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Spiking Prices:
**How Economics, History and Law have shaped the New
Zealand Electricity Authority's UTS Regime**

A thesis submitted in fulfilment
of the requirements for the degree

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Abstract

The March 26th price spike in Genesis Energy's Huntly power station prices has focussed attention on the regulatory powers of the newly established Electricity Authority. The Authority's weapon of choice, the Undesirable Trading Situation regime, allows them to intervene in the market and was applied in this case to reset prices retrospectively. The decision caused a storm of controversy in the media and numerous submissions, both for and against, from market players.

The Authority has a mandate to regulate competition in the electricity markets and because of the overlapping jurisdiction, has signed a Memorandum of Understanding with the Commerce Commission. How the two bodies interpret and apply their co-existing statutory obligations will be of great interest to businesses operating not just in the energy sector, but across the whole economy. For those in the electricity industry any indication as to how the Electricity Authority intends to regulate wholesale electricity markets will be crucial for implementing future market strategies and investments.

The question for this paper will therefore be to assess the decision in light of these overlapping jurisdictions, the policy documents used to guide each decision maker, and the previous decisions which may have influenced or misled market players. Given the focus on efficiency in New Zealand's competition law, particular attention will be paid to the economic history of theories of contestability, the total surplus standard, price squeezes and wealth transfers, and the interplay between static and dynamic efficiency.

The conclusion will be that the March 26th decision, although made under a very different legislative scheme to the Commerce Act, bears remarkable similarities to the general competition law. The decision applies a very similar remedy to the standard ECPR counterfactual analysis seen in s 36 prosecutions. The main difference between the two regimes is that the UTS provision is not applied punitively, reflecting a determination on the Authority's part to maintain flexibility and restore orderly trading.

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Spiking Prices: How Economics, History and Law have shaped the New Zealand Electricity Authority's UTS Regime

By Steven Farnworth

Antitrust is a subcategory of ideology.¹

Robert Bork

Introduction – The Purpose of Competition Law

On March 26, 2011, prices in the New Zealand wholesale electricity market, forecast to reach a mere \$160/MWh, spiked to a record \$23,047/ MWh.² It seemed that Genesis Energy had taken advantage of a temporary monopoly of electricity supply to Hamilton and regions to the north to engineer a \$50 million transfer of wealth from rivals and customers alike. The Electricity Authority (“the Authority”) received 35 claims under the Undesirable Trading Situation regulations (“UTS”) of the Electricity Industry Participation Code (“the Code”). In its Draft Decision the Authority concluded that an Undesirable Trading Situation in the form of a ‘market squeeze’ had occurred and that the proper remedy was to reset offer prices to \$3000/MWh. This decision was reached even though the New Zealand Electricity Market’s defining characteristic has been that it has no price cap, and was intended from its inception to be lightly regulated.³

The decision raises important issues which go beyond the regulation of electricity markets. It prompts us to reconsider the economic concepts which underpin competition law. We must reflect on the proper role of the law and ask what its

¹ Robert Bork *The Antitrust Paradox: A Policy at War with Itself* (Basic Books Inc, New York, 1978) at 3.

² *Bay of Plenty Energy Ltd v The Electricity Authority* [2012] NZHC 238 at [1].

³ See “Final Decision”, below n 453, at [119].

overall objective is, to pursue economic efficiency, to seek the equitable distribution of wealth or to find some compromise between the two ends.

This thesis will explore the economic history of concepts such as contestability, workable competition and dynamic efficiency. It will reveal how New Zealand policy makers selected Chicago School ideas in the 1980s and used them to form the Commerce Act 1986. Those ideas were themselves shaped by debates such as the ‘marginal cost controversy’, and the total surplus versus consumer surplus standard with its search for a proper balancing between static efficiency and dynamic efficiency objectives. A guiding theme will therefore be whether our regulatory authorities will apply more of a total surplus or a consumer surplus standard when regulating potentially anti-competitive behaviour.

The thesis will examine the development of s 36 and Part 4 of the Commerce Act to see how control of monopoly behaviour has changed from the days of state control of prices and the prime necessity doctrine, and how that doctrine was excluded by the Commerce Act. The shift to light handed regulation and subsequent re-regulation of the economy will be assessed in light of a few of the landmark judgments of the last two decades. We will then look at policy documents which lead to the establishment of the Electricity Authority (“the Authority”), how the Authority’s employed its UTS powers in the March 26th Price Hike, and how that decision was subsequently approved in the High Court. Finally, we will consider the significance of the decision for competition law issues in electricity regulation given the interrelationship between the Commerce Commission and the Electricity Authority and their overlapping mandate to promote competitive outcomes in New Zealand markets. Would the two agencies come to a different result given the same set of circumstances?

The purposes of competition law are inseparable from their historical development. As Robert Bork said:

Antitrust policy cannot be made rational until we are able to give a firm answer to one question: What is the point of the law – what are its goals? Everything else follows from the answer we give.⁴

The question of how to balance the interests of workers, investors, consumers and producers lies at the heart of both economics and the law. The debate over static

⁴ Bork, above n 1, at 50.

versus dynamic efficiency, the total surplus versus consumer welfare standard and the marginal cost controversy, all have at their core the basic question of how society's resources are to be shared between producers and consumers. These academic conundrums are revisited time and time again, and it is the most convincing solutions of the day which inform the next generation of competition lawyers and policy makers. Is the objective of competition law to guarantee the cheapest possible goods for the short term of consumers, or is it to provide incentives for the innovative to find solutions leading to long term growth? It is often said that these two objectives must be balanced, just how difficult that can be is the reason why the debate has continued for so long.

The Commerce Act 1986 defines competition as “workable or effective competition”.⁵ Workable competition is a term of art. Discerning its true meaning requires a deep understanding, not just of the Commerce Act, but of how a whole historiography of economic concepts have shaped the free market system itself.

Beginning with Adam Smith, we can see how ideal of perfect competition gradually gave way to workable competition based initially on Schumpeterian ideals of contestability and dynamic efficiency. The story begins with state centred control of economies, and, in the US, the Jeffersonian ideal of protecting the democratic economic rights of numerous, self-sufficient, small business men. The goal was to allow self-interest to motivate individuals to provide consumer and public goods at the best possible prices. This objective has shifted to the promotion of an oligopolistic system, where a few large firms are encouraged to accumulate wealth to fund research and development for long term growth. It is this oligopolistic market system, where market power is constrained mainly by the potential for contestability, which really exemplifies workable competition.

As the objective of competition policy has shifted from perfect to workable competition, a somewhat lax attitude towards anticompetitive behaviour evolved. In the last decade however, we have seen a shift from neo-liberal reliance upon light handed regulation of the free market embodied by the Commerce Act 1986, to a more interventionist competition law policy. James Every-Palmer has called

⁵ Commerce Act 1986, s 3(1).

this the “re-regulation” of the economy.⁶ The recent ‘Datatails’ decision for one, may indicate that the Commerce Commission is willing to use its powers under the s 36 of the Commerce Act to penalise breaches of s 36 of the Commerce Act with a determination we have not seen ever before.⁷

The Authority’s objective is under the EIA, meanwhile, is “to promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.”⁸ This raises more questions. Does this mean that the Electricity Authority will define competition as workable competition in the same way as the Commerce Commission? And if so, would it make the same decision as the Commerce Commission might, given the same set of circumstances? Will the Authority be influenced by this quiet shift towards re-regulation or will it maintain the neo-liberal ideals of its intellectual forefathers? The goal of this thesis is to explore these questions in light of the events of March 26th, 2011.

Historical Development of Competition Law – From Perfect Competition to Workable Competition

Since Adam Smith first posited the concept of the invisible guiding hand of the market, the central question has been how to balance the needs of society with the needs of the individual. Liberal economic theory requires that government should not interfere with the workings of the market. By allowing individuals the freedom to make their own self-interested decisions in pursuit of profit, and in competition with each other, a mutually beneficial equilibrium will naturally and inevitably be reached. The invisible hand thus built on the older laissez faire idealists who demanded that the state should “let (them) act”.⁹ The theory is elegant and the overwhelming success of Western capitalism provides emphatic empirical proof that it works. History also teaches, however, that market failure, corruption and anti-competitive behaviour caused by those same frustrating utility

⁶ See Dr James Every-Palmer, “The State and Monopolies: New Zealand’s Experience” (2010) 12 Otago LR 227.

⁷ *Commerce Commission v Telecom Corporation of New Zealand Ltd* (2011) 13 TCLR 270; [2011] NZCCLR 19.

⁸ Electricity Industry Act 2010, s 15.

⁹ HarperCollins *Collins Dictionary* (11th ed, HarperCollins Publishers, Glasgow, 2011) at 924.

maximising individuals may result from too much freedom. The recent Global Financial Crisis, for example, has renewed calls for a fundamental and far-reaching reassessment of free market ideology.

Along with the rise of Western capitalism we have seen the rise of the limited liability corporation. Ronald Coase predicted that individuals would organise themselves into firms when to do so would make carrying out market transactions less expensive.¹⁰ Where such organisations come to dominate the market, regulation of the market may become necessary to protect democracy itself. There is then the countervailing notion that Smith's invisible hand may sometimes need to be guided, or, to continue the metaphor, an arm wrestle between state and citizen may become necessary.

Smith's insight was that individuals guided by the price signals of the market and their own self-interest would do far more to promote the public weal than any central planner.¹¹ The Lockean pursuit of life, liberty and property would provide a far more flexible and reliable guarantee of wealth than could be achieved under any feudal or mercantilist state. The revolutionary suggestion was that the remnants of the *Ancien Régime's* archaic and repressive state centered structures must be excluded from the business realm.¹² It is no coincidence that this seminal work was published in the year of the American Declaration of Independence, the liberal revolution was a universal phenomenon encompassing all aspects of eighteenth century society.

Smith was fully cognizant of the dangers of monopoly and collusion. He is frequently quoted as having said that: "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."¹³

Smith was equally clear that competitive pressure had beneficial effects for consumer welfare:¹⁴

¹⁰ Ronald Coase *The Firm, the Market and the Law* (The University of Chicago Press, Chicago, 1988) at 7.

¹¹ Adam Smith *The Wealth of Nations* (J.M. Dent & Sons Ltd, London, 1910).

¹² Robert Heilbroner *The Essential Adam Smith* (Oxford University Press, Oxford, 1986) at 151-152.

¹³ Smith, at 117.

¹⁴ At 54.

The price of monopoly is upon every occasion the highest which can be got. The natural price, or the price of free competition, on the contrary is the lowest which can be taken, not upon every occasion, indeed, but for a considerable time together. The one is upon every occasion the highest which can be squeezed out of the buyers, or which it is supposed, they will consent to give; the other is the lowest which the sellers can commonly afford to take, and at the same time continue their business.

The goal of competition policy must therefore be to minimise the opportunities for collusive and domineering behaviour by the rich and powerful, while maximising the beneficial effects of fair competition. The challenge then, as now, was to balance this search for fairness to consumers and competitors alike, without strangling the incentives which encourage the investor and entrepreneur to engage in risky but rewarding business activities.

Adam Smith also said that:¹⁵

The appropriation of herds and flocks, which introduced an inequality of fortune, was that which first gave rise to regular government. Till there be property there can be no government, the very end of which is to secure wealth, and to defend the rich from the poor.

It is the monopolisation of common wealth by the few from the many which first created inequalities in wealth. If the purpose of government is to protect that appropriation then, according to this reading of Smith, necessarily the state must make the political decision to stand with the rich against the poor. For Smith then success in the marketplace was not simply about the freedom to fairly compete and prevail through superior ideas and products. The *raison d'être* of government itself was to promote and protect those divisions of wealth.

Robert Frank proposes that Smith may be supplanted by Charles Darwin as the founder of modern economic thought.¹⁶ Frank's idea is that individuals may make rational choices in their own interest which in fact harm wider society:¹⁷

... unbridled market forces often fail to channel the behavior of self-interested individuals for the common good. On the contrary, as the pioneering naturalist Charles Darwin saw clearly, individual incentives often lead to wasteful arms races.

The example Frank gives is of the peacock who advertises his sexual health through the maintenance of the largest most brilliant tail possible.¹⁸ Carrying such

¹⁵ Adam Smith *Lectures on Jurisprudence* (1766) (Oxford University Press, Oxford, 1978) at 404.

¹⁶ Robert Frank *The Darwin Economy: Liberty, Competition and the Common Good* (Princeton University Press, Princeton; New Jersey, 2011).

¹⁷ At xi.

¹⁸ At 7.

a weighty status symbol around makes every male peacock more vulnerable to predators, however, so what is good for the individual is bad for the species. The rational choice would be for every peacock to reduce its tail size by half, but the nature of the individual arms race is such that the rational individual choice is an irrational communal choice.

Frank contends that libertarians in the United States have co-opted Adam Smith as the basis for the claim that the invisible hand always benefits society,¹⁹ and the powerful meme that government is always wasteful and foolish.²⁰ But as we have seen Smith was well aware of the dangers of collusion. Smith wrote that the profit seeking business owner:

... intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which has no part of his intention. Nor is it always the worse for society that it was not part of it.

Charles Darwin saw the underlying problem clearly. Natural selection favours traits that grant an advantage to the individual, and sometimes those traits will be beneficial to the species and sometimes they will not. The interests of the species and the individual may diverge. In the same way, large, powerful and gaudy firms act for their own self-interest, not necessarily in the interests of society at large, this must always be kept in mind when considering the invisible hand doctrine.

Monopolies can arise either from the actions of single firms with substantial or complete control of a market, or from the actions of multiple firms independently, tacitly or explicitly colluding.²¹ Yet, are monopolies in fact less efficient at promoting public goods than perfectly competitive markets? The answer to that question may not be as straightforward as expected:²²

A substantial controversy has long been waged by economists as to whether monopoly promotes or deters innovation. Will a monopolist, in effect, rest on its laurels and not have any incentive to innovate because of the lack of market pressure, or will monopolists be spurred on by the prospect of capturing all of the gains from innovation that a monopoly can obtain, whereas a firm in a perfectly competitive market would lose some of the benefits of innovation as its innovation is copied by competitors?

¹⁹ At 7.

²⁰ At 4.

²¹ Matt Sumpter *New Zealand Competition Law and Policy* (CCH New Zealand Ltd, Auckland, 2010) at 34.

²² Viscusi, W and others *Economics of Regulation and Antitrust* (3rd ed, MIT Press, Cambridge (Mass), 2000) at 5.

If it could be conclusively proven that monopolies were an evil, then the solution would be clear, ban all monopolies. If the goal of the economy is to provide the lowest possible prices, then the solution is also clear, legislate maximum prices for all goods. If the history of capitalism has provided one lesson, however, is that autocratic central control of the economy is a recipe for disaster. The insight, heavily influenced by Smith, is that a measure of laissez faire is the best means of providing for the public good. How far that freedom should be extended is what continues to be explored.

Underlying the debate is the search for the proper goal of competition law, fairness or efficiency? Economists of the Chicago School, such as Robert Bork, argued that the only proper goal of competition law should be economic efficiency, though what is meant by that differs from person to person. Competition regulation has likewise been used to pursue socially equitable distribution of societies resources. Ordoliberalism, as an example, is a European school of thought which seeks to preserve a strong role for the state in preserving democratic liberal values through protecting the individual's democratic right to economic self-sufficiency. As Amato said:²³

Antitrust law was, as we know, invented neither by the technicians of commercial law (though they became its first specialists) nor by economists themselves (though they supplied its most solid cultural background). It was instead desired by politicians and (in Europe) by scholars attentive to the pillars of the democratic systems, who saw it as an answer (if not indeed 'the' answer) to a crucial problem for democracy: the emergence from the company or firm, as an expression of the fundamental freedom of individuals, of the opposite phenomenon of private power; a power devoid of legitimation and dangerously capable of infringing not just the economic freedom of other private individuals, but also the balance of public decisions exposed to its domineering strength.

Concerns about the power of the private firm and the potential threat to democracy were not confined to Europe, and in fact were very much on the mind of Thomas Jefferson, one of the most influential authors of the United States Constitution. As Areeda put it:²⁴

The symbols are those of Jeffersonian democracy, in which small, local, responsible, and individually owned enterprises are contrasted with large, politically irresponsible, absentee-owned, and possibly corrupt giants

²³ G Amato *Antitrust and the Bounds of Power* (Hart Publishing, Oxford, 1997) at 2.

²⁴ Phillip Areeda, Louis Kaplow and Aaron Edlin *Antitrust Analysis: Problems Text and Cases* (Aspen Publishers, New York, 2004) at 21.

capable of crushing smaller business and of subverting democratic government.

Before continuing, it would be useful to define some of the basic terms. First of all, what is static efficiency? Static efficiency is the focus on maximum output at the minimum price possible at the present moment. Static efficiency has two components, allocative efficiency which focuses on the efficient allocation of resources throughout society, and productive efficiency which concentrates on the processes and procedures inside an individual business.²⁵

As both allocative and productive efficiency are assessed at a particular point in time, the implication can be that further improvement becomes unnecessary once consumers are able to enjoy the greatest output of the lowest priced goods for their present needs. Firms might produce a given product for the least cost and at the required amount ad infinitum, with the only improvements coming from further reductions in cost and refinements of the proper output for maximum profit. Static efficiency is conducive to price regulation because if a particular price at a particular point in time can be easily calculated, then it can also be enforced.

A focus on static efficiency would emphasise the importance of perfect competition. A perfectly competitive market is one where numerous competitors, with perfect knowledge of the market, compete to supply homogenous goods and services. Because of their great number, and because there is no collusion amongst them, neither producer nor consumer is able to influence the pricing or output decisions of its rivals.²⁶ Any decision to increase prices would lead to the instantaneous loss of market share to the next cheapest competitor. Any attempt to reduce output to raise prices would have the same result.²⁷ Prices would therefore be driven down to the marginal cost or what Smith called “the lowest which the sellers can afford to take, and at the same time continue in business.”²⁸

The central assumption is that a perfectly competitive market will reach a point of equilibrium where goods are produced at the marginal cost and at the exact quantity required to meet demand. A perfectly competitive market will, by

²⁵ Sumpter, above n 21, at 32-33.

²⁶ Areeda, above n 24, at 5; Alison Jones and Brenda Sufrin *EU Competition Law: Text, Cases and Materials* (4th ed, Oxford University Press, Oxford, 2011) at 7-9.

²⁷ Sumpter, at 34.

²⁸ Smith, above n 11, at 54.

definition, be Pareto Optimal in that no improvements could be made to market arrangements without detriment to some participant.²⁹ A market which is in the proper equilibrium will exactly balance producer surplus with consumer surplus, in other words, the value to each from market arrangements will be as fair and equal as is possible given the constraints of technology and resources.

By that rationale, a market which was not perfectly competitive in that it was dominated by one or a few monopolists would be one where it was possible to raise costs or reduce output without fear of losing market share.³⁰ The monopolist would be free to transfer wealth from consumers without giving any corresponding increase in value, a result generally considered to be inefficient. Typically, economic texts demonstrate this effect by means of the supply and demand curve, which describes prices above the marginal cost taken by the monopolist as a “dead weight loss”.³¹ A monopolist is able to shift the balance of producer surplus in its favour, without a corresponding increase in the total surplus available to society.

As the focus in statically efficient and perfectly competitive markets is on the reduction of costs and prices at a given point in time, they are not conducive to the recovery of fixed long run costs.³² Dynamic efficiency, by taking a longer term view, provides for the recovery of sunk or fixed costs over time.³³ A dynamically efficient competition policy would allow mergers and market strategies aimed at longer term growth, strategies which might be prohibited under a shorter term statically efficient view. It is therefore more flexible for the needs of new entrants or companies needing to cash in on past investments in order to fund the ‘next big thing’.

Dynamic efficiency therefore allows competitors to obtain higher profits, and unlike the perfect competition paradigm, accepts that this can occur without instantaneous loss of market share. The wealth accumulated is not counted as a ‘dead weight loss’ so long as it results in a beneficial innovation. It is the

²⁹ Viscusi, above n 22, at 75-78.

³⁰ See Sumpter, above n 21, at 33-39.

³¹ Viscusi, at 78-80; Sumpter at 36-39.

³² Sumpter at 33.

³³ Sumpter at 33.

exception to the rule that wealth transfers are inefficient, because the result is an increase in value over the long term.

It often seems to be overlooked in this debate that marginal cost includes a normal level of profit. The criticism of monopolistic prices in relation to marginal cost is twofold. First, that the monopolist obtains supranormal profits³⁴ which result in a transfer of wealth from the consumer to the producer, and secondly, that profits above the marginal cost constitute a deadweight loss to society, which is inefficient. The problem with monopoly profits according to Chicago School theorists, is not so much that such wealth transfers are inequitable, but rather that the rent-seeking behaviour of the monopolist results in a misallocation of resources.³⁵ Others, as we will see, would question the equity of wealth transfers as well.

Another principal objection to monopoly is derived from Harvey Leibenstein's conception of X-inefficiency. X-inefficiencies are the "internal inefficiencies and rising costs resulting from high salaries, excessive perks, over-manning and the lack of the need to minimise the cost of production."³⁶ The concept charts the differences between expected market behaviour under perfect competition and the real empirical evidence of internal firm behaviour.³⁷ Liebenstein's initial premise was that that gains which could be made from increases in allocative efficiency due to abolishing monopolies would be minuscule, at around one thirteenth of one per cent of the GDP of the United States for example.³⁸

X-Efficiencies are the improvements to be obtained from properly motivating managers and workers to make the best of available technology and capital, absent other efficiencies.³⁹ Improvements made through clever management of otherwise virtually identical means of production, lead to rather large differences in performance between individual firms. Improved management practices provided more immediate benefits than those available due to technological

³⁴ Supranormal profits are any profits over and above those contained in the marginal cost.

³⁵ Jones and Sufrin, above n 26, at 9-11.

³⁶ At 10-11.

³⁷ Harvey Leibenstein "Allocative Efficiency vs. 'X-Efficiency'" (June, 1966) 56(3) Amer. Econ. Rev. 392.

³⁸ At 393.

³⁹ At 398.

innovations, suggesting that x-efficiencies could outweigh dynamic.⁴⁰ Liebenstein concluded that:⁴¹

... [F]or a variety of reasons people and organizations normally work neither as hard nor as effectively as they could. In situations where competitive pressure is light, many people will trade the disutility of greater effort, of search, and the control of other peoples' activities for the utility of feeling less pressure and of better interpersonal relations.

The implication is that even with best available technology, the best allocation of resources and the most productively efficient internal procedures and policies, the motivation and work ethic of managers and staff is the most important factor in determining overall efficiency. Competitive pressure should operate to induce the sorts of attitudinal changes necessary to improve x-efficiencies, but not always.

Where firms in an oligopolistic market are all operating under the same x-inefficiencies, the result might be that there are, in fact, no incentives to reduce the inefficient transfer of wealth from society to the management elite of those firms. That is, if it were accepted across an industry that golden parachutes, high salaries and other expensive perks for managers were the norm, then it would take a significant competitive jolt to upset the corporate culture. The firms themselves would be trapped by those closely guarded privileges into extracting supranormal profits to pay for them, which on basic principles is both unjust and a misallocation of resources.

This aspect of x-efficiency, it is submitted, is the Achilles heel of dynamic efficiency. Wealth accumulation should only be tolerated where it is efficient, that is, where it is invested in long term growth and innovation. X-inefficiencies are in effect examples of rent-seeking behaviour. Dynamic efficiency does not imply that firms should invest at the greatest rate possible, but rather that there is a particular rate of investment that is socially optimal. More innovation is not always better, because resources must be used in order to discover and adopt innovations. There must therefore be a point where wealth accumulation is surplus to the requirements of dynamic efficiency. The danger is that such surplus profits will be used to pad executive perks rather than being used to come up with the next big innovation.

⁴⁰ At 403.

⁴¹ At 413.

Robert Frank's insight can be applied to Liebenstein's X-Inefficiency. Each firm maintains wasteful perks, which it uses to hire the most talented possible individuals, who then jealously guard and extend those perks. The resulting waste is bad for the species, but if left to the free market, no collection of individuals would rationally pass up those benefits. The role of the state remains, that it must balance the interest of the individuals against the interest of society as part of a sensible competition policy. Government must govern.

Dynamic Efficiency and the Schumpeterians

The search for dynamic efficiency benefits has its origins in the Schumpeterian school of thought, which argues that monopoly may be beneficial and that there are factors other than price competition which need to be considered. Of greatest importance are the incentives to come up with the new technology, product or process from which true wealth gains are derived. This line of thinking has developed in opposition (or as a complement) to static efficiency, and was the fruit of thinkers associated with the Chicago School, such as Richard Posner, Robert Bork, Joseph Schumpeter of course, and, more recently, William Baumol.

As we will see, Schumpeterians often argue that Smith's invisible guiding hand is the only regulation the market needs, and that too stringent an application of perfect competition ideals will simply wreck the economy. It is the logical endpoint of the ideal of dynamic efficiency.

In short, the Schumpeterians argued that supranormal prices are not inefficient, and constitute no deadweight loss to society because they provide the incentive for "technical progress".⁴² They challenged the assumption that monopoly was necessarily evil, arguing that to automatically reject monopolistic behaviours via per se prohibitions risks discarding the efficiency benefits those practices may achieve. It is throwing out the baby to get rid of the bathwater. Hence, notions of contestability and the 'dollar is a dollar' total surplus standard were developed to justify tolerance of a certain level of monopoly power in the interests of wealth generation.

⁴² Viscusi, above n 22, at 88-89.

The goal of dynamic efficiency is for the producer to invest time and resources to acquire a monopoly created by a new invention, whose benefits will spillover to the consumer. Despite patent protections, competitors will eventually copy and adapt to their rivals ‘technical progress’, until the successful innovation becomes the new norm. The constant search for temporary monopoly profits thus motivates competing producers to make their own investments in research and development in an attempt to make the next breakthrough. Workable competition, based on the Schumpeterian ideals of Bork, Posner, Baumol and Scherer, assumes that oligopoly is the best means of obtaining innovation, as it mixes competitive rivalry and knowledge of competitor’s activities with the economies of scale necessary to accumulate the investment funds necessary for the investment to take place.

Much of the Chicago School and neoliberal theory of contestability and workable competition was developed in opposition to the Structure-Conduct-Performance (“S-C-P”) paradigm. The S-C-P paradigm holds that the structure of the market dictates the conduct and subsequent performance of firms.⁴³ Competition is assumed to be lessened in concentrated markets and which leads to decreased consumer welfare. This equation is sometimes referred to as the “concentration-competition-consumer welfare” presumption.⁴⁴ Monopolistic behaviour could therefore best be regulated by breaking up those large firms whose dominance constituted significant barriers to entry.

The reaction from the Chicago School was largely an effort then to prove that the monopolistic or oligopolistic structure could in fact be beneficial, particularly in terms of technical progress and therefore perfectly competitive markets were not essential. Despite that reaction, the S-C-P paradigm has continued to be influential. As Herbert Hovenkamp said:⁴⁵

The S-C-P paradigm left certain marks that seem all but indelible – for example, the greatly increased attention to market definition, barriers to entry, and proof of market power that even the most convinced members of the Chicago School acknowledge to be important. Antitrust without

⁴³ Herbert Hovenkamp *The Antitrust Enterprise: Principle and Execution* (Harvard University Press, Cambridge (Mass), 2005) at 36-37.

⁴⁴ Michael Katz and Howard Shelanski “‘Schumpeterian’ Competition and Antitrust Policy in High-Tech Markets” (2005) 14 *Competition* 1 at 7.

⁴⁵ H. Hovenkamp *Federal Authorities Policy: The Law of Competition and its Practice* (3rd ed, Thomas/West, 2005) at 46 cited in Jones and Sufrin, above n 26 at 22-23.

structural analysis has become impossible, thanks largely to the S-C-P writers. To be sure, they may have gone too far in emphasizing structure over conduct, but that is a question of balance, not of basic legitimacy. Not even S-C-P's most vehement critics would roll the clock back completely.

The problem for the regulator in the context of these competing ideals is to determine what market structure best stimulates such oligopolistic market rivalry. In another words, how many competitors can the market bear, and what market share should each be entitled to. A properly designed market, much like a precisely engineered time-piece, requires minimal intervention. The cost of regulation is likewise minimised because no single participant is able to bring monopoly power to bear without provoking a reaction from competitors or customers. The system works because it contains its own checks and balances.

The regulator must also give thought to the distributional justice question posed by the inevitable X-inefficiencies which accompany too concentrated a market. How much of the profit is being optimally invested in research and development, and how much is being lost to society through the featherbedding of the elite ranks of the dominant business entity?

The tension between the static and dynamic efficiency standards is really about the question of profit. A statically efficient society would produce the cheapest goods, but with little room for improvement. If society reaches a static, unchanging, 'perfect' equilibrium then there can, logically, be no improvement. A dynamically efficient society allows for rapid technological advancement, but potentially at the cost of large wealth transfers.

It is this latter model which provides justification for what has come to be called the total surplus standard. The total surplus standard rationalizes the transfer of wealth from consumers to producers, so long the efficiency gains result in an increase to the total wealth. The standard therefore relies upon a principle attributed to Harberger, that 'a dollar is a dollar' and it matters not in whose hands the dollar lies.⁴⁶ The policy is said to be neutral towards wealth transfers between consumers and producers. As long as the pie is increased it does not matter if the slices of the pie become increasingly unequal. It is an utterly utilitarian form of Pareto optimality.

⁴⁶ See Geoff Bertram "What's Wrong with New Zealand's Public Benefits Test?" (December, 2004) 38(2) NZEP 265.

Pareto optimality is closely related to the utilitarian doctrine of the greatest good for the greatest number.⁴⁷ It asks which arrangement would provide the greatest share of wealth to the greatest number of people. But would a state which provides more equal shares of wealth be Pareto superior to one which was more unequal, but with a greater pool of wealth? Pareto optimality presumes that the best state is one in which no person could be made better off, without making one person worse off, and that no state exists which is superior.⁴⁸

A state of incredible wealth co-existing with appalling poverty could not logically be superior to one of more equitable distribution, however, even where the total amount of wealth available to the former society exceeded the latter. Even if it could be argued that a particular economic system should be preferred to another because the alternative was between wealth for some and poverty for all, for example capitalism versus Stalinist socialism, the moral justice of perpetuating extreme economic distinctions where there is a choice is questionable. Not only that, but the choice of economic policy options is seldom so stark.

John Rawls therefore proposed that it would not be ethical to accept an arrangement in which the rich got richer, unless the lot of the poor was improved as well.⁴⁹ This ‘difference principle’ clarified the distribution problem posed by an uncritical acceptance of Pareto optimality. Only an arrangement which made everyone richer would be superior. Yet this virtuous approach is fundamentally opposed to the total surplus standard, which, by being blind to the direction and distribution of wealth transfers, holds that it is the total surplus available to society which is important. This is why the total surplus standard fits so comfortably with Schumpeterian model and why dynamic efficiency arguments may pose a threat to the equitable objectives competition law originally envisaged.

The accusation is that Adam Smith’s original insight, the Invisible Hand Theorem, (now referred to as the First Fundamental Theorem of Welfare Economics) has been so uncritically accepted by contemporary economists and world leaders that it has led to a justification of the vast inequalities in modern society.⁵⁰

⁴⁷ Amartya Sen *On Ethics and Economics* (Blackwell Publishing, Oxford, 1988) at 38.

⁴⁸ Viscusi, above n 22, at 75-76.

⁴⁹ See generally John Rawls *Theory of Justice* (Oxford University Press, Oxford, 1972).

⁵⁰ Kaushik Basu, *Beyond the Invisible Hand: Groundwork for a New Economics* (Princeton University Press, Princeton, New Jersey, 2011) at 10-11.

Smith's great insight gradually ossified into a hard and unbending doctrine.... [and] Even today, many economists equate the Invisible Hand Theorem with the normative proposition that we should leave individuals free to pursue their own selfish ends without restraint.

A counterbalancing thesis is that societies that do distribute wealth more evenly, out-perform liberal free market capitalism in terms of basic measures of health and well-being by any measure. Acemoglu suggested that there are significant links between oligarchic societies and barriers to investment, which suggest that the more democratic a society is the more likely it is to eventually surpass politically concentrated societies.⁵¹ What Acemoglu does not conclude is the reverse, that democratic societies which allow the formation of oligarchic elites become less democratic, but that point has been made elsewhere.⁵²

Wilkinson and Pickett's useful work in *The Spirit Level* demonstrates how disparities in income within societies are corrosive to social unity.⁵³ Empirical evidence shows how little difference increases in GDP play in promoting health, wellbeing and happiness, yet how damaging inequalities within societies can be. The research shows that the most unequal societies, the US, UK, Australia, and surprisingly New Zealand, all perform very poorly against other OECD countries in terms of health and social problems. Countries such as Norway, Sweden and Japan which are characterised by income equality (as well as healthy per capita GDP) score much more highly.⁵⁴

Wilkinson and Pickett do not provide a blueprint for how a society is to obtain improvements to net wealth and the social goods which seem to coincide with income equality. But their work does provide a foundation for criticizing the fundamental assumption underlying arguments in favour of dynamic efficiency and the total surplus standard. The implication is rather that oligarchic firms should be free to take high profits as just recompense or as a stimulus to investment in innovative technologies only so long as it does not result in the excessive concentration of wealth and power. Given the poor performance of New

⁵¹ Daron Acemoglu "Oligarchic versus Democratic Societies" (2008) 6 JEEA 1.

