Competition law and policy — theoretical underpinnings

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Introduction

Traditionally competition policy has been perceived fairly narrowly, with legal prohibitions on anti-competitive agreements, misuse of market power, and anti-competitive mergers. However, views have altered and competition policy is now perceived to have a wider role. Extension of competition law to government business activity and unincorporated businesses and its relationship to micro-economic reform will be integral to this discussion.

Reasons for competition policy

In most countries unrestricted competition is not a goal in itself. Competition generally promotes efficient allocation of resources and ultimately economic growth which benefits all participants in the economic process. However, the aim of competition policy is not exclusively related to efficiency. Competition should be thought of as a dynamic process of rivalry for sales between market participants and potential market participants, who invest capital in the production and development of goods and services. In addition, competition policy may encompass a broader set of policy objectives including consumer welfare, more equitable income distribution and encouragement of small business. However, there is a presumption in favour of competition unless it can be shown that efficiency or some other public policy goal overrides it.

Why is competition preferred?[1]

Central to competition policy is the assumption that there is something undesirable about an environment in which there is less competition compared with one in which there is more competition. Under normal circumstances, a competitive market structure will allocate resources in such a way as to produce the goods and services which consumers value most highly and are prepared to pay for, and it does so at the lowest possible cost in terms of resource use. Such a market is held to be efficient. In a highly competitive market, the individual firm is so small in terms of total market supply that it will have no impact on market price, irrespective of whether it chooses to produce a very large output or a very small output. Assuming that the firm sets out to maximise its profits, it will choose to produce the output which results in the lowest average cost of production. In this way, production efficiency is achieved. Similarly, as there are no

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[1] For a more comprehensive coverage see: F.M. Scherer and David Ross, 1990, *Industrial Market Structure and* Economic *Reform*, Houghton Mifflin Company, Boston, Chapter 2 or Dennis W. Carlton and Jeffrey M. Perloff, 1994, *Modern Industrial Organisation*, Harper Collins College Publications, Chapters 4 & 5.

barriers to entry/exit to a competitive market, resources will move into/out of the market in response to price changes which reflect the value consumers place on these products, thereby also achieving allocative efficiency.

On the other hand, if there is only one seller in a market, the monopolist will restrict output below the competitive level in order to raise prices. This means that, for corresponding technology, higher average costs will be incurred and so the industry is technically inefficient. Neither does the monopolist achieve allocative efficiency as too few resources will be allocated to production. X-inefficiency is commonly associated with monopoly.

Thus, competition policy is based on the belief that a competitive market will result in economic efficiency and increased social welfare. Ideally competition policy would be non-interventionist and non-regulatory. It would leave market forces to operate. In practice, however, this is not possible. Not all markets are competitive and even those that are competitive initially may change as a result of market conduct.

A difficulty encountered in competition policy/law is the possibility that conduct may impair static efficiency in the short run but may increase dynamic efficiency in the long run. This is especially difficult in a legal environment where a judge wants to see evidence of the outcome claimed. Yet, as it is dynamic efficiency which drives growth, on public interest grounds, this would surely be a priority. It is an issue which may arise in relation to privatised and/or deregulating industries.

Conduct of concern from a competition policy perspective

It follows then that there is concern amongst policy makers about conduct which results in an increase in market power or conversely which results in a substantial lessening of competition. Market power may be defined as the ability to 'give less and charge more'. It refers to a situation where a firm (or group of firms acting jointly) has discretion in its decision making because it is free from constraints imposed by competition[2]. The type of conduct which may be of concern for this reason can be categorised as:

- contracts, arrangements and understandings between competitors (horizontal) — such as market sharing, price setting;
- misuse of existing market power — where firms already have significant market power, most governments would not seek to make such power illegal. Rather they would seek to curb its abuse (but not seek to prevent the maximisation of profits);
- exclusive supply arrangements (vertical restraints) and other vertical relationships (such as resale price maintenance) — the problem here is that these may in some circumstances appear to be efficiency enhancing but there are usually other ways of achieving the same results without the associated reduction in competition;

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2 Trade Practices Commission, 1990, *Misuse of Market Power*, Section 46 of the *Trade Practices Act 1974*, pp 16ff.

- mergers and acquisitions — these are different in that they are the only conduct which has the potential to directly alter market structure (although other conduct may change structure indirectly).

