Review of the competition provisions of the Trade Practices Act 1974 (Cth)

Submission on economic issues

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A Executive summary

1. On 9 May 2002, the Government announced the formation of a Committee to review aspects of the Trade Practices Act 1974 (Cth) (the "Act") (the "Review"). Telstra Corporation Limited ("Telstra") has commissioned this paper from the Network Economics Consulting Group ("NECG") as a submission to that Review. The views expressed in this submission are those of NECG. Throughout this submission, references to the "Act" are to be read as references to the competition provisions that form part of the terms of reference for the Review, rather than as references to the Act as a whole (unless the context demands otherwise).

2. This submission focuses on some economic issues in the operation and administration of the Act that are of greatest relevance to Telstra and to other firms involved in the 'information economy' – that is, firms that participate in activities shaped by the rapid development and diffusion of information and communications technologies.

3. The submission sets out in some detail the economic analysis that needs to be conducted of the principal competition policy provisions. The goal is not to introduce economic concepts for their own sake, but to use them to clarify the key issues with which the Review should grapple. The major implications drawn from the analysis set out in this submission are as follows.

4. Overall, the Act has made a major contribution to the efficiency and competitiveness of the Australian economy. The Act's overall architecture has stood the test of time, with the scope for authorisation of conduct which would otherwise breach the Act being a particular strength of the Australian approach to competition policy. Although the Act undoubtedly remains a work in progress, there is no need for a fundamental reconsideration of its competition provisions.

5. The competition provisions of the Act are more prescriptive and detailed, in important respects, than similar legislation in the United States and the European Union. While intended to provide greater certainty, the result has been to introduce unnecessary complexity, and to slow the adaptation of the law and practice of competition policy to changes in the Australian economy and in our understanding

of competition policy issues.

6. The provisions affecting contracts, arrangements or understandings raise a number of major concerns. As regards horizontal agreements,[1] it appears that network joint ventures – in which participants share, on agreed terms, in the use of a network, while competing in providing services over that network – may be caught by the deeming ("price fixing") provisions in section 45A of the Act. The wide reach of this provision is unique in international terms and could materially harm the efficient development of network industries.

7. There is also a need to review the provisions relating to vertical agreements.[2] There is no justification for the current reach of the section dealing with exclusionary provisions,[3] which is also unique in international terms. This section needs to be revised and at least made subject to a "substantial lessening of competition" test. There is also no policy justification for the prohibition on third line forcing,[4] which is again unique in international terms. Here too, at a minimum, the provision should be made subject to a "substantial lessening of competition" test. Finally, the current section 47 - dealing with vertical agreements - is baroque in its complexity, and could be much simplified.

8. While these changes would improve matters, consideration should be given to more far-reaching reform. In particular, from an economic point of view, there is a case for repealing section 47 of the Act and relying solely on section 46 to catch vertical

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1 That is, generally, agreements between competitors at the same functional level in the chain of supply.

2 That is, generally, agreements between parties operating at different functional levels in the chain of supply.

3 As defined in section 4D of the Act – generally, a provision of a contract, arrangement or understanding between parties in competition with each other where the provision has the purpose of preventing, restricting or limiting the supply or acquisition of goods or services.

4 Generally, a supply of goods or services on terms that the purchaser also agrees to acquire other goods or services from another person.

agreements that are economically harmful.

9. Turning to section 46 itself, the current wording of the section seems poorly aligned with its underlying economic objective – namely, to prohibit conduct that, relying on market power, reduces competition in ways that harm efficiency and welfare. However, the interpretation of the section by the courts has been reasonably well aligned with this objective.

10. At least in part, the fact that the courts have been able to judicially interpret the section in a way that has been reasonably well aligned with the section's underlying economic objective has been facilitated by the fact that the section ***does not*** refer to a substantial lessening of competition test. Were such a test included in section 46, that section would then necessarily have been interpreted in a similar manner to the other competition test-based provisions of the Act – that is, in a way that plainly distinguishes competition from efficiency. Not having such a test in section 46 has made it possible for the section to be given a more flexible, economically-desirable interpretation in practice that recognises and accommodates the fact that efficiencies can arise from conduct that reduces competition.

11. Nonetheless, proposals have been made to introduce an 'effects test' into the section. While there is some sense in these proposals, it needs to be recognised that conduct that lessens competition may nonetheless enhance efficiency and hence community welfare. Were the section modified so as to include an 'effects test', it is likely that it would catch a significant amount of conduct which is desirable from an efficiency perspective. The experience of Part XIB of the Act, which provides for an 'effects test' in the context of telecommunications, shows that the risks involved are great.

12. There is no easy or cost-effective way of addressing this problem. Allowing for authorisation of section 46 conduct on efficiency grounds would place an unacceptably large burden on firms, and would merely harm competition. The other options that have been suggested – such as allowing a defence for 'legitimate business conduct' – are also shown to be ineffectual.

13. High costs would be incurred were the current section altered in a way that increased the risk of desirable business conduct being impeded. These costs are likely to be greater than the costs associated with any deficiencies in the section as it currently stands. As a result, the case for amending the section has not yet been made out.

14. Overall, the Act has stood up well to the test of time. However, it needs to adjust to

changing circumstances – including the increasingly global character of Australia's economy, and the greater openness to competition that characterises the Australia of today, when compared to that of the time of the Act's passage into law. Further substantial economic change lies ahead as Australia participates in the rapid growth of the industries and activities that make use of advanced computer and telecommunications technology. The Act can and should be adapted to those changes, without in any way losing its influence or effectiveness. The changes proposed in this submission are intended to facilitate that adaptation and hence to contribute to an increasingly competitive and efficient economy in the future.

15. In view of the complexity of some of the economic issues involved, NECG would be pleased to meet with the Review Committee to discuss any aspect of this submission, if requested.

B Purpose and structure

16. It is not the goal of this submission to review the entirety of the issues that are to be considered by the Review or that are being canvassed in the ongoing debate about the Act. Rather, it focuses on some economic issues that are of greatest relevance to Telstra and to other firms involved in the 'information economy' – that is, firms that participate in activities shaped by the rapid development and diffusion of information and communications technologies.

17. Obviously, these issues are not distinct from those faced by other firms in the Australian economy. There are, however, some differences in emphasis. Additionally, certain issues which, ultimately, are likely to affect all firms, have come into relief sooner and more sharply for those involved in the industries most exposed to rapid technological change. The experience of these industries, and the light this experience throws on an assessment of the main provisions of the Act, ought therefore to be of concern to the Review.

18. The structure of this submission is as follows:

- section C sets out some important background to the Act. More specifically, it contrasts the distinctive structure and design of the Australian approach to competition policy with that adopted in the United States and the European Union. Having explained that the Act has a wider reach than would be the case in the contrasted jurisdictions, this section places that difference in the context of the way in which the Act deals with the relationship between competition and efficiency;

- section D, which concentrates on the sections of the Act that deal with concerted conduct, examines the implications of the (at least potentially) wide scope of the Act's reach in the context of network industries, particularly those that involve information and communications technology. This section examines some of the circumstances in which agreements that appear to impose restrictions on competitive behaviour can nonetheless promote competition overall, including by efficiently resolving the 'free-riding' problem in the presence of network externalities. On the basis of a consideration of how these circumstances are dealt with in the Act, this section advances a number of proposals for reform of the relevant provisions of the Act;

- section E considers unilateral conduct, which refers to situations in which a firm uses its market power to reduce competition in ways that harm efficiency and overall welfare. The section:
  - explains that there is no easy way of defining and identifying unilateral conduct in a manner that lends itself to a simple competition policy rule;
  - considers the possible choices of rule in terms of the theory of decision-making in the face of uncertainty, with a focus on the impacts and issues arising in network industries; and
  - in the light of that theory, and of experience with Part XIB of the Act, examines the calls for the introduction of an effects test into section 46 of the Act; and
- section F concludes this submission.

C The background: competition and efficiency

19. Although it is approaching its thirtieth anniversary, the Act is still a work in progress. It continues to raise complex issues of economic policy and of legal interpretation. The extent to which it meets its broader goals, and the efficiency with which it does so, remain matters of lively debate, as does the administration and enforcement of the Act’s provisions.

20. Continuing debate about the Act is to some extent inevitable. Competition policy is economic law and views about how the economy ought to be regulated, and more particularly about the desirability or otherwise of individual business practices, have changed over the years and will continue to change. In turn, these changing views lead to pressures for realignments in the substance, administration and enforcement of the competition laws.

21. This phenomenon is by no means peculiar to Australia. There are, however, factors that make the tensions between changing and differing conceptions of appropriate regulation, on the one hand, and the substance, administration and enforcement of the competition laws on the other, particularly acute in this country.

22. The first of these factors is the central role the competition laws and their enforcement play in Australia. Compared to overseas practice, the Act and its main

enforcement agency, the Australian Competition and Consumer Commission (the "ACCC"), serve an almost uniquely wide range of roles:

- the prevention of anti-competitive conduct;
- the protection of consumers, both through fair trading provisions and by means of price surveillance; and
- the active promotion of competition, including through the administration of economic regulation in industries traditionally regarded as public utilities.

Given the scale and breadth of the Act's reach, and the vesting of administrative responsibility for its enforcement in a single agency, it is unsurprising that issues as to its proper substance and implementation should be of especially vital and lively concern.

23. A second, perhaps even more important, factor is the particular nature of Australian trade practices law. More specifically, compared to the major jurisdictions overseas, the Act is quite distinctive in its structure and design.

24. In the United States and the European Union, the competition laws are primarily set out in very general provisions, which are then interpreted and re-interpreted by the enforcement agencies and the courts. The generic terms in which the provisions are formulated allows for on-going adaptation to changing economic views. For example, the United States' courts have dramatically changed their stance towards vertical restraints (such as tying, exclusive dealing and even resale price maintenance) since the 1970s, largely reflecting the greater emphasis economists have placed on these restraints as means of achieving efficient outcomes.

25. In contrast, the Australian legislation is detailed and prescriptive. Specific practices are prohibited, unless they have been explicitly authorised, and the drafting, though in practice often extremely unclear, seems aimed at specifying the conduct that may be caught in an exhaustive way. Undoubtedly, this reflects both a general preference for specificity in legislation and the feeling, at the time the Act was being drafted, that – faced with a very substantial change in the regulatory landscape – firms ought to know what is and what is not caught by the Act's provisions. Its effect, however, is to make it more difficult for competition policy and the Act's interpretation to evolve in line with changing views of appropriate economic regulation.

