

SUBMISSION TO THE COMPETITION POLICY REVIEW

MISUSE OF MARKET POWER

6 June 2014

Introduction

1. This submission responds to the Review's Issues Paper dated 14 April 2014 and the Review's terms of reference which require it to consider whether Australia's competition law is responsive, effective and certain in its support of its economic policy objectives. The focus of this submission is misuse of market power and a range of issues that touch upon or are affected by misuse of market power, such as policy objectives, the scope of the prohibition, implications for mergers, enforcement and authorisations.
2. The submission is a personal submission by Dr George Raitt, Partner, Piper Alderman, Lawyers. It is based on experience as a commercial law practitioner over a large part of the period in which s 46 of the *Competition and Consumer Act* 2010 has been in effect, i.e. since the 1974 Act. It also reflects the author's current research on law and economics at Deakin University. The views expressed are those of the author and do not represent the views of Piper Alderman or Deakin University. The author has no pecuniary interests, or obligations to any current or former clients, that would affect the views expressed in this submission.

Summary of recommendations

3. There is, as the Issues Paper notes, a disturbing lack of clarity, and consequential controversy, in Australia and around the world about misuse of market power. Due to the diversity of laws around the world, little would be achieved by bringing our law into line with, e.g. Europe or the USA, as divergences and controversy would continue unabated. To amend our provision in a uniquely Australian way would put us further out of step with the rest of the world and is not recommended at this time.
4. It is suggested that, pending further research and reform on a coordinated global basis, and in order to promote certainty and predictability for business, Australia should continue the status quo, i.e. make no substantial change to s 46. This is in line with the recent recommendation of the Antitrust Modernisation Commission in the US. Further, an 'effects test' should not be introduced into s 46 because it would not overcome the fundamental indeterminacy of 'market power' demonstrated in this submission. It goes without saying that the ad hoc 'Birdsville' amendments do not fit with the scheme of s 46 and should be repealed.
5. There is one specific change that is recommended for s 46: in the zero sum real world in which market participants compete, harm to competitors is a natural consequence (i.e. a dual purpose) of the self-interested conduct that competition laws seek to encourage. Section 4F provides that 'purpose'

includes any substantial purpose among many, and means that such conduct can be taken to have a prohibited purpose. Section 46 should be amended so that s 4F does not apply to it.

6. The concept of market power and the regulation of it by competition laws in Australia and around the world is deeply flawed and suffers from indeterminacy to a greater degree than would be tolerated with any other law. Current provisions clearly satisfy a perceived need, however, they operate by the 'placebo effect' rather than any determinable (i.e. empirically verifiable) economic effect. It is suspected that the transaction costs imposed by institutional arrangements regarding competition laws, i.e. regulators, lawyers, economists, courts and tribunals, outweigh any determinable benefits in the case of misuse of market power. It is suggested that further research is needed to identify legitimate policy concerns and address them in a way that does not chill legitimate economic activity, i.e. to re-make s 46 in a more effective form. The time required for this task probably exceeds the time available to the current Review. Nevertheless, this submission sets out some proposals for further consideration.
7. The institutional arrangements require consideration. The popular conception of the ACCC as a consumer advocate creates a possible perception of conflict between its prosecutorial role and its administrative role in e.g. mergers. These roles may require separation.
8. Data collection is a serious issue. There is a lack of data relevant to addressing the problem of market power. It is insufficient that the ACCC has data collection powers when a contravention is suspected. Key data concerning elasticity of demand and supply in markets of interest is not available. The Australian Bureau of Statistics should be empowered to obtain this data in markets of interest to be specified by the responsible minister from time to time. This ought to be publicly available in de-identified form, and available on a confidential basis for research, but should not be admissible in any proceeding by the ACCC.
9. Third line forcing provisions appear to have become a 'dead letter' and should be repealed, in line with the recommendations of previous reviews. Current procedures whereby parties notify the conduct and the ACCC appears to turn a blind eye are inappropriate. The competition test applicable to exclusive dealing should be adequate to deal with any perceived problem.
10. The merger provisions are a problem because of the effective reverse onus of proof, i.e. the practical ability of the ACCC to block mergers without effective independent review by a tribunal or court. This occurs because often market participants are captive to the immediacy of markets and delay has strategic implications. The analysis of 'market power' and policy issues affecting s 46 in this submission has implications for competition law assessment of mergers. The repeal of the 'market size' threshold was a retrograde step. There is a need for a transaction threshold for the law applying to mergers to avoid unnecessary transaction costs, e.g. transactions under say \$50M or \$100M should be excepted. The institutional arrangements need to be able to respond in a more timely way in the case of contested takeovers.

11. This leads to a more general point: enforcement provisions should not permit competition laws to be used by market participants as part of the strategic 'game' of competition. Private actions should only be permitted after a successful proceeding by the ACCC to enforce contraventions. This applies particularly to s 46 where law and economics does not provide a 'bright-line' between permitted and prohibited conduct and private actions may not be appropriate at all.

Layout of the submission

12. This submission is divided into sections that address the topics below:

Section I – Problems of law and economics with respect to 'market power'	3
Section II – The use of economic models and a new conceptual approach to market power	13
Section III – Dual purposes and models of incumbent response to new entry	26
Section IV – Conclusion	34

Section I – Problems of law and economics with respect to 'market power'

13. The Review notes that dominant firm conduct is one of the most complex and controversial areas in competition policy.¹ This is an understatement, as is shown in this Section of the submission. There is a lack of agreement in Australia and overseas concerning how we determine whether a dominant firm's conduct in the market amounts to an unlawful misuse of market power or may be permitted as a normal incident of competition.² It is submitted that a re-evaluation of policy objectives and our conceptualisation of 'misuse of market power' is long overdue.

¹ Competition Policy Review, *Issues Paper*, 14 April 2014, paragraph 5.7.

² See e.g. Brian Facey and Dany Assaf, 'Monopolization and Abuse of Dominance in Canada, the United States, and the European Union: A Survey' (2002-03) 70 *Antitrust Law Journal* 513; Paul Crampton, "Abuse" of "Dominance" in Canada: Building on the International Experience' (2005-06) 73 *Antitrust Law Journal* 803; William Reid, 'Aspen Skiing in a Sunburnt Country' (2005-06) 73 *Antitrust Law Journal* 209; George Hay and Rhonda Smith, "Why Can't a Woman be more like a Man?" – American and Australian Approaches to Exclusionary Conduct' (2007) 31 *Melbourne University Law Review* 1099; Antitrust Modernisation Commission, *Antitrust Modernisation Commission Report and Recommendations* (2007), 81; Department of Justice (US), 'Competition and Monopoly: Single-firm Conduct Under Section 2 of the Sherman Act' (2008), 18; Alan Meese, 'Reframing Antitrust in Light of Scientific Revolution: Accounting for Transaction Costs in Rule of Reason Analysis' (2010) 62 *Hastings Law Journal* 457; Hedvig Schmidt, 'Market power – the root of all evil? A comparative analysis of the concepts of market power, dominance and monopolisation' in Ariel Ezrachi (ed) *Research Handbook on International Competition Law* (Edward Elgar, 2012); Jeffery Cross, Douglas Richards, Maurice Stucke, and Spencer Waller, 'Use of Dominance, Unlawful Conduct, and Causation Under Section 36 of the New Zealand Commerce Act: A US Perspective' (2013) *New Zealand Business Law Quarterly* at <<http://ssrn.com/abstract=2170538>>.

14. There are opposing views about the relevant policy objectives and the extent to which such objectives may inform 'misuse of market power'.³ One view is that economic efficiency, i.e. maximising production and income from society's scarce resources (total welfare), should be the goal.⁴ This view is endorsed by the Australian Competition Tribunal's comments in the *Qantas/Air New Zealand* decision.⁵ However, the Tribunal was considering the meaning of 'public benefit' for the purpose of a merger authorisation, and cited only one author in support.⁶ The ACCC opposed that interpretation,⁷ and may still do so. The opposing view is that maximising consumer choice and satisfaction should be the goal, i.e. the purpose is to protect consumers (and small business) from big business.⁸ The US Antitrust Modernisation Commission recently considered the debate but did not attempt to resolve it because the Commission considered that in many cases the legal outcome would not be affected.⁹ It seems strange that policy objectives are thought not to inform the application of the law. It is suggested that in the case of misuse of market power, due to continuing controversies, we need to re-examine policy objectives – and what can be achieved by markets, and hence by competition laws.
15. Despite many previous reviews, s 46 is still based on purpose rather than effect,¹⁰ and requires the court to undertake a counter-factual assessment of how a dominant firm would be likely to conduct itself under circumstances of competition, i.e. in the absence of its market power. This submission will consider whether an 'effects test' would quell the controversy around the application of s 46, and concludes that it would not.
16. It is said that Australian judicial reasoning in this area of competition law 'mask[s] undisclosed policy decisions',¹¹ and consequently there is a need for a 'deeper theoretical understanding' of the role of economic theory, legal

³ See e.g. John Kirkwood, 'The Essence of Antitrust: Protecting Consumers and Small Suppliers from Anticompetitive Conduct' (2013) 81 *Fordham Law Review* 2425; Joshua Wright, 'The Antitrust/Consumer Protection Paradox: Two policies at war with each other' (2012) 121 *Yale Law Journal* 2216; and, Maurice Stucke, 'Reconsidering Antitrust's Goals' (2012) 53 *Boston College Law Review* 551.

⁴ See e.g. Robert Bork, *The Antitrust Paradox: A Policy at War with Itself* (Perseus Books, 1978), in Daniel Crane and Herbert Hovenkamp (eds), *The Making of Competition Policy: Legal and Economic Sources* (Oxford University Press, 2013) 408; Department of Justice (US), above n 2, 7.

⁵ *Qantas Airways Ltd* [2004] ACompT 9, paragraph 185.

⁶ Ibid, paragraph 170; M S Gal, *Competition Policy for Small Market Economies* (Harvard University Press, 2003) 203-205.

⁷ Ibid, paragraph 169.

⁸ See e.g. Kirkwood, above n 3, 2429.

⁹ Report, above n 2, 26, footnote 22.

¹⁰ See e.g. Hilmer Report, *National Competition Policy* (AGPS, 1993) 61-74; Dawson Report, *Review of Competition Provisions of the Trade Practices Act* (Commonwealth, 2003) 75-88; Steven Kates 'A Critique of the Role, Powers and Activities of the ACCC: the Business View' (2002) 35 *Australian Economic Review* 438, 443-4; Allan Fels 'The Past and Future of Competition Law' (2004) 23 *Economic Papers* 3, 8-9; Anne Davies 'Fels Calls for Tougher Laws' *Sydney Morning Herald* 7 March 2013; John Durie 'Cement Yet to Set on Whether ACCC Loss Can Support Effects Test' *Australian Financial Review* 11 September 2013; Allan Fels 'The Harper Review has to choose its targets well' *Australian Financial Review* 1 April 2014.

