Defences to Claims of Monopolisation

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Deakin Law School Research Forum
13 May 2016

Research Project

- Australian law prohibits a corporation with substantial market power from taking advantage of it for the purpose of excluding competitors (s 46 CCA).
- The section has a troubled history with frequent legislative amendments to 'correct' interpretations by the courts, and there is currently controversy over further amendments proposed by the Harper Review (accepted by the Government during March 2016).
- It is said that court decisions mask undisclosed policy decisions. This research project seeks to clarify the theoretical conception of market power, and by examining the different readings of the provision by the courts and others, to reveal underlying norms of commercial behaviour which may help reconcile these differences.

Today's topic

- Identify and test 'norms of behaviour' which could explain the differing views of economists, judges, regulators and legislators that we have experienced in Australia from inception of s 46 to the present.
- Re-consider the concept of market power and the underlying theory of economic harm, as well as cognate legal doctrines, to develop negative and affirmative defences.
- Test these norms and defences against key cases concerning s 46, i.e. refusal to supply, predatory pricing and meeting competition, and compare the Harper Review proposed 'strict liability' version of s 46.

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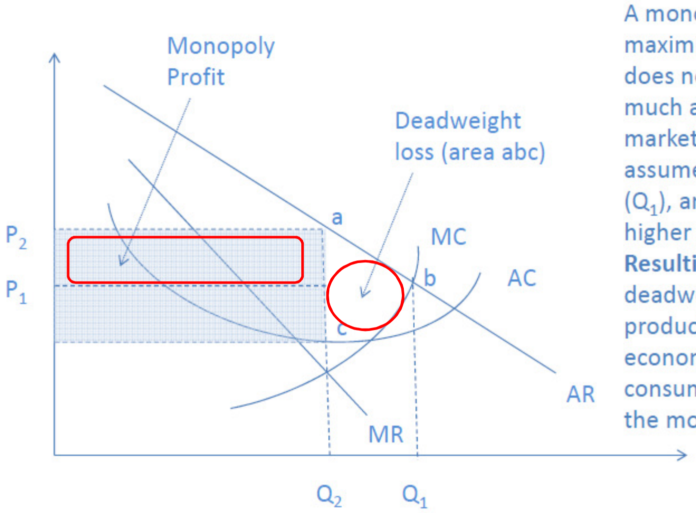
'Market power': theory of harm



A monopolist maximises profit, so does not produce as much as a competitive market may be assumed to produce (Q_1), and sells at a higher price (P_2). **Resulting harm:** deadweight loss of production to the economy; transfer of consumer surplus to the monopolist.

After Blair & Carruthers 2010

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‘Market power’: theory of harm

- **Problems:** It is typically assumed that the marginal cost curve (MC) represents the ‘supply curve’ that would obtain if there were many firms supplying, i.e. in a competitive market. However, under monopoly (and oligopoly) supply does not respond to price but to marginal revenue (MR).
- Further, many firms would duplicate the required capital investment, altering the relationship between MC and AC, i.e. most efficient industry output.
- This means that point ‘b’ is unlikely to represent the ‘competitive price level’.
- ‘The most that can be said with reasonable confidence is that the social costs directly ascribable to monopoly power are modest’ (Scherer & Ross 1990: 678)

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Direct and indirect measures of harm

- The ultimate harm attributed to monopoly is to economic efficiency: deadweight loss refers to reduction in GDP. [Note: will return below to ‘(re)distribution’ of producer/consumer surplus – red rectangle, slide 4.]
- Competition law uses ‘the process of competition’ as a surrogate for this harm.
- The ‘Structure Conduct Performance’ approach uses ‘market structure’ as a surrogate for ‘the process of competition’.
- SCP has been discredited (since 1974 in the US: Stroux 2004, Muris 2005). This creates a continuing unfulfilled need for ‘direct’ measures of harmful ‘competition effects’ (Cudahy & Devlin 2010, Crane 2014).
- **Proposition:** we should refocus our concept of harm on ‘interference with the market mechanism’, i.e. market impacts on price and output may provide the holy grail to directly measure harmful effects.

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Time frame to assess effects

- The 'process of competition' is conventionally defined by reference to the 'long run' (*QCMA*).
- Economists use the 'long run' in contradistinction to the 'short run', namely the period in which firms' output is constrained because at least one factor of production (i.e. labour or capital) is fixed, so that the 'law of diminishing returns' applies, and the familiar 'U-shaped' cost curve limits the size of the firm.
- In the long run all factors of production are variable so nothing limits the size of the firm; hence a firm can grow indefinitely, fuelled by economies of scale.
- You cannot define short and long run by a period of years, but the ACCC says a period of 1-2 years could be transitory (*Merger Guidelines*, ¶3.6).

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Big Business

- 1950s: The USSC believed that the intent of s 2 Sherman Act was to prevent concentration of economic power, even if there would be a loss of economic efficiency (Pitofksy, 1979). Economists noted non-economic advantages in constraining the power of Big Business (Brunt 1964, Larouche and Schinkel 2013). Whether this is still relevant in the US is 'increasingly unclear' (Scherer & Ross 1990: 483).
- The view persists that one aim of competition law is to protect small business from big business (Second Reading speech on 1986 amendments to s 46; Senate Economics References Committee report in 2004; French, 2007; Kirkwood 2013).
- Economic theory suggests only market size limits the size and number of firms, because the 'law of diminishing returns' does not operate in the long run (Marchionatti, 2003).
- **Conclusion:** The forces of competition and markets cannot control the power of big business. [Case study: global brewing]

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Market power: the concept

- The concept of 'market power' as the power to 'give less and charge more' derives from the US Attorney-General's report on antitrust law of 1955.
- It has been adopted by the Trade Practices Tribunal in *QCMA* (1976) and is still fondly regarded by economists, e.g. Frontier Economics expert's report in AGL/MacGen (2015), another case before the Tribunal.
- Articles by Landes and Posner (1981) and Blair and Carruthers (2010) confirm that standard measures of market power, the Lerner Index, which implicate industry concentration (Herfindahl Hirschman Index), are functionally related to *elasticity of demand*.
- **Proposition:** 'market power' is not possessed by a dominant firm but is the power of the *market*, which may be *manipulated* by the dominant firm.

