IMPLICATIONS OF THE DECISION OF THE HIGH COURT IN *QUEENSLAND WIRE*

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[The decision in Queensland Wire is the first decision of the High Court on the substantive economic issues of the Trade Practices Act. The decision makes it clear that: (i) the definition of market power under the Act should be object-oriented; (ii) power in a market under the Act is the economists' notion of market power; and (iii) to take advantage of power in a market is to engage in conduct that one could not undertake in a competitive market. The authors argue that the decision brings economic efficiency to the forefront of litigation under the Act. They discuss the implications of the decision for refusing to deal, dealings in intellectual property and investment strategy.]

1. *INTRODUCTION*

The decision of the High Court in *Queensland Wire Industries Pty Ltd v. The Broken Hill Proprietary Company Limited and Anor*[1] ('*QWI*') was handed down on 8 February 1989. This is the first decision of Australia's ultimate court of appeal on the substantive economic issues of the Trade Practices Act 1974 (Cth) ('the Act'). The case arose under the monopolization provision, section 46.

Section 46(1) states:

> A corporation that has a substantial degree of power in a market shall not take advantage of that power 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 in any other market;
> (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.

The issues of market, market power, taking advantage and purpose are discussed at length in the judgments. Even to non-specialists, the importance of the decision is apparent from extensive coverage by the press and the large number of seminars dedicated to the topic. A detailed commentary by a leading practitioner was published shortly after the release of the decision.[2]

The principal facts were not in dispute. Queensland Wire Industries Pty Ltd ('QWI') made an application against The Broken Hill Proprietary Company Limited ('BHP') and its wholly-owned subsidiary Australian Wire Industries Pty Ltd ('AWI') claiming that the respondents took advantage of their substantial

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1 (1989) 167 C.L.R. 177; 83 A.L.R. 577; 11 A.T.P.R. 40-925.

2 Pengilley, W., 'Denial of supply and misuse of market power in Australia: What follows from the High Court decision in Queensland Wire', Special Report, *Australian Trade Practices Reporter*, CCH Australia Ltd (March 16, 1989).

degree of power in a market by effectively refusing to sell to it a steel product known as Y-bar. Y-bar was produced by BHP at its Newcastle rolling mill. The only other producer of steel in Australia, Smorgon Consolidated Industries Pty Ltd ('Smorgon'), supplied only three *per cent* of Australia's steel and did not produce Y-bar; and no significant quantities of Y-bar had been imported.

Although BHP had exported some Y-bar its only domestic sales had been to AWI. AWI converted the Y-bar into star picket posts by cutting the Y-bar at fence post lengths, putting in holes through which wire would ultimately pass, trimming one end of the post to a point so that the posts could be hammered into the ground, and coating the posts with an anti-corrosive. These posts were then used in what was by far the most popular kind of rural fencing in Australia.

Between them, AWI and QWI supplied nearly all the rural steel fencing in Queensland, with QWI's share being about 28 *per cent*. AWI supplied most of the rural fencing in the rest of Australia — with the exception of South Australia. QWI sought supply of Y-bar feed from BHP. BHP responded that its policy was to refuse supply of Y-bar or to offer supply only at an uncompetitive price because it wished to preserve the business of manufacturing the star picket posts to itself.

Section 46 contains three principal elements: (i) the possession of substantial power in a market; (ii) the taking advantage of that power; (iii) for one of the purposes listed in paragraphs (a) through (c). At first instance, Pincus J.[3] was satisfied of the presence of all elements of QWI's claim except taking advantage. His Honour construed taking advantage as requiring some reprehensibility of conduct. But, because BHP's refusal would not be regarded in commerce as deserving of criticism, his Honour dismissed the proceedings.

The appeal to the Full Court of the Federal Court was heard by Bowen C.J. and Morling and Gummow JJ.[4] The Full Court did not find need to re-consider the construction of 'take advantage' because it ruled that there has never been a market for Y-bar so as to attract s. 46 of the Act in that there had been no trade or traffic between buyers and sellers of Y-bar as an article of commerce. The Full Court was unconvinced that a potential market was adequate for the terms of the Act.

The High Court unanimously upheld the appeal by QWI — but produced four judgments. Mason C.J. and Wilson J. signed one of these. Deane J. and Toohey J. wrote separate judgments. Dawson J. agreed generally with Deane J. but added further comments. The decision has done much to clarify the role of market definition within the Act and the meaning of the words 'take advantage of' in s. 46. However, the decision leaves certain issues unresolved and raises others.

This paper is organised around the elements of s. 46. With respect to each element we discuss the contribution of the judgment of the High Court and raise the issues that need further clarification. Following this, we discuss the implications of the decision for: (i) refusing to deal; (ii) dealings in intellectual property;

3 (1987) 75 A.L.R. 331; 9 A.T.P.R. 40-810.
4 (1988) 78 A.L.R. 407; 10 A.T.P.R. 40-841.

and (iii) investment strategy. We conclude with some observations about the framing of orders.

2. *MARKET*

2.1 *Market and Market Power*

One of the clearest messages to emerge from the decision is that the definition of the market should be object-oriented. As Mason C.J. and Wilson J. state:

> In identifying the relevant market, it must be borne in mind that the object is to discover the degree of the defendant's market power. Defining the market and evaluating the degree of power in that market are part of the same process, and it is for the sake of simplicity of analysis that the two are separated. Accordingly, if the defendant is vertically integrated, the relevant market for determining the degree of market power will be at the product level which is the source of that power.[5]

The High Court seems to be making these remarks by way of dismissing the argument on market of the Full Court. However, the Full Court seems to have been unable to match its principles with its practice. On the principles underlying the definition of market, the Full Court quoted the following passage with approval:

> In our view, in defining the market or markets involved in a particular dispute, one should begin with the problem at hand and ask what identification of markets best assists in analysing the process of competition, or lack of competition, with which the case is concerned.[6]

Despite this embracing of an object-oriented approach, the Full Court proceeded to define a market as trade or traffic.

The decision of the High Court makes it clear that an object-oriented approach to market definition demands that a market be considered as a field of rivalry.

This view of the market was proposed in the seminal decision of the Australian Trade Practices Tribunal in *Re Queensland Co-operative Milling Association Ltd v. Defiance Holdings Ltd*:

> A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them . . . Within the bounds of a market there is substitution — substitution between one product and another, and between one source of supply and another, in response to changing prices. So a market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive . . . Whether such substitution is feasible or likely depends ultimately on customer attitudes, technology, distance, and cost and price incentives. It is the possibilities of such substitution which set the limits upon a firm's ability to 'give less and charge more'. Accordingly, in determining the outer boundaries of the market we ask a quite simple but fundamental question: If the firms were to 'give less and charge more' would there be, to put the matter colloquially, much of a reaction?[7]

2.2 *Market and the Supply Side*

At first instance, Pincus J. was rather equivocal in his definition of market. The reasons for this equivocation are discussed at some length in the judgment of Toohey J.

[5] (1989) 167 C.L.R. 177, 187. This object-oriented approach to the definition of markets is a theme frequently expounded by Professor Franklin Fisher. See, for example, Fisher, F. M., McGowan, J. J. and Greenwood, J. E., *Folded, Spindled, and Mutilated: Economic Analysis and U.S. v IBM* (1983) Ch. 3.

[6] Norman, N.R., and Williams, P.L.,'The Analysis of Market and Competition Under the Trade Practices Act: Towards the Resolution of Some Hitherto Unresolved Issues', (1983) *Australian Business Law Review* 396, 400.

[7] (1976) 25 F.L.R. 165, 190; 8 A.L.R. 481, 517; 1 A.T.P.R. 40-012, p.17, 247.

Pincus J. did not expressly find that there was a market for the supply of steel and steel products. His Honour was not prepared to make that finding because of his views as to substitutability though, as suggested earlier in these reasons, he seems to have assumed the existence of such a market in his summary of conclusions.

In considering the question of substitutability, Pincus J. thought that regard should only be had to the 'demand end' and not to the 'supply end'. This was because his Honour was of the view that if s. 4E were read to include the wider notion of supply, 'odd consequences may ensue'. He mentioned by way of illustration a factory making diecast toys which could, with little expense, make diecast machine-gun parts. 'Yet', his Honour said, 'machine-guns and toys would not ordinarily be regarded by practical business people as competing in the same market. Section 4E suggests to me that it is not that sort of substitutability which the legislature had in mind.'

The notion of substitutability is of importance in the present case because it is apparent that, had Pincus J. been prepared to have regard to substitution at the supply end, he would have accepted the first market proffered by B.H.P., namely the market for steel and steel products in Australia.[8]

There are hints in the decision of the High Court from which anti-supply-siders might gain some comfort. Mason C.J. and Wilson J. refer to the authorities on market definition of two decisions of the European Court: *Hoffman-La Roche v. Commission*[9] and *United Brands v. Commission*.[10] But these two decisions are notorious for their neglect of substitution on the supply side. Similarly, Dawson J.'s statement that 'A market is an area in which the exchange of goods or services between buyer and seller is negotiated'[11] seems to suggest a market as trade or traffic rather than a market as field of rivalry.

