Structural and Behavioural Market Power under the *Trade Practices Act*: An Application to Predatory Pricing

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Recent trade practices decisions in Australia emphasise a structural approach to market power. Modern economic analysis, however, highlights situations where firms that currently lack 'structural' market power may engage in strategic behaviour aimed at altering market structure. Such firms have 'behavioural' market power in the sense that their conduct is inconsistent with competitive behaviour and aims at creating structural market power. Predatory pricing provides a simple example of such strategic behaviour and the current Australian approach to market power may fail to detect such behaviour. In this paper, we consider how the approach to market power under s 46 of the *Trade Practices Act* has evolved over time and how this approach now differs from underlying economic principles. We discuss how existing provisions of s 46 can be consistently interpreted to allow for firms that have either structural market power or behavioural market power. We argue that by either recognising the legitimacy of behavioural market power or by taking a broader approach to market definition that encompasses a time period long enough to detect structural change, the courts can effectively use the current Act to determine if a firm with substantial market power has taken advantage of that power for an anti-competitive purpose

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1 Introduction

The determination of market power under s 46 of the *Trade Practices Act 1974* (Cth)[1] has gained prominence following the recent decision of the High Court in *Boral*,[2] and the Full Federal Court in *Universal Music*.[3] In both of these cases, firms that had been prosecuted for an abuse of market power under s 46 and been found to have violated that section by lower courts, had their appeals upheld by higher courts. In each case, the courts decided that the firms lacked the necessary substantial degree of market power required by the Act.

The decisions by these courts highlight a structural approach to market power that is at odds with the modern economic analysis of market power. The test for determining whether a firm has market power for the purposes of s 46 largely focuses on the ability of the defendant firm to raise its price above a competitive level of pricing. However, this is a narrow view of market power that focuses on the current structure of the market. It does not take account of the dynamic nature of markets and avoids consideration of firm conduct that is aimed at altering the structure of the market. Further, there appears to be a reluctance by the Courts to infer substantial market power from anti-competitive behaviour that goes beyond the bounds of standard competitive conduct. Thus, a firm that has an ability to behave in a way that is detrimental to competition over the longer term – what we call behavioural market power – but that is not able to significantly raise prices in the short term due to the current structure of the market, appears to be exempt from a claim of abuse of market power under s 46.

The structural concept of market power that has been developed and adopted by the Australian courts creates significant concerns for the effectiveness of s 46. This is most obvious in cases of putative predatory pricing. Predatory pricing is *generally* seen to be a pricing strategy entered into by one firm that incurs a loss in the short run in order to eliminate equally efficient or more efficient competitors. This elimination of rivals enables the firm to raise prices in the long run. The short-run loss is incurred as a result of cutting prices below cost.

1 Referred to as "the Act".
2 *Boral Ltd v Australian Competition and Consumer Commission* [2003] HCA 5 ("*Boral* (High Court)").

A test for market power based on current market structure is clearly at odds with the very notion of predatory pricing. Why should the plaintiff have to prove that the defendant firm could most likely raise prices in order to show that it engaged in an anti-competitive strategy of price cutting?

This suggests that, under its current interpretation, the law in Australia does not cover cases of predatory pricing where the predator was unable to raise its prices at the time when it cut its prices. This anomaly was pointed out back in 1977, when the provisions of s 46 prevented corporations in a position "substantially to control a market" from taking advantage of their market power. Justice Breyer (as he was then known) wrote:

> "the Act does *not* prohibit predatory pricing when carried out by a firm with a comparatively small share of the market – a firm that may have large financial resources behind it. If such a firm engages in predatory pricing before it obtains control of the market, but then ceases its practice once it succeeds, it may remain free of s 46."[4]

In 1986 the wording of the provision was revised. Corporations needed now to only have a "substantial degree of power in a market" to be liable to prosecution under s 46.[5] The Explanatory Memorandum accompanying the bill explained that the conduct expected to fall within this provision included predatory pricing. However, there was a proviso. The Explanatory Memorandum made it clear that:

> "it would be necessary to establish the requisite degree of market power and that advantage had been taken of the power for one of the specified purposes."

In order to satisfy the provisions, the "predator" must have a substantial degree of market power. They must use that market power in order to eliminate or damage a victim; prevent entry; or deter or prevent competitive conduct. However, predation does not require the type of structural market power that Australian courts require when investigating s 46 claims. As we discuss in section 3 below, the structural definition afforded to market power by the

[3] *Universal Music Australia Pty Ltd v Australian Competition and Consumer Commission* [2003] FCAFC 193 (22 August) ("*Universal* (Full Federal Court)").

[4] Justice Breyer (1977) "Five Questions about Australian Anti-Trust Law" 51 *Australian Law Journal* 63, at 69.

[5] *Trade Practices Revision Act 1986* (Cth).

courts does not accord with the necessary elements for a successful predatory pricing scheme.

This failure to enable successful prosecution of predation is perhaps the clearest example of the gap in the provisions of Part IV of the Act. Firms deemed not to have a substantial degree of structural market power can still engage in conduct that is contrary to competition in order to alter market structure and achieve structural market power. This gap in the law arises due to the way in which the provisions of s 46 have been interpreted. Courts have in essence treated the three hurdles of s 46 cases in isolation.

In this paper, we consider how the approach to market power under s 46 has evolved over time and how this approach now differs from underlying economic principles. We also discuss how existing provisions of s 46 can be consistently interpreted to allow for firms that have either structural market power or behavioural market power. While amendment to the Act to overcome difficulties in the interpretation of market power is possible in the future, we do not canvass such amendments in this paper.[6] Rather, we note that by either recognising the legitimacy of behavioural market power or by taking a broader approach to market definition that encompasses a time period long enough to detect structural change, the courts can effectively use the current Act to determine if a firm with substantial market power has taken advantage of that power for an anti-competitive purpose.

Firms that have, over time, acquired structural market power by engaging in strategies while in a structurally competitive market could be successfully prosecuted were the courts are willing to take a broader view when determining the existence of market power. Essentially, judges have taken a very static and very structural approach to s 46, whereas what is required in the analysis of predatory pricing is an approach which examines the strategic nature of the behavior and the dynamic setting. As industrial economist Oliver Williamson argues:

[6] Geoff Edwards (2003) 'The hole in the section 46 net: The Boral case, recoupment analysis, the problem of predation and what to do about it' 31 *Australian Business Law Review* 151 at 169 briefly discusses potential amendments to s 46.

> "[P]redatory pricing involves strategic behavior in which intertemporal considerations are central. Static economic models that fail to capture these attributes miss crucial features of the predatory pricing issue."[7]

Section 2 of this paper discusses the ways in which the judiciary has interpreted the term "market power". Starting with the *Queensland Wire* case[8] and working through to the recent High Court decision in *Boral*, it can be seen that Australian courts have largely preferred a structural approach to market power. Section 3 examines modern theories about predation and explicitly outlines why the notion of structural market power which has perpetuated throughout s 46 cases is not a necessary element for predation. In Section 4 we examine the nature of the gap in law that allows firms in *prima facie* competitive markets to predate their rivals. We also discuss the various welfare effects of predation and discuss whether we should care about the existence of this gap in the law.

Section 5 discusses two possible ways in which the judiciary can broaden their approach to determining the existence of market power. The first way is to explicitly acknowledge the fact that the conduct of a firm can indeed influence the structure of the market. Courts can thus examine whether firms have the ability to engage in behaviour which would enable them to acquire more structural market power. Alternatively, courts could take a longer run approach to the issue of market definition and market power. By doing this, the courts can see whether the firm in question has had "structural market power" at either the implementation of the strategy or at the completion of the strategy. These interpretations of s 46 would enable the courts to successfully prosecute conduct which currently 'falls through the gap'.

2 Market Power under Section 46

2.1 Legislative requirements

Section 46 of the Act stipulates that a corporation with a substantial degree of power in a market shall not take advantage of that power for a proscribed purpose: eliminating or

[7] Oliver E Williamson (1987) *Antitrust Economics: A Strategic and Welfare Analysis*, at 225.

substantially damaging a competitor; preventing entry into a market; or deterring or preventing rivals from entering in competitive conduct.

Section 46 erects three hurdles that a plaintiff must clear in order to establish that a defendant has misused their market power:

1. does the defendant have a substantial degree of market power?
2. has the defendant taken advantage of that power?
3. did the defendant use the power for a proscribed purpose?

While all three hurdles must be satisfied, it is not sufficient to have mere co-existence of all three hurdles. There must be a causative element involved. As a result, the sequential nature of these three questions has largely been adhered to by Australian courts. This 'traditional' analysis adopted by the High Court in cases such as *Queensland Wire*, *Melway*[9] and, more recently, *Boral*,[10] has meant that the issue of whether the defendant has a substantial degree of market power is essentially examined in isolation. If the question is answered in the negative, the two remaining questions are rendered irrelevant.

The Act itself does not furnish us with a definition of "market power." It is left for the judiciary to determine what the phrase actually means in the context of Australian law. However, subsection 46(3) of the Act provides that in the determination of the degree of market power the court should make reference to the extent that the firms are constrained by competitors or potential competitors in that market; or constrained by customers or suppliers in that market.

2.2 Queensland Wire

The High Court's first major decision in relation to misuse of market power was decided in 1989. In this case, *Queensland Wire*, there was little doubt as to whether the defendant firm in question, BHP, had a substantial degree of power in the market for steel and steel products.

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8 *Queensland Wire Industries v Broken Hill Proprietary Co Ltd* (1989) 167 CLR 177 ("*Queensland Wire*").

9 *Melways Publishing Pty Ltd v Robert Hicks Pty* Ltd (2001) 178 ALR 253 ("*Melway*").

10 The judgments in the first instance and finality in *Boral* are symptomatic of the emphasis placed on structural elements of market power. First instance: *Australian Competition and Consumer Commission v Boral Ltd* [1999] FCA 1318 (Heerey J); High Court: *Boral* [2003] HCA 5 (High Court) (see esp, the judgments of Gleeson CJ and Callinan J).

In this case, BHP were charged with refusing to supply certain steel products and market power was not really an issue in the case. As Dawson J noted:

> "BHP clearly has a substantial degree of market power however widely the market is drawn."[11]

As a result, there was little need to discuss market power at any length. Nonetheless, two key judgments from the *Queensland Wire* have influenced the interpretation of "market power" in Australian cases. The first, a joint judgment by Mason CJ and Wilson J, primarily examines the power of the defendant firm to raise prices above costs. The other important judgment, delivered by Dawson J, takes a broader view and acknowledges that market power can be evidenced by persistent anti-competitive behaviour.

2.2.1 *The Approach Taken by Mason CJ and Wilson J*

Mason CJ and Wilson J adopted a relatively narrow approach to market power that has it origins in classical economics. Primarily, market power is defined by reference to the price constraints faced by the defendant. Alluding to a paper by economist Charles Baden-Fuller, they define market power as:

> "the ability of a firm to raise prices above the supply cost without rivals taking away customers in due course, supply cost being the minimum cost an efficient firm would incur in producing the product."[12]

This focus is in accordance with the traditional definition that economists have attributed to the term "market power". The approach that economists have traditionally taken assumes that power in a market can be defined by reference to the influence on market prices. This traditional analysis of market power is reflected in the work of a number of prominent industrial economists.[13]

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[11] *Queensland Wire* (1989) 167 CLR 177, at 201 (Dawson J).

[12] *Queensland Wire* (1989) 167 CLR 177, at 188 (Mason CJ and Wilson J) citing Baden-Fuller, Charles, 'Article 86 EEC: Economic Analysis of the Existence of a Dominant Position,' (1979) *European Law Review* 423, at 428.

[13] See for example, the following definitions proffered by industrial economists. Lawrence A Sullivan, *Antitrust* (1977), at 30: "the power of a firm to affect the price which will prevail on the market in which the firm trades"; William A Landes and Richard A Posner, 'Market Power in Antitrust Cases' (1981) 94 *Harvard Law Review* 937, at 937: "the ability of a firm (or a group of firms, acting jointly) to raise price above the competitive level without losing so many sales so rapidly that the price increase is unprofitable and must be rescinded"; Phillip E Areeda, John L.

