

**The Decision of the High Court in *Rural Press*:
How the literature on credible threats may have
materially facilitated a better decision***

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The decision of the High Court in *Rural Press* found that Rural Press and Bridge did not take advantage of their market power in issuing a threat to Waikerie to withdraw from the Murray Bridge market. The High Court adopted the reasoning of the Full Federal Court in finding that the threat was credible because any firm with the material and organisational assets of Rural Press and Bridge would have found it profitable to enter the Riverland market. The game theoretical literature on the credibility of threats demonstrates that this logic is flawed in that only non-profitable entry would have given credibility to the threat. In addition, that literature shows how the ACCC might have gone about trying to satisfy the courts that the conduct of Rural Press and Bridge might have constituted a taking advantage.

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1. Background to *Rural Press*

The facts

Rural Press was the publisher of a number of regional newspapers around Australia.¹ One of its wholly-owned subsidiaries, Bridge, published a newspaper called *The Standard* in a town called Murray Bridge. *The Standard* circulated in an area that included the town of Mannum (“Rural Press area”). In the nearby Riverland area, the Waikerie Printing House (Waikerie) published a newspaper called the *River News* that was initially distributed only in that area.²

In the second half of 1997, Waikerie began selling the *River News* in the Rural Press area.³ Rural Press reacted by threatening Waikerie that, unless it reversed this decision, Rural Press would consider establishing a rival newspaper in the Riverland area to compete with the *River News*.⁴ This threat was evidenced by written correspondence from Rural Press management to Waikerie management.⁵ In April 1998, Waikerie effectively withdrew the *River News* from the Rural Press area.⁶

The ACCC had originally claimed three key breaches of the *Trade Practices Act* – a contract, arrangement or understanding that had the purpose and effect of substantially lessening competition in a market (ss45(2)), an exclusionary provision (as defined in s4D) and a misuse of market power (s46). The Federal Court initially found in favour of the Commission on all three claims.⁷ However, the Full Federal Court upheld an appeal by Rural Press on the s46 and s4D claims.⁸ Rural Press then appealed to the High Court of Australia on the ss45(2) claim and the ACCC cross-appealed on the s46 and s4D claims.⁹

¹ *Rural Press Limited v Australian Competition and Consumer Commission; Australian Competition and Consumer Commission v Rural Press* [2003] HCA 75 (“Rural Press decision”), paragraphs 16-17.

² *Rural Press decision*, paragraph 19.

³ *Rural Press decision*, paragraphs 21-22.

⁴ *Rural Press decision*, paragraphs 23-24.

⁵ *Rural Press decision*, paragraphs 24 and 32-33.

⁶ *Rural Press decision*, paragraphs 25-26.

⁷ *Rural Press decision*, paragraph 13.

⁸ *Rural Press decision*, paragraph 14.

⁹ *Rural Press decision*, paragraph 15.

The High Court rejected the appeals on the s45 and s46 claims. This paper focuses on the appeal regarding the alleged misuse of market power under section 46. In this context, we note that there was no dispute at the High Court about the finding that Rural Press had market power in a relevant market (the sale of regional newspapers in the Murray Bridge area) or the finding that Rural Press had a proscribed purpose in making the threats to Waikerie. The High Court's decision was solely over whether Rural Press took advantage of its market power in engaging in the relevant conduct.

Reason the Commission failed

The High Court did not accept the Commission's contention that Rural Press took advantage of its market power in making the threats to Waikerie Printing.¹⁰ The Commission had argued that Rural Press would not have made the threat if Rural Press did not have market power.¹¹ The Commission claimed that Rural Press's market power facilitated its conduct by giving its threat a significance it would not otherwise have had, drawing on the *Melways* decision.¹²

However, the High Court was not convinced that Rural Press's market power gave its threats any additional significance to the significance those threats would have had in any case by virtue of Rural Press's material and organisational assets.¹³ The High Court found that:

The Commission failed to show that the conduct of Rural Press and Bridge was materially facilitated by the market power in giving the threats a significance they would not have had without it. What gave those threats significance was something distinct from market power, namely their material and organisation assets.¹⁴

The High Court instead characterised the impact of Rural Press's market power as going to the purpose of its decision to engage in the threatening conduct.¹⁵ The Commission's argument had therefore, according to the High Court, confounded purpose and taking advantage.¹⁶

¹⁰ *Rural Press decision*, paragraphs 51-53.

