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# the state of COMPETITION

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*The Harper Committee has been charged with ensuring that our competition laws are “fit for purpose”. In its draft report, it has set about this task by (amongst other things) proposing a radical re-write of our misuse of market power prohibition. But will the proposed new law address the shortcomings identified by critics of the current section 46? In this edition of TSoC, we road-test the Harper proposal, trying it out with examples of allegedly anti-competitive conduct said to fall outside the scope of the current law.*

## Building better mousetraps: Harper’s re-write of section 46

A FL fan and ACCC Chairman Rod Sims recently used a football analogy to advocate for an “effects test” in the misuse of market power prohibition contained in section 46 of the *Competition and Consumer Act*. It was not, he explained, about changing what happens on the playing field (where stronger teams will beat weaker teams) but rather to address “exclusionary behaviour akin to when the team with substantial market power has locked the other in their change rooms and is seeking to win by default”. Section 46 would not catch the business equivalent to such behaviour, he asserted, “because even companies without market power can have a policy to change locks on a regular basis”.

Well (happily for Mr Sims and yours truly at TSoC) the opposition in both footy finals might as well have been locked in their change rooms, so dominant was the performance by Hawthorn and the Bunnies. Fans of both codes were left asking, “what happened here”?

Sometimes everyone can see a particular market outcome occurring, but views might differ on how it has come about. Is it due to ruthless winner-takes-all “competition on the merits” by a stronger player, or evidence of an anti-competitive “win by default”?

As the OECD points out, there is no easy way to test for a misuse of market power

As the 2005 OECD policy roundtable on *Competition on the Merits* observed, lawyers, judges and competition agencies have been using this phrase for many years “but there is no consensus on what the term means”. The OECD considered various economic tests to sort pro-competitive from anti-competitive conduct, concluding that “no single test is suitable for every type of case”.

This is the problem for our policy makers: “Each of the tests has certain strengths and weaknesses”.

### The Harper proposal

With that in mind, let’s look at the Harper review’s draft proposal to re-frame section 46 to prohibit a corporation with substantial market power from engaging in conduct that has the purpose or likely effect of substantially lessening competition (SLC) in any market.

The main impact of the revision is to move the focus of inquiry in section 46 away from “misuse” of market power, and onto the *effect* of specific conduct on competition in an identified market (the existence of market power simply being a threshold box to tick in order for the section to apply).



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*Is Harper’s version of s46 itself a better mousetrap? Here at TSoC, we’re not convinced it will catch the right stuff*

The Harper proposal is seen as a win for the ACCC-led charge for an “effects test”. However, it is tempered by the inclusion of a defence aimed at reassuring those concerned that a pure effects test could “chill competition”. This would provide protection for a business able to show that its conduct would: (a) be a “rational business decision” by someone *without* market power, and (b) “benefit the long-term interests of consumers”.

Does the proposed test display the wisdom of Solomon as suggested by some? Or has the Harper panel just cut everybody’s favourite baby in half?

## Road-testing the Harper proposal

Let’s road-test the proposal against some of the examples cited by the leading campaigner for an effects test, the ACCC Chairman:

*The ACCC wants to ensure competition is on its merits by dealing with exclusionary behaviour... For example, buying up all the available land, restricting supplies of essential materials, engaging in predatory pricing or tying up customers in long term contracts with anti-competitive rebates (AFR, 12.09.14).*

and  
*[B]ehaviour that excludes others from the market... That’s what we’re trying to target, and that’s what’s not effectively dealt with at the moment under the current competition laws (ABC’s World Today, 02.09.14).*

### Example 1: (over-) buying land

Regarding the first issue, Rod Sims explained to ABC Rural listeners:

*So if I’m a big company and I buy up all the land, so that nobody else can build a competing facility, at the moment, you face the problem of firstly... show[ing] the purpose of buying up the land was to preclude competition and, of course, you won’t find anything written down to that effect. And secondly, you have to show that a company without substantial market power couldn’t have done that. Well, of course, all companies buy land. So the test is just very hard to use. If the law was changed the way we’re advocating, and somebody bought up all the land to exclude their competitor, you’d have a much more appropriate way for assessing that behaviour.*

Or would you? If land acquisitions are the *means* of obtaining market power rather than the *result* of market power, introducing an effects test is moot as the revised section 46 simply won’t apply (the *Boral* issue, as discussed below).

