# Stirling Harbour Services v Bunbury Port Authority: A Review of Some Economic Issues

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A paper prepared for the 2nd Australian Business Law Workshop, 11 May 2001

*(*) I am grateful to Jason Soon for his very valuable assistance in preparing this paper and to Eric Ralph and Justus Haucap for their comments.*

1. The purpose of this paper is to review the case of Stirling Harbour Services Pty Limited v Bunbury Port Authority as it was decided at first instance and then on appeal by the Federal Court. The paper will look at the questions, the main elements of the answers and some of the issues raised by the answers in this case. It will do this with a view towards evaluating the Court's discussion of economic concepts and its ultimate judgement on the main issue of whether the impugned conduct in this case had led to a 'substantial lessening of competition'.

2. The decisions at first instance and on appeal are of greatest importance because they clarify the meaning of, and proper tests for, whether conduct has the effect or likely effect of substantially lessening competition – a central concept in competition law in Australia and New Zealand. The decisions are also notable in their use of complex economic concepts, most particularly natural monopoly, contestability and strategic entry deterrence.

3. In **Section 1**, I briefly review the facts of the case. In **Section 2**, I list the main issues and the central contentions of the parties involved. Given that the main issue hinged on the Court's comparison between the state of competition in the relevant market with and without the impugned conduct, in the following sections I discuss the Court's evaluation of the state of competition in that order. In **Section 3**, under the heading of **Contestability and the relevant market**, I focus on the Court's discussion of the state of competition in the relevant market without the impugned conduct. This is followed by **Section 4**, which, under the heading of **The impact of an exclusive licence**, focuses on the Court's discussion of the likely state of competition in the relevant market with the impugned conduct. In **Section 5**, I conclude.

## 1. Background

4. Stirling Marine Services (SMS) is a subsidiary of Stirling Harbour Services Pty Limited (SHS), which is a company owned in shares of 50 per cent each by Adsteam Marine Limited and Howard Smith Limited. SMS supplied towage services in the Port of Bunbury pursuant to a licence granted by Bunbury Port

Authority ("**BPA**") in 1986 for a term of 14 years, determinable on two years notice. The licence was non-exclusive but SMS was the sole provider of the services in question for at least the 10 years prior to the proceedings.

5. On 24 February 1998, a meeting of the Board of the BPA was held. Among the matters discussed at that meeting was the tug services agreement with SMS, which was due to expire on 30 June 1999. The Board resolved to give SMS the appropriate 2 years notice in accordance with the contract, advising expiry of the contract and that tenders would be administered for the service. The decision was confirmed in writing with SMS on 16 March 1998.

6. On 17 July 1999 the BPA advertised both nationally and internationally for submission of tenders for an exclusive licence for a term of 5 years from 1 July 2000 to provide towage services in Port Bunbury, with an option for a 2 year extension, subject to compliance with other conditions. There were 11 responses and by the closing date for tenders on 9 September 1999, 6 tenders had been received, including one by SHS, albeit under protest.

7. On 6 September 1999, an application was filed in the federal court by SHS and Adsteam Marine Limited ("**Adsteam**"), claiming relief under ss. 80 and 87 of the *Trade Practices Act 1974* (Cth) ("**the Act**"). They sought a declaration that the letting of the proposed tender would be contrary to law in that it would involve a contravention by the BPA of ss 45, 46 and 47 of the *Trade Practices Act* and of the *Competition Code*. French, J., sitting in the Federal Court on 28 January 2000 rejected the application. SHS and Adsteam appealed the decision. The appeal was heard by Burchett, Carr and Hely, JJ. in the Federal Court on 29 September 2000 and rejected.