⁵² See Joel Bakan *The Corporation: the Pathological Pursuit of Profit and Power* (Free Press, New York, 2004).

⁵³ Richard Wilkinson and Kate Pickett *The Spirit Level: Why More Equal Societies Almost Always Do Better* (Penguin Books, London, 2009).

⁵⁴ At 19-20.

Zealand and the US in health and wellbeing, perhaps better models of economic growth should be sought from Japan and the Scandinavian nations.

How Useful are Economic Models – Cournot to Chaos Theory

This idea that the competitive process would resolve itself by precisely balancing supply and demand to reach a statically efficient end state can be traced to Cournot's 1838 work: *Mathematical Principles of the Theory of Wealth*.⁵⁵ While Smith saw competition as an ongoing race between business rivals to produce the most at the least cost, Cournot's model was based on a static perfect competition model.⁵⁶ Cournot realised that when a market contained a sufficiently large number of competitors, then no single producer would be able to influence market price, which was the crucial feature of perfect competition.

Under a Cournot equilibrium, the price of a given commodity will trend towards the marginal cost as the number of competitors increases.⁵⁷ The emphasis is on making the correct output decision, with no rival wanting to produce more or less than needed. This model is frequently contrasted with Bertrand equilibrium, which differs from Cournot by proposing that firms compete, not on quantity, but on price. The assumption is that a firm will be happy to take any price above the marginal cost, so long as it is below that of its rival, and that consumers will be attracted to the product with the lowest price.⁵⁸ The subsequent 'race to the bottom' pushes prices down to marginal cost.

These models may be theoretical, but they are practically applied by the Commerce Commission when assessing merger applications. Cournot modelling was used to evaluate Contact Energy's purchase of Natural Gas Corporation's

⁵⁵ Antoine Cournot *Mathematical Principles of the Theory of Wealth* (1838) (A. M. Kelley, New York, 1971).

⁵⁶ Mark Blaug "Is Competition Such a Good Thing? Static Efficiency versus Dynamic Efficiency" (2001) 19 Rev. Ind. Organ. 37 at 38.

⁵⁷ Matt Sumpter *New Zealand Competition Law and Policy* (CCH New Zealand Ltd, Auckland, 2010) at 307.

⁵⁸ At 43.

electricity generation plant in 2003,⁵⁹ while a Bertrand Model was behind the decision to approve the Cendant-Budget hire car company merger in 2002.⁶⁰

Their usefulness in evaluation of real world anti-competitive practices is limited however, as experience has taught how willing economic competitors can be to use violence, rumour, industrial espionage and disinformation to increase market share.⁶¹ The tool kit of the competition regulator should ideally then include the full range of investigative techniques available to police fraud and robbery squads.

Whether the mathematics of economics can ever accurately model real world behaviour is also highly questionable. Chaos theory teaches us of the unpredictability of complex systems based on small differences in initial conditions, commonly known as the ‘butterfly effect’.⁶² The suspicion therefore is that to use any sort of mathematical model to predict market results amounts to no more than a best guess, and if so, there will always be an ongoing role for the regulator. Only human agents have the intuitive capacity to flexibly deal with chaotic situations. Economics seems to guide decision making in complex situations in only a general heuristic sense. The charge is that economics provides only rules of thumb, based on unprovable assumptions of human behaviour, and of questionable predictive value.

In the context of the recent Global Financial Crisis, the demands for a complete revision of neoclassical economics have redoubled. In a recent Time Magazine article, David Rothkopf pointed out that we are now seeing the outcome of an international contest between different economic models developing in China, India and Brazil, and Singapore and the United Arab Emirates, all of which call for a more interventionist state regulatory policy.⁶³ Robert Johnson asked that economists accept the limitations of mathematic models and accept the necessity

⁵⁹ At 42 citing Commerce Commission Decision 491: *Contact Energy Ltd/Natural Gas Corporation Holdings Ltd* (4 February 2003). Contact Energy Limited and Natural Gas Corporation Holdings Limited; Decision No. 491 [2003] NZComComm 6 (4 February 2003).

⁶⁰ At 43 citing Commerce Commission Decision 482: *Cendant Corporation/Budget Group Inc* (6 November 2002). Cendant Corporation and Budget Group Incorporated; Decision No. 482 [2002] NZComComm 32 (6 November 2002).

⁶¹ Xavier Gabsion and David Laibson “Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets” (2006) 121(2) Q. J. Econ. 505 cited in Basu at 28.

⁶² Steve Keen *Debunking Economics: The Naked Emperor Dethroned* (St Martins Press, NY, 2011) at 190-192.

⁶³ David Rothkopf “Command and Control: Fixing capitalism means taking power back from business” Time Magazine (Jan 30, 2012) at 35-38.

for a multi-disciplinary approach to economic studies by taking advantage of lessons learned from all the Humanities.⁶⁴

Amongst the most acerbic of recent critics of neoclassical economics is Steve Keen. His work in *Debunking Economics* points out the fundamental flaw in economic education and theory is that of using static equilibrium models to predict dynamic time varying phenomenon.⁶⁵ If predicting future growth or declines amounts to no more than extrapolating lines of best fit, what predictive power do the models hold? Keen quotes Andre Mas-Colell, described as the “doyen of neoclassical instruction” to ask why economics fails to adequately address dynamic models.⁶⁶

The reason, informally speaking, is that economists are good (or so we hope) at recognizing a state of equilibrium but poor at predicting how an economy in disequilibrium will evolve.

Certainly there are intuitive dynamic principles: if demand is larger than supply, then the price will increase, if price is larger than marginal cost then production will expand, if industry profits are positive and there are no barriers to entry, then new firms will enter and so on. The difficulty is in translating these informal principles into precise dynamic laws.

Mas-Colell goes on to describe the use of even simple differential equations as not being an actual accurate model of the market economy but rather a “tentative trial-and-error process taking place in fictional time”.⁶⁷ So even Mas-Colell acknowledges that mathematical models can provide insights but that there is no crystal ball available to foresee how markets change over time.

Keen describes this reason as “nonsense”, economists only model in equilibrium because they cannot manage it in dynamic analysis. Using static models to predict a chaotic system is no more valid than assuming that chaos will result in static equilibrium. As Keynes said:

... this long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in

⁶⁴ Robert Johnson “A Profession at Sea: How to keep economists from missing the next financial crisis” Time Magazine (Jan 30, 2012) at 38-39.

⁶⁵ Keen, above n 62.

⁶⁶ At 186 citing Andre Mas-Colell and others *Microeconomic Theory* (Oxford University Press, Oxford, 1995) at 620.

⁶⁷ Andre Mas-Colell and others *Microeconomic Theory* (Oxford University Press, Oxford, 1995) at 621.

tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again.⁶⁸

There are dynamic models available, but they are inspired by fluid fractal chaos theory, not the dead hand of supply and demand curves.⁶⁹

Keen takes dead aim at Pareto Optimality:

Instead, what has to be abandoned is the economic obsession with achieving some socially optimal outcome. As noted... economists have conflated the concept of equilibrium with the vision of an ‘economic utopia’ in which no one can be made better off without making someone else worse off. But a free market economy could never remain in an optimal position, because economic equilibria are unstable. The real question is whether we can control such an unstable system – whether we can constrain its instability within acceptable bounds.

But by that rationale, surely allowing a laissez-faire style approach to competition regulation would make the most sense. If economic models are of limited value, then giving freedom to market participants without fear of external intervention based on static and inaccurate mathematical models would be both the fairest and most efficient solution. Perhaps the problem has no solution, what is clear is that the proper balance between static and dynamic efficiency concerns continues to trouble economists to this day.

How convinced anyone is by Keen’s criticisms depends entirely upon the individual’s commitment to economic theory. No doubt those who have spent many years studying the complex mathematics required for understanding and applying economics will feel more commitment than those who have not. Like all sciences, economic theory is best seen as having explanatory value and that value can only improve if the underlying theory is constantly and methodically questioned and improved. The frustration critics feel with when crashes like the Global Financial Crisis occur is understandable, but economic models are a necessary tool which cannot be discarded preemptorily without recourse to a viable alternative.

⁶⁸ Keen, at 186 citing J.M Keynes “A tract on monetary reform,” (1923) in *The Collected Works of John Maynard Keynes* vol IV (McMillan, London, 1971) at chapter 3.

⁶⁹ At 194.

Perfect Competition and the Development of Static Efficiency

We can see then that the perfect competition model was originally developed as a tool, a standard the market could be compared to. In 1881 Frank Edgeworth's *Mathematical Psychics* provided the complete ingredients for perfect competition.⁷⁰ His vision was of numerous competitors producing a homogenous product with perfect knowledge of the market who, because of the number of competitors, are unable to influence the price or output of their rivals and would simply lose market share if they could not achieve the stable market price.⁷¹ This concept of perfect competition would not be brought into mainstream economics, however, until Frank Knight published his *Risk Uncertainty and Profit* in 1921.⁷²

Knight's method was to explain economic energy flows by analogy to Newtonian physics. His concept was almost Aristotelian in supposing that, just as physical systems tend towards rest, so too would economic forces.⁷³

Water seeks its level, air moves towards a uniform potential.... water continues to flow, the wind to blow, etc., only because the sun's heat... constantly restores the inequalities which these movements themselves constantly destroy

So also in economic phenomena.... The circulation of goods continues because the life activities of man (the production of wealth) keep new supplies forthcoming.

Knight's goal in *Risk* was to demonstrate how perfect competition provided the friction by which economic forces would trend towards the equilibrium state of the 'normal' price.⁷⁴

The primary attribute of competition, universally recognized and evident at a glance, is the 'tendency' to eliminate profit or loss, and bring the value of economic goods to equality with their cost.... But in actual society cost and value only 'tend' to equality; it is only by an occasional accident that they are precisely equal in fact; they are usually separated by a margin of 'profit', positive or negative. Hence the problem of profit is one way of looking at the problem of the contrast between perfect competition and actual competition.

It is clear that Knight never imagined that a perfect equilibrium was actually possible, there would always be a difference between perfect and actual competition, the measure of which was profit. Knight was heavily influenced in

⁷⁰ Blaug, Mark "Is Competition Such a Good Thing? Static Efficiency versus Dynamic Efficiency" (2001) 19 Rev. Ind. Organ 37 at 39.

⁷¹ At 38.

⁷² Frank Knight, *Risk, Uncertainty and Profit* (1921) (Sentry Press, New York, 1964).

⁷³ At 17

⁷⁴ At 19.

this view by John Bates Clark, an American economist and father of John Maurice Clark, coiner of the term ‘workable competition’.⁷⁵ The contrast between perfect and actual competition in Knight’s mind, may therefore have been a precursor to what we would see as workable competition.

J. B. Clark observed that a static state would only be achieved if five sources of change could be eliminated. These were:⁷⁶

- increases in population;
- capital growth;
- improvements in production methods;
- the Darwinian elimination of the inefficient; and
- the changes in demand caused by the multiplying wants of consumers.

We can conclude that, as it would be either impossible or detrimental to do away with these sources of change, Clark had realised how impractical such a perfect static state would be. The third and fifth of these elements of change, taken together, are reminiscent of dynamic efficiency. The reference to the survival of the fittest or most efficient producer is a clear precursor to creative destruction. It seems then that the roots of these apparently modern ideas lie much deeper within our intellectual tradition than one would at first suspect.

We can see how Clark borrowed the word ‘dynamic’ from the language of physics and applied it to economics:⁷⁷

Profits are, then, the result exclusively of dynamic change.... The type of dynamic change is invention; an invention makes it possible to produce something more cheaply. It first gives a profit to entrepreneurs and then... adds something to wages and interest.... Let another invention be made.... It also creates a profit; and this profit, like the first, is an elusive sum which entrepreneurs grasp but cannot hold. It slips through their fingers and bestows itself on all members of society.

So the term ‘dynamic’ was being used in economics, perhaps for the first time as early as 1900, to describe the innovative process. We also see the notion that dynamic progress would produce benefits which would spillover from the

⁷⁵ J.M. Clark “Towards a Concept of Workable Competition” (June, 1940) 30(2) Amer. Econ. Rev. 241.

⁷⁶ Knight, above n 72, at 33 citing J.B. Clark *The Distribution of Wealth: A Theory of Wages, Interest and Profits* (Kelley, New York, 1965) at 29.

⁷⁷ Knight, at 34 citing Clark at 404-406.

inventor to society.⁷⁸ All that is absent from the definition is the acknowledgement that invention might come up with an entirely new product, rather than just productively efficient cost savings, but perhaps this point was too obvious to need to be stated.

To summarise, the perfect competition model requires that:⁷⁹

- Firms compete to supply indistinguishable products or services;
- Sellers and buyers each have access to the same perfect information;
- No single buyer or seller can by their actions alter the price offered or taken;
- There are no transaction costs, for example agents or lawyers fees which might vary from sale to sale;
- Zero externalities; costs may not be shifted but must be borne by each market player; and
- Exit and entry from the market is effortless.

In a state of perfectly competitive equilibrium, no one is able to influence the price of goods in the markets by their actions, all participants are ‘price takers’.⁸⁰ In economic terms, participants in a perfect equilibrium face a horizontal demand curve, as their price and output decisions neither increase nor decrease demand. As a result, in a perfectly competitive market any attempt by a firm to raise prices above marginal cost would result in the immediate loss of all its customers. If buyers had perfect information about alternative sources of the identical product at a lower price, and there were no sunk or transaction costs tying them to a particular supplier, they would instantly respond by taking their business elsewhere.

It is immediately obvious that perfect competition cannot exist, except as a model, a fact which was recognised very shortly after the ideal was fully described. The stringent and simplistic assumptions perfect competition relies on simply do not exist in the real world. There are almost no markets where firms compete to supply homogenous goods and service. Goods are often interchangeable so

⁷⁸ Compare with Baumol, below n 170.

⁷⁹ Matt Sumpter *New Zealand Competition Law and Policy* (CCH New Zealand Ltd, Auckland, 2010) at 34.

⁸⁰ Basu, above n 50, at 18.

competition may be provided by rivals in overlapping markets, for example, the market for home heating includes coal, gas and wood as well as electricity. Product differentiation is a crucial element of competition, with every rival seeking to set itself apart from the rest.

Buyers and sellers are subject to a commercial ‘fog of war’ and seldom know exactly what their competitor’s intentions are. There can therefore be no such thing as perfect information. And as Smith recognised so long ago, any attempt to ascertain a rival’s intentions could well result in just the sort of collusion that competition policy strives to prevent.⁸¹

Even so, while a market may contain numerous competitors there are extremely few markets which are not in reality dominated by a few large players whose actions set prices and whose influence shapes the fundamental rules of play. When we think of softdrinks we think of Coca Cola, personal computing is dominated by Microsoft and Apple. Any moves by these major players are bound to create shockwaves in the price and output decisions of competitors.

The irrecoverable sunk costs of plant, infrastructure, brand development and so on constitute significant barriers to entry and exit. Various transaction costs, such as the legal costs which attend the vetting and completion of contracts, prevent competitors and customers alike from easily leaving the fray. Externalities abound, the whole purpose of the corporate form was to limit liability and evade responsibility for them. The costs associated with entry, remaining in and then exiting from the market are greater the more substantial the resources involved with the particular industry are.

The Marginal Cost Controversy

According to Mark Blaug, perfect competition was assumed to be the ideal until the mid-1940s when Schumpeter and Hayek pointed out that such a perfectly competitive end state was “not only impossible but inferior”.⁸² But, as we have seen, J.B Clark was alluding to the impossibility of achieving a static state as early as 1900. We see the first direct shots being fired at the perfect competition ideal in the interwar period in what came to be known as the ‘Marginal Cost Controversy’.

⁸¹ See Smith, above n 1, at 11.

⁸² Blaug, above n 56, at 39.

This controversy has become so fundamental to the dynamic efficiency story that its details must be delved into at some length.

Before and during the Second World War, a group of economists, Hotelling, Lerner, Meade, Fleming and Keynes, advocated the use of marginal cost pricing for services provided by state enterprises.⁸³ The marginal cost of a good is the cost of producing additional units of that good. Setting the price at marginal cost would be efficient because as Samuelson put it:⁸⁴

Only when prices of goods are equal to Marginal Costs is the economy squeezing from its scarce resources and limited technical knowledge the maximum of outputs.... Because Marginal Cost has this optimality property, it can with some care be used to detect inefficiency in any institutional set up.

The problem is that while marginal cost includes a profit margin sufficient to cover average costs, if increases in output lead to a fall in the marginal cost, a price equal to marginal cost will not provide sufficient income to cover total costs.⁸⁵ In other words, pegging prices to costs over the short run can create problems in the longer term. It does not create sufficient profit to cope with long term capital investment, for example, where it became necessary to upgrade or replace expensive infrastructure.

To overcome this difficulty, it was proposed that the government should subsidize industries equal to the amount income fell short of total costs, the money to be raised through taxation.⁸⁶ The suggestion was not entirely new, having links to Pigou's *The Economics of Welfare*⁸⁷ and its derivative, Kaldor-Hicks efficiency.⁸⁸

Pigou suggested that it might be possible to have competent government departments intervening benevolently in the economy, but that interfering in the free market process by setting maximum prices would alter the pattern of investment thereby reducing the national dividend.⁸⁹ Changes in distribution of

⁸³ Ronald Coase *The Firm, the Market and the Law* (University of Chicago Press, Chicago, 1990) at 16.

⁸⁴ Paul Samuelson *Economics: an Introductory Analysis* (6th ed McGraw Hill, New York, 1964) at 462.

⁸⁵ Coase at 17.

⁸⁶ Coase at 17.

⁸⁷ A.C. Pigou *The Economics of Welfare* (4th ed, MacMillan, London, 1952).

⁸⁸ John Hicks "The Foundations of Welfare Economics" (1939) *The Economic Journal* 49 196, 696-712; Nicholas Kaldor "Welfare Propositions in Economics and Interpersonal Comparisons of Utility" (1939) 49 *The Economic Journal* 195, 549-552.

⁸⁹ See Pigou chapter XII.

wealth through taxation, however, would enable different, more intense needs to be satisfied.⁹⁰

Any cause which increases the absolute share of real income in the hands of the poor, provided that it does not lead to a contraction in the size of the national dividend from any point of view, will, in general, increase economic welfare.

That this might happen at the expense of “new machines and factories” (dynamic efficiency) was, if not inconsequential, at least less important than increasing the economic welfare of all citizens.⁹¹ It meant that the numerous poor would get more of what they needed and the rich few less of what they desired. So the ideal policy would be to enable the market to make free decisions about where and how to invest but then to compensate the losers for the costs of those decisions.

Nicholas Kaldor and John Hicks proposed in separate articles in the 1930s that if an efficiency improvement could be made and it allowed winners to compensate losers so that they voluntarily submitted to the arrangement, then the improvement should be made. Both based their articles on Pigou’s plan. Kaldor said:⁹²

...in all such cases it is possible to make everybody better off than before, or at any rate to make some people better off without making anybody worse off. There is no need for the economist to prove - as indeed he never could prove - that as a result of the adoption of a certain measure nobody in the community is going to suffer. In order to establish his case, it is quite sufficient for him to show that even if all those who suffer as a result are fully compensated for their loss, the rest of the community will still be better off than before.

Likewise, Hicks begins with Pigou’s proposition that every person seeks to maximise satisfaction of his or her preferences, subject to the obstacles that total wealth is finite and the fact that so much of that wealth is owned by other people.⁹³ Taking a Paretian point of view, Hicks said that “an optimum organization of the economic system is one in which every individual is as well off as he can be made, subject to the condition that no reorganisation permitted shall make any individual worse off.”⁹⁴ The problem is that any such reorganisation

⁹⁰ Pigou at 89.

⁹¹ At 87.

⁹² Kaldor at 550.

⁹³ Hicks at 699.

⁹⁴ At 701.

would inevitably result in a change in prices which would benefit some and harm others.⁹⁵

Nevertheless, this does not prevent us from applying our criteria to the case of private enterprise, because we can always suppose that special measures are taken through the public revenue to compensate those people who are damaged. A 'permitted reorganisation' must thus be taken from now on to mean a reorganisation which will allow of compensation being paid, and which will yet show a net advantage. The position is not optimum so long as such reorganisation is possible.

So in terms of competition policy, Kaldor-Hicks payments could be used to allow mergers resulting in monopolies and excessive profit taking, so long as the poor people most affected by excessive transfers of wealth were compensated. By applying Pigovian intervention to obtain Pareto optimality, Kaldor-Hicks payments sought to ameliorate the harsh consequences of strict application of liberal free market arrangements, an approach which would be rejected by the neo-liberals such as Ronald Coase.

According to Coase, and based on work he began in the 1930s:⁹⁶

The proposal is a recipe for waste on a grand scale. The policy would also mean a redistribution of income in favour of consumers of goods priced in conditions of decreasing cost. Furthermore, the policy involves additional taxation, and this will tend to raise prices.... The net gain from such a policy is not evident to me.

The policy would require extensive state intervention, particularly as the onus would be on the state to involve itself in administering production to minimise the compensation paid, an involvement which would inevitably lead to the "substitution of state for private enterprise and of centralized for decentralized operations."⁹⁷ Furthermore, such economic tinkering is an example of what Coase called 'blackboard economics' with the economist playing the role of the omniscient and omnipotent central planner. Yet the market itself is far too complex for any one mind to comprehend, there is in fact no central state planner capable of playing such a role.⁹⁸

So the suggestion that state enterprises should provide goods and services at marginal cost, or that imperfections caused by monopolistic arrangements could

⁹⁵ At 706.

⁹⁶ Ronald Coase, *The Firm the Market and the Law* (University of Chicago Press, Chicago, 1990) at 18.

⁹⁷ At 18-19.

⁹⁸ At 19.

be allowed if compensated for by Kaldor-Hicks payments, was dismissed. As we will see, however, the suggestion that, particularly for natural monopoly goods and services and particularly those provided by state owned enterprises should set prices at a fair rate of return persists. The neoliberal response to the marginal cost controversy stems from a paradigm shift. It was the abolition of the idea that perfect competition is something attainable and should in fact be the goal of competition regulators, and the acceptance that perfect competition is neither possible nor desirable. In order for that to happen, the perfect competition ideal would have to be deconstructed.

The first serious challenge to the perfect competition ideal was probably provided by John Maurice Clark's "Towards a Concept of Workable Competition" published in 1940. The article is particularly notable in coining that key term: Workable Competition.

Clark boldly asserted that:⁹⁹

... perfect competition does not and cannot exist and has presumably never existed, for reasons quite apart from any inescapable tendency toward collusion, such as Adam Smith noted in his familiar remark on the gettings-together of members of a trade. What we have left is an unreal or ideal standard which may serve as a starting point of analysis and a norm with which to compare actually competitive conditions.

Clark also took the opportunity to fire a shot in the marginal cost controversy:¹⁰⁰

A price which at all times covers only short-run marginal cost would lead to large operating deficits whenever demand is short of capacity, and would bankrupt most industries, no matter how shock-proof their capital structures. And since the horizontal individual demand curve of pure competition leads to a price that covers only marginal cost, it is not one of the conditions of workable competition. Instead, the requirement is an individual demand curve with sufficient slope to bring price, on the average, far enough above marginal cost so that average cost may be covered, over the run of good times and bad. Along with this should go, presumably, enough price flexibility to afford a stimulus to demand in dull times, and the reverse in boom times.

Clark established that too much competition is 'ruinous' because it results in a constant process of price 'chiselling' where competitors are continuously seeking to outdo each other on price, but which can only lead to their destruction when

⁹⁹ J.M. Clark, above n 75 at 241.

¹⁰⁰ At 250.

demand falls. What is needed instead is some midpoint between “pure oligopoly and the ruinously low prices likely to result from unlimited market chaos...”¹⁰¹

By the 1970s opposition to the perfect competition ideal and marginal cost pricing was well established. Robert Bork colourfully described the result of applying pure competition law principles to the American economy as follows:¹⁰²

The economist builds a pure model in order to clarify thought; such models are indispensable starting points for policy analysis, but they are not prescriptions for policy. They leave out too much. A determined attempt to remake the American economy into a replica of the textbook model of competition would have roughly the same effect on national wealth as several dozen strategically placed nuclear explosions.

The debate which began in the 1930s over the marginal cost controversy had, by the 1980s, morphed into an acceptance of dynamic efficiency and workable competition. Rather than expecting central state regulators to intervene and set prices based on the marginal cost and a consumer welfare focussed rate of return, the ideal would be to allow the market to operate according to Darwinian survival of the fittest. Excessive profits were simply a measure of success and the benefit to the consumer, and as long as the proceeds were re-invested in efficient improvements then the total surplus would grow to provide for all future demands. As Hildebrand said:¹⁰³

Dynamic efficiency is analysed in terms of how total surplus, consumer plus producer surplus, evolves over time with the introduction of a product or process innovation. A new product satisfied a demand that was not catered for before, If the product was supplied at its short run marginal production cost then none of the suppliers would recover their original research and development (R & D) investment, the anticipation of this by suppliers would mean that there would be no incentive to make the investment and develop the new product.

The dynamic efficiency arguments which grew out of the marginal cost controversy have obvious application to electricity industry and are frequently to be found in policy discussion to this day.

¹⁰¹ At 253.

¹⁰² Robert Bork *The Antitrust Paradox: A Policy at War with Itself* (Basic Books Inc, New York, 1978) at 92.

¹⁰³ D Hildebrand “The European School in EC Competition Law” (2002) 25 W. Comp. 3 at 8-9.

Steven Stoft wrote the basic general text on electricity regulation. He said:¹⁰⁴

If the expected market price is so low that a supplier cannot enter the market and cover all costs, no supplier will enter. More specifically, if a new generation unit cannot cover all costs, no new units will be built. The result will be a gradually diminishing supply of generation (due to retirements of old plants) in the face of gradually increasing demand. This tightening of the market will cause the price to rise, and eventually price will be high enough to cover all costs.

Similarly, if price is so high that costs are more than covered, suppliers will build new generating units. This will increase supply and cause the price to fall. The result of this long run dynamic is that profit in any competitive market returns to the normal level of profit (zero) in the long run competitive equilibrium.

Marginal cost pricing would therefore act as a significant deterrent to new entry and would result in the long term deterioration of supply. The issue came to the forefront in New Zealand when a series of dry winters raised the spectre of blackouts due to lack of investment in non-hydro generation. The problem as Grant Read saw it was:¹⁰⁵

... that market prices do not go high enough, often enough, to justify investment in plant capacity to provide 'acceptable' load coverage in situations of tight supply, due to dry years, peak loads, or whatever. To be exact, it has been suggested that potential investors do not have sufficient assurance that spot market prices will go high enough, often enough, to justify investment in plant capacity that will only be required to run in such situations of tight supply.

Much like with health care, New Zealanders expect to get cheap electricity as of right and are resistant to the idea of paying premiums now for guaranteed electricity supply later. Instead the public demand is for low electricity prices with any shortfall to be met by a political solution at a later date. The New Zealand public are like the grasshopper in Aesop's fable, we expect the times of plenty to last for all time, without having to pay the price for it.

The NZEM wholesale electricity market has no price cap, in part because the price signal must be allowed to operate undistorted by regulation, but also because prices must be allowed to reach a sufficiently high level to justify investment in

¹⁰⁴ Steven Stoft *Power System Economics: Designing Markets for Electricity* (IEEE Press, New Jersey, 2002) at 58-59.

¹⁰⁵ Grant Read "Scarcity Pricing for New Zealand: A Personal Perspective" (12 October, 2010) <[hwww.ea.govt.nz](http://www.ea.govt.nz)> at 2.

infrastructure to cover future demand. Regardless of public preferences, insisting upon pricing at Short Run Marginal Cost (“SRMC”) would mean having:¹⁰⁶

... to calculate SRMC prices, which, in this country, implies a requirement for mutually inter-dependent “opportunity costing” of all energy limited fuels, including not only water but coal and gas stockpiles and/or contracts. Such a regime would be intrusive, controversial, and ultimately costly. And, if it succeeded, it could be expected to increase price volatility, and hence risk, thus increasing required rates of return and ultimately consumer prices

For Bart van Campen, Stephen Poletti, David Young and Golbin Zakeri the basic problem with marginal cost or ‘rate of return’ regulation is that it is costly to administer and, while it guarantees a return on investment, there is no incentive on industry to minimise costs.¹⁰⁷ A properly structured competitive market requires little intervention and is much more efficient at providing incentives to invest wisely and reduce costs.

Like Read, van Campen and others recognise the crucial problem posed by SRMC pricing. As SRMC excludes capital costs there is no way to retrieve the Long Run Marginal Costs which include operational expenditures as well as capital expenditures. And as the NZEM needs investment sufficient to satisfy a 1.8% per annum growth in demand, SRMC pricing will not foot the bill.

The marginal cost controversy was thus resolved, both generally and as applied to the New Zealand Electricity Market, in favour of profit motivated dynamic efficiency. Rather than ascertaining and enforcing an acceptable marginal cost, which included a reasonable rate of return, the market itself would be left free to markup costs so far as the market would bear. Price control in natural monopolies is an important exception to this principle, but in general, government regulation or state centred redistribution of wealth was to be roundly rejected. The Jeffersonian objective of European style competition law, to guarantee and protect democratic values of economic self-sufficiency, would be lost in favour of autocratic but efficient corporate command of the market. Dynamic efficiency, by taking the long term view that investment in the market requires a higher rate of return than would be available in Short Run Marginal Cost pricing, required that regulators tolerate monopolies and supranormal monopoly profits.

¹⁰⁶ At 15.

¹⁰⁷ Bart van Campen, Stephen Poletti, David Young and Golbin Zakeri “A Guide to the New Zealand Electricity Market” (University of Auckland, Auckland; NZ, 2011).

The Sherman Act and American Antitrust Theory

The United States, that most capitalist of nations, entered its first serious interventionist phase with the Sherman Act of 1890.¹⁰⁸ The rampant behaviour of the ‘Robber Barons’ who had come to dominate the major industries, oil, coal, steel and rail, had provoked a popular backlash. As Representative Heard said of the “dressed-beef combine”:¹⁰⁹

[T]his giant robber combination, while perhaps the most damaging of all of its class to the interests of our people, is only one of many which by their methods extort millions from the citizens of this Republic without adding one cent of value to our productions or one iota of increase to our prosperity. In fact, the very object of these giant schemes of combined capital is not to increase the volume of supply, and thus lessen the cost of any useful commodity, but rather to repress, reduce, and control the volume of every article that they touch, so that the cost to consumers is increased while the expenditure for production is lessened and thereby profit secured.

A favourite strategy of these serial oligopolists was to combine businesses at successive levels of the productive chain into vertically integrated Trusts. Antitrust became the umbrella term describing the prohibition of numerous anticompetitive trade practices.

Investigation into the activities of these robber combinations resulted in the passage of the Sherman Antitrust Act of 1890.¹¹⁰ The Sherman Act’s goal was clearly stated:¹¹¹

Every contract, combination in the form of a trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations is hereby declared to be illegal.

Senator John Sherman himself said that the main intention of the Act was to do away with cartels:¹¹²

The sole object of such a combination is to make competition impossible. It can control the market, raise or lower prices, as will best promote its selfish interests, reduce prices in a particular locality and break down competition and advance prices at will where competition does not exist. Its governing

¹⁰⁸ Sherman Act 15 USC §§ 1-7.

¹⁰⁹ Robert Bork “Legislative Intent and the Policy of the Sherman Act” (Oct., 1966) 9 J. Law Econ. 7 at 19.

¹¹⁰ Jerry Markham, “A Financial History of the United States” (Armonk, N.Y. : M.E. Sharpe, 2002) chapter 6 <www.credoreference.com>.

¹¹¹ Sherman Act 15 USC §§ 1-7.

¹¹² Senator John Sherman, 21 Cong. Rec. 2457 (1890) cited in Bork, at 25-26.

motive is to increase the profits of the parties composing it. The law of selfishness, uncontrolled by competition, compels it to disregard the interest of the consumer.... Such a combination is far more dangerous than any heretofore invented, and, when it embraces the great body of all the corporations engaged in a particular industry in all the States of the Union, it tends to advance the price to the consumer of any article produced, it is a substantial monopoly injurious to the public, and, by the rule of both the common and the civil law, is null and void and just subject of restraint by the courts, of forfeiture of corporate rights and privileges, and in some cases should be denounced as a crime, and the individuals engaged in it should be punished as criminals.

