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Dear Treasury

Submission on the Competition Policy Review's Misuse of Market Power proposal

Thank you for the opportunity to make submission to Treasury in relation to the Competition Policy Review's proposed introduction of a competition effects based standard for misuse of market power.

This letter comprises our personal submission to the Treasury process, drawn from our experience in both private practice and in public enforcement of the *Competition and Consumer Act 2010* (**CCA**) and its predecessor legislation.

What are the right principles to consider in framing a misuse of market power prohibition?

In our view, the debate around the misuse of market power in Australia has tended to move too quickly to the structure and language of section 46 and could usefully return to the fundamental principles and objectives underlying the section. In our view the principles underlying the Final Report's proposed section 46 are unclear and as a result the application of the proposed law can only be – and remain – uncertain.

Competition and antitrust laws worldwide recognise that the unilateral conduct of firms with market power presents a unique challenge.

A business doing everything it can to win customers from its rivals is the essence of competition, and should not be discouraged simply because it may result in less efficient competitors leaving the market or prevent them from entering the market. On the other hand, a market with fewer competitors or potential competitors may be a less competitive market, and may deliver fewer benefits to consumers.

So when should unilateral conduct that may damage or exclude competitors be permitted, and when should it be prevented? This is not a straightforward question, and standard industrial organisation economics does not provide simple answers. Most unilateral conduct that could be considered exclusionary can have both positive and negative impacts on competition and on efficiency.

This challenge may be even more complex than the Final Report suggests. It is not only a question of distinguishing between competitive and anti-competitive conduct; it is also a question of how to treat conduct that is competitive in one respect – or timeframe – and anti-competitive in another.

The recognised challenge for a monopolization or abuse of dominance provision is how to balance:

- the benefit to consumers in the short term arising from the competitive freedom of firms to offer low prices or attractive productive bundles (even where that involves a use of market power); against

- the potential detriment to consumers from a lessening of competition in the long term.

Given the immediate benefits to consumers and the uncertainty of the longer-term impacts on competition, most such provisions are typically framed conservatively – and more conservatively than general prohibitions that apply to bilateral or multilateral conduct, such as agreements or mergers.

Every response to this challenge involves some compromise. An ideal solution might prohibit only conduct that would damage consumer welfare overall. But requiring a business to base its actions on a prediction of consumer welfare – or face the legal consequences – is likely to dull or deter vigorous competition and itself reduce consumer welfare. While the provision would be well directed *in principle* to neither overreach nor underreach, in application its breadth and uncertainty would be likely to have adverse consequences for competition.

As a result, jurisdictions around the world have developed legislative, administrative and judicial rules or standards to help businesses and enforcement agencies determine what kind of conduct should be permitted or prevented. Each of these rules must balance the risk of under-capture, the risk of over-capture and the ease and certainty of applying and administering the rule.

Antitrust laws generally apply only to companies with a particular market position – most commonly a dominant position. They tend to focus on exclusionary conduct, and often on particular kinds or categories of exclusionary conduct. They may characterise conduct according to its purpose – where a subjective purpose may be taken into account, but an objective purpose inferred from the circumstances is usually determinative – and also by its likely effect. They have developed a range of tests to determine whether conduct should be considered pro-competitive or anti-competitive, either generally or in specific cases such as predatory pricing.

Each of these rules acknowledges that, while the ultimate goal of competition law is to protect and promote consumer welfare, this goal may best be achieved through more specific and administrable standards of conduct to guide decision-making. These may be imperfect proxies for consumer welfare, but may deliver the best results in practice.

There is agreement internationally – including, we think, within Australia – that the law should prevent a business from using its market power to engage in exclusionary conduct to the ultimate detriment of consumers. However, there is little consensus as to the best mechanism to achieve this result.

Criticism of the existing section 46 and the case for a competition effects based standard has largely been argued as a point of principle or based on a critique of legal construction by the courts.

Some argue that the current section 46 appears poorly framed as is directed to competitor-specific consequences and not broader effects on competition. Others are concerned that the “take advantage” test is overly technical, hypothetical and misdirected. It will be apparent from our comments below that we do not share these concerns, but we do acknowledge them.

There is also a contrasting concern, not based in sound competition law principles, that section 46 is not doing enough to protect small business. The focus of small business on section 46 is raised as a problem with the current drafting: that is, it creates an expectation in the minds of specific businesses that the provision is there to protect them rather than the competitive process.

