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PREDATORY PRICING AND THE PORT NELSON SAGA

The Prohibition of Predatory Pricing Under Section 27 of the Commerce Act 1986.

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CONTENTS

ABSTRACT

The decision *The Commerce Commission v Port Nelson* McGechan J found predatory pricing behavior by Port Nelson Limited to be a breach of section 27 of the Commerce Act 1986. Section 27 prohibits contracts arrangements or understandings that contain a provision that has the purpose effect or likely effect of substantially lessening competition. This paper is an analysis of whether section 27 of the Commerce Act is a useful section to prohibit predatory pricing behavior by firms in the markets of New Zealand.

1 INTRODUCTION

The Commerce Commission v Port Nelson Limited [1] *(Port Nelson)* is a landmark case in the area of competition law. The High Court ordered Port Nelson Ltd to pay penalties amounting to 500 000 dollars for three breaches of the Commerce Act 1986 (The Act). *This is the highest total yet imposed under this Act on a single company.*[2]

Since the Privy Council decision of *Telecom Corporation of New Zealand v Clear Communications*[3] it was predicted that succeeding in any action alleging unilateral anti-competitive action would be very difficult[4]. However in the *Port Nelson* decision Justice McGechan sidestepped the difficulties created by the narrow approach to section 36, by utilising section 27 in an innovative manner.

The *Port Nelson* decision is the first New Zealand case to address predatory pricing and for that reason alone is worthy of attention. Yet it is McGechan J's analysis of section 27, and its applicability to predatory pricing conduct, that is the focus of this paper. This paper is an analysis of whether section 27 of the Commerce Act 1986 is a useful section for the prohibition of predatory pricing behavior.

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[1] Unreported, 2 June 1995, High Court, Nelson Registry, CP 12/92.

[2] *Fairs Fair* Commerce Commission Publication, June July 1995, 3.

[3] Privy Council Appeal No 21 of 1994.

[4] *The test for "use" of a dominant position put forward by the Privy Council in Clear Communications has the potential to be very narrow in scope, and to exclude from the ambit of s 36 a good deal of conduct which has in earlier cases been held to be contravention's of that section.* Yvonne Van Roy " The Privy Council decision in *Telecom v Clear:* Narrowing the Application of s 36 of the Commerce Act 1986" (1995) NZLJ 54, 60.

2 *THE PORT NELSON SAGA*

Port Nelson is a natural haven formed between an off-shore boulder bank and inshore beaches. It includes extensive unnavigable mud flat areas. The entrance to the port is through a man made narrow "cut" through the boulder bank. The harbor itself is shallow and strongly tidal, added to which complications of wind and tide make manoeuvering within it a delicate operation. It is therefore a compulsory pilotage district. Vessels of eighty meters or more in length must utilize tugs and the majority of larger vessels employ both tugs and pilots.

In the 1980's the organisational structure of the Port of Nelson underwent major reform. The intention was to reorganise aspects of port operations into the control of separate companies in the interest of efficiency gains, cost reduction and commercial constraints upon pricing, the benefits of which would be ultimately passed on to the shippers. The company Port Nelson Limited (PNL) was incorporated in anticipation of these events. The activities that were defined as "commercial undertakings" to be controlled by PNL included wharves, berths, slip ways, reclamation land, tug services and pilotage services. The package was transferred to PNL in 1988 for the sum of $32.439 million dollars.

Prior to the restructuring, the pilots of port nelson were the employees of the Nelson Harbour Board. They were paid a set salary to pilot incoming ships, using tugs owned by the Harbour Board when required. However the employment relationship between the parties ended after 1988. PNL would not take over the pilots of the Harbor Board as employees. It was stipulated by the Port Plan that the process would run as a tendering process. The Port Company would call for tenders on pilotage on a contractual basis. It was contemplated that the contracted pilot services would be for labour only.

The Managing Director of PNL was headed by Mr Green (Green), an aggressive business person, dedicated to objectives to "operate a successful business"[5]. Green regarded the Nelson Harbor Pilots as under employed, and saw the advantages of making them redundant, and calling for competitive tenders for the initial five years. PNL maintained control of the pilot launch, which transported the pilots to the ships, and the tugs, ensuring the pilots could not hold PNL to "ransom". However the hopes of PNL were not realised, as there were no competitive tenders.

The pilots organised into a company, called Tasman Bay Marine Pilots Limited (TBMPL). The terms of the contracts for pilotage were negotiated on a yearly basis. In 1990 the relationship between the PNL and TBMPL broke down. That year the pilots had sought a 7.6 percent pay increase, PNL considered the pilots were well remunerated already and offered a contract that did not include the increase. Negotiations[6] continued, until they broke down completely and it seemed that the contract could not be settled.

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[5] The Nelson Port Plan - Statement of Corporate Intent.

[6] The following exchange, described as "brisk and challenging" is an example of the kind of negotiations involved, Above n 1, 89:

> *Captain Tregidga asked Mr Green rhetorically what was to stop TBMPL from dealing with shipping companies directly? Mr Green, used to robust industrial negotiation, replied spontaneously. His words were close to "Whose wharves are you going to berth them at? I'll run you out of business within a month". Captain Tregidga responded the Court might have something to say about that. So Mr Green responded "So you want to see the cost of going to Court?" The implication being that TBMPL could never afford that option.*

TBMPL was left with an obvious choice. They could detach themselves from PNL and approach shippers directly, instead of contracting with PNL, to do the pilotage that PNL attracted. They would strike out on their own and form an independent pilotage service. This was innovative thinking as all other pilots in New Zealand are employed by port companies. TBMPL knew that PNL was in a vulnerable position if they chose this course of action, as PNL had only one pilot to do all their manoeuvering. TBMPL however, had three pilots to utilize. TBMPL started to operate and competed directly with PNL in the provision of tug and pilotage services.

PNL proceeded to conduct business in a manner which TBMPL alleged was deliberate in attempting to eliminate them from the market. Three actions by PNL were considered in the case, and all three were held by McGechan J to be a breach of The Act. They were a 5 percent discount offered to shippers if all of PNL services were employed, a refusal to supply tugs if PNL employees were not piloting, and a minimum charge for the cost of vessel movement.[7] Thus the minimum charge was not imposed in isolation. McGechan J saw the minimum charge combined with other conduct as part of an overall strategy to eliminate TBMPL from the market.[8] Although it is the minimum charge that is the focus of this paper, the other actions will be outlined, to give a more complete picture of PNL's anticompetitive conduct.

2.1 *The 5 Percent Discount*

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[7] The focus of this paper is the imposition of the minimum charge by PNL that was held to be a breach of section 27 of The Act. Due to the confines of this paper the tug-tie and discount can only be briefly discussed.

[8] Above n 1, 201.

When the new port company came into existence it had inherited the Nelson Harbor Board scale of charges. PNL also brought in its own, including a wharfage charge and wharf user levy. Litigation ensued involving a rival stevedoring firm USSL[9] USSL alleged that when calculating their charges that double counting elements might exist in their quantification. A recommendation was made that PNL undertake *"a proper cost accounting analysis of the constituent elements of the wharf, charge, rebate, and wharf user levy, isolating and eliminating any double counting, and ascertaining a commercially appropriate overall level"*[10]

Consequently PNL engaged an independent accountant consultants Deloittes to carry out the analysis. A discount had been in contemplation since November 1990. PNL favoured a discount for an "all services" package, a 5 percent discount was offered if a shipping company engaged all of PNL's services. Green was concerned that all of PNL labour was optimized, and considered this could only be assured by such a discount he considered:[11]

> *...it is fundamental to our continued profitability that the use of labour is fully optimized...it is only by ensuring that this happens that we can maintain our efficiency and profitability, and to this end I recommend that we introduce a system whereby a discount is offered, where all our services are employed, including pilotage, stevedoring, ship lines etc.*

PNL had a natural monopoly in the areas of port services.[12]

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[9] [1990] 2 NZLR was that a vessel which elects to take TBMPL pilotage and TBMPL provided tugs would have to forego the 5 percent discount

[10] Above n 1, 71.

[11] Above n 1, 133.

[12] The incontestible services PNL had a monopoly over were port access, berthage, utilities, equipment, wharfage and storage.

