PRODUCTIVITY COMMISSION

Productivity Commission Submission to the Review of the *Trade Practices Act 1974*

July 2002

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ISBN 1 74037 092 9

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An appropriate citation for this paper is:

Productivity Commission 2002, *Productivity Commission Submission to the Review of the Trade Practices Act 1974*, AusInfo, Canberra, July.

The Productivity Commission

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Foreword

The Trade Practices Act is an important regulatory instrument with far-reaching impacts throughout the economy. As markets evolve and regulatory experience accumulates, it is important to review the Act's provisions and their administration to ensure that they continue to be appropriate. The present review of Part IV of the Act is therefore timely.

In the time available for submissions, the Productivity Commission has not sought to cover all matters relevant to the Review. Instead, it has focussed this submission mainly on the provisions relating to the misuse of market power (section 46). This is a part of the Act where significant changes have been proposed by different interested parties, which could have major implications for the efficient operation of markets and thus economic outcomes. It is also an area where the Commission's views have been able to be informed by its own recent reviews of related parts of the Act.

Ultimately, any changes to the Act need to be made with some confidence of yielding a net benefit to the community. That requires not only careful consideration of the potential costs of the actions of market participants under different degrees of regulatory oversight, but also the potential costs of the regulatory interventions themselves.

Gary Banks
Chairman

July 2002

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Key points

- Regulatory provisions against anticompetitive conduct need to tread a fine line between limiting genuinely anticompetitive conduct and sustaining procompetitive rivalry among firms.
- The introduction of an effects test into section 46 of the *Trade Practices Act 1974* (TPA) would lower the threshold for regulatory intervention where misuse of market power is suspected.
- While such a test has some advantages, problems in its interpretation and implementation mean that it is likely in practice to have adverse impacts on efficiency and on the process of competition itself.
- The prospect of regulatory error would be higher under an effects test, because it would be more likely to catch behaviours that have unintended impacts on competition and that do not detract from economic efficiency.
  - The potential direct and indirect costs are significant.
- Any need for a more expansive section 46 would appear to have diminished.
  - The economy is increasingly open, so that the scope for substantial market power, which must underlie anticompetitive conduct, has declined.
  - Under National Competition Policy, specific regulatory regimes have now been developed for those areas of the economy where the risks of market power and its abuse are greatest.
- Administratively applied cease and desist orders would lack accountability and also would risk regulatory errors in their application.
  - These risks are not justified given the current ability to seek court injunctions.
- There is evidence that the existing penalty regime for breaches of Part IV of the TPA may not be enough to deter anticompetitive conduct by firms and individuals.
- The adoption of a penalty regime that provided better deterrence, subject to appropriate safeguards and careful design, would further reduce the case for strengthening section 46 in other ways.
- There are grounds for considering anew whether the market share and concentration thresholds for regulatory scrutiny of mergers should be raised.

Overview

The *Trade Practices Act 1974* (TPA) is one of Australia's most important instruments of economic regulation, with wide-ranging impacts on the conduct of Australian businesses. The present review is timely. It is imperative to keep the Act, its guidelines, and its implementation up to date with developments in the economic and regulatory environments facing Australian industries and with new understanding about the behaviour of firms. Indeed, the Productivity Commission considers that further reviews of the TPA are warranted at appropriate intervals to ensure the continued relevance and effectiveness of its provisions.

In this submission, the Commission focuses on issues relating to misuse of market power (section 46). This is the area where significant changes (both increases and decreases) in regulatory power have been advocated by interested parties and where the lessons from the Commission's most recent assessments of competition regulation — particularly Part XIB of the TPA — are most relevant. The Commission also provides some brief observations on matters relating to mergers (section 50).

Dealing with anticompetitive conduct

Regulatory provisions against anticompetitive conduct — despite their obvious popular appeal — need to tread a fine line between, on the one hand, limiting the damaging efficiency consequences of genuine anticompetitive conduct and, on the other hand, the maintenance of property rights, pro-competitive rivalry by firms and entrepreneurial freedom.

This suggests changes should be made cautiously, since regulatory error in either direction — an excessively permissive or harsh regime — could damage competitive processes and market outcomes in the Australian economy. And it is the operation of markets, through competitive processes, that drives Australia's growth — contributing to greater productivity, lower costs and improved service, and ultimately to higher incomes and standards of living.

Clear objectives are needed

Unfortunately, because of some vagueness about the objectives of the section, even the criteria on which an assessment of section 46 should be based are currently rather poorly specified.

The framework of competition policy in Australia encompasses a range of policies and legislative instruments. Section 46 does not have a specific objects clause. Rather, it relies on the objects clause in section 2 of the TPA, which identifies the object of the Act rather broadly, encompassing not only competition, but also fair trading and consumer protection.

The Productivity Commission supports the view — generally applied in cases of suspected anticompetitive conduct — that the key objective of section 46 should be the enhancement of economic efficiency. Clarifying the objectives of section 46 to focus on this economic objective would provide clearer guidance to the regulatory agency and courts in administering and enforcing the legislation and interpreting statutory criteria. It would prevent the intrusion of other issues — such as the protection of small business or distributional goals — that can be more effectively dealt with under other mechanisms.

'Purpose' versus 'effect'

Unlike other sections in Part IV and Part XIB (relating to telecommunications), section 46 requires an anticompetitive purpose rather than effect, or likely effect, to be proved in order to prosecute a case successfully. Several commentators have proposed that section 46 be strengthened by introducing 'purpose or effect or likely effect' as the relevant test.

The use of an 'effect or likely effect' test has some advantages conceptually and operationally. Vigorously competing businesses will often and reasonably use pugnacious rhetoric when attempting to win in the market — complicating the assessment of when an anticompetitive purpose has genuinely been present. Establishing anticompetitive purpose can also be demanding for regulators and courts, given that true anticompetitive conduct can be expected to be furtive.

Notwithstanding these advantages, there are persuasive reasons for not changing to an effects test:

- The benefits claimed for such a test are exaggerated given that section 46(7) of the TPA permits courts to infer purpose from anticompetitive effects.
- The test is more expansive than the present one, because, in addition, it would proscribe conduct arising from the use of market power that has the effect of

reducing competition, even where that effect is unintended. This is likely to increase the scope for regulatory error. Problems in defining markets and determining market power are profound — and would be exacerbated by a harsher regime. The history of antitrust around the world, including Australia, is littered with error, the detection of which is itself not a simple task.

  - Regulatory error can have its own anticompetitive effect, and it appears inconsistent to establish a regime that has higher regard for one source of that effect (private conduct) than another (regulatory conduct).

- The costs of errors are not trivial. An incorrect action damages the firm concerned, while the risk of regulatory errors can deter procompetitive behaviour that might be mistaken for anticompetitive conduct. Regulatory errors could potentially delay or eliminate investments, advantage higher cost rivals at the expense of a more efficient dominant firm, and eliminate practices that may produce sizeable benefits for consumers. Compliance and administrative costs of new cases are also likely to be significant. Even were the regulator to be prudent, the TPA also permits private actions, which may be opportunistically motivated.
- As an effects test is much more likely to catch unintended acts, widening of section 46 is likely to increase business uncertainty about how regulators and courts may interpret the clause.
- No past reviews of the TPA have considered it appropriate to amend the purpose test, and since then competitive pressures in the economy have increased rather than decreased.
  - Tariffs and financial controls have been liberalised, promoting more open trade and capital flows.
  - National Competition Policy has developed specific competition regimes for those areas of the economy where the risks of market power and its abuse are greatest.
  - While the 'new economy' has thrown up new challenges for competition policy, many of its developments have strengthened competition by providing new intermediaries and better information exchange.
- Arguments that section 46 needs strengthening to protect small business lack substance. Small business is vitally important to the Australian economy, but section 46 should not be particularly oriented to the needs of small businesses or overhauled because of size-specific problems. Small firms may themselves exert market power and many disputes between firms that might be seen through the lens of market power are really about the distribution of gains from exchange. There are better instruments than section 46 — both in and out of the TPA — to deal with small business concerns about market power exerted by big business.

- Claims that strengthening section 46 are justified because it would bring the section into line with the rest of the TPA or with overseas jurisdictions do not withstand scrutiny.
  - Different parts of the TPA apply different tests because the context and standard of proof required are different. For example, an effects test is justified in telecommunications (Part XIB) because there is already a prima facie case that strong market power exists, and the design of the access regime (Part XIC) creates strong incentives for anticompetitive conduct in that sector.
  - It can be dangerous to draw inferences for Australia from overseas jurisdictions, especially without a full understanding of how their antitrust regimes function. For example, when gauging predatory pricing, US courts use a much more stringent standard of proof, while the European Union employs a higher threshold (dominance) when gauging market power.

In sum, the Productivity Commission's assessment is that a move to a 'purpose, effects or likely effects' test in section 46 would have more disadvantages than advantages.

Cease and desist orders

It has been proposed that the regulator be able to issue — without scrutiny from the Federal Court — temporary cease and desist notices.

The Productivity Commission questions whether such orders would achieve the purposes intended for them. They do not necessarily lead to speedily resolved cases, since they would typically be the forerunner of a subsequent substantive case before the Federal Court.

Since it is proposed that there be limited scope for a stay on a cease and desist order, accountability is limited and regulatory error would be in prospect. The costs of such error may be significant. For example, even temporary curbs on (what transpires to be lawful) business conduct can have enduring effects (key customers may be lost, contracts reduced, or inframarginal investments made marginal).

The Productivity Commission considers the existing scope for interlocutory injunctions — which must be given by a court based on evidence — already provides short-term protection for parties being harmed by anticompetitive conduct.

Enforcement issues

The conceptual underpinning for a penalty regime in an economic statute such as Part IV is primarily deterrence, not punishment. Yet there is evidence that the existing penalty regime may not be sufficient to achieve the optimal deterrent effect.

In particular, maximum penalties for breaches may be significantly below the returns from anticompetitive conduct, especially for larger firms. Some firms — for example, those in financial distress — face no effective sanctions against participating in anticompetitive conduct. And individuals within firms presently have weak incentives to avoid anticompetitive behaviours.

A move to incentive compatible penalties could involve several complementary moves, including:

- setting penalties based on some multiple of the harm induced by anticompetitive conduct or gain by the perpetrator;
- the introduction of criminal penalties for some serious offences; and
- mimicking some US innovations in the design of antitrust provisions, such as the establishment of an automatic right to leniency for the first party to divulge a cartel to the regulator.

The Productivity Commission has analysed these options, pinpointing some potential weaknesses that would need to be addressed before any were implemented. For example, the standards for proof would need to be very high for criminal cases and it would be inappropriate to base criminal convictions merely on identification of a breach of a per se restriction in Part IV. Were criminal penalties implemented, they should not exempt small and medium businesses. Empirical evidence suggests that small enterprises may also engage in 'hard core' offences — and indeed, in the United States, they make up the bulk of recorded convictions.

It also is relevant to note that the adoption of a penalty regime that provided better deterrence, subject to appropriate safeguards and careful design, would reduce the case for strengthening section 46 in other ways — such as through cease and desist powers.

Mergers

Pro-competitive regulation needs to be designed to ensure that the regulatory costs of a merger regime (such as deterring potentially beneficial mergers and raising industry compliance costs) do not outweigh the benefits (of achieving more efficient pricing and potentially pre-empting anticompetitive conduct).

The Commission has made several recommendations in past reports about optimal merger policy that bear independent re-examination. In particular, it has argued that there are grounds for raising the thresholds on market shares and concentration ratios for setting ‘safe harbours’, where mergers can proceed without ACCC scrutiny. This reflects:

- that regulators have greater incentives to avoid situations in which they allow a merger that increases market power to proceed, than to avoid cases where they stop a pro-competitive or efficient merger from occurring;
- a tendency in competition policy to define the boundaries of a market in terms of close substitutes, which results in excessively narrow market definitions. However, some rules-of-thumb must be used so that not all mergers require regulatory scrutiny. The solution is to define a market in the conventional way, but use a more generous threshold to counter the natural bias engendered by this method; and
- recent evidence that the existing thresholds may be unnecessarily capturing too many mergers in the regulatory net.

Finally, it is sometimes alleged that merger policy may prevent the establishment of national ‘champions’ — large-scale enterprises that can take on global markets. It is claimed that merger policy pushes Australian firms offshore to other destinations where they can achieve such competitive scales. The Commission has found little evidence to support this in surveys of firms’ offshore location decisions. It notes, however, that merger policy should not preclude the emergence of even highly concentrated market structures where adequate substitution possibilities exist or entry barriers are not high.

1 Introduction

Periodic reviews of the *Trade Practices Act 1974* (TPA) are important in ensuring that the provisions remain relevant and workable as the economic and regulatory environment facing Australian industries change.

The Productivity Commission has recently reviewed various parts of the TPA:

- Part 2D — local government exemptions (PC 2002d);
- Part IIIA — national access regime (PC 2001b);
- Part X — international liner cargo shipping (PC 1999a); and
- Parts XIB and XIC — telecommunication competition regulation (PC 2001d).

The Productivity Commission has also recently undertaken public inquiries that have examined competition regulations outside the TPA — such as regulation of tugboat services (PC 2002a), price regulation of airport services (PC 2002b) and the *Prices Surveillance Act 1983* (PC 2001c).The effective regulation of areas of the economy where market power issues arise has been central to each of these inquiries. This review of Parts IV and VII of the TPA is timely and complementary to these other assessments. Indeed, the Productivity Commission considers that further reviews of the TPA — including Part IV — are warranted at appropriate intervals to maintain the relevance and effectiveness of one of Australia's most central economic statutes.

