To: Commerce Select Committee

Submission on the Regulatory Responsibility Bill

My name is Geoffrey Bertram. I am a Senior Lecturer in Economics at Victoria University of Wellington. My submission to the Committee is that the Regulatory Responsibility Bill should be rejected outright. My reasons are set out below.

1. The Bill does not contain sound principles on which the regulatory actions of a modern state should be based, not does it propose administrative procedures that would facilitate the effective and efficient discharge by state agencies of their regulatory responsibilities.

2. On the contrary, the Bill's principles amount to a monopolists' charter, streamlined for use against the interests of ordinary consumers, taxpayers and competitive businesses; while the Bill's procedures would bog down any prospect of quality regulatory decision-making in a morass of bureaucratic form-filling and document-signing.

Matters of Principle

3. The Bill commences from a fundamental misconstruction of the so-called "second duty of the state". In the Explanatory Note, second paragraph, this second duty is described as "to maintain internal order so as to secure the liberty and property of any person from assault, theft, trespass and other unlawful acts". The Explanatory Note then goes on (third paragraph on page 1) to note that the state may take property "in order to achieve an essential public interest". Clause 4 of the draft Bill however defines "public interest" to exclude any "mere transfer of benefits … between consumers and producers", thereby treating any regulatory intervention simply to defend consumers against predation by monopolists as lying outside the scope of "public interest". Clause 4 further excludes, by definition, any "transfer of benefits from one producer to another", thereby removing the regulation of a wide swathe of anti-competitive behaviour from the public-interest arena.

4. The very narrow specification of the state's role, combined with the exclusions embedded in the "public interest" definition, render the Bill an extremist document of the sort generally associated with neoconservative and corporate-libertarian ideologies, and far removed from mainstream accounts of either constitutional principle or the economic theory of regulation.

5. The standard Enlightenment philosophers' description of the "second duty of the state" is far more wide ranging, and incorporates long-standing common-law notions of fairness and of protection of the weak against predation by the strong. Adam Smith, for example, describes the second duty of the state ("the sovereign") as "the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice"[1]. This wording is by far preferable, and closer to the spirit of the Enlightenment, than the narrow statement of police powers against assault, theft and trespass in the Explanatory Note to the draft Bill.

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[1] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, first published 1776, Cannan edition (1904) Book IV Chapter IX paragraph 51. The full paragraph reads [with emphases added]: "All systems either of preference or of restraint, therefore, being thus completely taken away, the obvious and simple system of natural liberty establishes itself of its own accord. Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men. The sovereign is completely discharged from a duty, in the attempting to perform which he must always be exposed to innumerable delusions, and for the proper performance of which no human wisdom or knowledge could ever be sufficient; the duty of superintending the industry of private people, and of directing it towards the employments most suitable to the interest of the society. According to the system of natural liberty, the sovereign has only three duties to attend to; three duties of great importance, indeed, but plain and intelligible to common understandings: first, the duty of protecting the society from violence and invasion of other independent societies; secondly, the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice; and, thirdly, the duty of erecting and maintaining certain public works and certain public institutions which it can never be for the interest of any individual, or small number of individuals, to erect and maintain; because the profit could never repay the expence to any individual or small number of individuals, though it may frequently do much more than repay it to a great society.

6. Smith's description of the sovereign's "second duty" sets out clearly the basis upon which the modern state has a mandate to regulate monopolies, in order to protect consumers against the expropriation of their wealth by means of monopolistic price-gouging and consequent excess-profit-taking.

7. It is also the basis upon which the state regulates various types of anti-competitive behaviour which have the effect of foreclosing would-be competitors from entry to markets in which they have a prospect of succeeding on the merits, but where their entry would threaten the profitability of entrenched incumbent firms.

8. It is also the basis upon which the state regulates resource management in order to prevent individual private developers from encroaching unduly upon the interests both of other individuals and of the public in general.