The concern which would have been available on PNL charges for pilots, tugs, and port services. The rational vessel would compare the two options of foregoing the discount and electing to use TBMPL pilots and tugs, or utilising all of PNL's services and benefiting from the discount. *The fate of TBMPL pilotage could thus depend upon the value of discount offered by PNL not only on contestible services, where TBMPL can compete, but incontestible services, where no-one can compete.*[13]

The Commerce Commission contended that the discount, given on a bundle of services, some monopoly, which TBMPL would be unable to match, had the purpose and effect of substantially lessening competition in pilotage and tug markets. The purpose of PNL's discount was examined in the light of subjective and objective facts and McGechan J favoured the Commissions view:[14]

> *I am satisfied, particularly in the background of PNL animosity and acute concern as to competition from TBMPL, that PNL intended that hostile discount consequence, and an outcome which would hopefully eliminate TBMPL and deter others. Elimination in the circumstances, was not viewed as some mere incidental benefit of the proposed discount.*

McGechan found that the 5 percent discount had the likely effect of substantially lessening competition in the market and a breach of section 27 of The Act.[15]

2.2 *The Tug-Tie*

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[13] Above n 1, 171.

[14] Above n 1, 181.

[15] This action failed under section 36 of the Act due to the narrow application of section 36 set down by the Privy Council decision in *Telecom Corporation of New Zealand v Clear Communications* Privy Council Appeal No 21 of 1994. See discussion below, 32.

PNL adopted a policy not to hire out its tugs unless PNL pilots were employed as well. PNL justified this action by voicing concerns over insurance, claiming they would not be covered for any damage of, or caused by, their tugs when under the control of independent pilots.[16]

This in effect was a refusal to supply tugs if TBMPL pilots were employed. Such action was dangerous to TBMPL as they owned no tugs of their own, and had only ad hoc, temporary access to borrowed tugs, with no guaranteed availability. All vessels more than 80 meters required tugs for manoeuvering. TBMPL was thus restricted to work in the lower length vessel area, which gave only a low return, or work only as pilots.

McGechan J held that the imposition of the tug tie was a breach of section 36 of The Act. His Honour found that the tug tie, once of insurance concerns were dismissed, had no other explanation except to be part of a strategy to kill prospective competition in pilotage. McGechan J concluded:[17]

> *It follows when PNL acted, within its dominant position, by imposing the tug tie, it did not act as a non dominant firm would act in the same circumstances. Its actions, realistically, went past the competitive: they amounted to use of dominance for proscribed s36 purpose.*

2.3 *The Minimum Charge*

PNL's charging system for the provision of pilot and tug services was in accordance with a gross registered tonnage (GRT) scale. Put simply it was a system of "the more you weigh,

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Above n 1, 226.

routines were. rejected as "persiflage" by McGechan J. [17] Above n 1, 227.

the more you pay". Ships were charged for maneuvers according to their weight. There was however a minimum charge, its low value being the cause of an allegation of predatory pricing on the part of the Commission. The charge was for ships that weighed less than 2500 tonnes, and was priced at 100 dollars by PNL. This was half the amount of what had been charged prior to TBMPL's entry into the market.

This charge could be particularly damaging to TBMPL as they operated in the lower GRT end of the market. TBMPL would be forced to compete directly with the minimum charge offered by PNL on a regular basis. Due to the sporadic supply of tugs that TBMPL had access to, and their low power capacity, TBMPL was confined to smaller vessels that required small tugs, or no tugs at all. By use of the minimum charge PNL could further undermine the small market niche that TBMPL was being forced to be active in.

The Commerce Commission contended that the 100 dollar minimum charge was capable of being defined as a contract, or an inducement to enter into a contract that contained a provision that had the purpose of substantially lessening competition. The allegation surrounded the introduction in 1991 of a new schedule of charges, including the minimum charge.

PNL contracted with the owners of vessels, and shipping companies, wishing to enter Port Nelson for provision of port services. The contracts included a schedule setting out the charges for pilotage services. Therefore such offering of pilotage services at 100 dollars minimum charge constitutes contravention, attempted contravention, or inducement of contravention of section 27. In doing so the Commission argued that section 27 was applicable to the assessment of allegations of predatory pricing:[18]

[18] Above n 1, 7.

> *The inclusion of the schedule incorporating a minimum charge substantially below the cost to the defendant of providing a pilotage service constitutes predatory pricing on the part of PNL.*

McGechan J agreed with the Commission that section 27 applied. It is the effectiveness of this decision and subsequent analysis that is the focus of this paper.

3 PREDATORY PRICING

> *Predatory pricing is an attempt by a firm with a substantial share of the market to cut its prices in order to force competitors out of the market or to deter potential market entrants. The period of price cutting is then followed by a period of supernormal prices when the monopolist seeks to recoup any losses.*[19]

It is noted that predatory pricing may prove to be of increasing significance in New Zealand due to the changing face of our market structure:

> *Deregulation and the privatisation of state-owned enterprises have raised concerns that previously restrained monopolies may become free market giants that use their market*

[19] K McMahon "Predatory Pricing under section 46 of the Trade Practices Act and the Decision in *Eastern Express v General Newspapers*" (1993) 1 Antitrust Law Journal 75, 76.

power to destroy smaller competitors. One of the ways they may do so is to engage in predatory pricing.[20]

No definition of predatory pricing has gained the assent of all commentators however, it is generally considered to be detrimental to society in theory.[21] The predator subverts the natural competitive process by preventing its rival from entering the market, or by strangling their attempts to compete should they become established. This results in a misallocation of resources as the predator has no incentives to increase efficiency or increase quality as their conduct ensures no threat of competition. The consumer continues to be charged at levels of supranormal profit to the benefit of the predator.

The issue of predatory pricing has produced a plethora of works from academics, most of which refuting and conflicting with the observations of each other.[22] This wealth of

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[20] J Eisenberg J "Predatory Pricing in the Context of Australian and New Zealand Competition Law" *Competition Review: Current Issues in New Zealand Competition and Consumer Law,* 4, Commerce Commission, Wellington, 1991, 25.

[21] Not all critics agree that predatory pricing should be proscribed by antitrust law. Some argue that it is impossible, and that their need be no prohibition against this empty concept. See Campbell "Predation and Competition in Antitrust: The case of Nonfungible Goods" (1987) 87 Columbia Law review 1625. See also Bork *The Antitrust Paradox: A Policy At War Within Itself* (Basic Books, New York, 1978) 91.

[22] P Joskow and A Klevorick in their paper "A Framework for Analysing Predatory Pricing Policy" (1979) 89 The Yale law Journal 887 at 889, outlined why commentators have not provided a unified structure for evaluating the different approaches to

predatory pricing and choosing among them:

1. Writers rely on different theoretical models ie a static framework while others concentrate on strategic aspects in a dynamic context. Still others concentrate on social goals so focus on short-run social welfare maximization, while some prefer an emphasis on long run social welfare maximization.

2. Different policy conclusions are at least partially the result of different empirical guesses about market characteristics.

analysis has not however aided the success of prosecutions of predatory pricing in Courts.[23]

It would be an impossible task to canvas in detail all the recommended method of analysis of predatory pricing, but it is possible to identify three main approaches. These are the cost based tests, considerations of subjective intention approach, and the recoupment approach. In practice these tests overlap and are often used in conjunction with each other, yet for the sake of simplicity they will be discussed separately.

3.1 *Cost Based Tests*

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3. Another factor is the different views of the ease with which legal controls on price output can be administered. Although almost all of the contributors to the recent literature voice dismay at the prospect of instituting anything that resembles public-utility regulation for dominant firms, they hold substantially different views of the degree of control that is feasible within the current framework of antitrust institutions.

4. Writers differ on the question of institutional competence: authors have different conceptions about what the courts can do well, what kinds of information they can process and what kind of issues are too "speculative" for judges or juries to decide.

5. In framing a policy or approach, different authors attach different weights to the importance of having a simple per se rule instead of a rule of reason approach.

[23] There has ben only one successful prosecution of predatory pricing in Australia *The Victorian Egg Marketing Board v Parkwood Eggs Pty Ltd (1978) ATPR para 40-081*, no successful cases in New Zealand prior to Port Nelson, and it was seven years after the famous Areeda and Turner test was published that there was a successful case in America (Discussed below).

