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# Submission by RBB Economics in response to the Issues Paper for the Competition Policy Review

**RBB Economics, 20 June 2014**

## 1. Executive Summary

RBB Economics welcomes the opportunity to make a submission to the Australian Government in response to the Competition Policy Review ('the Review') Issues Paper (IP) by the Review Panel chaired by Professor Ian Harper released on 14 April 2014. The overarching objective of the Review is to identify competition-enhancing microeconomic reforms to drive ongoing productivity growth and improvements in the living standards of all Australians. The Review has been asked to examine competition policy and make recommendations to ensure the framework is responsive to today's economy and resilient to any changes that may occur.

This submission is structured around the three points that we make in response to questions or issues raised in the IP.

Section 2 explores some of the issues relating to anti-competitive conduct undertaken by firms with a substantial degree of market power. The section begins by questioning whether the Review Panel's IP has struck the right balance between the promotion of competition and the achievement of economic efficiency. It then discusses the current interpretation of the "taking advantage" test in the misuse of market power prohibition in Australia and explores whether that test sets the hurdle for intervention too high. One consequence of this is that the ACCC, as a result of the difficulties it faces in demonstrating that a firm has "taken advantage" of its market power, may increasingly turn to other provisions – such as those prohibiting firms which do not necessarily even have a substantial degree of market power from engaging in "unconscionable" conduct – and to intervene even when efficiency considerations are not at stake.

Section 3 responds to the questions raised in the IP regarding the administration of competition policy and argues that the operations and processes of the ACCC, in particular, are not transparent and are not subject to appropriate external scrutiny. This means that there can be no comfort for parties that the decisions made by the ACCC have been based on robust economic analysis of the available market evidence. Other jurisdictions have taken steps to subject the analysis of competition authorities to greater external scrutiny and the Review should explore how lessons from other jurisdictions could help to improve the standards of transparency and consistency in enforcement decisions in Australia.

Section 4 of the submission then discusses whether there is a need for a general prohibition against excessive pricing in the Competition and Consumer Act (CCA) in Australia. Our submission argues that the CCA currently lacks a general mechanism for dealing with excessive pricing in Australia. The effect of this is that ad hoc proposals are developed by policy-makers and discussed by various parliamentary committees as a way to deal with concerns over high prices to consumers. Although we would not be in favour of a competition policy that routinely sought to control price levels, the Review Panel should explore the extent to which a general prohibition against excessive pricing might help reduce some of the more extreme proposals for dealing with high prices (such as calls to regulate international price discrimination and proposals that direct firms to reduce their market share) and determine how such a prohibition, if considered to be desirable, could be limited to exceptional circumstances where competition has broken down irretrievably.

# 2. Issues relating to anti-competitive conduct by firms

This section discusses the approach that the Review Panel have taken when balancing the different objectives of the CCA as well as responding to questions raised in the IP regarding the appropriateness of the misuse of market power provision and the use of the unconscionable conduct provisions in the CCA.

## 2.1. More competition at the expense of economic efficiency?

The general tone of the IP is that competition is an end in itself and that the purpose of the Review is simply to update and refine the National Competition Policy (NCP) Elements outlined in Box 1 of the IP to ensure that they are fit for purpose.

While a competitive market often provides an efficient outcome, the tone in the IP risks equating the competitiveness or efficiency of the market with the number of competitors in the market. The number (and size) of firms in a market will often be a poor indicator of the strength of competition in a particular market. For example, the presence of economies of scale or scope may result in continual declines in unit costs as production expands. In that case, it may be more efficient for the entire output in the market to be supplied by a single firm at a lower cost than by any combination of two or more firms. Similarly, there may be circumstances where a manufacturer of a specialised product may benefit from higher prices charged by retailers (for example, by reducing intra-brand competition) if this encourages retailers to help ensure consumers appreciate the full benefits of the product. In those circumstances, a competitive market may not deliver the most efficient outcome.

This raises the question of whether the IP has placed too much emphasis on competition as a policy objective at the expense of economic efficiency. Sir Daryl Dawson and his colleagues in the Dawson Review seemed to strike a better balance between these two policy objectives:

> *Although the competition provisions in Part IV of the Act focus on the promotion of competition in markets, Part VII provides for authorisation of conduct when that conduct is justified in the public interest, notwithstanding a lessening of competition. This reflects the fact that, whilst competition is an important means whereby an economy can achieve economic efficiency, competition is not an end in itself. The achievement of economic efficiency is the ultimate goal, because it results in high productivity, which in turn sustains economic welfare. Maximising competition is the means to that end.*[1]

The Review Panel could explore whether more emphasis can be placed on economic efficiency as an objective of the CCA and should resist the temptation to label markets where there are relatively few businesses operating as markets that are not necessarily subject to workable or effective competition.