**2. Central issues and main contentions**

8. The central issue in the proceedings was conveniently summarised in the following terms:

> … the substantial issue was whether the entry into of a licence agreement with the successful tenderer has the purpose, or is likely to have the effect, of substantially lessening competition in the market for the provision of towage services in the Port of Bunbury.[1, 2]

9. The relevant test was also conveniently summarised by the Full Court:

> Conduct has the effect of lessening competition in a market only if it involves a reduction in the level of competition which would otherwise have existed in that market but for the conduct in question.[3]
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> ...in determining whether the proposed conduct has the purpose, or has or is likely to have the effect, of substantially lessening competition in the relevant market, the Court has to:
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> > consider the likely state of future competition in the market "with and without" the impugned conduct; and
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> > on the basis of such consideration, conclude whether the conduct has the proscribed anti-competitive purpose or effect.[4]

10. Adsteam contended that though the relevant market was a natural monopoly, it was one in which the incumbent operator was continuously subject to the risk of displacement, because entry and exit barriers were low. As a result, its operations at Bunbury were effectively constrained by market disciplines, from which can be inferred that they were likely to yield outcomes similar to those that would have been observed in a workably competitive market. In contrast, competition under the exclusive license would be limited to the phase prior to the issuing of that license, that is, to the bidding process. By its discontinuous nature, and the protection accorded the licensee during the exclusive term, that

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1 For ease of referencing, I will refer to the decisions in the following way: "Jan" refers to the decision at first instance; "S1" to refer to the Reasons for Judgement of Burchett and Hely JJ; and "S2" to refer to the Reasons for Judgement of Carr J.

2 S1 at ¶ 9.

3 S1 at ¶ 66.

4 S1 at ¶ 12.

competition would be substantially less than that previously prevailing, and hence involved a breach of the Act.

11. BPA agreed that the relevant market was a natural monopoly but contended that that monopoly was not exposed to a realistic threat of displacement. Entry and exit barriers were material and resulted from the capital costs required to obtain tugs, from the established relations between the incumbent and its customers and from the risk that the incumbent would respond aggressively to entry. These barriers in turn allowed the incumbent to profitably set prices for its services above the competitive level. In contrast, a tender would allow BPA to elicit competitive bids for the service, providing durable benefits in the form of lower prices to users. That competition would be substantial and would have on-going effects, as prices during the exclusive period would be constrained by the bids made. As a result, competition would not be lessened but promoted.

12. The Federal Court, both at first instance and on appeal, substantially adopted the contentions advanced by BPA. These contentions, and the specific reasons for which they were adopted, nonetheless raise concerns that are outlined below.

**3. Contestability and the relevant market**

13. The proceedings turned on a comparison of the extent of competition under a non-exclusive license on the one hand and an exclusive license on the other.

14. It was noted at first instance that "It was common ground that the relevant market was the market for the provision of towage services and for the right to provide such services at the Port of Bunbury",[5] though "Absent concessions there might be a case for a broader definition of the relevant market".[6]

15. Accepting for the current purpose the market as defined, to what extent was that market exposed to competitive disciplines?

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5 J at ¶ 50.
6 J at ¶ 111.

16. It was accepted by the parties that the market at issue is a natural monopoly, that is:

> .. a market which could only support one supplier of the relevant services. In this case, that circumstance resulted from the volume of demand not being sufficiently high to enable more than one supplier to cover its costs.[7]

17. The competitive pressures bearing on this market were then debated in terms of whether it was "more" or "less" contestable, with the conclusion being that "the market was at best only weakly contestable".[8] From an economic point of view, however, contestability refers to a situation in which the sunk costs involved in entry are so low, relative to the time it takes an incumbent to respond to entry, that entry will occur whenever the incumbent's revenues prior to entry exceed total costs. In that sense, contestability is a 'razor's edge' attribute, which a market either does, or does not, possess.[9] Nonetheless, it is clear that the term "contestability" is used in the proceedings in the looser sense of "more or less exposed to entry".

18. In considering the disciplines bearing on the incumbent, it is convenient to consider first, the question of whether the structural characteristics of the market were such as to create barriers to entry and exit; and second, whether there was evidence of such barriers in the behaviour of the incumbent and in market outcomes.

***Market structure and entry barriers***

19. From an economic point of view, entry barriers are simply factors that allow an incumbent firm to earn monopoly profits – that is, profits that arise from market power. The essence of an entry barrier is that it involves an asymmetry between

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7 S2 at ¶ 87.

