists where contestability is uncertain or in situations where the "vulnerable" groups - usually the consumers - are dependent on goods or services supplied by the monopolist. For the threat of regulation to be effective a firm must believe that regulation is a very real possibility. The firm must also have sufficient information available for it assess the risks of non-compliance. If consumers are unhappy with a firm's behaviour and are able to organise effective political action, the threat becomes more acute and prices will remain lower to pacify the consumers. Consumer discontent can be avoided by firms hiding the extent of their profits or buying protection by, for example, lowering prices for politically influential groups. These actions would result in less efficient pricing structures, but this may be avoided by making disclosure requirements mandatory.

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189. *Above n113, p3*
190. *Above n162, p52*

A credible threat of regulation will be cost-effective as it does not impose inflexible, interventionist constraints on the industry. Firms realise that to prevent the threat becoming a reality they must avoid anti-competitive practices, but beyond that they are free to perform as they wish. Firms are often in the best position to meet consumer demands, especially where those demands change rapidly and the consumers have different requirements.[191] Production is more efficient as it responds quickly and easily to changing market needs.

Regulation, if it has to be imposed, creates high administration and compliance costs[192] and makes firms slow and clumsy in their response to market demand. If the threat is ignored and the costs in terms of price, supply and quality are too great, regulation can always be implemented. Regulation often favours new entrants, stimulating investment but resulting in uneconomic and inefficient duplication of facilities.[193] For these reasons regulation should be avoided unless strictly necessary.

The threat of regulation can apply pressure without these disadvantages. If successful, the benefits of market freedom are retained for minimal cost. Beyond the necessity of publicising the possibility of regulation there are few costs involved. If full disclosure requirements are to be implemented the Government is in a good position to assess the need for regulation, which makes the threat more potent: firms will find it difficult to hide monopoly behaviour. If the threat fails and monopolies do need to be constrained regulation may always be imposed.

191. *Above n162, p53*
192. *Above n113, p6*
193. *Above n113, p7*

E. Control by a central body: Banking

The creation of a central body to regulate an industry is more of a political device than a means to encourage competition or efficiency, although these objectives can also be actively promoted. Where the failure of an entity may cause widespread political and economic damage a central body may be created to step in to prevent that failure.

Central body control is commonly found in the financial sector. Today most countries have a government owned central bank which is used to help stabilise the financial system and to implement Government monetary policies.[194] The Reserve Bank of New Zealand (the Bank) was established in 1934 as a central bank and until the 1980s financial institutions were heavily regulated and subject to the Bank's policies.

Although the financial sector has been dramatically de-regulated financial institutions are still largely constrained by the Bank and the provisions of the Reserve Bank of New Zealand Act 1989 (the RBNZ Act). Indeed, the Executive Director of the New Zealand Bankers' Association, Mr Bradford, states that the Government and monetary authorities now have a greater control on money supply and monetary policy than they ever had under the direct controls in place in the 1960-70s.[195]

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194. *A. Grimes "The Theoretical Basis for Monetary Policy" (1990) 53 Reserve Bank Bulletin, No.2 p118, 123*
195. *M R Bradford "Deregulation and the Financial Sector: Boon or A Bust?" Address to Christchurch Rotary Club 9 April 1985, New Zealand Bankers' Association p8*

The major areas of reform in the new RBNZ Act are the implementation of the current monetary policy and prudential supervision of the financial system.[196]

Monetary Policy

The Bank is no longer controlled by the Government, but its functions[197] include formulating and implementing monetary policy in line with the Government's objectives. In an agreement between the Minister of Finance and the Governor of the Reserve Bank[198] made pursuant to the RBNZ Act the Bank is committed to stabilising prices by reducing inflation to 0-2% before the end of 1992.

The Bank dominates the market and its actions in implementing monetary policies may breach the Commerce Act 1986. Section 13 of the Act expressly enables the Act to override other Acts:-

> *Except as provided in sections 9 to 12 of this Act, nothing in this Act or in any other Act whether passed before or after the commencement of this Act limits or affects the obligation of the Bank to carry out its primary function.*

There is some doubt as to the effectiveness of this provision as section 43 of the Commerce Act requires that an action be "specifically authorised" by an Act before it is excepted from the Commerce Act. The law is not settled on the meaning of "specifically authorised".[199] Section 13 is very generally worded and

