Chief Justice Robert French, in a 2005 speech to a workshop on competition law in PNG, observed that: “For our courts the introduction of the Trade Practices Act 1974 (Cth) was the beginning of a long learning curve. We are still on it.”

This year has been a time to reflect on that learning curve. The 40th anniversary of our Act (now renamed) and the passing of Gough Whitlam, the Prime Minister who introduced it, has made us think about how far we’ve come at the same time that the Harper Review is making us think about where we’re heading.

We’ve also – finally! – received judgment in one substantial lessening of competition case (Cement Australia), and seen the launch of 3 more SLC cases: the exclusive dealing allegations in the Visa dynamic currency conversion case; allegations that a pricing data service had the effect of substantially lessening competition in petrol retailing markets; and allegations that the terms of use for medical facilities had the purpose of substantially lessening competition in day surgery markets.

All of which has brought the elusive SLC test – which asks whether conduct has the purpose or likely effect of substantially lessening competition in a market – to the forefront of the public debate concerning our competition laws.

The SLC test lies at the heart of our competition regime and everyone seems to agree it’s the right test to have in the statute books. But the debate so far has revealed an alarming lack of understanding about applying the SLC test in practice and the implications of using it as the basis for legal liability.

Much of the discussion seems to suggest that, like Santa Claus at Christmas time, we know who’s been “naughty or nice” and we just need to find the right words to put in the Act to make sure the courts get it right.

Reading the many submissions to the Harper review, it’s interesting that, in the long-running battle of ACCC v Big Business, neither side seems willing to admit that in hindsight they might have got something wrong. Indeed the only person to do so appears to be former Federal Court judge Peter Heerey AM (referring in his submission to the High Court overturning his market definition in Boral) – and he’s probably the last person who needs to acknowledge a mea culpa moment, given he authored several of the “must-read” judgments for anyone wanting to come to grips with this area of law.

“Some problems are so complex you have to be very well-informed just to be undecided about them.”

– Alfonso Lamadrid de Pablo

“A reference to French J in AGL v ACCC: “The theatre of competition is a theatre of real actors & shadow actors.”
Perhaps this just demonstrates the point made by Alfonso La-
madrid de Pablo in a recent presentation on two-sided markets:
“Some problems are so complex that you have to be very well
informed just to be undecided about them”.

So what exactly is an SLC and how do you prove one? Who
should decide what’s an SLC and, from a compliance sense, isn’t
it just a simple matter of not doing anything anti-competitive?

**Competition is a process**

Let’s start with the concept of competition, or more precisely
“competition in a market”.

The 1974 Trade Practices Act prohibited exclusive dealing (sec-
tion 47) and mergers (section 50) when they were “likely to have
the effect of substantially lessening competition in a market
for goods or services”. At the time, section 45 looked at competition
between specific firms, prohibiting any contract, arrangement or
understanding “in restraint of trade or commerce” where “the re-
straint has or is likely to have a significant effect on competition
between the parties… or on competition between those parties
or any of them and other persons”. (Price fixing was caught as a
restraint of trade or commerce but it was not prohibited under
section 45 if its effect on competition was “insignificant”.)

That position changed in 1977 with amendments that brought
the SLC formulation into section 45 but removed it from sec-
tion 50 (such that mergers were subject to a dominance test for
the following 15 years – as discussed in Issue 6).

The early debates about how to formulate the right “compe-
tition” test for Part IV prohibitions drew heavily on guidance
from the Competition Tribunal – and in particular the discus-
sion in the Tribunal’s 1976 QCMA decision about the concept
of competition in a market.

---

**Perfect competition – while**

**providing our benchmark – is “a**

**kind of nirvana state which exists**

**nowhere in the real world”**

---

*French CJ*

The Tribunal explained the fundamental economic role of com-
petition “as a device for controlling the disposition of society’s
resources”. Competition is a dynamic process, emphasised the
Tribunal, “a mechanism for discovery of market information and
for enforcement of business decisions in the light of this
information”. The theoretical end point of that dynamic process
is, of course, a perfect equilibrium in which no rearrangement
of inputs, outputs or distribution will make someone better
off without making someone else worse off – but, as our Chief
Justice eloquently put it, “[t]hat is a kind of nirvana state which
exists nowhere in the real world”.