Although it is not made explicit in the judgment, when economists refer to the notion of "price" in this context, they do not merely refer to the dollar amount that a good or service can be bought or sold for. The term "price" encompasses a range of factors such as the terms and conditions of sale and the quality of the product sold. Thus, from an economic perspective a firm might effectively raise the 'price' of a product by reducing the quality of the product while holding the monetary price fixed. Similarly, a reduction in the terms and conditions of sale is a rise in price from an economic perspective even if the monetary price is unchanged. Effectively, the price rises from an economic perspective whenever the terms of trade become more favourable to the seller and less favourable to the buyer.

The fact that price does not merely refer to the monetary value ascribed to the product has served as a source of confusion in some cases,[14] but the correct economic interpretation of price in this context was clearly enunciated by Hill J in the *Universal* case.[15]

In examining whether a firm has this "ability to raise prices above the supply cost," Mason CJ and Wilson J note that the courts can examine certain proxies for market power. As the issue of market power was not at issue in the case, the judges do not provide an exhaustive list of factors that should be taken into account when deciding the issue of market power. Rather, they merely discuss two important factors that can be used: market share and concentration; and the existence of barriers to entry.

Their Honours noted that market share and concentration is an important factor, but is in no way determinative. It is generally recognised that there is an inverse relationship between the degree of market power enjoyed by a firm and the level of concentration in that market. However, market share does not by itself indicate market power:

> "The relative effect of percentage command of a market varies with the setting in which that factor is placed."[16]

Mason CJ and Wilson J also noted the importance of barriers to entry in detailing the inadequacy of simply using market share as a proxy for market power:

Solow and Herbert Hovenkamp, *Antitrust Law* (1995) vol IIA, at 85: "the ability to raise prices by restricting output...[or the ability] to raise price without a total loss of sales."

14 See eg, *Australian Competition and Consumer Commission v Safeway Pty Ltd (No.2)* (2001) 119 FCR 1

15 *Australian Competition and Consumer Commission v Universal Music Australia Pty Ltd* [2001] FCA 1800, at para 405 ("*Universal* (Federal Court)").

16 *Queensland Wire* (1989) 167 CLR 177, at 188, adapting the language of Reed J in *United States v Columbia Steel Co* (1948) 334 US Rep 495.

> "A large market share may well evidence market power… but the ease with which competitors would be able to enter the market must also be considered. It is only when for some reason it is not rational or possible for new entrants to participate in the market that a firm can have market power…"[17]

Their Honours also noted that there may be other factors which courts can take into account in determining whether the defendant firm has the required degree of market power:

> "Another indictor of market power… is vertical integration… but its presence does not necessarily mean that market power exists."[18]

As noted above, market power was easily found in this case. After Mason CJ and Wilson J had found that the plaintiffs had cleared the first hurdle, they continued to examine the second and third hurdle. They found that BHP did indeed take advantage of their market power for a proscribed purpose.

2.2.2 *The Approach Taken by Dawson J*

In the same case, Dawson J came to the same conclusion about BHP's refusal to supply. His Honour found that BHP had indeed illegally taken advantage of their market power. However, Dawson J's judgment differed to that of Mason CJ and Wilson J. Though not important in the case being heard, His Honour indicated that market power should be defined more broadly than simply analysing the ability of the defendant firm to simply raise price above the competitive level. He felt that the definition proffered by Mason CJ and Wilson J would largely be inadequate:

> "[M]arket power has aspects other than influence upon the market price. It may be manifested by practices directed at excluding competition such as exclusive dealing, tying arrangements, predatory pricing or refusal to deal… The ability to engage persistently in these practices may be as indicative of market power as the ability to influence prices."[19]

Dawson J's definition of market power is thus more inclusive than the interpretation of Mason CJ and Wilson J. Put simply, his Honour believes that market power can reveal itself if a firm persistently engages in conduct or practices that is inconsistent with the behaviour of a competitive firm. This ability to behave contrary to competitive behaviour undoubtedly

17 *Queensland Wire* (1989) 167 CLR 177, at 189.
18 *Queensland Wire* (1989) 167 CLR 177, at 190.

subsumes the ability to raise prices above the competitive price in line with the test proffered by Mason CJ and Wilson J.

Dawson J's definition of market power is based primarily on the definition propounded by Kaysen and Turner in their 1959 book *Antitrust Policy*:

> "A firm possesses market power when it can behave persistently in a manner different from the behavior that a competitive market would enforce on a firm facing otherwise similar cost and demand conditions."[20]

This definition of market power focusing on the ability of a firm to persistently depart from expected behavior of a competitive firm is more consistent with the legislative framework for deciding market power. As noted above, s 46(3) provides that the judiciary should seek to analyze the capacity to act in a manner unconstrained by the conduct of competitors, suppliers and customers. The test proffered by Dawson J would appear to reflect this direction more than the test propounded by the Chief Justice and Wilson J. A firm persistently engaging in anti-competitive practices directed at excluding competitors appears to be significantly free from constraint of competitors, suppliers and customers. The Mason-Wilson test over prices only reflects one element of this constraint.

While the definition of market power differs from that proffered in the judgment of the Chief Justice and Wilson J, Dawson J still runs through the sequential nature of the three hurdles that has characterized misuse of market power cases in Australia. First he examines the market boundaries and the level of market power, and then goes on to discuss whether BHP took advantage of that power for a proscribed purpose.

It is clear that when the structural market power of the defendant firm is patent, the courts can simply follow the traditional approach taken by both judgments in *Queensland Wire*. However, Dawson J does not explicitly outline a method by which courts can identify the existence of market power by analyzing the conduct of the defendant firm. It is questionable as to whether Dawson J is implicitly advocating that market power can be shown to exist by merely examining whether the firm has engaged in anti-competitive practice. His Honour notes that the "ability to engage persistently in practices directed at excluding competition

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19 *Queensland Wire* (1989) 167 CLR 177, at 200.

20 Carl Kaysen and Donald Turner, *Antitrust Policy* (1959), at 75.

may be… indicative of market power."[21] It is unclear whether this means that Dawson J believes that courts in future cases can make a determination as to the existence of market power by merely noting the existence of putative anti-competitive behaviour.

2.3 Decisions following Queensland Wire

2.3.1 *The judicial predominance of the Mason-Wilson test*

Section 46 cases since *Queensland Wire* have, perhaps in deference to the judgment of the Chief Justice, largely cited the "traditional" Mason-Wilson test when determining the existence of market power. In doing so, the courts have examined a number of factors in determining whether firms are able to price supra-competitively.

To a large degree the factors have reflected the factors of competition enumerated in the *QCMA* tribunal decision:[22] market share and concentration; barriers to entry; product differentiation; existence of vertical integration; and long-term contractual arrangements.[23] Even when the test proposed by Dawson J has been stated, the courts still examined the issue of market power from a static viewpoint. The preference for analysis based on structural factors became increasingly obvious throughout the 1990s. Take for example, the decision of Lockhart J in *Dowling v Dalgety*.[24] His Honor outlined a number of important factors to be considered, none of which is determinative in its own right. These factors were largely drawn from *Queensland Wire* and the *Arnotts* merger case.[25] They included the ability to raise price above supply cost without rivals taking away customers in due time; the market share of the firm; the existence of vertical integration; and the extent to which it is rational or possible for new entrants to enter the market.

The Mason-Wilson approach to market power focuses heavily on structural factors. While the legislation guides the courts when examining whether a defendant has market power towards an examination of freedom from constraints, the courts have chosen to adopt a

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21 *Queensland Wire* (1989) 167 CLR 177, at 200 (Dawson J).

22 *Re: Queensland Co-operative Milling Association* (1976) 25 FLR 169 ("*QCMA*").

23 Although the *QCMA* case involved a merger, courts have examined the five 'competition' factors in cases of misusing market power. The analysis of these factors reflects the belief that market power is the antithesis of competition.

24 *Dowling v Dalgety Australia Ltd* (1992) 34 FCR 109 ("*Dowling v Dalgety*").

25 *Arnotts Ltd & Anor v Trade Practices Commission* (1992) 35 FCR 43 ("*Arnotts*").

"structural" approach, focusing on prices. The judicial emphasis placed on the ability of a firm to price supra-competitively effectively means that the Mason-Wilson test merely looks at what we shall call "structural market power". Under this test, little consideration is given to the dynamic elements of oligopolistic markets or the strategic interaction that characterizes such markets. Issues of strategic behaviour can infiltrate the Mason-Wilson approach if the court chooses to examine strategic barriers to entry, or if the court takes a long-run view of the behaviour of the defendant when analysing pricing behavior. However, the precedent has been read with overbearing focus on the structural elements of the market.

In addition, the courts have taken a very static approach to the definition of market power. When analyzing markets and the degree of power held by participating firms, courts have merely examined the degree of power *at the time* that the conduct was engaged in. The failure of the Mason-Wilson test to take into account the fact that the conduct of a firm can influence the market power of that firm in a dynamic setting has made the job of prosecuting s 46 cases, for example where predatory pricing is at issue, more difficult. In the predatory pricing case of *Eastern Express v General Newspapers*,[26] it was noted that the defendant firm may have had market power before the entry of the plaintiff, however after the entry Lockhart and Gummow JJ noted that the competition between the two firms was so strong that the defendant firm was unable to raise its prices by restricting output in a sustainable manner. Beaumont J agreed that the defendant firm did not have a substantial degree of power in the relevant market "at any material time".[27] This notion of "material time" that His Honour alludes to is the period of time when the defendant firm engaged in price cutting behavior.

2.3.2 *Barriers to entry*

Barriers to entry into the market, defined by reference to the extent to which it is rational or possible for new entrants to enter, has been seen as the most important factor in the determination of whether a defendant has market power or not. In support of this assertion, Australian courts have cited the industrial economists Scherer and Ross who refer to barriers

[26] *Eastern Express Pty Ltd v General Newspapers Pty Ltd* (1992) 35 FCR 43 ("*Eastern Express v General Newspapers*").

[27] *Eastern Express v General Newspapers* (1992) 35 FCR 43, at 72 (Beaumont J).

to entry as "the *sine qua non* of monopoly."[28] The underlying economic idea is that if entry and exit is relatively easy then incumbent firms have no discernible advantages and market power simply cannot exist. In *Eastern Express v General Newspapers*, Lockhart and Gummow JJ stated:

> "[t]he primary consideration in determining market power must be taken to be whether there are barriers to entry into the relevant market… [T]o what extent is it rational or possible for new entrants to enter the market in this case? That is the primary question in considering whether each of the respondents has a substantial degree of market power."[29]

Although economists sometimes disagree about what constitutes a barrier to entry, the courts in seeking to provide a working definition for the purpose of competition law in Australia have favored a structural approach to entry barriers. For example, Bain's oft-cited definition of barriers to entry focuses on the advantages flowing to incumbents:

> "[Barriers to entry are] the advantages of established sellers in an industry over potential entrant sellers, these advantages being reflected in the extent to which established sellers can persistently raise their prices above a competitive level without attracting new firms to enter the industry..."[30]

Courts have also employed the approach of George Stigler, which tends to examine the disadvantages for entrants:

> "[A barrier to entry is] a cost of producing (at some or every rate of output) which must be borne by a firm which seeks to enter an industry but is not borne by firms already in the industry."[31]

As Mason CJ and Wilson J noted in *Queensland Wire*, barriers to entry into a market may exist due to legal barriers (such as patents, government regulation and licensing) or they may be a result of large economies of scale. In the first instance case of *Eastern Express v General Newspapers*, Wilcox J found that factors such as strong reputation, loyalty in the supply chain both upstream and downstream as well as the substantial capital costs involved constituted

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28 F M Scherer and D Ross, *Industrial Market Structure and Economic Performance*, at 18; cited by Finkelstein J in *Australian Competition and Consumer Commission v Boral Ltd* [2001] FCA 30 ("*Boral* (Full Court)"), at para 332.

