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ANNUAL REPORT ON COMPETITION POLICY DEVELOPMENTS IN NEW ZEALAND

-- September 1, 2005 through August 31, 2006 --

This report is submitted by the Delegation of New Zealand to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 18-19 October 2006.

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Executive Summary

1. This report summarises the major developments in New Zealand's competition law, the enforcement of that law and in competition policy generally, over the period 1 September 2005 - 31 August 2006.
2. New Zealand's key competition statute is the Commerce Act 1986 which is enforced by the Commerce Commission. In the reporting period, the government emphasised the strategic importance that it attaches to timely investment in infrastructure by regulated businesses through new statements of Government Policy which the Commerce Commission and Electricity Commission are required to have regard to.
3. New Zealand and Australia have made significant progress towards implementing the recommendations of a 2005 study by the Australian Productivity Commission on long term issues relating to the harmonisation of competition law between Australia and New Zealand. For example the New Zealand Commerce Commission and the Australian Competition and Consumer Commission signed a cooperation protocol for the consideration of trans-Tasman mergers. Government officials are developing legislative proposals to enhance the ability of the Commerce Commission to share information with overseas competition regulators.
4. In May 2006, the Minister of Commerce announced a Review of Parts 4 and 5 of the Commerce Act, which relate to regulatory control and to authorisations and clearances. Final policy proposals are expected to be recommended to Cabinet in late 2007.
5. A major review of the telecommunications regulatory regime and telecommunications policy settings was conducted in 2005/2006. As a result, the Telecommunications Amendment Bill is being considered which includes proposals for local loop unbundling.
6. The Commerce Commission completed 35 investigations into suspected anti-competitive market behaviour over the year to 30 June 2006. The Commission also completed 10 merger or acquisition investigations, and decided on 20 clearance applications. It resolved 2 merger authorisations under the Electricity Industry Reform Act.
7. During the reporting period the Commerce Commission also published its intention to control the electricity distribution services of Unison Networks Limited and the electricity transmission services supplied by Transpower New Zealand Limited. Both companies are constructively negotiating towards an administrative settlement with the Commission.

1. Changes to competition laws and policies, proposed or adopted

8. The Commerce Act 1986 is the central pillar of New Zealand's competition legislation. Its purpose is to promote competition in markets for the long-term benefit of consumers in New Zealand. It therefore prohibits various types of conduct that substantially lessen competition in New Zealand markets. There is specific competition legislation for the electricity industry (the Electricity Industry Reform Act 1998 and Part 4A of the Commerce Act), the telecommunications industry (the Telecommunications Act 2001), and the dairy industry (the Dairy Industry Restructuring Act 2001). However, the general competition law set out in the Commerce Act applies to all industries, including those with industry-specific competition legislation, and both the public and private sectors.

9. The Commerce Commission continues to be the primary competition authority in New Zealand. It is an independent statutory body with predominantly adjudicative and public enforcement functions. The Commission is also the industry-specific regulator for electricity (along with the Electricity Commission), telecommunications and dairy markets.

1.1 Summary of new legal provisions for competition law and related legislation

1.1.1 Commerce Act 1986

10. Only one very minor change has been made to the Commerce Act in the reporting period. A minor technical amendment was made to clearance and authorisation provisions to correct a drafting error.

1.2 Other relevant measures, including new guidelines

1.2.1 Draft Amendments to the Government Policy Statement on Electricity Governance

11. The government has announced plans to amend the Government Policy Statement on Electricity Governance to emphasise the strategic importance that the government attaches to timely investment in transmission infrastructure. The Electricity Commission is required to give effect to the amended statement once the amendments are approved.

1.2.2 Statement of Economic Policy to the Commerce Commission under section 26 of the Commerce Act 1986

12. The government has issued a new statement under Section 26 of the Commerce Act¹, which focuses on the importance of regulated businesses, such as Transpower and electricity lines businesses, investing in infrastructure such as new lines and related plant. It emphasises the need for these businesses to have the confidence and the incentives to make new investments. The Commerce Commission is required to have regard to the statement.

1.2.3 Electricity Act

13. There have been no changes to the Electricity Act during the reporting period. The Electricity Commission is required to endeavour to ensure that New Zealand's electricity supply is secure, with adequate reserves for dry years, and to promote and facilitate the efficient use of electricity. The Electricity Commission holds powers to recommend regulations for certain matters relating to wholesale, generation, transmission, distribution and retailing markets, including consumer protection.

¹ Section 26 of the Commerce Act requires the Commission, in the exercise of its powers under the Act, to have regard to the economic policies of the government as transmitted in writing to it by the Minister.

14. The industry as a whole continues to be subject to the general provisions of the Commerce Act and to the broad oversight of the Commerce Commission.

1.2.4 Jurisdiction of the Electricity Commission and Commerce Commission under Part 4A of the Commerce Act 1986

15. The Commerce Act contains provisions that provide for the transfer of all of the powers of the Commerce Commission in respect of the control regime for Transpower to the Electricity Commission. Transfer was considered in the reporting period. The Minister of Energy decided not to transfer jurisdiction under Part 4A of the Commerce Act in respect of Transpower from the Commerce Commission to the Electricity Commission at this time.

1.2.5 Open Access to Maui Pipeline

16. In October 2005, an open access regime was implemented on commercial terms to the Maui pipeline, New Zealand's most significant gas transmission pipeline. The Minister of Energy approved the regime as an industry arrangement and no regulations were made in this regard.

1.2.6 Co-ordination with Australia

17. In August 2003, CER² Ministers approved a joint work programme for further co-ordination of competition law, enforcement and institutions. Some aspects of the work programme have already been delivered - for example, co-ordination on leniency programmes, and the appointment of Australian lay members to New Zealand's High Court to sit on Commerce Act cases.