We agree that a discussion of principle is important. However, practical consequences matter as well. In deciding whether and how to amend section 46 it is necessary to consider how effectively the agreed principles relating to the conduct of firms with market power have been implemented under the current section 46, and what changes would be likely to be more effective in practice – taking into account the relative risks of over-capture, under-capture and administrability, together with the uncertainty that would arise from the change in the law.

How has section 46 performed against these considerations?

In our view, section 46 has proved to be an effective provision that has been applied and interpreted consistently with the agreed principles relating to the antitrust treatment of unilateral conduct.

Section 46 clearly identifies particular categories of *exclusionary* conduct – eliminating or substantial damaging a competitor, preventing the entry of a person into a market, or deterring or preventing a person from engaging in competitive conduct in a market – giving practical guidance to business.

It characterises conduct as exclusionary based on its *purpose* – which may be inferred from all the circumstances – to avoid deterring vigorous competition on the merits that may result in the exit or prevent the entry of a competitor or competitors.

These two elements of section 46 enhance the ability of firms to understand the application of the provision in the context of their business decisions. Business decisions that are made for an exclusionary purpose are at risk. Decisions that are not made for such a purpose are not at risk.

Recognising that even in a competitive market, competitive "animal spirits" may be expressed in terms of exclusionary purposes, in order to avoid overcapture that may be based on punishing exuberance or ill-advised internal statements, section 46 further distinguishes between conduct that would be engaged in by a firm in a competitive market and conduct that draws on the firm's market power.

It does this by requiring that the firm has *used* its market power. The "take advantage" element has been interpreted by the courts to assess whether the firm could profitably have engaged in the conduct in the absence of market power. The test seeks to prevent conduct that is incompatible with a competitive market to excuse conduct that is pro-competitive or efficiency-enhancing.

The current section 46 may both permit some conduct that has a net consumer detriment (underreach) and prohibit some conduct that has a net consumer benefit (overreach), since:

- conduct that has a legitimate purpose and does not take advantage of market power will be permitted even if it results in a loss of consumer welfare – for example through a structurally less competitive market – that outweighs its benefits; and

- conduct that takes advantage of market power for an objectively exclusionary purpose will be prohibited even if it may fail to achieve its purpose and result in no loss of consumer welfare.

However, it is not clear that these theoretical circumstances justify a broader test that would be difficult to apply and could deter genuinely competitive activity.

On this basis, the current section 46 – as interpreted by the courts, as any provision must be – does not appear to raise any objection in principle. The courts have made clear that the section operates to protect the competitive process by preventing exclusionary conduct, which by necessity involves a reference to competitors. Purpose – whether objective or subjective – is used worldwide to characterise conduct as exclusionary, since legitimate conduct can have exclusionary effects.

The principle that only conduct that constitutes a *use* of market power is prohibited should also be unobjectionable. With the exception of the High Court's *Rural Press* decision, the outcomes of decided cases are in our view appropriate and the track record of enforcement is in line with what would be expected – given the fine judgments involved.

Rural Press is the outlier in the application of the "take advantage" test. The majority decision, in our view, reflects an artificial analysis of the conduct. In part this appears to be just an unfortunate decision on the facts, and in part it appears to have been affected by an undue reliance on the *Melway* reference to whether a firm *could* have engaged in conduct in the absence of market power (although *Melway* referred just as often to whether a firm *would* have engaged in such conduct).

The "could" test has now effectively been overturned with the 2008 amendments to section 46, which was applied without apparent difficulty in the *Pfizer* case. Even before the amendments, in the *Cement Australia* decision, Justice Greenwood was able to resolve the apparent conflict between "could" and "would" standards by framing the question as "whether a profit maximising firm operating in a workably competitive market *could* in a commercial sense *profitably* engage in the conduct".

It is noted that one complaint regarding the "take advantage" element is that it involves comparison with a hypothetical scenario. This is inherent in all causation tests built on a "but for" standard, such as the counterfactual analysis that is undertaken under a substantial lessening of competition test.

In our view the current section 46 is appropriate in principle and has generally worked well in practice. There is no particular evidence that it has been either unduly narrow or broad in its application.

How well does the proposed section 46 align with accepted principles?

The Final Report considers that "section 46 can be focused more clearly on the long-term interests of consumers and enhanced to restore its policy intent" and suggests a prohibition on any conduct with the purpose, effect or likely effect of substantially lessening competition (**SLC**).