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Market Manipulation

- In proposing that market power is the power to manipulate the market we can draw on the US literature on antitrust and **commodity market manipulation** – 'corners' and 'squeezes' (Kern 1987, Pirrong 1994, Kelliher 2005, Spence & Prentice 2012).
- Recent US cases confirm the application of s 2 Sherman Act to alleged manipulation in cotton, crude oil and silver futures markets (*Shak v JP Morgan* SDNY 2016; *Cotton Futures* SDNY 2013; *Crude Oil* SDNY 2012)
- In *JP Morgan*, the court held that **direct evidence of price effects could suffice to demonstrate market power** – in contrast to usual methods relying on market definition and market share, which are notoriously unreliable (Smith 2010, Trindade & Smith 2010).
- **Theory of harm:** commodity market manipulation may (i) redistribute gains/losses between market participants, but (ii) is the operation of the *market* impeded and (iii) are there external (social) costs?

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Market power: conceptual problem

- If MP is the ability to manipulate the market by sliding up or down the residual demand curve it clearly cannot explain practices that exclude competition.
- The High Court has accepted the concept of MP as the power to 'give less and charge more' (*Queensland Wire*), but some judges have realised there is a problem with the concept:
  - if 'market definition' is a matter on which opinions might reasonably differ (per Deane, J in *QWI*), 'market power' is likewise susceptible (per Mason, CJ and Wilson, J in *QWI*);
  - to explain exclusionary conduct, we need to propose that MP is power to 'behave differently than a competitive market would enforce' (Dawson, J in *QWI*, citing Kaysen & Turner, 1959)

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Market power: Kaysen & Turner

- Stroux 2004 reviews the debates in the US in the 1950s and 1960s concerning the 'structuralist project':
  - structuralists argued that the harm from oligopoly is that firms adopt parallel conduct without the need for actual collusion, thus markets perform much the same as a monopoly [Note: as we will see, game theory suggests otherwise]
  - Kaysen & Turner advocated a policy of breaking up large firms to eliminate oligopoly power, which was rejected in the US after about 1974
  - they also advocated a 'strict liability' approach to abuse of market power, which was rejected in the US in 1976 (Scherer & Ross 1990: 481); and is still not favoured (Hovenkamp 2005).

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Market power: Harper Review

- The Harper Review is critical of the focus of s 46 on an 'exclusionary purpose', suggesting this offends the often stated proposition that competition law protects 'competition not competitors'.
- Despite this, the US and EU literature is clear that the apprehended harm from market power is that the dominant firm may somehow use its power to exclude more efficient competitors (Hovenkamp 2005, Hay & Smith 2007, EC 2009).
- Williams (2013) argues that evidence that a more efficient competitor has been excluded should be conclusive that market power has been used.
- **Proposition:** the connection between market power and harm (exclusion of more efficient firms or impeding the process of competition) is conceptually unclear.

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SLC: the predictive test

- The 'substantial lessening of competition' test used in other provisions in Part IV of the CCA is a predictive test, i.e. courts assess the 'likely' effect on competition (with reference to traditional structural factors).
- The view favoured by French, CJ is that this is satisfied if there is a 'real chance' (as opposed to a likelihood on balance of probabilities). This is not universally accepted by judges (Buchanan, J in *Metcash*, Heerey 2011).
- The ACCC generally assumes that the past is a reliable indicator of the future (Merger Guidelines). Analysis of what happened in markets after key competition law cases suggests there are problems with our predictive ability (e.g. steel markets after *Queensland Wire* 1989).

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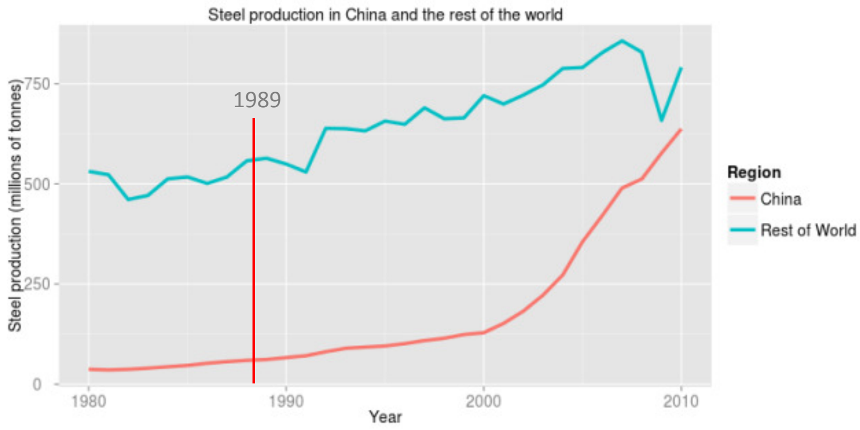
Global steel market



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First norm: rational behaviour

- It is generally accepted that a monopolist is permitted to reap the rewards of success by deriving above-normal profits, i.e. the firm is expected to increase output to the profit-maximising level (Q_2 in the diagram) and no further (Hanks & Williams, 1990; Hilmer, 1993; Hovenkamp 2005; USSC in *Linkline* 2009; Hylton 2010).
- Hanks & Williams conclude, *based on that norm*, that the 'competitive level' (point 'b' in the diagram) *cannot be the relevant benchmark to assess harm*.
- **Proposition:** the standard of conduct implicit in this norm is 'rational profit-maximising behaviour' under *monopoly* rather than under a hypothetical competitive standard.
- **Proposition:** we need something like the ill-defined US defence of rational business decision, which Williams (2013) argues is implicit in s 46 'taking advantage' [Harper will repeal this].
- **Proposition:** above-normal profits do not indicate 'harm'.

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Competitive paradigm

- Paradoxically, not only is there no MP in the economic model of perfect competition, but also there is no competition.
- The model posits that a firm can sell as much or as little as it wants without affecting price, and can increase sales without taking sales away from other firms. I call this ‘non-zero sum competition’.
- In the real world, economists and judges agree that ‘competition’ is rivalry between firms for the same object, i.e. a firm succeeds by taking sales away from its rivals (Hilmer, *QWI*). I call this ‘zero-sum competition’.
- Perloff (2007: 36) argues, based on the work of Sutton modelling oligopoly competition, that competition is *more intense* in more highly concentrated markets. I suggest this is due to ‘zero-sum competition’.

