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# Mechanics of Market Definition

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Should you pick up a newspaper or watch the evening news, chances are you will see or hear a story about the *Trade Practices Act 1974* (Cth) (the TPA) or its administering body, the Australian Competition and Consumer Commission (the ACCC). Whether the details involve claims of price fixing in a particular industry, a planned merger between competing firms, a refusal by a powerful corporation to deal with others in the chain of supply, or other allegations of anti-competitive behaviour, invariably the provisions of the TPA will be relevant.

The stated object of the TPA is 'to enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection'. To achieve this end, the provisions of Part IV of the Act, which are intended to stamp out 'Restrictive Trade Practices', prohibit companies in Australia from engaging in conduct (such as collusive behaviour by a cartel of corporations) that will 'substantially lessen competition'.

However, as any economist will tell you, competition between rival firms takes place in a market. Hence it is impossible to assess the level of competitive activity between firms, or the effects of particular conduct on a certain level of competition, without first identifying the boundaries of the relevant market. This is why market definition is accepted as the crucial first step in competition analysis under Part IV of the TPA.

In *Dowling v Dalgety Australia Ltd*,<sup>1</sup> Lockhart J of the Federal Court recognised as much in the following comment:

'As is often said, "market" is an instrumental concept, designed to assist in the analysis of processes of competition and sources of market power.'<sup>2</sup>

In fact, the point deserves further and forceful emphasis. The practical reality is that the effective operation of the TPA hinges on accurate market definition in every case. Otherwise, as Burchett J noted at first instance in *News Ltd v Australian Rugby Football League Ltd*<sup>3</sup> (the Super League case), 'the identification of too narrow or too broad a market will completely distort the picture gained of the competitive forces at work.'<sup>4</sup>

The potential for distortion arises because, as a general rule, the more narrowly the market is defined, the greater the likelihood that anti-competitive breaches of the TPA will be established. Conversely, broad market definitions tend to limit the potential applicability of the Act.

## **Substitutability is the key**

The TPA itself does not attempt to comprehensively define the term 'market'. Section 4E of the Act merely states that '*market* means a market in Australia and, when used in

relation to any goods or services, includes a market for those goods or services and other goods or services that are substitutable for, or otherwise competitive with, the first-mentioned goods or services.’ We must therefore look to decisions of the Australian Competition Tribunal (previously incarnated as the Trade Practices Tribunal) and the courts when considering how the scope of a market for goods or services is delineated.

What s 4E does make very clear is that the notion of *substitutability* is central to the concept of ‘market’. This was confirmed in a 1976 decision, *Re Queensland Co-operative Milling Association Ltd*<sup>5</sup> (the *QCMA* case), in which the Trade Practices Tribunal said:

‘A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them ... Within the bounds of a market there is substitution – substitution between one product and another, and between one source of supply and another, in response to changing prices. So a market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive ... Accordingly, in determining the outer boundaries of the market we ask a quite simple but fundamental question: If the firm were to “give less and charge more” would there be, to put the matter colloquially, much of a reaction? And if so, from whom?’<sup>6</sup>

The *QCMA* case sets out the basic approach to defining a market in Australia, and it is difficult to improve on the explanation cited above. More than a decade later, the High Court’s endorsement of this approach was plain in *Queensland Wire Industries Pty Ltd v BHP Co Ltd*.<sup>7</sup>

At the heart of the *QCMA* approach is the SSNIP (Small but Significant Non-transitory Increase in Price) test, which asks these questions: What happens if the price of a certain product increases by 5-10%? Will there be a switch to other products?



The SSNIP test is concerned with substitution possibilities on both the demand side and the supply side. On the demand side, the question is whether consumers would change from one product to another in response to changing prices. On the supply side, the question is whether producers would substitute production of one product for another in response to changing prices.

In the High Court’s 2003 decision in *Boral Besser Masonry Ltd v ACCC*,<sup>8</sup> McHugh J specifically reinforced the importance of demand and supply side substitutability to the concept of a ‘market’ by saying:

‘[T]he market is the area of actual and potential ... interaction between producers and consumers where given the right incentive – a change in price or terms of sale – substitution will occur. That is to say, either producers will produce another similar product or consumers will purchase an alternative but similar product.’<sup>9</sup>

Furthermore, the repeat reference in the above passage to ‘similar product’ suggests that effective ‘substitution’ depends on the presence of *close* substitutes. In other words, for products to form part of the same market, they must be shown to be *close* or *good* substitutes for each other.