18. Under the agreed work program, the Australian Productivity Commission conducted a study on competition and consumer policy co-ordination between Australia and New Zealand and released its final report in January 2005. The purpose of the study was to examine options for greater cooperation, coordination and integration of the two countries' general competition and fair trading regimes, and to assess whether the expected benefits will outweigh the costs. The Productivity Commission noted that there was already a high degree of convergence between Australian and New Zealand competition laws and that any continued differences were not acting as a significant impediment to the development of a single economic market between the two countries. Both governments accepted the Commission's recommendations, which included:

- Regular meetings between Australian and New Zealand competition policy officials;
- Cross appointments between competition agencies to consider transactions which apply to both jurisdictions;
- Working towards a 'single track' process for mergers that have competition impacts in New Zealand and Australia; and
- Amending competition legislation to provide for enhanced information sharing powers between competition agencies.

19. Both countries have made significant progress towards implementing all of these recommendations which include:

² CER is a series of agreements and arrangements that began with the entry into force on 1 January 1983 of the New Zealand Australia Closer Economic Relations Trade Agreement.

- In September 2005, New Zealand and Australian officials held their first formal annual meeting on competition issues;
- In July 2006, the New Zealand Commerce Commission and the Australian Competition and Consumer Commission held their first formal joint annual meetings to discuss strategic issues of mutual interest;
- In August 2006, the New Zealand Commerce Commission and the Australian Competition and Consumer Commission signed a cooperation protocol for the consideration of mergers which are subject to review in both New Zealand and Australia; and
- Government officials are developing legislative proposals to enhance the ability of the Commerce Commission to share information with overseas competition regulators. The Government aims to introduce these legislative proposals in 2006.

1.3 Government proposals for new legislation

1.3.1 Information Sharing Bill

20. Following the release of a public discussion paper: *Information Sharing by the Commerce Commission*, in September 2004, the Government decided in May 2005 to amend the Commerce Act to authorise the Commission to provide investigative assistance to, and share confidential information it holds and compulsorily acquired, with overseas competition authorities, subject to specified safeguards. The main impetus for the amendment is to facilitate increased enforcement cooperation with the Australian Competition and Consumer Commission consistent with promoting a single economic market for Australia and New Zealand.

21. Under legislative proposals currently being developed, the Commission will be able to use its statutory powers (including its power to search) under the Commerce Act to provide investigative assistance to overseas regulators for suspected contraventions of overseas competition laws. The Commission will also be able to share information it holds and obtained by compulsion through the use of its statutory powers under the Commerce Act, with an overseas competition regulator if that information indicates a likely contravention of overseas competition laws.

22. The Commission will be able to provide such investigative assistance and information sharing only pursuant to formal agreement between governments, government departments, or competition regulators (as the case may be). The Commerce Act will specify matters to be considered prior to entering into, and to be included in, any formal cooperation agreements to ensure that the public interest is protected. The Commission will have the discretion, taking into account specified matters, as to its response to requests for assistance.

23. Information obtained other than through the use of the Commission's statutory investigative powers may continue to be exchanged outside of formal agreements, and if confidential or personal, by consent of the parties involved.

24. The Commerce Act will also be amended to allow the Commission to share confidential information obtained through the use of its powers under the Act with other domestic regulators for enforcement purposes (e.g. suspected contravention of other domestic laws).

25. A Bill is currently in development to implement the government policy decisions and is expected to be introduced to the House in late 2006. Legislation is likely to be passed in 2007.

1.3.2 *Review of Parts 4 and 5 of the Commerce Act 1986*

26. In May 2006, the Minister of Commerce announced a Review of Parts 4 and 5 of the Commerce Act, which relate to regulatory control and to authorisations and clearances. The Review will be run in two streams as follows:

- Stream one will examine the regulatory control provisions of the Commerce Act (Part 4 and sections 70-74 of Part 5). Part 4 of the Commerce Act allows for goods or services to be placed under price, revenue, or quality control (regulatory control) subject to specific tests being met. Once a decision has been made to impose control under Part 4, the controlled good or service may not be supplied unless an authorisation to supply has been made under Part 5.

27. The overarching objective, in reviewing the regulatory control provisions of the Commerce Act, is to ensure that the imposition of regulatory control is consistent with providing for the long-term benefit of consumers within New Zealand. The Review will look to ensure: there is clarity around the policy intent of imposing control; there is appropriate guidance for businesses and regulators on when control is likely to be imposed; there is appropriate guidance for businesses and regulators on how regulatory control should be imposed; and there are effective and efficient processes to determine when and how control is imposed.

- Stream two will examine the processes relating to the authorisation and clearance of restrictive trade practices and business acquisitions (sections 58-69B of Part 5 of the Commerce Act). Authorisation is able to be sought for most types of practices and business acquisitions substantially lessening competition, if sufficient benefits to the public are shown that outweigh any detriments arising from the practice. Clearance is able to be sought for business acquisitions that may or may not substantially lessen competition.

It is generally accepted that New Zealand's clearance and authorisation processes are of a high standard. The Review will draw on the experiences of regulators and practitioners to further improve the authorisation and clearance processes. In particular, the Review will look to ensure that the authorisation and clearance processes within the Commerce Act provide the appropriate degree of: accountability and transparency of decision making; participation by interested parties; analytical rigour and due process; and timeliness of decision making.

28. It is expected that discussion documents on both streams of the Review will be released for full public consultation in early 2007. Final policy proposals are expected to be recommended to Cabinet in late 2007. Any legislative amendments resulting from the Review are expected from 2008 onwards.

1.3.3 *Gas*

29. In April 2003, the Minister of Energy asked the Commission to make recommendations on whether or not the supply of gas pipeline (transmission and distribution) services should be controlled under Part 5 of the Commerce Act.