8 S2 at ¶ 94.

9 See Schwartz and Reynolds, American Economic Review, 1983, 73 (3) June 488-90, and Schwartz, Oxford Economic Papers, 1986, 38, pp.37-57. The "razor's edge" aspect of contestability arises from the fact that if the expected value of entry is positive, it will occur regardless of whether the incumbent's pre-entry profit is large or small; conversely, if the expected value of entry is negative, no matter how large the pre-entry profit may be, entry will not occur.

the incumbent and potential entrants; absent such an asymmetry, any monopoly profits accruing to the incumbent would be exposed to being competed away.

20. The looser approach adopted in the decisions, and most notably by Justice Carr, to the effect that:

> …it would be appropriate to regard anything which impedes ready entry into the market as being a barrier to entry[10]

can readily mislead. This is because it focuses on the difficulties entrants face in the abstract, rather than concentrating on what it is that makes entrants *less well placed* than is the incumbent to serve the market.

21. Adsteam submitted that, properly defined, the barriers to entry into the market were low.[11] Adsteam's contentions in this respect were not accepted essentially for three reasons: doubts as to whether the sunk costs associated with procuring tugs were low; claims that Adsteam could rely on established relations with clients; and claims that entrants would be deterred by the threat that Adsteam would react aggressively to entry.

22. The bulk of the capital costs involved in providing the services at issue are accounted for by the purchase of tugs. There seems little doubt that there is an international market for tugs, including second hand tugs, and that the costs involved in modifying tugs for use as between different markets are low relative to tugs' "new build" cost. Justice Carr nonetheless would not draw from this the inference that the sunk costs involved in entry were likely to be low, because despite the existence of a second hand market:

> there was a risk of significant loss or substantial transaction costs if an unsuccessful entrant had to dispose of its tugs. Indeed, as counsel for the

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10 S2 at ¶ 108.
11 J at ¶ 55.

> respondent suggested to us, the existence of such a risk **is a matter of commonsense, hardly needing evidence**.[12]

This is difficult to accept. While any market involves some risk, there were no claims that prices in the market for tugs were exposed to particularly serious fluctuations. And even if there had been such fluctuations, firms operating in several markets would to some degree be insured against losses from those fluctuations by the ability to redeploy the tugs as between alternative uses. The inference that Adsteam drew, that the capital costs involved in acquiring tugs could not be counted as a material barrier to entry, seems inescapable.[13]

23. A second entry barrier pointed to in the decisions relates to "the incumbent's established connection with shipping operators, particularly through its volume rebate agreements"[14], to "client inertia"[15] and, even more loosely, to the claim made by a witness on behalf of BPA that:

> "...nobody wants to use you first when you are trying to break into a new business, especially in the port situation around Australia."[16]

Again, these arguments seem difficult to accept. Volume rebates are simply a form of price discount, and there was no evidence that an efficient competitor, even if it operated only at a single port, could not match the prices Adsteam offered. If Adsteam could charge higher prices than potential rivals because it had a superior "understanding of the systems and processes of client(s)"[17] or an established reputation for providing reliable service, the resulting earnings were not monopoly rents, nor were the factors that allowed those earnings to persist entry barriers. Rather, such advantages are merely a form of differential efficiency, and the returns on them are the returns to the investments securing such efficiency requires. Indeed, from a wider point of view, society gains rather

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12 S2 at ¶ 107, emphasis added.
13 This seems to have been accepted by Professor Williams, an economist who appeared on behalf of BPA – see J at ¶ 99.
14 S1 at ¶ 49.
15 J at ¶ 54.
16 J at ¶ 53.
17 J at ¶ 54.

than loses when more efficient firms secure higher returns than their less efficient rivals.

24. Given the weaknesses set out above, it is unsurprising that the greatest weight was placed by the Court, both at first instance and on appeal, on the costs an entrant would face "fighting an entry battle with a determined incumbent"[18]. These costs and their deterring effect on entry, it was said, would "allow the incumbent to set a price at a level which is higher than the prices which might be charged in a fully competitive market, but which is low enough to deter entry by a competitor"[19] – that is, in economic terms, to "limit price". At first instance, the underlying theory, as put by the economic experts called by BPA (Professors Williams and Kolsen) was summarised in the following terms:

> .. the barriers to entry, at the very least the cost of fighting the entry battle with a determined incumbent, provide the basis of a margin of support for a higher than competitive price to be charged by the incumbent which may nevertheless be sufficient to deter entry.[20]

Expressed at its simplest, the risk of predatory conduct by the incumbent in the face of entry would allow it to profitably maintain prices above the competitive levels.

