TECHNOLOGICAL TYING IN THE COMPUTER INDUSTRY: WHEN DOES IT CONTRAVENE S 46 OF THE TRADE PRACTICES ACT?

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I INTRODUCTION

While Australia is still heavily reliant on 'old economy' industries, such as primary production and manufacturing, there is now general recognition of the importance of high-value 'new economy' industries. The term 'new economy' refers to industries such as computer software and hardware, the internet, mobile telephony, biotechnology and others that are primarily based on intellectual property rights (IP rights) and that are undergoing rapid technological change.

The appropriate relationship between competition law and IP rights has been the subject of review both in Australia and in the United States of America. In Australia, the application of the *Trade Practices Act 1974* (Cth) (TPA) to IP rights has been the subject of an independent inquiry and the Government has announced that it proposes to amend the TPA to take account of the recommendations of the Review Committee.[1] In Washington D.C., the Federal Trade Commission and the Department of Justice have, since February 2002 been conducting lengthy public hearings on Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy.

In the past, the reward/incentive function for IP rights has been subordinated to the policy objective of competition law; however, the stringent application of competition law may result in a loss of consumer welfare.

Developments in the 'new economy' industries are throwing up new problems for competition lawyers. The purpose of this paper is to consider one such problem, namely, the tying or bundling of two or more products into one integrated product. Increasingly, firms within the computer industry are bundling one or more separate products through technological integration. Bundling is also occurring across different sectors in 'new economy' industries.[2]

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1 Intellectual Property & Competition Review Committee, *Review of intellectual property legislation under the Competition Principles Agreement, Final Report* (September 2000).

2 For example, on 18 October 2002, Telstra and Microsoft announced the release of a sophisticated pocket computer and phone combination device, the first of a planned series of 'bundled' products. See, *The Australian*, 18 October 2002, 25.

The courts in Australia have very little experience of the complex issues that arise when allegations are made about anti-competitive bundling or tying in relation to the supply of computer products. The paper falls broadly into two parts. The first part considers some special characteristics of computer based markets, and the elements that need to be established in order to make out a contravention of s 46 of the TPA.

The second part of the paper considers two different types of technological tying: first, the tying of two separate products through the creation of one integrated product; and secondly, tying the sale of a product with its repair or servicing in such a way that independent service organizations (ISOs) are foreclosed from the market. Both types of technological tying are open to a claim that they are anti-competitive and constitute a form of leveraging contrary to s 46 of the TPA.

II SPECIAL CHARACTERISTICS OF COMPUTER BASED MARKETS

There are a number of structural features that distinguish computer based markets. First, many computer based markets exhibit supply side *economies of scale*. They tend to have high fixed costs and low marginal production costs. Firms often have to invest a great deal to develop these types of products through research and development, but once the initial investment has been made, it does not cost much to produce an additional copy. Many 'information goods' (particularly software) have a marginal cost that is close to zero.

Secondly, some computer based markets exhibit *network effects*, that is, the value of the product increases if more people use it. For example, Microsoft's Operating System has become the de facto industry standard. It then becomes attractive as a platform for the developers of applications software. In the *Microsoft* case[3] the network effect was referred to as the 'applications barrier to entry' which protected Microsoft's dominance in Intel-compatible PC operating systems.[4] The problem has been described by one commentator in the following terms:

> The market for computer operating systems- through its interaction with the software applications industry- exhibits strong network effects. Providers of software applications generally write first for the operating system with the largest installed base, providing it with more software applications than are available for other operating systems with smaller installed bases. Consumers generally want to acquire the operating system for which the largest number of applications are written. New consumers accordingly choose the operating system with the largest installed base, thus enlarging that base and increasing the incentive of software applications providers to write first for that operating system. This mutually reinforcing positive feedback loop fosters the further growth of the largest operating system.[5]

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3 *United States v Microsoft Corp.*[2001-1] Trade Cases (CCH) 73,321. On this topic see, generally, Royall, 'Coping with the Antitrust Risks of Technological Integration' (2001) 68 *Antitrust Law Journal* 1023.

4 See Werden, 'Network Effects and Conditions of Entry: Lessons from The *Microsoft* Case' (2001) 69 *Antitrust Law Journal* 87.

5 Gifford, 'What is Monopolization anyway? The D.C.Circuit grapples with some perplexing issues' (2001) *Antitrust Bulletin* 797,803.

Network effects have important implications for market structure in that they tend to result in monopoly structures. The dilemma for competition policy is that any attempt to break them up is likely to lead to a loss of consumer welfare, since their attractiveness to consumers depends on their large installed base and the large number of applications written for them. Thus, while network effects are often characterized in a negative way, it should not be forgotten that they are also a major source of consumer welfare.

Thirdly, it is said that competition in some computer based markets takes the form of competition *for* the market, rather than competition *in* the market. The distinction between the two types of competition, namely competition for the new commodity and price competition among firms selling similar products, was made by Schumpeter in 1943. According to Schumpeter, the former kind of competition is much more important than the latter.[6] Schumpeter described competition in terms of a dynamic process of rivalry in which entrepreneurs and innovators constantly seek to discover new profit opportunities through innovation, research and development. This dynamic competition for profits produces 'the new commodity, the new technology, the new source of supply, the new type of organization'.[7] This 'perennial gale of creative destruction'[8] in which new markets are created and old ones are destroyed is the type of competition that counts.[9]

Competition in computer based markets takes place on a 'winner takes all' basis. Rival firms invest heavily and innovate to be the first to create a new category of product. If they succeed they win all or most of the market. Other firms then try to develop a new technology that will make the incumbent's product obsolete. For example, in the software applications market Microsoft Word has replaced WordPerfect in relation to word processing; Quicken has emerged as the current market leader in relation to personal finance; and Microsoft Excel has taken the lead over Lotus in relation to spreadsheets.

As a result of this process of 'creative destruction' these monopolies in computer based markets may be 'inherently fragile' and hence not a cause for regulatory concern. While 'creative destruction' may take place eventually, the market power held by the incumbent may be sustained for a considerable period of time, and during that time its conduct will need to be regulated.

Section 46 of the TPA regulates the conduct of firms that have achieved positions of market power to ensure that they are not taking advantage of their market power for a proscribed anti-competitive purpose. Acquiring substantial market power is not unlawful, but once a firm satisfies the market power threshold it must take care not to misuse its market power by engaging in anti-competitive conduct.

In order to establish a contravention of s 46 it is necessary to establish three elements:

- first, it is necessary to establish that the respondent satisfies the threshold test and has a substantial degree of market power;

6 Schumpeter, *Capitalism, Socialism and Democracy* (first published 1943, 5th ed, 1976) 85.
7 Ibid 87.
8 Ibid.
9 Ibid 84.

- secondly, it is necessary to prove that the respondent has taken advantage of its market power in the sense that it has used its market power to engage in the impugned conduct; and
- finally, it is necessary to prove that the respondent had one of the proscribed anti-competitive purposes when it engaged in the conduct.

Difficult issues are likely to arise in relation to the first two elements of s 46 in the context of the computer industry.

III MARKET DEFINITION

To determine whether a firm has substantial market power it is first necessary to identify a relevant market, and then examine the state of competition in that market having regard to the structure of the market. It is important to appreciate that competition and market power are the central issues in Part IV and that market definition is but a preliminary first step to identify entry barriers, calculate market shares and provide a context in which competition is to be analysed. Market definition is generally conducted first as a separate exercise before considering the nature and degree of market power, however, there is some interplay between the two stages in the analysis. After conducting the first stage of the analysis important questions concerning market power will already have been answered; after conducting the second stage it may be necessary to go back and revise what market means.[10]

The interconnection between the two stages in the analysis was recognised by Mason CJ and Wilson J in their joint judgment in *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Co Ltd*.[11]

Their Honours stated:

> In identifying the relevant market, it must be borne in mind that the object is to discover the degree of the defendant's market power. Defining the market and evaluating the degree of power in that market are part of the same process, and it is for the sake of simplicity of analysis that the two are separated. Accordingly, if the defendant is vertically integrated, the relevant market for determining degree of market power will be at the product level which is the source of that power…After identifying the appropriate product level, it is necessary to describe accurately the parameters of the market in which the defendant's product competes: too narrow a description of the market will create the appearance of more market power than in fact exists; too broad a description will create the appearance of less market power than there is.[12]

This discussion of the relationship between market definition and market power is important. It recognises that the market definition inquiry is subsidiary to the market power analysis, rather than being important for its own sake and necessarily preceding

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10 See Norman and Williams, 'The Analysis of Market and Competition under the Trade Practices Act: Towards the Resolution of Some Hitherto Unresolved Issues' (1983) 11 *Australian Business Law Review* 396.