30. The Commission's Final Report was released by the Minister of Energy in December 2004. The Commission recommended to the Minister that:

- Control under Part 5 should be imposed on the gas pipeline services of two gas distribution companies (Vector Ltd and Powerco Ltd); and
- A targeted (thresholds) control regime akin to the electricity targeted control regime should be introduced for all gas (distribution and transmission) pipelines.

31. In July 2005, the Minister of Energy accepted the Commission's recommendations, and announced that the gas pipeline services operated in respect of the gas pipelines owned by Powerco and Vector will be subject to control under Part 5 of the Commerce Act 1986. The Order in Council took effect on 25 August 2005 for a period of 11 years.

32. Following the outcome of the Gas Control Inquiry, the government will introduce legislation to implement a targeted (thresholds) control regime for all gas pipelines. This will also involve transferring the responsibility for information disclosure from the Ministry of Economic Development to the Commerce Commission. Once this regime is in place, the gas pipeline services in respect of the gas pipelines owned by Powerco and Vector will be transferred from Part 5 Control to the new targeted (thresholds) regime.

1.3.4 Telecommunications

33. Two Government Bills relating to the telecommunications sector regulatory regime have been introduced to Parliament for consideration this calendar year: the Communications Legislation Bill and the Telecommunications Amendment Bill.

34. The Communications Legislation Bill is an omnibus Bill that extends the term of regulation on 10 telecommunications services by 2 years. This is necessary due to the potential risk that the regulator would be unable to complete the required process for extension of these regulations prior to their statutory expiry date. Despite the legislation, the regulator will still be able to continue its investigations and remove the regulations if they are deemed no longer necessary.

35. The Communications Legislation Bill is currently being considered by Parliament and is expected to be enacted in 2006.

36. A major review of the telecommunications regulatory regime and telecommunications policy settings was conducted in 2005/2006. As a result, the Telecommunications Amendment Bill has been introduced to Parliament and is now being considered by a select committee. The Bill introduces significant changes to the telecommunications regulatory regime in New Zealand. The main amendments include:

- regulation of unbundled local loops and sub-loops (including supporting backhaul and co-location services);
- amendments to remove performance constraints on the unbundled bitstream service and to clarify that it can be purchased without a requirement to also purchase an analogue phone service;
- introduction of an accounting separation regime for Telecom New Zealand;
- amendments to enhance the processes for setting and enforcing terms and conditions of supply; and

- enhancements to the ability of the regulator to monitor sector developments.

37. The Telecommunications Amendment Bill is expected to be enacted in 2006.

2. Enforcement of competition laws and policies

2.1 Action against anticompetitive practices, including agreements and abuses of dominant positions

38. The Commerce Commission is charged with enforcing a range of regulatory regimes, both general and industry specific. Its key enforcement activities during the year to 30 June 2006 are outlined below. More information can be obtained from the Commission's web site: www.comcom.govt.nz

2.1.1 Anti-competitive Practices

39. The Commission undertakes investigations as part of its responsibilities under the Commerce, Dairy Industry Restructuring (DIR), Electricity Industry Reform (EIR) and Telecommunications Acts.

40. Where, as the result of an investigation into alleged anti-competitive behaviour or an alleged breach of the DIR, EIR or Telecommunications Acts, a breach can be established, the Commission has the option of administrative resolution or prosecution. The Commission employs two broad types of administrative resolution: warnings and settlements. The particulars of warnings and settlements are decided on a case-by-case basis. The emphasis is on the most effective outcome towards enhancing the role of competition in New Zealand markets.

2.1.2 Market Behaviour Investigations (Anti-competitive Behaviour)

41. The Commission completed 35 significant restrictive trade practice investigations under Part 2 of the Commerce Act during 2005/6. The vast majority of the investigations focussed on anti-competitive arrangements between competitors, or the unlawful unilateral use of market power.

42. This year the Commission has relied upon its full range of enforcement options to ensure that competition is restored in markets affected by anti-competitive behaviour. The Commission issued five warnings, made one decision to negotiate a Commission settlement, made decisions to commence civil proceedings in two investigations and made one decision to take a criminal proceeding for misleading or obstructing the Commission. The Commission also made a decision to seek to obtain its first Cease and Desist Order from the Cease and Desist Commissioner. This enforcement option was introduced to the Commerce Act through an amendment in 2001.

43. One of the decisions to prosecute relates to an investigation into price fixing. The main players are alleged to have operated a highly organised cartel in an international market, including New Zealand, for more than a decade. This prosecution is at an early stage and it is not possible to disclose further details in relation to this matter.

44. The other decision to prosecute related to a resale price maintenance investigation and followed unsuccessful attempts to resolve the matter through a Commission settlement. Ultimately the parties did agree to a court sanctioned settlement and the matter has now been resolved.

45. In the application for the Cease and Desist order the Commission alleged that Northport Limited, a port operator, had taken advantage of its substantial degree of market power by tying marshalling services with other port services and may have entered into an exclusive arrangement with Northport

Services Ltd for the provision of marshalling services. The use of the cease and desist provisions allows the Commission the opportunity to seek to quickly restore competition in certain suitable circumstances.

46. Late in the year the Commission completed its investigation into Tourism Milford Limited's compulsory tying of dinner and accommodation at the Hermitage. The Hermitage is a remotely located hotel in a significant tourist destination. The hotel was considered likely to have a substantial degree of market power. The Commission decided it was likely that the behaviour was a taking advantage of market power in breach of section 36 and that the appropriate resolution of the matter would be to enter into a settlement with Tourism Milford Limited. There is agreement in principle to the terms of that settlement. Should final agreement not be reached, the Commission's fall back position is expected to be penalty action.

47. The Commission also experienced good results in two ongoing prosecutions. The Commission's investigation into cartel activity in the timber preservatives industry achieved a critical milestone in April of this year, with the High Court imposing a record penalty of \$3.6 million on Koppers Arch Wood Protection (NZ) Limited and its Australian parent, Koppers Arch Investment Pty Limited. This penalty was more than double the previous record, and comprises \$2.85 million for price-fixing and \$750,000 for attempting to exclude a new competitor from entering the market.

