

Review of the Competition Provisions of the Trade Practices Act 1974

Submission to Trade Practice Review Committee

by

Stephen Corones

Professor of Law

Queensland University of Technology

18 June 2002

1. Executive Summary

1.1 The purpose of this submission is to suggest an improvement in relation to the drafting of s 46 of the Trade Practices Act 1974 (Cth) (TPA).

1.2 Section 46 prohibits a corporation with a substantial degree of market power from taking advantage of that market power for a proscribed purpose. There are three elements involved in establishing a contravention of s 46: the definition of the relevant markets and the measurement of market power; the element of improper conduct; and the element of proof of a proscribed purpose.

1.3 In its present form the prohibition in s 46(1) does not mention the word “competition”. The proscribed purposes draw attention to an intent to harm or damage an actual or potential competitor which may mislead potential litigants into thinking that the section is designed to protect competitors rather than competition. Rather, the policy objective of s46 is “...to protect the interests of consumers, the operation of the section being predicated on the assumption that competition is a means to that end.” (*Queensland Wire Industries Pty Ltd v Broken Hill Pty Ltd* (1989) 167 CLR 177 at 191 per Mason CJ and Wilson J).

1.4 The issue is an important one as recent Australian case law suggests that the courts are struggling to apply s 46 in its current form. The judicial history of cases such as *Queensland Wire*, *Melway*, and *Boral* illustrates the point. I have written on this elsewhere: see “Section 46 of the Trade Practices Act: What are the Rules of Battle?” (2001) 29 ABLR 175 and “Section 46 of the Trade Practices Act: Rules of Battle Revisited” (2001) 29 ABLR 252.

1.5 In my view, s46 requires re-drafting so that the emphasis is placed on the effect of the conduct on *competition* rather than the purpose or intent of the defendant to harm or injure a particular *competitor*. Evidence of the intent behind conduct should only be relevant to the extent that it may help the court to interpret the facts and predict the effect

of the conduct in question on competition. In my view, the court will best be able to interpret the facts and predict the effect of the conduct on *competition* if s 46 is re-drafted to provide for a shared onus of proof along the lines adopted by the Court of Appeals (DC Circuit) in *United States v Microsoft*.

2. Current Test for Determining Improper Conduct Under s 46

2.1 The basic approach to analysing when conduct contravenes s 46 of the *Trade Practices Act 1974* (Cth) (TPA) was established by the High Court of Australia in *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Co Ltd* (1989) 167 CLR 177 and confirmed by the High Court in *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd* [2001] ATPR 41-805.

2.2 In *Queensland Wire Industries v Broken Hill Proprietary Co Ltd*, Mason CJ and Wilson, Dawson and Toohey JJ considered that the way to test whether BHP had taken advantage of its market power was to ask how it would be likely to behave if it lacked a substantial degree of market power (the hypothetical question).

2.3 Referring to this approach the High Court majority in the *Melway* case [2001] ATPR 41-805 stated (at 42,758):

“The four members of the court reasoned by inference from the premise that BHP could not have refused to supply to QW1 in a competitive market to the conclusion that its behaviour was made possible by the absence of competitive constraint (ie by market power). To ask how a firm would behave if it lacked a substantial degree of power in a market, for the purpose of making a judgment as to whether it is taking advantage of its market power, involves a process of economic analysis which, if it can be undertaken with sufficient cogency, is consistent with the purpose of section 46.”

2.4 The conduct at issue in that case was a refusal to supply a former distributor. Melway published a Melbourne street directory. It adopted a segmented distribution system. The wholesale distributor for a particular market segment was granted an exclusive appointment. Melway changed its appointed wholesale distributor for a particular segment and subsequently refused to supply its former distributor. The former distributor did not intend to open up a new retail market for Melway; rather it proposed to take sales away from existing distributors including the new wholesale distributor which Melway had appointed in its place.

2.5 As regards the taking advantage element of s 46, the High Court stated (at 42,757):

“Section 46 ... requires, not merely the coexistence of market power, conduct, and proscribed purpose, but a connection such that the firm whose conduct is in question can be said to be taking advantage of its market power.”