Cost based tests have been used to establish a predatory purpose of a firm. The object is to construct some "benchmark", below which all prices would be deemed to be predatory without exception. The test attempts to introduce elements of objectivity into the analysis, in order to avoid reliance on complex inquiries into subjective intention. Anticompetitive purpose is inferred by pricing at a level below that of any rational firm. If pricing is in a manner that is unprofitable, then the obvious conclusion is that the pricing strategy is to further an anticompetitive objective. *After all there would be no rational reason to employ this dangerous strategy if there were not supranormal profits to be gained by its success.*[24]

In 1975, Areeda and Turner (A&T) formulated a test to establish predation[25]. Put simply A & T maintained that a price less than short run marginal cost is predatory, and any price above that is non predatory. A & T recognised that marginal cost data, which describes how costs vary with each additional unit of output, is not easily computed. Consequently "average variable cost"[26] (AVC) was used as a proxy, as it is of more empirical value than marginal cost data.

Average total cost is not always an ideal substitute for marginal cost. A firm that consistently prices below AVC without, reasonable justification, should be considered a predator as it is not recovering all of its variable costs.[27] However it is still possible to price

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[24] Above n 20, 14.

[25] The A & T test was first postulated in "Predatory Pricing and Related Practices Under Section 2 of the Sherman Act" (1975) 88 Harvard Law Review 697. The authors statedtheir formula was devised in response to the fact that *Courts in predatory pricing cases have generally turned to such empty formulae as "below cost pricing", ruinous competition, or predatory intent in adjudicating liability.* Their arguments were later developed in *Antitrust Law* (Little Brown and Company, Boston, 1978).

[26] Average variable cost describes how marginal cost behaves on average, over a given range of input.

[27] Eisenberg 29

above AVC,[28] yet still be pricing predaciously. This is because AVC does not include fixed costs such as rent, interest payments and depreciation. Another "benchmark" has been quantified, that include these fixed costs.

A firm can price above AVC yet still not cover the ATC. It is considered that if a firm prices consistently below ATC without reasonable justification, then that firm too should be considered a predator.[29]

The test has undergone a lot of criticism since it was first put forward. The test is considered by some to be under-inclusive, though it is recognised that this is probably deliberate.[30] Some prices above this set threshold can still be predatory.

New Zealand commentators have realised that *...there may have been a cost advantage, say of economies of scale, associated with a firms powerful position in the market, so that it was able to undercut and eliminate/deter rivals without necessarily pricing below its own cost.*[31] This behavior is known as limit pricing.

Other commentators challenge the A&T test as an objective test.

The result of the quantification of the appropriate cost is too dependant on what variables are added to the equation:[32]

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[28] The AVC test has not proved easy to satisfy, the A&T had great influence on predatory pricing cases in America, yet a successful case against a defendant did not come until seven years later in *D&S Redi-Mix v Sierra Redi-Mix and Contracting Co* 692 F. 2d 1245 (9th Circuit, 1982).

[29] Above n 20, 30.

[30] See G A hay "Predatory Pricing" (1990) 58 Antitrust LawJournal 913, 914. See also Posner *Antitrust Law: An Economic Perspective* (University of Chicago Press, Chicago, 1976).

[31] Above n 20, 34.

[32] Above n 19, 79.

Different results can be achieved depending upon whether a static or long run model is examined, or whether costs such as depreciation are included. There are real difficulties in classifying a cost as fixed or variable. Should the test embrace only a single product in a multiple product firm? As more and more factors are introduced any test is rendered meaningless.

The time and resources of Courts are pored into determining the "appropriate level of cost", which is essentially a highly technical, economic debate. *The more important issue, to what extent can these quantitive economic models constitute "legal standards" is largely ignored.*[33]

3.2 *Subjective Intention - "Purpose" Test*

This approach is based on the assumption that it is not the cutting of prices that breaches the law, it is the motives behind it. Evidence of subjective intention can be useful in establishing liability. Any purpose element is problematic in a predatory pricing analysis as cutting prices is the essence of competitive behavior. Some thresholds need to be set to distinguish between competing aggressively, and pricing predaciously.

Competitive behavior is, by its very nature, an intent to exclude competitors. A desire to disadvantage and gain an edge over competitors is inherent in competitive conduct. The United States Courts have commented on the lack of probity "subjective intent" evidence holds:[34]

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[33] Above n 19, 79.

[34] *AA Poultry Farms Inc v Rose Acre Farms Inc* 57 ATRR 260 (7th Circuit 1989) 260, 263.

> *Intent does not help to separate competition from attempted monopolisation and invites juries to penalise hard competition. It also complicates litigation. Lawyers rummage through business records seeking to discover tit bits that sound impressive (or aggressive) when read to a jury. Traipsing through the warehouses of business in search of misleading evidence both increases the cost of litigation and reduces the accuracy of decisions.*

The Areeda and Turner cost based test was formulated as a response to the difficulties with a subjective purpose test. Analysis of intent is not necessarily conclusive evidence of predation, but is used in combination with other factors, ie a cost based analysis, that point to liability.[35] One approach is to use the cost based test to set up presumptions which can be rebutted by evidence of intention.[36]

3.3 The Recoupment Test

A definite trend has developed in American antitrust law from the cost based, or "purpose" focus to concentrate on the issue of "recoupment".[37] It appears *that recoupment will likely be the focus of American predatory pricing cases for the foreseeable future.*[38] Actions alleging predatory pricing in the American jurisdiction are taken under section 2 of the Sherman Act 1890[39], or section 2(a) of the Clayton Act[40] as amended by the Robinson-Patman Act.

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[35] Other factors included in an analysis of a predators purpose can be market structure factors such as barriers to entry and market share.

[36] See *William Inglis and Sons Baking Co v ITT Continental Baking Co 668 F 2d 1014 (9th Circuit 1981).*

[37] See *Matsushita Electric Industrial Co Ltd v Zenith Radio Corporation 475 U.S 572, Cargill Inc. v Monfort of Colarado Inc 479 US 104 and Brooke group Ltd v Brown & Williamson tobacco Corporation 113 s. Ct 2578.*

[38] G A Hay and K Mcmahon *Predatory Pricing in an Oligopoly Context* Discussion Paper, Consumer Law Conference, Sydney 1995.

[39] Section 2 of the *Sherman Act* is the United States monopolisation provision. It provides that :

The recoupment test embraces the Chicago School[41] theory that predatory pricing conduct is irrational behavior for a profit maximizing firm and therefore rarely, if ever, occurs.[42] In order for a predatory pricing strategy to be successful the losses incurred by a firm must be outweighed by future profits, plus interest. It is argued it is difficult, if not impossible for a firm to be able to ensure that such losses could be recouped as high prices encourage new entry into the market.

The use of a preliminary test of recoupment can avoid the cost of resources spent on the technical questions of cost based tests. The complicated cost based tests, and intention tests of low probity are side-lined until the issue if recoupment is satisfied. The predatory firm *must have a reasonable expectation of recovery, in the form of later monopoly profits, more*

> *[e]very person who shall monopolise, or attempt to monopolise, or combine or conspire with any other person or persons, to monopolise any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a felony....*

[40] Section 2(a) as amended by the Robinson-Patman Act

states:

> *It shall be unlawful for any person engaged in commerce...to discriminate in price between different purchasers of commodities of like grade and quality...where the effect of such discrimination may be to substantially lessen competition or tend to create a monopoly in any line of commerce...*

[41] This term describes the economic theories of antitrust law made prominent by academics of the University of Chicago ie George Stigler, Robert bork, Frank Easterbrook and Richard Posner. This school advocates that the goal of antitrust law is allocative efficiency, which is best achieved by a free market.

[42] See R H Bork *The Antitrust Paradox: A policy at War with Itself* (Basic Books, New York, 1978), and R Posner *Antitrust law: An Economic Perspective* (University of Chicago Press, Chicago, 1976).

than the losses suffered.[43] The plaintiff must demonstrate this likelihood (reasonable expectation) to succeed in attaching liability to the defendant.

