the state of COMPETITION

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Issue 24 (Feb 2016)

*Lately we've spent an awful lot of time thinking about the misuse of market power provision in section 46. In light of even more consultation by the government, TSoC wanted to check out the problem child that is the "take advantage" element and its application via the counterfactual. Is it as difficult as so often stated? What could (should) be done instead?*

*Whatever happens next, the counterfactual will be around for a while – both as old conduct comes to light and as the courts search for a causal link between market power and problematic conduct. So here's our take on things, complete with a bonus discussion on that other problem child, purpose.*

# Even better than the real thing:

## the ongoing relevance of counterfactuals

While the lightning rod for disaffection with our section 46 has been the issue of whether or not to have an effects test, our friends across the ditch have focused their concern on the complexity of counterfactual analysis when applying their similarly worded section 36. The common view of enforcement bodies on either side of the Tasman seems to be that the "take advantage" element of the tripartite formulation we share – substantial market power + taking advantage + a proscribed purpose – simply makes it too hard to prosecute misuse of market power cases.

The solution, according to the Harper Report, is to remove the taking advantage element, replacing it with the language of "substantially lessening competition" as found in sections 45, 47 and 50. A similar idea has been mooted in New Zealand. But what would that mean for the use of counterfactual analysis in section 46 cases?

Reading the Harper Report, one could be forgiven for thinking we have a civil law system, where all that matters is how we word the prohibition. But the reality of the common law is that it is for the courts to put flesh on the bones of the statute. So we need to understand what our courts have done with section 46 and glean whatever lessons we can from the significant body of precedent we have developed. After all, five High Court judgments and numerous Full Court decisions, accrued over four decades, are nothing to sneeze at.

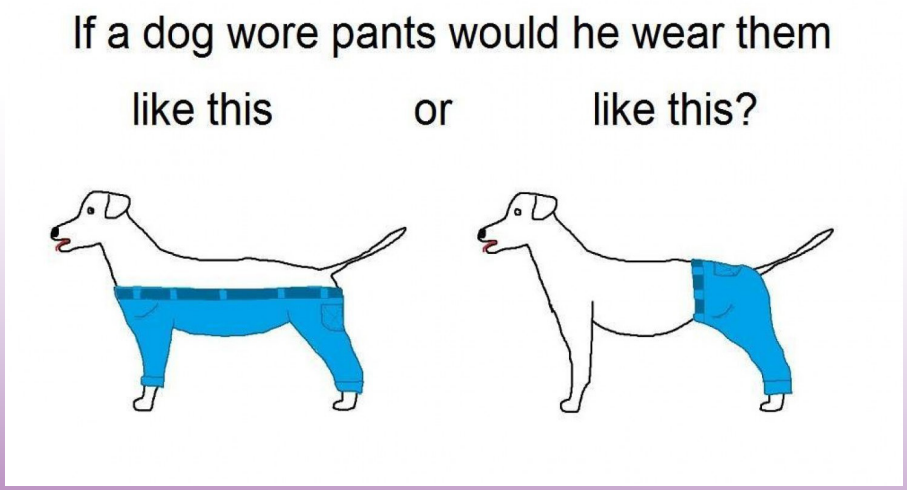
**'What if...?'**

**A question we ask to hurt ourselves.**

**Susan Fletcher,**

**British author**

**(& lawyer in a past life?)**




*Competition lawyers & economists aren't the only ones to struggle with formulating the counterfactual. Here's one of 2015's most popular memes, by Norbert K: see the* ***Washington Post*** *for the story.*

## A rose by any other name?

While we're all familiar with counterfactuals in merger analysis, what does it mean to talk about a "counterfactual" in the context of section 46? The starting point is to go back to the test propounded by Mason CJ and Wilson J in *Queensland Wire*, which asks how a corporation with substantial market power would behave in the absence of such power:

> *It is only by virtue of its control of the market and the absence of other suppliers that BHP can afford, in a commercial sense, to withhold Y-bar from the appellant. If BHP lacked that market power – in other words,* ***if it were operating in a competitive market*** *– it is highly unlikely that it would stand by, without any effort to compete, and allow the appellant to secure its supply of Y-bar from a competitor.*

Dawson J employed a similar methodology, observing that BHP's conduct was made possible "only by the absence of competitive conditions… BHP could not have refused to supply Y-bar to QWI *if it had been subject to competition* in the supply of that product".