¹¹ Kathryn McMahon, 'Competition Law, Adjudication and the High Court' (2006) 30 *Melbourne University Law Review* 782, 784.

precedent and public policy in the regulation of economic activity.¹² It has been suggested that Australian judges have tended to rely on 'commercial intuition' and that there is a need for legal and economic reasoning that provides certainty and predictability for business.¹³

17. Even in the US context where there is a more significant body of legislative and judicial experience in the field, 'surprisingly few scholars have attempted to provide either a positive or normative theory of monopolisation law',¹⁴ and consequently 'lack of clarity has been a long running problem'.¹⁵ It has been suggested that these problems have led the US courts to be sceptical of intervening to apply s 2 of the Sherman Act.¹⁶
18. It seems likely that the debate about policy objectives will be re-opened in connection with the current Competition Policy Review.¹⁷ The Review's terms of reference include considering whether Australia's competition law is 'responsive, effective and certain in its support of its economic policy objectives'.¹⁸ The policy objectives are not stated in the terms of reference. However, in relation to misuse of market power, the Review must consider whether the provisions 'support the growth of efficient businesses regardless of size'.¹⁹ Section 46 does not expressly indicate what kind of conduct may be outside the scope of the prohibition, i.e. lawful, though some suggest that conduct which promotes efficiency could be justified on that ground.²⁰
19. The lack of clarity about policy objectives is evident in the Review's Issues Paper, which seems to endorse the objective of total welfare, i.e. maximising productive efficiency of Australia's resources.²¹ However, the Issues Paper characterises competition as rivalry between *businesses* which seek to maximise profit by providing what consumers want.²² This is only one side of the market mechanism: we need to remind ourselves of what can and cannot be achieved through the competitive market mechanism, and to test the law against benchmarks such as certainty and predictability.²³

¹² Ibid, 836.

¹³ Michael O'Bryan, 'Section 46: Law or Economics? (1993) 1 *Competition & Consumer Law Journal* 64, 78; see also Michael O'Bryan, 'Section 46: Legal and economic principles and reasoning in *Melway and Boral*' (2001) 8 *Competition & Consumer Law Journal* 1.

¹⁴ Keith Hylton, 'The Law and Economics of Monopolization Standards' in Keith Hylton (ed) *Antitrust Law and Economics* (Edward Elgar Publishing, 2010), 82, 88.

¹⁵ Ibid, 107; see also Jonathan Baker 'Exclusion as a Core Competition Concern' (2013) *Antitrust Law Journal* 527; Herbert Hovenkamp, *Antitrust Enterprise: Principle and Execution* (Harvard University Press, 2005), 95.

¹⁶ William Kovacic, 'The Intellectual DNA of Modern U.S. Competition Law for Dominant Firm Conduct: The Chicago/Harvard Double Helix' (2007) *Columbia Business Law Review* 1, 71-3.

¹⁷ See e.g. Marianna Papadakis, 'Review's small business focus wrong, says Hilmer' *Australian Financial Review* 14 February 2014, 9.

¹⁸ Competition Policy Review, Australia, *Terms of Reference*, 27 March 2014, paragraph 3.1.

¹⁹ Ibid, paragraph 3.3.2.

²⁰ O'Bryan, 'Law or Economics,' above n 13, 64.

²¹ Competition Policy Review, *Issues Paper*, above n 1, paragraph 1.2.

²² Ibid, paragraph 1.3.

²³ Stucke, above n 3, 574-5 calls these 'rule of law concerns'.

20. It is also necessary to be cognisant of the influence of opposing 'world views' in the policy debate. These are polarised and easily identified. On the one hand, some have confidence in the ability of markets to 'self-correct' (i.e. believe that market power creates excess profits which encourage entry of new firms thus returning profits to normal levels) and a corresponding lack of confidence in governments to intervene effectively, and on the other hand, some have a diametrically opposed lack of confidence in markets and belief in the ability of regulators to intervene effectively.²⁴ That the unresolved debate is relevant to the regulation of market power is demonstrated by the release in 2008 and subsequent withdrawal in 2009 of the US Department of Justice's report on dominant firm conduct.²⁵ In announcing the Department's decision to withdraw the report, Assistant Attorney-General Christine Varney states that she does not agree with the view implicit in the report that markets are generally self-correcting, and in her view enforcement must proceed on the basis that the market alone cannot be relied on to ensure that competition and consumers will be protected.²⁶ Section III of this submission examines the issue more closely and concludes that the 'self-correcting' mechanism does not work in imperfect markets, but that competition laws (such as s 46 in its current form) do not adequately rectify the situation.
21. Neither of the opposing world views is adequate to elucidate competition law or its application to dominant firm conduct, and it is necessary to interrogate the opposing world views to progress the debate. It is submitted that there is a critical distinction between removing impediments to the market mechanism to facilitate market outcomes and intervening in the market to 'correct' perceived undesirable market outcomes.
22. It appears that despite the attention given to 'law and economics' in the US and elsewhere since the 1970s key questions about 'market power' remain unsettled. Australian thinking about market power appears largely untouched by these developments. For example, in their expert's report in the current merger authorisation case *AGL/MacGen*, Frontier Economics refer to US thinking about 'market power' from 1955, adopted by the Tribunal in 1976, which remains unquestioned in Australia.²⁷

²⁴ Herbert Hovenkamp, 'Post-Chicago Antitrust: A Review and Critique' (2001) *Columbia Business Review*, in Daniel Crane and Herbert Hovenkamp (eds), *The Making of Competition Policy: Legal and Economic Sources* (Oxford University Press, 2013) 482. See also David Gerber, *Global Competition: Law, Markets, and Globalisation* (Oxford University Press, 2010), 142; David Spence and Robert Prentice, 'The Transformation of American Energy Markets and the Problem of Market Power' (2012) 53 *Boston College Law Review* 131, 133; Alan Devlin and Michael Jacobs, 'Antitrust Divergence and the Limits of Economics' (2010) 104 *Northwestern University Law Review* 270; and John Vickers 'Competition Law and Economics: A Mid-Atlantic Viewpoint' (2007) 3 *European Competition Journal* 1, 6.

²⁵ Department of Justice (US), above n 2.

²⁶ Department of Justice (US), 'Justice Department Withdraws Report on Antitrust Monopoly Law, Press Release 11 May 2009.'

²⁷ Frontier Economics, 'Competition Issues' 26 March 2014, Expert's Report prepared for AGL, filed in the Australian Competition Tribunal, paragraph 6. No criticism intended of Frontier Economics – an expert's report is not the place to engage in the critical debate.

23. In a 1981 article, William Landes and Richard Posner argue that the determinants of market power are the responsiveness of demand and supply to price changes ('elasticity', which is not empirically measurable) and suggest improvements to US judicial approaches of inferring market power from market shares.²⁸ Despite a recent similar study by Roger Blair and Celeste Carruthers the implications for the conceptualisation of 'market power' have not been fully explored.²⁹
24. Frontier Economics state that elasticity can be estimated if there is historical data available.³⁰ This is a big 'if', which has so far proved insurmountable for studies of the economic effects of, e.g. bundling in the petrol and grocery markets, to which reference will be made below. In fact we lack empirical data to be able to verify whether we have a problem with market power or whether the law prohibiting market power is delivering any net public benefit. For example, Daniel Simon observes that 'theories of entry deterrence and incumbent response to entry ... [yield] a variety of predictions' and the results of empirical studies are 'very inconsistent'.³¹ In Section III below the question of incumbent response to new entry, and the application of s 46, is examined further. In calling for amendments to the Australian provision in 2004, Allan Fels observed that the ACCC at that time had only one success in litigating abuse of market power, and asked 'Does anyone believe that there has been only one instance in which Australian business with substantial market power has misused it to harm competition in that period?'.³² Ordinarily, you would expect evidence based policy discussion to put forward empirical evidence of abuses, rather than to presume abuses and to recommend lowering the prosecutorial bar until successful prosecutions result to validate the existence of the presumed problem. Apparently the evidence is lacking.
25. In the recent Federal Court decision *ACCC v Cement Australia*,³³ the ACCC succeeded in establishing an anti-competitive agreement, but failed in its s 46 claim that the respondent has misused its market power.³⁴ The court was prepared to hold that the respondent had market power when it entered into or renewed certain contracts to acquire a particular raw material. The issue of misuse of market power therefore turned on whether the respondent had 'taken advantage' of its market power. The court examined evidence of business decisions, made over a period of 5 years, to consider what reasons the respondent had to enter into, perform and renew contracts, and whether those reasons would be rational in a workably competitive market, i.e. could have been made by a party lacking market power. The court found that the respondent did not take advantage of its market power but entered into the agreements for purposes that included a proscribed anti-competitive purpose.

²⁸ William Landes and Richard Posner, 'Market Power in Antitrust Cases' (1981) 94 *Harvard Law Review* 937, 941-943 and 979.

²⁹ Roger Blair and Celeste Carruthers, 'The Economics of Monopoly Power in Antitrust' in Keith Hylton (ed), *Antitrust Law and Economics* (Edward Elgar Publishing, 2010) 64.

³⁰ Frontier Economics, above n 27, paragraph 61.

³¹ Daniel Simon, 'Incumbent Pricing Responses to Entry' (2005) 26 *Strategic Management Journal* 1229.

³² Fels, 'Past and Future', above n 10, 8.

³³ [2013] FCA 909.

³⁴ Durie, above n 10.

26. The *Australian Cement* case might be thought to concern issues of exclusive dealing rather than unilateral conduct by a dominant firm. Ironically, that decision turned on the 'purpose' test in s 45, which also contains an 'effects' test of the kind some argue should be legislated for in s 46. This may inform the debate concerning the appropriate test for abuse of market power under s 46. As this submission will show, the purpose test established in s 4F is inappropriate in the context of s 46.
27. The concept of market power is relevant to another area of competition law – the prohibition of anti-competitive *mergers*. While the specific legal test is whether the merger would be likely to substantially lessen competition, the underlying enquiry is often expressed to be whether the merger is likely to create or enhance market power.³⁵ Again, the analysis of competition effects has tended to be crude.³⁶ Refinement of our understanding of market power will affect our thinking about mergers.
28. For a law that is underpinned by economics, courts and tribunals seem to be increasingly sceptical of what economics has to offer. The High Court has stated that economic analysis may be consistent with the purposes of s 46 'if it can be undertaken with sufficient cogency' and observed that 'in some cases, a process of inference, based upon economic analysis, may be unnecessary'.³⁷ The Antitrust Modernisation Commission says much the same thing when it suggests that 'bright-line legal rules' that business can easily follow are to be preferred over rules that depend on often conflicting views of economists.³⁸ However, we do not yet have 'bright-line legal rules'. To give one example, the Australian Competition Tribunal in *Qantas/Air New Zealand* expressed some dissatisfaction with the neutrality of economics experts.³⁹ The feeling is probably mutual, as economics experts have expressed some dissatisfaction with the legal process. For example, the Hilmer Report noted 'a degree of dissatisfaction with the current court procedures for the utilisation of economic material',⁴⁰ and considered it worthwhile that further consideration be given to measures to address the situation, including 'arrangements for increasing the specialisation of judges involved in competition matters'.⁴¹

³⁵ Herbert Hovenkamp, above n 15, 210.

³⁶ See, e.g. Hovenkamp, *ibid*; Gregory Sidak and David Teece, 'Dynamic Competition in Antitrust Law' (2009) *Journal of Competition Law and Economics* available at <<http://ssrn.com/abstract=1479874>> advocate reform of the US merger guidelines, subsequently addressed to some extent in the 2010 guidelines; Richard Feinstein, '2010 Revisions to the US Horizontal Merger Guidelines' (2011) 7 *Competition Law International* 6; US Department of Justice and Federal Trade Commission 'Horizontal Merger Guidelines' 19 August 2010; cf Australian Competition and Consumer Commission 'Merger Guidelines' November 2008.