The most recent leading case embracing the recoupment theory is the Supreme Court decision *Brooke group Ltd v Brown & Williamson Tobacco Corporation*[44]. The defendant in this case had only a 12 percent market share. The case involved firms in the highly concentrated cigarette manufacturing industry, in which only six firms operated. The party taking the action Ligget (formerly Brooke group Ltd) had only a 2 to 5 percent market share. Ligget developed a line of cigarettes which it priced at a level approximately 30 percent lower than other brands. Within four years their market share had increased to 4 percent. Later Brown & Williamson also entered the lower end of the market pricing their product at a level equal to the Ligget brand, and offered volume discounts to wholesalers.

> *Ligget filed suit claiming that Brown and Williamson had engaged in predatory pricing, selling its generics at a loss to pressure Ligget to raise its generic prices. The eventual goal, according to Ligget, was to halt the growth of the economy segment and thereby preserve the supranormal profits that were being earned industry-wide on branded cigarettes.*[45]

Brown & Williamson had only a 12 percent share in the market.[46]
Counsel for Ligget argued that if the alleged predation was successful, the result would not be a single firm monopoly, but a strengthened oligopoly. The Supreme Court had to

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[43] Matsushita Electric Industrial Co Ltd v Zenith Radio Corp 106 S Ct. 1348 (1986) at 1357.

[44] 113 S. Ct 2578 (1993). For an analysis of this case see G A Hay & K McMahon "Predatory Pricing in an Oligopoly Context" (1995) Discussion Paper, Trade Practices and Consumer Law Conference, Sydney.

[45] Above n 38, 1.

[46] The other leading firms were R J Reynolds with a 28 percent market share and Phillip Morris with a share of approximately 40 percent.

determine if in this case ,a firm with only a 12 percent share, could be liable for predatory pricing. The Areeda & Turner approach was not followed, instead the focus was, ability for Brown & Williamson to recoup any losses. The crux of the case was succinctly put by Hay:[47]

> *...below cost pricing was not sufficient for a predatory pricing scheme to be sustained. The plaintiff must show first, that, as a result of the predation, the victims will succumb (i.e. either leave the market or raise their prices to supracompetitive levels), and, second, that the predatory scheme would cause an increase in prices above a competitive level that would be sufficient to compensate for the amounts expended on predation.*

The Court found that Ligget had failed to establish any capacity on the part of the defendants to recoup loss. The plaintiffs had the hard task of first having to prove that oligopolistic[48] price coordination produced, or was likely to produce, supracompetitive prices if the strategy succeeded. Such long term coordination would be difficult to prove in any case.[49]

3.4 "The New Zealand Approach"

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[47] Above n 38, 4.

[48] This term refers to the particular market structure when market power is held by only a few firms , ie the six cigarette manufacturers.

[49] The Supreme Court did not reject the proposition that a firm with a small market share may be guilty of predation, but only it seems, when a coordinated oligopoly substitutes a monopolist (ie holder of dominant position etc) in recouping loss.

There are no leading cases on predatory pricing in New Zealand to date. Indication has been given in the past on how a predatory pricing complaint would be analysed. In 1991 the Commerce Commission published a paper by a member of the Commerce Act Enforcement Division on the subject of predatory pricing.[50] The aim of the paper was stated as being:[51]

> *...attempting to reduce the uncertainty surrounding predation...clarify what are not predatory prices just as much as it does clarify what are. It also aims to provide some certainty to businesses on how the competition authorities will analyse predatory pricing complaints.*

The only section of The Act that was considered applicable to predatory pricing was section 36.[52] Consequently only the application of that section to predatory pricing was

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[50] J Eisenberg "Predatory Pricing in the context of Australian and New Zealand Competition Law" *Competition Review: Current Issues in New Zealand Competition and Consumer Law,* vol 4, Commerce Commission, Wellington, 1991, pp 25-41.

[51] Above n 50, 26.

[52] Above n 50, 30. Section 36 states:

No person who has a dominant position in a market shall use that position for the purpose of -

(a) Restricting the entry of any person into that or any other market; or

(b) Preventing or deterring any person from engaging in competitive conduct in that or in any other market; or

(c) Eliminating any person from that or any other market.

discussed. The Commission outlined a two tiered approach to the problem. The first tier tests plausibility. *The primary consideration in this tier is whether the alleged predator has enough market power for the relevant competition law to apply*[53]. Only if the alleged predator meets the stringent market power test of dominance, will the investigation proceed.

The test for dominance acts as a filter in a similar way to the test for "recoupment" in the American approach. The "dominance" requirement is premised on the assumption that predatory pricing will only occur if the alleged predator, once successful can go on to recoup the sustained losses by charging monopoly profits once the competition has been eliminated. The following factors would be taken into account in such an approach. The list is long, but it is a useful indicator of the importance of this first tier:[54]

3.4.1 Tier One

. Short run market power- In contrast with a merger policy view of substantial market power, the restrictive trade practices view focuses on the shorter run. Does the firm have market power during the time of the alleged breach?

. The degree of market concentration

. The size distribution of the firms

. Conditions for effective entry- How difficult would it be for a new firm to enter the market as a viable competitor?

. Speed of entry - How quickly would a competitor be able to enter the market?

. Costs of entry - How much investment would be required to enter the market? How much of that investment would be unrecoverable upon exit from the market?

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[53] Above n 50, 13.

[54] Above n 50, 16.

. The firms ability to determine market prices without constraint from other participants in the market

. Excess capacity - How easy would it be for the incumbent to increase production quickly?

. Economies of scale and scope - How large and diversified must a firm be to achieve competitive production costs?

. Institutional barriers to entry - Is the industry regulated?

. Demand advantage of incumbent firm - Does the incumbent enjoy strong brand loyalty?

. Cost advantage of incumbent firm - Is the incumbent able to procure inputs at a cost lower than entrants?

. Strategic barriers to entry - Has the incumbent purposefully made entry more difficult (e.g. via large advertising and promotional expenditures, and product differentiation)?

. The nature of any formal stable, fundamental contracts, arrangements, or understandings among firms in the market

. The extent of corporate integration in the market Does the integration effectively increase market concentration and/or the ability of an incumbent firm to control prices?

. The extent of vertical integration Does the firm operate at several levels of the chain of production, and what advantages if any, are associated with the integration?

. The extent to which competition exists, has existed, and is likely to continue.

Market share is described as a vital factor for two main reasons. *To succeed a predator must be able to absorb the demand currently being absorbed by its rivals. It must also be able to supply the additional market demand stimulated by its price cuts.*[55] The extent of this demand is called the price elasticity demand. Price elasticity describes the percentage change in quantity demanded caused by a 1 percent change in price.

[55] Above n 50, 17.

High elastic demand, would mean that a one percent drop in price cause, say, a ten percent increase in quantity demand. However,
an inelastic demand would be much lesser. The focus is that the larger the market share a firm has the less the required expansion to satisfy the additional demand. However a firm with only a small, say 20 percent market share, may have to double its productivity to absorb the demand elasticity.

The other important factor is barriers to entry. The importance of this factor is premised on the assumption that, by definition, dominant firms operate in markets with high barriers to entry. Such barriers are essential if the firm is to have any hope of recouping its losses incurred. Supranormal profits encourage new entrants into a market. If the predator cant charge these supranormal profits without risk of someone seeing an opportunity, there would be little point in starting the exercise. In conclusion the factors of dominance go to establishing the ability to cope with increased demand, and ensure the predator is operating in a market with high barriers to entry, which are essentially examining questions of recoupment.

3.4.2 Tier Two

Once plausibility has been established the next question is purpose. The A&T test is a proposed aid to determining whether the dominant firm had the anticompetitive purpose required under section 36. Additionally subjective purpose evidence is also of evidential benefit. The criticisms of the cost based tests are acknowledged, and alternative approaches are proposed.[56] The fact that an alleged predator may have a reasonable

[56] Above n 50, 35. Such approaches take into account price histories, the magnitude and scope of the price cuts, future costs and competitive initiatives. The following conduct is also listed as of probative value:

justification for the pricing behavior in question is also allowed for. In conclusion the proposed approach by the Commerce Commission involves a process that is close to the "recoupment" approach. Plausibility is established, and from there further investigation is made to satisfy the "purpose" and "use" requirements of section 36.