The economic analysis of competition issues

Obviously not all (or even most) conduct of this sort would raise the concerns of the competition authorities. A test is needed to identify conduct which does give rise to concern. The test generally applied is:

- does the conduct result in a substantial lessening of competition in the relevant market or markets; or

- in the case of a firm with substantial market power, is there a misuse of that power. This might be more usefully expressed in the form: is the firm behaving in a manner which would be unlikely if it operated in a competitive market?

Economic analysis of competition — structural or strategic[3]

The conceptual framework for the analysis of competition issues raised by the types of conduct referred to above, is derived from the structure-conduct-performance paradigm which had its origins in the writings of E. S. Mason in the 1930s. A causal relationship between the three elements is assumed, such that structure determines conduct and this in turn determines performance, although backward linkages are recognised. The relevant market is defined and then the conduct at issue is assessed according to whether the structural features of the market indicate that as a result of the conduct there will be an increase in the firm's market power and consequently a substantial lessening of competition. The structural features of the market are the basis on which this conclusion is drawn. Little or no attention is paid to the dynamic interplay of rivalrous interaction between current sellers, as well as between these incumbents and potential entrants. Dynamic non-price rivalry is given scant attention. Few conclusions can be drawn about competition simply by looking at the structural characteristics of markets.

Corporate behaviour has become much more sophisticated and strategic as oligopolistic structures have increased in importance in the economy. Under oligopolistic conditions firms have an incentive to alter their relative position in the market through strategic behaviour. Strategic behaviour is not inherently anti-competitive. Generally, it is pro-competitive.

To date competition authorities have had difficulty dealing with most forms of strategic behaviour perhaps because they have sought comparatively simple rules. The primary difficulty is that a particular piece of conduct is often viewed in isolation where it is really part of a package of actions (e.g. innovation and learning by doing) and because generally such conduct is open to various interpretations (e.g. a price cut may be predatory or it may

3 Rhonda L. Smith and David K. Round; 'Strategic Behaviour and Dynamic Efficiency in Competition Analysis: A New Approach for Australia', 1997, Trade Practices Workshop, Glenelg; subsequently revised and published as A Strategic Behaviour Approach to Evaluating Competitive Conduct, 1998, *Agenda*, vol. 5, no. 1.

be intended to secure market share in order to achieve economies of scale or scope). It may be that the only way to assess strategic behaviour in relation to competition policy is to seek to identify whether it is likely to result in increased efficiency in the long run or whether it is likely to result in foreclosure of markets.

There can be little doubt that in most public utility businesses there is the potential for strategic behaviour. Of particular concern has been the role of strategic ownership and the ability to use this to influence prices. The solutions to date appear to be restrictions on cross ownership and ring fencing arrangements.

Market failure — authorisation[4]

The theory of market failure points to situations in which preserving or increasing competition may not be enough to promote good economic performance. An increase in competition will only result in an increase in efficiency in the absence of market failure i.e. anything which causes a divergence between the opportunity cost of the resources used in production and the value which consumers place on the good or service. A variety of factors can give rise to market failure including economies of scale and/or scope; externalities/spillover effects; public goods; transactions costs, including those associated with information asymmetries; and a non-competitive market structure.

Where economies of scale are such that unit costs continue to decline for all levels of output, market failure arises because of the non-existence of a competitive equilibrium. The consequence is 'natural monopoly'. Under such conditions, even if price were set equal to marginal cost to promote allocative efficiency, the monopolist would be operating at a loss. Under such conditions, price discrimination may be a second best solution. Natural monopoly is obviously a key characteristic of at least part of the supply chain of most public utilities.

Mergers may allow the merged firm to achieve economies of scale and/or of scope through pooling production and distribution facilities and these savings may encourage investment in research and development which reduce costs and represent dynamic efficiencies. However, to the extent that mergers reduce competition they may adversely affect at least short run static efficiency.

Where some costs or benefits associated with production or consumption are not paid for, i.e. where there are externalities, producers or consumers are able to free ride on others. Private costs and benefits diverge from social costs and benefits resulting in a misallocation of resources. An example would be where a firm invests in innovation only to have other firms copy the results without compensation to the original innovator. There are frequently externalities associated with traditional public sector activities — for example street lighting not only results in greater safety, it also increases personal security.