48. The penalty also reflects a 50% discount on \$7.2 million as the company admitted the breach prior to a significant hearing. The illegal behaviour occurred between 1998 and 2002 in the chrome copper arsenate and light organic solvent preservatives markets, markets worth an estimated \$35 million in 2002. Action against the other alleged cartel participants is still ongoing.

49. In the other prosecution four Palmerston North ophthalmologists were ordered to pay \$85,000 by the High Court for fixing the price for provision of their services to their local District Health Board. By choosing to remove competition from the pricing of ophthalmology services, the surgeon's arrangement created the potential for MidCentral Health Limited to pay a higher price for eye surgery, draining funding from other areas of the health budget.

50. In terms of new investigations, cartels remain a high priority. The Commission received two further leniency applications during the year including the first regarding a wholly domestic cartel.

2.1.3 Market Behaviour Authorisations (Anti-competitive Behaviour)

51. An application for authorisation of a restrictive trade practice requires the Commission to consider the benefit to the public of the trade practice, and to weigh this against the resulting or likely detriment to competition.

52. One such application came from the New Zealand Rugby Union, seeking authorisation for various components of their new Air New Zealand Cup competition starting in 2006.

53. The Rugby Union was proposing to introduce a cap on the total salary payments each union in the new Premier Division could make in a season. They were also proposing changes to the player transfer regulations, including removing the transfer fee for Premier Division players, and a prohibition on paying remuneration to players in the new Modified Division One competition.

54. The Rugby Union submitted that the salary cap would create a more even spread of players, resulting in closely contested matches that would attract bigger television audiences and earn more money. The Commission analysed four years of viewing figures and found that closely contested games were not necessarily more popular with the public. However, the quality of players in a match did affect the match's popularity. The Commission concluded that, by encouraging a more even spread of good rugby

players, the salary cap could increase the quality of play, and hence the popularity of rugby and the income to be earned from it.

55. The Commission approved the application, subject to a number of conditions. The salary cap is to last for six years, with the NZRU evaluating the effectiveness of the cap in a review after four years. The NZRU must also monitor and enforce compliance with the salary cap framework, including putting in place anti-avoidance clauses and ensuring they are complied with, as well as ensuring that no remuneration is excluded from salary cap calculations.

56. The Commission also authorised the changes to the player transfer regulations, including removing the quota system, extending the transfer window and removing the transfer fee for Premier Division players. The Commission had previously indicated in its Draft Determination that it would not approve the arrangements for Modified Division One; the Rugby Union withdrew these from its application, with a view to possibly presenting a modified approval application at a later date.

57. There was also a revocation of an existing authorisation, in this case the 2003 authorisation granted to Shell (Petroleum Mining) Company Limited, Todd (Petroleum Mining) Company Limited and OMV New Zealand Limited to jointly sell gas from the Pohokura field. The Commission had authorised the joint sale of Pohokura gas to avoid a forecast one-year delay in using the gas, avoiding the need to negotiate complex contractual arrangements to sell the gas separately. Due to the potential impact on the economy, the Commission believed avoiding the one-year delay outweighed the anti-competitive nature of joint selling.

58. However, the Pohokura owners were ultimately unable to agree on arrangements to jointly sell the gas and each owner separately sold their share, without any of the anticipated delays in production. The Commission could see no public benefit in allowing the anti-competitive arrangement to continue to exist so decided to revoke the authorisation.

2.2 Mergers and acquisitions

2.2.1 Market Structure Investigations (Mergers and Acquisitions)

59. The Commission completed 10 business acquisition investigations into non-notified mergers or acquisitions during the year. Half of these investigations were completed in less than three months. However, the remainder took more than the 100 working day target due to staff being diverted to manage the heavy clearance and litigation workload. The Commission took action following two investigations, as outlined below.

Telecom New Zealand Limited / Counties Power Limited

60. In October 2005, Telecom New Zealand Limited (Telecom) applied for clearance to acquire radio spectrum management rights from Counties Power Limited. Shortly before the Commission was due to make a determination on the matter, and just after the Commission had written to Telecom expressing concerns about the proposed acquisition, Telecom withdrew its application for clearance and proceeded to acquire the rights without Commerce Commission clearance.

61. The Commission then opened an investigation into whether the transaction had breached s47 of the Act, which prohibits acquisitions that have the likely effect of substantially lessening competition. This investigation ultimately concluded that the acquisition was unlikely to have resulted in a substantial lessening of competition.

62. However, as it considered the actions of the companies, the Commission became concerned that communications from the parties and their lawyers may have breached section 103 of the Commerce Act. Section 103(2) establishes that it is a criminal offence to attempt to deceive or knowingly mislead the Commission in relation to any matter before it. Therefore, a second investigation was opened into this matter, which concluded that there was an arguable case that parties attempted to deceive or knowingly mislead the Commission. The Commission issued a written warning to Telecom, and to certain lawyers involved in the transaction.

New Zealand Bus Limited / Mana Coach Services Limited

63. In January 2006, New Zealand Bus Limited (NZBL) applied for clearance to acquire the remaining 74% shareholding that it did not already own, in Mana Coach Services Limited (Mana). Shortly before the Commission was due to make a determination on the matter, and after the Commission had expressed concerns about the proposed acquisition, NZBL withdrew its application for clearance and advised the Commission that it intended to proceed with the acquisition without Commerce Commission clearance.

64. The Commission then opened an investigation into whether the transaction had breached s47 of the Act, which prohibits acquisitions that have the likely effect of substantially lessening competition. This investigation concluded that acquisition of the remaining 74% shareholding in Mana, its only major competitor in the Wellington bus market, was likely to breach s47 of the Commerce Act.