In this submission, the Productivity Commission focuses on issues relating to section 46 (misuse of market power), because this is the area where the pressure for significant increases in regulatory power has been advocated and where the lessons from our most recent assessments of market power — particularly Part XIB of the TPA — are most relevant. However, we also provide some limited coverage of matters relating to section 50 (mergers) in section 7.

2 The role of section 46 and Part IV

Section 46 of the TPA prohibits firms with substantial market power from taking advantage of that power *for the purpose of*:

- eliminating or substantially damaging a competitor;
- preventing entry to markets; or
- deterring or preventing a person from engaging in competitive conduct.

Section 46 does not define the specific forms of anticompetitive conduct, but they are generally taken to include refusal to supply with an anticompetitive intent, predatory pricing, leveraging from one market to another to damage competition, and vertical restraints. While the section is expressed in the form of impacts on an actual or potential 'competitor', it is widely understood to mean competition more broadly.[1]

It is important to delineate the limits to the section. It does *not* proscribe market power in itself (such as might be obtained by a firm achieving market domination through innovation or greater cost efficiency than rivals), nor prohibit a firm from charging high prices.[2] Nor does the section aim to elevate the concerns of any one group of competitors above others. For example, there is no assumption in the TPA that it is intended particularly to protect small businesses from the abuse of market power by big business. Section 46 solely aims to prevent firms with substantial market power from using (the accepted definition of 'taking advantage of') their market power to reduce competition.

Section 46 sits among a group of per se restrictions on conduct deemed to be anticompetitive, such as price fixing (section 45A), exclusionary contracts (section 45(2)a(i)), contracts that more generally lessen competition substantially (section 45), third line forcing or 'tying' (section 47(6&7)), non-price vertical restrictions that damage competition (section 47) and resale price maintenance (section 48). These are regarded *a priori* as likely to indicate anticompetitive behaviour. In contrast, section 46 is an 'open' clause, that leaves the interpretation of anticompetitive behaviour initially to the regulator and ultimately to the courts. Hence, section 46 gives considerable discretion to the regulator and its application inevitably involves significantly more judgment than other aspects of Part IV.

That said, the Productivity Commission's view is that it is probably not possible to list all the possible behaviours that are anticompetitive, so that the existence of a prudently applied 'open' clause is appropriate.

Regulatory provisions against potential anticompetitive conduct — despite their obvious popular appeal — have to tread a fine line between, on the one hand, limiting the damaging efficiency consequences of genuine anticompetitive behaviour, and, on the other, the maintenance of property rights, procompetitive rivalry by firms and entrepreneurial freedom. This suggests changes should be made cautiously, since regulatory error in either direction — an excessively permissive or

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1 For example, in *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd* (2001) the High Court majority decision said that the Act is not concerned to protect the private interests of particular persons or corporations.

2 As suggested by the Federal Court's ruling in the *Pont Data* case (No. 2).

harsh regime — could damage competitive processes and market outcomes in the Australian economy. This is important because it is the operation of markets, through competitive processes, that drives Australia's growth — contributing to greater productivity, lower costs and improved service, and ultimately to higher incomes and standards of living.

Unfortunately, even the criteria on which an assessment of section 46 should be based are currently poorly specified, largely because of some vagueness about the objectives of the section. Since this is a threshold issue, this submission first explores the appropriate statutory objectives for section 46 (section 3).

The submission then examines some of the key emerging issues. There have been several calls for strengthening section 46 and Part IV generally, which seek to alter the existing balance of the regime — making it more similar to provisions that apply in telecommunications in Part XIB. These include:

- supplementing the existing *purpose* test with an *effects* test (section 4); and
- introducing administratively-applied cease and desist provisions in Part IV that cannot readily be stayed by courts (section 5).

The proposals to strengthen Part IV appear to reflect a view that there are costs to the economy of hitherto unrecognised or poorly regulated anticompetitive conduct. However, the options being considered need to take account of evidence for such costs — particularly in the context of other policy changes that have made markets more competitive — and set these against any offsetting costs associated with the risks of regulatory error, and administrative and compliance burdens, as well as considering any alternative mechanisms that might better achieve the purposes of the TPA. Sections 4 and 5 of this submission examine the appropriate test for section 46 and the cease and desist orders.

There have also been proposals to amend the enforcement regime in Part IV to make it more effective. Enforcement principles and issues are discussed in section 6.

3 The objectives of section 46

Good regulations should have clearly stated and appropriate objectives. When incorporated into the legislation they:

- guide the regulatory authority and courts in exercising their powers and functions;

- provide greater confidence to those businesses to which the policy measures may apply in how they conduct their day-to-day operations; and
- provide a basis upon which the regulatory authority can be held accountable to the government and courts for its actions (PC 2001b).

Section 46 does not have a specific objects clause. Rather, it relies on the objects clause in section 2 of the TPA, which identifies the object of the Act as being:

> … to enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection.

In the Productivity Commission's view, an important issue for this inquiry is whether this broad objective, and specifically the references to fair trading and consumer protection, is appropriate for guiding the general application of Part IV, and section 46 in particular.

A widely accepted objective of competition policy is to enhance economic efficiency and community welfare by protecting the competitive process in circumstances where government intervention can be shown to generate a net benefit.

In recent years Australian courts have recognised the centrality of economic efficiency to Part IV (for example, the Australian Competition Tribunal *Re 7-Eleven Stores Pty Ltd*, 1994 ATPR 41-357).

There are others, however, who argue that Part IV should also be used to pursue supplementary objectives. Typically, these auxiliary objectives are socioeconomic in nature. In addition to income redistribution, they can include the protection of small business and employment in particular industries (Carlton and Perlof 1994, World Bank and OECD 1999).

Even where these supplementary objectives may be perceived to have public benefits, they can give rise to confusion and conflicts. Echoing the assessments of the World Bank and OECD (1999, p. 4), the Ministry of Commerce New Zealand (1998, p. 5) has noted:

> … having multiple objectives for competition laws can undermine the economic efficiency/competition objective. Some possible objectives such as protecting small businesses and maintaining employment can lead to decisions that will protect competitors, not competition. A second group of alternative values such as fairness and equity mean different things to different people. Attempts to incorporate them into competition law decisions can lead to legal and business uncertainty and distortions in the functioning of markets … Thirdly, there should and there shouldn't be a role for fairness under competition law. The part for which there shouldn't be a role is the design of the substantive provisions in the law. Competition is often ruthless, stressful

> and unpredictable but it delivers economic efficiency. If there are to be laws that are aimed at protecting the process of competition then it is axiomatic that those seemingly undesirable characteristics are, in fact, desirable.

Multiple objectives often mean that tradeoffs must be made between the different objectives, leading to business uncertainty about how regulation will be applied. For example, protecting small businesses may conflict with attaining economic efficiency. Although regulatory guidelines and transparent and open processes help reduce this uncertainty, regulatory outcomes will involve a large amount of subjective judgment where a number of potentially conflicting goals must be considered by regulators and courts.

The Productivity Commission supports the generally accepted view that the key objective of section 46 should be the enhancement of economic efficiency.[3] Clarifying the objectives of section 46 to focus on economic efficiency would provide clearer guidance to the regulatory agency and courts in administering and enforcing the legislation and interpreting statutory criteria.

Although the Competition Principles Agreement (s. 3(d)-(i)), provides for matters other than efficiency to be taken into consideration when assessing competition policy matters, it is preferable not to extend these to Part IV. Indeed Clause (4) excludes them from the public benefit test in relation to authorisations and notifications under the TPA. This is not to belittle non-efficiency objectives — such as fairness or income distribution — but to apply policy instruments that are well designed to achieve them.

A focus on efficiency in Part IV also makes it clear that competition is not an end in itself. Regulatory actions to promote some conception of competition that did not raise efficiency, and ultimately community living standards, would not be desirable (PC 2001d, pp. 257–62).

4 Purpose versus effect in section 46?

One major proposal is to amend section 46(1) (and presumably parallel provisions in section 46A) from:

> A corporation that has a substantial degree of market power in a market shall not take advantage of that power for *the purpose of* … [achieving outcomes prejudicial to competition]

3 The Ministry of Commerce New Zealand (1998, p. 5) has adopted a similar interpretation of the corresponding New Zealand statute: 'the underlying objective of the Commerce Act is economic efficiency, with the protection of competitive processes being the means to achieve it.'

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> A corporation that has a substantial degree of market power in a market shall not take advantage of that power for *the purpose, or with the effect or likely effect*, of … [achieving outcomes prejudicial to competition]

This is similar to the current tests that apply in other parts of Part IV, which allow for any of purpose, effect or likely effect to trigger action by the ACCC (for example, section 45(1)). It is somewhat broader than the test applied in the telecommunications-specific anticompetitive provisions in Part XIB, where purpose is not identified at all as a trigger for action.

There are several issues relevant to the assessment of whether the introduction of an effects test is appropriate:

- what is the conceptual basis (and benefits) from using an effects test versus a purpose test?;
- to what extent does the change represent a lowering in the threshold for action by the regulator?;
- is there evidence that abuse of market power is a growing problem?;
- what is the scope for regulatory error in an expanded test?;
- what are the possible costs associated with its introduction?;
- is an effects test relevant to small business concerns about big business market power?;
- is an effects test better suited to high technology markets?; and
- is the introduction of an effects test justified on the basis of consistency with other parts of the TPA and with international practice?

These will be considered in turn.

4.1 Conceptual issues in purpose versus effects tests

There are strengths and weaknesses in the current approach. From a conceptual perspective, there are flaws in applying a purpose test literally, because vigorously competing businesses will often and reasonably use pugnacious rhetoric when attempting to win in the market (Armentano 1989, p. 63). They may aim to ‘beat’ or ‘kill’ the opposition and strive to capture sales at the expense of competitors through innovation, clever marketing, or cost efficiency — all of them desirable commercial behaviours. So even where internal memos reveal an aim to ‘damage’ competitors, they provide relatively weak evidence that that conduct is

anticompetitive.[4] The crux of the matter is whether a firm with market power has 'abused' this power at a cost to efficiency. Abuse is determined by whether the effect achieved (or intended) would have been likely had the market been competitive.

From an economic perspective, the efficiency *outcomes* of conduct are more important than the motives for reaching them. In business competition, what some might consider to be badly-based motives may sometimes amplify the common good, while in public policy, well-intentioned regulation might actually attenuate it. Section 46 is an economic, not a moral clause. In that sense, effect seems superior. When introducing Part XIB of the TPA — which does not refer to purpose — the Government's Explanatory Memorandum argued that:

> Reliance on a 'purpose test' alone risks a focus on the perceived morality of conduct rather than its economic effect (p. 10).

At times, purpose has been subject to substantial interpretational problems, such as in *South Sydney District Rugby League Football Club v News Limited* about whether a merger clause in an agreement between the ARL and News Ltd had an exclusionary purpose.

There are, therefore, some clear imperfections in a purpose test. That said, previous actions under section 46 appear to have largely been driven by the consideration of punishing conduct that intended and had (or was likely to have) an anticompetitive effect. Despite the ambiguities of a literal translation of the existing section 46, the successive interpretations by courts of the section have given it much greater clarity.[5] As the Hilmer Committee (1993, p. 71) observed when considering (and rejecting) an effects test for section 46:

> The courts have indicated that they are alert to the distinctions which the legislatures have attempted to make. There is a growing body of case law dealing with the misuse of market power, and over time the limits of the existing provision will be explored. The current provision has the advantages over an effects test of an appropriate interpretation and a greater level of certainty for businesses.

It should be further noted, as a footnote to this discussion, that the proposal to change section 46 aims for consistency with the existing provisions of Part IV outside section 46 — and thus refers to 'purpose or effect or likely effect'. Expressed in that form, the proposed change appears to take a 'belts and braces' approach by incorporating *any* of these criteria for determining anticompetitive

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[4] As noted by Schmalansee (2000, p. 195), this is particularly true in a 'winner take most' business, where one product type tends to dominate (for example, word processing software).

[5] For example, witnessed by the full Federal Court's clarification of 'take advantage' in *QWI v BHP*.

conduct. Accordingly, it does not resolve the conceptual pitfalls of a literal reading of purpose, but adds a regulatory accretion to it.

4.2 Does an effects test represent a real lowering of the threshold for action?

While an effects test has some conceptual advantages, there are questions about whether it would have greater operational advantages than the purpose test in correctly detecting and facilitating action against anticompetitive behaviour. As emphasised by the Hilmer Committee (1993, p. 65), under section 46(7), the existence of a prohibited purpose may be inferred from the circumstances even though there is no direct evidence of it:

> Section 46(7) … a corporation may be taken to have taken advantage of its power for a purpose referred to in subsection (1) notwithstanding that, after all the evidence has been considered, the existence of that purpose is ascertainable only by inference from the conduct of the corporation or of any other person or from other relevant circumstances.

For example, in the High Court decision in *Queensland Wire Industries Pty v BHP* (1989) anticompetitive purpose was inferred from the behaviour of BHP because BHP had not offered any business justification for the refusal to supply Y-bar to Queensland Wire. In a competitively functioning market, BHP could be expected to supply the steel to QWI. The Court argued:

> The only reason why BHP is able to withhold Y-bar (while at the same time supplying all the other products from its rolling mills) is that it has no other competitor in the steel product market who can supply Y-bar (para. 37).