Transaction costs are another source of market failure. Market transactions involve costs of search, advertising and promotion, contract specification and monitoring. The transactions costs problem is essentially one of insufficient markets and/or monopoly

[4] For a fuller discussion see Australian Competition and Consumer Commission (ACCC), 1995, *Guide to authorisations and notifications,* AGPS, Canberra, November.

power over information. These problems tend to be greatest in situations of asset specificity, creating the possibility of opportunistic behaviour by purchasers, where transactions are frequent and/or where there is uncertainty. Asset specificity is again a feature of many essential facilities. Such transaction costs tend to encourage vertical integration or other vertical relationships. Where market power exists, vertical restraints or vertical integration may allow an extension of market power to another stage in the supply chain.

In the presence of market failure, although proposed conduct may result in a substantial lessening of competition, it may also give rise to various public benefits. These may include fostering business efficiency; industry rationalisation resulting in more efficient resource allocation and lower costs; increased employment or reduction or avoidance of increased unemployment; promotion of industry cost saving resulting in lower prices; promotion of competition; promotion of equitable dealings in the market; growth of exports; development of import replacement; economic development by encouraging R & D, mineral exploration and development etc; assistance to efficient small business which promotes competition; industrial harmony; improved quality and safety of goods and services and expansion of consumer choice; and supply of better information to consumers.[5]

Rather than lose these benefits a means must be found of determining whether they are sufficient to compensate for the loss of competition associated with the conduct. One means of dealing with this problem is to make increased efficiency a defence against a breach of the antitrust or trade practices provisions. Another is to authorise conduct which results in a net benefit to the community and thereby exempt it from the relevant provisions of the Trade Practices Act.

Changes to competition policy

The late 1980s and the early 1990s saw changes which had important implications for competition policy in Australia and especially for the treatment of public utilities. Difficult and increasing economic problems forced a reassessment of the performance of Australian businesses and also of government businesses. It was accepted that ways had to be found to make the former more internationally competitive. Both as part of this, but also as part of reducing the cost of government, it was also accepted that government business activity in many cases needed to be more market oriented. Solutions varied but governments generally embraced corporatisation, privatisation and deregulation.

Privatisation

A reassessment of why governments were operating particular businesses revealed opportunities for exit. Often in the past, identification of what was regarded as a natural monopoly component within an industry resulted in the government of the day concluding that it was in the best interests of the public if the whole operation was

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5 Australian Competition and Consumer Commission, 1995, *Guide to authorisations and notifications*, p. 18.

government run. This view has been substantially reassessed as is evident from the vertical separation introduced into the Victorian electricity industry for example.

A number of competition issues may arise in the context of privatising government owned assets. There is a temptation to introduce anti-competitive arrangements for these businesses prior to privatisation to increase the sale value of the assets. An important concern from a competition policy perspective is that government monopolies do not simply become private sector monopolies. Section 4G is relevant in this context. To avoid this, it is preferable where possible to divide up the assets to maximise the number of market participants. For example, ports may be able to be sold as separate docks. The competition authority also needs to be alert to re-aggregation of assets via subsequent mergers.

Where competition cannot be injected through disaggregation a monopoly situation continues it may be appropriate to provide for:

- access arrangements;
- undertakings; and/or
- prices oversight.

Hilmer reforms

As part of government policy to encourage international competitiveness, tariff reform was commenced in 1988 with across the board tariff cuts. It was also accepted that vigorous competition was an effective means of increasing business efficiency and so the government established the Hilmer review of competition policy. The key recommendations of this review were incorporated into the Competition Policy Reform Act. This effectively:

- made changes to Part IV of the Trade Practices Act to the effect that its coverage was extended to all unincorporated businesses and the shield of the crown protection of government business activity was removed; and
- Part IIIA, an access provision to the services of infrastructure facilities of national significance, was introduced.

As a consequence of these changes, government businesses became subject to the provisions of the TPA in exactly the same way as private sector activity. This put them at risk for conduct such as agreements between competitors if such agreements were likely to substantially lessen competition. As a consequence, the electricity industry sought authorisation for its code of conduct; the gas industry is following a similar course.

In this context Fisse and Simpson, 1995,[6] point to the constraint imposed on operations such as (former) public utilities and telecommunications companies via legislative

6 Brent Fisse and Andrew F. Simpson, 1995, ‘Compelled to Compete? Assessing Market Power in Regulated Markets’, *Competition and Consumer law review*, vol. 3, no. 2 pp 113–143.

provisions, and query whether this diminishes in any way their market power in a Trade Practices context.

Changes to the regulatory system can:

- restrict the decisions made by market participants;
- create competition where none existed before e.g. telecommunications and entry of new players;
- alter markets by bringing products which were previously not in close competition into competition e.g. removal of regulations which required that all wheat had to be carried by rail rather than by truck; access arrangements.