It also proposes to direct the court in any SLC analysis to have regard to both:

- the extent to which the conduct has the purpose, or would have or be likely to have the effect, of *increasing* competition in the market including by enhancing efficiency, innovation, product quality or price competitiveness in the market; and

- the extent to which the conduct has the purpose, or would have or be likely to have the effect, of *lessening* competition in the market including by preventing, restricting or deterring the potential for competitive conduct in the market or new entry into the market.

We recognise that the intention of the proposed section 46 is appropriately to prevent a business with market power from engaging in exclusionary conduct to the ultimate detriment of consumers. However, we are not convinced that the proposed section 46 presents a superior solution to the challenge of identifying the conduct to be prohibited with sufficient certainty and predictability.

The ACCC has confirmed that it considers that the proposed section will be directed at exclusionary conduct. It has explained that the SLC test will first examine whether conduct is exclusionary in nature and then whether it has the purpose or effect of substantially lessening competition.

In our view, relying on the SLC test to first identify the form of conduct to be examined risks uncertainty that may deter legitimate conduct. The current section 46 more transparently sets out the kinds of conduct that will be assessed by the test.

Removing the "take advantage" element would break the connection between a firm's market power and its conduct, and with it a key filter in determining whether behaviour is likely to be pro-competitive or anti-competitive overall. The new formulation of the element in the defence is not an improvement, and the additional requirement that the conduct be in the long-term interests of consumers is an admirable ambition but not a useful test and would be likely to render the defence unworkable.

Without the take advantage element, it is difficult to see how the proposed provision distinguishes "good" from "bad" conduct. For example, each of the following categories of conduct may be in the interests of consumers directly or indirectly through efficiency benefits, but may also be potentially anti-competitive:

- discount pricing, potentially leading to exit of a competitor (see *Boral*);

- attractive consumer bundles that can't be replicated by other competitors (see *Baxter* or fuel discount shopper dockets);

- unilateral implementation of an exclusive distribution system resulting in reduced downstream competition (eg *Melway*); and

- acquisition of preferential rights, such as exclusivity provisions (eg *Cement Australia* or *Ticketek*).

While the proposed court directions usefully define the kinds of conduct that would tend to constitute legitimate commercial conduct and those that would usually be anti-competitive, in our view they do not sufficiently protect the former while preventing the latter. In particular, where conduct may have both kinds of purpose or effect, the directions give no guidance on how those purposes or effects might be weighed – including whether purposes or effects generally should be given different weights.

Further, the alternative bases of purpose, effect or likely effect of substantially lessening competition could result in significant over-capture and would be broader than any test internationally. Overseas tests usually require both an exclusionary purpose *and* an effect on competition or consumer welfare.

It is not clear how a competition effects-based test would better target the conduct that should be prohibited and avoid the conduct that should not. Whether it will better target the ultimate problem or not, it is clear that such a test will:

- be harder for business to comply with, as it will be harder to assess in advance whether the firm's conduct will be likely to substantially lessening competition in any market over time;

- open up more areas of conduct for investigation, if not ultimate litigation and successful prosecution; and

- require a substantial period of time for a well-developed jurisprudence to provide clarity as to its operation.

Each of these factors increases the practical uncertainty for business and necessarily increases the risk of chilling the competitive conduct of firms with substantial market power.

If a competition effects based standard were to be applied, how should that be framed?

In our view, if a competition effects based standard is to be adopted, any new section 46 should have the following elements:

- It should explicitly apply only to exclusionary conduct (either to specific categories or to exclusionary conduct in general). The targeted conduct should ideally be defined in the legislation and further elucidated in ACCC guidelines.

- Purpose should be relevant to the identification of exclusionary conduct but it should not provide an alternative SLC test. Any competition test should require either an effect or a likely effect of substantially lessening competition.

The prohibition of conduct that has both an exclusionary purpose and an effect of lessening competition or consumer welfare is common in the jurisprudence of the major antitrust jurisdictions.

In legislative form it is most clearly expressed in Canada, where the *Competition Act* prohibits dominant businesses from engaging in "anti-competitive acts" that have the effect or likely effect of "preventing or lessening competition substantially in a market" – and defines "anti-competitive acts" as acts directed against competitors for anti-competitive purposes.