Similarly, in *ACCC v Universal Music Australia Pty Ltd* anticompetitive conduct was inferred from the refusal by the defendant to supply CDs to retailers who sold parallel imported stock (although documents obtained through section 155 of the TPA were also adduced as evidence).[6]

As noted in the Productivity Commission's inquiry into telecommunications (2001d, p. 176), the inference of purpose from effect has been endorsed more broadly by the Privy Council in the New Zealand *Clear Communications Ltd v Telecom Corporation of New Zealand* (1995) case:

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[6] The Court said: 'On the evidence I have no difficulty in inferring that the refusal by Universal and Warner to supply was motivated by their intention to bring about the result that persons would not import recordings into Australia, whether those persons were wholesalers who carried on the business of importing or were retailers who purchased their requirements from overseas' (*Australian Competition & Consumer Commission v Universal Music Australia Pty Limited* [2001] FCA 1800 (14 December 2001), para. 443).

> In the *Clear* case, the Privy Council took the view that if a firm uses market power it can readily be inferred from that fact alone that it has a prohibited purpose. For example, if a firm refused to supply goods or services in circumstances where that would not make commercial sense unless it had market power, it might be readily inferred that, in the absence of some alternative explanation, its purpose, or at least one of its substantial purposes, was to deter or prevent competitive conduct (Taperell and Dameery 1996, p. 51).

Section 46(7) is a relatively powerful addition to section 46 because it would allow a judge to discount obviously artificial claims of innocent intention if the more credible explanation of the behaviour was an underlying intention to act anticompetitively. Thus, a firm that engaged in predatory pricing (that passed the 'recoupment test' — see later) might state that its purpose was merely to lower its price to increase its market share, but the effect of the action would suggest that the stated purpose was a wilful construction. Courts are permitted under the present section 46 to go beyond a mere statement of innocent purpose to an assessment of the credibility of such statements.

Moreover, the purpose test is stronger than it might at first appear. To find against a defendant, the court does not have to prove that the only purpose of the conduct was anticompetitive, but rather that an anticompetitive purpose 'was or is a substantial purpose' of the conduct (section 4F).

So both section 4F and section 46(7) rescue 'purpose' from the difficult task of uncovering a single-minded intent on the part of the corporation to engage anticompetitively.

At times it is has been claimed that a purpose test is ineffectual in cases where the alleged anticompetitive conduct is a failure to do a positive act (such as refusal to supply), and that an effects test overcomes this problem.[7] However, it is not clear that the purpose test has this defect — again as suggested by the *QWI vs BHP* decision.

Nevertheless, there is a stark difference between an effects and a purpose test. Under an effects test, an action could be mounted by the regulator without the need to establish intent at all. The proposed new test *could* take account of purpose (revealed by documents or inferred), *but it would not need to do so*. Indeed, a defendant may provide credible commercial rationales for its behaviour, but this would not be sufficient to avoid prosecution if the conduct used market power and damaged competition. An example is shown in box 1.

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[7] This was the view of the ACCC in discussing the merits of the effects test in Part XIB of the TPA (PC 2001d, p. 177).

In those cases — and where the regulator and the courts were satisfied that the defendant was using market power — an effects test could lead to successful actions where none could have proceeded under the existing section 46. The proposed test is therefore more expansive than a purpose test. Moreover, by including 'likely effect' and 'purpose' as triggers as well as effect, the proposed test would also cover circumstances in which a party set out to undermine competition, but failed to do so.

Box 1 **Getting better terms than rivals**

A manufacturing firm, *SmartWidget* has attained market power through its innovative technology and brand recognition. It has an increasing share of its market, though it does have two smaller rivals. It bargains with a supplier, *TechPut*, whose complex inputs it uses in its manufacturing process. *TechPut* holds patents for its products and usually can charge high prices — reflecting the market power given by its intellectual property. When *TechPut* and *SmartWidget* come to sign a new contract, *SmartWidget*'s market power and market share allow it to exert greater bargaining power than before. (*SmartWidget* is not attempting to manipulate quantities, but merely to get a better price — this is a 'cake sharing' game between parties that both hold some degree of market power — and is not illegal.) However, *SmartWidget's* rivals cannot get such a good deal and the prices they end up paying are higher than *SmartWidget's*. They slowly lose market share and finally exit the market. Given Smartwidget's technology lead, the prospect for new entry looks discouraging.

SmartWidget leveraged off its market power to negotiate better terms with *TechPut* than its rivals. It did not have any explicit intention to damage its rivals and certainly no such purpose could be inferred. Indeed, a raid by the regulator on *SmartWidget's* office records reveals only a deep interest by *SmartWidget's* executives in bargaining successfully with *TechPut*. However, the deal achieved by *SmartWidget* could only have been achieved through using its market power, and the ultimate effect of that use has been to raise the relative costs of its rivals, with the apparent effect of reducing competition.

Under the proposed changes to the Act, an action could be undertaken against *SmartWidget* for anticompetitive conduct.

This hypothetical example illustrates the extent to which the proposed change to section 46 could materially expand the basis on which an action could be brought against apparent anticompetitive conduct. (As discussed later, the Productivity Commission does not consider that there would be benefits in such cases being brought.)

However, an effects test is not as expansive as some have implied. A party with market power that undertook actions that had the effect of damaging a competitor would not necessarily be in breach of section 46. For example, a firm with market power might lower its costs by undertaking proprietary R&D, with the effect that

entry barriers were higher and effective competition by rivals was reduced. This would not be in breach of the section because the R&D that gives it an advantage does not rely on it using its market power. Successful prosecution of an effects test would require the court to establish that the defendant had undertaken behaviour that could not have been sustained in a competitive market — that they had *used* their market power, not merely possessed it.

Accordingly, proposals to augment section 46 with an effects test would clearly lower the threshold for regulatory action, but not by as much as some commentators have implied. This in turn suggests that the potential losses may not be as great as supposed by some of those opposed to the change (this does not imply such losses need be trivial — see sections 4.4 and 4.5). But it also suggests that the alleged gains from the change may not be as great as asserted by those advocating greater regulation.

A review of the specific cases that may have been undertaken successfully under the revised section that could not have been undertaken in its absence would help establish the likely magnitude of the impact of the change.[8] It would also provide a test of the reasonableness of the move. If experts were to find that such additional cases would be actionable, even though there were doubts about whether this was appropriate on economic welfare grounds, this would be evidence against lowering the threshold for action in section 46. A contrary finding would provide evidence in support of a change.

4.3 Is abuse of market power a growing problem?

The TPA has been reviewed many times in the past — reflecting the imperative to ensure that it responds to changes in the economic environment or developments in economic analysis. All past reviews have either opted for, or not argued against, maintenance of the purpose test — notwithstanding its limitations.[9]

[8] The ACCC, in its submission to the present review, argues that that it had not taken action under section 46 for about six years and that, on *a number of occasions,* the TPC and the ACCC did not take court action for breach of section 46 because it was considered that they would not be able to prove the necessary purpose (p. 81). In another part of their submission they argue that there are *many* other cases that have not been prosecuted due to the ambiguity of purpose (p. 88). It would be useful to establish more clearly how many cases have failed to pass the purpose test and to use these specific cases of alleged anticompetitive conduct (where necessary, stripped of details that would identify the parties) as case studies of the impact of the proposed new regime.

[9] While their objectives varied, there have been seven reviews encompassing section 46, prior to the present review. These were reviews by the Blunt Committee (Trade Practices Consultative Committee) in 1979; the Griffiths Committee (the House of Representatives Standing Committee on Legal and Constitutional Affairs) in 1989; the Cooney Committee (the Senate Standing Committee on Legal and Constitutional Affairs) in 1991; the Hilmer Committee (the Independent

This raises the question of whether in recent years the economic environment may have been evolving in a way that has exacerbated the risk of market power, and which might justify strengthening section 46. In short, should we be increasingly pessimistic or optimistic about the scope for markets to work without greater regulatory intervention in Australia?

In the Productivity Commission's view, barriers to entry have generally declined in most markets, reflecting a range of microeconomic reforms, as well as technological change and demand shifts. This reduces the basis for claims that section 46 of the TPA should be strengthened. Three trends should be considered.

Microeconomic reform and a more open economy

Most sectors of the Australian economy are now subject to greater competition because of changes brought about by Australia's greater integration into the world economy. The ratio of imports plus exports (of goods and services) to Gross Domestic Product (GDP) has increased from 30 per cent in 1984 to 46 per cent in 2001 (ABS 2002a).

There have been significant reductions in industry protection — progressing from industry-by-industry reductions to phased general reductions in tariffs, combined with the dismantling of quantitative restrictions (PC 2001e). The average effective rate of tariff assistance for manufacturing has fallen from 16 per cent in 1989–90 to under 5 per cent in 2000–01. Although textiles, clothing, footwear and leather goods and passenger motor vehicles are more highly protected, their assistance levels have also declined significantly.

More generally for the economy as a whole, liberalisation of foreign investment restrictions has brought direct competition into domestic markets from foreign firms. For example real direct investment increased from $3 billion in 1977-78 to $11 billion in 2000-01 (in 1999–2000 prices) — more than double the growth of real GDP (ABS 2002a, ABS 2002b).

Committee of Inquiry) in 1992; the Reid Committee (the House of Representatives Standing Committee on Industry Science and Technology) in 1996/7; the Baird Committee (the Joint Select Committee on the Retailing Sector) in 1999; and the McKiernan Committee (the Senate Legal and Constitutional References Committee) in 2002. These have covered the issue of a purpose versus effect test in varying levels of detail (for example, the Reid Committee did not reach a conclusion on the effects test, while the McKiernan Committee did not make recommendations in the light of parallel reviews of the TPA). However, if there is any common theme in relation to an effects test, it is a general deference to the capacity of courts to establish a clear meaning for a purpose test through accumulated case law (with the aid of section 46(7)), and the risks that a wider test would pose.

The exposure to international competition of the services sector — which comprises around 80 per cent of GDP — has also increased. For example, regulatory impediments to entry to the banking and telecommunications industries have been removed or relaxed.

Taken together, reduced barriers to international trade and freer capital movements mean that many products and firms are exposed to much greater competitive pressure than previously.

National Competition Policy (NCP)

Prior to the report of the Hilmer Committee and the subsequent adoption of the NCP, the traditional view of competition policy in Australia was focussed on Part IV of the TPA. This was recognised by the Hilmer Committee (1993, p. xvi):

> Australian competition policy is sometimes seen as solely comprising the provisions of Part IV of the Commonwealth *Trade Practices Act 1974*. While laws of that kind are an important part of competition policy, the relevant field of policy interest is much wider. In its broadest sense, competition policy encompasses all policy dealing with the extent and nature of competition in the economy. It permeates a large body of legislation and government action that influences permissible competitive behaviour by firms, the capacity of firms to contest particular economic activities and differences in regulatory regimes faced by different firms competing in the one market.

Today, however, the framework of Australia's competition policy is considerably broader than the general provisions of Part IV. Following the adoption of the NCP, competition policy now includes a series of measures whose cumulative effects are likely to alleviate market power problems across the economy:

- reforming regulation that unjustifiably restricts competition, where this is in the public interest;
- reforming the structure of public monopolies and implementing regulatory regimes to facilitate competition and to regulate where there is a concern about residual market power; and
- providing for third-party access to certain facilities that are essential for competition.

Under the umbrella of NCP, governments around Australia have introduced a range of industry-specific and general regulations that apply to industries where a lack of competition is likely to remain a significant problem. Examples include:

- the introduction of measures in the TPA, outside Part IV, such as the national access regime (Part IIIA) and telecommunications specific competition regulation (Part XIB and XIC); and

- industry-specific regulation at the Commonwealth and State and Territory level, such as the National Gas Code, National Electricity Code and water and port regulation. An example of such a code for gas is shown in box 2.

These regulations have influenced markets previously dominated by government-owned legislated monopolies, such as airports, electricity, gas, ports, channels, postal services, rail, telecommunications and water, having a profound effect on the Australian economic landscape:

> … the economy has changed as a result of the application of competition policy over the last five years. There has been a growth in national markets, privatisation has occurred in certain utility markets and the application of access provisions has brought about major structural changes in the economy. (ACCC 2000, p. 15)

The access regimes provide for access by competitors to facilities on fair and reasonable terms. They represent regulations that are intended to reduce certain types of anticompetitive behaviour — such as refusal to supply — in those parts of the economy where market power is most likely to be encountered (that is, non-traded services and facilities where sunk costs are very high).

Changing technological and demand patterns

Lowered real transport, postal costs, a more efficient wholesale sector[10] and modern communications (including the growth of the internet) have further increased competitive pressures in some key industries. For example, goods and services that were once exclusively sold in local markets — books, software, CDs, electronic durables and stock trading services — are now increasingly distributed via the Internet.[11] Information on prices and quality — which also underpin consumer choice and competitive pressures — is now far more available. And increased automation and greater demand for customisation of goods and services have increased the scope for smaller firms to find global market niches.[12]

Of course, there are opposing trends that also have to be monitored. Microsoft's domination of computer operating systems and business office software is a case in point. Price dispersion in identical goods and services traded on the Internet

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[10] As documented in Johnston et al. (2000).

[11] For example, see Bakos 2001 and Barber and Odean 2001.

[12] There has also been a sectoral shift to the services sector in the Australian economy, which has led to a size distribution of firms that favours smaller enterprises. While small enterprises may still wield market power, sunk costs, and therefore entry barriers, are typically lower than in many traditional manufacturing activities, such as steel, pharmaceuticals and building products. (Where barriers to entry are high in the services sector — such as in essential utility services — access regimes typically address the use of market power).

contradicts simplistic notions that the new medium creates perfectly competitive markets (Borenstein and Saloner 2001, pp. 9–12). Business to Business information exchange can, in theory, help to sustain cartelisation by allowing for identification of defection by single members (Popofsky 2001).