The question that needed to be answered in that case was: could Melway have maintained its exclusive wholesale distribution systems if it lacked the market power?

2.6 While the High Court accepted in *Melway* that the refusal to supply was for a proscribed purpose, namely to prevent competitive conduct between its appointed wholesalers, it pointed out (at 42,756) that:

“it is not the case that the adoption by a manufacturer, whether with or without a substantial degree of market power, of a system of distribution involving ... vertical restraints necessarily manifests an anti-competitive purpose ...”

2.7 In an earlier passage (at 42,755) the majority warned:

“There are cases in which it is dangerous to proceed too quickly from a finding about purpose to a conclusion about taking advantage.”

3. Taking advantage and business rationale

3.1 As part of the consideration of the taking advantage element, some courts have found it helpful to ask whether the firm had a good business rationale for adopting the conduct. This question is asked as part of the taking advantage element of s 46, although it is also relevant in relation to the purpose element of s 46.

3.2 In *ACCC v Boral Ltd* [1999] ATPR 41-715 the trial judge, Heerey J, stated (at 43,231):

“If the impugned conduct has a business rationale, that is a factor pointing against any finding that conduct constitutes a taking advantage of market power. If a firm with no substantial degree of market power would engage in certain conduct as a matter of commercial judgment, it would ordinarily follow that a firm with market power which engages in the same conduct is not taking advantage of its power. Thus a TV advertising campaign might be a sensible exercise for any firm in a particular market. If one firm happens to have a substantial degree of market power that does not make its campaign a taking advantage of market power.”

3.3 In a similar vein, Heerey J, in his dissenting judgment in the Full Federal Court, stated in *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd* [1999] ATPR 41-693 at 42,863-864:

“Although expressed in perhaps guarded terms, the learned trial judge did accept that Melway was satisfied that its system constituted ‘a reasonable commercial regulation of its distribution system in order to maximise sales of its directories’. Melway tendered a body of evidence as to the reasons for adopting the system. Wholesalers were dealing with customers in a market they knew as specialists. The wholesalers had a good understanding of customer requirements and an ability to sell different types of products to customers, giving supply and selling efficiencies. Major retailers like McEwans preferred ‘distributors of substance’ who could service the product adequately. Wholesalers were given confidence to

invest in marketing and customer development and especially promotion which was a crucial element of Melway's success. The wholesalers were permitted to maximise customer service and the meeting of customer needs including promotion. The wholesalers were able to service the public need for the product, including small unprofitable accounts."

3.4 The High Court, without expressly referring to the relevance of a business rationale in *Melway*, seems at least to have favoured giving firms considerable latitude in their choice of distribution strategy. Section 46 seeks to promote competition not to protect particular competitors in the marketplace that may have become economically dependent on a corporation with substantial market power for their continued existence. Support for this view is to be found in the following passage from the majority judgment (at 42,752):

"Section 46 aims to promote competition, not the private interests of particular persons or corporations. If Melway was otherwise entitled to maintain its distribution system without contravention of the Act, it is not the purpose of s 46 to dictate to Melway how to choose its distributors.

18. What was said in *Burdett Sound Inc v Altec Corporation* by the United States Fifth Circuit Court of Appeals in relation to United States legislation is in point:

'[W]e reiterate that it is simply not an antitrust violation for a manufacturer to contract with a new distributor, and as a consequence, to terminate his relationship with a former distributor, even if the effect of the new contract is to seriously damage the former distributor's business.'

19. There was no legal obligation upon Melway to have any wholesale distributors at all. If it had chosen to do so, it could have supplied retailers directly itself, or it could have supplied the retail market through a single wholesale distributor. Distributorship arrangements may restrict intrabrand competition but promote interbrand competition."