26. Accentuating the resulting pressures is the fact that the range of prohibited conduct is wide when compared to major jurisdictions overseas. There are *per se* prohibitions on exclusionary provisions, on price fixing (which is defined widely, with exceptions that are very narrowly cast), on third line forcing and on resale price maintenance. The other provisions are subject to a competition test, but – for reasons that are set out below – that test has a wider reach than would be the case in the United States or the European Union. As a result, the Australian test tends to catch and hence prohibit a somewhat broader range of conduct than would fall foul of the competition laws overseas.

27. The reason the competition test has a wide reach is the specific manner in which the Act deals with the relationship between competition and efficiency.

28. From an economic point of view, competition is a means to an end. That end is economic efficiency, which simply means a situation in which society secures the greatest possible benefit from the scarce resources at its disposal. Competitive markets generally promote efficiency, but there are instances in which the goal of making the best use of resources clashes with that of preserving competition in the supply of goods and services. In some cases, for example, economies of scale and scope may only be capable of being realised by consolidating existing competitors into a single entity. In other cases, efficient supply requires entities to coordinate aspects of their operations – say the operating system that the computer software they are developing will use – to an extent that falls short of full consolidation but nonetheless eliminates independence of decision-making in some, potentially competitively significant, dimensions of performance. In these instances and others, society faces a trade-off between the enhanced efficiency that concerted action can bring and the greater market power that results from the elimination of independent, rivalrous conduct.

29. The Act recognises and provides for this trade-off. It does this by:

- specifically distinguishing competition from public benefit;
- recognising that conduct which reduces competition – and hence would breach a 'substantial lessening of competition' test – might nonetheless confer net benefits on the public; and
- providing for this conduct to be authorised through an administrative process, so long as it can be established (in practice, by the parties) that the

benefits the conduct allows will outweigh the competitive detriments the conduct is likely to cause.

30. The efficiencies that can arise from conduct that reduces competition are therefore accommodated, in the Act, by means of a process ***separate from*** and ***subsequent to*** the assessment of competitive impacts. Implicit in this two-stage architecture is a *de facto* reversal of the burden of proof. The burden of establishing that the conduct breaches the competition provisions rests on the enforcement agency and/or on plaintiffs; however, to the extent to which the conduct either is, or could be, in breach, it is then up to the parties engaged in the conduct to demonstrate, through a public, transparent and accountable process, that the public benefits likely to flow from the conduct exceed its likely competitive detriments. In practice, the burden of making this out has proven to be considerable, in terms of resource costs, time and the disclosure of information.

31. These aspects of the Act, and indeed the Act more generally, need to be seen in the context of its time. As the discussion in Annexure A shows, the Act came into effect in an Australian economy which was substantially less competitive and open than the Australian economy of today. Set against that backdrop, the Act was exceptional in accepting and providing for the trade-off that can occur between competition and efficiency. At that time, the United States and European Union jurisdictions gave relatively little weight to the public benefits that might arise from conduct that otherwise seemed to reduce competition.

32. However, while the Act was certainly ahead of its time, the importance of taking account of wider public benefits has, over the years, gained ever greater recognition in the United States and, albeit somewhat unevenly, in the European Union. The case law, and hence the reality of the laws, has evolved in line with this growing recognition.

33. In these major foreign jurisdictions, the consideration of public benefits has largely taken place as ***a part of*** the assessment of whether or not the competition law has been breached. In the European Union, this occurs through specific recognition in the provisions of the Treaty Establishing the European Community[5] of the

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5 Treaty Establishing the European Economic Community, 25 March 1957, as amended by the Treaty of Amsterdam signed 2 October 1997 (the "Treaty of Rome") (consolidated version

desirability of promoting economic growth. The Commission of the European Union, in its role of administering the provisions, then takes account of these considerations, both through individual and group exemptions and in its assessment of individual cases. In the United States, the case law has broadly evolved in the direction of viewing conduct that promotes efficiency as in some sense synonymous, or at least not inconsistent, with the protection and promotion of efficient competition. In other words, rather than 'competition' and 'efficiency' being viewed as distinct concepts, 'competition' has come to be seen as involving or encompassing 'conduct that promotes efficient outcomes'.[6] The rather general terms in which the relevant statutory provisions in the United States are framed has facilitated this substantial change in interpretation.

34. Seen from an economic perspective, competition and efficiency are distinct concepts – as noted above, efficiency is an end, while competition is one means, among others, for pursuing that end. Conflating these concepts is analytically incorrect and creates scope for confusion. The Australian approach, which keeps these concepts distinct, makes for greater clarity and rigour in analysis and, in the process, makes for greater discipline on those responsible for the administration and enforcement of the policy.

35. Additionally, there are sound reasons for the two-stage mechanism built into the Act. From the perspective of public policy, it is quite sensible to have a presumption in favour of competitive markets, and hence to place on those who would engage in conduct that is likely to reduce competition, the burden of demonstrating, through a publicly accountable process, that the conduct will nonetheless yield net benefits to the community.

36. Having said that, the net effect of the complex of factors noted above is that there are significant respects in which competition policy now imposes greater restraints

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published in the Official Journal C340, 10 November 1997, pages 173-308).

6 See, for example, the formulation of Judge Stephen Breyer in *Interface Group Inc v Massachusetts Port Authority* 816 F 2d 9, 10 (1st Cir 1987) that the competitive process is "a process that aims to bring to consumers the benefits of lower prices, better products and more efficient production methods".

on Australian firms than on their counterparts overseas. These include:

- the wider range of *per se* prohibitions;
- the relatively prescriptive definition of conduct that may raise competition concerns;
- the interpretation of competitive impacts as being largely distinct from the analysis of overall effects on efficiency; and
- the requirement that overall effects on efficiency be mainly considered through a separate authorisation mechanism.

Taken together, these mean both that conduct is more likely to come within the scope of regulatory review and that once it does so, parties face greater difficulties, costs and uncertainties in securing clearance for that conduct.

37. The (at least potentially) wide scope of the competition law's reach has implications that are especially marked in network industries, and particularly in those that involve information and communications technology. It is these implications that are examined here. First, the issues associated with concerted conduct – that is, business arrangements that involve contracts, arrangements or understandings between otherwise independent parties - are reviewed. This is followed by a discussion of the issues raised by the control of unilateral conduct, that is, the anti-competitive use by an entity of the market power on which it can draw.

D Concerted conduct

38. Concerted conduct involves situations in which otherwise independent firms enter into contracts, arrangements or understandings that may have the effect of reducing competition.

39. It is obvious that there are many circumstances in which contracts, arrangements or understandings do not in any way harm the competitive process. By the same token, however, there are cases in which the impact of a contract, arrangement or understanding is to substantially lessen competition. The reduction in competition may occur directly between the firms at issue - as when firms that would otherwise be competitors agree on terms of trade - or indirectly, as when a solus agreement between a manufacturing firm and its distributor limits the scope for other firms to

enter the market for that manufacturing firm's products.

40. Determining whether a contract, arrangement or understanding will substantially lessen competition can and often does involve a balancing of offsetting considerations. For example, an agreement on product standards between firms in the same market may eliminate rivalry, or at least differentiation, in one dimension on which suppliers might otherwise compete. However, in doing so, it may make it easier for consumers to compare the products different suppliers offer, and to switch among competing suppliers, thus increasing competition overall.[7] Equally, an exclusive distribution agreement between a manufacturer and its distributor may reduce the range of distribution channels available to the manufacturer's competitors. However, if the agreement permits that distributor to be more effective as a distribution outlet for that manufacturer, it may strengthen competition between that manufacturer and the suppliers of rival brands.

41. These examples highlight a fairly general and important principle. That principle is that conduct which appears to impose restrictions on competitive behaviour (in the first case, in restricting the product standards used; in the second case, in limiting the ability of competitors to access the distribution outlets covered by the exclusivity) can nonetheless promote competition overall. The following sections consider the circumstances in which this is likely to occur and then examine the implications for the current provisions of the Act.

D.1 The analytical background

42. Seen from an analytical perspective, contracts, arrangements or understandings between suppliers are most likely to promote competition and efficiency when they involve ***complements*,** and are most likely to harm competition and efficiency when

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7 Of course, standard setting can also resolve uncertainty and create incentives for firms to invest in new technologies. In particular, the efficient functioning of the telecommunications industry and the Internet require interconnection, standardisation, coordination and other types of co-operation between competitors. Actual or perceived limits on the ability of firms to agree to establish standards can therefore be harmful, though there are also circumstances in which standard-setting can be used to anti-competitive effect.

they involve ***substitutes***. Complements are goods whose value is increased by their joint consumption (for example, shoes and socks, plugs and sockets, internet access and web sites, are all complementary goods). In contrast, substitutes are goods where consumption of the one replaces demand (and hence reduces the value of demand) for the other – one brand of car is likely to be a substitute for another, just as an STD call provided by Telstra is a substitute for an STD call provided by Optus.[8]

43. Contracts, arrangements or understandings between suppliers of complements are most likely to promote competition, or least likely to harm the competitive process, for two reasons. First and most obviously, the suppliers themselves do not compete, so that the contracts, arrangements or understandings between them do not eliminate or reduce rivalry that would otherwise occur. Secondly, the contracts, arrangements or understandings may facilitate the supply of the combined goods ('shoes from manufacturer A and socks from manufacturer B', 'internet access from supplier 1 and web content from supplier 2'), making them more effective competitors to similar packages of combined goods available from other sources ('shoes from manufacturer C and socks from manufacturer D', 'internet access from supplier 3 and web content from supplier 4'), and thus enhancing competitive disciplines overall.

44. At the same time, contracts, arrangements or understandings that involve suppliers of complements are most likely to enhance efficiency, as compared to a world without those contracts, arrangements or understandings in place. This is because it would often be difficult or more costly for the supplier of one of the goods at issue to itself also supply the other, say through internal diversification. The contracts, arrangements or understandings then allow economies of coordination to be achieved which would otherwise not be achieved at all, or only achieved at higher

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8 More strictly, two goods are substitutes if an increase in the price of one good, all other things being held constant, increases demand for the other. An increase in Telstra's STD price will, all other things being held constant, increase demand for Optus' STD service. Conversely, two goods are complements if an increase in the price of one good, all other things being held constant, decreases demand for the other. An increase in the price of cars will, all other things being held constant, reduce the long run demand for petrol.

cost.

45. A fuller understanding of these impacts on competition and efficiency relies on two crucially important economic concepts.

46. The first is the concept of ***externalities***. An externality is an impact on third parties not taken into account in an agent's decision making. Externalities are typically divided into two types.