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196. *S. Dawe "Reserve Bank of New Zealand Act 1989" (1990) 53. No.1 Reserve Bank of New Zealand Bulletin, p29*
197. *Section 8*
198. *Above n5*
199. *The most recent decision was The New Zealand Apple and Pear Marketing Board v Apple Fields Ltd (1989) 2 NZBLC 103,741 where two different tests were set out by the judges. Cooke P stated the test as whether the Act contemplated anti-*

does not contemplate any particular actions. Clearly, however the RBNZ Act gives the Bank the task of meeting the Government's monetary policy and some control is envisaged in the scheme of that Act. In any event the Bank's actions are unlikely to be in breach of the Commerce Act. The implementation of monetary policy affects the market as a whole, rather than targeting a few competitors and thus affecting competition. Most policy moves will have little significant effect on the extent of competition in the market. Indeed, under the newly de-regulated regime competition has been encouraged by the Bank and flourishes. The possibility does remain that for economic reasons the Bank may wish constrain competition and act accordingly. If an action were to be brought against the Bank and the Bank was acting to implement its monetary policy it is likely the action would be dismissed. Parliament would, no doubt, be quick to legislate if this were not the case.

It has been suggested that the interventionist policy of controlling money growth through a tight monetary policy is defective because it distorts the pattern of investment and saving.[200] Investors are encouraged away from productive enterprise and into speculation. It has also induced major collapses in confidence in other economic systems, which has damaged economic recovery.[201] Some form of intervention may be necessary to prevent economic collapse in times of crisis, but would it not be better to let the market self-regulate, grow, and develop the confidence for

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competitive measures (103,748) and Richardson J as whether the act were "of a kind" specifically authorised, which depended on the significance of the act in the statutory scheme (103,756). The case is on appeal to the Privy Council.

200. *D.K. Sheppard "Reserve Bank of New Zealand's Interest Rate Management Programme" Unpublished paper for the Economic Department, University of Victoria, 5 February 1988, p2*

201. *Above n200, p2*

balanced productivity? The result would be a natural falling of inflation as the economy grew and prospered. Any form of central control will cause economic distortions because, as with regulation, institutions are slower to respond to market demand. The central body will have different objectives and its goals may not be conducive to short term efficiency and competition.

Prudential supervision

The RBNZ Act gives the Bank greater powers to gather information about financial institutions to ensure that they remain stable.[202] It also controls the registration of new banks[203] which requires that the Bank be satisfied (among other things) both of "the ability of the applicant to carry on its business or the proposed business in a prudent manner" and of the applicant's standing in the market. The Bank also has "last resort" intervention powers to rescue failing banks, but has adopted as much of a "hands-off" approach as possible to the market it monitors.[204] The aim of the regulation is to prevent the failure of financial institutions.

The RBNZ Act contains provision for public disclosure of information to be made by registered banks as prescribed by the Bank and approved by Order in Council. Provision also exists for regulations to be passed to control advertising by registered banks.[205] No Orders in Council or regulations have been passed to date. The Bank also has powers of "prudential supervision" under section 68 of the RBNZ

202. *Section 81*
203. *Section 73*
204. *E. Carew* *__New Zealand's Money Revolution__* *(1987) Allen & Unwin, p26*
205. *Sections 80-88*

Act over registered banks. These are to be exercised to promote the maintenance of a sound and efficient financial system and to avoid the significant damage to the system that a failure could cause. These disclosure powers do not relate to the pricing policies of registered banks, but are more global. The Bank may step in to rescue a failing bank but it may not, under these powers, step in to control the bank's actions in the market place unless those actions are causing the bank to fail.

Under these disclosure requirements, the financial status of banks and their fees and other charges will become publicly available. Investors will thus have a greater amount of knowledge before investing and anti-competitive practices can be prevented or restrained either by court action or simply by public pressure. In addition, bank loans, overdraft facilities and credit arrangements all constitute credit contracts and come under the jurisdiction of the Credit Contracts Act 1981, which also has stringent disclosure requirements. The lender must disclose not only the interest rate, but also the finance rate, (the real cost of borrowing) and any application, valuation or insurance fees.[206] The penalties for non-disclosure are high. Failure to disclose such details at all stages of the application for a loan may also breach section 9 of the Fair Trading Act 1986.[207] With these provisions it becomes possible for consumers to bring actions for anti-competitive practices.

Control of the Bank - a monopoly

The RBNZ Act sets up extensive statutory disclosure requirements with which the Bank must

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206. *Press Statement by the Commerce Commission, 6 April 1988*
207. *Above n206*

comply, so that it can be publicly and politically monitored. Under section 15 the Bank has to issue policy statements at least once every six months in which it must specify its policies, the means by which it intends to achieve these policies and the reasons for them. There must also be a statement of formulation and implementation of policies for the next 5 years and the Bank must review and assess the preceding months.

These requirements enable the financial sector to examine the strategies of the Bank and analyse their success. Armed with this knowledge the financial sector can place pressure on the Government and the Bank if it is unhappy at the way monetary policy is being implemented. It may better judge moves that appear, short-term, to be damaging to the market but which have medium or long term advantages. The Bank can also explain and confirm the signals it is giving to the financial institutions in its tightening or relaxing of monetary policy.

