John Curtin Institute of Public Policy Forum

Promoting competition or protecting consumers – the role of competition policy and its implications for Australian businesses

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Introduction

Every one of us enjoys the benefits that competition reform has delivered to this country. Unfortunately, the way in which competition delivers us those benefits is not always well understood.

Everyday as consumers we reap the fruits of a series of tough decisions started more than 30 years ago with the introduction of competition policy to our economy. Those moves culminated in the reforms emanating from the Hilmer review and a bipartisan government commitment at all levels to extend competition law and policy across all jurisdictions. The benefits have been that combination of lower prices, improved choice and quality of service that meets consumer preferences. An unwavering commitment to improving competition has played a large part in sweeping aside the uncompetitive, sluggish aspects of our industries and contributing to the comforts many of us now enjoy.

Evidence of the success of these reforms is not hard to find. In recent times Australians have experienced unprecedented increases in disposable income, putting more money in the pockets of every member of society and leading to improved living standards. While many factors have led to this improvement in living standards, increased competition has certainly made a significant contribution.

In the decade leading up to the mid-90s the lowest income earners in our society saw their incomes increase by 22 per cent. Per capita national wealth has continued to grow, and productivity has been steadily improving at an annual rate of around 1.3 percent while unemployment continues at 30-year lows.

In short, Australian consumers and businesses are probably better off today than they've ever been and owe some of that prosperity to those difficult competition reforms.

It would therefore seem logical that there would be widespread acceptance and praise of the foundations laid down to allow that economic prosperity to occur. But this is not always the case for two related reasons.

First, while the overall impact of competition reforms has been very positive there have been people who have lost out. The beneficiaries of the reforms are the 21 million Australians who enjoy increased choices and better quality products. But businesses that were shielded from competition have lost out. In some cases these businesses have innovated and evolved and prospered, but in others they have not. Just as the tariff reforms over the last 30 years were opposed by those sectors that were protected from import competition, so competition reforms are opposed by those who benefit from being shielded.

Second, and related to this, there remains some misunderstanding of the way competitive markets work. Some groups fully understand how competitive markets work and oppose competition reforms because they will lose their protected status. Other groups oppose the reforms because they don't understand the way that competitive markets work.

It is the way competitive markets work and how intelligent regulation can enhance this objective that I wish to discuss today. In short, our approach must be to protect competition and the competitive market – not to protect competitors from the rigours of that competition.

Promoting competition, not competitors

Competition is a very useful means to an end. What we know from decades of experience both domestically and internationally is that pursuing and promoting vigorous competition delivers the benefits we wish to provide to the public. It encourages and rewards innovation, leads to lower prices, improves choices and services that consumers want. It does this partly by weeding inefficiency out of our economy, allowing the best performers to rise to the top.

But therein lies an uncomfortable truth about competition. Competition is a hard master – as well as rewarding strong performers and delivering benefits to millions of Australian consumers, it also punishes those who are unable to provide the best prices, and more relevant services and conditions – and it is important to remember that businesses compete on service and conditions – not just price. Firms that cannot compete will go out of business, firms that do not innovate go out of business, firms that offer inferior products will go out of business.

It is exactly this system that has delivered the productivity growth and economic growth that Australians enjoy. But the consequence of a robust competitive system is that inefficient firms go out of business. When governments intervene to protect inefficient firms, the economy and productivity do not grow as fast as they otherwise would.

It does not always sit comfortably with business owners when I remind them that the ACCC's job is to promote and protect competition, not competitors.

As the High Court confirmed in the Queensland Wire Industries Pty Ltd v Broken Hill Pty Ltd case[1]:

> *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.*

This principle was also reaffirmed most recently by the Court in the *Boral Besser Masonry v ACCC* case[2].

One way in which firms in some industries can increase their efficiency and reduce their costs is through economies of scale. A large firm may well be able to sell at lower prices than a smaller competitor while obtaining the same rate of return, because its larger scale of operations means that it has a lower unit cost. This in itself is an inherent benefit to the larger business of achieving those efficiencies.

