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the state of COMPETITION

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Living on Noah's Ark: competition policy for the oligopoly economy

Australia, as recently observed, is an oligopoly economy. But what does that mean exactly? And – in this time of reflection – does (or should) this fact impact upon our competition policy? A very smart lawyer and academic, Michal Gal, has researched this issue closely. She recommends that small economies such as Australia favour efficiency over competition, via a liberal merger policy combined with strong conduct rules. Here we outline her research, highlighting the key insights as well as some potential pitfalls. We then consider Gal's work specifically in the Australian context.

Two telcos, two supermarkets, two airlines, two political parties, and so it goes. "Of everything that creeps on the ground, two and two… went into the ark with Noah." Such is life in modern Australia.

In 2013 Andrew Robb observed, "We are an oligopoly economy. We shouldn't fight it. We should make the most of it…". But what does it mean to be "an oligopoly economy"? The concept carries with it clear implications for the formulation of our competition policy, best explored in Michal Gal's 2003 book *Competition Policy for Small Markets*. In this, the last of our policy series, we do the reading for you, pulling out Gal's key insights and adding some of our own thoughts as we contemplate the issues of the day.

> **"Oligopoly markets create some of the principal competition policy dilemmas for small economies…"**
> **— Michal Gal**

The characteristics of small economies

An Israeli academic and lawyer, Gal's expertise in relation to small economies is unmatched. Much of her research is based on extremely small – sometimes even micro – economies, but Australia's isolation and dispersed population clearly, in her assessment, qualifies us as a small economy. Indeed, Australia's approach to many key competition issues forms a significant plank of her research.

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In a nutshell, Gal identifies the key competition challenge for small economies as the fact that (productive) **efficiency necessitates concentration**. In other words, if we are to produce goods in a cost effective manner, we must accept that – for many industries – there will be a limited number of producers.

Gal identifies three basic characteristics of a small economy: high concentration levels; high barriers to entry (often due, in part to geographic isolation and/or protectionist trade policies); and production that is frequently below "minimum efficient scale" (**MES**). Such economies also tend to have weaker self-correcting tendencies, meaning that one cannot blithely assume the market will fix itself. This in turn has implications for the reception of overseas approaches to particular issues, many of which are premised on the notion that – over time – any exercise of market power will be moderated by new or existing competition.

Minimum efficient scale

Minimum efficient scale is a key driver. Its technical definition is the lowest point of production to enable a firm to minimise long run average cost. Thinking in terms of a child's lunch box, the minimum efficient scale for muffins in a family kitchen is 12: one box of cake mix, one muffin tray, one stint in the oven. If one were running a bakery, however, the MES for muffin production is likely to be much higher, once one takes into account the fixed costs of the business, costs such as labour, and the variable costs associated with the specific product. That said, efficiency is a "lumpy" not linear concept – accordingly, small players can be more effective in using their capacity than their larger competitors.

Generally speaking, in a small economy, the significance of fixed costs is greater than for larger economies, meaning that the MES in an industry such as telecommunications can be extremely high.

Such fixed costs, combined with the limited demand resulting from the smallness of the economy, mean that fewer firms are able to achieve MES. Indeed, sometimes only one or two can maximise the available efficiencies by producing in a cost-effective manner.

This is why small economies experience a higher incidence of natural monopolies (where the exigencies of demand and cost of production mean social welfare is maximised when only one player services the market), "unnatural" monopolies (where, over time, a single player emerges as dominant, whether or not it is literally a *mono*polist), and oligopolies (where just two or three players satisfy the majority of demand).

The minimum efficient scale of production itself creates a substantial barrier to entry – if the market can only support a couple of efficient producers and they are already incumbent, then that market is going to be extremely difficult to break into. MES can also explain high concentration as players merge to achieve efficiencies while at the same time inefficient producers exit.

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The efficiencies of muffin production appear - in our view at least - to have been inadequately researched. Mmm, time for a cuppa!