Box 2 **An example of an 'access regime': the National Gas Code**

Part IIIA of the TPA provides a national framework for access to facilities with natural monopoly characteristics. The regime averts the need to use section 46 as an ex post remedy for denial of access to the services of such facilities. Part IIIA provides, ex ante, for ongoing access at appropriate prices to the relevant services (PC 2001b). Part IIIA also allows for the certification of State and Territory access regimes, of which one example is the National Third Party Access Code for Natural Gas Pipeline Systems. This code establishes a national access regime for natural gas pipeline systems.

The objective of the code is to establish a framework for third party access to gas pipelines that:

- facilitates the development and operation of a national market for natural gas;
- prevents abuse of monopoly power;
- promotes a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders;
- provides rights of access to natural gas pipelines on conditions that are fair and reasonable for both service providers and users; and
- provides for resolution of disputes.

Under the code, a service provider must establish an access arrangement outlining the policies and basic terms and conditions that apply for access to a pipeline (including reference tariffs for some services). The access arrangement must be submitted to the relevant (state-based) regulator for approval. The provider and user can agree to terms and conditions that differ from the access arrangement (with the exception of the Queuing Policy). However, if an access dispute arises, the arbitration process uses the provisions of the access arrangement to resolve the dispute.

The code is implemented through the States' and Territories' access regimes. The ACT, New South Wales, Northern Territory, South Australian, Victorian and Western Australian gas access regimes have been certified as effective under Part IIIA.

The National Gas Code takes pressure off section 46 in terms of the expected misuse of market power (access issues) for natural gas pipelines.

Source: http://www.coderegistrar.sa.gov.au and PC 2001b.

Moreover, in an Australian context, there are some exceptions to this general trend towards competition, such as in broadcasting. But, as highlighted in the Productivity Commission's analysis of broadcasting regulations (PC 2000; 2001d, p. 5,

pp. 557ff), this has more to do with faulty regulation than the failure of markets to function well. Strengthening section 46 would not be an antidote for these problems.

In sum

The last decade or so has witnessed a transformation in the structure, dynamics and openness of Australian industry. This change has been complemented and driven by a comprehensive institutional framework conducive to effective competition that goes well beyond the TPA. The potential for the abuse of market power is significantly more constrained in this new environment. In addition, although section 46 remains important, its role as an instrument for controlling anticompetitive behaviour in 'bottleneck' industries has been reduced by the new industry-specific initiatives and the broader National Access Regime. In that sense, section 46 has an increasingly residual role to play, which further suggests caution in strengthening it.

4.4 The scope for regulatory error

Acting on and interpreting anticompetitive conduct is a subtle and complex task. Even experienced and informed regulators can make errors. Analysis of imperfectly competitive markets is particularly complex because the range of possible behaviours explaining observed market outcomes is large. This means that section 46 inevitably treads a fine line — balancing the risk of deterring potentially efficient practices and behaviour against the risk of allowing practices that damage competition and efficiency. The goal is to institute processes that allow appropriate scope for judgment while minimising the chance of error (Demsetz 1989, Hilmer 1993, Ordover and Saloner 1989, PC 2001d, Viscusi et al 2000).

There is scope for regulators and courts to make three types of errors:

- condemning competitive behaviour (a false positive);
- not acting against anticompetitive behaviour (a false negative); and
- indirectly deterring firms from legitimate competitive behaviour because of concerns about potential actions being brought against them (PC 2001d, p. 156).

As noted earlier, a 'purpose, effects or likely effects' test is more expansive than a purpose test alone, and it will tend, therefore, to have a lower false negative rate than a purpose test alone.

But equally it is also likely to have a higher false positive rate and a greater tendency to deter some forms of procompetitive conduct. This was one of the concerns in past reviews of Part IV. For example, the Cooney Committee (1991, p. 96) expressed the view that:

> The Committee accepts that the process of effective competition involves engaging in conduct the potential effect of which is to produce the very ends proscribed in section 46, and considers that prohibiting such conduct by reference to its effect may challenge the competitive process itself.

The Hilmer Committee (1993, p. 70) echoed these concerns:

> Firms should be encouraged to compete aggressively by taking advantage of new and superior products, greater efficiency and innovation. There is a serious risk of deterring such conduct by too broad a prohibition of unilateral conduct. The Committee takes the view that an effects test is too broad in this regard.

The scope for an expanded test to be welfare-enhancing depends on the tradeoff between the above regulatory errors and on its indirect deterrent effects on legitimate competitive behaviour. There would be a case for a more expansive test if the cost of inaction were seen as relatively high and the likelihood of errors were low. For example, in telecommunications, one firm has an dominant position, technologies are very fast moving and there are first-mover advantages (for instance, in provision of high bandwidth services such as asymmetric digital subscriber line services). Too slow or forensically demanding an anticompetitive regime might put at risk the capacity for entrants to compete in new markets where the incumbent could gain leverage from its existing market power. Moreover, the ACCC has developed, over a number of years, considerable expertise in the analysis of the telecommunications industry and has special information collection powers under the TPA (section 151BU of Part XIB) in addition to the general information collection powers in section 155.

Accordingly, the costs of a false negative (not acting when one should) is probably higher in telecommunications than in more technologically stable industries, while the likelihood of a false positive is probably lower, given the informational advantages of the regulator in that sector. This was another consideration in the Productivity Commission's final judgment to recommend the retention of Part XIB, including an effects test (albeit with considerably improved transparency and accountability provisions to reduce regulatory error).

But the Productivity Commission considers that what holds for telecommunications does not hold generally. Application of the same test as in telecommunications risks applying a criterion that is excessively expansive. It should be emphasised that, even in the case of telecommunications, the Productivity Commission was sufficiently concerned about the scope for regulatory error that its draft report

proposed the elimination of Part XIB. The final report reversed that judgment, but it was a finely balanced decision. (Notably, the use of 'purpose, or effect or likely effect' in section 46 would be an even more expansive test than that currently applying in Part XIB.)

The new test would risk catching procompetitive behaviour by any business assessed with substantial market power that had the effect of damaging competitors (as competitive behaviour is wont to do). Under a revised statute, a firm with market power competing aggressively to maintain its market lead might therefore unintentionally breach section 46, which is less likely under the present section 46. Box 1 (above) provides an example where perfectly legal and commercially acceptable behaviour — hard bargaining between a firm and its suppliers — would suddenly assume an anticompetitive hue.

Since the 'counterfactuals' are hard to observe, it is difficult to establish how real are the prospects for regulatory error in a strengthened anticompetitive regime. But some factors suggest that the prospects are genuine:

- the record established by the current effects-based anticompetitive provision in Part XIB suggests that regulatory errors have been made (at least in terms of the policy instrument applied — PC 2001d, pp. 178, 186, 197);
- the global history of antitrust[13] is replete with errors, reflecting changes in institutional practices and biases, and in the sophistication of the economic tools brought to bear. The lesson is that errors are inevitable and that policymakers should factor the inevitably of such errors and their consequences into the statute's design, its guidelines and the institutions charged with administering it; and
- an effects test would be only part of the application of section 46. It must also be demonstrated that the defendant has substantial power in the relevant market — which requires tests of market power and the definition of a market. If diagnosing these two auxiliary aspects were straightforward then strengthening section 46 in other ways would involve less risk of regulatory error. But these diagnoses are themselves very difficult and also prone to error. This suggests that the overall prospects for error in section 46 would be even greater were these auxiliary conditions allied with a more expansive effects test.

These are pivotal issues, since there is sometimes overconfidence about the capacity for regulators to right the perceived wrongs of market conduct, without a corresponding awareness of the risks of regulatory error. Accordingly, these three points are worth examining in more detail.

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[13] A US term that succinctly covers policies dealing with market power and its abuse.

Problems in the application of Part XIB

In examining the application of (the effects-based) Part XIB in telecommunications, the Productivity Commission agreed, on face value, with the ACCC's diagnosis of certain problems in the market — for example, the high costs of churning customers from Telstra to rivals, the failure by Telstra to pay for access to rival internet access providers (the internet peering case) and the pricing of asymmetric digital subscriber line services for rivals. However, the Productivity Commission considered that the solution adopted by the ACCC — issuing competition notices under Part XIB — may well have been better resolved through the access regime (Part XIC) or through codes (PC 2001d, pp. 178, 186, 197).

The lesson from the Productivity Commission's examination of the use of Part XIB is that if a regulator can make an error in Part XIB — where its expertise and access to information is good — then there are higher chances elsewhere in the economy.

A further related concern from the proposed change is that it would increase the overlap between policy instruments that target market power. Section 46 continues to apply to all facilities and services covered by access regimes — State and Federal. It provides some benefits to parties that cannot be obtained from such regimes (for example, private damages are not available under Part XIB). Widening the scope of section 46 could potentially result in forum shopping by aggrieved parties that seek to shift the resolution of problems from industry-specific regimes to Part IV, even though from an efficiency perspective such disputes are better resolved in the specific industry regimes.

The history of antitrust and the evolution of the economics of industrial organisation

If the history of antitrust around the world suggested that regulators and courts had applied the necessary discretion and judgment with few errors, then this would provide some reassurance that the costs of strengthening the provisions might be low.

However, with the benefit of hindsight, the history of antitrust suggests that regulatory errors have been pervasive. Box 3 provides some examples for Australia, Europe and the United States.

Box 3 **Dealing with alleged market power: examples of potential regulatory error in Australia and elsewhere**

A recent Australian case was the decision in 2000 by the regulator (the NCC) to declare the Eastern Gas Pipeline (the 'Duke' decision). Such declaration gives other parties regulated access to these facilities. However, the Australian Competition Tribunal concluded that the regulator's declaration decision was in error because Duke Energy did not possess market power given competitive pressures from other sources of gas supply and other energy forms.[14]

In its inquiry into telecommunications, the Productivity Commission (2001d, p. 282, p. 405) questioned whether mobile telephony (GSM) should be declared under Part XIC, given evidence of workable and intensifying competition, and the capacity for entry.[15] However, regulation has *increased* in mobile telephony. Most recently, the ACCC has declared (previously unregulated) CDMA services (ACCC 2002a). CDMA — is a mobile phone technology — that offers similar functionality to GSM. Prior to regulation, interconnection and roaming agreements had been commercially negotiated for CDMA services, without the pressure of the regulator. The ACCC was sufficiently happy with the state of competition in the GSM services that it advocated a lighter-handed regulatory approach that avoids setting access prices. The advent of mobile number portability has further stimulated competition in the general mobile services market, which in any case, has been described by the ACCC as one in which competition is already growing. (Notably there is no scope for review by the Australian Competition Tribunal of declarations under Part XIC as there are under Part IIIA of the TPA.)

In a European legal context, the appeal court has recently found that the European Commission was in error in seeking to block the merger of two British package holiday operators (*Airtours plc. v Commission of the European Communities,* 2002). The Court found that:

> … the Decision [by the European Commission], far from basing its prospective analysis on cogent evidence, is vitiated by a series of errors of assessment as to factors fundamental to any assessment of whether a collective dominant position might be created. It follows that the Commission prohibited the transaction without having proved to the requisite legal standard that the concentration would give rise to a collective dominant position of the three major tour operators, of such a kind as significantly to impede effective competition in the relevant market (Court of the First Instance 2002, para. 294).

Lipsky (1995, p. 5) cites the example of antitrust action against IBM Corp. in the United States in the 1960s and 70s:

> IBM Corp. was challenged by antitrust enforcers … based on fears that the company might lock up the electronic data processing industry, becoming an invincible 'computer utility', dispensing services from monolithic mainframes squirreled away in secure redoubts, like nuclear reactors or ammo dumps. More than ten years after dismissal of the government's monopolization suit against IBM, the fear seems exaggerated — even silly — in light if the demolition by the person computer of a competitive structure that had evolved in the era of brontosaurus-like mainframes.

Another classic case of regulatory error — that errs in the opposite direction — is the famous 'cellophane' fallacy (*US v. Du Pont 1956*). The US Supreme Court ruled that Du Pont did not have market power in the cellophane industry because the elasticity for demand was high. In fact, for cases involving anticompetitive conduct (but not mergers), the relevant econometric benchmark for elasticities is the competitive one, since (under conventional assumptions) a firm with market power will price up to the point where demand is elastic (Yarrow 1998).

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[14] While the *Duke* decision relates to State-based access regimes under the umbrella of Part IIIA of the TPA, the decisions are still relevant to the risk of error in section 46 since the same concepts are applied and access matters can also fall under section 46 (as they did in both the *Pont Data* and *QWI v BHP* cases).

In the United States, the pattern of regulatory errors has been particularly well documented. For example, the *Sherman Act* was initially interpreted in a way that was excessively permissive of monopolisation and anticompetitive conduct. By the 1960s the pendulum had swung the other way, with a steep rise in actions undertaken by the regulator (Bittlingmayer 2001, pp. 300–1). In retrospect, this surge in regulatory activity has been seen as overzealous:

> Most commentators … view the Supreme Court's antipathy [in the 1960s] towards mergers and doubts about market forces as indefensible (Kovacic and Shapiro 2000, p. 51).

The burgeoning field of Industrial Organisation increasingly suggests that it is hard to determine per se rules about what constitutes anticompetitive behaviour, and that increasingly a 'rule of reason' requiring detailed case-by-case examination is necessary for resolving antitrust issues.[16] Game theory, simulation and more elaborate econometrics have increased the arsenal of economic tools available in the assessment of antitrust cases, but there is also a much greater appreciation that the resolution of these cases is, if anything, much more prone to error than was once considered.