A constant pressure to regress to protectionism

In 1995 the Australian, State and Territory governments agreed to a program of competition policy reform that would act as a broom through the economy, targeting and dealing with competition stifling regulation across all levels of government. Implementing such major reform was a difficult and painful journey that has nevertheless delivered significant benefits to Australia. You need only to look at competition payments made to states for evidence of its success.

But since the start of those reforms, constant calls for protection of particular competitors, or sectors, has threatened to eat into some of the hard-won gains.

The difficulty for legislators has been to resist the constant calls from various sectors to shield them from some of the impact of vigorous competition. Life would no doubt be much easier and more comfortable for many businesses if they were not forced to constantly defend their corner of the market from the assault of competition. This would not, however, serve the broader community at all well.

Much of the call for protection has focused on price competition – where larger businesses with cheaper cost structures can price lower, for longer than smaller businesses. This is not a new phenomenon – nor will it go away. But small businesses have other advantages that allow them to compete with big businesses. They can be more nimble and respond to their own market across a range of domains, from when they open to what they make or what they stock, to changing their business structures through opportunities like franchising, to building up loyal client bases – people value dealing with businesses that know their name. It is the dynamism and innovation of small business in what they do and how they do it that offers the most effective protection, not government intervention.

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[1] Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd [1989] 167 CLR 177; 63 ALJR 181; 83 ALR 577; ATPR 40-925

[2] Boral Besser Masonry Ltd (Now Boral Masonry Ltd) v ACCC [2003] HCA 5

It is inevitable that some businesses will fail as a result of not being able to keep up with the constant pace of improvement, and the need to innovate and evolve. It is not our job, nor should it be, to somehow protect those businesses from the rigours of normal, fair competition – both price competition and non-price competition. It is also these businesses - those most likely to suffer - which are often the first to agitate for change.

When problems emerge in a market, often the first response from those affected is to call for greater government protection for one section in the form of regulation or other control. The recent hearings into the price of petrol have been a case in point.

A number of motoring organisations and other industry representatives made strong claims during the beginning of hearings around the country that they were in no doubt that collusion was rife in the petrol retailing market. They were convinced motorists were bearing the brunt of that collusion in the form of inflated prices. At the same time, these groups were also alleging predatory pricing – sustained selling below cost. The irony of the contradiction contained in those two positions seems to have escaped those making the contradictory claims.

I do not want to pre-empt our final report to the Government of that inquiry, but what I can say is that when some of those claims when tested in an analytical way by senior lawyers, ACCC commissioners and others, there was often little concrete evidence on which substantial claims were being based.

In fact, it is the ACCC's experience that often those making claims for protection are the ones most resistant to having those claims tested with thorough analysis. What we have found in the past is that once proper analysis is conducted, vested interests, rather than genuine competitive problems, are often the driving force behind complaints.

As the Dawson Committee Review into the Competition Provisions of the Trade Practices Act stated:

> *Often the complaint when analysed is not about reduced competition but about the structure of the market which competition has produced. Concentrated markets can be highly competitive. It may be possible to object to the structure of such markets for reasons of policy (the disappearance of the corner store, for example) but not on the grounds of a lack of competitiveness.*

However, protecting competition and competitive markets does not mean taking a hands-off approach. Exploiting economies of scale to deliver lower cost products to consumers is pro-competitive, exploiting market power to eliminate competitors is anti-competitive.

This is where the ACCC sees itself playing a significant role in promoting competition and at the same time protecting small businesses from being driven out of the market where they can provide a truly competitive dynamic. The Trade Practices Act is replete with provisions which, while not specifically referring to small business, have the impact of protecting small business from anti-competitive activity. Thus, all of the provisions of Part IV of the Act dealing with anti-competitive arrangements and conduct, are intended to

operate to protect vulnerable businesses engaged in lawful, competitive behaviour but which might be subjected to unlawful anti-competitive activity from both big and small businesses.

The two most recent examples, where the ACCC has successfully prosecuted big business under these provisions, for behaviour in relation to competing small businesses, both relate to the Woolworths group. The first concerned attempts by Woolworths subsidiary Safeway to prevent bread manufacturers supplying bread to discounting retailers. The other concerned attempts by Woolworths and Coles to prevent small bottle shop proprietors setting up viable retail businesses in NSW. In both cases the ACCC succeeded in obtaining restraining orders and securing penalties amounting to many millions of dollars.