Control by a central body provides, in a de-regulated framework, some measure of control and protection in an industry where failures can be catastrophic. Government policies implemented through central institutions will affect market freedom for the greater goal of economic stability. While economic stability is a desirable and efficient goal to aim for, the central body's short term goals may not be the same as those of free enterprise which may impair short term efficiency. The cost of market failure is, however, so great that the loss of some efficiency is a necessary price to pay.

CONCLUSION

Until the 1980s New Zealand had a rigidly controlled economy with little market freedom. As it was such a small market the result of this control was the creation of monopoly industries, well protected from the vagaries of free market enterprise. Price control was necessary to protect the consumers from the protected industries.

The removal of regulation, speeded up from 1984 onwards, has meant that many previously controlled industries now face strong domestic and international competition and to survive they must become efficient and competitive. Statutory controls are often no longer necessary; market forces provide the restraint in a much more flexible and efficient manner than statutory provisions ever could.

Political philosophies have changed. After the First and Second World Wars the main concern was stabilisation of an economy rocked by wartime debilitations. Continued high inflation also created a need to introduce controls to stabilise the economy. In the last ten to fifteen years, however, there has been a change in philosophy away from stabilisation and towards allocative efficiency. In New Zealand the objective of efficiency has been sought through the promotion of competition and free market policies. With the increased levels of competition there has been less need for regulation.

Competition is not always possible. Natural monopolies exist where it is either economically infeasible or impossible to duplicate resources. Even where competition is possible the market may still fail to regulate itself. It is in these cases that

regulation and control may still be necessary in order to safe-guard the interests of consumers.

Some industries (such as natural gas) have too great a concentration of power and are too important a resource to be uncontrolled. The natural gas industry is undergoing some restructuring but the statutory price control regime applied under the Commerce Act will fix natural gas prices until competition can be introduced at all levels in the market and satisfactory self-regulation is possible.

Recent re-examination of statutory price control under Part IV of the Act has resulted in considerable changes to its application. The methodology used in the determination of price is now based on more accurate and realistic components and the new statutory criteria take into consideration factors which will promote and encourage efficiency and competition where possible. As a method of control, however, it is still very much a last resort. As price determinations are generally made only once a year it is incapable of responding rapidly to changing market conditions and the cost of bringing an application is high. There is little incentive for potential competitors and investors. Rigid control can never be very efficient, no matter what methodology is used, but with no control the potential exists for monopoly rents, poor quality products, poor service and a limited selection of goods, which could be far less efficient than a price controlled industry. Price control becomes the lesser of two evils.

These are the extremes, however. Most industries are not totally free from restraint and the Commerce Act or light-handed, non-interfering regulation may be all that is required. The Commerce Act contains provisions which protect and promote competition.

While they are effective in free markets where competition thrives (but needs some protection) they often have no application in monopolistic and oligopolistic industries where competition is not really possible. They do provide protection against some monopoly activities. They are a more flexible and less constraining form of regulation in that the provisions do not dictate terms and conditions to the industry but provide a set of guidelines in which the industry must work. The industry is otherwise free to determine policies and strategies. The Act's provisions are designed to promote competition because competition generally improves efficiency. The goal of efficiency is reflected in the provision of authorisation for illegal practices where it is in the public benefit.

Price undertakings too provide constraints within which a company may freely operate. They are more specific to the firm than the Commerce Act provisions and can be aimed at whatever type of behaviour the parties to the undertakings wish to address. The problem is that they tend to be of limited application and only the parties to the agreement can take any action if they are breached. As illustrated by Telecom's undertakings, loose wording reduces their effectiveness as do escape clauses (if Telecom's profits are unreasonably impaired) though their use may be difficult to justify. The undertakings are a useful public relations exercise: because Telecom does not wish to damage its public image it will be careful not to be seen to be behaving predatorily. Its American owners will also be conscious of the scrutiny from the United States on its success in a de-regulated market.

The requirements for full disclosure provide the most effective means of monitoring monopoly

behaviour. Without full disclosure there is no way of knowing the extent to which prices are raised due to inefficient processes. Full disclosure is necessary before any decision on regulation can be made; no alternative can be truly successful without it.

Some form of monitoring by an independent body may be necessary to ensure that the disclosures are more than cosmetic; that they contain enough substance to accurately present the true position of the firm. The compliance costs to the industry in compiling and presenting full reports to be assessed by a monitoring body will not be unreasonably high when considering the long-term benefits of an independent monitor in encouraging economic efficiency.[208] The monitor will not affect the flexibility and efficient operation of the firm it monitors, but will only intervene where anti-competitive practices are being carried out. There is the danger that it could lose its independence, in which case it will become merely a tool of the industry. This likelihood is less if the monitor has no power to set prices or direct the policy.