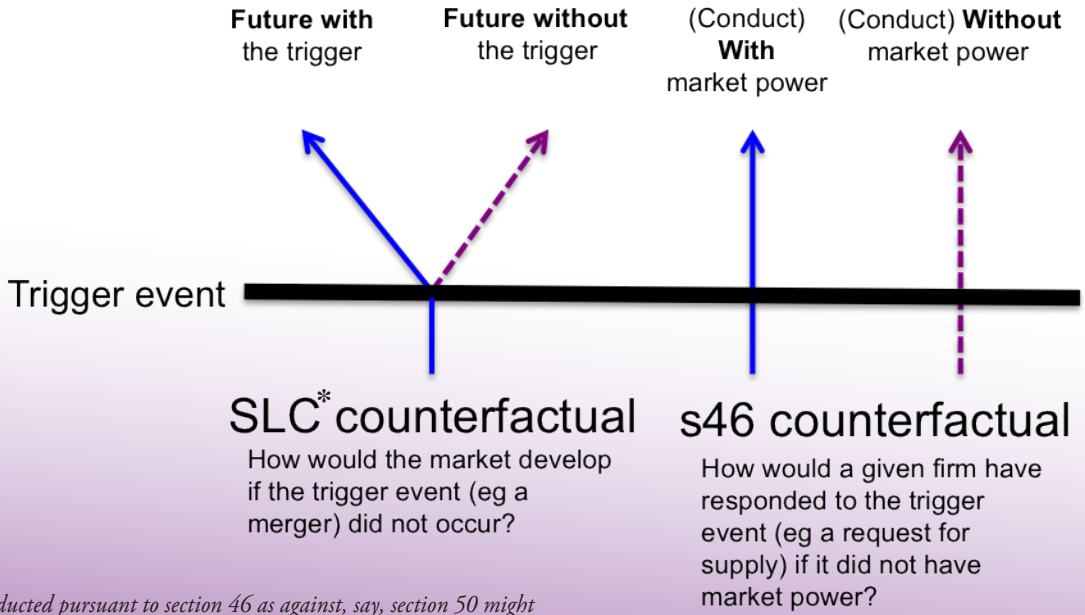
Interestingly, judges (both then and now) don't tend to call this approach to section 46 analysis the "counterfactual"; they just *do* a counterfactual. But the profession generally does use this terminology for their section 46 analysis, which can cause confusion. See for example a submission by the Queensland Law Society to the Harper Review, objecting to a proposed defence outlined in the draft report which was said to:

> *give[] rise to the same problems that flow from the "take advantage" test. It requires the application of a counterfactual test that inverts the traditional counterfactual test applied elsewhere in the Act…*

The problem above is the apparently exclusive association of the word "counterfactual" with the type of contrary-to-fact conditional hypothesis used pursuant to the "substantial lessening of competition" test (in section 50 or sections 45/47). We give them the same name, but then complain that the differences in analysis are causing confusion! To be clear, SLC analysis typically involves projecting from a known point immediately prior to a specific event or conduct (being the trigger for the enquiry) in order to assess what would occur (how the market would develop) with or without that trigger. This assessment may be made in a prospective sense – *what would occur if a given merger were to proceed* – or it may be retrospective – *how would the market have developed but for this contractual arrangement*. Either way the state of play immediately before the trigger event is necessarily grounded in reality. This is true even when projecting the future "with and without" is extremely difficult – for example, when examining a merger in a very dynamic environment, or analysing a contractual arrangement that has been in place for some time and may have changed the market's structure.

In the case of section 46, however, the beast might bear the same name but is quite different in nature: indeed, typically, the contrary-to-fact conditional involved is more complex. Most of the time (unless there is a convenient "natural experiment" on hand), we don't have a known starting point grounded in reality because the market power pre-dates the trigger event. Rather, we have to create a parallel universe, asking *what conduct we would expect to see if market power were taken out of play*. Effectively it's a form of regressive analysis – keeping all else equal, what happens if we change the single variable of a competitive vs uncompetitive market?

The diagram below illustrates the two distinct analytical processes. If you're not a diagram person, perhaps a metaphor might help. Think about competition problems as a form of theatre sports, a game of *Thank God You're Here*. This game has three basic elements: the stage (or backdrop), the actors and the action (which generally is a response to a particular "problem" – in other words, a trigger). When applying a counterfactual to a merger or authorisation assessment, we change the *action* to see what happens to the stage: if two players join forces, will their power be such that they can effect structural change to the market? But when testing "taking advantage" using a counterfactual, we change the *stage* to see what happens to the action. Specifically, we're testing how the actors would respond to a particular trigger if they were playing on a different stage.




*The exercise conducted pursuant to section 46 as against, say, section 50 might have the same name, but it does not involve the same analytical process.*
**Other "future with and without" analyses, such as for authorisation and access issues, are of the same nature as shown on the left.*

Both cases involve a subjunctive reasoning thought experiment in which the actors should behave in a reliable and predictable manner, informed by our knowledge of the market generally, an overriding need for rationality and the actors' specific characteristics. But in the first scenario our stage is grounded in reality and we're testing what we expect to happen next; whereas in the second we're in a hypothetical parallel universe and we're testing what would be the rational thing for the actors to do on this stage. It's the difference between the questions posed for Gwyneth Paltrow's character in *Sliding Doors*, as against Sam Worthington's in *Avatar*.

So given that we know this parallel universe does *not* exist, how realistic do we have to make the stage for the results of our thought experiment to be useful? New Zealand courts have grudgingly accepted the use of assumptions that are unrealistic or impractical in constructing a "realistic" hypothetical competitive market but continue to be worried by it. But before we come to the musings of our courts (and theirs) on this issue, let's talk about the origins of the counterfactual in our case law before considering some of its shortcomings.