Nevertheless, the clear finding of the High Court is in favour of considering supply-side substitutability in defining a market. With the exception of Deane J., all judges state this explicitly.[12] In the words of Mason C.J. and Wilson J.:

> Pincus J. found that once a rolling mill is in operation it is relatively easy to convert production from one shape of steel to another. Consequently, any market power BHP has with regard to Y-bar would be dependent on power in the market for steel and steel products.[13]

The practical difference to the analysis of market power of adopting this definition of the product market rather than confining it to Y-bar is that Smorgon is classified as an incumbent rather than as a potential entrant. If one classifies Smorgon as an incumbent, one's analysis would be deficient if one failed to acknowledge that Smorgon cannot convert at zero cost to produce the Y-bar section.

At the first hearing, counsel for BHP claimed that the cost of purchasing the rollers needed to produce a section of this shape was 'about $100,000. . . certainly to people like BHP and Smorgons, a modest amount of money, particularly of course if the steel industry has surplus capacity'.[14] The first hearing produced evidence to suggest that certain persons had attempted to arrange for Y-bar to be imported and that Smorgon had considered making the necessary expenditure themselves. Why did these considerations lead to nothing?

In the case of Smorgon, the cost would be greater than $100,000. Evidence

8 (1989) 167 C.L.R. 177, 209-10. Section 4E states:

> For the purposes of this Act, 'market' means a market in Australia and, when used in relation to any goods or services, includes a market for those goods or services and other goods or services that are substitutable for, or otherwise competitive with, the first-mentioned goods or services.

9 [1979] 1 E.C.R. 461.

10 [1978] 1 E.C.R. 207.

11 (1989) 167 C.L.R. 177, 199.

12 *Ibid.* 199 *per* Dawson J.; *Ibid.* 210 *per* Toohey J.

13 *Ibid.* 192.

14 *Queensland Wire Industries Pty Ltd v. The Broken Hill Proprietary Company Limited & Anor*, Federal Court of Australia, No. Qld G 125 of 1984, Transcript of Proceedings, Brisbane, 657.

before the Court disclosed that Smorgon did not have any excess steel making capacity and that it was content to follow BHP's prices. Accordingly, if Smorgon were to produce Y-bar, it would have to forgo the profit on the sections that they are currently producing — as well as incurring the cost of the new equipment.

Even if Smorgon were not operating at full capacity the expenditure of $100,000 would still not be undertaken lightly. It would only be undertaken if management considered such an investment to be profitable. A key issue in such a decision would be the market share that Smorgon would need to gain in order to earn the margins on Y-bar needed to justify the investment expenditure. Smorgon would be less likely to undertake the investment, the larger the break-even market share.

Because Smorgon could not produce Y-bar without incurring a non-trivial investment cost, it may have been most appropriate to analyse the extent to which Smorgon constrained BHP's policy with respect to Y-bar under the heading of conditions of entry. Accordingly, the field of competition would be Y-bar. Alternatively, if one wished to analyse the competition offered by Smorgon as an incumbent, one would have to acknowledge a possible barrier to mobility across sub-markets.[15] In principle, the outcome of the two analyses ought to be the same. The consequence of defining the product market as Y-bar is that it directs attention to the (non-trivial) investment decision that Smorgon (and foreign producers) would need to make in order to produce the product in question.

3. *POWER IN A MARKET*

The decision makes it plain that the phrase 'power in a market' must be read as a composite: one cannot consider the market separate from the power. Time after time, the judgments use the economists' phrase 'market power' as equivalent to that of 'power in a market'. The judgment of Mason C.J. and Wilson J. quotes an article by an economist, Baden Fuller, on the definition of market power:

> Market power can be defined as the ability of a firm to raise prices above the supply cost without rivals taking away customers in due time, supply cost being the minimum cost an efficient firm would incur in producing the product.[16]

3.1 *Market Power and Barriers to Entry*

The same judgment quotes the well-known text book in industrial economics by F.M. Scherer to the effect that 'significant entry barriers are the *sine qua non* of monopoly and oligopoly . . . sellers have little or no enduring power over price when entry barriers are nonexistent.'[17] Standard economics texts are also cited by Dawson J. as the basis for his proposition that the existence of barriers to entry may be conclusive in determining the degree of market power.[18] So the

[15] See Caves, R. E., and Porter, M. E., 'From Entry Barriers to Mobility Barriers: Conjectural Decisions and Contrived Deterrence to New Competition', (1977) *Quarterly Journal of Economics* 241.
[16] Baden Fuller, C. W., 'Article 86 EEC: Economic Analysis of the Existence of a Dominant Position', (1979) *European Law Review* 423, 428, quoted (1989) 167 C.L.R. 177, 188.
[17] Scherer, F. M., *Industrial Market Structure and Economic Performance* (2nd ed. 1980), 11, quoted (1989) 167 C.L.R. 177, 189-90.
[18] *Ibid.* 201.

High Court in *QWI* has drawn particular attention to the condition of entry as the determinant of an incumbent firm's market power and has acknowledged that the concept is drawn from economics.

The last twenty years have witnessed much debate by economists on the theory of barriers to entry.[19] This work has resulted in clarification of the concept of barriers. Even though some controversy persists, 'barrier to entry' is a term of art in economics. If, because it is already established, an incumbent has an advantage over the best- qualified potential entrant, a barrier to entry may be said to exist.

It is now generally agreed among industrial-organization economists that barriers can derive from two sources. In the first place the incumbent may face lower costs at some or every level of output than a potential entrant. These are known as absolute-cost barriers. Many of these barriers result from government regulation of some type, for example, government licensing. The potential entrant may face an infinite cost disadvantage compared with the established firm because, no matter what it does, it cannot get a licence. Alternatively, it can only get a licence by incurring costs of lawyers, lobbyists and so on — which costs were not incurred by the incumbents when they secured their licences.

The first few examples of barriers to entry referred to in the judgment of Mason C.J. and Wilson J. — patent rights, exclusive government licences and tariffs — are instances of absolute-cost barriers.

An example of an absolute-cost barrier can be found in the analysis by the Trade Practices Tribunal of competition between brewers *In re Tooth & Co. Ltd; In re Tooheys Ltd*. In the absence of licensing laws, which operated to restrict the number of retail outlets, entry at the retail level would have been relatively free. Consequently, any new brewer who was at least as efficient as an established brewer, could enter the beer industry and sell its beer through a new set of hotels. In such a world it would not matter that the established hotels were tied to the established breweries. Entry at both stages in the production process would be relatively easy. However, entry at the retailing level was restricted by regulation. As the Tribunal noted:

> It is clear that such restrictive licensing laws may create an opportunity for tie policies with the purpose or effect of market foreclosure at both wholesale and retail levels. For if new — and untied — retail outlets can enter easily, it is clear that the brewery ties cannot serve as a barrier to entry.[20]

The second type of barrier results from the need for costs to be sunk upon entry coupled with economies of scale that are large compared with the size of the market. Sunk costs are defined as those which need to be incurred upon entering an industry and which cannot be recovered if one leaves immediately. Sunk costs can create a barrier to entry because, if they are substantial, they may cause incumbent firms to remain in the industry even after more efficient firms have entered. The result may be that the industry would have such excess capacity after entry that prices would be depressed and no firm would be viable. The very

[19] For a review of this debate, see Schmalensee, R., 'Ease of Entry: Has the Concept Been Applied Too Readily?', (1987) 56 *Antitrust Law Journal* 41.
[20] *In re Tooth & Co Ltd; In re Tooheys Ltd* (1979) 39 F.L.R. 1 at 27.

prospect of such a ruinous outcome may be sufficient to deter the best-qualified entrant from entry *even though* the incumbent[s] is [are] not operating efficiently.[21]

3.2 *Capital Cost as a Barrier to Entry*

The judgments in *QWI* have the potential to create confusion over the conditions under which the need to make an investment in order to enter a market constitutes a barrier to entry.

The judgment of Dawson J. states:

> There is, of course, vigorous debate in economic circles about what constitutes a barrier to entry into a market. There are those who would and those who would not accept that the high cost of entry constitutes a barrier.[22]

In the seminal modern work on barriers to entry[23] capital costs are included as a barrier to entry. However, as noted in the judgment of Dawson J., this inclusion has been subject to much criticism in the ensuing thirty-four years.

The current received economics wisdom on this issue can be summarized in two propositions. In the first place, many economists would concede that capital markets can be imperfect. They may be imperfect in the sense that, although it may be profitable for a person to enter a market, that person may fail to enter because no one is willing to finance the entry.[24] The judgment of Mason C.J. and Wilson J. refers to the efficiency of capital markets when discussing capital costs as a barrier to entry:

> BHP is one of Australia's two steel producers, and, as Pincus J. found, there are significant barriers to entry. Pincus J. did not identify what those barriers to entry were except to note that among them was the high cost of setting up a rolling mill. Economists, with their faith in the efficiency of capital markets and the rational behaviour of businessmen, would question the conclusion that high capital costs could constitute a barrier to entry.[25]

As stated above, many economists do not share the faith in the efficiency of capital markets which is attributed to them in this passage. However, the finding of capital-market imperfections does not imply a finding of a barrier to entry to a market. The imperfection may create a barrier to an individual person but this does not necessarily constitute a barrier to the market.