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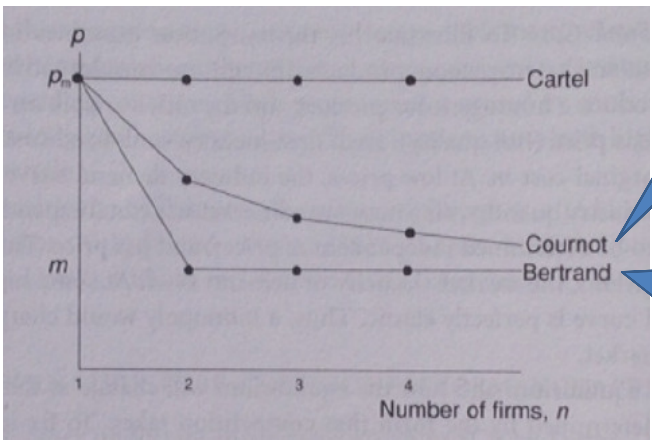
Relationship between prices and number of firms under 3 competitive paradigms



Cournot competition: each firm decides its output, leaves market to set price

Bertrand competition: each firm sets its price, lets market decide how much to buy

Source: Perloff 2007: 36 (after Sutton 1991, 1998).
Key: p_m is monopoly price and m is marginal cost .

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More than terminology

- ‘Zero sum’ technically means my loss and your gain are equal, e.g. *outcome* of a football game is zero sum.
- However, the *scores* are non-zero sum, i.e. each team could score any finite number but the higher wins.
- ‘Non-zero sum’ therefore refers to games in which the payoffs could be a range of non-equal independent outcomes.
- In what follows, I am using ‘zero sum’ to connote *inter-dependent ‘win-lose’ outcomes* (i.e. not exactly as game theory uses the term). In game theory the concept I want to use might be called a ‘survival game’ (Scherer & Ross 1990: 209, fn 26).

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Barriers to exit

- Unlike the perfectly competitive model, in the real world a firm cannot realise and re-deploy its assets without transaction costs, i.e. there are ‘barriers to exit’ (Nargundkar 1996).
- These ‘barriers to exit’ suggest that firms will invest in unprofitable trading (or may ‘peaceably co-exist’) as the lesser evil.
- This may help explain why competition is *more intense* in more highly concentrated markets, i.e. if firms are locked into a ‘survival game’.
- In *NT Power*, the court considered that competition law does not allow an inefficient monopolist time to adjust to entry by an (allegedly) more efficient competitor. Is the court assuming, as in perfect competition, that there are no barriers to exit?

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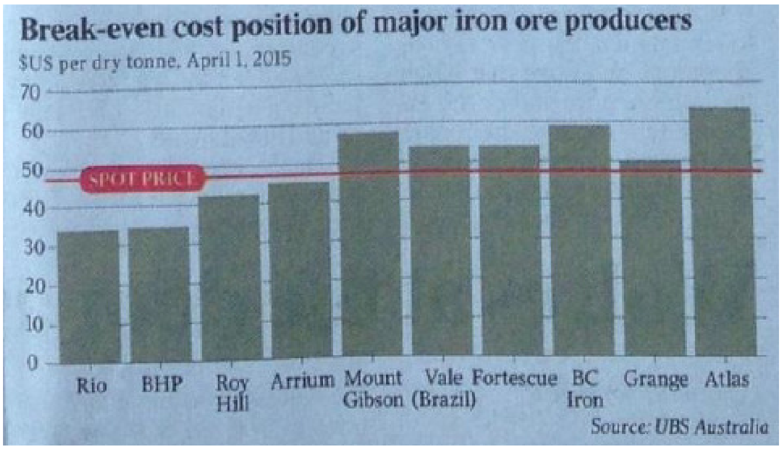
Iron ore market mid 2015



The Australian, 8 April 2015

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Response to new entry

- **Thought experiment:** would you expect the Blackberry company to graciously cede the market to Apple and Samsung and become, e.g. a biotech company?
- Conventional wisdom is that market dominance is an effective barrier to entry (e.g. Scherer & Ross 1990: 222-3, Church & Ware, 2000). However, we can extrapolate from Scherer's research (2001) to suggest new entrants will over-estimate their chances of success and so will not necessarily be deterred, i.e. may not act in a conventionally rational way.
- I use Blair & Carruthers' model of a monopolist's cost and revenue functions to model entry by an *equally* efficient producer. The red overlay is the 'equally efficient firm', giving a price-output 'box' diagram.
- **Proposition:** consistent with 'zero sum' competition, each firm may be expected to attempt to expand output to leave an unviable market share for the other, i.e. to destroy the other. Under what norm should the law intervene? Does game theory provide relevant norms of conduct?

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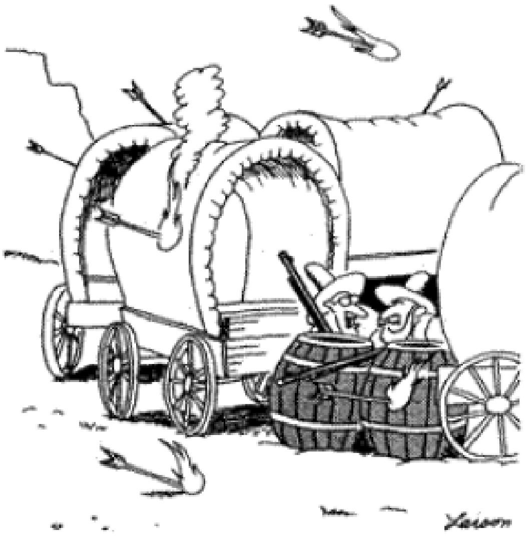

"Hey! They're lighting their arrows! ... Can they *do* that?"

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Game theory and norms

- In our thought experiment we do not seek to predict what incumbent and new entrant are *most likely* to do ('anything can happen', Scherer & Ross 1990: 199), but to assess what they *may* do, and whether there are norms to support state intervention.
- We may ask whether given conduct is obviously harmful according to our theory of harm, and also whether the conduct is 'blameworthy' according to any relevant norm.
- Game theory predicts a defensive strategy (Nash equilibrium) under Cournot competition. Under Bertrand competition the same strategy provides a 'floor' price equivalent to 'perfect competition'. Under Stackelberg competition (leader/follower) the equilibrium falls in between (Scherer & Ross 1990: 221-6).
- Each model of competition, or game, makes certain assumptions, which we need to interrogate.