General policy implications

These realities have clear implications for firm size (and hence concentration). In Gal's view, the systematic protection – at least pursuant to competition policy – of small business is too costly. To prefer small business over its larger counterpart adversely impacts productive efficiency and, Gal argues, innovation. If, as a society, we wish to favour such enterprises, industry or tax policy should be preferred (an invitation clearly accepted by Joe Hockey in his last budget!). As we argued in Issue 16, however, there is a difference between saying small business should not receive special advantage and having a system which gives rise to inherent *dis*advantage.

Gal posits several other key implications from this "background-er" in small economies, amongst them:

- the typical market shares to raise eyebrows in a competition sense should be lower in a small economy than in a large economy;
- presumptions of market power should take into account relative market shares, not just absolute numbers – in other words, markets in small economies are frequently characterised by two or three large players and, in the parlance, "rats and mice" (more technically known as the competitive fringe). Competition assessments need to involve much more than a mere head count of competitors – understanding their relative size and strength is also critical;
- "Monopoly should be tolerated, as it is often necessary to achieve productive efficiency. Nonetheless, small economies should consider conduct regulation of monopolies more seriously than large ones." Such regulation – perhaps in the form of regulated access or price controls – is best undertaken by competition authorities rather than the courts; and
- small economies need to take exclusionary conduct very seriously, focusing on conduct that is likely to lead to the *creation* of market power rather than just conduct that maintains or strengthens existing market power. In other words, we should have an attempted monopolisation provision, as discussed in our last edition.

Taking these various factors into account, Gal concludes that small economies should adopt a liberal merger policy in conjunction with strict conduct rules. We explore this is further detail below.

Conduct rules

Unilateral conduct

Gal is not naïve to the problems inherent in restricting market power primarily via conduct rules rather than merger control. In particular, she acknowledges the difficulties with effective enforcement of conduct provisions. Such problems, however, can themselves result in poor policy selection: **"The inability to deal effectively with established monopoly may result in excessive expansion of anti-merger enforcement".**

So Gal turns our current understanding of the structure of Part IV on its head: we should not see merger control as our principal weapon against monopoly power with section 46 only as a safety net. Rather, for reasons discussed in further detail below, our merger policy should accept that firms will merge to positions of dominance and instead rely on the conduct rules to manage the problems which ensue. Consequently, our conduct rules – and their enforcement – need to be top-notch.

In Gal's view, some types of conduct – such as exclusive dealing, tying and refusals to deal – are likely to affect competition more severely in a small economy than in a larger one. While the *nature* of the impact on competition is unchanged whatever the size of the economy, the *extent* of that impact is magnified. For example, exclusive dealing has greater potential to *effectively* foreclose potential competitors from entering particular markets. In other words, the (relative) lack of competitive pressure at each stage of the vertical supply chain means that potentially adverse effects are subject to feedback effects and consequently exacerbated.

Likewise, predatory strategies are likely to be more effective, meaning that the standard Chicagoan approach suggesting that such strategies are unlikely to succeed, therefore are irrational, and therefore very unlikely to occur needs to be closely reviewed. The strong tendency to oligopoly, along with high barriers to entry, means conduct targeting particular competitors or potential entrants may well result in exit, raise entry barriers and/or further entrench market power. When viewed through a prism of a greater likelihood of market power *and* oligopoly, predation might not seem such a silly strategy after all.

High barriers to entry must remain a constant back-drop to any competition analysis in a small economy. Such barriers mean that self-correcting tendencies are much weaker than in larger economies. Accordingly, when one looks to overseas jurisprudence for guidance – particularly the United States – one has to bear in mind that their analysis is premised upon markets self-correcting and "unnatural" monopolies themselves being very rare beasts.