It is now generally acknowledged that it is difficult to distinguish between firms that are misusing market power and reducing the economic welfare of the community on the one hand, and those engaging in vigorous competition that is welfare enhancing on the other. In essence, the problem is that the observed market outcomes can be consistent with a number of alternative competitive and anticompetitive behavioural hypotheses.

Detecting 'real' predatory pricing

The issue of predatory pricing exemplifies the difficulties besetting judgments of anticompetitive conduct. For example, it may be difficult to know when a low retail price is a predatory pricing strategy, a legitimate loss-leader, a reflection of technological obsolescence in production facilities, or efficient price discrimination. Even pricing below short run marginal cost (the basis for the oft employed Areeda-Turner legal test) can be a rational non-predatory strategy in some cases (OECD 1989).

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[15] The Productivity Commission also questioned whether inter city transmission services should have been declared in 1998 because of the prospects for entry (p. 272, p. 344). The ACCC finally removed the intercapital transmission services from declaration in 2000–01.

[16] For example see Kirzner (1998); Crews Jr. (2000) and Kovacic and Shapiro (2000) generally; Kamecke (1998) in relation to tying, Corts (1995) on price matching, Mathewson and Winter (1986) on exclusive dealing, Comanor and French (1984) on vertical agreements, and Spector (2001) on predatory pricing.

In its assessment of predatory pricing, the OECD (1989) concluded:

> … cases of predation may arise, but at most only very infrequently. Complaints of predation, however, are presented to competition authorities with some regularity, although the great majority of these cases involve nothing more than healthy price competition.

In the United States, predatory pricing is increasingly being identified by whether it passes the 'recoupment' test — that is, that prices fall below some acceptable cost threshold *and* that the defendant could subsequently recoup these losses through higher prices. If such recoupment was not likely, then it was supposed that the action could not have the adverse welfare implications imputed to it. For example, a dominant airline might set low prices for tickets to capture market share and then raise prices. However, given the general view that aeroplanes are 'capital on wings' and that sunk costs are not very high, such a strategy is (under most assumptions) unlikely to be economic for the airline, since new entrants could still enter. In this case, the predatory airline could not recoup its losses. The recoupment test has been applied in a number of major US cases such as *Matsushita, Cargill v Monfort of Colorado Inc*; *Brook Group v. Brown and Williamson Tobacco Corp.* and more recently *United States of America v AMR Corporation* (Ordover 1998 and Serje 2001). To the extent that recoupment can be verified one way or the other, the recoupment test differentiates pricing behaviour that ultimately adversely affects consumers from pricing that benefits them.

In contrast, in the most recent Australian action against predatory pricing under section 46, *Australian Competition & Consumer Commission v Boral Ltd* [2001], the Full Court of the Federal Court rejected the recoupment test as a requirement for proving predatory pricing (overturning the decision of the initial Federal Court judgment, which partially based its dismissal of the case by the ACCC on a failure to show recoupment):

> However adaptable the primary judge's criteria may have been to s 46, as originally enacted, in a practical sense the criteria would necessarily limit predatory pricing under s 46 to a firm that is a monopolist or dominant in a market. This is because a firm in a market in which more than one firm has a substantial degree of power is unlikely to ever have the capacity to recoup its losses by subsequently extracting supra competitive or monopoly prices, assuming the absence of complicity. Thus, his Honour's test is based upon misuse of monopoly power rather than upon misuse of a substantial degree of market power. The test would render nugatory the lowering of the s 46 threshold by the 1986 amendments in respect of predatory pricing cases, which were clearly intended to fall within s 46 in its amended form (see Explanatory Memorandum at [53] and the Second Reading Speech at 1626).

Either way, the difference in views suggests regulatory error in either Australia or the United States. Incidentally, it reveals that accumulated case law and the

precedents set in any jurisdiction are as important in determining case outcomes as black letter law.

Predatory pricing is often in the eye of the beholder and its real incidence is likely to be rare. Given this, the threshold for detecting it should be high. At least the present requirement to show purpose or inferred purpose puts some constraint on actions against a behaviour that in many cases actually generates lower prices for consumers.

Problems in defining markets and diagnosing market power

Market definition is a surprisingly evasive concept (PC 2001d, pp. 54–56) that plays a critical role in practice in cases under section 46. For example, in the initial judgment of the Federal Court in relation to the Boral Besser Masonry case, the Court dismissed the claim that the company was engaging in predation because the Court deemed that the relevant market was the wider market for walling and paving products, in which Boral could not exert market power. Subsequently, this judgment was overturned on the basis that the appropriate market was the narrower concrete masonry product market (Serje 2001). Market definition was a key matter important to the resolution of the case.

Unfortunately, markets are often not readily defined, suggesting significant scope for error. An important tenet in determining whether workable competition exists is not to focus on narrow technological descriptions of markets, or indeed on mechanically defining markets at all.[17] Rather, the extent of competitive pressure on firms should be based on assessing the collective impact of all supply and demand substitution possibilities (Yarrow 1998). For example, many weak substitution possibilities may be enough to make a market workably competitive. However, this is not necessarily the approach taken by Australian courts or regulators and is harder to implement than a relatively mechanical breakdown of markets based on apparent close substitutes.

An example that illustrates the pitfalls of a technologically-oriented approach to market definition is given by the declaration of analogue subscription pay TV services in 1999 under Part XIC of the TPA (ACCC 1999b, pp. 24–25). The regulator claimed that videos are not a substitute for pay TV because people have to go out to get them, and that free-to-air TV is not a substitute because it is paid for by advertisers' revenue rather than by subscription. Simply because the form in

[17] Perhaps the most narrow market definition applied in an Australian competition case was in *Top Performance Motors Pty Ltd v. Ira Burk (Queensland) Pty Ltd (1975).* The court considered the relevant market was for Datsun motor cars (rather than motor cars more broadly). Fortunately, amendment to section 4E in the TPA has undercut its precedent value.

which these services are provided differs from pay TV does not necessarily disqualify them as substitutes. In any case, a set of weak substitutes may cumulatively exert enough influence to remove the capacity for significant excess profits. If a regulator or court ignores all weak substitution possibilities, the relevant market is always at risk of being too narrowly defined, and market power is more likely to be found when it does not exist or is not significant.

The case of airports illustrates some of the subtleties of defining markets and gauging market power (PC 2002b, pp. 132ff). Competition for a particular airport comes not only from the potential for airport substitution (which can be high in some instances, for example, Coolangatta), but also from the potential for:

- modal substitution (for example, this is relatively high in the case of Canberra, given traffic patterns and the scope for using road transport as an alternative mode); and
- destination substitution (for example, this is high in the case of holiday destinations, such as Coolangatta, Darwin and Alice Springs).

A further constraint on the exercise of market power in airports is that more than aeronautical revenue is at stake. A significant share of the revenue of airports is derived from non-aeronautical services, such as retailing and parking fees. Airport owners would not want the volume of passengers to fall as a result of aeronautical charges because of its flow-on effects to a major source of profits (PC 2002b, pp. 181ff). In that sense, airports operate in a wider market than might initially seem apparent.

A further risk of narrow market definitions is that they may also underplay the significance of other factors that moderate market power. For example, the countervailing power held by airlines (for example, derived from the capacity of international airlines to shift some of their traffic between airports) has the potential to limit, though not eliminate, the exercise of market power of some airports when setting aeronautical charges (PC 2002b, pp. 190ff).[18]

The case of airports is an illustration of how multiple factors that limit market power — some quite weakly by themselves — may collectively place a considerable brake on market power.[19]

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[18] Though the Productivity Commission considered this countervailing power was probably not strong for the key metropolitan airports, such as Sydney.

[19] There have been increases in aeronautical charges at some major airports since 1 July 2002, which some have interpreted as an indication that airports are using their market power. However, the price increases seem largely to reflect a shift to dual-till pricing and detailed assessment of the aeronautical cost base. The Productivity Commission considered that such a re-basing of airport charges was desirable (whether or not price caps continued) in order to

It is also critical to see the potential for substitution in a dynamic sense — markets have a temporal dimension. Ignoring this temporal dimension amounts to again adopting an overly narrow conception of the market. If entry barriers are sufficiently low, a firm may have a 100 per cent market share, but the threat of substitution posed by entry can eliminate market power ('contestability'). In tugboat services, the Productivity Commission found that economically there was often only room for one supplier — so local market shares could be 100 per cent, seemingly suggestive of substantial market power (PC 2002a, pp. 67ff). However, there is an established second-hand market for tugboats and the technology and skills to run a tug operation are readily transferable among operators. This, and the fact that tugboats are highly mobile capital, suggests that any market power exerted by an operator is weakened by the credible threat of entry.

Just as there is scope to define markets too narrowly, there is scope for regulators to define barriers to entry too widely when determining when intervention might be efficiency augmented (see for example, ACCC 1999a, p. 49). For example, while in theory product differentiation and brands may act as barriers to entry, new entrants have demonstrated how easy old brands may be vanquished. There is a danger in nuancing the concept of barriers to entry beyond a capacity of regulators and courts to really distinguish how enduring these are.

There is, therefore, a fallibility in the determination of market boundaries, the presence of market power and its possible use in anticompetitive behaviour that suggests caution in widening the scope of section 46 in a way that might further increase the scope for error. This fallibility is compounded by the reality that in the area of economic regulation, regulatory authorities and courts have imperfect information about firms and the markets they are making decisions about.

4.5 The costs of additional regulation

Quite apart from the direct costs of regulatory error when that occurs, it is also relevant to consider other costs associated with widening the scope of section 46. These include any:

- possible costs associated with changes in the behaviour of firms that wish to avoid certain behaviours, even if procompetitive, rather than risk action under a statute whose interpretation remains uncertain; and
- administrative and compliance burdens associated with the increased caseload under section 46.

encourage appropriate service provision and investment. These airports seem to have adopted the pricing methodology approved by the ACCC last year for Sydney Airport.

Direct and flow on costs

An incorrect judgment about anticompetitive conduct may generate substantial economic costs because it reduces the scope for effective competition. (Fines are assumed to be transfers and not relevant as such costs.) It could potentially delay or eliminate certain investments, advantage higher cost rivals at the expense of a more efficient dominant firm, and eliminate practices that may produce sizeable benefits for consumers (for example, bundling of certain services or the creation of distributorships that have strong incentives for providing high quality services).

However, the most damaging efficiency effects of regulatory error in a statute such as section 46 may not be felt as direct costs, but as responses to the prospects of error. Widening of section 46 is likely to increase business uncertainty about how regulators and courts may interpret the new clause. This is because an effects test is much more likely to catch unintended acts — such as might arise from procompetitive behaviour by a firm with market power that damages a competitor. It would take some time for courts to interpret the new test and to give it the appropriate boundaries — something they have largely achieved for the existing purpose test.

As a consequence of this uncertainty a firm with market power, which the regulator may perceive as substantial, may be unwilling to undertake strategies — such as loss leadership, certain forms of price discrimination or product bundling — for fear of regulatory response, while rivals with less market power remain free to do so.[20] (In theory, some sort of authorisation process could allow such actions, but there are many practical problems in creating a workable authorisation process in the context of section 46.)

Such a firm may be reluctant to pursue the at-risk behaviour even if it considered that a court would find it innocent, because allegations of anticompetitive conduct, even if ultimately not proven, can be damaging to the firm's reputation.[21] For example, in the Productivity Commission's telecommunications inquiry, one of Telstra's key concerns about the regulatory regime were the 'significant costs in terms of brand damage [that] can arise from the threatened and actual use of Part XIB' (submission DR101, p. 37).

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[20] The increase in uncertainty could also be expected to generally reduce the returns from investments that might create market power — such as new product innovation. Bittlingmayer (2001) has provided some empirical evidence that uncertainty associated with the exercise of US antitrust regulation adversely affected investment.

[21] In theory, this disincentive could be overcome by awarding damages for loss of such goodwill. Damages (and costs) can be awarded to a defendant at the discretion of the court, but this is not routine.

These deterrence effects may therefore favour rivals to a firm with market power, regardless of their efficiency or dynamism. The cost associated with tilting competition in this way is not readily observed.

Compliance and administrative costs

The relevant incremental costs associated with additional caseloads fall into several categories:

- the costs incurred by the affected business in its dealings with the regulatory authority and court actions, including staff, consultancy and legal costs;
- the costs incurred by the regulatory authority in bringing action against the business; and
- the costs to third parties who may have initiated the action or have a vested interest in being part of the deliberations on the matters concerned.

The overall costs of actions brought under section 46 cases are usually large, resulting from protracted, complex disputes between plaintiffs and defendants, the involvement of many experts and costly legal representation — often going to multiple appeals. Compliance costs are directly related to the complexity of the issues and the incentives that participants have for dispute. (Most private disputes take place between big businesses, which typically have deep pockets.)

One practical limit on such costs is the restraint and resource limitations of the regulator. The ACCC can use its discretion to limit the cases it initiates. The Productivity Commission's view of the ACCC's administration of Part XIB was that it was generally careful and cautious about taking action against alleged anticompetitive practices:

> Judging from the number of formal investigations by the ACCC (just 15 reached the investigative stage), compared to the number of complaints it has received (over 130), it appears that the ACCC is cautious in commencing a formal investigation (PC 2001d, pp. 184–5).