47. A ***technological externality*** arises when the outcomes from one agent's activities impact on the well-being of another agent directly, that is, without being mediated through a market mechanism. For example, a technological externality arises when, as a result of a house-owner deciding to plant a fruit tree on the boundary of his or her property, a neighbour benefits from the resulting overhanging fruit.

48. ***Pecuniary externalities*** are external effects which work through the price system, or more generally are market-mediated. Whenever prices change, agents can be better or worse off. When a firm produces enough to lower price, its rivals are worse off and consumers better off. When one consumer buys enough fish to push up the price of fish, other consumers are made worse off.[9]

49. Pecuniary externalities represent transfers in wealth that result from equilibrium pricing behaviour. As a result, pecuniary externalities usually do not undermine efficient decision-making. In contrast, technological externalities, if uncorrected, may do so. For example, if the benefits of the house-owner planting the fruit tree accrue largely to the house-owner's neighbours, the tree-planting house-owner may not face appropriate incentives to maintain and renew the tree as it ages.

50. To understand why externalities may undermine the efficient allocation of resources, a second concept is important – the concept of ***transaction costs***. These include all of the costs associated with a transaction, including costs associated with writing and enforcing contracts, obtaining information, and engaging in exchange.

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[9] More specifically, technological externalities have a direct impact on demand or cost functions, while pecuniary externalities only affect these functions through their impacts on prices.

Interpreted broadly, transaction costs refer to the entire costs of organising economic activity.

51. If the costs of transacting were extremely low – say, zero – externalities would not distort the efficient allocation of resources. The house-owner that planted the tree could negotiate with the neighbours that benefited from the overhanging fruit, a contract that covered the tree's costs and hence provided incentives for the efficient level of investment in tree planting. However, transaction costs in the real world are often not at all low. As a result, externalities can go uncorrected, or may only be capable of being corrected in ways that themselves impose some costs.

D.2 Applications to competition policy

52. The relevance of these concepts to competition analysis is readily illustrated. Consider the relation between a producer and its distributor. The production and distribution of goods are complements, and both the producer and the distributor gain when demand for the good rises. The producer's investments in enhancing demand, say through the active marketing and promotion of the good, will therefore confer some benefits on the distributor. Assume the producer, so as to capture the benefits of this investment, increased the wholesale price of its product. In practice, the distributor could 'free ride' on the producer's investment by (1) stocking the advertised product, thus attracting to its outlet the increased custom generated by the promotional effort, and (2) diverting those customers to substitute products on which it earned a higher retail margin. The result would be that the distributor's activities would confer an uncompensated externality on the producer, reducing to inefficiently low levels the producer's incentives to engage in those outlays on marketing and promotion.

53. Were transaction costs negligible, the producer could prevent this free-riding by monitoring the behaviour of the distributor and then charging it a fee for the diverted sales. In practice, though, monitoring of that kind will often be prohibitively costly. Alternatively, the producer could simply impose a fixed fee for the right to stock the advertised product and then charge the distributor for each sale at a price which made it attractive for the distributor to engage the appropriate level of selling effort. Again, however, serious difficulties would be involved in setting the fixed fee at the right level, since the information needed for this may well only be available to each distributor.

54. Given these constraints, the producer may react to this situation by imposing an

exclusive distribution agreement, which prevents the distributor from stocking substitutes to the goods the producer produces. The solus agreement is, in the circumstances, a second-best but readily implemented solution to the 'free riding' problem. More specifically, given the transaction costs involved in structuring the relationship between the producer and the distributor, the exclusivity requirement may be the most efficient way of correcting the externalities the distributor's behaviour described above would otherwise create.

55. Many types of concerted conduct between suppliers of complements can be seen as responding to externalities in situations where the costs of transacting are high. The restrictions on choice which parties enter into in these types of arrangements are ways of enforcing an alignment of incentives between parties who each have scope to impose costs and benefits on others. Because the efficient provision of complements relies on aligning incentives throughout the chain of supply, contractual restrictions on the inter-dependent suppliers are common.

56. Having said that, it is fair to note that concerted conduct, even when it involves suppliers of complements, can quite properly raise competition concerns. It can do so by means of two broad types of effects.

57. First, the conduct may have ***exclusionary*** impacts. More specifically, it may increase the costs efficient rivals would face in entering or expanding in the market(s) affected. For example, solus agreements secured by incumbents may impose on an entrant producer the need to build its own distribution outlets. Entry will then have to occur at two levels of supply at once, thus increasing the sunk costs and risks the entrant will have to bear.

58. Secondly, the conduct may facilitate pricing and output coordination between incumbent suppliers. It may, in other words, have ***collusive*** impacts. For example, exclusive distribution agreements may make it easier for rival producers to monitor each other's wholesale pricing (since the prices of each distributor will reflect those of the producer whose goods it distributes) and hence reduce competition at the production layer.

59. Historically, competition policy placed considerable weight on these possible anti-competitive impacts. However, it is now more widely understood that they are only likely to be relevant in cases where entry barriers are especially high. Usually, this type of conduct will not harm competition and will enhance efficiency. Competition policy must therefore strike a careful balance between the possibility of

harm in exceptional cases and the likelihood of benefits to competition and efficiency in most circumstances.

D.3 The relevance of structural change

60. These tensions between the competition (and efficiency) enhancing aspects of concerted conduct on the one hand, and its potential for competitive harm on the other, are not new. The case law, both in Australia and overseas, provides numerous illustrations of the recognition by courts and enforcement authorities of the complexities which the proper analysis of these forms of conduct involves. Nonetheless, the tensions have become more apparent in recent years, at least in part because of structural change in the economy. Of particular relevance is the rapid development and diffusion of information technology, and most notably of the networks based on the integration of advanced computing and telecommunications.

61. The ever-greater role these networks play in advanced economies generally, and in the Australian economy in particular, has a range of significant impacts. There is, for example, strong evidence that the diffusion of information technology has materially affected overall growth rates of productivity. At the same time, the sustained innovation which has characterised advanced computing and telecommunications has greatly increased competition, both in the supply of information technology itself and in the many goods and markets affected by that technology's use. In all of these ways, the diffusion of information technology has made, and has the potential to continue to make, a substantial contribution to increasing living standards.

62. Historically, the development and diffusion of each major new economic and social infrastructure – such as the railroads in the nineteenth century, electricity and automobiles in the first half of the twentieth century, and information technology from the 1950s onwards – has required the putting into place of a wide range of inter-working, complementary, assets. All far-reaching technological transitions, in other words, confront 'chicken and egg' problems, as economies must find ways of coordinating the supply of the various elements that give value to new infrastructures. The rise of networks based on the integration of advanced computing and telecommunications has brought these 'chicken and egg' problems to the fore.

63. Economists describe these 'chicken and egg' problems as involving 'network effects'

and ‘network externalities’.

64. A ***network effect*** arises when an agent’s benefit from joining or using a network depends on the number of other agents belonging to or using the network. More precisely, a network effect arises whenever the ‘net value of an action depends on the number of other agents taking similar actions’. Often, as a result, agents will prefer to join the larger network. For example, when a consumer prefers to hold a Visa card rather than a Diners Club card, this may well be because the Visa network is bigger, and so that consumer’s card will be accepted more widely.

65. It is conventional to divide network effects into two types: direct and indirect. A *direct network effect* occurs if existing subscribers benefit directly when an additional customer joins the network. A communication network, in which the value of the network to each consumer depends on the number of parties that network connects, is a classic example of a direct network effect.

66. An *indirect network effect* occurs when users benefit indirectly from other consumers’ decisions to subscribe. In other words, they gain not from being able to contact or interact with other consumers, but simply because more consumers mean lower network costs or a broader higher quality supply of goods associated with the network. The network effect is indirect because a user’s benefits do not depend on the actual number of other users directly, but through some intermediate channel – for example, the effect the network’s size has on the availability of complementary products or services. Thus, someone considering between purchasing a Sony PlayStation®2 and a Nintendo GameCube may care how many other users of each system there are, not because they want to interact directly with any of these users, but because if they invest in the more popular system they are more likely to have access to a wider range of software, cheaper software, and better customer support in future years.

67. Both the direct and indirect network effects affect the viability and growth of new networks. A firm proposing to develop a new type of operating system that is incompatible with existing systems will face the challenge that, until it develops a large customer base, the difficulties each of its customers will face in communicating with users of existing systems will make adoption of its system unattractive. Equally, until the firm has developed a large customer base, it may find it difficult to induce the development of complementary products or services – such as applications software that exploits the unique capabilities of that operating system.

68. Not all network effects give rise to network externalities. A ***network externality*** (or consumption externality) is a special case of a network effect where there is an unpriced spill-over (either positive or negative). Thus, network effects are only network externalities when the participants in the market fail to 'internalise' these effects.

69. For example, there is undoubtedly a network effect between the supply of operating systems and that of applications software. However, if a single firm supplies the two, then that firm's operating system business will benefit whenever it improves the supply of applications software designed with its operating system in mind. The spill-overs between the two activities will have been 'internalised', thus ensuring appropriate incentives for their supply. By contrast, if the two activities are not internalised, there may be externalities between them – so that part of the benefits of investments in promotion of the operating system business flow to the supplier of the applications software. In that event, the supplier of the operating systems may not have sufficient incentives to engage in the development of new and superior products.

70. The successful development and deployment of all major technological systems depends on the effective resolution of the 'obstacles to growth' associated with network effects and network externalities. Information technology is by no means unique in this respect.

71. Nonetheless, there are some aspects in which the economic issues associated with the diffusion of information technology do differ from those raised in earlier technological transitions.

72. To begin with, the technologies of computing and telecommunications are inherently associated with the communication, and more generally transfer, of information. They therefore involve far greater direct network effects than did earlier networks. For example, the utility a consumer derives from train travel, or from consuming electricity, in no way depends directly on the number of other consumers of those services; however, the value of virtually all telecommunications services and of many types of applications software does depend directly on the number of users with whom communication is possible. The benefit of getting new services and applications to a threshold size is therefore greater.

73. At the same time, the challenge involved in getting new networks to threshold size is itself greater than it was in earlier large-scale technological transitions. This is

mainly because the context within which that challenge is being addressed differs in crucial respects from that which characterised earlier transitions.

74. To understand this change in context, it is useful to start by noting that the challenge of getting new networks to threshold size is essentially two-fold: it involves first, covering the costs of attracting early users to the system and secondly, ensuring the development and availability of the complementary services required to make the system attractive. The simplest way of addressing these requirements is to vest responsibility for the overall supply of the network, including all complementary services, in a single economic entity. That entity can then bear the up-front costs, knowing that it will reap the gains when the networks grow past the threshold of long run viability.