Although we can get a little proprietorial, neither competition law nor economics owns the concept of the counterfactual. The term was coined by the philosopher Nelson Goodman in 1947. Put simply, it's a contrary-to-fact conditional thought experiment. We use this type of "if [... ], then [...]" subjunctive reasoning in many different contexts and it is the subject of significant philosophical and psychological study.

Not to mention memes...

## How did the counterfactual come about?

As indicated above, the counterfactual emerged from the first High Court decision on Part IV, *Queensland Wire*. The court was addressing a question that had troubled the first instance judge (and was completely ducked by the Full Court): did the words "take advantage" have a moral overtone and, if not, how should they be interpreted? As seen, Mason CJ, Wilson J, Dawson J and, to some extent, Toohey J tested the conduct by reference to what would be expected to occur if the market was *not* affected by substantial market power. As it turned out, BHP's conduct in other, more competitive, markets provided the litmus test.

## Problems with the counterfactual

The High Court's adoption of the counterfactual in the form of the market minus market power offered a neat and seemingly simple solution to establishing a causal connection between the alleged conduct and the firm's market power (so as to distinguish anti-competitive conduct from "competition on the merits"). Courts initially did not seem overly concerned with analysing the evidential basis for a counterfactual. They were happy to accept it as a theoretical construct. As competition litigation has become more complicated, however, this approach has caused consideration vexation.

Problems post-*Queensland Wire* have arisen where:

- applying the counterfactual seems to result in ambiguous outcomes
- the counterfactual subsumes the alleged anti-competitive purpose, and
- the counterfactual is said to be too unrealistic, thereby creating an inappropriate benchmark by which to assess conduct.

## Ambiguity

The first of these issues was quickly recognised. It arises when the conduct may involve a use of substantial market power but, depending on the circumstances, may be profit maximising (rational) even in a competitive market.

The oft-cited example is a refusal to deal which, as in *Queensland Wire*, may be found to be a taking advantage of market power because, in a competitive market, refusal would generally mean a loss of sales to competitors. But if, say, sales are made on credit and there is concern about the credit-worthiness of the customer, a rational supplier in a competitive market may well refuse supply. (Of course, this standard scenario merely begs the question – why not demand upfront payment? But that's a whole other discussion.)

*Melway* taught us that the solution to this problem lies in ensuring that the problematic conduct is characterised properly *before* the counterfactual is applied: returning to our theatre analogy, all three courts in *Melway* agreed on how to set the stage, but it was the High Court that posed the right question (identifying the correct trigger) before considering how the actors would respond.

There were some grumpy references by the High Court in *Melway* to the counterfactual as first devised in *Queensland Wire* (which one might attribute to Gleeson CJ, who happened to be lead counsel for BHP way back when). In particular, the majority wondered exactly how competitive this imaginary market needed to be and queried the unstated assumptions which informed its structure. The majority concluded, however, that:

> *An absence of a substantial degree of market power does not mean the presence of an economist's theoretical model of perfect competition. It only requires a sufficient level of competition to deny a substantial degree of power to any competitor in the market…*

Subsequently the High Court examined what this does and does not require:

> *[T]he hypothesis that Melway lacks a substantial degree of power in the market does not require the assumption that the distribution arrangements or practices of Melway and its competitors are such that they are all commercially obliged to supply anyone who seeks to become a wholesaler, or that, at the wholesale level in the market, there exists a state of perfect competition, or that a decision to confine supply to one or a small number of wholesalers will result in a loss of sales. The only purpose of the hypothesis is to seek to test whether Melway has taken advantage of its degree of market power...*

Between *Queensland Wire* and *Melway*, we thus have a well-developed counterfactual test for refusals to deal. It was further honed by Heerey J (and Sackville J) in *Boral* and *Safeway* to work in a broader context, nimbly incorporating focus on the company's business rationale for engaging in the conduct. We'll discuss this in a little more detail shortly.

Our relative ease in dealing with refusals to deal using the counterfactual is a feat that should not be underestimated. In the United States, for example, the Antitrust Modernization Committee found the issue of refusals to deal extremely hard to address, seeking further clarification from the courts. But we'd suggest, in Australia, the counterfactual can be readily applied in advance to most refusal to deal scenarios, leaving the majority of practitioners relatively comfortable in advising business.

## The counterfactual subsumes (presumes?) the anti-competitive purpose

The second problem with counterfactuals is illustrated by *Rural Press*. The ACCC had argued Bridge Printing/Rural Press had threatened to enter the primary distribution area of Waikerie Printing with a free newspaper. On appeal, the Full Court considered that Bridge Printing/Rural Press *could* have entered the River News territory at any time – it did not need to have market power to do so.

The High Court agreed with the Full Court and found that in making the threat of entry, Rural Press was not taking advantage of its *market* power. It dismissed the ACCC's claim on the grounds that it attempted to explain "take advantage" in terms of the proscribed anti-competitive purpose.