29 *Eastern Express v General Newspapers* (1992) 35 FCR 43, at 63.

30 Joseph S Bain, *Barriers to New Competition* (1956), at 3.

31 George J Stigler, *The Organisation of Industry* (1968), at 67.

high barriers to entry.[32] Heerey J in the first instance *Boral* case contended that the following matters were relevant to the determination of barriers to entry: intellectual property owned by incumbents; customer loyalty; technology; availability of raw materials; capital expenses; and availability of commercial information.[33]

While the factors outlined by Heerey J would certainly affect the degree of ease with which a potential entrant could enter a given market, these factors are largely "structural" factors. That is, the deterrent to entry is inherent in the structure, composition and nature of the industry. One factor that has largely been overlooked is that of the ability of incumbent firms to create or heighten barriers to entry in a given market. These "strategic barriers to entry" will be discussed in further detail below.

2.3.3 *Behaviour and market power in* Universal Music

In recent cases, courts have leant towards the broader test proposed by Dawson J in *Queensland Wire*. In doing so, courts have acknowledged the fact that market power can be evidenced by the manner in which firms conduct themselves. Most notably, the majority of the High Court in the more recent case of *Melway* cited Dawson J's obiter with approval and added:

> "[M]arket power means capacity to behave in a certain way (which might include setting prices, granting or refusing supply, arranging systems of distribution), persistently, free from the constraints of competition."[34]

However, as in the *Queensland Wire* case, market power was not at issue in the *Melway* case. Accordingly, it was given scant consideration. The court in *Melway* did not discuss in any length the potential ramifications of Dawson J's definition of market power.

In the first instance case of *Universal*,[35] Hill J attacked the over-reliance by courts on the Mason-Wilson test. His Honor noted that the term "market power" necessarily goes beyond

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32 *Eastern Express Pty Ltd v General Newspapers Pty Ltd* (1991) 30 FCR 385 ("*Eastern Express v General Newspapers*").

33 *Boral* [1999] FCA 1318.

34 *Melway* (2001) 178 ALR 253, at 269 (per Gleeson CJ, Gummow, Hayne and Callinan JJ).

35 *Universal* [2001] FCA 1800 ("*Universal* (Federal Court)".

the simple power to increase prices beyond the competitive level.[36] In referring to both the *Queensland Wire* and *Melway* cases, Hill J asserted:

> "Although the passages cited refer to the normal test of power over prices as being indicative of market power, there is nothing in what is said that makes power over prices the sole test of market power."[37]

Preferring Dawson J's definition of market power, Hill J noted that any test designed to identify market power that is not connected to conduct or effect could result in erroneous decision-making. He referred to an article by the economist Professor Steven Salop that outlined two such possible traps: "marginal cost trap"; and the "price-up trap".[38] The marginal cost trap is to mistake the inability to raise price above marginal cost for an inability to exercise market power by excluding rivals through the adoption of anti-competitive restraints. The price-up trap is to mistake the inability to profitably raise price above the current level for an inability to exercise market power by excluding rivals.

Despite the structural evidence of the market not necessarily being conducive to the defendant firms (Warner and Universal) having market power (both firms had about 20% of the market share and the structural barriers to entry were deemed to be insignificant), Hill J found that both firms did indeed have the requisite degree of market power for the purposes of s 46. Hill J argued that the defendant firms did not conduct themselves in a manner that suggested they were firms in a competitive market. However, he used that analysis to establish that the defendant firms had *some* market power. Hill J then analysed the nature of such behaviour given the market structure in order to establish that the firms had a *substantial* degree of market power.

This approach by Hill J has been substantially overturned by the Full Federal Court on appeal.[39] The Court was influenced by the High Court decision in *Boral* that is discussed in detail below.

> "As we see the position, in the light of *Boral*, it is necessary for a court considering a case brought under s 46 of the Act to determine, as a threshold point, whether the relevant corporation has a substantial degree of power in the relevant market.

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36 *Universal* [2001] FCA 1800 (Federal Court), at para 405.

37 *Universal* [2001] FCA 1800, at para 409.

38 *Universal* [2001] FCA 1800, at para 358, citing Steven C Salop (2000) "The First Principles Approach to Antitrust, *Kodak* and Antitrust at the Millennium" 68 *Antitrust Law Journal* 187.

39 *Universal* [2003] FCAFC 193 (Full Federal Court).

> This requires attention to the whole of the evidence relating to the market and the conduct of its participants. It is not legitimate for a court to base a finding of substantial market power simply upon incidents of abuse of power in that market. Almost all participants in a market have a degree of market power, which may on occasion be abused. The power of the abuser may or may not be substantial within the meaning of s 46(1)."[40]

While we agree that a determination of market power must be based on the whole of the evidence (and we believe that this approach is potentially being undermined by the structural approach adopted by the Courts), it seems odd to conclude that market power cannot be inferred from an abuse of that power. While it is legitimate to argue that a minor 'abuse' may be associated with insubstantial market power, it seems equally legitimate to argue that if there is a substantial abuse of market power by a firm then this must imply that the firm has a substantial degree of market power.

The Full Federal Court rejects this approach.

> "Hill J went to some pains the make detailed findings about the market. We think that he was also cognisant of the difference between a static situation where a market participant has a relatively small market share, but is in a position to monopolise a limited number of key products, and the active exploitation of that position. As we read *Boral*, it is permissible to take into account the first of these alternatives, in conjunction with all other relevant items of evidence, in determining whether the participant has substantial power in the market. However, it is not legitimate to reason directly from the fact of the second alternative, although this may have some evidentiary value."[41]

In this sense, while evidence of behaviour can be taken into account when determining the presence or absence of significant market power, such conduct is limited to a 'supporting role'. Behaviour that is only consistent with an abuse of substantial market power cannot by itself be used to infer the existence of such market power.

[40] *Universal* [2003] FCAFC 193 (Full Federal Court), at para 150.
[41] *Universal* [2003] FCAFC 193 (Full Federal Court), at para 147.

2.4 *The Boral Decisions*

The recent *Boral* case has enabled courts to revisit the meaning of market power within the ambit of s 46. In particular, it has enabled the courts to examine how predatory conduct fits into the scope of Australian law.

Of particular interest is the decision of Finkelstein J in the Full Federal Court. In his decision, His Honor adds an extra element to the concept of market power. Instead of simply focusing on the ability to influence prices, Finkelstein J notes that market power can manifest itself in the power to exclude competition. This decision was roundly criticized by commentators and the High Court on appeal. The majority of the High Court attacked the approach on the grounds that it may be counter to logical deduction and may obfuscate analyses of s 46 cases. Nonetheless, some of the concepts and issues raised by Finkelstein J help to overcome many of the problems created by the overly structural approach to market power that subsisted (and given the High Court judgment, *still* subsists) in Australian competition law.

2.4.1 *The Approach Taken by Finkelstein J (Full Court)*

In the Full Federal Court decision of *Boral*, Finkelstein J starts from the idea that the Dawson J test is superior to the Mason-Wilson test from *Queensland* Wire. However, Finkelstein J departs even further from the Mason-Wilson test, dismissing the idea that an analysis of market power should be confined to a discussion of whether a firm can raise its prices above marginal cost without losing sales at such a pace that the increase in price is unprofitable.[42]

His Honor follows the Dawson J line by arguing that a firm can have market power even if it cannot immediately raise its price above the competitive level.[43] Rather, market power can

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42 Finkelstein J cites a number of economic papers and books where the predominant test of market power is whether the firm can raise it price above the competitive level. Many of these are referred to in the notes above notes 13 and 14.

43 However, note: *Boral* [2003] HCA 5 (High Court) where the three majority judges argue that Dawson J's judgment in *Queensland Wire* is erroneously interpreted by the judges in Full Court decision of *Boral:* "What was said by Dawson J does not supply any adequate foundation for the approach taken in this case in the Full Court." (Gaudron, Gummow and Hayne JJ, at para 188)

manifest itself if a firm has the "power to exclude competition".[44] Finkelstein J cites the opinion of Reed J, delivering the opinion of the US Supreme Court in the *du Pont* case, where monopoly power was determined by examining whether the firm had:

> "a power of controlling prices *or* unreasonably restricting competition."[45]

This dual test (the power over prices *or* the power to exclude rivals) has been widely applied by courts across the United States.[46]

The power to exclude competition turns on the barriers to entry in the market. His Honor explains that economists are increasingly departing from the "structural" notions of barriers to entry to the examination of dynamic market behavior:

> "Barriers to entry are obstacles which inhibit the ability of firms outside a market to enter and compete with established insiders."[47]

Finkelstein J argues that judicial recognition of strategic barriers as well as structural barriers is consistent with recent economic theory[48] and "the realities of a market".[49] If firms are able to create or heighten barriers to entry through their strategic behavior, then Finkelstein J believes that this is consonant with having market power and misusing it. What determines the illegality is the purpose for which these strategic barriers were erected:

> "Incumbents are often willing to take action that will result in short-term reductions in profit to prevent the establishment of a new entrant. Some economists refer to these deterrent activities as 'strategic' barriers to entry, 'purposely enacted to redress the possibility of entry' as opposed to 'innocent' entry barriers 'unintentionally erected as a side effect of innocent profit maximization'."[50]

This analysis of the scope of market power and the ability of a firm to alter the barriers to entry through strategic behaviour takes Dawson J's test in *Queensland Wire* one step further.

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44 *Boral* [2001] FCA 30 (Full Court) at para 325.

45 *United States v El du Pont de Nemours* (1956) 351 US 377 ("*du Pont*") at 389, cited in *Boral* [2001] FCA 30, at para 389 (emphasis added).

46 See eg, *Eastman Kodak Co. v Image Technical Services, Inc.*(1992) 504 US 451 at 481, *Mullis Arco Petroleum Corp.* (1974) 502 F.2d 290, at 296.

47 Citing P Geroski and J Schwalbach (eds), *Entry and Market Contestability: An International Comparison* (1991).

48 Finkelstein J cites P Geroski, R J Gilbert and A Jacquemin, *Barriers to Entry and Strategic Competition* (1991); and A van Witteloostuijn, *Barriers to Entry and Dynamic Economies – A Survey and Critique* (1986).

49 *Boral* [2001] FCA 30 (Full Court), at para 341.

50 *Boral* [2001] FCA 30 (Full Court), at para 342; citing Steven Salop, 'Strategic Entry Deterrence' (1979) 69 *American Economic Review* 335.

Rather than simply note that market power can be defined by reference to exclusionary conduct, His Honour analyses the problems generated by a static analysis of market power and the erroneous decisions that can be generated if courts fail to take into account the ability of firms to behave strategically. Rather than simply change the approach that courts have taken to the definition of market power, Finkelstein J offers an alternative to the traditional method of analysing s 46 cases.

His Honour stipulates that where market power exists by virtue of the power to exclude competition, the traditional method of analysing each of the three hurdles sequentially and in isolation is no longer appropriate.[51] Finkelstein J asserts that if market power can be ascertained by virtue of the power to engage in conduct that excludes competition then:

> "[t]he evaluation of market power and the abuse of that power is part of one analysis. The existence of market power based on this approach cannot be examined independent of the alleged exclusionary conduct. *It is the exclusionary conduct that establishes the market power, not the reverse.*"[52]

Essentially, the test is based on inferring the existence of market power by examining the nature of the defendant firm's behaviour. That is, Finkelstein J is essentially arguing that some s 46 cases can be examined using backward induction. That is, start off by looking at the conduct. Determine whether such behaviour is "exclusionary". If it is exclusionary, then it follows that firms *must* have had the power to exclude competition, which is one branch of market power. Put simply, the ability to exclude competition and raise entry barriers is intimately connected with market power so that if a firm behaves in a manner that is exclusionary then that firm must have market power.