Assuming there is already market power, what is the specific “conduct” that lessens competition? Does each acquisition have to be assessed individually or can buying sites over time be treated as a single course of conduct?

And if a substantial lessening of competition *is* likely, there is still the “rational business decision” defence to consider – involving similar questions to the present “take advantage” test (but only after a costly and complex SLC analysis). So, for someone without market power, would the acquisition program amount to a rational business decision? Are the relevant sites good investments? Is the firm expanding to improve scale and lower costs?

The buying land issue was specifically considered when section 50 was amended in 2012 to address “creeping acquisitions”. The [Regulatory Impact Statement](#) discussed the exception in the Act for acquisitions of assets “in the ordinary course of business”, referring to “untested contentions in the retail grocery sector” that acquisitions of vacant land to build supermarkets fell within this exemption and noting that: “The ACCC has taken a contrary view...”.



Road-testing Harper’s proposed re-write of section 46 throws up some mud

It went on to say:

*It is appropriate for section 50 to apply in these circumstances because: it applies to acquisitions of legal or equitable interests in real property, which are “assets” within the scope of section 50; and because such an acquisition has the potential to substantially lessen competition in the market.*

So it is not clear why the ACCC would *want* to use section 46 (and have to prove market power *and* SLC) when all section 50 requires is proof of an SLC (regardless of market power).

### Example 2: restricting supplies of essential materials

Refusals to deal have traditionally been considered a section 46 issue. Indeed, it’s here that the courts have shown how surgically precise the “take advantage” test can be.

To illustrate, in both the *Queensland Wire* and *Melway* cases (discussed in more detail in [Issue 14](#)), the economic argument focused on the rationality of foregoing sales. The difference picked up by the High Court was that BHP was prepared to sell other products that faced competition to avoid losing sales, but not Y-bar. In *Melway*, on the other hand, the “lost” sales were just a reallocation of sales to existing distributors, as market penetration using its existing system had reached saturation point. In the *Safeway* case (also discussed in [Issue 14](#)), the Full Court used the “take advantage” test to draw a fine line as to when a refusal to deal was genuinely about making Safeway more competitive and when it was really about making rival retailers *less* competitive.

Would the revised section 46 be a blunter instrument? At least initially, all these situations may well fall foul of the SLC test; so the task of distinguishing between them would fall to the “rational business decision” limb of the defence, effectively asking the courts to continue using a de facto “take advantage” test to do the heavy lifting. (Bearing in mind, the Harper Committee thinks the “take advantage” test is “subtle and difficult to apply in practice”. Whilst we concur on the issue of subtlety, we’re not sure we agree on the second point - certainly not when contrasted with the current proposal!)

### Example 3: predatory pricing

Will the Harper formulation of section 46 make it easier to deal with predatory pricing or will it simply end up being tomorrow's "Birdsville amendment" (which Harper recommends be repealed)?

An important question is which comes first: the "conduct" or the market power? As McHugh J in *Boral* remarked, even if vigorous price-cutting leads to an uncompetitive market, if the firm does not first have market power, there is a timing "gap" which section 46 is not equipped to overcome.

The ACCC's concern in the *Boral* case involved an "irrational" capacity expansion followed by below-cost pricing. At trial, the two were treated as separate items (rather than integrated conduct) and, by the time the matter came to the High Court, the capacity expansion aspect seemed to have disappeared altogether from the case theory. Yet it was the "irrationality" of the capacity expansion (or "capacity predation") that held the key to why the ACCC saw the subsequent pricing as more than just vigorous discounting.