It’s worth recalling exactly what the Tribunal said about this
dynamic process:

> It is a mechanism, first, for firms discovering the kinds of goods
> and services the community wants and the manner in which
> these may be supplied in the cheapest possible way. Prices and
> profits are the signals which register the play of these forces of
demand and supply. At the same time, competition is a mecha-
nism of enforcement: firms disregard these signals at their peril,
> being fully aware that there are other firms, either currently in
> existence or as yet unborn, which would be only too willing
to encroach upon their market share and ultimately supplant
> them.

This does not mean that we view competition as a series of
passive, mechanical responses to ‘impersonal market forces’. There
is of course a creative role for firms in devising the
new product, the new technology, the more effective service
or improved cost efficiency. And there are opportunities and
rewards as well as punishments.

The Tribunal explained further that the extent to which firms
“compete” (in the sense of responding to the “invisible hand”
of these forces at work) is “very much a matter of the structure
of the market in which they operate”.

**Market structure as the cornerstone of analysis**

That structure is determined by a variety of basic conditions:
for example, the availability of raw materials, technology,
unionisation, business attitudes and the legal framework
on the supply side and on the demand side, the elasticity of
demand, cyclical and seasonal variation in demand, trends in
demand, purchase methods and marketing. And so on.

Traditionally, the basic conditions that determine market
structure have been treated by economists as static (hence the
description of “structure”) – this is premised on the assump-
tions that they change relatively slowly and that individual
firms are unable to influence them. Those may have held true
in the decades leading up to the introduction of our Act.
However, since then modern analysis has recognised that
actions taken by firms to improve their position relative to
rivals or to secure long-term commercial advantage (“strategic
behaviour”) can change market structure – in ways that are
pro-competitive or anti-competitive. Competition analysis
therefore needs to be more nuanced and flexible than the
traditional linear structure-conduct-performance paradigm.

So now we’re well into the 21st century, when we talk of mar-
ket structure, we’re generally talking about the dynamic market
environment in which firms compete and we’re looking for
the constraints that shape and influence the dynamics of that
environment. The totality of these market constraints is what

---

![Competition analysis involves a lot more than a simple headcount.](image-url)
reveals the scope for market power (either at an individual or collective level), there being an inverse relationship between these two concepts. The lower the level of total constraint, the more scope there is for market power (as the High Court famously said in Boral, the essence of market power is the absence of constraint). Conversely, the greater the level of total constraint and the more variety in the sources of constraint, the less scope for market power.

**It's all about the constraints**

Constraints can come from a variety of sources. We have previously suggested (Trindade & Smith, ABLR, 2007) using Porter’s Five Forces framework to help capture constraints in a dynamic setting – ie rivalry between existing firms, the threat of new entry, pressure exerted by customers or suppliers, and threats to profitability from the impact of other substitutable or complementary products.

The degree of pressure that existing firms exert on each other will be influenced by factors such as cost structures, capacity utilisation, product differentiation and branding, costs they will incur in switching between customers etc. The threat of new entry will be impacted by considerations such as access to customers and suppliers, economies of scale and scope, the extent of sunk costs, asymmetric information, the need for branding and reputation, government policies and expected responses from incumbents. Pressure exerted by customers will be affected by the size of purchases, substitutes, switching costs, the information available to buyers, the ability to vertically integrate and so on, while the strength of suppliers’ bargaining power will depend on matters such as the number of alternative suppliers, switching costs, the extent of differentiation and customisation of inputs supplied, the extent of economies of scale and scope in supply and distribution, the potential for suppliers to vertically integrate forward into the relevant downstream industry and for industry participants to integrate backwards into the upstream input industry etc.

Threats to profitability can also come from the impact of other products, whether substitutes (depending on such factors as functionality and buyer perception, relative price, and switching costs) or complementary products that create opportunities for tying or bundling.

![Porter's Five Forces](image)

**Analysis requires consideration of the totality**

Thus when we talk about substantially lessening or increasing competition, we’re really talking about whether something makes the totality of these market constraints weaker or stronger.

