Law Council
OF AUSTRALIA

Via email: economics.sen@aph.gov.au

Mr Peter Hallahan
Secretary
Senate Standing Committee on Econmics
P O Box 6100
Parliament House
Canberra ACT 2600

Dear Mr Hallahan,

Inquiry into: **Provisions of the Trade Practices Legislation Amendment Bill (No 1) 2007**

Trade Practices Amendment (Predatory Pricing) Bill 2007

I refer to your letter of 22 June 2007 addressed to the Administrator of the Business Law Section inviting submissions to the Standing Committee on Economics Inquiry into the provisions of the Trade Practices Legislation Amendment Bill (No 1) 2007 and the Trade Practices Amendment (Predatory Pricing) Bill 2007.

I have pleasure in enclosing comments which have been prepared by the Trade Practices Committee of the Business Law Section of the Law Council of Australia.

These comments have been approved by the Executive of the Business Law Section. Owing to time constraints, they have not been considered by the Council of the Law Council of Australia.

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Thank you for giving us the opportunity to submit comments to this Inquiry.

Yours sincerely,

Peter Webb
Secretary=General

9 July 2007

09.07.07

Submission to Senate Inquiry re Proposed Amendments to the Trade Practices Act 1974

1. *Introduction and Executive Summary*

Introduction

1.1 This submission has been prepared by the Trade Practices Committee of the Law Council of Australia, Business Law Section (the "TP Committee") in response to the request by the Senate Standing Committee on Economics on 22 June 2007. The TP Committee is constituted by experienced lawyers and economists who deal regularly with the provisions of the Australian *Trade Practices Act 1974 (Cth)* ("**Trade Practices Act**").

1.2 Given the short time frame in which this note has been prepared, it has not been possible for the Law Council of Australia to review its contents.

1.3 Several introductory points are important:

(a) The object of the *Trade Practices Act* is to "enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection".[1]

(b) All Australians are consumers. Whereas businesses, large and small, may also be Australians, in framing policy in this area, their interests ought to be secondary to those of Australian consumers.

(c) Generally, consumers are best served by persistent and, at times, ruthless competition between the businesses supplying goods and services to them:

> "*Competition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away. Competitors almost always try to "injure" each other in this way. ... these injuries are the inevitable consequence of the competition section 46 is designed to foster.*" *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Ltd* (1989) 167 CLR 177 at p191, per Mason CJ and Wilson J.

It ought to be recognised that the failure of relatively inefficient businesses is inherent in the rigorous process of competition which serves consumers' interests.[2]

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1 Section 2 of the *Trade Practices Act.*

2 Equally, in the United States: "Antitrust legislation is concerned primarily with the health of the competitive process, not with the individual competitor who must sink or swim in competitive enterprise. In an industry plagued by falling demand and excess capacity, the sinking of a competitor may be an indication of a healthy competitive process." *Pacific Engineering and Production Company of Nevada v Kerr-McGee Corporation* 551 F.2d 790 (10th Cir 1977) at p 795.

(d) Promoting competition among the businesses which make up the Australian economy requires a delicate regulatory balance. Inherently anticompetitive practices, such as collusion (including price fixing and exclusionary provisions[3]), must be and are prohibited. However, there is a danger that further regulation, no matter how well-intended, may stifle competition. This can occur where businesses threaten legal action or a complaint to the regulator to deter their competitors from competing as vigorously as they might otherwise have done.[4]

The Full Federal Court has expressly recognised this possibility – see *Eastern Express Pty Ltd v General Newspapers Pty Ltd* (1992) 35 FCR 43 per Lockhart and Gummow JJ:

> "*The Court should be vigilant to ensure that its jurisdiction is not invoked to interfere with normal and legitimate competitive pricing activities ... under the guise that such activities are predatory.*"

Getting the balance right is especially difficult when dealing with "predatory pricing". Discounting prices is the very heart of competition between suppliers. Any law which might dull the urge of Australian companies to discount their products, for fear of litigation from their competitors or investigation by the regulator, risks chilling competition and must be considered very carefully. When considered through the eyes of Australian consumers, the "cure" may well be worse than the "disease".[5]

The Australian Parliament must be alive to this possibility. For example, the Antitrust Modernization Commission ("AMC") in the United States of America recently concluded[6] that the provision equivalent to section 46 - section 2 of the *Sherman Act* - should set clear standards, which are clear and predictable in application and administration. The AMC also concluded that the standards set by section 2 of the *Sherman Act* should be designed to minimize over deterrence and under deterrence, both of which impair long run consumer welfare[7].