³⁷ Majority in the High Court, *Melway Publishing v Robert Hicks* (2001) 178 ALR 253, 266. See also Sir Anthony Mason 'Law and Economics' (1991) 17 *Monash University Law Review* 167, 173; Michael Trebilcock, 'The Value and Limits of Law and Economics' in Megan Richardson and Gillian Hadfield (eds), *The Second Wave of Law and Economics* (Federation Press, 1999) 12.

³⁸ Report, above n 2, 87.

³⁹ Tribunal decision, above n 5, paragraph 227.

⁴⁰ Hilmer Report, above n 10, 170-1.

⁴¹ *Ibid*, 178.

29. Both perspectives probably misunderstand the other. Neither law nor economics is a value-free science: both require a framework, or view of the world, within which to make sense of both the positive and the normative. Of particular interest to this submission is the way in which legal and policy thinking has used economics. F. M. Scherer suggests that the *choices* made by regulators and courts in reading 'what economics has to say; that is, on which among conflicting propositions they have placed emphasis and which ones they have downplayed depend importantly upon the values [of] the decision-makers',⁴² i.e. their view of the world. By examining the way economic models have been used in legal reasoning, underlying views of the world, and their policy implications, can be critically examined.
30. In fact economic models are of limited utility in drawing policy conclusions, though this is often overlooked. For example, Frontier Economics in a recent report note that the economic models that inform our concepts of 'market power' are extremes not encountered in the real world,⁴³ but the implications of this for our conception of 'market power' are not commonly explored. The models of perfect competition and monopoly demonstrate optimality under such an unrealistic set of assumptions that the models cannot be used to explain the real world.⁴⁴ Richard Posner does not consider this 'lack of realism' to be a problem, however, his argument that economic theory nevertheless has 'predictive power' is not sufficiently developed to be convincing.⁴⁵ When economists compare monopoly to perfect competition the outcome of the comparison depends on the assumptions they make, i.e. their view of the world.⁴⁶
31. According to Lipsey and Lancaster's 'theory of second-best', strategies indicated by a model to achieve optimality cannot be reliably predicted to achieve it when all the assumptions are not satisfied, i.e. in the real world we cannot predict whether such strategies will make things better or worse.⁴⁷ In the real world data are not readily available to use economic concepts of opportunity cost and marginal cost as they do not correspond with management or financial accounting measures that businesses use to make decisions and report to owners. Economists argue that this does not affect the predictive value of economic theory.⁴⁸ That has always seemed far-fetched, however, even if it is accepted, Landes and Posner describe the

⁴² F. M. Scherer, 'Conservative Economics and Antitrust: A Variety of Influences' (2008) originally published in Robert Pitofsky (ed) *How the Chicago School Overshot the Mark* (Oxford University Press, 2008) reprinted in Daniel Crane and Herbert Hovenkamp (eds), *The Making of Competition Policy: Legal and Economic Sources* (Oxford University Press, 2013) 469.

⁴³ Expert's Report, above n 27, paragraph 7. Again, no criticism intended.

⁴⁴ See e.g. Richard G. Lipsey, *An Introduction to Positive Economics* (Weidenfeld and Nicholson, 1963), 375-9; Richard G. Lipsey and K. Alec Chrystal *An Introduction to Positive Economics* 8th ed (Oxford University Press, 1995), 407-8; Alfred Eichner and J. A. Kregel 'An Essay on Post-Keynesian Theory' (1975) 13 *Journal of Economic Literature* 1293, 1310.

⁴⁵ Posner *Economic Analysis of Law*, 7th edition (Aspen Publishers, 2007), 16.

⁴⁶ Lipsey, above n 44, 373.

⁴⁷ See Richard Markovits 'Second-best Theory in Law and Economics' (1998) *Chicago-Kent Law Review* 73.

⁴⁸ Lipsey above n 44, 394.

economic concept of 'marginal cost' as a 'hypothetical construct', and there appears to be no doubt that it is extremely difficult to measure empirically.⁴⁹

32. It appears that for a variety of reasons, pragmatic and political, harm to consumers in terms of higher prices or reduced output of products has become a rhetorical figure for the harm that may be created through inefficient markets and impaired economic development and also for misuse of market power. As noted above, the Review's Issues Paper suggests total welfare is the policy objective of Australian competition laws, however, the Issues Paper uses the rhetoric of consumer welfare to explain the benefits of competition. John Kirkwood argues there is widespread support in contemporary debate for a normative framework which recognises it is wrong for firms to exploit their market power to harm consumers and small business.⁵⁰ Stated in this way the proposition is 'motherhood', i.e. no-one would argue that corporations should be allowed to 'abuse' or 'exploit' their power to 'harm' consumers, but the proposition does not enlighten us as to the content of these concepts or prove that the harm is real.
33. It is submitted that it is wrong to suggest (apparently based on the theory of monopoly) that consumers are harmed by higher prices or reduced output of particular products. It is likewise wrong to suggest that higher prices or reduced output of products in a given market corresponds with a reduction in total welfare. And finally, higher prices or reduced output of products is not the same as market power, or even a symptom of the use of market power. These propositions will be discussed further below.
34. Based on their analysis of fraud and market manipulation in the California energy markets in 2000-2001, David Spence and Robert Prentice argue that there is a natural tendency for suppliers who have market power to use it to drive 'prices beyond levels attributable to the forces of supply and demand'.⁵¹ This of course assumes that one can hypothetically determine prices that would be attributable purely to supply and demand, and further, that such prices will be congenial to all consumers. However, this is not the function of the market mechanism, which is simply a means of rationing scarce supplies between consumers, not on the basis of fairness or social objectives, but on the basis of willingness and ability to pay.
35. Kirkwood argues that, in a time of shortages, it would be unfair for firms to increase prices and it is part of the project of competition law to constrain unfair or unreasonable market outcomes.⁵² This would require an *intervention* in the market mechanism since the unimpeded market mechanism simply produces a price and output that equates demand with supply with the result that some producers and consumers are excluded from the market. As is recognised in the literature on the regulation of energy markets, the task of ensuring that prices are fair and reasonable, ensuring access for all

⁴⁹ Landes and Posner, above n 28, 941; see also Hovenkamp, above, n 15, 163.

⁵⁰ Kirkwood, above, n 3, 2448.

⁵¹ Spence and Prentice, above n 24, 150.

⁵² Kirkwood, above n 3, 2447.

consumers, is a project that the unimpeded market mechanism does not and cannot address.⁵³

36. Hovenkamp states that economic theory does not give us 'normative ideas about what the optimal price and output should be'.⁵⁴ Despite this, he asserts that 'the indicia of antitrust harm' are 'reduced output and higher prices in a properly defined relevant market'.⁵⁵ Leaving aside problems of market definition, if his earlier statement is correct it would not be possible to establish whether higher prices depart from or approach the indeterminate optimum. Hovenkamp goes some way to acknowledge this when he says that to provide a remedy the court would have to determine the 'correct' price.⁵⁶ Since the optimal price and output are indeterminate, we can conclude that 'reduced output and higher prices' are merely rhetorical figures for the public harm to economic efficiency.
37. As David Gerber notes, it is not universally accepted that the nature and role of competition is to constrain excessive prices, and thus advance consumer welfare, or that this is the appropriate objective of antitrust law.⁵⁷ According to Gerber, Michael Porter considers that the nature and role of competition is economic productivity, i.e. efficiency in the sense of maximising production from the use of limited resources.⁵⁸ Hovenkamp observes that the question whether economic welfare is to be assessed in terms of consumption or production is a long-standing unresolved debate.⁵⁹ Both arguments are probably misdirected, as the 'nature and role' of competition is merely to mediate between demand and supply in the allocation of scarce resources, i.e. the mere fact that the market may 'ration' scarce resources to produce goods and services at a price that equates demand and supply does not mean that: (a) consumers receive access to goods and services at fair and reasonable prices; (b) resources could not be more productively employed producing some other mix of goods and services; (c) human resources will be fully employed and will share in production/income such that all consumers participate equitably in consumption.
38. Perfect competition assumes that conditions for optimality 'exist simultaneously everywhere in the economy'.⁶⁰ In a mixed economy (i.e. one with both public and private sectors), this assumption is not satisfied. As a result of this and other respects in which the models of perfect competition and monopoly depart from the real world, Richard Lipsey concludes that the models cannot be used to predict strategies to 'increase the efficiency of

⁵³ Joseph Kelliher, 'Market Manipulation, Market Power, and the Authority of the Federal Energy Regulatory Commission' (2005) 26 *Energy Law Journal* 1, 15.

⁵⁴ Hovenkamp, above n 15, 15.

⁵⁵ Ibid, 101.

⁵⁶ Ibid, 102.

⁵⁷ Gerber, above n 24, 144.

⁵⁸ Ibid, 144.

⁵⁹ Herbert Hovenkamp, 'Coase, Institutionalism, and the origins of Law and Economics' (2011) 86 *Indiana Law Journal* 499, 514.

⁶⁰ Lipsey, above n 44, 376.

resource allocation in the economy'.⁶¹ That is, there is no assurance that strategies to encourage output of more and cheaper goods for consumers will increase the productive efficiency of the economy.

39. Further, in an open economy the differences between efficiency in consumption and production are polarised: Australian consumer preferences feed into global production of goods; whereas the most efficient (i.e. productive) use of resources in Australia must respond to global demand. Thus the objectives of advancing consumer welfare through constraining prices and advancing productive efficiency of Australia's resources are different, and inconsistent, objectives.
40. Hovenkamp describes capitalism as a free market ideology, i.e. it adopts the thesis that 'the uncontrolled, apparently chaotic, and completely self-interested behaviour of businesspersons actually produces more welfare than governmental command and control'.⁶² He observes that economists are not concerned with consumer preferences themselves 'but with the mechanisms by which they are asserted'.⁶³ That is, 'freedom of choice' as an underlying policy objective is more important than the actual choices. Theoretically, if consumers choose a product mix weighted towards, e.g. guns, alcohol, tobacco and other drugs, gambling, fast food and against, e.g. education, housing and medical attention for their children, under all the assumptions of the model of perfect competition (including the absence of externalities) the economy's resources will be efficiently allocated to produce the mix of goods and services that best meets those consumer preferences. Thus laws which promote the *mechanism* of competition reflect no normative framework regarding the 'best' allocation of resources, but embody a view of the world in which consumer choice should be free of influence from government and business alike.
41. On the other hand, Bruce Kobayashi and Timothy Muris argue that the Chicago School approach to competition law is not unbridled free market ideology, but an application of price theory and economics to test specific practices.⁶⁴ It is suggested, however, that the way economics is used in the discourse on competition law and policy is not innocent. Economic theory concerns itself with the *mechanism* rather than any normative framework to determine the merits of, e.g. particular prices and outputs resulting from the market mechanism. There is no such normative framework and freedom of choice is a policy objective that underlies the discourse on 'consumer harm' and 'market power', i.e. the influence of business in markets is seen by many as inimical to consumers' freedom of choice.
42. As admirable as 'freedom of choice' is, when we use markets as the mechanism we need to acknowledge that we are talking about something

⁶¹ Ibid, 377.

