RBB | Economics

Response by RBB Economics to proposals relating to the misuse of market power and the introduction of "concerted practices"

RBB Economics, November 2014

This paper had been prepared in response to the Draft Report prepared by the Panel undertaking the Competition Policy Review in Australia ("the Panel"). Specifically, this paper comments on two aspects:

- The proposal to reframe the primary prohibition in section 46 to prohibit a corporation that has a substantial degree of power in a market from engaging in conduct if the proposed conduct has the purpose, or would have or be likely to have the effect, of substantially lessening competition in that or any other market (see section 1 below).
- The proposal to extend section 45 to cover concerted practices which would have the purpose, or would have or be likely to have the effect, of substantially lessening competition (see section 2 below).

1. Proposed change to the misuse of market power provision

Draft Recommendation 25 ("DR 25") proposes reframing the primary prohibition in section 46 to prohibit a corporation that has a substantial degree of power in a market from engaging in conduct if the proposed conduct has the purpose, or would have or be likely to have the effect,

of substantially lessening competition in that or any other market. To mitigate concerns about over-capture, the Panel proposes that a defence be introduced so that the primary prohibition would not apply if the conduct in question:

- would be a rational business decision or strategy by a corporation that did not have a substantial degree of power in the market; and
- the effect or likely effect of the conduct is to benefit the long-term interests of consumers.

1.1. Policy objectives of s 46

Section 46 of the CCA exists to prevent the unilateral exercise of market power from leading to anti-competitive outcomes that are inefficient and adversely affect consumer welfare.

It is clear that only an effects-based test – that is, one that focuses on those outcomes and intervenes only where adverse effects arise (or are likely to arise) – can meet this policy objective. As such, we cannot see any valid reason to oppose the adoption of an effects-based test.

Some of the prominent objections to an effects-based test[1] see an effects-based test as synonymous with a law that condemns firms with market power whenever they succeed in competition – i.e. when they beat competitors and win market share. If an effects-based test were interpreted in this way, then that would indeed be a serious problem, but we would not agree that winning on merit constitutes an anti-competitive effect even if it harms competitors.

Moreover, the Panel and the ACCC have both placed an appropriately high weight on the need for the effects-based test to be aimed at protecting the competitive process, and not protecting individual competitors. So the stated opposition to an effects-based test seems misconceived.

1.2. False positives and false negatives

Any law in this area runs the danger of decisions that create *false positives* (i.e. wrongly condemning pro-competitive conduct just because it harms competitors) and *false negatives* (i.e. failing to intervene against genuinely anti-competitive conduct that harms welfare). The enforcement of laws against the unilateral exercise of market power is invariably controversial and the losing parties in any case inevitably claim that they are victims of a false positive/negative. The risks of enforcement errors cannot be eradicated by careful law drafting, and the certainty that disappointed parties will contest outcomes (whether right or wrong) will not go away.

---

[1] For example, Samuel, G. and King, S. (2014, 12 August). The effect of the ACCC's ambitions is dangerous. *The Australian Financial Review*, p. 47.

Errors of either kind are costly. False positives have the potential to create chilling effects on competition both in the case at hand and also more widely (e.g. through persuading firms to compete less aggressively for fear of section 46 intervention). In view of this, it is probably valid to place greater weight on ensuring that the risk of false positive errors is minimised. But an absolute focus on avoiding false positives would probably fail to strike an optimal policy balance.

1.3. Absence of workable form-based rules

It would be convenient if reliable and administrable *form-based* rules existed in this area – i.e. rules that drew a clear line between a category of conduct (e.g. price discrimination or exclusive dealing) and a predictable adverse outcome for competition (e.g. an SLC due to the exclusion of equally efficient competitors). But economic theory and international experience with laws in this area clearly shows that such relationships do not exist. Conduct that leads to anti-competitive outcomes in some circumstances is a useful part of the competitive process in others.

We have extensive experience in working with the EU abuse of dominance laws, and it is important that the Australian review should learn from the policy errors that have prevented a more rational enforcement approach from emerging in the EU. Despite efforts by the EU Commission to move away from ill-judged form-based rules and towards a more effects-oriented approach to Article 102, the EU case law retains an unhealthy tendency to condemn behaviour because of the form it takes, without due consideration for its actual effects on the competitive process. In the June 2014 Judgment in the *Intel v Commission* case, the General Court in Luxembourg went so far as to state that, when addressing discounts granted by a dominant firm in return for exclusivity, there is no need for the enforcement body to consider effects-based questions such as the size of the discounts, the proportion of the total market they covered or the impact that these discounts had on the market share of rival suppliers.[2] Such an approach creates an obvious and seriously damaging risk of false positive errors and a general chilling effect on competition.

Unless the EU manages to find a way out of its current problems, the EU experience on unilateral exercise of market power does not provide a positive template for Australia. In particular, the consensus in Australia around the need for the law to protect the competitive process and not competitors provides a much healthier foundation for the creation of a revised law and for its eventual enforcement.