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3 See s45, s45A and s4D

4 The Supreme Court of the United States of America has also recognised this:
"It would be ironic indeed if the standards for predatory pricing liability were so low that antitrust suits themselves became a tool for keeping prices high." *Brooke Group Ltd v Brown and Williamson Tobacco Corp* 509 US 209 (1993) at p 226-7

5 The Supreme Court of the United States of America has also recognised this:
"It would be ironic indeed if the standards for predatory pricing liability were so low that antitrust suits themselves became a tool for keeping prices high." *Brooke Group Ltd v Brown and Williamson Tobacco Corp* 509 US 209 (1993) at p 226-7

6 Antitrust Modernization Commission Report and Recommendations - April 2007

7 The Supreme Court of the United States of America has explained that:
"cutting prices in order to increase business often is the very essence of competition". *Matsushita Elec. Indus. Co. v Zenith Radio Corp.*, 475 U.S. 574, 589 (1986).

In the recent decision of the Supreme Court of the United States of America in *Weyerhaeuser Co v Ross-Simmons Hardwood Lumber Co. Inc* (20 February 2007), which restated the position in *Brooke Group*, at p 6 it was noted that:

> *"We also reiterated that the costs of erroneous findings of predatory pricing liability were quite high because '[t]he mechanism by which a firm engages in predatory pricing - lowering prices - is the same mechanism by which a firm stimulates competition', and therefore, mistaken findings of liability would 'chill the very conduct the antitrust laws are designed to protect'".*

(e) The development of case law under the *Trade Practices Act* is important so as to provide context and precedent in addition to the legislative requirements. However, it can be slow and expensive - prosecutions by the ACCC and private action to enforce the *Trade Practices Act* inherently involve complex and fact-intensive litigation. Changes to the legislation, even where those changes are intended to codify current judicial interpretation of that legislation, introduce new uncertainty and opportunity to depart from settled principles which will exacerbate the time and costs involved in further prosecutions and private action. Indeed, the Dawson Committee concluded that no amendment should be made to section 46, a recommendation that the Federal Government accepted.

1.4 The provisions of the *Trade Practices Act* are largely of general application to all Australian businesses.[8] This attribute should be preserved so far as possible. Sector specific competition regulation introduces demarcation issues and may deter investment in those sectors.

Executive Summary

1.5 The TP Committee has previously submitted (including to the Dawson Committee) that there should be no change to section 46, in light of our concerns expressed above[9]. However, in recognition of the current clear political will to make change irrespective of our previous submissions, then our comments below must be taken as recognising that if changes are to be made, the Federal Government's proposed amendments, with some suggested changes, are preferable to those changes put forward by Senator Fielding which we strongly oppose.

2. *Trade Practices Act Amendment Bill (No 1) 2007*

2.1 The TP Committee generally supports the proposed amendments set out in the Federal Government's *Trade Practices Act Amendment Bill (No 1)* 2007 on the basis noted above.

In *Verizon Communications Inc. v Law Offices of Curtis v Trinko, LLP* 540 U.S. 398 at 14 - 25 (2004), the United States Court of Appeals for The Second Circuit stated at p 414:
"The cost of false positives counsels against an undue expansion of section 2 liability".

8 It is only in the case of telecommunications markets (where historically, are government owned monopoly dominated) that specific regulation is currently provided for.

9 See Law Council submissions to the *Dawson Inquiry*, for example.

2.2 The TP Committee supports the amendment to facilitate the appointment of a Deputy Chairperson.

2.3 Although members of the TP Committee has expressed reservations regarding the proposed amendment to the unconscionable conduct provisions of the *Trade Practices Act*, the TP Committee is generally understanding of the rationale for the amendments:

- to introduce a higher $10 million maximum "price" for application of the unconscionable conduct provisions of the *Trade Practices Act*; and
- to introduce into section 51AC a further factor, in relation to rights of unilateral variation of a contract, to which the Court may have regard in determining whether conduct is "unconscionable".

The concerns of some members of the TP Committee with section 51AC relate to the possible application of this section to corporations which, while not listed entities would normally be considered to be significant corporations or, having regard to the $10 million maximum "price", are in reality significant commercial entities. In addition to this threshold application issue, the issue is then whether it is appropriate for such corporations to have the ability to raise arguments based on this section against the general principles of freedom of contract.