This test has some merit. It explicitly acknowledges that a firm can indeed have market power without actually having the power to price in a supra-competitive manner. Finkelstein J acknowledges that there are cases where the traditional industrial organization approach of "Structure-Conduct-Performance" cannot help us. Rather we must look to more recent theories that help to explain how a "structurally competitive" firm's unilateral

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51 However, Finkelstein J refers to the test as a 'two-stage test'. His Honour notes that the first part of the test is whether the defendant has a substantial degree of market power. The second part of the test is whether they have taken advantage of the power for a proscribed purpose. That is, Finkelstein J has merely combined the second and third hurdles into one.

52 *Boral* [2001] FCA 30, at para 331 (emphasis added).

actions can influence not only the performance of the market but also the structure of the market. That is, structural market power can be endogenously affected by the conduct of firms in a *prima facie* competitive market.

2.4.2 *Criticisms of the Approach Taken by Finkelstein J*

While the idea that merely proving exclusionary conduct is indicative of the existence of market power has its advantages, it also raises a number of issues and potential problems. When the case was appealed to the High Court, the belief that market power can be somehow inferred from market behaviour came under criticism. Gleeson CJ and Callinan J argued:

> "a process of reasoning that commences with a finding of a purpose of eliminating or damaging a competitor, and then draws the inference that a firm with that objective must have, and be exercising, a substantial degree of power in a market, is likely to be flawed. Firms do not need market power in order to put their prices down; and firms that engage in price cutting, cause damage to their competitors."[53]

In his evidence, Professor George Hay argued against the adaptation of such reasoning:

> "[T]he idea that one could comfortably infer market power simply from observing that prices were for a period of time allegedly below the average variable cost is very uncertain economics and more important, very bad policy."[54]

Additionally, Gleeson CJ and Callinan J found that the alleged predatory scheme, if implemented, was unsuccessful. While two firms had left the market during the relevant period, a successful new firm entered the market. The High Court judges questioned how market power could be established if the alleged predation was unsuccessful. That is, how can market power be established by exclusionary conduct if the conduct fails to exclude competitors? Their Honours argue:

> "If the ACCC had alleged that [Boral] had the ability to eliminate a competitor at will, then [Boral's] failure to eliminate C&M would have been an embarrassing fact."[55]

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[53] *Boral* [2003] HCA 5 (High Court) at para 123.

[54] *Boral* [2003] HCA 5 (High Court) at para 183 (Gaudron, Gummow and Hayne JJ).

The main problem with Finkelstein J's decision is that it does not proffer any test for distinguishing conduct which is genuinely exclusionary from other conduct that might be similar but is not exclusionary. For example, low prices are indicative of effective competition. However, as a result of low prices, weak competitors may be forced out of the market. Such "shake-ups" would not and should not be considered to be conduct in contravention of the competition laws. In a s 46 context, the fact that a firm that survived the price war has engaged in conduct that *prima facie* appears anti-competitive does not necessarily mean that the first hurdle has actually been cleared. Indeed, the mere fact that the survivor in a price war had "aggressive intent" provides us with little assistance in seeking to distinguish pro-competitive and anti-competitive conduct. As Mason CJ and Wilson J noted in *Queensland Wire*:

> "Competition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away. Competitors almost always try to 'injure' each other in this way… and these injuries are the inevitable consequence of the competition s 46 is designed to foster."[56]

Gleeson CJ and Callinan J in *Boral* felt that the probability of confusing this aggressive intent with anti-competitive behavior was especially strong in predatory pricing cases. Their Honors cited the American case of *AA Poultry Farms Inc v Roser Acre Farms Inc*[57] noting:

> "Almost all evidence bearing on 'intent' tends to show both greed-driven desire to succeed and glee at a rival's predicament… [T]ake [a witness's] statement that [his firm's] prices were unrelated to its costs. Plaintiff's treat this as a smoking gun. Far from it, such a statement reveals [the firm] to be a price taker. In perfect competition, firms must sell at the going price, no matter what their own costs are."[58]

The legislation explicitly allows for purpose to be inferred from conduct. The reverse inference is not prohibited, but neither is it expressly permitted. If the starting point of a s 46 analysis is whether the firm has engaged in anti-competitive conduct with proscribed purpose, and the analysis suggests that firms *must* have taken advantage of some market

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55 *Boral* [2003] HCA 5, at para 147.
56 *Queensland Wire* (1989) 167 CLR 177, at 182 (Mason CJ and Wilson J).
57 *AA Poultry Farms Inc v Rose Acre Farms Inc.,* 881 F.2d 1396 (7th Cir. 1989).
58 *Boral* [2003] HCA 5 (High Court).

power to engage in such conduct, then the analysis becomes somewhat circular and confused. If this approach were to be adopted, courts would attribute liability merely on the basis of the fact that the conduct appears anti-competitive.

2.4.3 *The Approach Taken by Gleeson CJ and Callinan J (High Court)*

As noted above, in their High Court decision in *Boral*, Gleeson CJ and Callinan J criticize the judgment of Finkelstein J. They argue that the inference of market power from the proscribed purpose is inherently dangerous and flawed. The judges do not explicitly argue that market power in Australian law does not include the power to exclude competition. However, they assert that such a power is not relevant in the *Boral* case. In obiter they argue that the power to exclude competition is essentially part of the power over prices:

> "in any event, eliminating a competitor, unless it is done out of pure malice, is ordinarily only a means to the end of being able to raise prices."[59]

In referring to Mason CJ and Wilson J's judgment in *Queensland Wire*, Gleeson CJ and Callinan J argue:

> "Pricing may not be the only aspect of market behavior that manifests power. Other aspects may be the capacity to withhold supply; or to decide the terms and conditions, apart from price, upon which supply will take place."[60]

Here, Gleeson CJ and Callinan J fall into the common trap of failing to realize that the terms and conditions of supply are included in the economic interpretation of "price". This supports the notion that the traditional idea of market power is ultimately whether a firm can "give less and charge more".[61] Putting aside this minor point, Their Honours conspicuously fail to acknowledge, or even discuss, the power to exclude competition when discussing the types of behavior that characterize power in a market. They continue:

> "pricing is ordinarily regarded as the critical test; and it is pricing behavior that is the relevant conduct in the present case."[62]

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59 *Boral* [2003] HCA 5 (High Court), at para 147.
60 *Boral* [2003] HCA 5 (High Court), at para 136.
61 See eg, *QCMA* (1976) 25 FLR 169.
62 *Boral* [2003] HCA 5 (High Court), at para 136.

This statement is explained by an earlier passage in their judgment. Gleeson CJ and Callinan J argue that the legislation offers some guidance in deciding which test of market power should be employed. Their Honours argue:

> "The essence of power is absence of constraint. Market power in a supplier is absence of constraint from the conduct of competitors or customers. This is reflected in the terms of s 46(3). Matters of degree are involved, but when a question of the degree of market power enjoyed by a supplier arises, the statute directs attention to the extent to which the conduct of the firm is constrained by the conduct of its competitors or its customers".[63]

That is, Gleeson CJ and Callinan J argue that the correct analysis of market power depends on the nature of the alleged conduct which is said to have taken advantage of the market power. Implicitly, they are following a line of argument that both judges employed in *Melway*, that there must be some element of causation between the market power and the taking advantage of the power. Their Honours are relating the conduct of the defendant firm back to the degree to which they are constrained in engaging in such conduct.

However, the judges then confuse the analysis. When they attempt to apply this logic to the predatory pricing at hand, the result is somewhat anomalous and confusing:

> 'The main aspect of the conduct of [Boral] in question in the present case was its pricing behavior. Therefore, the Federal Court was required by the statute to have regard to the extent to which [Boral's] pricing behavior was constrained by the conduct of other… suppliers or… purchasers."[64]

However, the real focus, or "main aspect", of predatory conduct is to exclude competition and to raise barriers to entry. As Richard Posner noted, predatory pricing can be defined as:

> "pricing at a level calculated *to exclude* from the market an equally or more efficient competitor".[65]

If we are to selectively examine the exact nature and source of the market power in terms of the constraints, then in cases of predation, the courts should examine the constraints that

63 *Boral* [2003] HCA 5 (High Court), at para 121.

64 *Boral* [2003] HCA 5 (High Court), at para 121.

65 Richard A Posner, *Antitrust Law* (1976), at 188 (emphasis added).

limit the ability to exclude competition and raise barriers to entry. The constraint over the ability to raise prices is not the primary constraint we should be concerned about.

The judges try to offer a reason why a test over pricing is preferred rather than the test over the power to exclude competition. However, their reasoning is essentially flawed. Gleeson CJ and Callinan J argue that because the court has been asked to analyse whether the defendant firm's behavior in pricing below cost was misusing market power, they feel the correct analysis of market power is to focus on whether the defendant firm was constrained in its pricing behavior. However, the concern here was whether Boral was constrained in its ability to engage in a predatory pricing scheme – not whether it was constrained in its ability to raise prices. That is, to justify their assertion that market power in this case should be evidenced by an absence of constraint over pricing behavior, Gleeson CJ and Callinan J depart somewhat from the Mason-Wilson test of power to *raise* prices. Instead, they examine the power to *set* prices.

Their Honours later seek to elaborate on their reasoning that the market power should consider the ability of the defendant firm to set prices.

> "As the case was framed, the contravening conduct was price-cutting. If the manner in which [Boral] set its prices was an exercise of market power, the relevant kind of power lay in its supposed ability to set prices free from constraint resulting from the conduct of its competitors or its customers."[66]

This argument would appear to advocate that the ability to act unconstrained in *cutting* prices is consonant with the existence of market power. This is clearly wrong. The Chief Justice and Callinan J had already argued:

> "the ability to cut prices is not market power. The power lies in the ability to target an outsider without fear of competitive reprisals from an established firm, and to raise prices again later."[67]

This "ability to target an outsider" would appear to be tantamount to the power to exclude competition that Finkelstein J discusses in the Full Court decision. Thus, in seeking to depart from Finkelstein J's test, Gleeson CJ and Callinan J implicitly promote the idea that

[66] *Boral* [2003] HCA 5 (High Court), at para 146.

market power in cases of predation lies not in the ability to raise prices, but rather in the ability to exclude competition.

Nonetheless, the ruling of Gleeson CJ and Callinan J in *Boral* stresses that market power should be defined with reference to price in cases where the main aspect of the conduct is pricing behavior. Thus, in cases of predatory pricing Their Honors believe that the test of market power should examine the degree of constraint placed upon the defendant firm in making their pricing decisions. That is, if a firm charged with engaging in a predatory pricing scheme is unable to freely set their prices at the time they engage in the alleged predatory scheme, the defendant will not be liable under s 46. The plaintiff will not be able to clear the first hurdle.

2.5 The Safeway case

The judgments in *Universal* and *Boral* approach market power on the basis of structural market features and the constraints that operate on a firm's pricing. The Full Federal Court decision in *Safeway* takes a more eclectic approach.[68]

The *Safeway* case related to the behaviour of Safeway as a buyer of bread rather than as a seller. Thus the issue of market power revolved around monopsony rather than monopoly power. Heerey J and Sackville J note that "[i]n the case of a buyer, such as Safeway in the Wholesale Market, market power might be evidence by a firm's ability to extract favourable prices from suppliers".[69] However, Their Honours also note that "[i]t is consistent with s 46(3) of the Act to approach the question of market power by examining the actual conduct of the alleged contravener in the market over the whole of the relevant period".[70] Indeed, it appears that factors other than pricing discretion led to the conclusion that Safeway had a substantial degree of power in the wholesale market. Their Honours, in paragraph 310, note that the evidence suggested that any pricing discretion held by Safeway was limited, but conclude that "other factors" support the conclusion that Safeway had a substantial degree

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67 *Boral* [2003] HCA 5 (High Court), at para 139.

68 *Australian Competition and Consumer Commission v Australian Safeway Stores Pty Limited*, [2003] FCAFC 149 (30 June), ("*Safeway*").

69 *Safeway* [2003] FCAFC 149 at para 300.

