

Predatory Pricing and the Expectation of Recoupment: *Boral* and the Pathway forward

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Abstract

The High Court recently handed down its long-awaited decision in Boral v ACCC. The case of Boral v ACCC was the first case of alleged predatory pricing to be considered by the High Court. The High Court, in overturning the decision of the Full Federal Court, held that Boral's strategy of below cost pricing did not constitute a misuse of market power contrary to s 46 of the Trade Practices Act, as the nature of the relevant market was such that Boral was not able to recoup its losses by charging supra-competitive prices. In doing so, the High Court endorsed the test of recoupment as an indicator of whether a corporation that has engaged in below cost pricing has substantial market power and has misused that power. In this article, the authors outline and examine the facts and decision in Boral, and then propose that the ability to recoup be elevated to the central test in predatory pricing cases to determine whether there has been a misuse of market power.

Introduction

On 7 February 2003, the High Court handed down its judgment in *Boral Besser Masonry Limited (now Boral Masonry Ltd) v Australian Competition and Consumer Commission (Boral)*.¹ This was the first case that came to the High Court involving an allegation of predatory pricing in contravention of s 46 of the *Trade Practices Act 1974* (Cth) (the Act), which prohibits a corporation with a “substantial degree of market power” from misusing that power. The High Court, by a majority of 6:1, overturned the decision of the Full Federal Court which found that Boral had engaged in predatory pricing and misused its market power in contravention of s 46. A

¹ [2003] HCA 5 (7 February 2003).

majority of the High Court also rejected the proposition contained in the Full Federal Court judgment that the ability of a corporation to recoup its losses by charging extra high prices after a sustained period of below cost pricing did not evidence that the corporation had substantial market power in the relevant market.

This article is made up of two main sections. The first deals with the *Boral* case, outlining the facts of the case, the legislation in question, and then giving a detailed explanation of the decision and the reasoning adopted in the separate judgments to arrive at the court's final conclusion. The second looks specifically at the issue of recoupment and the role that it should play in determining breaches of s 46 of the Act. An approach is proposed that suggests how "the recoupment test" can best be utilised, and what elements of the test should be emphasised by the court, when considering whether a corporation has engaged in anti-competitive predatory pricing.

Facts

Boral Better Masonry (BBM) was a producer of concrete masonry products (CMP) operating in Melbourne. From approximately 1990 to 1998, the market for CMP was suffering due to a Victorian recession in the early 1990's. There were approximately five major corporations (including BBM) competing in a quiet market that did not require much CMP, and there was also a large over-supply of capacity in the market.

The nature of CMP was that they were a commodity. There were no intellectual property rights involved, production was relatively simple, product differentiation in all respects was minimal and there was little reference to brand names. By far the biggest factor in selecting a CMP manufacturer was price, although some personal factors, such as reliability of supply, sometimes played a part.

The CMP market operated in a number of steps. When a major project that required CMP began, tenders would be sought from blocklayers on a supply and lay basis. In turn, the blocklayers would seek tenders from CMP manufacturers. As such, blocklayers were "critically important customers for manufacturers".² Blocklayers generally

² *Boral* [2003] HCA 5 at [22].

received tenders from a number of suppliers, and had the capacity to play suppliers off against each other, decreasing the quoted price of each supplier.

The recession lasted until approximately 1994. However, its effects on the commercial building industry were felt until almost 1998, and there was a very low level of demand in addition to the abovementioned excess production capacity. Moreover, CMP was not in fashion at the time, and customer acceptance of it was low, as CMP was competing with, and often losing sales to, other building products.

The Australian Competition and Consumer Commission (ACCC) accused BBM of breaching s 46 of the Act from April 1994 to October 1996. At first instance, there were a number of allegations made by the ACCC regarding the actions of both Boral and its subsidiary BBM. By the time the case was heard in the High Court, the action against Boral had been discontinued. Originally, the ACCC made a number of accusations against BBM. The first was that BBM was colluding with one of its competitors, and was communicating with its competitor through market signals. The second of the ACCC's accusations was that there was something sinister in BBM's interest in purchasing the plant of another of its competitors. Both these claims were rejected by Heerey J in the Federal Court, and that rejection was not challenged on appeal. Two other claims, however, were challenged in the Full Federal Court, and eventually went to the High Court for determination. These two issues were based on the pricing behaviour of BBM, and the upgrading of its facilities. The first was that during the specified time period, BBM had reduced the price of CMP to a price below the cost of manufacture and supply. The second was that BBM had increased the capacity of its primary production plant in Melbourne. The ACCC claimed that these two actions, combined with BBM's market power, had the intended purpose of eliminating one or more of BBM's competitors from the market, or deterring one or more of BBM's competitors in the market from engaging in competitive conduct.

Relevant Law

The ACCC's action in the High Court was based primarily on an alleged breach by BBM of s 46 of the Act. Section 46 reads in part:

- (1) 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 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.
- (3) In determining for the purposes of this section the degree of power that a body corporate or bodies corporate has or have in a market, the Court shall have regard to the extent to which the conduct of the body corporate or of any of those bodies corporate in that market is constrained by the conduct of:
 - (a) competitors, or potential competitors, of the body corporate or of any of those bodies corporate in that market; or
 - (b) persons to whom or from whom the body corporate or any of those bodies corporate supplies or acquires goods or services in that market.

A number of the judgments made reference to s 2 of the Act, which states that the purpose of the Act is “to enhance the welfare of Australians through the promotion of competition and fair trading and provision for customer protection”.

The Decision

The High Court, by a majority of six to one (Kirby J dissenting) allowed the appeal, holding there had been no breach by BBM of s 46 of the Act. Common themes of the judgments of the majority were that s 46 is designed to protect competition (as a process) rather than protect competitors, that financial strength is not indicative of market power, and that BBM was not in breach of s 46 as it never had the ability nor the intention of raising prices to a supra-competitive level at the end of the price war. This led to discussion regarding the effect that recoupment should have on breaches of s 46 (an issue that will be discussed below).