11 (1989) 167 CLR 177 (*Queensland Wire* case).

12 Ibid 187-188. This approach was adopted by the Full Federal Court in *Australia Meat Holdings Pty Ltd v TPC* (1989) ATPR 40-932 (*AMH* case). See especially the judgment of Pincus J, 50,104. See also the Tribunal's determination in *Broken Hill Pty Co Ltd v Koppers Pty Ltd* (1981) ATPR 40-203, 42,828.

the market power inquiry. Whether one focuses on market definition or market power, the ultimate inquiry is the same: what are the constraints on the production and selling policies of the respondent? If it is free from constraints and has some degree of discretion in its production and selling policies it is said to possess market power.

This notion of freedom from constraints is inherent in the definition of market power in s 46(3) which provides:

> 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 —
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> (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.

As Gleeson CJ and Callinan J observed in *Boral Besser Masonry (now Boral Masonry Ltd) v ACCC* :

> The essence of power is absence of constraint. Market power in a supplier is absence of constraint from the conduct of competitors or customers. [13]

In relation to the first step, market definition, it is arguable that a copyright product such as computer software, is capable of constituting a separate, unique product market. In *Broderbund Software Inc v Computermate Products (Aust) Pty Ltd* [14] it was argued by the cross-claimant, Computermate, that Broderbund and Dataflow, in having exclusive distributorships and bringing an action for breach of copyright, had contravened ss 46, 45 and 47 of the TPA. Computermate contended that a computer software program, ‘Where in the World is Carmen Santiago,’ was a unique product market.

Beaumont J found that there was a national market for software for educational purposes and a national market for software for entertainment purposes. The Carmen Santiago range was generally regarded as falling into the former market although it sometimes fell into the latter market. It did not constitute a separate and unique market.[15] Within this broader market the Carmen Santiago range achieved a market share of only 10-17 per cent.

Where there is some degree of interconnection and complementarity between two products, it may be that they form part of the same market. For example, it was held in *Regents Pty Ltd v Subaru (Aust) Pty Ltd* [16] that there was a broad market for cars and car parts because there was evidence that Subaru had regard to the prices of the parts for other makes of cars to ensure that consumers did not reject Subaru cars because Subaru parts were too expensive.

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13 [2003] HCA 5 (7 February 2003) (*Boral Masonry* case) [121]. See also [136] - [138].

14 (1992) ATPR 41-155, 40,112 (Beaumont J) (*Broderbund Software* case).

15 Ibid 40,112.

16 (1998) ATPR 41-647.

IV MARKET POWER AND POTENTIAL COMPETITION

In relation to the second step, market power, s 46(3) of the TPA set out above provides some statutory guidance as to the meaning of the concept 'market power' and relevant factors in determining the degree of power in a market.

This definition makes it clear that market power is to be judged in accordance with the degree of competitive constraint to which the respondent corporation is subject, not just from existing competitors, but from *potential* competitors as well.

In the computer industry, these potential competitors may be working on a new superior product, but it may be difficult to estimate when they will be ready to launch their products on to the market. If the Court ignores the threat of potential competition, and the incumbent firm has a large market share, it is likely to make a finding that the market power threshold is satisfied. However, high market share may not be a reliable indicator of market power in such circumstances.

The importance of innovation and the threat posed by potential competition is specifically recognized in s 50 (3)(g). In assessing whether a merger will have the effect or likely effect of substantially lessening competition in a market, the Court must have regard to the dynamic characteristics of the market, including growth, innovation and product differentiation.

In the *Queensland Wire* case,[17] Dawson J expressed the view that substantial market power required something like a monopoly or near monopoly situation. This dictum has been followed in other cases.[18] However, it does not accord with Parliament's intention in adopting the new threshold test as part of the 1986 amendments to the TPA.

The Attorney-General in his second reading speech stated that the previous test of market control was being replaced because it only applied to monopolists or near monopolists. The new test of substantial market power was intended to provide a lower threshold for the operation of s 46 so that more than one firm in the same market may come within the ambit of the section. It seems that the courts are prepared to set a low threshold where the products are protected by IP rights.

V IP RIGHTS AND TEMPORARY MONOPOLIES

In the computer based markets, the existence of a statutory monopoly brought about by copyright law with respect to computer software may confer on the copyright owner some degree of market power.[19] Copyright is seen as creating a real barrier to entry where it is for a specialized component, or essential part for which there is no close substitute.

17 (1989)167 CLR 177, 200.

18 See the *Broderbund Software* case (1992) ATPR 41-155, 40,112.

19 Computer programs have been the subject of protection since the *Copyright Amendment Act 1984* (Cth). A new definition of computer program was inserted into the *Copyright Act 1968* (Cth) in 2000: 'a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result.'

A good example is provided by *ACCC v Universal Music Australia Pty Ltd.*[20] The ACCC alleged that the major record companies, Universal and Warner, had contravened s 46 in refusing to supply stock to retailers who sold imported CDs. The case is significant in that it demonstrates the uncertainty that still surrounds the elusive concept of market power and how to prove its existence. It also demonstrates the uncertainty surrounding the concept of a barrier to entry, and, in particular, whether product differentiation should be regarded as a barrier to entry. Similar issues are likely to arise in relation to proving market power in the computer industry.

The dilemma for the trial judge, Hill J, was whether to focus on the market for recorded music generally where barriers to entry were not high, or whether to have regard to the monopoly afforded to each record company in relation to CDs as a result of the *Copyright Act*. Did such temporary power in relation to hit singles that were charting well confer substantial market power for the purposes of s 46(1)?

Prior to July 1998 parallel importation of CDs was illegal. Copyright law ensured that there was only one legitimate source from which a Universal or Warner CD could be obtained. Once parallel importation was legalized retailers were able to acquire CDs overseas, import them into Australia, and re-sell them at lower prices than the same CDs acquired from Universal and Warner in Australia. In order to remove this source of price discounting and improve distributor returns, Universal and Warner refused to supply stock to retailers who imported CDs.

While the Court did not conclude that each CD constituted a separate market, it did recognize the rather controversial notion of a 'temporary monopoly'. The term 'temporary monopoly' was said:

> …to refer to the phenomenon apparent in the record industry (it would exist also in the market for books, magazines and films) that the popularity of a particular title gives to the record company which produces it temporary powers to act unconstrained by competition…it means no more, so far as I can see, than the fact that there is a significant element of product differentiation in a market dominated by hits.[21]

Hill J identified the relevant market as involving:

> …a flow of product, some of which will, in the short term have distinctive characteristics (reflecting popularity of chart ratings) and others of which will not and that to analyze dominance by reference to short lived advantages ignores commercial realities….[22]

His Honour concluded that the relevant market was the wholesale market for recorded music Australia-wide, rather than a separate product market for each CD and that there was a retail market for recorded music which was also Australia-wide.

As regards the issue of market power, Professor Hausman, the economist for Universal and Warner, defined market power to mean 'the ability of a firm to charge a price above the competitive level for a non-transitory period of time.' He argued that Universal and Warner were not able to raise their prices for CDs above the competitive level because

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20 (2002) ATPR 41-855 (*Universal Music* case).

21 Ibid [368].

22 Ibid [351].

they were constrained by other competing record companies in their price setting. If either sought to raise prices, consumers would switch and purchase the CDs of their competitors. They were also constrained by the countervailing power of large buyers such as Sanity and HMV who were able to extract large discounts and other favourable terms of trade by threatening not to buy Universal and Warner CDs.