In determining the outer boundaries of a market, it is necessary to look for a ‘break’ in the substitution possibilities. That is to say, it is necessary to identify the point where products are no longer reasonably interchangeable with each other or reasonable alternatives for each other. The Trade Practices Tribunal observed in *Re Tooth & Co Ltd*<sup>10</sup> that ‘the economy as a whole is a network of substitution possibilities in consumption and production’,<sup>11</sup> but ‘at the ‘extremities of the market, there is ... a break in substitution possibilities’.<sup>12</sup>

## Dimensions of the market

In *Re Tooth & Co Ltd*, the Trade Practices Tribunal also explained that *market* is a ‘multi-dimensional concept – with dimensions of product, functional level, space, and time’.<sup>13</sup> All of these dimensions must be considered before it can be said that firms are competitors of each other and are therefore in the same market.

### 1. Product

In relation to this dimension, the High Court has held: ‘[The] process of defining a market by substitution involves both including products which compete ... and excluding those which because of differentiating characteristics do not compete.’<sup>14</sup>

The assumption underlying the notion of substitutability is that there are usually a number of reasonably close substitutes for any particular product. The degree of differentiation between products clearly affects their degree of substitutability, so that drawing the boundaries of a market is not an exact science. In fact, appropriate market definition is often an extremely complex issue in restrictive trade practices cases.

In economic terms, the SSNIP test embodied in the *QCMA* case is concerned with gauging the cross-elasticity of demand between particular products. This looks at the change in quantity demanded for one product as a result of a change in the price of another product. (For example, does the demand for margarine increase when the price of butter increases?) If the cross-elasticity of demand between two products is relatively high, it is more than likely that those

products, and the firms which produce them, form part of the same market.

Since supply side substitutability can shift market boundaries as well, the SSNIP test is also concerned with assessing cross-elasticity of supply. This involves determining the availability of all alternative sources of supply in the event of an increase in the price of a product. From a supply side perspective, firms which are currently supplying close substitutes or which can easily switch production to supply the relevant product should be considered part of the same market too.

Interestingly, a review of restrictive trade practices decisions in Australia since the enactment of the TPA reveals that there are many cases in which narrow market definitions have been accepted, and just as many in which wider definitions have prevailed.

Case examples abound, as the following selection illustrates:

- **Narrow markets.** In *Re Tooth & Co Ltd*, the market consisted of beer (both bulk and packaged), rather than alcoholic beverages in general. In *Arnotts Ltd v TPC*,<sup>15</sup> the market was restricted to biscuits and excluded other snack foods such as chocolate. In *Davids Holdings Pty Ltd v Attorney-General (Cth)*,<sup>16</sup> the market was limited to the supply of grocery products by independent wholesalers to independent retailers and did not encompass the operations of the national supermarket chains. More recently, in *Boral Besser Masonry Ltd v ACCC*, the market comprised concrete masonry products and no other building materials.
- **Broad markets.** On the other hand, in *Application of Southern Cross Beverages Pty Ltd*<sup>17</sup> (the *Soft Drinks* case), the market included not only carbonated soft drinks, but also concentrated cordials, fruit drinks and juices, and flavoured milk. In *Singapore Airlines Ltd v Taprobane Tours WA Pty Ltd*,<sup>18</sup> tours to the Maldives belonged to a broader 'holiday destination' market. In *Morwood v Chemdata Pty Ltd*,<sup>19</sup> the market consisted of a variety of business database software and not simply dispensary software. In *Regents Pty Ltd v Subaru (Aust) Pty Ltd*,<sup>20</sup> the market was not confined to 'Subaru' spare parts, but included all motor vehicle spare parts.

However, in and of itself, a mix of narrow and broad market definitions carries no particular significance, assuming that each outcome is the result of a consistent and principled approach.

## 2. Geographic

The geographic market (the *area* or *space* of rivalry) is determined not by reference to the locality from which the vendor sells, but by reference to the areas from which buyers make their purchases. The wholesaler who sells in Brisbane may make sales to retailers throughout Australia, so that the wholesaler's market would be Australia-wide.