The premier example of the application of the Act was provided by the *Standard Oil* case.¹¹³ Rockefeller's Standard Oil company controlled drilling, refineries and sales of oil making it one of the largest businesses in the world, until its breakup by the United States Supreme Court in 1911. In doing so, Chief Justice White declared:¹¹⁴

The evils which led to the public outcry against monopolies and to the final denial of the power to make them may be thus summarily stated: 1. The power which monopoly gave to the one who enjoyed it to fix the price and thereby injure the public; 2. The power which it engendered of enabling a limitation on production; and 3. The danger of deterioration in quality of the monopolized article which it was deemed was the inevitable result of the monopolistic control over its production and sale.

The story is well presented in Daniel Yergin's *The Prize*.¹¹⁵ Part of the debate over competition has always been about whether monopolies in fact are detrimental to the common weal. While Standard Oil's massive profits provoked public outcry (over \$500 million distributed as dividends between 1882 and 1906) its business model was based on efficiency, reduction of waste and maintaining high quality standards. For example, where competitors poured gasoline into nearby rivers as a waste product, Standard used it to power its machines. Even the choice of the name Standard reflected Rockefeller's determination to provide oil of an even consistency, due to the tendency of oil lamps to explode when fed more volatile or dirtier fuels causing up to 5000 deaths per year.

According to Yergin's account, Rockefeller was highly motivated to prevent the waste caused by uncontrolled competition for a finite resource. The picture which emerges is of an unrestrained stampede for swiftly depleted resources, a classic 'tragedy of the commons' dilemma. Multiple competitors for a single widely

¹¹³ *Standard Oil Co. of New Jersey v. United States* 221 US 1, 55 L. ed 619 (1911).

¹¹⁴ *Standard Oil*, 55 L. ed 619, at 642.

¹¹⁵ Daniel Yergin *The Prize: The Epic Quest for Oil, Money and Power* (Free Press, New York, 1992).

dispersed and unregulated resource lead to inefficient production and massive waste. The boom and bust speculation rampant in this wildcat economy caused extreme price volatility which threatened the steady supply of oil to market.

By vertically integrating and aggressively acquiring oil leases over as wide an area as possible, Rockefeller was able to take advantage of economies of scale and bring stability and predictability to the oil economy. Paradoxically, despite the breakup of Standard Oil after 1911, many of his organizational innovations came to be the standard within the industry.

In *Standard Oil* the United States Supreme Court had endorsed the ‘rule of reason’, that freedom of contract must be preserved and only unreasonable restraints of trade were to be prohibited.¹¹⁶

... although the statute... makes it certain that its purpose was to prevent undue restraints of every kind or nature, nevertheless by the omission of any direct prohibition against monopoly in the concrete, it indicates a consciousness that the freedom of the individual right to contract, when not unduly or improperly exercised, was the most efficient means for the prevention of monopoly.... In other words, that freedom to contract was the essence of freedom from undue restraint on the right to contract.

The Court therefore preserved the right of monopolies to exist, only trusts in restraint of trade were illegal. By inference, if unreasonable restraints of trade were illegal, then reasonable restraints of trade must be allowed. Freedom of contract was the paramount virtue. But in the instant case, the methods by which Standard Oil gained control of all levels of production, distribution and supply of oil led inevitably to the conclusion that the intention was to “drive others from the field and to exclude them from their right to trade, and thus accomplish the mastery which was the end in view.”¹¹⁷ The proper remedy therefore was to dissolve the combination altogether.

For the founding neoliberal theorists such as Frederick Hayek it was the state centralised economy that was the true threat to freedom. In his seminal work, *The Road to Serfdom*, Hayek said that central planning was the greatest danger to democracy:

Our point... is not that dictatorship must inevitably extirpate freedom but rather that planning leads to dictatorship.... The clash between planning and democracy arises

¹¹⁶ *Standard Oil* 221 US 1 at 62.

¹¹⁷ At 76.

simply from the fact that the latter is an obstacle to the suppression of freedom which the direction of economic activity requires.¹¹⁸

Hayek's work spoke to economic planners of the 1970s and 1980s faced with rising inflation, falling returns from investment of public funds, the political intransigence of unions and an uncontrollable economic decline. The prescription for the Chicago School's program for economic reform came to be called the 'Washington Consensus.' The full list, as set out by John Williamson in 1990 is:¹¹⁹

- Fiscal discipline to reduce deficits to 2% of GDP;
- Redirecting public expenditure towards neglected but valuable fields;
- Tax reduction;
- Deregulation to improve competition while protecting environmental protection, public safety and prudent financial management;
- Encouraging foreign direct investment;
- Financial liberalization;
- A single exchange rate;
- Reduction or abolition of tariffs;
- Privatization of state assets; and
- Protection of property rights.

Rather than having a large interventionist state centred economy, the new economy would distribute economic power throughout the 'ownership society'. The mercantilist approach which saw economies as national fortresses in competition with hostile neighbours for capital would be rejected in favour of a system characterised by the free flow of capital. By use of David Ricardo's theories of comparative advantage each country would focus on producing what it did best. Local industries would not be protected from international competition at the expense of the consumer, but would have to thrive on their own merits. The new consensus was much more than an economic programme, it was a fundamental revision of the relationship between State and society based on a total rejection of anything smacking of state centred control of the economy.

¹¹⁸ Frederick Hayek "The Road to Serfdom" (University of Chicago, Chicago, 1944).

¹¹⁹ John Williamson "In Search of a Manual for Technopols", in John Williamson (ed) *The Political Economy of Policy Reform* (IIE, Washington DC, 1994) at 18 cited in Jane Kelsey *The New Zealand Experiment* (Auckland University Press, Auckland, 1995) at 18.

Schumpeter and Baumol on Contestability and Dynamic Efficiency

Schumpeter and Hayek were amongst the first of the Chicago School writers to have influenced the new right. Schumpeter has come to be associated with the term ‘creative destruction’, the process by which old inefficient monopolies are constantly undermined and destroyed by innovative newcomers. Creative destruction is the basic initial premise of contestability theory.¹²⁰

Schumpeter was unashamedly supportive of the role ‘big business’ played in creating the high standard of living Americans enjoyed in the post-war years.¹²¹ Like Smith, Schumpeter assumed that this happy state of affairs was the result of an ongoing “evolutionary process.”¹²² It followed that:

The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory to such concerns as U.S. Steel illustrate the same process of industrial mutation... that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism.

Schumpeter was dismissive of critics of big business who objected to huge profit taking and subsequent transfer of wealth. Rather he proposed that it is necessary only to look at the big picture and ask how these large industrial units are created or destroyed.¹²³

The core statement of the Schumpeterian analysis comes from the man himself:¹²⁴

Every piece of business strategy acquires its true significance only against the background of that process [of innovation] and within the situation created by it. It must be seen in its role in the perennial gale of creative destruction; it cannot be understood irrespective of it or, in fact, on the hypothesis that there is a perennial lull.

¹²⁰ See Joseph Schumpeter *Capitalism, Socialism and Democracy* (1942) (Unwin University Books, London, 1956).

¹²¹ At 81-82.

¹²² At 82.

¹²³ At 84.

¹²⁴ At 83.

But economists who, *ex visu* of a point in time, look for example at the behavior of an oligopolistic industry – an industry which consists of a few big firms – and observe the well-known moves and countermoves within it that seem to aim at nothing but high prices and restrictions of output or making precisely that hypothesis.... the problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them.

Contestability theory's fundamental idea is that, by lowering the barriers to entry, a Darwinian process of competition and improvement might be activated. It is the ever-present threat of competition which disciplines the monopolist. If large profits are in the offing then newcomers with new ideas will be attracted, forcing incumbents to adapt with lower prices or better products and services. The role for the regulator, if there is one, is to ensure that incumbents cannot use political influence, corruption or force to block that competitive pressure.

Perfect competition, with its focus on reducing costs and refining output through allocative and productive efficiency, is not really the issue:¹²⁵

... it is not that kind of competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization... competition which strikes not at the margins of the profits and the outputs of the existing firms but at their very foundations and their very lives. This kind of competition is as much more effective than the other as a bombardment is in comparison with forcing a door...

Schumpeter's insight and his contribution to dynamic efficiency, was that it is necessary to take a longer term view about the fruits of investment in innovation. It is more fruitful to accept the existence of oligopolistic markets, because only oligopolies can accumulate the capital necessary to fund such investment in the long term.

As mentioned earlier, many of the Chicago School theories were developed in opposition to the S-C-P paradigm's ideal of deconcentrated market structures. The assumption was that perfectly competitive markets (if they even existed) could be statically but not dynamically efficient, while monopoly markets would be far less efficient. Frederic Scherer built on Schumpeter's hypothesis that "industrial and innovative effort ... increases with the concentration of market power" to develop

¹²⁵ At 84-85.

the inverted-U model which predicts that oligopolistic markets provide a better environment for innovation than do either perfectly competitor or monopolistic ones.¹²⁶

Scherer derived the inverted-U model from three conclusions. First, the relationship between technological opportunity and market concentration is complex; any apparent patterns may be coincidental. Secondly, the relationship between concentration and employment of scientists and engineers is positive but modest. And thirdly, increases in “technological vigor” mainly occur at low to mid levels of concentration and are dampened in monopolies.¹²⁷ The final point is the source of the inverted-U model of the relationship between concentration and innovation. If both monopolistic and perfectly competitive markets dampen innovation, then oligopolistic arrangements afford the best environment for dynamic efficiency. Scherer provided the empirical proof for Schumpeter’s insight and thus workable competition has come to be equated with oligopolistic markets.

The influence of Robert Bork

Robert Bork’s *The Antitrust Paradox* is widely regarded as one of the most influential books of the Twentieth Century, so far as the neoliberal approach to competition regulation is concerned. A scathing critic of the courts’ interference with efficient business practices, Bork directly confronted the interventionist objectives behind the Sherman Antitrust Act 1890 and the Clayton Antitrust Act 1914.¹²⁸

Bork’s paradox was that, in attempting to level the playing field between big and small business in the interests of fairness, antitrust policy was achieving too little at too great a cost. Bork believed antitrust had lost its proper focus on maximising efficiency and total wealth. The courts had misinterpreted the ‘rule of reason’ since the breakup of Standard Oil in 1911. By promoting Justice Brandeis’ “goal of small business welfare” and incipency, the idea that damaging practices could

¹²⁶ F. M Scherer “Market Structure and the Employment of Scientists and Engineers” (June, 1967) 57(3) Amer. Econ. Rev. 524.

¹²⁷ At 530.

¹²⁸ Clayton Antitrust Act 15 USC §§ 12-27 and 29.

be caught and arrested in their early stages, antitrust had evolved into a system for protecting the inefficient from the pressures of competition.¹²⁹

“In modern times the Supreme Court, without compulsion of statute, has inhibited or destroyed a broad spectrum of useful business structures and practices”¹³⁰ Not only that but in justifying the rationale of his 1890 Act, Sherman had misrepresented its common law basis by selecting cases which prohibited predatory pricing, cartels and monopolistic horizontal mergers, while ignoring those cases which would have allowed them.¹³¹

Bork says the ‘rule of reason’ was developed to deal with two categories of offences. Per se practices, a form of strict liability where it would only be necessary to show that the practice had occurred to incur liability, and practices which should be prohibited because they were motivated by anti-competitive intent or would have a bad effect on the competitive process.¹³² We can see that same intent behind the Commerce Act 1986, but the difficulty, as in Bork’s time, is defining the line between competitive practices which do damage to competitors but should be allowed because they are efficient and anticompetitive practices which harm competition itself and should be prohibited.

Bork boldly asserted that:

Basic microeconomic theory is of course a science, though like many other sciences it is by no means complete in all its branches. Were it not a science, rational anti-trust policy would be impossible.¹³³

Taking a ‘scientific’ approach then, Bork said the problem of monopoly is not only that it results in higher prices and reduced output, but that it misallocates resources. This misallocation means that “unneeded resources must either lie idle, an obvious social waste, or migrate to other [less valuable] industries”.¹³⁴ Allocative efficiency is therefore about making sure that resources, including raw materials, labour and so forth, create the most wealth possible by being distributed in the most sensible way.

¹²⁹ Robert Bork *The Antitrust Paradox*, above n 1, at 17.

¹³⁰ At 4.

¹³¹ At 20.

¹³² At 18.

¹³³ At 8.

¹³⁴ At 101.

Static allocative efficiency was differentiated from productive efficiency as “any activity by a business firm which creates wealth.”¹³⁵ Productive efficiency could therefore include the kind of forward thinking innovation we normally associate with dynamic efficiency. The efficiency of the firm can be measured by its relative success in attracting consumers.¹³⁶ By that rationale the most successful firm would be the one which attracted all consumers which by definition would be a monopoly.

Bork said that: “Consumer welfare is greatest when society’s economic resources are allocated so that consumers are able to satisfy their wants as fully as technological constraints permit.”¹³⁷ This efficiency objective must be the sole purpose of the law and other concerns, such as the equitable distribution of resources, could not be left to the courts:¹³⁸

... [C]ompetition must be understood as the maximization of consumer welfare, or, if you prefer, economic efficiency, That requires economic reasoning because courts must balance, when they conflict, possible losses of efficiency in the allocation of resources with possible gains in the productive use of those resources. In a word, the goal is maximum economic efficiency to make us as wealthy as possible. The distribution of that wealth or the accomplishment of noneconomic goals are the proper subjects of other laws and not within the competence of judges deciding antitrust cases.

Then in 1993 *The Antitrust Paradox* was revised with a new epilogue in which Bork reiterated:¹³⁹

consumer welfare [means] economic efficiency... to make us as wealthy as possible..... [t]he distribution of that wealth or the accomplishment of noneconomic goals are the proper subjects of other laws.

Bork was asserting that not only was maximum total consumer welfare the primary goal but that if there were competing considerations, they should be discarded. Giving voice to concerns for, say promotion of social justice or preventing the concentration of political power in the hands of the commercial

¹³⁵ At 104.

¹³⁶ At 105.

¹³⁷ At 90.

¹³⁸ Robert Bork *The Antitrust Paradox* (2nd ed, Free Press, New York 1993) at 426-429.

¹³⁹ Bork *Antitrust Paradox* (2nd ed), at 427, cited in Barak Orbach “The Antitrust Consumer Welfare Paradox” (2010) 7(1) JCLE 133 at 151.

elite, would in fact be a source of judicial error.¹⁴⁰ In support of this, Bork cites Judge Learned Hand as an example of what judges should not do:¹⁴¹

We have been speaking only of the economic reasons which forbid monopoly; but... there are others, based upon the belief that great industrial consolidations are inherently undesirable, *regardless of their economic results*. In the debates in Congress Senator Sherman himself... showed that among the purposes of Congress in 1890 was a desire to put an end to great aggregations of capital because of the helplessness of the individual before them. (Emphasis added.)

Bork's use of the term 'consumer welfare' is somewhat misleading. Usually when we think of consumer welfare, we think of the competition for wealth transfers between producers and consumers. The assumption is that in single firm monopoly markets, too much wealth is transferred which results in a dead-weight loss to society. When Bork contrasted consumer welfare with producer welfare he was in fact advocating that the total wealth of society should outweigh the interests of the individual. Maximisation of consumer welfare therefore meant an adoption of the total surplus standard. It has been said that: "The confusion arising from this use of the term 'consumer welfare' has been called the 'Chicago trap' and should be borne in mind when reading Chicago school sources." ¹⁴²

For Bork producer welfare meant the Jeffersonian ideal of protection of small business men, but when small businesses were less efficient than large monopolies, they should not be protected. The proper intention of the Sherman Act was to outlaw only those predatory practices which might lead to inefficient monopoly, rather than those which produce greater efficiency and therefore greater consumer welfare. Thus monopolies which were obtained by efficiency would be protected regardless of the cost to democracy or resulting concentration of economic power.¹⁴³ It followed that predatory commercial tactics which actually benefited the consumer, such as setting super low prices, should only be prohibited where the purpose was anticompetitive.

This judicial obsession with the inherent undesirability of big business would lead to economic disaster. Pursuing a competition policy which idealised perfect competition would result in the:

¹⁴⁰ Bork "Legislative Intent", above n 107, at 10-11.

¹⁴¹ *United States v Aluminum Co. of America*, 148 F.2d 416, 428 (2d Cir. 1945) cited in Bork, "Legislative Intent", above n 107, at 8.

¹⁴² Jones and Sufrin, above n 24, at 26.

¹⁴³ Bork "Legislative Intent", above n 109, at 12.

atomization of society.... [and] would call not only for general abject poverty but for the death by starvation of millions of people. We may assume the antitrust laws were not designed to place the United States in worse economic condition than Bangladesh.¹⁴⁴

The true Congressional intention, according to Bork, had been to allow monopoly if it were obtained by efficiency. The courts were therefore mistaken in that:¹⁴⁵

Congress' decision to permit monopoly achieved by efficiency is completely inconsistent with the view that courts should use the Sherman Act to ameliorate the noneconomic 'helplessness of the individual' before 'great aggregations of capital' or that they may take into account the alleged desirability of preserving for its own sake an economy of small business units.

Bork concluded that there was no possibility that antitrust policy could achieve the equality its proponents claimed to seek.¹⁴⁶ Instead the costs would include:

1. The "destruction of wealth through the inhibition of efficiency";
2. The "accumulation of power in government";
3. The "replacement of free markets with government regulated markets";
and
4. The "shift of lawmaking from elected representatives to courts and bureaucracies".¹⁴⁷

Antitrust was its own worst enemy, and was in fact the enemy of economic and democratic freedom, hence the antitrust paradox.

Jack High is critical of the ambiguity in Bork's definitions of the static and dynamic efficiency concepts.¹⁴⁸ While Bork should be given credit for refocusing antitrust on efficiency, and largely disposing of opposition to efficient practices such as vertical integration, High says that Bork's analysis is flawed in that it retains static efficiency concepts in a dynamic efficiency analysis.¹⁴⁹ This combination of static efficiency concepts of perfect competition with dynamic productive efficiency is the true paradox of Bork's antitrust theory.¹⁵⁰

¹⁴⁴ Bork *Antitrust Paradox*, above n 1, at 59.

¹⁴⁵ Bork "Legislative Intent" above n 109, at 30.

¹⁴⁶ Bork, *Antitrust Paradox*, above n 1, at 423.

¹⁴⁷ At 423.

¹⁴⁸ Jack High "Bork's Paradox: Static Vs. Dynamic Efficiency in Antitrust Analysis" (December, 1984) 3(2) *Contemporary Econ. Pol.* 21.

¹⁴⁹ At 24.

¹⁵⁰ At 21.

In attempting to apply the two models Bork is conflating incompatible theoretical concepts, the first of which requires strict prohibition of restrictive trade practices, and the second which would dictate dropping all restrictions. High's point is that static and dynamic efficiency are mutually exclusive, accepting one requires that the other be abandoned. Antitrust cannot truly balance such fundamentally opposing concepts and the attempt to do so can only lead to inconsistent results.

A second useful critique of *The Antitrust Paradox* was provided by Barak Orbach. Orbach agrees with High that Bork's basic conception of static versus dynamic efficiency is flawed:¹⁵¹

Borkean consumer welfare has never been anything but some weak form of allocative efficiency. It was and still is a misuse of the term. Intentionally or not, Bork obfuscated basic concepts in economics when he popularized consumer welfare as the prescription of antitrust laws.

Orbach submitted that a search for the meaning of Bork's 'consumer welfare', "the only articulated goal of antitrust law in the United States", will be largely fruitless.¹⁵² A search in caselaw or academic literature will provide no single meaning of the term. It is this confusion which adds to the antitrust paradox, that the misapplication of antitrust laws, particularly equating competition with the protection of small businesses, harms both consumers and producers.

Bork mistakenly equated competition, efficiency, wealth maximization and consumer welfare. Orbach's point is that these microeconomic concepts are related, but they are not synonyms. We can see the ramifications are profound and have rebounded throughout the total surplus standard debate. It is not sufficient to conclude that because a practice is efficient that it will promote competition, or that because wealth is maximised that consumer welfare will be enhanced, yet these are the conclusions which are constantly made in support of workable competition.¹⁵³

The ultimate goal of Borkean antitrust is to properly balance productive efficiency and allocative efficiency while making as much wealth as possible.¹⁵⁴ The fair distribution of wealth should be left to other laws, such as tax or social welfare policy. New Zealand's workable competition model likewise aims to balance

¹⁵¹ Barak Orbach "The Antitrust Consumer Welfare Paradox" (2010) 7(1) JCLE 133 at 149.

¹⁵² At 133.

¹⁵³ At 146-147.

¹⁵⁴ At 151.

static efficiency goals, such as minimizing costs and prices with the long-run dynamic efficiencies of increased innovation leading to new products and processes. This means that our competition policy, from 1986, has been borne unmistakable Borkean characteristics. Therefore any valid criticisms of Bork's work may also be applied to our workable competition model.

The ongoing question remains, what is the proper role of competition regulation? What is workable competition? If the focus is on static efficiency to minimise prices and maximise output then extensive intervention to prevent 'bigness' and preserve the S-C-P perfectly competitive model is warranted. If the focus is on dynamic efficiency then the market should be free to operate, organisations which are efficient in producing what consumers want at least cost will, and should be free to, acquire monopolies and charge monopoly pricing as just reward. But will balancing the two concepts really result in confusion and arbitrary judicial lawmaking? In any event, competition policy choices will directly affect the distribution of wealth and are therefore inherently political. That fact must be recognised, to do otherwise is the worst form of hypocrisy.

Richard Posner and Law and Economics

The next most influential antitrust writer to emerge from the Chicago School closely associated with Robert Bork is Richard Posner. Currently a senior lecturer at the University of Chicago Law School and Judge in the United States Court of Appeal in the Seventh Circuit, Posner has played a key role in the rise to ascendancy of Law and Economics.¹⁵⁵

The picture that emerges from the literature over the last century is that competition law became more permissive as the judiciary allowed neoliberal economists to take the lead in the interpretation of competition legislation. A striking example of this shift can be taken from the first and second editions of Richard Posner's book – *Antitrust Law*.¹⁵⁶ These two editions span 25 years of

¹⁵⁵ University of Chicago "Richard A. Posner" <<http://www.law.uchicago.edu>>.

¹⁵⁶ Richard Posner *Antitrust Law: An Economic Perspective* (University of Chicago Press, London, 1976) and (2nd ed, University of Chicago Press, Chicago and London, 2001).

Posner's intellectual development and coincide with the period in which the Chicago School became so influential.

Again like Bork, Posner's initial premise was that the Sherman Act was motivated by the public perception that the American economy was being taken over by cartels and monopolies.¹⁵⁷ Competition law up to that late nineteenth century had been more concerned with ensuring Parliamentary supremacy, stopping unionization and limiting competition in the sale of particular goods.¹⁵⁸ The writers of the Sherman Act, on the other hand, aimed to promote the Jeffersonian ideal of protecting small businessmen and the poor from monopoly pricing rather than on promoting any allocative efficiency effects. The result was that competition law had become too protective of the inefficient. Only when the role of antitrust law shifted to promotion of economic efficiency did:¹⁵⁹

... it became recognised that the lawful monopolist should be free to compete like everyone else; *otherwise the antitrust laws would be holding an umbrella over inefficient competitors*. 'A monopolist, no less than any other competitor, is permitted and indeed encouraged to compete aggressively on the merits'...

Posner's suggestion was that this disjuncture between the common law and the anti-elitist concerns of contemporary legislators led to a failure to set clear standards. The resulting confusion and damage to the economy was only resolved when the judiciary abandoned its search for answers in the common law and turning to economics for solutions, hence the rise of the Law and Economics style of legal analysis.

If we compare Posner's conclusions from the 1976 edition of *Antitrust Law* with the same point made again in 2001, we can observe a paradigm shift in action:¹⁶⁰

The discontinuity between the common law of trade regulation and the Sherman Act is important to remember whenever one sees a lawyer or judge attempting to buttress his antitrust theories by reference to some common law doctrine that he contends was incorporated into the antitrust laws by the Sherman Act. Such an argument is almost always unhistorical. The Sherman Act did not enact the common law of restraint of trade. *A better guide to interpreting the Sherman Act is the economic analysis of monopoly*. [emphasis added].

And in 2001:¹⁶¹

¹⁵⁷ Posner (1976), at 33.

¹⁵⁸ At 34.

¹⁵⁹ *Olympia Equipment Leasing Co v Western Union Telegraph Com* 797 F 2d 370 at [16].

¹⁶⁰ Posner (1976), above n 156, at 24.

Populists would like the interpretation of the antitrust laws to be guided neither by the common-law background nor by economics, but instead by the prominent vein of populist thought that runs through the legislative history of all the major federal antitrust statutes.... For guidance the courts perforce turned elsewhere. *After a century and more of judicial enforcement of the antitrust statutes, there is a consensus that guidance must be sought in economics.* [emphasis added].

The point here is not how the Sherman Act should be interpreted, but rather that it is evidence of Posner's increasing confidence in the role of economics in antitrust. After 25 years he could unequivocally state that, 'guidance must be sought in economics' and, by implication, that economists must have the final say.

Perhaps Posner's most significant contribution was to emphasise the importance of the total surplus standard with its focus on overall growth and neutrality towards wealth transfers:¹⁶²

Populists complain that monopolization transfers wealth from consumers to the stockholders of monopolistic firms, a redistribution that goes from the less to the more wealthy. The transfer, unlike the restriction in output that monopoly pricing entails, has no direct effect on efficiency, ... [but] a transfer of income from wealthy to a poor person increases the utility of the poor person more than it reduces the utility of the wealthy person. The argument is plausible in extreme cases: a dollar surely confers more utility on an indigent person than on a billionaire. but applied to monopolies and cartels, it is undermined ... by the increasingly broad ownership of common stock ...

Posner's point, that investors are also consumers and gain or lose just as much as others in any wealth transfer, sits well with the Borkean definition of consumer welfare and its exclusion of all objectives unrelated to pure economic efficiency. But the argument that wealth is fairly transferred via 'broad ownership of common stock' may not apply to New Zealand's shallow share market. A careful analysis of the composition of stockholders of our largest companies, compared to the size of wealth transfers from consumers, would be required.

The argument may be directly applicable to our state owned enterprises, however, as the owners are all taxpaying citizens. Wealth transfers to state owned enterprises are more like taxes, in that dividends are not paid in proportion to shareholding, but the accumulated capital goes to pay for public goods. This indirectly undermines Bork's point that social distribution of wealth is the proper

¹⁶¹ Posner (2001), above n 156, at 24

¹⁶² At 24.

subject of other laws. If the wealth transfer is essentially a tax, then the distinction disappears.

If a given society contains a disproportionate number of indigent and low income citizens and the major industries are owned by the middle and upper classes then Posner's wealth transfer neutrality could amount to double dipping by the rich. A rich household may be far more expensive to run and maintain than a poor one, but not so much that it outweighs the disproportionate ratio between earnings and outgoings of the rich relative to the poor. It is an undeniable fact that poor people pay a far higher proportion of their yearly earnings on basic necessities than do the rich. Secondly, if costs of consumer goods do increase due to the extraction of monopoly profits then that is more than compensated for by the payment of higher shareholder dividends.

Rudolf Peritz described Posner's claims to scientific objectivity as "ill founded" and a rather hypocritical mask for a political agenda.¹⁶³ Not only that, but the single-minded insistence upon efficiency risks doing away with subsidiary, but crucial, benefits of competition:¹⁶⁴

... competition is important both in and of itself, as a fair, meritocratic process, and in light of a whole ensemble of expected benefits including not only efficiency but also low prices to consumers, product innovation, and a preference for independent entrepreneurs.

Even Posner's basic definitions of allocative and productive efficiency are unclear and differ from mainstream economics. Peritz argues that, for mainstream economists, allocative efficiency is about utility, or the subjective personal satisfaction each individual seeks.¹⁶⁵ As this is unquantifiable the Chicago Schoolers opted for wealth maximization, as money may be easily counted. The same criticism might be made of Bork's efficiency definition, which measures efficiency by success in the market place.¹⁶⁶ Changes in wealth distribution necessarily change the preferences of consumers, however, which makes market

¹⁶³ Rudolf Peritz *Competition Policy in America, 1888-1992: History, Rhetoric, Law* (Oxford University Press, New York, 1996) at 238.

¹⁶⁴ At 239.

¹⁶⁵ At 240.

¹⁶⁶ Bork, above n 1, at 134.

success as much about the political choices of the market regulators as it is about the consumer's own self-selected satisfaction.¹⁶⁷

Peritz claims that, in preferring easily quantifiable total wealth maximisation Posner has abandoned Pareto optimality as a measure of efficiency. Benthamite cost-benefit analysis justifies the total surplus standard and makes the neutrality of wealth transfers far more palatable.¹⁶⁸ Secondly, Peritz objects to the misuse of the Law of Demand. This most fundamental of all economic concepts holds that the price consumers are willing to pay for a good subsides as supply increases. Posner applies this to all things except his treatment of money. Posner refuses to accept that an extra dollar means less to the wealthy than it does to the poor (with the exception of the extreme case of the indigent versus the billionaire). Taking this 'dollar is a dollar' position absolves regulators from responsibility for social inequity. As consumer welfare is easily measured as a factor of GDP, we can therefore say that the economy is doing well if it is growing, regardless of who is truly benefiting, which again is a political choice.¹⁶⁹

Baumol and the Wave of Creative Destruction

Following on from Posner and Bork, William Baumol reinvigorated Schumpeter's creative destruction hypothesis and formulated much of modern contestability theory.¹⁷⁰ A candidate for the Nobel Prize in economics and co-creator of the Baumol-Willig rule, Baumol testified as an expert witness for Telecom in New Zealand's leading competition case.¹⁷¹

Baumol agreed with Scherer that true innovation would come from a market composed, not of numerous competitors as in the perfect competition model, but from an 'oligopoly'. A workably competitive market would entail a few large firms, not competing on price but engaged in a technological arms race fueled by routinized research and development programmes.¹⁷² Perhaps because this model closely resembles New Zealand, with the limitations posed on it by the small size

¹⁶⁷ Peritz, at 241.

¹⁶⁸ At 240.

¹⁶⁹ At 241.

¹⁷⁰ William Baumol *The Free-Market Innovation Machine* (Princeton University Press, New Jersey, 2002) at 1.

¹⁷¹ *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385.

¹⁷² Baumol at 4.

of our economy, Baumol came to be very influential here, an influence clearly seen in Alan Bollard's writing.¹⁷³

Like Schumpeter, Baumol identified innovation as the key factor for success. Firms which fail to invest in the "innovation race" will lag behind and "even a firm that is in the vanguard may find that super-competitive profits are very transitory because they attract ambitious entrants."¹⁷⁴ Oligopoly was necessary for rivalry in innovation as single firm markets, by definition, contain no competition. The perfect competition model, with its large number of small firms tending to a marginal cost equilibrium, fails to provide sufficient capital for investment in new products.¹⁷⁵

Only in an oligopoly are firms in a position to observe and react to the actions of the limited number of competitors, which then sparks a 'spillover' of benefits. This spillover is due to the sharing of ideas amongst competitors and the cross-fertilisation from the licensing or sale of patented inventions. Baumol calculates the "spillover ratio – the share of the benefits of innovation that goes to persons other than the investors..." as the true measure of the innovative fertility of a market.¹⁷⁶

The spillover problem is created where competitors lose those benefits through being unable to copy or learn from each other's advances. What Baumol appears to be advocating is collusion between oligopolistic competitors, the sharing of ideas and technologies as a means of more creatively exploiting niches in the market. The line between collusion and cartel is blurred if not extinguished and as Jones and Sufrin point out:¹⁷⁷

The downside of the information sharing between oligopolies, whether it is deliberate or accidental, is that it increases the potential for collusion. While some oligopolistic markets are characterised by fierce competition others are not. This presents a formidable problem for regulators.

But for a Schumpeterian like Baumol, prevention of all collusion between rivals would result in a world where a few trillionaires completely monopolised the

¹⁷³ Bollard was appointed Governor of the Reserve Bank in 2002, and was the Chairman of the Commerce Commission from 1994-1998. See Alan Bollard "The Applicability of Contestability Theory in New Zealand" (NZEIR, Wellington, 1987) and Allan Bollard (ed) *Influence of United States Economics on New Zealand* (NZEIR, Wellington, 1988).

¹⁷⁴ Baumol, above n 170, at 41.

¹⁷⁵ At 44-45, see also Clark, "Workable Competition" above n 75.

¹⁷⁶ Baumol at 122.

¹⁷⁷ Jones and Sufrin, above n 26, at 11.

profits of technologies they had developed, while the rest of us languished in a state of seventeenth century style poverty.¹⁷⁸ Citing George Bernard Shaw's dictum that poverty is the greatest crime,¹⁷⁹ Baumol makes a case for a free market in innovation, while only obliquely addressing the distributive justice questions raised by the capitalist process itself.