Mr Ergas, the economist for the ACCC, defined market power more broadly. It was not just the ability to raise prices above the competitive level that needed to be considered but also 'the ability of a firm to act persistently in a manner unconstrained by competition.' He maintained that market power can also be inferred from the ability to engage in anti-competitive conduct such as refusing to supply or imposing restraints that could not be imposed under competitive conditions.

Hill J summarized the conflicting economic evidence in the following terms:

> The difference between them arises in part because Mr Ergas is concerned to explain market power by reference to the context of s 46 of the Act, concentrating upon the conduct and purpose or effect with which the section is concerned. The very language of s 46 of the Act requires that eliminating or damaging a competitor, preventing entry to the market or deterring persons from engaging in competitive conduct can…be outcomes of the exercise of market power. From that it must follow that market power encompasses at least the ability to engage in anti-competitive conduct of this kind. That leaves open the question whether there is nevertheless the need to demonstrate as well that the firm said to have substantial market power have the ability to maximize profits by charging a price in excess of marginal cost.[23]

Hill J preferred the approach of Mr Ergas. After considering the economic evidence, Hill J posed the question he had to consider in the following terms:

> …whether it is possible for a firm to have a substantial degree of market power for the purposes of s 46 of the Act, notwithstanding that the firm is unable to raise existing prices as a result competitive constraint, but where nevertheless the firm is able to act in a way that is unconstrained by competitive forces to bring about a result of the kind contemplated by s 46, the result of which might be expected in turn to bring about a reduction in the prevailing competitive price.[24]

His Honour concluded that the concept of the ability to charge prices above marginal cost was not the *sole* measure of market power for the purposes of s 46 of the TPA; one also needs to consider the ability to engage in anti-competitive or exclusionary conduct.

Hill J endorsed the comment by Finkelstein J in *ACCC v Boral Ltd* [25] that a firm that is not in an immediate position to set its price above marginal cost may still have market power. Hill J observed:

> What is important is that Finkelstein J approached the question of market power by reference to the conduct that was proscribed (at least by implication) by s 46(3). He said it was the exclusionary conduct that established market power and not the reverse.[26]

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[23] Ibid [356].

[24] Ibid [360].

[25] (2000) FCR 328, 411.

Even though the record companies only had a market share of between 15- 18 per cent the Court took account of the fact they had 'temporary monopolies on a frequent basis' in respect of individual CD titles. No two titles were perfect substitutes for one another. Hill J accepted the evidence that more than half of the consumers would not purchase a substitute product. [27]

His Honour also accepted the evidence of Mr Ergas that the record industry differed from other industries where product differentiation occurred. First, there was a need for variety in the titles available - to stock an assortment of titles. Secondly, in relation to chart music, there was a rapid turnover of titles as each album rose or fell in the charts, referred to as 'a continuous stream of hits', and there was a need for retailers to be able to stock the latest hits in order to be viable.

While most barriers to entry are structural in nature, Hill J considered whether some barriers to entry may arise as a result of the strategies and conduct of incumbent firms.

His Honour again referred to the judgment of Finkelstein J in *Boral Masonry*[28] as containing a useful discussion of what constitutes a barrier to entry.

In the *Boral Masonry* case, Finkelstein J noted the distinction between structural barriers to entry and strategic barriers to entry and referred to some of the new Industrial Organisation literature.

His Honour observed:

> More recently, economists have turned from economic models to dynamic market behaviour to determine what is a barrier to entry P Geroski and J Schwalbach (eds) *Entry and Market Contestability* (1991) give this definition:
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> 'Barriers to entry are obstacles which inhibit the ability of firms outside a market to enter and compete with established insiders.'
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> This definition has significant advantages over some of the earlier ones. It follows the recent trend for economists to broaden barriers beyond those that are structural, to incorporate the strategic behaviour of incumbent firms. In particular, it is now accepted by many economists that the behaviour of incumbent firms to exclude rivals by a variety of restrictive or uncompetitive practices is as much a barrier to entry as any structural condition that may exist in a market.
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> …
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> Incumbents are often willing to take action that will result in short-term reductions in profit to prevent the establishment of a new entrant. Some economists refer to these deterrent activities as 'strategic' barriers to entry, 'purposely enacted to redress the possibility of entry' as opposed to 'innocent' entry barriers 'unintentionally erected as a side effect of innocent profit maximisation': Salop, 'Strategic Entry Deterrence' 69 (1979) *American Economic Review* 335.[29]

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26 Ibid [416].

27 Ibid [384].

28 (2000) FCR 328, 413-15.

29 (2001) ATPR 41-803, 42,710 [340]-[342]. In the High Court, one of the majority judges in the *Boral Masonry* case, McHugh J, endorsed these views:

> …Merkel and Finkelstein JJ were correct in saying that a market may have strategic barriers to entry as well as structural barriers to entry. Structural barriers can be assessed objectively by looking to the existence of intellectual property, capital investment, the availability of labour and

Hill J noted:

> The present is a case where the ability of the major record companies to prevent retailers from selling imported CDs in fact does operate as a barrier to the entry into the market of sellers of imported Warner and Universal titles. However, it is not necessary to decide whether that is properly to be seen as a barrier to entry.[30]

There were no significant barriers to entry to the record industry generally. This was demonstrated by the evidence of new entry by independent recording companies from time to time. Production costs for CDs were relatively low. Publicity and promotion costs were the most significant item of expenditure.

Hill J stated:

> I find the issue of market power and its related issue of barriers to entry extremely difficult to decide. It is really at the heart of the controversy between the parties. The case of a firm acting in an oligopolistic market with only 15% market share and unable to fix prices in the overall market above the competitive level but which has, as a result of a temporary monopoly power over a limited number of products in that market, substantial power to exclude competitors is not one which has been the subject of any authority in Australia or, so far as my researches indicate, in any other country…
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> It is not unreasonable to ask what kind of power was Universal (or Warner) seeking to exercise when it set out to deter retailers from parallel importation by the conduct it engaged in. It was only because it had power in the market that it could achieve its aim, at least with so much of the retail market as comprised the smaller retailers. The threat to refuse supply was not one which the small retailers could ignore, especially when it became clear that it was more than a threat and would be implemented. The retail business was threatened, particularly if more than 50% of customers were likely to go elsewhere to purchase the title which the retailer no longer stocked. Even the large retailers would be likely to think twice before importing CDs from overseas, if only because of the inconvenience of having to import their entire stock and in many cases having to establish a separate warehousing and distribution network. They would still not be able to stock some locally released titles not available overseas. In my view, whatever may be the view of economists, particularly American economists, business people in Australia would regard such behaviour as involving both market power and the exercise of that power.
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> In reaching this conclusion I am conscious that the definition of the market requires that a common sense approach be taken so as not to concentrate on what is but a snapshot of the market at a particular point in time. I accept that the definition of the market focuses in a case such as the present upon the continuous flow of product over time in a process where new albums displace old so as to compete for the attention of the public…[31]

Hill J concluded that Universal and Warner each had market power by virtue of each having ‘hits’ from time to time and ‘back catalogue’ which retailers needed to be able to

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materials, the nature of technology and similar matters. Strategic barriers to entry may include matters such as economies of scale, pricing policies and the expansion of plant to generate excess capacity.

30 Ibid [422].

31 Ibid [425]-[427].

stock. This market power was substantial in the sense that it was real or of substance and more than trivial or minimal.

The case is presently on appeal. It is difficult to reconcile with the *Broderbund Software Case* where a market share of only 10-17 per cent was held to be well short of the degree of market power required to satisfy the threshold test of market power required for s 46, even though the computer software in that case was also the subject of copyright.

What are the implications of the *Universal Music case* for the computer industry? Assuming that it is not overturned on appeal, the case highlights the importance of the copyright monopoly in any assessment of market power under s 46. While the relevant market was that for recorded music, rather than each CD released by the record company, the existence of the copyright monopoly in each CD conferred some degree of market power which could not be ignored. Market power was construed to mean more than the ability to 'charge more'; it extended to the ability to impose unfavourable conditions or withhold supply, so that although none of the record companies had a market share that exceeded 15 per cent, they were held to have contravened s 46 by threatening to refuse to supply CDs to retailers who engaged in parallel importing.

