
# Death Knell of the Counterfactual? The 0867 Case

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*The price which society pays for the law of competition, like the price it pays for cheap comforts and luxuries, is great; but the advantages of this law are also greater still than its cost / for it is to this law that we owe our wonderful material development, which brings improved conditions in its train. But, whether the law be benign or not, we must say of it: It is here; we cannot evade it; no substitutes for it have been found; and while the law may be sometimes hard for the individual, it is best for the race, because it ensures the survival of the fittest in every department.*

Andrew Carnegie (1835 - 1919)
Scottish-born American industrialist and philanthropist

***The successful competitor, having been urged to compete, must not be turned upon when he wins.***

Judge Hand, *United States v Aluminium C. of America*, 48 F.2nd 416 (2d Cir. 1945), at 430.

## United States

- **US DOJ 2008 Report on single firm conduct (2 years, 200 pages):**

"The U.S. antitrust laws reflect a national commitment to the use of free markets to allocate resources efficiently and to spur the innovation that is the principal source of economic growth. Section 2 of the Sherman Act plays a unique role in U.S. antitrust law by prohibiting single-firm conduct that undermines the competitive process and thereby enables a firm to acquire, credibly threaten to acquire, or maintain monopoly power.

Competition and consumers are best served if section 2 standards are sound, clear, objective, effective, and administrable. After more than a century of evolution, section 2 standards have not entirely achieved these goals, and there has been a vigorous debate about the proper standards for evaluating unilateral conduct under section 2. …"

## United States

- **On 11 May 2009, Christine A. Varney, Assistant Attorney General in charge of the Department's Antitrust Division advised:**

> …the Department is withdrawing, effective immediately, a report relating to monopolization offenses under the antitrust laws that was issued in September 2008. As of today, the Section 2 report will no longer be Department of Justice policy. Consumers, businesses, courts and antitrust practitioners should not rely on it as Department of Justice antitrust enforcement policy.
>
> **The report, "Competition and Monopoly: Single-Firm Conduct Under Section 2 of the Sherman Act," raised too many hurdles to government antitrust enforcement and favored extreme caution and the development of safe harbors for certain conduct within reach of Section 2, Varney said**. Varney announced the withdrawal of the report today at a speech at the Center for American Progress.

# Australia

- **The Trade Practices Legislation Amendment Act (No. 1) 2007 (No. 159, 2007) (the "Birdsville amendments") was passed into law and commenced on 25 September 2007.**

- **The Birdsville amendments resulted in the insertion of s 46(1AA), which:**

  - altered the existing test for predatory pricing, requiring only that a company
    - have a substantial market share (not 'market power')
    - priced below cost for a sustained period
  - removed the requirement for a connection between market power and its 'misuse'.

## Australia (cont)

- **The amendments were not unanimously well-received in the competition community:**
  - The Act offered no guidance as to what constitutes a 'substantial share of a market', what will amount to a 'sustained period', or how to determine whether a price is 'less than the relevant cost to the corporation'.
  - The ACCC even commented that creating 'dual' prohibitions against predatory pricing (s 46(1) and 46(1AA)) could give rise to 'considerable confusion' arising from application of these 'fundamentally different concepts' and that this uncertainty has the 'potential to dampen legitimate competitive behaviour'.

## Australia (cont)

- **Trade Practices Legislation Amendment Act 2008 (No. 116, 2008) which commenced on 22 November 2008. The new amendment inserted:**
  - Subsection (1AAA) - explaining that predatory pricing may breach s 46(1) even if the firm cannot recoup the losses incurred by it.
  - Subsection (6A) - codifies case law to aid in interpreting 'take advantage of.'
- **Although the original Bill initially proposed to remove 'substantial market share' from the subsection (1AA) and explicitly provide that predatory pricing may breach section 46(1), rather than being a separate offence, the removal of subsection (1AA) was opposed and failed to pass into law.**