¹¹ *Rural Press decision*, paragraph 50.

¹² *Ibid.*

¹³ *Rural Press decision*, paragraph 53.

¹⁴ *Ibid.*

¹⁵ *Rural Press decision*, paragraph 51.

¹⁶ *Ibid.*

2. Market Power and Economic Profits

The only issue before the High Court with respect to s 46 was whether the conduct of Rural Press constituted a taking advantage of their substantial market power. The market in which Rural Press and Bridge were found (at trial and at the Full Federal Court) to have substantial power was the Murray Bridge newspaper market.

The judgment of Mason CJ and Wilson J in *Queensland Wire*, defined market power as follows:

Market power can be defined as the ability of a firm to raise prices above the supply cost without rivals taking away customers in due time, supply cost being the minimum cost an efficient firm would incur in producing the product: see Fuller, "Article 86 EEC: Economic Analysis of the Existence of a Dominant Position", (1979) 4 *European Law Review* 423 at p. 428. Section 46(3), which was added in 1986 by the *Trade Practices Revision Act*, provides that in determining the degree of market power a court should consider "the extent to which the conduct of [the defendant] in that market is constrained by the conduct of ... competitors, or potential competitors ...".¹⁷

The two elements of this definition are linked together by economic theory that dates back to the middle of the eighteenth century. If price is raised above the long-run competitive level for long periods of time, economics would predict that other incumbents or potential new entrants will try to share in the high profits that are being earned by the incumbent(s).

So if a firm is facing a strong threat of competition from other incumbents or from potential entrants, it will not be able to sustain a high rate of profit, that is, it will not be able to sustain 'prices above supply cost,' because these competitors will attempt to replicate the activities that lead to the high profits. It is only when a firm is free of such threats that it will be able to sustain a high rate of return on the funds that it has invested.

3. A Simple Model of the Possible Conduct of the Parties

Game theory has a well-developed literature on the nature of threats and when to regard them as credible. We can use this literature to

¹⁷ *Queensland Wire Industries Pty Ltd v The Broken Hill Proprietary Company Limited & Anor* (1989) ATPR 40-925 pp 50,008-9.

analyse the behaviour of Bridge and Waikerie. To do this, we shall produce a stylised version of the facts. The version that we give is needed to illustrate certain general principles of the literature. These principles hold whether or not we have represented the facts of the case too simplistically.

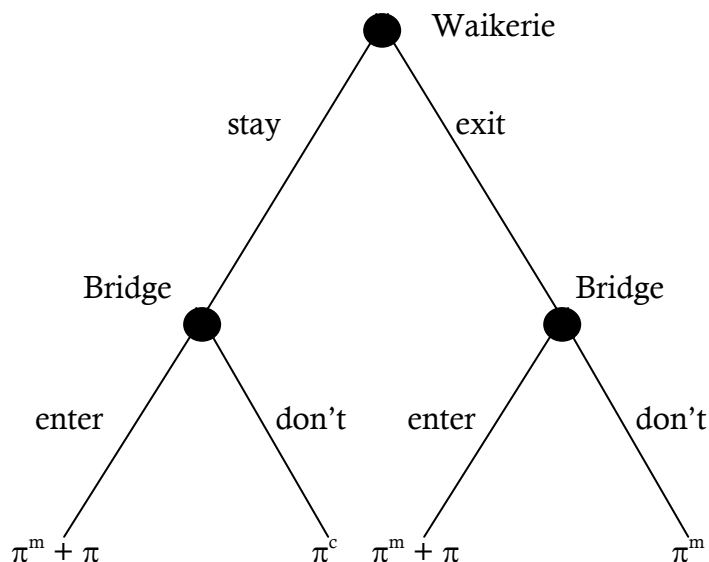
Economics tends to analyse conduct by assuming that businesses seek to maximise profit. Of course, not all businesses seek to maximise their profits; and some businesses wish to maximise their profits but behave in ways that seem to be quite inconsistent with the maximisation of their profits. Nevertheless, economics persists with its assumption of profit maximisation because it has been found the best way of explaining fundamental trends in business behaviour. For example, the link between profits and competition that was outlined in the previous section is contingent on the assumption of profit maximisation.