It is difficult to reconcile the *Universal Music case* with the *Broderbund Software case* considered earlier. Both cases involved products that were the subject of copyright and copyright was held to be a barrier to entry. Both cases were characterized by product differentiation. In both cases the market share of the copyright owner was approximately 15%. In the *Universal Music case* the Court held Universal possessed substantial market power, while in the *Broderbund Software case* the Court held that Broderbund did not possess substantial market power.

It is to be hoped that the Full Federal Court in the *Universal Music case* will settle this difference of views.

VI TAKING ADVANTAGE OF MARKET POWER

The test for taking advantage of market power was first adopted by the High Court in the *Queensland Wire* case[32] and confirmed by the High Court in *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd*.[33] The High Court majority in the *Melway* case referred to the tests of 'taking advantage' adopted by the various members of the High Court in its earlier decision, in the *Queensland Wire* case. According to the majority in *Melway*, two tests were adopted in the *Queensland Wire* case. A majority, consisting of Mason CJ and Wilson, Dawson and Toohey JJ, considered that the way to test whether BHP had taken advantage of its market power was to ask how it would be likely to behave in a 'competitive market'.

Referring to this approach the High Court majority in *Melway* stated:

> The four members of the court reasoned by inference from the premise that BHP could not have refused to supply to QWI in a competitive market to the conclusion that its

32 (1989) 167 CLR 177.

33 (2001) 205 CLR 1 at [52] per Gleeson CJ, Gummow, Hayne, and Callinan JJ (the *Melway* case).

> behaviour was made possible by the absence of competitive constraint (i.e. by market power). The source of the premise is not entirely clear. It seems to involve unstated assumptions about the nature and structure of the competitive market. …To ask how a firm would behave if it lacked a substantial degree of power in a market, for the purpose of making a judgment as to whether it is taking advantage of its market power, involves a process of economic analysis which, if it can be undertaken with sufficient cogency, is consistent with the purpose of section 46. But the cogency of the analysis may depend upon the assumptions that are thought to be required by section 46.[34]

While accepting that the *Queensland Wire* approach to the 'taking advantage' element was the correct approach, the High Court majority in *Melway* did not provide much guidance as to the structure of the 'competitive market' to be used as a backdrop for the hypothetical question. It did, however, indicate that the respondent's conduct is to be assessed by reference to what it would be likely to do in a workably competitive market rather that a perfectly competitive one.[35]

According to the majority in *Melway*, the second test of 'taking advantage' in *Queensland Wire* was adopted by Deane J who '…saw the case as one in which the identification of the purpose for which BHP was refusing to supply QWI led directly to the conclusion that BHP was taking advantage of its market power.'[36]

The majority stated that this approach was potentially flawed, since '… there are cases in which it is dangerous to proceed too quickly from a finding of purpose to a conclusion about taking advantage.'[37] Accordingly, it is always necessary to follow the approach of the majority in *Queensland Wire* and ask whether the respondent has used its power in a manner made possible only by the absence of competitive conditions.[38]

Competitive conduct is exclusionary by its very nature. Business firms try to win market share from their competitors by engaging in research and development; making innovations and product improvements; and enhancing the level and quality of pre-sales and post-sales services. This is competitive rivalry that the TPA seeks to promote, even though it may have an exclusionary effect on rivals. It is the type of rivalry that enhances economic efficiency and consumer welfare. The danger with focusing on an exclusionary purpose alone is that it might lead one to characterise exclusionary competitive conduct as a taking advantage of market power. In order to avoid this error, one needs to ask the hypothetical question: would the espondent be likely to engage in the conduct at issue under competitive conditions? If so, it is not to be characterised as a taking advantage of market power.

The High Court majority in *Melway* accepted the finding of the trial judge that the refusal to supply the respondent was for an exclusionary purpose, namely, to deter or prevent competition at the wholesale level. However, one could not conclude from this alone that there was a taking advantage of market power. One needed to consider the

34 Ibid [52].
35 Ibid.
36 (2001) ATPR 41-805 [28].
37 Ibid [31].
38 Ibid [48].

counter-factual: would Melway have refused supply if it were acting in a competitive market?

The High Court accepted that the segmented distribution maximised sales of Melway's street directories and that it was likely to adopt such a distribution system under competitive conditions. The segmented distribution system did not depend on the possession of market power. Economic analysis was unnecessary to determine this issue. It was possible to answer the question based on direct observation.

Referring to the dissenting judgment of Heerey J in the Full Federal Court, the High Court majority stated:

> He [Heerey J] observed that Melway had adopted its segmented distribution system before it secured its position of market dominance, and there was no reason to believe that it would not be both willing and able to continue that system in a competitive market. He pointed out that, in refusing to supply the respondent, Melway was not denying itself sales, and there was no justification for assuming that in a competitive market it would be denying itself sales. The reasoning of Heerey J is to be preferred.[39]

The primary judge and a majority of the Full Federal Court had erroneously concluded that the creation and maintenance of the segmented distribution system was an exercise of market power. The High Court majority noted:

> The respondent's argument depends upon equating the exercise of the power in a market with deciding to grant or withhold supply. That begs the question….market power means the capacity to behave in a certain way…persistently free from the constraints of competition…Freedom from competitive constraint might make it possible, or easier, to refuse supply, and if it does, refusal to supply would constitute taking advantage of market power. But it does not follow that because a firm in fact enjoys freedom from competitive constraint, and in fact refuses to supply a particular person, there is a relevant connection between the freedom and the refusal...[40]

If there is a rational business explanation for the conduct at issue where the corporation has market power, this suggests that the corporation could rationally engage in the same conduct without market power, and therefore has not used its market power. The rational business criterion as an aid to the characterisation of conduct under the taking advantage element is contentious and has yet to be receive the blessing of the High Court.[41] Its origins can be traced to two decisions of Heerey J.

In *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd,*[42] Heerey J, in his dissenting judgment in the Full Federal Court, closely examined Melway's business rationale before attempting to decide whether it would have engaged in the same conduct if it lacked market power. His Honour stated :

> Although expressed in perhaps guarded terms, the learned trial judge did accept that Melway was satisfied that its system constituted 'a reasonable commercial regulation of

39 Ibid [62].

40 Ibid [67].

41 See Corones, 'The Characterisation of Conduct under Section 46 of the Trade Practices Act' (2002) 30 *Australian Business Law Review* 407.

42 [1999] ATPR 41-693.

> its distribution system in order to maximise sales of its directories'. Melway tendered a body of evidence as to the reasons for adopting the system. Wholesalers were dealing with customers in a market they knew as specialists. The wholesalers had a good understanding of customer requirements and an ability to sell different types of products to customers, giving supply and selling efficiencies. Major retailers like McEwans preferred 'distributors of substance' who could service the product adequately. Wholesalers were given confidence to invest in marketing and customer development and especially promotion which was a crucial element of Melway's success. The wholesalers were permitted to maximise customer service and the meeting of customer needs including promotion. The wholesalers were able to service the public need for the product, including small unprofitable accounts.[43]

The ACCC was granted leave to intervene in the proceedings in the High Court on the basis that its interests were affected because it was a frequent litigant in matters under s 46 and was the regulator of the TPA. Counsel for the ACCC argued:

> the test applied by Heerey J wrongly looks to the existence of a business rationale. The phrase ['take advantage'] does not require or permit such a concept or qualification to be considered. The existence of a business rationale is relevant only to …the question of purpose.*'* [44]

It was also challenged by Counsel for the Respondent:

> Melway's submissions relating to legitimate business purpose require the overturning of the Queensland Wire Industries case. There is no basis to do that. The object and language of s 46(1) support the interpretation given in that case. Moreover, to import notions of 'legitimacy' would introduce an inquiry (what constitutes legitimate business conduct) which would produce uncertainty.[45]

The High Court majority, without expressly referring to the relevance of a business rationale approach, seems at least to have favoured an approach of trying to understand what options were available to Melway in terms of a distribution strategy, and perhaps the rationale for adopting the chosen strategy, before characterizing it as a taking advantage of market power.[46]

The rational business criterion was also applied by the primary judge, Heerey J, in *ACCC* v *Boral*.[47] There were two aspects to the conduct at issue in the *Boral Masonry* case. The first was the allegation of below cost pricing that was carried out in a sustained fashion between 1993 and 1996. The second aspect was the upgrade of Boral's plant to improve efficiency and increase production capacity. The ACCC alleged that the creation of excess capacity was a strategy designed to erect a barrier to new entry.