One way small business can even the imbalance often found in bargaining power when dealing with large suppliers or customers is to take advantage of the facilitation of collective bargaining arrangements now contained in the Act.

Specific previsions in Part IV(A) of the Act relating to unconscionable conduct and to the mandated codes of conduct are designed to protect small businesses from harsh and oppressive or misleading and deceptive conduct by more powerful industry players. The ACCC views these provisions as providing powerful tools for dealing with misconduct by businesses that has the effect of significantly damaging small industry players and as a consequence, the Australian economy.

But we also need to be aware that these provisions have their limitations and will not operate to diminish the rigours of a tough, competitive business environment. Drawing the distinction between the two is one of the toughest tasks that the ACCC faces on a daily basis.

Reforms to the misuse of market power provisions of the TPA

One of the most referred to provisions of the Act relating to the interaction between big business and small business is section 46, directed towards misuse of market power, namely the provision designed to prevent powerful businesses from misusing their size and power to stamp out competitors.

This provision of the Act is among its most contentious, debated and misunderstood. But the provision is an important element of effective competition law and sits alongside restrictions that prevent businesses from accumulating excessive market power through mergers and acquisitions and those that prohibit anti-competitive agreements between competitors.

The recent amendments to section 46 are the culmination of a protracted process of review looking at the effectiveness of the provision. This process commenced with the Dawson inquiry into the workings of the competition provisions of the Act, whose report was produced in January 2003, and then continued in the form of a similar review by the Senate Economic Reference Committee, which reported in March 2004. The ACCC had the opportunity to make detailed submissions to both inquiries in which it offered its views about desirable changes to section 46.

The ACCC expressed its concerns that section 46 was not being applied consistently by the courts, and that there was a need for further guidance on the application of the law.

The submission that the ACCC made to the Senate's review became the focal point of subsequent submissions from both big and small business groups to the inquiry. The recommendations made by the ACCC also became the focal point of the ultimate report.

There were two fundamental issues the ACCC raised in its comments relating to section 46. First, what constitutes a substantial degree of power in a market, and secondly, what constitutes a company improperly taking advantage of that power.

It is pleasing to note that the latest amendments to s46 provide the court with some guidance to assist it in determining when a corporation might possess a substantial degree of market power. For example, they make it clear that a company may have substantial power even though it does not substantially control the market or have absolute freedom of constraint from competitors or customers or suppliers.

However, the Commission's submissions on what constitutes the taking advantage of that power, have not been addressed by the current amendments.

This notwithstanding, the ACCC will certainly be taking these amendments into account when assessing potential action for breaches of section 46.

Of recent weeks, the significant changes to the substance of section 46 have escaped the attention of most commentators, who have been diverted by the potentially far reaching changes relating to the practice of predatory pricing contained in section 46(1AA) and section 46(1AB), which have become known as the Birdsville amendments, put forward by Senator Barnaby Joyce.

These changes, and in particular those designed to stamp out the practice of predatory pricing, raise a whole new set of interesting questions.

I do not intend to make comment on the merits of these changes, as others have done. What I think we need to do is concentrate on how these changes can be applied. The amendments introduce three new concepts into this provision of the Act –

- Substantial share of the market
- Relevant cost
- Sustained period

Substantial share of a market

The Birdsville amendments first of all raise the question of what is a 'substantial share of a market' as distinct from having a substantial degree of power in a market.

Of course, as was always the case with section 46, before we can decide what constitutes a substantial share of a market, we need to decide how we define what fits into that market.

That can range from a large, national market such as perhaps that for mobile phone services, right down to a very small local geographical and product market, say cafes catering to a particular part of town.

So what then is a substantial share? Bear in mind that when addressing this question the amendments say we may have regard to the number and size of competitors in the market. If I have a 20 percent share of a market, do I have a substantial share? How would the answer differ if I had eight competitors each with a 10 percent share as opposed to, say, a scenario of two competitors both with a 40 percent share of the market, or one competitor with an 80 percent share? This is an issue that will need to be tested in the courts, as it is presently unclear - and may well differ on a case-by-case basis.