Consider the following simple game theoretic model that is based on the facts in *Rural Press*. The model is only based on the facts of the case because the reader must consider what were the options available to Waikerie and Bridge prior to the behaviour that the subject of the litigation.

In this model, Waikerie has a choice – it can stay in Murray Bridge or exit. Bridge also has a choice – it can enter Riverland or not. Suppose that Bridge's expected profits from that market would be π . We can also assume that for Bridge, its profits in Murray Bridge would be π^m if Waikerie were not in that market and π^c if both players were competing in the market.

Before we analyse the effect of the threat, consider the case in which Waikerie 'moves first' by choosing whether to stay or exit in Murray Bridge and then Bridge, observing this decision, chooses to enter or not. It is customary to represent games that involve sequential decision of this kind in the form of a game tree (Figure 1).

Figure 1: Simple Game



Each node (i.e., black circle) on the tree represents a decision; and the firm which makes that decision is named against the node. The tree involves a 'root' node representing the point where Waikerie chooses to stay or exit. That decision moves us down a particular branch to another node. Regardless of the branch taken, Bridge has a node with two branches representing its choice to enter or not. At the end of those branches we write Bridge's ultimate payoff. If Bridge were to choose to enter the Riverland market its payoff includes its overall Riverland profits of π . However, its profits in the Murray Bridge market depend upon whether Waikerie earlier chose whether to stay or exit that market. If Waikerie enters the Murray Bridge market and Bridge retaliates by entering the Riverland market, we assume that Waikerie will succumb to that move by withdrawing from the Murray Bridge market.¹⁸

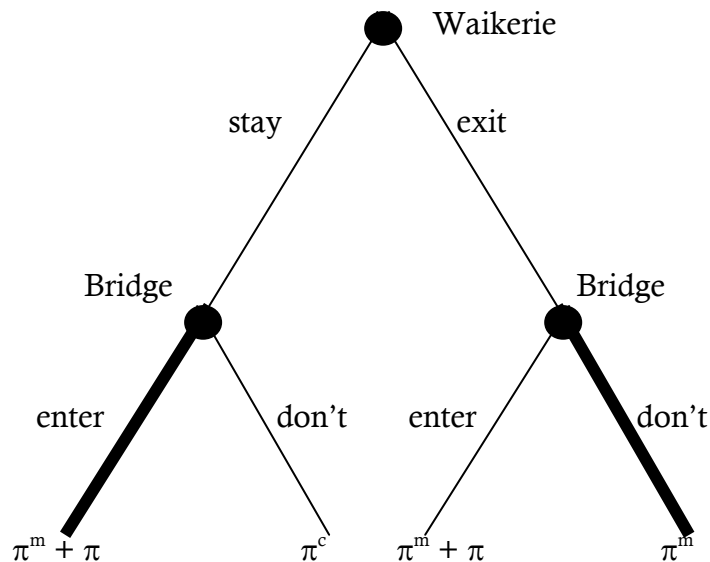
The diagram can be read as follows:

¹⁸ There is a subtle issue here as to whether Waikerie would exit the Murray Bridge market in response to the Bridge's entry in its own market. In this exposition, we treat it as an assumption. However, why this is so is not modelled here. In a more comprehensive game, it is possible to demonstrate that this would be Waikerie's appropriate response. The full model is provided in the technical appendix to this paper.

1. If Waikerie decides to enter the Murray Bridge market and Bridge decides to retaliate by entering the Riverland market, Waikerie will retreat to the Riverland market and Bridge's profit will be the (monopoly) profit in the Murray Bridge market and the (competitive) profit in the Riverland market.
2. If Waikerie decides to enter the Murray Bridge market and Bridge decides not to enter the Riverland market, Bridge will earn the competitive profit in the Murray Bridge market.
3. If Waikerie decides not to enter the Murray Bridge market and Bridge decides to enter the Riverland market, Bridge will earn the monopoly profit in the Murray Bridge market, the (competitive) profit in the Riverland market and it will have incurred the cost of entering the Riverland market.
4. If Waikerie decides not to enter the Murray Bridge market and Bridge decides not to enter the Riverland market, Bridge will earn the monopoly profit in the Murray Bridge market.

