

## **Australia's Radical Predatory Pricing Reforms: What Business Must Know**

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### **Abstract**

Radical changes to the Trade Practices Act have the potential to affect significantly the ability of businesses to engage in vigorous price competition. These changes are designed to prohibit what is colloquially referred to as predatory pricing; the practice of a firm temporarily reducing its prices to a level designed to eliminate its competitors so that, free of competition, it can thereafter lift them to supra-competitive levels. Unfortunately, because of its scope and the ambiguous new concepts it employs, the section has the potential to apply to all forms of vigorous price competition and creates significant risks for those businesses who seek to compete with their rivals by systematically, or irregularly, selling at lower prices than they do. This note examines the section's nature and scope and identifies the pitfalls that it presents for such firms.

## Introduction

Radical changes to the Trade Practices Act 1974 (Cth) (the Act) came into operation on 25 September 2007 that have the potential to affect significantly the ability of businesses to engage in vigorous price competition. These changes add a new provision to the Act, s 46(1AA), designed to prohibit what is colloquially referred to as predatory pricing. This is the practice of a firm temporarily reducing its prices to a level designed to eliminate its competitors so that, free of competition, it can thereafter lift them to supra-competitive levels. Section 46(1AA), commonly referred to as ‘the Birdsville amendment’, as it was drafted by Senator Barnaby Joyce whilst he was visiting Birdsville, seeks to prohibit this practice by making it unlawful for a firm with a substantial market share to sell goods or services below cost for a sustained period of time for any one of three anti-competitive purposes. Unfortunately, because of its scope and the ambiguous new concepts it employs, the section has the potential to apply to all forms of vigorous price competition and thereby to threaten the very freedoms the Act seeks to promote. As a result, it creates significant risks for those businesses who seek to compete with their rivals by systematically, or irregularly, undercutting their prices. This note examines the section’s nature and scope and identifies the pitfalls that it presents for such firms.

## Predatory Pricing prior to the Birdsville Amendment

Prior to the Birdsville amendment, the Act did not specifically prohibit predatory pricing. However, this practice could contravene s 46(1) of the Act which provides that a corporation with substantial market power must not take advantage of that power for one of a number of specified purposes, including eliminating or damaging a competitor. Therefore, predatory pricing would be an issue for a firm where (i) it had substantial market power (ii) its pricing policies took advantage of that power and (iii) those policies were pursued for one of the proscribed reasons. However, following the High Court’s decision in *Boral Besser Masonry Ltd v ACCC* (2003) 215 CLR 374 it was thought unlikely that s46(1) could be used successfully in this manner. In that case, although Boral sold certain of its products below cost with the

intention of harming a competitor, the action against it failed because it did not have substantial market power in the relevant market.

Although it is arguable that popular opinion overstated the effect of Boral – bearing in mind that s 46(1) was used successfully in predatory pricing cases both before (see *Victorian Egg Marketing Board v Parkwood Eggs Pty Ltd* (1987) 33 FLR 294) and after it was decided (see *ACCC v Eurong Beach Resort Ltd* [2005] FCA 1900) - the case nevertheless provided the catalyst for a Senate Inquiry into the Effectiveness of the Trade Practices Act 1974 in *Protecting Small Business 2004*. The report of this inquiry recommended that the Act be amended to deal specifically with predatory pricing issues: see recommendation 3. The Government accepted this recommendation, but only in part. The result was the following provision which appeared in the original version of the Trade Practices Legislation Amendment Bill (No 1) 2007 (the Amendment Act):

- (4A) Without limiting the matters to which the Court may have regard for the purpose of determining whether a corporation has contravened subsection (1), the Court may have regard to:
- (a) any conduct of the corporation that consisted of supplying goods or services for a sustained period at a price that was less than the relevant cost to the corporation of supplying such goods or services; and
  - (b) the reasons for that conduct.

This provision has now passed into law but is relatively cosmetic and probably obsolete given the passage of the Birdsville Amendment.

### **The Birdsville Amendment**

Senator Joyce drafted the 'Birdsville Amendment' in a motel room in Birdsville (Senate Hansard, 11 Sept 2007, p 60) and extraordinarily, managed to persuade the Federal Government to introduce it without consultation or satisfactory explanation in the dying moments of the last Federal Parliament. Dispensing with its previous caution on the topic,

the Government embraced this amendment and paraded it as a victory for small business. Aimed specifically at predatory pricing, the amendment introduces a new s 46(1AA) into the Act which provides as follows:

46 (1AA) A corporation that has a substantial share of a market must not supply, or offer to supply, goods or services for a sustained period at a price that is less than the relevant cost to the corporation of supplying such goods or services, for the purpose of:

- (a) eliminating or substantially damaging a competitor of the corporation or of a body corporate that is related to the corporation in that or any other market; or
- (b) preventing the entry of a person into that or any other market; or
- (c) deterring or preventing a person from engaging in competitive conduct in that or any other market.