The Judgments

Gleeson CJ and Callinan J

Gleeson CJ and Callinan J divided the case into a number of issues. After an examination of the nature of the CMP market and the economic conditions in Victoria at the time of the alleged breaches, the major elements examined were the price war between suppliers of CMP, the business strategy of BBM, market power and the upgrade of BBM's facilities. The reasoning of Heerey J and of the Full Federal Court was also examined.

The Price War

After recognising the important notion that customers (blocklayers and builders) could force the price of CMP down,³ a detailed analysis of some major projects requiring CMP showed the extent that prices had fallen. However, Gleeson CJ and Callinan J made the important distinction between reducing prices in order to damage or remove competitors and reducing prices in order to survive in a competitive market with the hope that one or more competitors would "break first".⁴ An important element that their Honours took into account

³ *Boral* [2003] HCA 5 at [31]. Importantly, the lack of recognition by the Full Federal Court of this factor (or any discussion of the demand side of the distribution regarding market power analysis) was one of the main reasons that the judgment of Heerey J and his analysis of market power at first instance was overturned.

⁴ *Boral* [2003] HCA 5 at [44].

was the fact that BBM had twice seriously considered leaving the market themselves. BBM eventually decided to stay, hoping that their deep pockets would see them through, and conscious of other factors such as the fact that they were making a substantial contribution to Boral by purchasing supplies from them,⁵ that Boral was the only national operator in the market (which gave it some advantage),⁶ and that Boral did not want competitors to think that it could be “muscled” out of a market.⁷ Moreover, BBM never intended to charge supra-competitive prices after the price war – given the nature of CMP and the market, their aim was to return to making profit in a competitive market.

Business Strategy

The important question to determine was whether BBM was taking advantage of market power in its actions. If it was, it was in contravention of s 46, and its actions were illegal. However, if not, it was simply acting in a “lawful, vigorous and competitive”⁸ manner. Gleeson CJ and Callinan J recognised that as a result of competition there would be damage to some corporations in the market, and that if one or more corporation left a market (as BBM had seriously considered doing on a number of occasions), it did not mean that there had been illegal competition,⁹ especially where the actions of a corporation could be justified by reference to the nature of the market.¹⁰ Short term views of a market, particularly a market as cyclical as the building industry, are not appropriate, and BBM had clearly set its price by reference to the market,¹¹ believing that at the end of the price war it could again operate at a profitable level.¹²

⁵ *Boral* [2003] HCA 5 at [75].

⁶ *Boral* [2003] HCA 5 at [44].

⁷ *Boral* [2003] HCA 5 at [75].

⁸ *Boral* [2003] HCA 5 at [87].

⁹ *Boral* [2003] HCA 5 at [86].

¹⁰ *Boral* [2003] HCA 5 at [123].

¹¹ *Boral* [2003] HCA 5 at [89].

¹² *Boral* [2003] HCA 5 at [92].

Market Power

The trial judge, Heerey J, held that BBM did not have a substantial degree of market power.¹³ On appeal, this was overturned by the Full Federal Court, which concluded that BBM had a substantial power in the CMP market, and that it had misused its power by introducing a predatory pricing scheme.¹⁴ In their joint judgment, Gleeson CJ and Callinan J accepted that having market power and using that power are two separate questions,¹⁵ and that market power was the ability of a corporation to raise prices above supply costs without rivals taking away customers.¹⁶ They added that in a situation such as BBM was in, where prices had been lowered to such an extent, the power lay in the ability to raise prices in the future. Moreover, the position in *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd (Melway)* was affirmed – the conduct of the corporation must be examined from the start, rather than beginning with the perspective that the corporation set out to eliminate or damage a competitor.¹⁷ In BBM's case, from the beginning to the end of the period of the alleged breach, market share stayed approximately the same: two corporations left and one corporation joined the market and there were rational reasons, such as efficiency, to upgrade the CMP plant. The aim of BBM was to eventually return to a competitive market. The capacity to eliminate rivals from the market does not mean that a corporation has market power, rather it allows for prices to be raised to a profitable level.¹⁸

¹³ *Boral* [2003] HCA 5 at [103].

¹⁴ See *Boral* [2003] HCA 5 at [119].

¹⁵ *Boral* [2003] HCA 5 at [132]. This was the position that was taken in *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd* (2001) 205 CLR 1.

¹⁶ This was the definition of market power expounded by Mason CJ and Wilson J in *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Co Ltd* (1989) 167 CLR 177 at 188, and supported by economists called by both the ACCC and Boral as witnesses.

¹⁷ *Boral* [2003] HCA 5 at [141].

¹⁸ *Boral* [2003] HCA 5 at [147].

Upgrade of Facilities

The Chief Justice and Callinan J reaffirmed that financial strength is not the same as market power,¹⁹ and as such the upgrading of plant facilities to improve the running of the corporation did not show that BBM was attempting to eliminate competition from, or prevent entry into, the market.

Gaudron, Gummow and Hayne JJ

Justices Gaudron, Gummow and Hayne approached the issue before the court in two parts. The first, and more technical part, dealt with an analysis of the structure and meaning of s 46 and some foreign laws, particularly the United States of America's *Sherman Act* and *Clayton Act*, dealing with similar issues of misuse of market power (there referred to as "monopolisation") and predatory pricing. The second part dealt with the specific issues before the court, and outlined the reasons for the final decision that concurred with Gleeson CJ and Callinan J.

The structure and meaning of s 46

Justices Gaudron, Gummow and Hayne were quick to note that s 46 does not specifically prevent the practice of cutting prices to below cost, and that the section must be interpreted in light of the "subject, scope and purpose" of the legislation, and especially in light of s 2 of the Act, which aims to enhance the welfare of Australians through the promotion of competition.²⁰

Three structural elements of s 46 were held to be particularly important and reflective of American anti-trust legislation. The first is that the law is designed to protect competition rather than competitors. The second is that acts motivated purely by the malice of one business against another do not necessarily breach the Act.²¹ The third is that it is in the interest of competition to permit corporations with substantial

¹⁹ *Boral* [2003] HCA 5 at [149].

²⁰ *Boral* [2003] HCA 5 at [159].

