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Some Economics of a “Misuse of Market Power”[1]

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Key Points

- Changes to Australian competition law on misuse of market power are likely to come into effect soon. These changes mean that certain types of business conduct by larger businesses will be assessed in a new way.
- Conduct will now be prohibited if it has the effect of “substantially lessening competition.” Exactly what this means in legal terms will remain somewhat uncertain until the courts have been asked to apply the new legal test in different circumstances.
- As a filter, the new test might appear to catch types of business conduct that are often pro-competitive, and many were concerned that the new test could lead to withdrawn competition. We briefly describe techniques from economics that can distinguish conduct that is more likely to be anti-competitive or to lessen competition.
- An important part of economic tests is whether a price increase occurred, or was likely to occur, following a change in competitive conditions that was caused by the conduct, including when a competitor exits from a market. This aspect is similar to the current legal tests used to evaluate mergers, which can indicate when a merger is more likely to be closely scrutinised.

Background

Australia’s competition laws include a prohibition known as a “misuse of market power” that only applies to businesses with a “substantial degree of market power.” The law is designed to deter types of business conduct that are anti-competitive. In basic terms, this means conduct that does not tend to win customers through a better offer, but instead acts to prevent or hinder the process by which customers receive other offers.

Changes to the law will soon take effect that provide for a new way for this conduct to be assessed. It will now be possible for conduct to be considered illegal if it has the "purpose, effect or likely effect of substantially lessening competition."[2]

Pro- or Anti-Competitive?

Many types of business conduct that could be caught by this law also look very much like pro-competitive behaviour. So, without a clear understanding of where the goal posts are located, it could be tempting for businesses to opt for the safer route and curtail pro-competitive behaviour. This would probably harm consumers in the end, particularly because the law only applies to larger businesses, which often drive competition through lower prices and innovation.

This concern was expressed by a substantial number of submitters during the recent review of this law.[3] A particular worry is that existing court guidance will be lost after the changes come into effect. Until now, courts have tested the previous wording of the law across a range of cases and found that, in order for conduct to be illegal, it had to represent the firm "taking advantage" of its market power.

Many thought that this provided some measure of clarity and certainty to businesses managers. For them, it meant a fairly simple "green light" if a firm without market power could (or would) also undertake the same conduct.[4] So, for example, if strong price discounting caused other potentially less efficient firms to close down, or exit a market, business managers could take comfort knowing that competing hard on prices would be no different from what smaller firms do.

Now, the new test is based on the effects that the conduct has on competition, which could at first seem concerning to business managers. On the face of it, any exit of a competitor could be viewed as a substantial lessening of competition, even when it happens as a result of more efficient firms passing on lower costs through price competition.

In reality, the way markets work is not as simplistic as this, and economics explains clearly how the exit of firms is not always anti-competitive.[5]

In the remainder of this article, we describe how economists view a substantial lessening of competition in relation to these types of conduct. In particular, we describe the types of evidence that an economist would tend to use to try to infer whether or not conduct is likely to be anti-competitive. We will not attempt to cover the wide range of conduct that the law could potentially apply to. Instead, we focus on two very common examples: predatory pricing and product bundling/tying. Our key goal is to describe aspects of the economic perspective that we hope will be helpful to business people thinking about the new laws.

Predatory Pricing

Predatory pricing describes a situation where low prices are used to eliminate or exclude one or more competitors from a market. This conduct (by a firm with substantial market power) will be prohibited under the new test if it has, or would be likely to have, the effect of substantially lessening competition (also known as an "SLC").

Given that this law is new, the courts will develop more guidance about what an SLC from predatory pricing actually means in practice. But one important feature of this guidance will almost certainly be that there should be a way to distinguish price discounting that was or is more likely to be pro-competitive.