75. This approach – of using centralised or vertically and horizontally integrated supply to 'internalise' network effects – played a crucial role in the other major transitions recalled above. The nineteenth century railroads and the energy utilities of the twentieth century are examples of administrative coordination, within a single economic entity, of a complex of inter-dependent supply decisions. Where reliance on a single entity was not enough to resolve the coordination problems, or simply not possible, responsibility for ensuring coordinated supply typically fell on the State. The development of the infrastructure of automobile transport, for example, relied heavily on governments both to supply key components of the infrastructure and to regulate its use.

76. In its early days, information technology too relied on coordination largely within a single integrated supplier to 'internalise' and hence manage network effects. In computing, for example, the dominant model of supply – exemplified, from the 1950s to the early 1980s, by IBM – involved the combined provision of the full suite of hardware and software products. In telecommunications, the common carriers, generally operating as statutory monopolies, provided the full suite of services and applications, in many cases extending to the equipment on customers' premises.

77. However, reliance on such sole supply as a means of addressing network effects and externalities is no longer a viable option. Both markets themselves, and governments in their regulatory and policy-making roles, have effected a transition to a far more decentralised pattern of supply. It is this shift from a centralised pattern of provision to one that is inherently decentralised that makes the challenge of getting new networks to threshold size substantially greater than it was in the past.

78. Significant efficiency gains can be obtained from the decentralisation of supply: that is, from allowing services that might once have been supplied by a single entity to be provided by a range of distinct suppliers. To begin with, these suppliers may be able to achieve economies of specialisation – it may be preferable for Microsoft to specialise in developing software, while other firms build the hardware on which its software will run. At the same time, to the extent to which the inter-working elements can be broken down into distinct modules (just as sound systems are made up of elements such as CD players and stereo amplifiers), with clear interfaces between them, innovation can be facilitated as changes can be made to any one element without the need to scrap the system as a whole. Last but not least, greater and more effective competition can be secured than would otherwise be possible, as – at least in some layers of the full chain of supply – there may be scope for many rival producers to contend.

79. Substantial though they are, these efficiency gains come at a cost. In particular, *the price mechanism alone is generally not sufficient to overcome the coordination problems associated with network effects when supply and demand decisions are decentralised*. At least two such problems require concerted solutions:

- the setting of ***standards***, which allow inter-working of complements and reduce switching costs among substitutes; and
- the provision of incentives for ***complementary investments*** – that is, investments whose benefits flow to several distinct suppliers.

Addressing these problems in the context of rapidly evolving and uncertain technologies, industry structures characterised by ongoing changes in competitive positions, and markets with difficult to predict demands, poses a challenge to which there are no easy answers.

80. In short, the Australian economy, like its competitors overseas, is undergoing a major period of structural change associated with the continued development and rapid diffusion of information technology. Like other large-scale episodes of technological change, the widespread deployment of new networks, services and applications based on information technology involves overcoming the obstacles created by network effects and network externalities. The importance of direct network effects accentuates these obstacles – which are all the more difficult to overcome in the decentralised supply structures which now characterise advanced computing and telecommunications.

D.4 The challenge for competition policy

81. In practice, resolving the coordination issues described above involves extensive reliance on contracts, arrangements or understandings between suppliers. Moreover, this reliance is likely to become even heavier in the future.

82. The reason reliance on contracts, arrangements or understandings between suppliers will increase in the future is two-fold:

- the networks based on the integration of advanced computing and telecommunications are becoming ever more service- and application-rich; and
- the supply of the necessary complementary products will need to come from a wide range of distinct, but economically inter-dependent, producers.

83. It is important here to understand some basic aspects of the architecture of modern information technology networks. More specifically, in telecommunications technology, it is useful to distinguish three broad levels of supply: the *network* layer, which allows for connectivity between end-user points; the *services* layer, which manages that connectivity and defines its technical characteristics; and the *applications* layer, which defines and provides the functions and features perceived by the end-user.[10] For example, the copper pairs that link households to telephone exchanges in the Public Switched Telecommunications Network ("PSTN") form part of the network layer; the establishment and control of a switched connection on demand forms part of the services layer; and the use of that switched connection to engage in a conversation with the called party is an application usually referred to as 'voice telephony'.

84. In the PSTN (the network that provides telephony service), the suite of applications

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10 Strictly, these three layers are themselves comprised of a number of distinct functions specified as 'layers' in the Open Systems Interconnection (OSI) Reference Model. That model defines seven layers. The three specified here broadly correspond to layers 1 and 2, 3 to 5, and 6 and 7 respectively of the OSI Reference Model.

available has been largely limited to "plain old telephone services", though overlay networks have been used to extend the basic network's capabilities. In contrast, the networks that are being designed and built now are capable of carrying a very wide range of services and applications – and indeed will need to do so if they are to be commercially attractive. These networks therefore involve and require a rich supply of complementary products, both at the network (infrastructure) layer and in terms of services and applications.

85. Assuring the coordinated supply of complementary products will therefore become more important in future, thus making the management of network effects and externalities even more significant than it is currently.

86. At the same time, the supply of this set of complementary products will need to come from a wide range of distinct, but economically inter-dependent, producers. It is true that future networks will continue to display significant economies of scope as between the network layer and the provision of services. Additionally, there are reasons to believe that economies of scale will remain important in the supply of the network layer itself. However, these trends will not mean a move to an industry structure that is less decentralised. Rather, the scope for extensive product and service innovation, notably but not solely at the applications layer, will create extensive opportunities for entry and specialisation, leading to a 'network of networks' in which distinct suppliers provide complements at some layers while competing in the supply of substitutes in others.

87. It is the combined impact of these two forces – networks that are ever-richer in terms of the range of inter-working services and applications they require, and an industry structure that remains highly decentralised – that will underpin the ever greater importance of contracts, arrangements or understandings in assuring and structuring efficient supply.

88. For example, the development of third generation mobile networks – generally referred to as '3G' technologies – will require the coordinated development of physical infrastructures, software systems that control that infrastructure, and applications (mainly involving content) that make use of 3G attractive. As a range of suppliers will be involved in each of these activities, and the value of the investments made by any one supplier will depend on the investments made by the other suppliers, securing efficient levels of investment will require arrangements that appropriately allocate and reward costs and risks.

89. The question then is how competition policy will affect the costs and difficulties involved in putting these arrangements into place. The answer to this question is simple: Australian competition policy, as it currently stands, places substantial obstacles in the face of these arrangements.

90. This is true even insofar as these arrangements solely involve contracts, arrangements or understandings between suppliers of complements (that is, firms that are not directly in competition, at least in the market for the services covered by an arrangement). This is mainly because these arrangements, to be effective, will frequently involve various forms of exclusivity.

91. For example, were Telstra to invest in building 3G infrastructure, it may well want to contract with third party suppliers to develop applications, uniquely suited to Australian circumstances, that would make usage of this infrastructure more attractive, and hence increase take-up of the new service. In these circumstances, there would be clear efficiency incentives for Telstra to seek exclusivity in respect of that application, at least within Australia. At the same time, it might well be commercially advantageous for Telstra to require those consumers who wanted that type of application on Telstra's network to obtain that application exclusively from the software developer with whom it had contracted.

92. This course of conduct would encounter greater competition law difficulties in Australia than in any major jurisdiction overseas. As a practical matter, it is highly likely that the ACCC could force Telstra to seek authorisation for each of the conduct's components; indeed, insofar as the conduct involves third line forcing, it would have no option but to do so. This *per se* approach to third line forcing is unique in international terms.

93. The problems are, however, even more extreme than this simple example suggests. In effect, it is extremely rare for the parties involved in the joint supply of network services to be entirely complementary – that is, not to be competitors in any relevant market. Rather, it is the essence of network competition, as it has developed over recent years, that the parties involved compete in some services, while being suppliers of complements in others.

94. For example, Telstra and Optus compete in the supply of long distance telecommunications services. However, there are many areas of Australia (most notably in the less densely populated parts of the country) where they do not compete in the supply of local services, at least at present. In these areas, Telstra and

Optus supply complements – the Telstra local network is a complement to the Optus long distance service – ***and*** compete in the overall sale of telecommunications services to final consumers. In this situation, for Optus to access the complementary service it requires – that is, usage of Telstra's local network – it will need to enter into an arrangement with a competitor.

95. More generally, when (1) the economies of scale are greater in one network layer than another, and (2) it is efficient for the firm(s) supplying at that layer to also supply in the other layers, albeit in competition with specialised suppliers, then (3) the arrangements by which shared access is obtained to the scale-intensive layer will require some measure of agreement between competitors. The 'network of networks' that is emerging as part of the transition to a broadband world plainly displays each of these characteristics.

96. The development of 3G networks, for example, may well involve some degree of sharing of infrastructure costs between firms that then compete in the supply of high bandwidth mobile services. If these costs are not shared, the deployment of 3G networks will be deferred, perhaps indefinitely.

97. However, the arrangements involved in this cost sharing could, under the competition law as it now stands, face formidable obstacles. These obstacles come from the very wide reach of the *per se* prohibitions. Two elements are particularly important.

98. First, it appears that the deeming provisions of section 45A of the Act, which define a *per se* prohibition on price fixing, may be triggered by agreements over input costs, even when these agreements are essential for competition to occur in a different functional market. In other words, when two firms that compete in a downstream market (say, high bandwidth mobile services) agree on the terms on which one firm, which does not own or operate a 3G network, purchases access to such a network from the other firm, that agreement can be deemed to amount to price-fixing and hence, independently of any competition analysis, will breach the Act.

99. Extreme though this theory seems, it forms the basis for the ACCC's claims in its proceedings:

- against the National Australia Bank in respect of the setting of credit card interchange fees;[11] and
- against Pauls Limited, Malanda Dairy Foods and Australian Co-operative Foods in respect of a tolling arrangement involving the supply of milk processing services in the Northern Territory.[12]

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11 Broadly, in those proceedings, the ACCC has alleged that the National Australia Bank, by agreeing with other financial institutions on the level of interchange fees to be levied under credit card schemes in which it and those other institutions participate, has engaged in price fixing in breach of s45A of the Act. 'Interchange fees' are the fees charged by an issuer (the financial institution that issues a credit card to a particular consumer) to an acquirer (the financial institution that provides credit card transaction services to a particular merchant) for: (a) processing credit card transactions transmitted by the acquirer to the issuer; and (b) reimbursing the acquirer for the value of those transactions. The ACCC alleges that such agreements have the effect or likely effect of controlling or maintaining the level of merchant service fees that acquirers charge their merchant customers in exchange for supplying credit card transaction facilities. The interchange services provided by the issuer to the acquirer constitute an essential input into the credit card services provided by the acquirer to its merchant customer.