The timing "gap" in the current section 46 is the only structural short-coming identified by the courts. It would not be fixed by the Harper proposal as the existence of market power would still be a threshold requirement.

### Example 4: tying up customers in long-term contracts

This type of conduct is typically assessed under section 45 or 47 using the SLC test and it is unclear why the ACCC would want to use section 46 for this conduct as it would mean having to establish market power as a threshold requirement before looking at any SLC.

There is also the issue of aggregating conduct within or across agreements to establish effect under the SLC test as is currently provided for in both sections 45 and 47. Would the revised section 46 allow for the effect of conduct to be aggregated and if so, what would be the basis of that aggregation? In section 45, it is other provisions within the contract or in other contracts to which the firm is a party, while in section 47 it is exclusive dealing of the "same or similar kind" by that firm.

It would be very open-ended to allow for the effect of conduct by the firm with market power to be aggregated with any other conduct of any kind by that firm at any time – but unless you join the dots through use of market power (back to a "take advantage" test), what would a sensible linking be?

## Lesson of the day: the proposed test has the potential to be very confusing

### Exhibit 1: the role of the SLC test

*[I]t is instructive to note that in both Rural Press and Cement Australia, while the courts struggled with the interpretation and application of section 46, the conduct was found to substantially lessen competition in breach of section 45 (Commissioners Jill Walker and Roger Featherston, AFR 14.08.14; a contention echoed in the draft Harper report).*

The ACCC's concern in the *Cement Australia* case was about conduct aimed at preventing rivals from getting access to an essential input, flyash (see Issue 18).

The court found that Cement Australia by contracting to secure all of the flyash from relevant power stations, breached section 45 because its contracts had the purpose and effect

of substantially lessening competition (and that's all you need to establish for section 45).

The ACCC's failed section 46 allegation required more. The ACCC claimed the flyash was being acquired at a cost that was lossmaking, which made no commercial sense for a buyer lacking market power.

The court framed the question as follows:

*whether a profit maximising firm operating in a workably competitive market could in a commercial sense profitably engage in the conduct in question having regard to the business reasons identified by the witnesses, assuming such a firm is confronted with similar circumstances?*

It concluded that, on the facts, the contract was not so hopelessly uneconomic that the answer would be no. And, given that factual finding, there is nothing inherently wrong or inconsistent with an outcome that says there was an SLC but no misuse of market power. Indeed, the court's analysis suggests that at least the first limb of the Harper defence might have been made out.

The court in *Cement Australia* observed that, consistent with section 46 case law to date: "there is no contravention of s46(1) of the Act when a firm with market power acts with the purpose of protecting it, so long as the method of so acting does not engage a method of use of market power".

This analysis echoes the High Court's point in *Rural Press*: if a firm has a choice of methods, one of which involves power distinct from market power (eg financial power) and one of which does not, "choice of the method distinct from the market power will prevent a contravention of s46(1) from occurring even if choice of the other method will entail it."

## Thought for the day

*It is not self-evident that a case in which there is a finding of SLC but no misuse of market power (eg Rural Press or Cement Australia) demonstrates a failing in the law. But that seems to be the proposition put forward by both the ACCC & the Harper Committee.*

*If applying the prohibitions always resulted in the same outcome, why bother having both? You don't get higher penalties for proving both.*

And here's the rub. The point of an effects test is to remove that distinction so that whichever method is used, if the effect is the same, then both should be prohibited. And removing the "take advantage" element from section 46 means that it doesn't matter whether it is market power, financial power or some other power that is used: if there is a substantial lessening of competition, the conduct is prohibited.

That's why business leaders along with former ACCC Commissioners Graeme Samuel and Stephen King have raised concerns. A good compliance culture means understanding the distinction between conduct that uses market power and that which doesn't – stick to the safe path and you don't need to have lawyers run the ruler over each and every bit of conduct along that path. Absent that distinction, it may well be necessary "to have senior competition lawyers engaged on a full time basis to look at every single strategic proposal by... a big business at almost every sort of transaction" (Graeme Samuel, ABC World Today, 02.09.14).