Even if one acknowledges that Mr or Mrs Average may face a barrier to entry into the steel market, it does not follow that barriers to entry exist when barriers are defined *with respect to the market as a whole*.[26]

21 See Dixit, A. K., 'The Role of Investment in Entry Deterrence' (1980) *Economic Journal* 90, 95.

22 (1989) 167 C.L.R. 177, 201.

23 Bain, J., *Barriers to New Competition* (1956).

24 For a survey of the literature, see Tirole, J., *The Theory of Industrial Organization* (1989) 377-9.

25 (1989) 167 C.L.R. 177, 192.

26 This mistake of logic is the explanation for the recent assertion by the Trade Practices Commission that capital cost can constitute a barrier. In its *Misuse of Market Power* Background Paper issued in February 1990, the Commission says (at 20):

> Some economists argue that the requirement for a large initial capital outlay should not be regarded as a *per se* barrier to entry to a market, and the only factor which is important is the level of 'sunk' costs involved in an assault on a market. The Commission takes the view that such an argument depends for its validity upon the unrealistic propositions that capital markets function freely, ie that they are unimpeded by government regulation, that financiers possess perfect knowledge about the prospects of individual enterprises, including prospective entrants, and that new entrants do *not* face a capital cost differential which is due to investors perceiving greater risk in backing a new entrant's challenge to incumbents for a share of the market. There *will* be situations where high capital costs in themselves must be reckoned as a barrier to entry . . . (emphasis in original).

Of course, Mr or Mrs Average would have to pay a higher rate of interest to borrow one hundred million dollars to establish a steel mini mill than would a large mining or manufacturing company. (Indeed, it is more likely that Mr or Mrs Average could not get such a loan at any rate of interest.) But this fact does not constitute a barrier to entry to the market — because the most likely entrant to the steel market is a company that already is involved in the mining or processing of metals. Such a company will have the same access to finance as BHP. Accordingly, the need to invest a large sum of money in order to enter the steel market would not, of itself, constitute a barrier. However, as explained in section 3.1, a barrier is erected to the extent that the investment represents a sunk cost.

Because of these considerations the recent economics writing on barriers to entry is full of references to sunk costs but access to finance is rarely mentioned and, if mentioned, the reference is highly qualified. The best and most-recent survey of the economics of barriers to entry does not mention access to finance.[27]

This leads to the second proposition by which one can summarize the current received economics wisdom on capital costs as a barrier to entry: access to finance does not, of itself, constitute a barrier to entry to a market as a whole. This does not suggest that barriers rarely exist. Sunk costs are quite ubiquitous.[28] The questions in any case ought to be as to the magnitude and significance of sunk costs.

4. *TAKE ADVANTAGE*

The decision of the High Court in *QWI* disposes of Pincus J.'s construction of 'take advantage'. The judgment of Mason C.J. and Wilson J. gives the following reasons:

> Pincus J. suggested that the phrase 'take advantage' requires that the defendant be doing something 'reprehensible'. His Honour also used the phrases '[competition] deserving of criticism' and 'predatory or unfair', apparently as equivalents for 'reprehensible'. It is unclear precisely what the phrases are supposed to mean, but they suggest some notion of hostile intent. For our part, we have difficulty in seeing why an additional, unexpressed and ill-defined standard should be implanted in the section. The phrase 'take advantage' in s. 46(1) does not require a hostile intent inquiry — nowhere is such standard specified. And it is significant that s. 46(1) already contains an anti-competitive purpose element. It stipulates that an infringement may be found only where the market power is taken advantage of for a purpose proscribed in para. (a), (b) or (c). It is these purpose provisions which define what uses of market power constitute misuses.[29]

Of course, the decision does not merely dispose of Pincus J.'s construction of take advantage: it proposes a clear alternative. To take advantage of one's market power is to do something which can only be done because of one's market power — that could not be done if the market in which one operated were vigorously competitive. It is worth quoting the judgments at length to establish this point. First, the judgment of the Chief Justice and Wilson J.:

> In effectively refusing to supply Y-bar to the appellant, BHP is taking advantage of its substantial market power. It is only by virtue of its control of the market and the absence of other suppliers that BHP can afford, in a commercial sense, to withhold Y-bar from the appellant. If BHP lacked

27 Gilbert, R. J., 'Mobility Barriers and the Value of Incumbency' in Schmalensee, R. and Willig, R. D. (eds), *Handbook of Industrial Organization* (1989) Vol. I, 475-535.

28 See Shepherd, W. G., 'Contestability vs. Competition' (1984) 74 *American Economic Review* 572, 577.

29 (1989) 167 C.L.R. 177, 190-1.

> the market power — in other words, if it were operating in a competitive market — it is highly unlikely that it would stand by, without any effort to compete, and allow the appellant to secure its supply of Y-bar from a competitor.[30]

Secondly, the judgment of Dawson J.:

> I am of the view that the words 'take advantage of' do not have moral overtones in the context of s. 46. That being so, there can be no real doubt that BHP took advantage of its market power in this case. It used that power in a manner made possible only by the absence of competitive conditions.[31]

Finally, Toohey J. discusses at length the argument between counsel over the meaning of 'take advantage'. After summarizing the argument of counsel for QWI, he states:

> On that approach, the relevant question to ask in determining whether there has been an infringement of s. 46 is this: Is BHP refusing to supply Y-bar because of its dominant power (due to the absence of competitors) in the steel product market? The answer to that question, it is said, must be yes.
>
> In my view the answer is correct. The only reason why BHP is able to withhold Y-bar (while at the same time supplying all the other products from its rolling mills) is that it has no other competitor in the steel product market who can supply Y-bar.[32]

The meaning of 'take advantage' is thus clear. But is this construction an invitation to value judgments as claimed by Warren Pengilley?[33] We believe that it is not and that economics can be used to explain why. The principal proposition of modern welfare economics is that, providing rights over property are well-defined, competition will ensure that business decisions are efficient from the viewpoint of society as a whole. Accordingly, if a firm refuses supply there are four possible explanations:

1 The firm is not maximizing profit. Although this explanation would not appeal to many economists, the fact is that people sometimes act in anger: personal feelings sometimes cloud the commercial judgment of people in business — whether those businesses are operating in competitive markets or not.

2 The refusal promotes efficiency. The point can be illustrated by an example proffered to Pincus J. by counsel for BHP. If a single-firm monopolist producer of glass bottles were asked to supply molten glass, it would probably refuse. Its refusal would not be contingent on its market power because the refusal would be forthcoming even if it were in a highly-competitive market. One could prove this hypothesis by one of two courses. In the first place one could point to glass producers operating in competitive markets. Secondly, one could point to the inefficiencies (that is, the increases in costs) caused by breaking the process of production at the stage of the molten glass. In effect, these two methods of proof are inter-twined: if the costs of the whole process would increase if one were to break the process of production at the stage of the molten glass then economics would predict that firms in a competitive industry would not break the production process at that point.[34]

30 *Ibid.* 192.

31 *Ibid.* 202. Pincus J. had found that in every steel product line where BHP experienced some competition it sold that product; but in the case of Y-bar, a product which it alone produced, it refused to sell.

32 *Ibid.* 216.

33 *Supra* n. 2, 15.

34 Panzar, J. C., and Willig, R. D., 'Economies of Scope' (1981) 71 *American Economic Review* 268.

3 The refusal is contingent upon the market power of the firm which is refusing supply. This was the finding of the High Court in *QWI*. Clearly, the court found it easier to reach this decision because BHP did not attempt to justify the refusal along the lines suggested under 2. above.

4 The refusal to supply to a particular group of firms is contingent upon the market power of other firms to whom supply is not refused. The obvious example of such a case is the pressure brought by retailers on a supplier (even in a competitive industry) to refuse supply to those retailers who are likely to engage in price competition at the retailing level.

The construction put on 'take advantage' by the decision means that a refusal to supply will only contravene the section if that refusal falls under the third of these four categories. In particular, we anticipate that defendants under s. 46 will generally conduct their defence by bringing evidence about the efficiencies which could explain a refusal to supply. The effect of the decision of the High Court in *QWI* is to encourage parties to argue efficiencies before the courts. Far from introducing value judgments into the section, the construction places economic efficiency at the heart of s. 46.