We are now in a position to examine the effect of the threat that Bridge made. In terms of Figure 1, the threat was designed to eliminate two of the four possible plays. This is represented in Figure 2. The threat is designed to convince Waikerie that Bridge will choose the blocked-in strategy - depending on whether or not Waikerie decides to exit the Murray Bridge market. Specifically, the threat is a contingent one: if Waikerie stays, Bridge will enter but if Waikerie exits, Bridge will refrain. On the game tree (Figure 2), this threat is illustrated by the two highlighted branches. From a game theoretic perspective, for this threat to be effective, Waikerie must believe that the highlighted actions will actually be undertaken by Bridge if it reaches each respective node. It is only in this case that the threat itself can be considered credible.

Figure 2: The Threat



4. Credible Threats

Game theory tells us that a threat will only be effective if it is credible; and a threat will only be credible if the threatened party believes that the person who issues the threat will act upon it.

Dixit and Skeath¹⁹ present the example of the parents who threaten their children that if they fail to eat their vegetables they will get no dessert. The threat will only be effective if it is credible. That is, it will only be effective if the children (who can reason things through at least as effectively as the parents!) believe that the parents will carry through with the threat. This requires that, when the time comes for dessert, the parents will find it in their interest to deny dessert to the children who have failed to eat their vegetables.

If the children know that their parents are soft-hearted, the threat will not be credible. The children will not eat their vegetables because they know that, whether they eat their vegetables or not, they will be served their dessert.

¹⁹ Avinash Dixit and Susan Skeath, *Games of Strategy*, WW Norton, 1999, 292 ff.

The game-theoretic analysis of threats argues that a threat will only be credible if, when it comes to acting on the threat, it will be in the profit-making interests of the firm that issued the threat to carry it out. In this circumstance, the firm that is subject to the threat will take the threat seriously.

Will the threat by Bridge, as represented in our game tree, be credible? That depends on the magnitude of the pay-off expressions for Bridge. Waikerie will believe the threat to be credible if Bridge, when ultimately faced with its choice, will find it profitable to take the highlighted action. Specifically,

1. (*Costly Punishment*) If Waikerie exits, Bridge will only choose not to enter if $\pi^m > \pi^m + \pi$ or, equivalently, that $\pi < 0$.
2. (*Probable Recoupment*) If Waikerie stays, Bridge will only choose to enter if $\pi^m + \pi > \pi^c$.

If these conditions hold, Bridge's conditional threat, to enter if Waikerie stays, and not otherwise, will be credible.

The first of these conditions requires that, if Waikerie does not enter, Bridge will *not* enter the Riverland market. For this to be the case, entry into the Riverland market, taken by itself, must be unprofitable for Bridge. This is a standard proposition from the theory of threats: that a threat is only credible if it is costly to the person issuing the threat.

Consider the example from Dixit and Skeath of the threatening parents. If the parents are malicious, they are likely to deny the children dessert whether they eat their vegetables or not. The children will not find the threat credible because they are likely to be denied dessert in any event. This leads Dixit and Skeath to point to a standard lesson from game theory:

Therefore an essential aspect of a threat is that it should be costly for the threatener to carry out the threatened action. In the dinner game, the parent must prefer to give the child desert. Threats in the true strategic sense have the innate property of imposing some cost on the threatener too; they are threats of *mutual harm*.²⁰

The second condition says that Bridge would only choose to enter as a means of punishing Waikerie if carrying out the punishment is

²⁰ *Ibid.*, p 292, emphasis in original.

profitable at that point. Recall that π^m is the profit Bridge expects to earn in Murray Bridge if enters Riverland and π^c is the profit Bridge expects to earn in Murray Bridge otherwise. Recall, also, that the first condition required that entry to Riverland, by itself would be unprofitable for Bridge. This means that the second condition demands that π^m exceed π^c by a big margin – sufficient to compensate Bridge for entering the Riverland market.