Traditionally, three factors are considered relevant to determining the geographic market:

- **Transportation costs.** Especially pertinent here is the volume-to-weight ratio of the product in question. Generally, the heavier the product is, the harder it is to transport and so the smaller will be the geographic market. Thus the possibilities for transporting watches are greater than the possibilities for transporting wet cement. In the *QCMA* case, the cost of transporting flour was low enough to

make the state of Queensland one geographic market for that product.

- **Perishability.** *Re Tooth & Co Ltd* provides a useful illustration of the impact of this factor. In that case, the geographic market was limited to a certain region of New South Wales because bulk beer is perishable (it only keeps for 7-10 days) and consequently cannot be transported long distances.
- **Legal restrictions.** The size of the geographic market will be affected by legal restrictions on transportation across state/regional borders. Thus, in *Victorian Egg Marketing Board v Parkwood Eggs Pty Ltd*,<sup>21</sup> statutory restrictions on the sale of eggs resulted in the Australian Capital Territory being considered a separate geographic market for eggs.

## 3. Functional level

This dimension involves consideration of whether the competitors perform the same function in the market. Put another way, it requires recognition that competition takes place on different levels. Manufacturers, for example, do not compete with wholesalers, and neither manufacturers nor wholesalers compete with retailers.

The geographic and functional aspects of the market for beer were clearly differentiated in *Re Tooth & Co Ltd*, where the Trade Practices Tribunal said:

'We consider it appropriate to consider two functional levels, wholesaling and retailing ... [E]ach of these functional levels has its appropriate geographical dimensions.'<sup>22</sup>

## 4. Temporal

This dimension serves as an important reminder that when defining markets, the concern is with substitution possibilities in the longer run, since 'it serves no useful purpose to focus attention upon a short-run, transitory situation'.<sup>23</sup>

## Conclusion

Judicial and administrative decision-making under the restrictive trade practices provisions in Part IV of the TPA – typically relating to allegations of collusion, misuse of market power or exclusive dealing, or to proposed mergers – continues to confirm that market definition is a vital issue both in theory and in practice. The accuracy of the market definition process substantially influences the outcomes in such cases, since any assessment of the impact of corporate conduct on the degree of competition within a market necessarily depends on how the boundaries of the relevant market are determined.

Experience shows that market definition is rarely a straightforward task, and a detailed case-by-case assessment will always be required. Nevertheless, there are sound fundamentals in place.

## References

- <sup>1</sup> (1992) ATPR 41-165.
- <sup>2</sup> *Ibid* 40,268.
- <sup>3</sup> (1996) ATPR 41-466.
- <sup>4</sup> *Ibid* 41,667.
- <sup>5</sup> (1976) ATPR 40-012.
- <sup>6</sup> *Ibid* 17,247.
- <sup>7</sup> (1989) ATPR 40-925.
- <sup>8</sup> (2003) ATPR 41-915.
- <sup>9</sup> *Ibid* 46,703.
- <sup>10</sup> (1979) ATPR 40-113.
- <sup>11</sup> *Ibid* 18,196.

<sup>12</sup> Ibid 18,197.

<sup>13</sup> Ibid.

<sup>14</sup> *Queensland Wire Industries Pty Ltd v BHP Co Ltd* (1989) ATPR 40-925, 50,008 (Mason CJ and Wilson J).

<sup>15</sup> (1990) ATPR 41-061.

<sup>16</sup> (1994) ATPR 41-304.

<sup>17</sup> (1981) ATPR 40-200.

<sup>18</sup> (1992) ATPR 41-159.

<sup>19</sup> (1998) ATPR 41-629.

<sup>20</sup> (1998) ATPR 41-647.

<sup>21</sup> (1987) ATPR 40-081.

<sup>22</sup> (1979) ATPR 40-113, 18,197.

<sup>23</sup> *Re Tooth & Co Ltd* (1979) ATPR 40-113, 18,196.

### **Critical thinking:**

*In Top Performance Motors Pty Ltd v Ira Berk (Qld) Pty Ltd (1975) ATPR 40-004, an early trade practices decision, the relevant market was held to be 'a market for the sale of Datsun cars on the Gold Coast'. Subsequently this market was criticised as being far too narrow. Do you agree that a single brand market should be a rare finding? Consider the notion of substitutability.*