By way of contrast to the liberal use made of the economics literature and judgments from other jurisdictions when discussing the concepts of market and market power, the judgments in the High Court treat the phrase 'take advantage of [market] power' as *sui generis* and pay virtually no attention to the overseas experience in distinguishing between monopolistic practices and vigorous competition. Dawson J. is the exception to the extent that his Honour recognised that finding 'a satisfactory basis upon which to make the distinction' lies at the heart of the United States law as well as the Australian. However he found nothing in the decisions of the American courts except 'synonyms which are not particularly helpful' such as 'honestly industrial', 'predatory' and 'exclusionary'.[35]

Despite their decision to treat the conduct element of s. 46 as a matter of first impression, the High Court judges have explained it in a way that corresponds quite closely to the interpretation given by courts in the United States to s. 2 of the Sherman Act over the last decade. For instance, in *Berkey Photo, Inc. v. Eastman Kodak Co.*[36] the Second Circuit Court of Appeals described a use of monopoly power as 'an action that a firm would have found less effective, or even counterproductive, if it lacked market power.'[37] In *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*,[38] in its first opportunity for nearly twenty years to restate the elements of the offence of monopolization, the Supreme Court explained what it meant by 'exclusionary' and 'predatory': 'If a firm has been attempting to exclude rivals on some basis other than efficiency, it is fair to characterize its behaviour as predatory.'[39]

35 (1989) 167 C.L.R. 177, 202.
36 603 F.2d 263 (2nd Cir. 1979).
37 *Ibid.* 291.
38 472 U.S. 585 (1985).
39 *Ibid.* 605.

4.1 *Use of market power and use of legal rights*

The High Court decision also disposes of a persistent line of judicial interpretation of s. 46 that has excluded from the reach of the section any conduct of a dominant firm that could be characterized as an exercise of some power or right other than its power as a trader in its market. The distinctive feature of this line of cases has been that they have treated market power as severable from the rights and assets owned by the powerful firm. Thus use of market power has been contrasted with exercise of a contractual right,[40] exercise of a right in intellectual property,[41] and access to information.[42]

The limitations of this construction were first noted by Pincus J. in *QWI*. His Honour pointed out that s.46(3), as it had stood until amended in 1986, illustrates that:

> [A] firm has market power, not only because it has a certain percentage of the market, but also because of its assets, physical and intellectual, 'technical knowledge, raw materials or capital'. Those assets include in my view rights under contracts it has with others in the market, such as distributors. . . . If one were to exclude from the concept of taking advantage of market power the use of rights which are available under the general law, there would be not much left of the section.[43]

Thus his Honour declined to dispose of the case before him by the application of a simple principle that a decision not to sell is an exercise of a property right rather than an exercise of market power. He concluded that the concept of taking advantage of market power: 'was probably not intended to require that what has been done was *purely* an exercise of power in the market place, as opposed to an exercise of the power of an owner *qua* owner or a contracting party *qua* contracting party. Powers of these kinds are components of market power.'[44]

The only judge in the High Court to discuss this issue was Dawson J. who described it as not helpful '. . . to categorize conduct, as has been done, by determining whether it is the exercise of some contractual or other right', and listed four of the offending decisions.[45] Although the issue was not addressed in the joint judgment of the Chief Justice and Wilson J., it is clear that the distinction between use of market power and use of legal rights is not consistent with their Honours' approach to identifying a use of market power. Whether market power has been taken advantage of is to be answered simply by asking whether the firm would have acted differently if it was operating in a competitive market. There is no room in this test for the application of technical distinctions between market power and property or contractual rights.

40 *Top Performance Motors Pty Ltd v. Ira Berk (Queensland) Ltd* (1975) 24 F.L.R. 286; 5 A.L.R. 465; 1 A.T.P.R. 40-004, *per* Smithers J.; *J. Ah Toy Pty Ltd v. Theiss Toyota Pty Ltd* (1980) 30 A.L.R. 271; 3 A.T.P.R. 40-155.

41 *Warman International Ltd v. Envirotech Australia Pty Ltd* (1986) 67 A.L.R. 253, 277; 8 A.T.P.R. 40-714, p.47, 827.

42 *Williams v. Papersave Pty Ltd* (1987) 73 A.L.R. 475, 491; 9 A.T.P.R. 40-781, 48, 526.

43 (1987) 75 A.L.R. 331, 343-4.

44 *Ibid.* 345.

45 (1989) 167 C.L.R. 177, 202.

5. *PURPOSE*

Over the past twenty years commentators in the United States[46] and, more recently, Courts in that country,[47] have pointed to the futility of attempting to identify anti-competitive conduct solely by reference to the purpose of the firm engaging in the conduct.

It was the concern of Pincus J. that ordinary competitive conduct will often evince the purposes in s. 46 that led him to conclude that the section required containment by confining its operation to conduct that could be described as reprehensible. Like Pincus J., the High Court has contained the operation of the section by confining it to a particular type of conduct — but it has selected an economic criterion in preference to Pincus J.'s moral criterion. As interpreted by the High Court, the phrase 'take advantage of market power' is sufficient, of itself, to distinguish between competitive and non-competitive conduct.

Having established that 'take advantage' is a concept devoid of overtones of intent to injure, each of the judgments assigns to the list of proscribed purposes in s. 46(1) the role of distinguishing between those uses of market power that are acceptable and those which are misuses in contravention of the section.[48]

Notably absent from the section are purposes such as 'making excessive profits' or 'limiting production'. Mere exploitation of market power — of which the classic example is restriction of output to raise price and maximise profits — is not objectionable. Even though it is market conduct different from that which a competitive market would enforce (and so an instance of taking advantage of market power), because it is not pursued for any of the proscribed purposes, it is not a misuse of power in the terms of the section.

In the High Court, epithets such as 'predatory' and 'exclusionary' were said to be 'not particularly helpful' as a basis on which to make the distinction between monopolistic practices and vigorous competition,[49] and to 'add nothing to an understanding of the section'.[50] A reason why recourse to terms such as these is unnecessary in the Australian law is that the purpose provisions spell out one of the criteria regarded by commentators on antitrust law as necessary for the identification of conduct as exclusionary or predatory; namely, that it impairs the opportunities of competitors.[51] This is reflected in the judgment of Mason C.J. and Wilson J. which refers to the provisions as 'an anti-competitive purpose element' and point out that they are 'cast in such a way as to prohibit conduct designed to threaten . . . competition'.[52] Thus the purposes in paragraphs (a) to

46 Hawk, B. E., 'Attempts to Monopolize — Specific Intent as Antitrust's Ghost in the Machine' (1973) 58 *Cornell Law Review* 1121; Cooper, E. H., 'Attempts and Monopolization: A Mildly Expansionary Answer to the Prophylactic Riddle of Section Two' (1974) 72 *Michigan Law Review* 375, 393-394; Areeda, P. and Turner, D., *Antitrust Law* Vol. III (1978), 314; Easterbrook, F. H., 'On Identifying Exclusionary Conduct' (1986) 61 *Notre Dame Law Review* 972, 977.

47 *Olympia Equipment Leasing Co. v. Western Union Telegraph Co.* 797 F.2d 370 (7th Cir. 1986) 379; *Ball Memorial Hospital, Inc. v. Mutual Hospital Insurance, Inc.* 784 F.2d 1325 (7th Cir. 1986), 1139.

48 *Per* Mason C.J. and Wilson J. (1989) 167 C.L.R. 177, 190; *per* Deane J. 194; *per* Toohey J. 215.

49 *Per* Dawson J., *ibid.* 202.

50 *Per* Toohey J., *ibid.* 214.

51 Areeda, P. and Turner, D. F., *Antitrust Law* Vol. III (1978) 78.

52 (1989) 167 C.L.R. 177, 191.

(c) of s. 46(1) serve to filter out of the section conduct that is not anti-competitive in the sense that it has the potential to restrict, distort or prevent competition.

6. *POSSIBLE EFFICIENCY JUSTIFICATIONS OF A REFUSAL TO SUPPLY*

In section 4 we argued that defendants to claims under s. 46 would be encouraged by the decision of the High Court in *QWI* to argue that their conduct could be explained by economic efficiencies. The types of economic efficiencies which may justify conduct under s. 46 are even more varied than the types of conduct which that section may catch. However, this section of the paper attempts to indicate the types of efficiency considerations which may be relevant to an assessment of whether a firm with the requisite degrees of market power which refused supply could be said to be taking advantage of that power.

The decision of the U.S. Court of Appeals for the Second Circuit in *Berkey Photo, Inc. v. Eastman Kodak Co.*[53] invites the same inquiry. The Court contrasted the use of monopoly power, in violation of s. 2 of the Sherman Act, with competitive rewards attributable to efficiencies that flow from integration:

> [A]n integrated business [does not] offend the Sherman Act whenever one of its departments benefits from association with a division possessing a monopoly in its own market. So long as we allow a firm to compete in several fields, we must expect it to seek the competitive advantages of its broad-based activity — more efficient production, greater ability to develop complementary products, reduced transaction costs, and so forth. These are the gains that accrue to any integrated firm, regardless of its market share, and they cannot by themselves be considered uses of monopoly power.[54]

In principle, these efficiencies are likely to fall into two categories: (i) gains from the co-ordination of the marketing policies across successive levels in the process of production; and (ii) gains from the undertaking of the process of production within the one enterprise.

6.1 *Co-ordination of Marketing*

The economics literature suggests many possible efficiency gains that can accrue as a result of the co-ordinating of the marketing strategies of successive stages of production. This literature is surveyed in a recent article by the current authors.[55] Many of these efficiency gains derive from the elimination of free-riding. If a firm incurs costs in order to create an asset (such as a good business reputation) and others attempt to derive a benefit from such an asset they are said to be free-riding on the assets of the first firm. Firms which try to prevent such free-riding will be furthering economic efficiency because their efforts will create a co-incidence of costs and benefits in the persons (themselves) who have made the investment. Because the attempt to eliminate free-riding is justified on the ground of economic efficiency the attempt would be made whether or not the firm had substantial market power.