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43 Ibid [31].

44 (2001) 205 CLR 1, 6.

45 (2001) 205 CLR 1, 7-8.

46 Ibid [17]-[19].

47 [1999] ATPR 41-715.

Heerey J, in considering the taking advantage element of s 46 once again found it helpful to ask whether BBM had a business reason for adopting the conduct. Heerey J stated:

> If the impugned conduct has a business rationale, that is a factor pointing against any finding that conduct constitutes a taking advantage of market power. If a firm with no substantial degree of market power would engage in certain conduct **as a matter of commercial judgment**, it would ordinarily follow that a firm with market power which engages in the same conduct is not taking advantage of its power. Thus, a TV advertising campaign might be a sensible exercise for any firm in a particular market. If one firm happens to have a substantial degree of market power, that does not make its campaign a taking advantage of market power. [48] (Emphasis added)

Heerey J held that BBM did not have a substantial degree of market power and accordingly, the threshold test for the application of s 46 was not satisfied. While it was unnecessary for him to do so, his Honour examined the nature of the below cost pricing claims and the circumstances in which below cost pricing may contravene s 46.

Heerey J held that selling below avoidable cost, even for a prolonged period, can be a rational business decision and does not necessarily depend on the possession of market power.[49] Where an industry is characterized by over-capacity and some sort of 'shake-out' is inevitable, it may be a rational business strategy to price below cost to win business and upgrade plant to improve efficiency to be amongst the survivors – to live to fight another day and protect sunk costs. Such a business rationale was supported by the evidence of an independent expert economist, Professor Hay.[50]

On appeal,[51] the ACCC expressly challenged the notion of a rational business criterion being relevant to the issue of 'taking advantage':

> The adoption by the primary Judge of a 'rational business decision' criterion as an exculpatory consideration is, in truth, an attempt to introduce into s 46 an ingredient of moral reprehensibility- a notion specifically rejected both by Deane J and Dawson J in *Queensland Wire*. [52]

Beaumont J was the only member of the Full Federal Court to comment on this aspect of the ACCC's submission. His Honour stated :

> …upon an analysis of the reasoning in *Queensland Wire*, it does not appear that there is any scope in the operation of s 46 for an absolute exception in the case of activities which may be seen as 'rational' or 'commercial' in character. Such a characterisation of the activities of a firm can be no more than equivocal for present purposes. There is no express exception of these activities from the operation of s 46, and there is no reason, in logic or experience, to imply such an exception.[53]

48 Ibid [158].
49 Ibid [175].
50 Ibid [177].
51 *ACCC v Boral Ltd* [2001] ATPR 41-803.
52 Ibid [124].
53 Ibid [154].

The High Court found that Boral Masonry did not have substantial market power. Even if it did have marker power the High court majority held that it would not have taken advantage of that power. This finding relied on the Court's characterization of Boral's conduct. The majority recognised that Boral faced difficult market circumstances and both its pricing and capacity expansion were reasonable commercial responses given that the building industry was in severe recession and that C&M had entered the market with a state-of-the-art machine. Gleeson CJ and Callinan J stated in their joint judgment:

> To 'hang on' in the expectation that one or more of the other suppliers would 'break first' may have been a rational commercial response in what was hoped to be a period of severe, but temporary difficulty. It is different from forcing prices down in order to damage or eliminate some competitors.[54]

McHugh J concluded:

> Thus, even if BBM had a substantial degree of market power, a finding may have been open that it had not taken advantage of that power. Contrary to views expressed in the Full Court, the commercial reasons that led to its participation in the price war might also have required a finding that it had not taken advantage of a substantial degree of market power.[55]

It seems both logical and reasonable to consider the business rationale for the conduct as part of the taking advantage element since it indicates that the corporation may have engaged in the same conduct if it lacked market power. The 'taking advantage' test requires proof that the conduct involved a *use* of the respondent's market power. This is a legal question rather than an economic question although economic analysis may assist the court.[56]

Before the question of *use* can be answered, the conduct at issue needs to be correctly characterized. Before the court can characterize the conduct, it needs to understand why the firm engaged in the conduct. If there is a good business reason for the conduct, then it can be inferred that the firm would have engaged in the conduct without its market power, and, therefore, that the conduct does not involve a use of the market power.

If a firm gives a business reason for the conduct, the court will have to decide whether *objectively* the reason is valid in terms of economic theory and best business practice. The question for the court is: would a rational actor be likely to adopt the conduct without market power? Whether the conduct is 'normal' or consistent with industry practice would be a relevant consideration.

This process of characterisation is not as easy as it might appear. Some of the judgments in the *Melway* case, incorrectly characterized the conduct as a refusal to supply, without considering Melway's business rationale in adopting the segmented wholesale distribution system. Some of the judgments in the *Boral Masonry* case incorrectly characterised the below cost pricing as predatory without considering BBM's business

54 [2003] HCA 5 [44]. See also [70] and [86]. See also the joint judgment of Gaudron, Gummow and Hayne JJ at [170]-[171].

55 Ibid [321].

56 *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd* (2001) 205 CLR 1, [52]-[53].

rationale which was to survive a severe cyclical downturn in the building industry during a period of over-capacity in the concrete masonry products market.

VII TAKING ADVANTAGE AND CAUSATION

The 'taking advantage' element also requires the applicant to establish that there was a causal link between the conduct at issue and the respondent's market power. The question that remains unresolved is: how high is the threshold of causation? Is it enough that the market power merely facilitated the conduct (a low threshold of causation), or is it necessary to show that the conduct could *only* be engaged in because of the exercise of substantial market power (a high threshold of causation)?

For example, market power is a necessary condition to engage in price discrimination, but is market power a necessary condition to bring about anti-competitive effects in the case of a refusal to deal? Must the market power cause the anti-competitive effect because buyers or distributors were coerced or forced to accept the respondent's terms, as in the case of tie-ins or exclusive dealing? There is no simple answer to the question.

Counsel for the ACCC argued before the High Court in *Melway* :

> The expression 'take advantage of' may have various meanings in its context. It may mean that the conduct:
>
> (a) was impossible without the relevant market power;
>
> (b) was not commercially rational without the relevant market power;
>
> (c) was more commercially attractive than it would have been without the relevant market power; or
>
> (d) was facilitated by the relevant market power.
>
> We contend that (d) is correct A company without a substantial degree of market power could conceivably refuse to supply. That would ordinarily lead to insolvency. Where a company possesses market power and that power facilitates the refusal to supply, by insulating the company from the ordinary commercial consequences of its conduct, it has taken advantage of its market power. It is not necessary to show that the conduct was impossible without the market power: such a test would destroy the efficacy of s 46. It is not necessary to show that the conduct would be unlikely without the relevant market power…The phrase is satisfied if the existence of the market power protects the company from the usual commercial consequences of its conduct and that protection is more than de minimis. [57]

Although the High Court majority in the *Melway* case reached its decision on the basis of the construction of 'taking advantage' in *Queensland Wire,* it took the opportunity to comment on the ACCC's expanded formulation of the taking advantage test:

> Dawson J's conclusion that BHP's refusal to supply QWI with Y-bar was made possible only by the absence of competitive conditions does not exclude the possibility that, in a given case, it may be proper to conclude that a firm is taking advantage of market power

[57] (2001) 205 CLR 1, 5.

> where it does something that is **materially facilitated** by the exercise of the power, even though it may not have been absolutely impossible without the market power. [58] (Emphasis added)

Under the expanded formulation accepted by the High Court majority in *Melway*, a corporation may 'take advantage' of its market power where the market power *materially* facilitates the conduct? The word 'materially' is a relative one and its application to a particular fact situation is bound to produce a divergence of views.