4 *THE PORT NELSON SECTION 36 CASE*

Section 36 prohibits the misuse of market power:

> **36. Use of a dominant position in a market-**(1) No person who has a dominant position in a market shall use that position for the purpose of
>
> (a) Restricting the entry of any person into that or any other market; or

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. Building immense capacity in a ,market that is obviously not able to use that capacity fully at a profitable price.

. Meeting the price competition of smaller rivals in a bizarre and inconsistent manner, so as to be particularly injurious.

. Escalating advertising outlays sharply for a prolonged period of time, or any other means of raising entry barriers

. Buying up scarce resources substantially beyond one's long term needs to foreclose or raise the cost to rivals

. Any other action(s) taken to raise rivals costs.

(b) Preventing or deterring any person from engaging in competitive conduct in that or in any other market; or

(c) Eliminating any person from that or any other market.

4.1 *Market Definition*

Before a case can proceed under this section the relevant market(s) must be defined. The way a market is defined can impact greatly on the final outcome of a case. The wider a market is defined the less likely it is that a finding of lessening of competition will be made. McGechan J was faced with two definitions of the market proffered by the respective parties to this dispute. The Commission argued separate "pilotage" services market and "tug" services market. The former providing the provision of pilot transfer, pilot and crew, the latter providing a tug master and crew. The Commission ceded the two services were in part complimentary, as most pilot acts require tugs, and visa versa, yet argued that the two services were not substitutable.

This was backed up by evidence of practice.[57] In the majority of overseas cases pilot services and tug services were provided by different organisations. The Commission even went as far as to find different markets demarcation within the tug service market. It was argued that the degree of substitutability between the large and small tug service was sufficiently small to define the markets for those two services as being separate.

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[57] *In the majority of cases overseas, pilot services and tug services are provided by different organisations. Reference was made in particular to South Australia; to which could be added the examples of the "Blue Boats" at Auckland, and indeed USS Co Tugs at Wellington before 1968.* Above n 1, 165.

PNL was of course in opposition to the idea of separate pilotage and tug service markets. PNL argued an "integrated vessel movement service". It was claimed pilotage could not be taken in isolation, as most vessels required both pilot and tug. Moreover from the user perspective the demand was for vessel movement as a whole, and there was no concern for separate services. Counsel for PNL stated:[58]

> *In essence the relevant market is the physical control of the ship movements in the compulsory pilotage area at Port Nelson. This definition seems to conform, inter alia, with the "commercial common sense" criterion of the Commerce Act.*

McGechan J rejected PNL's arguments. The decision was premised in arguments of substitutability. His Honour held that[59]

> *To a considerable extent the services are complementary. The one most often involves the other. However, they are not inter-dependant. Nor are they substitutable. Pilot is guidance. Tugs are motive power. the one cannot be substituted for each other , as if such were alternatives. We are not persuaded commercial perceptions, to the extent such assist, are otherwise. The vessel needs a pilot to guide it in or out. The vessel also needs whatever tugs safety requires to assist manoeuvering during that process....We consider the postulated merger into one wider "vessel movement services" market, in which each loses its own distinctive identity, goes further than substitutability and commercial common sense permit.*

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[58] Above n 1, 167.

[59] Above n 1, 168.

Both markets were restricted geographically to Nelson. McGechan J also held that the pilotage market was a Port Nelson geographical market. Due to the particular features of Port Nelson and the associated difficulties of navigation the pilots are considered to require unique skills. Consequently, pilots could not be "flown in" from other areas to perform the service.[60]

McGechan J also held that evidence pointed to tugs based in Nelson being only successfully operational in that harbour. The conclusion was that:[61]

> *Tugs are fuel hungry vessels, expensive if put out to roam. there is a distinct Port Nelson towage services market*[62].

With the markets defined so narrowly, the Commission was provided with a much easier task in proving dominance in all, or any one of them. McGechan J found PNL to be dominant in all pleaded markets.

4.2 *The Decision*

PNL was a natural monopoly, that as the Commission argued, were using their dominance to eliminate the potential competition created by the newly formed TBMPL in relevant markets. However since the decision of the Privy Council in *Telecom v Clear*[63] section 36 was potentially narrowed significantly in its application. This decision merged

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[60] Above n 1, 170.

[61] Above n 60.

[62] Above n 1, 170.

[63] Above n 3.

the test for "use" and "purpose" to the extent that purpose element of section 36 was ignored in order to concentrate on the "use" factor.

The imposition of the minimum charge, and the 5 percent discount were both tested under section 36. Both actions failed. The only successful action under this section was the tug tie. The Commissions lack of success under section 36 caught the attention of the Government and the media[64].

> *Some lawyers with expertise in the Commerce Act believe the Privy Council decision has made it impossible for firms entering the market to use the Act against anti-competitive behavior. Aware of that view, Mr Burdon said he had been advised by his officials the courts would continue to apply section 36 in a manner consistent with the objectives of the Commerce Act. "The decision of the High Court in the Commerce Commission versus Port Nelson case, indicates the courts would be able to use section 36 effectively against anti-competitive behavior by dominant firms." Some concerns remain however, and further decisions would help establish if the test for "use" has been significantly narrowed, he added.*

It is somewhat optimistic to consider the *Port Nelson* decision as an example of the continued success of prosecutions under section 36.

The major stumbling block for the Commission was the "use" requirement of section 36. The role of the "use" inquiry is to provide the causal link between the firms market dominance, and its conduct. The tests applied by the Privy Council in *Telecom v Clear* was as follows:[65]

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[64] The Evening Post *Govt Acknowledges Concerns,* Monday August 28, 9.

[65] Above n 3, 22.

In their Lordships view it cannot be said that a person in a dominant market position "uses" that position for the purposes of section 36 [if] he acts in a way which a person not in a dominant position but otherwise in the same circumstances would have acted.

In terms of the discount McGechan J assessed whether a hypothetical firm, without benefit of dominance do the same? His Honour recognised that the subsequent benefits of the full optimization of the labour force, and economies of scale and scope would be attractive to a non dominant firm as well. His answer to the question posed was "probably, yes"[66] and the allegations failed.

The same approach was taken to the question of the minimum charge. The question was asked if a firm not dominant in tugs, wharves or pilotage but otherwise in the same circumstances as PNL which faced competitors (say a neighboring port), would this firm impose a minimum charge at this level? McGechan J reasoned that minimum charges are a standard business practice, and there were no fixed principles to determine the price of an appropriate minimum charge. Consequently the answer to the question posed was again "probably yes" and the action failed also.

5 *THE SECTION 27 CASE*

5.1 *Section 27 of the Commerce Act 1986*

Section 27 when read appears to be a straight forward prohibition of behavior that has anti competitive effects. It prohibits contracts, arrangements or understandings that

[66] Above n 1, 227.

substantially lessen competition. Section 27 is often pleaded in conjunction with section 36, yet covers quite different behavior. It reads:

> **Section 27 Contracts, Arrangements or understandings substantially lessening competition prohibited** -(1) No person shall enter into a contract or arrangement or understanding, containing a provision, that has the purpose or has or is likely to have the effect, of substantially lessening competition in a market.
>
> (2) No person shall give effect to a provision in a contract that has the purpose, or has or is likely to have the effect, of substantially lessening competition in a market.
>
> (3) Subsection (2) of this section applies in respect of a contract or arrangement entered into, or an understanding arrived at, whether before or after the commencement of this Act.
>
> (4) No provision of a contract, whether made before or after the commencement of this Act, that has the purpose, or has or is likely to have the effect, of substantially lessening competition in a market is enforceable.

In order for this section to be capable of prohibiting unilateral anticompetitive behavior on the part of one company there were a number of legal steps for McGechan J to work through.

5.2 *The Required Purpose*

There are two interpretations of the purpose requirement of this section. Its scope of this section is affected depending upon which interpretation is adopted. The difficulty lies in the drafting of the section. Section 27(1) bears close resemblance to section 45(2) of the Australian Trade Practices Act 1974, its curious has been remarked upon in that jurisdiction in *ASX Operations Pty Ltd v Pont data Australia Pty Ltd* [67]

> *...counsel for Pont drew attention to the undoubted curiosity of legislation which speaks of the purpose of a provision, not of the purposes of those who devised and propounded the provision.*

The essential question is what is the purpose requirement of section 27? Justice McGechan rightly describes this as an "acute question"[68], and one that had not yet been fully analyzed by the Courts of New Zealand.