Where the jurisprudence has developed through court decisions, as in the United States and Europe, the purpose requirement is introduced in addition to an effect requirement by examination of legitimate business or efficiency defences or justifications. That is, where conduct has a legitimate purpose it will be exempted even where its effect may be to lessen competition or consumer welfare – unless the

purpose is simply a pretext, or the anti-competitive effects are manifestly disproportionate. An accused business may need to prove that it had a legitimate purpose, or it may need only to raise a *prima facie* legitimate purpose and shift the burden on the claimant to dislodge that purpose.

The Final Report's proposal to capture any conduct that has the purpose of substantially lessening of competition – without requiring any likely anti-competitive effect or, indeed, any taking advantage of market power -- is much broader than the equivalent laws in sophisticated antitrust jurisdictions and risks significant overcapture.

This is particularly because conduct can be undertaken for a number of simultaneous purposes – including different purposes held by different people within the business – and any over-enthusiastic executive may suggest a substantial anti-competitive purpose even where the conduct has a legitimate business justification and/or no likely anti-competitive effect. It is hard to see how it would be realistic to control for these possibilities in a large business. It will be very difficult to sufficiently instruct businesses and their employees to stay within the law as drafted and encourage competitive animal spirits. As a result, any reframed section 46 should treat purpose as a necessary but in no circumstances a sufficient condition.

A reframed section 46 that should address the issues raised by the Competition Policy Review, and would closely track the Canadian legislation without introducing any new concepts to the existing law could be constructed as follows:

Example 1

(1) A corporation that has a substantial degree of power in a market shall not ~~take advantage of that power~~ ***engage in conduct*** *in that ~~or any other~~ market for the purpose of:*

(a) eliminating or substantially damaging a competitor of the corporation or of a body corporate that is related to the corporation in that or any other market;

(b) preventing the entry of a person into that or any other market; or

(c) deterring or preventing a person from engaging in competitive conduct in that or any other market,

and with the effect, or likely effect, of substantially lessening competition in that or any other market.

Alternatively, the section 46 proposed by the Final Report would be most effectively reframed by removing the guidance describing exclusionary conduct to the purpose element, as follows:

Example 2

(1) A corporation that has a substantial degree of power in a market shall not engage in conduct if the conduct:

(a) has the purpose ***of preventing, restricting or deterring the potential for competitive conduct in the market or new entry into the market;*** *~~, or~~* ***and***

(b) would have, or be likely to have, the effect of substantially lessening competition in that or any other market.

(2) Without limiting the matters that may be taken into account for the purposes of subsection (1), in determining whether conduct ~~has the purpose, or~~ would have, or be likely to have, the effect of substantially lessening competition in a market, the court must have regard to the extent to which the conduct has the purpose, or

would have or be likely to have the effect, of ~~increasing competition in the market including by~~ enhancing efficiency, innovation, product quality or price competitiveness in the market.~~; and~~

*~~(b) the extent to which the conduct has the purpose **of** , or would have or be likely to have the effect, of lessening competition in the market including by preventing, restricting or deterring the potential for competitive conduct in the market or new entry into the market.~~*

In order to more clearly exempt pro-competitive conduct, it may alternatively be desirable to frame the reference to efficiency and innovation as a defence rather than a factor to be taken into account.

Example 3

(1) A corporation that has a substantial degree of power in a market shall not engage in conduct if the conduct:

*(a) has the purpose **of preventing, restricting or deterring the potential for competitive conduct in the market or new entry into the market;**~~, or~~ **and***

(b) would have, or be likely to have, the effect of substantially lessening competition in that or any other market.

*(2) ~~Without limiting the matters that may be taken into account for the purposes of subsection (1), in determining whether conduct has the purpose, or would have, or be likely to have, the effect of substantially lessening competition in a market, the court must have regard to the extent to which the~~ **For the purposes of subsection (1), any** conduct **that** has the purpose, or would have or be likely to have the effect, of ~~increasing competition in the market including by~~ enhancing efficiency, innovation, product quality or price competitiveness in the market **will not have, or be likely to have, the effect of substantially lessening competition in that or any other market.***

*~~(b) the extent to which the conduct has the purpose **of** , or would have or be likely to have the effect, of lessening competition in the market including by preventing, restricting or deterring the potential for competitive conduct in the market or new entry into the market.~~*

In our view Example 1 would provide the least uncertainty and cost for business particularly in the short term, but all examples would tend to converge on a suitable position in the longer term.

We would welcome the opportunity to further discuss these proposals with the Review Panel.

Sincerely

Luke Woodward and Matt Rubinstein