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Game theory and norms (2)

We make a qualitative analysis of the Prisoners Dilemma game, a simple zero sum game, to assess behavioural strategies (Scherer & Ross: 1990: 210; Stroux, 2004). We will contrast differing views between economists and lawyers about what is 'normal'.

Lose-lose Nash (best outcome given competitor strategy; defensive, not destructive) 'Conscious parallelism' (rational and legal)	Win-lose (e.g. exclusionary strategy; **irrational**) (illegal for more powerful firm)
Win-lose (e.g. exclusionary strategy; **irrational**) (legal for powerless firm)	Win-win Cartel (best outcome under collusive strategy) (rational but illegal)

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Game theory and norms (3)

- Game theory suggests that pursuing a Nash equilibrium under Cournot competition is rational (and hence 'normal'), whereas win-lose strategies are not, and can only be explained by ulterior motives.
- Key assumptions of the Cournot, Stackelberg and Bertrand games:
  - peaceful co-existence, i.e. both remain viable in the market; no-one would price below MC; implicitly, no exit costs.
  - non-zero sum, i.e. the market is the bank, absorbs the impact of output or price competition;
  - price or product differentiation alone wins customers, i.e. there is no difference between firms in their incentive, desire or effort to win customers;
  - no fixed costs, so scale economies not relevant;
  - in Stackelberg, the incumbent has an advantage, which suggests the new entrant will *follow* (Scherer & Ross 1990: 223)

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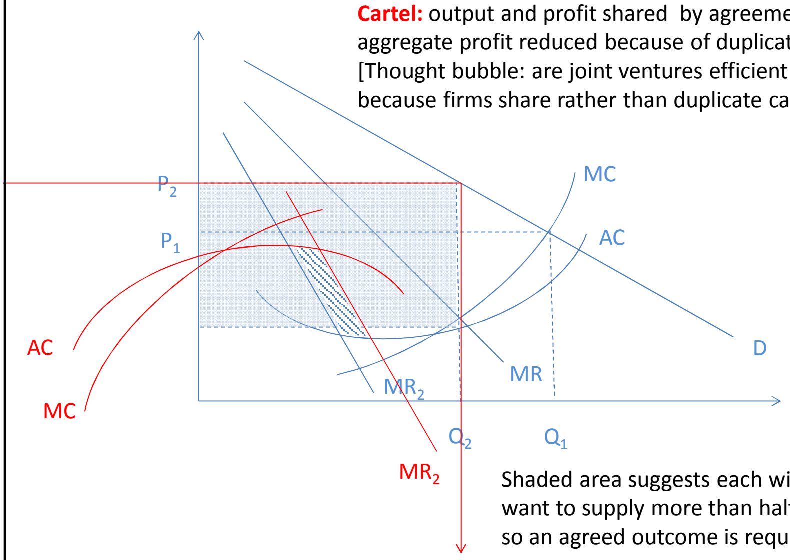
Monopolist response to new entry

Cartel: output and profit shared by agreement. But aggregate profit reduced because of duplicated capital. [Thought bubble: are joint ventures efficient (and legal) because firms share rather than duplicate capital?]



Shaded area suggests each will want to supply more than half Q_2, so an agreed outcome is required

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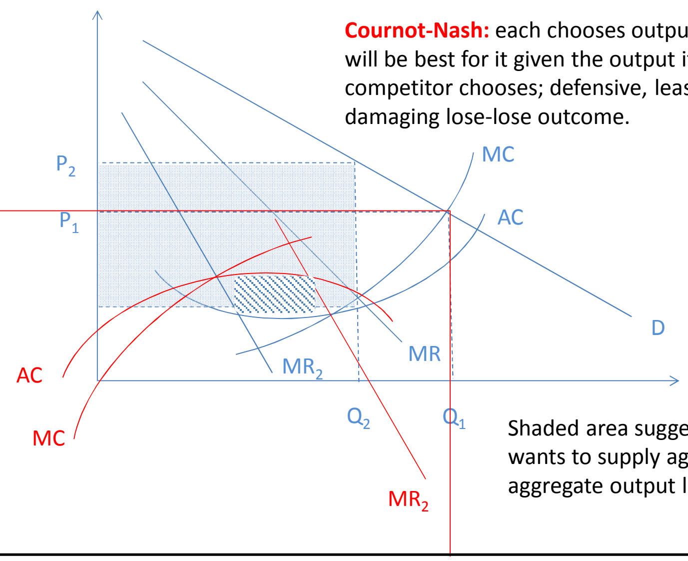
Monopolist response to new entry

Cournot-Nash: each chooses output that will be best for it given the output its competitor chooses; defensive, least damaging lose-lose outcome.



Shaded area suggests neither wants to supply aggregate Q_1, so aggregate output likely to be less

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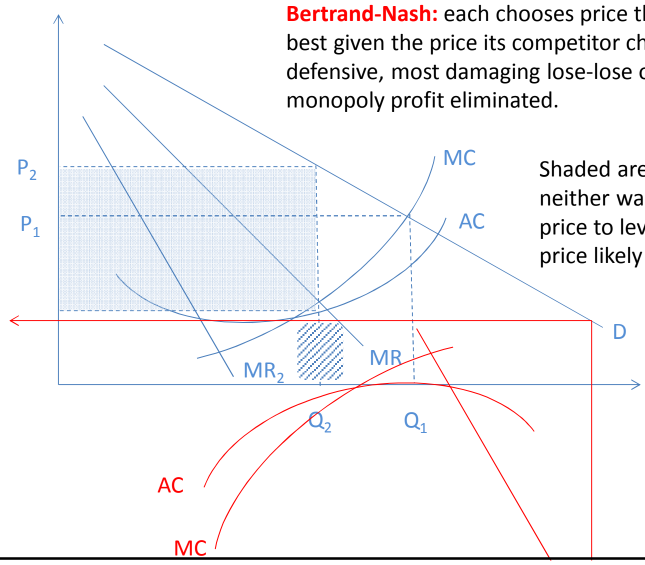
Monopolist response to new entry



Bertrand-Nash: each chooses price that will be best given the price its competitor chooses; defensive, most damaging lose-lose outcome, monopoly profit eliminated.