5.2.1 Common Purpose

A requirement of common purpose is the narrower of the two possible interpretations of this section. It requires that all parties entering the contract etc have an anticompetitive purpose. Both parties entering the contract would have the intention of including the provision that had the purpose, effect or likely effect, of lessening competition.

Authority for this approach is the High Court decision *Magic Millions v Wrightson Bloodstock Limited*[69] In this case New Zealand Magic Millions (MM) was trying to set up in competition with Wrightson Bloodstock (WBS) in the horse auction market. WBS had a virtual monopoly and attracted those who wanted to buy and sell from around the country. WBS consistently set the dates of their auctions to clash with those of MM so that

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[67] [1990] 97 ALR 513, 526.

[68] Above n 1, 16.

[69] [1989] 1 NZLR 731.

few would attend the latter's auctions. MM brought proceedings, the High Court agreed to grant injunctive relief specifying dates upon which WBS could not hold auctions. WBS argued that this relief was in breach of section 27. It was contended that the Court could not grant an injunction in the terms sought, as it would give MM a monopoly over particular dates for perpetuity. Such would be an which has the effect of substantially lessening competition, and this should be taken into account when the Court exercised its discretion.

Tipping J ruled that:[70]

> *I cannot accept this submission....Section 27 is aimed at contracts or understandings between parties having the collusive effect of reducing competition. To bring section 27 into play there must, I would have thought, be some meeting of the minds between the parties to the alleged contract arrangement or understanding.*

The precedent value of this comment is not strong as Tipping J's comment was essentially obiter, and it could be said it was a reaction to the argument that even if there may be a clear breach of section 36, relief could not be granted because of section 27.

PNL were no strangers to Commerce Act litigation. In the 1992 case of *Stevedoring Services (Nelson) Limited v Port Nelson Limited*[71] Stevedoring Services Nelson Limited (SSNL) were alleging anticompetitive behavior on the part of PNL. In this case PNL were offering a 5 percent discount to customers if they employed PNL's full line of services, including PNL stevedoring labour. The argument was made that the resulting contract between PNL and their customers containing a provision with a purpose of substantially lessening competition.

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[70] Above n 23, 765.

[71] (1992) NZAR 5.

McGechan J, the Judge in this case also, was uncomfortable with such a contract being proscribed by section 27. He stated that:[72]

> *I have considerable doubts whether provisions in those contracts for such discounts can be said to have such purpose A contract is a two way affair. Sometimes the purpose of a provision is clear. A contract between two wholesalers not to supply a particular retailer unless he meets certain terms carries its own united message. However, provision for a discount between supplier and customer may arise from quite different and divergent purposes. The supplier offering the discount may seek to capture the market. The purchaser taking the discount may be seeking simply to save money. that purchaser may not seek to lessen competition at all. To the contrary, he may be all in favour of its continuance , with further healthy discounts. It can be hardly be said that is such situations that the dominant purpose was to substantially lessen competition.*

Technically this is also obiter as McGechan J found a lack of anticompetitive purpose at all, so there was no definitive ruling on whether unilateral or common intention was appropriate for section 27.

5.2.2 *Unilateral Purpose*

McGechan J felt constrained by authority to accept the unilateral approach. Hence PNL's alleged anticompetitive purpose alone would suffice. *In Tui Foods Ltd v NZ Milk Corporation*[73] *(Tui Foods)* the Court of Appeal was considering an action under section 29 of the Act. This section relates to arrangements, contracts or understandings that contain

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[72] Above n 24, 20.

[73] (1993) 5 TCLR 406.

exclusionary provisions, the Court of Appeal held that a unilateral purpose satisfied that section. McGechan J held that the distinction between the sections was of degree, not kind, and therefore this analysis was applicable to section 27.

The Court of Appeal in *Tui Foods* found support for their finding in the deeming provision of section 2(5)(a) of The Act. It reads:

> (5) For the purposes of this Act-
>
> (a) A provision of a contract, arrangement or understanding shall be deemed to have had, or have, a particular purpose if-
>
> (i) The provision was or is included in the contract, arrangement or understanding, or the covenant was or is required to be given, for that purpose or purposes that included or include that purpose; and
>
> (11) That purpose was or is a substantial purpose:

This section lead the Court to conclude that:[74]

> *It is sufficient in the light of section 2(5)(a) that one of the purposes of the inclusion of the provision should be an exclusionary one, provided that it is a substantial purpose. It seems inevitably to follow that the party responsible for the presence of the provision in the contract, has had such a purpose, then the purpose of the other party is not material; for the purpose of the first-mentioned party is likely to be a substantial purpose and thus to satisfy the definition.*

However such this interpretation of section 2(5)(a)is not the only one. The references to more than one purpose could be an acknowledgement that one party alone may have

[74] Above n 73, 410.

many purposes for entering into any one contract. As long as a substantial purpose of those is anticompetitive, the section is still met.

McGechan J observed that the *Tui Foods* view was not the only workable interpretation of section 2(5)(a), but ceded to the view of the higher court unless a distinction could be drawn between *Tui Foods* due to the fact that section 29 was the section analysed and not section 27.[75] Such a distinction was not upheld:[76]

> *If, as the Court of Appeal has ruled, unilateral purpose will suffice for section 29, it would be anomalous to apply a different test to section 27. If any different course is to be taken it is a matter for that Court. In that regard, I record (as requested by Counsel for PNL) reservation of right to submit Tui Foods should be reconsidered on the point.*

The Commerce Commission argued that TBMPL was being induced by PNL to enter into an anticompetitive contract[77] Consequently, the Court can, and did, focus upon the actions of TBMPL alone, and side-lined the participation of the shipping customers. However, this does not absolve the latter from potential liability. PNL's conduct as the "inducer" becomes the primary issue, however as soon as the shipping customers contracted with PNL on the anticompetitive terms, they breached the Act. The shipping customers have to be considered to breach The Act otherwise PNL cannot be liable of any inducement to do so.

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[75] Section 29 deems contracts, arrangements and understanding that contain exclusionary provisions to have the purpose of substantially lessen competition. McGechan J recognised that with exclusionary contracts, one party (supplier) will wish to restrict the other (acquirer) while the latter will wish to remain free. As a result unilateral anticompetitive purpose would be the norm, whereas the same cannot be said for section 27 as it has a potentially much wider focus. However McGechan J did not see this as a "sensible" distinction between the two sections. Above n 1, 21.

[76] Above n 1, 21.

[77] Section 80(d) and 82(c) make it an offence for any person who has "induced, or attempted to induce, any other person, whether by threats or promises or otherwise, the contravention..." of a provision of Part II of The Act.

Albeit reluctantly[78], His Honour opened the road for PNL's actions to be considered under section 27.

5.2.3 *Liability of the Parties*

If unilateral anticompetitive purpose is sufficient to meet the section then the Act has been breached. Section 27 prohibits <u>any person</u> from entering into such a contract etc. Consequently it is more than the party with the anticompetitive purpose that is liable for penalties under section 80 of the Act.[79] It also leaves any party open for an action for any loss or damage caused by that person engaging in any conduct that constitutes a breach of part II of the Act. [80]

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[78] McGechan J's decision was in line with a recent Australian Full Court decision, *ASX Operations Pty v Pont Data Australia Pty Ltd* (1990) 97 ALR 513 (Full Court, FCA). In this case the Full Court decided that the relevant purpose for analysis of anticompetitive provisions in contracts was *the purpose of the party as a result of whose efforts they were included.*

[79] **80.Pecuniary penalties-** (1) If the Court is satisfies on the application of the Commission hat a person-

(a) Has contravened any of the provisions of Part II of this Act;or

(b) Has attempted to contravene such a provision

(c)-Has aided or abetted, counselled or procured any other person to contravene such a provision; or

(d)-Has induced, or attempted to induce, any other person, whether by threats or promises or otherwise, to contravene such a provision;or

(e)-

(f)

the Court may order the person to pay the Crown such pecuniary penalty as the Court determines to be appropriate, not exceeding [$500,000] in the case of a person not being a body corporate, or [$5,000 000] in the case of a body corporate, in respect of such act or omission.

[80] Section 82 Commerce Act 1986.