9. All of these are matters which hinge upon "transfers of benefits" from one party to another, where such transfers are considered against the public interest, broadly defined. A price-gouging monopolist[2] transfers monopoly rent (excess profit) from its customers to itself. An incumbent monopolist which forecloses would-be competitors from the market by anti-competitive practices transfers potential benefits from other producers to itself. A resource developer who proceeds without regard to the negative external effects of its activities upon other parties, and/or upon society in general, transfers benefits from those other affected parties to itself, taking a subsidy equal to all costs which have not been internalised.

10. The definition of "public interest" in Clause 4 of the draft Bill seeks to enshrine in law the so-called "total surplus standard", which is the standard fare of neo-conservative lobby groups worldwide but has been routinely rejected by courts and legislatures throughout the OECD for precisely the reasons outlined in the preceding four paragraphs. The draft Bill's definition

[2] Here and elsewhere in this submission I use the generic term "monopolist" to refer to firms in possession of power in a market. The arguments are most clearcut in the case of a pure monopoly but apply by extension to a wide spectrum of firms with market power.

proposes that the public interest "does not include a mere transfer of benefits from one producer to another or between consumers and producers". Translated to ordinary language, this says that protecting consumers from price-gouging is not in the public interest, and that protecting small business from predation and foreclosure by a dominant firm is not in the public interest.

11. The alternative is the "consumer surplus standard" which is universally accepted as the basis for price regulation of monopoly in other OECD jurisdictions, and which appears in the guise of the "acquirer benefit standard" in various sections of the Commerce Act 1986[3]. The consumer standard would be eliminated by the proposed definition, leaving the protection of consumers against price-gouging outside the legitimate scope of state intervention. The current state of the law in New Zealand already restricts such protection to the very small subset of sectors where Ministerial decisions and/or delegation of powers to the Commerce Commission and Electricity Commission have reopened the way to price-cap regulation, following the statutory suspension of common-law protection by the Commerce Act 1986 (see below).

12. Similarly, under the principles espoused by the draft Bill, protection of the process of competition as provided for in section 36 of the Commerce Act 1986 would cease to be treated as a matter of public interest insofar as it involved a "mere transfer of benefits from one producer to another" when small competitors are protected, by the state or a state agency, against being foreclosed from any market by a firm exercising market power. The present state of the law in New Zealand already severely restricts the set of anti-competitive behaviours that are captured by section 36 of the Commerce Act[4]; the draft Bill could well virtually eliminate them.

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[3] I have discussed in detail the issues in this and the preceding two paragraphs in my paper *The New Zealand Commerce Commission's Public Benefits Test*, presented to the 4th Annual Competition Law and Regulation Review Conference, Wellington, 16-17 February 2004. A drastically shortened version was published as "What's Wrong With New Zealand's Public Benefit Test?", *New Zealand Economic Papers* 38(2): 265-278, September 2004.

[4] I have discussed the issues of predatory pricing and bundled discounting in "Exclusionary Bundling, Predatory Pricing and Section 36: *Carter Holt Harvey Products Group Ltd v Commerce Commission*", *Waikato Law Review* 14: 17-33, December 2006.

13. Clause 6(2)(c) of the draft Bill refers to preserving and respecting "causes of action at common law that have provided long-standing protection against harm caused by strangers". Alas, citizens of New Zealand have long been stripped of their key common-law rights of action in the courts against monopolies. By passing the Commerce Act 1986, Parliament suppressed a centuries-long common-law tradition of appeal to the courts against price gouging and price predation. The ability to initiate action against monopolistic pricing of essential services was transferred, by that Act, from ordinary citizens to the Executive Branch of Government[5], which is inevitably subject to lobbying pressure and to the political dictates of the moment.