It’s a complex equation, in part because these constraints play off against each other. Sometimes the weakening of one constraint increases another – for example, significant excess capacity in an industry can heighten pressure from existing rivals but reduce the threat of new entry. But also, the impact of the change may depend on how weak or strong the totality of these market constraints were in the first place. Thus, one of the forgotten lessons from *Rural Press* is that if there is already significant market power, any small nipping of competition in the bud may well be “substantial” in the sense of being meaningful in the context of the competitive process.

Further, pinpointing a causal nexus between suspected agents of change can sometimes be difficult, especially in markets affected by fluid regulation, constant Government intervention or the kind of disruptive innovation we’ve come to expect this century.

For example, in a 2003 merger case, the ACCC argued that the acquisition by electricity retailer AGL of a 35% interest in a large generator would encourage further vertical integration by other National Electricity Market (NEM) participants. This in turn would reduce the number of independent wholesalers and retailers, expose remaining retailers to vertical market foreclosure, and raise barriers to entry for new participants. But French J found that there was “a natural tendency on the part of major retailers in the NEM to undertake some degree of vertical integration” – “the practical considerations which generate a commercial pressure in that direction will operate independently of any acquisition by AGL”. Thus the acquisition was unlikely to make any difference to the trend to vertical integration already apparent in the NEM.

**But surely we know anti-competitive conduct when we see it?**

The ACCC Chairman captured a popular sentiment in his speech at the RBB Economics Conference in November this year when he dismissed criticism of the use of the SLC test in section 46, saying:

*To be held to have substantially lessened competition you have to do something anti-competitive; pro-competitive behaviour, whatever the outcome, cannot be held to SLC…. To repeat, to SLC there must first be behaviour that could be seen as anti-competitive. There cannot be an SLC through competition on its merits.*

Many people appear to agree with this general approach, but it’s actually putting the cart before the horse. Conduct itself tells you very little. Conduct is, well, just conduct. It’s the likely effect of the conduct that determines whether or not it’s anti-competitive and the same conduct in different market environments is likely to produce different results.

Innovation is a classic example – in most scenarios, we welcome innovation as essential to effective competition. In some circumstances, however, we may be concerned that particular innovation is specifically designed to exclude competitors; that concern was in fact a critical component of the case against Microsoft at the turn of the century, and it remains an allegation regularly levied at the likes of Apple and Google.

Put differently, in the context of predatory pricing (Boral, HC):

*If one begins with the fact that a firm is a monopolist, or is in a controlling or dominant position in a market, then, by hypothesis, such a firm has an ability to raise prices without fear.*
of losing business. If such a firm reduces its prices, especially if it reduces them below variable cost, then it may be easy to attribute to the firm an anti-competitive objective, and to characterise its behaviour as predatory. But if one finds a firm that is operating in an intensely competitive environment, and a close examination of its pricing behaviour shows that it is responding to competitive pressure, then its conduct will bear a different character.

"Easy" ways to spot anti-competitive conduct (and why they don't work)

One simply cannot determine whether something is anti-competitive (or conversely “competition on the merits”) without doing a proper competition analysis. The result of the competition analysis is what allows you to attach the label “anti-competitive” – in other words, conduct that substantially lessens competition in a market is anti-competitive. You can’t start by characterising conduct as anti-competitive and then work backwards – that’s exactly the type of error of reasoning our High Court has warned against.

Nor can you characterise conduct based on knowing market structure (as not all monopolies have market power): some times, as stated above, the "mischief" in conduct lies in the way it changes market structure into the future. Strategic behaviour that may raise such competition issues includes entry deterrence (creating excess capacity, predatory pricing, raising rivals costs); brand proliferation (crowding out); tying customers and/or increasing their switching costs; and long-term contracts that lock in key suppliers and/or customers. Microsoft employed many of these strategies, simultaneously.

One also can’t spot anti-competitive conduct by looking at whether prices are increasing or decreasing or by looking at profits. That’s a little like seeing a team score 500 in its first innings, and then asking who’s winning. A whole lot more information is required before you can form a view.