The economics literature[56] observes that co-ordination of the marketing

53 603 F.2d 263 (1979).
54 *Ibid.* 276.
55 Hanks, F. and Williams, P. L., 'The Treatment of Vertical Restraints Under the Trade Practices Act' (1987) 15 *Australian Business Law Review* 147.
56 Mathewson, F. and Winter, R. A., 'An Economic Theory of Vertical Restraints' (1984) 15 *Rand Journal of Economics* 27.

policies across successive stages of production can occur by one of two means: vertical restraints or vertical integration. The choice between these two methods will be contingent on transactions costs.[57]

Whichever method is adopted some or all potential dealers may be refused supply. For example, if transactions costs cause a firm to co-ordinate marketing policies by means of vertical integration, that firm will refuse to supply the upstream product to a firm which wishes to operate only at the downstream stage. Alternatively vertical restraints may take forms such as exclusive dealing arrangements or the granting of exclusive geographic territories. These will entail a refusal to supply to some potential purchasers.

In *Mark Lyons Pty Ltd v. Bursill Sportsgear Pty Ltd*[58] Wilcox J. regarded it as self-evident that a wholesale-distributor which had a substantial degree of power in a market took advantage of that power when it denied supply to a retailer in the knowledge that no other source of supply was available. It followed that if a purpose for the denial of supply was to protect its established dealers from competition from a dealer engaging in unconventional selling practices (in that case hit-and-run discounting sales), the refusal to supply contravened s. 46(1)(c). By this reading, any attempt by a manufacturer/wholesaler with market power to maintain a network of dealers who pursued a coherent marketing strategy for the product would be likely to contravene the section. So would a vertical restraint (or a criterion for the selection of dealers) which limited the capacity of outlets which stocked the dominant firm's product from stocking the products of its competitors: one purpose of such a restraint could well be to prevent competitors from displaying their wares alongside those of the dominant firm. The same applies to the adoption by the powerful firm of a policy of complete self-distribution.

However such vertical restraints as these may yield benefits that have nothing to do with their potential to damage rivals. The record of antitrust litigation in the United States,[59] Europe[60] and Australia[61] bears witness to the fact that restraints are often imposed by parties who lack market power and, it must therefore be assumed, value the restraint for reasons unconnected with exploitation of power.

6.2 *Economies of Scope in Production*

Two vertically-related processes are said to exhibit economies of scope if the cost of conducting the processes under one management is less than the sum of the cost of operations when they are conducted under independent managements.

57 Teece, D., 'Economies of Scope and the Scope of the Enterprise' (1980) 1 *Journal of Economic Behavior and Organization* 223.

58 (1987) 75 A.L.R. 581; 9 A.T.P.R. 40-809.

59 *E.g. Continental T.V., Inc. v. GTE Sylvania, Inc.* 433 U.S. 36 (1977) (territorial restriction imposed by manufacturer when its product accounted for only 1% to 2% of the national sales).

60 *E.g. Brasserie de Haecht v. Wilkin* [1967] E.C.R. 407 (tie imposed by brewery that was one of 300 breweries in Belgium); *Pronuptia de Paris GmbH v. Pronuptia de Paris Irmgard Schillgalis* [1986] 1 C.M.L.R. 414 (ancillary restraints in franchising agreement are not restrictions on competition within Article 85(1)).

61 See *e.g. Shell Company of Australia* [1975-6] A.T.P.R. (Com.) 15,635 (territorial restriction in appointment of exclusive distributor for a product not yet established in the market); *Double Bay Steak House Providores Pty Ltd* [1977] A.T.P.R. (Com.) 15,737 (restraints ancillary to a franchising agreement).

An example of an economy of scope was provided by the molten-glass example in section 4 above. In that case, the source of the economy was the saving in heat when the heat used to create the molten glass could be utilised to keep the molten glass in a form suitable for making the glass into bottles.

This example also serves as an example of the most frequently-encountered source of economies of scope: a source referred to by the economics literature as shareable inputs. If a set of inputs is needed for one process that does not fully utilize those inputs, and the same inputs are needed for a second process, the two processes may exhibit economies of scope if the single set of inputs can be utilized by both processes.

Under competition, only least-cost producers will survive. Accordingly, if significant economies of scope exist between two vertically-related processes, only a vertically-integrated firm would survive in a competitive market.[62] Such a firm would refuse to break the integrated process to supply to a firm which wished to undertake only the second-stage process. Alternatively, the integrated firm would only consent to supply if the acquiring firm compensated the supplier for the cost disadvantage suffered by interrupting the process of producing. Such a price would, of course, ensure that the processing by the acquiring firm would not be viable.

In *QWI* there was no evidence of any economies of scope from having the manufacture of the Y-bar conducted by the same management as that which processed the Y-bar into the star-picket fence posts. Indeed, all the Y-bar feed was produced in Newcastle. This feed was then transported hundreds of miles to Kwinana in Western Australia and to Brisbane in Queensland — as well as to a separate processing plant in Newcastle — before conversion into star-picket fence posts.

The implications of economies of scope are as important for the United States doctrine of essential facilities as they are for the Australian law of misuse of market power. These implications can be illustrated by the decision of the Seventh Circuit Court of Appeals in *MCI Communications Corporation v. American Telephone and Telegraph Company*.[63] The facts arose out of the partial deregulation of the telecommunications industry. MCI sought to interconnect its new long-distance microwave communication system with the local switched distribution networks owned by AT&T. AT&T refused for some time. According to the Court, a refusal to deal may be unlawful under the essential facilities doctrine because a monopolist's control of an essential facility 'can extend monopoly power from one stage of production to another, and from one market into another.'[64] The court set out the elements necessary to establish liability under the doctrine: (1) control of the essential facility by a monopolist; (2) a competitor's inability practicably or reasonably to duplicate the essential facility; (3) the denial of the use of the facility to a competitor; and (4) the feasibility of providing the facility.[65]

62 Panzar, J. C. and Willig, R. D. *supra* n. 34.
63 708 F. 2d 1081 (7th Cir. 1983).
64 *Ibid.* 1132.
65 *Ibid.* 1132-1133.

Economies of scope are relevant to the last element. It may have been the case that significant economies of scope existed between a long-distance microwave communication system and a local switched distribution network. (For example, if these two processes were conducted within the one enterprise the process of attributing fault for the malfunctioning of a particular connection may be undertaken at a lower cost.)

The Court of Appeals found that the evidence supported the finding of each of the factors necessary for the application of the essential facilities doctrine. In respect of the last element, the Court noted that 'no legitimate business or technical reason was shown for AT&T's denial' and that MCI had produced sufficient evidence for the jury to conclude that it was 'technically and economically feasible for AT&T to have provided the requested interconnections'.[66] It appears that if economies of scope were significant then providing the facility would not be 'feasible' for the purposes of the essential facilities doctrine. Nor would refusal to supply constitute 'taking advantage' under s. 46 of the Australian legislation.

7. *APPLICATION TO INTELLECTUAL PROPERTY*

In a limited sense, intellectual property rights may confer on their holder some market power. Patents, copyright, registered designs and trade marks all comprise the exclusive right to do certain acts in relation to the subject matter of the right.

Of the various forms of property, patents are the most likely to be associated with market power because of the type of innovation protected by the patent system and because a patentee can prevent even independent conceivers of the same invention from using it. The public policy justification for the patent is that the state must enforce the property right of the patentee in order to encourage competition in research and development.

7.1 *Market power*

In an industry such as pharmaceuticals, competition can be thought of in two stages.[67] In the first stage, firms compete in the production of knowledge. In order to simplify, one may suppose that the first firm to invent the knowledge can secure the property right to that knowledge by means of a patent. Secondly, after the knowledge has been produced and protected by means of a patent, firms compete in producing the products, such as pharmaceuticals.

Whether or not one perceives the holder of a patent as having monopoly power depends on one's time horizon and the related issue of how one defines the relevant market. An analogous two-stage process of competition arose in the New Zealand case of *Tru Tone Ltd & Ors v. Festival Records Retail Marketing Ltd.*[68] Festival was one of many distribution companies that competed vigorously

66 *Ibid.*

67 Dasgupta, P. and Stiglitz, J., 'Uncertainty Industrial Structure & the Speed of Research and Development' (1980) *Bell Journal of Economics* 1.

68 High Court of New Zealand, Auckland Registry, C.L. 31/87, judgment of Smellie J. and H. G. Lang delivered February 17, 1988 reported only in CCH (1988) 2 N.Z.B.L.C. 103,081; affirmed on appeal, [1988] 2 N.Z.L.R. 352.

for the exclusive Australasian rights to distribute the recordings of a production company or artist for a number (typically three) of years. Once it had secured those rights it may have been argued that Festival had substantial market power. However, the High Court of New Zealand found (and it was upheld in the Court of Appeal) that one should not concentrate on the market power associated with the distribution of a particular album. The Court made this finding for two principal reasons. In the first place, a distributor gained synergies (that is, economies of scope) by distributing more than one album. Secondly, the life of a particular album was limited; no distributor who wished to remain viable for any length of time could confine itself to one album. For these two reasons the High Court found that 'in reality no distributor or retailer could run a business on the basis of a market confined to one unique album. None of them do and as a matter of commercial commonsense none of them could.'[69]

Section 4E of the Australian Act states:

> For the purpose of this Act, 'market' means a market in Australia and, when used in relation to any goods or services, includes a market for those goods and services and other goods or services that are substitutable for, or otherwise competitive with, the first-mentioned goods or services.