If all other measures fail industries are aware that heavily regulatory industry specific legislation or complete price control under the Commerce Act may be imposed as a final sanction. Neither the industries nor the Government wish to put in place such legislation as it is inflexible, inefficient and restricts growth. The threat of regulation is very effective in restraining the behaviour of large industries, has virtually no compliance costs and if it fails to constrain, regulatory measures can always be implemented.

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208. *Above n149, p9*

Where the success or failure of an industry has far-ranging effects or is used to implement political policies it is best controlled through a central body, such as the Reserve Bank of New Zealand. In line with the general moves towards de-regulation the Bank's regulatory provisions have become more "light-handed" and encourage efficiency and competition. Such central regulation does distort the economy, but is necessary where the effects of an organisation's failure could be catastrophic.

The New Zealand economy comprises many heterogeneous industries, with different needs, obligations and consumer requirements. Each industry faces different levels of competition and requires different intensities of control. One method of price control will not be the best and most efficient method for every industry. For this reason the provision of a range of different measures, all of which share the ultimate aim of maximising efficiency for the public good, is the best solution for the diverse market conditions.

De-regulation is still quite new in New Zealand. Some of the regulation measures which have arisen where markets have been left unprotected have not been fully implemented, others are not fully tested. A final verdict cannot yet be made as to their efficacy. What is clear, however, is that there is room for a range of price control and regulatory measures which vary in intensity, degree of intervention and flexibility. Each industry's structure, attitudes, and the degree of competition and internal restraint it faces will determine which regulatory regime is best. The ultimate goal is efficiency, it does not really matter which method is used to promote it.

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that Person shall deliver or send to the Company a notice in writing signed by that Person stating that he or she so elects. If he or she elects to have another Person registered he or she shall testify his or her election by executing in favour of that Person a transfer of the Shares. All the limitations, restrictions, and provisions of these Articles relating to the right to transfer and the registration of transfers of Shares shall be applicable to any such notice or transfer as aforesaid as if the death or bankruptcy of the Shareholder had not occurred and the notice of transfer were a transfer signed by that Shareholder.

10.2.3 Where the registered holder of any Shares becomes mentally disordered, dies or becomes bankrupt his or her personal representative or the assignee of his or her estate, as the case may be, shall, upon the production of such evidence as may from time to time be properly required by the Board in that behalf, be entitled to the same Dividends and other advantages, and to the same rights (whether in relation to meetings of the Company, or to voting, or otherwise), as the registered holder would have been entitled to if he or she had not died or become bankrupt; and where two or more Persons are jointly entitled to any Shares in consequence of the death of the registered holder they shall, for the purposes of these Articles, be deemed to be joint holders of the Shares.

11. KIWI SHARE AND RIGHTS OF KIWI SHAREHOLDER

11.1 Definitions

In these Articles, if not inconsistent with the context:

"Affected Share" means any Share which is treated as such pursuant to Article 11.6;

"Crown" means Her Majesty the Queen in right of New Zealand;

"Kiwi Share" means the convertible preference share of $1 referred to in Article 2.1 and having the rights and limitations specified in Article 11.2;

"Kiwi Shareholder" means the Minister of Finance on behalf of the Crown, as holder of the Kiwi Share;

"New Zealand Business" means, for the purposes of paragraph (d) of the definition of the term "New Zealand National", any one or more of the following:-

(a) a Person exempted from the requirements of Parts II and III of the Overseas Investment Regulations 1985 by virtue of an exemption notice issued under those regulations;

(b) any Person named in, or in a schedule to, any such exemption notice;

(c) if the regulations referred to in paragraph (a) of this definition are revoked, any Person falling within that paragraph or paragraph (b) of this definition at the date of the revocation;

(d) any Subsidiary of any Person referred to in paragraph (a) or paragraph (b) or paragraph (c) of this definition;

(e) underwriters or sub-underwriters of any offer of Voting Shares for subscription or purchase;

"New Zealand National" means:

(a) any New Zealand citizen, or any Individual who has attained the age of 18 years and is of full capacity who would, in the opinion of the Board, meet the requirements for citizenship set out in section 8(2) of the Citizenship Act 1977 (or any provision enacted in substitution for that section) if that Individual made an application for citizenship on the date on which his or her status as New Zealand National is considered for the purposes of these Articles;

(b) the Crown or any department or instrument of the executive government of New Zealand or any Person acting on behalf of the Crown or any such department or instrument;

(c) any municipal, local, statutory or other authority formed or established

in New Zealand or any instrument of local government in New Zealand;

(d) any New Zealand Business;

(e) any company, or other body corporate, that -

(i) is established in New Zealand and has its registered office in New Zealand and that is substantially owned and effectively controlled by Persons coming within any of paragraphs (a) to (d) of this definition; or

(ii) is not an Overseas Person within the meaning of the Overseas Investment Act 1973;

(f) the trustees of any employee share purchase scheme operated by way of a trust for the benefit of any Employees, where all the trustees are Persons coming within any of paragraphs (a) to (e) of this definition and where all voting rights in respect of all shares to which the scheme relates are held by the trustees;

"Relevant Interest" has the meaning set out in Article 11.8.