The result is that in theory, parties with no anticompetitive purpose (ie PNL's shipping customers) are breaching the Commerce Act and are vulnerable to action from the Commerce Commission, and from firms that may suffer harm, for simply taking advantage of a good deal. Such customers may not know that struggling firms like TBMPL even exist, let alone suffer any harm from their actions. It would be impractical, even possible for such customers to determine if in contracting with firms they were breaching the Act.

Theory aside, it would be unlikely that the Commerce Commission would ever take an action against such innocent parties.[81] However it could never be guaranteed that victims of predatory behavior, taking any private actions, would be as restrained. In the *Port Nelson* scenario the shippers dealing with PNL would be in breach of the Act, by simply entering into a contract that contained a schedule of prices offering a minimum price. The shippers might be liable to TBMPL for any proven subsequent loss the latter suffered.

Importantly, the Courts when exercising their discretion to order penalties are provided by guidelines under the Act.[82] However actions taken under section 82 of the Act are not

[81] In the *Port Nelson* the shipping customers of PNL were not named as co-defendants in the action. Any liability they may have had under section 27 was not an issue, or even mentioned, in the case.

[82] **Section 80** (2)

(2) In determining an appropriate penalty under this section, the court shall have regard to all relevant matters, including-

(a) The nature and extent of the act or omission:

(b) The nature and extent of any loss or damage suffered by any person as a result of the act or omission:

(c) The circumstances in which the act or omission took place:

tempered by such considerations. A person engaging in conduct that breaches Part II of the Act is simply liable for <u>any loss or damages</u> with no limitations in place.

This issue is not discussed by McGechan J but if all parties are liable for entering into a contract that breaches the Act, then surely all parties to the contract should have an anticompetitive purpose. There is nothing to gain in the interests of competition law by potentially placing innocent parties in such positions of vulnerability to private actions.

6 *THE PORT NELSON PREDATORY PRICING ANALYSIS*

Once Justice McGechan was analysing predatory pricing under section 27 he was left with the difficult ask of trying to set thresholds for liability in section 27 to fit a predatory pricing scenario. To make it plausible section 27 must only prohibit pricing that is predatory and not pricing that is competitive.

6.1 *What makes Pricing Predatory*

In the above analysis of predatory pricing it is evident that there are a number of factors that go towards making pricing predatory. It is their combination that makes the conduct culpable. Without any of the above elements, it is submitted, predatory pricing loses

(d) Whether or not the person has previously been found by the Court in proceedings under this Part of the Act to have engaged in similar conduct.

plausibility. When culpability is sought under section 27 there are few avenues to go down to find predation. Under section 36 there must be dominance, one of the purposes prescribed in 36 (a), (b) or (c), and the causative link between the capacity and the purpose, being the "use"of the dominance. Under section 27 the thresholds are the existence of a contract, arrangement or understanding, containing a provision with an anticompetitive purpose or effect, of substantially lessening competition.

Is this enough to make pricing predatory? As Justice McGechan himself recognises, every time someone cuts prices they have an anticompetitive purpose. Surely an essential facet of predation is the size of the predator. It is the combination of market share, purpose and cutting prices that makes conduct predatory.

6.2 The Decision

Any case alleging predatory pricing usually involves a complicated cost based analysis to establish predation. This case was no exception. McGechan J was faced with a number of different methods of analyzing whether the 100 dollar minimum was below cost. His honour took the option of not deciding which analysis was the decisive one[83]

> *In the outcome it is not necessary to choose between average fully allocated cost, or opportunity/avoidable/incremental cost approaches as somehow the more appropriate comparator for PNL's 100 dollar minimum. All cost approaches lead to "cost" per sub 2500 GRT movement "substantially above" the 100 dollar minimum. The plea to that extent is made out. 194*

[83] Above n 1, 194.

McGechan J then moved to consider whether there was the necessary purpose (or effect or likely effect) of substantially lessening competition. McGechan J opens his analysis with a very telling paragraph. In it His Honour was seeking to form a methodology in which competitive pricing would be distinguishable from predatory pricing under section 27:[84]

> *With apologies for fatuity, it is not a breach of section 27 simply to price competitively. A firm which through efficiency, or a willingness to contain profit margins, undercuts rivals or potential entrants may have the elimination of competition as one of its purposes. (Despite ritualistic public pronouncements welcoming competition, most firms would much prefer a clear field). Such efficiencies and profit containment are nevertheless are regarded as in the public interest. Such scenarios are competition in action; to be promoted by the Act, not prevented by it. If a less efficient or rapacious firm be killed off then so be it.*

In this paragraph McGechan J states the obvious, that, every time a person cuts their prices they will have an anticompetitive purpose. Such is the essence of competition. Should less competitive firms be bumped out then that is the natural selection process of the market in action. Yet this is exactly what the behavior of PNL was described as. They cut prices, had an anticompetitive purpose, which was the attempted elimination of a less competitive firm. The conduct of PNL was in breach of the Commerce Act, but section 27 does not require the elements that make predatory pricing a breach of the act.

As section 27 does not include any of these elements McGechan J was forced to find some other factor, some other magic element that could be pointed to, within the context of section 27, to identify the predatory nature of the pricing.

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[84] Above n 1, 194.

His honour found such a magic element:[85]

> *For a breach of section 27 to occur pricing* (of the kind described in the above paragraph) *must go rather further. Pricing must be below cost.*

In searching for an element of predation McGechan J fixes the attention upon how low the pricing is. With respect, it is difficult to appreciate how His Honour could have come to this conclusion. It has long been appreciated that pricing need not be below cost to be predatory.[86]

McGechan J then considers that there is no need to enter into the normal analysis as to whether or not there is any predatory pricing:[87]

> *It will be noticed that this discussion has not referred to "predatory pricing". That is deliberate. Neither does the legislation. The statutory provision is whether the provision concerned has the purpose (or effect or likely effect) of substantially lessening competition. If it does, the section is met. If it does not, then whether or not the activity amounts to predatory pricing - a term of uncertain scope- the section is not met. The section will be met if the activity has the features of pricing below cost, with associated substantial purpose of eliminating or deterring present competition, and the creation of a deterrent aggressive reputation.*

McGechan J is not prepared to be constrained by the normal approach to a predatory pricing question. It is submitted that this is because he cannot. Section 27 does not provide for it. McGechan may have refused to label the behavior as predatory pricing, but

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[85] Above n 1, 194.

[86] See discussion above, 22.

[87] Above n 1,195.

that does not prevent it from being so. Nor does it mean that its associated problems can be dismissed. McGechan J's analysis holds that the only distinction between permissive pricing behavior and predatory pricing behavior is the level, ie below cost.

His Honour also rejects any merit in the recoupment approach: [88]

> *While there is support for a reasonable prospect (or a dangerous probability) of recouping outlay as a "prerequisite to predatory pricing...and indeed the Commission paper describes such recoupment as the "key factor" in establishing plausibility of predatory pricing, such views should be read with one eye on the Full Court in Eastern Express.*

The court on the *Eastern Express*[89] decision has warned against translating United States Judgments, which place glosses upon the text of the United States anti trust laws, to the interpretation of Australian Law. Instead the Court should infer purpose from 'logic' and "general human experience".[90]

The fact that PNL engaged in a pricing system that charged on a GRT scale which undercharged at one end and overcharged at the other was not considered problematic behavior. For *Such minimum charges,below actual cost movement, are standard. TBMPL, indeed, intended a similar approach. The real complaint here is that PNL went about it in such a way as to eliminate TBMPL and deter followers.*[91]

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[88] Above n 1, 196.

[89] *Eastern Express Pty Limited v General Newspapers Pty Limited* (1991) 103 ALR 41.

[90] Above n 89, 78.

[91] Above n 1, 197.

The benefits of using such a minimum charge were canvassed by his Honour. Quantification of a minimum charge is very much a matter of "commercial intuition" taking into consideration what the market would stand and what would pass as commercially reasonable. McGechan J concludes that the 100 dollar minimum figure makes objective commercial sense. Yet it is admittedly substantially below actual market cost. Additionally McGechan J was aided by a plethora of evidence relating to the subjective purpose of PNL. His Honour held that PNL needed to establish a pilotage rate which would cause difficulty to TBMPL's new and much leaner operation. PNL was determined to prevail.