Even looking at what existing competitors are doing can’t really tell you how “competitive” the market is. Firms may have the appearance of vigorous rivalry, but similar cost structures and incentives mean there is little real difference between them, and behind their apparent rivalry they are in fact able to sustain supra-competitive prices. This reflects the “confusopoly” scenario coined by Scott Adams in The Dilbert Future, as developed by our very own Joshua Gans. On the other hand, firms may appear to be co-operating or even colluding, but in fact have no capacity to sustain supra-competitive prices.

Whilst reducing rivalry between existing competitors may have been enough for the original formulation of section 45, it is not necessarily an SLC. As discussed above, rivalry between existing firms is one source of constraint. If the others are sufficient, there may not be an SLC; indeed another source of constraint might increase as a consequence of this one weakening.

But if something’s efficient, then we know the answer... right?

Focusing on efficiency is not necessarily going to simplify things either. Efficiency is a measure; you can say something is more or less efficient than an alternative but, particularly if both static and dynamic efficiency are considered, then the analysis is every bit as complex as focusing on constraints.

Two submissions on the draft Harper report in particular illustrate some of the complexities surrounding efficiencies. The NZ Commerce Commission expressed the view that “there is a legitimate role for firms to put forward forward efficiency and other justifications for their conduct as this helps to sort the pro-competitive effects from the anti-competitive effects”. That reflects the way that in NZ (and in other countries), efficiencies are captured – ie the test is applied so as to net off pro-competitive and anti-competitive effects.

This is not necessarily how it’s been done in Australia, as we discussed in Issue 12 where we talked about our tendency to adopt a more sequential approach of considering anti-competitive effects in the SLC test and pro-competitive effects in the public benefit test. This leads us to characterise conduct as “anti-competitive” before all the pros and cons have been considered, in contrast to a more integrated approach.

The American Bar Association raised another issue in its comments on the proposal to use the “long term interests of consumers” in a revised section 46:

Like great art, there is a sense that we know an SLC when we see it. But this approach can suffer from personal prejudices. © Katie Hoad, 2014
It is true that dynamic efficiencies can be as significant as shorter-term efficiencies, even if the benefits are not immediately realised in the form of lower prices to consumers. Efficiencies can benefit consumers equally whether they involve short-term cost savings that are channelled back to consumers or longer-term innovations that may result from combining product features or improving product quality, for example. That just highlights the problem of dealing with conduct that might be an SLC in the short-term, but leads to better competition in the long-term. This was of course the critical issue the High Court had to resolve in *NT Power.*

### Come down from the mountain

So how do you establish an SLC? Well, again, we have some excellent guidance about what doesn’t work.

In the 2003 AGL merger case, the ACCC produced modelling by respected economist Professor Frank Wolak to show the ability of Victorian generators to influence spot price outcomes, assuming all else being equal. Part of the ACCC’s SLC argument was that post-merger, the target generator (LYP) would reduce change by LYP or any other generator, it is not capable of out of account the potential supply response to any unilateral action by LYP or any other generator, it is not capable of being used to test the likely outcome in the real world of the behaviour he prospectively attributes to LYP. I agree with that submission.

In the recent air cargo case concerning airline fuel surcharges (*ACCC v Air NZ* (2014) FCA 1157 – which the ACCC has just appealed), the ACCC had alleged an understanding between airlines to exchange future pricing information which amounted to a (per se) price fix; as an alternative, the ACCC argued that the understanding nonetheless had the likely effect of substantially lessening competition.

Justice Perram summed up the ACCC’s attempt to establish the likely SLC as follows:

> To demonstrate that likelihood the Commission relied upon the evidence of Professor Church and Dr Williams. This part of the evidence was referred to by the Commission as its “qualitative” methodology. It consisted of a series of propositions about circumstances in which an exchange of future pricing information might lead to a substantial lessening of competition. I found this discussion interesting but it is overstated to call it a methodology. Like the Commission’s case on market it was no more than a series of thought experiments. It is a matter for the Commission how it proves its cases but I do not think that one can readily establish the propositions for which the Commission contends without coming down from the mountain and engaging in some analysis of the market by reference to actual market participants and actual pricing data.