14. Under the effective suspension of effective regulation from the late 1980s to the early 2000s, the taking of excess profits by firms with market power has been a central feature of the New Zealand economic scene. The process has driven inflation in the prices of "non-traded" goods and services far ahead of the inflation rate for tradeable goods and services, most of which are produced under (relatively) competitive conditions and exposed to world market prices. It has been the sheltered suppliers of services such as electricity, gas, telecommunications, ports, and airports who have been able to benefit from

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5 The authoritative statement of this outcome was provided by the Court of Appeal in *Vector Ltd v Transpower* [1999] 3 NZLR 646 at 663 ("We consider that in principle and on the authorities what may be called the common law doctrine of prime necessity came to form part of the common law of New Zealand. As noted above the doctrine embodies a principle that monopoly suppliers of essential services must charge no more than a reasonable price") and at 665 ("we are satisfied that there is no room for the operation of the common law doctrine in relation to the transmission of bulk electricity by Transpower to Vector. It is precluded by the effect of the Commerce Act and that is reinforced by the effect of the State-Owned Enterprises Act.") and further at 666 ("it is inherent in those features of the statutory scheme that Part IV [of the Commerce Act] is the exclusive means of achieving price control over the transmission of bulk electricity by Transpower. That conclusion is reinforced by consideration of the limited private remedies for misuse of monopoly power provided under s 36. First, as noted earlier … s 36 does not impose an obligation to supply as such, Parliament having deliberately departed from the 1975 legislation and having deliberately discarded the initially proposed paragraph to that effect. If supply is refused, s 36 applies only where constraints on supply are for one of the specified anti-competitive purposes. Second, as noted in para [9], there is no control under s 36 over monopoly rents, the Privy Council seeing their elimination in the short term as being within the province of Part IV."). The Appeal Court's position was reaffirmed by the High Court in *Metrowater Ltd v Gladwin and Ors* [2000] 6 NZBLC 102,966 at 102,968; and by the Appeal Court in *Pacifica Shipping v Centreport* [2003] 1 NZLR 433 at 438. The restriction to the Executive branch of the ability to initiate regulatory proceedings was established by the Privy Council in *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385, at 407-408.

their new found (post-1986) freedom to exercise market power at consumers' expense, and who have consequently come to occupy the top slots in the New Zealand stock exchange listings.[6]

15. If indeed there is to be some restoration of the position of the common law relative to statute law[7], then the appropriate first step would be to restore to ordinary citizens their rights of access to the courts to contest monopolistic pricing – not to bog down regulators with red tape and form-filling as is proposed in clauses 6(3) – 9.of the draft Bill.

16. The expression "taking of property" which appears several times in the Bill's Explanatory Note, in the definitions of "full compensation" and "take" in clause 4, and at various subsequent points throughout the draft (for example clauses 6(2)(c), 7(2), and 7(3)), has undesirable connotations, associated with the extensive history of litigation in the USA under the Fifth and Fourteenth Amendments to the US Constitution. This jurisprudence is not readily translatable to New Zealand conditions, and in general no good purpose would

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[6] In my paper "Deregulation and Monopoly Profits in New Zealand's Gas and Electricity Sectors", *Energy Studies Review* 12(2): 208-227, Spring 2004, I estimated the internal rate of return (real, post-tax) for the Enerco gas pipeline business 1992-2000 as 31.6% and that for Natural Gas Corporation as 16.3%. Electricity lines companies in aggregate were estimated to have had a real pre-tax IRR of 22.4% 1992-2000. In "Price-Cost Margins and Profit Rates in New Zealand Electricity Distribution Networks since 1994: the Cost of Light-Handed Regulation", *Journal of Regulatory Economics* 27(3): 281-307, May 2005, Daniel Twaddle and I estimated excess profits of the electricity distribution networks as $2.6 billion over the nine years 1994-2002, with ongoing excess profits of the order of $200 million per year, at consumers' expense. In a July 2007 study available at www.med.govt.nz/upload/48562/04-air-nz-**returns**-report.pdf , PriceWaterhouseCoopers estimated annual excess profits at Auckland International Airport in 2006, relative to a 2000 benchmark, to be $91 million. Backdating the PWC benchmark to 1990 using the data and calculations published by myself and two co-authors *Rates of Return at Auckland International Airport* (Simon Terry Associates report for Air New Zealand, August 2000) this figure rises to over $300 million per year excess profit as at 2006. In *Portly Charges: Port Company Profitability* (Simon Terry Associates report prepared for KPMG Legal, March 2002) Ian Dempster, Simon Terry and I estimated that port companies on average had been securing roughly 8% above their Weighted Average Cost of Capital by price-gouging their captive users, and in *Port Company Profits to 2004: Updating 'Portly Charges'* (Simon Terry Associates report prepared for KPMG Legal, November 2004) I confirmed that calculation. I have traced the changing composition of the New Zealand stock exchange listings from 1980 to 2000 on p.98 of my paper "New Zealand Since 1984: Elite Succession, Income Distribution and Economic Growth in a Small Trading Economy", *Geojournal* 59(2): 93-106, 2003.