25. Economic theory certainly identifies conditions under which predatory pricing can occur and also under which limit pricing may be observed – these conditions being related in fundamental respects. However, it is at least questionable whether proper consideration was given to the applicability of those conditions to the facts at hand.

26. To begin with, how plausible is the threat of predation in a market in which few or no sunk assets are required to participate? The answer is surely not at all.[21] A predatory strategy cannot be credible in such a market for three reasons: first,

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18 S1 at ¶ 40.
19 Ibid.
20 J at ¶ 104.
21 See Milgrom and Roberts, *Journal of Economic Theory*, 1982, (27): 280-312.

because the entrant can more or less promptly redeploy the assets at issue, the damage the incumbent can cause is limited; second, because the incumbent could otherwise be using those assets elsewhere, the opportunity cost to it of slashing price is high; and third, again because the assets are fungible, any attempt by the incumbent to eventually recoup any losses incurred will be vulnerable to new entry. As all of these facts will be known to all of the relevant players, a threat of predatory conduct by the incumbent cannot be regarded as credible.

27. Even putting aside predation, could an incumbent in such a market nonetheless rely on limit pricing to secure and protect monopoly rents? Again, the answer is surely not. Whether entry occurs depends on the entrant's expectation of prices post-entry, not on prices prior to entry. Pre-entry prices are only relevant to the extent to which they can shape expectations of market behaviour once entry has occurred. Where (1) there are sunk costs involved in entry, and (2) information is incomplete, in the sense that the entrant is uncertain as to demand or cost conditions that are known to the incumbent, then the incumbent may be able to set pre-entry prices in such a way as to signal that it can operate in the market more successfully than the entrant – for example, because of uniquely lower costs.[22] However, in the market at issue, sunk costs are low and information, especially as to costs, seems readily available. It is consequently difficult to see how expectations as to future conduct could be manipulated through the setting of pre-entry prices.

28. The implausibility of these strategies is even clearer when full account is taken of the structure of the market and of the strategies open to an entrant. More specifically, the buying side of the market is accounted for by a relatively small number of players. Evidence was given and accepted that typically the customers are:

> ..global operators with extensive experience of ports and towage providers worldwide. They maintain comparative records of service and costing levels and use those to place pressure on Adsteam to reduce the cost of towage and

[22] See Kreps A Course in Microeconomic Theory, 1990, at pages 468 and follows.

> to improve service levels. In some cases, they have towage operations in their home countries. In Frederick's opinion, the capacity exists within many of them to establish their own towage operations in Australian ports if there were an incentive to do so …shipping representatives will make references to prices charged by other ports in the context of such negotiations. He is also aware that these customers receive regular inquiries from other towage service providers.[23]

Had the incumbent shown any sign of monopoly pricing, these customers would surely have had strong incentives to, as well as the ability to, enter into long term contracts with an alternative supplier.[24] Equally, an entrant offering genuinely better terms than the incumbent could insure itself against the "losses associated with the cost of competition against a determined incumbent"[25] by securing such contracts on a long term basis. The lack of attention paid to this possibility both in the evidence provided by the economic experts for BPA and by the Court is striking.

29. Does it matter, in considering these issues, that Adsteam operates across a range of ports, so that its conduct would be influenced by "interests which transcend its immediate interests in the Port of Bunbury and include strategic concerns related to its position throughout Australia and perhaps even globally"?[26] Economic analysis would say that in the absence of significant sunk assets and of incomplete information, the multi-market nature of the interaction is unlikely to have any significant effect on behaviour – for, as is shown in one of the most influential papers in post-war economic theory, an entrant would know that the incumbent could not in those circumstances afford to combat market entry each time entry occurred.[27] But even if this is put aside, the impact of multi-market contact cuts both ways. For just as the incumbent has an interest in defending its overall position, so too do customers that operate across a range of markets and

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23 J at ¶ 56.