The Commission had argued that the only rationale for this threat was to exclude Waikerie's River News from Mannum, an area which had previously been part of the market for Rural Press's Murray Standard. The High Court, however, concluded that "[t]o possess the purpose of protecting [market power] is not necessarily to rely on it". This kicked off the infamous could/would debate, which the High Court later silently recanted in its straight-forward decision in *NT Power* (and which could have been easily avoided if it had applied the qualifying words "in a commercial sense" that Mason CJ and Wilson J were thoughtful enough to have included in *Queensland Wire*).

## The counterfactual is not realistic

The final – and perhaps most confronting – problem with the counterfactual relates to how the market would look absent the firm's substantial market power. In a way, the genesis for this problem arose in the manner in which the majority rounded out the passage from *Melway* extracted earlier: "It is one thing to compare what it has done with what it might be thought it would do if it lacked that power. It is a different thing to compare what it has done with what it would do ***in circumstances that are completely divorced from the reality of the market…***".

Returning to our theatre analogy, we would interpret this to mean that the actors must still behave in a reliable and predictable manner, informed by their own characteristics (that is, "realistically"): in other words, play with the backdrop, but let's not change the character of the actors. The only rider is that the actors must behave rationally (ie in a manner that is profit maximising). One can think of this in terms of the movie *Inception*: the surrounding architecture could be completely fantastical at any given time, but the movie's characters always behaved in a recognisable fashion regardless of their environs. It's when *this* grounding in "reality" is missing that the exercise becomes nonsensical (*Mulholland Drive*, anyone?).

Nonetheless, the above gloss in *Melway* clearly sowed the seeds for a debate about the need for the counterfactual to be realistic. This issue was very live in *NT Power*, but was happily resolved at the Full Court level. Nonetheless, it continues to prompt vigorous debate, particularly for our friends across the Tasman, and warrants detailed attention.

## How realistic a stage do we need to set?

One of the best constructions of a counterfactual occurs in Finkelstein J's judgment (at Full Court level) in *NT Power*. He explains the genesis of the counterfactual:

> *Where the firm has a substantial degree of power it is logical for the point of comparison to be between, on the one hand, the firm's behaviour in the uncompetitive market and, on the other hand, the firm's hypothetical behaviour if it had competitors but was otherwise in the same circumstances…*

As noted in *Melway*, sometimes this can be done by direct observation of competitive markets that exist elsewhere (whether geographically or in time) – in short, one can identify a natural experiment. In that case, Melway's conduct was unchanged from its earliest days (when it clearly had no market power) and across markets (including Sydney, where it had virtually no market presence). One could therefore conclude that – absent its market power – it would have behaved in the same manner; thus it could not be said to be *using* its market power.

Given there was no handy natural experiment in *NT Power*,

> *it is necessary to ask how PAWA would have behaved in an hypothetical competitive market making certain assumptions about the nature of that market. The reason why it is necessary to construct an hypothetical market is that there has never been a competitive market for the supply of [electricity] infrastructure in the Northern Territory, and there is never likely to be one because of the cost involved.*

Acknowledging that this hypothetical market need not be a model of perfect competition, Finkelstein J went on to examine what it might involve in the present case: in essence, he creates a world in which there is a second firm, in the same region, with the same infrastructure (ie an electricity grid, capable of providing transmission and distribution services to third parties). While such a counterfactual is "unrealistic", it's also a long way from perfect competition. Perhaps it could best be described as workably competitive.

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*The architecture of our constructed counterfactual world can be fantastical, but the behaviour of the players within that world must be realistic.*

Finkelstein J continues:

> *Let us now examine the issues which PAWA would face in a competitive market if it were asked to make its facilities available to a third party who wished to distribute and transmit electricity… so that it could compete with PAWA... A profit maximising firm in a competitive market… would not stand by and allow a competitor to supply the third party with distribution facilities. At least it would make a bid for that business. PAWA, however, is faced with this difficulty. If it were to permit access to its facilities it would open the door for the third party to become its competitor in the electricity supply market where it could take business from PAWA. Would that be a reason why a rational firm would deny access to its infrastructure as a means of protecting its downstream business? The answer must be no. In a competitive market for the supply of distribution and transmission facilities PAWA could not prevent the third party from competing for PAWA's customers with the potential that it would lose business. This is because in our hypothetical competitive market there is an organisation that can provide distribution and transmission facilities to the third party. So it is impossible for PAWA to keep the third party away from its customers. How would a rational firm act in that situation? In my view a rational firm would act pragmatically and make its infrastructure available. It would do so to get what it could from the difficult situation in which it found itself. The only thing it could get by way of recompense for the loss of business that it would be likely to suffer in a competitive market is a, perhaps smaller, return from letting out its infrastructure.*

A similar approach was adopted (with little controversy) by Jacobson J in *Pacific National v Queensland Rail*, in which he envisaged a duplicate rail terminal at Acacia Ridge.