2.4 The proposed amendments to section 46 of the *Trade Practices Act* are the focus of this submission on the basis noted above. Subsection 46(1) of the *Trade Practices Act* is supported. There must be a "causal connection" between the substantial market power held by a corporation and the conduct which is alleged to have "taken advantage" of that market power. This important principle appears to be undisturbed by the proposed amendment. However, the proposed amendment usefully removes any doubt in relation to the proposition that the substantial market power and the conduct which takes advantage of it need not occur in the same market.[10]

2.5 The proposed new subsections 46(3A), (3B) and (3C) of the *Trade Practices Act* are also supported. These provisions will confirm expressly propositions which, to varying degrees, may be accepted law in the prevailing judicial authorities. They are as follows:

(a) the Court may have regard to a corporation's contracts, arrangements and understandings with others in assessing that firm's market power;[11]

(b) a Court may find that a firm has substantial market power, even when it "does not substantially control the market" and when it does not have "absolute freedom from constraint" by competitors or suppliers or customers – this amendment confirms the legislative intention for section 46[12] and makes it quite clear that the

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10 The Full Federal Court decision in *Rural Press Ltd v ACCC* (2002) 193 ALR 399 may have raised some doubts in relation to this proposition, notwithstanding the statement by the Court that "market power in one market may be used to deter competition in another market".

11 See *Dowling v Dalgety Australia Ltd* (1992) 106 ALR 75

12 See the Explanatory Memorandum to the *Trade Practices Revision Bill* 1986, which stated that, "...'substantial' in this context is not intended to require the high degree of market power connoted

analysis pursuant to subsection 46(3) in relation to whether a firm is 'constrained' by competitors, customers or suppliers, is to be a relative one;[13] and

(c) more than one firm in a market may hold substantial market power.[14]

2.6 That being said, the Federal Court has indicated[15] that the words "dominate" and "dominant" connote a lower level of competitive pressure than the word "control". While those comments arose in the context of section 50 of the *Trade Practices Act*, it is possible that any litigation involving new subsection 46(3C) - which uses the word "control" - may rely on the previous judicial interpretation of the word "control" to undermine this new provision.

2.7 It is also possible that the particular drafting of new subsections 46(3C)(b)(i) and (ii), which refer specifically to the constraints that a corporation may face from its competitors, customers or suppliers, may have the limiting effect of 'elevating' those particular constraints above other factors which also form part of an assessment of substantial market power, such as the height of barriers to entry. We suggest that this deficiency be addressed.

2.8 The proposed new subsection 46(4A) of the *Trade Practices Act* is an important substantive addition to the Australian law on predatory pricing, as a form of misuse of substantial market power. The new provision states that a Court, in assessing whether a contravention of subsection 46(1) has occurred, may have regard (among the wide range of other factors properly relevant to a contravention of subsection 46(1)) to whether the corporation concerned has supplied goods or services "for a sustained period at a price that was less than the relevant cost to the corporation of supplying such goods or services" and the reasons for any sustained below-cost pricing. While we appreciate the compromise the draftsperson is seeking on the interpretation of costs and the issue of recoupment there is no assistance in the proposed provision as to what the "relevant cost"

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by the reference in (the then) existing s46(1) to being in a position substantially to control a market ...", cited with approval in *Dowling v Dalgety* (supra).

13 The High Court in *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Ltd* (1989) 167 CLR 177 at 200, quoted the following passage from Kaysen and Turner, *Antitrust Policy* (1959), that:

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

In subsequent cases, this proposition has arguably been exaggerated. See for example, *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd* (2001) 205 CLR 1 where the majority held that, "market power means capacity to behave in a certain way ... free from the constraints of competition", and *Boral Besser Masonry v ACCC* (2003) 195 CLR 609 where Gleeson CJ and Callinan J held that, "The essence of market power is absence of constraint", although this sentence is quickly followed with the qualification that, "Matters of degree are involved...".

14 The Explanatory Memorandum to the *Trade Practices Revision Bill* (1986) confirms that this was the intention of the legislature in amending section 46 to its present form – see para 45.

15 *TPC v Ansett Transport Industries (Operations) Pty Ltd* 32 FLR 305

to the corporation might be or how it might be made up.[16] This has the potential to lead to protracted litigation and raises the prospect referred to earlier that the amendments to the *Trade Practices Act* will lead to increased regulatory costs in the need to provide advice on such interpretation rather than have any meaningful benefit to consumers.