²¹ This principle was expounded in the US in *Brooke Group Ltd v Brown & Williamson Tobacco Corp* 509 US 209 at 225 (1993) (*Brooke Group*).

degrees of power in the market to engage in vigorous pricing competition,²² and to make it illegal to reduce pricing in order to maintain or increase market share would be a “perverse result”.²³ The emphasis on s 46 being designed to benefit competition, not competitors, reinforced what was said by the High Court in *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Co Ltd (Queensland Wire)*.²⁴

Why s 46 was not breached by BBM

At first instance, Heerey J held BBM did not have the power to act independently of competition – all corporations in the relevant market faced the same conditions.²⁵ Equally important was that BBM had no prospect of being able to recoup its losses by charging supra-competitive prices.²⁶ However, the Full Court heard arguments from the ACCC that BBM had charged too little (although Gaudron, Gummow and Hayne JJ appeared to have reservations as to whether there was anything anti-competitive about cutting prices)²⁷ and accepted the ACCC’s contention that selling goods below cost for thirty months showed a corporation had market power.²⁸ Justice Finkelstein held that when market power is based on one corporation excluding others, it is the exclusionary conduct that establishes market power rather than the reverse. Justices Gaudron, Gummow and Hayne disagreed, holding that the appropriate test is two-staged rather than one. They held that Finkelstein J’s test inverted the reasoning of the test and the object of s 46, and that their opinion was supported by *Queensland Wire* and *Melway*.²⁹ If the test had been properly applied, given that BBM was essentially forced to act in the way it did, the

²² This principle was expounded in the US in *Cargill Inc v Monfort of Colorado Inc* 479 US 104 at 116 (1986).

²³ *Boral* [2003] HCA 5 at [160].

²⁴ *Boral* [2003] HCA 5 at [164]. See Mason CJ and Wilson J in *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Co Ltd* (1989) 167 CLR 177 at 191. See also *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd* (2001) 205 CLR 1 at 13.

²⁵ *Boral* [2003] HCA 5 at [174].

²⁶ *Boral* [2003] HCA 5 at [191].

²⁷ *Boral* [2003] HCA 5 at [178].

²⁸ *Boral* [2003] HCA 5 at [180].

²⁹ *Boral* [2003] HCA 5 at [194].

result would have been the opposite in the Full Federal Court, and the decision of the Full Federal Court was overturned on that basis.

McHugh J

Justice McHugh was clear from the outset that he did not believe that BBM had a substantial degree of market power, a requirement that must be fulfilled in order to take advantage of market power and breach s 46. The broad reasons for McHugh J's views stem from the fact BBM would not have been able to raise prices to a supra-competitive level without losing customers, and because it was not in a position, after the price war, to recover losses made by pricing below cost.³⁰

These opinions answer some, but not all, of the questions that McHugh J raises in his judgment. Beyond the primary issue of the case, defining the market, was there market power, and was that power taken advantage of for one of the purposes of s 46? Justice McHugh identified a number of "sub-issues", only some of which were answered. These included questions such as:

[D]oes a corporation breach s 46 by selling below avoidable cost for the purpose of damaging competitors if it will be unable to recoup the losses resulting from that conduct?

[D]oes s 46 of the Act distinguish between vigorous competition through pricing and anti-competitive pricing ... if so, on what basis?

[C]an a corporation deny taking advantage of market power by showing that it priced below avoidable cost only to maintain its market share or for some other legitimate business reason?³¹

Defining the Market

Justice McHugh emphasised the importance of defining "the market". If the market is defined broadly, events will tend to show that a particular corporation has less market power than it would have in a

³⁰ *Boral* [2003] HCA 5 at [199].

³¹ *Boral* [2003] HCA 5 at [204].

market defined narrowly.³² The definition of the market involves “a value judgement upon which reasonable minds may differ”, and as such McHugh J suggests that an appellate court should be slow to overturn ‘the market’ as defined by the trial judge.³³ Justice McHugh finally held that the ACCC’s case must fail, as BBM did not have a substantial degree of market power. This conclusion was made based on the recoupment test.

The recoupment test

Conscious of the difference in the wording of anti-trust legislation in the United States compared to Australia, jurisprudence from the United States requires there to be a real probability of an “alleged predator recouping losses resulting from price cutting”,³⁴ and if that probability does not exist, consumer welfare is enhanced.³⁵ The same position exists in the United Kingdom.³⁶ Section 46 of the Act, whilst not using the specific term “predatory pricing”, is essentially dealing with the same issues and very similar requirements³⁷ – something that

³² *Boral* [2003] HCA 5 at [255].

³³ *Boral* [2003] HCA 5 at [255]. Despite this, McHugh J found that on the evidence, the Full Court had been correct in overturning the finding of the trial judge.

³⁴ *Boral* [2003] HCA 5 at [274]. This was stipulated in *Brooke Group*. It was stated that there are two requirements for recovery in a predatory pricing case. The first is that the prices must be proven to be “below an appropriate measure of its rivals costs”. The second is that there must be a “dangerous probability in [the corporation] recouping its investment in below cost prices”.

³⁵ *Boral* [2003] HCA 5 at [275], and Kennedy J in *Brooke Group*. This position was also stated in the earlier US case of *Matsushita Electric Industrial Co Ltd v Zenith Radio Corp* 475 US 574 at 588-589 (1986).

³⁶ *Boral* [2003] HCA 5 at [277]. In the UK, the Office of Fair Trading states supra-normal profits in the future are a required element of predatory pricing.