12 Generally, in these proceedings, the ACCC has alleged that the parties entered into an arrangement whereby Australian Co-operative Foods Ltd ("ACF") would ensure that Malanda Dairy Foods Limited ("Malanda") and the owner of the only commercial dairy farm in the Northern Territory would supply to Pauls Limited ("Pauls") all of the raw milk requirements of Pauls, ACF and Malanda for the production of packaged milk in the Northern Territory. Pauls would process and package all of the requirements of the parties to the arrangement of packaged milk products for sale in the Northern Territory at an agreed charge on the basis that ACF cease processing and packaging milk in the Northern Territory. The ACCC alleges that the arrangement had the substantial purpose of fixing, controlling or maintaining (or providing for such) of the price at which Malanda would supply raw milk (in competition with the owner of the only commercial dairy farm) to Pauls for processing into Pauls' and Malanda's products. The arrangements related to the fixing of the price of an essential input (raw milk) into the downstream production of packaged milk products. There is a close and direct analogy between the fixing of that essential input price and the

100. Secondly, further issues arise to the extent to which the arrangements involve, or could be construed to involve, exclusionary provisions.

101. For example, were Telstra to roll-out a 3G network, and to seek to host on that network third party providers of applications who did not themselves operate 3G networks, it may well be efficient for Telstra to impose on those third parties the condition that they not obtain similar services from other networks. Given that Telstra and those third party providers would then compete in the supply of the high bandwidth mobile services, this restriction could amount to an exclusionary provision and hence involve a *per se* breach of the Act.

102. Three aspects of section 4D of the Act make this possibility more than merely hypothetical. First, it appears, most notably from *Australian Competition and Consumer Commission v Visy Paper Pty Limited*,[13] that the phrase 'who are in competition with each other' can be read widely, thus covering arrangements between firms that are, at most, only potential competitors or compete very indirectly. Secondly, for the arrangements to be caught, the 'particular persons' from whom supply is being prevented, restricted or limited do not need to be competitors of either of the parties (a feature that distinguishes the Australian legislation from that in, say, the United States). Thirdly, the arrangements will be caught independently of any effect on competition, so long as they have "the purpose … of preventing, restricting or limiting" supply to, or acquisition from, the particular persons.

103. The result of the Act as it now stands, then, is to catch a wide range of conduct that seems essential to the efficient development and deployment of new communications and information technologies. This is paradoxical indeed, as its main impact is to favour vertically and horizontally integrated supply – which is not

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determination through commercial negotiation of the terms on which a firm supplying retail services over a network will obtain access to that network from a vertically integrated network provider.

13 *Australian Competition and Consumer Commission v Visy Paper Pty Limited* [2001] FCA 1075 (10 August 2001); (2001) ATPR ¶41-835 (at the time of writing, on appeal to the High Court of Australia).

caught by the prohibitions – while penalising precisely those decentralised arrangements that the competition laws might be thought to promote.

D.5 The scope for reform

104. It is true that authorisation is available for conduct that may breach the provisions of the Act that deal with contracts, arrangements or understandings. However, authorisation is costly for the parties and for society more generally. The issue then is whether the scope of the prohibitions is too wide, and if so, how that scope ought to be revised.

105. The current scope of the provisions to do with contracts, arrangements or understandings appears to reflect two broad sets of factors.

106. The first is a high level of distrust with respect to business practices which may be harmful, but often are not. It may well be that this reflects the circumstances of the time at which Australia's competition laws were enacted – circumstances characterised by an economy which had high levels of concentration, extensive protection from import competition, and widespread price-fixing. Nonetheless, the presumptions embodied in the provisions, most notably in respect of arrangements with respect to complements, now seem anachronistic, both in the light of the evolving economic scene and of our understanding of how the economy works.

107. The problems to which this first factor gives rise are then compounded by the second factor, namely a legislative preference for prescriptive and detailed drafting. This makes the Australian legislation far more specific in its coverage than the comparable legislation enacted by Australia's major trading partners. While this preference is often sensible, in this specific case it results in a greater level of prescription than seems consistent with the need to accommodate economic change. The fact that many of the Act's provisions are characterised by great complexity and lack of clarity can then result in the worst of all possible worlds, where it is easy to get caught by the prohibitions, but not at all certain quite how that catching will occur.

108. These issues are particularly acute in telecommunications. In part, this reflects the central role network effects and network externalities play in the development of new and innovative telecommunications services. However, no less important are the distortions that, in the Australian environment, arise from the interaction of the provisions of Part IV of the Act with those of Part XIB of the Act – again, a regime

that is unique in international terms. Under the 'competition rule' set out in Part XIB of the Act,[14] a carrier or carriage service provider will be in breach of the rule, and hence liable to extraordinary penalties, if it infringes any of the key provisions of Part IV of the Act.[15] The uncertainties and complexities that surround the provisions of Part IV with respect to contracts, arrangements or understandings therefore expose telecommunications carriers to especially great jeopardy. This has the potential to severely distort efficient behaviour, most notably behaviour aimed at correcting the network externalities discussed above.

109. Viewed in the light of contemporary economics and of the evolving circumstances of Australia's economy, it would seem desirable to cut through the overly prescriptive and excessively complex rules the current Act sets out. It may be useful, in this respect, to distinguish between changes which are likely to be acceptable on almost any reasonable assessment, and changes which are more far-reaching and hence controversial.

110. In terms of changes which are likely to be acceptable on almost any reasonable assessment, four issues stand out. First, the exclusionary provisions sections ought to be brought into line with the remainder of the Act, at the very least in specifying that the arrangement would only constitute a breach of the Act if it substantially lessened competition.

111. Secondly, both the exclusionary provisions sections and section 45 ought to be clarified to ensure that network joint ventures, in which agreements at one layer are necessarily used to permit competition at another layer, are not capable of being deemed on a *per se* basis, but rather require assessment in terms of a competition test. This can be done either by clarifying what is meant by a competitor for the purpose of the provisions, or by making the current joint venture exemption clearer in its coverage.

112. Thirdly, full line forcing should be treated no differently than any other vertical arrangement. Indeed, there is no case in economics for the current differential

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14 Refer sections 151AK and 151AJ of the Act.

15 Refer section 151AJ(3) of the Act.

treatment, which is quite unique in international terms.

113. Fourthly, the drafting of the relevant provisions should be simplified and clarified, and drastically so. There is, for example, no need for the baroque structure of section 47 of the Act. At the same time, if the current structure of the provisions is retained, the mechanisms that define the way those provisions interact with the Act's other provisions also needs to be simplified and clarified.

114. While these changes would go some way to improving the Act, and would especially help in providing business, consumers and those involved in the Act's enforcement with a greater degree of certainty, the question must also be faced of whether there is a case for going further.

115. There are strong grounds in analysis and experience for retaining a *per se* prohibition on horizontal price fixing, with scope nonetheless for authorisation. Horizontal price fixing as such rarely increases efficiency and usually harms competition. It is sensible to have a strong presumption against it.

116. There is also a case, though it is far less certain or compelling, for retaining a presumption against minimum resale price maintenance. Minimum resale price maintenance can facilitate tacit and overt collusion. The cases in which it is efficient may be sufficiently rare to be capable of being dealt with through the authorisation processes within the Act.

117. However, it is by no means apparent that there is a need in the Act for specific provisions in respect of vertical arrangements other than minimum resale price maintenance.

118. More specifically, it is not clear that, to the extent to which a firm's vertical arrangements reduce competition, they could not or would not be more appropriately dealt with under section 46 of the Act. Indeed, several important cases involving potentially anti-competitive vertical restraints – such as *Australian Competition and Consumer Commission v Universal Music Australia Pty Ltd*[16], *Australian*

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16 [2001] FCA 1800 (14 December 2001); (2002) ATPR ¶41-855.

Competition and Consumer Commission v Australian Safeway Stores Pty Limited (No 2)[17] and *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd*[18] – have been dealt with under the provisions of section 46 of the Act, with the section 47 claims being largely ancillary to those being made under the prior section. In practice, section 47 has increasingly become a means for pursuing section 46 claims but with different requirements in terms of the tests that need to be met.

119. Relying on section 46 alone would better accord with current economic understanding of the likelihood of vertical arrangements causing economic harm. Unlike some proposals in the United States, it would not treat these arrangements as *per se* legitimate; but it would substantially narrow the range of conduct likely to require regulatory scrutiny.

120. As well as being consistent with current economic understanding, such an approach may better accord with Australia's economic circumstances. In an economy open to domestic and international competition, it may be sensible to lower the degree of concern about arrangements that indeed can, but only rarely do, harm competition. The key role these arrangements play in securing competitiveness and efficiency in emerging networks underscores the scope for gains from reform in this area.

E Unilateral conduct

121. Unilateral conduct involves the use by firms of market power with the result of preventing, impeding or lessening the competitive discipline that rivals would otherwise bring to bear, with the ultimate result of reducing welfare.

122. While concerted conduct necessarily relies on contracts, arrangements or understandings between firms – that is, it rests on an element of consent – unilateral conduct may involve the firm acting alone (as in a predatory pricing case), though it can also encompass instances in which the use of market power expresses itself in an anti-competitive agreement (as in exclusionary agreements with respect to distribution channels).

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17 [2001] FCA 1861 (21 December 2001).

18 [2001] HCA 13 (15 March 2001); (2001) ATPR ¶41-805.

E.1 The analytical background

123. The precise definition and nature of unilateral conduct is a matter of continuing controversy. Firms in competition naturally seek to harm one another – indeed, as has often been observed, the attempt to damage rivals is an inherent part of the competitive process. Commentators at times seek to define anti-competitive conduct by distinguishing it from 'competition on the merits', but terms such as these can do little to clarify the bounds of the phenomenon.

124. From an economic point of view, an important feature of unilateral conduct is that it involves behaviour that is only profitable to the firm undertaking it because that behaviour will reduce the effectiveness of competitive constraints in subsequent periods. In other words, unilateral conduct, to be anti-competitive, (1) consists of conduct by the firm today that will enhance its market power tomorrow; (2) where absent that enhancement of market power, the firm would not choose to enter into that conduct; and (3) the overall effect is to reduce efficiency and welfare.