## 2.2. Is the administration of per se prohibitions in the CCA efficient?

The extract from the Dawson Review above raises another question that is relevant for the Review, namely whether the current approach of authorising or notifying conduct that may otherwise be prohibited by the CCA – including through the use of per se prohibitions – provides sufficient protection to some arrangements that may otherwise be prohibited. This question is explored in this section.

The CCA in Australia currently makes an allowance for firms to engage in certain conduct that promotes efficiency at the expense of competition through the notification and authorisation process. The ACCC may grant an authorisation if it is satisfied that that there would be a benefit to the public from the conduct that outweighs the detriment to the public likely to result from any lessening of competition.

Two practices that are currently subject to per se prohibitions in the CCA are resale price maintenance (RPM) and third line forcing and the IP has asked whether the provisions in the CCA relating to these operate effectively and whether they further the objectives of the CCA.

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[1] Trade Practices Act Review ('Dawson Review') 2003, Review of the Competition Provisions of the Trade Practices Act – Final Report, p 32.

### 2.2.1. Third line forcing

Third line forcing conduct can be described as the supply by one party of a discount or other offering in relation to goods or services on condition that the purchaser has acquired goods or services from a third party. As the Dawson Report identified, third line forcing may mean that consumers will benefit when they have the opportunity to purchase a product at a discount from one supplier even if that discount is conditional on the purchase of a further product from another supplier.

At present, the third line forcing laws prohibit pro-competitive conduct that the ACCC itself acknowledges is unlikely to have an anti-competitive effect. For example, if a firm offers to supply a product (product A) at a particular price or offers a discount, allowance or rebate for the supply of that product on the condition that the buyer acquires a second product (product B) from another supplier, then consumers have a choice of either buying product A at its normal price or at a discounted price if they also purchase product B. In this situation, the ACCC accepts that this conduct is less likely to have anti-competitive effects if buyers have a genuine choice in buying product A, but also notes that the arrangement may result in public detriment if it leads to a loss of transparency in the pricing of products A and B, preventing customers from making an informed decision on the supplier's offer.[2]

Although third line forcing is prohibited outright under the CCA (even if it does not substantially lessen competition), a party considering engaging in the conduct could lodge a notification to the ACCC in order to gain immunity from any legal action. The ACCC assesses third line forcing notifications by applying the public interest test outlined in section 93(3A) of the CCA, which requires the ACCC to be satisfied that the likely public benefit will outweigh the likely public detriment from the conduct.

The existence of a large number of instances in which the conduct does not threaten effective competition itself suggests that the use of a per se rule or a presumption against third line forcing is inappropriate. It does not meet the basic criterion that such a prohibition should be applied in cases where the conduct is anti-competitive in the vast majority of cases. The ACCC receives (and almost always approves) hundreds of notifications regarding third line forcing every year. So although we have an administrative process that requires firms to spend time and resources seeking approval to engage in efficiency-enhancing, pro-competitive conduct, the Review Panel should consider whether such a process is a necessary and efficient part of modern competition law administration.

The presence of a per se prohibition in the CCA may create other distortions in the economy. One risk of maintaining a per se prohibition on third line forcing in the CCA is that it places undue emphasis on the *form* of the transaction rather than its *effect* on competition. In the cases on this issue that have gone before the Courts, for example, one question that the Courts have addressed is whether the services provided by the different firms are two separate services or whether they are one genuinely bundled service.

[2] ACCC, 2011 Guide to Exclusive Dealing Notifications, p 11.

For instance, in *Castlemaine Tooheys Ltd v Williams & Hodgson Transport Ltd*,[3] the High Court had to determine whether the provision had been breached when a brewer sold beer to publicans transported only by a carrier arranged by the brewery. In that case, the High Court ultimately determined that there was only one product – delivered beer – being sold to the publican rather than two separate products.

Whether one service (for example, "delivered beer") has been provided by a firm or two or more services (for example, beer and transport) in any particular case will, of course, need to be assessed on a case-by-case basis. But the need for a law that relies on clear lines to be drawn around products or services, to determine if a firm has breached a per se third line forcing rule, should be carefully reviewed. Those clear lines often may simply not exist and even if they did, they may not necessarily tell you anything that would help you get to a result that achieves any of the objectives of the CCA.

Subjecting third line forcing to a competition test would bring Australia's competition law in line with overseas jurisdictions, remove the need for an administrative and unnecessary process that has developed to allow ubiquitous, pro-competitive conduct by businesses in Australia, and would remove the need for firms to structure their contracts in an artificial way – for example, by creating one "contracted" product – in order to avoid adverse findings by courts.