VIII TECHNOLOGICAL TYING: PRODUCT INTEGRATION

With these legal authorities in mind, let us now consider the circumstances in which tying two or more products into one integrated product is likely to contravene s 46. Tying and bundling are generally regarded as two separate practices. With bundling, the seller sells goods or services as a package, but continues to sell the separate components on a stand-alone basis. With tying, the seller sells one product (the tying product) on condition that the buyer purchases another separate tied product.

Nothing in the legal authorities considered suggests that efforts to develop integrated products will contravene s 46 of the TPA. On the contrary, these authorities can be read as endorsing the merits of product integration.

The central question in any claim based on tying is whether the product is a single integrated product or whether it consists of two or more separate products packaged together. In the United States the test for determining whether there are two products or one was considered by the Supreme Court in *Jefferson Parish Hospital District No 2 v Hyde*.[59] The Court stated that if there is sufficient consumer demand, such that it is efficient to offer the products separately, then for tying purposes one must conclude that they are separate products.[60]

In relation to computer software, the matters that are likely to be relevant are first, has there been some genuine integration of the separate software programs? It would not be enough to simply sell two programs in the same box, covered by the same software licence agreement. Assuming that there has been a genuine integration in the sense that the same code runs both programs, it is necessary to ask the further question, is there some technological value to the integration? If the integrated product is not superior in some way, it will be difficult to rebut the inference that the purpose behind the integration was an anti-competitive one.

Such as approach is consistent with the decision of the Federal Court of Appeals (D.C. Circuit) in *United States v Microsoft*.[61]

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58 Ibid [51].

59 466 US 2 (1984).

60 Ibid 21-22.

61 *United States v Microsoft Corp.* [2001-1] Trade Cases (CCH) 73,321. For an analysis of the issue see Hovenkamp, 'IP ties and Microsoft's rule of reason' (2002) *Antitrust Bulletin* (Summer –Fall), 369.

The relevant product market was defined as that for operating systems or PC Intel-compatible operating systems. A significant feature of the market is that it gives rise to network effects.

The overwhelming majority of consumers will only use a PC operating system for which there already exists a large and varied set of high-quality, full-featured applications, and for which it seems relatively certain that new types of applications and new versions of existing applications will continue to be marketed at pace with those written for other operating systems. This was referred to as the 'applications barrier to entry'.

While it would be prohibitively expensive for a new Intel-compatible operating system to be developed, applications could be written that relied solely on servers or 'middleware' instead of PC operating systems. Thus, the Netscape browser had the potential to become the platform for the writing of applications that might then run on non-Windows operating systems.

The Court of Appeals (D.C. Circuit) adopted a four step 'onus-shifting' approach as a means of correctly characterizing Microsoft's conduct. [62]

The first step is the establishment of monopoly power. The plaintiff bears the onus of proof in relation to this element.

In the second step the plaintiff must offer a hypothesis that shows that the conduct has had an 'anti-competitive effect' i.e. 'it must harm the competitive process and thereby harm consumers…harm to one or more competitors will not suffice.'[63] Such anti-competitive effects include an increase in prices, or a reduction in innovation, or a reduction in output.

In the third step, if the plaintiff demonstrates this anti-competitive effect, then the monopolist may proffer a 'pro-competitive justification,' which the court described as:

> a non-pretextual claim that its conduct is indeed a form of competition on the merits because it involves, for example, greater efficiency or enhanced consumer appeal..[64]

For example, it may be trying to prevent free-riding and safeguard the rewards of its investment. This would count as a justification. When a person makes a substantial investment in research and development for example, there is nothing wrong with putting in place reasonable restraints to ensure the ability to reap the rewards of that investment. In that case, the burden shifts back to the plaintiff to rebut that claim.

In the fourth step,

> …if the monopolist's pro-competitive justification stands unrebutted, then the plaintiff must demonstrate that the anti-competitive harm of the conduct outweighs the pro-competitive benefit. [65]

62 Ibid 90,791-792.
63 Ibid 90,791.
64 Ibid 90,792.

Where there is a mix of anti-competitive effects and pro-competitive justifications it is for the court to decide which prevails, the gains or the harms.

To determine whether the conduct needed to be justified the Court employed a diversion standard. The conduct at issue was the threat posed by Netscape as a rival platform for the development applications software. To meet this threat, Microsoft engaged in a variety of practices some of which were designed to prevent Netscape acquiring the necessary critical mass to become attractive to applications software developers.

In applying the onus-shifting approach the Court of Appeals considered whether Microsoft's conduct was diversionary in the sense that it diverted browser usage from Netscape to Microsoft's Internet Explorer. If the conduct was diversionary it was prima facie anti-competitive and in need of justification. Microsoft took actions, both ***contractually and technologically*** to bind its browser with its Windows operating system.

As regards, the ***contractual*** restrictions, Original Equipment Manufacturers (OEMs) were prohibited from:

(1) removing any desktop icons, folders or 'Start' menu entries;
(2) altering the initial boot sequence; and
(3) otherwise altering the appearance of the Windows desktop.[66]

The anti-competitive effect of the licence restrictions was that OEMs were not able to promote rival browsers and this diverted browser usage away from Netscape to Internet Explorer. The burden shifted to Microsoft to justify the restrictions. Microsoft contended first, that it was merely exercising its rights under copyright law, and, secondly, that the licence restrictions prevented the OEMs from taking actions that would reduce the value of Microsoft's copyrighted work. The first claim was dismissed as frivolous. While US copyright law protects a work against significant alteration, it did not give the copyright owner absolute control over the product. The second justification was not substantiated.

There were three specific ***technological*** actions Microsoft took to 'weld' Internet Explorer to Windows:

(1) excluding IE from the 'Add/ Remove programs' utility;
(2) designing Windows so as in certain circumstances to override the user's choice of a default browser other than Internet Explorer; and
(3) commingling browsing source code and operating source code.

Microsoft proffered no justification for the first and third of the challenged actions although it did make general claims regarding the benefits of integrating the browser and the operating system. The Court held:

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65 Ibid 90,792.

66 Ibid 90,793.

> Plaintiffs plainly made out a prima facie case of harm to competition in the operating system market by demonstrating that Microsoft's actions increased its browser usage share and thus protected its operating system monopoly from a middleware threat and, for its part, Microsoft failed to meet its burden of showing that its conduct serves a purpose other than protecting its operating system monopoly. Accordingly, we hold that Microsoft's exclusion of IE from the ADD/Remove programs utility and its commingling of browser and operating system source code constitute exclusionary conduct, in violation of s 2.[67]

As regards the second practice, product design to override the user's choice, the Court held:

> The plaintiff bears the burden not only of rebutting a proffered justification but also of demonstrating that the anti-competitive effect of the challenged action outweighs it. In the District Court, plaintiffs appeared to have done neither, let alone both and in any event, upon appeal, offered no rebuttal whatsoever. Accordingly Microsoft may not be held liable for this aspect of its product design. [68]

The integration of Microsoft's browser, Internet Explorer into its operating software was seen as a form of innovation and prima facie pro-competitive. The Court had no problem with simple bundling so long as the licensees were free to unbundle the package and substitute a different web browser. The Court only objected to the conduct aimed at tying which prevented the OEMs from removing the browser.

A similar approach to tying is likely to be adopted under the taking advantage element of s 46 of the TPA. The court is required to examine the counter-factual and ask whether the corporation would be likely to engage in the same conduct if it were operating under competitive conditions.

In most cases the bundling of two products will be warranted by technological developments or by customer demand and a monopolist will not contravene s 46 for doing so. But what if there is a substantial consumer demand for the stand-alone products and the firm decides to withdraw support for the stand-alone products? Is there a good business rationale for discontinuing the stand-alone products in such circumstances? Is the decision to withdraw the stand alone products to be based on cost considerations relative to expected revenues? Will the integrated product be deemed to be a single product or multiple products packaged together?

There is very little in the way of Australian authorities on point although some useful *dicta* is to be found in *Monroe Topple & Associates v Institute of Chartered Accountants.*[69] In that case the applicant was in the business of providing support services such as prescribed reading lists, workshops, and workbooks including solutions to workshop problems to candidates undertaking the 'Professional Year' in order to qualify to apply to become a member of The Institute of Chartered Accountants in Australia (ICAA) and practise as a Chartered Accountant.