# The New Zealand position

- **On 25 February 2009:**
  - The Commerce Commission has commenced a review of the effectiveness of the enforcement framework for addressing allegations under section 36 of the Commerce Act that a firm has taken advantage of its market power.
  - **Commission Chair Paula Rebstock noted that** virtually all competition law regimes have similar provisions addressing prohibited unilateral or 'single-firm' conduct (known elsewhere as 'abuse of dominance' or 'monopolisation') and that **there is presently ongoing debate internationally regarding the appropriate scope and effective enforcement of such provisions.**
- **The Commission has withdrawn its review pending the Supreme Court decision in 0867.**

## The New Zealand position (cont)

- Two judgments were issued in 2009 in relation to the application of s36 to Telecom.
- The first, *Telecom Corporation of NZ Ltd v Commerce Commission* referred to as the "0867 litigation" was a decision of the Court of Appeal, upholding a High Court decision that Telecom had not misused its market power.
- The second was a High Court decision issued in October 2009, in what is referred to as the "Data Tails litigation", in which the Court found Telecom had misused its market power. Both cases relate to conduct that occurred approximately a decade ago.

# What is the counterfactual test?

- **In order to show a breach of s 36 of the Commerce Act, a plaintiff must prove:**
  - a substantial degree of market power (or, prior to 2001, dominance);
  - the defendant 'took advantage' of that market power in engaging in the affected conduct (or, prior to 2001, it 'used' its dominant position); and
  - one of the prohibited exclusionary purposes described in s 36.

- ***Telecom Corporation of New Zealand Ltd v Clear Communications Ltd ("Telecom v Clear")*** and ***Commerce Commission v Carter Holt Harvey Building Products Group ("CHH")*:**
  - Ask whether the company acted in a **way in which a person not in a dominant position in that market but otherwise in the same position would have acted**. The counterfactual test therefore requires the Court to **postulate a hypothetical business**, which was not in a dominant position in that market but otherwise in the "same circumstances" as the company under investigation, and ask itself how that company would have acted.

# Why is the counterfactual test used?

- French J observed in *Natwest Australia Bank Ltd v Boral Gerrard Strapping Systems Ltd* [1992] FCA 511, after referring to *Queensland Wire*:

> **"It is... an essential element of a cause of action based upon s46 that the alleged contravener is said to have used its market power.** The conduct must either by necessary implication from its very nature or by reference to other pleaded facts and circumstances constitute a use of that power. It is not sufficient to show that a corporation with market power has engaged in conduct for the purpose of preventing entry of another person into a market or deterring or preventing a person from engaging in competitive conduct in that or any other market. An extreme example illustrates the point. If a corporation with substantial market power were to engage an arsonist to burn down its competitor's factory and thus deter or prevent its competitor from engaging in competitive activity, it would not thereby contravene s46. **There must be a causal connection between the conduct alleged and the market power pleaded such that it can be said that the conduct is a use of that power."**

# Why is the counterfactual test used? (cont)

- **The majority of the Privy Council concluded that:**

  "..if a dominant firm is acting as a non-dominant firm otherwise in the same position would have acted in a market which was competitive, it cannot be said to be using its dominance to achieve the purpose that is prohibited."

- **Similarly, the Court of Appeal in 0867 held:**

  "For it is hard to see why in any exercise such as the present a court would not at least ask, in relatively straightforward terms: "What would have happened if the impugned firm was not dominant in the particular market?""

## Why is the counterfactual test used? (cont)

- Some form of counterfactual analysis is the underlying basis for most statements about causation.
- Counterfactual analyses used in philosophy, psychology, and other sciences as it intuitively reflects our understanding of basic causation
- Philosophy 101: "Do unto others as you would have them do unto you" faces a similar conundrum in the application of the counterfactual analysis

# What are the problems with it?

- **No real guidance on how to formulate the Counterfactual**
  - What does the hypothetical competitor look like? Is it a financially prudent operator? Or an entrepreneurially minded operator, who could stand the loss of a few thousand dollars? How are the attributes of the counterfactual comparator to be identified? The dissenting judges comment that the construction of an accurate counterfactual in this scenario was "highly unreal".
- **Use of financial resources have been a significant point of contention:**

  "[T]he use by a dominant firm of its financial ability to cut prices must be distinguished from its use of its position of dominance, the measure of which is its market power. The financial ability to cut prices is not market power."