---

[2] Judgment of the General Court, Intel Corp v Commission, Case T-286/09, 12 June 2014. See, for example, paragraph 80 of the General Court's Judgment: *"the question of whether an exclusivity rebate can be categorized as abusive does not depend on an analysis of the circumstances of the case aimed at establishing a potential foreclosure effect."*

1.4. Dealing with practices that do not depend on the existence of market power

One of the key issues raised by the Panel's discussion of section 46 is how to deal with the conduct of a firm with substantial market power when that conduct can be shown to be similar to the conduct of firms without market power. Specifically, to what extent should the fact that firms without market power behave in this same way create a safe harbour (or at least a presumption of innocence) for the firm with market power that adopts this same conduct?

Some commentators have observed that the "taking advantage" provisions of the current section 46 have been interpreted such as to provide such a safe harbour. In its submission to the Competition Policy Review, the ACCC comments that this situation has led to an enforcement gap – an inability of the ACCC to prosecute cases in which it believes that market power has been used to generate anti-competitive outcomes.

We leave it to legal experts to comment on the state of the case law and whether it does create such a safe harbour, but as a matter of economics it is clear that any such safe harbour would not be appropriate, and would carry a significant risk of false negatives. It would prevent the law from intervening in some instances where the unilateral exercise of market power does lead to adverse effects on the competitive process.

This is a natural corollary of the fact that there are no reliable form-based rules in this area. Since the same conduct can have different economic effects in different circumstances, it follows that conduct can be anti-competitive when it is pursued by a firm with market power even if it is unproblematic in situations where such power is absent. If one considers most of the categories of conduct that can give rise to anti-competitive outcomes – price discrimination, exclusive dealing, loyalty rebates, bundling, refusal to deal, etc. – it is evident that these are also commonly observed phenomena in many well-functioning competitive markets.

Of course, if a firm that is accused of anti-competitive exercise of market power can point to firms without market power behaving in a similar way, then that is a factor that is relevant to the competitive assessment. It shows that the conduct in question is capable of having a valid pro-competitive explanation, and suggests that action to condemn the firm for such conduct creates a risk that consumers will lose out on the benefits that would flow from this pro-competitive form of conduct. That makes life complicated for the enforcement authority, but such complexity is inherent in this area of law enforcement. This does not justify the adoption of a safe harbour for such conduct.

1.5. The need for further guidance in section 46 beyond an SLC test

As regards the Panel's proposals, the key substantive issue is whether there is a need for the two defence provisions in DR 25, which are designed to minimise the risk of false positives ("over-capture" as it is described by the Panel).

The first of these defences – "[whether it] *would be a rational business decision or strategy by a corporation that did not have a substantial degree of power in the market*" – could obviously

carry a risk of replicating the enforcement gap that the ACCC believes to have come about from the current "taking advantage" test, especially if this defence is contemplated as a stand-alone provision. Whilst we sympathise and agree with the desire to avoid false positive errors, given the absence of any clear link between the form of conduct and its effects we do not believe that this provision performs a useful role, and it could well provide an unwarranted safe harbour for many classes of anti-competitive conduct.

The second provision – "[whether] *the effect or likely effect of the conduct is to benefit the long-term interests of consumers*" – is hard to object to in principle, since no competition law intervention should occur if it fails to justify itself in terms of a beneficial effect on consumer welfare. Our query would be whether it is possible that the proposed prohibition itself, which confines itself to conduct that will or is likely to have the effect of substantially lessening competition, requires any additional defences. Pro-competitive conduct that harms competitors through the superior efficiency of the firm with market power should not in our view be categorised as creating an SLC in the first place. Provided that was made clear in the framing and context of the law, the need for defences against false positives should not arise.

2. The proposed introduction of "concerted practices"

2.1. Policy objectives of introducing concerted practices into s 45

Draft Recommendation 24 ("DR 24") has been proposed in response to the application of price signalling laws to the banking sector. While we agree with the Panel that there is no rationale for price signalling laws to apply only to the banking sector, expanding the scope of section 45 to cover concerted practices does much more than simply extend price signalling laws to all sectors of the economy and could provide exceptionally wide discretion to the competition authority to intervene in markets that are characterised by imperfect competition and relatively high levels of concentration.

This response argues that if DR 24 is to be adopted, the discretion of the competition authority would need to be constrained so that it only applies the new laws in very well defined and exceptional circumstances. In our view, a concerted practice should only be found if the competition authority has identified a particular conduct that has substantially lessened competition in the relevant (concentrated) market and in a way that is clearly linked to an identified theory of coordination (discussed in section 2.4).

2.2. When should DR 24 apply?

Concerted practices are most likely to be found in concentrated markets where firms typically set prices that depart – and in some instances, depart quite substantially – from those that we would see under the conditions of perfect competition.