Returning to *NT Power*, Finkelstein J observed that the same result can be reached via a slightly different path: asking what was the purpose of the conduct and considering whether that purpose was achievable absent market power (the "direct inference" approach). Thus, at least in the case of a refusal to supply, one can see that Deane J's "test" for taking advantage morphs with the counterfactual proposed by Mason CJ and Wilson J.

## Lost in a Long White Cloud

In our humble opinion, Australian practitioners are generally slow to recognise the value of New Zealand analysis. The ComCom and the NZ courts have a history of producing extremely well-considered succinct (!) competition assessments, which we would do well to emulate. But in the application of the counterfactual, our friends across the Tasman seem to have got themselves into a right pickle. We're inclined to show sympathy and blame the Privy Council (but maybe that's just our republican tendencies). Nonetheless, it now means that section 36 of the Commerce Act is under review with the cost and delay involved in making a case under the counterfactual test being blamed for making the prohibition too "defendant-friendly" (see the **Issues Paper** released late last year).

The issue came to a head in the predatory pricing case, *Carter Holt Harvey* (although one could trace it to an earlier time). The first instance judge did not expressly employ the counterfactual, stressing the need for a "practical and common sense" approach. While upholding the decision, the Court of Appeal felt the need to incorporate Australian precedent more clearly into the NZ jurisprudence (a common theme in NZ analysis – because they believe in Closer Economic Relations!). The Privy Council overturned both earlier decisions by a 3:2 majority. While the majority endorsed the counterfactual, the minority were unconvinced – they were concerned about the court's ability to assign the correct attributes to participants in the hypothetical analysis and queried how the behaviour of a hypothetical participant should be assessed. Ultimately, they considered the counterfactual to be "highly unreal".

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*Judges in New Zealand – and on the Privy Council – seem a little lost when it comes to constructing & applying the counterfactual.*

This reticence – which, in the language of theatre sports, misdirected attention to the actors rather than the stage – was further entrenched in the *0867* decision. This case was effectively a re-run of the *Telecom v Clear* saga that dominated NZ courts during the 1990s. This version concerned residential internet dial up products (remember dial up?), prompting the issue of how to incorporate Telecom's community service obligations into the analysis. The High Court and Court of Appeal relied on the counterfactual as explained by the Privy Council in *Carter Holt Harvey*, accompanied by a confusing analysis of Australian decisions and subject to some reservations. These were outlined by Hammond J:

> *This case exposes the realities of the difficulty of counterfactual analysis and that it is not always of utility in the context of a case such as the present. The reality of the case is that it is about terminating charges which are markedly above cost and the willingness of Telecom, under threat of regulation, to share its monopoly rents with Clear. Any realistic counterfactual must take monopoly rents as a given. It is difficult to see how there can be any plausible counterfactual about the distribution of monopoly rents where non-dominance has to be assumed: in the absence of dominance there can be no monopoly rents.*

The case then proceeded to the Supreme Court, now NZ's highest court and a home grown one at that. In constructing a hypothetical market, the Supreme Court postulated a scenario in which there was at least one other company with its own telephone network but in which the community service obligations remained. Controversially, the Court also incorporated a feature of the market which clearly impacted upon Telecom's incentives: an asymmetrical number of ISPs using this second imaginary network. While it seems appropriate to incorporate the community service obligations (as they are a key restraint impacting on the actors' behaviour), it seems contrary to a hypothetically competitive market to play with their incentives via the ISP distribution in this manner. After all, we are asking whether their behaviour would change if their incentives were different.

## Alternatives to the counterfactual

Although it seems that today the norm for establishing the nexus between substantial market power, taking advantage and anti-competitive purpose is the counterfactual, it's worth considering the alternatives our courts have thrown up along the way. This exercise can be enhanced by reference to the potential difficulties discussed above.

There is no legislative bar to the adoption of a different way: Deane J's approach has never been formally rejected, and section 46(6A) (inserted in 2008) clearly invites alternative approaches:

> *(6A) In determining for the purposes of this section whether, by engaging in conduct, a corporation has taken advantage of its substantial degree of power in a market, the court may have regard to any or all of the following:*
>
> *(a) whether the conduct was materially facilitated by the corporation's substantial degree of power in the market;*
>
> *(b) whether the corporation engaged in the conduct in reliance on its substantial degree of power in the market;*
>
> *(c) whether it is likely that the corporation would have engaged in the conduct if it did not have a substantial degree of power in the market;*
>
> *(d) whether the conduct is otherwise related to the corporation's substantial degree of power in the market.*

Arguably, (a) and (b) relate to the "strength" of the relationship between market power and the conduct rather than how that link is to be established. Paragraph (c) is the counterfactual we have been discussing, while (d) accommodates methods other than a counterfactual for providing the link between substantial market power and a proscribed purpose. Interestingly, one of the potential reform options flagged in the New Zealand review is to insert something similar to section 46(6A) into their Act.

"It's all set – [Batman] puts his foot here, my secret jack-in-the-box fires, shooting him up through the window, out over the sea, into the waiting arms of Penguin's exploding octopus!"