³⁷ In the judgment of Finkelstein J in the Full Federal Court, it was held that the recoupment test in the United States was inappropriate because the US legislation dealt with monopolisation whereas s 46 is concerned with a substantial degree of market power, and if adopted the test would “make it impossible to establish a case of a predatory pricing scheme against a firm that is not a monopolist”. However, this view failed to take into account that in the US there is no distinction between a monopoly and market power – “no distinction is drawn between a monopoly and a ‘disciplined oligopoly’”. Finkelstein J also held that another reason the recoupment test was not necessary was that intent is at the heart of the offence in s 46. However, McHugh J found that s 46 is concerned with more than intent, and also disagreed with Merkel J’s assertion that it is only in a monopoly situation that a firm is likely to be able to increase prices to supra-competitive levels, finding that in a market with two or three oligopolists, a firm

was demonstrated in the High Court's decision in *Melway*. This raises the question of how any price-cutting can constitute taking advantage of market power. Justice McHugh suggested that s 46 would "be a vehicle for anti-competitive conduct if the most efficient firm [sic] in the market had substantial market power and by reason of its efficiency could not take market share from its rivals [without breaching s 46]". In McHugh J's view, "this makes little sense from the perspective of achieving an efficient economy with efficient resource allocation or for the benefit of consumers who can be provided with quality goods or services at lower prices".³⁸ Justice McHugh, however, clarified the position by stating that the answer lay in the taking advantage of the market power. In the above example, the corporation has not sought to "act free from the constraints of competition", and as such market power is irrelevant.³⁹ This contrasts starkly with a corporation with substantial market power that cuts prices below cost with the intention of later recouping losses by abusing its market power to charge supra-competitive prices.⁴⁰

Kirby J

Justice Kirby stood alone in his dissenting judgment. His contention was primarily that the other members of the court interpreted s 46 too narrowly, and did not give it the effect that Parliament intended when it was enacted.⁴¹ Supporting the right of the Full Federal Court to come to its own conclusions regarding the facts and result,⁴² Kirby J found that the approach taken by Beaumont, Finkelstein and Merkel JJ was "correct and orthodox".⁴³ Justice Kirby's judgment focused on two main issues: the issue of whether there was market power and whether it was abused, and the issue of recoupment.

may charge supra-competitive prices if it is allowed to by the other firms. Finally, McHugh J disagrees with what appears to be Finkelstein and Merkel JJ's views of what market power means, holding that the ability to *cut* prices does not equate to market power, but rather the ability to *increase* prices, recoup losses and charge at a supra competitive level. See *Boral* [2003] HCA 5 at [282 – 289].

³⁸ *Boral* [2003] HCA 5 at [280].

³⁹ *Boral* [2003] HCA 5 at [280].

⁴⁰ *Boral* [2003] HCA 5 at [280].

⁴¹ *Boral* [2003] HCA 5 at [323].

⁴² *Boral* [2003] HCA 5 at [326].

⁴³ *Boral* [2003] HCA 5 at [328].

Before exploring those issues Kirby J presented a definition of “market power”. After a detailed textual analysis of s 46, Kirby J found that the definition of market power is related not to market share, but rather to “the context and characteristics of the market”.⁴⁴ Accordingly, he held that the Full Federal Court was correct in holding that BBM had a substantial degree of market power, one of the major influencing factors being a corporation’s *capacity* to influence market outcomes.⁴⁵ Moreover, the finding that BBM had market power based on increased market share and economic strength was accepted,⁴⁶ based on the trial judge, and the judges of the High Court in agreement with him, having misconstrued the phrase “power in a market” to reduce the scope and effectiveness of s 46.⁴⁷

Did BBM have market power, and was it abused?

Justice Kirby found BBM did have the required degree of market power. There were a number of areas where his Honour disagreed with other members of the bench. Justice Kirby held “dynamic or strategic entry barriers” are particularly relevant by blurring economic realities with barriers to entry (finding barriers to entry high due to supply and demand situations)⁴⁸, and did not accept that a corporation whose intention was to damage or eliminate its rivals can be acting out of the reach of s 46.⁴⁹ Further, Kirby J found that financial power and market power are not particularly far removed from each other (with financial power perhaps being a “marker” for the existence of a substantial degree of market power as s 46 requires)⁵⁰, and that the vertical integration of BBM into Boral (one element of which meant that BBM was not entirely independent of Boral) gave BBM even more market power.⁵¹ The definition of “market power” as being able to act without relation to the actions of competitors was rejected outright as being too narrow, with a test based on the specific case

⁴⁴ *Boral* [2003] HCA 5 at [344].

⁴⁵ *Boral* [2003] HCA 5 at [345-52].

⁴⁶ *Boral* [2003] HCA 5 at [352].

⁴⁷ *Boral* [2003] HCA 5 at [353].

⁴⁸ *Boral* [2003] HCA 5 at [356].

⁴⁹ *Boral* [2003] HCA 5 at [359].

⁵⁰ *Boral* [2003] HCA 5 at [365].

⁵¹ *Boral* [2003] HCA 5 at [365].

preferred. The traditional test, the power of a corporation to raise prices, was to be used.⁵² According to Kirby J, the problem with the test proposed by other members of the court was that it did not examine market power by reference to the alleged breach of s 46.⁵³ The sum of these parts was that BBM had the requisite market power to breach s 46.

Justice Kirby also held that BBM took advantage of its market power in a way that breached s 46. The purpose of s 46, to protect competition and promote consumer interests, should be realised in its interpretation, as should the intention of the legislature.⁵⁴ According to Kirby J, the section should be examined in its entirety in order to determine its intention,⁵⁵ thereby enabling the section to achieve its purpose.⁵⁶ This approach allowed Kirby J to dismiss claims that BBM's actions were rational business actions and to view them in the context of BBM attempting, and succeeding, in destroying its competitors by strategically pricing below cost or matching the prices of its rivals.⁵⁷ Justice Kirby focused on BBM's aim of eliminating rival firms. This aim, when combined with BBM's already established market power and large market share, fulfilled the requirements for breaching s 46.⁵⁸

Justice Kirby held that, once it appeared that there was the requisite degree of market power, and that market power had been taken advantage of, the aims of BBM proved its intention to use its advantage for anti-competitive purposes.

Market Analysis and the Recoupment Test

The recoupment test should, according to Kirby J, be taken into account when analysing alleged breaches of s 46.⁵⁹ The connection

⁵² *Boral* [2003] HCA 5 at [369].

⁵³ *Boral* [2003] HCA 5 at [375].

⁵⁴ *Boral* [2003] HCA 5 at [383].

⁵⁵ *Boral* [2003] HCA 5 at [385].

⁵⁶ *Boral* [2003] HCA 5 at [384].

⁵⁷ *Boral* [2003] HCA 5 at [391].

⁵⁸ *Boral* [2003] HCA 5 at [396].