Put simply, this means that the benefit of carrying out the punishment ($\pi^m - \pi^c$) must exceed the cost (π). This is precisely the same type of calculation that arises in analyses of predatory pricing; that is, is it likely that the predator will recoup the losses it makes during the predatory period. What differs in this case is that the predatory act (here counter-entry) was not actually carried out. However, the very fact that the desired behaviour (exit by Waikerie) did occur gives support that it, at least, believed that such recoupment was likely and that Bridge would indeed have carried out the punishment.

Thus, Bridge's threat will only be credible if Waikerie's exit allows Bridge to raise prices and earn monopoly rents for a sustained period – either because there were no other tough competitors in Murray Bridge or no potential entrants constraining price. In that case, π^m would be sufficiently high relative to π^c .

The same reasoning can be applied to the example of the threatening parents. The threat to serve no dessert will only be credible if the children know that the parents will not be overwhelmed by their sorrow at seeing the child denied dessert. If the parents see that the carrying out of the threat will yield large benefits in the future because their children will eat more-healthy food (and that this benefit outweighs the temporary pain the parents suffer by seeing their child unhappy one evening) the threat will be credible.

The second condition for credibility provides the reason why the market power of Bridge may have (to use the words of the High Court) 'materially facilitated' the conduct of Bridge 'in giving the threats a significance they would not have had without it.'²¹ Without the market power, the threat would not have been credible because recoupment would be unlikely. Indeed, the greater the market power of Bridge, the more likely is it that the threat would have been credible.

²¹ Para 53.

5. Credibility and the High Court's Findings

The decision of Gummow, Haynes and Heydon JJ summarises the findings of the Full Federal Court. In the course of this summary, they say:

Rural Press and Bridge could have credibly threatened to enter the Riverland market, and could have actually entered it, regardless of whether they had a substantial degree of power in the Murray Bridge regional newspaper market.²²

In giving the reasons for their decision with respect to taking advantage, Gummow, Haynes and Heydon JJ refer to this finding of the Full Federal Court: "... that Rural Press and Bridge were in the same position as if they had been new entrants to the Murray Bridge market, lacking market power in it but possessing under-utilised facilities and expertise."²³ This suggests that Bridge's threat to enter the Riverland market was credible because entry would have been profitable for any business that had the same under-utilised facilities and expertise as had Bridge.

As we showed in Section 4 of this paper, this reasoning is inconsistent with the game-theoretic literature on credible threats. That literature argues that a threat will only be credible if it is costly to the party that issues the threat. If any firm with the material and organisational assets of Bridge would have found it profitable to enter the Riverland market then Bridge's threat would not have been credible. It would not have been credible because Bridge would be likely to enter that market whether or not Waikerie withdrew from the Murray Bridge market.²⁴

The reasoning of the Full Federal Court and the High Court commit the mistake of arguing that the parents' threat to deny their children dessert is credible because the parents are malicious and they will always deny their children dessert. Malice may explain why the parents may deny their children dessert; but the malice of the parents will not materially facilitate the eating of the vegetables. The children will have learnt that their parents are malicious; and the children will understand that eating vegetables will not solve this problem.²⁵

²² Para 49.

²³ Para 53.

²⁴ Indeed, the very fact that Bridge did not (and has not) entered that market belies this conclusion.

²⁵ Of course, there is a subtle difference between child rearing and anti-competitive threats in

That is, to be effective, the threat has to be (in the words of counsel for the ACCC) conditional. Dixit and Skeath explain this with reference to their parent example:

A strategy must specify what you will do in each eventuality along the game tree. Thus, “no dessert if you don’t finish your vegetables” is an incomplete specification of the strategy; it should be supplemented by “and dessert if you do.” Threats generally don’t specify this latter part. Why not? Because the second part of the strategy is automatically understood; it is implicit. And for the threat to work, this second part of the strategy – the implied promise in this case – has to be automatically credible too.²⁶

To use a threat to modify behaviour requires that the threat not be carried out if the behaviour is modified. If a malicious parent reneges on the promise, the child will learn not to believe the promise. Had Bridge entered Riverland anyway, what reason would Waikerie have had to exit the Murray Bridge market that it had assessed was profitable?