24 See Innes and Sexton, American Economic Review, 1994 (84): 566-84 and Sewell Plastics Inc. v Coca-Cola Co., 720 F Supp. 1196 (NC 1989), aff'd, 912 F2d 463 (4th Cir. 1990).

25 J at ¶ 107.

26 Ibid.

27 Selten, Theory and Decision, 1978 (9): 127-59.

entrants considering entry into a range of markets. As the wider dimension of the game raises the stakes for both sides, it cannot properly be concluded, as the Court seemed to do, that it necessarily advantages the incumbent.

30. Overall, the analytical and empirical basis underpinning the Court's analysis of the structural characteristics of the market and of the extent of the resulting entry barriers seems significantly open to question.

***Market conduct***

31. Because assessments of market structure are inevitably complex and controversial, it is generally important to also pay close attention to market conduct and performance – that is, to the way in which the market at issue has operated. In particular, the question is whether the behaviour of the market is consistent with that one would expect to observe in the presence of effective or workable competition.

32. In the case at hand, attention seems to have focussed on two indicators. The first is the behaviour of prices; the second, the extent of entry. The Court concluded that both of these pointed to an absence of effective competition. Closer examination, however, casts doubt on the validity of this conclusion.

33. In considering market outcomes, it is natural to ask, when faced with a claim that a firm has a substantial degree of market power, whether there is any evidence of monopoly rents. It seems unlikely that a firm would have such a degree of power and yet not use it either to raise price or benefit in some other tangible way.

34. It is accepted that there was no "direct financial evidence that SMS had been earning monopoly profits."[28] There was, in other words, no evidence that went directly to the reasonableness of the level of prices. Given this, the Court might have done well to examine whether the pattern of change in prices was or was not consistent with workable competition.

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[28] S1 at ¶ 47.

35. Charges for the service had been stable for some time in nominal terms, with the result that, in inflation-corrected terms, they had declined by around 2.5 per cent a year since the late 1980s.[29] Given that in a competitive market, prices will decline in line with productivity, it is worth noting that this rate of decline is more than double the rate of growth in multi-factor productivity for the Australian transport sector over the period, and 2.5 times the rate of growth in multi-factor productivity for the Australian economy as a whole.[30]

36. This performance seems all the more remarkable for two reasons.

37. The first is that the Court accepted the evidence of Professor Kolsen, an economic expert for BPA, to the effect that the price elasticity of demand for the service was low.[31] When demand is inelastic, a firm with substantial market power will mark prices steeply above costs, so that there should have been ample evidence of monopoly rents. Additionally, even a monopolist, when faced with productivity increases, will pass some of these on to consumers; but the pass-through will be small. As a result, if Adsteam was effectively insulated from competition, it is unlikely to have reduced prices to any significant extent.

38. Second, the Court found (A) that "provision of towage services is essentially a fixed cost business" in which "prices should decrease with volume increases",[32] and (B) that "the volume of towage services required at the Port is historically relatively stable and unlikely to undergo any significant increase in the foreseeable future."[33] As a result, on the Court's own theory, price declines would not have been expected – yet were observed.

39. This, one would think, might point the Court towards competitive factors forcing prices down. It is relevant here that "there was some evidence from Mr Frederick and from other witnesses such as Messrs Riordan (Brambles) and Fletcher (P and

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29 S1 at ¶ 5.

30 Forsyth in Reserve Bank of Australia (Gruen and Shresta, editors) The Australian Economy in the 1990s, 2000, at pages 237-38.

31 J at ¶ 107.

32 S1 at ¶ 5.

33 J at ¶ 116.

O) that they are constrained to act efficiently because they are always looking over their shoulder for potential entrants."[34] Nonetheless, this evidence was dismissed as being "in the nature of a subjective assertion or argument."[35]

40. Rather, the Court, effectively setting aside the evidence from price trends, relied on the subjective assertion of BPA's Chief Executive Officer "that 'there is an opportunity there' for price reduction."[36]

41. In addition to prices, considerable emphasis was placed on the extent of entry. Justice Carr, for example, said that:

> In some 14 years no competitor had emerged. It was quite clearly open to his Honour to disbelieve Mr Frederick's evidence that Adsteam was constrained in its behaviour in the Port of Bunbury by the perception of threatened competition, when so much time had passed without the threat becoming a reality.[37]

42. In interpreting this fact, the Court seems to have been influenced by views put by Professor Williams. In cross-examination, he said:

> "If somebody perceives a threat of entry and to deter that threat becoming a reality puts their prices down, would one not see that? --- Yes, but the point of the argument is that because the incumbent is able to lower prices when it sees the new entrant, you won't observe entry.
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> So that they will set their prices sufficiently low to deter a competitive entry? --- No. They will set them high, higher than the competitive level, but because any potential entrant when doing its feasibility study will know that the incumbent is able to decrease prices as soon as it appears on the horizon, it will never appear on the horizon so we'll never observe the up and down of the prices.

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34 S1 at ¶ 45.
35 Ibid.
36 Ibid.
37 S2 at ¶ 103.

> Have you ever heard anybody say that that's the reason that they don't enter a towage market? --- Yes, I heard a number of people, as I said earlier, say that that is the reason why nobody has entered the Port of Bunbury - one reason why nobody has entered the Port of Bunbury over the last 10 years."[38]

In other words, no entry occurred because limit pricing made entry unattractive – which establishes that the market at issue cannot be effectively competitive.

43. Even putting aside the essentially legal issue of whether what Professor Williams has "heard" is evidence (much less expert evidence), there are two problems with this line of argument from an economic point of view. The first, discussed above, is that none of the analytical predicates for limit pricing seem to have been established. But second and perhaps even more important, the fact that entry had not occurred is surely at least as consistent with Adsteam's contentions, as it is with those put forward by BPA. In effect, if Adsteam was indeed "constrained to act efficiently"[39], with the result that prices were set at competitive levels, no entry would have been observed. It is consequently not reasonable to infer merely from the fact that entry did not occur that, in Professor Williams' words, the market at issue was a "fundamentally non-competitive environment".[40]

44. Overall, the reasons given for dismissing Adsteam's contention that it was subject to the disciplines exercised by the threat of entry seem flawed, both in terms of the underlying structural determinants of "contestability" and in terms of market behaviour.

**4. The impact of an exclusive license**

45. As noted above, the central issue in the proceedings was a comparison of the market with and without the conduct at issue – that is, the grant of an exclusive license. It is therefore important to consider the Court's assessment of the impact of the exclusive license on market behaviour.

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38 S1 at ¶ 57.
39 S1 at ¶ 45.
40 J at ¶ 101.

46. Essentially, the grant of an exclusive license was seen as a form of "competition **for** the market" that would supplant an ineffectual "competition **in** the market". More specifically, it was said that:

> The absence of competition **in** the market is sought to be overcome by competition **for** the market.[41]

47. The terms competition "for" and "in" the market have a long history in economics. The distinction was first drawn by the Victorian social reformer, Edwin Chatwick (1800-1890) in an article published in 1859. Chadwick argued that in a wide range of activities, the failure of markets to work effectively could be cured through centrally administered competitions "for the field".[42] Rival firms, in bidding to secure the market as a whole, would set prices at cost, while regulation could be used to ensure adequate service quality. Although discussed by J. S. Mill,[43] and practiced in parts of continental Europe,[44] Chadwick's views were largely forgotten until an influential article by Demsetz.[45] In that article, Demsetz argued that franchise bidding for natural monopolies, as originally proposed by Chadwick, could make direct regulation unnecessary, while being more effective than known means of regulation in protecting the consumer interest.