Shaded area suggests neither wants to depress price to level indicated, so price likely to be higher

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Conclusions from experiment (1)

- Game theory suggests a range of 'rational' outcomes: sharing markets with levels of prices and profits depending on the 'strategies' chosen. Thus we can condemn cartels and behaviour that rational economists would not expect to be normal, e.g. win-lose exclusionary conduct and predatory pricing. Zero-sum (or survival) competition is regarded as an 'exception' (Scherer & Ross 1990: 209, fn 26)
- **Paradox:** conventional wisdom suggests that above-normal profits provide an incentive to new entry, and that self-interest will prevent outcomes that completely erode above-normal profits (Bertrand equilibria), which are thus not economically rational (Church & Ware 2000: 247, 256). This may be because the 'games' modelled by economists are non-zero sum (Stroux 2004: 13, fn 52), i.e. assume away 'zero sum' style contestability.
- **Proposition:** changing our competitive paradigm may solve this paradox.

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Conclusions from experiment (2)

- **Stackelberg game assumptions:** the leader/follower assumption suggests the leader dominates and leaves a small space in the market for the follower, and suggests both will happily co-exist with price close to the 'competitive level'.
- **Asymmetry:** the incumbent is assumed to have MP and competition law prohibits the incumbent excluding an equally efficient competitor (i.e. the incumbent must submit to harm from new entry); the new entrant is assumed not to have MP (and so may inflict harm on the incumbent). **Problem:** the new entrant appears equally able to manipulate the market by producing output that has demand response and price effects.
- **Efficiency:** entry of an equally efficient firm duplicates capital investment and could be said to be inefficient because AC>MC, i.e. each firm lacks efficient scale (not a problem if assumed to be no fixed costs).

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Conclusions from experiment (3)

- **Problem:** *If we posit that competition is 'zero sum' then apparently irrational 'win-lose' strategies can be expected to emerge in real life*. The adversarial legal system is a win-lose system that may view win-lose strategies to be normal (and lose-lose, i.e. mutually assured destruction as irrational and vindictive). Experience training lawyers in dispute resolution using a prisoners dilemma game suggests 'win-lose' strategies are deeply ingrained in lawyers (e.g. Maughan 1998)
- **Problem:** *Viewing MP as ability to manipulate the market, we see that a new entrant possesses MP*.
- How can public interest considerations assist the state determine whether to take sides when two citizens are setting out to harm each other? We will next consider how the criminal law deals with 'self-defence' and tort law deals with 'voluntary assumption of risk'

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Second norm: *private* interests

- **Criminal law:** at common law, if an accused believed upon reasonable grounds that it was necessary in self-defence to do what he did, then he is entitled to an acquittal (*Zecevic*, HCA 1987).
- This is a troubled area of criminal law in Victoria, with major legislative changes over the last 10 years:
  - in 2005 the offence of 'defensive homicide' was introduced where the accused held the belief but lacked reasonable grounds (s 9AD Crimes Act 1958);
  - from 2015 a person is acting in self-defence if they believe that the conduct is necessary in self-defence and their conduct is a reasonable response in the circumstances as they perceive them (s 322K);
  - this reflects the self-defence provisions in states which adopt the Model Criminal Code.

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Second norm: *private* interests

- **Criminal law (cont'd):** self-defence can be explained on the basis the aggressor by his or her own act assumes the risk of injury (Bakircioglu, 2008). However, it is not necessary that the aggression be unlawful (*Zecevic*).
- 'Necessity' is assessed subjectively and the 'reasonableness' of the response objectively (but based on the subjective assessment of the circumstances).
- This roughly corresponds with the tort law principle that you take your victim as you find them.
- **Problem:** judges might be well equipped to assess the reasonableness of inter-personal violence, but are they equipped to second-guess business decisions?

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Second norm: *private* interests

- **Corporations law:** company directors must carry out their duties with the degree of care and diligence that a reasonable person would exercise (s 180 Corporations Act).
- However, possibly in recognition of the difficulties of judges being able to assess 'reasonableness' in the context of business decisions, s 180(2) sets out the 'business judgment rule', relevantly, that the person 'inform themselves about the matter to the extent they reasonably believe to be appropriate' and 'rationally believes' that the judgment is in the best interests of the company. Rationality is satisfied unless 'no reasonable person in their position would hold' the belief.
- There appears to be some leeway in the definition of 'rationality', though it does not quite correspond with criminal self-defence, which is based on the subjective assessment of the circumstances.

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Second norm: *private* interests

- **Tort law:** sports players voluntarily assume the risk of injury from contact permitted under the 'rules of the sport' and incidental infringements of the rules (though not to deliberate violence unconnected with the play) (Richards 2013: 149-150).
- Again, the 'lawfulness' of the conduct is not determinative, the courts assess the nature and quality of the act.
- Like 'defensive homicide', the doctrine of 'contributory negligence' facilitates judicial intervention where partial exoneration may be preferred to complete exoneration (but not in the case of intentional torts – Richards 2013: 156).
- Economic torts recognise that a firm may justifiably protect its legitimate interests (*OBG v Allan*, 2008: 63). The concepts of 'justification' and 'legitimate interests' facilitate qualitative intervention by the judges.

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Second norm: *private* interests

- **Competition law:** the plaintiff's own unlawful act does not deny the plaintiff a remedy under EU and US competition law (*Crehan*, 1998)
- In zero sum competition, the 'dual purpose problem' arises, i.e. self-interested conduct at one and the same time may harm competitors (Heerey, J in *Melway*). The legislative intent appears to be to treat such conduct as blameworthy: s 4F provides that a proscribed 'purpose' can be established if one substantial purpose among many is a proscribed purpose.
- This is akin to abrogating the doctrine of 'self-defence', and appears to have been resisted by the judges, who have held that 'purpose' refers to the 'subjective purpose' of the party (*Pont Data*, 1990, *News v South Sydney*, 2003), on the basis this is necessary to distinguish 'purpose' from 'effect'.