Although it was not constrained by this definition, the High Court of New Zealand was saying, in effect, that the 'first-mentioned goods or services' comprised the range of services that a distributor provides with respect to all of its albums. For the same reasons it could be said that when assessing the market power of a pharmaceutical company, it may be inappropriate to take a successful patented drug as the 'first-mentioned good.' Rather, it may be more appropriate (depending on the synergies shown by the facts) to take as one's starting point the range of activities undertaken by the company. The result of such a process may be that one would find that, even if the company in question holds the patent of a drug for which there are no close substitutes, the company does not have the degree of market power needed to overcome the threshold of s. 46.

As in the case of *Tru Tone* this more inclusive view of competition may depend not only on static synergies but also on a reasonably long time horizon. The longer time horizon would lead to a consideration of the activities of the firm as including both the R & D stage and the production of the drug. A longer-term view of competition has been advocated by the Australian Tribunal[70] and in a recent paper by Logan, Milne and Officer.[71]

7.2 *Take advantage*

The only Australian case to date which has examined the interface between s. 46 and intellectual property rights is *Warman International Limited v. Envirotech Australia Pty Ltd.*[72] In a judgment delivered prior to *QWI*, the Federal Court held that a dominant firm does not take advantage of its market power by issuing proceedings to restrain a competitor from infringing its copyright because its

69 (1988) 2 N.Z.B.L.C. 103,081, 103,089.

70 *In re Tooth & Co. Ltd; In re Tooheys Ltd.* (1979) 39 F.L.R. 1, 38; 2 A.T.P.R. 40-113, p.18, 196.

71 Logan, J., Milne, F., and Officer, R. R., 'Competition Policy in Regulated Markets' in James, M. (ed.), *Regulating for Competition? Trade Practices Policy in a Changing Economy*, Centre for Independent Studies (1989) 115-139.

72 (1986) 67 A.L.R. 253; 8 A.T.P.R. 40-714.

action is an exercise of legal rights — success in the proceedings is not dependent on market power. Thus any conduct that could be characterized as an exercise of an intellectual property right would be excluded from s. 46.

Even before *QWI* this case was a problem because it seems to disregard s. 51(1)(a) of the Australian Act. Although s. 51(1) grants immunity from the Act to conduct specifically authorized by legislation, this blanket immunity is quite specifically not available to conduct authorized by intellectual property statutes.[73]

Although s. 51(1) denies a *Warman* type defence to people trying to protect intellectual property rights, this does not mean that the Court should ignore the property right. Section 51(1) does not preclude the Court from recognizing the regime of intellectual property that is embodied in the statutes listed in the sub-section.

The reasoning in *Warman International* is inconsistent not only with s. 51(1) but also with the approach of the High Court in *QWI* to take advantage.[74] After the High Court, the question becomes not, 'would a powerless owner of property rights be able, as a matter of law, to act in this fashion?' but, 'would the firm have acted in this way if it faced competition?'

The application of the High Court's test of take advantage to the facts in *Warman International* would not change the result. No firm in a competitive market would be expected to stand by and permit one of its competitors free access to one of its assets.[75] Therefore, provided the litigation is an exercise in good faith to recover its property,[76] rather than a use of litigation as a means to harass competitors, a firm does not take advantage of its market power by bringing proceedings for infringement.[77] This is the position under s. 2 of the Sherman Act: unless the proceedings are a sham,[78] the commencement of proceedings for infringement has not been found to violate the section in the absence of agreement between competitors, or a history of accumulation of patents from competitors.[79]

73 Sub-section 51(1) states:

> In determining whether a contravention of a provision of this Part has been committed, regard shall not be had —
>
> (a) to any act or thing that is, or is of a kind, specifically authorized or approved by, or by regulations under, an Act other than an Act relating to patents, trade marks, designs or copyrights.

74 Dawson J. included *Warman* in a list of decisions in which, in his view, the Federal Court had erred in its approach: (1989) 167 C.L.R. 177, 202.

75 The situation is analogous to a refusal to assist competitors in marketing by sharing an employed sales force which Posner J. ruled not to be anti-competitive conduct in *Olympia Equipment Leasing v. Western Union Tel. Co.* 797 F.2d 370 (7th Cir., 1986) 378.

76 Even in *Warman International & Ors v. Envirotech Australia Pty Ltd* the exemption from s. 46 of actions for infringement is expressed to apply to actions brought 'in good faith': (1986) 67 A.L.R. 253, 278; 8 A.T.P.R. 40-714, p.47, 827.

77 Before the decision in *QWI*, it was argued that some presumed overriding parliamentary intent must establish a boundary for the operation of the Act — a boundary which a monopolist does not cross merely by enforcing its intellectual property rights: O'Bryan, M., 'Interaction Between Intellectual Property and Sub-section 51(3) of the Trade Practices Act', a paper delivered at the Trade Practices Workshop in Melbourne on 19 July 1987, 4. The interpretation of 'take advantage' removes the need for recourse to such arguments.

78 *Dollac Corp. v. Margon Corp.* 164 F.Supp. 41 (D.N.J. 1958), 62.

79 Violations were found in *U.S. v. Besser Mfg Co.*, 96 F. Supp. 304 (E.D. Mich. 1951), affirmed, 343 U.S. 444 (1952) where competitors pooled patents and agreed to act together in deciding whether infringement actions should be brought and any further licences granted; *Kobe, Inc. v. Dempsey Pump Co.* 198 F.2d 416 (10th Cir.), cert. denied, 344 U.S. 837 (1952) where

7.2.1 *Refusal to license*

The question of whether a dominant firm may offend competition laws by refusing to license competitors in order to preserve its economic monopoly has received different answers in the United Kingdom on the one hand and the United States and the European Economic Community on the other hand.

In the United Kingdom the Monopolies and Mergers Commission has on two occasions reached the conclusion that a refusal to grant licences under a copyright constituted an 'anti-competitive practice' under the Competition Act 1980.[80] The Commission rejected an argument that the Act was 'not intended to apply to the ordinary exercise of intellectual property rights',[81] albeit by a process of reasoning that is not applicable in Australia: a general exemption for intellectual property was inconsistent with s. 51 of the Patents Act 1977 (U.K.) which permits the Comptroller of Patents to declare that licences as of right are available under a patent after the Monopolies and Mergers Commission has concluded that a refusal to grant licences operates contrary to the public interest. There is no equivalent to s. 51 in the Australian patents legislation.[82]

In the United States, the antitrust legislation has been read as qualified by intellectual property legislation. The mere exercise of rights inherent in the grant of intellectual property has been seen as beyond the reach of the antitrust laws.

The issue was raised squarely in *SCM Corporation v. Xerox Corporation.*[83] Xerox enjoyed a monopoly position in the plain-paper sub-market of the office copier market by virtue of its control over Xerographic patents. Xerox refused to license its plain-paper copier patents to SCM, and SCM claimed that because of Xerox's monopoly position, this refusal was a violation of the Sherman Act. SCM contended that a unilateral refusal to license a patent should be treated like any other refusal to deal by a monopolist, and referred to several previous cases in which the Supreme Court had found a refusal to deal in goods or services to be monopolistic conduct.[84] The Second Circuit Court of Appeals responded in terms peculiar to patents. It pointed out that where a patent holder merely exercised its right to exclude others from making, using, or selling the invention, it was engaging in conduct expressly permitted by patent laws: 'a patent holder is permitted to *maintain* its monopoly through conduct permissible under the patent laws.'[85] It drew support for this special limited immunity of patents from many

infringement proceedings were announced before the patent-holder had an opportunity to know whether the patent had been infringed and there had been a history of patent accumulation and refusal to license. Compare with *U.S. v. L.D. Caulk Company* 126 F. Supp. 693 (D. Del. 1954) where there was no pooling or joint control of competing patents.

80 *Ford Motor Company Ltd* Cmnd. 9437 (1985); *The British Broadcasting Corporation and Independent Television Publications Ltd* Cmnd. 9614 (1985). Criticised by Merkin, R. M., 'The Interface Between Anti-trust and Intellectual Property' [1985] *ECLR* 377, 391.

81 *Ford* Cmnd 9437, para. 6.14-6.20.

82 The Australian provisions for compulsory licensing of patents are directed towards fostering Australian manufacture, not towards countering monopoly: Patents Act 1952 (Cth), ss 108, 110. See Ricketson, S., *The Law of Intellectual Property* (1984) 1026-1028.

83 645 F.2d 1195 (2nd Cir. 1981), cert. denied, 455 U.S. 1016 (1982).