3.5 In *Monroe Topple & Associates Pty Ltd v The Institute of Chartered Accountants in Australia* (2001) ATPR 46-212, the applicant was in the business of providing support

services such as prescribed reading lists, workshops, and workbooks including solutions to workshop problems to candidates undertaking the “Professional Year” in order to qualify to apply to become a member of The Institute of Chartered Accountants in Australia (ICAA) and practise as a Chartered Accountant. ICAA also sold support materials in competition with the applicant. Candidates paid the ICAA an enrolment fee, but had the option of buying or not buying ICAA’s support materials. The ICAA replaced the Professional Year program with the “CA program”. For an increased enrolment fee, candidates were now provided automatically with ICAA’s support materials. It was alleged that ICAAs conduct, in not permitting the supply of enrolment, examination and certification services to be separately priced or unbundled from the supply of support services, contravened s 46.

3.6 Lindgren J applied the High Court’s decision in *Melway*. His Honour stated (at [202]):

“It is not the object of s 46 to protect the private commercial interests of a competitor, perhaps, a fortiori, one whose business is parasitic ... on the activities of a professional association.”

3.7 His Honour provided the following analogy to explain why, in his opinion, MTA’s claim under s 46 failed:

“207 Periodically, a machine needs to be serviced and to have parties replaced. A competitive ‘service market’ develops. The manufacturer of the machine may or may not have facilitated this development, for example, by supplying information about its product to the participants in the service market, that is, those who have made a business out of manufacturing and supplying the spare parts and servicing the machine.

208 The manufacturer decides to cease production of the machine and to start manufacturing another. Existing stocks of spare parts are inappropriate for the new machine, and the employees of the participants in the service market are not

trained to service the new machine, although no doubt with time and money, those companies could adapt to it.

209 But the manufacturer has decided to establish a network of service centres equipped with spare parts supplied by the machine manufacturer itself. Worse still for the service industry, the manufacturer has decided, for a small increase in price, to include in the price of the machine all servicing and spare parts it will ever need. The manufacturer has taken the view that this arrangement benefits both itself and its customers.

210 While it remains possible for participants in the service market to continue in business (customer loyalty and geographical convenience may still favour them to some extent), they predict that the effect of the manufacturer's change of course on their businesses will be disastrous.

211 In my opinion, the manufacturer has not contravened s 46. It has not taken advantage of substantial market power in the service market for the purpose of preventing competition with it in that market. Rather, it has lawfully exercised its rights as manufacturer. Inherent in its position as manufacturer is the right to abandon one product and to manufacture a new one in its place and to provide servicing and spare parts for it and to sell them and the new product for a single undifferentiated price, even if this forecloses any possibility of the development of a second service market.”

3.8 One could not conclude from the adverse impact of ICAA's conduct on MTA alone whether the conduct involved a use of market power. One needed to ask whether ICAA would have been likely to engage in this sort of bundling if it were acting in a competitive market. Or, to put the question another way, would ICAA have been likely to engage in bundling if it lacked market power?

3.9 Lindgren J, in the passage set out above specifically refers (at [209]) to testing the effect of the conduct on customers or consumers. So long as a manufacturer is acting in what it perceives to be the best interests of its customers, bundling will not contravene

s 46 even if it has an exclusionary effect on competitors in the service market. In other words, so long as the conduct is efficiency enhancing and likely to lead to good performance from a consumer welfare point of view, a competitor who is adversely affected by the adoption of a new business strategy, such as bundling two products which were previously supplied separately, has no right to complain under s 46.

3.10 There may well be efficiencies associated with vertical integration, which mean that the two products can more cheaply be supplied as one. It would only be if competition was adversely affected and the conduct was not conducive to economic efficiency and likely to lead to poor performance from a consumer welfare point of view, that a competitor could complain under s 46.

4. The Burden-Shifting Approach under s 2 of the Sherman Act

4.1 The offence of monopolization in the United States of is contained in s 2 of the Sherman Act, 1890. Monopolization, requires a showing of monopoly power plus a conduct requirement. The plaintiff must show that the monopoly power in question was obtained improperly or maintained improperly. As the Federal Court of Appeals (D C Circuit) noted in *United States v Microsoft* [2001-1] *Trade Cases* (CCH) 73,321 (at 90,791):

“From a century of case law on monopolization under s2, however, several principles emerge. First, to be condemned as exclusionary a monopolist’s act must have an “anti-competitive effect.” That is, it must harm the competitive *process* and thereby harm consumers. In contrast, harm to one or more *competitors* will not suffice.”