The SLC concept has been applied by the Australian Competition and Consumer Commission (ACCC) and the courts for a substantial length of time, most commonly in relation to mergers.[6]

Put simply, a merger is evaluated using an SLC test by comparing the state of competition assuming that a merger proceeds, with that of a "counterfactual" scenario in which the merger does not proceed. The two scenarios are compared in terms of prices, or other aspects of competition, such as quality or service levels.[7] If the price, for example, is likely to be 5% or 10% higher, then the merger might fail the SLC test.[8]

For predatory pricing, the key is to distinguish between whether a competitor's exit was the result of a predatory strategy, or for another reason, such as the exiting firm just not operating as efficiently. Economics can help in making this distinction.

A way of making this distinction in economics is if there is evidence of 'recoupment.' This refers to the "payback" period of profits resulting from the success of the predatory strategy, after the "preyed upon" firm leaves the market.[9] Evidence of recoupment is important for economic analysis because it would suggest a rational business profit motive for the allegedly predatory conduct.

Recoupment is also important because it would also reflect one outcome of an SLC associated with predatory pricing. As with a merger, higher profits would generally accompany an SLC, particularly when the SLC consists of the firm raising prices. Because these higher profits are consistent with recoupment, to an economist, the price rise, or reduction in quality, would identify the SLC in an economic analysis of predatory pricing, and not just the reduction in the number of competitors.

Profit Sacrifice

Business people understand well how to make investments that pay off. For example, a new business may run at a loss, or a product can be priced at an "introductory" level. These are investments that are usually pro-competitive because they could generate enough interest and demand to establish the business and to reach a sustainable scale. Pricing bundles of products together also usually follows an investment logic, and we will discuss bundling below.

So, the general idea of sacrificing some near-term profits for a later return is commonplace and usually makes good business sense. What is less common in most markets is the hope of creating conditions later that allow price increases above the competitive level. This is because continued competition limits any real prospect of that outcome, even if some competitors could successfully be forced out through low pricing. This is a key economic reason that the law here and elsewhere in the world applies only to firms with market power. For firms subject to continued strong competition, low pricing aimed at forcing out competitors in order to raise prices is just too remote of a possibility.[10]

On the other hand, for businesses that could be assessed as having market power, competition authorities often first investigate whether price discounting was or is likely to involve a substantial and sustained sacrifice of profit.[11] This may be enough to suggest whether any further investigation for predatory pricing is warranted, because it could suggest whether any investment was or is being made.

Even at this initial stage, there are a number of complex questions about the correct measure of costs. A measure of costs will need to be compared to the price at which the goods or services were supplied in order to determine whether profits were sacrificed. One question, for example, is should the price be compared to the firm's variable costs only, or should other costs also be counted, such as costs that could or would be avoided in the absence of the pricing conduct?

As yet, the ACCC has not outlined the cost measures that it might use to evaluate profit sacrifice. From economics, a suggestion would be that in most cases (but not always), prices set above average variable costs, plus other avoidable costs, are likely to be on safe ground. At prices above these levels, no type of avoidable sacrifice of profits is indicated, which could otherwise make economic sense as a predatory strategy.[12]

Recoupment of Profits

If there is evidence that a business with market power made a substantial sacrifice of profit, then effects of the business's conduct on the marketplace may get a closer look by a competition authority like the ACCC. From an economist's perspective, this part of the analysis could be expected to focus more closely on the actual or potential for recoupment of the earlier sacrificed profits.

To put this in more concrete terms, we can look more closely at the examples of conduct provided by the ACCC in its framework of guidelines about the laws.[13] Two of the examples relate to pricing conduct; a newspaper example that the ACCC indicates would be concerning, and an example involving a retail chain, which the ACCC indicates would not be concerning.

In the first example, a regional newspaper business responds to the entry of a competitor by cutting prices.[14] The incumbent firm "does not cover its costs … [and] persists with its reduced [prices] for 12 months incurring substantial losses."[15] After the new entrant closes operations, the incumbent firm raises its prices to their original level.

A second example also describes pricing conduct that leads to the exit of competitors, but in circumstances the ACCC states it would consider to not breach the new law.[16] One clear distinction from the first example is the absence of any recoupment.