84 *Otter Tail Power Co. v. United States* 410 U.S. 366 (1973); *Lorain Journal Co. v. United States* 342 U.S. 143 (1951); *Eastman Kodak Co. v. Southern Photo Materials Co.* 273 U.S. 359 (1927).

85 645 F.2d, 1204 (emphasis in original).

previous judgments — both judgments in cases concerning patents[86] and judicial pronouncements about monopolization in general. In the latter group of authorities, it relied particularly on Judge Learned Hand's caution in *Alcoa* against turning on the 'successful competitor' when he wins[87] and the contrast drawn by the Supreme Court in *United States v. Grinnell Corp.* between monopolizing conduct and 'growth or development as a consequence of superior product, business acumen, or historic accident.'[88]

In its interpretation of Article 86 of the EEC Treaty the European Court of Justice has adopted an approach similar to that in *SCM v Xerox*. In *Volvo v. Veng*[89] the Court ruled that the refusal by a proprietor of a registered design in respect of motor body panels to grant a licence to third parties, even in return for reasonable royalties, could not by itself be regarded as an abuse of a dominant position within Article 86. The Court saw this result as a logical consequence of the protection granted in the Treaty to industrial and commercial property.[90] It reasoned that the imposition of an obligation on a proprietor of a registered design to grant licences to third parties would deprive the proprietor of the very subject matter of his property right.

In all these systems there is a recognition that competition policy requires the preservation of incentives to innovate. Under the British law the need to encourage innovation is a factor to be taken into account in determining whether the anti-competitive practice is adverse to the public interest.[91] The rulings in *SCM v. Xerox* and in *Volvo v. Veng* go further by giving absolute privilege to a refusal to deal to maintain the monopoly granted by intellectual property rights. Neither approach is available in Australia.

The separate enquiry into the public interest that is part of the United Kingdom law has no counterpart in proceedings under s. 46. And it is not consistent with s. 51(1) of the Australian Act, noted in section 7.2 above, to grant to the rights created by the Australian intellectual property statutes the absolute privilege of *SCM v. Xerox* and *Volvo v. Veng*. The Trade Practices Commission does not appear to share this view. In a recent paper the Commission referred to the *Xerox* and *Volvo* cases and expressed the belief that s. 46 would not apply to apply to a refusal to license intellectual property rights because 'it is implicit in the grant of the statutory monopoly associated with intellectual property rights that the owner is free to exploit the results of this innovation alone or to license others to exploit them.'[92] It is curious that the paper makes no mention of s. 51(1).

86 *Bement v. National Harrow Co.* 186 U.S. 70 (1902); *Zenith Radio Corp. v. Hazeltine Research, Inc.* 395 U.S. 100 (1969); *Continental Paper Bag Co. v. Eastern Paper Bag Co.* 210 U.S. 405 (1908).

87 *U.S. v. Aluminum Co. of America* 148 F.2d 416 (2nd Cir. 1945), 430.

88 384 U.S. 563 (1966), 570-571.

89 Case No. 238/87, *AB Volvo v. Erik Veng (UK) Ltd.* [1989] 4 C.M.L.R. 122.

90 The Court referred to its judgment in Case No. 144/81, *Keurkoop v. Nancy Kean Gifts* [1982] E.C.R. 2853. This case involved the application of Article 36 to registered designs. Article 36 exempts measures for the protection of industrial and commercial property from the provisions of the Treaty prohibiting quantitative restrictions on trade between Member States.

91 *Competition Act* 1980 (U.K.) s. 8(2); *Fair Trading Act* 1973 (U.K.) s. 84(1). See *Ford Motor Company Limited* Cmnd. 9437 at para 6.48-6.50.

92 *Supra* n. 26, 35.

Indeed, the possibility that the High Court's interpretation of 'take advantage' may catch patent holders who refuse to license was one of the factors that has prompted Pengilley to doubt the wisdom of the Court's departure from the pejorative reading given to the phrase by Pincus J.[93] Pengilley's concern is similar to that which greeted the release of the judgment in *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.* in the United States.[94] However there are two factors which will severely limit the circumstances in which a refusal to license will be classified as 'taking advantage of market power'.

In the first place, as was noted in section 7.1 above, holding a patent does not necessarily confer on the holder a degree of market power that would satisfy the threshold of s. 46. If one were to adopt the long time horizon suggested in 7.1 above, the most likely cases in which the patent would serve to satisfy the threshold would be those in which the product dimension of the market was co-extensive with the patent. An example from the U.S. case referred to above may be the Xerox Corporation in the period between 1960 and 1970. Secondly, even if the market-power threshold is crossed, the refusal to license must represent a 'taking advantage'. According to the test proposed by the High Court, the refusal would not represent a 'taking advantage' if the refusal would have occurred even if the industry were highly competitive. The licences acquired by Festival records in *Tru Tone* were exclusive licences to distribute within Australasia. Festival did not grant sub-licences. Yet the High Court of New Zealand found Festival's market to be competitive. Refusals to license are common in competitive industries; and so do not necessarily constitute a 'taking advantage'.

8. *IMPLICATIONS FOR INVESTMENTS*

A strategy available to a firm with market power to increase that power is to make an investment which will deter potential entrants to the market. Barriers that are created deliberately by enterprises are known in the economics literature as strategic barriers to entry.[95] A strategic barrier is an asset which will be owned jointly by the incumbents in a market; but the asset will generally be acquired as a result of investment by one of these incumbents. These investment strategies can take two principal forms: (i) investment in productive capacity; and (ii) investment in a reputation. Each of these will be discussed in turn.

8.1 *Investment in Capacity*

As mentioned in section 3.1, an enterprise may invest in capacity and, providing the investment involves a sunk cost and providing economies of scale are large compared with the size of the market, that investment may create a barrier to entry.

93 *Supra* n. 2, 15.

94 472 U.S. 585 (1985). See Turner, D. F., 'The Durability, Relevance, and Future of American Antitrust Policy' (1987) 75 *California Law Review* 797, 810; Areeda, P. E. and Hovenkamp, H., *Antitrust Law: An Analysis of Antitrust Principles and Their Application* (Supp. 1987) 578.

95 Salop, S. C., 'Strategic Entry Deterrence' (1979) 69 *American Economic Review* 335.

Although strategic barriers erected by investment in capacity would satisfy one of the purposes proscribed by s. 46(1), s. 46(5) must also be considered. Section 46(5) provides that a corporation 'shall not be taken to contravene [s. 46(1)] by reason only that it acquires plant or equipment'. It is not clear whether s. 46(5) was intended to operate as a complete exemption for acquisitions of plant and equipment. It was inserted into the Act in 1977 on the recommendation of the Swanson Committee,[96] apparently in response to fears that the section might be given the sweeping interpretation given to s. 2 of the Sherman Act thirty years before in *Alcoa*.[97] That case, contrasted a dominant position 'thrust upon' the monopolist (not a violation) with a dominant position acquired through a deliberate policy of expanding production facilities to meet increased demand (a violation of s. 2).

The High Court's interpretation of 'take advantage' suggests that the fears that led to the insertion of s. 46(5) were groundless — expansion merely to meet an anticipated increase in demand will not infringe s. 46. The reason is that such conduct is to be expected from a firm operating in a competitive market. Investment in expansion will not constitute taking advantage of market power unless it differs (in scale or in kind) from that which would be undertaken by a firm acting in its own self-interest in a competitive market. We suggest that the most appropriate interpretation of s. 46(5) is one that starts with the recognition that s. 46(1) is never contravened by conduct alone — only the combination of conduct and a proscribed purpose. The role of s. 46(5) in the scheme of the section is then to prevent the inference of a proscribed purpose from proof only of an acquisition of plant and equipment (whatever its scale or kind), and so to require the purpose element to be established by separate evidence.

8.2 *Investment in Reputation*

Just as investment in physical assets can create a barrier to entry (under the conditions that the investment represents a sunk cost and that economies of scale are large compared with the size of the market) so investment in developing a reputation can (given the same conditions) create a barrier. Investment in a reputation will nearly always represent a sunk cost because the value of goodwill realizable through sale is generally less than the cost incurred in acquiring it. Economies of scale are necessary because, if an entrant could be viable without taking sales of a significant degree from an incumbent, entry would be possible without provoking any retaliation. Over the last decade, the theoretical literature of industrial organization has applied this form of analysis to predatory behaviour. Predation has been analysed as undertaking an investment in the form of foregone profit in order to signal to potential entrants that any entry is likely to be difficult.[98]

[96] Trade Practices Act Review Committee, *Report to the Minister for Business and Consumer Affairs* (1976) para. 6.11.

[97] *U.S. v. Aluminum Co. of America* 148 F.2d 416 (2nd Cir. 1945). See R. Baxt, *Report to the Industrial Property Advisory Committee* Vol. 2, Monash University Law School (1983) para. 4.32.

[98] Milgrom, P. and Roberts, J., 'Information Asymmetries, Strategic Behavior, and Industrial Organisation' (1987) 77 *American Economic Review* 184.