Perram J went on to say that even if these airlines charged the same fuel surcharge (FSC), he had “no confidence” that this price fix would have the likely effect of substantially lessening competition in the air freight market:

> This is because no attempt has been made by the Commission to show how the freight rates were affected by the FSCs. One can well understand that in some markets an exchange of pricing information might soon give rise to a risk of reduced competition. Obviously, this will depend on the market in issue. But where the exchange of price information relates only to a component of an overall price, one needs to keep in mind that one is gauging the competitive effects in the overall market. I do not see how I could begin to assess the effect of the surcharge on the market without knowing what had happened with the freight rates.

This is the challenge with hypothetical examples devised by economists to distinguish anti-competitive from pro-competitive conduct.

For jurisdictions such as the US where liability is decided by a jury, this process can be very helpful – enabling ordinary people, who by definition are not going to have technical expertise in this area, to “join the dots” and thereby to understand why certain facts presented to them might be relevant or significant. But it doesn’t really help our Federal Court judges (many of whom have practised in this area or have academic expertise) to determine whether specific conduct is or isn’t anti-competitive, particularly where the substantial penalties available mean the *Briginshaw* standard applies (see *Issue 3*).

The point, as explained by current Chief Justice French in the 2005 speech referred to earlier, is that competition laws typically embody evaluative concepts with normative dimensions. As such:

> They require more for their interpretation and application than the mere discovery of pre-existing meaning. Indeed, their application in particular cases almost approaches a legislative function. They require characterisation of facts under some generic designation informed by a values-based judgment.
In that sense, they are similar to the concept of “reasonableness” familiar to lawyers from the common law. One can construct clear-cut examples of conduct most people would agree is reasonable or unreasonable but that doesn’t necessarily help us deal with the nuances, ambiguities and general “mess” of real life situations. You have to come down from the mountain and get your hands dirty with the details.

**But don’t think it’s going to be easy or cheap**

The SLC test is the right test to have on the books if we want to catch anti-competitive conduct without discouraging pro-competitive conduct – but it’s not an easy test to apply in practice, nor is it a cheap one. On a ballpark basis, the cost of upfront legal advice on proposed conduct would have to start in the order of tens of thousands of dollars (and may cost hundreds of thousands for complex industries), while for litigation it would definitely be in the order of millions.

No-one would dispute that it’s appropriate to have some per se prohibitions that avoid the need for full blown SLC analysis and lower the cost of enforcement litigation, but they too come at a price. Amongst the reasons to be wary of per se offences is a fallacious assumption that again arises if we work backwards: just because certain conduct looks per se (even if, technically, it falls outside the provisions), it doesn’t follow that it actually SLCs.

Conduct that breaches per se prohibitions is illegal but not necessarily anti-competitive. In fact, the prohibition might reflect community values (eg a sense of equity or “fair competition”) as much as any presumption of harm. For example, even if one could show that not all cartels substantially lessen competition, we might still insist that cartel behaviour be banned because it’s seen as “unfair” and akin to “cheating”.

Being heavily fact intensive, the SLC test requires significant resources to do it properly. Even large overseas regulators acknowledge that they have limited resources to manage major SLC investigations concurrently. Professor William Kovacic, speaking to Melbourne University’s Competition Law & Economics Network (CLEN) this month about good regulatory institutions made the interesting remark that the US Federal Trade Commission (FTC) could only handle a few major mergers at one time. Once they had too many on the books (“too many” kicked in at a surprisingly low number), there were simply too few staff sufficiently skilled to undertake the necessary analysis.

That said, because SLC analysis involves specialist skill-sets, the more you do it day in and day out, the more efficient and accurate you become at identifying the heart of the matter with more limited resources. That’s why the informal public reviews undertaken by the ACCC mergers branch are so important; it’s where the ACCC really gets to hone its skills at SLC analysis alongside practitioners in a (reasonably) cooperative setting.

But as the nature of an SLC test involves evaluative concepts, its application needs to be tested regularly in the courts and the ACCC should continue to make this a focus. There is always the risk that agencies, left to their own devices, will lapse into reinforcing their own value judgements (they are, after all, monopolies in their own “business”).

Professor Kovacic at CLEN gave an example of the dangers of such “confirmation bias” in the FTC Whole Foods merger case involving organic supermarkets. The FTC’s initial case theory was that there was a niche market for whole/organic food, and that led to it becoming “blind” to the development of more traditional supermarkets moving into that space.

