IAG Submission on the Boosting Service Sector Productivity (Second Interim Report)

7 March 2014

Introduction

IAG welcomes this opportunity to provide views on the Productivity Commission's (the Commission) 2nd Interim Report (Report) for its Inquiry into Boosting Services Sector Productivity (Inquiry).

IAG's focus in making this submission is to address the role of competition law and policy in the services sector. The Commission has identified competition policy as a particular area of interest. We welcome this renewed level of policy interest in an area of ongoing debate and discussion in New Zealand. The points discussed in this submission represent our principal observations as a business operating in the New Zealand services sector.

Our submission is broadly divided into two sections. The first section addresses the Commission's assessment of the 'intensity of competition' in the services sector. The second section responds to the Commission's recommendations concerning reform of New Zealand's monopolisation provisions. A key overarching theme of our submission is that while the Commission's analysis represents a useful contribution in respect of these issues, deeper analysis is required before firm conclusions can be drawn.

We are happy to provide more detail on any of these points if that would assist the Commission as it looks to finalise its Inquiry. IAG's contacts for matters relating to this submission are:

Martin Hunter, General Counsel and Head of Risk and Strategy

T : +64 9 969 6172

E : martin.hunter@iag.co.nz

Bryce Davies, Senior Manager External Relations

T : +64 9 969 6901

E : bryce.davies@iag.co.nz

About the IAG New Zealand Group Limited

IAG New Zealand Limited trading under the NZI and State brands and AMI Insurance limited. IAG New Zealand Limited also underwrites general insurance for some of the country's leading financial institutions (including ASB, BNZ and The Cooperative Bank). IAG New Zealand Limited and AMI Insurance limited have a combined 42% share of the general insurance market, managing 3.8 million policies of 1.5 million New Zealanders. IAG New Zealand Limited and AMI Insurance limited are wholly owned subsidiaries of Insurance Australia Group (IAG), Australasia's largest general insurer.

IAG New Zealand Limited, Private Bag 92 130, Auckland

Summary

Effective competition is essential to the successful functioning of New Zealand's business environment. Real world competition is a complex phenomenon, and can be highly context specific. It is important that competition policy recognises and addresses these complexities if it is to successfully promote efficient business practices and a more productive economy.

To that end this submission addresses the following points:

- meaningfully assessing the intensity of competition implicates a broad range of factors;
- assessment based on high-level segmentation can obscure areas where competition is vibrant;
- competition policy should not be conducted in isolation from wider policy considerations;
- the 'counterfactual test' has important strengths as well as challenges; and
- proposals for reform of monopolisation provisions would benefit from adopting a broader perspective.

Recommendations

In summary, our key recommendations to the Commission are:

- to broaden the scope of its assessment of competition in the services sector;
- to refrain from drawing firm conclusions on the competitiveness of particular markets until market level analysis can be undertaken;
- to consider the impact of the wider policy and economic environment on both the nature and intensity of competition;
- to undertake a cost benefit analysis of any proposed new 'market study' powers;
- to more seriously investigate the benefits of retaining the current counterfactual test; and
- to examine the institutional arrangements that inform current competition law practice.

Assessment of competition

In chapter 2 of the Report, the Commission undertakes an assessment of the intensity of competition in the services sector. The Commission's general approach towards assessing competition has some merit as an initial filter to identify particular issues for closer consideration. However, without going on to undertake deeper, more detailed analysis there is a risk that some of the Commission's conclusions lack the necessary evidential support. We suggest that the Commission would be able to enrich the debate, and reach more robust conclusions, if it were to engage in deeper competition analysis at the market level and explore the wider contexts of particular markets in which competition is required to operate.

These points are important because competition takes on different – sometimes very different – characteristics in different markets. This of course reflects the different characteristics of those markets themselves, but it means that any set of generic indicators of the intensity of competition can only be relied on for limited or tentative results. Our experience of the general insurance sector in particular suggests that the Commission's analysis is still too 'broad brush' to draw meaningful conclusions about the vibrancy of competition in many markets.

We emphasise that we are not arguing that the Commission's analysis is flawed or unhelpful. It remains a useful starting point for further analysis. The heart of our submission is simply that it is incomplete if the goal is to draw conclusions on the competitiveness of particular markets within the services sectors. Addressing the points we raise here would allow the Commission to put more weight on its final conclusions, and we anticipate that these points would usefully inform any future conversation about possible competition law reform.

Deeper, more detailed analysis needed

Competition is not a single 'one-size-fits-all' concept that is equally applicable to all markets. The dimensions along which competition occurs will change from sector to sector and market to market.