⁶² Hovenkamp, above n 15, 15.

⁶³ Ibid, 501.

⁶⁴ Bruce Kobayashi and Timothy Muris, 'Chicago, Post-Chicago, and Beyond: Time to Let Go of the 20th Century' (2013) George Mason University Law and Economics Research paper Series, No. 12-31, pages 2-3 at < <http://ssrn.com/abstract=2021196> >.

quite different – ‘freedom of choice mediated by ability to pay’. There are many cases where society makes a value judgment that such freedom is no freedom at all, and seeks to redress this for social justice reasons. We may conclude that simply ensuring the effective working of the market mechanism through competition law is not the means to that particular desirable end.

43. The role of world views in conceptualising ‘market power’ obscures policy objectives. There are several areas of law, e.g. various doctrines of equity that champion free will and protect the rights of individuals not to have their free will suborned.⁶⁵ If that is truly the objective of preventing ‘misuse of market power’ there may be more effective ways to achieve it. In the next section the influence of economic models on conceptualising ‘market power’ is critically examined and a new conceptual approach is proposed that may inform, e.g. the analysis and application of ‘market power’ in the case of bundled discounts.

Section II – The use of economic models and a new conceptual approach to market power

44. The economic analysis of monopoly has had an insidious influence on conceptualising ‘market power’. The limits of this analysis are widely known to undergraduate students of economics but less well known to lawyers and are not adequately addressed in the field of ‘law and economics’. For example, Hovenkamp concludes that, because a monopolist appears to curtail output, to the level that maximises prices and profits, ‘consumers are either poorer or else they make inefficient substitutions’, i.e. they choose products ‘that they would regard as “inferior” if their first choice were competitively priced’.⁶⁶ In any market situation there will be a body of consumers who choose not to buy because the price does not yield them the benefits they desire. It cannot be concluded that they suffer a loss because of their choice or that the alternative choices are inefficient.
45. Blair and Carruthers, in their recent article on market power, discuss consumer and producer surplus under market equilibrium: consumer surplus is the benefit to consumers who would have paid more than the equilibrium price; producer surplus is the benefit to producers who would have supplied at less than the equilibrium price.⁶⁷ In the model of perfect competition the equilibrium price is the producer’s break-even point (i.e. it covers normal profit). At lower prices producers will make a loss, and will stop producing if prices do not cover their variable costs.⁶⁸ The supply curve at prices above the equilibrium does not indicate additional supply from new entrants but the rising marginal costs of firms already in the market.
46. Economists do not apparently take into account the ‘detriment’ to producers who are excluded from the market simply because at the equilibrium price the

⁶⁵ See e.g. *Johnson v Buttress* (1936) 56 CLR 113; *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447.

⁶⁶ Hovenkamp, above n 15, 19.

⁶⁷ Blair and Carruthers, above n 29, 66.

⁶⁸ Peter Dooley, *Elementary Price Theory* (Appleton-Century-Crofts, 1967), 70-71.

market is not large enough for more producers, or the 'detriment' to consumers who are excluded from the market because they are unwilling to pay at least the equilibrium price. There could be several reasons for this. First, it may be presumed that the economy would be better served by equally or less efficient firms applying their resources elsewhere; and it may also be presumed that consumers who consider themselves better off by not buying would be better served by spending their money elsewhere. Second, the purpose of the market is to ration scarce goods: there must be a sufficient benefit to both producers and consumers to use this mechanism. The model of perfect competition demonstrates an elegant community of interest if all markets in an economy are at equilibrium: (a) consumers who are prepared to pay get the quantities and mix of goods and services they desire; (b) producers in each market produce the volume that minimises costs and provides them with normal profits.

47. Some argue that the sum of producer surplus and consumer surplus indicates the welfare outcomes from a market.⁶⁹ However, these benefits are internal to the market, sometimes described as the gains from trade, i.e. without mutual gains to producers and consumers there would be no trade, no market. It is inaccurate to describe these surpluses as indicators of welfare outcomes because producers and consumers excluded from the market apply their resources elsewhere. Thus such surpluses are suggestive only of private welfare of producers and consumers in a market.⁷⁰
48. There is argument for and against an objective of competition law being to ensure an equitable distribution of surplus between producers and consumers.⁷¹ It is common in the economics of public finance (i.e. taxation) to speak of distributional equity, and taxation often has clear (though controversial) re-distributive objectives. The Tribunal in *Qantas/Air New Zealand* appears to reject re-distribution as an objective of competition law,⁷² however, the debate continues. It can be seen that distributional equity is an objective that underpins notions of 'consumer harm' and 'market power' derived from the neoclassical economic model of monopoly. Such an objective would appear to run counter to the project of competition law, i.e. far from protecting the market mechanism to work unimpeded, such an objective would require a judgment that the unimpeded mechanism would produce excessively high prices and excessive profit for producers and should for social justice reasons be 'corrected'. Assuming competition law could do this, e.g. by discouraging exit of firms through merger or by protecting smaller less efficient firms from competition by dominant firms, thereby encouraging excess capacity, it will nevertheless be the *markets* (importantly the capital markets) that decide whether sufficient profits can be made to justify investment of resources in producing the increased volume.

⁶⁹ See e.g. Kirkwood, above n 3, 2453-4.

⁷⁰ See e.g. Stucke, above n 3, 575.

⁷¹ See discussion by Kirkwood of the argument in favour, above n 3, 2434, and Joseph Farrell and Michael Katz, 'The Economics of Welfare Standards in Antitrust' (2006) *Competition Policy International*, available at <<http://escholarship.org/uc/item/1tw2d426>> who argue against.

⁷² Australian Competition Tribunal, above n 5, paragraph 170.

49. Another policy objective of competition law is said to be 'dynamic efficiency,' which refers to the ability of firms to initiate or respond to changes in technology, consumer choice and the global economy (and is therefore difficult to measure).⁷³ The neo-classical model does not explain how firms self-select for entry to or exclusion from the market: the model *assumes* that firms and consumers have perfect information and may freely enter or leave the market, that transformation of production between goods happens effortlessly and that technological change 'happens'; thus firms know which producers are more cost-efficient and move efficiently in and out of the market. Nothing, of course, could be further from the truth in the real world where these processes are both destructive and imperfectly understood. Accordingly, economics does not elucidate the key concern of s 46: to distinguish situations where the market itself excludes firms from situations where a dominant firm uses its power to exclude rivals. Section III of this submission examines incumbent response to new entry and how firms self-select for exit.
50. Turning to more traditional concepts of economic efficiency, 'allocative efficiency' refers to the allocation of resources in the economy to produce the mix of goods and services that satisfies consumer preferences. 'Productive efficiency' refers to the maximisation of production in the economy from given resources by a process in which each firm is governed by the presumed law of diminishing returns, i.e. it would be inefficient to apply more resources to produce goods and services beyond the equilibrium due to increasing costs. In perfect competition, productive efficiency serves consumer preferences, i.e. 'equilibrium' achieves both allocative and productive efficiency. As has been noted, economic theory does not provide a normative framework to assess consumer preferences. That is, there is no means of valuing any particular resource allocation that may be driven by consumer preferences: what is valued is freedom of choice (according to your means).
51. In an imperfect world allocative efficiency and productive efficiency are inconsistent objectives: pursuit of one can only be achieved at the expense of the other. It may well be impossible to resolve the necessary trade-off in general terms (i.e. it may not be possible to frame a law which is capable of operating generally with certainty and predictability), as the nature and circumstances of markets for particular goods and services will differ, and socially desirable trade-offs between competing objectives will differ. For example, in a pandemic, with scarce supply of medicines, the market mechanism would determine a price to ration supplies among consumers based on consumer preferences (i.e. willingness to pay), and would ensure that efficient producers would enter the market to profitably supply the required medicines. Access to medicines is, however, an area where society has been prepared to sacrifice allocative efficiency in the interests of equity. Nevertheless, in a pandemic, the government would ration supplies to give priority to workers in essential services, i.e. the government is prepared to sacrifice equity to keep institutions working in the interests of society as a whole. These are administrative decisions more suitable to the executive branch of government than to the judicial branch.

⁷³ See e.g. Hilmer Report, above n 10, 4-5; Stucke, above n 3, 577.

52. The generally accepted definition of 'market power' is the 'ability to profit by reducing output and raising price above the competitive level'.⁷⁴ The reference to the competitive level is to a hypothetical that may or, more likely, may not be known.⁷⁵ It is incorrect to describe the monopoly price as being above the competitive level, as there is no way to compare the two theoretical models. In principle, this could be done empirically in the case of any particular market by hypothetically modelling costs of production if suppliers were dis-aggregated. The generally accepted definition of 'market power' leaves us uncertain about the source and nature of the power. As Hovenkamp observes, in perfect competition a supplier 'is said to have no market power'.⁷⁶ Such a firm also has the ability to increase prices and reduce output, but because the demand 'curve' for the individual firm's product is perfectly elastic an increase in the firm's price will result in the loss of all business; a reduction in output will not affect the price received and so would merely diminish the firm's revenue with no compensating benefit.
53. It is wrong to suggest that firms 'compete' in a perfectly competitive market. Contrary to the views of William Redmond, when firms are 'price-takers' they do *not* compete, i.e. there is no competition between suppliers in a perfectly competitive market; nor is there competition (i.e. bidding or negotiation) between suppliers and consumers which, as Redmond observes, is another mode of competition.⁷⁷ Neri Salvadori and Rodolfo Signorino examine the absence of competition in the perfectly competitive equilibrium, where firms are price-takers.⁷⁸ They conclude that 'competition' occurs *only in disequilibrium*, i.e. when demand exceeds supply, buyers compete to bid up prices, and when supply exceeds demand, firms compete to cut prices.⁷⁹ The downward sloping demand curve indicates that consumers compete with each other for scarce products, and those who are willing to pay the equilibrium price obtain supplies, while those who are out-bid do not.⁸⁰ Redmond observes that competition between consumers 'rarely springs to mind when market competition is discussed'.⁸¹ In the discourse on law and economics 'competition' is typically conceived of as competition between *producers* which is necessary to keep prices down. This is incorrect – competition between *consumers* is part of the market mechanism envisaged by classical authors.⁸²
54. It is submitted that it is the responsiveness of consumers to changes in the price of goods, relative to both close (if any) and distant substitutes, that is the source of 'market power' and that this is largely unobservable empirically. Hovenkamp says that 'substantial market power is not something that a firm

⁷⁴ Hovenkamp, above n 15, 95.

⁷⁵ Ibid, 102.

⁷⁶ Ibid, 97.

⁷⁷ William Redmond, 'Three Modes of Competition in the Marketplace' (2013) 72 *American Journal of Economics and Sociology* 423, 425 and 427.

⁷⁸ Neri Salvadori and Rodolfo Signorino, 'The Classical Notion of Competition Revisited' (2013) 45 *History of Political Economy* 149.

⁷⁹ Ibid, 159.

⁸⁰ Redmond, above n 77, 432.

⁸¹ Ibid, 435.