Like Coase, Baumol describes the use of a Kaldor-Hicks or Pigouvian style solution, that efficient yet sub-Pareto optimal arrangements could be compensated for by lump sum redistributions (tax), as a "fairy tale".¹⁸⁰ Baumol asserts that lump sum redistribution is frequently impossible and is unnecessary as the spillovers alone would cater to a Pareto optimal result. Consistent with the marginal cost controversy, Baumol's premise is that if the state appropriates the profits of innovation from investors, the incentives to innovate would disappear. Stopping investors enjoying the fruits of their competitively correct decisions would, in the long-run, prevent anyone benefiting from investment at all. Kaldor-Hicks style compensation would only deter other socially desirable investments.¹⁸¹

The bottom line, simply, is this: there is no way *in reality* to escape the tradeoff between the incentives required to elicit the "optimal" level of investment in innovation and the desire for the resulting rise in real production to benefit everyone, and not just the innovators.

Perhaps not but to do so ignores other moral justifications for taxation based on citizenship and communal obligation. The rich benefit from stable egalitarian societies just as much, if not more so, than do the rest of us.

The Dynamic Efficiency Debate in New Zealand

Musings on the relative merits of and proper balance between static and dynamic efficiency are not limited to the American and British academics. The debate is a continuing one and it has found its way to our shores. Matt Sumpter, Michael Katz, Lewis Evans and Geoff Bertram amongst others demonstrate its enduring influence on contemporary economic policy.

¹⁷⁸ Baumol at 136 and 142.

¹⁷⁹ At 142.

¹⁸⁰ At 122.

¹⁸¹ At 133.

The ideals of dynamic efficiency, contestability and the total surplus standard have been so influential that they have become the economic orthodoxy. Economists' claims as to the wisdom of any particular course of action are seemingly unimpeachable, especially as the models used require advanced degrees in mathematics and economics to decipher. The problems posed by market failure and the increasing wealth gap, however, continue to stimulate questioning of the orthodox, particularly amongst the left and especially in the years since the Global Recession.

Sumpter explores the tension between static and dynamic efficiency and concludes that where the two conflict, dynamic efficiency should prevail.¹⁸² The overall logic is that while static efficiency focuses on improving performance in existing products and markets, dynamic efficiency results in the creation of entirely new products and markets. Therefore the gains from dynamic efficiency must exceed those of static efficiency.

As an example of the economic orthodoxy, take these statements from a speech made by Michael Katz of the University of Berkely, California:¹⁸³

Total surplus is the leading concepts [sic] of economic efficiency used in practice. Total surplus is defined as the gross benefit to consumers minus the total cost to producers, so the aim is to maximise consumer welfare, while minimising producer cost.

Katz was concerned that a consumer surplus based standard would lead to a situation of monopsony, where all power lies with the consumer, which would result in lower consumption. Presumably this would be because producers would have less incentive to come up with better products and services which might stimulate greater consumption. Prices which maximise consumer welfare would reduce the incentives to invest. Likewise a focus on lowering barriers to entry would favour new entrants at the cost of incumbent investors burdened with large sunk costs.

Katz takes the Borkean position that antitrust is poorly suited to dealing with distributional issues and that it is better to use tax policy to deal with social policy questions. If the state were to involve itself in questions of wealth transfers it

¹⁸² Sumpter, above n 21, at 46-48.

¹⁸³ Michael Katz "The Appropriate Objective of Competition Policy", (25 January, 2011) <www.iscr.org.nz>.

would only create opportunities for rent seeking behaviour. Katz quotes Posner: “A major conclusion is that public regulation is probably as large a source of social costs as private monopoly”.¹⁸⁴ One is reminded of Reagan’s pronouncement: “Government is not the solution to our problems, government is the problem.”¹⁸⁵

Despite these qualms Katz also said in an article in 2006 that Schumpeterian ideals could not be used as an excuse for backing off from all regulation of anti-competitive behaviour.¹⁸⁶ Katz defines Schumpeterian competition as competition over innovation, equivalent to dynamic efficiency. The difficulty Katz sees for antitrust officials in the US, although they have long recognised the importance of innovation competition, is how that should be implemented in actual policy. Does taking a pro-dynamic efficiency position necessitate a full scale retreat from antitrust enforcement as the Schumpeterians appear to advocate?¹⁸⁷ Profits from short term anticompetitive behaviour may in fact be justifiable in the long term. Indeed, as Katz put it:¹⁸⁸

...if firms are in fact competing by making risky investments in R & D, then the existence of high margins and apparent profits does not establish that the incumbent is earning excess returns as a consequence of market power. The apparent profits may simply be returns on past investments. The fact that, in the Schumpeterian view of the world, any profits and associated welfare losses due to unilateral practices or a merger are transitory reinforces the Schumpeterian theme that antitrust enforcers should focus on long-run innovation concerns rather than short-run price and output decisions.

The conclusion is that regulation of such markets on the basis of short term indicators, such as prices or output, is counter-productive unless it also takes incentives and opportunities for innovation into account. In fact, externally imposed price caps may well impede incentives for innovation. Likewise

¹⁸⁴ Ibid.

¹⁸⁵ Ronald Reagan, “Inaugural Address” (Jan 20, 1981)

<www.issues2000.org/celeb/Ronald_Reagan_Government_Reform.htm>.

¹⁸⁶ Michael Katz and Howard Shelanski “Schumpeterian Competition and Antitrust Policy in High-Tech Markets” *Competition* (vol 14, 2005) at 47.

¹⁸⁷ At 50.

¹⁸⁸ Katz at 7.

preventing mergers may thwart the accumulation of technologies and valuable economies of scale.¹⁸⁹

Katz's conclusion to the question 'are the Schumpeterians right?' is yes and no.¹⁹⁰ Increasing concentration in a market does not necessarily harm innovation or consumer welfare, but it would be going too far to say that dynamic efficiency warrants a total and systematic retreat from market regulation. Katz recalls Scherer's point that perfect competition may be as harmful to innovation as monopoly. While it is a given that incentives are needed to promote business strategies and structures which promote progress, this should not result in carte blanche to practice monopoly behaviour as advocated by laissez-faire Schumpeterian idealists. A balance must be found. As Katz succinctly put it:¹⁹¹

At some point, the benefits of an incremental increase in innovation incentives will be outweighed by the harms from the loss of static competition. Moreover, although exclusionary practices might yield profits that could finance R&D or strengthen R&D incentives by increasing the prize earned by a successful innovator, such practices may also reduce competitive pressures on incumbents. Importantly, such practices may also make it less profitable and more difficult for entrants to innovate so as to perpetuate the Schumpeterian cycle of 'creative destruction'.

Giving too much power to antitrust enforcement officials runs the risk of allowing the state to pick the winners, a task it has demonstrably failed in the past. On the other hand, the consumer has a right to be protected from the 'great aggregations of capital' which has been the concern since the days of the Sherman Act. It is this search for balance, for some form of workable competition, which so consumes competition policy to this day. The case for sensible antitrust enforcement remains intact, even amongst the orthodox.

State Control of Prices and Competition Pre-1984

Prior to 1984 and the election of the neoliberal-inspired Lange Labour government, New Zealand utilities had been closely regulated. Electricity in particular was a state monopoly and so the onus was upon the state to set fair prices and conditions.

¹⁸⁹ Katz at 4-5.

¹⁹⁰ Katz at 19.

¹⁹¹ Katz at 8.

State centered control of prices was the norm across the economy. For example, the Control of Prices Act 1947 fixed prices for consumer goods as of 1 September 1939, the outbreak of World War II.¹⁹² Any change in price could require recourse to the courts to decide whether the good had changed in its nature or quality.

The main competition legislation was the Trade Practices Act 1958 (“TPA”) which intended to prevent “trade practices deemed contrary to the public interest.”¹⁹³ While the TPA was not the first competition law statute in New Zealand, it was pioneering in that it set up its own tribunal and appeal authority with specific procedures, principles and methods.¹⁹⁴ The Act was criticised, however, for giving too little resources to the Trade Practices and Prices Commission (the “TPP Commission”) and for creating an Appeal Authority which could second guess those decisions.¹⁹⁵

The TPA was extremely detailed compared to the generally proscriptive phrasing of the Commerce Act 1986. For example, profiteering, black marketing and hoarding all specifically prohibited.¹⁹⁶ It was deemed an offence under s 20 to unreasonably increase costs and prices or to prevent, reduce or limit competition.¹⁹⁷ But deciding which practices unreasonably harmed the public interest, outside of those listed, might not be so straightforward a process.

Section 20 was tested in *Re the Associated Booksellers of New Zealand*.¹⁹⁸ The High Court dealt with an appeal from a decision by the TPP Commission that an agreement between retailers to fix prices covering ninety per cent of all imported books was against the public interest. In prescribing the agreement, the Commission had taken what was basically a quantitative approach, in which price was the only factor and other competitive advantages of the practice were disregarded.¹⁹⁹

Judge Dalglish criticised the quantitative approach and said that to determine whether a practice was reasonable or unreasonable: “All facets of competition in

¹⁹² Control of Prices Act 1947, s 10.

¹⁹³ Trade Practices Act 1958, s 20.

¹⁹⁴ Collinge, John *The Law relating to Restrictive Trade Practices and Monopolies, Mergers and Takeovers in New Zealand* (2nd ed, Butterworths, Wellington, 1982) at 15.

¹⁹⁵ Alex Hunter “Restrictions of Competition in New Zealand” (1963) 39(86) Econ. Rec. 131.

¹⁹⁶ Control of Prices Act, ss 23-25.

¹⁹⁷ Trade Practices Act, s 20.

¹⁹⁸ *Re the Associated Booksellers of New Zealand* [1962] NZLR 1057.

¹⁹⁹ At 1062-1063.

the sale of books such, for example, as services, breadth of selection and display of stocks are relevant for consideration.”²⁰⁰ Reasonableness of prices was a factor to be taken into account in considering the public interest, but it was not the only factor. The Court seemed to be particularly impressed by testimony from J.C. Beaglehole of Victoria University that the advantage of not having to ‘shop around’ for the best prices far outweighed gains from competitive pricing.²⁰¹ The TPP Commission might have a wide discretion to determine the public interest, but it had misdirected itself in taking a view based solely on the price effects of the bookseller’s agreement.²⁰²

In the context of the previous staunch controls of pricing, the decision is somewhat surprising. The focus on effects of competition, and the idea that the regulator should not prevent collusive retail price maintenance, if the overall efficiency gains was in the public interest, is surprisingly modern. Perhaps this signalled that competition issues were in a transitional stage in 1961. But as John Collinge (former chair of the Commerce Commission) pointed out, it was still not clear whether the balancing of beneficial and detrimental effects to determine the public interest should apply only to the question of the unreasonableness of the practice, or whether it applied to the broader question of the public interest.²⁰³ Subsequent cases only deepened the confusion. For example, at what stage should the inquiry take place? What did unreasonable mean? Did it apply to purpose, means or effects?²⁰⁴ The commentary had become awash with trivial legal ephemera. And as these tests applied to the subsequent 1975 Act as well, the confusion would have lasting effects.

By the late 1960s several statutes with competition law implications remained on the books. Along with the TPA, there was the Monopoly Prevention Act 1908, the Commercial Trusts Act 1910, the Control of Prices Act 1947 and the Trade and Industry Act 1956, all of which dealt with anti-competitive practices either

²⁰⁰ At 1064.

²⁰¹ At 1060.

²⁰² At 1065.

²⁰³ John Collinge *The Law relating to Restrictive Trade Practices and Monopolies, Mergers and Takeovers in New Zealand* (2nd ed, Butterworths, Wellington, 1982) at 254.

²⁰⁴ At 255-256.

directly or indirectly.²⁰⁵ One goal of the authors of the Commerce Act 1975 would therefore be to repeal and consolidate these several Acts.

The 1975 Act created the Commerce Commission (the “Commission”) which, in determining the public interest, would be guided by:²⁰⁶

- (a) The promotion of interests of consumers;
- (b) The promotion of the effective and efficient development of industry and commerce;
- (c) The need to encourage improvements in productivity and efficiency in industry and commerce in New Zealand;
- (d) The economic policies of the Government as transmitted in writing from time to time to the Commission by the Minister and as published by him in the Gazette.

Reconciliation of these conflicting objectives would be the responsibility of a body whose members were selected for their commercial and practical as well as legal expertise.²⁰⁷ Far from being guided by *laissez-faire* free market ideals, the prevailing philosophy was that “where the freedom of the individual businessman or combination of businessmen conflicts with essential public interest, then the public interest must prevail.”²⁰⁸ But as we have seen, discerning that public interest and the proper degree of intervention would continue to vex. For the purposes of this thesis, the main significance of the 1975 Act was that it established the Commerce Commission without resolving the deeper underlying issues.

The 1984 Labour Government, Bollard and Contestability

To put the shift in competition policy in context, it would be useful to pause and take note of historical events prior to 1984. The mid-1970s were a climactic period for energy policies world-wide. The oil crisis of 1973-74 saw the price of oil quadruple, forcing a contraction of global economies, including New Zealand’s, and causing recessionary effects which persisted into the 1980s. Political demands for energy self-sufficiency led directly to the Muldoon

²⁰⁵ At 58.

²⁰⁶ Commerce Act 1975, s 2A.

²⁰⁷ Collinge, at 7.

²⁰⁸ At 9.

government's notorious 'Think Big' Plans. Unfortunately, when high oil prices collapsed and high demand for electricity failed to materialise, the rationale for debt laden public works energy projects disappeared. These events led to a popular belief amongst the right wing that government was simply unsuited to directing the economy.

That belief was exacerbated by the epic scale of the public sector circa 1984. With government expenditure transfers making up approximately 39% of GDP,²⁰⁹ state owned enterprises included, not just utilities such as electricity and telecommunications, or flagship services such as Air New Zealand or NZ Rail, but also shipping, hotels, insurance, finance, computers, coal, forestry, steel, radio and tourism.²¹⁰ Such dominance of the economy did not leave much room for the entrepreneur and, within the public sector itself the highly centralised bureaucracies were regarded as simply stifling.

This was the context within which the Muldoon government fell and was replaced by Lange/ Douglas with their commitment to small government, privatization and deregulation of the economy. It has frequently been asserted that the Chicago School styled Washington Consensus was accepted wholesale by elements within New Zealand society who then came to dominate the formation of public policy following the 1984 election.²¹¹ As Richard Miller put it, what lay behind the new policies was:²¹²

... a newly discovered concern with economic efficiency and a renewed faith in the competitive powers of market rivalry as a means to approach or to attain that efficiency.... [The] central role of the market mechanism is to provide goods and services that consumers want by allowing market prices to reflect costs, by encouraging entrepreneurial enthusiasm and by removing the deadening visible hands and feet of government regulation. Private avarice can be harnessed for the public good by a competitive environment.

It has even been said that in many respects the liberalisation and deregulation of the New Zealand economy would out-do that of the United States or United

²⁰⁹ S Gale, "The New Zealand Experience of Liberalisation and Deregulation" (NZEIR, Wellington, 1990) at 9.

²¹⁰ At 10.

²¹¹ Jane Kelsey *The New Zealand Experiment* at 29 and 55, and J Culy and others, "The Evolution of New Zealand's Electricity Supply Structure," (NZEIR, Wellington, 1995) at 1.

²¹² R Miller, "From Macro to Micro: The Re-emergence of Efficiency Considerations in Economic Policy," in S Gale "The New Zealand Experience of Liberalisation and Deregulation" (NZEIR, Wellington, 1990) at 32.

Kingdom. New Zealand provided a ‘test bed’ for free market theories allowing them to be applied on a level not seen elsewhere.²¹³

The paradigm shift was staunchly opposed by trade unions, Maori, and many amongst the intelligentsia. Opposition to the new regime accelerated amongst Victoria University economists and at the Wellington meeting of the New Zealand Association of Economists in February 1985, the two sides came head to head.²¹⁴ The ‘Victoria Group’ criticized the “Monetarist Doctrine” for rejecting aggregate demand management as a means of managing unemployment, and focusing on reducing wages and restructuring the labour market. By floating the exchange rate, and concentrating on lowering wages to control inflation, Treasury was accused of abandoning the working class to the whims of market forces, cynically disregarding the social cost. These American-inspired supply-side monetary policies ran the risk of inducing a full scale recession.²¹⁵ As Bertram put it:²¹⁶

Treasury had fallen into the trap of treating the real world as though it matched exactly the pure theoretical neoclassical model, and had therefore failed to warn the incoming government of the real-world consequences of the policies being recommended.

The policy arena itself was, and may still be, dominated by simply too few players. The market may fail to provide the most efficient outcomes if it is dominated by the few, and this is just as true for the market for ideas as it is for any other commodity. The wholesale importation of these ideas meant that the public failed to appreciate that what was being put to them as common sense propositions, were in fact highly speculative, ideologically driven thought experiments. Bertram characterised the period as one of an ideological regime change, an “internal coup d’etat” in which Treasury and the Reserve Bank took control of government from the large Ministries of Works and Development, Energy and Trade and Industry.²¹⁷ Henceforth, ‘light handed regulation’ was embraced as a key component of New Zealand’s financial resuscitation. The free market would now be the primary mechanism used to order society. The great danger was that the state had been so involved with the administration of the economy that too many

²¹³ Gale, at 2.

²¹⁴ Geoff Bertram “Keynesianism, Neoclassicism, and the State” in Brian Roper and Chris Rudd (eds) *State and Economy in New Zealand* (Oxford University Press, Oxford, 1993) at 44.

²¹⁵ See Alistair Barry *In a Land of Plenty – the Story of Unemployment in New Zealand* (Vanguard Films, Wellington, NZ, 2002).

²¹⁶ Bertram, at 45.

²¹⁷ At 48.

working people's livelihoods were tied up in the state owned enterprises. Simply replacing a commitment to state centered full employment and the guaranteed provision of public services at a fair price with reliance upon market forces, would cause mass social disruption.

Led by Roger Douglas, Rod Deane, Ron Trotter, Roger Kerr amongst others, a group of businessman, Treasury and Reserve Bank luminaries and members of the Business Roundtable were moving as quickly as possible to privatise, deregulate and liberalise the New Zealand economy.²¹⁸ The strategy was deliberately designed to intimidate and overwhelm opposition, as Douglas put it:²¹⁹

Do not try to advance one step at a time. Define your objectives clearly and move towards them in quantum leaps. Otherwise the interest groups will have time to mobilize and drag you down.

These same sentiments echo those of an earlier political theorist: "For injuries ought to be done all at one time, so that, being tasted less, they offend less."²²⁰

The neo-liberal programme was comprehensive and wide ranging, and as we can see, its birth was attended by numerous mid-wives. One of the most significant, and recognizable names to enter the discourse, was that of Dr Alan Bollard. Current Governor of the Reserve Bank of New Zealand (at the time of writing), Bollard also served as Secretary to the Treasury (1998-2002), head of the Commerce Commission (1994-1998) and Director of the New Zealand Institute of Economic Research (NZIER) from 1987-1994. Bollard made his philosophy clear in 1987 with a seminal paper which applied William Baumol's contestability theories to competition law in New Zealand.²²¹ The paper therefore provides a clear link between the American microeconomic theories propounded by Baumol and Commerce Commission's support for Baumol's conception of Dynamic Efficiency.

According to Bollard, and it is important to be clear about his views given his position at the centre of competition policy in New Zealand, contestability is achieved where "entry is absolutely 'open' and exit absolutely costless."²²² The

²¹⁸ At 37-47.

²¹⁹ Roger Douglas *Unfinished Business* (Random House, Auckland, 1993) at 229.

²²⁰ Niccolo Machiavelli *The Prince* [1531] (Alfred A. Knopf, Toronto, 1996) at 74.

²²¹ Alan Bollard "The Applicability of Contestability Theory to New Zealand Competition Law and Policy" (NZEIR, Wellington, 1987) at 1.

²²² At 3.

aim must be to reduce the barriers to entry and exit so that should a firm gain monopoly control of a market, its dominance can be easily challenged by innovative newcomers. After that the Darwinian law of survival of the fittest will determine which firms remain.

The major barriers to entry are sunk costs. These would include outlay on assets which cannot be easily redeemed. These are contrasted with fixed costs, which constitute a minimum price for entry to the market, but which are more easily recouped. The example Bollard gives is the difference between railway cars, a fixed cost which can be moved and sold separately if the business fails, and rail tracks, a sunk cost which cannot be easily liquidated.²²³ The electricity market contains both fixed and sunk costs. The rolling stock, to analogise with the rail example, would be the retail assets (customers) and gas powered turbines, and the rail tracks would be the immovable hydro dams, geothermal assets and wind turbines.

In a perfectly contestable market large monopoly profits would attract ‘hit and run’ operators, new entrants taking short term positions in the market until the increased supply drove prices back down. Either the new entrants, or inefficient incumbents, would then be forced from the market. The threat from new entrants should, according to the theory, keep prices at the Pareto optimal level.²²⁴

Bollard maintained that contestability was the best possible policy, but, “it has not yet become clear just how contestability theory can be operationalized in the courtroom or the regulation office.”²²⁵ Bollard acknowledged the challenge to creating contestability in industries where entry required large financial outlays in terms of brand development, human resources and capital intensive infrastructure. He also recognised that there may be a flaw in the assumption that there even exists a ready-made body of potential entrants, large and powerful enough to affect outcomes in the market, and eager to enter at the first sign of weakness.²²⁶

Despite the difficulties, on a transaction costs analysis the benefits of contestability outweighed the detriments. Transaction cost theory is the Coasian

²²³ At 3.

²²⁴ At 3.

²²⁵ At 9.

²²⁶ At 5-6, citing W Sheperd “Contestability v Competition” (1984) 17(4) Amer. Econ. Rev. 572 and J Hatch *The Theory of Contestable Markets and Other Recent Developments in the Theory of Competition* (Economic Society of Australia, Canberra, 1984).

idea which provides that, particularly where sunk costs are very high, firms and individuals will organize their own affairs in the best way possible. Government regulation cannot be as efficient.²²⁷ So while cautious about contestability theory, Bollard still recommended a free market approach where possible.

The tenor of the article suggests that Bollard was acquiring Schumpeterian ideas in the mid-80s which would guide his career in the Commerce Commission. We can see that he believed a free market was a Darwinian self-evolving mechanism which would tend towards the most efficient outcome so long as regulation (for example by the Commerce Commission) was kept as a last resort. Yet while Bollard was keen to learn from the American example, there is evidence that he attempted to moderate and adapt the lessons for the New Zealand context. In 1988, he edited a series of Fulbright Seminars titled: “The Influence of American Economics on New Zealand Policy and Thinking.”²²⁸ The book contains a series of articles by Richard Miller, Douglas Greer and Lewis Evans, amongst others, which criticise the American influence in terms which range from cautionary to scathing. A brief survey of these authors’ views provides a valuable critique of some of the theories this thesis has introduced so far.

Miller tells the story of how Keynesian demand-side economic policies were used successfully to contain the damage of the Great Depression.²²⁹ The goal was to provide full employment through large public works projects which would stimulate consumption and economic growth. Cartels were encouraged and prices fixed in the interests of economic stability. Growing inflation following the oil shocks of the 1970s caused a seismic shift to supply-side monetary policy in the Thatcher and Reagan administrations, however, and inflation would henceforth be controlled by restricting the supply of money, but at the cost of full employment. Incentives for the individual to succeed would be provided by fostering economic inequality, a notion heartily subscribed to in New Zealand by David Lange.²³⁰

²²⁷ At 5-6.

²²⁸ Alan Bollard (ed) *The Influence of American Economics on New Zealand Thinking and Policy* (NZEIR, Wellington, 1988).

²²⁹ Richard Miller “From Macro to Micro: the Re-emergence of Efficiency Considerations in Economic Policy” in Bollard, at 14.

²³⁰ At 34. Lange once said “Economic inequality is the engine which drives the economy”.

Intervention in markets would be restricted to that necessary to improve efficiency, with fairness considerations excluded.²³¹ Instead Schumpeter and Baumol's theories of contestability in an oligopolistic market would be followed. Perfect competition might be impossible, but at the other extreme single firm monopolies markets were not necessarily to be feared, so long as entry conditions were attractive:²³²

... structural fewness came to be viewed as not automatically producing monopoly performance, despite the static oligopoly models of micro theory. By this theoretical development of contestability, competitive rivalry and performance may exist in industrial markets with only two firms, if appropriate entry conditions exist. And even a single firm may be forced to exercise considerable pricing restraint if it fears rapid loss of sales through entry of a new rival.

If competitive pressures could be provided merely by leaving the door open for potential competition, then the role of the state in deconcentrating markets could be drastically reduced. While wholesale and complete withdrawal by the state from economic regulation was popular with some elements of the business community, few academics agreed.²³³ Even Baumol and Willig themselves are oft quoted as saying, "Specifically we will deny emphatically that [contestability] offers carte blanche to mindless deregulation and dismantling of antitrust safeguards."²³⁴ What had changed since the 1930s was society's view of what was possible.²³⁵ Deregulation, removing government from playing an active part in controlling the economy, was now much more acceptable, even if there was no single accepted view of how far this process should be taken.

Douglas Greer lambasted the exaltation of contestability theory, arguing that "seldom has a new theory been promoted with such extravagant exhortation by its natural and foster parents".²³⁶ The "ultra-free" exit and entry principles required by contestability had "revolutionary" implications that were neither plausible nor

²³¹ At 21-22.

²³² At 23.

²³³ At 33.

²³⁴ W Baumol and R Willig "Contestability: Developments Since the Book" 38 Oxford Econ. Pap. 9 at 10, cited in Miller at 23.

²³⁵ Miller at 24.

²³⁶ Douglas Greer "Contestability in Competition Policy: Replacement, Supplement or Impediment" in Bollard, above n 228, at 39.

backed up by empirical evidence, its growing influence in the United States and New Zealand was really based on only “ideology and ignorance”.²³⁷

Greer pointed out that the significance of conditions for exit and entry and the opportunities they played in obtaining monopoly profits (or losses) had been well known for more than a century.²³⁸ But while previously most neo-classical economics had required ‘actual’ exit and entry from a multitude of competitors as per perfect competition, Baumol’s contribution was to emphasise the importance of potential competition. If a market is perfectly contestable, the entry barriers should be sufficiently low that any rival may enter and extract profits from the underperforming incumbent, then leave again without undue cost.²³⁹

Even a very transient profit opportunity need not be neglected by a potential entrant, for he can go in, and, before prices change, collect his gains and then depart without cost, should the climate grow hostile.

The threat of such ‘hit and run’ profit taking alone should then be sufficient to discipline the market and prevent the evils of monopoly practices.²⁴⁰

Given contestability one need not worry about mergers that create monopoly or about collusive activities. A cavalry of hit-and-run contestants is always read to ride to the rescue.

That contestability theory was significant in New Zealand’s competition regulation from an early stage is revealed by these 1985 comments from former Commerce Commission chairman, John Collinge:²⁴¹

The emphasis in contestability theory is away from ensuring a number of independent sellers in the relevant market and whether there is a history of competition between them. It is upon whether there is a history of competition between them. It is upon whether, notwithstanding that there may be a monopoly or oligopoly in the relevant market, potential entrants could reasonably enter the market. *Contestability theory has the important practical consequence* that, in the absence of independent sellers in the market [ie. monopoly], *there need be no concern* if there is reasonably costless entry and exit for potential competitors (emphasis added).

For Greer, it is the impracticality of the last point, the necessity for reasonably costless entry and exit, which makes contestability implausible and historically rare. Contestability lacks robustness, internal consistency or believable

²³⁷ At 39.

²³⁸ At 40.

²³⁹ William Baumol “Contestable Markets, An Uprising in the Theory of Industrial Structure” (March 1982) 72 Amer. Econ. Rev. 1 at 10, cited in Greer at 41.

²⁴⁰ At 42.

²⁴¹ At 57.

assumptions.²⁴² It is simply too unlikely that the potential ‘hit-and-run’ profit taking newcomer would fail to be deterred by sunk costs or that an entrenched incumbent could be easily displaced by a newcomer without responding by changing tactics. In fact, such strategic behaviour increases and becomes more effective as markets become more concentrated.²⁴³ Having a competition policy which tolerates monopolies can only concentrate markets thereby destroying the opportunities for the hit-and-run profit taking contestability relies upon.

Furthermore, refusing to break up the corporate structures which occupy all vertical and horizontal niches in such markets, on the basis that some competitor could theoretically challenge the incumbent, seems to amount to an abdication of the state’s responsibility. This aspect of contestability theory put it at the forefront in the war of ideas between the Chicago School’s Schumpeterian views, and its populist rival, the Structure-Conduct-Performance paradigm (“S-C-P”). The goal of S-C-P was to preserve many small firms, in the interests of the perfect competition ideal and democratic economic equality, even at the expense of ‘efficient’ wealth accumulation for a few large firms.²⁴⁴ The decision to move away from the S-C-P paradigm was therefore a political choice to favour large firms, which had more to do with how it was embraced by Reagan’s administration, than the objective and somewhat flimsy merits of contestability.²⁴⁵

Evans compared public utility regulation in New Zealand and the United States, submitting that our state owned organisations had very different regulatory requirements to those of American shareholder owned corporations.²⁴⁶ In the United States, regulatory commissions were established to oversee existing firms, whereas in New Zealand state ownership was necessary to build infrastructure in the first place. The mandate for state intervention was built into New Zealand utility regulation from its very inception.²⁴⁷

²⁴² At 43.

²⁴³ At 55.

²⁴⁴ At 60.

²⁴⁵ At 61.

²⁴⁶ Lewis Evans “Public Utility Regulation in New Zealand and the United States” in Bollard, above n 228, at 96.

²⁴⁷ At 97-99.

In the United States it is necessary to observe and understand the behaviour and motivations of four types of agents. These are:²⁴⁸

1. the managers and stockholders of the regulated firm,
2. advocates for the buyers of all goods and services produced,
3. advocates for the buyers of a subset of the goods and services, and
4. the courts (to which all regulatory decisions can be appealed).

It is assumed that managers and stockholders will be motivated to procure higher profits, while consumer advocates push for lower prices. Rate of return price setting, which sets prices at a set percentage above the marginal cost, is a popular tool. Buyers of a particular subset of goods and services might demand cross-subsidization from other products, for example, paying for free local calls with higher toll charges in the telecommunications market. The difficulty for the courts is balancing these competing objectives while developing and following a consistent policy narrative.

Stigler's "capture theory" revealed the problem posed by the revolving door between regulator and regulated.²⁴⁹ Industry representatives are hired from the ranks of regulatory commissions and vice versa, creating an 'old boys' network reluctant to take the harsh action sometimes required to properly police powerful privately owned organisations. Regulators are co-opted and become highly politicised creatures forced to balance self-interest with duty.²⁵⁰

Evans argues that in New Zealand, state owned enterprises are subjected to many of the same political and economic pressures, but an additional layer of political complexity is evident, particularly in election years.²⁵¹ The level of government ownership, which entails a somewhat oxymoronic and contradictory self-regulation, has eliminated the detailed scrutiny shareholders and financial analysts afford to stock exchange listed companies.²⁵² Shareholders have the power to vote with their feet, and exit a low performing asset en masse. State ownership, at least pre-1984, guaranteed the continued existence of politically important industries, no matter how unprofitably and incompetently run. This defeats the self-correcting powers of creative destruction, to the long term detriment of both the enterprise and the taxpayer.

²⁴⁸ At 104.

²⁴⁹ At 104.

²⁵⁰ At 106.

²⁵¹ At 107.

²⁵² At 108.

This of course assumes that private shareholders and analysts are better at picking winners than politicians and voters. Worldcom, Enron, Lehman Brothers and the Titanic were not state owned enterprises.

As New Zealand makes the transition from state-owned to publicly-owned corporations, the choice of regulatory model will be crucial. Evans identified the need for full disclosure as, in order to police an industry, the regulator must know as much, if not more about it than do market players.²⁵³ He therefore recommended the United States system of separate industry specific regulatory commissions for New Zealand, post-privatisation.

Whether or not the foregoing authors were outraged or cautiously optimistic, free market reforms were a fait accompli. The task for practitioners and industry participants alike would now be to adapt to the new regime.

The Shift from Prime Necessity to Light Handed Regulation

As previously discussed, the Commerce Act 1986 (“Commerce Act”) was intended to replace tight, highly detailed and prescriptive statutory controls with so-called light handed regulation. The rationale according to Peter Allport, former chair of the Commerce Commission, was that:²⁵⁴

‘Light handed’ regulation provides an attractive, less economically distortionary alternative to heavier forms of regulation with the associated industry-specific regulatory bodies and higher compliance costs. For example direct regulatory control imposed by an industry-specific regulator can generate its own inefficiencies including the costs of operating the regulatory body, the information supply costs imposed on the regulated firms, and the compliance costs arising from the distortions caused by imperfect regulation. The possibility of ‘regulatory capture’ is often noted as another possible concern, that is, where the regulator is ‘captured’ by the regulated with the monopoly firms influencing the regulator to their own advantage.