[7] On the relationship between the two see Dame Sian Elias, *The Usages of Society and the Fashions of the Times (W[h]ither the Common Law?)*, address at the 13th Commonwealth Law Conference, Melbourne, 15 April 2003, especially pages 6-9.

be served by including the "takings" terminology in a statute of the New Zealand Parliament.

17. The beneficiaries of any such provision would be mainly big business interests seeking to avoid regulatory restraint upon their exercise of market power at the expense of consumers and/or competitors, and seeking to portray state action in defence of the weak against the strong as in some sense an illegitimate extension of the appropriate role of the state, and an encroachment upon the alleged property right of a monopolist to enjoy the fruits of its exercise of market power. Opening the way to cases of this sort in the New Zealand courts is highly undesirable, especially in light of the now-well-established track record in the past two decades of legalistic obstruction of New Zealand regulators by large corporate entities with deep pockets and skilled legal counsel.

18. Clause 6(2)(f)(vi) appears to reject any legislative provision that recognises the special status of Maori under the Treaty of Waitangi. This is hard to reconcile with the Bill's emphasis elsewhere on respect for contracts and common-law rights.

Matters of Procedure

19. The thrust of the procedural parts of the draft Bill (clauses 6(3) – 9) is to create reams of red tape, in which any state agency will quickly become enmeshed if it takes any action that adversely affects large corporate interests. The Bill's philosophy is one of deterrence of decisions, not of efficient governance leading to quality decisions. The entire thrust of the suggested provisions is to bog down the regulator, not to facilitate the efficient and effective conduct and completion of regulatory procedures.

20. The Bill's procedures would create open slather for one of the most wasteful activities known to economics, namely "rent seeking" – the devotion of scarce skills and time to the pursuit of legal and policy favours, instead of directing those resources to productive activity. Rent seeking is socially and

economically wasteful, and legislation which promotes it is destructive of good government. Resource diversion by rent-seekers condemns many countries around the world to inferior growth performance[8]. Monopolists have strong incentives to divert scarce resources from productive use to frustrating attempts to regulate them and to the preservation and defence of their ability to foreclose market entry of competitors.

21. Clause 6(2)(e)(iii)-(iv) would require the payment of full compensation to any party "whose property is taken". The fiscal implications of this compensation demand are fundamental, and fatal to any prospect of efficient and effective regulation of anti-competitive behaviour. The compensation principle would apply to the monopolist's enjoyment of the fruits of his or her price-gouging of consumers. When a regulator took steps to limit monopolistic profit-taking by regulating the price the monopolist was allowed to charge, the monopolist would be entitled to claim compensation from taxpayers for the loss of its ability to gouge its customers. Similarly, when a regulator put an end to an anti-competitive practice used by an incumbent firm to foreclose entry by competitors, the firm could seek full compensation for the monopoly profits foregone.