⁸² Salvadori and Signorino, above n 78, 159 (discussing Adam Smith) and 163 (Karl Marx).

acting alone can easily create'.⁸³ Posner concludes that market power 'depends entirely on the elasticity of demand',⁸⁴ and asks rhetorically 'whether such power can be obtained or enlarged through the efforts of one firm'.⁸⁵ It is suggested that a firm cannot create or possess market power at all, but it may be possible to *manipulate* the power of the market.

55. As the firm's ability to set its own prices and output are present whether a firm can be said to have market power or not, we must focus on the *consequences*, which are a function of how *others respond* to the firm's unilateral conduct. First consider the responsiveness of others to price and output decisions in monopoly, indicated by the following diagram:

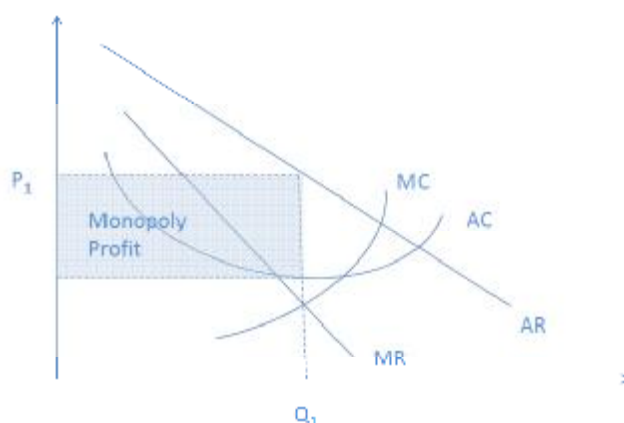


Figure 1 – Monopoly Equilibrium

56. In monopoly, the source of 'market power' is the sloping demand curve (i.e. competition between consumers for scarce goods or services), and the inability or reluctance of would-be suppliers to enter the market. To consider the impact of competition between suppliers, we need to consider less than perfectly competitive markets. In this case likewise the firm-facing (residual) demand curve is downward sloping rather than horizontal (as it would be under perfect competition). Should the firm seek to reduce prices it will not realise the benefit of selling as much product as it could make (as it would under perfect competition), because it can be anticipated that other suppliers would follow suit. Thus market power is a function of the response of consumers in competing for scarce supplies (i.e. elasticity of demand), but is detracted from by the tendency of other suppliers to compete on price.
57. The argument that 'market power' is a function of the *responses of others*, rather than any inherent capacity of the firm, is supported by Blair and Carruthers' discussion of the 'Lerner Index,' which attempts to define and measure monopoly power as the margin by which a monopolist's prices

⁸³ Hovenkamp, above n 15, 15.

⁸⁴ Posner, above n 45, 312; see also Landes & Posner, above n 28, 938.

⁸⁵ Hovenkamp, above n 15, 317.

exceeds its marginal cost.⁸⁶ They show that the index is closely related to the elasticity of demand, and thus does not measure 'monopoly power', which they describe as the 'degree to which one firm can exclude others from competing'.⁸⁷ As noted above, the market itself excludes less efficient rivals and equally efficient rivals for whom there is no place in the market (i.e. because additional output would depress prices below the level required for profitable production). Blair and Carruthers conclude that, given the role of elasticity of demand, 'market share is not the only determinant of market power'.⁸⁸ As noted above, Posner discusses the role of market share: a higher market share enables a firm to have a greater capacity to influence the market; but the result depends entirely on elasticity of demand.⁸⁹ The response of competitors may detract from market power but is not the source of it.

58. Redmond regards competition between suppliers and consumers as an undesirable contribution to suppliers' market power.⁹⁰ He considers that the object of antitrust laws is 'to hold prices down for consumers'.⁹¹ However, s 2 of the Sherman Act does not 'prohibit the setting of a monopoly price or the monopoly quantity'.⁹² It is true that the Hilmer Report states the benefits from competition include 'lower prices'.⁹³ The context of the report was recommended legislative reform to expose publicly owned enterprises in Australia to the rigor of competition, and the report firmly recommends that competition law should not attempt to regulate monopoly prices.⁹⁴
59. To correctly frame the objective of the monopolisation law that can be achieved we need to consider the economic analysis of monopoly and the 'deadweight loss' that results from reduced output and higher prices that the model suggests will result. What is said to be inefficient about monopoly equilibrium is 'reduced output'. The inefficiency *cannot* be explained by reference to the level of prices in an assumed competitive market (as there is no way of determining them) but can only be 'internal' to the model of monopoly. When Blair and Carruthers refer to 'competitive prices' in the context of monopoly, they mean the price that would apply if the monopolist continued to produce (at an increasing loss for each additional unit produced) *until profit were reduced to some acceptable level*. Landes and Posner appear to use the term 'competitive price' in the same way.⁹⁵ This is indicated by the diagram below, at the output (Q_1) at which marginal cost equals price, but exceeds average cost (so the monopolist still earns excess profits).⁹⁶

⁸⁶ Blair and Carruthers, above n 29, 69.

⁸⁷ Ibid, 69.

⁸⁸ Ibid, 73-4.

⁸⁹ Posner, above n 45, 312.

⁹⁰ Redmond, above n 77, 428-9.

⁹¹ Ibid, 439.

⁹² Hovenkamp, above n 15, 112; Hylton, above n 14, 85.

⁹³ Hilmer Report, above n 10, 1.

⁹⁴ Ibid, 269.

⁹⁵ Landes & Posner, above n 28, 941.

⁹⁶ Based on the diagram used by Blair and Carruthers, above n 29, 68.

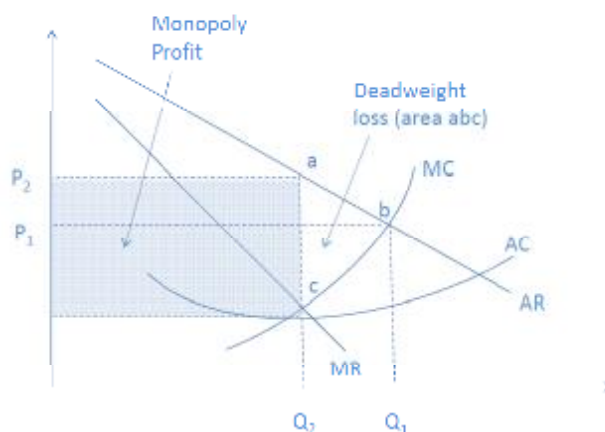


Figure 2 – Deadweight loss

60. The reason for preferring output Q_1 (and P_1 as the competitive price) is not stated, but is presumably because, in the model of perfect competition, the aggregate supply curve is the horizontal sum of each firm's marginal cost curve. However, horizontal summation only applies because the individual demand curve facing each firm is horizontal: as Lipsey and Chrystal point out there are no supply curve for a monopolist.⁹⁷ In perfect competition the firm's equilibrium output is the point where marginal cost equals average cost, as production becomes increasingly inefficient if increased beyond that. In the above diagram this point is Q_2 .
61. Allocative efficiency and productive efficiency coincide in perfect competition because the firm's demand curve is flat, i.e. price = marginal revenue = marginal cost. When the demand curve facing a firm is downward sloping the conditions required by the model are not satisfied, and allocative efficiency and productive efficiency no longer coincide.⁹⁸ This is demonstrated graphically below by the point, E_p , at which the production possibilities frontier touches the consumers indifference curve,⁹⁹ representing all combinations of two goods that maximise consumer satisfaction. The tangent line at E_p represents relative prices (i.e. the marginal rate of substitution, MRS).

⁹⁷ Lipsey and Chrystal, above n 44, 241.

⁹⁸ Ibid, 297.

⁹⁹ Ibid, 406, footnote 6 observe that this requires constructing a community indifference curve.

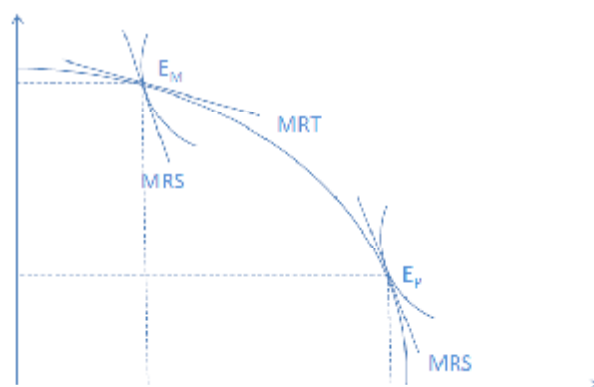


Figure 3 – Allocative and productive efficiency

62. At equilibrium in perfect competition the substitution of goods will occur until consumer satisfaction is maximised, at E_p . Because each producer's marginal cost equals price, the transposition between production of the two goods will continue until profit is maximised. In perfect competition both profit and consumer satisfaction would be maximised at point E_p , so the production possibilities curve and indifference curve would touch, sharing the same tangent.
63. In any model *other than* perfect competition the demand curve facing the firm will be sloping, i.e. price \neq marginal cost. Therefore the marginal rate of transformation, MRT (ratio of marginal cost of producing the two goods), will differ from the ratio of prices at the optimum, E_m . Assuming E_m to represent monopoly equilibrium, the monopolist's profit maximisation will prevail over consumer choice, so there will be other possible production mixes of the two goods (to the right of E_m in the above diagram) that would increase consumer satisfaction and approach allocative efficiency, but this would come at the sacrifice of productive efficiency. To show this, refer back to Figure 2: if we induce the firm to increase production until price = marginal cost, we could theoretically move production to Q_1 , but because marginal cost > average cost, production is inefficient, the firm incurs a loss on the extra production, and profit is not maximised.
64. Accordingly, in an imperfect world we cannot achieve both allocative and productive efficiency, and must trade one off against the other. If we can never align marginal cost and price, some economists argue that allocative efficiency is not an achievable objective of competitive markets and the more reliable strategy to increase consumer welfare is to increase productive efficiency, i.e. to move the production possibilities frontier outwards.¹⁰⁰ This will again not result in an allocatively efficient equilibrium, but consumer welfare will be increased by the greater income produced. Allocative

¹⁰⁰ Ibid, 410.

efficiency may have even less policy appeal if we doubt that consumer preferences are truly the product of rational self-interest.¹⁰¹

65. Returning to Figure 2, economists have differing approaches to the possible regulation of monopoly prices. As noted above, some suggest that output should be increased until price = marginal cost. Others suggest that the acceptable output is where price = average cost, so excess profits are completely eliminated.¹⁰² In Figure 2 this point is to the right of Q_1 (where average cost equals average revenue). These strategies require *intervention* in the market, which cannot be achieved by competition laws that aim to facilitate the unimpeded operation of the market mechanism. Further, there is no way of comparing the equilibrium price under the models of monopoly and perfect competition to determine whether equilibrium prices would be higher or lower under monopoly. What Blair and Carruthers describe as a 'deadweight loss' reflects a *value judgment* in which lower prices for consumers are achieved at the cost of increasingly inefficient production. In other words, this *intervention re-distributes* welfare from producers to consumers.
66. When theorists refer to the 'competitive' output or price in the model of monopoly, they fail to address the incomparability of the two models. As noted above, Hovenkamp, Blair and Carruthers do not expressly state the assumed correspondence. Posner mentions the assumption but does not consider the implications.¹⁰³ As Lipsey points out, the conclusion that monopoly equilibrium is at a lower output and higher price than competitive equilibrium depends entirely on the *assumption* that the monopolist has the same marginal cost as producers in a competitive market.¹⁰⁴ The conclusion will not hold where a monopolist could produce more efficiently.¹⁰⁵
67. As it is impossible to determine whether or how far price may have been raised above the hypothetical competitive level it seems that this must remain an objective which can only be achieved if at all by intervening in the market, i.e. it is not sufficient merely to ensure there are competitive constraints on market power. Hovenkamp states that 'if we could confidently predict that new firms would enter a market whenever price exceeded the competitive level, antitrust would have little to do'.¹⁰⁶ However, he acknowledges that conduct which excludes rivals is 'often ambiguous and difficult to assess'.¹⁰⁷ Hovenkamp observes that 'an overly aggressive antitrust rule would chill innovative conduct, so we frequently give the firm acting unilaterally the benefit of the doubt'.¹⁰⁸ This appears to explain the scepticism of US courts to intervention in cases of dominant firm conduct, and could well be a factor

¹⁰¹ See e.g. Max Huffman, 'Marrying Neo-Chicago with Behavioral Antitrust' (2012) 78 *Antitrust Law Journal* 105, 117.