We can see the influence of Coase’s transaction cost theory, that a generic competition authority would be more objective and less prone to capture, easier to comply with and cheaper to run than industry specific bodies. As Evans pointed out above, however, the United States experience had been that it was necessary to have expert bodies armed with full disclosure to properly police complex

²⁵³ At 113-115.

²⁵⁴ Peter Allport *Natural Monopoly Regulation in New Zealand* (Paper presented to Institute of Public Affairs Deregulation Committee, 24 July 1998) at 6, cited in J Every-Palmer “The State and Monopolies: New Zealand’s Experience” (2010) 12 Otago LR 227 at 230.

industries. Time would tell whether a generic body like the Commerce Commission would, or could, effectively monitor market abuses.

The three elements of the light handed regime were “‘generic competition law’, information disclosure requirements, and the threat of further intervention such as price control.”²⁵⁵ These coupled with contestability theory should have allowed efficient market based solutions for complex regulatory dilemmas. If all else failed the threat of future regulation would be a sufficient check on abuses of market power. However the shortcomings of the light handed regime lead to complaints that it was in fact a “no-handed” regime.²⁵⁶

Michael Taggart reviewed the development of public service price regulation and the prime necessity doctrine, which guaranteed the supply of essential public services at a fair price. His thesis was that the privatization of public utilities since the mid-1980’s had resulted in the de facto monopolization of supplies of essential services.²⁵⁷ Under the State Owned Enterprises Act 1986 the principle objective would be to operate as “successful businesses ... As profitable and efficient as comparable businesses that are not owned by the Crown.”²⁵⁸ For Taggart, the potential for exploitation inherent in this corporatization and privatization of public services demanded that the common law doctrine be revisited. This was of particular importance as previously the state monopoly of essential services like electricity supply and distribution meant that it had not been necessary to properly explore those common law duties.²⁵⁹ The pattern had been to grant territorial monopolies, to prevent inefficient competition, and then to impose statutory duties which replicated the common law prime necessity duties.

Taggart complained that replacing these statutory duties with contestability and free market ideals had “put pressure on the article of faith of New Zealand’s welfare state, that public utilities should be universally available to all at a fair and reasonable price...”²⁶⁰ Great effort had been made to separate natural monopolies, where prices should be regulated, from contestable markets, where the free market

²⁵⁵ At 230.

²⁵⁶ At 234-235.

²⁵⁷ Michael Taggart “Public Utilities and Public Law” in Philip Joseph (ed) *Essays on the Constitution* (Brookers, Wellington, 1995).

²⁵⁸ State Owned Enterprises Act 1986, s 4.

²⁵⁹ Taggart, at 254-255.

²⁶⁰ At 257.

price signals would efficiently guide consumer choices. Yet domestic consumers were still:²⁶¹

... just as much captive of the new privatised and corporatized entities as they were when these utilities were owned and run by Government departments or municipalities. The legal shift from ‘public’ to ‘private’ ownership has made not one whit of difference to the plight of domestic consumers, except that several complaint and protective mechanisms have been removed in the transition.

For Taggart this was a sufficient rationale for making the case that the doctrine should be reapplied to protect the public from corporate greed:²⁶²

Public utilities are truly businesses affected with a public interest, whether in public or private ownership. For as long as they are practical monopolies – as they are in relation to domestic consumers – public utilities must be subject to regulation in the public interest.

That relevance of prime necessity style duties was considered by the High Court in *Auckland Electric Power Board v Electricity Corporation of New Zealand Ltd.*²⁶³ The plaintiff complained that the parties had entered into an interim agreement to supply electricity until a new substantive agreement could be negotiated “as soon as reasonably practicable.”²⁶⁴ Electricorp then gave 12 months notice of termination the agreement, which the plaintiff argued was a breach of a tortious statutory duty under the State Owned Enterprises Act to act in a “socially responsible manner”.²⁶⁵ The question was whether that duty was overwhelmed by the principle objective to behave efficiently and competitively as a ‘successful business’.²⁶⁶ This cause of action was struck out on the grounds that the primary responsibility was to be commercially successful, other considerations only need to be balanced, not given primacy.²⁶⁷

Of the application of common law principles to the monopoly suppliers obligation to supply an essential commodity, Barker J said:²⁶⁸

... at common law, the defendant, as a monopoly supplier of an essential commodity, owes a duty to the plaintiff and to the public generally to conduct itself reasonably and not to seek to abrogate existing contractual

²⁶¹ At 257-258.

²⁶² At 257-258.

²⁶³ *Auckland Electric Power Board v Electricity Corporation of New Zealand Ltd* [1993] 3 NZLR 53.

²⁶⁴ At 56.

²⁶⁵ At 56.

²⁶⁶ At 58.

²⁶⁷ At 59.

²⁶⁸ At 59-60.

arrangements. This cause of action is based on the proposition, accepted by the defendant, that a monopoly supplier of an essential commodity has a duty to supply and to charge a fair and reasonable price with a corresponding duty on the recipient to pay a reasonable price. This principle has been accepted in many cases...

That cause of action was also struck out, arbitration being the most practicable remedy in the circumstances, but the Court had approved of the prime necessity rule that monopoly suppliers of essential commodities must behave reasonably and charge fair and reasonable prices.

Judicial review of the terms of private contracts is somewhat anathema to the free market principles upon which the Commerce Act 1986 was founded, and it is somewhat surprising to see a case like this post-1986. The fact that a court in 1993 was still commenting favourably about these common law duties demonstrates their persistence.

Attempts to judicially review pricing decisions via use of the prime necessity doctrine were ultimately dismissed by the courts, however. When *Mercury Energy Ltd v Electricity Corporation of New Zealand Limited*²⁶⁹ was appealed in *Vector v Transpower*,²⁷⁰ the Court of Appeal accepted that the prime necessity doctrine remained part of the law of New Zealand, but that the passing of the Commerce Act and the State Owned Enterprises Act precluded its application. It was becoming clear that the prime necessity doctrine was not going to gain much traction against the harsh application of free market principles. The Court of Appeal approved of the High Court's judgment where it said:²⁷¹

...there can be little doubt that in enacting the relevant statute, Parliament did not intend that doctrine to survive.... Since the mid-1980s New Zealand has opted for a light handed regulatory regime as encapsulated in the Commerce Act 1986 and the State-Owned Enterprises Act 1986. Direct intervention is clearly intended as a last resort ...

The legislative intent behind the Commerce Act was to prohibit restrictive trade practices only where they abridged proscribed purposes as in s 36 or where it was necessary to control natural monopolies through Part 4 price regulation.²⁷² The Court accepted that while it had the expertise to set prices, as a practicality this

²⁶⁹ *Mercury Energy Ltd v Electricity Corporation* [1994] 2 NZLR 385; sub nom *Auckland Electric Power Board v Electricity Corporation of New Zealand Ltd* [1994] 1 NZLR 551 (CA); [1993] 3 NZLR 53 (HC).

²⁷⁰ *Vector Ltd (formerly Mercury Energy Ltd) v Transpower New Zealand Ltd* [1999] 3 NZLR 646.

²⁷¹ At [33] citing *Mercury Energy Ltd v Transpower New Zealand Ltd* (1998) 8 TCLR 554 at 582-583.

²⁷² At 666.

was a complex process, which must be continuously repeated and would involve the ongoing attention of the courts, “Had Parliament intended the Court to fulfil such a role, in our view it would have said so unmistakably clearly.”²⁷³

Thomas J dissented in part, however, saying that while the prime necessity doctrine was in general excluded, because of the separation of Ministerial control from operation of what were basically commercial enterprises, it could still play a role in regulating state owned enterprises.²⁷⁴ Thomas J highly approved of Taggart’s “oviferous” work. Prime necessity might be a “crude instrument” but the doctrine could still be used to prevent the monopoly abuse of refusing to supply or offering services on terms, such as “extortionate” prices, which effectively precluded supply. Though still complex, this was “a much narrower question than the question of what is a fair and reasonable price” and one which presumably the courts could manage.²⁷⁵ The door to prime necessity was left slightly ajar.

James Every-Palmer said that the shift from heavy handed state owned monopolies to light handed regulation, has been followed by a re-regulation which has tended to be “political, reactive and *ad hoc*”.²⁷⁶ The changes have been driven by political philosophies rather than empirical analysis, have been purely reactive to excesses of the previous regimes, and were formulated on a case-by-case basis rather than as a coherent programme. Barry Barton has contested this conclusion seeing rather that the increasing control of natural monopolies and coordinated approach to investment in infrastructure has shown a consistent logic, even if it has not been explicitly planned.²⁷⁷

The Commerce Act 1986

New Zealand competition law, post-prime necessity and the extensive controls of earlier legislation, because of obligations under the New Zealand and Australia Closer Economic Relations Agreement, drew its inspiration from Australia.

²⁷³ At 666.

²⁷⁴ At 670.

²⁷⁵ At 670.

²⁷⁶ Every-Palmer, above n 254, at 239.

²⁷⁷ Barry Barton “Law and Regulation for Energy Networks in New Zealand” in Martha Roggenkamp and others (eds) *Energy Networks and the Law: Innovative Solutions in Changing Markets* (Oxford University Press, Oxford, 2012) at 291.

Australian legislation in turn was rooted in United States and European Community law, and logically would follow Bork and Posner and the other Chicago School economist lawyers whose influence was so clearly felt in the United States.²⁷⁸

Developing a system of state control of private affairs is not an easy matter, as we have seen. The first question is to decide what the objective of the policy is, only then can all other issues about the extent of intervention be resolved. Originally the purpose enacted was “to promote competition in markets within New Zealand” which lead Richardson J to remark:²⁷⁹

In terms of the long title the Commerce Act is an act to promote competition in markets in New Zealand. It is based on a premise that society’s resources are best allocated in a competitive market where rivalry between two firms ensures maximum efficiency in the use of resources

The search for the proper balance between consumer and producers interests continued, however, and while it was accepted that efficiency gains were desirable, to be of public benefit these gains had to find their way to the consumer in terms of lower prices, improved quality and so on.²⁸⁰ The purpose statement was replaced by the Commerce Amendment Act (2001) and, true to dynamic efficiency, the new section 1A states that the Act’s purpose is to “promote competition in markets for the long-term benefit of consumers in New Zealand.”

Under the 1990 amendment to s 3A efficiency considerations must be cast in terms of their “benefit to the public” and in 1992 the Interdepartmental Review of the Commerce Act recommended that this test should be amended to:²⁸¹

1. Replace the words “benefit to the public” with benefit to New Zealand;
2. That allocative, productive and dynamic efficiency would be the primary considerations;
3. That “decision makers should take no account of the identity of those who were the beneficiaries of efficiency gains; and

²⁷⁸ Korah, Valentine “Compulsory Access to Essential Facilities Under section 36 of the New Zealand Commerce Act” (November, 1999) <www.iscr.org.nz> at 2.

²⁷⁹ *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [1988] 2 NZLR 352 (CA) at 358.

²⁸⁰ LexisNexis *Commercial Law in New Zealand* (LexisNexis, NZ, 2012) at 31.2.1 citing *re New Zealand Cooperative Dairy Co Ltd/Auckland Cooperative Milk Producers Ltd* (1988) 1 NZBLC (Com) 104,320.

²⁸¹ LexisNexis at 31.2.1.

4. A s 26 statement would be released explicitly stating that it was government policy to remain neutral over wealth transfers.

This was a clear adoption of the total surplus standard. Benefit to the public was the goal, with the inferences that consumer welfare was less important than the total wealth of the nation. Pursuing efficiency measures to create maximum total wealth, while disregarding whose hands that wealth is in, is the very definition of the total surplus standard. The relevance of social welfare and equity in distribution remained an issue, but not for the courts to dwell on.²⁸²

While these amendments were never made, the Commerce Commission incorporated many of its recommendations in *Guidelines to the Analysis of Public Benefits and Detriments in the Context of the Commerce Act* (Oct 1994). The guidelines “adopted a total welfare approach and ignored distributional effects”, and have since been followed.²⁸³ It is interesting, however, that in its submission to the Commerce Select Committee on the s 1A purpose statement the Commerce Commission declared:²⁸⁴

We... considered whether the words ‘long-term’ may lead the courts and the Commission to over emphasise dynamic efficiency at the expense of more immediate benefits. We accept the words ‘long-term’ on the basis that welfare is defined as the welfare of consumers within New Zealand

This seemed to suggest that the focus would be on consumers, not on the total surplus. The Hon Paul Swain, then Minister of Commerce, remarked that while “Consumers are given special mention as they are the ultimate beneficiaries of competition... the welfare of all New Zealanders will continue to be important”.²⁸⁵ This suggests that the Minister considered the purpose statement should in fact be interpreted consistently with the total surplus standard approach and that the welfare of producers would also be a significant factor.

The High Court likewise rejected the suggestion that s 1A would require acceptance of a consumer surplus approach:²⁸⁶

We are satisfied that the introduction of s 1A should not disturb the Commission’s established practice of treating as neutral any wealth transfers between New Zealand consumers and producers.... The inclusion of ad hoc

²⁸² at 31.2.1

²⁸³ at 31.2.1

²⁸⁴ at 31.2.1

²⁸⁵ (27 February 2001) 590 NZPD 7972.

²⁸⁶ *Air New Zealand v Commerce Commission* (No 6) (2004) 11 TCLR 347 at paras [241]-[242].

welfare transfers, which are not losses to society, would distort the efficiency assessment by assuming additional economic harm to the public of New Zealand. In any event consumers might well be the ultimate beneficiaries.

Long term benefit would therefore be equated with dynamic efficiency and the total surplus standard. The conclusion must be that workable competition is equivalent to dynamic efficiency, with a total surplus slant.

As the legal framework of the Commerce Act was taken from the Australian Trade Practices Act,²⁸⁷ Australian decisions such as *Re Queensland Co-operative Milling Assn Ltd (QCMA)*²⁸⁸ would be influential. QCMA reveals the Schumpeterian ideals which informed so much competition law at the time:²⁸⁹

This does not mean that we view competition as a series of passive, mechanical response to 'impersonal market force'. There is of course a creative role for firms in devising the new product, new technology, the more effective service or improved cost efficiency. [Schumpeter] And there are opportunities and rewards as well as punishments. Competition is a dynamic process; but that process is generated by the market pressure from alternative sources of supply and the desire to keep ahead.

While the absence of price competition was not considered to be a concern, the S-C-P focus on market structure was still significant. The Tribunal identified five elements to market structure analysis. These are:²⁹⁰

- (1) the number and size of independent sellers, especially the degree of market concentration;
- (2) the height of barriers to entry, that is, the ease with which new firms may enter and secure a viable market;
- (3) the extent to which the products of the industry are characterised by extreme product differentiation and sales promotion;
- (4) the character of 'vertical relationships' with customers and with suppliers and the extent of vertical integration; and
- (5) the nature of any formal stable and fundamental arrangements between firms which restrict their ability to function as independent entities.

Reducing barriers to entry was, true to form, seen as the key to a competitive market, on the grounds that it is contestability which guarantees workable competition:²⁹¹

²⁸⁷ Alan Bollard, "The Role of Antitrust in a Small Open Economy: The Commerce Act in New Zealand" in David Round (ed) *The Australian Trade Practices Act 1974: Proscriptions and Prescriptions for a More Competitive Economy* (Kluwer Academic Publishers, Netherlands, 1994) at 213.

²⁸⁸ *Re Queensland Co-operative Milling Assn Ltd (QCMA)* (1976) 8 ALR 481.

²⁸⁹ *QCMA* at 515.

²⁹⁰ At 516.

... it is the ease with which firms may enter which establishes the possibilities of market concentration over time; and it is the threat of entry of a new firm or a new plant into a market which operates as the ultimate regulator of competitive conduct.

New Zealand legislators would synthesize these lessons and apply them to the formulation of s 36 of the Commerce Act 1986.

Section 36 and the Use of Market Power

Section 36, like the purpose statement, has been the subject of significant debate and revision. As originally written, it was intended to prohibit the use of a dominant position in the market for the purposes of restricting entry to a market, preventing or deterring any person from engaging in competitive conduct, or eliminating any person from a market.²⁹² Person is defined to include local authorities and is “any association of persons whether incorporated or not”,²⁹³ a definition broad enough to include limited liability companies.

As for overall role of the court in defining competition policy, McGechan J commented:²⁹⁴

It is the permission of competition which the Court is directed to foster. Parliament, as a matter of policy, has decided benefits will flow from that course. Whether such is a correct economic or social analysis is not a matter for the Court. Within that objective, the particular objectives of ss 27 and 36 are clear... Section 36, following in the footsteps of a tradition at least as old as the Sherman Act (USC 15 ss 1-7) recognises that even in competitive markets dominant positions do arise which in the end can generate anti-competitive activity. Accordingly it is intended to prohibit the use of such dominant position within a market for serious anti-competitive purposes. Such provisions are directed at the protection of the concept of competition as such. They are not directed at the protection of individual competitors except in so far as the latter may promote the former.

It is clear from the previous discussion that the principle picked up is Bork's, monopoly obtained by efficiency is to be rewarded not prohibited. It is not the holding of a dominant position in the market which was prohibited, but merely

²⁹¹ At 516.

²⁹² Commerce Act 1986, s 36 as enacted 1 May 1986 to 30 June 1990.

²⁹³ Commerce Act 1986, s 2.

²⁹⁴ *Union Shipping v Port Nelson Ltd* [1990] 2 NZLR 662 at 669.

using that power for one of the three prohibited purposes, restricting, preventing or eliminating competitors from a market.²⁹⁵

One of the starting points for any s 36 analysis is the Australian case of *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd*.²⁹⁶ Broken Hill Pty Ltd (“BHP”) had a near total monopoly of the production and supply of steel in Australia, and it used this position to refuse to supply Y-bar (used for fencing) to Queensland Wire, except at an exceptionally high price. In other words, this was a classic ‘refusal to deal’ case, in which one monopolist was able use its power to restrict output and increase price for a product, with the intention of eliminating its rival from the market. BHP were able to use the inelastic demand features of the Y-bar market to impose standard Ramsey pricing, or all the price that the market could bear, on a captive consumer.

The line between what behaviour was competitive, and what was exclusionary was explored by the Court. Dawson J said:²⁹⁷

The difficulty in determining what conduct constitutes taking advantage of market power and what does not, stems inevitably from the need to distinguish between monopolistic practices, which are prohibited and vigorous competition, which is not. Both here and in the United States the search continues for a satisfactory basis upon which to make the distinction. For the most part, all that emerges are synonyms, which are not particularly helpful. Words such as ‘normal methods of industrial development’, ‘honestly industrial’, ‘anti-competitive’, ‘predatory’ or ‘exclusionary conduct’ merely beg the question.

As Mason CJ and Wilson J put it:

... the object of s. 46 [Australia’s equivalent to s 36] is to protect the interests of consumers, the operation of the section being predicated on the assumption that competition is a means to that end. Competition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away. Competitors almost always try to ‘injure’ each other this way.... The question is simply whether a firm with a substantial degree of market power has used that power for a purpose proscribed in the section, thereby undermining competition, and the addition of a hostile intent inquiry would be superfluous and confusing.

²⁹⁵ Compared with the prohibition on “partial or complete monopolies” in the Trade Practices Act 1958.

²⁹⁶ *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* (1989) ATPR 40-925; 167 CLR 177.83 ALR 577.

²⁹⁷ At 202.

Again as in Bork's work, competition is equated with efficiency which equals consumer welfare. Correctly, the Court held that by refusing to deal with Queensland Wire for the supply of Y-bar, BHP were in effect preventing competition in the parallel star picket post market, and that brought them afoul of the prohibited purposes in s 46.²⁹⁸

In order to establish liability under ss 27 and 36 of the Commerce Act 1986, the market in question must be defined.²⁹⁹ Again the *QCMA* case is taken as the starting point, the "market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them".³⁰⁰ If the market is defined too narrowly or too broadly, then anticompetitive behaviour may not be apparent. Too narrow an approach may be too permissive in failing to recognise the impact of non-competitive behaviour on competitors, too broad a view may unfairly penalise useful practices.

Once the market has been defined then the question becomes, what behaviour should be prohibited? Rather than detailing specific trade practices, as was the common practice in earlier legislation,³⁰¹ section 36 allows monopolistic practices in the interests of efficiency, but penalises those which have an anticompetitive purpose. The proper application of the law can be taken from Australian case of *Boral Besser Masonry Ltd v Australian Competition and Consumer Commission*³⁰² McHugh J identified the issues relevant to application of s 46.³⁰³

Section 46 of the Act poses four issues for determination. First, the court must identify the relevant market in which the conduct occurred. Second, the court must determine whether the alleged offender has taken advantage of that market power. Finally, the alleged offender must have engaged in the conduct for one of the proscribed purposes. This is the way in which s 46 is structured, and that is the way courts should apply it.

The apparent clarity and simplicity of section 36 is deceptive, however. Surely there can be few other legislative statements which have provoked more judicial and academic debate than have been provoked by asking whether market power has in fact been used for a proscribed purpose, or whether it was just rivalrous

²⁹⁸ At 193.

²⁹⁹ LexisNexis, above n 280, at 32.10.1.

³⁰⁰ *QCMA*, above n 288, at 517.

³⁰¹ Such as the Trade Practices Act 1958.

³⁰² *Boral Besser Masonry Ltd v Australian Competition and Consumer Commission* (2003) 195 ALR 609; (2003) ATPR 41-915.

³⁰³ At [263].

behaviour necessary in the ruthless cut and thrust of commercial life. The case of *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd*³⁰⁴ provided the solution in the notorious yet still accepted “counterfactual test”. The counterfactual test asks, if the firm whose conduct was in question was operating in a competitive market, and was not in a dominant position, would it have acted the same way? If so, then there was no abuse of market power for the purpose of s 36.

The counterfactual test was directly applied in New Zealand’s most important competition case of the 1990s, *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd*.³⁰⁵ Telecom, as a former state owned enterprise, had enjoyed a monopoly of the telecommunications market, until the 1st April, 1989, when the market was opened to competition. Thereafter it was required to allow its main competitor, Clear Communications, access to the Public Service Telecommunications Network (“PSTN”). The question then would be what should the company in the dominant position charge for access to an essential facility? With no regulating body to arbitrate, and no guidance from government, the solution would depend upon how well market forces could be constrained by the general prohibitions contained in s 36.

As the Privy Council asserted:³⁰⁶

Monopolies act to the detriment of the consumer by permitting the monopolist to charge higher prices than would be the case if there were a fully competitive market. This problem can be tackled in one or other or both of two ways viz by a regulatory body artificially restricting the price chargeable by introducing efficient competition.... The Commerce Act, inter alia, directed itself to both these processes: s 36 is designed to produce the competition which will, it is hoped, in due course compete out monopoly rents: Part IV of the Act enables immediate price restriction to be imposed by regulation.

The case is perhaps most famous for its institution of the Baumol-Willig or Efficient Component-Pricing Rule (“ECPR”). Professors Baumol and Willig instructed Telecom that they could charge their competitor a price equivalent to the opportunity cost of the service, without breaching s 36.³⁰⁷ In other words, the

³⁰⁴ *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* (1989) 83 ALR 577; (1989) 167 CLR 177 reaffirmed by the Supreme Court in *Commerce Commission v Telecom Corporation of New Zealand Ltd* (2011) 13 TCLR 270; [2011] NZCCLR 19.

³⁰⁵ *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385.

³⁰⁶ At 407-408.

³⁰⁷ At 394-397.

price would include the profit Telecom would lose by not supplying those customers. Their reasoning, familiar to us from the marginal cost controversy, was that marginal cost would not be the “correct yardstick” as that would not include the longer term costs of running the network.³⁰⁸ Rather the correct charge would be what a firm might charge in a perfectly contestable market, where ease of entry meant that monopoly pricing might attract new entrants. This was the counterfactual then; competitive behaviour would be defined according to what a firm acting in a competitive market and not in a dominant position would do.

The High Court found that under the ECPR Telecom did not breach s 36, but that decision was reversed on appeal.³⁰⁹ In the Court of Appeal, Gault J accepted that a firm in a dominant position was entitled to compete, he accepted that it would not amount to use of a dominant position to demand prices equivalent to those obtainable in a contestable market, but where he disagreed was that those prices could include the opportunity costs without breaching s 36.³¹⁰ The fact that the ECPR would allow the inclusion of monopoly profits invalidated the model altogether, particularly as it contained the risk that prices would be so high as to exclude Clear from entering the market at all. That Telecom had an anticompetitive purpose could be inferred from “the inevitability of the consequences of refusing to deal except on terms that lead to competitive disadvantage.”³¹¹ A fairer model would be to charge the “true cost” which would include only the incremental costs plus a reasonable rate of return. Cooke P added that in his judgment, a rule which required a competitor to indemnify its rival for the loss of custom was clearly anticompetitive.³¹²

The High Court judgment would be restored on appeal to the Privy Council, however. The Privy Council held that while it can be inferred from the effects of its actions that a firm in a dominant position has an anticompetitive purpose, it cannot be assumed that because that purpose exists that the dominant position was used.³¹³ The Privy Council applied Posner’s dictum: “A monopolist is entitled,

³⁰⁸ At 395.

³⁰⁹ At 400-402.

³¹⁰ At 400.

³¹¹ At 401.

³¹² At 401.

³¹³ At 402.

like everyone else to compete with its competitors: if it is not permitted to do so it ‘would be holding an umbrella over inefficient competitors.’³¹⁴

The ECPR rule was an entirely valid model for the way a “hypothetical firm would conduct itself.”³¹⁵ The key statement and application of the counterfactual is that:³¹⁶

In their Lordships’ view it cannot be said that a person in a dominant market positions ‘uses’ that position for the purposes of s 36 unless he acts in a way which a person not in a dominant position but otherwise in the same circumstances would have acted.

Gault’s ‘true costs’ model, with its reliance upon ephemeral benchmarks like a ‘reasonable rate of return’, would only create uncertainty, as “different minds can easily reach different views on what is reasonable or justifiable.”³¹⁷ Monopoly markets should be dealt with in two ways, either by introducing efficient competition, or by empowering a regulatory body to restrict prices. Section 36 could not be used as a “quasi-regulatory system” for controlling prices, when Part 4 had already been designed for that purpose.³¹⁸ Calculating a reasonable monopoly profit under Gault’s model would be too complicated for both the courts and the firm itself. Such investigations are “the function of regulatory bodies who can make decisive value judgments. They are the daily diet of a regulatory body.”³¹⁹ Furthermore, the choice of whether to invoke the Part 4 machinery was for the Governor-General, on the recommendation of the Minister, to decide, “But what policy the government adopts is no concern of the Courts.”³²⁰

The Privy Council was satisfied that the ECPR still provided scope for competitive pressure through efficiency and better service, but the reduced ability for rivals to compete on price seems to have been less of a concern. The possible existence of monopoly rents did not invalidate the model.³²¹ The point of s 36 is to promote competition, not to control prices. So long as Clear and Telecom were charging customers on the same basis, then there was a level playing field, no

³¹⁴ At 102.

³¹⁵ At 403.

³¹⁶ At 403.

³¹⁷ At 403.

³¹⁸ At 408.

³¹⁹ At 408.

³²⁰ At 408.

³²¹ At 396.

matter how high those prices might be. So long as Clear efficiently competed for customers up to the “point alpha”, the point the customer connected to the PSTN, there would still be a downward pressure on the opportunity cost which would compete out monopoly prices and benefit consumers. Forcing Telecom to charge less than ECPR for access to the PSTN would amount to subsidizing Clear which would reduce competition in the contested area.

On the question of monopoly rents, the Privy Council accepted the High Court’s finding of fact that these could not be proved. Adoption of the ECPR might allow Telecom to recover monopoly rents, but deciding whether they existed or not would require investigations of such complexity that they were beyond the competence of the court. The point is crucial to the price squeezing issue:³²²

The High Court ... next considered whether the amount of the monopoly rents included in Telecom’s opportunity cost might lead to the price payable by Clear for access to the PSTN being so high that it could not possibly enter the contested area as a competitor at all. So far as Their Lordships can detect, the High Court made no finding of fact on this issue specifically, presumably because, having found that the existence of any monopoly rents had not been proved, the point did not arise.

What should have been the heart of the matter was dismissed. The sort of in-depth analysis which might have revealed that Telecom’s behaviour constituted a price squeeze was assumed to be beyond the proper remit of the Court. Allowing the ECPR to function would probably compete out such monopoly rents if they existed, and if it did not, then the decision to control prices should be left to government to decide.

Telecom v Clear was therefore a crucial step in the development of competition law in New Zealand. It established that the Baumol-Willig rule was the appropriate s 36 counterfactual test for a dominant vertically integrated firm’s conduct in the market. It considered the relationship between s 36 and Part 4 price control and decided that s 36 could not take the place of Part 4 price regulation. Controlling prices should be left as a matter for government policy and executed by the appropriate regulatory agency.

The decision also holds a special place in the history of the marginal cost controversy and the total surplus versus consumer welfare debate. To recap, the marginal cost controversy was the debate sparked in the 1940s by the suggestion

³²² At 398.

that essential services should be supplied at the marginal cost. Coase's response has become one of the foundations of dynamic efficiency to this day. Marginal cost cannot be the benchmark by which prices are measured because marginal cost pricing fails to provide sufficient capital for long term development. Chicago School theories hold that monopoly profits are necessary for long term growth, they stimulate new entry, new technology and the investment required to deal with growing demand. Regulation should be kept to the absolute minimum and price controls are only necessary in natural monopoly markets, such as electricity transmission networks, where competition is not feasible. This is workable competition as it was conceived by the Chicago School and realised in the Commerce Act.

Telecom v Clear observably fits within this dialectic. By rejecting Gault's alternative to ECPR, the 'true cost' model, the Privy Council had all but eliminated the option of using the courts s 36 powers to control prices. By including opportunity costs, the ECPR would allow for monopoly profits which could then contribute to dynamic efficiency and long term development. Unfortunately, for the rule to operate, the courts would still have to regularly review those access charges to ensure they reflected the downward trend on that opportunity cost created by Clears competition.³²³ That would seem to undercut the argument that the courts would not have a role, but that point was something of an aside. The main thrust was to allow the market to set prices, and to reduce the role of the courts as far as was practicably possible.

According to Rex Ahdar the result has been that, while the legislation promised much, it failed to deliver.³²⁴ Ahdar argues that this ineffectuality stems from "a specious fairness or parity premise ... that powerful firms are entitled to compete as much as small, ordinary firms."³²⁵ Ahdar argues that the dominant firm by the reason of its overwhelming economic force cannot and should not be treated in the same way as the small business.³²⁶ By adopting Posner J's well known objection to holding an 'umbrella' over the inefficient, the Privy Council

³²³ At 406.

³²⁴ Rex Ahdar "Escaping New Zealand's monopolisation quagmire" (2006) 34 ABLR 260.

³²⁵ At 260.

³²⁶ At 261.

rationalised monopolistic behaviour to the point where s 36 could almost never be breached.³²⁷

The prospect that innovative and efficient behaviour by the monopolist will be ‘chilled’ is a real danger and not to be lightly dismissed. By 2006, however, the time Ahdar was writing, there had only been four successful s 36 actions since its enactment in 1986. This was so even after the high threshold set by the dominant position standard was softened to prohibiting taking advantage of a “substantial degree of power in a market.”³²⁸ But then in 2009 in *Commerce Commission v Telecom Corporation of New Zealand Ltd*,³²⁹ Telecom was successfully prosecuted for breach of s 36 and fined \$12 million, a record penalty under the legislation.

The case arose competitors were required to pay Telecom for the right to connect to potential internet customers through the local access network datatail links which, outside of the major CBDs, were in Telecom’s sole possession.³³⁰ The Commerce Commission’s allegation was that Telecom had been setting its price for access to these datatails deliberately high with the intention of excluding its competitors from the retail market, a classic price squeeze.³³¹ This was a breach of the “duty on a vertically integrated incumbent to supply an essential wholesale input to a competitor in a downstream market as found in *Queensland Wire Industries Pty Limited v Broken Hill Pty Co Limited*.”³³² The case is therefore somewhat analogous to the *Telecom v Clear*, and the Court accepted that there was no real distinction between the two cases in terms of pricing issues, so why then was the result so different?³³³ Was Telecom’s behaviour really so much more egregious, or was it simply because of the changes to s 36?

The Court considered s 36, and as Telecom’s conduct traversed both regimes, what changes had been made by the 2001 amendment which shifted focus from

³²⁷ *Olympia Equipment Leasing Co v Western Union Telegraph Co.* (1986) 797 F (2d) 370 at 375 cited in *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385 at 402.

³²⁸ Commerce Act 1986, s 36 as amended 25 May, 2001.

³²⁹ *Commerce Commission v Telecom* HC Auckland CIV-2004-404-1333, 9 October 2009.

³³⁰ At [42].

³³¹ At [3].

³³² At [127].