⁵⁹ *Boral* [2003] HCA 5 at [404]. Kirby J notes the 'Areeda-Turner' view based on the early influential work on predatory pricing by Harvard Professors Areeda and

between lowering prices and breaching s 46 must be through later recoupment,⁶⁰ and the Act allows the test to be employed to assess whether a corporation with substantial market power has taken advantage of that power for a reason forbidden by s 46.⁶¹ The test should be allowed in light of the history and purpose of the Act.⁶² In the present case, while acknowledging that BBM was never going to become a monopolist, according to Kirby J using the recoupment test shed light on BBM's claims that its actions were rational business decisions.⁶³ BBM's actions were consistent with its internal documents, highlighting the fact that BBM wanted to remove its competitors from the market, and expected that once they were gone prices would be able to rise again.⁶⁴ The fact that competitors were maintaining their market share, and that new competitors entered the market, did not mean the market was competitive, especially when BBM reduced its prices to a level to punish competitors only after it began to lose market share,⁶⁵ and this was the only way that prices could be raised to supra-competitive levels in the future.⁶⁶ Despite these actions being economically rational they were born out of

Turner. (See Areeda and Turner, "Predatory Pricing and Related Practices Under Section 2 of the Sherman Act" (1975) 88 *Harvard Law Review* 697) They state that the only requirement to infer that a corporation engaged in predatory or exclusionary pricing is that prices are set below the costs involved. This has developed into a two staged test in the US Courts, where if it is found that later recoupment through high prices is unlikely there is no investigation of whether costs were too low; if later recoupment is likely, investigation as to the level of pricing is undertaken. The difference between the US law and the Australian law (the US law deals with the results of particular conduct whereas the Australian law deals with the conduct itself) is highlighted.

⁶⁰ *Boral* [2003] HCA 5 at [402].

⁶¹ *Boral* [2003] HCA 5 at [409].

⁶² *Boral* [2003] HCA 5 at [427].

⁶³ *Boral* [2003] HCA 5 at [414].

⁶⁴ *Boral* [2003] HCA 5 at [420].

⁶⁵ *Boral* [2003] HCA 5 at [422].

⁶⁶ Kirby J made no mention of the fact that at the time of the alleged breach, the prices that were being charged were below cost. This leads to the question of what to do in a situation where conduct is required by a corporation that would allow it to charge at a profit without charging supra-competitive prices. When discussing the upgrade to the plant, however, Kirby J did note that the court should be reluctant to "adopt any principle that would discourage... investment".

BBM's desire to avoid any future price wars,⁶⁷ and as such they breached s 46.

In overruling Heerey J's decision that BBM was never likely to be able to recoup its losses by charging supra-competitive prices, Kirby J held that BBM's chances of recoupment were subjective, and that s 46 does not require proof that recoupment is a certainty, nor that it is even likely.⁶⁸ The fact that prices were below cost for so long allowed anti-competitive purposes to be implied, and if recoupment was relevant to purpose, BBM's pricing conduct proved that BBM expressly acted in an anti-competitive manner.⁶⁹

Analysis - An Appropriate Role for a Recoupment Test in Predatory Pricing Cases

As was explained in the overview of *Boral* above, a majority of the High Court (particularly McHugh J and Kirby J) disagreed with the treatment of the recoupment⁷⁰ test by the Full Federal Court. A majority of the High Court found that in predatory pricing cases, the issue of whether or not a competitor has demonstrated an ability to recoup its losses from below cost pricing is a necessary consideration when determining whether a corporation has substantial market power and has taken advantage of that power. As Gleeson CJ and Callinan J noted in their judgment in *Boral*:

[P]ower in a supplier ordinarily means the ability to put prices up, not down. But if a market is not competitive, and a firm [sic] puts prices down, seeking to eliminate a potential rival, in the expectation that it will thereafter be in a position to raise prices without competitive constraint, its ability to act in that manner may reflect the existence of market power.⁷¹

⁶⁷ *Boral* [2003] HCA 5 at [430].

⁶⁸ *Boral* [2003] HCA 5 at [436].

⁶⁹ *Boral* [2003] HCA 5 at [438].

⁷⁰ *Boral* [2003] HCA 5 at [289] McHugh J, (when considering United States jurisprudence) spoke of recoupment in the sense of "the capacity of a firm to price in a manner inconsistent with what a competitive market would dictate in order, at a minimum, to make good the losses sustained during a price war".

⁷¹ *Boral* [2003] HCA 5 at [138].

The relationship between the existence of market power and the ability to recoup was also raised by McHugh J in *Boral*:

[A]lthough s 46 does not use the term “predatory pricing”, two of its key components are “a substantial degree of [market] power” and a taking “advantage of that power”. A firm [sic] does not possess “substantial market power” if it does not have the power to recoup all or a substantial part of the losses caused by price-cutting by later charging supra-competitive prices. If it cannot successfully raise prices to supra-competitive levels after deterring or damaging or attempting to deter or damage competitors by price-cutting, the conclusion is irresistible that it did not have substantial market power at the time it engaged in the price-cutting.⁷²

The present authors have no issue with recoupment being the main test to determine whether a corporation that has engaged in below cost pricing for an extended period of time has substantial market power in the relevant market, and whether it has taken advantage of that power in contravention of s 46. As the court said in *Boral*, below cost pricing by itself is of no concern as consumers benefit from lower prices, and any corporation, whether constrained by competitive forces or not, can engage in a process of price-cutting.⁷³

In market reality, this is usually the sign of a competitive rather than an anti-competitive market. What does warrant the attention of competition law, however, is when a corporation engages in below cost pricing with the expectation of forcing out competitors so the corporation can later charge supra-competitive prices (prices well above those that could be charged in a competitive market) in order to recoup losses suffered during the “price war”. This ability to raise prices without fear of losing market share is perhaps the clearest indication that the corporation has used its resources to limit, restrict or prevent competition in the relevant market. It also has a detrimental

⁷² *Boral* [2003] HCA 5 at [278].