The analysis in the Report is (perhaps necessarily) limited to high level, generic indicators of competitiveness. If firm conclusions are to be drawn on the competitiveness of particular markets, this initial work needs to be extended to market level analysis that is sensitive to the actual drivers of competition in those markets. IAG's experience in the New Zealand general insurance sector provides useful examples of where competition may be more vibrant than the Commission's initial analysis suggests.

Competition assessment involves a range of diverse factors

The Commission has employed a relatively simple model of competition for the purposes of its analysis. This approach allows for ready comparisons between sectors on certain dimensions, but it may overlook some of the ways in which competition in the services sector maintains its vibrancy.

For example, tradability, entry and exit statistics and price cost margins are all useful but limited indicators of competitiveness in particular markets. As indicators they have the advantage of allowing cross sector comparisons to be

drawn, but only at the expense of a more nuanced assessment of the diversity of actual drivers of competition in particular markets. As the Report itself acknowledges, these indicators tend to reflect "textbook models of perfect competition" rather than workable competition in the real world (Report, p 35).

A reasonable interpretation of the Commission's assessment of the intensity of competition in the general insurance sector may suggest, for instance, that competition is only modest. In IAG's experience, however, the general insurance sector is highly competitive.

In the Report the Commission identifies the importance of consumer switching. Customer search and switching costs are very low in the general insurance sector (as shown in the Colmar Brunton research prepared for the Commission). While some information asymmetries remain, these are heavily mitigated by the relative commoditisation of personal insurance products and the availability of intermediated broker services in respect of commercial insurance products. Many markets for services may well be able to deliver these pro competitive features more successfully than in the goods or primary sectors.

In addition, there is very high supply side substitutability in the general insurance sector. This may also be a feature of other services, but is less likely to be a pro-competitive feature of the goods-producing or primary sectors. This ability for insurers to easily expand into adjacent markets blurs the distinction between near and direct competitors in a way that promotes much greater overall competition between suppliers. It is comparatively easy for existing insurers to expand into complementary product lines, for example, meaning that an incumbent's potential to earn higher profits is quickly competed away. These features of the market place a competitive discipline on insurers, but are overlooked by an exclusive focus on the Commission's chosen competitiveness indicators.

Segmentation

The Commission has segmented the services sector simply, which means competitive and non competitive markets are sometimes grouped together. This is not sufficient to pinpoint areas where competition is vibrant and where is it lacking. This is, of course, the reason that standard competition law analysis is undertaken on a market basis, rather than being extended to entire sectors of the economy.

The Commission has grouped insurance and financial services together, for example. While this grouping may broadly make sense from the point of view of the types of services supplied, the grouping appears to be somewhat arbitrary if the object is to assess the workability of the key drivers of competition. It fails to differentiate between the insurance and financial services sectors, but also potentially overlooks the very different market categories that exist within these sectors. These market categories include, for example, general insurers, life and health insurers, travel insurers, corporate banks, retail banks, and non-bank deposit takers.

Average price cost margins vary significantly between banking services and insurance. IAG's experience is that margins would still be 3-4 times larger in the banking sector when the general insurance sector achieves its target margin levels. For many insurers, the difference between an annual loss and profit may

be one or two significant weather events. Banking and financial services do not face this type of volatility.

Competition issues need to be put into the context of a wider policy debate

Competition law is not an isolated discipline. It forms part of a wider social and economic policy agenda. If taken in isolation, the drive for 'more' or 'more effective' competition in particular markets can obscure the important trade-offs between enhanced competition and other social and economic goods. At a recent presentation for the Ministry of Business Innovation and Employment, Australian academic Professor Fred Hilmer began his discussion of competition law by referring to labour market policy, access to capital and the broader regulatory environment.

We would encourage the Commission to adopt a similarly broad perspective. Such an approach would have the benefit of better identifying key features that determine the success or otherwise of efforts to promote competitive market outcomes. Adopting this broader perspective would likely identify the following features as relevant.

Market stability

In certain markets scale may be an important consideration, especially where market stability is a recognised policy goal. Sectors of strategic importance to the economy at a macro level often rely on a comparatively high degree of concentration to secure necessary scale among key market participants. The general insurance sector in which IAG operates is an example, with the Reserve Bank ensuring capital adequacy requirements for insurers.

Scale and market concentration are often interpreted as signs of weak competition, but in certain markets these features may actually have a pro competitive effect. Scale can contribute to competition directly by unlocking productive efficiencies that would not otherwise be available. Scale also promotes market stability, allowing all market participants to compete with a degree of confidence.