### 2.2.2. Resale price maintenance

Although treated as a per se prohibition, resale price maintenance can be authorised by the ACCC if it finds that it is in the public benefit. However, unlike the situation with third line forcing where hundreds of notifications are approved each year by the ACCC, no authorisation for RPM has been, to date, granted in Australia.

The willingness of the Review Panel to explore whether the provisions in the CCA on RPM operate effectively is welcome. RPM arrangements could, in some – and perhaps even in most – circumstances have anti-competitive effects such as helping to facilitate a collusive outcome in upstream or downstream markets, softening competition, or foreclosing efficient low-cost retailers.

But even if it is justified to be inherently suspicious of RPM, it is important to keep in mind that there will be some circumstances where an RPM agreement may be pro-competitive and efficiency-enhancing. For example, RPM may be one way to overcome the "free rider" problem by ensuring that retailers that provide services to consumers (such as product displays, and pre-sales demonstration or other information services) are not undercut by retailers that do not provide those services. Manufacturers may therefore be content to suppress intra-brand competition in order to provide a material degree of protection to retailers to provide services that consumers want or need.

In the US, these benefits were the reason why the Supreme Court recently decided that RPM should no longer be treated as a per se prohibition and should instead be treated according to

[3] *Castlemaine Tooheys Ltd v Williams & Hodgson Transport Pty Ltd* [1986] HCA 72; (1986) 162 CLR 395 (2 December 1986).

the rule of reason. The reason for this change was the recognition that economic analysis of these agreements has demonstrated that RPM – along with other forms of vertical restrictions between manufacturers and their dealers, including agreements on minimum resale prices – can enhance competition. In the EU, Article 101(3) of the TFEU sets out the conditions for an efficiency defence which, if met, would mean that RPM would be permitted. These conditions are that the agreement must:

- contribute to improving the production or distribution of goods or to promoting technical or economic progress;
- while allowing consumers a fair share of the resulting benefit;
- without imposing on the undertakings concerned restrictions which are not indispensable to the attainment of those objectives; and
- without affording such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

The Review should, therefore, explore whether there are any lessons for Australia from the changes in the treatment of RPM in the US and whether the efficiency defence used in the EU has a role in trying to identify those RPM arrangements that would be welfare enhancing and are currently deterred in Australia.

One advantage of moving away from a per-se treatment of RPM is that it removes the temptation for the ACCC to associate and condemn practices that share some similar features with RPM without due consideration of their economic effects. As manufacturers and retailers experiment with more and more innovative forms of distribution agreements and retailer incentive mechanisms, there is a danger that the line between RPM and other vertical restraints becomes blurred, and that competition authorities seek to apply per se rules or presumptions against RPM to these other forms of conduct that share some features with RPM. The UK competition authorities have fallen into this trap with respect to investigations into distribution arrangements in the tobacco sector and most favoured nation (MFN) clauses in the hotel booking sector in recent years. Whilst it is clearly legitimate for competition authorities to investigate such vertical agreements for the possibility that they harm competition, it should not be open to them to rely on the existence of a per se rule against RPM to sidestep the requirement to conduct a proper economic analysis of the effects of such arrangements.

## 2.3. “Taking advantage” of market power

Section 46 in the CCA will only be engaged if the firm with a substantial degree of market power “takes advantage” of that market power for one of three purposes. These are:

- to substantially damage or eliminate a competitor;
- to prevent the entry of a firm in that or any other market; or

- to deter or prevent a person from engaging in competitive conduct in that or any other market.

The IP alludes to "the longstanding debate in Australia about whether the focus on purpose of the conduct in the misuse of market power provisions sufficiently captures conduct considered to adversely affect competition and the competitive process, and whether there should also be a focus on prohibiting the anti-competitive "effect" of the conduct".[4]

While the Review Panel will need to form a view on that debate, it should not let that issue distract it from addressing some of the more serious concerns relating to the important role that the "taking advantage" limb of section 46 plays in differentiating between pro-competitive conduct, which the law allows and encourages, and anti-competitive conduct, which the law should prohibit.

The first concern is that the term "take advantage" lacks a clear meaning and this creates uncertainty for firms that have a substantial degree of power in a market. Inconsistent judicial guidance on the interpretation of the term "taking advantage" in a number of cases in the highest court of Australia, and recent legislative amendments that have yet to be fully tested have led to considerable uncertainty about both how the term can be used to identify "monopolistic" conduct and where the hurdle for intervention in a misuse of market power is currently set.