³³³ At [128].

use of a dominant position to taking advantage of a substantial degree of power.³³⁴ Whether there was any difference between the two versions was not considered to be an issue, rather the question was whether Telecom's pricing policy had breached the counterfactual test.³³⁵ The easy assumption that the two tests could be read in the same way is surprising, but at least it demonstrates confidence that ECPR is a definite test for anticompetitive behaviour in pricing involving a "dominant vertically integrated provider of network infrastructure and services".³³⁶

Telecom was found to be consistently charging rivals above the efficient price, and well above the price it charged its own retail customers.³³⁷ It seemed that Telecom's strategy was to charge at such an extortionate level, that the rival service provider would not be able to compete on retail price at all. Despite Telecom's submissions, the Court held that the *Telecom v Clear* was clearly applicable.³³⁸ Telecom's behaviour had amounted to a price squeeze which occurs when:³³⁹

... a dominant vertically integrated supplier sets prices in the upstream wholesale market in a manner that prevents equally or more efficient competitors from profitably operating in the downstream retail market.

As purpose can be inferred from effects, Telecom's imposition of such high prices amounted to refusal to supply, which was sufficient evidence of anticompetitive purpose to breach s 36.³⁴⁰

The case is predicated on the assumption that the holder of an essential facility owes a duty to supply to its competitors, and at a price consistent with the ECPR, which is extremely similar to the prime necessity doctrine. The high sunk costs relative to potential business involved in building alternative local access networks outside the CBDs implied that Telecom had a duty to provide access.³⁴¹ The difference is that, rather than a reasonable price standard, the maximum price is set by the ECPR. Pricing above ECPR would impede efficient entry, which

³³⁴ At [7].

³³⁵ At [9]-[12].

³³⁶ At [11].

³³⁷ At [123]-[124].

³³⁸ At [128].

³³⁹ At [3].

³⁴⁰ At [136]-[151] and [188]-[189].

³⁴¹ At [127].

would reduce contestability, but the inclusion of opportunity costs could mean that prices themselves were quite high.

In *Telecom v Clear* the Court had shown a reluctance to investigate complex price issues more appropriate to the functions of a regulatory agency. Where there is a natural monopoly, the appropriate price control mechanism has long been held to be under Part 4. The Court took a far more relaxed approach to the difficulties of investigating breaches. Even if the Commerce Commission was unable to prove the complete extent of Telecom's violations of the ECPR, that would not prove fatal to their case. So long as the breaches were more than "*de minimis*" their actual number and extent would only go to "the gravity of the breach, not to its existence."³⁴² Anecdotal evidence of financial losses, and that one telecommunications company was forced from the field, was held to be consistent with the economic theory.³⁴³ Part 4 was not considered at all, which makes the case tantamount to acceptance of the proposition that s 36 can be used as a price control, if only because pricing above ECPR will be penalised.

The Commission requested a penalty fine of \$20-25 million under s 80 of the Commerce Act.³⁴⁴ Section 80 gives the court discretion to impose up to \$500,000 for an individual, or the greater of \$10,000,000, or 3 times the value of the gain for a body corporate, or if that cannot be ascertained, 10% of the turnover of the body corporate.³⁴⁵ The factors to be considered when imposing a penalty are:³⁴⁶

- (a) The nature and extent of the contraventions.
- (b) The duration of the contravening conduct.
- (c) The deliberateness of the conduct.
- (d) Knowledge of senior management.
- (e) The commercial gain derived.
- (f) Loss or damage to others.

Rodney Hansen J said, that because of the "bewildering complexity" of Telecom's submissions: "Without expert assistance, I am not competent to resolve the plethora of issues which must be determined in order to quantify gains from non-

³⁴² At [131].

³⁴³ At [134]-[135].

³⁴⁴ *Commerce Commission v Telecom Corporation of New Zealand Ltd* (2011) 13 TCLR 270; [2011] NZCCLR 19.

³⁴⁵ Commerce Act 1986, s 80(1).

³⁴⁶ *Commerce Commission v Telecom Corporation of New Zealand Ltd* at [7].

compliant sales.”³⁴⁷ The Commission’s position was that even if the gains were “inherently unquantifiable...their assumed effects support a severe penalty.”³⁴⁸ The Court agreed and reasoned that as the primary objective of the pecuniary penalty is deterrence, it must be sufficiently high to amount to more than a licence fee for the prohibited behaviour.³⁴⁹ Telecom’s group annual turnover was assessed at \$2.792 billion, so the maximum penalty was potentially \$279.2 million. Telecom might consider themselves fortunate to have escaped with a mere \$12 million slap on the wrist.

What are the implications of the Datatails judgment? First, it is the largest penalty ever imposed under s 36 of the Commerce Act and as such reflects a new determination to treat anti-competitive behaviour severely. Secondly, it opens a new category of anti-competitive behaviour, market cornering or price squeezing, up to scrutiny. Thirdly, far from distinguishing *Telecom v Clear*, it confirms that a dominant vertically integrated firm’s refusal to supply access to an essential input at ECPR can be used to infer anticompetitive purpose in breach of s 36. Fourthly, it implies that s 36 may be used to involve the courts in a ‘quasi-regulatory’ role, which blurs the line between s 36 and Part 4. Finally, as the case is precedent for the proposition that market cornering can breach s 36, it may well have relevance for analysis of the Electricity Authority’s UTS decision of March 26, 2011.

Price Control under Part 4 of the Commerce Act

While s 36 was intended to prohibit abuse of market power, routine price control of the free market was intended to be a thing of the past. Part 4 of the Commerce Act provides the proper mechanism for the imposition of price control, and as we have seen, attempts to use s 36 as a ‘quasi- regulatory system’ were supposed to have been rejected.³⁵⁰

Like s 36, Part 4 has been extensively scrutinized and amended. The Commerce Amendment Act 2001 introduced Part 4A which gave the Commerce Commission

³⁴⁷ At [26].

³⁴⁸ At [28].

³⁴⁹ At [4] citing *Commerce Commission v BP Oil New Zealand Ltd* [1992] 1 NZLR 377 (HC) at 383.

³⁵⁰ See *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] above n 305.

authority to impose ‘targeted control’ of electricity lines distribution prices.³⁵¹ Under Part 4A the Commerce Commission set thresholds for price and quality performance, and would only intervene if those were breached. Perceptions that the process was unpredictable and arbitrary lead to the 2006 review of price control which resulted in the Commerce Amendment Act 2008 and the replacement of Parts 4 and 4A with a new part 4.³⁵²

The Cabinet Economic Development Committee suggested that the preferred option would include a clearer purpose statement, a “more conventional qualitative test for when regulation may be imposed and a wider range of regulatory options.”³⁵³ They referred to economic efficiency versus “consumer protection/distributional considerations” and pointed out that the debate “does not fit well with the key regulatory objectives of clarity, certainty, transparency and predictability.”³⁵⁴ The option of an efficiency-only purpose statement was considered and rejected in favour of a purpose statement which balanced protection of producers, investors and consumers.

The Court of Appeal, referring to the pre-amendment Part 4, said that it is:³⁵⁵

... aimed not at the promotion of competition, which is not possible in monopolistic (or monopsonistic) markets, but at mimicking the economic externalities of effective competition for the benefit of either acquirers (s 52(b)(i)) or suppliers (s 52(b)(ii)) of goods or services.

The goal is to provide, via external monitoring and administration, the same kinds of competitive pressures which would be provided by a workably competitive market but where such a market does not and cannot exist.

In deciding whether to regulate markets under the new Part 4, the Commission must have regard to the purpose of the Commerce Act, to “promote the long term benefit of consumers in New Zealand.”³⁵⁶ It must consider first, the incentives to

³⁵¹ See Barry Barton, “Law and Regulation for Energy Networks in New Zealand” in Martha Roggenkamp and others (eds) *Energy Networks and the Law: Innovative Solutions in Changing Markets* (Oxford University Press, Oxford, 2012) at 277-279. See also Minister of Commerce and Minister of Energy “Review of Parts 4 and 4A of the Commerce Act” (Cabinet Paper, published 22 November, 2007).

³⁵² Minister of Commerce and Minister of Energy “Review of Parts 4 and 4A of the Commerce Act” (Cabinet Paper, published 22 November, 2007) at 39.

³⁵³ At 41.

³⁵⁴ At 41.

³⁵⁵ *Powerco v Commerce Commission* [2008] NZCA 289 at [3].

³⁵⁶ Commerce Act 1986 s 1A, see above n 279.

innovate and to improve efficiency, secondly, that the benefits of those improvements are shared with consumers and, thirdly, that suppliers of regulated goods and services are “limited in their ability to extract excessive profits.”³⁵⁷ These three components are represented by the following three tests:³⁵⁸

1. The Competition Test;
2. The Other Constraint Test; and
3. The Net Benefit Test.

The Competition Test has two limbs. There must be:

- little or no competition; and
- little or no likelihood of a substantial increase in competition.

The first limb would be satisfied if the market was dominated by a monopolist who is free to act independently of constraints posed by actual or potential rivals. There should also be little or no possibility of customers substituting alternate goods or services or using their countervailing power to lower prices or lift output. Part 4 applies, but is not explicitly limited, to natural monopolies such as electricity lines businesses. In markets where there is the possibility of competition, however, contestability will be allowed to operate, and Part 4 will have no application.

For the purposes of the second limb, whether or not there is the likelihood of a ‘substantial increase in competition’ will be judged over a significant period of time. The procedure is that, on the recommendation of the Minister, the Governor General makes an Order in Council which must contain an expiry date of no more than 20 years.³⁵⁹ There is no explicit ban on using Part 4 to prevent short term market cornering, but the Commerce Commission has stated that “the appraisal should not be limited to immediate or short term changes”.³⁶⁰ Part 4 regulation, in its current form, would be an unlikely remedy to correct price spikes as a consequence of one off market cornering events in normally contestable markets.

The Commission must then apply the Other Constraints test. This test considers how much market power a participant is capable of exercising, “taking into

³⁵⁷ Section 52A(1)(a)-(d).

³⁵⁸ Section 52G(1)(a)-(c).

³⁵⁹ Section 52N.

³⁶⁰ Commerce Commission, “Milk Markets: Consideration of Whether to Initiate a Commerce Act Inquiry into Milk Prices” (Wellington, August, 2011) < www.comcom.govt.nz > at 27.

account the effectiveness of existing regulations or arrangements, (including ownership arrangements)”.³⁶¹ In the electricity market, the alternate regulatory restraint would be provided by the Electricity Authority and the market restraint would be provided by the various competing entities, particularly the big five generation retailer companies, Genesis, Mighty River Power, Contact, Trustpower and Meridian.

The final test is the Net Public Benefit test (“NPB”), which may only be applied if the first two tests have been satisfied. The NPB requires the Commission to make a qualitative analysis of all “efficiency and distributional considerations.”³⁶² The Commission must first quantify allocative, productive and dynamic efficiency effects, then consider “distributional and welfare consequences on suppliers and customers” and finally, “assess the direct and indirect costs and risks of any type or regulation considered, including administrative and transaction costs, and spill-over effects.”³⁶³ The reference to spill-over effects is interesting in that it reflects Baumol’s continuing influence. The ideal regulation then should minimise administrative costs while encouraging innovation in the interests of promoting the total surplus. The focus is on whether the benefits of regulation materially exceed the costs. The default setting, after all, is not to regulate. There must be a clear case that the wealth transfers are so great, that the balance is so clearly in the producer’s favour, that the Commerce Commission has no choice but to intervene.

Applying this test requires demanding in-depth analysis on the part of the regulator. Quantifying the three main forms of efficiency, as well as the ongoing welfare consequences, costs and unintended consequences of regulation in any detail, would absorb significant resources, which may, in themselves, actually act as a deterrent on the regulator. Given this high threshold, that the benefits of regulation materially exceed cost, and considering the extensive and expensive scrutiny required, it is likely that price regulation will seldom occur. Indeed as Ben Hamlin put it:³⁶⁴

A Pt 4 inquiry can be triggered by the Commission itself or by the Minister requesting that the Commission hold an inquiry (s 52 H). In practice the

³⁶¹ Section 52G (1)(b).

³⁶² Section s 52I (2)(b).

³⁶³ Section 52I (3)(a-c).

³⁶⁴ Ben Hamlin “Part 4 Commerce Act Regulation” in Matt Sumpter *New Zealand Competition Law and Policy* 345, above n 21, at 352.

Commission is unlikely to conduct one on its own motion because the cost is enormous. Indeed a price-control inquiry is so expensive that the Commission generally needs an additional specific appropriation of funds from Parliament to do the job.

It should also be noted, however, that Part 4 provides a range of regulatory responses including information disclosure, negotiation or arbitration, default or customised price-quality regulation and individual price-quality regulation.³⁶⁵ Under the Net Public Benefit test, the more expensive the analysis and intensive the regulation required, the less likely it is that it will be undertaken. The cheapest options requiring the least intervention will be preferred, expensive price control need not be the first choice. As the Commission has said: “Any regulation should be the least intrusive necessary to meet the objectives of the purpose statement.”³⁶⁶ The wider range of regulatory responses allows the Commission to take a more reasoned and flexible approach to intervention; it is less of a zero sum game.

The Commerce Commission, the Electricity Authority and Applying the Total Surplus Standard

A guiding theme of this thesis is whether our regulatory authorities will apply a total surplus or a consumer surplus standard when regulating potentially anti-competitive behaviour. As we have seen in the 2008 review which led to the new Part 4, the efficiency only purpose statement was rejected. The Commerce Commission’s approach after the 2001 amendment, on the other hand, had been to take a neutral position on wealth transfers.³⁶⁷

For the purpose of determining both detriments and benefits, the longstanding practice has been to ignore wealth transfers from New Zealand consumers to producers that result from higher prices. The underlying principle is that the welfare effect of changes in the distribution of income, where one group within the public of New Zealand gains while another simultaneously loses, is neutral. ... we are satisfied that introduction of s 1A should not disturb the Commission’s established practice of treating as neutral any wealth transfers between New Zealand consumers and producers.

³⁶⁵ Commerce Act 1986 subparts 4-7.

³⁶⁶ Minister of Commerce and Minister of Energy “Review of Parts 4 and 4A of the Commerce Act”, above n 352, at 7.

³⁶⁷ *Air New Zealand v Commerce Commission (No 6)* (2004) 11 TCLR 347 at [238]-[241].

The determination to treat wealth transfers neutrally was consistent with the total surplus standard. The Commission would not intervene in distributional questions which might favour producers or consumers, but focus on encouraging efficiency gains which might increase the total welfare.

How then did this approach sit with practice overseas? Geoff Bertram argued that the whole-hearted adoption of wealth transfer neutrality and its total surplus standard premise made New Zealand almost unique amongst OECD countries.³⁶⁸ In countries like the United States and the United Kingdom the application of the consumer welfare approach “gives primacy to the welfare of consumers and therefore counts the elimination of monopoly-rent transfers as a public benefit.”³⁶⁹ Here Bertram failed to give weight to the strength of total surplus arguments which have found their way into the consumer welfare debate in the US, and may in fact have fallen into the Chicago trap which equates total benefit with consumer welfare.³⁷⁰

In Canada the courts have gone a long way towards rejecting wealth transfer neutrality and Bertram argued that New Zealand should follow their lead. In *Canada (Commissioner of Competition) v Superior Propane Inc.*,³⁷¹ the Canadian Federal Court of Appeal was faced with determining whether a merger which would result in the creation of a monopoly in gas distribution should be allowed in the interests of efficiency. This ‘efficiency defence’ would allow monopolies if there was a clear public benefit. The question was whether the total surplus or the ‘balancing weights standard’ would provide the proper balance between public benefit and efficiency.³⁷²

The merger would have resulted in gains to the Canadian economy of \$29.2 million and losses of only \$6 million. Under the total surplus standard the overall economic gain was the sole consideration and, by applying that standard, the Tribunal allowed the merge. Under the total surplus standard:³⁷³

³⁶⁸ Bertram “What’s wrong with New Zealand’s Public Benefits Test” (December, 2004) NZEP 38(2) 265.

³⁶⁹ At 266-267.

³⁷⁰ See Jones and Sufrin, above n 142.

³⁷¹ *Canada (Commissioner of Competition) v Superior Propane Inc.*, 2001 FCA 104, [2001] 3 FC 185.

³⁷² Bertram at 267.

³⁷³ *Superior Propane* at [42]-[47].

... the wealth likely to be transferred from consumers to producers as a result of the merger is not considered to be an anti-competitive effect, because such a transfer is neutral: that is, it neither increases, nor decreases total societal wealth. Proponents of the total surplus standard argue that there is no economic reason for favouring a dollar in the hands of consumers... over a dollar in the hands of the producers or its shareholders, who are, after all, also consumers.

The Court preferred that a flexible balanced weights approach be followed, giving consideration to the full range of anti-competitive effects, including the wealth transfers which would result from increased prices.³⁷⁴

The purpose of the Canadian Competition Act is to:³⁷⁵

... maintain and encourage competition in Canada in order to promote the efficiency and adaptability of the Canadian economy, in order to expand opportunities for Canadian participation in world markets while at the same time recognizing the role of foreign competition in Canada, in order to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the Canadian economy and in order to provide consumers with competitive prices and product choices.

The Commerce Act 1986 makes no such provision for the protection of local or small business from the effects of globalization, which somewhat undermines Bertram's suggestion that *Superior Propane* is applicable in New Zealand. Even so he does raise a valid point, why does New Zealand, whose economy is orders of magnitude smaller than Canada's, not make such provision?

The matter was sent back to the Tribunal to be re-determined according to the balanced weights approach. It is interesting to note the subsequent events. In its redetermination, the Tribunal again approved the merger, and did so by applying a 'socially adverse effects approach'.³⁷⁶ Of the entire \$40.5 million of wealth transferred, only \$2.6 million was extracted from low income households and only that amount was offset against the efficiency gains.

This time the Court approved of the Tribunal's reasoning, affirming that it is not monopolies per se which are prohibited but rather the effects of monopoly which are to be considered.³⁷⁷ The ultimate result is that *Superior Propane* [2003] must be interpreted as a backward step away from the balanced weights approach of the original appeal and a long step towards the total surplus standard. Again this

³⁷⁴ *Superior Propane* at [159]-[162].

³⁷⁵ Competition Act, RSC 1985, c C-34, s 1.1.

³⁷⁶ *Canada (Commissioner of Competition v Superior Propane Inc.*, 2003 FCA 53, [2003] 3 FC 529 at [23]

³⁷⁷ At [46]-[51].

suggests that the total surplus standard, or versions of it, are influential world-wide and Bertram's thesis that New Zealand is out of step with international practice is further weakened.

In New Zealand, the 2008 case of *Powerco Ltd v Commerce Commission* directly confronted the relevance of wealth transfers in Part 4 price regulation.³⁷⁸ In *Powerco* the Commerce Commission had included wealth transfers from consumers to Powerco as a factor in its decision to regulate Powerco's gas distribution prices. The decision applied to Part 4 prior to its 2008 amendment, but the discussion of wealth transfer issues is still revealing. Under ss 52(b)(i) and 56(1) of Part 4 as they were then, price control could be imposed where the goods are being "supplied or acquired in a market in which competition is limited or is likely to be lessened" where the acquirer is purchasing from a person who "faces limited or lessened competition for the supply of those goods or services."

According to the Commission, Powerco's basic argument seemed to be that a "cost-benefit analysis that subjects the interests of acquirers [of gas] to the interests of the economy... as a whole" must be applied.³⁷⁹ In other words, the welfare of consumers must be subjugated to the greater good, a classic restatement of the total surplus standard. Powerco denied that this was the case, but rather that as the "net efficiencies" obtained by acquirers were the sole concern of the court, the question of wealth transfers should be ignored.³⁸⁰

The Court responded:³⁸¹

We find no substance to this point. ... It amounts to the proposition that what is good for the economy as whole is good for any sub-set of it, and therefore good for a particular sub-set, in this case acquirers.

The Court accepted that it is correct to exclude wealth transfers when controlling restrictive trade practices such as mergers and acquisitions, but that such reasoning had no place in Part 4 regulation. The Court indeed seemed to be rejecting the utilitarian Net Public Benefit test altogether.³⁸²

We cannot accept that s 52 envisages only an NPB [net public benefit] test, even if that test is couched in terms of acquirers. NPBs, by their nature, do not discriminate between discrete groups in the economy. They are truly

³⁷⁸ *Powerco v Commerce Commission* [2008] NZCA 289.

³⁷⁹ At [18]-[19].

³⁸⁰ At [20].

³⁸¹ At [21].

³⁸² At [29]-[30].

utilitarian, with each economic actor counting for no more or less than any other. But s 52 expressly provides for acquirers. ... The reference to acquirers must have a practical effect on the consideration to be undertaken.

The fact that other parts of the Act properly exclude valuation of wealth transfers does not determine the correct interpretation of Part 4. We are satisfied that to adopt the appellants approach would so shrink the application of Part 4 as to render control virtually a practical, if not a theoretical, impossibility.

In both *Powerco* and *Superior Propane* the courts appeared to have rejected the total surplus standard in order to retain control of natural monopolies. In New Zealand the focus was on protecting the rights of acquirers (consumers), in Canada the legislation explicitly provided for protection of ‘small and medium-sized enterprises’. In both cases it appeared that the Total Surplus Standard was finding less favour with the courts demonstrating a willingness to take a more interventionist stance.

Superior Propane, however, was re-determined according to the ‘socially adverse effects’ approach which severely diluted the ‘balanced weights’ approach. Rather than being concerned with ensuring that wealth transfers from consumers to producers be outweighed by the total efficiency benefits, only the wealth transfers from low income families would be included. This is not a pure total surplus standard approach, but it is very close to it.

As for the *Powerco* case, the Ministry of Economic Development’s review of Parts 4 and 4A and sections 70-73 of Part 5 of the Commerce Act had resulted in significant amendments which suggest that the balanced weights approach may be closer to the legislative intent.³⁸³ It is possible therefore that a very different judgment might have been delivered on those facts after the amendment occurred. The wider range of regulatory measures available under the new Part 4 might have resulted in a different remedy, for example to arbitrate or negotiate different terms. The cost/benefit threshold is still very high however, and may have precluded regulation altogether.

³⁸³ Minister of Commerce and Minister of Energy “Review of Parts 4 and 4A of the Commerce Act”, above n 352. *Powerco*’s judgment was delivered on 11th August, 2008. The Commerce Act was amended as of 14 October, 2008.

Gault on Commercial Law discussed the amendment, in light of the *Powerco* decision, and concluded that:³⁸⁴

While the new provision focuses on promoting the long term benefit of consumers, the Court of Appeal's reasoning in relation to the interpretation of the interests of acquirers suggests that the cost benefit analysis required before control can be imposed will value wealth transfers to consumers as a benefit to consumers.

It is submitted, however, that the threshold requirements of the three tests are still extremely high, and price control will be the exception rather than the rule.

Regulating Electricity After Wolak and the ETAG Report

This section of my thesis will analyse the powers of the Electricity Authority, particularly with reference to the 'Undesirable Trading Situation' regime and the Authority's response to the price spike of 26th March, 2011.

Electricity regulation has its own distinct challenges. These stem from the peculiar physical characteristics of electricity as a commodity and the unique history and development of the electricity industry, both in New Zealand and internationally.³⁸⁵ Regulation of the industry has broadly followed the familiar trend from state monopoly to light handed regulation. Once a wholly stated owned monopoly, the responsibility for electricity generation was delegated to an oligopolistic vertically integrated market dominated by a few corporatized state owned enterprises.³⁸⁶ Transmission was the domain of Transpower, the system operator, with the final distribution in the hands of 28 Local Network Companies. Competition has been fostered only at the wholesale generation and retail stages. Regulation of the wholesale and retail sectors would be limited to that provided by general competition law, information disclosure and the threat of further regulation, but with no industry specific regulatory body.³⁸⁷ It was intended that the New Zealand Electricity Market ("NZEM") would be self-regulating, but after

³⁸⁴ T.M. Gault and Barry Allan, *Gault on Commercial Law* (Thomson Reuters, Wellington, 2010) at 2B.3.02.

³⁸⁵ See Barry Barton, "Electricity Regulation in New Zealand: the Early Stages of a New Regime" (2008) 26 JERL 207 and Rex Ahdar, "The New Zealand Electricity Industry and the Limits of Competition Law" (2010) 18 ULR 51.

³⁸⁶ With the exception of Contact Energy Limited, a publicly listed company, which holds a 27% share of generation, see Ahdar at 53.

³⁸⁷ Barton "Electricity Regulation" at 209.

a 2003 industry referendum failed to come to a consensus on the appropriate self-regulatory mechanisms, the Electricity Commission was established.³⁸⁸ The attempt to self-regulate was over.

The Electricity Commission's objective was to ensure the production and delivery of electricity "in an efficient, fair, reliable and environmentally sustainable manner."³⁸⁹ Concerns were raised that these broad statutory objectives might prove contradictory. The decision not to renew Electricity Commission chief Roy Hemmingway's contract after the Commission rejected Transpower's controversial Whakamaru to Otahuhu transmission line also raised apprehension about a lack of independence.³⁹⁰ At the same time concerns continued to be raised about the rising cost of electricity and the seeming failure of the corporatization to provide benefits to electricity consumers. In one horrendous incident a low income sickness beneficiary died after the power to her oxygen machine was switched off for an alleged unpaid account.³⁹¹

Two influential reports were prepared about the problems of regulating electricity. These were the Commerce Commission's *Investigation Report: Commerce Act 1986 s 27, s 30 and s 36 Electricity Investigation*³⁹² ("Investigation Report") and the Electricity Technical Advisory Group and Ministry of Economic Development's "Improving Electricity Market Performance: Volume one"³⁹³ ("ETAG report").

The Commerce Commission and the Wolak Report

The *Investigation Report* included conclusions from the well-known "Wolak Report" that the four main generators had used their market power over a six and a half year period to extract some \$4.3 billion in excess profits from the NZEM wholesale electricity market.³⁹⁴ When the monolithic Electricity Corporation of

³⁸⁸ At 210.

³⁸⁹ Electricity Authority "About the Electricity Commission" <www.ea.govt.nz>.

³⁹⁰ Barry Barton "Electricity Regulation in New Zealand" at 214-215.

³⁹¹ Ahdar at 52.

³⁹² Commerce Commission "Investigation Report: Commerce Act 1986 s 27, s 30 and s 36 Electricity Investigation" (21 May 2009) <www.comcom.govt.nz/investigation-reports/>.

³⁹³ Electricity Technical Advisory Group and Ministry of Economic Development "Improving Electricity Market Performance: Volume one" (August, 2009) <www.med.govt.nz>.

³⁹⁴ Commerce Commission "Investigation Report" at 6.

New Zealand was broken up between 1995 and 1998, it was expected that a four firm market structure with low barriers to entry and light handed regulation would stimulate contestability and dynamic efficiencies. The Commission concluded that the results had been somewhat different:³⁹⁵

The Commission... considers that these four companies have exercised their market power, for substantial periods, by offering their generation output into the wholesale market at prices above those that they would have offered under competitive conditions. The periodic and recurring nature of these bouts of high prices, together with high entry barriers, means that potential entry has not been able provide a constraint on the exercise of market power.³⁹⁶

In other words, the basic assumption that oligopolistic markets would be disciplined by potential contestability had failed. The report also found that high prices occurred regardless of whether there had been transmission constraints or not.

Despite that conclusion, the Commission resolved that there was insufficient “evidence at this stage of further anti-competitive behaviour to warrant continuing its investigation”.³⁹⁷ Even though “serious systemic issues” with the market structure provided opportunities and incentives for the four main generators to game the system, the Commerce Act had not been breached.³⁹⁸ The lawful use of market power to maximise profits did not breach Part 2 of the Commerce Act.³⁹⁹ Rather, the behaviour was a product of the design of the market and the nature of electricity as a commodity. Whether or not there should be a Part 4 inquiry was for the Government to decide after consideration of the full range of regulatory responses.

Contestability in the NZEM was further reduced by the lack of a liquid hedge market. Hedges are typically contracts to provide a set amount of electricity at a set price over a certain period in time. Competitors and consumers (such as NZ Steel) who buy electricity in bulk from the wholesale market need to consider a purchasing policy which balances the overall lower prices in the NZEM with the risk that prices could spike. There is no cap on prices in the wholesale market and prices can go as high as the market will bear, with very little notice. Hedges can

³⁹⁵ At 6.

³⁹⁶ At 9.

³⁹⁷ At 6.

³⁹⁸ At 7.

³⁹⁹ At 11-12.

therefore been seen as a form of insurance, and must be included in any sensible risk management policy.

A properly liquid hedge market would do a great deal to even out the risks from price volatility in the wholesale market. It would also offer opportunities for contestability from new entrants who lacked generation facilities, but wished to compete in the retail sector, or vice versa. Attempting to obtain retail market share, with insufficient generation capacity to meet demand, was described by one participant as ‘insane’.⁴⁰⁰ New entrants were forced to purchase hedges from the big generators on the wholesale market, and then compete with the same generators who sold them for the same customers.⁴⁰¹ Only a vertically integrated company, able to cover its retail demand by selling electricity it generated itself, could hope to survive. Vertical integration was, in fact, the inevitable result of, and solution to, the lack of adequate hedging. Generation and retail base are geographically aligned and:⁴⁰²

Vertically integrated generator-retailers can limit competition because they operate in two markets and can cross-subsidize operations.... [T]he generation-retail structure means that companies are managing risk internally, to the detriment of transparency and price discovery – prerequisites for a competitive market.

Gentailers (the vertically integrated electricity generation and retail companies who account for 96% of the retail market)⁴⁰³ are thus able to manage their own supply and demand. New Entrants, without sufficient generation capacity to cover their customers demand, are exposed to the volatility of the NZEM. This does not make an attractive picture for investors or creditors and makes developing startup electricity retail companies even more prohibitive. Needless to say, stimulating the development of a deep and liquid hedge market has been a priority for the Authority and provides an important context for the UTS decision.

The Commerce Commission’s conclusion may have been frustrating to some, but it was consistent with prevailing dynamic efficiency ideal of workable competition and its toleration of monopoly prices. The Major Energy Users Group’s expressed their frustration about continuing high prices and the

⁴⁰⁰ At 70.

⁴⁰¹ Todd Energy Managing Director Richard Tweedie speaking in November 2008, “Investigation Report” at 70.

⁴⁰² International Energy Agency *Energy Policies of IEA Countries – New Zealand 2006 Review* <www.iea.org> at 145 cited in “Investigation Report” at 82.

⁴⁰³ Ahdar, above n 385, at 53.

Commission's seemingly blasé attitude to the loss of manufacturing jobs. The Commission's somewhat nonchalant response was that:⁴⁰⁴

Large profits may arise in a number of circumstances: they may be needed to adequately compensate investors for the large amounts of capital used by the company; they could result from the company possessing a superior product or from being more innovative or efficient than its competitors or they may be a signal that an expansion of supply is needed to meet increasing demand. Profit may also enable a company to expand and compete on a wider basis, or to invest in research and development to deliver better products and greater choice to its consumers.

These points could have been quoted directly from Bork and Posner, caselaw like Scalia's judgment in *Trinko* or the Privy Council in *Telecom v Clear Communications*, or Baumol's *The Free Market Innovation Machine*. The Commerce Commission's acceptance of dynamic efficiency and the total surplus standard seemed to be almost complete.

If the Wolak Report was correct in finding that the electricity market was gamed and that supra-normal profits were extracted in spite of a supposedly workably competitive market structure, then what does this say about the efficacy of competition policy in New Zealand? Is the Commerce Act itself flawed? Can the Electricity Authority and the Commerce Commission between them effectively police behaviour in the markets?

Wolak's findings have been criticised by Lewis Evans of Victoria University of Wellington and Bart van Campen of Auckland University's Energy Centre. For Evans, the counterfactual benchmark Wolak used was based on flawed assumptions about the short run marginal costs of hydro versus thermal generation and the responsiveness of demand to changes in pricing.⁴⁰⁵ Wolak assumes that in times of water shortage the marginal cost of water is the same as that of gas. In dry years generators were able to game the market and raise wholesale prices for hydro generated electricity to the same level offered by gas generators.⁴⁰⁶ But this assumes that gas prices themselves will not change as demand increases. Increases in gas prices would detract from profits available to generators and would reduce the overall profits, a factor which Evans says was underestimated in Wolak's calculations.

⁴⁰⁴ Commerce Commission "Investigation Report", above n 392, at 19.

⁴⁰⁵ Evans, Lewis and others "A Critique of Wolak's Evaluation of the NZ Electricity Market: Introduction and Overview" (University of Canterbury, Christchurch, NZ, 2011) at 1-2.

⁴⁰⁶ At 1-2.

Most interesting for the purposes of this thesis is the recurrence of the marginal cost controversy in terms of Short Run Marginal Cost pricing (“SRMC”):⁴⁰⁷

It is important to recognise that investment in the electricity market would be limited under Wolak’s counterfactual and marginal-cost estimation. In a SRMC-based energy-only pricing scheme (estimated as Wolak does), practically no firm would have the incentive to invest.... In this setting, firms will invest in additional plant when the marginal cost and frequency of scarcity, whether generated by energy or capacity concerns, generates sufficient operating surplus to justify new plants.... *High prices during scarcity periods are essential to pay for all capacity and provide an incentive for investment in new capacity.* (emphasis added).