125. The conduct at issue may reduce the effectiveness of competitive constraints in future periods by:

- increasing the *costs* rivals would face in entering, remaining in or expanding in the market affected;
- reducing the *revenues* they could expect to obtain by so doing; or
- both.

For example, when a firm forecloses the sales outlets available to potential rivals, it makes it more costly for those rivals to expand output, and hence causes an increase in the market's equilibrium price. Equally, when a firm cuts price to levels at which even efficient rivals would not be profitable, it must be hoping to reduce those rivals' expectations of the incomes they could earn by being in the market, and hence only cause them to enter when demand is higher than it would otherwise need to be.[19]

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19 In other words, the entrant defers entry or expansion until demand is higher than the level at

126. In both these cases, and in anti-competitive unilateral conduct more generally, the firm engaged in the conduct expends sunk costs today for the sake of increasing the sunk costs rivals would need to outlay if they were to engage in competitive behaviour in future periods.

127. Although economists' understanding of the types of behaviour at issue has increased significantly in recent years, no simple, fully effective, means has been found of translating these concepts into a clear, operational test that can be used in framing competition policy. There is, in other words, no simple way of defining and identifying conduct that harms competition in a way that reduces welfare. Rather, it is widely accepted that each of the types of behaviour that may give rise to concern in some circumstances can also be quite consistent with the competitive process, and with economic efficiency more generally, in others.

128. For example, sustained price cutting by a firm which has a high share of output in a market and is faced with entry into that market may be predatory; but it may also be no more than would be done by any firm that risks the loss of the customer relationships and goodwill it has secured over the years. Equally, a firm may build an especially large plant so as to deter competing entry; but it may also be that the plant is being built at that size to take advantage of scale economies and avoid the higher costs that would be incurred in a program of incremental expansion.

129. Additionally and importantly, there is no *a priori* reason to believe that any of the types of behaviour that can in some instances raise concerns will generally do more harm than good. There are not, in other words, clear presumptions that can justify placing the burden of legitimating particular types of conduct on the firm engaging in that conduct. The situation here is therefore quite different from that in respect of concerted action, where there are strong grounds for presuming that collusion, for example, will harm the competitive process and hence ought generally to be prohibited.

130. Rather, if there can be any presumption at all, it must be that unilateral conduct, even when it seems deliberate and ruthless in its focus on gaining at the expense of rivals, is most often merely the reality and essence of competition. Discouraging

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which, absent the conduct, it would have entered or expanded.

such conduct would blunt the competitive process, and hence harm consumers and society in the longer run. As a result, controls on unilateral anti-competitive conduct need to be crafted with great care.

131. It is useful to consider the choices that arise in crafting these controls in terms of the approach adopted in statistical decision theory -- that is, the theory of decision-making in the face of uncertainty. In that theory, two types of errors that can occur in the process of considering a hypothesis are distinguished:

- "Type I errors", which occur when a hypothesis that should be accepted is rejected; and
- "Type II errors", which involve accepting a hypothesis that ought to be rejected.

The 'power' of a test is defined by its ability to maximise the chances of rejecting false hypotheses for a given risk of rejecting hypotheses that are true.

132. From the point of view of the long-term welfare of Australians, the costs of incorrectly labelling behaviour as anti-competitive that is in fact merely competitive are likely to be high. To the extent to which that is indeed the case, then society would be better off if the risk of Type I errors - in which the hypothesis that behaviour is competitive is incorrectly rejected - were kept to low levels. This inevitably involves accepting a greater total risk that in some instances, Type II errors will occur, in which behaviour that is in fact anti-competitive will go unsanctioned. The fact that the tests that can be developed for distinguishing competitive from anti-competitive conduct generally have relatively little 'power' merely makes this trade-off more acute.

133. In considering whether the costs to Australian society of Type I errors are likely to be high relative to the costs of Type II errors, it is relevant that most Type II errors will be self-correcting, at least over the longer term.

134. Australia now has a relatively open economy, with few regulatory barriers to entry and with reasonably efficient capital markets that are themselves well-integrated into global capital markets. There is no obvious deficiency of domestic entrepreneurship and to the extent to which domestic entrepreneurship proves inadequate, foreign investment can act to ensure that potentially profitable opportunities for entry and expansion are taken up. Australia's telecommunications industry, for example, is significantly affected by the presence of a number of major

foreign-owned firms, including Singapore Telecom, Telecom Corporation of New Zealand and Vodafone. Finally, a strong macro-economy, with sound structural fundamentals and a proven capacity for sustained growth, creates a climate conducive to the emergence and expansion of viable competitors.

135. The view that competition is inherently fragile, and that too aggressive behaviour (as in "cut-throat competition") may threaten its long term viability, is consequently no longer appropriate, if it ever was. All of this makes it more likely that, at least over the longer term, Type II errors will not stifle competition, though they can obviously affect its timing and extent.

136. At the same time, Type I errors may well impose costs that are substantial and durable. Economies in which firms are deterred from competing aggressively lose the potential for rapid change and adaptation, and hence move further and further from the frontier of world's best practice. Once this process has set in, it is difficult and extremely costly to reverse, as the experience of the European economies since the early 1970s shows.

137. The claim has at times been made that the risks associated with unilateral anti-competitive conduct are especially great in the context of network industries, such as those associated with advanced computing and telecommunications. Underpinning this claim is the argument that firms with market power in a network industry can somehow use that power to 'tip' competition in favour of their own network, at the expense of rivals that are no less efficient and indeed may be more so.

138. As a matter of economic theory, it may be that these claims cannot be dismissed. However, what is clear is that most of the accounts on which these claims are based rely on complex chains of assumptions, which may be plausible in some instances but often will not be so.[20] Additionally, and importantly, it would be widely

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[20] For example, where the facilities at issue in the network industry either are within an access regime, or can be brought within such a regime, then the risk of anti-competitive conduct may be relatively low. This is because even if the firm owning those facilities engaged in such conduct, say by cutting price to predatory levels, it would not be able to prevent future entry from occurring when it raised prices to the levels needed to recoup the losses it has incurred. The point here is that the assessment of the risk of anti-competitive conduct in

accepted that discouraging vigorously competitive behaviour in network industries can be even more costly than in other industries.

139. This is for two reasons. First, to the extent to which weakening the intensity of competition in network industries involves allowing a greater degree of duplication of fixed costs than would otherwise occur (as is often associated with the protection of inefficient competitors), it will impose a productive efficiency loss on society, in contrast to the allocative efficiency loss mainly associated with monopoly power.[21] Losses in productive efficiency are generally costlier to society than losses in allocative efficiency alone.[22] Secondly, if duplicated fixed costs are being covered,

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these industries must not be based on abstract theoretical constructs, but rather must be informed by a careful consideration of the industry's actual circumstances.

21 *Productive efficiency* refers to the extent to which output is secured at least cost. *Allocative efficiency* refers to the extent to which society's resources are consumed in producing the goods that are valued most highly. Achieving allocative efficiency involves ensuring that the goods produced are valued by those who consume them at no less than their opportunity cost. Monopoly will generally involve some loss in allocative efficiency, to the extent that prices at the margin of consumption exceed cost, since this will discourage some consumption that is more highly valued than the cost of the resources it requires. Monopoly also generally entails some productive inefficiency, in the sense that the restriction of output will cause the mix of inputs to depart from that which would occur in a fully competitive equilibrium. However, this is a second order effect, relative to the distortion associated with the output reduction. The bulk of the effects of monopoly are distributional – that is, they involve transfers from consumers to producers – with the loss associated with the allocative inefficiency generally being small in magnitude. In contrast, when fixed costs are duplicated, as would happen were vigorous competition discouraged in the network industry case, then there is a pure productive inefficiency, and incomes are reduced accordingly.

22 This is often put in terms of 'rectangles being greater than triangles', where the rectangle refers to the area of excess costs due to the productive inefficiency, while the triangle refers to the area under the demand curve foregone when price exceeds marginal cost. The intuition underpinning this statement is that allocative efficiency losses affect marginal demand whereas losses in productive efficiency increase costs (and hence reduce welfare) for all the units consumed.

prices must be higher than they would otherwise need to be. In other industries, unduly high prices merely affect consumers at the margin. However, in industries characterised by direct network effects, the value all consumers derive depends on the size of the network. Reducing the size of the network therefore imposes welfare losses not only at the margin but also on consumers overall.[23]

140. Finally, if it is difficult to distinguish competitive from anti-competitive conduct generally, it can be even more so in network industries. More specifically, the characteristics of network industries can impel types of conduct which, though they might seem anti-competitive, in fact are not. For example, each firm involved in competition in the supply of services for which network effects are important will have incentives to grow its own service as rapidly as possible.[24] This may well lead the firm to set prices very low relative to any benchmark of current costs, as it invests now in having low costs in the future. Distinguishing this 'penetration pricing' from predatory behaviour may well be difficult for enforcement authorities and courts. Yet preventing or deterring 'penetration pricing' would have very high social costs indeed.

141. As a result, arguments to the effect that special vigilance for unilateral anti-competitive conduct, and a lower threshold of proof for establishing such conduct, is appropriate for activities characterised by network effects are unconvincing. The relative costs of Type I errors in these industries are no lower than they are in the economy generally.

142. In short, it is indeed possible for firms with market power to use that power to harm the competitive process in ways that reduce welfare overall. However, there are no 'bright line' rules, or even simple tests, that can distinguish conduct that has this

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23 More technically, the deadweight welfare loss is not only marginal but also infra-marginal.

24 This is often described by saying that competition is likely to be 'for the market' rather than merely 'in the market', in the sense that each of the competing firms will be seeking to establish its service or network as the standard for the market as a whole. Competition 'for the market' can be every bit as intense – and indeed in some cases is more so – than competition 'in the market', as the entire competitive process is concentrated and telescoped into a shorter period of time.

effect from conduct that is merely vigorous competition. Additionally, any rules or tests that resulted in conduct that is merely vigorously competitive being penalised as anti-competitive, would impose high costs on competition and efficiency. As a result, the competition laws need to exercise great prudence in the control of unilateral conduct, balancing the need to prevent market power from being abused with the no less pressing need to ensure that firms are, and feel, free to compete.

E.2 Current competition policy approach and proposals for reform

143. Section 46 of the Act responds to the need for this balancing by imposing a series of hurdles that must be overcome before unilateral conduct can be found to be in breach of the section. These hurdles involve the threshold requirements that:

- the firm has a significant degree of market power;
- the conduct at issue involves taking advantage of that power; and
- the firm engages in the conduct for a proscribed purpose.