11.2 Rights and Limitations

The following rights and limitations shall be attached to the Kiwi Share:

11.2.1 The Kiwi Share shall be held by, and registered in the name of, the Minister of Finance on behalf of the Crown. The Minister of Finance may from time to time give written notice to the Secretary of the Individual who is entitled to exercise the rights and powers of the Kiwi Shareholder. The Company shall regard as the Individual entitled to exercise the rights and powers of the Kiwi Shareholder, the Individual identified by name or office in the last such notice received by the Secretary.

11.2.2 Notwithstanding any provision of these Articles to the contrary, each of the following

matters shall be deemed to be a variation of the rights attaching to the Kiwi Share and shall accordingly not be effective without the consent in writing of the Kiwi Shareholder:

11.2.2.1 the amendment, or removal, or alteration of the effect of, all or any of the following Articles and definitions:

The following definitions in Article 1.2:

"these Articles", "Board", "Capital", "Company", "Director", "Holding Company", "Individual", "New Zealand Citizen", "Person", "Register", "Representative", "the Secretary", "Security", "Share", "Shareholder", "Subsidiary", "Voting Share";

Article 1.3: Meaning of "Related Body Corporate";

Article 9.8: Registration not to affect powers under Article 11.6;

Article 11: Kiwi Share and rights of Kiwi Shareholder;

Article 16.4: Half of Board to be New Zealand Citizens;

Article 19.1.5: Voting at meeting of Directors;

11.2.2.2 any act or omission to act that contravenes or fails to comply with any of the Articles specified in Article 11.2.2.1, whether or not the act or omission is that of the Board or the Shareholders in general meeting and whether or not the act or omission has been approved by a special resolution of Shareholders.

11.2.3 The Articles and definitions referred to in Article 11.2.2.1 are hereby deemed to confer rights which attach to the Kiwi Share and which are legally enforceable against the Company at the suit of the Kiwi Shareholder. In the event of the Kiwi Shareholder bringing proceedings to enforce the rights attaching to the Kiwi Share and having judgment awarded in

its favour, the Company shall indemnify the Kiwi Shareholder against all the costs of that action on a solicitor and own client basis.

11.2.4 The Kiwi Shareholder shall be entitled to receive notice of and, either by the Individual named in the last notice given pursuant to Article 11.2.1 or by that Individual's Representative, to attend any general meeting of Shareholders or any meeting of any class of Shareholders, and to speak on any matter relating to rights attaching to the Kiwi Share, but the Kiwi Share shall carry no right to vote nor any other rights at any such meeting.

11.2.5 In a distribution of Capital in a winding up of the Company, the Kiwi Shareholder shall be entitled to repayment of the capital paid up on the Kiwi Share in priority to any repayment of capital to any other Shareholder. The Kiwi Share shall confer no other right to participate in the Capital or profits of the Company.

11.2.6 The Kiwi Shareholder may convert the Kiwi Share into an ordinary Share at any time, by notice in writing to the Secretary, which notice shall be accompanied by the share certificate for the Kiwi Share. In that event the Kiwi Share shall be converted into an ordinary Share as from the date of receipt of the notice by the Secretary, the rights and limitations relating to ordinary Shares shall be attached to the Share in place of the rights and limitations specified in this Article 11.2, there shall cease to be a Kiwi Share and a Kiwi Shareholder, Articles 11.2 (except this Article 11.2.6) 11.3, 11.4 and 11.5.2 shall cease to apply, and all references to the Kiwi Share and the Kiwi Shareholder in these Articles shall cease to have any application.

11.2.7 Any approval or consent required of the Kiwi Shareholder under these Articles may be given on such terms and conditions as the Kiwi Shareholder thinks fit. The giving of any such approval or consent shall not derogate from the need to obtain any approval or consent of the Crown under any enactment.

11.3 Alteration of Article 11.2

Notwithstanding any other provision of these Articles, the rights and limitations attached to the Kiwi Share under Article 11.2 shall not be altered without the consent in writing of the Kiwi Shareholder.

11.4 Provision of Telephone Services

11.4.1 Notwithstanding Article 21.1.1, and any resolution of the Shareholders, unless the Kiwi Shareholder agrees otherwise in any particular case or class of cases -

11.4.1.1 The Company shall ensure that it and those of its Subsidiaries which from time to time provide an "ordinary residential telephone service" (as that term is defined in Article 11.4.3) (in this Article 11.4, together called "Telecom") observe the principles relating to the provision of telephone services set out in Article 11.4.2; and

11.4.1.2 The Board shall not manage the business, or exercise any powers, of the Company in a manner which is inconsistent with those principles.