Bart van Campen and others of Auckland University’s Energy Centre pointed out that the vertical integration of retail and generation had a significant effect on reducing the overall significance of the wealth transfers. The purchase of wholesale electricity by the retail arm of a single vertically integrated firm amounts to:⁴⁰⁸

... an internal transfer of funds between different arms of the same company, with zero net effect.... Thus the true transfer of wealth from generators to consumers during periods of high wholesale prices is likely to be much lower than Wolak’s estimate of market rents, even ignoring the way he estimates hydro costs.

This logic would apply to the UTS situation as well and may not have been factored into reports that the event cost \$45-50 million. High prices charged by Genesis would be downplayed by the transfer of funds between its retail and generation arms and should not have been included in the total cost to the market.

Taken together, the argument against Wolak is first, that the \$4.3 billion figure was overestimated, and second, that the electricity market must be profitable if the country’s long term electricity needs are to be provided for. Any criticism of the electricity industry which is based on that argument that it is ‘too profitable’ would necessarily involve calculation of how much profit is allowable. This is a short road to re-instituting routine price controls and the extensive oversight and costly intervention the Commerce Act aimed to avoid. The NZEM has been deliberately designed with an oligopolistic market structure, guided by policies aimed at lowering the barriers to entry, by deepening the hedge markets, for

⁴⁰⁷ At 10.

⁴⁰⁸ Bart van Campen, Rob Kirkpatrick, Steve Poletti, & David Young “A Response to the Wolak Report” (25th May, 2009). <www.epoc.org.nz>.

example. The system will never be entirely self-regulated but, like a well-engineered clock, it should only require only occasional adjustments.

As it is, the profitability of the system may well have already led to real improvements in dynamic efficiency. While the share of energy being generated by independent and cogeneration stations has been steadily reducing since 2000, 11 new generation stations have been commissioned by the main entities.⁴⁰⁹ There is evidence then that, even in a concentrated market, the incentives to invest in additional capacity are working. According to workable competition, a competitive market would exert downward pressure on prices, while providing incentive to invest in sufficient capacity to provide for future demand, thus satisfying both static and dynamic efficiency. Incumbent players are managing to entrench their positions on the other hand undermining contestability, but the additional generation capacity is being provided, which is a dynamically efficient outcome. One need only look westward from Hamilton to see the wind turbines sprouting at Meridian Energy and WEL Networks Te Uku wind farm to see the process in action.

If the critics like Evans and van Campen are correct and Wolak's figure of \$4.3 billion has been overestimated, then what is the correct figure? Have there in fact been any excess profits or are all high prices reinvested in generation infrastructure? What level of profit is sufficient to satisfy a profit maximising entity? At what point does greed fail to be good? What is efficiency? These are questions which may not be answered by this thesis, and perhaps can never be answered, but they are the very essence of this debate and it is vital that they continue to be put.

One final note about the Wolak report. Wolak based his findings on a six and a half year data set which covered over 113,800 time periods.⁴¹⁰ His work was peer reviewed by Professor Niljs Henrick von der Fehr, of Oslo University who described it as "fundamentally sound [and] well founded on accepted econometric methods and practices."⁴¹¹

⁴⁰⁹ Commerce Commission "Investigation Report", above n 392, at 76-77.

⁴¹⁰ At [56].

⁴¹¹ At [282].

The ETAG Report

In 2009 the Ministry of Economic Development published its Ministerial review of electricity market performance, the ETAG report.⁴¹² It was felt that more needed to be done to improve electricity market governance, in particular, that the Electricity Commission should be reconstructed as a more independent entity with more tightly focussed objectives. The Electricity Authority (“the Authority”) was thereafter established under the Electricity Industry Act 2010, (“EIA”).

In line with the ETAG report’s recommendations, the purpose and objectives of the Authority have been slimmed down. Section 15 of the EIA now merely requires that “the Authority is to promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.” Fairness has been excluded from the Authority’s concerns. Environmental sustainability is now under the ambit of local councils as provided for by the Resource Management Act 1991. Responsibility for energy efficiency has been transferred to the Energy Efficiency and Conservation Authority.

The Electricity Authority’s independence has been increased from that of a Crown entity to that of an independent Crown entity.⁴¹³ As an independent Crown entity, the Authority now has the same status as the Commerce Commission. While Crown entities “must give effect to government policy when directed by the responsible Minister”, independent Crown entities are generally independent of government policy.⁴¹⁴ This upgrade in status was a clear signal of the government’s expectations. The Authority was to intervene according to its own statutory objectives, and not according to the wishes of the Minister of the day, or of any lobby groups which may capture state policy, and was to have equal standing with the Commerce Commission.⁴¹⁵

Both the Electricity Authority and the Commerce Commission have a mandate to deal with competition issues, but the purpose statements differ. The Electricity Authority’s s 15 mandate, to promote competition, reliability of supply and efficiency, can be contrasted with the Commerce Commission’s purpose, to

⁴¹² Electricity Technical Advisory Group and Ministry of Economic Development “Improving Electricity Market Performance”, above n 393.

⁴¹³ Electricity Industry Act 2010, s 12.

⁴¹⁴ Crown Entities Act 2004, s 7.

⁴¹⁵ As landowners affected by the Whakamaru line seemed to in 2006.

“promote competition in markets for the long-term benefit of consumers within New Zealand.”⁴¹⁶ Because of this overlapping responsibility, the two bodies have signed a Memorandum of Understanding (“MOU”).⁴¹⁷ The Authority must consult with the Commission before amending the Code, or making any decision that is likely to affect the Commission’s performance or exercise of its functions.⁴¹⁸

The danger for industry participants is that both agencies could potentially involve themselves in a given situation. Regulatory uncertainty is created by the possibility that each agency could come to opposite conclusions, one allowing and one prohibiting the same behaviour. While the hope is that the MOU would be sufficient to prevent such conflicts of law, a key task for any market participant will be to conduct a thorough risk analysis including an assessment of the likelihood of transgressing laws and regulations administered by these two bodies. After all, an MOU does not have the status of an Act of Parliament. The Electricity Authority’s foundation documents might create the basis for a legitimate expectation, but the final answer must be found in the legislation itself.

Under s 32(b) of the EIA, the Authority may not “purport to do or regulate anything that the Commerce Commission is authorised or required to do or regulate under Part 3 or 4 of the Commerce Act 1986”.⁴¹⁹ As we have seen, Part 4 of the Commerce Act is supposedly the sole means by which price control can be imposed on monopolistic markets in New Zealand. One could perhaps make an argument from this that the Authority would be acting *ultra vires* if it used the UTS regime to regulate prices in natural monopoly situations which are the purview of the Commerce Commission. Yet as we have seen from the Datatails case, the Commerce Commission has treated market squeezes as a breach of s 36. The potential remains for both agencies to be legitimately involved in a market cornering incident.

The issue is complicated by the fact that authors of the ETAG report expected that the Commerce Commission would retain competition oversight, while the

⁴¹⁶ Commerce Act, s 1A.

⁴¹⁷ Commerce Commission “Memorandum of Understanding between the Electricity Authority and the Commerce Commission” (December, 2010) <www.comcom.govt.nz>.

⁴¹⁸ Commerce Act 1986, s 54V(1) and (12).

⁴¹⁹ Electricity Industry Act, s 32.

Electricity Markets Authority (which became the Electricity Authority) would only be responsible for developing and enforcing industry rules.⁴²⁰ In its foundation document, “Interpretation of the Authority’s statutory objective”, the Authority confirmed that its role was to set the rules of the Market, while the Commerce Commission would regulate the behaviour of individual participants:⁴²¹

The Authority interprets *promoting* competition to mean exercising its functions to facilitate or encourage stronger competition. The Authority is not focussed on the conduct of individual participants with respect to competition in the electricity industry as this is the responsibility of the Commerce Commission. Rather the Authority is focussed on improving the arrangements in the electricity industry to promote competition.⁴²²

The MOU likewise states that:⁴²³

In regard to monitoring competition the Authority’s focus is on the competitiveness of electricity markets, rather than on the conduct of any particular market participant or group of market participants.

This suggested that the Authority would focus on policy objectives aimed at improving competition in the market, for example promoting hedge fund arrangements or making alterations to the structure of the market itself. Prosecution of anticompetitive behaviour and price control decisions would be left to the Commerce Commission. The authors of the Statutory Objective and the MOU perhaps underestimated the scope for intervention in market conduct contained within the Undesirable Trading Situation regime.

What might provide a further clue to the potential for disagreement between these two agencies is how consumer benefit is to be measured. In interpreting its Competition limb, the Authority has settled for the total surplus standard, stating that: “The benefits of competition refer to efficiency benefits, not wealth transfers, arising from price movements, but it includes any efficiency effects that may arise from wealth transfers.”⁴²⁴ Just as in the Commerce Act, competition means

⁴²⁰ “Improving Electricity Market Performance”, above n 393, at 66.

⁴²¹ Electricity Authority, “Interpretation of the Authority’s statutory objective” (Wellington, 14 February 2011) <www.ea.govt.nz> at [A.28].

⁴²² At [A.28].

⁴²³ MOU, above n 417, at 4.

⁴²⁴ “Statutory objective”, above n 421, at [2.2.1(c)].

“workable or effective competition”, but the focus on efficiency benefits differs from the Commerce Act’s current more balanced weights approach.⁴²⁵

While s 15 of the Electricity Industry Act refers simply to consumers, the Act defines consumers to mean: “any person who is supplied, or applies to be supplied, with electricity other than for resupply.”⁴²⁶ As practically every individual and organisation in the country uses electricity in some form or other, the definition extends to virtually everyone in New Zealand with the exception of the electricity retailers, Transpower and the lines businesses themselves. The Authority bunches electricity consumers under the term “aggregate consumers” and clearly intends to apply the total surplus standard.⁴²⁷

The implication of this approach, is that, in virtually all circumstances, only the efficiency gains of an initiative should be treated as benefiting consumers, with wealth transfers excluded because they net off among all electricity consumers once indirect wealth effects are taken into account.

The Authority’s intention was to allow large transfers of wealth from consumers to suppliers of electricity, so long as the result would improve efficiency. The focus must be on “expanding the ‘size of the economy pie’”.⁴²⁸ If wealth transfers were taken into effect, the pie would undoubtedly shrink. And as dynamic efficiency promotes the accumulation of capital for investment in the next big thing, a Schumpeterian would have argued that almost any transfer of wealth which accumulates capital should be allowed.

The Authority’s goal is to encourage competitive pressure, via contestability which includes situations where there are only potential competitors.⁴²⁹

The Authority uses the term *competitive pressure* because it covers a broad range of competitive circumstances, including circumstances where industry participants behave competitively because they anticipate competitor responses (or the entry of new competitors) if they do not do so. In these cases, a lack of rivalrous activity is not necessarily an indication of weak competition.

⁴²⁵ At 2.2.1(a). Compare with discussion of Commerce Commission’s Part 4, above n 352, and the analysis of the Commerce Commission’s approach to the total surplus standard and wealth transfer neutrality, *Superior Propane* and *Powerco*, above n 371.

⁴²⁶ Electricity Industry Act, s 5 and “Statutory objective” [at A.2].

⁴²⁷ At [A.6].

⁴²⁸ At [A.7].

⁴²⁹ At [A.18].

Equating potential rivalry with actual rivalry is pure Baumol. One of the major implications of the Commerce Commission's *Investigation* Report was that barriers to entry in electricity markets were so high, that the main gentailers were unlikely to be influenced by the fear of new entrants. Anticipating responses from competitors is another question altogether and there is every reason to believe that the competition between existing rivals is fiercely competitive. If nothing else, the fact that the March 26th Price Hike provoked 35 complaints to the UTS demonstrates just how jealously industry participants will defend their prerogatives.

By taking a wealth transfer neutral approach to efficiency, the Authority's aim was to make reliability of supply a priority over reduction in prices. In logic straight from the marginal cost controversy, the Authority said:⁴³⁰

... this approach is an aggregate consumer interpretation of the benefits to consumers, which excludes wealth transfers to consumers. If direct wealth transfers were taken into account (but not indirect wealth transfers), then price reductions would be valued ahead of reliable supply, which the Authority does not believe was intended by the Act. Adopting an efficiency (i.e. aggregate consumer) approach achieves an even-handed treatment of resource costs versus avoided costs.

Profits must be sufficiently high to encourage investment in infrastructure to deal with the long run costs of supply of electricity. Long term security of supply is more important than ensuring that electricity consumers enjoy the lowest prices possible in the short run. A focus on low prices would only mean that eventually demand would outstrip supply, necessitating political intervention.⁴³¹

The Authority's commitment to the total surplus standard was completed by their emphatic rejection of the *Powerco* decision. The Authority acerbically stated that they were "aware of the legal position established" in *Powerco* but that the judgment was relevant only to Part 4 control of natural monopoly markets prior to the 2008 amendment.⁴³² Instead the Authority would continue to ignore wealth transfers even if they penalised electricity consumers in the short run. It determined to adopt "standard cost-benefit analysis when assessing net benefits to electricity consumers."⁴³³

⁴³⁰ At [A.39].

⁴³¹ See discussion by Lewis Evans and Bart van Campen, above n 405.

⁴³² "Statutory objective", above n 421, at [A.8]-[A.10].

⁴³³ At [A.10].

The Authority's position might therefore be summarised as this. Efficiency would be assessed according to cost-benefit analysis excluding the effects of wealth transfers on aggregate consumers. Monopoly profit taking would be allowed in the interests of providing for the long run reliability of supply. The short term transfer of wealth would have to be traded-off against the long term benefit of guaranteeing that the lights stayed on no matter what the demand. Monopoly profits would be just the incentive competitors needed. Excessive behaviour would be reined in by the anticipation of a response from rivals and potential rivals, even where no such rivalrous behaviour was evident. The warnings from the Commerce Commission's *Investigation Report* that excessive profits were being taken could therefore be comfortably disregarded. Price control was something the Commerce Commission might do under Part 4 of the Commerce Act (as it stood in 2008), but it had no place in a properly designed electricity market.

And yet when the time came to make a decision to intervene to control prices following the March 26th Price Spike, this fine neo-liberal rhetoric was simply abandoned. Why?

If in hindsight the result seems obvious, that is only because the decision itself is couched in the terms of the *Statutory Objective* which showed that the Act and Code had been crafted to give the Authority flexibility to deal with unlikely events. The Authority made two key statements which, while referring to the logic of contestability and dynamic efficiency, do demonstrate the Authority would not be bound by a strict Schumpeterian non-interventionist ideal. The Authority would retain the right to intervene because, first:

... the benefits of competition refer to efficiency benefits, not wealth transfers, arising from price movements, however [we will intervene] if wealth transfers seriously undermine confidence in the pricing process or in the electricity industry more generally...

And secondly:

... efficient entry and exit in markets are not necessarily orderly, however if disorderly situations undermine confidence in the pricing process or in the electricity industry more generally then that can inhibit efficient entry and investment decisions and these dynamic efficiency effects should be taken into account... [when deciding to intervene].

In light of these provisos, the Authority retained its mandate to intervene to protect the confidence and the integrity of the market, despite its clearly stated

commitment to Schumpeterian ideals. Which still left open the question; at what point would the Authority find that the confidence and integrity of the market was threatened? To understand what might trigger the Authority's intervention, we must now turn to the details of the Undesirable Trading Situation regime.

The Undesirable Trading Situation Regime

One of the Authority's principal functions is to investigate and enforce compliance with the Electricity Industry Act, the regulations and the Code.⁴³⁴ Complaints or appeals may be referred to the Rulings Panel. The Rulings Panel may set its own procedures, subject only to the Act, the regulations and the Code and the "requirements of natural justice".⁴³⁵ The Rulings Panel has some reasonably fearsome teeth under the Act. It may give a public warning to an industry participant, order a pecuniary penalty up to \$200,000, order payment of a "sum" in compensation to any other person, and make orders of costs.⁴³⁶ In determining pecuniary penalties the Rulings Panel can take into account all circumstances of the breach, including its impact on industry participants and the gain the wrongful party obtained or expected to obtain.⁴³⁷ This suggests that the sum awarded could be equal to the damage caused; an open-ended sum which could be immense.

The Authority may itself intervene to enforce the code via application of the Undesirable Trading Situation regime contained in part 5 of the Electricity Industry Participation Code 2010.⁴³⁸ The UTS regime is broad and deliberately phrased to capture a wide range of circumstances. Undesirable Trading Situation ("UTS") is defined as:⁴³⁹

... any contingency or event –

- (a) that threatens, or may threaten, trading on the wholesale market for electricity and that would, or would be likely to preclude the maintenance of orderly trading or proper settlement of trades; and

⁴³⁴ Electricity Industry Act 2010, s 16.

⁴³⁵ Section 53.

⁴³⁶ Section 54.

⁴³⁷ Section 56.

⁴³⁸ Sections 25 and 45.

⁴³⁹ Electricity Industry Participation Code 2010, Part 1, cl. 1.1.

- (b) that in the reasonable opinion of the Authority, cannot be satisfactorily resolved by any other mechanism available under this Code...

Activation of the UTS is the Authority's prerogative, but the decision to use the UTS and not some other mechanism must be based on reasonable grounds. The door might be open to judicial review if other mechanisms were available under the Code and had not been applied first. Other mechanisms could include the Authority's powers to "make and administer" or amend the Code.⁴⁴⁰ Any proposal to amend the Code must include publication of a draft statement of the amendment, and a regulatory statement which the Authority must then consult on, presumably with industry participants and other interested parties. The regulatory statement must include an evaluation of the costs and benefits of the amendment and the alternative means of achieving its proposed objectives. These requirements would prove to be relevant when the UTS decision was made, as some participants would complain the decision was a de facto price cap, which amounted to a change to the Code without adherence to these formal procedures.

Furthermore, the Authority must consult with the Commerce Commission before making any amendment which will, or is likely to, affect the Commission's performance of its powers or functions.⁴⁴¹ Failure to consult on an amendment which affected the Commission could therefore result in an argument between the two agencies. How that situation might be resolved is unclear, but presumably judicial review could occur, particularly if the complaint was raised by a third party affected by the amendment. Arguably a decision which amounted to an amendment should receive the same treatment. The point is that amendments are supposed to be made according to a measured process. The complaint that the UTS decision did not follow the same process may have merit, if only because it did not result in an actual amendment to the Code. If the Code had been amended without recourse to the correct consultation procedures, then that would certainly lend weight the argument that the decision or amendment was wrong and should be reviewed.

Events which may trigger a UTS include:⁴⁴²

- (i) manipulative or attempted manipulative trading activity; and

⁴⁴⁰ Electricity Industry Act ss 16 and 39.

⁴⁴¹ Electricity Industry Act, s 39 and Commerce Act, s 54V.

⁴⁴² Electricity Industry Participation Code 2010 Part 1 cl. 1.1 at 63.

- (ii) conduct in relation trading that is misleading or deceptive, or likely to mislead or deceive; and
- (iii) unwarranted speculation or undesirable practice; and
- (iv) material breach of any law; and
- (v) any exceptional or unforeseen circumstance that is at variance with or that threatens or may threaten, generally accepted principles of trading or public interest.

Even if the events did not fit neatly within clauses i-iv, clause v is a residual clause which is sufficiently broad to capture ‘any exceptional or unforeseen circumstance’. Somewhat surprisingly, a UTS may occur even when there has been no actual breach of the Code.⁴⁴³ It is sufficient only that it be some “contingency or event outside the normal operation of the wholesale market for electricity.”⁴⁴⁴

These provisions are kept extraordinarily broad for a reason:⁴⁴⁵

UTS provisions are adopted by market providers because they cannot foresee all future eventualities and hence cater for these in the market rules. Also, some practices are particularly difficult to specify in the rules, and so are better covered by generic UTS-type rules.

The economic rationale behind the Authority’s competition and reliability statutory objectives, after all, is “to achieve operationally efficient and competitive markets.”⁴⁴⁶ To protect the integrity of the market place it is vital that “contract terms are transparent and prices are competitively determined.”⁴⁴⁷ A fair summation might be that a UTS is something that is incapable of precise definition, but everyone would know it when they saw it.. Deceptive or fraudulent behaviour, for example, harms the integrity of the market because it undermines the faith that the game will be fairly played. The full spectrum of manipulative and underhanded behaviour available to the unscrupulous cannot be defined, hence the need for flexibility. The overall complexity of the NZEM means that serious unintended consequences can still occur, even with the best of intentions. Specific and detailed proscriptions would be easier to avoid and perhaps harder to apply.

⁴⁴³ Electricity Authority, “Draft Decision regarding alleged UTS on 26 March 2011” <www.ea.govt.nz> at [15].

⁴⁴⁴ At [15].

⁴⁴⁵ At [31].

⁴⁴⁶ At [29].

⁴⁴⁷ At [29]-[30].

The Authority had broad powers to intervene in the market, but had avowed a determination to take a neutral approach to wealth transfers. They would not intervene unless the integrity of the market was threatened. What would happen then if the UTS regime was tested by anticompetitive behaviour?

The March 26th Price Hike.

On March 26th, 2011, the New Zealand Electricity Market experienced what has come to be known as the March 26th Price Hike. Scheduled maintenance on transmission lines in the central North Island resulted in constraints of supply to Hamilton and the regions to the north of Hamilton. For seven hours that Saturday afternoon only one company had a power plant available to supply the upper North Island. That plant was Genesis Power Limited's Huntly power station.

Prices on the spot market had been forecast to reach a mere \$160/MWh but in fact exceeded \$20,000/MWh. Although many claimants treated their actual losses as confidential trade secrets, it was estimated that some \$45-\$50 million was transferred that day.⁴⁴⁸

The incident has provided the first significant test of the Electricity Authority's Undesirable Trading Situation ("UTS") regime. It has raised substantial questions about the proper role of this newest of regulatory authorities is to take in a historically lightly regulated free market. What should the Authority do when it appeared that an attempt had been made to use transitory market power to corner the market, especially when the incident was so spectacular in terms of the size of the wealth transferred and in such a short space of time.

Simply put, the conclusion of the Authority was that Genesis had taken advantage of its position to execute a "market squeeze." The proposed remedy was to reset market prices for the day at \$3,500/MWh, which was still more than 20 times the anticipated price. Paradoxically.⁴⁴⁹

The UTS Committee's preliminary view is that Genesis' conduct is not unlawful, does not constitute manipulative or attempted manipulative trading activity, and does not amount to conduct in relation to trading that is misleading or deceptive, or likely to mislead or deceive.

⁴⁴⁸ *Bay of Plenty Energy Limited v The Electricity Authority* [2012] NZHC 238 at [57].

⁴⁴⁹ "Draft Decision", above n 443, at 2.

Why then, if Genesis' behaviour did not fit within at least these first four subclauses of the definition of a UTS, did the Authority feel justified in intervening? It is confusion over the actual rationale for intervening which partially explains why the decision was appealed to the High Court. This confusion may have even lead to the market squeeze in the first place. If industry participants realised what could trigger a UTS, then logically they would have taken steps to avoid it. One is reminded of Oliver Wendell Holmes famous dictum: "The life of the law has not been logic; it has been experience."⁴⁵⁰

Despite the feeling that the events of that day did not fit easily within the intended framework of the UTS, the Authority had a mandate and an obligation to intervene. The starting point for the exercise of this UTS discretion is whether the events would threaten trading on the wholesale market:⁴⁵¹

Allowing the interim prices to become final prices would have increased uncertainty in the spot market as it would signal that generators that find themselves in a net pivotal position could set whatever prices they wished regardless of whether there was a genuine scarcity of supply or not and regardless of whether parties exposed to those prices had an opportunity to curtail demand or increase their own generation.

A UTS had occurred, and everyone knew that it had occurred, even if its precise definition was unclear. The generally proscriptive rules provided the mandate for intervention; it only remained to decide how to fit the events of the day within the Code, and what remedy would best fit the justice of the case. A more detailed narrative of the course of events that day will reveal how the decision was reached.

Key Events⁴⁵²

Transpower had notified industry participants of the need for maintenance on the Whakamuru C transmission line between Whakamaru and Otahuhu as long ago as

⁴⁵⁰ Oliver Wendell Holmes *The Common Law* (1881) (Harvard University Press, Cambridge (Mass), 2009) at 1.

⁴⁵¹ Electricity Authority "Questions and Answers relating to the Electricity Authority's decision that the events of 26th March 2011 constitute an undesirable trading situation (UTS)" <www.ea.govt.nz> at 4.

⁴⁵² See "Draft Decision", above n 443, at 20-21 and Electricity Authority "Proposed Actions of the Electricity Authority under Part 5 of the Electricity Industry Participation Code to Correct an Undesirable Trading Situation that occurred on 26 March 2011" ("Final Decision") <www.ea.govt.nz> at 20-23 and *Bay of Plenty Energy Limited v The Electricity Authority* [2012] NZHC 238.

late 2009.⁴⁵³ Additional maintenance of the Arapuni/Otahuhu line was also planned. Maintenance was delayed until 26 March 2011, but between December 2010 and March 2011 the fact that both lines would be affected had been notified.

On Friday 25th of March, 2011, Genesis kicked off the affair at 9:51 am when it moved 320 MW of offered generation from a low priced band (<\$100/MWh) to the \$19,000/MWh offer band. At around 1:00 pm Contact Energy withdrew 425MW of offered energy at Stratford, at which point the System Operator's Security Despatch Schedule ("SDS") system forecast prices for 26 March at \$20,000/MWh.

In response, Mighty River Power ("MRP") offered an additional 125MW from its Southdown plant in Auckland at \$.01/MWh, prompting the System Operator to reforecast prices to a maximum of \$150/MWh. As actual demand the next day would be much higher than expected, the effect of MRP's offer was to mask the anticipated prices. The System Operator underestimated the actual demand by 100-120MW, and the inevitable result was that the system was constrained on and prices spiked.⁴⁵⁴

That afternoon, still troubled by the direction events were taking the wholesale market, MRP sought hedge cover from Genesis. Genesis offered two 50MW tranches at \$350/MWh and \$750/MWh. By this time the forecast prices had dropped again to \$150/MWh, and MRP rejected the offer.

Beginning at 10:40 am the next day, the System Operator successively reduced the Whakamaru-Otahuhu transmission constraints from 404MW to 390 MW and then down to 380MW. In a move initially described by the Electricity Authority as being "consistent with an attempt to bring about a market squeeze affecting the rest of the North Island", MRP followed Genesis' lead in moving Waikato generation to the highest priced bands.⁴⁵⁵ Genesis countered by reducing the low priced energy offered at Huntly by 30 MW, while increasing the low priced energy offered at Tokaanu south of the constraint by 20MW. It was this action

⁴⁵³ Bay of Plenty Energy Limited v The Electricity Authority at [35].

⁴⁵⁴ "Final Decision" at [86].

⁴⁵⁵ Electricity Authority Final Decision at [147].

that exacerbated the separation of prices and lead to accusations that Genesis had engineered the spring washer effect.⁴⁵⁶

One can imagine the heated discussions in control rooms up and down the country, particularly at Meridian Energy that afternoon, when the decision was made to seek hedge cover from Genesis and Genesis refused. At 3:37 pm Meridian again sought hedge cover and this time were offered 30MW at \$10,000/MWh. Hands must have been thrown up in the air in disgust. Meridian declined the offer and the decision to complain to the Authority would have been made, if not on the spot, then very shortly afterwards.

Reactions must have been even more horrified amongst the major users who did not find out about the high prices until well after the fact. One of the major surprises for someone fresh to this field is the fact that, given the well-known volatility of the wholesale market, anyone would risk exposure to spot prices without closely observing trading. That this is a feature of the NZEM is quite astonishing. It lends credence to arguments that industry participants, who failed to employ more defensive hedge and demand response arrangements, should not complain when the market turned against them. The justice of enjoying overall lower spot prices, without paying a premium for hedge cover, and then appealing to the Authority to make up for their own complacency, is questionable.

Thirty five market participants would complain to the Electricity Authority and, following the decision that a UTS had occurred, also make submissions about the decision.⁴⁵⁷ Most, like MRP and Meridian, would agree that a UTS had occurred but that the remedy resetting prices to \$3000/MWh was insufficiently punitive towards Genesis and would in fact cost innocent participants dearly. A few like Contact, King Country Energy and, of course, Genesis, would disagree that a UTS had occurred, and argue that prices should be left to fall where they lay. This was a competitive market after all, it was well known that it had no cap on prices. The price signal was supposed to operate according to the purest application of the rules of supply and demand. The familiar marginal cost controversy arguments

⁴⁵⁶ The spring washer effect describes the exceptional increases in prices caused by changes to the physical flow of electricity when the power system is constrained on. See Lu Feiyu “Spring Washer Effect: A Market Clearing Engine Study of the NEMS” (October, 2004) <www.emcsg.com>.

⁴⁵⁷ See “Draft Decision”, above n 443, and “Final Decision”, above n 452.

came into play, the market should take into consideration the long term benefits of profits for contestability and dynamic efficiency. Static efficiency considerations which focus on short term price movements should take second place.

In light of Authority's summary of the events of the day, we can now re-examine exactly how the provisions of the UTS were applied, and more importantly, how they were disputed and rationalised.

Clause i: Manipulative or Attempted Manipulative Trading Activity

The heart of the allegation was that Genesis had manipulated its offer prices to taken advantage of a transitory monopoly position. It was alleged that Genesis' strategy of reducing generation at Huntly, while increasing generation at Tokaanu south of the constraint, had been deliberately designed to cause the separation of prices.⁴⁵⁸ The Authority decided that the allegation was not founded for three reasons.

First, the System Operator's SDS forecasts were inaccurate.⁴⁵⁹ Demand north of the constraint was some 100-120 MW higher than expected and the failure to forecast this was the System Operator's responsibility. More accurate demand forecasts would have alerted the market to the possibility of high prices. Industry participants could have made different hedging or demand response decisions if forecasts had been more accurate.

Secondly, Contact Energy's decision to withdraw 425 MW from the market was a significant factor in causing the constraint to bind.⁴⁶⁰ Again, had forecasts been more accurate, Contact would most likely have made the decision to stay in the market and prices would have been "unexceptional".⁴⁶¹ For many participants Contact's decision, following so soon after Genesis' withdrawal, must have seemed more than coincidental and suggestive of collusion. The Authority accepted Contact's explanation for the withdrawal, however. The Authority could see no reason why Contact would have foregone those profits, if they had actually anticipated that prices would spike.

⁴⁵⁸ "Final Decision" at [83].

⁴⁵⁹ At [84]-[87].

⁴⁶⁰ At [89].

⁴⁶¹ At [89].

Finally, after extensive consideration of Genesis' offer strategy, including use of vectorised Scheduling Pricing and Despatch ("vSPD" software) to simulate events under different pricing and demand conditions, the Authority concluded that Genesis had simply been rationally managing its own risk position. Even if Genesis had not pursued its offer strategy at Tokaanu, it was still the marginal generator for Hamilton and the regions north of Hamilton. There were still sufficient lower price offers south of the constraint to cause prices to separate, regardless of Genesis' offer strategy.⁴⁶²

Genesis' position was described as net pivotal.⁴⁶³ A generator is net pivotal when it is the sole supplier to a market where demand exceeds its own load commitment.⁴⁶⁴ The position of a net pivotal generator can be contrasted with that of a pivotal generator. Pivotal situations, where the electricity demanded from a generator is greater than it can supply, are reasonably common. A pivotal generator has no incentive to set higher prices as its contracted demand commitments are greater than its generation capabilities. It would have to purchase electricity at the higher price from its rivals to provide for its own customers, and the result would be a net loss.

A net pivotal generator, on the other hand, is free to set high prices because any "additional revenue it earns will exceed its additional costs (from purchasing electricity from the wholesale market and meeting hedge contract commitments)."⁴⁶⁵ In other words, it sets the market price and then profits because it is the sole supplier to its rivals. As a vertically integrated entity there will be an internal transfer of funds, but so long as the internal transfer is exceeded by revenue obtained from rivals, the event will be profitable.

The Authority reasoned that Genesis was entitled to offer just enough low priced electricity to cover its total position, and no more.⁴⁶⁶ The increase in low price offers at Tokaanu compensated for the reduction at Huntly:⁴⁶⁷

If Genesis reduced the Huntly low-priced energy offer by 150MW (as it did) without increasing the low-priced offer by the same amount at Tokaanu,

⁴⁶² At [99].

⁴⁶³ At [113].

⁴⁶⁴ At [113], see "Box 1: Explanation of net pivotal".

⁴⁶⁵ At [113].

⁴⁶⁶ At [100]-[103].

⁴⁶⁷ At [102].

Genesis would have been exposed to the possibility of being short 150MW. In other words, if the constraint between Otahuhu and Whakamaru was removed or relaxed, and the North Island interim price was high but below Genesis' next offer price, Genesis would have been short by 150MW.