In this second example, a national retail chain opens a new store in a regional area. As a result of "operating a retail chain, the firm is also able to achieve substantial efficiencies … This enables the store to offer low prices to customers, while operating profitably. Some existing small retailers in the town are unable to match the retail prices offered by the firm and become unprofitable and close."

An important fact to an economist in this example would be that the new store continued to be operated with a retail product offering and prices that were consistent with other existing stores in the chain. This is an indicator that there was no recoupment. So, there is no suggestion that a subsequent price increase or other changes to the retail offer occurred that were enabled by the exit of smaller retailers.

In the first example, the exit of the rival newspaper appears to have enabled the incumbent to subsequently raise its price. This could represent recoupment if the exit was caused by the earlier profit sacrifice, and could provide an economic basis to infer that the price cutting was consistent with a predatory pricing strategy. By contrast, in the retail chain example, there is no evidence that competition was lessened because there was no price increase or other signs of a lessening of competition, whether or not this was caused by the earlier price reductions.

Despite all we can make from these examples given by the ACCC, a significant level of detail remains unknown.[17]

For example, in this newspaper hypothetical, what would make the lessening of competition "substantial"? From a practical perspective, were consumers actually harmed by the price discounting, if the subsequent price increase only reached the price that consumers were already paying before the entrant appeared?

There could be an argument that the conduct was nonetheless harmful to consumers because in the counterfactual, prices would have been lower and more competitive over the longer term, due to the entrant not being forced out of the market by the shorter term below-cost pricing. This might at first seem like an argument for higher prices, but it could be aimed at protecting lower prices over the long term and other benefits from competition which may have continued beyond the point that the entrant closed its operations.

The reliability of predictions like this would be tested by the courts, and this could limit the types of competitive impacts that can be proven. Just as in cases where mergers are challenged, the court will be asked to weigh the possibility of different counterfactuals and prices that can have different likelihoods of unfolding. With less certainty about the correct counterfactual, a court could be more inclined in circumstances like the ACCC's newspaper example, to adopt an assumption that the pre-entry price would have continued in the counterfactual.[18]

Summary on Predatory Pricing

Legal guidance for business will evolve as Australian courts consider what an SLC from predatory pricing actually means in practice. From an economist's perspective, the key suggestions are that:

- It should be unlikely for companies to face predatory pricing allegations for supplying at prices above average variable costs, and even less so when other avoidable costs are added.
- As for mergers, the exit of a competitor does not necessarily imply that a substantial lessening of competition will occur, because there can be a range of other factors that ensure that aspects of competition, such as quality or service levels, are maintained.
- The concept of recoupment is equivalent to a substantial lessening of competition that has been enabled by a significant and sustained sacrifice of profits.

Bundling or Tying

Product bundling or tying is another type of business practice that can now be assessed under an SLC test. Like for predatory pricing, the economic analysis shows that bundling is more often pro-competitive, and uses a very similar logic to determine whether the effects in the market are potentially anti-competitive.

Bundling or tying refers to the practice of making two or more goods or services available for purchase together for a specific bundled price. For example, mobile phone providers offer consumers both a telephone service and a mobile handset together at a combined price.[19] Tying also refers to products being sold together, but applies when at least one of the products is not available separately.

The practice of tying and bundling products is widespread and usually reflects competitive efforts to provide greater customer convenience and value. Like in the example of the mobile phone service and handset, customers may appreciate buying the set of products together. And economics shows that in general, bundling is pro-competitive and should not be discouraged.[20]

A given bundle can be quite successful and result in the bundling firm outcompeting its rivals. As with predatory pricing, this can cause the exit of firms from an industry, so it is important to understand how to distinguish bundling that has potentially anti-competitive effects.

The economic analysis of bundling would indicate that there may be anti-competitive effects when there is evidence for every one of the following:

- The bundling firm has market power in one of the products in the bundle;
- the bundling strategy hindered the ability of rivals to compete; and
- the bundling firm could subsequently raise price or lower quality, without worrying that its rivals would be able to re-expand.[21]

Notice that, as for predatory pricing, the economic analysis of the conduct could establish that it was anti-competitive if it enabled a substantial price increase, or equivalently, a substantial lessening of competition. To economists, this price increase would reflect the rational business profit motive or "payoff" that provides a potential basis to infer the bundling was consistent with an anti-competitive strategy.