Relevant cost

The next question is what constitutes relevant cost. This question has already been opined upon in the past, but we do need to consider a few alternatives.

As has always been the case in relation to predatory pricing, the Court will need to determine which is the appropriate price-cost test to apply in each case. That is, which price-cost test will provide the appropriate basis on which to calculate the 'relevant cost' for the purposes of sections 46(1AA)? Some of the price-cost tests that have been advocated by economists, and considered by the Court in the past, include Average Variable Cost, Average Total Cost and Average Avoidable Cost.

In the *Boral* case, for example, the ACCC asserted that price-cost estimations based on avoidable cost were appropriate. Avoidable cost is the amount of expense that would not occur if a particular decision were to be implemented. For example, if an employee is laid off at a company that is self-insured for unemployment compensation, the avoidable cost is total direct salary less payments for unemployment benefits plus savings in employee benefits.

The High Court accepted this view but did not confirm that such a test was to apply in all predatory pricing cases. The ACCC has not adopted a specific price-cost test to be applied in every case, but has preferred a case-by-case approach.

In summary, which of the price-cost tests will provide the basis for calculating the 'relevant cost' for the purposes of establishing predatory pricing will continue to be determined on a case-by-case basis.

At this point, it is important to note that it is the relevant cost of supply of the firm that is the subject of a predatory pricing allegation which must be considered. The cost of supply of the affected competitor is irrelevant. So when a more efficient firm prices above their 'relevant cost' but at a price that is below the lowest cost that a less efficient competitor can offer, that will not fall foul of these provisions..

Sustained period

What constitutes a sustained period is a relative question. In some cases a sustained period might be measured in months, in other cases it might be weeks. It may be a case of looking at the period that might be necessary to achieve one of the three proscribed purposes in relation to the market at hand. For example, if four weeks was likely to be a sufficient time to damage a competitor in a particular industry, well that might be enough to constitute a sustained period. However, six months or more might be necessary in another market where a month might be irrelevant due to the existence of long term contracts with customers.

What is the purpose?

As I've already pointed out, a breach of s46 (1AA) requires a party having a substantial share of a market to sell products below relevant costs for a sustained period. But in addition to satisfying these three conditions, the alleged misconduct must also be for one of the three proscribed purposes, namely –

- to eliminate or substantially damage a competitor;
- prevent the entry of a person into a market or;
- deterring or preventing a person from engaging in competitive conduct.

One of the immediate concerns expressed by larger businesses and others at the passing of these amendments was that they may scare companies off matching the prices of their competitors. As the basic argument goes, customers will miss out on discounts because larger companies will not want to risk breaching the new provisions contained in s46(1AA).

So the question becomes, if you lower your prices to match a competitor, do you risk prosecution?

Putting aside the issues associated with the new requirements of 'substantial share of a market', 'sustained period' and 'relevant cost', mere discounting (even if significant) will not be sufficient of itself to breach the section. It will of course depend on the purpose of the company in engaging in the discounting. If the true purpose was to match (or even beat) a competitor's price reductions so as to retain market share, it seems unlikely the amendment will be triggered.

What I have outlined here are just a few examples of the types of questions we need to be asking about how these changes to our competition laws will be applied, and what they will mean for businesses trying to stay within the law while still pushing to be as competitive as possible.

Unfortunately, some of these questions cannot be answered overnight, and in some cases will require direction from the courts. This process could take years, as cases go through appeals and ultimately all the way to the High Court.

In the media Senator Joyce has explained the amendments in the following way:

If I own a bottle shop and Coles or Woolworths start selling a case of beer below cost and I start to go broke, that's now illegal.

I would rephrase that slightly in the following way: if I own a bottle shop and Coles or Woolworths start selling:

- some or maybe all of their products;
- at a price that is below their (that is Coles' or Woolworths') relevant cost;
- and they do it for a sustained period of time (which is certainly longer than a weekend special);
- and they are doing it for the purpose of reducing competition

then it may be illegal – and as we have seen in other cases, proving purpose before the courts is not trivial.

The ACCC will be doing its best to clarify as many of these issues as it can, and will be seeking senior legal advice on this matter and reviewing the operation of the section as we see it.