However, even were the ACCC to take a prudent approach to a widened section 46, the section also allows private parties to take action. Indeed, in common with other countries, private actions relating to alleged anticompetitive conduct tend to significantly outnumber those undertaken by the competition regulator (Roberts 2000, Shughart 1990). Such private actions would not necessarily be characterised by restraint in the public interest, and indeed might sometimes be strategically motivated to defend against procompetitive actions by rivals with market power. As noted (in a United States context):

> There is now a wider recognition among antitrust specialists that competition is a *process* — not an equilibrium condition — and that antitrust (especially in the private

cases) may have been employed as a legal club to thwart rivalrous behaviour and protect existing industry structures (Armentano 1989, p. 62).[22]

Compliance costs may also be borne without any regulatory actions under section 46. Firms with potential market power will also be careful about many commercial judgments (for example, a joint venture with a competitor, R&D cooperation and even joining an industry association) — passing them through their legal departments for compliance assessment. This may somewhat frustrate responsive decision-making. The costs of corporate lawyers overseeing such issues are not trivial. In its review of the telecommunications-specific competition regime, the Productivity Commission found that Telstra was the biggest consumer of legal services in Australia (2001d, p. xv). Of course, a regulator may intend just such prudence by firms — but it is not costless.

4.6 Relevance to small business

Some commentators support change to section 46 and the adoption of an effects test to meet better the needs of small businesses in dealing with anticompetitive practices by big business. In this context, it has been argued that section 46 should be conceived of as a fair trading clause.

Small business is very important to the Australian economy (Lattimore et al. 1998; Revesz and Lattimore 1997). But it does not follow that section 46 should be particularly oriented to their needs or be overhauled because of firm size-specific problems.

First, this view ignores the way markets actually work. Rarely do markets conform with the idealised perfectly competitive model. Firms — big and small — typically operate in imperfectly competitive markets. When they deal with each other directly — such as negotiating the supply of goods or services — the price outcomes will reflect their respective bargaining power. Game theory and common sense suggests that the party with the greater bargaining power will get a bigger slice of any excess profits that might be available (Kreps 1990). That will often (but not always) be the large firm. The firm that misses out on extracting the returns it would like may be

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[22] A notable contributory feature to the possible strategic abuse of anticompetitive provisions in the United States is the potential for awards of treble damages to successful private plaintiffs. It was notable that New Zealand avoided this feature in their recent changes to anticompetitive conduct regulations precisely because of the risks of opportunistic behaviour. The existence of these apparently subtle differences in the design of antitrust regimes across jurisdictions can have large material effects. This is one reason why the Productivity Commission is cautious about drawing too much from comparisons of single features of different jurisdictional approaches (section 4.8).

unhappy with the distribution of the gains, but efficiency is typically not at stake in such distributions. A problem with seeing section 46 as a 'fair trading' clause is that it may encourage the regulator, and then courts, to arbitrate in the distribution of gains in bargaining arrangements where efficiency considerations are not at stake. However, since regulatory interventions involve costs, efficiency would be likely to suffer if the regulator or courts were to intervene in this way. Moreover, such a shift in policy may distort the size distributions of firms.

Second, it is easier to identify the disadvantages of small firms — and assume that these require policy intervention — than to see the firm size distribution of an industry as a process largely determined by costs and demand conditions. Small firms have advantages as well as disadvantages compared with large firms. They are often more flexible, quick in discovering new market niches, and less affected by complex governance and bureaucratic structures. On the other hand, they often lack economies of scope and scale, and the gains from creating specialisation in management or production. They may often be vulnerable in maturing markets as large enterprises find lower cost methods or employ better marketing. This vulnerability can easily be interpreted by small businesses as the signature of market power exerted by big business — but often, to the contrary, it is the process of vigorous competition at work. (Indeed, large firms are merely successful small firms — it is incongruous to depict as adverse to the interests of small business that some of them may grow.)

Effective competition is not about the number or size of competitors per se, but about entry barriers, which may still be low in an industry in which there are few small firms. In many cases, small firms may lose out in a particular industry as costs and technology favour larger firms. There should be no encouragement of the belief that section 46 is, or should be, a remedy in this case. It is telling that the origin of some antitrust laws in the United States can be traced to the attempts of small farmers to protect themselves from larger, more efficient, farms (Boudreaux and DiLorenzo 1993).

Third, there is no evidence that small business is facing any systematic or deep-rooted problems that stem from anticompetitive behaviour by large businesses. On the whole, changes in the structure of the economy — particularly the phenomenal growth in services and the rise of outsourcing — have favoured the growth of small business (Revesz and Lattimore 1997). Indeed, a widespread phenomenon — quite at odds with growing incentives for anticompetitive conduct by big business — is voluntary divestiture by big business of functions they used to perform internally.

Fourth, while large firms are probably the most visible users of market power, small and medium enterprises (SMEs) often possess it too, but because their actions have a small footprint, their market power is harder to detect:

- For example, an SME may have geographic market power or be highly specialised and possess market power in a product niche. In recent cases involving the automotive industry, it has been the relatively small labour forces of the specialised producers of motor vehicle parts required for the just-in-time large-scale assemblers that appear to have wielded most power.
- Another example was apparent in the Productivity Commission's inquiry into the telecommunications industry. A non-dominant ISP was able to exert market power by charging high terminating charges to the incumbent, to which it could not readily respond because of price and access regulations (PC 2001d, p. 275). This was a case where a regime intended to be procompetitive, actually gave some small parties the scope to exert market power, illustrating the subtleties and dangers of regulatory policy.

Finally, there can be better alternatives. Part IVA — dealing with unconscionable conduct — is an existing vehicle for dealing with problems relating to relations between large and small firms, which reduces the need for section 46 also to assume this mantle. Furthermore, there are also alternatives outside the TPA that may be far more effective at preventing and resolving disputes between firms, such as the Grocery Code (box 4) and the Oil Code.[23]

4.7 Is an effects test better suited to high technology markets?

It is sometimes argued that high technology markets are particularly vulnerable to anticompetitive conduct by incumbents, reflecting:

- the large role often played by high fixed costs and low marginal costs of production (for example, software development, telecommunications, manufacture of pharmaceutical active ingredients and semiconductors) which mean that product prices have great flexibility — thus allowing predation to be more readily concealed;
- the potential for networks effects — which occur when the value of use increases the more people use a particular technology (such as in a particular telecommunications network (PC 2001d, pp. 28–30) or computer operating systems);
- the fact that the huge costs in some R&D and production developments and the need to combine complementary expertise results in research and production collaboration (for example, aerospace technologies) — behind which collusive practices may also develop; and

[23] Hansard, from evidence given to the Joint Select Committee on the Retailing Sector by the Chairman of the ACCC, 13 July 1999, RS 1172.

- the fast moving nature of the technologies and the benefits from moving first — so that existing market power advantages may be leveraged into new markets, excluding potentially more efficient rivals. Some economists have expressed concern that the increasing capacity for different network platforms to carry similar services — convergence — risks reinforcing the market power of incumbents in telecommunications, broadcasting and computing and content ownership (for example, Mackie-Mason 2000).

Box 4 **Alternative instruments for dealing with small business concerns: the Grocery Industry**

The *Retail Grocery Code* was finalised in 2000 and is aimed at assisting primary producers in the supply chain relationship. Its objectives are to:

- promote fair and equitable trading practices amongst industry participants;
- encourage fair play and open communication between industry participants as a means of avoiding disputes; and
- provide a simple, accessible and non-legalistic dispute resolution mechanism for industry participants in the event of a dispute (ACCC 2001).

The *Retail Grocery Industry Ombudsman* was appointed in July 2001 to deal with commercial disputes between participants in the retail grocery industry supply chain.

An *authorisation process* can also be used where groups of growers can be authorised to enter into collective bargaining arrangements with large buyers. In its inquiry into the Citrus industry, the Productivity Commission noted that some proposals for dairy producers to bargain collectively with large buyers (such as milk processors) over matters such as farmgate prices and milk standards had been authorised.

Source: ACCC 2001a; Productivity Commission 2002e (pp. 202–3); Retail Grocery Industry Ombudsman http://www.mediate.com.au/rgio/ombudsman.htm.

An effects test — by eschewing the need to find intent or deduce it — enables the regulator to use its discretion when seeking to combat anticompetitive conduct in such high technology markets.

However, there are good reasons to be particularly wary about advocating an effects test in section 46 on the grounds that it would better capture anticompetitive conduct in high technology industries.

First, in the one area where this appears to be an issue, telecommunications, there is already a regime that allows for an effects test. Other high technology areas where this *might* constitute a problem — computer operating systems, aerospace, and semiconductors — are not big industries in Australia. A pre-emptive approach does not appear warranted.

Second, in recognition of the value of innovation, significant inventions are able to be patented. Protection of intellectual property is given statutory immunity from Part IV under the TPA. High technology firms already have a legal basis for refusal to supply intellectual property and for protecting themselves from entry by rivals, which may reduce the incentives for prohibited forms of anticompetitive behaviour.

Third, it is by no means certain that the process of convergence in telecommunications, the internet, broadcasting and content will accentuate market power (PC 2001d, pp. 57–61). For example, the packet-switching basis for the internet means that the network infrastructure owner cannot know the use to which the net is being put (email, fax, local, national or international calls, video-on-demand) and so cannot readily seek to set monopoly prices for carrying any of these services. Convergence may also intensify competition by bringing new players into the market — such as Transact in the Australian Capital Territory, which is using its access to ACTEW electricity poles as a basis for building a high bandwidth network to compete with the local copper wire network owned by Telstra. The point to emphasise is that rapidly evolving technologies are typically just those in which incumbents find themselves outflanked technologically or strategically by nimble new entrants. Antitrust is not intended to deal with transient market power.

Finally, the application of an effects test to rapidly developing technologies carries with it a particular risk of regulatory error. Because of the dynamic nature of technology markets, regulators and courts are not well informed about what might constitute reasonable costs or reasonable strategies by rivalrous firms, from which to infer the anomalous behaviour that lies at the heart of an assessment that a firm has 'taken advantage' of its market power. Where information is poor and analytical frameworks underdeveloped, there are genuine risks that antitrust action would be strategically used by weaker competitors to thwart, rather than to encourage competition.

This does not mean that there should be no action against anticompetitive conduct in high technology markets, but merely that strengthening of the existing provisions is probably not warranted on that basis, especially in the context of the existing pattern of industry specialisation in Australia. As Breshahan (2001) has concluded after a detailed examination of 'new economy' competition policy:

> … these novel features of the industrial organization of innovation in high tech industries compel a new application of standing antitrust principles. They do not compel the creation of either a new highly interventionist doctrine nor a new doctrine with stronger laissez faire elements, as various observers have suggested. The key analytical elements of an anticompetitive agreement, and of a procompetitive one, remain the same familiar ones we already know, suitably translated to think about technological competition (p. 117).

4.8 Does the proposal achieve consistency?

As noted earlier, the per se restrictions under Part IV and the telecommunications-specific part of the TPA (Part XIB) already include effect or likely effect as the criterion for action. Similarly, it appears that a number of overseas jurisdictions also employ either explicitly or implicitly an effects test when gauging anticompetitive conduct. On the face of it, extending an effects test to section 46 could be seen as merely ensuring greater consistency in the TPA.

This view does not withstand deeper scrutiny. Several points should be emphasised:

Sameness does not equal consistency

Use of the same words in different parts of the TPA may result in tests that are inconsistent in their effects on economic welfare. Sameness should not therefore be equated with consistency. Context matters. In particular, the use of an effects clause in the telecommunications-specific anticompetitive provisions in Part XIB and, perhaps to a lesser extent[24], the per se restrictions in Part IV of the TPA, occur in the context where there is already a prima facie case of abuse of market power. This means that the likelihood of regulatory error is reduced, providing greater scope for using a more expansive test.

For example, in the case of the telecommunications industry:

- natural monopoly characteristics are present for some services (such as the copper wire local loop);
- there was a legacy of a statutory monopoly, which meant that, when the market was liberalised, the incumbent had the advantage of a large market share; and
- the incumbent was vertically integrated.

As the Chairman of the ACCC has noted:

> … [Part XIB] was put in by the parliament because it considered that Telstra had such huge market power—it is an incumbent; it started off with a huge market share; it controls a network facility; it is vertically integrated; it has a big established customer base. We have an effects test there, but not elsewhere.[25]

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[24] The reason for this caveat is that increasingly the practices subject to per se restrictions, which orthodox economics saw as obvious abuses of market power, are now seen as far more ambiguous indicators.

[25] Hansard, from evidence given to the Joint Select Committee on the Retailing Sector, 13 July, RS 1161.

Moreover, telecommunications carriers and carriage service providers were subject to an access regime for declared services (which covers most services) under Part XIC. Once a regulator enforces low access prices for rivals seeking to gain access to the bottleneck facility, it creates strong incentives for the vertically integrated incumbent's wholesale arm to find other ways of discriminating against rival access seekers, so as to foreclose the downstream market and retain excess profits. Among essential services, the complex nature of telecommunications is particularly amenable to the ability to put these incentives into practice. Anticompetitive conduct might include strategies such as providing different complementary services for rivals and the incumbent's retail arm (for example, billing services), or a myriad of frustrating strategies to undermine effective access by competitors (for example, tardy number portability).

So there is a strong prima facie case that market power and incentives for anticompetitive conduct would exist in the present telecommunications market. This justifies special treatment to abate these risks, until the market is more competitive. (Notably, it was always intended that Part XIB would be a temporary measure).

Test thresholds should take account of the costs of false negatives

As noted above, the special characteristics of telecommunications suggest that the cost of failing to address anticompetitive behaviour is likely to be more significant than in other industries.