In our view, one of the most critical conclusions to be drawn from Gal – that the *creation* of market power should be subject to review – is little developed. This notion as ever draws us back to McHugh J's observation in *Boral* as to a timing gap: section 46 was not designed to capture conduct that pre-dates market power, even if such conduct creates market power. We were surprised to read in the Harper Report that, "The threshold test of substantial market power enjoys broad support, and the Panel did not receive any submissions making a case for change". TSoC knows of submissions that called for consideration of an equivalent to attempted monopolisation, but the term is only mentioned in Harper once, in its summary of overseas approaches. Gal would suggest such a provision is more necessary here than in its homeland.

A key implication of Gal's analysis is the need, in a small economy, for limitations on the *creation* of market power, not merely its use: prohibiting attempted monopolisation is more important here than in the US

Co-ordinated conduct and conscious parallelism

Unsurprisingly, Gal considers that strict enforcement of laws against cartels is critical in a small economy. She also regards conscious parallelism – in which competitors unilaterally "co-ordinate" their conduct – to be an issue requiring close consideration. In essence, the concern with conscious parallelism is that competitors in an oligopolistic market adopt supra-competitive prices in the knowledge that it is in their competitors' best interests to also supply at high prices.

Image courtesy of hin255 at FreeDigitalPhotos.net

It's a lot easier to articulate the evils of tacit collusion and conscious parallelism than it is to frame workable prohibitions

Such conduct has frequently been of concern in Australia: see for example the *Email* case back in the early '80s and more recently the Ballarat and Geelong petrol price fixing claims. In these cases, there is no doubt that competitors adopted parallel pricing regimes; they also took active steps to ensure pricing by individual competitors was readily transparent to others in the market. But they did not, in the court's view, form a contract, arrangement or understanding which itself had the purpose or effect of fixing prices. Accordingly, the conduct did not fall within the *per se* prohibition and – while each case clearly involved a broader contract, arrangement or understanding of some sort – it was never alleged that there was an umbrella arrangement which had the purpose or likely effect of substantially lessening competition.

By and large, Australian law has been reluctant to infer collusion from conscious parallelism in the manner that occurs elsewhere, such as in the United States where parallel pricing together with other conduct or context ("plus" factors) can form a sufficient package of circumstantial evidence to infer the existence of a tacit agreement to collude.

Gal observes that most jurisdictions find regulating conscious parallelism to be problematic for several reasons, including equitable considerations and the problem of remedies. The first issue is demonstrated by the sheer rationality of parallel pricing in an oligopoly – we can't condemn BHP for, say, setting prices so high as to amount to an "irrational" refusal to deal, but at the same time require oligopolists to disregard the realities of their market when setting prices. As to the second issue, how does one craft appropriate remedies – just what behaviour is to be injuncted? As observed by US Supreme Court Justice Stephen Breyer, "it is close to impossible to devise a judicially enforceable remedy for 'interdependent' pricing".

Again, Gal notes that merger policy can be employed to limit the potential for conscious parallelism – this would fall under the ACCC's "co-ordinated effects" line of concern in its merger analysis. But this provides a limited solution, as the problem is hardly driven by mergers. In any case, as we've already learnt, Gal thinks mergers by and large are a good thing.

Accordingly, she proposes two alternative solutions: regulating facilitating practices and – less conventionally – providing active government support (in the form of subsidies) to mavericks, in recognition of the broader value of their disruptive behaviour. This second solution, while intriguing, seems improbable but the first approach is surely what lies behind the Harper proposal (as discussed in our previous edition).

One implication of Gal's reasoning could be the greater use of *per se* prohibitions than one would see in a larger economy. This creates an interesting conundrum, as recent research by the TSoC team (due to be published shortly) suggests that *per se* conduct is regularly prosecuted in Australia even where there is virtually *no* risk of the conduct actually having affected competition. Such an approach might prompt us to question why we have *per se* prohibitions in the first place.