(1AB) For the purposes of subsection (1AA), without limiting the matters to which the Court may have regard for the purpose of determining whether a corporation has a substantial share of a market, the Court may have regard to the number and size of the competitors of the corporation in the market.

As result, a firm will now contravene the Act if it -

1. has substantial share of the market
2. supplies, or offers to supply, goods or services,
3. for a sustained period
4. at less than the relevant cost
5. for the purpose of:
  - (i) eliminating or substantially damaging a competitor
  - (ii) preventing entry of a person into the market; or
  - (iii) deterring or preventing competitive conduct

This represents a substantial change in the Act which is now fraught with potential risks for firms who seek to compete, at any stage, with their rivals by aggressive price cutting. The

key elements of the change and why they make price cutting a competitive tactic that must now be undertaken with caution, are as follows:

**(a) Substantial market power is no longer required**

Previously, a firm could be guilty of predatory pricing under s 46(1) only if it had substantial market power; that is, the power to act independently of its rivals (see Gleeson CJ and Callinan J in *Boral Besser Masonry Ltd v ACCC* (2003) 215 CLR 374 at para 121). As noted earlier, it was because this could not be established in *Boral* that the ACCC's case failed. The requirement was, however, neither radical nor surprising, with the general consensus among economists being that predatory pricing is only rational or effective (if ever) when the predatory enjoys a position of market dominance, enabling it to subsequently recoup losses sustained during the period of predation. Section 46(1AA), on the other hand, adopts the much lower threshold requirement of "substantial share of a market" and the explanatory memorandum makes clear that the possibility of recoupment should not be considered essential to a claim being successful. The difference may be demonstrated by the following example; if there were five competitors in a market, each with a 20% market share, it is quite likely that none of them would have substantial market power because none of them would be able to act independently of its competitors. On the other hand, applying the judicial definitions of "substantial" that have been used in connection with the Act, including 'meaningful or relevant' (*Rural Press Ltd v ACCC* (2003) 203 ALR 217 at para 41 per Gummow, Hayne and Heydon JJ) or 'more than trivial or minimal' (*Tillmanns Butcheries Pty Ltd v Australasian Meat Industry Employees' Union* (1979) 42 FLR 331 at 338 per Bowen CJ), each one would be likely to have a "substantial share of a market" and so would come within the scope of the prohibition. This possibility is even more alarming when we change the number and size of competitors to, say, just two firms, one having 20% of the market and the other 80%. This is because the company with just 20% market share will still have a "substantial" market share and thus be exposed to liability were it to challenge its larger rival by aggressive and sustained price cutting. In addition, unlike the 'market power' test, the 'market share' test does not pay any regard to barriers to entry or import competition,

which might effectively constrain the ability of a corporation to take advantage of its market share.

The new 'market share' test also generates some confusion by providing that when determining whether a corporation has substantial market share regard may be paid to the number and size of the firms in the market: s 46(1AB). Thus, for example, a firm with 5% of a highly competitive market might be considered to have substantial market share if its nearest rival holds only 2% of the market. The test requires clarification, and until such time that the court provides some guidance, business would be prudent to assume that they hold substantial market share if that share is not insignificant – say 15% or more – or if, while not high, is such as to make them one of the 'bigger' competitors in the market, regardless of whether this market share translates into market power.

#### **(b) The taking advantage element – it's gone!**

The second key difference between s 46(1), and the new s 46(1AA) is that in the case of the later there is no need to establish that the firm has pursued a prohibited purpose by taking advantage of its position in the market. This is required by s 46(1) and is the means by which that provision seeks to distinguish between vigorous competition on the part of a firm, which is to remain lawful even though it may have the effect of eliminating its rivals, and anti-competitive behaviour which alone is to be prohibited.

The taking advantage requirement in s 46(1) has often been a stumbling block in predatory pricing cases. This is because, as Boral shows, a firm can engage in aggressive price cutting even though it does not have market power and similarly, a firm with market power can engage in that conduct without using its market power to do so. In addition, it is inherently difficult to distinguish between pro-competitive discounting and predation - a difficulty faced by competition regulators around the world. It is, therefore, not surprising that a radical response to predatory pricing would omit a similar requirement; such an omission will, no doubt, be justified by arguing that below cost pricing is an anti-competitive practice.

Unfortunately, however, it has the potential to significantly dampen price competition by increasing the likelihood that pro-competitive discounting may be captured by the legislation.

### **(c) Sustained below cost pricing**

The next difficulty presented by the new provision is the definition of sustained below-cost-pricing. The Act adopts the phrase 'less than the relevant cost to the corporation of supplying such goods or services' but fails to define 'cost'. The Senate Inquiry's recommendation that 'variable cost' be adopted in predatory pricing cases was rejected by the Government, who considered it may not always be the appropriate test and could be hard to quantify. No guidance is provided on what test may be more appropriate and economic and legal opinion is divided on the issue. At the very least, it is likely (though not certain) that pricing that continues to generate a profit for the goods or services involved will not be captured, although such conduct may still, in appropriate circumstances, be captured directly by s 46(1) which imposes no such requirement.