48. Demsetz recognised that all franchise bidding involved the determination of a contract between the licensing agency and the franchisee. "Because of the difficulty of devising suitable contracts"[46], the process could yield outcomes that fell short of the competitive ideal. Particular problems attach to the monitoring and enforcement of efficient behaviour during the period of the exclusivity, as market forces would not act as a corrective mechanism. Also, if an incumbent operator gained advantages from incumbency in seeking contract renewal, then the strong competition that might have surrounded the initial grant would

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41 S1 at ¶ 21.
42 Chadwick, Journal of the Royal Statistical Society, 1859 (22):381.
43 See Pedro Schwatrz, Economica, 1966 (33): 71.
44 See Schmalensee The Control of Natural Monopolies, 1979: 67-84.
45 Demsetz, Journal of Law & Economics, 1968 (11): 55.
46 Demsetz, Journal of Political Economy, 1971 (79): 356 at 357.

progressively weaken. As it did, the outcome under franchise bidding would approach that yielded by an unregulated monopoly.[47]

49. As a result, it cannot be said that franchise bidding will necessarily result in an improvement in market performance. Where it suppresses competition in the market, be that competition actual or potential, some harm will likely result from the rigidities any form of exclusivity is likely to involve; that harm needs to be weighed against any gains competition for the franchise may bring.

50. In considering these issues, the Court seemed to start from the premise that the competition in the market was inadequate if not completely inexistent:

> ..the issue is not whether competition **for** a market is a perfect substitute for competition **in** a market. As Professor Kolsen said there is no perfect solution to the problems of a limited market protected in various ways from direct competition. The identified "defects" are obvious problems likely to be encountered when it is sought to replicate competitive outcomes for a market in which there is no competition.[48]

However true this may be, it cannot eliminate the need to examine quite how well the proposed competition for the market would work, and compare the nature and effects of competition under that scenario with the alternative of continuing the prior arrangements.

51. In practice, the Court made three points in this respect. Each seems to go in the direction of showing the superiority of competition for the market over the existing alternative; but on closer assessment, each is problematic.

52. The first indicator pointed to is the substantial number of firms that the tender process attracted. This was most strongly expressed by Justice Carr, though he was merely echoing views also put at first instance and by his colleagues on the Full Court. Having referred to the large number of firms interested in the tender, he went on to say that:

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47 See generally Williamson The Economic Institutions of Capitalism, 1985.
48 S1 at ¶ 63.

> The weight of the evidence from the would-be competitors was that it was the prospect of obtaining an exclusive licence which caused them to be interested in tendering.[49]

53. This may well be true, but it hardly confirms the desirability of issuing such a license. It is surely unsurprising that a number of firms will be attracted by the right to be a monopolist, and will bid for that right. Interest by a number of bidders may help secure a more competitive outcome for the tender; but whether the results will be in the public interest cannot be evaluated without some attention to the precise arrangements that it is proposed to put in place.

54. A second indicator, directly related to the query put immediately above, related to the prices likely to result from the tender. More specifically, it was found that the tender was likely to result in gains for users of the port:

> The likely implication of the tender process is that the towage charges in the Port of Bunbury will fall as tenderers compete for the right to service the market.[50]

55. It appears that firms were expected to bid the prices they would charge users, and that these charges were to embody ongoing declines. However:

> The tender documents do not contain any entitlement on the part of BPA to terminate the licence in the event that the licensee fails to implement proposed "reduction in costs to port users", as this is not identified as a "critical KPI", and BPA's entitlement to terminate the licence prematurely for failure to meet a KPI is limited to a "critical KPI".[51]

56. Moreover, even if charges fell, this cannot be regarded as evidence of increases in efficiency. Consider an industry that operates according to a **U**-shaped average cost curve, but where the size of the market is such that though marginal costs are higher than average costs at the efficient scale of output, the market as a whole is most efficiently served by a single operator. This seems a reasonable

[49] S2 at ¶ 94.
[50] S1 at ¶ 21.
[51] S1 at ¶ 28.

characterisation of markets such as the one at issue, where capacity is provided in strictly replicable lumps. A Chadwick-Demsetz auction will, in general, result in firms bidding in their average costs, with price being set to the lowest average cost bid in. That average cost may well be lower than marginal cost at the resulting level of demand, and hence will be lower than the price that would prevail under first-best pricing. Output will be higher than would otherwise have been the case, but welfare need not be.[52] Indeed, despite the strong claims that seem to have been made by the economists retained by BPA, it can be readily shown that the mere fact that some vaguely described bidding process yields no profit to the winning supplier imports no presumptions whatsoever as to resulting welfare impacts.[53]

57. Finally, it was argued that the gains from competition for the market would be on-going, both during the period of the exclusive license and from one license period to the next.