Competition authorities can apply analytical techniques to the evidence of bundling or tying conduct prior to a full analysis of the effects or potential effects on competition.[22] The focus is generally on the design and price structure of the bundle, and whether the choice to include a component, and the bundled price, is likely to have caused (or did cause) a competing firm to withdraw from a market. For example, the pricing might be such that an equally efficient competitor loses market share, perhaps to the point it is sub-scale, or to the point its marginal costs rise making it less competitive.[23]

One technique to make this assessment is known as the "discount allocation test." This test calculates an "imputed" price for the component of the bundle which is also sold by a competing firm. The imputed price is calculated by subtracting the value of the bundled discount from the price the bundling firm sells that product for separately. The test is then to compare this imputed price to an appropriate measure of the bundling firm's cost for the component product in the bundle.

To see more clearly how this works, we can add some hypothetical numbers to Example D at Table 1 from the ACCC's framework guidelines document.

In the ACCC's example, "Monopolist" is a firm that has the patent over the active ingredient in the only drug (Drug A) that can treat a common heart condition. The patent for Drug A lasts for another five years, and as in the ACCC's example, the assumption is that Monopolist has a substantial degree of market power in the supply of drug A.
Monopolist also has the patent for another drug (Drug B) that treats a different heart condition. The patent for Drug B is about to end. Manufacturers of generic drugs, such as "Rival," are making plans to manufacture a generic version of Drug B.

Monopolist decides to alter its selling practices, by offering Drug A and Drug B as a bundle with a discount. Monopolist also continues to sell Drug A and Drug B at standalone prices.
The discount allocation test works by comparing the standalone and bundle prices to the incremental costs of production for the different drugs. Some example values are provided in the following table.

Table 1.

Cost/Price	Value ($)	Description/Comment
$c(A)_{monopolist}$	25	Monopolist's incremental costs to produce Drug A.
$c(B)_{monopolist}$	15	Monopolist's incremental costs to produce Drug B.
$c(B)_{rival}$	15	Rival's incremental costs to produce Drug B. This is assumed to be equal to Monopolist's incremental costs to produce Drug B.
$p(A)_{monopolist}$	50	Monopolist's price for Drug A on a standalone basis.
$p(B)_{monopolist}$	30	Monopolist's price for Drug B on a standalone basis.
$p(A+B)_{monopolist}$	65	Monopolist's price for the bundle of Drug A and B.

The discount allocation test makes the following comparison:

$$p(A+B)_{monopolist} - p(A)_{monopolist} \geq c(B)_{monopolist}$$

Based on the assumed costs and prices shown in the table above, the bundled pricing in this example passes the discount allocation test.

This shows in practical terms how the structures of the bundled and standalone prices make it possible for any customer to buy the separate pieces of the bundle from either Monopolist or Rival. This would mean buying Drug A from Monopolist for $50, and Drug B from Rival firm for $15, giving the same price of $65 as if the entire bundle was bought from Monopolist.
Given this possibility, it indicates that Rival has not been excluded from making any sales to these customers because of Monopolist's chosen price structure.

Additionally, at these prices Rival is able to cover its incremental costs, assuming it is at least as efficient as Monopolist.[24]

Passing the discount allocation test should provide some comfort for Monopolist. However, even if the pricing failed the discount allocation test, for there to be an effect of substantially lessening competition in this example, it would be necessary to show that after excluding Rival, Monopolist could or did subsequently raise prices or lower quality, without being prevented by Rival actually re-expanding or having the ability to re-expand.