# What are the problems with it? (cont)

- **In many, if not all, cases, the attributes chosen within the counterfactual will determine the end decision. This was identified by counsel for the Commission in 0867:**

> "Counsel for the Commission was critical of this formulation in this Court largely (though not exclusively) because he argues **that the counterfactual as thus constructed effectively defines away the problem**. The Privy Council had decreed that there be the same workable competitive market, save that there would be a nondominant Telecom. But as the Commission argues, the asymmetric and above cost termination payment regime in the 1996 ICA, Telecom's KSO obligations, and the disproportionate number of residential customers on Telecom's network compared with its competitors had led to a huge traffic imbalance. But all of these circumstances are said to be attributes of Telecom's *actual* dominant position, and if they are attributed to X (a non-dominant Telecom) then that company also has market power.
>
> Mr Farmer's argument is, at heart, that by definition what was constructed cannot be a competitive market. It assumes that no firm would be earning supranormal profits."

# What are the problems with it? (cont)

- **In 0867, the Court of Appeal ultimately found in favour of Telecom as it took the view that the Commission's case depended on the hypothetical Telecom giving undue weight to the potential loss of customers as a result of introducing the 0867 service.**

> "The issue is not what company X "would" or "should" have done. The issue is what it "could" rationally have done in this particular competitive market. The answer to that is not the expression of precise economic modelling or the production of a mathematical proof. Company X had to consider a number of factors, only one of which was the effect of a potential loss of customers.
>
> [The Commission's case that] …the potential loss of customers would necessarily and inevitably have outweighed the other matters at issue is a very long bow indeed. We would have thought that it would have to be demonstrated that there was highly likely to be a very significant loss of customers for that factor to become ascendant."

# The Australian tests

- **Subsection (6A) now provides:**

(6A) In determining for the purposes of this section whether, by engaging in conduct, a corporation has taken advantage of its substantial degree of power in a market, the court may have regard to any or all of the following:

(a) whether the conduct was **materially facilitated** by the corporation's substantial degree of power in the market;

(b) whether the corporation engaged in the conduct **in reliance on** its substantial degree of power in the market;

(c) whether it is likely that the corporation **would have** engaged in the conduct if it did not have a substantial degree of power in the market;

(d) whether the conduct is **otherwise related** to the corporation's substantial degree of power in the market.

This subsection does not limit the matters to which the court may have regard.

# The "materially facilitated" and "direct observation" tests - *Melway*

- **The "materially facilitated" and "direct observation" tests are derived from the decision of the Australian High Court in *Melway Publishing v Hicks* in which the Court referred to the decision in *Queensland Wire* and the standard counterfactual test, and observed:**

> "Dawson J's conclusion that BHP's refusal to supply … was made possible only by the absence of competitive conditions **does not exclude the possibility that, in a given case, it may be proper to conclude that a firm is taking advantage of market power where it does something that is materially facilitated by the existence of the power, even though it may not have been absolutely impossible without the power.** To that extent one may accept the submission made by the ACCC, intervening in the present case, that s 46 would be contravened if the market power which a corporation had **made it easier for the corporation to act** for the proscribed purpose **than would otherwise be the case**.

# "Materially facilitated" and "direct observation" tests - *Melway*

… **An absence of a substantial degree of market power does not mean the presence of an economist's theoretical model of perfect competition**. It only requires a sufficient level of competition to deny a substantial degree of power to any competitor in the market. …**To ask how a firm would behave if it lacked a substantial degree of power in a market,** for the purpose of making a judgment as to whether it is taking advantage of its market power, involves a process of economic analysis, which, if it can be undertaken with sufficient cogency, is consistent with the purpose of s 46. But the cogency of the analysis may depend on the assumptions that are thought to be required by s 46… **In some cases a process of inference, based on economic analysis may be unnecessary. Direct observation may lead to the correct conclusion.** Deane J thought that *Queensland Wire* was such a case.