There was an evidential problem as to whether Green, when formulating the minimum charge, was aware of TBMPL's minimum charge. The charge set by TBMPL was 130 dollars. TBMPL had set their prices in January 1991, it had been public information for over a year. Yet Green claimed no knowledge of such charges until well into 1992. This is an important factor as it provides the link between the two parties. In order to price in a predatory manner the predatory company must know of the prices charged by their competitor in order to undercut them. It might be harder to prove purpose if these actions were taken oblivious to the competitors exact prices. McGechan J was unhappy with accepting that it was mere coincidence that the prices set considerably undercut those of TBMPL:[92]

> *There are of course limits to which a Court must accept statements which are incredible, simply because not challenged. One is not obliged to accept the earth is flat. However in the present situation, it would not be appropriate to reject the PNL witness' unchallenged evidence which, while suprising, conceivably could be true. Despite real suspicion, it is not*

[92] Above n 1,199.

shown PNL was aware of TBMPL's minimum charge at the point where it proceeded to set its own.

It is submitted that this is not, in these particular circumstances, a crucial point.

There is no evidence what so ever as to the source or rationale of that 100 dollar figure. He (Mr Green) blandly stated in evidence that "I do not feel PNL could have a minimum charge of less than 100 dollars". Evidently it was seen as absolutely the minimum.[93]

There is arguably little difference between setting prices below a known particular price, and, setting prices at the absolute minimum, in order to undercut a competitor. Both are means to the same end. The object was to price in a manner with which TBMPL could not compete.

In summing up McGechan J tied all the aspects of PNL's anticompetitive behavior together. In its context the predatory pricing allegations fitted into the general tactics of PNL. The 100 dollar minimum would have been extremely important to TBMPL's operation. With the refusal to supply tugs confined TBMPL to the smaller end of the market, operating without tugs due to the tug tie, or with only one small tug. This was accentuated by the 5 percent discount pushing TBMPL into the smaller vessel area. Put together the intentions of PNL were to eliminate TBMPL. He concludes[94]

The balance is a moderately fine one, given the objective indicia arising from the number chosen, and the absence of proof that TBMPL's actual competitive minimum was known and undercut in a calculated manner. The standard of proof of a serious allegation is to be

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[93] Above n 92.

[94] Above n 1, 201.

kept in mind. However in the end I am satisfied by the accumulation of other circumstances...that a real and substantial purpose of the 100 dollar minimum charge was to substantially lessen competition in the pilotage services market. That real and substantial purpose was to eliminate TBMPL, and deter any like minded firms. [95]

7 PORT NELSON AS A PRECEDENT

McGechan J's decision in *Port Nelson* could have wide reaching ramifications in the area of antitrust law in New Zealand. This case sets the precedent that unilateral, anticompetitive conduct can be analysed under section 27.

By doing so, it is submitted, McGechan J has altered the drafted focus of the section. What is section 27 intended to prohibit? The opening sentence to the section contains the answer. Section 27 prohibits anticompetitive contracts, arrangements and understandings, it is these contracts etc and their effect that should be the focus of any analysis. However in this case, McGechan J identified a contract as a symptom of, or vehicle for, predation. This "symptom" became a secondary concern in the decision. McGechan J's analysis worked backwards until the focus of the case became the motives and actions of the PNL. The arguments made under section 27 weren't about the contract and its anticompetitive effect, they were about whether PNL wanted to eliminate TBMPL from the market.

Additionally, section 27 is concerned with contracts etc that substantially lessen <u>competition</u>. McGechan J's analysis was essentially focussed on what effect PNL's tactics were having on another <u>competitor</u> ie TBMPL. The object of predatory pricing is to eliminate a competitor from the market. Nothing is achieved by a predator if they cut

[95] McGechan went on to hold that the minimum charge had, unsurprisingly, the likely effect of substantially lessening competition under section 27 of the Act.

prices and incur loss for a period, but still have a competitor at the end to prevent them from charging supranormal profits. McGechan J interpreted having the purpose of "substantially lessening competition in a market" as equivalent to the purpose of eliminating TBMPL. His Honour held:[96]

> *...a real and substantial purpose of the $100 minimum charge was substantially lessen competition in the pilotage services market That real and substantial purpose was to eliminate TBMPL, and to deter any like minded firms.*

Elimination or deterrence from a market, is behavior proscribed by section 36 of The Act. McGechan J was testing section 36 conduct under section 27. Instead at looking at what effect the contract etc would be having on competition in the market, the analysis concentrated on what effect PNL was having on TBMPL.

Section 27 has low evidential thresholds for the Commerce Commission to prove before liability is established. Unlike section 36, the defendant does not have to have a dominant position in the market before The Act is breached. The result is non-dominant firms could be found liable for predatory pricing.

Is this a desirable result? Non dominant firms may engage in predatory pricing strategies in order to attain a dominant position. Predation by such a firm is feasible as long as that firm has sufficient financial resources to sustain the losses incurred, and the capacity to provide the increased demand in their product. The firm could force its competition out of the market, but under section 36, does not breach The Act until its objective has been achieved, ie it has gained market dominance. It could be said that by the time the law steps in, the harm has been done.

[96] Above n 1, 201.

In a recent paper[97] presented to the 6th Annual Trade Practices and Consumer Law Conference, George Hay examined the applicability of the Australian Trade Practices Act (ATPR), section 46,[98] to the oligopolistic fact situation of the *Brooke Group* case.[99] Hay highlighted that such predatory pricing behavior by a firm with a small market share, may not be proscribed by the ATPR:[100]

> *The argument, for example, that "shared market power" in the sense of power gained through "interdependence" with other firms in an oligopoly, can amount to substantial market power under section 46 or further could provide the means, as in Brooke, for the recoupment of profits lost through predatory pricing has not been fully explored.*

Under section 27 the question of whether alleged predatory pricing by a firm with a small market share, but in an oligopolistic context, could lessen competition, might be open for

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[97] Above n 38.

[98] Section 46 of the ATPR is the equivalent to section 36 of the New Zealand Commerce Act 1986. The Australian provision reads:

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.*

[99] Discussed above p 19.

[100] Above n 38, 18.

examination. Prior to this case such an analysis may have been prevented by the "dominance" threshold in section 36 of The Act.

However the benefits of "market dominance" as a filter to analysing anticompetitive behavior, are weighty. It would be perhaps, a difficult task for the Courts to distinguish between aggressive competition by non-dominant firms, and anticompetitive behavior that should be prohibited by the law. The *Port Nelson* decision is indicative of the problems of making such a distinction within the framework of section 27. The circumstances in which non-dominant firms would threaten competition would be very rare indeed, and the threat of liability could discourage such aggressive competition. It may be in the interests of public policy to "under-regulate" such predatory behavior, rather than constrain competitive conduct in the market.

8 CONCLUSION

McGechan J held that section 27 prohibited unilateral anticompetitive behavior that amounted to predatory pricing.

In deciding what constituted a pricing scheme that breached the Act McGechan J found that when pricing was below cost it met this standard. Having deviated from the traditional approach to a predatory pricing analysis it was necessary to find some benchmark that distinguished predatory pricing from acceptable price cutting, and that was the result. This finding denies the possibility that above cost pricing may still be predatory.

As a precedent, this decision offers no guidance to the business sector as to how to avoid liability under The Act. McGechan's approach was in no way similar to the suggested one outlined by the Commission in their 1991 paper. Aggressive competition such as offering discounts and minimum prices to customers is suddenly questionable under section 27 as illegal behavior. A firm no longer has to be dominant before its conduct is questioned. McGechan J effectively rejected the validity of the American "recoupment" approach, and the necessity for the filtering effect of the "dominance" requirement in section 36 of the Act.

Additionally, customers who take up these deals are also breaching The Act. Customers who lack any anticompetitive intent should not be described as acting illegally. This unsettling idea is not ameliorated by concentrating only on their "inducer" when litigating, as the contracts are still illegal.

McGechan J, justifiably unimpressed with PNL's motives and actions, and constricted by the Privy Council narrow approach to section 36, has given section 27 unprecedented bite. Perhaps too much bite. Section 27 should not be applied in a manner to make up for the current narrow application of section 36.

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