Summary on Bundling/Tying

Similar to predatory pricing, the economic analysis of bundling or tying conduct suggests that:

- Bundled pricing that passes the discount allocation test should be less likely to attract close scrutiny from the ACCC.
- For mergers, the exit of a competitor does not necessarily imply that a substantial lessening of competition will occur. Similar to recoupment, if a competitor is excluded by the bundling, there could be an effect of substantially lessening competition if a subsequent increase in price or lowering of quality occurred.

Conclusions

- There are analytical techniques from economics available to assist businesses with market power to distinguish business conduct that is pro-competitive from conduct that is anti-competitive.
- In our view, it seems likely the way that these types of business conduct could be assessed under the new law will share some similarities with the way mergers are currently assessed:
    - For example, it is likely to be important that the correct counterfactual is used when assessing the impact on competition.
    - Additionally, as in merger analysis, the exit of a business from the market is unlikely to necessarily mean there is an effect of substantial lessening competition—what matters are the longer-term outcomes for consumers.

Notes

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2 The conduct could also be illegal if it has the purpose of lessening competition. We will focus on the effects part, which is the new aspect of this law. When enacted, the new form of sub-section 46(1) will read:

(1) A corporation that has a substantial degree of power in a market must not engage in conduct that has the purpose, or has or is likely to have the effect, of substantially lessening competition in:

(a) that market; or

(b) any other market in which that corporation, or a body corporate that is related to that corporation:

(i) supplies goods or services, or is likely to supply goods or services; or

(ii) supplies goods or services, or is likely to supply goods or services, indirectly through one or more other persons; or

(c) any other market in which that corporation, or a body corporate that is related to that corporation:

(i) acquires goods or services, or is likely to acquire goods or services; or

(ii) acquires goods or services, or is likely to acquire goods or services, indirectly through one or more other persons.

as per the Competition and Consumer Amendment (Misuse of Market Power) Bill 2016.

3 As the Competition Policy Review Final Report stated (335), "Those opposing [section 46] reform are concerned that introducing an effects test would 'chill' competitive behaviour by firms in the market, which would be harmful to consumer welfare."

4 "The courts have suggested a number of tests to judge whether or not a business has taken advantage of its market power, which come down to whether a business *without* substantial market power would have, or profitably could have, engaged in the conduct in question." Gilbert + Tobin, "Where to now for big business, small business, and market power?," 13 April 2015, https://www.gtlaw.com.au/where-now-big-business-small-business-and-market-power.

5 Indeed, the Australian Competition and Consumer Commission (ACCC) concludes as much in relation to many mergers that may involve the removal of a competitor. For example, if there are low barriers to entry, the exit of a competitor may not enable a merged firm to raise prices, or equivalently, to substantially lessen competition.

6 The government stated that it intends for existing jurisprudence on the SLC be applied to conduct covered by the updated section 46. See *Competition and Consumer Amendment (Misuse of Market Power) Bill 2016*, *Explanatory Memorandum*, paragraph 1.23, p. 9.

7 Counterfactual scenarios to mergers can include a number of different possibilities besides the status quo, including the takeover of the merging firm by a separate company, or the merging firm going out of business.

8 In the ACCC's *Merger Guidelines 2008*, the commission advises that it would likely view a merger as substantially lessening competition if it results in the merged firm "… being able to significantly and sustainably increase prices," p. 11.

9 The term may also refer to profits gained by the competitor refraining from competing as forcefully, or from choosing not to enter and compete in the market in the first place. The terminology is mixed.[10] IATA, "Air Travel Demand", April 2008, IATA Economics Briefing No 9, Table 4, p. 30.11 Commons, J.R., The Economics of Collective Action, The Macmillan Company, 1950, p. 21.

10 It is worth noting, however, that it is not impossible, at least in theory. If below-cost pricing by a business without market power resulted in the elimination of significant sources of competition, then the recoupment made possible would, to an economist, make the below-cost pricing consistent with a predatory strategy. In practice, such instances are rarely seen.

11 For a summary of best practice analytical approaches, see the 2015 Unilateral Conduct Working Group of the International Competition Network (ICN) recommended practices document "Predatory Pricing Analysis Pursuant to Unilateral Conduct Laws."[13] Ibid, paragraphs 5.13 and 5.14, p. 46-47.