If below cost pricing can be established it is also necessary that it be engaged in for a 'sustained' period. This again lacks definition, though it would appear to exclude momentary price-cuts to meet or beat existing competition and probably short-run sales. The line between short-term and 'sustained' discounting is, however, blurred; it is possible a month long catalogue sale could fall foul of the provision, but in the absence of judicial interpretation, it is only possible to speculate in this regard.

### **(d) Purpose**

To breach s 46(1AA) one of the three proscribed purposes must be satisfied. These include deterring competitive conduct or eliminating or substantially damaging a competitor. This element is normally easily satisfied in predatory pricing cases, as observed by Gleeson CJ and Callinan J in the Boral case:

‘Where the conduct that is alleged to contravene s 46 is price-cutting, the objective will ordinarily be to take business away from competitors. If the objective is achieved, competitors will necessarily be damaged. If it is achieved to a sufficient extent, one or more of them may be eliminated. That is inherent in the competitive process. The purpose of the statute is to promote competition; and successful competition is bound to cause damage to some competitors.’ (Boral Besser Masonry Ltd v ACCC (2003) 215 CLR 374)

Purpose may be established by inference and a purpose of damaging competitors need not be the sole purpose of the conduct, provided it is a substantial purpose; thus, even discounting prompted by a desire to meet existing competition could infringe the legislation if another substantial purpose (determined objectively) is to injure a competitor. Where, however, the purpose of below-cost pricing is not to compete on existing products but to assist in the introduction of a new product line, it would be more difficult to establish the requisite anti-competitive purpose. This type of pricing conduct is inherently pro-competitive in that it serves to increase the level of competition in the relevant product or service market.

#### Example

Assume there is a geographic product market within Australia for the retail supply of golf clubs. Further assume that there are three such retailers, Companies A, B and C, that each provides a range of branded golf clubs and hold a relatively even share of the market. Each company is also capable of expanding supply to meet any increase in demand. If Company A places an existing brand of golf clubs on sale at a cost less than its own cost of supply (which may, or may not, permit a modest profit), for a sustained period of time (let’s say two months), then it would clearly be at risk of infringing s 46(1AA). This is so even if the primary purpose is to attract new custom, rather than harm competitors, given that attracting customers from existing competitors necessarily also involves damaging a competitor by depriving them of customers. Under no



reasonable economic analysis would this conduct be considered predatory, such as to warrant prohibition, and it would not have risked infringing s 46(1) because Company A could not be said to have substantial market power.

On the other hand, should Company B choose to introduce a *new* brand of golf clubs to compete with the existing brands, and promote them by offering them for sale for a period of two months at below the relevant cost of supply, it is likely the courts would view the matter quite differently; the purpose in this instance is likely to be viewed as the promotion of a new product line to enhance inter-brand competition, rather than one of harm to competitors, even if the competitive effect is similar.

Business have also expressed some concern that in markets which face import competition, importers may achieve competitive advantage by avoiding the operation of the provision because, as markets are domestically defined, they may not meet the market share requirement or, alternatively, may not have assets in the jurisdiction making them judgment proof. This may, it is argued, encourage dumping; genuine dumping activity may also fail to satisfy the purpose element of the provision, especially where there is no intention of breaking into the market for the long term. Although it is likely this fear is overstated, as any attempt to meet existing import competition through below cost pricing is likely to be regarded as failing the 'purpose' test, the concern highlights the uncertainty brought about by the new legislation.

### **The Verdict; Discounters Beware!**

Predatory pricing remains an area of continued debate and divergence in competition policy internationally. It is widely recognised that attempts to regulate predatory pricing are also likely to reduce beneficial competitive pricing, especially where the legislation is drafted in broad terms. Thus, despite the Government's persistent claims that the Amendment is not about deterring retail discounts, it is likely that the Amendment will have this effect, either

directly by prohibiting some such conduct or indirectly by creating confusion and uncertainty about the scope of the prohibition.

There is no doubt the Birdsville Amendment was designed to capture the small business vote (unsuccessfully as it transpired); in discussing the Amendment, Senator Joyce claimed that small businesses are the 'cornerstone of our economy', that he believes 'in the aspiration of the small business person above all other' (presumably including consumers), that the Amendment is 'a dramatic step in the right direction for the protection of small business' and that it is a reflection on 'hard work and the aspiration of democracy' (Senate Hansard, 11 Sept 2007, p 61). It is clear, then, that while the Act is designed to protect the competitive process and not individual competitors (a fact acknowledged by Senator Brandis when introducing the Amendment (Senate Hansard, 17 Sept 2007, p 12)), the effect of the Birdsville Amendment is clearly the protection of competitors. Small business should, therefore, feel assured that they can no longer lawfully be ousted by larger firms pricing below cost to capture their market share (even if their own inefficiencies make them vulnerable) and medium-to-large business should be cautious when discounting below cost for anything longer than a brief sale period for fear of falling foul of the Amendment.