22. Precisely such compensation for lost profits due to competition was, it may be recalled, a central consequence of the use of the "Baumol-Willig Rule" to price Telecom New Zealand's interconnection services. This Rule is so designed that it maximizes productive efficiency in a market so long as prices are held to competitive levels, but in an unregulated market it has the effect of

[8] Hall, Robert E., and Charles I. Jones, "Why Do Some Countries Produce So Much More Output per Worker than Others?" *Quarterly Journal of Economics* 114: 83-116, 1999; Olson, M., *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships*, Basic Books, New York, 2000; Parente, S.L. and Prescott, E.C., "Monopoly Rights: A Barrier to Riches", *American Economic Review* 89(5): 1216-1233; Posner, R., "The Social Costs of Monopoly and Regulation", *Journal of Political Economy* 83: 807-827; Tullock, G., "The Welfare Costs of Tariffs, Monopolies, and Theft", *Western Economic Journal* 5: 224-232, June 1967, reprinted as Chapter 3 in Buchanan, J.M., R.D. Tollison, and G. Tullock (eds) *Toward a Theory of the Rent-Seeking Society*, Texas A&M Press 1980; Tullock, G., *The Economics of Special Privilege and Rent Seeking* , Kluwer Academic Publishers 1989 Krueger, A.O., "The Political Economy of the Rent-Seeking Society", *American Economic review* 64: 291-303, June 1974; Rogerson, W.P., "The Social Costs of Monopoly and Regulation: A Game Theoretic Analysis", *Bell Journal of Economics and Management Science* 13: 391-401, Autumn 1982; Torvik, R., "Natural Resources, Rent Seeking and Welfare", *Journal of Development Economics* 67: 455-470, 2002.

fully compensating the incumbent monopolist for all profits lost as a result of entry by a more efficient competitor into the downstream market[9].

23. So repugnant was the Baumol-Willig Rule to Parliament, once its implications were understood, that its use was explicitly prohibited in Schedule 1 of the Telecommunications Act 2001. Yet the present Bill rehabilitates the principle of fully compensating a regulated monopolist for lost monopoly profits, as though such profits are legitimately to be classed as "property". Adam Smith's response would have been robust, forthright, and absolutely opposed to any such provision[10].

24. An important consequence of indiscriminately paying compensation to regulated monopolists for being regulated is that the fiscal cost of regulation would become extremely high – potentially so high as to deter a fiscally-responsible Minister from approving regulation, since every dollar saved to consumers by slashing monopolistic profits would have to be made up by taxpayers. This sort of corporate welfarism is the epitomy of the rent-seeking syndrome. It is subversive of good government because it holds taxpayers to ransom as a means of preventing the state from performing the most basic part of its second major duty – that of protecting the poor and powerless against exploitation by the powerful.

25. Clause 6(2)(f)(iv) aims to make a wide range of administrative decisions subject to judicial review. Included here are all decisions to "change the use of assets in the public sector". The prospect of court action over every relocation of a photocopier from one office to another is yet another quick route to sclerosis of the entire state sector – an outcome which, one suspects, is precisely one of the (undeclared) intentions of the promoters of this Bill.

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9 On this point see *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385, at 404-405.

10 Relevant authorities on Adam Smith's views regarding monopoly include Jacob Viner, "Adam Smith and Laissez-Faire", *Journal of Political Economy* Vol. 35, No. 2. (April 1927), pp. 198-232; Nathan Rosenberg, "Some Institutional Aspects of the *Wealth of Nations", Journal of Political Economy*, Vol. 68, No. 6. (December 1960), pp. 557-570; and Donald Winch, "Science and the Legislator: Adam Smith and After", *Economic Journal*, Vol. 93, No. 371. (September 1983), pp. 501-520.

26. Clause 6(3) sets out in precise detail the bureaucratic treadmill to which the Bill would subject any regulatory agency of the state. By the time this example of extremist prescriptivism has been worked through in relation to any decision, the opportunity for timely and effective decision-making will have long slipped away. The central consequence of requiring these largely pointless and enormously time-wasting reports is to raise the transaction costs of regulating. In my view the sole intelligible intent of deliberately loading so much deadweight cost onto the regulatory process is to deter policy makers from taking decisions at all, for fear of the excessive costs that will attend even the most richly-justified interventions against large corporate interests.

Concluding remarks

27. It is ironic that a party (Act New Zealand) which purports to be concerned with the interests of consumers and taxpayers should thus seek to achieve paralysis of the state (at substantial cost to taxpayers) and consequent inability of the state to protect the interests of consumers.

28. I would be happy to appear in support of this submission.

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