Merger policy

As already mentioned, Gal favours a liberal merger policy where it delivers efficiency benefits. She observes, for example, that, while the anti-competitive effects of conscious parallelism may be the same as those of a merger which lessens competition, at least the merger will result in efficiency gains. In short, "[a] small economy cannot afford to protect competition rather than its outcomes".

Nonetheless, Gal acknowledges:

> *an overly permissive merger policy might entrench monopoly elements in a small economy. Especially in industries characterized by high entry barriers, once market structures are in place, they are difficult to alter. Moreover, merger policy is the most powerful weapon available in the competition policy arsenal to combat tacit collusion or cooperative behavior. Because such conduct cannot generally be reached directly, preventing the creation of market structures that tend to facilitate such outcomes becomes more important. Merger policy in a small economy should thus comprise a set of flexible instruments to mitigate competition concerns while promoting economic efficiency.*

How in Australian should one apply Gal's need for strict conduct rules (particularly in relation to co-ordinated conduct) with a more liberal merger test when our statute uses the same language – the SLC (substantial lessening of conduct) test, as it appears in sections 45, 47 and 50. One point of distinction is the role of purpose: the SLC test for conduct applies to relevant arrangements which have the *purpose*, effect or likely effect of substantially lessening competition, where as the mergers test (section 50) refers only to the effect or likely effect. Notwithstanding the *Universal Music* decision and the ACCC's more recent claim against Pfizer (where the focus was upon the *purpose* of the conduct, not the likely effect), this slight modification in language is hardly enough to create a clearly distinctive approach in enforcement. In any case, using purpose as the basis for a different approach does not appear based on any well-founded principle.

That said, if one applies the SLC test consistently across all relevant sections in Part IV (as should surely be the case), one can still rely on the authorisation test to permit mergers which are efficient, but nonetheless lessen competition. For various reasons, authorisation seems to have fallen out of favour over recent years (see Issue 12) – if nothing else, when the courts and Tribunal regularly say certain conduct/acquisitions do not lessen competition (think the *Qantas* decision), then parties can be forgiven for preferring the flexibility of informal merger clearance over the palaver of authorisation.

Gal, in particular, considers that there is a genuine role for an efficiency defence: the argument that, whilst anti-competitive (as that term is used in its narrow sense), the efficiency benefits of a proposed merger outweigh the costs of lessened competition. She makes a telling observation, however, about parties trying to have their cake and eating it too – something which we have regularly seen in Australia:

> *[T]he [efficiency] defense is relevant only in cases in which a merger is found to be anti-competitive. Parties are understandably reluctant to admit that their merger is anti-competitive and to base their entire defense on efficiencies. Thus, when they make an efficiencies defense, it is in combination with a defense on competitive effects. An efficiencies defense, however, can be inconsistent with a competition argument, particularly one involving ease of entry. It is difficult to argue, on the one hand, that entry into the relevant market is easy and, on the other, that the claimed efficiencies cannot be achieved by internal expansion or by an alternative merger.*

Just because a merger **should** result in efficiencies doesn't, of course, mean that it will.

A review of the literature "suggests that for every merger that results in an unambiguous increase in social welfare - efficiency increases and profits and sales both rise - there are two that unambiguously reduce social welfare, divided roughly equally between mergers that lower efficiency and mergers that increase market power. These results imply in turn that competition policy towards mergers should rest on a strong presumption **against** allowing mergers to take place, rather than... a presumption in their favour" (Dennis C Mueller, "Efficiency versus market power through mergers" in The International Handbook of Competition, 2004).

Of course, such research might just beg the question: would the results be the same if the focus was on mergers in a small economy? To this end, we can only encourage industry studies and post-merger assessments to understand the consequences of specific mergers. Did reality match the predictions?

But Gal's analysis is not without its hitches.

In one for the economists, we've drawn up some diagrams. Both describe a scenario where, initially, effective competition means prices are constrained to marginal cost. Following a merger, however, the merged entity obtains market power, as evidenced by its capacity to price above marginal cost. But the merger has also resulted in improved efficiency, shifting the marginal cost curve down. In other words, the firm has achieved/moved closer to minimum efficient scale.