Another issue to consider is the role of consistency in our Act. It is a laudable objective to have consistent laws - our competition laws started with one test for mergers, another for horizontal agreements and a seemingly unrelated test for misuse of market power (section 46). So the symmetry we have now is certainly welcome.

But one of the reasons given for changing section 46 is to further this consistency – SLC is the “paradigmatic” test for our competition laws, so shouldn’t it also provide the framework for section 46? But this reasoning is flawed. By definition, section 46 is a law of special application, relevant to very few businesses. If they are subject to the same test as everyone else, what’s the point of a special law for those with market power? Why not just prohibit any unilateral conduct that SLCs?

(That last question was rhetorical, in case you were wondering. But one reason NOT to do this would, of course, be the ambiguity of the SLC test!)

The fact that, in our system, it is really only the courts that can decide what is and isn’t anti-competitive (based on the SLC test) means we avoid some of the legitimacy concerns affecting European agencies (who have the power to make determinations and impose sanctions). Again it’s worth taking on board what Professor Kovacic had to say to CLEN about the prospect of the balance being “re-calibrated” in Europe as those concerns increase.

(As an aside, Malcolm Galdwell’s 2013 book *David & Goliath* contains a chapter on the issue of why legitimacy matters for institutions with power. It’s well worth reading – Rachel’s book of the year!)

From that perspective, there is something to be said for the view that novel situations (such as the *Flight Centre & ANZ Bank* cases involving dealings between agent and principal: see [Issue 5](#)) should be tested first by running an SLC case rather than prosecuting them as per se price fixing cases.

**Perhaps “novel” competition cases (such as *Flight Centre & ANZ*) should only be tried as SLC cases rather than squeezed into a per se prohibition?**
The SLC test is not a miracle drug for all our ailments …

The Hilmer review recognised that there may be situations where economically efficient conduct adversely impacts on some other valued social objectives (something we touched on in Issue 12).

As competition is a process that inexorably guides industries towards the ultimate nirvana of economic efficiency, then along the way the SLC test won’t always deliver market outcomes that meet all community expectations or values at a given time – hence the need for industry policy and other measures that have to work alongside or even temper our competition law.

So on that note we leave 2014 – the year of SLC – with some remarks from Justice Steven Rares in his paper to the Competition Law Conference in May this year:

"Like many things in life, competition has its own strengths and weaknesses. The first American astronaut, John Glenn, explained this neatly when he said: "As I hurtled through space, one thought kept crossing my mind – every part of this rocket was supplied by the lowest bidder."

That reflected the "efficiency" of the market and its potential weaknesses."

This is the first of a three part series looking at policy issues in light of the Harper Review. Next edition, we’ll be looking overseas - what lessons can we learn & what should we be wary of.

About the authors

Rachel Trindade specialises in competition and consumer law. She has advised on a wide range of business structures and commercial arrangements, particularly in the fields of energy, transport and logistics. Rachel may be contacted on 0402 038 301 or mail to: trindade@bigpond.net.au

Dr Alexandra Merrett is an independent competition lawyer and Senior Fellow at the University of Melbourne. She has a particular interest in the application of competition law to small businesses. Alexandra may be contacted on 0432 942 096 or mail to: alexandramerrett@bigpond.com

Dr Rhonda Smith is an economist and academic, specialising in competition issues. A former Commissioner of the ACCC, Rhonda provides strategic and expert advice to both commercial parties and regulators. Rhonda may be contacted on 03 8344 9884 or mail to: rhondals@unimelb.edu.au

Rachel and Alexandra are both Australian Legal Practitioners within the meaning of the Legal Profession Act 2004 (Vic), with liability limited by a scheme approved under Professional Standards Legislation.

Thanks again for your fabulous support this year.

Enjoy the festive season & we’ll see you in 2015.

Hopefully by now you’re a subscriber, but just in case you’re not, please join our mailing list using the “Newsletter Sign-up” button on our website.

You can also access past issues via our Archives page: http://thestateofcompetition.com.au/newsletter-archive/

www.thestateofcompetition.com.au