144. There is little reason to believe that section 46 of the Act has worked poorly to date. Individual decisions are inevitably controversial, as is the precise meaning to be given to individual aspects of the section. However, there are few decisions which seem so seriously flawed as to call into question the efficacy and utility of the section as a whole. Rather, the section has proved capable of accommodating the circumstances of individual cases, and the interpretation of the section by the courts has adjusted to advances in our understanding of the nature and consequences of anti-competitive behaviour.

145. Having said that, it is true that the current wording does not seem especially closely aligned with the section's underlying economic rationale. Anti-competitive conduct is of concern insofar as it reduces competition in ways that harm efficiency and welfare. This is not what is aimed at by the wording of the section as it stands, though it is not all that far from what the courts have read into the provision. Reflecting this apparent misalignment, there have been numerous proposals over the years to change the section into a prohibition on unilateral conduct that has the purpose, effect or likely effect of substantially lessening competition.

146. A major and unresolved difficulty associated with these proposals is that lessening

competition may not harm efficiency. For example, when a firm builds an exceptionally large plant, and thereby dissuades rivals from entering the relevant market, the firm's conduct may nonetheless lead to lower costs and ultimately lower prices than would otherwise prevail.

147. It could be argued that conduct of this kind – that lessens competition but enhances efficiency – would not involve 'taking advantage' of market power. This interpretation is at best uncertain, and arguably incorrect. There is, in this respect, the view the ACCC put in *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd*[25] that 'taking advantage' merely means that the conduct at issue is materially facilitated by the firm's market power. Under this interpretation, a firm that - thanks to its high market share - faced lower risks in building an especially large plant, with the effect of deterring entry or expansion by rivals, could be said to be 'taking advantage' of market power with the effect of substantially lessening competition.

148. Experience under the 'competition rule' set out in Part XIB of the Act is also highly relevant here. More specifically, the ACCC has consistently interpreted the 'effects test' set out in Part XIB in a way that focuses solely on impacts on competition, even in instances where the underlying conduct has strong efficiency justifications.

149. For example, the issue of whether the conduct was or was not efficiency enhancing played little or no part in the ACCC's consideration of Telstra's refusal to offer Internet peering to substantially smaller Internet Service Providers ("ISPs") with whom it competed. Rather, the claim made by the ACCC was that the conduct increased the difficulties these ISPs faced in competing with Telstra. Putting aside the merits or otherwise of that claim, the fact of the matter was that even then it was apparent in the market that peering was not an efficient way of structuring interconnection between larger and smaller ISPs.

150. Equally, efficiency considerations played no role in the ACCC's consideration of Telstra's proposed withdrawal of its Semi-Permanent Connection ("SPC") service. That investigation arose from uncertainty as to whether Telstra would continue to provide SPCs as an element of its Integrated Services Digital Network ("ISDN") suite of services, once the ISDN migrated from its previous mode of provision

25 [2001] HCA 13 (15 March 2001); (2001) ATPR ¶41-805.

(which was by means of a dedicated, overlay, network) to being supplied through Telstra's digital local exchanges.

151. Telstra was the only carrier internationally that offered SPCs; the reason it did so was to increase capacity utilisation on the dedicated facilities previously used for ISDN. As these dedicated facilities were being replaced by capacity shared with the PSTN, the continued provision of SPCs would be economically inefficient.[26] Moreover, the costs of that inefficiency were likely to be high, as the rapid growth of Internet-related traffic strained the supply/demand balance at local exchanges.

152. There were numerous users of SPCs, but Telstra had, over a period of time, made it clear that the future of the service was not assured. Alternatives to SPCs, that were more efficient in their use of network resources, were available. Moreover, those alternatives were within, or in the process of being brought within, the access arrangements set out in Part XIC of the Act. Hence, any pricing issues could be determined within the framework those access arrangements provide.

153. Despite these facts, the ACCC used the threat of Part XIB proceedings, with its risk of severe penalties, as a way of cementing the entitlements of the then users of SPCs. Underpinning the ACCC's claims in this respect was its view that the use of SPCs, regardless of its ultimate efficiency, enhanced competition in the markets for data transmission services.

154. A similar approach is apparent in the ACCC's investigation under Part XIB of the DC continuity complaint. At issue here was the use of lines that Telstra had provided essentially for telemetry purposes, to supply DSL. These lines could not be so used if the network was modernised;[27] moreover, their use for DSL created risks

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26 SPCs are effectively permanent circuits. They therefore tie up capacity even when they are not being used. The PSTN and the ISDN are both circuit-switched services, which means that they are designed to allocate resources on demand. Tying up capacity in the way SPCs do is therefore highly inefficient whenever peak demand is relatively close to the capacity available.

27 The lines could be used to provide DSL because they supported a continuous DC output from the customer's premise to the exchange on Telstra's network. Modernisation of the Customer Access Network generally involves providing a point of multiplexing between the

of interference, and could thereby undermine the effective carrying capacity of the network.

155. In practice, these efficiency concerns were not taken into account in the ACCC's analysis, which focused on impacts on competition. Rather, the ACCC's concern was with ensuring that existing competitors could continue to compete as they had in the past. Here again, the test applied, in considering whether competition was likely to be substantially lessened, was not whether Telstra's proposed course of conduct would increase efficiency overall, but rather and only whether there was an adverse effect on the extent of rivalry in supply.

156. It is not the merits of these cases that are at issue here; rather, the point is that they highlight the difference between a test that focuses on ***competition*** and one that is more widely concerned with ***efficiency***. What the cases plainly show is that conduct may be viewed as involving a taking advantage of market power in ways that lessen competition, quite independently of whether it does or does not promote efficient supply.

157. That the cases should highlight this point, and that the ACCC should act in a manner consistent with it, is entirely unsurprising, for the distinction between the concepts of competition and what promotes or lessens it on the one hand, and efficiency on the other, is central to Australian competition law.

158. As a result, it is likely that a test in section 46 that caught conduct that substantially lessens competition would expose firms, and most particularly those with a substantial degree of market power, to serious jeopardy whenever they undertook conduct that (1) increased efficiency, (2) was more readily implemented by them than by smaller rivals, and so (3) reduced the competitive effectiveness of those rivals. The economic consequences of exposing firms to this kind of jeopardy would be plainly adverse, all the more so as one of the costs of market dominance is the risk that firms will prefer a 'quiet life' to the uncertainties and difficulties involved in the aggressive pursuit of efficiency.

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customer and the exchange. At that point, an electrical to optical conversion occurs, which means that DC continuity is no longer available.

159. A number of approaches could be considered for addressing these difficulties with an 'effects test'. Two merit particular attention.

160. A first would be to create scope for authorisation of conduct that might otherwise breach section 46, on a par with the scope for authorisation that exists in respect of the other provisions of Part IV of the Act.

161. Any such proposal faces obvious and serious problems. Vigorous and aggressive competitive conduct, that might breach an 'effects test', is not an occasional and unusual event, as is the entering into of contracts, arrangements or understandings that may lessen competition. Rather, it is an ongoing event, in which firms make moves and countermoves. To force firms to seek authorisation of the various steps in the cut and thrust of competitive conduct would impose an unacceptable regulatory burden on management decision-making.

162. Additionally, it is absurd to think firms would willingly expose to the scrutiny of their rivals the details of the strategies they intended or hoped to implement. The public nature of authorisation, the delays it involves, and the scope for appeals, would create opportunities for endless gaming. Effectively, this would socialise the task of management, placing the ACCC in the position of making commercial choices for which it had neither the expertise nor the ultimate accountability.

163. It is consequently no surprise that the exemption process provided for under the provisions of Part XIB of the Act[28] has served no useful role. For exactly the same reasons, authorisation of an 'effects test' based section would not overcome any of the problems for efficiency such a test creates.

164. A second approach would be to include in the revised section 46 (or in an additional section which sat alongside the current section) a 'legitimate business conduct' defence, as exists under United States law.[29] This could act as explicit guidance in

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28 Refer Subdivision B of Division 3 of Part XIB of the Act.

29 See for example *United States of America v AMR Corporation, American Airlines Inc and AMR Eagle Holding Corporation 99-1180*-JTM United States District Court for the District of Kansas, page 94. According to *Multistate Legal Studies* 63 F 3d 1540 at 1550 (10th Cir 1995) (citing *Eastman Kodak Co v Image Technical Services* 504 US 451 at 483 (1992)) business activity is not

respect of the 'taking advantage' requirement, to the effect that conduct would not amount to a taking advantage of market power if it merely involved "ordinary business practices typical of those used in a competitive market".[30]

165. While this would be a more satisfactory solution than allowing for authorisation, it is not without its difficulties. The interpretation by the United States courts of what constitutes 'legitimate business conduct' is varied, controversial and uncertain. It is not clear whether the term refers to a defence, or is in fact a restatement, in the alternative and by exclusion, of the intended rule – that is, that what is being prohibited is conduct that is illegitimate.

166. Equally, the other references in the current Act to 'legitimate', as in the usage of the term 'legitimate business interests',[31] seem to have had little real bite to date in influencing decisions taken by the ACCC. This suggests that the term itself is of little help.

167. This is not surprising. Unlike concepts such as 'market' and 'market power', the term 'legitimate' has no particular meaning in economics, and hence is not well placed to guide the interpretation of economic law. It can merely do so to the extent to which a connection is implied to some other, better defined, set of concepts.

168. For example, it is possible to define the 'legitimate business interests' of the owner of a facility used to provide a service declared under Part IIIA or Part XIC of the Act as being those interests that are not illegitimate; and to consider that these interests are those that do not arise from or depend on the monopoly power such an owner may have. However, all that the term 'legitimate business interests' is then doing is

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"anti-competitive" so long as there is "a legitimate business justification for the conduct".

30 "Ordinary business practices typical of those used in a competitive market do not constitute anti-competitive conduct violative of Section 2": *Trace X Chemical, Inc v Canadian Industries, Ltd* 738 F 2d 261 at 266 (8th Cir 1984).

31 See, for example, sections 44X(1)(a), 44ZZA(3)(a), 44ZZAA(3)(a), 152AH(1)(b) and 152CR(1)(b) of the Act. The phrase 'legitimate interests' is also used in the Act: see sections 51AB(2)(b), 51AC(3)(b) and 51AC(4) of the Act.

replacing the fuller expression, here phrased somewhat loosely, 'interests that would characterise a business in a competitive environment'.

169. Equally, it might be inferred that 'legitimate business conduct' is simply conduct that is not illegitimate; and that conduct is illegitimate insofar as it in some way depends on monopoly power. While this would not be incorrect, it means that the term would add little to the section, as it simply begs the question of what constitutes 'conduct that depends on monopoly power'. The uncertainties involved in an 'effects test' would therefore persist, as would the potential tensions between the protection of competition and the promotion of efficiency.