¹⁰² Dooley, above n 68, 87-90.

¹⁰³ Posner, above n 45, 281 and 291; see also Landes & Posner, above n 28, 941.

¹⁰⁴ Lipsey, above n 44, 373; Lipsey and Chrystal, above n 44, 408.

¹⁰⁵ Lipsey, *ibid*, 379-80.

¹⁰⁶ Hovenkamp, above n 15, 102.

¹⁰⁷ *Ibid*, 103.

¹⁰⁸ *Ibid*, 109.

affecting judicial decisions in Australia which may appear to be based in commercial intuition. Either way, such a law lacks certainty and predictability and will inevitably lose the confidence of the business community, though it may provide a placebo for consumer interests fearful of the perceived power of business.

68. The commonly accepted definition of market power as the ability to reduce output and raise prices is based on prejudicial *assumptions* concerning the comparison between neoclassical models of perfect competition and monopoly which are *not comparable*. Thus our concept of market power is built on foundations of sand. It is impossible to benchmark a firm's profits against the hypothetical 'competitive level' whether this be conceived as the 'perfectly competitive' or 'workably competitive' level. It is similarly impossible to benchmark a firm's conduct against what it may be expected to do in a competitive (or workably competitive) market. If we are realistic about what markets can achieve we would focus on letting the market achieve what it can unimpeded, and leave equity or social justice objectives (e.g. achieving 'fair and reasonable' prices) to measures other than competition law.
69. Market power is not something that can be possessed or taken advantage of – the power is that of the market, which is open to *manipulation*. Contrary to the common 'one-directional' conception of market power it is two-directional. When market prices rise consumers reduce the quantity they buy. Depending on the elasticity of demand, total revenue may rise or fall. The same holds true for a reduction in market prices: total revenue may rise or fall depending on the elasticity of demand. We should be asking under what circumstances the market can be *manipulated* by not just upwards but downwards price pressure. This should provide a useful insight into counter-intuitive dominant conduct such as price reductions, which give rise to problems concerning predatory pricing and bundled discounts.¹⁰⁹ To allow the market to work unimpeded we should consider 'abuse of dominance' in the broader context of preventing market manipulation.¹¹⁰ It is submitted that 'market manipulation' may be a more effective way of preventing harm from dominant firm conduct. It would provide a useful *counterpoint* to assist critical review of current diverse approaches in Australia and overseas to the problem of dominant firm conduct and is worthy of further research.
70. It is recognised in securities and derivatives markets such as commodity futures that sellers can manipulate the market by reducing their volume of sales ('cornering') or increasing their volume of sales ('squeezing') for the purpose of profiting from resulting price effects.¹¹¹ The problem with 'market manipulation' is distinguishing prohibited price manipulation from normal

¹⁰⁹ See, e.g. Daniel Simon, above n 31; Joshua Wright 'Simple But Wrong or Complex and More Accurate? The Case for an Exclusive Dealing Approach to Evaluating Loyalty Discounts' (2013) Bates White 10th Antitrust Conference, Washington, DC.

¹¹⁰ See e.g. Craig Pirrong, 'Commodity Market Manipulation Law: A (Very) Critical Analysis and a Proposed Alternative' (1994) 51 *Washington & Lee Law Review* 945, 951-2, who analyses market power and market manipulation in commodity futures markets.

¹¹¹ *Ibid*, 950-1; Kelliher, above n 53, 15.

market price volatility due to unimpeded forces of supply and demand,¹¹² a similar problem to that we encounter with misuse of market power. There would seem to be no difficulty condemning manipulation as it can be conceived as conduct intended to impede the market mechanism.

71. US opinion seems to be that there is insufficient theoretical analysis and empirical evidence to form a view as to anti-competitive effect of bundled discounts, and that they should be considered in relation to exclusive dealing rather than abuse of market power.¹¹³ It is worth noting, however, that the empirical study of Australian shopper dockets by Zhongmin Wang uses petrol price and cost data to support a conclusion that 'supermarkets offer grocery-gasoline bundled discounts for non-exclusionary purposes', but acknowledges that 'due to lack of grocery data [the study] cannot assess the bundling programs' impact on the grocery market'.¹¹⁴ Further, Wang acknowledges that future research would benefit from 'gasoline quantity data'.¹¹⁵ Joshua Gans and Stephen King model bundling to inform the Australian 'shopper docket' debate, however, their focus is on consumer welfare effects rather than competition effects.¹¹⁶ Two assumptions of their model in particular invite further attention: first, they conclude that discounts are substantially passed on to consumers (i.e. it appears that assumptions are implicitly made about elasticity of demand); second, they conclude that competitive responses can neutralise the effects of bundling (i.e. it appears that assumptions are implicitly made about the ability of independent firms to effectively share the costs and benefits of the bundled discount).¹¹⁷ Gans and King acknowledge that an integrated firm is able to maximise joint profits of offering the bundled discount but that independent firms face difficulties in coordinating a corresponding outcome.¹¹⁸ These aspects of studies to date seem to raise major questions for further investigation.
72. Applying the analysis of market power in this submission, it is possible to show how shopper dockets may increase what is said to be the market power of both supermarkets and petrol suppliers to the detriment of competition. Market power depends on the response of consumers to changes in price or output. Other things being equal, a rational supermarket acting in self-interest will reduce price only if consumers respond by increased buying such that total revenue and profit increases. By bundling the price of groceries with the price of petrol, both suppliers alter the response of consumers in their own markets to increase the supplier's market power. That is, they may alter the position and elasticity of the firm-facing demand curve as indicated in the

¹¹² Pirrong, *ibid*, 960-1.

¹¹³ See, e.g. Bruce Kobayashi 'The Economics of Loyalty Discounts and Antitrust Law in the United States' (2005) George Mason University, http://ssrn.com/abstract_id=794944 ; Joshua Wright 'Simple But Wrong or Complex and More Accurate?', above n 109; Zhongmin Wang 'Supermarkets and gasoline: An Empirical Study of Bundled Discounts' (2011) 5th Annual Conference on Empirical Legal Studies, <http://ssrn.com/abstract=1628770> .

¹¹⁴ Wang, *ibid*, 2.

¹¹⁵ *Ibid*, 27.

¹¹⁶ 'Paying for Loyalty: Product Bundling in Oligopoly' (2006) 54 *Journal of Industrial Economics* 43.

¹¹⁷ *Ibid*, 58 and 59-60.

¹¹⁸ *Ibid*, 56.

diagram below.¹¹⁹ Suppliers will only persist with bundling when it is more favourable to them than simply discounting prices.

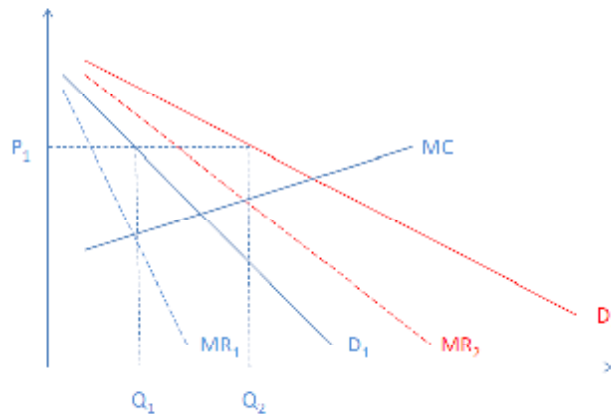


Figure 4 – Shifting elasticity of the firm-facing (residual) demand curve

73. By swinging the firm-facing demand curve upwards to the right from D_1 to D_2 the firm extends the range of profitable output from Q_1 to Q_2 . Further, it extends the range of output at which price decreases actually increase revenue (because marginal revenue previously became negative before Q_2 and now remains positive well beyond Q_2). Huffman for example observes that ‘behavioural exploitation might facilitate a merchant’s gaining or preserving a competitive advantage over a rival, raising concerns for monopolisation under s 2 of the Sherman Act’.¹²⁰ However, the key question will be whether conduct such as bundling *relies* on market power,¹²¹ i.e. could not be done without market power, or simply creates or enhances market power. To fully understand the implications of shopper dockets and bundling we need to know the effect on *volumes* as well as prices in both grocery and petrol markets.
74. As noted above, contemporary analysis of market power is not apt to deal with price reductions and increases in volume. If, however, we examine the conduct through the lens of ‘market manipulation’ we may be better able to analyse the situation from a positive and normative perspective. Ironically, while shopper dockets offered by integrated supermarkets and petrol retailers involve unilateral conduct, similar arrangements by independents would involve *bilateral* conduct apparently outside the scope of s 46. Section III discusses the interplay between sections 45 and 46 in the recent case of *Australian Cement* mentioned above.
75. It is desirable that the law be clarified because ‘shopper dockets’ are the subject of continuing controversy between supermarkets and the ACCC. Although the ACCC reached a voluntary agreement with the supermarkets in

¹¹⁹ Figure 4 is based on Lipsey, above n 44, 321, who uses the diagram for a different purpose.

¹²⁰ Huffman, above n 101, 133.

¹²¹ Wright, above n 109, 2251.

December 2013 to limit such discounts, the agreement quickly broke down, and the Federal Court ruled that the court-enforceable undertakings given by the supermarkets do not prevent them structuring discounts above the 4 cents a litre limit applicable to shopper dockets on supermarket purchases.¹²² The ACCC's concerns appear to focus exclusively on the retail fuel market: they believe that 'integrated' supermarket and fuel retailers are leveraging power in the grocery market to cross-subsidize their fuel business to harm competition in the retail fuel markets. Arguably this misses the point that competition in both grocery and fuel markets is adversely affected by bundled discounts that manipulate the market. In an integrated business it does not matter where the burden of the discount lies because the business as a whole benefits from increased revenue attracted by the discount offer. Insofar as the undertaking seeks to prevent cross-subsidisation it is hard to see what is achieved. Independent supermarkets and fuel retailers remain unable to compete with the integrated chains because there is as yet no mechanism for independents to share the net benefit of any revenue gains less the cost of the discount. This disadvantage applies even if the discount is limited to 4 cents. In fact, the discount is not effectively limited by the undertaking, which therefore does not level the playing field. The undertaking seems to be an *intervention* in the market mechanism, rather than a measure to allow the market to work unimpeded.