⁷³ See particularly the judgment of Gleeson CJ and Callinan J in *Boral* at [139]: “There can be circumstances in which price-cutting may be undertaken by a powerful firm [sic], or combination of firms [sic]. But the ability to cut prices is not market power. The power lies in the ability to target an outsider without fear of competitive reprisals from an established firm [sic], and to raise prices again later.”

effect on the welfare of consumers, a paramount objective of the Act pursuant to s 2, as consumers have to pay significantly more for the particular good or service compared to before the “price war”.

For these reasons, evidence of an ability to recoup is a reliable indication that a corporation has substantial market power in the relevant market, and has taken advantage of that power for one or more of the proscribed purposes under s 46. As Easterbrook J said in the United States decision of *AA Poultry Farms Inc v Rose Acre Farms Inc*,⁷⁴ the ability to recoup is a useful “filter” to sort genuine predatory pricing claims from instances of genuine pro-competitive conduct.⁷⁵

The recoupment test should have a fixed place in the *Trade Practices Act 1974* (Cth). It is an easy test that simplifies the often difficult analysis of whether a corporation has pushed pricing across the blurred line separating “good hard competition”, which the *Trade Practices Act* encourages, from the “rough play of predation”.⁷⁶

At this initial stage in the High Court’s consideration of predatory pricing it has been effective in endorsing the test of recoupment. What is lacking is a clear indication of the place the recoupment test has in the process of determining whether a corporation’s below cost pricing constitutes taking advantage of substantial market power, and the relationship the ability to recoup has with other factors, such as market share and barriers to entry, used to determine whether a corporation has substantial market power.⁷⁷ Not only is this aspect of the

⁷⁴ 881 F 2d 1396 (7th Cir 1989).

⁷⁵ See Edwards G, “The Perennial Problem of Predatory Pricing” (2002) 30 *Australian Business Law Review* 170 at 178.

⁷⁶ See Smith R L and Round D K, “Section 46: A Strategic Analysis of Boral” (2002) 30 *Australian Business Law Review* 202 at 212.

⁷⁷ For example, one question that should be resolved is whether it is necessary to examine barriers to entry (both structural and strategic) in a market if it is established on the facts that the corporation has an ability to recoup. The authors’ view, as discussed below, is that substantial market power can be inferred on the sole basis that a corporation has an ability to recoup its losses incurred during a “price war”. However, this is not the opinion of Geoff Edwards in his recent article, “The Perennial Problem of Predatory Pricing”, note 74. In that article, Edwards argues (at p182): “Predation will only be profitable, and should only be a concern for antitrust policy, if there is a prospect of ex post recoupment of profits sacrificed during the predatory period. It follows that a claim of predatory pricing should only be upheld if a plaintiff can show a court that, ex post, significant barriers to entry to relevant markets exist that permit the alleged predator to earn

recoupment test lacking in the reasoning of the judges of the High Court in *Boral*, but it has also not received sufficient academic attention. This part of the article deals expressly with how the recoupment test should be used in predatory pricing cases, now that it has been specifically endorsed by the High Court in *Boral*. The ability of a corporation to recoup through charging supra-competitive prices should be the central issue when determining whether a corporation's pricing policy involves a misuse of market power. Further, the process of reasoning in predatory pricing cases should be consistent with the express terms of the Act, which was the approach employed by a majority of High Court judges in *Boral*, and freed from complex economic analysis and theories making the law regarding predatory pricing confusing and unpredictable.

Consistent with these objectives, any development or reformulation of the way in which recoupment is used in predatory pricing analysis by the courts should start with the overriding objective of the Act, expressed in s 2, of "enhancing the welfare of consumers through the promotion of competition and fair trading". Any practice of below cost pricing engaged in by a corporation should only be a concern warranting the attention of the Act if it is detrimental to the welfare of consumers. The High Court (particularly McHugh J) reinforced in *Boral* a point that has been highlighted in numerous academic commentaries, namely, below cost pricing of and by itself should not be of concern because consumers benefit from cheaper prices.⁷⁸ Concern is only warranted if there is something more involved; something that works against the welfare of consumers. Logically, this means that an increase in prices to a level above that chargeable in a

high profits and recoup its losses, whether these barriers are structural (such as network effects, excess capacity, financial constraints or high sunk costs of entry or exit) or behavioural (such as newly acquired credible reputation for predation held by the alleged predator)."

⁷⁸ See *Boral* [2003] HCA 5 at [291] (McHugh J): "Reducing prices does not per se establish any degree of market power. That is true whether the supplier is pricing at marginal cost or below average variable costs. Price reductions are beneficial to consumers unless the quid pro quo is higher prices at a later date. If prices merely rise back to the levels that existed before the price-cutting began, consumers have the benefit of the reduced prices for the duration of the price cutting. They are no worse off at the conclusion of the price war when the market returns to its long-run equilibrium. Detriment to consumers arises only where competitors are removed and prices rise above the competitive equilibrium to levels that allow those remaining to earn supra-competitive profits that enable them to recoup losses because its price-cutting has removed competition and allowed it and perhaps others to charge supra-competitive prices that harms consumers."

competitive market (supra-competitive prices) would be required before a practice of below cost pricing became a concern. It is at this point that the ability to recoup becomes relevant.

Two factors in particular suggest the recoupment test is most suitable to adequately determine whether a potentially pro-competitive practice of below-cost pricing is on the facts an anti-competitive practice through the added dimension of an expectation of recoupment. The first is that below cost pricing by itself is not of detriment to the welfare of consumers and does not necessarily indicate that a corporation has substantial market power. This is so because, as McHugh J pointed out, “any firm [sic] can do that”,⁷⁹ regardless of whether they have any market power at all. The second is that charging supra-competitive prices to recoup lost profits is a clear indication that the competitive restraints limiting the ability of corporations to raise prices without fear of lost sales does not exist. As such, a test that combines the pricing situation of a corporation with its ability to later price goods at a supra-competitive level will determine the reasons for charging below cost in the first place, and it is this question that must be answered to determine whether the conduct breached s 46. Whilst McHugh J was of the opinion generally that it is unreasonable for the law not to intervene until prices rise, little in his judgment suggested a method to counter the problem recognised. The court, having the ability to decide on predatory pricing after the corporation begins to increase prices, would solve such problems.