65. In March 2006, the Commerce Commission issued proceedings against NZBL, its parent company Infratil, and Mana seeking an injunction preventing the transaction from being completed, an order cancelling the agreement, declarations and costs.

66. In June 2006, the High Court found that the acquisition was likely to result in a substantial lessening of competition. The Court has given a declaration to this effect, and held two of the directors of Mana liable as accessories for participating in the waiver of the requirement for Commission approval in the contract. Questions of penalties and costs were to be traversed in August.

67. This was the first time that the Commission has sought an injunction to prevent an acquisition under s47 of the Commerce Act.

68. The Court's decision has been hailed as a landmark for the Commerce Commission in terms of preserving the integrity of the voluntary clearance regime. It sends a clear message to the business community that there is an incentive to obtain clearance from the Commission for mergers and acquisitions where there are potential competition issues. The finding against NZBL as well as two of the directors of Mana, means that both the acquirer and vendor need to be mindful of the provisions of s47 of the Commerce Act.

2.2.2 *Market Structure Clearances (Mergers and Acquisitions)*

69. Under the Commerce Act, parties may lodge a notice with the Commission seeking a formal clearance or authorisation of a proposed merger or acquisition.

70. In considering a clearance application, the Commission's role is to determine whether the merger or acquisition has, or is likely to have, the effect of substantially lessening competition in any market. The clearance process has a statutory completion time of ten working days. This time can be extended by agreement between the applicant and the Commission. The average time taken to make clearance decisions in 2005-06 was 37 working days.

71. The Commission commenced the period with four clearances on hand, and received 20 applications during the financial year, completing 20. Seventeen applications were granted, one of which was conditional on undertakings by the parties that certain assets were to be divested. Of the remaining applications, in three cases the Commission was not satisfied that the acquisitions would not result in a substantial lessening of competition in a market and approval was declined. The Commission had one application on hand at the end of the year.

72. Comprehensive written reasons for all clearance decisions are available on the Commission's website, www.comcom.govt.nz.

2.2.3 Market Structure Authorisations (Mergers and Acquisitions)

73. The Commission considers applications for merger and acquisition authorisations under the Commerce Act and exemptions under the EIR Act.

Commerce Act

74. Market structure authorisations under the Commerce Act primarily involve proposed mergers and acquisitions where the parties consider that a proposed acquisition will result, or is likely to result, in a substantial lessening of competition in a market. The Commission must grant an authorisation if it is satisfied that the public benefit directly attributable to the acquisition outweighs any detriment. No applications for authorisation under s67 of the Commerce Act were received or decided in 2005-06.

Electricity Industry Restructuring Act

75. The EIR Act restricts relationships between electricity lines businesses and electricity supply businesses. Under the EIR Act, the Commission may grant exemptions if it is satisfied that the cross-ownership or involvement proposed would not inhibit competition in the industry or permit cross-subsidisation of generation assets or electricity retailing with electricity lines businesses. The Commission may also grant exemptions if it is satisfied that the involvement would result in relationships between lines and supply businesses that are at 'arms length'.

76. During 2005-06, the Commission received three applications for authorisation under the EIR Act, with five in hand from the previous year. Two applications were withdrawn, one was granted and one was declined.

77. Of the two applications which resulted in decisions, Unison Networks Limited and Eastland Networks Limited applied for exemptions from the 'arms length' provisions of the Act, in respect of investment in proposed wind farms.

78. A lines business is only allowed to have an interest in a renewable generation business if both businesses are run as separate companies and kept at arms length. In the case of Unison, the Commission granted a limited exemption from the arms length rules as Unison was not proposing to supply electricity from the wind farm in question to customers connected on its own network.

79. The Commission, however, had particular concerns over the proposal by Eastland to retail the electricity from its wind farm directly to its own customers. This created the potential for a number of anti-competitive scenarios, including Eastland inhibiting retail competitors from accessing its lines network or its own retail customers receiving preferential treatment. For these reasons, the Commission felt granting the exemption would create incentives and opportunities to inhibit competition in the electricity industry.

3. The role of competition authorities in the formulation and implementation of other policies, e.g. regulatory reform, trade and industrial policies

3.1 Dairy Industry

80. The Commission has both an enforcement and a regulatory control role under the Dairy Industry Restructuring Act 2001. The Commission's role is to promote the efficient operation of raw milk and other product markets in New Zealand by enabling new entrant processors to buy raw milk and ingredients from Fonterra Co-operative Group Limited (Fonterra) at non-discriminatory prices, monitoring whether Fonterra's farm suppliers are being prevented from entering or exiting in response to price signals, and determining disputes between Fonterra and existing or potential shareholders or independent producers.

81. The majority of the Commission's work has related to the ability of independent dairy processors to obtain raw milk from Fonterra. Under the Raw Milk Regulations independent processors can require Fonterra to supply them with raw milk at the default price. The default milk price is the wholesale milk price for the season plus the 'reasonable cost of transporting the raw milk to the independent processor'. These Regulations set out a formula for calculating the wholesale milk price and the Commission has been required to interpret the meaning of a number of components in that calculation.

82. In September 2004, the Commission received an application from Open Country Cheese Company Limited (Open Country) for a determination under the DIR Act relating to charges for reasonable transport costs with Fonterra. A conference was held during the year to hear submissions on both sides of this issue. Fonterra had applied a charge based on its budgeted national-average based transport cost. The Commission determined that this was not reasonable. The Commission felt it was more appropriate that the cost should reflect the particular characteristics of supply to Open Country Cheese and ordered Fonterra to pay Open Country Cheese \$211,426 in compensation.

83. Open Country Cheese also applied for a determination relating to what Fonterra can include as retained profits when calculating the wholesale milk price. The profits at issue came from Fonterra's sale of its shares in National Foods Limited and Wrightson Limited.