58. With respect to pricing during the period of exclusivity, this is difficult to judge without knowledge of the precise terms of the contract. There is nothing in the decisions which indicates a faster rate of price falls than characterised the pre-existing trend. The Court asserted that:

> The initial competitive impulse generated by the tendering process should be supported at a later stage during the term of the licence by commercial pressure on the successful tenderer to continue to look more attractive to shipping operators and BPA than any other likely bidder upon the renewal or regrant of the licence.[54]

However, as a matter of economics, whether the licensee in fact has such an incentive depends on the gains from the chance of contract renewal relative to the sure benefits from securing higher margins in the immediate. Since the Court

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52 See Telser, Journal of Political Economy, 1969 (77): 937.
53 Telser, Journal of Political Economy, 1971 (79): 364.
54 S1 at ¶ 23.

had no way of assessing this trade-off, it is difficult to see how it could legitimately come to the conclusion it expressed.

59. Also with respect to outcomes during the period of the exclusivity, it was said that:

> there is an incentive to reduce costs and increase efficiency even under a fixed price regime in order to increase returns.[55]

This is true, but irrelevant. In effect, what seems to have been proposed, although not fully set out, was some type of sharing scheme, in which productivity benefits would to some extent be passed on.[56] The incentives to increase efficiency would therefore not be those of a fixed price scheme but rather those under some variant of a sliding scale. Under almost any conceivable such scheme, these would be weaker than those that characterised the market as it operated without the exclusive license. Additionally, the fact that the terms of the exclusivity would be renegotiated each 5 to 7 years meant that behaviour in each period would affect base prices in the subsequent period, creating a further means by which efficiency gains would be redistributed away from the licensee. This too would blunt the incentives to innovate relative to the unregulated alternative.

60. The Court's conclusions with respect to behaviour during the period of exclusivity, and the comparison of that behaviour with the unregulated alternative, consequently rest on somewhat shaky foundations.

61. With respect to the intensity of competition in successive periods, it was said that the competition that would characterise the initial grant "will be repeated each time the licence is due for renewal."[57] As was recognised by Professor Williams, this depended on the assumption that incumbency would not confer a material advantage in subsequent license renewals. More specifically:

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55 J at ¶ 119.
56 See J at ¶ 75.
57 S1 at ¶ 21.

> Relying upon what Frederick said, Williams concluded that the potential limitation to competition for the market based on sunk costs and the advantages of incumbency did not apply. On the other hand if sunk costs were significant it would be expected that potential entrants would be unable to match the bid of the incumbent. In this case the advantage would accrue to the incumbent.[58]

This argument encounters obvious difficulties. In particular, if it is the case that the sunk costs are in fact very low – so that subsequent license grants will not be distorted by incumbency – then how can there be material barriers to entry? In other words, if this argument is correct, then the claim that the market without the exclusive license is not exposed to competitive disciplines cannot be. The inconsistency between these positions must call in to question the conclusion the Court reached.

**5. Conclusion**

62. The decisions reviewed here apply complex economic concepts to difficult questions. Inevitably, there will be differences of view as to whether they have been applied properly.

63. Perhaps the main merit of the case is that the Court clearly articulated the relevant tests, most notably for the assessment of whether conduct had the effect or likely effect of substantially lessening competition. These centre on a comparison between the world with and without the conduct.

64. The analysis set out above focuses on that comparison. It concludes that serious doubts can be expressed as to the reasons given for the finding that the relevant market was not exposed to the threat of entry. Equally, the finding that performance would be superior under the proposed exclusivity rests on numerous assumptions, not all of them adequately tested.

65. Without access to the primary evidence, it is not possible to say whether, from an economic point of view, the conduct would nonetheless have the effect or likely

[58] J at ¶ 102.

effect of substantially lessening competition. An analysis of a judicial decision, confined to the facts as selected and portrayed in that decision, can only assess the decision's cogency. The ultimate facts, to the extent to which such a concept has meaning, are inevitably beyond the analyst's grasp. However, it is open to the analyst to conclude that the decision itself reveals numerous flaws, most notably in the use of the economic concepts on which the Court seems to have relied.