2.9 In the circumstances, we are not pressing for the express inclusion of recoupment as we believe that this should be left to the circumstances of the particular case. However, we note the two limbs of establishing a predatory pricing claim, in the prevailing standard economic analysis and the law in the United States are:

- first, that the defendant firm must have sold its goods or services at prices below a measure of cost; and

- secondly, that the defendant must have had some prospect of recouping its losses from below cost pricing, by being able later (once competitor(s) have been driven from the market or otherwise disciplined) to raise its prices above the competitive level (that is, the prices which would otherwise prevail in a competitive market).

These points are made as the proposed changes by Senator Fielding have such an impact on normal competitive behaviour, that any suggestions of such changes must be met by at least express language to protect legitimate business conduct, which would in our view then need to include express language dealing with recoupment.

2.10 The TP Committee notes that the inclusion of the proposed subsection 46(4A) makes it clear that evidence of sustained below-cost pricing will be relevant to, but not of itself determinative of, a claim of misuse of market power, by way of predation. This amendment is consistent with orthodoxy in relation to predation claims. It is also, and should be, cautious, in the interests of Australian consumers.

2.11 Below-cost pricing is common – at least in relation to pricing below a measure of total, or fully allocated costs. Examples include, free samples, introductory offers, the tied product in product bundles, free incidental services such as delivery, loyalty awards (e.g. "buy 2, get one free" and frequent flyer airline awards) etc. Many of these types of conduct are "sustained". However, these sorts of below-cost pricing are also generally pro-competitive and pro-consumer – they ought not to be deterred, except in the very special case where anti-competitive harm (particularly, higher prices later) will occur.

2.12 The inclusion of subsection 46(4A) will direct the court's attention to sustained below-cost pricing conduct. This is likely to be useful for a business which is seeking to establish predation by a dominant competitor, and the regulator inquiring into such circumstances. However, sustained below-cost pricing is not, and ought not to be determinative. The form of the amendment will leave open for particular consideration in the context of all of the surrounding facts and circumstances, whether there has been a taking advantage of substantial market power for a proscribed purpose contrary to subsection 46(1). This is a sensible and practical approach in the view of the TP Committee.

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16 Note though that the Explanatory Memorandum to the Bill provides that any uncertainty generated by the Courts determining the appropriate measure of costs is preferable to the increased potential for wrongly penalising a corporation if a specific measure of costs were enshrined in the legislation.

2.13 However, to ensure consistency with other provisions of the *Trade Practices Act*, the TP Committee considers that new subsection 46(4A) should also refer to conduct which consists of "supplying, or ***offering to supply,*** goods or services for a sustained period at a price that was less than the relevant cost to the corporation of supplying such goods or services" [emphasis added]. This drafting change is recommended by the TP Committee.

3. *Family First Bill - Trade Practices Amendment (Predatory Pricing) Bill 2007*

3.1 The TP Committee does not support the amendments proposed in this Bill in any circumstances.

Subsection 46 AA (1) – the proposed contravention

3.2 The provisions of the *Trade Practices Act* in relation to misuse of market power should be applicable to all markets. The TP Committee does not support industry specific approaches. While the telecommunications industry has been given special attention in Part XIB, that is a product of former government monopoly and can be explained on that basis. None of the "markets" referred to are in a similar position and monopolised as telecommunications has been.

3.3 The "markets" identified will introduce unnecessary uncertainty, give rise to demarcation disputes (what is a "grocery" or a "toiletry"?) and will not be adaptable readily to developments in the economy and relevant markets. There is no clear rationale for special treatment in those cases especially.

3.4 Many of the grocery / pharmacy retail market to which this Bill refers will be local or regional in geographic scope. The application of the amendments proposed in this Bill to those markets is likely to catch small businesses, thereby decreasing the practical threshold application of the section and increasing regulatory error costs to business, as well as increasing the costs of compliance.

3.5 In addition, it is likely that the "markets" identified in the Bill are inconsistent with the general definition of "market" set out in section 4E and well established legal and economic theory and practice.

Subsection 46AA (2) - definitions

Cost

3.6 The proposed definition of "cost" (as "average total cost") fails to take into account that selling products below total allocated costs commonly is legitimate profit-maximising conduct, even on a sustained basis, and ought not to be deterred. This is economic orthodoxy.