Hey, not that the lawyers would complain...

## Exhibit 2: the ambiguity of a better mousetrap (or when efficiency & competition are at odds)

Rod Sims has argued it would be “ridiculous” to suggest that the reforms being pushed by the ACCC would chill competitive conduct: “if you’re good at what you do and you out-compete everybody, of course it won’t get caught”.

Would an SLC test applied to unilateral conduct stop enterprising businesses from building a better mousetrap? Is there still a safe path under the Harper proposal? The two main examples raised in this context are R&D resulting in better products, and lower production costs from scale economies. The concern behind these examples is that they both increase efficiency and hence total welfare *but may lessen competition* (we discussed the distinction in [Issue 10](#); in part it reflects a different approach to efficiency here than in say the US, due to our authorisation process). Thus, the revised section 46 may well apply.

The first limb of the proposed defence would address efficiency but the second seems to make *consumer welfare* the deciding factor. Does that introduce the potential for inconsistency between the defence in section 46 and the concept of “public benefit” used in the authorisation test (given the tilt of the Tribunal towards a total welfare approach: again see [Issue 10](#))? It also raises the question of whether authorisation should be available for section 46. Again, however, complexity attaches to identifying the relevant conduct that requires authorisation.



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*As a general proposition, we endorse Harper’s call for simplifying the competition laws (indeed, see [Issue 16](#)). But here we have two reservations: 1. it seems unlikely that the proposed s46 is in fact simpler; 2. is “simple” the appropriate benchmark for a law of extremely limited application? If anyone can afford good legal advice, it’s those with substantial market power. We definitely need a law governing unilateral conduct that’s coherent and predictable, but it needn’t be simple. Simplicity has a cost too.*

Other issues that increase the compliance task include:

- how many markets need to be considered? The SLC test in sections 45 and 47 is limited to (for section 45) the market/s in which the parties operate and (for section 47) any market in which the firm engaging in the conduct or the person whose business dealings are restricted by the conduct operates. Firms can be expected to know enough about these markets to apply

an SLC test. If the revised section 46 is applied to a supermarket buying up sites, for example, must all possible markets for all other possible uses for those sites be considered?

- and how does one distinguish between the effect of the conduct and other causal agents – the with and without problem that has come up in section 50 cases.

## Exhibit 3: using the long-term interests of consumers as a benchmark

The concept of “the long-term interests of consumers” is well known in regulatory circles (see [Issue 5](#) re the Competition Tribunal’s interpretation of it). But it doesn’t easily apply to specific conduct by an individual firm at a given point in time.

Applying the “long-term interests of consumers” limb might yield unpredictable results in cases like *Melway* involving intra-brand competition, and would certainly add a layer of complexity. In *Melway*, at least one High Court judge felt consumers might be better off with greater intra-brand competition.

In *NT Power*, the High Court found the NT Power & Water Authority (PAWA) had breached section 46 by denying a potential rival generator access to its transmission infrastructure. It accepted that the intent behind this was to achieve an orderly transition to a competitive market (something that would benefit the long-term interests of consumers) but concluded that:

*Section 46 does not permit the drawing of a distinction between short-term anti-competitive purposes (here keeping NT Power out of the market) and long-term pro-competitive objectives (establishment of an access regime), and does not permit the former to be nullified or excused by the latter. Nor is it relevant that, in PAWA’s submission, entry by NT Power might cause such losses to PAWA that it would cease to subsidise services to remote communities.*

What is now proposed would require such a distinction and a more complex balancing act, potentially changing the outcome and certainly impacting on the law’s predictability.

The concepts of “competition”, “efficiency” and the “long-term interests of consumers” are all important tools in the scholar’s toolkit, but it’s not necessarily helpful to throw them all in the wash together. You just might end up with a tortured analytical process that starts with conduct by a firm that is initially caught by a prohibition (because it lessens competition somewhere somehow), but is potentially rescued because it increases efficiency (and is thus “rational”), but is ultimately judged by considerations of consumer welfare in order to determine whether it is legitimate. And there has been a distinct lack of clarity from the courts and Tribunal when it comes to considering public interest tests of this nature in the competition space. That’s not just the proverbial lawyer’s picnic – it may turn out to be the profession’s ultimate all-you-can-eat buffet.