# "Materially facilitated" and "direct observation" tests - *Melway*

"Merkel J, and the majority in the Full Court, following the example given in *Queensland Wire* asked themselves whether, in a competitive environment, without its market power, Melway would have been compelled, in a practical sense, to supply to the respondent, and answered the question in the affirmative. [Kirby J agreed with this conclusion] …

In particular, the appellant contends that the reasoning was based on an erroneous view of the assumptions s46 required to be made for the exercise. … …the hypothesis that Melway lacks a substantial degree of power in a market does not require the assumption that the distribution arrangements or practices of Melway are such that they are all commercially obliged to supply anyone who seeks to become a wholesaler, or that, at the wholesale level in the market, there exists perfect competition… It is one thing to compare what it has done with what it might be thought it would do if it lacked that power. **It is a different thing to compare what it has done with what it would do in circumstances that are completely divorced from the reality of the market**."

# "Materially facilitated" test - *Rural Press*

- ***Rural Press Ltd v Australian Competition and Consumer Commission ("Rural Press")*** **:**
  - The High Court rejected the ACCC's criticism of the Full Federal Court for asking whether Rural Press and Bridge ‘‘could’’ engage in the same conduct in the absence of market power.
  - The High Court determined that the Commission had failed to show that the conduct of Rural Press and Bridge was *materially facilitated by the market power*.
- **Note, again, the High Court analysis <u>included</u> consideration of how an entity without market power might have acted - but set a <u>higher</u> threshold for the causal link between market power and conduct, by asking:**
  - "**could** the respondent do this because, and only because, of its market power?"

## "Reliance" test - *Queensland Wire*

- In *Queensland Wire,* Mason CJ and Wilson J referred to the fact that there must be a connection or causal link between the respondent's conduct and its market power in the sense that it *relied* on its market power, or used its market power in order to give effect to the conduct.

- The Court held that the way to test this was to ask whether BHP could have engaged in the conduct in a competitive market.

# "Would have engaged in the conduct" test

- **The first (higher threshold) approach requires proof that the conduct is *only possible because of the market power*.**
  - The question asked under this threshold is: "**could**" the respondent do this because, and only because, of its market power? (*Melway* and *Rural Press)*
- **The alternative (lower threshold) approach requires proof that market power contributed to why a company chose to act in a particular way.**
  - The question to be asked under this threshold is: "**would**" the conduct be more likely with market power? (Adopted by Mason CJ and Wilson J in *Queensland Wire* and endorsed by the majority in *NT Power*. Obiter in *Melway* and applied by the Full Federal Court in *Safeway*.)

# "Would have engaged in the conduct" test

- **The two variants of the "could"/"would" test were most recently expressed by Allsop J in a composite form in *Baxter Healthcare* as whether the conduct at issue:**

  > "... **would not or could not** be done in other circumstances where the substantial power did not exist."

- **Similarly, the Court of Appeal in the 0867 decision referred to the Privy Council's use of "would" in its *CHH* formulation of the counterfactual test and expressed the view that "would" means "could rationally".**

# "Otherwise related" test

- **This test is new.**
- **The apparent breadth of this factor also raises questions regarding the necessary connection between the conduct and the market power.**
  - The Australian commentaries have asked, if the test implies some new connection of 'relatedness', what degree of 'relatedness' is required?
- **At the very least the term 'otherwise related to' in (d) ought to be considered in the statutory context of the other elements (a), (b) and (c), in which case it adds no clarity to the analysis.**

# Other tests

- **"Direct observation"**
  - Lacks rigour. Never applied outside a standard counterfactual analysis
- **Legitimate business rationale**
  - *BOPE:* conduct which may be legitimate for a firm not in possession of market power can nevertheless be illegitimate if carried out by a firm with a substantial degree of market power so a legitimate business reason should not prevent a finding of breach of s 36

# Other tests

- **"Special responsibility" (EU)**
  - *Akzo Chemie BV v EC Commission*: …"Article 86 does not require that the dominant undertaking in the market should have used its economic power to bring about the abuse…"
- **"Effects balancing"/"disproportionality" (US and EU)**
  - Applies different statutory tests

# Policy considerations

- Competition law is sometimes hard for the individual, but "*best for the race, because it ensures the survival of the fittest in every department*".
- "The purpose of the [Sherman] Act," the Supreme Court instructs, "is not to protect businesses from the working of the market; it is to protect the public from the failure of the market".
- As Judge Posner explains, "It would be absurd to require the firm to hold a price umbrella over less efficient entrants… [P]ractices that will exclude only less efficient firms, such as the monopolists's dropping his price nearer to (but not below) his cost, are not actionable, because we want to encourage efficiency".