Other changes of significance which flowed from the Hilmer review were:

- legislative review
- requirement for competitive neutrality

Part IIIA of the TPA

A question which merits some consideration is the need for a separate access provision. One might ask: why, as under the Essential Facilities doctrine in the United States, could access not be adequately dealt with under Section 46 of the TPA?

The Hilmer report defines an 'essential facility' as a natural monopoly which cannot be economically duplicated and which occupies a strategic position in the industry which permits it to reduce output and/or service and to charge monopoly prices to the detriment of users (p. 239). Where the owner of the essential facility also operates in upstream or downstream markets in competition with those seeking access, there is obviously the possibility that the market power arising from ownership will be misused.

There are a variety of means by which this problem can be addressed and one of them is via the use of s. 46 of the Trade Practices Act. Both Queensland Wire Industries (QIW)[7] and Pont Data[8] could be interpreted as such an application. For s. 46 to be applicable it must be shown that:

- the facility owner has market power;
- there is a misuse of that market power; and
- the purpose is a proscribed purpose.

It has been argued that the essential nature of the facility establishes market power and that refusal to deal in this environment would be interpreted as taking advantage for a

7 Queensland Wire Industries Pty Ltd v The Broken Hill Pty Ltd Co and Amcor (1989), 167 CLR 177.

8 Pont Data Australia Pty Ltd v ASX Operators Pty Ltd (1991) ATPR 41–007.

proscribed purpose because in a competitive environment refusal would be unlikely i.e. the competition test of QWI would be met. However, s. 46 is a particularly difficult section of the Act to deal with. In QWI, it was argued that BHP's control of the steel and steel products market should be regarded as control of an essential facility and so, following the US essential facilities doctrine, BHP was required to supply Y-bar to QIW to allow it to compete in the rural fencing market. The Full Federal Court rejected this. On appeal, the High Court failed to address the issue.

Hilmer[9] concluded that s. 46 could not adequately address the access problem because:

- the inability of s. 46 to deal directly with monopoly pricing that is not for a proscribed purpose;
- the evidentiary problems of proving in court that refusal to supply on reasonable terms is for a proscribed purpose;
- the cost, time and risk involved in obtaining a court resolution of a commercial dispute;
- doubts about the ability of the courts to determine optimal pricing, and terms and conditions of access to essential facilities.

The last of these is of particular concern. The decision of Wilcox J. when he ordered marginal cost pricing in relation to Pont Data clearly illustrates the lack of desire or expertise of judges to set prices.

An alternative to relying on s. 46 is to create special access rights. An example is the *Telecommunications Act 1991* which established the right of any carrier to connect its facilities to the network of any other carrier and have its calls carried and completed over that network. However, this still begs the question of how the access price is to be determined.

Part IIIA of the Trade Practices Act is in some respects an intermediate position. It establishes a right of access with certain specified conditions. The conditions which the National Competition Council (NCC) must find in order to recommend Declaration by the relevant minister under Part IIIA are set out in s. 44G(2) of the TPA:

> (a) that access (or increased access) to the service would promote competition in at least one market (whether or not in Australia), other than the market for the service;
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> (b) that it would be uneconomical for anyone to develop another facility to provide the service;
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> (c) that the facility is of national significance having regard to:
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> (i) the size of the facility; or

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9 Report by the Independent Committee of Inquiry, 1993, *National Competition Policy*, AGPS, Canberra, August, Chap 11, pp 239–268.

(ii) the importance of the facility to constitutional trade or commerce; or

(iii) the importance of the facility to the national economy;

(a) that access to the service can be provided without undue risk to human health and safety;

(b) that access to the service is not already the subject of an effective access regime;

(c) that access (or increased access) to the service would not be contrary to the public interest.

Part IIIA provides for access either via Declaration, with pricing and other conditions to be negotiated between the parties or failing agreement provision is made for arbitration. Alternatively, the facility owner can provide an undertaking to the ACCC in relation to the terms and conditions on which access will be provided.