70 *Safeway* [2003] FCAFC 149 at para 303.

of market power. These other factors include a range of structural features such as excess capacity, market share and barriers to entry. The behaviour of Safeway, however, was also deemed relevant for assessing market power. In particular, Safeway's conduct led to a relevant anti-competitive market response in three instances and Their Honours note that as a result of Safeway's conduct other market participants "would have been subject to a powerful disincentive in relation to supplying discounted bread to independent retailers".[71]

The judgment in *Safeway* suggests that the courts are willing to consider behavioural factors in determining market power. This is in line with our discussion in section 5. However, given the *Boral* and *Universal* judgments, it appears that a structural approach to market power is likely to dominate trade practices analysis in the near term.

3 Structural Market Power and Predatory Pricing

The High Court decision delivered by the Chief Justice and Callinan J reflects the views held by the competition regulator at the start of the 1990s. The Trade Practices Commission (the forerunner to the Australian Competition and Consumer Commission) in their report into the failure of Compass Airlines in 1992 notes that that in order for predatory pricing to be feasible in practice, it is necessary for the predator to have a substantial degree of market power:

> "For predatory pricing to be feasible in practice, the predator must have exploitable market power and a reasonable expectation that new entry will not occur in future. The predator will also need to have the capacity to outlast its victim during the price war period, whether through greater cash reserves, better access to finance or the ability to cross-subsidise from other markets or products."[72]

The view that a defendant required "structural market power" in order to engage in a predatory scheme *was* a generally accepted theory. Under the interpretation given to s 46, it would appear that all possible predatory pricing cases are covered. However, this view does not concord with modern economic theory. This section seeks to explore the predatory

71 *Safeway* [2003] FCAFC 149 at para 322.

72 Trade Practices Commission, *The failure of Compass Airlines: Report by the Trade Practices Commission – main report*, February 1992, at 21.

pricing literature and critique the view that a firm requires a substantial degree of structural market power in order to engage in a predatory pricing strategy.

Much of the economic literature pertaining to predatory pricing has sought to identify a meaningful and workable test of determining when predatory pricing occurs. These theories seek to identify a precise formula for determining when prices are competitive and when prices are predatory. For example, the Areeda-Turner test stipulates that predation is when a firm prices below average avoidable cost. While it has been applied in American anti-trust cases,[73] no below cost test has been adopted in Australia when analysing predatory pricing.[74] Areeda and Turner's 1975 paper sparked a wave of literature outlining the various merits of different "cost tests" of predatory pricing.[75]

For the purposes of this paper such discussions are largely peripheral. Rather, the focus of this brief review of the predatory pricing literature is to outline a history of the literature on the necessary conditions for predatory pricing and the rationality underlying such behaviour. It will be shown that the scepticism held by courts reflects the sceptical nature of economists from thirty years ago. Additionally, we seek to impress the importance of "new" strategic literature, and ultimately argue that predation can be a rational strategy for a firm with no structural market power.

3.1 What conditions make predatory pricing a credible strategy?

The early economic literature sought to determine whether or not it was rational for firms to engage in predatory pricing. The so-called "Classical model"[76] of predatory pricing took the idea that a dominant firm was able to eliminate a rival by pricing below cost. Following the elimination of the rival, the predator was able to raise its prices and recoup its losses. This

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[73] For a comprehensive exposition of the US case law see Donald J Boudreaux, Kenneth G Elzinga, and David E Mills (1995) 'The Supreme Court's Predation Odyssey: From Fruit Pies to Cigarettes' 4 *Supreme Court Economic Review* 57.

[74] See eg, Finkelstein J in *Boral* [2001] FCA 30 (Full Court) where he argues, at para 262, the "terms of s 46 suggest that adoption of the test developed in the United States would frustrate the objects of the provision."

[75] Eg, The static nature of the Areeda-Turner model has been attacked. See esp, Scherer (1976) and Williamson (1987). See also, Louis Phlips (1995) *Competition Policy: A Game-Theoretic Perspective*, where he notes that none of the definitions of predatory pricing makes much sense from a game-theoretic stand.

model was attacked by a number of economic theorists. Most notably, in 1958 John McGee wrote a scathing review of the famous 1911 *Standard Oil* case[77] and the credibility of predatory strategies.[78] This paper started a wave of literature expressing extreme scepticism at the rationality of a dominant firm engaging in the practice of predatory pricing. Indeed, the dominant paradigm in economics for a period of time denounced predatory pricing as a "myth".[79] Chicago School economists argue that the best policy is to do nothing since predatory pricing is "rare or non-existent".[80] Their scepticism derived from the belief that a large predator would lose more money during the predation period than an equally efficient competitor; and that it is always cheaper for a firm to acquire rather than predate competitors. Additionally, the likelihood that supra-competitive pricing in an attempt to recoup losses will merely encourage further entry will render such practices irrational. Chicago School economists argue that such price cutting is beneficial to consumers in the short run and market forces will resolve any market power problems in the long run.[81]

These criticisms themselves have come under attack by simply adjusting some of the assumptions underlying the classical model. Posner notes that firms can only acquire competitors if the merger passes the required antitrust tests and that given predation is more difficult to detect than a takeover, the ability to circumvent antitrust laws in acquiring structural market power is greater with predatory pricing.[82] The idea that higher prices will encourage entry has been criticised on the grounds that the barriers to entry following a successful predatory pricing policy are unlikely to be as low as they were prior to engaging in the strategy. Indeed, this development of a reputation as a predator discourages entry in the

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76 This label is given to the model by George Hay in his 1981 survey piece 'A Confused Lawyer's Guide to the Predatory Pricing Literature' in Steven C Salop (ed), *Strategy, Predation and Antitrust Analysis* (1981).

77 *Standard Oil Co. of New Jersey v United States,* 221 U.S. 1 (1911).

78 John McGee (1958), 'Predatory Price Cutting: The Standard Oil (NJ) Case" 1 *Journal of Law and Economics* 137.

79 See Roland Koller II (1971), 'The Myth of Predatory Pricing: An Empirical Study', 4 *Antitrust Law and Economics Review* 105.

80 John McGee (1980), 'Predatory Pricing Revisited' 23 *Journal of Law and Economics* 289, at 316.

81 See eg Bork (1978); Easterbrook (1984); McGee (1958, 1980). For a less favourable take on the Chicago School see Schmidt and Rittaler (1988).

82 Posner (1976), at 185. See also Williamson (1987) at 228 for further references in support of this proposition.

future, not only in the market of the predatory pricing strategy, but also in other markets that the predator operates in.[83]

Critics of predatory pricing argue that even if the predator is successful at inducing exit, the prey's assets will remain in the market and these can be acquired for a cheaper price than the prey expended. Reputation barriers aside, there are compelling reasons that suggest that the exit of a firm would not facilitate entry of potential entrants.[84] For example, the predator perhaps has the greatest incentive to acquire the assets of failed firm.

The early criticisms of the classical model were rebuked. As George Hay noted:

> "[O]n analytical grounds it appears that predatory pricing… cannot be dismissed as an irrational or harmless tactic"[85]

Recent economic advances have developed a number of coherent theories underpinning the rationality of predatory pricing strategies. The theory of financial market predation departs somewhat from the traditional deep pocket theory of predation.[86] Except under stringent conditions, it is widely believed that just because a firm is financially endowed (that is, has "deep pockets") does not mean that the firm will be able to predate. Rather, the modern theory of financial market predation examines the relationship between the prey and its investors. A firm under attack by predatory prices will yield lower profits. Investors of capital face certain moral hazard problems in determining the source of the reduced profits. Essentially, the predator seeks to undermine the relationship between the investor and the prey, leading to withdrawal of finance on grounds of poor performance. This retraction of capital can prevent future expansion by the prey or drive them out of the market.[87]

83 See eg, Paul Milgrom and John Roberts (1982), 'Predation, Reputation and Entry Deterrence', 27 *Journal of Economic Theory* 280, Williamson (1987) at 228; John Roberts (1986), 'A Signalling Model of Predatory Pricing' 38 *Oxford Economic Papers* 75; and Greg Le Blanc (1992), 'Signalling Strength: Limit Pricing and Predatory Pricing', 23 *RAND Journal of Economics* 493.

84 Patrick Bolton, Joseph F Brodley and Michael H Riordan (2000) 'Predatory Pricing: Strategic Theory and Legal Policy' 88 *Georgetown Law Journal* 2239 present six reasons to support their contention that such a theory is largely implausible.

85 Hay (1981), at 165.

86 See eg, Patrick Bolton and David Scharfstein (1990), 'A Theory of Predation Based on Agency Problems in Financial Contracting' 80 *American Economic Review* 93.

87 This simple and non-technical description has been built upon by a number of economists in recent years. For a survey of the literature on this area see Bolton, Brodley and Riordan (2000), at 2285-2299.

Louis Phlips criticises the Chicago School's hypothesis that predation is rarely rational using game-theoretic models.[88] Phlips argues that if there is imperfect information such strategies are rational. These informational asymmetries play an important role in the signalling theories of predation. Essentially, it is argued that the predator has more information about the market and the nature of the payoffs to the predator.[89] Apart from the signalling of a reputation for predating which may lead to higher barriers to entry, a predator can mislead the prey into believing that conditions of the market are unfavourable inducing exit from the industry and deter future entry where the predator has more information than the prey.[90] The predator, for example, can signal to their competitors that they have lower costs than their competitors seeking to induce exit. This signal can be made by reducing prices drastically. The expected return in future periods for the prey will fall if they believe there is *some* probability that the predating firm has actually cut its costs. As Bolton, Brodley and Riordan note:

> "A strategic analysis of cost signalling shows that under a range of plausible conditions, the victim will leave the market even though it strongly suspects the predator is bluffing."[91]

These strategic developments have not been without their critics. Easterbrook for example, argues that there are a number of counterstrategies that other firms in the market may be able to engage in to foil the underselling of the predator.[92] In a recent book, John Lott criticises recent strategic theories by arguing that they overstate the informational asymmetry between the predator and the prey.[93] Lott believes that even if the predator does have an advantage in information the prey can speculate on this private information by taking positions in the predator's stock. Bolton notes that there is little evidence of this "ingenious

88 Phlips (1995).

89 See eg, David M Kreps and Robert Wilson (1982), 'Reputation and Imperfect Information' 27 *Journal of Economic Theory* 253.

90 Again, this simple description has given rise to a vast literature on signaling in potentially predatory environments. For a discussion of these papers see Bolton, Brodley and Riordan (2000), at 2299-2328.

91 Bolton, Brodley and Riordan (2000), at 2318.

92 Frank H Easterbrook (1981), 'Predatory Strategies and Counterstrategies', 48 *University of Chicago Law Review* 263.

93 John Lott, *Are predatory commitments credible? Who should the courts believe?* (2000).

and intriguing strategy"[94] and questions how this would affect the credibility of a predatory pricing scheme.

Lott also argues that the adverse short-run effects on profit of predation provide strong disincentives for corporate managers to engage in such a strategy. Corporate managers are often on performance sensitive contracts. The short-run losses associated with severe price cutting do not accord with managerial incentive. Bolton argues that there is not necessarily any contradiction between the alignment of managerial incentives and shareholder objectives if the strategy is designed to recoup greater gains than the short-run losses. Additionally, managerial incentives may have other components which outweigh the short-run profit component of the compensation package.[95]

3.2 Is structural market power necessary for predatory pricing?

The classical model of predatory pricing and its subsequent extensions largely focus on an incumbent monopolist facing entry. As such there has been a general belief that predation would only occur if the predator was a monopolistic firm before entry or, if they were in an oligopoly, the predator had to be a dominant firm. Take for example the analysis provided by Phlips. If the market is an oligopoly, then Phlips argues that:

> "the presumption is then that [the predator] has a dominant position."[96]

However, Phlips does not elucidate on the meaning of "dominant position", nor why it is important.

The idea that the firm engaging in the predation must have structural market power has often been accepted without thoughtful examination. As a result, predatory pricing in a structurally competitive environment has received little attention. However, it can easily be seen that there is not a necessary relationship between predation and structural market power. Even if the potential predator is a monopolist when a new firm enters the market, the ability of the incumbent firm to profitably raise its price above its supply cost after entry depends on the nature of competition between the incumbent and the entrant. That an

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94 Patrick Bolton (2000) 'Review of: Are predatory commitments credible? Who should the courts believe?' 38 *Journal of Economic Literature* 974, at 975.