The Joker's villainous plan might be a little unrealistic, but he's certainly acting in character

Prior to *Queensland Wire*, there was a view that "taking advantage" involved morally reprehensible or unethical conduct. This colours the approach taken in earlier cases under section 46 of the then Trade Practices Act. Nevertheless, they offer some insights into alternative means of establishing the required nexus – that is, they give us some idea as to what (d) might entail. These alternatives include:

- whether the conduct can be attributed to a power *other* than market power eg statutory power or property ownership (including intellectual property)
- whether the conduct is characterised as conduct necessarily requiring market power, eg predatory pricing. Thus if the firm is found to possess substantial market power and engages in the particular conduct, it will be accepted that it used its market power, and
- inferring taking advantage from purpose, as per Deane J.

## Identifying whether the conduct is made possible by factors other than market power

One possibility, having established that the relevant firm possessed substantial market power at the time of the alleged conduct, is to investigate whether the conduct has been made possible or facilitated by something *other* than market power. This could be seen as a swing of the evidential burden: if one has substantial market power and a proscribed purpose, then one is taken to have used that market power in the absence of a better explanation. Kirby J would certainly approve, although the High Court majority has repeatedly warned of the danger of such an approach.

Nonetheless, *Stirling Harbour* provides an example of a successful "defence" if viewed in this manner. Here, the Port of Bunbury Authority was found to possess statutory power and to have exercised that, even though it may have possessed substantial market power as well. Similarly, property rights (including intellectual property rights) might be identified as the basis for the conduct, although that can create its own confusion… the prosecution calls the High Court in *Rural Press* as its first witness.

## Applying specific rules depending on the nature of the conduct

A second approach that does not rely on a counterfactual is to "characterise" the conduct. This is premised on the idea that certain types of conduct almost always require substantial market power. Given this, if the conduct can then be characterised in a particular way, it can be inferred that the conduct involved a use of the firm's substantial market power. The Birdsville Amendment (section 46(1AA)) embeds this approach in the legislation in relation to predatory pricing.

The danger inherent in this approach is obvious. Particularly given our overriding concern with Type 1 error (which, via over-inclusive legislation, chills competitive conduct), one needs to be wary of presumptively concluding that, say, low prices are bad.

In *Boral* at first instance Heerey J did not apply a counterfactual; rather he sought to test the alleged predatory pricing by applying the *Brooke Group* rules devised by the US Supreme Court. The problem with this approach is that while predatory pricing often requires a firm to possess substantial market power, in some cases the conduct is the means by which the firm sets out to attain that power – a scenario which the law addresses in a fundamentally different way here to the United States. That said, where predatory pricing relies on excess capacity (as will generally be the case, other than in a tender scenario), it can be reasonably argued that any market power necessarily pre-dated the pricing conduct.

Heerey J went on to consider whether Boral had a legitimate business rationale for its pricing policy, seeming to reflect the fact that, even without market power, firms may drop their prices substantially in certain circumstances. Thus, considering the business rationale might help in assessing direct evidence of taking advantage, rather than (as generally assumed) assisting with the counterfactual. Given the High Court's position in both *Boral* and *Rural Press*, however, one needs to be wary of adopting an approach that seems to confuse purpose with taking advantage. While the High Court declined to hear an appeal against Heerey J's joint judgment in *Safeway*, the role of business rationale is clearly confined.

In *Baxter*, the ACCC's expert economist Barry Nalebuff focused on whether tying/bundling the various pharmaceutical products resulted in a price-cost squeeze on the premise that this was only possible if the firm possessed substantial market power.

Problems with this approach are illustrated by Allsop J's concern that the ACCC had to prove whether the bundled prices had been discounted *or* the à la carte prices had been inflated. He was reluctant to solve the puzzle by accepting, as a matter of logic, that it was doing one or the other – perhaps he was concerned that this slippery approach (hey, after all it was logic!) was inconsistent with the ACCC's obligation to discharge the burden of proof. If, however, this analysis occurred by way of a traditional section 46 counterfactual, there would have been no need to bridge the gap. Assuming a competitive market, if the bundled prices were too low, lost profits could not have been recovered by subsequently raising prices; alternatively, if the discrete prices were too high, Baxter would have lost sales to its putative competitors.

## Inductive reasoning

A third approach can be identified: the inductive reasoning of Deane J in *Queensland Wire*. Deane J (and to some extent Toohey J) considered that BHP's obvious objective was only achievable due to its market power:

> *Its refusal to supply Y-bar to QWI otherwise than at an unrealistic price was for the purpose of preventing QWI from becoming a manufacturer or wholesaler of star pickets. That purpose could only be, and has only been, achieved by such a refusal of supply by virtue of BHP's substantial power in all sections of the Australian steel market as the dominant supplier of steel and steel products. In refusing supply in order to achieve that purpose, BHP has clearly taken advantage of that substantial power in that market. If that purpose be one of those specified in s46(1) of the Act, BHP's conduct constituted a contravention of that sub-section.*

This reasoning, which has never been formally rejected by the High Court, has its limitations; arguably it makes sense in cases of exclusionary conduct (eg refusals to deal) but not necessarily for other types of conduct falling within the ambit of section 46. The approach has also suffered as a consequence of decisions such as *Universal Music*, where the Full Court found that the various music companies had an exclusionary purpose (thus finding that they *did* have a purpose of substantially lessening competition) but lacked the means to achieve that purpose (as they did not have substantial market power).