# Small economy considerations

- **Over-enforcement is recognised as having a chilling effect on competition as firms with market power structure their affairs to avoid breaching the Act. The DOJ Report observes:**

> … **Firms with substantial market power typically attempt to structure their affairs so as to avoid either section 2 liability …. If the lines are in the wrong place, or if there is uncertainty about where those lines are, firms will pull their competitive punches unnecessarily, thereby depriving consumers of the benefits of their efforts.** The Supreme Court has consistently emphasised the potential dangers of overdeterrence.

- **The chilling effect may be more significant in a small economy where markets are typically more highly concentrated, so a greater proportion of the market's operation relies on active competition by companies with higher market shares than are typically found in larger economies, and who may therefore consider themselves at risk of a finding that they have market power.**

# General vs Specific Rules

- **Commission Chair Dr Mark Berry has discussed the strong policy reasons why specific rules in many cases can (and arguably should) take precedence over general rules for s 36 conduct.**

- **There should be no objection to use of conduct specific rules, as developed in the case law, in New Zealand, Australia and the US, to act as guides, or 'rules of thumb' indicating what a company with market power would, or would not, do if acting in a competitive market.**

  - For example, it might be said that if acting in a competitive market, a company would not, as a general rule, price below cost with no opportunity for recoupment
  - In practice, the specific rules (for example, the Baumol-Willig rule - ECPR - in access pricing) have been developed in the cases through the application of the counterfactual test outlined above.

# Should NZ align with Australia?

- ***For***:
  - The Minister's address flagged the government's preference for a single legal framework to guide the conduct of firms operating across both sides of the Tasman.
  - There must be a strong presumption that New Zealand and Australian laws ought to align, at least in respect of s36 of the Commerce Act and s 46(1) of the Trade Practices Act, given the statutory language is in some respects the same
  - The Courts have acknowledged the general desirability for harmonisation of interpretation of laws where they are expressed in consistent terms.

# Should NZ align with Australia?

- ***Against:***
  - The ACCC noted in its submission to the ICN:
    - "… its objective of protecting smaller and more vulnerable firms from larger rival firms that engage in conduct designed to lessen competition helps to achieve another goal of promoting competition."
  - The ACCC and Commerce Commission, in outlining for the International Competition Network their respective countries' objectives of unilateral conduct laws, identified different criteria.
    - Both identified 'ensuring a competitive process', 'promoting consumer welfare', 'maximising efficiency', and 'achieving market integration' (CER objectives),
    - the ACCC also listed 'ensuring a level playing field for SMEs' which the Commission did not, and
    - the Commission identified 'facilitating privatisation and market liberalisation', which the ACCC did not.
  - Consider also the process by which s46 was amended…

# The Supreme Court's task

- **The Supreme Court could endorse the counterfactual test**
  - As demonstrated above, the alternative tests formulated b the High Court of Australia do not obviously set lower thresholds or provide greater clarity than the counterfactual test established in *Queensland Wire.*
- **It is hoped that the Supreme Court will also confirm:**
  - the purpose of the counterfactual analysis is to encourage efficiency by allowing all companies, including those with high market shares, to compete based on superior efficiencies, including those arising from diversified operations; and
  - conduct-specific tests as developed in the case law act as guides to evaluating whether a company in the same position as the defendant but in a competitive market would (or could rationally) have behaved the way it did
  - In most cases, when constructing the counterfactual, it is unhelpful to 'decompose' the actual firm in question. Often it is most helpful to postulate the same firm (F1), in the same market, but with a shadow firm (F2), identical to F1, ready and available to quickly make the investment necessary to serve the customer whose supply terms with F1 are in question.


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