Market attractiveness

The attractiveness of a market to investors directly influences the level of productive investment that service firms can attract. This in turn affects the capital and resources devoted to a particular market, and ultimately the number of suppliers competing in the market. Market attractiveness is therefore a critical factor in determining the intensity of competition.

In part, market attractiveness relates to return on investment, which is a particular concern for New Zealand firms that are often competing for international capital. It is also related to security of investment, the threat of regulatory undertakings and political stability. Policy that addresses these matters may successfully promote competitive outcomes indirectly.

Regulatory impact

Regulation can blunt the effect of competition, often in order to achieve a distinct social purpose. Over-regulation should be removed, but identifying instances of over-regulation is not as simple as identifying a material impact on competition. Regulation may be necessary, and competition can only be promoted within that context. The aim is to strike the right balance that optimises incentives for productivity gains while achieving the various policy goals.

The Commission has identified that licensing regulation is often used to address quality standards, and that this can impact on the competitive dynamic in play in certain markets for services. Licensing requirements will often perform additional functions. In the general insurance sector, for example, licensing requirements perform a prudential function in addition to any assurance it may provide around quality of financial and insurance products. In this situation, there is no simple trade-off between competition and quality standards.

Prudential regulation also deliberately promotes continuity within the insurance sector, so that entry and exit of market participants is carefully managed. This calls into question the use of entry and exit statistics as a meaningful measure of competition in these markets. Where exit is required, this is usually carefully managed, and can take some time to ensure wider shocks are not felt in the market. Other service suppliers, particularly in financial markets, may well face similar features of market structure. These structural features impact directly on how competition occurs and how it is best measured. It would be beneficial, in our view, for the Commission to address these additional dimensions in its considerations.

Trans Tasman harmonisation not decisive

The Report recommends that New Zealand competition law and policy should take account of the Australian Government's recently announced review of its competition law. This recommendation aims at achieving alignment within a single trans-Tasman market.

While it is prudent to take into account Trans-Tasman harmonisation, in our view it is unlikely to be a decisive factor in the application of best practice competition policy in New Zealand. While there are broad similarities between trading conditions in New Zealand and Australia, individual markets themselves and the drivers of competition within those markets will often be different.

Proposed 'market study' power useful but limited

The Commission's idea of developing a mechanism to assess the application of competition to particular markets is a useful one. It recognises and responds to the fact that competition is a complex phenomenon that varies from sector to sector, and from market to market. If workable, this type of mechanism could promote more informed and robust discussion of the effectiveness of competition in particular markets.

However, it is not clear that giving a new 'market study' function to the Commerce Commission is the best way to achieve this. The Commerce Commission's role is exclusively to promote competition. This skill set would obviously be an important part of any inquiry, but we anticipate that any

meaningful market study would include balancing pro-competitive factors against other legitimate interests that benefit New Zealand. Whether this type of assessment is best undertaken by a regulator that needs to maintain its political independence remains an open question worthy of further investigation.

There is also a question of appropriately resourcing for the Commerce Commission if it is to carry out this task. Market studies must be sufficiently detailed and robust to provide meaningful insights to those involved in the policy process and feedback to market participants who fall under the Commission's purview. If done properly this would be a resource intensive task, perhaps analogous to the costly power to inquire into the supply of particular goods and services the Commerce Commission currently has under Part 4 of the Commerce Act. We encourage the Commission to undertake a cost benefit analysis before finalising its recommendation, to ensure there is sufficient value in a new market study power.

Proposed Monopolisation Reform

The Commission has identified the protections against monopolisation/abuse of substantial market power in the Commerce Act as potentially needing reform. As the Commission acknowledges, reform of the monopolisation provisions of the Commerce Act is complex and controversial. Current debate has been focused on the apparent weaknesses of the 'counterfactual' test. Our submission on this point reflects our concerns set out above that competition is recognised to be a diverse concept that needs to be understood in an appropriate market context, and that the wider policy implications that impact on competition outcomes are considered fully.

IAG has not reached a firm view on the issue of reform of the counterfactual test, but believes that certain considerations not fully addressed in the Report need to be recognised as part of an informed debate. In particular, the potential strengths of that test and wider issues of enforcement of monopolisation conduct should be addressed if reform is contemplated as a genuine outcome of the Inquiry.

The current counterfactual test

The Commission's analysis relies heavily on information prepared by or on behalf of the Commerce Commission, and it has not taken into account a wide range of views on the matter. This needs to be done before any proposal for meaningful reform is advanced.