Predatory conduct of this sort seems to be disclosed by the facts of *Williams & Anor v. Papersave Pty Ltd.*[99] Papersave had rushed in to hire some premises which it had learned Williams proposed to acquire with a view to entering Papersave's market. There was evidence that the premises were not suitable for use in Papersave's business, and it was found that Papersave would not have acted as it did but for the potential of its action to thwart Williams' entry. Both the Trial Court and the Full Federal Court considered that this conduct did not amount to taking advantage of market power. But, in the light of the High Court's decision in *QWI*, this assessment should be questioned. A firm facing many existing competitors is not likely to spend money trying to deter a new competitor from entering the market.

One of the judges on the appeal left open the possibility that the assessment might have been different if Papersave had paid an 'inappropriately higher' amount than the new entrant offered for the premises.[1]

The value that Papersave placed on the premises reflected not merely their value as a physical asset but, in addition, included the value of the enhancement of Papersave's reputation as an incumbent not to be reckoned with lightly. Thus, if it were necessary, a firm in Papersave's position would be prepared to pay a higher amount than the new entrant for the same physical premises. Its good fortune in being able to pre-empt its rival without outbidding him does not alter the character of its conduct.

The investment in reputation to create a barrier which will enhance one's future revenue stream is usually analysed in this context of predation. However, it is possible that conduct that may be undertaken in a competitive market may also be interpreted as a strategic deterrence of entry. It could be argued that a company by serving the needs of its customers diligently for a long period of time is incurring a sunk cost which could create a barrier to enhance its future stream of revenue. Fortunately, the interpretation given to take advantage by the High Court in *QWI* suggests that such conduct will not be caught by s. 46. Such conduct would be undertaken by efficient firms in any market — regardless of the extent of competition in the market. The conduct is not contingent on market power and so cannot represent a 'taking advantage'.

9. *PROBLEMS WITH ORDERS*

In *QWI*, at first instance, Pincus J. was concerned that, in the absence of any history of supply, a finding that a refusal to supply was a misuse of power would confront the Court with the need to frame orders for relief that the Court was ill-equipped either to formulate or to supervise. His Honour found support for his reluctance to make orders requiring the firm to supply a new customer in the dearth of precedents for such orders in the United States[2] and Europe, and in the argument by Areeda and Turner that an order to supply would burden the Court

[99] (1987) 73 A.L.R. 475; 9 A.T.P.R. 40-781; affirmed on appeal (1987) 9 A.T.P.R. 40-818.
[1] Burchett J., *ibid.* p.48,867.
[2] Distinguishing *Otter Tail Power Co. v. U.S.* 410 U.S. 366 on the ground that the problem of terms was there handled by reference to a regulatory authority.

with a 'prohibitive administrative task'.[3] Because of the relief problem, Posner has gone so far as to suggest that unilateral refusals to deal should be *per se* legal.[4]

Nevertheless, the High Court remitted the matter to the Federal Court for further hearing and determination in relation to the relief sought by QWI — damages in respect of past contraventions and an injunction for the future. Thus the High Court is saying, like the Supreme Court of the United States in *Aspen Skiing Co. v. Aspen Highlands Corp.*,[5] that the Court will take on the task of setting the terms on which a monopolist deals with its rivals if it is persuaded that there is no legitimate justification for the refusal.

The High Court did not consider the terms on which dealing was to take place. In fact, far from laying down guidelines for the determination of the price at which BHP might be ordered to supply Y-bar, the judgments variously describe BHP's offending conduct as refusing to sell except at (1) an 'excessively high price relative to other BHP products' (products in which BHP met competition);[6] and (2) a price that was not 'realistic'[7] or 'competitive'[8] (apparently meaning a price that would not permit QWI to sell steel fence posts profitably in competition with AWI). Thus the prices with which BHP's offered price was contrasted were the price for which Y-bar would have been sold in a competitive market and the price at which BHP's subsidiary sold fence posts. No reference was made to the price that a monopolist in Y-bar might have set as its profit-maximizing price.

Like the antitrust law of the United States, the Australian law does not prohibit the attainment of monopoly power and the simple charging of a monopoly price.[9] The corollary might be expected to be that orders should be based on the monopoly price rather than the price that would be set under competition, or some other price.[10] Support for this proposition might also be found in the caution in several of the decisions in the United States against awarding compensation for anything except 'injury of the type the antitrust laws were intended to prevent'.[11]

However it is consistent with section 46 that, on facts like those in *QWI*, BHP

[3] Areeda, P. and Turner, D. F. *Antitrust Law: An Analysis of Antitrust Principles and Their Application* Vol. III (1978) 236.

[4] Posner, R., *Antitrust Law: An Economic Perspective* (1976) 211.

[5] 472 U.S. 585 (1985). See too *Byars v. Bluff City News Co.* 609 F.2d 843 (6th Cir. 1980) at 864: the Court commented that 'the difficulty of setting a price on which the monopolist must deal might well justify withholding relief altogether' but added in a footnote '[C]ourts must be careful not to abdicate their responsibilities under the Antitrust laws in the name of expedience. When the adverse effect of allowing a monopolist to maintain certain practices is clear, a court should stay its hand rarely, if ever.'

[6] *Per* Mason C.J. and Wilson J., (1989) 167 C.L.R. 177, 185.

[7] *Per* Deane J., *ibid.* 197.

[8] *Per* Toohey J., *ibid.* 216.

[9] See *Berkey Photo, Inc. v. Eastman Kodak Co.* 603 F.2d 262 (2nd Cir. 1979) 294. In Australia, see comments of Pincus J. in Queensland Wire (1987) 75 A.L.R. 331, 348; 9 A.T.P.R. 40-810, 48,821 ('s. 46 does not make it unlawful simply to have a monopoly, although a characteristic of monopoly may well be to keep consumer prices up.'); and, in the High Court, see Toohey J. (1989) 167 C.L.R. 177, 213.

[10] Areeda, P. and Hovenkamp, H., *Antitrust Law: An Analysis of Antitrust Principles and Their Application* (Supp. 1987) 608.

[11] *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.* 429 U.S. 477 (1977), 489; *Berkey Photo, Inc. v. Eastman Kodak Co.* 603 F.2d 263 (2nd Cir. 1979), 297.

might be ordered to supply to QWI at a price less than the price it would charge if it were simply an unintegrated monopolist in Y-bar. The section is contravened by any conduct (such as charging above a competitive price) that would not have been available to the defendant in the absence of market power, provided that that conduct is engaged in for one of the anti-competitive purposes. The misuse of market power in *QWI* was refusing to deal by setting a price that was designed to prevent QWI supplying star pickets and so offering effective competition to BHP in the rural fencing market. The value to BHP of its monopoly in Y-bar was not that it made large profits on fence posts,[12] but that there were advantages flowing to BHP in the rural fencing market from being the sole supplier of star picket posts.[13] It was for this reason that Mason C.J. and Wilson J. preferred to focus on the rural fencing market in identifying BHP's anti-competitive purpose:

> Although Pincus J.'s finding of an impermissible purpose with regard to excluding the appellant from the star picket post market is adequate to support the finding of an infringement of the section, that market is not the most informative one on which to focus. Pincus J. accepted that 'there are great advantages accruing to BHP as a participant in the rural fencing market, by virtue of its being the sole domestic supplier of star pickets' and that 'those advantages . . . extend well beyond being relatively free from price competition in selling star pickets'. The evidence regarding the importance to BHP of being the only supplier of a full range of rural fencing products indicates that it is in the market for rural fencing products where those advantages lie and where BHP's market power is being extended. Pincus J.'s finding of an impermissible purpose remains applicable, however, because star picket posts are a constituent element of the product which competes in the rural fencing market.[14]

It follows that an appropriate order might be for supply at a price that takes into account the price at which star pickets are sold by BHP's subsidiary.

Establishing the factors to be taken into account in determining the terms of dealing and working out the details of the order are not the same thing. The claims that it is inappropriate for courts to get involved in the detailed and continuous supervision of an ongoing commercial relationship are not based solely on the uncertainty about the principles to be applied. But the problems may have been overstated. The common experience in the United States when a patentee found guilty of patent misuse has been ordered to grant a licence at a 'reasonable royalty' has been that the parties have reached agreement without need to resort to the assistance of the Court.[15] And so in *QWI*: five months after the High Court decision, the litigants settled out of court.[16]

12 Gross annual income from sale of fence posts was about $33 million, of which about $4 million was profit: (1989) 167 C.L.R. 177, 184.

13 The advantages indicated by the evidence were the unique ability to supply a complete fencing system (an advantage emphasised in BHP's advertising) and the capacity to discourage its distributors from obtaining their other fencing requirements from other suppliers: (1987) 75 A.L.R. 331, 338-341; 9 A.T.P.R., 48,813-5.

14 (1989) 167 C.L.R. 177, 193.

15 *Staff Report, Compulsory Patent Licensing under Antitrust Judgments*, of the Subcommittee on Patents, Trademarks and Copyrights of the Committee of the Judiciary, U.S. Senate, 86th Cong. 2d sess. (1960), discussed in Bowman, W. S., *Patent and Antitrust Law: A Legal and Economic Appraisal* (1973) 244.

16 'BHP and Qld Wire battle ends', *The Australian Financial Review*, 15 August 1989. The terms of the agreement were not disclosed.