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Second norm: *private* interests

- **Proposition:** In 'zero sum' competition, some defence seems required analogous to 'self-defence' and 'voluntary assumption of risk' in other legal doctrines, e.g. which we might call 'meeting competition'. The ill-defined EU concept of 'competition on the merits' may be an acknowledgement.
- Conventional wisdom assumes the new entrant lacks MP and is at a disadvantage in having to overcome barriers to entry. [Structuralists argue that 'barriers to entry' are *proved* by above-normal profits; others argue that above normal profits might be otherwise explained, e.g. by success]. We have seen that a new entrant has an ability to manipulate the market, and that incumbents are locked in to markets by barriers to exit. Is there a rational basis for state intervention?

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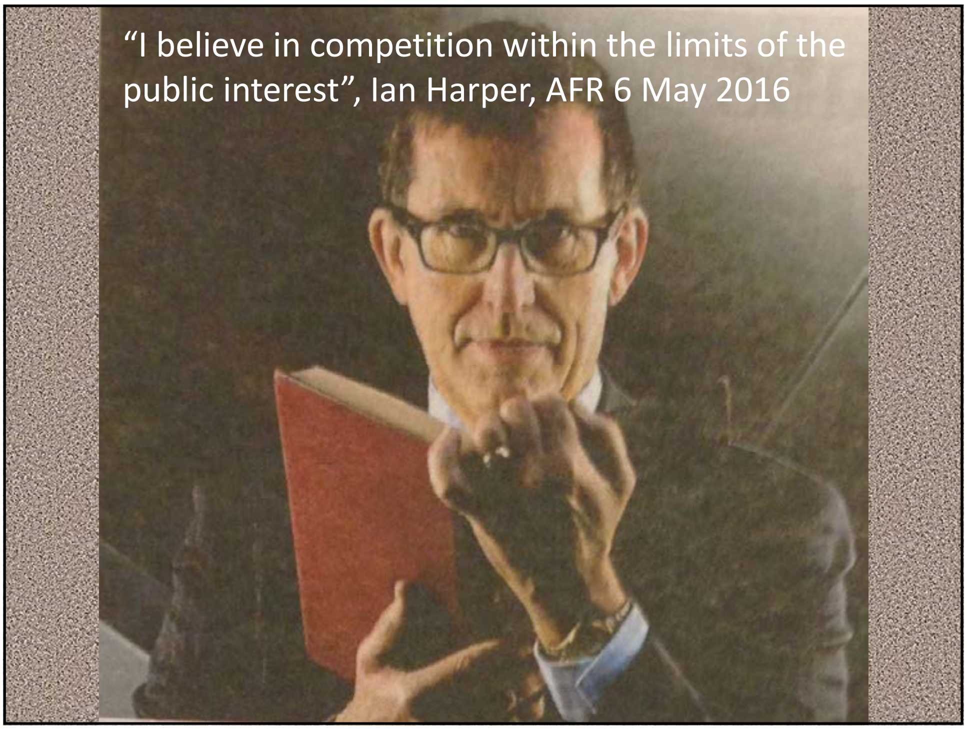

Second norm: *public* interest

- Sunstein (1989) suggests as a 'constitutional norm' that the state should not take sides when dealing with disputes or differences between its citizens, absent a public purpose.
- He goes on to argue in the antitrust context that there is no essential reason to protect small firms from large firms.
- Since we assume in the thought experiment about new entry that each firm is equally efficient, we can be indifferent as to which firm survives. There is a social cost of business failure, but that is not the concern of competition law (unlike the concerns of criminal law or tort law when two citizens injure each other).
- Thus we can propose as a norm that, absent harm to the public interest, the state should not intervene.

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What is the public interest #1?

- The Tribunal in *Qantas*, 2005 stated that redistribution of surplus between consumers and producers is not an objective of competition law (paragraphs 166-191).
- Others, e.g. Corones (2014: 35) assert that distributive equity is an objective, so efficiency gains that increase the firm's profit cannot be used to offset perceived harm to competition.
- It is suggested that the public interest is to be measured by efficiency: it is not in the public interest that a more efficient producer be excluded from the market (Williams 2013).
- **Problems:** Our experiment shows that new entry may bring price reductions at the cost of inefficiency. On the other hand, economic efficiency is indifferent to business failures of less efficient enterprises because markets and competition do that (Landes & Posner 1981; Mason, CJ and Wilson, J in *Queensland Wire*, 1989).

What is the public interest #2?

- The 'authorisation' procedure in competition law acknowledges that economic efficiency may not promote the public interest, i.e. in the real world there are externalities. [Thought bubble: are business failures due to barriers to exit such an externality?] Harper recommends the Tribunal now be permitted to authorise s 46 conduct.
- So the law provides for conduct that would otherwise contravene the law to be permitted if there are overriding public benefits. Only the Tribunal, not the courts, have the power to consider the public interest, e.g. *NT Power*, 2004.
- The EU provides a limited public interest defence, but not to abuse of dominance.
- **Proposition:** There should be a public interest defence. It makes no sense to condemn conduct that could be justified in the public interest, on the grounds that courts are ill equipped to make this judgment.

What is the public interest #2?

- Corones says the question whether efficiencies are relevant to analysis of competitive 'effects' is one of the most vexed questions in Australian competition law (2014: 39), concluding efficiencies *may* be relevant to assessing future competition (2014: 43).
- Gavil is clear that efficiency should be a defence (2008: 153-5), but acknowledges the underlying debates about welfare standards that appear to trouble Corones.
- Harper proposes modifying the competition test so the current second degree surrogate measure of harm (the 'process of competition') is considered in combination with the ultimate measure of harm, efficiency.
- We can now turn to some key Australian cases to test the proposed concept of MP and defences.

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Refusal to supply

- ***Queensland Wire*, HCA 1989**. The unanswered question is 'how do we define the supply price above which the dominant firm is constructively exercising market power (and below which the firm is lawfully deriving a monopoly profit)?'
- Pengilley 1991 says the determination of this price is a regulatory matter that is beyond the court's competence.
- The USSC in *Trinko* 2004 and *Linkline* 2008 says the court should not impose a duty to deal that it cannot explain or *adequately supervise*.
- The HCA in *Queensland Wire* evaded this responsibility by *declaring* BHP's refusal to be unlawful, and leaving it to the parties to work out the consequential detail.
- We can now attempt to fill in the gaps that the HCA and USSC have left for us.