95 Bolton (2000) at 975.

96 Phlips (1995), at 205.

incumbent cannot profitably maintain high prices after entry (and thus may fail to have structural market power) does not mean that it cannot effectively engage in predation through low prices after entry.

The importance of market power in engaging in predation was flagged in a 1979 paper by Joskow and Klevorick.[97] The authors offer a solution for courts trying to determine whether a firm has engaged in predatory pricing or not. They argue that the courts should establish a two-stage investigation of predatory pricing schemes. Their contention is that an analysis of the actual strategy is irrelevant unless the market structure supporting such predation is evident. One of the main determinants in evaluating whether the market structure is able to support predation is whether the defendant has a substantial degree of market power.[98] It is important to note that the authors do not explicitly state that such market power is a necessary element for engaging in predatory pricing, however they believe that a *prima facie* examination of market power will reduce the probability of prosecuting innocent firms and acquitting predatory firms. That is to say, the authors argue that the probability of a firm being able to engage in predatory pricing is reduced if they do not have structural market power.

Oliver Williamson in his 1987 book *Antitrust Economics* confines his discussion of strategic behaviour aimed at acquiring long-term structural market power to dominant firms with at least 60% of the market share in an industry with high barriers to entry:

> "Firms in competitively organized industries are exempted because the incentives are lacking. There is no purpose in sacrificing current profits unless offsetting gains in other geographical markets or in later periods are likely, and firms in competitive industries cannot reap these gains."[99]

Williamson notes that although behavior that appears like predation can happen in a competitive environment, he attributes this to "breakdowns in pricing discipline or personal animus" rather than any strategic efforts to predate.[100] However, the assumptions that Williamson makes about the necessary elements for "dominance" are made primarily for the purpose of simplifying his analysis.

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97 Paul L Joskow and Alvin K Klevorick (1979), 'A Framework for Analyzing Predatory Pricing Policy' 89 *Yale Law Journal* 213.

98 Joskow and Klevorick refer to the power as monopoly power.

The ability to predate does not *necessarily* depend on the structural market power of the alleged predator. The importance attributed to structural market power for predation does not accord with the strategic theories of economics.

Carlton and Perloff argue that there are two necessary conditions for a firm to engage in successful predatory strategies.[101] These conditions are that the predator must have an advantage over its victims and it must be able to signal its commitment to a predatory strategy over the necessary period of time. If these conditions are met, the predator can make a credible threat. Carlton and Perloff note that the model of predatory behavior does not make sense if the firms are identical. The credibility of the threat is compromised by the fact that the predator's strategy is not rational.

Conspicuously, structural market power is not listed as a required condition of engaging in a predatory strategy. This notion of dominance may be classified as an "advantage" and may assist in signaling a firm's commitment to the strategy however the mere fact that a firm does not have structural market power does not preclude the possibility of that firm engaging in predatory behaviour. While structural market power is not entirely irrelevant, it certainly is not necessary. Additionally, the mere fact that a firm has structural market power does not mean that it has the necessary advantages or credibility to engage in a predatory strategy.

The argument that structural market power is not required for predation was corroborated by Bolton, Brodley and Riordan. The authors argue that the courts should undertake a similar analysis to that prescribed by Joskow and Klevorick. In a similar line to Joskow and Klevorick, the authors establish that there are prima facie elements that should be examined. The first tier (favorable economic conditions) operates as a screening mechanism in determining whether the second stage (legal justifications) should be analysed. The first tier contains three elements: proof of a facilitating market structure; a scheme of predation with supporting evidence; and probable recoupment. The element of particular interest in our discussion is the notion of a facilitating market structure. The authors note, following the traditional theories, that a "predatory market structure most obviously exists when a

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99 Williamson (1987), at 233.

100 Williamson (1987), at 233.

dominant firm… has high market share, and when there are both entry and re-entry barriers."[102]

However, Bolton, Brodley and Riordan argue that "initial high market share and entry barriers" are not necessary elements of facilitating market structure for engaging in predatory pricing.[103] The authors contend that market power can be inferred, arguing along similar lines to Finkelstein J in the Full Court decision in *Boral*:

> "Proof of a facilitating market structure will not always require an explicit showing of high concentration, or entry and re-entry barriers. These factors are proxies for market power, but market power can also be proved directly by showing anti-competitive market effects. Therefore, if the incumbent is able to significantly raise prices after the prey's exit without inducing new entry or re-entry, market power can be presumed."[104]

As noted above, this method of determining whether the defendant had market power has been heavily criticized by the High Court of Australia. However, the idea that structural market power is a necessary element of predation is denied.

4 The Implications of the Judicial Construction of s 46

4.1 The gap in Part IV of the Act

It is clear from the way in which the courts have interpreted s 46, and in particular the way that courts have defined market power, that there is a gap in the competition law, not necessarily confined to, but amply demonstrated by the example of predatory pricing.

Part IV of the Act seeks to uphold competition principles deemed requisite for the efficient function of a market economy. These competition laws are designed to promote fair competition in order to achieve efficient outcomes and maximise surplus, most notably to

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101 Dennis W Carlton and Jeffrey M Perloff, *Modern Industrial Organization* (2000, 3rd Ed), at 334.
102 Bolton, Brodley and Riordan (2000), at 2264-2265.
103 Bolton, Brodley and Riordan (2000), at 2265.
104 Bolton, Brodley and Riordan (2000), at 2265.

consumers. This is achieved, in part, by prohibiting firms from acquiring structural market power. The acquisition of structural market power is detrimental to consumers as firms with greater market power are seen to have the ability to raise prices or provide customers with inferior quality products.

Competition laws seek to prevent firms from merging with other firms under certain circumstances. Section 50 of the Act prevents firms from acquiring shares in or assets from another firm if it is likely to substantially lessen competition. Firms that do not individually have a substantial degree of structural market power cannot merge in order to gain such structural market power.

Additionally, firms are prevented from entering into contracts, arrangements or understanding with each other if the agreement is to fix prices, contains or gives effect to an exclusionary boycott or it substantially lessens competition. Firms that do not have a substantial degree of market power by themselves cannot agree to competition reducing schemes in order to jointly increase their structural market power.

Firms with a substantial degree of structural market power are also prohibited from acquiring greater market power unilaterally if they seek to acquire this power by means contrary to the terms of s 46 of the Act. This means that the firms cannot misuse their structural market power. However, s 46 is limited to situations where the firm *a priori* has substantial market power.

There is a gap in the law. Under current judicial interpretation, Part IV does not provide for situations where a firm without a substantial degree of structural market power is able to act unilaterally in order to increase their structural market power. For firms without initial structural market power, anti-competitive merging with other firms is illegal; anti-competitive collusion with other firms is illegal; yet engaging in anti-competitive predatory schemes appear to fall through a loophole created by legal construction. This gap in the law arises due to the fact that the current legal view implicitly assumes that the law should not concern itself with "structurally competitive" firms engaging in anti-competitive practices if they are acting unilaterally. Indeed, McHugh J in the *Boral* judgment makes explicit reference to this gap in the law:

> "Conduct that is predatory in economic terms and anti-competitive may not be captured by s 46 simply because the predator does not have substantial market power when it sets out on its course to deter or injure competitors. That may be because until it achieves its object it has no substantial degree of market power. Or it may be that it is a firm in a cyclical industry which has had, but does not have a substantial degree of market power at the time of the predatory conduct."[105]

For example, take a market with two firms and these firms vigorously compete on price. The two firms are similar and they produce homogeneous products. There are no legal restrictions in the industry, the capital costs of entry are minimal and other structural barriers to entry are very low. At the start of this game, neither firm is able to raise their prices above the competitive level. If they do, they will lose most of their sales. In the eyes of the law in Australia, neither firm can be held to have market power as they are unable to raise their price above supply cost. In the High Court decision in *Boral*, a passage from Gleeson CJ and Callinan J suggests that such an example of vigorous price competition between the two competitors in a market would mean that neither firm has the required level of market power for a s 46 case:

> "[A]n absence of a substantial degree of market power *only* requires a sufficient level of competition to deny a substantial degree of power to any competitor in the market."[106]

However, assume that one of the firms, Firm *x*, has an "advantage" over its rival that enables them to engage in a price cutting strategy. The nature of these "advantages" will be discussed in further detail below. Also assume that they are able to credibly signal to the other firm that they can commit to this strategy. Accordingly, the strategy of Firm *x* is successful in the sense that the other firm's best response to the price cutting strategy is to exit the market. As a result of such a strategy, the firm is able to monopolize the market. Additionally, the strategy has signaled the reputation of Firm *x* as a predator to all potential entrants in the future. Thus, in spite of the fact that the structural barriers to entry may be low, the strategic barriers to entry are not only significant but they enable *x* to maintain a monopoly position. With this monopoly position guaranteed, the firm is able to price supra-competitively to the detriment of consumers.

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105 *Boral* [2003] HCA 5 (High Court), at para 269.

This example illustrates the gap in the competition law. The idea that structural market power may not be found in spite of the fact that there are a small number of competitors in the market and market shares appear relatively high is not without basis, especially where predatory pricing is alleged. The vigorous nature of the competition in pricing between the small number of firms is likely to be interpreted by courts as an inability to raise prices. This inability will inevitably be misread as the inability to engage in predatory schemes by virtue of the fact that the defendant firm does not have the requisite degree of structural market power. Indeed, in two cases of alleged predatory pricing heard under Australian law, this inability to raise prices at the time of the alleged predatory conduct was the ultimate reason why the claims failed. The courts did not need to consider the second and third hurdles of s 46 due to the fact that the plaintiffs failed to establish that the defendant firm had a substantial degree of market power.

In both *Eastern Express v General Newspapers* and *Boral* the defendant firm was ultimately found not to have the necessary degree of market power at the time they commenced the allegedly predatory strategy. In these cases, there were not a large number of competitors in the markets in which competition was held to be strong. In *Eastern Express v General Newspapers*, there were effectively only two firms in the market for the acquisition of services by real estate agents in local newspapers in Sydney's eastern suburbs. In the Full Court's decision, Lockhart and Gummow JJ found that the defendant firm did not have a substantial degree of market power when they engaged in the allegedly predatory pricing policy. They found that although the barriers to entry appeared high, this was a "special and unusual" case, in that there was a strong degree of countervailing power, to the extent that the real estate agents were able to form their own rival newspaper to challenge the defendant.[107] As noted above, in *Boral*, the defendant firm was found not to have the required degree of market power. This was in spite of the fact that they had approximately 30% of the market and there were only four or five other firms in the market.

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106 *Boral* [2003] HCA 5, at para 120 (emphasis added).

107 *Eastern Express v General Newspapers* (1992) 35 FCR 43.

4.2 *Is "structurally competitive" predation a concern?*

Structurally competitive predation involves a situation where a firm is gaining structural market power from a situation which was previously, in a structural sense, competitive. While the predator could not raise its prices above the competitive level before engaging in the strategy, the elimination of its competition has enabled it to raise its prices after the strategy revealed itself to be successful.

There are situations where this type of gain of market power is in accordance with the principles of competition. Take for example a firm in a structurally competitive industry that is more efficient than all of its competitors. Posner argues that:

> "a seller may want to weaken or destroy a competitor, but if the only method used is underselling him by virtue of having lower costs there is no rational antitrust objection to the seller's conduct."[108]

If a firm were able to eliminate all their competitors by such efficiency means, then the competition law has no complaint with such acquisitions of market power. Hay notes that even in these cases, there may be adverse welfare effects and that the economic literature is "curiously silent" on this point.[109]

Nonetheless, where the predator is equally or less efficient than its prey the adverse welfare consequences of predation in the long-run in such cases are clear. Reduced competition and heightened barriers to entry mean that the predator is able to raise prices in the long run. This has a deleterious effect on consumers. Consumers lose out in two ways. Those consumers who can still afford to pay for the product are forced to pay higher prices. In addition, there are consumers who can no longer afford the product as they are priced out of the market. These consumers, who would have purchased the product at a competitive price, are denied the use of the product.