The game-theoretic literature on the credibility of threats teaches that a conditional threat, of the kind Bridge made to Waikerie will only be credible if: (i) the threat is costly; and (ii) carrying out the threat will lead to such an improvement in profits in the home market that it will be worth incurring the cost of entering the new market. Considering evidence of both of these conditions should be critical for the analysis of misuse of market power in such cases.

6. Conclusion

The Full Federal Court and the High Court were alert to the issue of the credibility of threats. However, they did not have before them the literature from game theory as to what makes a threat credible. The ACCC could have used this literature to guide their presentation of their case – in which case they may have been able to show that the conduct of Bridge in issuing the threat did indeed constitute a taking advantage of its market power. Specifically, the threat would not otherwise have been effective in modifying Waikerie’s behaviour. Furthermore, access to the literature on credible threats by the Full

that the child, left with only vegetables, will eventually eat (maybe not today but some day).

²⁶ Dixit and Skeath, 292. The basic issue here has some similarity to the economic treatment of international trade or other sanctions. See Jonathan Eaton and Maxim Engers, “Sanctions: Some Simple Analytics,” *American Economic Review*, Vol.89, No.2, May 1999, pp.409-413.

Federal Court and the High Court would have prevented their error in classifying a costless threat as credible.

Technical Appendix

Here we provide a dynamic model of entry based on the model of ‘sanctions’ by Jonathan Eaton and Maxim Engers.²⁷ Suppose we have two firms – A and B – who are the monopolists in two markets of the same name. Firm i earns $\bar{\pi}_i^i$ in its own market if it has a monopoly and $\underline{\pi}_i^i$ if it does not. Suppose that each firm discounts the future with a discount rate of $\delta > 0$.

The *Rural Press* scenario involves a situation where one firm, A, has entered the B market. We need to suppose that $\underline{\pi}_A^B > 0$ (i.e., the profits from such entry are positive for A) for this to be plausible. We also assume that if A exits, then B does not find it profitable to enter: that is, $\underline{\pi}_B^A < 0$.

The game’s extensive form is as in Figure A. What are the possible subgame perfect equilibrium outcomes? There are two.

1. Credible Entry Threat Equilibrium

Suppose that B plays a trigger strategy: enter if A stays and not otherwise. And that as a result A exits. Clearly, not entering if A exits is credible as $\underline{\pi}_B^A < 0$.

Is the entry threat credible? If A chooses to deviate once and stay a single period, then B enters. For this entry to be credible, A must earn more profits from entering than not. That is,

$$\underline{\pi}_B^B + \underline{\pi}_B^A + \frac{\delta}{1-\delta} \bar{\pi}_B^B \geq \frac{1}{1-\delta} \underline{\pi}_B^B \Rightarrow \frac{\delta}{1-\delta} (\bar{\pi}_B^B - \underline{\pi}_B^B) \geq -\underline{\pi}_B^A$$

But also, given this threat, A must not find it profitable to deviate and stay. This will not be profitable if:

$$\underline{\pi}_A^A + \underline{\pi}_A^B < \bar{\pi}_A^A$$

2. Competitive Equilibrium

Suppose that $\underline{\pi}_A^A + \underline{\pi}_A^B \geq \bar{\pi}_A^A$. In this case, A will not exit following B’s entry. For B to find entry profitable under these conditions requires that:

²⁷ J. Eaton and M Engers, “Sanctions: Some Simple Analytics,” *American Economic Review*, Vol.89, No.2., May 1999, pp.409-414.

$$\frac{1}{1-\delta}(\underline{\pi}_B^B + \underline{\pi}_B^A) \geq \frac{1}{1-\delta} \underline{\pi}_B^B$$

which cannot hold if $\underline{\pi}_B^A < 0$. Thus, in this equilibrium, A stays and B does not enter.

This analysis confirms the conditions underlying the simple ('once off') game described in the body of the paper.

Figure A: Dynamic Game