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[67] Ibid 90,797.

[68] Ibid 90,797.

[69] (2001) ATPR (Digest) 46-212.

ICAA also sold support materials in competition with the applicant. Candidates paid the ICAA an enrolment fee, but had the option of buying or not buying ICAA's support materials.

The ICAA replaced the Professional Year program with the 'CA program'. For an increased enrolment fee, candidates were now provided automatically with ICAA's support materials. It was alleged that ICAAs conduct, in not permitting the supply of enrolment, examination and certification services to be separately priced or unbundled from the supply of support services, contravened s 46.

There was evidence of rivalry between the ICAA and the Society to attract the best candidates for further training leading to admission and membership of their respective professional bodies.

It was also alleged that there was a 'certification market' – either a narrowly defined Chartered Accountant certification market or a broader certification market for accounting services encompassing both professional bodies.

Finally, it was alleged that there was a market for the supply of 'support services', that is, the supply of course materials and other training support by the professional bodies and private providers to assist candidates to qualify for admission to the professional bodies.

The applicant failed to prove that there was a narrow market for the certification of Chartered Accountants and in the broader certification market for accounting services, MTA accepted that the ICAA did not have a substantial degree of market power. Lindgren J was satisfied that ICAA was constrained by competition from the Society in the certification market and that it did not enjoy a substantial degree of market power. Its market share of the 'certification' market (consisting of the ICAA and the Society) was only a quarter.

Lindgren J applied the High Court's decision in *Melway*. His Honour stated:

> It is not the object of s 46 to protect the private commercial interests of a competitor, perhaps, a fortiori, one whose business is parasitic … on the activities of a professional association.[70]

His Honour provided the following analogy to explain why, in his opinion, MTA's claim under s 46 failed:

> Periodically, a machine needs to be serviced and to have parties replaced. A competitive 'service market' develops. The manufacturer of the machine may or may not have facilitated this development, for example, by supplying information about its product to the participants in the service market, that is, those who have made a business out of manufacturing and supplying the spare parts and servicing the machine.
> The manufacturer decides to cease production of the machine and to start manufacturing another. Existing stocks of spare parts are inappropriate for the new machine, and the employees of the participants in the service market are not trained to service the new machine, although no doubt with time and money, those companies could adapt to it.

70 Ibid [202].

> But the manufacturer has decided to establish a network of service centres equipped with spare parts supplied by the machine manufacturer itself. Worse still for the service industry, the manufacturer has decided, for a small increase in price, to include in the price of the machine all servicing and spare parts it will ever need. The manufacturer has taken the view that this arrangement benefits both itself and its customers.
>
> While it remains possible for participants in the service market to continue in business (customer loyalty and geographical convenience may still favour them to some extent), they predict that the effect of the manufacturer's change of course on their businesses will be disastrous.
>
> In my opinion, the manufacturer has not contravened s 46. It has not taken advantage of substantial market power in the service market for the purpose of preventing competition with it in that market. Rather, it has lawfully exercised its rights as manufacturer. Inherent in its position as manufacturer is the right to abandon one product and to manufacture a new one in its place and to provide servicing and spare parts for it and to sell them and the new product for a single undifferentiated price, even if this forecloses any possibility of the development of a second service market.[71]

One could not conclude from the adverse impact of ICAA's conduct on MTA alone whether the conduct involved a use of market power. One needed to ask whether ICAA would have been likely to engage in this sort of bundling if it were acting in a competitive market. Or, to put the question another way, would ICAA have been likely to engage in bundling if it lacked market power?

Lindgren J, in the passage set out above specifically refers to testing the effect of the conduct on customers or consumers.[72]

So long as a manufacturer is acting in what it perceives to be the best interests of its customers, bundling will not contravene s 46 even if it has an exclusionary effect on competitors in the service market. In other words, so long as the conduct is efficiency enhancing a competitor who is adversely affected by the adoption of a new business strategy, such as bundling two products which were previously supplied separately, has no right to complain under s 46.

The decision was confirmed on appeal by the Full Federal Court.[73]

IX TECHNOLOGICAL TYING: WITHDRAWING SUPPORT TO INDEPENDENT SERVICE ORGANIZATIONS

A related decision a firm must take when a new product is released is whether to service the new product itself or to rely on Independent Service Organizations (ISOs).

To what extent is the firm obliged to lend a helping hand to ISOs? Are ISOs entitled to take a free- ride on its investment in innovation and research and development?

The refusal to license intellectual property rights or disclose confidential information to ISOs is unlikely to contravene s 46(1). The *acquisition* of IP rights is not a taking

71 Ibid [207]-[211].

72 Ibid [209].

73 (2002) ATPR 41-879.

advantage of market power, and a corporation with a substantial degree of market power is under no duty to license its IP rights to competitors.

The policy objective of s 46 is to promote the competitive process for the benefit of consumers. If a corporation has engaged in the risks and expenses of research and development resulting in the grant of IP rights, or the acquisition of confidential know-how about industrial processes and technology, the incentive for engaging in such desirable, pro-competitive conduct would be removed if the corporation were required to share its IP rights or know-how with its competitors. Refusal to license may thus be seen as constituting valid competitive conduct. The corporation has not exercised a right that it would be highly unlikely to exercise or could not afford for commercial reasons to exercise in a competitive market and so does not satisfy the High Court's test of 'taking advantage' set out in the *Queensland Wire* case.

However, if the original equipment market and the repair and service markets are treated as separate markets, and the refusal to license IP rights is seen as an attempt to leverage market power from the product market into the service market, s 46 may be contravened.

In the United States, the courts have expressed differing views when confronted with the issue of whether an original equipment manufacturer (OEM) infringes s 2 of the *Sherman Act* if it refuses to sell or license its patented repair parts or copyrighted software to ISOs.[74]

The holder of an intellectual property right can generally refuse to license it, or decide not to work it, without infringing s 2 of the *Sherman Act.* For example, in *Berkey Photo Inc v Eastman Kodak Co*[75] the Court adopted a high threshold and stated that s 2 of the *Sherman Act* is violated where '…actions are possible or effective only if taken by a firm that dominates its smaller rivals.' [76]

The Court distinguished between refusals to deal and refusals to pre-disclose confidential information. A supplier with only 5% of the market cannot successfully impose terms through threats to refuse to deal because buyers can turn to other suppliers. There is a direct correlation between the market power of the firm refusing to deal and the exclusionary effect. On the other hand, a refusal to pre-disclose confidential information to another competitor does not depend on market power.

However, in the *Eastman Kodak* case the Supreme Court noted that the use of intellectual property rights as a leveraging device would infringe s 2 of the *Sherman Act*.

Leveraging may occur where an equipment manufacturer refuses to sell or license its patented repair parts and copyrighted software to independent service organizations. For example, in *Eastman Kodak Co v Image Technical Services Inc*[77] Kodak originally co-operated with independent service organisations (ISOs) which repaired and serviced its

74 See Herndon, 'Intellectual Property, antitrust, and the economics of after-markets' (2002) *Antitrust Bulletin* 309 (Summer- Fall).

75 603 F 2d 263 (2nd Cir, 1979).

76 Ibid 274-275.

77 504 US 451 (1992).

photocopiers and they flourished. Subsequently, Kodak adopted a more restrictive policy as regards the servicing of its equipment and withdrew its co-operation. It sold replacement parts only to owners of Kodak equipment who serviced the equipment themselves or used Kodak's service.

The District Court granted summary judgment. The Court of Appeals reversed this finding and the Supreme Court affirmed the Court of Appeals. The Supreme Court rejected Kodak's primary argument that competition in the primary market precludes market power in the aftermarket. The Supreme Court accepted that where consumers face significant information and switching costs, they are locked into a particular brand of equipment. The Court concluded:

> In the end, of course, Kodak's arguments may prove to be correct. It may be that its parts, service, and equipment are components of one unified market, or that the equipment market doesn't discipline the after-markets so that all three are priced competitively overall, or that any anti-competitive effects of Kodak's behaviour are outweighed by its competitive effects. But we cannot reach these conclusions as a matter of law on a record this sparse. [78]

Furthermore, the Supreme Court stated:

> …the Court has held many times that power gained through some natural and legal advantage such as a patent, copyright, or business acumen can give rise to liability if 'a seller exploits his dominant position in one market to expand his empire into the next.'[79]

On remand, Kodak was found by the District Court to have used its monopoly over Kodak *parts* to gain a monopoly over the *service* of Kodak equipment contrary to s 2 of the *Sherman Act*. Kodak appealed. However, it seems that it did not particularly emphasize its intellectual property rights justification before the Court of Appeals which led the court to conclude that it was not the real reason for the refusal to deal.[80] There was no valid business justification for the refusal.