The short-run benefits flowing to consumers from the price cutting behavior of the predator are also patent. However, there are a number of factors which may render these short-run gains insignificant. Williamson notes three cases:

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[108] Posner (1976), at 188.

> "(a) the product or service is nonstorable and consumers recognize that the price cut is merely temporary; (b) the product is storable but the monopolist is unable to satisfy the demand for the product caused by the influx of orders from consumers attempting to increase their inventories; and (c) consumers mistakenly believe that the price cut will be permanent and adapt their investments accordingly."[110]

There are efficiency problems with pricing below cost. Essentially, such strategies can result in an economic loss to society. Consumers with low value purchase products at low prices from producers with high cost, effectively wasting society's limited productive resources.

On the other side of the market, there are issues of production inefficiency following a successful predatory pricing scheme. This will lead to further deadweight losses for society in the long run. The most efficient producer may not win a price war. Indeed, one of the inherent reasons for predatory pricing is that a firm wishes to eliminate an equally efficient or more efficient rival from the industry. As such the elimination of efficient rivals means that the product itself will cost society more than it would if the more efficient firm had been in the market. These long run misallocations of resources are costly to society and serve to further punish consumers.

Paul Milgrom has argued that in rapidly growing, high-technology industries involving continuing innovation there are additional costs to society:

> "[A] firm in an industry with rapid product change might cut prices sharply in answer to new entry in order to discourage the new entrant from continuing an active product development programme… it may be dissuaded from making new investments in and developing [n]ew products for the industry."[111]

Thus, in such industries, predation can serve to stifle future innovation and technological advancements.

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109 Hay (1981), at 164.

110 Williamson (1987), at 231-232.

111 Paul Milgrom, 'Predatory Pricing' in Giacomo Bonanno and Dario Brandolini (eds) (1987), *The New Palgrave Dictionary of Economics* 937, at 938.

In spite of these compelling reasons for prosecuting predatory behavior, there is an obvious problem with trying to litigate predatory strategies in practice.[112] The problem arises in trying to determine whether the strategies are indeed predatory or whether the defendant firm is reducing its prices in response to competitive constraints. If Australian law seeks to prohibit predation in markets that *prima facie* appear competitive, then this difficulty will only be compounded. As noted above, Joskow and Klevorick argued that American courts should examine the nature of the market prior to examining the nature of the strategy engaged in by the firm. They asserted that the probability of prosecuting non-predatory cases or acquitting genuinely predatory cases could be reduced if the courts only examine cases where the market power of the alleged predator is substantial.

5 Proposals to Overcome this Gap

The construction of s 46, and in particular the current interpretation of "market power" by Australian courts fails to adequately handle strategic behaviour by a firm that currently has no substantial structural market power, even though the behaviour aims to achieve such market power. The obvious example of this form of behaviour is predatory pricing. Additionally, the relatively static approach to market definition and market power adopted by the courts means that the dynamic elements that economists associate with predatory pricing cases are largely ignored. As a result of this construction, there is a gap in the competition law that enables firms to act in a predatory manner towards other firms in a structurally competitive market.

This section considers two ways in which the judiciary can overcome this gap. Essentially, both the proposals involve a departure from the manner in which the judiciary currently interprets the provision. In cases where a firm that currently does not have substantial structural market power is behaving in a way that is both inconsistent with standard competitive conduct and has the likelihood of creating such market power, we believe that

112 See for example Rhonda Smith and David Round (1998), 'Section 46: Oligopoly and Predatory Pricing' 6 *Competition and Consumer Law Journal* 112 where, at 112, it is noted that s 46 is "notoriously difficult" to prosecute.

courts should loosen their strict interpretation of s 46 in order for the law to accurately reflect the economic reality of the marketplace.

Predatory pricing is the obvious example of strategic behaviour that may be aimed at creating market power rather than involving the use of existing market power. However, the gap in s 46 and our suggestions below are not specific to predatory pricing and relate to any situation involving relevant strategic behaviour.

It could be argued that if this type of potentially anti-competitive behaviour, such as predatory pricing, is to be successfully prosecuted under the Act then a change in the legislation is required. Such potential changes in legislation have been considered elsewhere.[113] In our opinion, however, legislative changes to s 46 are not required. Rather, issues of behavioural market power can be dealt with through broader judicial interpretation.

The first proposal argues that courts should be more flexible in their examination of the three hurdles of s 46. That is, instead of merely examining structural market power in isolation and *then* proceeding to examine the conduct and purpose, the courts should allow for some "backflow" between the hurdles. That is, when examining the market power, it is necessary to examine the conduct of the firm in question to determine whether or not they are able to act free from constraints. Even when a firm does not have the requisite degree of "structural market power", the firm may still be able to act free from constraints. The conduct of the firm may provide evidence that the firm does indeed have market power. This notion that firms can have "behavioural market power" despite not having any "structural market power" is not accepted judicially in Australia, however, we believe such an interpretation would still fit within the language of the Act.

The second proposal contends that courts should take a more dynamic approach to the examination of market power. The current interpretation of market power is overly static and requires firms to have structural market power at the time that they engage in the alleged anti-competitive conduct. In predatory pricing cases, this interpretation does not appear to make sense. Why should it be an express requirement that the defendant firm is able to raise prices *at the time* that they engaged in a policy of cutting prices? If the courts are going to

113 Edwards (2003).

approach market power from a predominantly structural viewpoint, then they should examine not just the market power at the time of the initial predatory behaviour, but the market power *after* the predatory behaviour was completed. While this may create problems of causation between the three hurdles of s 46, again we believe that such an approach would still be consistent with the language of the Act. However, critics may argue that this approach would essentially turn s 46 into a reactive provision that operates after competition has been eliminated.

5.1 "Behavioural Market Power" in cases of predation

The failure of courts to recognise that market power can subsist in structurally competitive markets due to firms possessing the ability to exclude competition has meant that many predatory pricing cases will not and cannot be successfully prosecuted. We have argued that structural market power is not a necessary condition for firms wishing to engage in predatory strategies. Rather what is important in such cases is whether the defendant firm had sufficient power to exclude their rivals. This failure can be overcome if courts acknowledge that the structural elements of market power are not necessary for predation to occur, so long as the behavioural elements of market power are present.

Courts have primarily followed the idea that conduct is a function of the structure of the market. That is, the conduct of a defendant firm can be analysed by examining the structural elements of the market in which the firm operates. However, the courts are not so willing to acknowledge the inverse idea: that structure is a function of conduct. Courts should expressly acknowledge that the market structure can be influenced by the unilateral conduct of a firm over a period of time. This ability of a firm to engage in unilateral anti-competitive conduct even if they are in a *prima facie* structurally competitive market is not dependent upon the firm's power to raise prices above cost.

A firm in an otherwise vigorously competitive oligopoly can engage in predation to eliminate competitors and monopolise the market if it has specific strategic advantages. These advantages do not derive from the market structure and looking primarily at the market structure is not overly useful. Rather, in seeking to determine whether the firm in question

has the ability to exclude competitors from the market, the behaviour of the defendant is highly relevant.

Economic theory, and indeed the legislation, directs the courts to bear in mind a specific question when examining market power: To what degree was the firm able to make decisions unilaterally as opposed to merely responding to the competitive pressures of the market? If a firm was able to act with some degree of freedom from the constraints of competitors, suppliers and customers, then this conduct should necessarily be deemed to be evidence of some market power. If a firm makes all its decisions in response to competitive pressures then there is little doubt that the firm is in a competitive market, and does not have the requisite level of market power to contravene s 46.

The behaviour of the defendant firm is highly relevant for courts when examining market power generally, but when the case is one of predatory pricing, the conduct of the defendant firm is essential to the examination of market power. Of particular importance is whether the firm is persistently acting free from competitive constraints *and* whether they are acting in an anti-competitive manner. If they are acting free from competitive constraints and they are seeking to exclude competition, then the firm clearly has market power.

It may be argued that by analysing the conduct of the defendant firm the courts will face the same problems raised by the backward induction approach proffered by Finkelstein J in the Full Court judgment in *Boral*. As noted above, Finkelstein J believed that in cases where a firm's market power is defined by its ability to exclude competition, the "exclusionary conduct" *establishes* the market power. In our opinion, this goes too far. Conduct deemed to be "exclusionary conduct" can be used to evidence market power. However, it should not be used to establish its existence.

The mere fact that the firm is seeking to exclude rivals does not mean that market power will be established. Conduct by the defendant that *prima facie* appears to be exclusionary should not automatically result in establishing the claim that the defendant has market power.

Rather, a better approach is to argue that this putative exclusionary conduct is a factor in establishing the market power of the defendant. While it is an important factor, it should not be the sole factor. By itself, conduct that appears to be exclusionary does not assist us

greatly. In order to establish that the firm did indeed have "behavioural market power," it is necessary to show that the firm was *able* to act free from competitive constraint. That is, did the firm in question have some "advantage" over their rivals that enabled them to engage in anti-competitive behaviour.

This "advantage" however is not a generic term that can apply to any part of the firm that is seen to be better than in the same area of its rivals. For the purposes of establishing "behavioural market power" and the other limbs of the s 46 provision, the advantage must necessarily be causally linked to the behaviour being investigated. It must have some causal link to the exclusionary conduct. The courts essentially ask: what advantages did the defendant firm have over its rivals? What was it about these advantages that gave this firm (as opposed to its competitors) a special disposition to engage in a predatory strategy?

For example, an advantage such as greater ability to cover losses over a given period of time would be relevant to predatory pricing cases. If a defendant firm is able to cover losses by virtue of the fact that it is a multi-market, multi-product firm whereas the competitors were all single-market or single-product, then this may be a relevant factor in establishing that the defendant firm had "behavioural market power".[114]

Excess capacity would, in some circumstances, be considered to be such an advantage. For example, take a predator with large excess capacity in production that its competitors do not have. If this information is relayed to all players in the industry, then the predator is in an advantageous and credible position to engage in predatory pricing. Consequently, they have a greater ability to exclude their competitors from the market.

Another advantage can relate to "information".[115] Even in competitive industries the information asymmetries between established firms and newer firms may be vast, especially where there is a high degree of innovation and change.[116] These information advantages *may* be relevant if such advantages enabled a firm to engage in a predatory strategy.

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[114] See Manfred Neumann (1982) 'Predatory Pricing by a Quantity-Setting Multi-product Firm' 72 *American Economic Review* 825. See also discussion by Phlips (1995).

[115] See for example Luis Cabral and Michael Riordan (1994) 'The Learning Curve, Market Dominance and Predatory Pricing' 62 *Econometrica* 1115.

[116] See Anthony Creane (1996) 'An informational externality in Competitive Markets' 14 *International Journal of Industrial Organization* 331.

Strategic advantages are relative not absolute. The mere fact that one firm has excess capacity is irrelevant by itself. It must have an "advantage" over its competitors. It must be that the ability to exclude competition is derived from those advantages. If all the firms in the market are subject to exactly the same conditions and constraints, then no firm would be able to credibly engage in a strategy that would seek to exclude their competitors.

In needs to be stressed that the presence of strategic advantages can be indicative of market power but is not, by itself, determinative. Strategic advantages and firm behaviour together with market structure provide information about market power. We are not arguing that structure is irrelevant. Rather, we note that behavioural market power does not depend on market structure so that an analysis of market power based solely or predominantly on structural considerations will be flawed.

Additionally, to meet the "substantial" requirement in the legislation, a strategic advantage must not be insignificant. That is, in order for the firm to have a substantial degree of power to exclude competition, they must have substantial advantages over its rivals. This would preclude the possibility of trivial advantages being deemed to be the source of behavioural market power.

Thus, in cases where predatory pricing is alleged, it should be necessary for defendants to have substantial "behavioural market power" rather than "structural market power". This notion of market power based on the ability to engage in exclusionary behaviour is necessarily entwined with the conduct of the firm. If the firm has the ability to persistently engage in *prima facie* exclusionary conduct then this may seek to assist the court in finding that the firm did indeed have a requisite degree of market power. This ability can be seen by investigating certain elements of the conduct of the firm.