Predatory Pricing - Financial power in a market

3.7 Financial power ought not to be a separate basis of market power in competition regulation. The most fungible and readily accessible resource in the economy is money. If a business strategy is rational and profitable (and legal), it is clear that there will be funds made available from any number of sources in the Australian economy to resource it.

3.8 As is made clear in much of the writing on predatory pricing, it requires very considerable funds to predate successfully[17]. If the strategy is to succeed, by driving out or disciplining other competitors, the predator firm must incur significant, and disproportionately large losses. To this extent, financial resources may be relevant. However, a predation strategy is only ever likely to succeed if the predator firm enjoys or will clearly acquire substantial market power. Without substantial market power, the strategy is doomed – new entry and other competitive responses will defeat any subsequent price rise.

3.9 Hence, any provision designed to address predatory conduct ought to refer to the market power of the alleged predator – its financial power is not determinative.

3.10 **Even more importantly though, to set financial power as a qualifying element to the prohibition is dangerously over-inclusive and will raise barriers to entry in Australia's markets, particularly those markets which are local or regional in scope.** A hypothetical new entrant to Australia's supermarket industry provides an example. The entrant may have (indeed, will clearly require) substantial financial resources. It will also need to make very considerable initial marketing efforts to attract custom – this will require marketing devices such as very large discounts on products which are highly attractive to consumers, over a sustained period. Legislation that deters the sale of products below cost by such a new entrant, which enjoys substantial financial power but little or no market power, is highly likely to prevent such entry, or make it more difficult.

Predatory Pricing - "unreasonably low prices"

3.11 There is no specific guidance as to what would constitute an "unreasonably low price".[18] This concept is vague and will leave businesses, and their advisers, across Australia in doubt as to how they should price their products – except perhaps higher than they do now - to the clear detriment of Australian consumers. This is clearly contrary to the pro-consumer objective of the *Trade Practices Act*.

Predatory Pricing - Purpose or effect of lessening competition or eliminating competitors

3.12 Conduct which takes advantage of a substantial degree of market power and has the purpose of deterring competitive conduct or eliminating or substantially damaging a competitor, is already addressed by section 46.

3.13 The proposed provision, which omits the causative "taking advantage" element of the current test, will be detrimental to the interests of Australian consumers. For example, the provision will arguably prohibit a firm with financial or market power from pricing a product at below its "total average cost", so as to have the effect of "eliminating a competitor". Thus, if bread is sold near to its "use by" date at a price which is less than its full total cost to a major supermarket proprietor, which has the effect of damaging the profitability of a local bakery, the supermarket proprietor will have contravened the provision. Prohibiting conduct such as this, which enhances consumer welfare, ought not to be the case under Australian trade practices legislation designed to promote the interests, first, of Australian consumers.

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17 See for example, Bork, *The Antitrust Paradox* 1993, at p 149 et seq

18 In fact, this term is simply reproduced in the factors set out at section 46AA(3).

Subsection 46AA (3) – additional factors

3.14 To the extent that factors (b) to (e) may be of assistance in assessing anticompetitive conduct generally, they would be considered as part of an analysis under the current form of section 46 in relation to the issue of substantial market power.

Subsection 46 AA (4) - Recoupment

3.15 It is inherent in the debate over the Bill that low prices do not harm competition or consumer interests unless later prices rise beyond the normal competitive level. There have been many references to predatory pricing as dropping prices to drive out competitors before subsequently raising them, and the vice of predation being "higher prices in the long term".[19] Implicit in these statements is recognition that the prospect of recoupment is inherent in an anticompetitive predation claim.

3.16 Subsection 46AA(4) provides, in effect, that it is not necessary to establish an "intention" to recoup. This is, arguably, the position currently under s46. This is because the corporation's intention may be difficult to prove and may be irrelevant in any event. The High Court in Boral Besser Masonry rather looked to whether recoupment might occur, by references to the circumstances in the particular case.

3.17 To the extent that subsection 46AA(4) is intended to address only the "intention" of the corporation, it may achieve little, for better or worse. However, the TP Committee does not support any proposal that a predation claim might be established without regard to the prospects of recoupment in all the circumstances. If a change to the Trade Practices Act must be made, the Federal Government's proposal is a more economically prudent approach.

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[19] At page 32 of Hansard.