By way of contrast, in re *Independent Service Organizations Antitrust Litigation* [81] the Federal Circuit held that 'Xerox was under no obligation to sell or license its patented parts and did not violate the antitrust laws by refusing to do so.'[82] In this case Xerox had patents on key replacement parts, and its manuals, and operating and diagnostic software were the subject of copyright. Xerox announced that it would no longer sell parts for which there were no close substitutes to ISOs, and in 1989 it refused requests for supply of its parts to the ISOs. The ISOs relied on the leveraging theory, arguing that Xerox used its monopoly in the parts market, which was based on its IP rights, to acquire monopoly power in the service market contrary to s 2 of the *Sherman Act*.

The District Court held that Xerox's unilateral refusal to sell or license its patented parts did not constitute patent misuse or unlawful exclusionary conduct under the antitrust

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78 Ibid 471.

79 Ibid 480, fn 29.

80 125 F 3d 1195, at 1218 (9th Cir, 1997).

81 *In re Independent Service Organizations Antitrust Litigation* 203 F.3d 1322 (Fed Cir, 2000) (the *ISO* case).

82 Ibid 1328.

laws.[83] On appeal, the Court of Appeals for the Federal Circuit affirmed the District court's decision that Xerox's patents and copyright gave it the right to exclude specific purchasers.[84] The Federal Circuit takes exclusive jurisdiction over all appeals from district court decisions arising under the patent laws and has jurisdiction over patent/antitrust matters.[85] The Court distinguished the *Kodak* case on the basis that when it came before the Supreme Court it was a tying case and that no patents had been asserted in defence of the antitrust claims against Kodak, whereas there were no claims that Xerox had illegally tied its patented parts to unpatented products.

There is very little Australian authority on point. In order to make out a case for leveraging it would be necessary that the original equipment market was separate and distinct from the market for spare parts. This might not be as easy as it would at first appear. An attempt to do so failed in *Regents Pty Ltd v Subaru (Aust) Pty Ltd.* [86]

It was alleged that Subaru had contravened s 46 by terminating Regents' distributorship and thereafter refusing to supply it with genuine Subaru spare parts and authorize it to re-sell such parts and service Subaru cars. The applicant's case depended on a finding that there was a separate Subaru parts market and relied on the decision of the U S Supreme Court in *Eastman Kodak Co v Image Technical Services Inc* in support of their contention. The respondents contended that the relevant market was the market for the sale of cars and ancillary services in Australia, or alternatively Western Australia, or alternatively the Perth metropolitan area.

R.D. Nicholson J analysed the *Eastman Kodak* decision, which he said stood for the principle that the existence of a separate parts market depended on the 'commercial realities' faced by consumers.[87] There was evidence that was accepted by the respondent and the court that there was strong consumer preference for genuine Subaru spare parts.[88] There was also evidence that only 29 per cent of Subaru spare parts had a non-genuine equivalent. Nevertheless, the court found that the respondent's contentions regarding the relevant product market could be made out on the evidence as a whole:

- There was evidence of cross-elasticity of demand and supply at the *wholesale* level. If the price of Subaru parts was raised, buyers (retailers or parts) switched their patronage to other marques of cars/parts or to non-genuine parts. On the supply side manufacturers of Subaru parts and non-genuine parts could adjust their production plans.
- There was also evidence of cross-elasticity of supply and demand at the *retail* level. Non-genuine parts were not available for the majority of Subaru lines (81 per cent), so that substitution only took place in a few lines. However, these few lines were the high volume lines and there was evidence of strong substitution.
- As regards the inter-relationship between cars and the parts market, it was established that the gross profit margin on parts was around 50 percent while that on the sale of motor vehicles was only 7-14 percent. There were two reasons

83 964 F Supp 1488.
84 203 F 3d 1322, 1328 (Fed Cir, 2000).
85 See Janis, 'Transitions in IP and antitrust', (2002) *Antitrust Bulletin* (Summer-Fall) 253.
86 (1998) ATPR 41-647.
87 Ibid 41,175.
88 Ibid 41,177.

for the substantial difference in profit margins: first, the close and vigorous competition in relation to the supply of new motor vehicles; and secondly, the absence of competition in relation to Subaru parts. His Honour concluded:

> …the high prices of Subaru spare parts result from substantial regard by the respondent to prices of such parts in relation to other marques of cars. It is not therefore open to the inference that the prices only exist due to lack of competition in the market for Subaru parts. Rather the price results from the pricing of parts being competitive with other marques of cars and parts. That is a competition evidencing the interconnection and complementarity of the cars and parts markets, as the case for the respondent contends. [89]

Thus, while the parts of other car manufacturers were not physically substitutable for Subaru parts, in pricing its parts, Subaru nevertheless had regard to the prices of parts for other makes of cars to ensure that consumers did not reject Subaru cars because Subaru parts were too expensive. This finding is difficult to accept given the proven facts that consumers preferred genuine Subaru parts and that no substitutes existed for 81 percent of Subaru parts.

Nevertheless, it can be relied on as authority for the proposition that if computer hardware suppliers have regard to the parts prices of competing equipment manufacturers there may exist the necessary 'interconnection and complementarity' such that equipment and parts form one market and a separate parts market does not exist.

If, on the evidence it is established that there are two separate markets, one for the original equipment and another for spare parts, it will be necessary to demonstrate that the refusal to supply spare parts to ISOs is a taking advantage of market power. If the spare parts are subject to copyright then a refusal to license the copyright, it seems will not constitute a taking advantage of market power. Some support for this view is to be found in the obiter statement of Lindgren J in the *Monroe Topple* case that:

> Inherent in its position as manufacturer is the right to abandon one product and to manufacture a new one in its place and to provide servicing and spare parts for it and to sell them and the new product for a single undifferentiated price, even if this forecloses any possibility of the development of a second service market.[90]

X CONCLUSION

The appraisal of technological tying in the computer industry under s 46 depends on an understanding of the possible anti-competitive consequences and possible benefits for effective competition. Economists regard conduct as pro-competitive if consumers are better off, and anti-competitive if consumers are worse off through higher prices or reduced output or a restriction in choice or lower quality. Thus, tying is to be assessed according to its effect on consumers rather than the foreclosure of competitors. All contracts exclude competitors even in a competitive market. To prohibit conduct that forecloses competitors may deny efficiency enhancing behaviour that benefits consumers.

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89 Ibid 41,181.

90 (2001) ATPR (Digest) 46-212, [211].

Some preliminary questions will need to be considered. Are there two separate products or only one? In the *Subaru* case there was only one product consisting of cars and parts.

If there are two products, does the respondent have a substantial degree of market power in relation to the tying product? What is the anti-competitive effect in the market for the tied product? In the *Monroe Topple* case there were two products, however the tying was held to be pro-competitive because consumers were better off despite the foreclosure of Monroe Topple from the market.

Where the tying takes the form of product integration, it may be justified on the basis that it gives rise to a superior product with new functionalities. This will not be anti-competitive, simply because it harms one or more competitors who lose sales as a result. On the contrary, it is a form of competition on the merits involving greater efficiency and enhanced consumer appeal

Where a firm decides to develop an integrated product and to withdraw the stand-alone components from the market, it will need to give consideration to the level of customer demand for the stand-alone products. If there is a continued demand for the stand-alone components, they are likely to be seen as separate products. The decision to withdraw the stand-alone components may be seen as coercive and a form of tying which is not beneficial to consumers.

Similar considerations apply in relation to tying product sales with repair and service. The firm will need to justify the conduct in terms of increased benefits to consumers and the costs associated with continuing to assist independent service organizations.