170. In short, given the quite proper distinction the Act draws between competition and efficiency, changes to section 46 which made it a breach of the Act for firms with a substantial degree of power in a market to engage in conduct that had the effect or likely effect of substantially lessening competition could catch many forms of conduct that in fact make businesses more efficient and competitive. There are no simple or obvious remedies to the difficulties this would create and to the attendant economic costs.

E.3 The way forward

171. The language of section 46 of the Act as it now stands seems poorly aligned with the objectives of prohibiting anti-competitive unilateral conduct. However, it is by no means apparent that the manner in which those provisions have been interpreted is inconsistent with those underlying objectives. Rather, the section appears to have stood up well and, in particular, it has struck a not unreasonable balance between the various risks which prohibitions on anti-competitive conduct inevitably confront.

172. At least in part, the fact that the courts have been able to judicially interpret the section in a way that has been reasonably well aligned with the section's underlying economic objective has been facilitated by the fact that the section ***does not*** refer to a substantial lessening of competition test. Were such a test included in section 46, that section would then necessarily have been interpreted in a similar manner to the other competition test-based provisions of the Act – that is, in a way that plainly distinguishes competition from efficiency. Not having such a test in section 46 has made it possible for the section to be given a more flexible, economically-desirable interpretation in practice that recognises and accommodates the fact that efficiencies can arise from conduct that reduces competition.

173. It follows from this that there are obvious difficulties with the proposals for change – difficulties borne out by the experience of the 'effects test' under Part XIB of the Act. Although several ways of addressing these difficulties have been canvassed, they do not do well under careful scrutiny.

174. This suggests that great caution is needed in considering reforms to this section. While it may be that better wording could be found, the burden that proponents of change must meet has not, at least to date, been made out.

F Conclusions

175. It is not the objective of this submission to canvas the entire range of issues that arise from the Inquiry's Terms of Reference. Rather, this submission has concentrated on analysing the economic aspects of those issues that are of greatest relevance to Telstra and to other firms involved in the 'information economy'.

176. Seen in the light of this analysis, there are features of the Act that have stood up well to the test of time. Overall, the two stage approach adopted to contracts, arrangements and understandings – with consideration of competition impacts in a first stage, and scope for authorisation in a second stage of transactions that, though reducing competition, would yield net public benefits – is sound (although there is room to increase the timeliness and reduce the cost of authorisation). This two stage approach:

- recognises the difference between competition and efficiency;
- acknowledges the strength of the public interest in competitive markets; and
- broadly places the onus of proof in a manner consistent with the strength of that interest.

177. Having said that, the range of conduct that is capable and likely to be caught by the Act does seem unduly wide. The Act seems to embody presumptions with respect to vertical arrangements that may reflect the circumstances of its time, but are now out of step with economic analysis and with commercial reality. At the same time, the scope of the *per se* horizontal prohibition, though uncertain and controversial, also seems too broad, and may be especially constraining in respect of network joint ventures – that is, arrangements in which firms that intend to compete within a

network join in the supply of the network infrastructure by means of which their competition will occur.

178. At a minimum, these issues should be addressed by significant change to a number of provisions, including the sections dealing with exclusionary provisions, with the definition of joint ventures, the deeming of arrangements that fix, control or maintain prices and third line forcing. However, there would be a case for going beyond these changes to reviewing the Act's coverage of vertical arrangements as a whole. In particular, it would be worth considering simply repealing section 47 and allowing issues to do with anti-competitive vertical restrictions to be dealt with through section 46 of the Act.

179. As regards section 46 itself, the underlying objective should be that of prohibiting firms from exercising market power in ways that reduce competition and harm efficiency and welfare. That objective is not far removed from the manner in which the section has been interpreted, but is not explicitly reflected in the section's current wording. The issue this raises is whether the section's wording ought to be amended.

180. In considering reform proposals, it is important to note that there would be a high economic cost were the section amended in a way that created a serious risk of prohibiting conduct that, though vigorous and perhaps even ruthless, was merely part of the cut and thrust of competitive markets. It is also important to note that structural change, most especially the growing role of network industries, will make distinguishing anti-competitive conduct from conduct that may harm competitors but does not harm efficiency and/or competition, even more difficult in future. Finally, weight should also be placed on the fact that, despite the limitations of its drafting, the section as it stands has been interpreted by the courts in a manner which seems broadly reasonable.

181. Consideration of the main reform proposals highlights a number of important difficulties. At least under the current interpretations of the 'taking advantage' criterion, there are substantial problems with introducing an effects test into the section. In particular, an effects test might catch conduct which, though it lessened competition, did not harm efficiency overall. Indeed, experience with the effects test under Part XIB of the Act suggests this is a likely outcome. Neither providing an authorisation mechanism for section 46 nor introducing a 'legitimate business conduct' defence would seem readily capable of addressing these difficulties. As matters stand, the case for amending the section has consequently not been made

out.

182. The Act is undoubtedly one of the most important instruments of economic regulation affecting everyday economic activity in Australia. Over its now nearly thirty years of existence, it has helped reshape the Australian economy. A country which, when the Act was passed, had a sheltered, highly protected and regulated economy in which collusion was rife, is now fully integrated into economic activity worldwide and has markets that, by any international standards, are open and competitive.

183. The Act has played an important part in this transformation and has allowed Australians to benefit from exceptionally high rates of economic growth and rising living standards. However, the Act must also itself adjust to that transformation, if it is not to be an obstacle to economic progress in the years ahead. Tackling the issues identified in this submission should form part of the agenda with which that process of transformation must engage.

Annexure A: Historical context of the Act

The purpose of this annexure is to briefly set out the historical context within which the Act was introduced.

Generally, the Act came into being on the back of a populist movement concerned throughout the 1950s and 1960s with the concentration and cartelisation of Australian industry and, in the 1970s, with rapidly rising prices. In essence, the Act was introduced to serve consumer interests as a reaction to numerous structural problems.

In the United States, the concentrated involvement of the private sector in major industries, particularly rail, drove a populist movement to force the passing of competition laws around the turn of the 20th century. By contrast, in Australia, government provision of many major services made the utility of such laws at that time less obvious. The great Depression triggered a consolidation of industry in Australia and saw the rise of collusive practices as firms sought to secure minimum prices and some share of the markets that remained. These cartels and concentrated industries remained institutionalised over subsequent decades, even when business uncertainty had substantially declined.

Thus, high concentration has long been a distinctive feature of Australian industry. Through the 1950s and 1960s, Australian industry as a whole was far more concentrated than its American and British counterparts.[32] For example, of the 20 largest manufacturing firms in 1967, all but one was either a monopolist of a leading product or a leading firm in a fairly concentrated industry.[33]

The major industries of the time were characterised by stable markets, modest rates of innovation, and slow and infrequent entry and exit. High trade barriers protected these industries from the forces of international competition. Many industries were dominated by statutory monopolies (that is, protected from domestic competition by government-imposed

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32 Taperell, G Q, Vermeesch, R B and Harland, D J, *Trade Practices and Consumer Protection: A Commentary on the Trade Practices Act 1974 (Cth)*, (3rd ed), Butterworths Pty Limited, Sydney, 1983, pages 10-11.

33 Walker, G de Q, *Australian Monopoly Law: Issues of Law, Fact and Policy*, Cheshire Publishing, Melbourne, 1967, pages 13-14.

entry restrictions). For example, industries such as telecommunications, energy, domestic aviation, banking and insurance, as well as agricultural sectors such as sugar and egg marketing, all enjoyed substantial governmental protection from competition.

The 1965 Vernon Committee Report was the first of a series of Government-commissioned reports that drew attention to these structural problems. The Committee's findings on the problems faced by the Australian economy included the following:

- a proliferation of small-scale production facilities covering a wide range of products, thus foregoing gains from scale and specialisation;
- an excessive focus in the manufacturing industry on the domestic market, thus creating dependence on agriculture and mineral industries for export earnings;
- poor investment decisions and excessive manning in economic infrastructure;
- outdated or inappropriate technologies combined with low innovation and skill development; and
- a change-resistant production culture with a weak commitment to performance improvement.

Many of these structural problems could be traced back, whether directly or indirectly, to high trade barriers. Whilst these barriers had fostered industry diversification, they also sustained the proliferation of inefficiently small-scale production facilities, distorted resource allocation and diverted some energies away from competition and maintaining 'best practice' standards into political lobbying.

At the same time, trade association agreements establishing and maintaining restrictive practices were numerous and substantially unregulated. In 1961, for example, there were over 600 trade associations, of which an estimated 58-66% operated restrictive trade practices.[34] Collusive activities - including exclusive memberships, exclusive dealing,

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[34] Report by the Independent Committee of Inquiry, *National Competition Policy*, Australian Government Publishing Service, Canberra, August 1993, page 9.

collusive tendering and price fixing – were prevalent.[35]

While a move to introduce comprehensive and restrictive competition laws had been underway for some time, the real driving force behind the ultimate passing of the Act in 1974 was the inflationary pressure Australia experienced in the late 1960s and early 1970s. The acceleration in the inflation rate that began around 1970 increased consumer consciousness and pressure for any legislation that promised to curb prices.[36] Competition laws were seen as one mechanism to control prices, along with wage restraint.[37]

The drafters of the Act were also no doubt influenced by the interpretation of the United States' antitrust laws at the time. What has been called an "inhospitality tradition" prevailed in antitrust enforcement in the United States in the 1960s and early 1970s. Under this tradition, a presumption of monopoly 'explanations' for all unusual business practices prevailed, and the promotion of competition *per se* was given near exclusive pre-eminence over achieving economic efficiency.

Given all of these factors – the pervasiveness of concentration and collusion in the Australian economy at the time, the institutional arrangements that limited the scope for entry and competition and the pressing need to curb inflation – the drafters of the Act quite appropriately adopted an analytic framework for the Act based upon prohibiting a large range of suspicious conduct, while allowing for authorisation of certain conduct where a clear public benefit could be demonstrated.

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35 Walker, G de Q, *Australian Monopoly Law: Issues of Law, Fact and Policy*, Cheshire Publishing, Melbourne, 1967, pages 14-15.

36 Hopkins, A, *Crime, Law and Business: The Sociological Sources of Australian Monopoly Law*, Australian Institute of Criminology, Canberra, 1978, page 83.

37 Masterman, G and Solomon, E, *Australian Trade Practices Law*, Butterworths Pty Limited, Sydney, 1967, page 34.