4.2 The issue which confronted the trial judge, US District Judge Thomas Jackson, in *United States v Microsoft* [2000-1 *Trade Cases* (CCH) 72,839 was whether the Microsoft corporation integrated its Internet Explorer and Windows operating software for reasons of efficiency to benefit consumers or whether its purpose was to damage a

competing Internet browser, Netscape Navigator, which posed a potential platform threat to Microsoft's Windows operating system.

4.3 The District Court defined the market as that for operating systems or PC Intel-compatible operating systems (at [18-32]). A significant feature of the market is that it gives rise to network effects. A network effect arises where the value of a product or service to a user is affected by the number of other users. The District Court found (at [30]):

“ The overwhelming majority of consumers will only use a PC operating system for which there already exists a large and varied set of high-quality, full-featured applications, and for which it seems relatively certain that new types of applications and new versions of existing applications will continue to be marketed at pace with those written for other operating systems.”

The District Court referred to this feature as the “applications barrier to entry” (at [31]).

4.4 While it would be prohibitively expensive for a new Intel-compatible operating system to be developed, applications could be written that relied solely on servers or “middleware” instead of PC operating systems. Middleware was the “Trojan horse” that could enable rival operating systems to enter the market for Intel-compatible PC operating systems.

4.5 Professor Franklin Fisher, the expert economist who gave testimony for the Department of Justice, summarized the threat posed by Netscape (at [85] and [86] of his testimony):

“Because applications running on the browser are not operating –system specific, the Netscape browser could undermine the network effects and the applications programming barriers to entry that currently protect Microsoft's operating system monopoly. In particular, by lessening the reliance on the operating system, the

browser, while not performing all the traditional functions of an operating system, could provide opportunities for competing operating systems by reducing the applications programming barrier to entry that protects Microsoft's operating system monopoly.

With enough applications written to be operating-system independent, users might cease to care, or care as much, whether they had the same operating system as other users.”

Thus the Netscape browser had the potential to become the platform for the writing of applications that might then run on non-Windows operating systems.

4.6 Judge Jackson held that Microsoft sought to meet this threat by imposing “contractual and technological shackles” on computer manufacturers and customers by tying its own Web browser, Internet Explorer, to Windows. It refused to offer computer manufacturers who requested it a version of Windows without Web browsing software and it prevented computer manufacturers from removing Internet Explorer prior to shipment.

4.7 The District Court found that consumers were compelled to purchase Internet Explorer along with Windows 98 by Microsoft's decision to stop including Internet Explorer on the list of programs subject to the Add/Remove function and by its decision not to respect their selection of another browser as their default. The fact that Microsoft was giving away its browser for free did not matter. Microsoft would be able to recoup its money by charging higher prices in the future for Windows.

4.8 These actions harmed Microsoft's relations with computer manufacturers and denied consumers the right to choose their preferred Web browser. The conduct did not make business sense except as a means of removing Netscape Navigator as a platform threat and thereby protecting the Windows operating system monopoly. The conduct could not be described as competition on the merits and it did not benefit consumers.

4.9 Judge Jackson stated in his Conclusions of Law (at 87,243):

“In this case, Microsoft early on recognized middleware as the Trojan horse that, once having, in effect, infiltrated the applications barrier, could enable rival operating systems to enter the market for Intel-compatible PC operating systems unimpeded. Simply put, middleware threatened to demolish Microsoft’s coveted monopoly power. Alerted to the threat, Microsoft strove over a period of approximately four years to prevent middleware technologies from fostering the development of enough full-featured, cross-platform applications to erode the applications barrier.”

The judge added that Microsoft effort’s focused on the “two incarnations of middleware that posed the greatest threat, namely, Netscape’s Navigator web browser and Sun’s implementation of the Java technology.”