International comparisons can be misleading

The argument that other countries use an effects test is, at best, inconclusive about whether it should be implemented in Australia. Drawing inferences about best practice based on overseas practice is perilous — their regulatory settings may be wrong. For example, many scholars have questioned the appropriateness of existing antitrust structures in the United States.[26]

Second, before any inferences can be drawn it is essential to look at the particular regulatory context in each jurisdiction and especially what auxiliary requirements apply to regulatory action against anticompetitive conduct. It is important to gauge:

- *whether the market power test is similar*. If their market power thresholds are higher, then it may be appropriate for them to use an effects test. In the case of the European Union, Article 82 of the EC Treaty prohibits any abuse by one or

[26] For example, Schmalansee 2000; Armentano 1989; Crews Jr. (2001), and in a more extreme fashion, Block (1994).

more undertakings of a *dominant* position within the common market or in a substantial part of it. Dominance would require a large market share — and would seem to be a tougher test than the ‘substantial degree of market power’ criterion applied in section 46 of the TPA;

- t*he scope for defences* against the claim of anticompetitive conduct. For example, in the United States, the defendant has the opportunity to establish a defence by providing an alternative purpose — specific, procompetitive business motivations that explain the full extent of its conduct; and
- *any differences in interpretations of black letter law* by regulators and courts. This can only be assessed through a detailed examination of the case histories in each jurisdiction. In the area of predatory pricing, it appears that US courts have required a higher standard of proof than in Australia (Serje 2001). Revealingly, in *Australian Competition & Consumer Commission v Universal Music Australia Pty Limited* [2001] FCA 1800 (14 December 2001), the Federal Court argued for the existence of market power even where the defendant had a 15 per cent market share. The Court considered that such a judgment could not have been sustained under US antitrust law:

  > I find the issue of market power and its related issue of barriers to entry extremely difficult to decide [it was decided in favour]. It is really at the heart of the controversy between the parties. The case of a firm operating in an oligopolistic market with only 15% market share and unable to fix prices in the overall market above the competitive level but which has, as a result of a temporary monopoly power over a limited number of products in that market, substantial power to exclude competitors is not one which has been the subject of any authority in Australia or, so far as my researches indicate, in any other country. Having regard to the context of the US antitrust law it could not arise in that country (para. 425).

On these grounds, the Productivity Commission considers that the use of effects tests in some jurisdictions provides weak evidence for its adoption in Australia.

4.9 Conclusion

While an effects test has some conceptual and operational advantages, the benefits claimed for it are likely to be exaggerated given the existing scope to infer purpose from effect. While moving to a ‘purpose, effect, or likely effect’ test in section 46 is likely to identify some cases of anticompetitive behaviour missed by the present regime, it would also risk greater regulatory error and the scope for significant uncertainty to business at a time when structural conditions in the Australian economy have already reduced the capacity for exercising market power.

Similarly, arguments for an effects test based on the need to protect small business, to achieve comparability with other parts of the TPA or overseas practice, or the need to introduce the measure to protect the ‘new economy’, are not convincing.

On balance, the Productivity Commission considers that an effects test should not be introduced to section 46 of the *Trade Practices Act 1974*.

5 Cease and desist powers in Part IV

There have been several calls for the introduction of ‘cease and desist’ powers in Part IV of the TPA, akin to those that exist in a number of other jurisdictions, such as New Zealand. A cease and desist order would be issued by the regulator, the ACCC, to a corporation alleged to be engaging in anticompetitive conduct. It would be issued once the regulator was reasonably satisfied that the conduct represented anticompetitive conduct and that precipitate action was justified by the public interest — say because of the risk of irreversible or severe damage to competition. A failure to act on the order by the corporation would be subject to penalties. Such an order would apply only for a specified duration (several months) and expire earlier if court proceedings were initiated. In general, a court would not be empowered to stay a cease and desist order.[27]

Cease and desist provisions bear some resemblance to Part A and B competition notices that may be issued under Part XIB of the TPA (PC 2001d, p. 159). Like cease and desist orders these are issued, without court oversight, by the regulator if it has reason to believe anticompetitive conduct is occurring. However, notices do not formally require that the corporation stop its actions, although it would be subject to stiff penalties if it did not and was subsequently found in breach. Typically a firm will stop the alleged conduct. Part B notices also reverse the usual onus of proof, and require that the carrier or carriage service provider to whom the notice relates provide evidence that rebuts the notice. The notices are enduring. A specific Part A notice can remain in force for no more than 12 months, but may be renewed indefinitely. A flaw in the design of the notices — which the Productivity Commission has recommended be changed — effectively denies a firm appeal rights to courts (PC 2001d, pp. 192–3). However, despite concerns about accountability and transparency in their use, the Commission was satisfied that such notices served a useful purpose in the telecommunications industry.

[27] Except in circumstances where the relevant firm disobeyed the order or a violation of procedural fairness. In the former case, the matter would be subject to court review, but if the firm lost, it would face large fines. Thus, the process for seeking court review of a cease and desist order on the substantive issue would be a risky one for the firm.

In comparison, the proposed cease and desist orders under Part IV would be less onerous. They would be of more limited duration and would not require the defendant to rebut the claims in any subsequent court action. Ultimately, it is likely that a court would test the alleged conduct. It might therefore seem that such orders would be relatively benign, especially given the Commission's acceptance of a more stringent regime in telecommunications.

However, the Commission has several concerns about adopting such cease and desist orders where they could apply to firms across all sectors of the economy.

5.1 Conceptual concerns

There are concerns about the appropriateness of new cease and desist powers given the current capacity for the ACCC or any other party to seek an interlocutory injunction in the Federal Court against alleged breaches of Part IV (section 80). In other words, cease and desist orders effectively *already* exist. In granting an injunction, the Court must be satisfied that there is a serious matter at stake and that there are reasonable evidentiary grounds for providing the injunction.

The motive for a new administratively triggered cease and desist order is that it can be hard (and slow) to get evidence that would satisfy a court. However, if the regulator were itself satisfied that a cease and desist order was appropriate, it must have some evidence on which to base such an order — which in turn, if convincing, should be persuasive to the Court. The implication in seeking the administrative route, therefore, is that it is appropriate for the regulator to be able to make an order with weaker evidence than would be accepted by the Federal Court. Such a lower quality of evidence suggests an inevitably greater scope for regulatory error.

It might be supposed that the costs of such regulatory error would be low, because of the temporary nature of the order. However, that is uncertain.

- First, even temporary curbs on (what transpires to be lawful) business conduct can have enduring effects. (Key customers may be lost, contracts reduced, or inframarginal investments made marginal).
- Second, were cease and desist orders to involve requirements for positive acts, then they could extend to a wide range of behaviours. In the telecommunications inquiry, the ACCC revealed an ambitious scope for its proposed cease and desist powers in Part XIB:

  > … a notice could be issued which required a carrier/CSP to: discontinue tying the supply of one good or service with another good or service; enhance or replace technology; introduce a compliance program; or alter the terms and conditions on which a specified good or service is supplied or acquired (submission 16, p. 78).

Many of these requirements are of a 'Humpty Dumpty' nature — easy to achieve, but hard to remedy if proved wrong.

- Third, it is sometimes asserted that cease and desist orders are especially necessary because of the vulnerability of the 'new economy' to anticompetitive behaviour. But if this is correct, it also implies that a 'new economy' corporation engaging in procompetitive action that is halted by a mistakenly applied cease and desist order might itself be vulnerable. The proposed provisions deal with such a corporation in an asymmetric fashion. Where the corporation is found guilty it will face penalties and possibly damages. Where, however, the cease and desist actions do not progress to a court case because they were mistakenly issued, there would not be scope for an award of damages to the relevant corporation. It should be recognised that regulatory error is itself a form of conduct that has an anticompetitive effect, and it appears inconsistent to establish a regime that has higher regard for one source of that effect (private conduct) than another (regulatory conduct).

One of the concerns of the present injunction process is that it stifles the use of section 155 for acquiring information relevant to the assessment of the alleged anticompetitive behaviour.[28] Thus, the ACCC must make a tradeoff between seeking an injunction and the collection of certain sorts of evidence that will be useful in the subsequent substantive court case. However, it is uncertain how important this has been as a barrier to successful court action. In any case, there are grounds to investigate whether alternative amendments to the TPA could resolve this problem more efficiently than introducing administratively based cease and desist orders. (It is unclear whether such amendments might have constitutional implications.)

Moreover, a key underlying objective of Part IV is not to undertake prosecution of anticompetitive conduct, but to deter it in the first place. Deterrence is principally achieved through the prospect that a court will find a corporation engaging in anticompetitive conduct guilty. The defendant will then have to face public opprobrium, and bear court costs and sizeable penalties. Deterrence therefore

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[28] In *Brambles Holdings Ltd* v. *Trade Practices Commission* (1980) ATPR 40–179), the Federal Court found that the TPC did not have the power to use s. 155 to issue a notice to a party alleged to be involved in a contravention, once the TPC has instituted proceedings in respect of the matter. (The TPC was in contempt of court.) Other cases imply some capacity to issue notices. In *EPA* v *Caltex Refining Co Pty Ltd* (1993) 68 CLR 127 certain comments made by the members of the High Court support the proposition that in limited circumstances a statutory notice to produce may be issued during current proceedings. In *TPC* v. *Abbco Ice Works* (1994) ATPR 41–342 the Full Federal Court per Burchett J. held that ` ...now that the common law of Australia has been held by the High Court (in *EPA* v. *Caltex Refinery Co Pty Ltd*) not to extend to corporations a privilege against self-incrimination, the common law of Australia does not extend to them any privilege against self-exposure to a civil penalty either.'

depends principally on what the Court decides in the substantive case. Cease and desist orders are unlikely to materially increase deterrence. To the extent that they do, an equal deterrence effect can be achieved by changing penalties, rather than allowing orders whose diluted evidentiary basis may have other unintended impacts.

5.2 Operational concerns

There are also a number of operational concerns about the implementation of cease and desist orders.

- For one thing, it is not clear how specific they should be about the behaviours to be modified. An initial concern in the telecommunications-specific competition regime was that precise competition notices could be circumscribed by small changes in the behaviour of the incumbent, which led to the introduction of Part A competition notices. Broad-based notices have a justification in a sector where the probability of anticompetitive behaviour is high, but would have questionable acceptability in the wider economy.
- If the major intention is to resolve the matter speedily, an order that lapses after several months, leading then to a protracted court case, does not achieve its intention.

5.3 Conclusion

In the Productivity Commission's view, the case for a general power under Part IV to issue administratively based cease and desist orders is difficult to substantiate.

6 Enforcement issues

Effective enforcement is an imperative for a well functioning anticompetitive conduct regime. Given the presumption that most anticompetitive conduct is rationally motivated, an enforcement regime should aim to create strong economic incentives to avert and identify such conduct, while at the same time trying to reduce the costs of enforcement. That is, the conceptual underpinning for a penalty regime in an economic statute such as Part IV is *deterrence*, not punishment per se.[29] The penalties should in this instance be set so that the perpetrator will bear the cost of any prospective illegal conduct.

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[29] For example, the primarily deterrent role of penalties was raised by the Federal Court when determining penalties in *Australian Competition & Consumer Commission v Universal Music Australia Pty Limited* (No 2) [2002] FCA 192 (6 March 2002).

As several commentators have noted, the present enforcement regime in the TPA (set out in Part VI) has potential flaws in achieving effective deterrence:

- Maximum penalties for breaches are set at levels that may be significantly below the returns from anticompetitive conduct. For example, the maximum penalty for engaging in a price fixing agreement (a breach of section 45A) is $10 million for each contravention for the corporation and $500 000 for individuals. Price fixing cartels that succeed in raising prices significantly can generate substantial losses for consumers and generate benefits for cartel members that can be worth multiples of such penalties (Monti 2001).[30] While cartels are prone to instability due to entry and 'cheating' by cartel members, some cartels can operate for extended periods, which increases the gains of anticompetitive conduct relative to the expected value of any penalties (equal to the probability of detection x penalty).[31] The existing ceiling on fines also has the unintended implication that it favours large firms over small ones, since any conceivable harm from anticompetitive conduct by small firms would generally be less than the current penalty ceiling. This is not true for large enterprises.
  - On the other hand, Australian court-imposed penalties to date have mostly been below the ceiling set in the TPA, suggesting that courts have viewed the penalties as adequate. However, this does not mean that there might not be deterrence value in raising the uncertainty for a firm considering anticompetitive conduct about the magnitude of the penalty it might face.[32]
- Some firms in cartels may be unable to pay even modest penalties (financial hardship might be a motivator for initiating a cartel), in which case, penalties of any magnitude have few incentive effects.
- Individual agents may not respond much to the existing penalty regime. Unlike the firm, it is hard to make an assessment of the benefits to individuals from facilitating anticompetitive behaviour, which would form the normal basis for an incentive compatible penalty. Moreover, firms may be able to find ways of meeting individually levied financial penalties (as noted by the UK Department of Trade and Industry 2001, p. 40).

[30] The Ministry of Commerce New Zealand provide some compelling detailed examples (1998, pp. 52ff).

[31] For example, of a sample of forty cartels prosecuted by the United States and European Union in the 1990s, twenty-four lasted at least four years (Evenett et al. 2001).

[32] The courts' judgments on this matter may also underestimate what is required, especially if they have been guided by precedents that have not given enough weight to the incentive effects of penalties. The Ministry of Commerce (New Zealand) examined deterrence in detail in a New Zealand context. It found that while courts recognised the deterrence function of penalties, the deterrence function had been neglected by courts in practice (1998, p. 20).

- Some conduct — such as price fixing — is necessarily covert, and it can be hard to find the evidence to mount a case (Griffin 2001). The effectiveness of penalties depends on the probability of detection.