The second concern is that the test used to determine whether a firm has taken advantage of its market power – while sensibly trying to identify efficiency enhancing conduct which should be encouraged – risks condoning anti-competitive conduct that should legitimately be captured by a misuse of market power provision. That test has been referred to as the "counterfactual test" and has been explained by the courts as follows:

> *If the impugned conduct has a business rationale, that is a factor pointing against any finding that conduct constitutes a taking advantage of market power. If a firm with no substantial degree of market power would engage in certain conduct as a matter of commercial judgement, it would ordinarily follow that a firm with market which engages in the same conduct is not taking advantage of its power.*[5]

The Review Panel should explore whether the counterfactual test sets the bar for intervention too high. That test looked at whether a firm with no substantial degree of market power could engage in the same conduct as a matter of commercial judgement. If it could, the courts typically held that a firm with market power which engages in the same conduct is not taking advantage of its market power.

While looking at whether a firm *without* market power could (or would) engage in similar conduct to that which a firm *with* market power is a good place to start any investigation of whether a

4 Australian Government Competition Policy Review, Issues Paper, para. 5.8.

5 Heerey J in *ACCC v Boral Ltd* [1999] FCA 1318; (1999) 166 LR 410: ATPR 41-715 and quoted with approval by the majority in the High Court in *Boral*.

firm has misused its market power, making this also the end of the assessment poses a significant risk that some anti-competitive conduct could go unpunished.

Clearly, if a firm without market power is able to engage in similar conduct then it cannot be right to object in principle to that particular conduct when practised by firms that have a substantial degree of market power.

But at the same time, under some conditions, firms with a substantial degree of market power might achieve economic effects through conduct that could harm competition and damage consumer interests in a way that is clearly not feasible for the firm without market power. A failure to examine whether those conditions apply to the matter in question risks setting the bar for intervention too high and prevents courts and competition authorities from intervening in those cases where the competitive process is put at risk.

These important issues risk being obscured by the debate about the appropriateness of the “purpose” test and this Review therefore provides an excellent opportunity to re-visit the test contained in the terms “taking advantage” and to assess whether it fails to capture some anti-competitive conduct undertaken by firms with a substantial degree of market power.

## 2.4. The often unconscionable use of the unconscionable conduct provisions

Laws against unconscionable conduct – although not clearly defined – are aimed at preventing conduct between businesses that is particularly harsh or oppressive and which goes beyond commercial bargaining. The IP notes that statutory protection against unconscionable conduct, which recognised the disparity in bargaining power between buyers and sellers, was introduced into the CCA in 1986 as a consumer protection measure.[6]

It is no surprise therefore that firms that feel that they have less bargaining power than the party that they are negotiating with will use those statutory provisions to try to even up the playing field. Throughout 2013, the ACCC has been investigating whether the major supermarket chains (MSCs) in Australia have engaged in conduct that the ACCC argues “does not conform to acceptable business practice and which may be unconscionable or a misuse of market power.”[7] In particular, the ACCC has expressed concerns about the power imbalance between suppliers and retailers and is exploring whether the MSCs may have engaged in unconscionable conduct in their dealings with their suppliers. The conduct that the ACCC is investigating includes whether retailers are unilaterally deducting amounts due to suppliers, contrary to the relevant supply contracts, and whether retailers are misusing their market power by discriminating in favour of their own home brand products to deter or prevent suppliers of proprietary brands from engaging in competitive conduct.

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[6] Australian Government Competition Policy Review, Issues Paper, para. 5.12.

[7] Speech delivered by Marcus Bezzi, ACCC, entitled ‘Competition watchdog’s investigation into major supermarkets’ to the Victorian Farmers Federation 2013 Conference on 28 June 2013.

Retailers and suppliers will often negotiate over the wholesale price of products, the timing and funding of promotions, and whether a particular product or even an entire range of products will continue to be stocked on the shelves of a major retailer. The ACCC seems to be concerned that retailers will use this perceived power imbalance between retailers and suppliers to drive down the price that they pay for goods from suppliers. But the important question is how can the ACCC assess whether any buyer power that retailers have is actually being used in an anti-competitive way rather than being used to drive a bargain that is harder than the supplier would have preferred?

It is easy to see why large retailers would want to drive down the prices that they pay to their suppliers. The goods that they purchase from their suppliers are ultimately sold to customers in their stores and a reduction in the wholesale price paid by retailers could provide them with a competitive advantage in the downstream grocery retail market. In that context, one might expect that any power in the hands of retailers that enables them to drive down prices would be wholeheartedly welcomed by consumers and competition authorities as a sign that competition is working well.