There will undoubtedly be a variety of problems/issues in relation to Part IIIA but at this stage it is too early to make much comment. Of some significance is the role of the NCC which recommends Declaration or not to the relevant minister but the minister may decide to reject the recommendation for various reasons which are unrelated to competition issues. In relation to the Declaration process, as undertaken by the NCC, difficulties may arise due to the requirement to establish an increase in competition in 'a separate market'. [10]

Direct regulation

Regulation has been defined as the use of a government's power to coerce 'for the purpose of restricting the decisions of economic agents'.[11] Direct regulation may be appropriate where the government is desirous of achieving some social objective or where competition is absent or weak and is unlikely, at least for some time, to develop. The latter may be because activities are being deregulated and/or privatisation of formerly government owned assets is occurring. In Australia, competition policy can normally be described as general regulation, that is the framework is provided but specific requirements or directives in relation to particular decision variables is avoided. There are, however, exceptions. Regulation in many areas can be seen to be in conflict with the aims of competition policy, e.g. when it results in price fixing, market allocation. The aim of the review to be carried out by all governments of their legislation as it affects competition, it to remove these anti-competition effects subject to certain conditions. There are also other well documented problems associated with direct regulation and these are briefly outlined below.

Costs

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10 Rhonda L. Smith and Jill E. Walker, 'Part IIIA, Efficiency and Functional Markets', Competition and Consumer Law Journal (forthcoming).

11 W. Kip Viscusi, John M. Vernon and Joseph E. Harrington Jr, 1996, Economics of Regulation and Antitrust, MIT Press, p. 307.

It is generally accepted that in relation to any regulation the benefits resulting from it must exceed the costs associated with it. The costs of regulation include compliance, administrative and enforcement costs. In addition, direct regulation is likely to result in distortions as illustrated by the Sites Act in the petrol industry.

General v industry specific regulator

When a decision is taken to impose direct regulation on industry, a secondary issue is whether oversight of the regulation is via a general body such as the competition authority or via an industry specific regulator. A general regulator provides greater consistency in relation to competition policy, probably requires less resources to operate, and is less susceptible to industry-capture and empire building. However, a general regulator lacks the detailed technical expertise to understand the operation of the industry. As a consequence expensive additional staff may be needed and even this may not adequately address the issue. Consultancies are a possible solution. In Australia (in contrast to the UK) the various governments have in most cases deliberately rejected specialist industry regulatory bodies. As a consequence the non-technical aspects of Austel, the specialist telecommunications were subsumed into the ACCC.

National v state regulators

Another issue to be decided is whether regulation should be at a national level or state level. Most of the industries, such as the utilities, that are of concern in this respect are either national, are moving toward becoming national or are involved with at least some other states. Problems associated with state based regulation include:

- the risk of inconsistent decision-making where there are a number of separate state regulators.
- it is likely to be more costly, less efficient.
- there may be difficulty finding sufficient suitably qualified people to fill the regulatory roles in these offices.

In reality, Australia has a mix of national and state regulation and of general and industry specific regulation. Specific regulation has been chosen in some areas such as telecommunications but the economic/competition aspects are the responsibility of the general competition regulator.

Direct price controls

The task of competition policy should not be to replace the market, but rather to create an environment in which it can function better. Nevertheless, where markets are not competitive or where the product is one with significant implications for the cost structure of the economy, some form of prices oversight may be appropriate. If lower prices are seen as a worthwhile policy aim, then one element of competition policy may be direct price controls. Especially where monopoly is prevalent, or at least where market power is widespread, there may be a temptation to think that the simplest way to overcome the problem is to regulate prices. This is likely to be the case where public utilities are involved. In many of the public utilities, there is a significant degree of market power, whether they are in public or private ownership.

A major problem with this approach is that it leaves the regulators to determine the price. The track record of price setters is poor. Usually prices are set on the basis of cost plus a return so price increases are justified by and related to cost increases. This provides little incentive to increase productivity and efficiency. Linking prices to the inflation rate less a discount factor to encourage productivity improvements, is one way of addressing this problem. Alternatively, instead of directly setting prices, the authorities might set a maximum rate of return which can be earned: anything above this would incur a tax surcharge of 100 per cent. Each of these approaches has problems and they will be addressed in later sessions of this conference.

Conclusion

In conclusion, competition policy and competition law are not about removing or outlawing monopolies. However, they are concerned with preventing the abuse of existing market power and about maintaining a competitive market structure. The basis for this is the acceptance that generally such a market structure results in economic efficiency and encourages economic growth. Nevertheless, an effective competition policy should include provisions to deal with market failure where the promotion of competition will not necessarily result in an efficient outcome. The traditional approach to competition policy was structuralist, but increasingly it is recognised that to allow adequate consideration of dynamic efficiencies strategic behaviour may need to be analysed.