Without limiting the generality of Article 11.2.3, the Kiwi Shareholder may, in its discretion and without being required to do so, bring proceedings to enforce the rights conferred by this Article 11.4. It is expressly declared that this Article 11.4 is not intended to confer any benefit on, and is not enforceable by, any Person other than the Kiwi Shareholder. Nothing in these Articles shall limit, or require Telecom to contravene, any enactment or rule of law.

11.4.2 The principles relating to the provision of telephone services referred to in Article 11.4.1 are as follows:

11.4.2.1 Local Call Charging - A local free-calling option will be maintained for all residential customers. Telecom may, however, develop optional tariff packages which entail local call charges for those who elect to take them, as an alternative;

11.4.2.2 Price Movement - Telecom will charge no more than the standard residential rental for ordinary residential telephone service and from 1 November 1989 the pre-GST standard residential rental will not be increased in real terms provided that overall profitability of the subsidiary regional operating companies, as evidenced by their audited accounts, is not unreasonably impaired;

11.4.2.3 Standard Prices and Availability - The line rental for residential users in rural areas will be no higher than the standard residential rental and Telecom will continue to make ordinary residential telephone service as widely available as it is at the date of adoption of these Articles.

11.4.3 For the purposes of Article 11.4.2, the term "standard residential rental" means the Standard Residential Rental specified on page 6 of the Company's Standard List of Charges for Local Telephone Services effective 1 November 1989 (as amended from time to time in accordance with Article 11.4.2.2) and the terms "ordinary residential telephone service" and "local free calling option" mean the standard local telephone service provided to residential customers for the Standard Residential Rental in accordance with the Company's usual terms and conditions.

11.4.4 For the purposes of Article 11.4.2.2, real price calculations will be made using the Consumer Price Index (for all groups as defined at 1 November 1989) as deflator.

11.5 Limitations on Shareholdings

11.5.1 No Person shall have a Relevant Interest in 10 percent or more of the total Voting Shares for the time being without, and except in accordance with the terms of, the prior written approvals of each of the Kiwi Shareholder and the Board given under this Article 11.5.1.

11.5.2 No Person who is not a New Zealand National shall have a Relevant Interest in more

than 49.9 percent of the total Voting Shares for the time being without, and except in accordance with the terms of, the prior written approval of the Kiwi Shareholder given under this Article 11.5.2.

11.6 Power to sell where Article 11.5 Breached

11.6.1 The provisions of Articles 11.6.2 to 11.6.11 inclusive shall apply if either the Board determines, or the Kiwi Shareholder determines after consultation with the Board, that there are reasonable grounds for believing that a Person has a Relevant Interest in Voting Shares in breach of Article 11.5. Where the Kiwi Shareholder makes such a determination and the Board fails to act pursuant to the following provisions of this Article 11.6 within such period of time as the Kiwi Shareholder considers is reasonable, or fails (in the opinion of the Kiwi Shareholder) to act in a manner which remedies the basis of the determination, the Kiwi Shareholder may act pursuant to the following provisions of this Article 11.6, and where the Kiwi Shareholder has so acted, those provisions shall apply in relation to the Voting Shares in question as if every reference therein to the Board was a reference to the Kiwi Shareholder and not to the Board, and the Company, the Board and every officer of the Company shall do everything necessary on its, his, or her part to enable the exercise by the Kiwi Shareholder of the powers given to the Kiwi Shareholder under those provisions.

11.6.2 After such determination, the Board may, by notice in writing served on any registered holder of Voting Shares to which the determination relates, require that holder to lodge with the Board within 21 days of the date on which such notice is served by the Board, a statutory declaration (or other disclosure if required by the Board) giving such information as the Board may reasonably require for the purposes of determining whether to exercise its powers under this Article 11.6.

11.6.3 Where the registered holder of any Voting Shares does not comply with Article 11.6.2, or the Board in its discretion considers that any disclosure required by Article 11.6.2 or other information reveals that any Person, without the written consent of the Board and/or the Kiwi Shareholder, as the case may be, holds

a Relevant Interest in any Voting Shares in contravention of Article 11.5, the Board may, subject to Article 11.6.4, serve a notice on the registered holder of those Voting Shares declaring those Voting Shares to be Affected Shares.

11.6.4 The Board shall serve notice upon the registered holder of any Voting Shares of its intention to declare those Shares to be Affected Shares. The holder may make representations to the Board as to why any such Voting Shares should not be treated as Affected Shares, within 14 days of receiving the above mentioned notice from the Board. If after taking into consideration any such representations, the Board in its discretion determines that such Shares shall be treated as Affected Shares, it may immediately serve a notice on the registered holder declaring those Voting Shares to be Affected Shares.