## Q. Has anyone else considered using consumer welfare as a test? A. Why yes...

In that context, it is worth looking back at what the 2005 OECD roundtable had to say about using a consumer welfare (CW) test to assess misuse of market power:

*When a dominant firm’s conduct reduces welfare without contributing to any increase in the firm’s efficiency, this test is relatively easy to apply. The harder case, of course, is when the firm’s conduct has the potential both to reduce CW and to enhance the defendant’s efficiency. In that situation, there seem to be four possibilities:*

1. **always condemn conduct** if it is likely to have any negative effect on CW, regardless of any efficiencies;
2. **always allow conduct** if it is likely to have any positive effect on efficiency, regardless of harm to CW;
3. **balance the two effects** against each other to determine which one is likely to be stronger, and prohibit the conduct if likely harm to CW **outweighs** likely improvements in performance; or
4. **balance the two effects** and consider conduct unlawful only if it is likely to produce harm to CW that is **disproportionate** to the improvement in efficiency.

The roundtable observed that the last two options sound attractive but in practice are likely to result in courts undertaking a rough balancing exercise prone to subjective impressions and reasoning, making outcomes less predictable. The first two are simpler to apply and more predictable, but will not always arrive at the optimal result.

The roundtable also discussed in some detail a test proposed by Harvard Professor Einer Elhauge a decade ago, which operates on the neat premise that efficiency is “the merits” in the phrase “competition on the merits”. It involves answering the following sequence of questions:

1. Does the defendant’s conduct discriminate against its rivals in some manner? (This question is asked only in cases involving refusals to deal, exclusive dealing or conditional dealing.)
2. Does the conduct enhance or maintain the firm’s dominance, or is it likely to do so?
3. If so, then does the effect on dominance occur only if there is an improvement in the defendant’s efficiency?
4. If not, then is the effect on dominance caused by the conduct’s impact on rivals’ efficiency, regardless of whether the conduct also enhances the defendant’s efficiency?

For conduct to be found unlawful, the answers to these questions must be **yes** (if applicable), **yes, no**, and **yes**, respectively. Any deviation from that sequence of answers results in a finding in favour of the defendant.

It seems to us that this might be the type of economic test the ACCC Chairman is prompting us to consider by his public comments on section 46 – and, if so, then that’s a debate worth having. But it’s not the legal test the ACCC has been pushing and it’s certainly not what the Harper review has come up with.

## Conclusion

The draft Harper report observes that:

*The challenge is to frame a law that captures anti-competitive unilateral behaviour but does not constrain vigorous competitive conduct. Such a law must be written in clear language and state a legal test that can be reliably applied by the courts to distinguish between competitive and anti-competitive conduct.*

No-one would disagree. But it seems unlikely that the proposed revision of section 46 gets us any closer to such a law.

## About the authors



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Rachel and Alexandra are both Australian Legal Practitioners within the meaning of the Legal Profession Act 2004 (Vic), with liability limited by a scheme approved under Professional Standards Legislation.

## Links you should know about

To participate in the **second round of consultation** for the Harper review: see <http://competitionpolicyreview.gov.au/consultation/> Forums are happening across the country, starting in Perth on October 9 (attendance is open, but you must first register)

Clayton Utz has created a fabulous “**dawn raid**” app, outlining how to respond to raids by various regulators, including the ACCC. Request it via: <http://sites.claytonutz.vutvurevx.com/25/2013/landing-pages/request-form.asp>

The University of Toronto offers an annual MOOCs in **Behavioural Economics**. This year’s course started October 6, but there’s time to catch up. You can complete assessment to obtain a certificate or simply audit the course. Go to <https://www.edx.org> for more details