76. Our current thinking about market power is a product of views of the world underpinning a comparison of the economic models of monopoly and perfect competition. A new approach may free our thinking from these value judgments and assist apply competition policy to new problem areas. In the next Section this submission examines the problem of distinguishing permitted from prohibited conduct of a dominant firm in the context of new entry, and the problem of dual purposes.

Section III – Dual purposes and models of incumbent response to new entry

77. There is a gap in the economic models concerning how firms are selected for entry and exit. As has been noted above, s 2 of the Sherman Act does not 'prohibit the setting of a monopoly price or the monopoly quantity'.¹²³ This statement invites several questions. First, it appears to acknowledge that, given the differences of approach by economists to the regulation of monopolies, the regulation of price and output in the public interest is not a matter suitable for judicial determination. In Australia, the Hilmer Report appears to have adopted a similar approach, recommending that competition laws should not seek to regulate monopoly pricing but the competitive process itself.¹²⁴ Second, it seems to support the conclusion that the equilibrium price and output arise not from the exercise of market power but from the response of consumers, i.e. the elasticity of demand. Third, if the objective of antitrust is not to regulate the monopolist's profit, we can conclude it is to ensure that market forces will be allowed to operate to test the efficiency of the monopolist's position (i.e. if an equal or more efficient producer does not enter

¹²² *ACCC v Coles Group Ltd & Ors* [2014] 363; *ACCC v Woolworths Ltd* [2014] FCA 364.

¹²³ Hylton, above n 15, 85.

¹²⁴ Hilmer Report, above n 10, 269.

the market we may conclude that the monopoly price and output is most efficient).¹²⁵

78. As Blair and Carruthers observe, the market mechanism excludes less efficient firms.¹²⁶ Presumably the market excludes equally efficient firms not required to satisfy market demand. Posner suggests we should condemn conduct that is likely to exclude equally or more efficient firms.¹²⁷ In fact we may never know which firm is more efficient, due to the lack of data – even if we could gain access, financial and accounting data does not readily translate to economic concepts of opportunity cost, normal profit and marginal cost. The model of perfect competition does not tell us how the market excludes equally efficient firms. Do they self-select or is there a process akin to ‘survival of the fittest’ whereby equally efficient rivals enter the market by knocking out incumbents? If the latter applies it would seem difficult to make value judgments about the conduct of equally efficient competitors.
79. The economic model assumes that firms have perfect knowledge and can enter and leave the market without cost. So the fact that some firms are excluded and quietly deploy their resources in other productive activities is of no policy concern to the model. In the model, a monopolist would know, when confronted by a new entrant with new technology, who is more efficient. In the real world these assumptions are not borne out and so we encounter barriers both to entry and exit.¹²⁸ So for example, BlackBerry did not simply cease production, realise assets and return funds to its shareholders when the Apple iPhone came on to the market.
80. We can adapt Blair and Carruthers’ cost and demand curves (which in turn simply reflect arbitrary assumptions) to model the effect on a monopolist of a new entrant assuming first that the new entrant is equally as efficient and second that the market demand for the product does not change.

¹²⁵ Hovenkamp, above n 15, 156.

¹²⁶ Blair and Carruthers, above n 29, 74.

¹²⁷ Richard Posner, *Antitrust Law* 2nd ed (University of Chicago Press, 2001) 194-5, cited in Hovenkamp, above n 15, 153.

¹²⁸ See e.g. Satish Nargundkar, Fahri Karakaya and Michael Stahl, ‘Barriers to Market Exit’ (1996) 13 *Journal of Managerial Issues* 239, 241.

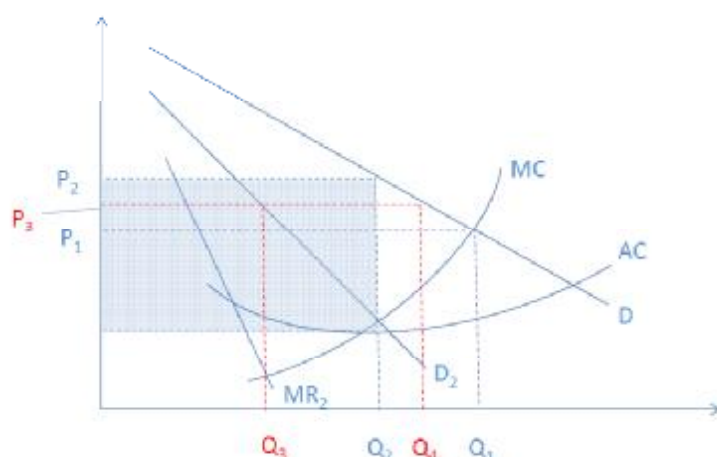


Figure 5 – Incumbent response (Cournot equilibrium)

81. Assuming the market were shared equally, each firm's demand curve would move to the left, to D_2 , and the marginal revenue curve to MR_2 . Each would produce Q_3 and total output Q_4 would result in price P_3 . Without using Cournot's precise methodology, this is broadly speaking a Cournot equilibrium.¹²⁹ The optimum output for each firm will depend upon its market share (which will position the average revenue curve D_2) and the firm's marginal cost curve. The result of market entry is that the monopolist would reduce output significantly, and because aggregate supply does not increase significantly, price reduces only slightly.
82. However, the situation is different in a Bertrand equilibrium,¹³⁰ where incumbent and new entrant have the possibility through price-cutting to capture the whole market. If we horizontally add their marginal cost curves we derive the aggregate supply curve S in the diagram below.

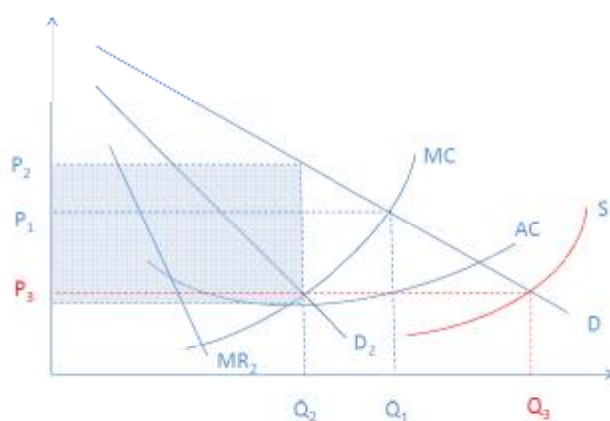


Figure 6 – Incumbent response (Competitive equilibrium)

¹²⁹ Lipsey and Chrystal, above n 44, 274-5.

¹³⁰ Ibid, 275-6.

83. We might conclude that forces of supply and demand would produce combined output Q_3 and result in the significantly reduced market price P_3 . Should that be our benchmark for permissible conduct by an incumbent monopolist? The above assumptions produce a result where there is hugely increased consumer surplus and modest producer surplus. However, the monopolist's marginal revenue curve MR would not correspond with that of the individual firm after entry (which would approximate MR_2 in the preceding diagram, depending on market share).
84. There would seem to be several possible strategies and resulting equilibria we could use to model incumbent conduct in the case of market entry:
- (a) Monopoly/cooperative equilibrium – if the incumbent and new firm actively or tacitly collude, they would share monopoly output Q_2 approximately equally, and prevent price falling significantly below P_2 . Thus the incumbent might retain prices in response to a new entrant, to signal this strategy. This is not a true equilibrium since 'each firm has an incentive to depart from it'.¹³¹ Based on the cost and revenue curves in Blair and Carruthers' diagram, we might conclude a Cournot equilibrium would suggest slightly increased output and slightly reduced prices.
 - (b) Competitive equilibrium – if each firm's marginal costs curves are horizontally added they could together supply Q_3 , and the 'competitive price' P_3 would result; however, monopoly profit would be dissipated and each would make only modest excess profit. If this is perceived by the new entrant as the obvious outcome the incentive to enter the market may not be sufficient. Either incumbent or new entrant may reduce price from the pre-entry price, for different reasons, that will set the firms on course for this outcome. If each firm follows this strategy it may be a Bertrand equilibrium, from which it would not be rational to depart.¹³² However, this is neither stable nor unique.
 - (c) Competitive/non-cooperative equilibrium – at price P_3 either firm could profitably produce beyond Q_1 , satisfying the bulk of the market and leaving the competitor with an unprofitable volume, which may drive out the competitor. The survivor might then restore a degree of monopoly profit. Either incumbent or new entrant may have an incentive to pursue this strategy. If one firm increases output beyond Q_1 , it is likely that the other would do so, and this would become a Nash equilibrium, destructive for both firms, until one succumbs.¹³³
85. Equilibrium (b) has some appeal as a benchmark for permissible conduct by an incumbent monopolist. However, as we will see, it will be difficult to argue normative grounds to intervene should mutual conduct tend toward equilibrium (c).

¹³¹ Ibid, 266, footnote 9.

¹³² Ibid, 264-5.

¹³³ Ibid, 265.

86. In the real world, the incumbent may not be able to match the technical features of the new product, or to sell its business and deploy resources elsewhere without loss to shareholders. An incumbent facing its own failure and loss might have an incentive, even a duty to shareholders, to protect the value of its assets. These problems do not arise in the perfect world. So we can expect in the real world a contest for market share, increased costs of advertising and product differentiation which might raise the stakes for both and ensure pyrrhic victory (i.e. if average cost curves rise as a result of competition). Again, using BlackBerry as a provocation, we can add to this situation dynamic features of the market such as a further new entrant, Samsung, and increasing consumer demographic (i.e. demand curve moves to the right), all of which make the outcome increasingly unpredictable.
87. If we accept the proposition by Blair and Carruthers that there are no policy issues arising from the exclusion of equally or less efficient firms, should we conclude that we are indifferent whether market power is used or misused in the above scenario? Is there market power at play at all? Arguably the answer to both is in the negative.
88. It seems obvious that consumer welfare will be increased by the entry of an equally efficient firm, as output may rise and price may fall to a more competitive level. In any event, our purpose is to consider whether the incumbent has market power and if so, whether it has used or misused its market power. On the analysis above, the mere fact that the firm faces a sloping demand curve does not mean that the incumbent has market power; and further, the fact of a new entrant emerging suggests that any market power evaporates at that point. However, assuming the incumbent does have market power, can we distinguish permitted use from misuse? In this regard, Daniel Simon observes that 'theories of entry deterrence and incumbent response to entry ... [yield] a variety of predictions' and the results of empirical studies are 'very inconsistent'.¹³⁴
89. Should conduct to protect the incumbent's business, in circumstances where its success means the failure of its competitor, be regarded as a normal incident of competition or a misuse of market power? We might conceptually distinguish between:
- (a) Pareto efficient self-interest, i.e. I can make myself better off without making anyone else worse off.
 - (b) Zero-sum self-interest, i.e. whatever I do to make myself better off makes someone else commensurately worse off.
 - (c) Altruism, i.e. I might do something to make someone else better off.
 - (d) Malice, i.e. I might take action to make someone else worse off, with no apparent benefit to myself. For example, I might set fire to a rival's BMW motor vehicle out of sheer envy or spite. However, if I do so to prevent

¹³⁴ Daniel Simon, above n 31, 1229.

my rival getting somewhere or something that I desire, then I am motivated by self-interest.¹³⁵

- (e) Indeterminate self-interest, i.e. the balance of the benefit or detriment to myself might not exactly correspond with the detriment to others. For example, cold war adversaries establish missile defence systems on the basis that 'mutually assured destruction' is an effective deterrent. Price cutting behaviour in a price war would be similar: self-interest dictates a response harmful to one-self to prevent further harm to one-self. In all these cases there appears to be a rational basis for action that harms another with uncertain or unquantifiable benefits to one-self, and this can be distinguished from pure malicious harm.