However, under our approach, it is not sufficient to merely use the conduct as a means of establishing the market power. Appearing to act in an anti-competitive manner would not be grounds for establishing power in a market. The firm must have some substantial advantage over its rivals that provides the firm with a power to exclude at least some of its rivals.

If this hurdle is satisfied, then the courts would examine whether the firm has used its market power. This is where the causal element between the advantage and the anti-competitive, exclusionary conduct would need to be established. If there is no causal element between the advantage and the conduct, then it has not used the market power that has been claimed.

An approach that analyses behaviour and strategic advantages in addition to market structure is preferred to the predominantly structural approach that courts have followed. The approach enables the analysis to get to the crux of the matter: to what degree was the firm acting unilaterally; and to what degree was the firm responding to the market? If the firm had a substantial advantage over its competitors that gave it power to exclude its rivals, then it should be held to have a substantial degree of market power. If firms have advantages over their rivals but they do not have power to exclude competition, then engaging in a putative predatory scheme will not contravene the law. They may have behavioural market power but have not taken advantage of that power as is required for liability to be established in predatory pricing cases.

5.2 Extension of the temporal dimension of the market in cases of predation

Instead of approaching market power from a strategic point of view, an alternative proposal would be to investigate the dynamic nature of "structural market power" when firms engage in putative predatory pricing schemes. The courts should recognise that the market is not static and an appropriate approach to market definition takes the temporal nature of the market into account. When analysing conduct aimed at altering market structure, market analysis requires temporal consideration of sufficient length to allow for any structural market changes. This means that when examining market power, instead of merely looking at the level of market power subsisting when the allegedly anti-competitive conduct took place, market power should be examined in a longer time frame in cases of predatory pricing.

This extension of time would enable courts to examine whether the defendant firm has had a substantial degree of market power *at any time* in the relevant period. With this extended "relevant period," courts could more easily determine that the firm in question had acted in a

manner designed to increase their structural market power to the detriment of competitors and, more importantly, competition in general.

As outlined above, one of the reasons that the hurdle of market power is rarely cleared when examining predatory pricing in a s 46 context is because of the overly static interpretation by courts. That is, the courts have only been willing to examine the nature of the market power that the defendant firm had at the time that the firm cut their prices. As we have noted above, this is not a necessary condition for predatory behaviour. However, the provisions can embrace such behavior if the courts are willing to define the market by reference to a longer time frame. Defining the market over a longer temporal interval means that the courts can examine whether the firm in question had a substantial degree of "structural" market power once the strategy had already been implemented.

Consider the example in Section 4 above. Even though neither firm had a substantial degree of structural market power *at the time* that our defendant firm cut prices below cost, once the strategy had been successfully implemented, Firm x was able to gain a monopoly in the industry. Under the construction given to s 46, the courts would look at whether Firm x had a substantial degree of market power at the time they engaged in the predatory pricing scheme. That is, when the defendant firm cut its price and maintained this below-cost price did they have a substantial degree of market power? As we have noted above, the courts would deem the firm not to have the requisite level of market power at such a point in time.

Once the competition had been eliminated, then Firm x has the power to raise its prices above cost. Clearly, the firm has the substantial degree of "structural market power" that the courts deem necessary for a s 46 case, however the defendant firm is no longer engaging in the conduct that would contravene the provision. The firm is merely raising its prices as a result of being the only firm left in the industry. It is not contrary to the trade practices law to be a monopoly. Nor is it contrary to raise prices if it is a monopolist. While the firm is taking advantage of its market power by raising its prices, the firm is not doing so for a proscribed purpose. It is not raising its prices to eliminate or damage a competitor (because it no longer has any competitors); prevent entry (if anything, higher prices should induce entry); or deter or prevent others from engaging in competitive conduct.

Under the construction of the law as it stands, Firm *x* would not be liable under s 46. The only time when the firm had a substantial degree of structural market power was once its competitors had been eliminated. Once these rivals had been eliminated, the defendant firm merely raised its prices – an action not contrary to the law. However, as noted above, overall the behaviour of the firm has led to a substantial lessening of competition which has severe detrimental effects for downstream businesses and consumers.

By extending the timeframe for market analysis the courts can overcome this problem. At the time of the price cut, the courts may hold that the defendant firm did not have the required degree of structural market power. However, once the competitor was eliminated, Firm *x* was able to raise its prices. Clearly at this point in time, the firm has a substantial degree of market power under the traditional Mason-Wilson test. Thus, if the court explicitly acknowledges that the relevant time period extends beyond the initial price cut to the period of time when the prices were raised, such behavior will be captured by the provision.

Extending the temporal dimension of the market allows for anti-competitive behavior to be captured under the law in circumstances where the law currently neglects to import liability. The analysis would not be vastly different from the current approach. Rather, this approach merely makes it easier for courts to clear the first of the three hurdles. It merely eliminates the task of determining at what exact point in time the defendant had structural market power. If at any time during the extended relevant period the defendant had market power, then the court would move on and investigate the second and third hurdles.

As the law stands, the fact that a firm has market power at the completion of a predatory strategy is entirely irrelevant. However, in the High Court's decision in *Boral*, a passage of obiter by Gleeson CJ and Callinan J hints at the possibility that the fact that the firm acquires structural market power *may* be taken into account.

Gleeson CJ and Callinan J noted that even if the defendant firm, Boral, had engaged in a predatory pricing scheme, they still did not even possess a substantial degree of market power after engaging in such conduct. That is, after Boral curtailed their allegedly predatory behaviour, they did not possess the ability to price supra-competitively:

> "If, after one or two firms leave a market in the course of a price war, the remaining firms are in strong competition, then their departure does not *achieve*, or evidence, market power… [Boral] demonstrated it had the financial strength to stay in the market. But it had not demonstrated, *or achieved*, a substantial degree of power in the market."[117]

It is interesting to see the judges discuss this. Under the interpretation of market power as it currently pertains to a s 46 case, the issue of whether or not the defendant has "achieved" market power is irrelevant. It has no bearing on whether or not the defendant was able to take advantage of any market power subsisting at the time of the allegedly predatory conduct.

While a relevant extension of the time frame for market analysis would appear to overcome the problems associated with the static approach favored by courts, it is possible to raise two major criticisms of this approach. The first problem is one of causation. As we have noted, courts have on many occasions stressed the importance of causation between the three hurdles of s 46. As Gleeson CJ and Callinan J noted in *Boral*:

> "It was pointed out by this Court in *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd* that s 46 requires, not merely the co-existence of market power, conduct, and proscribed purpose, but a connection such that the firm whose conduct is in question can be said to be taking advantage of its power."[118]

Taking this line of argument, it can be argued that extending the temporal dimension of the market definition will have no impact upon the liability under s 46. That is, the mere fact that the defendant firm had market power at the completion of the predatory strategy does not mean that they have taken advantage of that market power for one of the proscribed purposes in the legislation. We have already noted that raising prices is currently not viewed as "taking advantage for a proscribed purpose." The mere raising of prices when a firm is in the position of monopoly is not in breach of the law. Even if the firm is held to have a substantial degree of market power, the fact that it engaged in a predatory strategy while the market was structurally competitive would mean that the firm has not taken advantage of any power in a market.

117 *Boral* [2003] HCA 5 (High Court), at para 147 (emphasis added).
118 *Boral* [2003] HCA 5 (High Court), at para 120.

One way around this is to take a broad-brush approach. If the firm is held to have a substantial degree of market power at *any* point in time during a "relevant period" (that is, during the alleged predation and in the period immediately following), then it can be assumed that the firm had a substantial degree for the *entire* period. Taking this approach, causation would no longer be a problem.

Critics may argue that making such an assumption is an extreme measure. They may argue that this approach to overcoming the problem of causation is artificial. That is, it would not be achieved in substance, but rather in name only. It could be argued that there is an inherent difficulty in establishing that a defendant firm "used" putative market power at the beginning of the relevant period, when in actual fact the defendant firm only had actual market power at the end of the relevant period.

However, this approach would not be inconsistent with the analysis presented by Gleeson CJ and Callinan J in *Boral*, noted above. If the defendant firm had "achieved" market power by the end of the relevant period, then under our proposal, it could be assumed that they had market power for the entire period. As it turned out, Gleeson CJ and Callinan J decided that Boral were not able to achieve such market power. The conclusion would be the same.

A different approach to the problem of causation is to acknowledge that the strategic barriers to entry are still being erected and raised even after the competitors have left the industry. That is, when the firm actually does have structural market power, they are taking advantage of this power for a proscribed purpose (by deterring future entry). Critics may argue that the erection of strategic barriers in this sense took place when the firm commenced the predatory strategy. However, this is a very narrow and static outlook. Nonetheless, these arguments aside, proving that such strategic barriers to entry had indeed been erected may prove difficult.

Aside from the problems of causation associated with extending the temporal dimension of the market, critics may argue that analysing market power at the conclusion of the predatory policy would essentially turn the analysis of misusing market power into an analysis of the "effect". That is, only once the predatory policy has taken effect and competitors have been eliminated and potential entrants deterred can the defendant firm be found to have market

power and be found liable under s 46. Essentially, this would mean that the law could only react to anti-competitive strategies after they have taken effect. They would not be able to prevent firms in *prima facie* competitive markets from engaging in anti-competitive behavior.

However, such criticisms are not persuasive. The law cannot prevent predatory strategies in *prima facie* competitive markets under the current interpretation of the law. Indeed, even once the defendant's rivals have been eliminated and potential entrants deterred from entering the market, the defendant would escape liability under the current law. At least this proposal would be able to *ex post* prosecute predatory behaviour.

6 Conclusion

The potential failure of the *Trade Practices Act* to prevent firms from engaging in conduct designed to create structural market power is a clear cause for concern. At its simplest, this failure means that a variety of anti-competitive conduct may 'fall under the radar' of s 46. This possibility is highlighted by the recent High Court decision in *Boral* and the Full Federal Court decision in *Universal.*

At its simplest, the problem relates to the failure by the courts to pay due account to possible behavioural market power in situations where simple static structural market power is absent. Modern economic analysis and industry study provides a variety of examples of behaviour where a firm is able to alter market structure to its advantage over time. When engaging in anti-competitive conduct, such a firm does not have substantial structural market power. In fact, if it had such structural market power, it would have no need to engage in the anti-competitive conduct. After all, the conduct is aimed at altering market structure to gain structural market power. Structural market power is not the driver behind the anti-competitive conduct but is the aim of this conduct.

In such circumstances, the relevant firm has substantial behavioural market power. The firm has the ability, due to some specific advantage or set of advantages, to undertake conduct that is not consistent with reasonable competitive behaviour. As we noted above, these

advantages might involve information asymmetries, excess capacity, or multi-market structure when considering predatory pricing.

The failure of the courts to recognize behavioural market power and to limit the analysis of market power to the ability to raise prices means that certain types of anti-competitive conduct, such as predatory pricing, may be relatively immune from prosecution under the Act. This problem can be overcome in two ways under the existing legislation. First, the courts could retain its structural approach to market power but extend the temporal analysis of markets to include a timeframe sufficient to cover changes in market structure. However, as discussed above, this approach raises a number of issues with the wording of s 46 and in particular the link between market power and the use of that power.

Alternatively, the courts could recognise the importance of behaviour when considering market power. While the courts have noted that conduct can provide useful and important evidence of market power, recent decisions have stepped back from the inference of market power from behaviour that is only consistent with such power. In our opinion, this is inconsistent with modern economics. Behaviour that is only consistent with a firm that is acting with scant regard to competitive constraints provides powerful evidence that the relevant firm has market power. Even if the current structure of the market appears to be competitive, such behaviour, when tied back to specific advantages possessed by the firm relative to its rivals, is consistent with a firm that has market power. If the firm has substantial behavioural market power and takes advantage of this power to undermine the competitive structure of the market, then it appears that the firm is engaging in exactly the type of behaviour that s 46 is designed to catch.