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Passing the buck: the passing-on defence in cartel damages cases

Given the European policy of encouraging private claims in competition law, the legal position of the passing-on defence and the standing of indirect purchasers are of considerable importance. Indeed, the UK's Office of Fair Trading has called it 'the most controversial issue in relation to private actions in competition law'.[1] The European Commission has presented several options relating to the passing-on defence. What are the welfare implications of these options and the economics behind passing on?

In a private damages action where a downstream company is claiming damages from an upstream supplier for alleged overcharging, the defendant might rely on the passing-on defence to reduce or negate the damages claim. The passing-on defence allows the defendant to argue that some or all of the overcharge has been passed on to the final consumers, and was therefore not borne by the claimant.

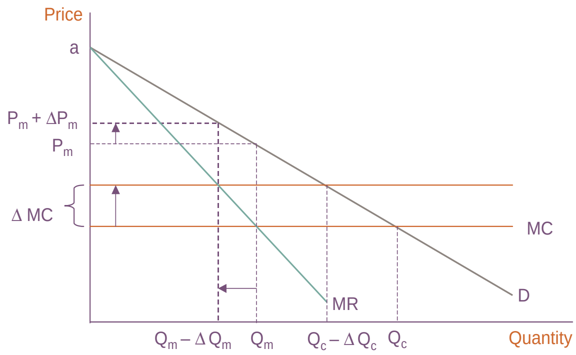
In the USA, the legal precedent for not allowing the passing-on defence has been shaped by two cases. In *Hanover Shoe, Inc. v. United Shoe Machinery Corp* the Supreme Court held that an antitrust conspirator cannot avoid liability to a direct purchaser by showing that the purchaser suffered no injury because it passed on any overcharge to its own customers.[2] Furthermore, in *Illinois Brick co. v. Illinois*, the Supreme Court ruled that indirect purchasers should not be permitted to sue for damages as this would not be consistent with the *Hanover Shoe* ruling.[3] However, the Antitrust Modernization Commission recently recommended that Congress overrule the Supreme Court's decision to the extent necessary to allow both direct and indirect purchasers to recover damages.[4]

The legal position on the passing-on defence in Europe is not clearly defined.[5] However, it is a significant issue as European competition policy is currently being reformed to encourage private enforcement of antitrust law. The Commission's Green Paper on private damages actions suggests four options for the passing-on defence.[6] This article discusses the welfare implications of these options.

The economics of passing on

The mechanism of passing on can be illustrated using a standard monopoly and perfect competition model. It is assumed that a cartel has been formed in the upstream market and that there is either a monopolist or perfect competition in the downstream market. Figure 1 shows a simplified scenario in which a downstream monopolist faces a linear downward-sloping demand curve, D. The profit is maximised by setting price Pm where marginal cost MC equals marginal revenue MR.

Figure 1 Cost pass-through by a monopolist



Source: Oxera.

In such settings the marginal revenue curve is exactly twice as steep as the D curve.[7] This will affect the rate of the cost pass-through.

In a situation where the upstream cartel increases the monopolist's costs such that the MC curve moves up by ΔMC, the output falls by ΔQm to Qm – ΔQm. As a result, the price increases by ΔPm to Pm + ΔPm. Under the simplifying assumption of a linear demand curve, the increase in P is exactly half the cost increase. In practice, the demand curve is rarely linear. The exact proportion passed on will depend on the shape of the demand curve.[8]

The opposite of having a single firm in a market is the case of perfect competition (as also shown in Figure 1), where there are many competitors and, as a result, the

Table 1 The extent of passing on in various markets

	Cost increase faced by one firm	Cost increase faced by the whole market
Perfect competition	No impact on market price as the firm will exit the market	The market price will increase by the average cost increase
Oligopoly (Cournot) with N companies	The market price will increase by 1/(N + 1), which may reduce the firm's market share. The firm will absorb some of the cost increase	The market will increase by N/(N + 1) of the average price increase
Monopoly (linear demand)	Half of the cost increase will be passed on to the final consumer	

Source: Oxera.

firms are unable to raise their prices above their marginal costs. Therefore, the perfectly competitive outcome is price MC and the corresponding industry output is Qc, as shown in Figure 1. The effect of a cost increase will depend on whether a single firm or a whole industry is faced with the increase.

If the marginal cost of a single firm is raised, the firm would have to raise its price to cover this increase. However, because the prices of its rivals are now lower in comparison, no buyer would pay the higher price and the company may have to exit the market. The overall impact on the market price would therefore be zero. Conversely, if all firms in a competitive industry are faced with a cost increase—as would be the case when there is an upstream cartel—the price will rise to MC + Δ MC and the output will be reduced to Qc – Δ Qc. Therefore, all of the cost increase will be passed on to the final consumer through an increase in the price.

A surprising (even counterintuitive) outcome emerges from this analysis. Contrary to a common misconception, a monopolist is unlikely to pass all of the cost increase on to the final consumer, whereas a perfectly competitive industry is likely to raise the price by the full amount of the cost increase. Thus, economic analysis shows that a monopolist in the downstream market will bear a higher proportion of overcharge, and may therefore be considered eligible for a greater damages claim than firms in a perfectly competitive downstream market. In fact, if the passing-on defence is permitted, perfectly competitive firms in the downstream market may not be able to claim damages at all.