4.10 Judge Jackson used three analytical concepts to deal with potentially offending conduct- “exclusionary”, “anti-competitive” and “predatory”- and in explaining these concepts relied on two decisions of the US Supreme Court in *Aspen Skiing Co v Aspen Highlands Skiing Corp* 472 US 585 (1985) and *Eastman Kodak Co v Image Technical Services Inc* 504 US 451 (1992), and a 1986 decision of the Court of Appeals (D.C. Circuit), *Neumann v Reinforced Earth Co* 786 F. 2d 424.

4.11 On appeal, in *US v Microsoft Corp* [2001 –1] *Trade Cases* (CCH) 73,321, the Court of Appeals (D.C. Circuit) adopted (at 90,791-792) a four step “burden-shifting” approach for evaluating the lawfulness of Microsoft’s conduct.

4.12 The first step is the establishment of monopoly power. The plaintiff bears the onus of proof in relation to this element.

4.13 In the second step the plaintiff must offer a hypothesis that shows that the conduct has had an “anti-competitive effect” i.e. “it must harm the competitive *process* and

thereby harm consumers...harm to one or more competitors will not suffice.”(at 90,791). Such anti-competitive effects include an increase in prices, or a reduction in innovation, or a reduction in output.

4.14 In the third step, if the plaintiff demonstrates this anti-competitive effect, then the monopolist may proffer a “pro-competitive justification,” which the court described as “a non-pretextual claim that its conduct is indeed a form of competition on the merits because it involves, for example, greater efficiency or enhanced consumer appeal.” (at 90,792). For example, it may be trying to prevent free-riding and safeguard the rewards of its investment. This would count as a justification. When a person makes a substantial investment in research and development for example, there is nothing wrong with putting in place reasonable restraints to ensure the ability to reap the rewards of that investment. In that case, the burden shifts back to the plaintiff to rebut that claim.

4.15 In the fourth step, “...if the monopolist’s pro-competitive justification stands un rebutted, then the plaintiff must demonstrate that the anti-competitive harm of the conduct outweighs the pro-competitive benefit.” (at 90,792).

4.16 Finally, the Court of Appeals emphasized “...in considering whether the monopolist’s conduct on balance harms competition and is therefore condemned as exclusionary for the purposes of s 2, our focus is upon the effect of that conduct, not upon the intent behind it. Evidence of the intent behind the conduct of a monopolist is relevant only to the extent it helps us understand the likely effect of the monopolist’s conduct.” (at 90,792). Where there is a mix of anti-competitive effects and pro-competitive justifications it is for the court to decide which prevails the gains or the harms.

Two examples of how the burden shifting approach was applied by the Court of Appeals will suffice.

Licences Issued to Original Equipment Manufacturers

4.17 Applying this burden shifting approach to the licences issued to the Original Equipment Manufacturers (OEMs) The licence restrictions prohibited OEMs “(1) removing any desktop icons, folders or ‘Start’ menu entries; (2) altering the initial boot sequence; and (3) otherwise altering the appearance of the Windows desktop.” (at 90,793). The anti-competitive effect of the licence restrictions was that OEMs were not able to promote rival browsers. The burden shifted to Microsoft to justify the restrictions. Microsoft contended first that it was merely exercising its rights under copyright law and second that the licence restrictions prevented the OEMs from taking actions that would reduce the value of Microsoft’s copyrighted work.. The first claim was dismissed as frivolous and the second was not substantiated.

Integration of Internet Explorer with Windows

4.18 There were three specific actions Microsoft took to weld Internet Explorer to Windows: (1) excluding IE from the “Add/ Remove programs” utility; (2) designing Windows so as in certain circumstances to override the user’s choice of a default browser other than Internet Explorer; and (3) commingling browsing source code and operating source code. Microsoft proffered no justification for the first and third of the challenged actions although it did make general claims regarding the benefits of integrating the browser and the operating system. The Court held (at 90,797):

“Plaintiffs plainly made out a *prima facie* case of harm to competition in the operating system market by demonstrating that Microsoft’s actions increased its browser usage share and thus protected its operating system monopoly from a middleware threat and, for its part, Microsoft failed to meet its burden of showing that its conduct serves a purpose other than protecting its operating system monopoly. Accordingly, we hold that Microsoft’s exclusion of IE from the ADD/Remove programs utility and its commingling of browser and operating system source code constitute exclusionary conduct, in violation of s 2.”