## Another option? Direct evidence of take advantage

Perhaps if we know what competitive conduct looks like, we could directly determine taking advantage. After all, a firm with substantial market power has, within its armoury, only two legitimate responses to competitive conduct: it can cut costs or add value (or a combination of the two). While these responses amount to competition "on the merits", any other strategy necessarily draws upon market power.

This approach – effectively a reversal of the onus of proof (where substantial market power has first been established) – would enable a defensive strategy to be assessed (eg Boral's response to CMM). Would it allow an offensive strategy to be assessed? Presumably so. However, would it be both simpler and more accurate than what we have at present?

## Conclusions

The heart of the matter is how to sort the wheat from the chaff when both might look the same to the naked eye. As the current review in New Zealand acknowledges, the holy grail we're seeking is a test that protects success achieved though vigorous competition. We do this through a causal connection between the market power possessed by a firm and its conduct, because the outcome of vigorous competition can often look like the outcome of anti-competitive conduct. The tool we use to establish causal connection both here and in New Zealand is the notion of "taking advantage" of market power, the implication being that if market power has been "taken advantage of" then success has been achieved other than on the merits.

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*Judges (and lawyers more generally) tend to feel more comfortable when playing with hard evidence, as opposed to spooky stuff like logic. But competition law doesn't always lend itself to direct evidence and – even when such "evidence" appears to exist – it can be misleading.*

Let's return to where the trouble started (at least in Australia) – the problem initially faced by Pincus J in *Queensland Wire* at first instance. While there was nothing about the words of section 46 that implied moral culpability, he felt uncomfortable condemning BHP's conduct. In short, the court did not want to punish the scorpion for using its stinger where the law did not prohibit scorpions in themselves (think **the parable of the scorpion and the crocodile**). The law does not prohibit market power per se – indeed, we *want* parties to seek it all the time; therefore, there had to be some reason – some causal link – that warranted BHP's condemnation. Changing the words of section 46 won't solve this basic dilemma. Courts will always look for causation.

If we want to protect "competition on the merits", then even if we get rid of the words "take advantage", our courts will still need an analytical tool to test causal connection. Even if they don't say the word "counterfactual", they will probably still *do* a counterfactual because, taken as a whole, our body of precedent suggests it has worked pretty well (certainly for refusals to deal which have proved problematic in other jurisdictions).

The New Zealand Productivity Commission recommended in May 2014 that the government should consider whether approaches other than a counterfactual might offer "greater accuracy in identifying situations where firms have taken advantage of market power and damaged dynamic efficiency with consequent detriments to competition, innovation and/or productivity". The counterfactual approach does seem to cause particular grief in the context of a natural monopoly. Many people struggle to wrap their heads around the idea of two transmission grids or two telephone

cables. As the High Court majority in *NT Power* observes, however, "The assumption on which the reasoning of four members of the [High] Court in *Queensland Wire*… proceeded – that BHP lacked market power and was operating in a competitive market – was highly unrealistic". They observe that the majority in *Melway* was merely "urging the need for cogent analysis on the basis of the assumptions…". Their conclusion on this point is compelling:

> *It can be necessary, in assessing what would happen in competitive conditions, to make assumptions which are not only contrary to the present fact of uncompetitive conditions, but which would be unlikely to be realised if the monopolist were left free to operate as it wished. But s46 and other provisions of Pt IV were introduced in order to stop monopolists being entirely free to act as they wish. If the difficulties in making assumptions were to prevent them from being made, possessors of market power that was hard to erode [ed: surely the only sort of market power we should care about] would be shielded from the Act. That would defeat its purpose.*

Moving to a "substantial lessening of competition" (effects) test along the lines of the Harper Report recommendation would introduce a more familiar merger-like counterfactual. As discussed in **Issue 3**, however, that would be a whole other box of dice: one that would involve a much more fact intensive exercise, rather than the thought experiment that is currently required. But it may well turn out to be an equally difficult and no more accurate exercise, especially for refusals to supply (eg, do we have to remove market power from the counterfactual to assume there would be supply in the "future without", and on what terms?).

The New Zealand review has flagged that, even if their section is not operating satisfactorily, it doesn't necessarily follow that any other approach is going to be better. Sometimes, you just need to love the one you're with.