The first diagram reflects a total welfare perspective (eg Williamson 1968) where the focus is upon on the cost reduction gain versus the deadweight loss – even if this means higher prices post-merger. Thus a merger that lowers marginal cost but increases the ability to raise prices above marginal cost and even pre-merger prices may nonetheless increase total welfare (see in the first diagram, how the area marked "Y" is greater than "X").

A consumer welfare perspective, however, qualifies that position by permitting an efficient but anti-competitive merger only where there is some benefit to consumers. Thus, as per the second diagram, the post-merger price should not exceed the pre-merger price (although the price will still be above the new marginal cost).

The question then arises: does the fact that we live in an oligopoly economy affect our choice between the two scenarios?

A key problem in either case is the unspoken economic premise that has been conveniently forgotten: absent competitive pressure, ***in***efficiencies are generally considered inevitable (Sir John Hicks' "quiet life"). In other words, MC2 – as it appears in either diagram – is likely to rise over time as there will be no competitive imperative driving productive efficiency. Gal is not alone in failing to discuss how best to manage this issue: after all, if over time a merger to monopoly results in both less competition *and* less productive efficiency, one could be forgiven for asking why it should be allowed.

The importance of mavericks

While Gal considers mavericks to play an important role in the context of disrupting oligopoly, she doesn't specifically discuss them in relation to merger policy. Nonetheless, a logical extension of her argument would require that mergers involving mavericks be very closely scrutinised by regulators.

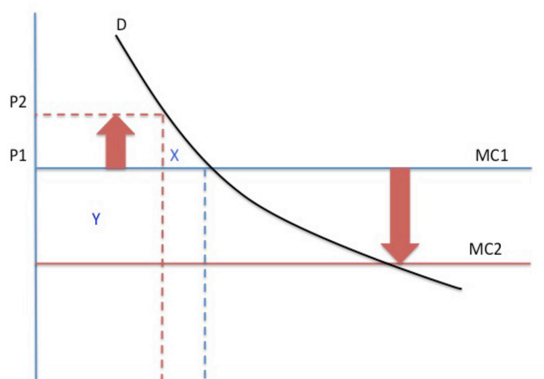
When considering mavericks, however, one needs to ensure that market perceptions are checked against the reality. Much like a teenage rebel, many mavericks actually want to belong. One only has to consider the likes of Virgin, an incredibly disruptive influence when it first entered the Australian airline market. Once invited to join the party, mavericks are often quick to adopt the dress code and bring flowers for the host. Virgin's latest advertising campaign is, in essence, all about how its offerings now match those of Qantas as it tries to displace its market perception as a maverick providing cheap, pared down flights, stripped of the unnecessary (and costly) lurks of full service airlines.

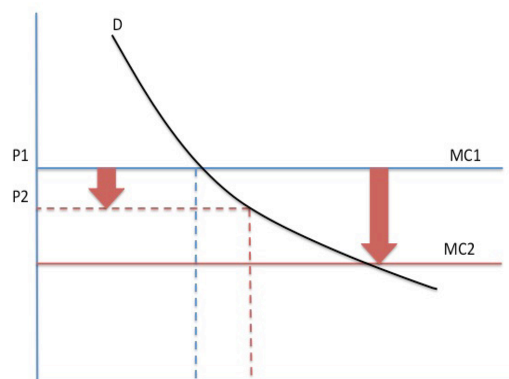
The Australian context

How then should we apply Gal's analysis in Australia?

As a preliminary question, we wonder whether Australia should be considered a small economy in all circumstances. When viewed on a national basis, clearly we satisfy Gal's definition of a small economy. But many of our cities are of comparable size to major cities overseas (Brisbane, for example, is not much smaller than Chicago). So for markets based in the larger population centres, maybe special rules shouldn't apply (and how would *that* work)? That said, it must be remembered that 60% of Australians *do not* live in Brisbane, Sydney or Melbourne.