But the laws relating to unconscionable conduct require the ACCC to ignore the benefits that hard bargaining provides to consumers and encourages them to intervene in commercial arrangements to try moderate the ruthlessness of competition that the CCA has specifically been designed to protect. This should not be part of the ACCC's remit. The ACCC has considerable skill and a great deal of experience in assessing whether firms have market power or not and whether particular conduct has the purpose or effect of substantially lessening competition. But the laws on unconscionable conduct do not require any analysis of market power or competition. The Review Panel should, therefore, carefully consider whether the ACCC is the appropriate body to enforce laws relating to unconscionable conduct. There are, in fact, a number of reasons why the ACCC is ill-suited to the task of acting as an arbitrator and evaluating whether MSCs have engaged in conduct which does not conform to acceptable business practice and may be unconscionable or a misuse of market power.

First, economic theory does not require firms to be of similar size to achieve an efficient outcome when dealing with one another and, in practice, commercial negotiations between firms are often characterised by an imbalance in the relationship between MSCs and their suppliers.

Second, it requires the ACCC to identify what it views as acceptable business practice and to explore the motive behind particular actions and to understand the reasons why firms have struck a particular bargain. In many situations, unilateral contract variations may turn out to have a legitimate purpose. In its 2008 inquiry into the competitiveness of retail prices for standard groceries ("the ACCC's Grocery Inquiry"), for example, the ACCC investigated demands from MSCs for compensation from suppliers if they had to lower the shelf price in order to clear products that had been de-listed. A closer inspection of these demands revealed that rather than being oppressive or harsh, suppliers were often willing to provide the compensation demanded by retailers as they would often be the supplier most likely to provide the new product to replace the de-listed product. It is impractical and unrealistic for the ACCC to review every such contract variation to determine whether the commercial agreement reached by the parties conforms to acceptable business practice and when too hard a bargain has been struck by the MSC.

Third, any intervention by the ACCC risks reopening commercial agreements reached by retailers and suppliers. Any such involvement also carries with it a clear risk that it will encourage a culture of complaint rather than of competition. Suppliers that are unhappy with the outcome of the commercial bargain that they have struck with retailers are likely to find it difficult to resist the temptation to turn to the ACCC to try to strengthen their hand in their negotiations with retailers. This could lead to unwarranted intervention in cases where there is no evidence of any actual harm to the competitive process.

The laws regarding unconscionable conduct in business-to-business transactions and their use by the ACCC to re-open commercial agreements between suppliers and retailers risks being categorised as a protectionist urge to force retailers to be nicer to their suppliers. Many, if not most commercial negotiations are characterised by some degree of imbalance between parties and the ACCC should not seek and nor should they expect commercial negotiations to be conducted by parties of broadly similar strength, or in a friendly and polite manner, particularly when the benefit of those tough negotiations flows to consumers through lower prices. Rather than arbitrating on and interfering in commercial outcomes negotiated by parties and assessing the nature of, and the motive behind, particular contractual terms, the ACCC's role should be limited to assessing whether any buyer power that retailers have is likely to be substantial enough to damage competition and to then identify a clear, fact-based theory of how that buyer power might lead to competitive detriment.

# 3. The processes and operations of the ACCC

This section of the submission comments on paragraph 3.2 of the Terms of Reference contained in Appendix B of the IP. Paragraph 3.2 asks the Review to consider whether:

> *The operations and processes of regulatory agencies are transparent, efficient, subject to appropriate external scrutiny and provide reasonable regulatory certainty.*

In this section, we argue that the operations and processes of the ACCC, in particular, are not transparent and are not subject to appropriate external scrutiny. This means that there can be no comfort for parties that the decisions made by the ACCC have been based on a sound economic assessment of the available market evidence. Other jurisdictions have taken steps to expose the analysis of competition authorities to greater external scrutiny and the Review is surely an excellent opportunity to explore how similar measures could have the potential to improve the rigour of competition law enforcement in Australia.

## 3.1. The transparency, efficiency, and scrutiny of the ACCC's processes

An important function of the ACCC is to review whether a merger between two firms will substantially lessen competition in the relevant market. In any horizontal merger – that is, in a merger between firms that produce goods or services that are substitutable with one another –

two firms that previously competed against each other will combine to form a single economic unit. The hard question for the ACCC is to assess whether this reduction in the number of rivals in an industry will lead to a substantial reduction in competition.[8]

Increasingly in Australia and around the world, empirical analysis has played a crucial role in helping to identify the boundaries of the relevant market and to determine whether the reduction in competition is substantial or not. Empirical analysis, for example, could help to assess whether branded soft drinks are in the same market as private label soft drinks, the extent to which two parties are close competitors in a relevant market, and how much more one firm discounts its products when faced with competition from the merging party pre-merger.

The precise type of empirical analysis that is undertaken in a given case will vary depending on the availability of data and the time available to conduct the analysis. However, in practically all cases, the economic questions that are the key to the likely competitive effects of a merger will be amenable to some empirical analysis.