In perfectly competitive markets, no one firm can influence the prices charged for the goods or services sold in that market and – in the absence of any fixed costs – competition between firms

can be expected to drive prices down to marginal cost. However, it is important to recognise that this perfect competition paradigm does not provide an operational benchmark against which to justify competition law intervention. Real world competition law cases involve real world imperfect markets in which prices do not neatly converge to marginal cost.

In particular, in concentrated markets, firms may influence the prices charged for the goods or services sold in that market by recognising their mutual inter-dependence with other firms in the market. When setting prices, firms will take into account the commercial decisions of rivals when formulating their own commercial strategy.

There is nothing suspicious or reprehensible about such firms recognising their mutual inter-dependence in the market and taking account of the commercial decisions of their rivals when setting prices. Even standard textbook models of oligopoly behaviour such as the Cournot and differentiated Bertrand models (which themselves are not good descriptions of real world oligopoly outcomes) envisage competitive outcomes in which prices depart from marginal cost. Many such imperfect outcomes are still consistent with effective competition and such outcomes do not therefore justify competition law intervention. It would clearly be wrong for a competition authority to label prices in these markets as being "supra-competitive" and to suggest that policy intervention may be justified.

Simple oligopoly models such as Cournot competition envisage one-shot games in which firms seek to find the best possible outcomes for themselves given an assumption about rivals' conduct. But in more complex oligopoly scenarios, repeated interactions between firms will sometimes enable firms to achieve outcomes that are even closer to a monopoly outcome. Yet such outcomes can arise simply from the intelligent adaptation of firms to the commercial environment in which they operate, and does not necessarily entail any conscious attempt to coordinate competitive conduct (or what we describe as "deliberate coordination" below).

Regardless of how one characterises the outcome of pricing in concentrated markets – in the absence of any specific conduct that deliberately tips a market to a monopolistic outcome – the introduction of a concerted practice provision is unlikely to make these concentrated markets work better. Even if a competition authority was able to clearly identify when prices in a market have departed significantly from effectively competitive levels (which would be extremely challenging to do in practice), there is simply no effective policy instrument for dealing with this and few competition authorities would wish – or have the skills required – to become price regulators to fine-tune price levels in this manner.

In theory one policy response here would be to grant the competition authority powers to break up and de-concentrate markets that exhibited high levels of concentration and uncompetitive outcomes. Another would be to allow the agency to impose price controls. But such draconian policy responses are likely to be disproportionate to the scale of the problem, and would envisage a level or industrial engineering that is well beyond anything that is anticipated under current discussion of s 45.

The important point here is that the Panel should state clearly that it does not intend DR 24 to be used by a competition authority as a way of justifying intervention in concentrated markets in order to get firms to set their prices in a way that overlooks their mutual inter-dependence with other firms in the market. Instead, the application of DR 24 should be confined explicitly to

situations where the competition authority has identified specific conduct that, through exerting a recognisable influence on coordination between the firms in the industry, tips a market towards an outcome that involves a clear and substantial lessening of competition.

2.3. Identifying conduct that substantially lessens competition

Identifying specific conduct that can be characterised as deliberate coordination and which tips a market towards an outcome that involves a clear and substantial lessening of competition will not be straightforward. Practices such as information exchange, price signalling, and most-favoured nation (MFN) clauses – which have strong and generally accepted pro-competitive benefits – are also likely to be widespread in many of the concentrated markets that competition authorities will typically watch closely.

Those same practices also, in certain circumstances, can have anti-competitive effects and could classify as examples of deliberate coordination that tip a concentrated market towards a substantial lessening of competition. But even in these cases there is a clear risk that DR 24 would provide a temptation for a competition authority to simply label any one of these practices as a "concerted practice" and to blame it for what it mistakenly or simplistically identifies as "supra-competitive" pricing by firms.

Given the uncertainty surrounding the types of practices that are likely to meet the Panel's broad definition of a concerted practice and the potential for over-reach by a competition authority, particularly given that most, if not all of the practices that may be investigated are likely to have pro-competitive benefits, what is needed is an analytical framework that could help guide a competition authority when applying the new law. That framework should start by identifying how, in principle, any of the practices identified by the authority might harm competition and then assess whether that hypothesis of competitive harm is compatible with the facts.

The deliberate coordination described above can only materialise if three specific conditions are met. First, the market must be sufficiently simple and transparent for firms to be able to reach an understanding. Second, firms must be able to monitor implementation of the agreement by the other firms and to deter deviations through suitable retaliation measures. Third, the agreement should not be destabilised by external factors such as entry or the reaction of powerful customers.

An acknowledgement by the Panel that such a structured approach to identifying conduct that might classify as deliberate coordination may be a useful way of constraining the enormous discretion that the competition authority will have when applying the new law and would help ensure that it is not used to justify intervention in those concentrated markets where it believes it could generate better outcomes than the continued operation of what is likely to be effective competition, even if that competition generates outcomes that a competition authority finds unpalatable.