90. From a normative perspective it is easy to condemn category (d) malicious conduct, but not so easy to form a value judgment under category (e). We might draw an analogy with self-defence under the criminal law. Hovenkamp for example argues that *misuse* of market power involves conduct which limits the opportunities of rivals and produces harm 'seriously disproportionate to the resulting benefits'.¹³⁶ So for example, it might have been disproportionate for me to destroy my rival's BMW when I could have achieved the purpose by letting down the tires, but in the heat of the moment who is to judge what is 'proportionate'? A further analogy with the business judgment rule in corporate law, which protects directors of corporations exercising rational business judgment,¹³⁷ might suggest the courts are not equipped to make, and should not undertake, such value judgments. At least one judge in Australia has commented adversely on 'metaphysical analysis of dual purposes' in the context of misuse of market power.¹³⁸ According to William Reid, there is support in Australian court decisions for category (e) rational business judgment as a way to distinguish category (b) dual purposes.¹³⁹ However, one substantial purpose among many is sufficient to satisfy the Australian 'purpose test' by virtue of s 4F.¹⁴⁰ O'Bryan argues that there is no harm in the 'purpose' test applying broadly, e.g. to category (b), (c) or (d) above, because the 'taking advantage' requirement in s 46 discriminates between prohibited and permitted conduct.¹⁴¹ However, on that view the 'purpose' test would play no part in the function of s 46. In a subsequent article, O'Bryan acknowledges that 'purpose' and 'taking advantage' are linked.¹⁴²
91. The ACCC's attempt to use s 46 in the bilateral situation of *Australian Cement*, and the court's analysis of dual purposes, supports the need for a new approach. Baker discusses exclusionary conduct that seeks to raise

¹³⁵ See e.g. Julian Young, *Schopenhauer* (Routledge, 2005) 175-8.

¹³⁶ Hovenkamp, above n 15, 152.

¹³⁷ See s 180(1) of the *Corporations Act* 2001 (Cth).

¹³⁸ Heerey, J (dissenting) in *Melway Publishing v Robert Hicks* (1999) 169 ALR 554, 562; His Honour's judgment preferred by the High Court of Australia on appeal, (2001) 178 ALR 253, 268.

¹³⁹ Reid, above n 2, 227-232.

¹⁴⁰ See s 4F of the *Competition and Consumer Act* 2010 (Cth).

¹⁴¹ O'Bryan, 'Law or Economics?', above n 13, 81-3.

¹⁴² O'Bryan, 'Principles', above n 13, 30-1.

rivals' costs through bilateral agreements that foreclose access to inputs.¹⁴³ In concept this is similar to the case brought against Australian Cement. There are a number of interesting points that follow from this: s 46 was found to be unnecessary to support the outcome in *Australian Cement*, which could be achieved with s 45 alone; s 46 would not apply to conduct that creates market power where none existed before, but s 45 would apply; the application of s 45 to dual purposes in a zero sum world (where everything a firm does in its own interests harms other firms) sets the prosecutorial bar too low; and, although Baker does not use the term, it will be seen that the concept he is addressing is the same as 'cornering' in the literature on 'market manipulation' mentioned above. In that literature, it is recognised that market power is not necessary for manipulation to occur but may assist.¹⁴⁴

92. Turning to the unlikely case of category (c) conduct, Hovenkamp suggests that harm to rivals can also be justified by benefits to consumers.¹⁴⁵ We may doubt he is contemplating altruism on the part of firms competing in a market, as the model of perfect competition assumes that firms act in their own self-interest to maximise profits.
93. Let us apply the above taxonomy to the market entry model above. Referring to Figure 6, if the monopolist increases output to Q_1 and lowers prices to P_3 it *may* prevent the new entrant obtaining a viable market share, i.e. harm the new entrant. Such action would diminish the monopolist's excess profits, but no more than expected, so excess profits cannot provide an incentive for new entry. In the monopoly scenario, some economists would argue that the monopolist should be forced to increase output to Q_1 . In the assumed scenario of an equally efficient new entrant, supply and demand will be expected to reduce the market price to P_3 . We might conclude that rivalry for market share is category (b) or (e) conduct (i.e. zero sum self-interest or indeterminate self-interest) which is to be expected in competition, particularly given barriers to exit which apply to every firm. Accordingly, assuming the incumbent has market power, the conduct modelled above should be regarded as normal self-interested competitive conduct.
94. According to Simon, empirical research does not support theories of price as an entry deterrent, either by reducing pricing before or after entry.¹⁴⁶ Assuming perfect knowledge, it must be obvious that pre-entry price cutting would be ineffective, because the market may be expected to remove excess profits due to increased supply post-entry.¹⁴⁷ There may be reason to believe that maintaining pre-entry prices may signal a Cournot equilibrium, i.e. incumbent and new entrant share the market. Another strategy to deter entry may be an attempt by the incumbent to raise barriers to entry by investing in excess capacity. Simon observes that empirical research does not support

¹⁴³ Baker, above n 15, fn 178.

¹⁴⁴ Shaun Ledgerwood and Dan Harris, 'A Comparison of Anti-Manipulation Rules in the US and EU Electricity and Natural Gas Markets: a proposal for a common standard' (2012) 33 *Energy Law Journal* 1, 30.

¹⁴⁵ Hovenkamp, above n 15, 154.

¹⁴⁶ Simon, above n 31, 1230.

¹⁴⁷ Ibid, 1232.

the use of such strategy.¹⁴⁸ The strategy seems inherently improbable as idle capacity will not cover the cost of capital.¹⁴⁹ Some studies apparently show incumbents in concentrated industries tend to increase capacity after entry,¹⁵⁰ which is consistent with the above modelling that suggests a contest for market share and efficiency post-entry. According to Simon, theories of predatory pricing have not been widely studied empirically 'because it is difficult to identify predatory pricing' and also because incumbents may use non-price responses, i.e. product differentiation.¹⁵¹

95. Based on the above model of new entry and expected response of an incumbent monopolist, we may conclude that a new entrant would be induced by the incumbent's excess profits to enter the market *only if* the new entrant expects to be able to destroy the incumbent. This is the effect which can be expected from unbridled competition in imperfect markets. The current 'purpose' test is a blunt instrument which does not assist us distinguish self-interested conduct, which competition should allow, from malicious conduct, which should be condemned. Given there are barriers to exit in the real world it is not unreasonable to expect the incumbent to fight for survival. It is hard to discern a normative case for competition law to condemn either the defensive conduct of the incumbent or the predatory conduct of the new entrant in this scenario. Further, applying competition law to mergers in this scenario by reference to norms of the perfectly competitive model would appear to condemn the parties to the destructive consequences of the imperfect market.

Section IV– Conclusion

96. The generally accepted concept of market power, as the ability to reduce output and increase price, is derived from a comparison of the neoclassical economic models of perfect competition and monopoly which *assumes* that one firm is no more efficient, or productive, than many smaller firms assumed to exist under the model of perfect competition. The economic models themselves are not comparable and do not provide us with an answer to this question. Accordingly, our current understanding of market power is the product of a value judgment, or world view. Further, the economic models are static analyses of equilibria and do not answer our questions about how firms enter and leave the market under dynamic real world conditions where, e.g. demand curves move constantly to the right as markets grow and their curvature changes as consumer preferences constantly change. Under these conditions, where growth in revenue and profits becomes the mantra of success, a business strategy by which a dominant firm would seek to hold back output to increase price is counter-intuitive to say the least.
97. While contemporary concepts of 'market power' are one-directional (i.e. ability to reduce output and increase price), this submission argues that 'market power' is a function of the way the market responds to a firm's price and

¹⁴⁸ Ibid, 1231.

¹⁴⁹ See critical discussion by the Antitrust Modernisation Commission of *US v Alcoa* (1945) 148 F.2d 416 (where building new capacity was held to infringe s 2 of the Sherman Act), above n 2, 85.

¹⁵⁰ Simon, above n 31, 1234.

¹⁵¹ Ibid, 1231-2.

output decisions: a firm may be said to have the ability to *manipulate* the market if it can increase revenue and profits by altering price or output in either direction. We should condemn dominant firm conduct that excludes rival firms that the market would not otherwise exclude. If there is over-supply, firms leave the market so that those that remain cover their costs and earn 'normal' profits, i.e. the *market* excludes firms. This is a natural part of competitive markets which makes it difficult to distinguish dominant firm conduct that should be proscribed.

98. It appears that people are uncomfortable with the idea that firms may exercise 'market power', or as we should say, may *manipulate* the power of the market by exploiting consumer responsiveness, i.e. elasticity of demand. It is suggested that we should consider an alternative approach to preventing harm by considering the prohibition of 'market manipulation', a concept that does not rely on 'taking advantage of market power' but would focus on interference with market forces.
99. We must, however, be realistic about what the unimpeded market can achieve: by promoting competition we cannot achieve objectives beyond the reach of the unimpeded market. The discourse concerning consumer welfare objectives, in particular the suggestion that competition law results in lower prices for consumers, creates a real danger that competition law will be asked to deliver benefits that it cannot. It is frequently overlooked that competition between *consumers* drives the price up to the point that those consumers who consider themselves better off by *not* buying the goods or services exclude themselves from the market. Consumers who are excluded from the market are not harmed, because they apply their resources in other ways. The market mechanism is a means of rationing scarce supplies among consumers who are willing and able to pay the market price. If society deems it equitable that consumers have access to goods or services regardless of willingness, or ability to pay, then the unimpeded market mechanism, and competition laws which promote it, will not be effective to achieve that policy objective.
100. Effective deterrence of harm resulting from 'misuse of market power' would be facilitated by a 'bright line' law that clearly defines when competitors are being excluded by strategic conduct of dominant firms, i.e. would not be excluded by the market. Introducing an 'effects test' into s 46 would not alter the fundamental problem of law and economics, i.e. we still need to be able to distinguish between situations where the *market* excludes competitors from situations where exclusion flows from the impugned conduct. Static economic models of perfect competition and monopoly, which are not comparable, are used to conceptualise 'market power' as something that can be possessed, and to identify 'misuse' by reference to conduct that would not be expected in a hypothetical competitive market. These concepts do not assist us determine whether the 'purpose' or 'effect' flows from the impugned conduct or from market forces.
101. The differing ways that market power, and the objectives of competition law, have been portrayed in the literature on law and economics, including decisions of courts and tribunals, reflect underlying views of the world, which need to be brought to light and critically examined. Pursuit of the welfare of

individuals *as consumers* leads us in different policy directions to pursuing collective welfare of society through productive efficiency. Whichever competing policy objective might be preferred, the challenge is to frame a law that provides certainty and predictability.

102. Based on the analysis set out in this submission, the recommendations set out in paragraphs 3 to 11 inclusive above are commended to the Review Panel.