It is difficult to decide whether this logic is convincing or not. No explanation is given for Genesis' decision to reduce generation at Huntly, necessitating the increased generation at Tokaanu in the first place. Presumably it was accepted as a commercially rational, profit-maximising decision, given that offers in excess of \$19,000/MWh were possible. The UTS Committee noted that:⁴⁶⁸

... there is no price cap on offers made in the wholesale market for electricity and in its view offering generation at high prices is not *per se* evidence of manipulative or attempted manipulative trading activity.

Just as in the general competition law since the passing of the Commerce Act, monopoly profits are not prohibited, and for the same reasons. According to the Schumpeterian logic of dynamic efficiency, it is the potential for profits which create incentives investment for long term growth and for contestability to discipline the market. Should the onus have been on Genesis to offer as much low-priced energy as possible at Huntly? Was there an obligation to protect rivals and customers alike by turning down the sure profits available to it as a result of a temporary monopoly it had played no part in obtaining? To enforce such an obligation would amount to requiring competitive rivals to protect each other's interests, which seems to be a short cut to collusion, and certainly would not be consistent with a policy aimed at encouraging competitive rivalry.

Clause ii: Misleading or Deceptive Trading

Genesis' offers of \$19,000/MWh were posted on the 25th of March, 2011, the day before the price hike. These offers were visible in several SDS forecasts for any participants who cared to look. Yet, as there had only been five half hourly trading periods in the past in which Genesis had been the 'net pivotal' generator, it was found that there was no way the market could have been pre-warned that prices

⁴⁶⁸ At [105].

would reach that level.⁴⁶⁹ At the same time, Genesis had made offers at \$10,000/MWh thousands of times since March 2011. The result was that:⁴⁷⁰

This limited ability of Genesis to forewarn participants, coupled with the fact that Genesis has made offers at \$10,000/MWh over an extended period, do not support an allegation of misleading or deceptive conduct.

The logic here is odd. The Authority associates a lack of opportunity to monopolise the market with an ‘ability to forewarn participants’, as though having not engaged in predatory pricing before was sufficient to excuse the intention to do so on this occasion. If Genesis was not pivotal, they would obviously seek to extract high prices from the market, even if that had not happened before. A more literal interpretation of ‘forewarning’ might have included the expectation that Genesis would have directly contacted major users it knew to be unaware of the spiking prices, let them know what exactly was happening in the market, and offer them the appropriate hedge cover.⁴⁷¹ The warning industry participants are required to give to the market goes directly to the nature of misleading or deceptive conduct. The Authority’s position seems to be that misleading by omission is not blameworthy. There is no requirement to forewarn industry participants in the Code, and perhaps this is an area that should be considered for amendment.

The explanation is also inconsistent in that it treats the offer of \$19,000/MWh as equivalent to an offer of \$10,000/MWh, when it is obviously almost twice the amount. The quantum of possible damage, particularly in a market where it is well known that several major users lack the facilities for detailed up to the minute market analysis, implies that on basic principles of causation and remoteness, Genesis behaviour was blameworthy. Again the difficulty for participants is that there is no price cap on the NZEM, the market clearly operates on the basis of caveat emptor. Genesis’ position would be that, as Huntly was the marginal generator with a coal and gas fired plant, offers in the \$20,000/MWh range were to be expected.⁴⁷² The problem was caused by the transmission constraint, which was beyond their control, not by their offer strategy. And, consistent with dynamic efficiency arguments, without those high prices there is no incentive for

⁴⁶⁹ At [111]-[116].

⁴⁷⁰ At [116].

⁴⁷¹ See generally New Zealand Steel “Draft Decision on UTS of 26 March 2011” <www.ea.govt.nz>.

⁴⁷² See Genesis Energy “Draft Decision on UTS Claims” <www.ea.govt.nz> at 3-4.

Genesis to maintain and operate the aging Huntly power station, particularly when it is only required on those occasions when hydro power is insufficient to cover demand. Not only that, the decision amounts to a price cap which runs counter to the Authority's own commitment to deepening the hedge market.

This is the problem. The volatility of the market is well known, whether or not it is a result of deliberate action. Normal market price movements include unpredictable and massive price spikes. Not all industry participants run specialised market clearing teams and many complained that they were unable to reduce demand or seek hedge cover because they were not made aware of the price changes until after the fact. But what about the caveat emptor principle? King Country Energy opposed the Authority's decision to reset offer prices on the grounds that it frequently advises customers of the risks of operating in the spot market without taking the appropriate precautions.⁴⁷³ Even then, advance knowledge would be of little use if hedges were not available and/or demand could not be reduced. Without market volatility, however, there is no incentive for consumers to purchase hedge insurance, to observe the market more closely, or to reduce demand where possible. All of which reduces the profitability and efficiency of the NZEM. So on the one hand, we can see that Genesis' offer behaviour may have been unpalatable, but it arguably was well within the rules of the NZEM and was consistent with the Authority's own stated objectives and policies, and the stance on efficiency and wealth transfers.

This conclusion also did not sit well with many in the market who considered that there had been an informal 'gentlemen's agreement' not to take advantage of such situations.⁴⁷⁴ Genesis Energy's decision to do so seemed to be motivated by the need to maximise profits from the aging Huntly Power Station than by the short run scarcity in supply. This merely brings us back to the argument that the prices should have been left to lie where they fell for the good of the long run efficiency of the electricity industry.

⁴⁷³ See generally King Country Energy "Re: 26 March 2011 Event" <www.ea.govt.nz>.

⁴⁷⁴ New Zealand Herald "NZ power industry's 'gentlemen's agreement' on market power at risk." (March 30, 2011) <www.nzherald.co.nz>.

Clauses iii and v: Unwarranted Speculation or an Undesirable Practice

The Authority here have lumped clauses iii and v of the definition of a UTS together.⁴⁷⁵ The intention was to consider whether Genesis could “determine prices in a significant portion of the wholesale market”, whether industry participants could have substituted supply or reduced demand, and whether the prices threatened the market sufficiently to amount to a UTS.⁴⁷⁶

The first two points constitute the Authority’s definition of a price squeeze. The term ‘squeeze’ originates in commodity futures markets where they were assumed to be undesirable.⁴⁷⁷ In the context of the wholesale electricity market, a market squeeze occurs when a generator is in a position where it is able to ‘name its price’, but parties exposed to that price are unaware of it until it is too late. Typically a market squeeze was part of a deliberate market coup, which, depending upon the circumstances, could amount to an out and out fraud. The Authority used the concept, but did so by applying a no-fault approach which avoided the question of whether the behaviour should have been penalised or not.

The Authority’s initial premise was that Genesis was not solely responsible for creating the conditions which put them in a ‘net pivotal’ position. For one thing, Contact Energy had played a part by withdrawing 425 MW of capacity. If this capacity had been made available prices would have been unexceptional, leading some submitters to speculate that there may have been collusion between Contact and Genesis. When the Authority put the question to Contact, however, the written response was:⁴⁷⁸

- ‘The expectation at the time was that prices were likely to be low for 26 March and that it would not be economic to run the Taranaki Combined Cycle power station’; and
- ‘The Stratford peakers were being run for commissioning, under the control of the generation development project team. The peaker offer was changed as the result of a new commissioning plan provided to Contact Energy’s trading team (received around 10:58am on 25 March) by the generation development team.’

⁴⁷⁵ See Electricity Industry Participation Code 2010 Part 1 cl. 1.1.

⁴⁷⁶ “Final Decision”, above n 452, at [128].

⁴⁷⁷ At [129], see “Box 2: Explanation of corners and squeezes.”

⁴⁷⁸ At [131].

When asked whether they were aware that the result of this withdrawal of 425MW had been a factor in creating high prices on March 26, Contact's response was a laconic "No."⁴⁷⁹

Given that the Authority now has powers and status equivalent to the Commerce Commission, it is submitted that more could have been done to investigate this allegation. Collusion under s 27 of the Commerce Act is a serious matter and the Authority has the option of including material breaches of law under a UTS investigation. Any investigation should reflect a determination to treat anticompetitive behaviour with the same diligence as any other form of organized crime. Simply taking the accused party at their word is an inadequate where so much money and power is involved. The Authority's position was that, had the price forecasts for 26 March been more accurate then Contact might have made its TCC plant at Stratford available, demand reduction might have been more responsive and hedge arrangements may have been more diligently sought.⁴⁸⁰ Perhaps if price forecasts had been accurate at the \$20,000/MWh mark, and Contact had still withdrawn supply, then that explanation might have been given a harder look.

Exceptionally high prices alone are not sufficient to constitute a UTS.⁴⁸¹ The difference between a legitimate price signal and a UTS, is the possible harm undesirable practices cause to the integrity of the market. As the prices were not caused by any actual scarcity, they could not be said to be "competitively determined."⁴⁸² If prices are not competitively determined then industry participants will lose faith in the market, with inefficient results. The example the Authority provides is that industry participants could go outside the NZEM and purchase higher cost distributed generation, which does not make sense if there is lower cost generation already in place. Yet if demand continues to grow beyond the capacity of our hydro generation, it makes sense to provide incentives to develop distributed generation, particularly carbon neutral alternatives such as solar and wind. Where is it written that the electricity generation and distribution must continue along its historic trajectory of domination by a few large

⁴⁷⁹ At [132].

⁴⁸⁰ At [131].

⁴⁸¹ At [127].

⁴⁸² At [147].

corporations with a monopoly of generation? Encouraging distributed generation would reduce the demand for more generation and more transmission lines which is driving industry pressure to force retail prices ever higher.

The Authority also said that increased market volatility would result in the increased use of fixed price/variable volume hedge contracts which would actually reduce the sensitivity of demand side responses.⁴⁸³ This last point assumes industry participants would buy expensive hedges without also reducing demand. It seems an odd aside when the Authority has also made developing a liquid hedge market one of its priorities. Demand side response is not just about reducing power use, but is also intended to allow the selling of unused power to other consumers, a matter the Authority is required to address.⁴⁸⁴ Intervening in the market to reduce price volatility will affect the development of demand side mechanisms, as well as hedges. It is not a simple matter of prioritising one over the other.

The overall conclusion was that an intervention was called for, and prices were reset to the Long Run Marginal Cost of a new entrant peaking generation, \$3000/MWh.⁴⁸⁵ This conclusion was based on the assumption that reducing demand was to be prioritised over encouraging hedges. It was also based on the assumption that distributed generation was not a realistic solution for New Zealand's long term electricity needs. The solution was to set a high price for marginal generation, not excessive, but high enough to make for a reasonable profit. This thesis argues that this sort of reasoning sounds more like prime necessity than one might have expected from the dynamic efficiency arguments which grew out of the Chicago School writings of Schumpeter and Baumol.

Clause iv: Material Breach of Law

One fundamental question, which the Authority almost entirely ignored, was the importance of s 36 of the Commerce Act. Section 36 is the prohibition on taking advantage of a substantial degree of market power for a proscribed purpose, and it would seem to have been a natural start for any investigation into anticompetitive behaviour. The Authority simply said that s 36 was for the Commerce

⁴⁸³ At [149].

⁴⁸⁴ Electricity Industry Act, s 42(2)(d).

⁴⁸⁵ "Final Decision", above n 452, at [165]-[179].

Commission to investigate, but that in its opinion, s 36 had not been breached.⁴⁸⁶ If it had been breached it would only have been relevant to paragraphs (a) and (b) of the UTS clause, in that it could threaten trading on the wholesale market and couldn't be resolved by any other mechanism. Perhaps it was felt that bringing the UTS under s 35 was superfluous, perhaps the Authority was simply showing respect to the Commission's jurisdiction. That the question arose shows that anticompetitive behaviour could prove to be a flashpoint between the two agencies. What if the Authority had determined that no UTS had occurred and the matter was then referred to the Commission? Industry participants would then face a situation of double jeopardy, acquitted by one regulatory authority, but then faced with the expense and difficulty of defending the same case before the next. Perhaps the High Court judgment would shed some light on the matter.

The High Court Judgment

Bay of Plenty Energy Ltd and others, including Contact Energy Ltd and Genesis Power Ltd, appealed the Authority's decision to the High Court. Justice Ronald Young's judgment was delivered on the 27th February, 2012. *Bay of Plenty Energy Limited v The Electricity Authority*⁴⁸⁷ is a repetitive and scrappy judgment, however. It appears to have been hastily compiled from work done by a number of different authors. One quote from the Final Decision, about the consequences of allowing the high prices to stand, was repeated three times.⁴⁸⁸ The judgment repeatedly restates the same points about the UTS clauses. It also lacks internal consistency in that it identifies different points of the arguments as being the most significant, all of which makes its logic difficult to follow. That confusion is not helped by a conclusion which, rather than summarising the arguments presented in a succinct ratio, simply states:

For the reasons detailed in this judgment I am satisfied that the Authority made no error of law upon which its conclusions that a UTS existed on 26 March 2011 could be challenged.⁴⁸⁹

⁴⁸⁶ At [79]-[82].

⁴⁸⁷ *Bay of Plenty Energy Limited v The Electricity Authority* [2012] NZHC 238.

⁴⁸⁸ At [143], [214] and [221].

⁴⁸⁹ At [319].

The decision makes confusing references to kV and MW, seemingly using these basic units interchangeably. For example, at [47] where it says: “The System Operator seriously underestimated demand for 26 March, by as much as 120kV”, then at [160] where the underestimated demand is said to be “100MW to 120MW.” This is the difference between thousands of volts and millions of volts. It is perhaps not of major significance to the outcome, but it does show that the decision is technically inexact. More care needed to be taken in the proof-reading, perhaps indicating the time pressure the Court was under. The suspicion is that there may be other errors of fact.

No doubt the manner in which the judgment was presented reflected the difficulty of compiling and responding to submissions from some thirty-one parties. The result is that it is not practical for this thesis to deal at length with all the points made in as logical an order as would be preferred. Rather the attempt will be made to summarise some of the key arguments and to identify their implications for competition law and electricity regulation in general. Perhaps if the matter were to be appealed at a later date, future scholarly efforts might prove more fruitful.

The case amounts to an affirmation that the Electricity Authority is the sole arbiter of its own justice. The result could be seen as the Court simply rubber stamping the Authority’s approach, “What is orderly in this context the Authority are uniquely qualified to assess.”⁴⁹⁰ A more useful and objective approach might have been to carefully consider all parties submissions on the events and, more importantly, the significance of those events. Nevertheless the Court was following the precedent of the New Zealand Supreme Court approving Lord Donaldson MR’s comment that:⁴⁹¹

It does not matter whether, with whatever degree of certainty, the appellate court considers it would have reached a different conclusion. What matters is whether the decision under the appeal was a permissible option.⁴⁹²

The Court’s role was not to come to a different conclusion on the facts, but to ask whether the Authority’s decision “was not legitimately available on the facts

⁴⁹⁰ At [99].

⁴⁹¹ *Piggott Brothers & Company Limited v Jackson* [1992] ICR 85 (CA) at 92 cited in *Bay of Plenty Energy Limited*, above n 489, at [86].

⁴⁹² *Vodafone NZ Ltd v Telecom NZ Ltd* [2011] NZSC 138 at [53] citing *Piggott Brothers & Company Limited v Jackson* [1992] ICR 85 (CA) at 92.

found.”⁴⁹³ The only grounds for overturning the decision of such an expert body are if its conclusions are so untenable as to be illegitimate.⁴⁹⁴

The Court found that, while the market prizes consistency in that like cases should be treated alike, “UTS provisions are inherently fact dependent.”⁴⁹⁵ That means that the decision cannot be criticised for being the first to impose a price cap, nor can it be used as a precedent for the imposition of a price cap as a remedy in the future, “past decisions do not have a precedential effect as understood in law.”⁴⁹⁶ This is consistent with *Telecom New Zealand v Commerce Commission*,⁴⁹⁷ where it was held that the Commerce Commission:

... has made it clear it is not bound by its own decisions and therefore on each occasion where the meaning of those phrases is in issue, it must consider their appropriate meaning anew. It is trite that this must occur in a factual context. In isolation from the relevant facts the interpretative function is effectively impossible. This proposition is highlighted in this case because this is a factually complex area where a specialist tribunal, the Commerce Commission, has been given exclusive statutory powers to find the facts.

In accepting the Authority’s unique qualifications, however, the judgment appears to have fallen into a circular logic trap:⁴⁹⁸

I am satisfied, therefore, that the Authority understood what a squeeze was because it defined the term itself. It then applied its definition of a squeeze to the facts of this case and its knowledge of the electricity industry and concluded this event was undesirable. It then used these facts together with other factual findings to test whether a UTS had occurred. No error of law has been identified in this approach nor was any conclusion by the Authority reached which was not available on the facts.

In other words, the Authority correctly defined the squeeze because it defined the squeeze. Is there then no external test for a squeeze? If the Authority is not to be held to its own previous decisions then does that mean that terms such as ‘market squeeze’ will be defined anew for each fact situation, and further, does it mean that each new definition will also be accepted simply because of who defined it?

The Authority took it upon itself to apply its discretion under the UTS as broadly as possible, because this is the best means of dealing with the vast array of practices which could threaten orderly trading. Such constraint on market

⁴⁹³ *Bay of Plenty Energy Limited*, above n 487, at [84].

⁴⁹⁴ at [84].

⁴⁹⁵ At [118].

⁴⁹⁶ At [118].

⁴⁹⁷ *Telecom New Zealand v Commerce Commission* HC Wellington CIV-2004-485-2118, 6 October 2005.

⁴⁹⁸ At [195].

behaviour is “common to many organised markets”⁴⁹⁹ The Authority has therefore taken a best practice approach, on the theoretical basis that the preeminent need is for flexibility. The point is, not so much that the decision was so incorrect, but that in choosing flexibility over certainty, the Authority may have opened the door to capricious and indiscriminate decision-making in future. Cases are always ‘inherently fact dependent’ but fair play requires clear rules, which may not be provided for by general proscriptions in a code. This decision seems to miss the importance of setting those clear benchmarks to guide future behaviour.

Nowhere is discretion more apparent than in the relationship between clauses (a) and (b) and clause (c) of the UTS provisions.⁵⁰⁰ The Authority must establish that (a), the event threatens trading on the wholesale market, and (b), the matter cannot be resolved by other mechanisms.⁵⁰¹ Clause (c) lists behaviour which might be considered a UTS, including manipulative trading, misleading or deceptive conduct, undesirable practices, material breach of law and so forth. The Authority has determined, however, that behaviour which might fall within one or more of these descriptions will not necessarily amount to a UTS, unless trading itself is threatened.⁵⁰² The five clauses themselves, are only included as general examples of undesirable situations. Treating them as definitive would mean that clause (c) would need to be expanded to include a “fully comprehensive and exhaustive list” which would be counterproductive.⁵⁰³

To trigger a UTS the Court held that it is crucial to bring the conduct within clauses (a) and (b), but clause (c) will only be illustrative of a UTS.⁵⁰⁴ Therefore the Authority’s decision cannot be criticised for failing to fall within any of clause (c)’s categories, including the (c)(iv) material breach of law provision. Material breach of law, such as anticompetitive conduct under s 36, will only amount to a UTS if it also threatens trading and cannot be resolved by any other mechanism. This means that a failure to address a possible breach of s 36 will not necessarily be treated as an error of law.

⁴⁹⁹ “Final Decision”, above n 453, at [29]-[32].

⁵⁰⁰ See above n 443.

⁵⁰¹ *Bay of Plenty Energy Limited*, above n 487, at [66], [107], [130] and [172]

⁵⁰² At [140].

⁵⁰³ At [137].

⁵⁰⁴ At [138].

Clause (b) stipulates that the other mechanisms of the Code do not have to be used if the Authority makes a reasonable decision not to use them. Other mechanisms include making amendments to the Code, an option some submitters felt should have been explored before setting what could be seen as a de fact price cap. As the decision to amend the Code is at the Authority's discretion, it is not an error of law to reset prices without amending the Code. As each decision is treated as entirely fact dependent, and as the court's respect for the Authority's expertise is complete, that discretion is almost unreviewable. The Authority may have to show that its choice was reasonable, but that may be such a formality that in fact (b), as well as (c), may be redundant. That leaves clause (a) as the true test, that is, did the conduct threaten the integrity of the market?

If the Commerce Commission were approaching a market cornering problem under s 36, there would have been extensive analysis of the market structure, inquiries into the degree of market power the defendant firm held, and whether or not that firm had taken advantage of its power for a proscribed purpose.⁵⁰⁵ In a case involving a vertically integrated firm with control of an essential wholesale input, the ECPR rule would be used as part of the counterfactual analysis.⁵⁰⁶ The prices the firm charged to its competitor could include its opportunity costs, but exceeding ECPR over a long period of time causing damage to a competitor, could provide evidence of anticompetitive purpose sufficient to breach s 36. The object of the exercise would have been to decide whether or not the firm was at fault, in that it was using its power to drive competitors from the field to the detriment of the competitive process, a necessary step before the Commerce Act's punitive remedies can be imposed. Instead, the Authority takes a no-fault approach:⁵⁰⁷

The Authority did not find that Genesis created a squeeze. It found that a squeeze occurred. It did not matter to the Authority whether any individual company created the squeeze or whether the squeeze was created as a result of a combination of circumstances. It was the existence of events the Authority identified as a squeeze which matter.

Perhaps this is in line with the division of jurisdictions first indicated in the MOU. The Authority's role would be to focus on market arrangements and leave

⁵⁰⁵ See discussion of s 36, above n 292, and *Commerce Commission v Telecom*, above n 329.

⁵⁰⁶ *Telecom v Clear*, above n 305.

⁵⁰⁷ At [251].

questions about market conduct to the Commerce Commission.⁵⁰⁸ Yet given the power that the Authority's Rulings Panel has, to order penalties of up to \$200,000, to award compensation of any sum and costs, it is arguable that this was not the legislative intent.⁵⁰⁹ Either the Authority or an Industry Participant may refer a complaint to the Rulings Panel, the Authority's own appeal body.⁵¹⁰ The fact that the Rulings Panel has these punitive powers indicates that it would have to find fault, and that might entail a harder look at the sort of issues a s 36 investigation would entail.

The closest the Court came to considering the s 36 question was when it said that "the Authority considered whether Genesis had taken advantage of market power to achieve high prices and thereby engaged in manipulative behaviour."⁵¹¹ The Court acknowledged that the UTS arose because the prices were "the product of the exercise of transient market power."⁵¹² Exercising market power to charge prices far in excess of underlying costs is the very essence of monopolistic behaviour, but it will only breach s 36 if done for one of the proscribed purposes. Purpose can be inferred from effects, and that anticompetitive purpose could have been inferred from the resulting and inevitable damage to Genesis' rivals.

Taking advantage of market power is a phrase so closely associated with s 36 as to be considered a term of art. It requires the use of counterfactual analysis. Did the Authority actually consider the question of how a market participant in a competitive market would have behaved in the same circumstances? The Court acknowledged there is no price cap on the NZEM and that Genesis submitted its offers at the correct time, which put some of the onus on market participants. The market squeeze was then a result of the transmission outages, and the unforecast demand, which divorced prices from actual supply and demand. The approach was simply to consider the combination of factors *in toto* and decide whether all circumstances amounted to a UTS.⁵¹³ Genesis was not at fault because its "strategy around 25-26 March was consistent with managing its own risk of being able to supply all the electricity it had agreed to supply as well as (as it was

⁵⁰⁸ "Statutory Objective", above n 422, at [A.28].

⁵⁰⁹ See above n 435.

⁵¹⁰ Electricity Industry Act, s 50.

⁵¹¹ At [73].

⁵¹² At [243].

⁵¹³ At [199].

entitled to) maximising the price it received for the electricity it generated.”⁵¹⁴ The inference is that any competitor in the same circumstances would have behaved in the same way, so in fact the Authority was doing a form of counterfactual analysis.

The concomitant conclusion was that if there had been a genuine scarcity or that the high prices had been signalled sufficiently far in advance that they could be foreseen, no UTS would have occurred.⁵¹⁵ This reinforces the point that prices are not capped, and that high prices may in fact be necessary to signal scarcity or to encourage contestability and investment. One wonders whether those circumstances did arise in the future whether the Authority would, in fact, have the courage of its convictions.

If the incident had threatened orderly trading then one might have expected that similar conditions would have had similar results. But when similar market conditions did occur on the weekend of the 2nd April, no price squeeze occurred. The market had learned its lesson, proper hedging and demand response measures were employed and prices were unexceptional.⁵¹⁶ Genesis argued that this showed that March 26 could not have abridged clause (a), threatening orderly trading, because orderly trading demonstrably occurred. The Court replied that, as forecasts were accurate, no generator was net pivotal, and no squeeze actually occurred, the scenario was in fact quite different.⁵¹⁷

The fact that on another occasion the potential for the exercise of transient market power was avoided does not somehow undermine the Authority’s conclusions about the events of 26 March and the fact that they constituted a UTS.

It would never then be possible for Genesis to show that March 26 was actually good for the market. The Court has not only treated March 26 as inherently fact dependent, but it has refused to accept any beneficial impact events may have had on the market over time. It is an argument Genesis cannot win. The resolution to ignore *Powerco* and treat wealth transfers neutrally in the interests of ‘increasing the pie’, has not been forgotten, but such reasoning will not apply to price squeezes.

⁵¹⁴ At [72].

⁵¹⁵ At [157] citing “Final Decision”, above n 453, at [159].

⁵¹⁶ At [235]-[245].

⁵¹⁷ At [243].

Was the remedy the correct one? The Authority set prices at the Long Run Marginal Cost (“LRMC”) because.⁵¹⁸

The \$3000/MW offer price cap is intended to remove the effects of the market squeeze, while retaining incentives on participant that are aligned with those in a workably competitive market. In a situation where there is a willing buyer and willing seller, a net pivotal generator should be able price up to the economic alternative of the buyer, which would approximate the LRMC of a new entrant generation option or the opportunity cost of electricity for consumers (i.e. the price at which demand response occurs).

Setting prices for an essential wholesale input at the LRMC is basically the same as the Baumol-Willig ECPR from *Telecom v Clear*.⁵¹⁹ Recall that ECPR is the basis for the counterfactual test in monopoly situations involving vertically integrated suppliers of essential wholesale inputs under s 36. Just like the LRMC, it accepts that charges can include the opportunity costs for foregone revenue. By applying the same calculation the Authority seems to have replicated *Telecom v Clear* and applied it to UTS decisions. This cannot be a coincidence. If the Authority had been able to impose a punitive penalty as a deterrent, then the result would have been identical to the Datatails case. Nevertheless the decision did create winners and losers, and seemed to penalise those who had made the proper risk assessments and paid a premium for hedge arrangements to cover just such occasions or who had responded to the increases in prices by cutting production.

Could the Final Decision breach the Memorandum of Understanding the Authority has with the Commerce Commission? The whole issue of the interrelationship between Commerce Commission and Authority is left unexamined by the Court. The requirement to advise the Commission before amending the code is something still to be considered, as is the potential for *res judicata* problems created by the potential for parallel s 36 and UTS proceedings. The EIA prohibits the Authority from regulating anything that is the Commerce Commission’s domain under Part’s 3 and 4 of the Commerce Act.⁵²⁰ Yet as this decision has no precedential effect, it cannot be seen as a price cap and cannot be a form of price control as we would understand it under Part 4, nor is it an amendment which affects the Commission’s powers and functions. Parallel proceedings are also a common occurrence. So long as the Authority’s reasoning

⁵¹⁸ At [301] citing “Final Decision” at [188].

⁵¹⁹ See *Telecom v Clear*, above n 305.

⁵²⁰ Commerce Act s 32(2)(b).

continues to be consistent with the prevailing competition law, then that too should not prove too problematic. One can only hope that any such jurisdictional questions could be resolved in a common sense matter, and if they are not, academics can always use a legal drama.

Conclusion

Competition law has evolved away from the ideal that statically efficient perfect competition was possible, or even preferable. Adam Smith's invisible hand became constrained by the static efficiency models of Cournot and Edgeworth who believed that efficiency meant the greatest output at the cheapest price. The Jeffersonian ideal held that democratic self-sufficiency was an inalienable right. The Structure Conduct Performance Paradigm predicted that concentrated markets would have inefficient results. The role of the state was therefore to identify when excessive profits were being obtained by monopoly firms, and then either control prices by regulation, or reform the market structure, breaking up cartels and monopolies.

Beginning with the work of Frank Knight and J.B. Clark, economists began to realise that the difference between perfect and actual competition may be impossible to gap. J.M. Clark coined the term workable competition to make the point that perfect competition probably did not exist, and if it did it would be ruinous, a point that would be echoed in Robert Bork's influential *Antitrust Paradox* in the 1970s.

Nevertheless, some very influential writers suggested that goods should be produced at the marginal cost, and that prices should be calculated and maintained by regulation. Where prices could not be controlled, Pigovian subsidies or Kaldor-Hicks payments could be used to compensate for disparities in Pareto Optimality. Ronald Coase stridently argued that such a proposal was a recipe for economic disaster, not just for the amount of wasteful state intervention it would require, but for costs to long term development which would be undermined by the low profits of marginal cost pricing. These marginal cost controversy arguments continue to be proffered to this day, particularly in New Zealand by economists like Grant Read, Bart van Campen and Lewis Evans.

The resurgence of Adam Smith's liberal ideals was thus based on a rejection of an interventionist state. Robert Bork and Richard Posner both argued that the populist ideals of the Sherman Antitrust Act as applied by the Supreme Court in *Standard Oil*, had made it a crime for a monopoly firm to profit, even where efficiency gains could be made, which was utterly illogical. Schumpeter argued that the real power of capitalism was derived from the waves of creative destruction, which destroyed the inefficient, making way for new ideas and new products. Baumol took the idea one step further, arguing that contestability only required potential rivalry to discipline the incumbent monopolist. These ideas were transmitted to New Zealand, as evident in the writings of Alan Bollard, and were encapsulated in the light handed regulation of the Commerce Act 1986.

The two key elements of the Commerce Act were s 36, which prohibited anticompetitive behaviour, and Part 4, which provided for price control of natural monopolies. As the dynamic efficiency versus consumer welfare debate waxed and waned, both elements were amended with the intention of lowering the threshold for s 36 prosecutions, and enabling price regulation to take a more balanced approach. Efficiency benefits could be achieved by applying cheaper and more flexible control options and indeed the costs of regulation had to be weighed against the benefits. Ahdar pointed out that the acceptance of the overweening power of the monopolist to compete had resulted in s 36 being hamstrung, despite the lower threshold, as evidenced by the lack of successful s 36 prosecutions until very recently. Typical of this was the development of the Baumol Willig ECPR rule which indemnified vertically integrated firms from prosecution where their charges to rivals for essential wholesale inputs included the opportunity costs, the revenues lost through competition. The recent Datatails case demonstrates, however, that pricing in excess of ECPR in market cornering situations could well result in stiff penalties.

The Electricity Authority meanwhile has had its own evolutionary history, which has had to take into account the problems peculiar to regulation of electricity and the development of the industry as a state owned monopoly. Concerns in Wolak's report about monopoly profit taking on a massive scale, in an investigation by the Commerce Commission, still failed to activate s 36. Monopoly profits alone are not illegal, a clear result of the Chicago School influence of Posner amongst

others. The Authority itself has stated that, unlike the Commerce Commission's position in *Powerco*, it would not take wealth transfers into account, but would apply a total surplus standard approach. Efficiency benefits would trump consumer welfare considerations, because the assumption was that consumers would benefit in the long run.

When the UTS regime was applied to the March 26th price hike, however, the Authority intervened because to allow market cornering behaviour on this scale would shatter the confidence and integrity of the market. The Authority cast no blame, but reset prices to the LRMC of a new entrant. The remedy reaffirmed the Authority's faith in contestability, balanced with the need to ensure that prices are competitively determined. Despite the fact that the outcome was not based on an explicit s 36 analysis, the result was extremely similar to the application of the ECPR counterfactual in *Datatails*. The fact that similar circumstances have had similar results before two very different regulatory agencies, should be reassuring to industry participants and consumers alike. The fact that UTS decisions lack the usual precedential value still contains the risk of very different and even arbitrary decision making in future.

One final note, even though the marginal cost controversy resulted in a rejection of state centred pricing, and even though light handed regulation sought to exclude prime necessity arguments that utility services should be provided at a reasonable price, we still see echoes of those sentiments in the ECPR and the LRMC calculations of the Commerce Commission and the Electricity Authority. There is still the sense that where consumers and rivals are captive, the illimitable power of monopolist must be constrained. The marginal cost arguments of last century have shifted the calculation of what profit is reasonable, but the same logic applies. Dynamic efficiency takes a long run view, but in this new era of re-regulation, abuse of monopoly power will ultimately be resisted by the Commerce Commission and the Electricity Authority.

Spiking Prices: How Economics, History and Law have shaped the New Zealand Electricity Authority's UTS Regime

By Steven Farnworth

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