84. The Commission's view was that this was not a breach of the Raw Milk Regulations. The regulations do not distinguish between 'capital' and 'operating profits' and the profits realised from the sale of investments would fall within the definition of 'retention'.

85. Open Country Cheese appealed this decision but later withdrew the appeal.

86. The Commission also received judgements in two cases before the Court of Appeal relating to the calculation of the default price of milk.

87. The first proceeding related to an application by Fonterra for a declaration on statutory interpretation as to whether 'new co-op retention' should include the amount of Fonterra's after-tax loss. In its first year of operation Fonterra recorded an after-tax loss of \$50 million. Rather than recording this as a negative amount in the calculation of the default price of raw milk, Fonterra recorded the retention as nil.

88. The Commission was concerned that by not recording the after-tax loss in the formula, independent processors paid a higher price for raw milk. The Court of Appeal disagreed, holding that Fonterra's after-tax loss does not fall within the definition of retention.

89. The Court of Appeal did agree with the Commission that the payout to be included in the formula should mean “the total payout from profits in that season”. This means that the after-tax loss would still be taken into account through a reduction in the amount of payout to be included in the formula.

90. The second proceeding also revolved around statutory interpretation and the unbundling of the milk price, in particular the calculation of the discount rate.

91. The payout to farmers includes both a return on their invested capital and the payment for milk, less the annualised share value. The discount rate (cost of capital) is used in calculating the annualised share value, which represents this return on invested capital. Under the Raw Milk Regulations, the Commission is required to set a discount rate where Fonterra does not use a cost of capital rate in calculating the price of a co-operative share.

92. Fonterra had used a weighted average cost of capital but the Commission argued that a cost of equity capital should be used to be consistent with the purpose of the regulations. The Court of Appeal held that reading ‘cost of capital’ as ‘cost of equity capital’ would be straining the words of the regulations.

93. The Commission has applied for leave to appeal to the Supreme Court on this issue.

For more information, refer:

www.comcom.govt.nz/IndustryRegulation/DairyIndustryRestructureAct/Overview.aspx

Electricity Lines Industry

94. The Commission has responsibility for electricity sector regulation under the Electricity Industry Reform Act (see section II above) and Part 4A of the Commerce Act. The electricity sector is also subject to general market regulation under the Commerce and Fair Trading Acts.

95. Part 4A of the Commerce Act provides the Commission with regulatory responsibility over the one transmission business (Transpower) and 28 distribution businesses that make up the large electricity lines businesses. This regulatory responsibility allows the Commission to:

- Assess lines businesses against thresholds set by the Commission and determine whether these thresholds have been breached;
- Develop and administer an electricity information disclosure regime for disclosure of financial and other performance information; and
- Ensure that the valuation of lines businesses’ system fixed assets reflects the correct application of the optimised deprival valuation (ODV) method, and undertake a review of the valuation methodologies for the fixed assets of lines businesses.

Performance Thresholds

96. The Commission assessed compliance statements for the 31 March 2005 assessment date. Five businesses indicated that they had breached the price path threshold. Three of the businesses had previously breached these price paths and were subject to post-breach inquiries. Five businesses also reported breaches of the quality threshold set for electricity lines businesses. Two of the businesses are currently under post-breach inquiries.

97. The Commission ran a consultative process following issuance of a paper entitled Regulation of Electricity Lines Businesses Targeted Control Regime: Next Steps for Implementing Proposed Changes to

the Distribution Thresholds Gazette Notice. This resulted in the Commission gazetting a number of amendments to the thresholds for distribution businesses, originally set on 1 April 2004. The amendments included a change to the provision relating to notional revenue during an assessment period to more accurately reflect the intent of the Commission's decisions and an extension to the provisions relating to exemptions from the information requirements to, among other things, permit the granting of an exemption to a business that has agreed to an administrative settlement with the Commission; or that the Commission has determined not to assess at a particular date. These took effect from 1 April 2006.

98. In June 2006, the Commission gazetted the *Commerce Act (Transpower Thresholds) Notice 2006* to take effect from 1 July 2006. By this Notice, the Commission rolled over Transpower's existing price path and quality thresholds for a further year.

Regulatory Control Declarations

99. On 24 August 2005, the New Zealand Court of Appeal dismissed an appeal from Unison Networks Limited that sought to prevent the Commission from deciding whether to publish an intention to declare control of that company's electricity lines business activities. In dismissing the appeal, the Court of Appeal noted that regulatory processes could be distorted if the Courts insisted that a challenge to one step of the statutory process was required to be fully resolved before the Commission could complete any subsequent procedural steps.

100. On 9 September 2005 the Commission published its intention to control the electricity distribution services of Unison Networks Limited. This was the first time since the regime commenced in August 2001 that the Commission had done so. The Commission subsequently held a public consultative process during November and December to determine whether to control Unison Networks Limited's electricity distribution services assets. During this time the Commission held public conferences in each of the major towns associated with the Networks owned by Unison. Subsequently in March 2006, the Company sought to enter into an administrative settlement offer with the Commission and in an interim move confirmed that from 1 April 2006 it would reverse its most recent distribution price increases that applied to two of its three networks. The Company has consequently been preparing an administrative settlement offer. No final offer had been proposed to the Commission by August 2006 but constructive negotiations were still under way.

101. On 22 December 2005 the Commission published an intention to declare control of the electricity transmission services supplied by Transpower New Zealand Limited, the sole owner operator of the national transmission grid. Transpower was in breach of its price path thresholds and had announced an intention to increase prices by 19% as from 1 April 2006.

102. On 31 January 2006 the written reasons for the decision to declare control were released. This was followed by expanded reasons following consultation with Transpower on confidentiality issues. Subsequently on 31 March, Transpower made an interim commitment that the proposed price increase would not go ahead on 1 April whilst it prepared an administrative settlement offer to present to the Commission. By August 2006 an administrative settlement offer had not been finalised by Transpower but constructive negotiations were continuing.