The OECD (2002) identified that inadequate sanctions were a general problem internationally:

> While there is a trend towards stronger sanctions in cartel cases, available evidence indicates that current sanctions are not sufficiently large to provide an effective deterrent against such conduct (p. 3)

In this context, it is useful to consider the potential remedies for this problem (and their relative weaknesses and strengths).

6.1 Higher penalties?

Penalties could be explicitly crafted to achieve better deterrence by seeking to extract some multiple of the harm associated with the anticompetitive conduct. It is necessary to apply a multiplier because the costs of enforcement are non-zero, while the probability of detection is far from being one hundred per cent. Of course, harm may be hard to assess. One option would be to base the penalty on some multiple of the commercial gain to the firm engaging in anticompetitive conduct. Where neither harm nor commercial gain is estimable, some have advocated fines set as a share of turnover. This is a problematic base, because it may be weakly correlated with the excess returns of the firm. It would generally over-penalise firms with low value added and under-penalise those with higher value added. Some share of the profits made in the period over which the cartel operated may be preferable.

There are also several potential pitfalls in the implementation of higher penalties. A firm engaging in a cartel and anticipating a possible penalty may undertake costly strategies:

- It would have incentives to invest more in measures to lower the probability of detection. Such resources are 'deadweight' costs to the economy.
- Firms may convert fungible assets into non-fungible ones (for example, an irreversible investment in some specialised assets — such as R&D or sunk infrastructure), so that the firm would appear unable to pay the penalty out of existing funds if it were convicted. This would leave the court in a difficult position as to its imposed penalty (since the court may not wish to liquidate the firm), while distorting the capital and investment structure of the firm.
- If penalties cannot be set proportional to harm or to the perpetrator's gain, then high penalties based on simple rules of thumb, such as turnover fees, can have the perverse impact of increasing incentives for harmful anticompetitive action.

> As Block and Sidak (1980) note, the problem is akin to the risk that a death sentence for minor crimes might incite more serious crimes on the 'in for a penny, in for a pound' basis.

High penalties also occasion other problems:

- Such penalties will also not work for financially distressed firms.
- If private agents can take action to retrieve damages and such damages are multiples of the actual harm caused, then it may create incentives for opportunistic use of the TPA by rivals or other private parties.
- If the penalties lead to liquidation of the firm/s concerned, then it may lead to a relatively concentrated market and the perverse growth of market power and prices (Evenett et al. 2001, p. 16).
- Once there is scope for regulatory error, there is a risk of setting higher than optimal penalties (Kobayashi 2002, pp. 20ff).

That said, there are probably ways of moderating some of the risks associated with a more incentive compatible penalty regime. For example, this could be achieved by generally encouraging either penalties based on estimates of harm or perpetrator gain (noting that if it is impossible to provide reasonable estimates of these, the evidence of a violation is likely to be weak) and by limiting private damages.

6.2 Criminal sanctions?

Several commentators in the Australian context advocate the introduction of criminal penalties for certain types of 'hard core' anticompetitive conduct, such as price fixing. A growing number of international jurisdictions have already introduced such measures for at least some per se trade practices restrictions (the United States, Japan, New Zealand, Canada, Austria, France, Norway and Ireland, Germany), while others are contemplating it (the United Kingdom).

From an economic perspective, the advantage of criminal penalties is that they may have strong deterrent effects on individuals that could not readily be matched by financial penalties. They will be effective in deterring anticompetitive behaviour in firms that otherwise have nothing to lose, such as financially distressed firms, and they overcome the problem that side financial deals between the firm and an executive may remove the likelihood of financial penalties being borne by individuals.

But like other measures, they also have drawbacks that need to be balanced against their advantages. As noted by Evenett et al. (2001, p. 16) at the most prosaic level, imprisonment represents a deadweight cost to society:

> … incarceration involves costly losses in and re-allocation of output: managers' productivity is less during their period of incarceration, and resources must be devoted to the construction and operation of prisons. If these were the sole considerations, then incarceration would be a less desirable alternative to fines.

However, the most important drawback is the cost of regulatory and judicial error — imprisonment not justified by the conduct. As Block and Sidak (1980, pp. 1132-9) point out, this is the major concern with harsh penalties in a regime where the regulator and courts have imperfect information:

> … the solution to the enforcement-cost problem appears to be straightforward: Hang a price fixer now and then. Lumber for gallows is relatively inexpensive, and few offenders would actually be hanged; thus, the cost of enforcing the antitrust laws would be trivial … Until perfect characterisation of horizontal behaviour is possible, however, society cannot optimally allocate its enforcement resources by threatening price fixers with draconian sanctions.

This problem could be overcome by:

- requiring a high standard of proof that the individuals concerned were guilty— as in other criminal cases; and
- only applying such sanctions to 'hard core' anticompetitive behaviours where there is little ambiguity about their adverse effects on competition and economic efficiency (such as explicit price fixing in cartels). Criminal sanctions should not apply to all per se restrictions in the TPA given that the welfare implications of some of these is uncertain.

One area of concern in the current proposal for Australia is to give small and medium enterprises immunity from such criminal penalties. The grounds for such immunity are not clear. A number of the cartel cases brought to trial have involved SMEs — for example, the Queensland Fire Protection cartel. The New Zealand Commerce Commission (1998) reports that, in the United States, most cases of 'hard-core' per se violations of the anti-trust law (such as price fixing, bid rigging and market allocation schemes) that led to criminal prosecutions by the Department of Justice, involved small firms in local or regional markets.[33] In that context, any use of criminal sanctions should not differentiate between firms based on size.

6.3 Corporate and individual amnesty

Just as incentive compatible penalties may deter anticompetitive conduct, so too may measures that increase the likelihood of detection. Drawing from game theory (Kovacic and Shapiro 2000, p. 56), the United States has led the way with amnesty

[33] Although they are attempting to shift their detection efforts to large players.

or leniency provisions that give immunity from criminal penalties to the first corporation in a cartel that provides information on the cartel. The immunity is automatic rather than discretionary, which increases the likelihood of defection by cartel members (Hammond 2001). The US amnesty provisions are engineered to encourage a race by cartel members to divulge cartel activity, and this feature deters cartels or reduces their lives.[34] The new enforcement policy has had several major successes. In particular, it led to the prosecution by the Justice Department of BASF and Hoffman-La Roche for fixing vitamin prices, with criminal penalties of $750 million imposed (Kovacic and Shapiro 2000, p. 56).

Hammond (2001, p. 195) provides evidence from cooperation by a French firm using the US amnesty provisions that leniency provisions still work in a jurisdiction where there is no individual liability and, accordingly, no potential for imprisonment of the responsible executives.

The ACCC (2002b) has issued draft leniency provisions for Australia modelled along US lines for comment by August this year.

6.4 Conclusion

Improvements in enforcement — through incentive compatible penalties and sanctions, and inducements to cooperate with regulators — offer the prospect for improved deterrence of 'hard core' anticompetitive conduct. The adoption of such measures, subject to safeguards and careful design, also reduces the case for strengthening section 46 in other ways — such as through cease and desist powers. Any measures adopted should be neutral with respect to firm size.

7 Mergers

The Commission last fully considered the mergers regime in an Industry Commission submission to the 1996 review of the ACCC's (then) draft merger guidelines (IC 1996b). Since that review, the Commission has briefly commented on the mergers regime on a number of occasions:

- the inquiry report on firms locating offshore (IC 1996a); and
- a survey of factors affecting offshore investment by Australian firms (PC 2002c).

[34] The design of the leniency provisions affect their ability to elicit defection from a cartel — and suggest careful analysis will be required to maximise the effectiveness of any such measure (see for example, Brisset and Thomas 2002 and Kobayashi 2002).

This section briefly reviews merger issues raised in these reports.

It is widely recognised that procompetitive regulation needs to be designed to ensure that the regulatory costs of a merger regime (such as deterring potentially beneficial mergers and raising industry compliance costs) do not outweigh the benefits (of achieving more efficient pricing and pre-empting anticompetitive conduct). In its 1996 submission, the Productivity Commission made a number of suggestions regarding the ACCC's administration of the TPA's provisions that were intended to reduce costs and uncertainty, whilst ensuring that the Act's objectives were met. These suggestions included:

- giving consideration to raising the thresholds on market shares and concentration ratios for setting 'safe harbours', where mergers can proceed without ACCC scrutiny, by:
  - increasing the threshold market share for a merged firm from 40 per cent to 50 per cent; and
  - replacing the threshold test, in which the post-merger concentration ratio for the four largest firms is 75 per cent or more (with the merged firm having at least 15 per cent of the market), with one in which the three firm concentration ratio is 75 per cent or more (with the merged firm having at least 20 per cent of the market);
- including an additional 'safe harbour' rule so that where total arm's length imports have accounted for at least 10 per cent of sales for three years, the merger will be free of ACCC scrutiny;
- giving consideration to increasing the time period for judging the effectiveness of the threat of entry from two to five years; and
- improving and making more transparent the treatment of market definition, the identification and measurement of entry barriers, and the use of enforceable undertakings.

In its report on firms locating offshore, the Industry Commission (IC 1996a) made similar comments in relation to the threshold test, and the treatment of market definition and barriers to entry.

Some of these suggestions were reflected in the ACCC's 1999 merger guidelines (1999a). In particular, the guidelines now include an 'indicative' safe harbour rule that, where imports have accounted for at least 10 per cent of sales for three years, the merger is unlikely to be opposed (ACCC 1999a). Other suggestions were not taken up, in particular, those relating to the threshold concentration test and the time period for judging the effectiveness of the threat of entry.

7.1 Increasing the merger threshold

In commenting on the Industry Commission's suggestion to increase the merger threshold, the ACCC (1999a, p. 44) stated:

> The thresholds have been reviewed following a recommendation from the Industry Commission (now the Productivity Commission) to raise them. However, significant competition issues were found to arise in mergers which only just breached the thresholds, including one merger which the Commission [the ACCC] considered breached the Act. The Commission has therefore decided to retain the existing thresholds

However, the Productivity Commission sees merit in the Review independently reassessing whether the threshold test should be raised, for three reasons.

First, regulators have incentives to avoid false negatives more than false positives, and so will tend to favour too encompassing a test. A competition regulator is particularly concerned to avoid price rises resulting from mergers or mergers that could be perceived to augment market power. It is also likely that a regulator will give some weight to distributional issues (for example, from shareholders to consumers), even where efficiency issues are not at stake.

Second, there is a tendency in competition policy to define the boundaries of a market in terms of close substitutes. Thus, the ACCC (1999c, pp. 28–29) argues:

> Where two products are regarded as closely substitutable, they are regarded as being in the same market. Hence, in order to establish the relevant market, the [ACCC] is concerned to establish the actual and potential sources of close substitutes for the good or service in question.

As noted previously, and as emphasised by Yarrow (1998), this approach will automatically lead to too narrow a market definition, because it ignores the whole field of weaker substitution possibilities — including those that arise from entry — which collectively may restrain price rises. Ideally, the regulator would worry less about drawing precise market boundaries in merger cases, but make an empirical assessment of whether a merger was likely to lead to a price rise after considering *all* of the substitution possibilities and responses by rivals. Interestingly, the US Department of Justice is increasingly employing simulation methods to evaluate mergers that avoid the traditional market-share approach (Werden 1996 and Shapiro 1995). However, the informational and analytical issues are so complex that this cannot be done for all mergers, so that simple rules-of-thumb must be employed as a filter to look at those cases really meriting regulatory consideration. A solution is to define a market in the conventional way, but use a more generous threshold to counter the natural bias engendered by this method.

Third, empirical evidence suggests that the existing thresholds could be unnecessarily capturing too many mergers in the regulatory net. The data indicate that the ACCC does not object to most informal notifications about mergers. The number of merger proposals considered informally by the ACCC has increased by about 250 per cent over the eight year period to 2000–01 (ACCC 2001b, p. 69). The bulk of these mergers did not raise competition concerns, with only around 7 per cent being opposed by the ACCC or subject to modification.[35]

7.2 Merger regulation and firms locating offshore

One concern sometimes advanced is that merger policy may prevent the establishment of 'national champions'. The argument is that to succeed internationally an Australian firm will often need a large domestic base, which may be precluded by merger policy. In addition to stifling export potential, it is argued that the constraint on domestic expansion will encourage Australian firms to establish offshore production facilities and perhaps even relocate their headquarters overseas (leading to the 'branch office economy' effect). Some see these moves as being at the expense of domestic production and investment, and as leading to the loss overseas of skilled personnel.

The Productivity Commission questions the extent to which this is a problem in practice. First, it is not aware of any empirical evidence that suggests that domestic size is closely related to export performance or propensity. Second, in our recent survey of Australian offshore investment (PC 2002c) mergers regulation is not identified as a major influence on firms' decisions to locate offshore. According to the survey, commercial (or market-related) factors, unrelated to regulatory or government matters, were seen as the most important influences. Even among government factors, domestic merger policy did not rate as a major influence on most respondents decisions to relocate or produce offshore.

That said, for those firms that have relocated their headquarters offshore, or are planning to do so, it was seen as the most important regulatory impediment to domestic expansion (PC 2002c, p. 30).

The key requirement is to examine mergers from a primarily economic perspective and to only block significant market consolidation when it is likely to detract from economic efficiency. Where barriers to entry (properly defined) are not substantial or there is scope for product substitution, even mergers that lead to highly

[35] To the extent that merger policy was too restrictive and cumbersome a process then, at the margin, some firms considering a merger might decide not to proceed at all — and these would not be reflected in these data.

concentrated industries are not a problem, but can produce win-win outcomes for firms and consumers.

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