The empirical analysis needed to determine whether a merger substantially lessens competition or not needs to take place within the processes that have been put in place to review mergers in Australia. There are currently three processes in place:

- An **informal merger review process** which provides the merger parties with the ACCC's informal view on whether a merger proposal is likely to breach s.50 of the *Competition and Consumer Act*. An informal view by the ACCC not to oppose a merger does not provide the merger parties with protection from legal action by the ACCC or other parties.

- A **formal merger clearance** confers legal protection to the person to whom clearance is granted from the application of s.50 of the Competition and Consumer Act. This means that neither the ACCC nor any other party may initiate legal action on the basis of an alleged contravention of s.50 so long as the merger takes place in accordance with the clearance.

- Mergers can also be **authorised** by the Federal Court if their anti-competitive effect is outweighed by public benefits.

The informal merger review process is currently the way almost all proposed mergers are assessed in Australia. The process is preferred by parties because of its flexibility and relative speed. There are, however, concerns over the ability of the informal process to deal with more complicated mergers in large part because of the opaqueness of the evidence and data which the ACCC relies on to undertake empirical analysis. Although the formal process could, in theory at least, address the concerns around the lack of transparency of the informal process, it has not been used since its introduction in 2007 suggesting that it is not a credible way to overcome the concerns that have been raised with the informal process.

[8] As discussed in section 2.1 of this submission, the number (and size) of firms will often be a poor indicator of the strength of competition and of competitive constraints operating in a particular market.

The questions for the Review Panel are whether the merger review processes in Australia are appropriate for reviewing more complicated mergers and what lessons, if any, can be drawn from the experience of competition authorities in other jurisdictions. Some of the insights from those jurisdictions include the following.

- A proper evaluation of the market evidence and the empirical analysis of that evidence upon which the ACCC relies to determine whether the merger substantially lessens competition is only possible if that evidence and analysis is subject to meaningful external scrutiny. Currently, the ACCC under the informal merger process is subject to no meaningful scrutiny. At present, the ACCC collects data from the merger parties, from other parties including rivals and customers and from other sources, and makes a decision on whether to oppose the merger or not. The ACCC has recently begun to speak more openly about its concerns with merging parties throughout the merger process, but is still reluctant to expose any of its analysis to any external scrutiny. Its approach, effectively, asks parties to trust that it has made the right decision on each and every (difficult) question it faced while undertaking its economic analysis.

- The ACCC needs to have its decisions subjected to external review. To date only two decisions in the past decade have been appealed and both of those were overturned by the Federal Court of Australia. More frequent exposure to external review may help foster a culture within the ACCC that encourages continuous improvement and the development of procedures and systems that help generate better decisions. In Europe, for example, the European Commission undertook a review of its guidelines and procedures following three decisions by the Court of First Instance (CFI) which overturned its decisions and which were very critical of the EC.[9] That review led to a complete overhaul of its guidelines and processes aimed at exposing the EC's decision making processes to greater external scrutiny.

Any move towards greater external scrutiny of the ACCC's empirical analysis will inevitably raise questions on how to deal with confidential data and views from market participants. These are serious issues but they are not insurmountable. In Europe, data room procedures and confidentiality rings have been developed that allow advisors to access the data that the EC has relied on, and the economic analysis it has undertaken, during its investigation.

There are ongoing debates about the guidelines and procedures that have been implemented by the EC and by Member States to review mergers as well as debates about the disclosure rules that have been put in place across Europe to deal with confidentiality concerns. These debates reflect the fact that there is no perfect process for reviewing mergers anywhere in the world. But what we do have from around the world are a number of different systems each with their own strengths and weaknesses and the Review Panel should assess the extent to which

[9] The Court of First Instance annulled, on appeal, three of the Commission's merger prohibition decisions – Airtours/First Choice (Judgment of the Court of First Instance in Case T-342/99, 6 June 2002), Schneider/Legrand (Judgments of the Court of First Instance in Cases T-310/01 and T-77/02, 22 October 2002) and Tetra Laval/Sidel (Judgments of the Court of First Instance in Case T-5/02 and Case T-80/02, 25 October 2002) – on the basis that the Commission had failed to provide sufficient economic and factual evidence to prove its theories of competitive harm.

the merger review processes in Australia could benefit from incorporating some of the strengths of those regimes.