103. During the fourth quarter two new post-breach inquiries were opened. Otago Net breached both price path and quality thresholds for the assessment year ended 31 March 2006. The Power Company breached its price path only.

Information Disclosure and Asset Valuation

104. The Commission has been reviewing the information disclosure regime to ensure the quality and availability of reliable and timely information supplied by electricity lines businesses. This is important information for consumers. Two key papers were published, the *Valuation of the Regulatory Asset Base* paper and the *Review of the Information Disclosure Regime* paper, outlining what the Commission believed needed to be disclosed under the regime and how system fixed assets should be valued. These decisions will help inform the drafting of the revised disclosure requirements.

105. Information disclosure workshops were also held with auditors and representatives from the electricity lines industry. The aim of the workshops was to develop specifications for regulatory financial statements and financial performance measures, enabling new financial information disclosure requirements to be issued in the first half of 2006/2007.

106. Sound asset management planning is essential for electricity lines businesses and to assist in this process, the Commission published its *Asset Management Plans: Revised Information Disclosure Requirements and Handbook Decision Paper* on 31 March 2006. This outlined the Commission's final decisions on revisions designed to implement best practice for asset management planning as well as requirements to improve interpretation and consistency of the disclosures. Under the targeted control regime, there is no prior approval of investments, unlike that required in many regulatory environments overseas. The new asset management planning key decisions are that asset management plan disclosures must be approved by the Board of the disclosing entity and will be disclosed at the same time as the financial information disclosures by those entities. Asset Management Plans will be reviewed by the Commission annually and forecast capital expenditures must be disclosed and any forecast variances explained as part of the disclosures. It is intended that this will assist in identifying the increasing investment needs at an earlier stage, addressing many of the issues that have arisen in the past around investment planning.

107. For more information, refer:
www.comcom.govt.nz/IndustryRegulation/Electricity/Overview.aspx

Telecommunications Industry

108. The Telecommunications Act 2001 provides for a dispute resolution regime for designated and specified telecommunications services to be administered by a Telecommunications Commissioner and the Commission. In addition, the Commission is required to report on compliance with the telecommunications service obligations, and allocate the costs of these obligations to all liable parties.

109. The Commission also has a role under the Telecommunications Act in recommending to the Minister of Communications whether the scope of regulation should be expanded to include new services, or altered to amend or remove existing services.

110. In May 2006 the Government announced fundamental changes to the New Zealand telecommunications sector, which included an announcement by the Minister of Communications of the intention to introduce the Telecommunications Amendment Bill. This advocated new regulated services, particularly local loop unbundling, an option that had been explored by the Commission in its investigation in 2003. At that time, the Commission recommended New Zealand adopt an unbundled bitstream service, with monitoring by the Commission to ensure broadband access targets were met. A number of other changes have been proposed that will strengthen and change the way the Commission regulates access to the incumbent networks.

Access Determinations

111. The Commission started the year with 11 applications for access determination on hand. The Commission received a further six applications; nine were withdrawn by the applicants, with seven resolved during the period, leaving one outstanding at the end of the 2005/06 period.

Interconnection

112. In January 2006, Telecom and TelstraClear reached a settlement on various disputes and withdrew their applications for a review of the interconnection price.

113. The Commission has received an application from Vodafone, seeking interconnection with Telecom's fixed phone network. Vodafone is looking to launch a local service, using mobile phones that have the ability to work as home phones also, and the application seeks a service that allows local calls to be passed between Vodafone and Telecom customers. The Commission issued a draft Determination on the pricing of this service in June and expects to make its final decision in the first quarter of 2006/2007.

Wholesale (Resale) Services

114. Due to the settlement between Telecom and TelstraClear, both parties withdrew from all outstanding wholesale pricing review determinations.

115. During the year, the Commission set the terms for access to Telecom's residential broadband network for several of its competitors and released a final Determination on the resale of several Telecom business broadband services by TelstraClear.

Number Portability

116. The Commission issued its final determination on the allocation of costs of number portability in August 2005.

117. The Commission identified four classes of cost arising from the implementation of number portability: industry common set-up costs, operator specific set-up costs, per-line set-up costs and additional call conveyance costs.

118. The Commission determined that these costs should be borne as follows:

- *Industry common system costs:* Allocated amongst all providers of local and cellular telephone number portability services on the basis of market share based on active numbers.
- *Per-operator set-up costs:* Each operator will bear its own costs.
- *Per-line set-up costs:* Recoverable by the donor network operator from a recipient network operator.
- *Additional call conveyance costs:* Each operator will bear its own costs.

119. In May 2006 the Commission issued a clarification to its number portability determination to deal with some implementation issues.

120. The Commission's decision requires that the industry launch number portability by 1 April 2007. The industry is currently on track to meet this target.

Telecommunications Service Obligations

121. In December 2005, the Commission released its draft determination on the calculation of Telecom's net cost of complying with its TSO for the period 1 July 2003 to 30 June 2004 (the end of Telecom's financial year). The Commission considers the cost for that period to be \$41.2 million.

122. The cost will be apportioned between Telecom, TelstraClear Limited, WorldxChange Communications Limited, Vodafone New Zealand Limited, CallPlus Limited, Compass Communications Limited, Teamtalk Limited, and The Internet Group Limited (ihug) in proportion to their share of industry revenue.

123. The Commission's draft calculation of the TSO net cost involved two key factors:

- the Commission determined that the number of commercially non-viable customers was approximately 54,000 of the 1.3 million residential customer lines covered by the TSO obligation; and
- the net cost includes a reasonable return on capital to service the non-viable customers. The Commission concluded this is a low risk business and that an after tax return of 6.4 percent was reasonable.

124. The TSO cost is determined on an annual basis, with the Commission already commencing work on the TSO cost allocation for 2004/05.