11.6.5 A registered holder of Affected Shares shall, if the Board so directs, not be entitled to vote in respect of such Affected Shares at any general or class meeting of the Company and in that event the votes attached to such Affected Shares shall vest in and may be exercised by the chairman of any such meeting who may act entirely at his or her discretion. This shall be without prejudice to the right of any such registered holder to attend or speak at any general or class meeting of the Company.

11.6.6 A registered holder of Affected Shares shall, within three months (or such longer period as the Board may determine) of receiving the notice declaring those Voting Shares to be Affected Shares, ensure that either the Affected Shares or one or more Persons' Relevant Interests therein are disposed of, in whole or in part, so that no Person has a Relevant Interest in the Affected Shares in breach of Article 11.5. If, after three months (or such longer period as aforesaid), the Board is not satisfied that such a disposal has been made, the Board may arrange for the sale of some or all of the Affected Shares on behalf of the registered holder at the best price reasonably obtainable at the relevant time, based upon advice obtained by it for the purpose, so that no Person has a Relevant Interest in the Affected Shares in breach of Article 11.5. For this purpose, the registered holder shall be

deemed to have appointed, and does hereby appoint, the Company as its agent and its attorney, in each case with full authority to act on its behalf in relation to the sale of the Affected Shares and to sign all documents relating to such sale and transfer of the Affected Shares and the Board may register a transfer of the Affected Shares so sold, whether or not the transfer has been properly completed and whether or not it is accompanied by the Share certificates for the Affected Shares. If the certificate for the Affected Shares is not delivered up to the Company, the Board may issue a new certificate distinguishing it as it thinks fit from the certificate not delivered up, whereupon the latter shall be deemed to have been cancelled. The Person to whom such Voting Shares are transferred shall not be bound to see to the application of the purchase money, nor shall his or her title to the Voting Shares be affected by any irregularity or invalidity in the proceedings relating to the sale of those Voting Shares.

11.6.7 If the Board considers that no Person has a Relevant Interest in breach of Article 11.5, in any Voting Shares which have been declared to be Affected Shares, (whether because of the sale of the Affected Shares or otherwise), it shall withdraw the declaration. On withdrawal, those Voting Shares shall cease to be Affected Shares. The Board shall serve notice on the then holder of those Voting Shares of such withdrawal within 14 days of having so resolved.

11.6.8 The Board shall not be obliged to serve any notice required under this Article to be served upon any Person if it does not know either the identity or address of the Person. The absence of service of such a notice in such circumstances, and any accidental error in or failure to give any notice to any Person upon whom notice is required to be served under this Article shall not prevent the implementation of or invalidate any procedure under this Article. Article 30 shall apply to the service on Persons of notices required under this Article 11.6 as if references in Article 30 to Shareholders were references to those Persons and references to the registered addresses of Shareholders were references to the last addresses of those Persons known to the Company.

11.6.9 Any resolution or determination of, or decision or declaration or exercise of any discretion or power by, the Board or by the chairman of any meeting under or pursuant to this Article 11.6 shall be final and conclusive; and any disposal or transfer made, or other things done, by or on behalf of, or on the authority of, the Board pursuant to this Article 11.6 shall be conclusive and binding on all Persons concerned and shall not be open to challenge, whether as to its validity or otherwise on any ground whatsoever.

11.6.10 The proceeds of sale of any Voting Shares sold on behalf of the registered holder under this Article 11.6 shall be applied as follows:

> 11.6.10.1 first, in payment of any expenses incurred in regard to the sale;
>
> 11.6.10.2 the residue (if any) shall be paid to, or in accordance with a direction of, the Person who was the registered holder of the Voting Shares immediately before the sale.

11.6.11 A certificate signed by a Director and countersigned by the Secretary, or by a second Director, or signed by the Kiwi Shareholder, that a power of sale under this Article 11.6 has arisen and is exercisable by the Board, or that a Voting Share has been duly transferred under this Article 11.6 on the date stated therein, shall be conclusive evidence of the facts stated therein.

11.7 Transfers of Shares

11.7.1 The Board may decline to register a transfer of any Voting Shares if, in the reasonable opinion of the Board, any Person would, upon transfer, have a Relevant Interest in those Voting Shares in breach of Article 11.5.

11.7.2 The Board shall decline to register a transfer of Voting Shares if it is aware that the acquisition of the Voting Shares by the transferee results, or would result, in a breach of Article 11.5.