# 4. Is there a need for a general prohibition against excessive pricing in the CCA?

The price discrimination discussion in the IP suggests that the Review Panel may be concerned about the lack of competition in some industries leading to higher prices. Concerns about high prices paid by consumers are not new and have led to investigations into petrol and grocery prices in 2007 and 2008 using the powers of the old Prices Surveillance Authority (which was one of the bodies that preceded the ACCC) now contained in Part VIIA of the CCA. Those concerns have also led to a new amendment to section 46 being proposed which is aimed at providing the Court with the power to order a firm with a substantial degree of market power to reduce its market share where it has been found to have misused its market power. This amendment has been proposed in response to the high concentration of many Australian retail markets including groceries, fuel, liquor and hardware, and in response to concerns that the lack of competition in those markets is putting those who deal with these firms such as suppliers under increasing financial strain.

Attempts by policy-makers to require firms to reduce their market share or to regulate international price discrimination may well be a sign that policy-makers are frustrated with the lack of a mechanism in the CCA that enables them to address market failures leading to excessive pricing. In response, policy-makers are increasingly turning to ad hoc or extreme proposals to force prices down for consumers. It would be useful, therefore, for the Review Panel to consider whether there is a need for a general prohibition against excessive pricing, what the scope of such a provision may be, and importantly, whether a general prohibition would minimise some of the more contentious proposed interventions currently being explored in Australia.

## 4.1. Is there currently a general prohibition against excessive pricing in Australia?

There is currently no general prohibition against excessive pricing in the CCA. Section 46 of the CCA prevents a firm with a substantial degree of market power from "taking advantage" of that power for one of the proscribed purposes. Those purposes suggest that section 46 is aimed at preventing firms with market power from engaging in anti-competitive *exclusionary* conduct, not *exploitative* conduct. In other words, the misuse of market power prohibition in Australia does not address excessive pricing by firms with a substantial degree of market power.

Excessive pricing could, theoretically, be addressed through Part VIIA of the CCA which deals with prices surveillance or through the pricing principles contained in Part IIIA of the CCA (which the ACCC is required to consider when making a determination as part of arbitration proceedings following declaration of a service, as well as in making decisions on undertakings or access codes). Section 95E of Part VIIA states that the "object of this Part is to have prices surveillance applied only in those markets where, in the view of the Minister, competitive pressures are not sufficient to achieve efficient prices and protect consumers." Part VIIA of the CCA allows the ACCC or another body to hold price inquiries or to undertake price monitoring in relation to the supply of goods or services.

Part VIIA inquiries can be a useful way for the ACCC to gain a deeper understanding of the features of different markets and how competition is actually working in those markets. The ACCC's grocery inquiry in 2008, for example, produced a number of useful insights into how suppliers and retailers actually interacted with each other, while the petrol price inquiry in 2009 managed to identify what the underlying drivers of petrol prices really were. But these inquiries seem to be better suited to reviewing the structure of particular industries and have not, to date at least, been used as a general tool to deal with excessive pricing by firms with a substantial degree of market power.

## 4.2. The economic case for a general prohibition against excessive pricing

Excessive pricing by firms with a substantial degree of market power can cause harm to consumers. The basic economic reasoning for this is clear: market power results in prices above competitive levels allowing firms to charge higher prices to consumers and to earn higher profits.

But while the economic problem is easy to define, it is far harder to address. One reason for this is that it will often be difficult to identify when prices are excessive. In some types of industries, for example, in those with intellectual property rights or in industries characterised by very high fixed costs, it will be very difficult to measure the relationship between costs and prices. In these sorts of markets, prices will usually exceed the unit cost of production by a significant amount.

Some jurisdictions, such as the United States, however, are less concerned about the potential harm to consumers from firms charging excessive prices, provided that the market power that those firms have has been gained through legitimate means. The courts there have said that "competition is ill-served by insisting that firms pull their competitive punches so as to avoid the degree of marketplace success that gives them monopoly power or by demanding that winning firms, once they achieve such power 'lie down and play dead.'"[10] The position in the US with regard to excessive pricing appears to be that provided a firm has gained its market power through lawful means (for example, if it pursued efficiencies), it is then allowed to increase its prices even to monopoly levels.

By contrast, in the EU, in Article 102 of the Treaty on the Functioning of the EU (and in the national competition laws of EU member countries, which typically reflect EU competition law), there is no doubt that the prohibition on abuse of a dominant position can be used to address excessive pricing. However, cases where the EU prohibition on abuse of a dominant position

[10] Goldwasser v Ameritech Corp., 222F.3d 390, 397 (7th Cir. 2000).

has actually been used to deal with excessive pricing are rare, as the EU Commission is rightly careful to resist playing the role of pricing regulator.

An important task for the Review Panel is, therefore, to articulate whether they believe that the CCA should contain a general prohibition against excessive pricing, even when gained lawfully by a firm with a substantial degree of market power. Such a provision exists for many utilities such as for gas and electricity transmission networks through the regulatory regimes that have been introduced since those sectors were de-regulated, but not for prices charged by firms in industries that fall short of being a natural monopoly (or that have not been recognised as a natural monopoly).