Accordingly, what must be implemented is a stand-alone test of recoupment for predatory pricing cases.⁸⁰ This could either be

⁷⁹ *Boral* [2003] HCA 5 at [287] per McHugh J.

⁸⁰ For a similar reform initiative see Edwards G, “The Hole in the Section 46 Net: The Boral Case, Recoupment Analysis, the Problem of Predation and What to do About It” (2003) 21 *ABLR* 151. Edwards’ proposal is to amend s 46 to deal with the fact that a corporation that has recoupment prospects may not have substantial degree of market power at the time it engaged in a price war. Under this proposal, Edwards states, at p 169: “A corporation would be prohibited from taking advantage of substantial market power either presently existing or anticipated to exist in the future. The effect would be to make the relationship between recoupment prospects and substantial market power identical. Showing recoupment prospects would be a *necessary and sufficient* condition for establishing substantial market power for the purposes of s 46. There would be no need to show the firm [sic] had discretionary ability *at the time* of the conduct.” Edwards suggests that would be achieved by replacing the word “has” in s 46 with “has, will have, or will likely have”.

legislative-based (included in s 46 or a separate section) or form part of the common law, building on what was said by the High Court in *Boral*. The test should be as straight forward as possible, freed from the variables and complex economic analysis which has made predatory pricing such a “perennial problem”⁸¹ in Australian competition law.

The proposed test of recoupment would comprise a two-stage process.⁸² The first step would be to determine whether a corporation has charged below “an appropriate measure of cost” involved in producing the good or service over a “sustained” period of time. What is an appropriate measure of cost would be left to the court to decide based on the evidence presented, and on the application of common sense. What is “appropriate” should be based on one’s own intuition, rather than being a concept preserved for economic analysis and modelling. Accordingly, the court would decide the question of cost without requiring each party to call economists as expert witnesses to explain the finer details of cost analysis, a process which tends to be expensive. Putting the task of determining cost in the hands of the court will not lead to a perfect estimate of cost, however no method has or ever can, due to the imprecise nature of cost analysis. For these reasons, established forms of cost analysis (and there remains quite a deal of uncertainty as to what is the best method for determining cost in predatory pricing cases),⁸³ have been criticised for containing deficiencies.⁸⁴ Indeed, Finkelstein J, in the Full Federal Court’s judgment in the *Boral* case, went so far as to say:

In my opinion the existence of predatory pricing should not be determined by reference to some precise formula or definition. Predatory pricing is no more than a price set at a level designed to eliminate a competitor or keep a potential competitor from the market. ... In my view, it does not matter that the price

⁸¹ See Edwards G, note 74.

⁸² The authors’ proposed process is similar to the two stage-test to determine predatory pricing allegations established by the United States Supreme Court in *Brooke Group v Brown & Williamson Tobacco Corp* 113 S Ct 2578 (1993). For a discussion of *Brooke Group*, see Edwards G, note 74, at p 172.

⁸³ See, for example, the discussion by Steinwall R, “The use of cost based tests and the test of recoupment by Australian courts in predatory pricing cases: Some further insights from the recent Federal Court decision in *Boral Ltd*” (1999) 7 *Competition and Consumer Law Journal* 140.

⁸⁴ See Edwards G, note 74, at pp 182-186.

charged might exceed either the average total cost or average variable cost. In the circumstances of a particular case it may nevertheless be a predatory price.⁸⁵

As to what constitutes a “sustained” period of time, would also be a matter for the court to determine, again applying common sense. A “sustained” period of time would be a length of time sufficient to evidence a strategy that facilitates later recoupment by the corporation. This analysis would exclude “once-off” or “temporary” below cost pricing (such as selling fresh produce at a discount close to its expiry date, or “fire sales” to move damaged or out-of-season stock) because even in a low competition environment, consumers (as a matter of market reality) would not be prepared to pay supra-competitive prices for such products to enable a corporation to recoup its losses. As a general rule, the “sustained period of time” test would usually be satisfied when the relevant goods or services are such that it would not usually be necessary for a corporation to engage in discounting to maintain sales, and where there is a possibility that consumers would be willing to pay supra-competitive prices for the relevant goods and services in a market unrestrained by competition.

The second part of the test would come into play if the court was satisfied that prices were below an appropriate measure of cost and had been for a sustained period of time. The purpose of the second stage of the test would be to determine whether the corporation subsequently increased its prices to a level “unreasonably” above prices obtained before the corporation engaged in a strategy of below cost pricing. The indicator of “unreasonably” would enable the court to make a decision based on the particular facts of the case without being burdened by technical economic analysis and theories that complicate the process. This would be a significant development, as traditionally the analysis and judgment of economists, statisticians and others have been seen as an indispensable part of competition law. However, this does not need to be the case. Competition law primarily involves the interpretation and application of Part IV of the Act and associated case law, which is the domain of lawyers. This was

⁸⁵ *Australian Competition and Consumer Commission v Boral Limited* [2001] FCA 30 (27 February 2001) at [348], discussed in Corones S, “Section 46 of the Trade Practices Act: What are the Rules for Battle?” (2001) 29 *Australian Business Law Review* 176.

confirmed by the view of the majority of the High Court in *Boral* that the starting point, in a predatory pricing case, is the text of the Act.⁸⁶ The task of judges is to grasp the facts involved in a case and apply the law to the facts to determine the rights and duties of persons. Like any other area of law, non-lawyers with particular expertise should only become involved when the facts involve specialist or technical matters where expert opinion would better equip lawyers to apply the law to the facts. Predatory pricing is an area that does not require the input of non-lawyers, particularly if the test for determining whether predatory pricing has occurred is devoid of non-legal elements, thus enabling judges to feel confident they can resolve the matter without the need for outside assistance.

Naturally, economists and other non-lawyers believe that it is crucial that a “holistic approach” to determining predatory pricing issues is employed which requires “even more reliance on detailed economic analysis than is the case today”.⁸⁷ It needs to be recognised that it is in their own interest to say that. Competition law is not subservient to the theories and assumptions of economics or related fields. Rather, it is part of the overall body of law which is intended to promote clarity and certainty, being central elements of the rule of law.⁸⁸ While complex theories to do with market structure, cost and pricing might be extremely useful in economics, finance and related fields, their place in the field of law must be questioned if they generate confusion and uncertainty, and provide an answer that could have been obtained by a much simpler process.