125. For more information, refer:

www.comcom.govt.nz/IndustryRegulation/Telecommunications/Overview.aspx

Mobile Termination

After the Commission recommended to the Minister of Communications in June 2005 that the termination of fixed-line voice calls on a cellular telephone network be regulated, the Minister asked the Commission to reconsider its recommendation on several grounds. The Commission issued a draft reconsideration report in December 2005, and after considering submissions issued a final report in April 2006. The Commission continued to recommend that mobile termination be regulated but decided that regulation should also apply to calls terminating on 3G networks given it considered the likelihood of regulation slowing or limiting investment in 3G services was small.

Mobile Services Review

On 10 May 2006, the Commission announced that it would examine the reasons for lack of new entry into the mobile services market as a prelude to deciding whether or not to commence an investigation into possible changes to the regulatory framework. The Commission was still gathering information for this examination at the end of the 2005/06 year.

Broadband Monitoring

126. The Commission continued its monitoring of Telecom's performance against its broadband targets of no fewer than 250,000 residential broadband connections by the end of 2005, of which more than a third will be wholesale Jetstream or bitstream products.

127. As at the end of December 2005, Telecom had achieved 111.6 per cent of the connection target with a total of 279,123 residential broadband connections. Of this number, 63,495 were wholesale connections, representing 76.5 per cent of the wholesale target.

Regulatory Control Gas Pipeline Services

128. Part IV of the Commerce Act provides that goods and services may be controlled where competition is lessened and the imposition of control would be in the interests of acquirers. The Commission can initiate its own study into whether control should be imposed or alternatively, a study may be requested by the responsible Minister.

129. During 2004, the Commission worked on an inquiry into the supply of gas pipeline (transmission and distribution) services at the request of the Minister of Energy. The Commission delivered its findings in the Gas Control Inquiry Final Report to the Minister of Energy in November 2004. In the report the Commission recommended control of both Powerco Limited and Vector Limited.

130. In August 2005, the Minister of Energy accepted the recommendations of the Commission that were contained in its Gas Control Inquiry Final Report pursuant to Part IV of the Commerce Act, announced the imposition of control over the gas pipeline services of Powerco Limited and Vector Limited. On 24 August, the Commission issued a Provisional Authorisation in respect of the prices and quality of the gas pipeline services for these companies to take effect the next day. The Provisional Authorisation also enabled the companies to continue providing these services. The Provisional Authorisation requires Powerco to ensure its average price for controlled services as at 1 October 2005 was at least 9% lower than the average price charged at 30 June 2005. For Vector the average price was required to be at least 9.5% lower than the average price charged at 30 June 2005.

131. The release of the Provisional Authorisation followed a decision of the New Zealand High Court rejecting applications by both Powerco Limited and Vector Limited for urgent interim orders directing the form of control that the Commerce Commission could implement.

132. Powerco and Vector both separately applied to the Wellington High Court for judicial review seeking orders quashing the Commission's finding in the Gas Control Inquiry Final Report itself. The High Court has determined that the two claims will be heard at the same time. A hearing date is set for November 2006.

133. On 24 January 2006, the Commission published its *Authorisation for the Control of Supply of Natural Gas Distribution Services by Vector Ltd and Powerco Ltd Process Paper*. This paper described the Commission's proposed approach for issuing the final determination for the authorisation of the supply of gas distribution services of the companies.

134. At year end the Commission issued a discussion paper seeking submissions on the form of control to advance the process towards the issuance of final authorisations. The authorisation process was a very new process for the Commission. This fact, coupled with difficulties in obtaining the relevant information resulted in the original timetable being amended and extended so that the final authorisations would take effect on 1 October 2007.

135. At the end of the year the Commission consulted on whether to amend the provisional authorisations set in August. It was determined shortly after year end that the provisional authorisations would not be amended but would stay in place as determined in August 2005 until such time as the Final Authorisation takes effect or, alternatively the Commission decides to amend the authorisations, at which point it would consult again.

136. For more information, refer:
www.comcom.govt.nz/RegulatoryControl/GasPipelines/Overview.aspx

4. Resources of competition authorities

4.1 Resources overall (current numbers and change over previous year):

a) Annual budget (in your NZD and USD):

Total Annual Budget 2005/06:	\$(NZ) 10.3 million	\$(US) 6.2 million
Total Annual Budget 2004/05:	\$(NZ) 7.6 million	\$(US) 4.6 million
Annual Enforcement Budget 2005/06:	\$(NZ) 7.4 million	\$(US) 4.4 million
Annual Enforcement Budget 2004/05: (conversion rate @ 0.64 cents)	\$(NZ) 5.1 million	\$(US) 3.1 million

b) Number of employees (person-years):

Category	Numbers	FTE
Economists	5	5
Lawyers	4	4
Other professionals	28	22
Support staff	6	5
All staff combined	43	36

4.2 Human resources (person-years) applied to:

Category	Numbers	FTE
Enforcement against anticompetitive practices	28.5	23.5
Merger review and enforcement	12.5	10.5
Advocacy efforts ³	2	2

4.3 Period covered by the above information:

137. The information collated in the above tables relates to Commission resources as at 30 June 2006.

5. Summaries of or references to new reports and studies on competition policy issues

138. New Zealand recently began a project which seeks to develop a deeper understanding of the relationship between competition policy, growth and innovation. It is intended that the knowledge that

³ The Commission does not advocate. These figures are litigation efforts for the period

arises out of the project will help inform the Review of Parts 4 and 5 of the Commerce Act, and any other issues associated with the competition policy regime that the government may wish to pursue.

139. The project is divided into two parts. The first part is a review of literature on competition and innovation (with a particular focus on the issues of small and distant economies such as New Zealand) and identification of important issues for further consideration. The second part will then involve discussing these issues with relevant stakeholders to work towards developing an analytical framework for exploring the issues in greater depth and identifying the scope of further empirical research.