In any case, one shouldn't adopt Gal's thinking uncritically. At times, her understanding of Australian law is dubious, leading one to assume that similar issues may apply to her analysis of





The first diagram shows a scenario where, following merger, marginal cost falls but prices rise. As Y is larger than X, however, a total welfare approach would allow the merger. A more consumer-focused perspective is shown in the second diagram –prices are still above marginal cost, but they are lower than before the merger (which does prompt questions regarding the application of the "with and without" test).

There's an unspoken challenge set out in both diagrams: if you permit an anti-competitive merger on the basis of efficiencies lowering marginal cost, how do you ensure that marginal cost (and hence prices) don't rise over time? If you're looking at section 46 to do the heavy lifting, remember it is not at all designed to prevent monopoly pricing. Would this then mean a greater role for price regulation (generally used only as a last resort)?

other jurisdictions. Notwithstanding some of our quibbles over details, however, many of the principles underpinning her main arguments appear sound.

That said, an issue which Gal does not explore in great depth is the problems that occur when markets are efficient, but uncompetitive. Other than pursuant to an authorisation (which may involve conditions that effectively require efficiency gains to be passed on), one may assume that an efficient firm which is not subject to competitive pressure will supply at supra-competitive prices. This has flow-on effects for the entire economy, particularly as – given the role of fixed costs in determining the minimum efficient scale – it is essential services that are more likely to experience a lack of competition. This in turn renders many dependent industries less efficient than they otherwise should be, creating a ripple effect throughout the economy.

Dominant firms might also have better resources to engage in R&D, as Gal argues, but fundamentally have less need to do so. Accordingly, the economy becomes increasingly dependent upon innovation that occurs elsewhere. Such innovation tends to be adopted at the whim of the dominant firm(s), which can determine what developments will be adopted and when. Innovations that drive down production costs are likely to be adopted early, but innovations that focus upon better meeting consumer needs or desires are less likely to be prioritised.

For better or worse, however, such problems are inevitable in an oligopoly economy. So to what extent do we see Gal's thinking applied in Australia? The ACCC certainly appears to adopt many of Gal's principles: there is no doubt we have a liberal merger policy with very few blocked in any given year. That said, the ACCC tends to be more concerned about concentration in larger markets as opposed to smaller (especially regional) markets, an approach which completely reverses Gal's logic.

Furthermore, almost all mergers in Australia are considered pursuant to the SLC test in section 50, rather than the public benefit test required by authorisation. Such an approach makes it difficult to strictly enforce the SLC test in relation to conduct-related matters, as the ACCC's long-standing emphasis on *per se* provisions suggests. But as Gal stresses, effective enforcement of the conduct provisions is essential for a small economy – this goes well beyond the *per ses*.

When it comes to cases before the courts and arguably the Harper Report itself, Gal's insights appear largely overlooked. Many of our competition cases rely on overseas – particularly US – economic analysis, with its emphasis on self-correction. Such analysis views oligopoly as the exception rather than the rule, and assumes firms are independent actors with their conduct determined only by their individual ability to meet consumer demand.

But Gal's assessment does encapsulate – in a manner firmly underpinned by an understanding of both legal and economic issues – the "vibe" that makes many outside the competition world leery. "Non-players" are regularly expressing their unease with the application of competition law in this country: the Senate's current inquiry into the meat processing sector is one of many recent examples of "laymen" second-guessing the experts. Perhaps if we were to better articulate the choices being made – and allow the rest of the country to say whether or not those choices are appropriate – the apparent preference for efficiency over competition would be better accepted.

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Now's the perfect time to enrol in Rhonda & Alexandra's Masters subject, Market Power and Competition Law. The course will be held in Melbourne from 21-27 October (excluding the weekend). It won't be running next year, so this is your last chance for a little while!

More details at the Melbourne Law School's website.

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