The “unreasonably” high price increase would simply involve the court looking at the price the corporation charged for the goods or services prior to the “price war” which lead to a practice of below cost pricing, and comparing that price with the price following the cessation of the price war. Again, the difference between a price increase and an “unreasonable” price increase would be a matter of common sense based on the facts presented to the court. A price increase that reflected the effects of drought, exchange rate variations, higher interest rates or

⁸⁶ See *Boral* [2003] HCA 5 at [168] per Gaudron, Gummow and Hayne JJ: “It is necessary to look first to the text and structure of the Act, particularly s 46.”

⁸⁷ See Edwards G, note 75, at p 201.

⁸⁸ See Fuller L, *The Morality of Law*, Yale University Press, London, 1964; McConvill J and Bagaric M, “The Yoking of Unjust Enrichment and Unconscionability” (2002) 7 *Deakin Law Review* 225 at p 245.

other concrete costs would not be “unreasonable” as it was not influenced by the state of competition in the relevant market. Participants in a highly competitive market, and participants in a market that can be characterised as a monopoly, will be under the same pressure to increase prices in such circumstances. A price increase would typically be “unreasonable” if the nature of the relevant market was such that the only explanation for the price increase was that the corporation was recouping the loss it incurred during the price war. In other words, the corporation has limited or restricted its competition, and is now taking advantage of its market power.

The process should not be complicated by adopting a “wait and see” approach to determine whether a corporation is actively recouping its losses,⁸⁹ and a time component should not be incorporated into the test. Requiring a certain period of time to pass before the courts can decide whether the second part of the two-stage test has been satisfied would generate uncertainty and confusion. For example, should a line in the sand be drawn so that a practice of excessive price increases for ten days does not demonstrate a policy of recoupment, yet a practice in place for eleven days does? The law should not have to concern itself with such trivial issues. Enough confidence should be placed in the court being able to determine such questions without arbitrary rules clouding its judgment. The views on recoupment that have derived from the works of Professors Areeda and Turner, suggesting that market power may be determined without referral to the recoupment test, propose that market power may be inferred if a corporation sets prices below cost.⁹⁰ Such views are inappropriate, as they do not take into account market factors that act to force the price down. Indeed,

⁸⁹ On this point, see Kirby J in *Boral* [2003] HCA 5 at [442]:
[T]he rules against exclusionary conduct, of the kind with which s 46(1) of the Act is concerned, should obviously be capable of application before events later impugned by the ACCC have been fully played out. This is so because the Act contemplates that corporations and their officers, and the ACCC, should be aware in advance of the kind of conduct that is prohibited and sanctioned by the section. It would not be satisfactory to suggest that a corporation, or the ACCC, must wait to see how things pan out. Otherwise, whether a breach of the section has occurred or not would depend upon whether, as a matter of evidence, one or more competitors had decided to leave the market or one or more had successfully entered the market. That would hardly represent an acceptable interpretation of s 46.

⁹⁰ Areeda and Turner, Note 59, cited in *Boral* [2003] HCA 5 at [404].

evidence presented to the court by Professor Hay suggested that such a theory was unsound economically and “very bad policy”.⁹¹

What must be proved is that the “unreasonable” price increase is detrimental to the welfare of consumers, returning to the overriding object of the *Trade Practices Act* contained in s 2. As Kirby J said in his dissenting judgment in *Boral*, “If the charging of low prices constitutes the alleged contravening conduct, it will usually be appropriate, as a threshold question, to ask whether it would be possible for consumers to suffer harm as a result of such conduct”.⁹²

Once these two steps have been satisfied, the obvious conclusion is that by engaging in below cost pricing with the expectation of recoupment, the corporation has substantial market power in the relevant market and has taken advantage of that power for an anti-competitive purpose, namely, to prevent, limit or restrict competition contrary to s 46 of the Act. By the very fact that the corporation has been able to raise its prices to supra-competitive levels, it can be inferred that the corporation has substantial market power. There is no necessity to engage in a lengthy examination of what level of market share the corporation has, whether or not there are barriers to entry in the relevant market and, if so, the nature of those barriers. Based on the reasoning outlined, the practice of the corporation raising its prices to an “unreasonably” high level in a market that has been subject to strong competition indicates that such competition no longer exists, and acts as a strategic or behavioural barrier to entry, thereby deterring possible future competition in the relevant market.

Conclusion

The High Court’s 2001 decision in *Melway*, that a causal connection must be established between a corporation’s market power and anti-competitive purpose, opened up for questioning much of the reasoning used by the Full Federal Court in deciding that *Boral* had “taken advantage” of its market power when engaging in its strategy of below cost pricing. In the authors’ view, the High Court has adequately resolved much of the uncertainty arising from *Melway* with its most recent decision in *Boral*. Following the decision in *Boral*, what will

⁹¹ *Boral* [2003] HCA 5 at [183].

⁹² *Boral* [2003] HCA 5 at [410].

need to be established in future predatory pricing cases under s 46 is, firstly, that the particular corporation had substantial market power in the relevant market, and secondly, that it had “taken advantage” of this power through its pricing behaviour to achieve one or more of the proscribed purposes in s 46 (that is, to limit, restrict or prevent competition).

Although this would seem to be a clear-cut test to apply, *Boral* has demonstrated that the vagaries of market analysis and the general nature of competition make it very difficult to satisfy one, let alone both, of the above tests. According to both Australian and United States cases, the most effective way to gauge whether predatory pricing has occurred is if the corporation has misused its market power and the corporation has demonstrated a willingness and ability to recoup the losses it incurred by charging supra-competitive prices. It is for this reason that the importance of elevating recoupment to being the central test to apply, when determining whether a corporation has misused its market power by way of its pricing strategy, is stressed. Either through legislative or judicial initiative, the ability of the *Trade Practices Act* to regulate predatory conduct would be considerably enhanced if an allegation of misuse of market power involving predatory pricing could be resolved by answering one question. That question being: Is the nature of the relevant market such that the corporation is willing and able to charge supra-competitive prices to recoup its losses?