To inform a more balanced assessment, we note here some of the key reasons that might be put forward in favour of retaining the current counterfactual test. The Commission's interim conclusions should be further tested against these points before any final recommendation is made.

Additional perspectives are needed

The Commission's analysis of monopolisation in New Zealand appears to place heavily reliance on materials provide by or on behalf of the Commerce Commission. In particular, the Report draws on a recent conference organised by the Commerce Commission, where the issue of reform was debated.

Regardless of the relative merits of reform, we consider that such strong reliance on a limited set of views does not bring the level of robustness required to support calls for reform. The legal and business community in New Zealand continue to hold a wide variety of views on the desirability and implications of reform, and we urge the Commission to take this diversity into account. The significance of competition law to the New Zealand economy means that these views require more serious consideration.

The counterfactual test works in practice

A feature of the debate on the merits of the counterfactual test is the absence of empirical analysis, with proponents and detractors of the current law both relying heavily on theoretical arguments. The extent of any empirical investigation appears to be that there is a number of monopolisation cases that the Commission has simply failed to win.

Examining the actual decisions of the courts shows two recent cases in particular demonstrating that the counterfactual test can be successfully applied: Turners and Growers v Zespri Group [2011] NZHC 913; and Telecom Corporation of New Zealand v Commerce Commission (Datatails) [2012] NZCA 344.

Both cases were decided after the 0867 case that the Commerce Commission identifies as frustrating its ability to prevent abuses of market power. This suggests there is nothing about the 'counterfactual test' itself or the interpretative approach of the courts that prevents workable application of New Zealand's monopolisation provisions.

Certainty

From a business perspective, certainty remains a key concern. Uncertainty as to the application of the monopolisation threshold test following any reform can chill productive investment and market competition for a period of time. While the need for certainty is not itself a complete argument against reform, the purported benefit of any reform needs to be assessed against the need to maximise certainty as to the competitive environment for businesses.

The Commission's dismissal of certainty as an important consideration is, in our view, too hasty. Certainty is recognised as a legitimate policy concern in the regulation of monopoly businesses in other areas, particularly under Part 4 of the Commerce Act (s 52R). The need for suppliers and consumers to have certainty is all the greater where a competitive dynamic continues in the market.

Reform proposals must be set in a broader perspective

Focusing narrowly on the 'threshold test' for abuse of market power overlooks the wider issues with monopolisation legislation. How monopolisation provisions are enforced in practice can effect competition as much as the formal thresholds for identifying undesirable conduct. Discussion on these wider issues is an essential part of any proposal for reform.

For example, we consider that there are institutional questions concerning the respective roles of the Commerce Commission and the courts with enforcement of monopolisation provisions that also need to be addressed.

The Commerce Commission is an expert economic regulator, whereas the courts are not. However, the current law necessitates a role for the courts because of the quasi penal nature of competition law and the heavy sanctions it carries for breach. Relying on the appellate courts to develop competition law is a very costly approach. It also means that the primary decision maker does not have expertise appropriate for a complex area of economy policy, and opportunities to secure improvements in application of the law are limited and sporadic. These challenges with the current monopolisation regime arise independently of the particular threshold test for market conduct that is adopted.

Rather than a singular focus on the current counterfactual test – though a clear hurdle is needed to warrant intervention, reform should look to secure accessible, informed decision making that can be applied as a body of precedent to promote certainty of application in competitive markets. This suggests a greater role for the Commerce Commission as an expert, primary decision maker is appropriate, with the courts playing only a supporting role.

As the natural focus would be on areas where market power is a particular concern, reform of this nature would offer a more focused guidance to market participants than the generic 'market studies' power the Commission has suggested. The ability for the primary decision maker to undertake cogent economic analysis in identifying undesirable market conduct would also be the most effective way to address the Commission's concern with 'false positives' and 'false negatives' under the current regime.

The trade-off with any new enforcement power for the Commission would be lower level sanctions in respect of impugned conduct, albeit a clear hurdle is need to warrant intervention. Formal warnings, the ability to seek binding undertakings as to future conduct, and other 'soft' forms of law should be considered. These would ideally complement, rather than replace, the role of the Courts in identifying and punishing quasi-penal conduct by providing regular, accessible market-specific guidance to large and small firms alike without the need for costly and uncertain court proceedings. It would also ensure enforcement actions, and the costs of pursuing such actions, are graduated to be commensurate with the seriousness of the alleged conduct.