11.8 Meaning of "Relevant Interest"

11.8.1 For the purposes of these Articles, a Person has a Relevant Interest in a Voting Share (whether or not that Person is the registered holder of it) if that Person:

11.8.1.1 is a beneficial owner of the Voting Share; or

11.8.1.2 has the power to exercise any right to vote attached to the Voting Share; or

11.8.1.3 has the power to control the exercise of any right to vote attached to the Voting Share; or

11.8.1.4 has the power to acquire or dispose of the Voting Share; or

11.8.1.5 has the power to control the acquisition or disposition of the Voting Share by another Person; or

11.8.1.6 under, or by virtue of, any trust, agreement, arrangement, or understanding relating to the Voting Share (whether or not that Person is a party to it):

(i) may at any time have the power to exercise any right to vote attached to the Voting Share; or

(ii) may at any time have the power to control the exercise of any right to vote attached to the Voting Share; or

(iii) may at any time have the power to acquire or dispose of the Voting Share; or

(iv) may at any time have the power to control the acquisition or disposition of the Voting Share by another Person.

11.8.2 For the purposes of these Articles, where two or more Persons act jointly or in

concert in respect of the exercise of the rights attaching to a Voting Share in which any one or more of those Persons has a Relevant Interest, then each of those Persons shall be deemed to have a Relevant Interest in the Voting Share.

11.8.3 A body corporate or other body has a Relevant Interest in a Voting Share in which another body corporate that is related to that body corporate or other body has a Relevant Interest.

11.8.4 A Person who has, or may have, a power referred to in any of Articles 11.8.1.1 to 11.8.1.6 has a Relevant Interest in a Voting Share regardless of whether the power:

11.8.4.1 is expressed or implied;

11.8.4.2 is direct or indirect;

11.8.4.3 is legally enforceable or not;

11.8.4.4 is related to a particular Voting Share or not;

11.8.4.5 is subject to restraint or restriction or is capable of being made subject to restraint or restriction;

11.8.4.6 is exercisable presently or in the future;

11.8.4.7 is exercisable only on the fulfilment of a condition;

11.8.4.8 is exercisable alone or jointly with another Person or Persons.

11.8.5 A power referred to in Article 11.8.1 exercisable jointly with another Person or Persons is deemed to be exercisable by either or any of those Persons.

11.8.6 A reference to a power includes a reference to a power that arises from, or is capable of being exercised as the result of, a breach of any trust, agreement, arrangement, or understanding, or any of them, whether or not it is legally enforceable.

11.8.7 For the purposes of Article 11.5, notwithstanding Articles 11.8.1 to 11.8.6, no account shall be taken of a Relevant Interest of a Person in a Voting Share if:

11.8.7.1 the ordinary business of the Person who has the Relevant Interest consists of, or includes, the lending of money or the provision of financial services, or both, and that Person has the Relevant Interest only as security given for the purposes of a transaction entered into in the ordinary course of the business of that Person; or

11.8.7.2 that Person has the Relevant Interest by reason only of acting for another Person to acquire or dispose of that Voting Share on behalf of the other Person in the ordinary course of business of a sharebroker and that Person is a member of a stock exchange; or

11.8.7.3 that Person has the Relevant Interest solely in its capacity as a recognised clearing house, a nominee of a recognised clearing house, a recognised stock or investment exchange or a nominee of a recognised stock or investment exchange; or

11.8.7.4 that Person has the Relevant Interest solely in its capacity as a custodian or depositary under arrangements whereby that Person holds Shares in the Company and either itself or some other person issues receipts or other securities evidencing the right to receive such Shares; or

11.8.7.5 that Person has the Relevant Interest solely in its capacity as an underwriter in respect of obligations (whether contingent or otherwise) to acquire or subscribe for Shares in the Company pursuant to an underwriting or subscription agreement; or

11.8.7.6 that Person has the Relevant Interest by reason only that he or she has been authorised by resolution of the directors or other governing body of a body corporate to act as its representative at any meeting of Shareholders or class of Shareholders of the Company; or

11.8.7.7 that Person has the Relevant Interest solely by reason of being appointed as a Proxy to vote at any meeting of Shareholders, or of a class of Shareholders, of the Company; or

11.8.7.8 that Person:

(i) is a trustee corporation or a nominee company; and

(ii) has the Relevant Interest by reason only of acting for another Person in the ordinary course of business of that trustee corporation or nominee company; or

11.8.7.9 the Person has the Relevant Interest by reason only that the Person is a bare trustee of a trust to which the Voting Share is subject; or

11.8.7.10 that Person has the Relevant Interest solely in its capacity as a trustee of an Employee share purchase scheme of the Company.

11.8.8 For the purposes of Article 11.8.7.9, a trustee may be a bare trustee notwithstanding that he or she is entitled as a trustee to be remunerated out of the income or property of the trust.

PART III - GENERAL MEETINGS

12. GENERAL MEETINGS

12.1 Annual General Meetings

12.1.1 The Company shall in each calendar year hold a general meeting as its annual

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