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QWI under Market Manipulation

- BHP has power to manipulate the market. With hindsight we may doubt BHP had MP in the traditional sense (i.e. the constraint provided by the rise of Chinese steel production in the 1980s and subsequently was under-estimated).
- To address direct harm we ask: has BHP restricted supply and inflated price in any market, or has it simply charged a monopoly price to earn legitimate profits?
- We may suspect that QWI's additional productive capacity could be used to increase total output and reduce price (but this would be the case only if it is more efficient – in which case the public interest would favour state intervention).
- Proposed defences:
  - Rational business decision: BHP should not be forced to produce more than its profit-maximising output.
  - Less efficient competitor: BHP could establish a defence if QWI is less efficient in producing downstream product.

QWI under MM (2)

- **Problem:** If QWI is a more efficient downstream producer, does BHP instantly have to exit the market?
- Recalling the slide showing costs in the iron ore market, is it OK for non-dominant inefficient firms to keep trading, harming the public interest? E.g. should Arrium have exited 12 months ago rather than soldiering on and going broke? Should Atlas Iron have been permitted to raise more capital to keep trading? Is it OK if they have become more efficient e.g. Fortescue?
- **Conclusion:** there appears to be some public tolerance of firms wishing to avoid the costs of exit (so long as they reman solvent).

Harper Review

- s 46 presumes harm flows from a dominant firm 'taking advantage' of its MP. Harper says this enquiry has become bogged down in courts pondering hypothetically what a firm could or would do in the absence of MP.
- Propose removing this requirement, i.e. s 46 should prohibit anything a firm with MP does which results in a substantial lessening of competition.
- This presumes conduct, which might be innocuous if undertaken by a firm without MP, might nevertheless cause SLC if undertaken by a firm *with* MP. The Harper proposal aims to make it unnecessary to enquire into the nexus between MP and effect (other than that the defendant *has* MP). This seems like the 'strict liability' approach rejected in the US, e.g. by Hovenkamp, 2005: 246-7 who says it increases the risk of discrimination against larger more efficient firms.
- The Harper effects test requires the court to *consider* the extent to which the conduct hinders or promotes competition, e.g. creates efficiencies (a new legal enquiry in which Australian courts have no experience).

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QWI under Harper

- MP is merely an identifier used to discriminate between firms which have or do not have MP, i.e. same conduct by a firm without MP is not impugned.
- The Harper test utilises SLC: Australian courts still use a 'structural' approach, i.e. indirect or surrogacy approach to determining harm, which has been discredited overseas (and in the Competition Tribunal).
- It is unclear under current jurisprudence how the courts will interpret the words 'hinder or promote competition' and the inclusive reference to 'efficiency'.
- Standard SCP thinking suggests 'more firms' = 'more competition', but game theory suggests this is not necessarily so. The quandary in construing the Harper s 46 is how the court will determine whether QWI is a more efficient competitor, and if so, whether entry will increase or reduce efficiency.

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QWI under Harper (2)

- Harper recommends that s 46 conduct now be capable of being authorised by the Tribunal.
- Conceivably, BHP (if replayed under Harper) might seek authorisation of its supply price on the grounds of public benefits in avoiding social and economic costs of forced exit. [Noting that BHP subsequently divested its steel making assets, which have progressively become non-viable]
- This would seem to add weight to the need for a public interest defence in litigation.

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Predatory pricing

- ***Boral*, HCA 2003**. The s 46 case failed because the court held the dominant firm does not have MP in a declining market, i.e. when S>D; the dominant firm did not in fact increase its market share, nor was the (presumed more efficient) competitor forced out of the market.
- Under the Market Manipulation approach, the dominant firm has the power to manipulate the market despite oversupply. It seems that it may have done so. But the new entrant likewise has such power by expanding output in the market. Is the new entrant more efficient, and has it acted rationally or has it manipulated the market to harm Boral?

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Predatory pricing

- Note: Australia adopted changes to s 46 in 2007-8 regarding predatory pricing that take a diametrically opposed approach to the US (i.e. obviate any enquiry whether the dominant firm could have recouped losses from alleged predatory pricing).
- The Harper Review recommends repeal of those provisions (on the basis the 'effects test' solves that problem), so this presentation does not address them.

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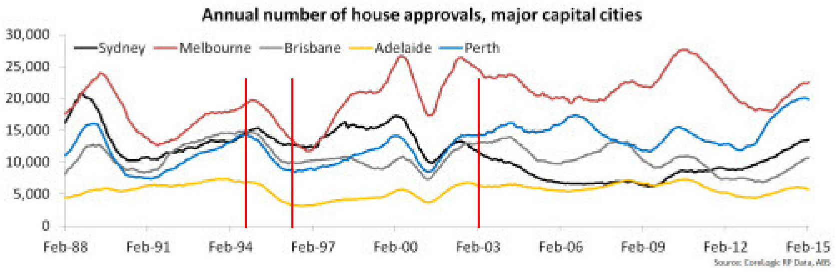
Boral market conditions



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Strategy in a declining market

- Boral's strategy was to maintain volumes in conditions similar to the iron ore markets in 2015, which is cause for conjecture about firms' strategies.
- The period in *Boral* was a 6 month period during a cyclical downturn in demand for building products. Too short a period for market effects?
- In *Boral*, Kirby, J (dissenting) argues (in effect) that dominant firms maintain volume in a declining market, knowing that will depress prices and cause others to exit. The next page could be a page from his honour's notebook (but is not – it is a simplistic attempt to understand the iron ore markets in 2015).