Most economists would readily agree that public policy ought to be capable of dealing with excessive pricing in situations where a severe market failure exists and where competition will have irretrievably broken down. In those situations, the monopoly supplier would have the power to raise prices above costs and to earn profits in excess of the normal or competitive level. The outcome would be a loss of static economic efficiency as less output would be produced than is socially desirable. Rather than simply monitor prices in these situations, detailed, intrusive price controls will usually be required to ensure a fair deal for consumers.

But most economists would also agree that the use of such powers would need to be heavily constrained due to the risks that actual or threatened price controls could pose for dynamic incentives in a market economy. In some industries – such as in some concentrated markets – a prohibition against excessive pricing is much less likely to be the appropriate response where competition is still capable of providing a constraint on the incumbent's market power. In such situations, profits perform a dynamic function of rewarding success and providing incentives for investment and innovation. As the Productivity Commission argued in its review of the prices surveillance regime in 2001:

> *There are severe limitations to the role that price control can play in areas where competition is not strong. In such markets, regulators attempt to set prices at the levels they estimate would occur if there were more active competition. Yet this is a complex task requiring information that typically is not available. So, in practice, regulators are likely to end up setting prices above or below the efficient level. Yet if they are set too high, consumers are penalised, unless there is a market response which drives prices down. For firms that use the good or service, it could impede their performance and discourage investment. If prices are set too low, investment can be discouraged and firms may exit the industry, leading to more severe problems for consumers and the economy generally in the long term, including limited capacity, less innovation or inadequate maintenance or new investment.*

The Productivity Commission ultimately decided against setting prices in concentrated industries that fell short of being natural monopolies and cautioned governments and regulators to be wary of intervening to set prices, particularly in markets other than where there is a natural monopoly, even when competition was not strong.

So while a general prohibition could play a useful role in thwarting some of the more extreme solutions being proposed to deal with the problem of excessive pricing in Australia, it would be extremely difficult to design in practice and its use should be heavily constrained to those situations where there is an enduring lack of effective competition. Instead, what may be more useful would be a clearer understanding of why prices may be excessive in different situations and a deeper understanding of the advantages and disadvantages of intervening to address those concerns in those different situations, perhaps through strengthened Part VIIA investigations.

## 4.3. An argument against regulating international price discrimination

One question posed by the Review Panel in the IP is whether there is a case to regulate international price discrimination. The IP states that international price discrimination occurs when sellers charge different prices in different countries and those prices are not based on the different costs of doing business in each country. The IP also notes that a recent parliamentary inquiry found that Australian consumers and businesses often paid more for their IT products than their counterparts in comparable economies and in some cases, paid 50 to 100 per cent more for the same product. The suggestion here appears to be that the introduction of a new law in Australia that prohibits sellers from charging different prices in Australia would remove an anti-competitive practice and improve consumer welfare.

Price discrimination (whether between geographic areas, including countries, or between types of customer) is neither automatically anti-competitive nor detrimental to consumer welfare. As earlier inquiries such as Hilmer and the Dawson Review found, price discrimination is widely used as an effective instrument to achieve dynamic efficiencies and consumer benefits. For example, price discrimination may result in efficient fixed cost recovery, or allow additional markets to be served. Importantly, by enabling firms to compete aggressively for new customers without creating spill-over effects to other markets, price discrimination may give rise to important dynamic benefits in terms of more intense competition overall.

Price discrimination is a ubiquitous phenomenon occurring in countless markets, including highly competitive ones. In a simple static model, price discrimination always leads to some loss of efficiency. For example, customers facing a high price who, at the margin, decide not to buy the product may value the product more highly than marginal customers facing a low price who do decide to purchase the product. This may give rise to a so-called “allocative inefficiency” – welfare would increase if, for example through arbitrage, the product was reallocated from the latter group of customers to the former. However, such inefficiencies occur everywhere in the economy and do not in themselves justify taking a hostile stance towards price discrimination.

Consequently, differences in the price of similar products across countries cannot necessarily be presumed to be related to any exploitative motivation of suppliers. In addition, a law that looked to regulate or prohibit international price discrimination would likely serve to harm consumers and economic efficiency. It may mean that international suppliers will choose to stop making sales to Australian consumers rather than have their pricing flexibility appropriated by the Australian government. It may also affect Australian suppliers. An Australian producer, for example, who could make incrementally profitable sales to consumers in other countries, may be deterred from achieving those profitable exports if it was unable to price the (similar) products that it was exporting at a lower price than that which it set for domestic sales.  A ban on incrementally profitable exports would harm global consumer welfare and constrain the ability of Australian firms to grow and to achieve the scale that they may need to compete in some international markets.