It is clear that the operation of this section may be relevant to issues of retail pricing of petrol, including the discount schemes offered by major supermarket chains. It could therefore be expected that the Commission's report, following its current inquiry into the retail pricing of unleaded petrol will include some analysis of these provisions.

Inevitably, we will prosecute appropriate cases to test some of these questions before the court. However, it should be remembered that businesses which have suffered as the result of anti-competitive conduct of larger rivals can bring their own legal actions under the Act.

It should not necessarily be assumed that the ACCC will be the first to bring forward such a case. It is equally conceivable that a private party could be the first mover in this area. In fact, historically, the majority of actions under section 46 have been taken by private litigants.

Regardless, clarification from the courts on these issues will be welcome when it arrives.

The two-way expectation gap

As with any relatively new legislation, it can take a while for business to come to terms with exactly what the full ramifications of any changes are.

But by far one of the biggest concerns the ACCC has in this area of predatory pricing is the expectation gap that businesses both large and small have of what the laws do and do not allow us to do.

It is a two-sided expectation gap that we risk running up against in this case. Firstly, as I've already briefly touched, on, there is some trepidation from big business that their normal, competitive activity may now place them at risk of breaching the Trade Practices Act.

From the comments I have heard so far, I believe big business has an expectation gap that overemphasises the impact of the provisions, whereas the reality is likely to be less drastic than many may fear.

Woolworths Chief Executive Officer Michael Luscombe illustrated that view very recently when he warned that the Birdsville amendments could lead to the death of discounting by major traders such as the supermarkets. He also warned overseas entrants would be able to undercut incumbent Australian businesses, safe in the knowledge that the local competitors would be too afraid to match their low prices for fear of being prosecuted for predatory pricing.

These are no-doubt terrifying concepts, but it would be hard to imagine any sensible legal argument that matching a competitor's lower prices was anti-competitive or in breach of the Act.

His further claims that Woolworths will need "an army of lawyers to work out whether we can mark down the bread at the end of the day to clear" ignore legal reality. To suggest that marking down bread at the end of the day, may in some way constitute sustained below-cost pricing, for the purpose of destroying a competitor, goes beyond the realms of any legal imagination.

On the small business side the expectation gap may run the other way. There is a risk that small businesses - bolstered by the words of commentators who claim the amended section 46 will solve many of their woes - may be overestimating the impact of these provisions versus the legal reality.

Based on that expectation, small businesses may be looking at the actions of their larger competitors and calling on the ACCC to take action, based on unrealistic expectations of what the provisions are actually able to do.

For instance, as discussed earlier, a more efficient business selling at a price that is above its cost, but below the cost of a competitor, is not in violation of the Act. Competitive markets are designed to encourage efficient firms to prosper and deliver benefits to consumers – not to inhibit their ability to do so. Competition encourages firms with higher cost structures to compete on non-price elements - to innovate or to offer niche products or use different marketing or organisational approaches to deal with their cost disadvantage.

This is not a new problem for the ACCC in relation to s46 of the Act. Many in small business believe it to provide all-encompassing protections designed to assist small business, when the reality is it only deals with very specific concerns. This unrealistic expectation, based on a misunderstanding of the law, inevitably leads to questions of "why isn't the ACCC taking action" on specific issues.

In some cases the ACCC does not take action because, in its view, there hasn't been a breach of the Act. In other cases, the evidence available does not adequately support the case. This is why the ACCC has such an exhaustive education and outreach program designed to increase understanding of business rights and responsibilities. This, combined with clarifying for businesses exactly what the law means to them, is our best chance of countering some of the expectation gap that exists in the community**.**

Conclusion

With a Federal election just weeks away, competition and Trade Practices Act issues have again come to the fore in public debate. While these public debates are welcome, they need to be based on logical analysis of changes that have been made to the law.

It will be some time before we know the full implications of changes that have been made and there has been some overreaction from a number of quarters as to how far the law has changed.

The answer at this stage is that we will not know the full implications of these changes until they are properly tested by the courts, but we will be examining carefully some of the new concepts we have been given to work with.

By reaffirming our commitments to the basic principles of promoting competition to the benefit of all Australians and taking a step by step, logical approach to analysis, we can bring these debates into some focus.

Thank you.