4.19 As regards the second practice, product design to override the user's choice, the Court held (at 90,797):

“The plaintiff bears the burden not only of rebutting a proffered justification but also of demonstrating that the anti-competitive effect of the challenged action outweighs it. In the district Court, plaintiffs appeared to have done neither, let alone both and in any event, upon appeal, offered no rebuttal whatsoever. Accordingly Microsoft may not be held liable for this aspect of its product design.”

4.20 In applying the burden-shifting approach the Court of Appeals considered whether Microsoft's conduct was diversionary in the sense that it diverted browser usage from Netscape to Microsoft's Internet Explorer. If the conduct was diversionary it was prima facie anti-competitive and in need of justification.

4.21 Some conduct was diversionary but did not need to be justified because it was anti-competitive. Microsoft's distribution of its browser free of charge was diversionary, but was seen as a form of price cutting and identified by the Court as pro-competitive (at 90,798):

“ The rare case of price predation aside, the antitrust laws do not condemn even a monopolist from offering its product at an attractive price, and we therefore have no warrant to condemn Microsoft for offering [Internet Explorer] free of charge...”.

5. Conclusion

5.1 At present under s 46 there is no formal requirement for the defendant to proffer a pro-competitive business justification although some defendants will submit in evidence that there was a business rationale for their conduct, and the court may, or may not, take it into account in deciding whether there has been a taking advantage of market power.

5.2 In its present form the prohibition in s 46(1) does not mention the word “competition”. The proscribed purposes draw attention to an intent to harm or damage an actual or potential competitor which may mislead potential litigants into thinking that the section is designed to protect competitors rather than competition.

5.3 In my view s 46 needs to be re-drafted to shift the emphasis away from a purpose or intent to harm competitors in favour of emphasizing the effect of the conduct in question on competition. Purpose or intent should only be relevant in so far as it assists the court to gauge the effect of the conduct on competition.

5.4 The “burden-shifting” approach of the Court of Appeals in the *Microsoft* case would assist the court to interpret the facts and predict the consequences of conduct on competition.

5.5 A burden-sharing approach has been adopted in relation to another provision of the TPA where the rationale for the conduct is within the province of the defendant and the plaintiff is likely to encounter problems of proof.. Section 51A (1) of the TPA provides:

“...where a corporation makes a representation with respect to any future matter...and the corporation does not have reasonable grounds for making the representation, the representation shall be taken to be misleading.

(2) For the purposes of the application of subsection (1) in relation to a proceeding a representation made by a corporation with respect to any future

matter, the corporation shall, unless it adduces evidence to the contrary, be deemed not to have reasonable grounds for making the representation.”

5.6 A burden-shifting approach is a feature of other statutory prohibitions in Australia. For example, s 9 of the *Workplace Health and Safety Act* 1989 provides:

“An employer who fails to ensure the health and safety at work of all his employees, save where it is not practicable for him to do so, commits an offence against this Act.”

Under s 9, the plaintiff must first satisfy the Court that, leaving aside the matter of impracticability, the defendant breached s 9. The onus then shifts to the defendant employer to prove impracticability. See *Kingshott v Goodyear Tyre and Rubber Co Australia Ltd (No 2)* (1987) 8 NSWLR 707 and *Rogers v Brambles Australia Ltd* [1998] 1 Qd R 212.

5.7 The burden-shifting approach is open to the criticism that it throws some of the burden on the defendant. As with the *res ipsa loquitur* doctrine in torts, the defendant is obliged to come forward and explain itself. Some will argue that a defendant may be disadvantaged if it is compelled to justify its conduct. This may occur if, for example, the conduct is neutral in the sense that it is neither efficient nor inefficient, or where there are no standards for evaluating efficiency. Nevertheless, in my view, the burden-shifting approach would be a significant improvement on the current position.

S G Corones

18 June 2002