*At TSoC, we're interested in what* other *levers might be pulled to improve the workability of section 46 (and indeed the competition-tested provisions more generally). Stay tuned for our next edition... On that note, if it seems like it's taking a while between editions lately, you're right. We've made the decision to write longer pieces less often. Feedback from the field suggests our readers like this idea too.*

*In the meantime, if you want to read shorter pieces more frequently, follow Alexandra on LinkedIn where she posts regularly:* ***https://au.linkedin.com/in/alexandramerrett****. She writes items like the short discussion overleaf, on the role of purpose in section 46.*

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*This year's Baxt Lecture will be a cracker – Professor Eleanor Fox of New York University. She'll be speaking about the intersection between trade and competition policy – particularly the impact of regional pacts, such as ASEAN and the Trans-Pacific Partnership Agreement.*

*The lecture will be held at the Melbourne Law School on the evening of 4 August. It's a free event, but we'd strongly recommend you register early:* ***http://law.unimelb.edu.au/centres/clen/engagement/annual-baxt-lecture***

*Don't forget, past TSoC editions are always available via:* ***http://thestateofcompetition.com.au/newsletter-archive/***


*Read on to understand the surprising link between figure skating & section 46...*

*Connect with/follow Alexandra on LinkedIn for similar posts: https://au.linkedin.com/in/alexandramerrett*

## Competitors, competition & the curious role of purpose

In 1994, Tonya Harding won the US Figure Skating Championships following a savage attack on her bitter rival (and the defending champion) Nancy Kerrigan.

Investigations into the attack revealed that Harding's husband and bodyguard had hired a thug to break Kerrigan's leg with the express purpose of preventing her from competing, both in the championships and in the upcoming Olympics. Fortunately, the scheme didn't quite succeed; while Kerrigan missed the US Champs, she was still selected for the national team and went on to win silver at the Olympics.

The FBI were called, the bodyguard confessed and criminal charges were promptly filed. Ultimately, all those directly involved in the attack served prison time and Harding herself pleaded guilty to conspiring to hinder their prosecution (she copped probation, community service and a whopping fine). Meanwhile, skating authorities conducted their own investigations and promptly stripped her of the title. Concluding that Harding knew about the attack in advance, they also handed her a life ban.

It's true - we don't follow figure skating particularly closely. But apart from Harding herself, we haven't heard anyone seriously suggest that the US Figure Skating Association – in punishing Tonya Harding so severely – was inappropriately focused on protecting **Nancy Kerrigan**. No one claims that the Association's principal concern was defending a favourite daughter, rather than the integrity of the competition itself (here, the 1994 US Championships, the Olympics and, presumably, other future events).

Yet this is the argument consistently put forward about the role of purpose in section 46. Let's just think about those purposes in the context of the Harding/Kerrigan scandal. Eliminating or substantially damaging a competitor? Check. Preventing a person's entry into a market [event]? Check. Deterring or preventing competitive conduct? Check.

The ACCC, in a position adopted by the Harper Review, contends these purposes inappropriately focus on protecting individuals rather than the competitive process. Harper concludes – absent any apparent reasoning, inductive or deductive – that "the purpose test in section 46 focuses on harm to individual competitors...".

We would argue that the focus – or, perhaps more accurately, the role – of purpose in section 46 is the exact opposite; indeed, it demands that those who focus on individual competitors be punished! Consider what it means to establish a proscribed purpose. Remember, any inquiry into purpose means that we have already demonstrated that a corporation has taken advantage of its substantial market power (this is the effect of the High Court's decision in Boral). It is only when it is further shown that the corporation's conduct in doing so was for a proscribed purpose (perhaps the targeting of Nancy Kerrigan) that legal liability is established. In other words, section 46 clearly condemns someone who uses substantial market power where, in doing so, they focus an individual competitor.

We want competition to be a relatively anonymous process – indeed, there is nothing so anonymous as the economists' concept of perfect competition. Tonya Harding was supposed to try to win by putting in the best performance she could, not by nobbling her nearest rival. But in some contests, one has to be more aware of one's opponents than in others (hence the use of the word "relatively"). For example, Novak Djokovic, in winning the Australian Open recently, said his preparation had specifically focused on his closest competitors (Nadal, Federer and losing finalist Andy Murray). One presumes, however, this focus resulted in tweaks to his forehand, not crank calls to Murray's hotel room in the middle of the night. Thus, while not unaware of his opponents, Djokovic's principal strategy involved refining his **own** game. This approach also reflects our expectations of the business world where a market falls short of perfect competition, perhaps tending to oligopoly or even monopoly.

Sporting analogies aptly capture our expectations about how the competitive process should work. If competition is a foot race, we want those in front to keep their eye on the finishing line rather than looking about to see who is closest to them. That's the fastest way to run! Or, in economic terms, the way that will maximise welfare.

It is thus a very curious proposition indeed to say that – in prohibiting conduct which does **not** adhere to this "veil of ignorance" – the proscribed purposes are all about protecting individual competitors, not the competitive process. There may be issues with section 46 (whether its drafting or application), but a failure to prioritise the competitive process is not one of them.

For Tonya Harding's take on events, check out ESPN's documentary, The Price of Gold (available on **YouTube**) - fascinating, notwithstanding the surprising failure to mention section 46.