12 ICN (2015), p. 4. The ACCC is a participating member of the ICN. The guidelines issued by the ICN are not binding upon members, but reflect the combined input of member countries and regulators.

13 The ACCC issued a document "Framework for Misuse of Market Power Guidelines" in September 2016 (available at: https://consultation.accc.gov.au/compliance-enforcement/consultation-on-draft-framework-for-misuse-of-mark/), which it stated was "a summary of the proposed content of the guidelines," that it would publish once the law commences, p. 2. The hypothetical examples are intended to provide "… broad guidance as to the types of conduct and circumstances that are likely to raise concerns under the proposed s.46," p. 9.

14 Example C given at Table 1, at p. 11.

15 Ibid.

16 Example B of Table 2, at p. 13.

17 Details could be forthcoming in guidelines that the ACCC intends to publish once the law commences.

18 It may be easier for the court to make this comparison in cases where it is alleged that the recoupment phase has already occurred, because a price after the conduct has occurred might serve as a starting point for measuring the effects of the conduct.

19 It is also common to sell the two separately. When the components are also offered at separate prices, alongside a bundle, the practice is known as "mixed bundling."

20 Bundling and tying can, for example, allow economies of scale or scope in production to be achieved, or can promote economic efficiency by expanding the market. For a summary of the economics literature on the efficiency of bundling see sections 7.3.2.1 and 7.3.2.2 of Massimo Motta, *Competition Policy: Theory and Practice*, Cambridge University Press, 2004; and Dennis W. Carlton, Patrick Greenlee, and Michael Waldman, "Assessing the anticompetitive effects of multiproduct pricing,"*Antitrust Bulletin*, 53(3), 2008, p. 587-622.

21 For example, Carlton and Waldman state that "the key issue is whether the price of [the competitive good in the bundle] can ultimately be elevated above the competitive level as a result of the competitive impairment of the rival," Dennis W. Carlton and Michael Waldman, "Safe Harbors for Quantity Discounts and Bundling," *George Mason Law Review*, 15(5), 2008, p. 1237. Carlton, Greenlee, and Waldman, op cit., make a similar point at p. 613.

22 For a summary of the ways bundling and tying are assessed across a range of jurisdictions (but not including Australia) see the 2009 "Report on Tying and Bundled Discounting" by the Unilateral Conduct Working Group of the International Competition Network (ICN), available at http://www.internationalcompetitionnetwork.org/uploads/library/doc356.pdf.

Notes

[23] See Carlton, Greenlee, and Waldman, op cit., who state that "for a pricing strategy to have an anticompetitive effect on rival firms, the strategy must alter the ability of rival firms to compete. This can be accomplished by denying a rival firm sales which otherwise would insure its survival or reduce its marginal costs," p. 611. Similarly, Murphy, Snyder and Topel state that bundling practices that "do not impair the rival's ability to compete – that is, do not drive the rival from the market or raise its marginal costs – do not impinge the rival's ability to discipline market prices," Kevin M. Murphy, Edward A. Snyder, and Robert H. Topel, "Competitive Discounts and Antitrust Policy," ed. Roger D. Blair and D. Daniel Sokol, *The Oxford Handbook of International Antitrust Economics*, Vol. 2, Oxford University Press, 2015, p. 102.

[24] Some debate exists in similar contexts (particularly price squeezes) about whether it is appropriate to use Monopolist's incremental costs rather than those of Rival. The antitrust literature generally finds that it is appropriate to run the discount allocation test against the monopolist's own costs, rather than an estimate of the efficient rival's costs, for the following reasons:

- They are known and understood by the monopolist; and
- Any rival with higher costs than the monopolist cannot be as efficient.

For a survey of this debate, see George A. Hay and Kathryn McMahon, "The Diverging Approach to Price Squeezes in the United States and Europe," *Journal of Competition Law and Economics*, 8(2), 2012, p. 271-272.

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