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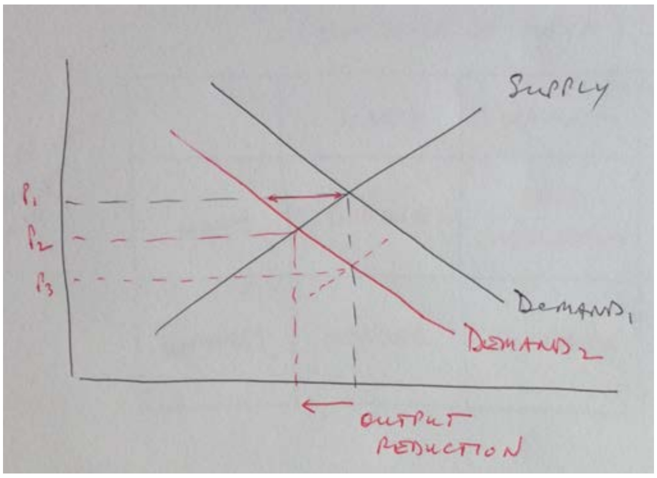
Strategy in a declining market



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Rational conduct

- Kirby, J's analysis is incorrect because some firms will be unprofitable at lower prices and will have to exit or become more efficient (and the concept of a supply curve in imperfect competition doesn't work, because output responds not to price but to marginal revenue).
- Boral's conduct would be rational if it was trying to minimise its revenue loss (i.e. revenue at P_3 is equal or greater than revenue at P_2).
- In *Boral*, the dominant firm improved its plant to become more efficient. In the current iron ore market, Fortescue says it has become more efficient. Has the market been manipulated, and if so by whom, and has economic efficiency been harmed?

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Harper s 46

- The problem for Harper is it uses the same concept of MP, which the HCA held to be absent in *Boral*.
- Thus the result under the current s 46 (causal nexus required) and Harper s 46 (no causal nexus required) in the circumstances of Boral would appear to be the same. **Proposition:** Harper appears to entrench 'asymmetric' analysis of MP, which is not justified on a Market Manipulation standard.
- Conventional wisdom suggests dominant firms can depress price more because of their market share. However, smaller firms may have power to affect price by their output decisions, and so may contribute to the 'harm' they suffer.
- If it were necessary to consider the effects test, the quandary remains whether the 'competition test' requires us to consider whether the new entrant was more efficient and if so was forced out. Subsequent events in *Boral* are equivocal: new entrant was crippled by debt and forced to sell (shortly after the HCA decision).

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Meeting competition

- ***Rural Press*, HCA 2003**. A firm in a neighbouring region enters your market. Can you respond by entering its market? If it withdraws are you both liable for cartel conduct?
- The s 46 claim failed because the HCA held no 'taking advantage' of MP. Section 46 subsequently amended to capture conduct 'materially facilitated' by MP. Harper review repeals 'taking advantage' and all that goes with it.
- The HCA effectively applied cartel conduct, because there had been communication between the parties leading to withdrawal of the new entrant.
- The HCA discussion appears critical of the incumbent's manager, Ms Price, for advocating a commercial response to the incursion, e.g. by expanding into the new entrant's home market (¶24, 45). Is this blameworthy?

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Market and Market Power

- The market concerned local newspapers in adjacent regions of South Australia. At trial these were treated as separate print media markets, not subject to competition from broader print or electronic media. No issue was raised about this on appeal to the HCA (¶27).
- Seems highly questionable, but assume that is correct for present purposes.
- If the incumbent and new entrant each can profitably enter the other's geographic market, we can arguably conclude that each has power to manipulate respective markets. [Probably also there is only one market?]
- The FCA considered that 'perfect competition' is the relevant benchmark (HCA ¶49). What norms can we apply to assess the incumbent's permitted response?

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Market manipulation

- If each has power to manipulate the market, should the state intervene, and on what basis? Should intervention apply asymmetrically?
- Proposed defences:
  - Rational business decision: has the incumbent restricted supply in its home market, i.e. are its price/output decisions in its home market rational profit-maximising decisions; should the court prevent it entering the rival's home market?
  - Less efficient competitor: which is the more efficient competitor; if both equal should the law decline to intervene?
- In a recent US decision on 'monopolisation' the court says it should not 'insert itself into the market', and on the question of efficiency, should 'let the market decide' (*Suture Express*, 2016).

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Harper s 46

- As noted above, Harper uses the same concept of MP, which must be questionable on the facts of *Rural Express*.
- Nevertheless, under the Harper s 46, where no causal nexus is required, an 'asymmetric' analysis of MP is undertaken (i.e. new entrant without MP can do things the incumbent with MP may not do).
- We again see that a new entrant may have power to affect price by their output decisions, and so may contribute to the 'harm' they suffer from competitive conduct.
- The Harper s 46 modifies the effects test, so we must apparently consider whether the new entrant was more efficient and if so was forced out (or predict whether that result is likely).
- We do not know this from the record in *Rural Express*. Presumably the court will have to insert itself in to the market and it will be the court, rather than the market, that decides this question.

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Economic efficiency

- While profit maximisation requires MC = MR, the amount of profit depends on average costs (including fixed costs) and average revenue (price). [Noting that rational business conduct does not always require profit maximisation, e.g. trade-off for growth]
- In our experiment, new entry creates inefficiencies because sharing market demand reduces profit maximising output, and duplication of capital investment raises costs.
- The result may mean that reduced consumer prices involves a redistribution of producer surplus at the cost of reducing productive efficiency. As noted above, though opinions differ on this in competition law, it is proposed as a norm that the state should not intervene to effect 'naked interest group transfers', i.e. for redistributive purposes.

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Conclusions (1)

- The current concept of MP based on a hypothetical competitive paradigm does not gel with the real world, and does not explain 'harm' in the real world, i.e. the conceptual framework and decisions on s 46 lack coherence.
- That is, while the traditional view of MP might explain real world *market manipulation*, it does not explain harm to *efficiency*, i.e. exclusion of more efficient competitors. The Harper s 46 is based on current problematic concepts of MP and harm.
- The real world 'zero-sum' competitive paradigm should cause us to adopt 'ability to manipulate the market' as our concept of MP and 'manipulation, i.e. direct interference with the market', as our concept of harm.

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Conclusions (2)

- The Harper s 46 introduces efficiency into the current effects test, without elucidating how the courts might develop negative and affirmative defences, which are acknowledged though ill-defined in the US and EU.
- Defences should be recognised, i.e. rational business decision based on expected behaviour in 'zero sum' competition (rather than perfect competition), exclusion of an equally or less efficient competitor, meeting competition, and a public interest defence similar to that available in authorisation proceedings before the Tribunal.
- Clarifying our concept of MP and defences as suggested above would create an internally consistent, i.e. coherent, approach to s 46 cases which would do much to dispel perceptions that judges decide cases based on undisclosed policy criteria.

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