An oligopoly case (ie, an industry with a few firms) produces a result which lies in between the monopoly and the perfectly competitive outcomes. Ten Kate and Niels (2005) provide a detailed analysis of the derivation of the pass-through in a Cournot oligopoly; the key conclusions drawn from the analysis are as follows.[9]

– If there are N firms in the market, and one of them experiences a cost increase, the market price will be increased by a fraction, 1/(N + 1), of that cost increase, regardless of whether the firm has a large or small market share.
– If a cost increase is expressed as an average across all firms—as with an upstream cartel—the market price will increase by a fraction, N/(N + 1), of that average cost increase.

Thus, in a market with a small number of firms, if a single firm is faced with a cost increase, it will be able to pass through a larger proportion of that increase than a single firm in a perfectly competitive market. The remainder of the cost increase might be offset against the company's profits. Hence, the cost increase does not necessarily force an oligopolistic firm out of the market.

If all firms in the oligopoly are faced with the cost increase, the price will increase by N/(N + 1), which will be larger than the price increase under a monopoly but smaller than the outcome under perfect competition. Table 1 provides a summary of outcomes for different types of downstream market. As shown in the table, the less competitive the downstream market, the higher the proportion of the overcharge it bears and, thus, the greater the damage it may be entitled to claim.

However, if the passing-on defence is permitted, what would be the wider implications for private damages actions and the economy? Does the permission to use the passing-on defence ensure that all parties that suffered damages are compensated fairly?

Welfare impact of the passing-on defence

The European Commission's Green Paper presents four policy options (Options 21–24, see Table 2), which explore two dimensions:

– whether the passing-on defence should be allowed;
– whether the indirect purchasers should have legal standing.

Direct purchasers can claim damages under all four options. Interestingly, only one option allows the passing-on defence, and two options allow indirect purchasers to claim damages even when the passing-on defence is excluded.

Table 2 Options 21–24 from the European Commission's Green Paper

	Passing-on defence allowed	Direct purchasers allowed to claim damages	Indirect purchasers allowed to claim damages	Damages are shared among the affected parties?
Option 21	✓	✓	✓	×
Option 22	×	✓	×	×
Option 23	×	✓	✓	×
Option 24	×	✓	✓	✓

Source: European Commission (2005), 'Damages Actions for Breach of the EC Antitrust Rules', Green Paper.

To examine the welfare impact of the four options in a comparable manner, the following assessment criteria are of relevance.

- **Equity**—the redistribution of wealth between private agents in an economy. An optimal antitrust regime enhances equity by ensuring that all parties that suffered losses as a result of anticompetitive behaviour by a third party are compensated fairly.

- **Efficiency**—the distribution of resources in the economy. Under an optimal antitrust system, efficiency is enhanced such that an optimal amount of enforcement of the antitrust laws is generated at minimum cost.

- **Optimising the number of private actions**—the goal of a welfare-maximising competition policy to encourage an optimal amount of public enforcement of antitrust laws (which is not the same as maximising the number of public claims). Arguably, under the current European policy there is under-enforcement of competition rules; a revised policy may therefore need to provide more incentives to private agents for initiating private actions.

  Such incentives arise when the expected gains of a private action are greater than the expected losses, which can be formulated as follows:

  $$s(D - C_W) > (1 - s)C_L$$

  where s is the chance of the private action being successful; D is the damages payable if the private action is successful; C_W is the cost incurred by the plaintiff (such as legal fees) if the case is won; and C_L is the cost incurred by the plaintiff if the case is lost. In general, it would be expected that $C_L \geq C_W$ since the losing party is often ordered by the court to pay the winner's costs. An optimal antitrust system provides incentives to encourage an optimal amount of private enforcement.

In addition to the three criteria above, the effectiveness of the options as a deterrent to further anticompetitive behaviour is also discussed where appropriate.

- **Option 21: the passing-on defence is allowed and both direct and indirect purchasers can sue the infringer.**

Under Option 21, if both direct and indirect purchasers successfully claim damages, the equity objective will be achieved because all affected parties are compensated for the incurred losses. However, as highlighted in the Green Paper, there is a risk that the direct purchaser's claim will be unsuccessful because of the passing-on defence, and the indirect purchasers' claim unsuccessful because they are unable to show that damages are passed on along the supply chain. In this case, the affected parties may not be compensated, which may weaken the effectiveness of the competition policy as a deterrent.

Furthermore, the passing-on defence may significantly complicate the legal proceedings and increase the cost of private actions because proof of distribution of damages along the supply chain may be required. In addition, if a large number of parties are involved in the private action, a duplication of costs may be expected. This particularly applies if there are no provisions for class actions. As a result, the cost of private actions under this option may be greater than optimal.

Finally, allowing the passing-on defence would reduce the amount of damages awarded to the direct claimant and could therefore diminish the propensity for claims from direct purchasers. Furthermore, other factors such as the complexity of legal systems and the scale of legal costs (relative to the benefits from the private action) faced by individual indirect purchasers may discourage them from initiating the action. As a result, this option might lead to under-enforcement of antitrust laws by the private sector.

- **Option 22: the passing-on defence is excluded and only direct purchasers can sue the infringer.**

If Option 22 is chosen, the direct purchasers will have a greater incentive to take actions for damages. This is because if the action is successful, the purchasers will extract a payment that is greater than the losses incurred from the overcharge if some of the overcharge was passed on to the final consumer.

Furthermore, the legal process would be more straightforward and less costly in the absence of the passing-on defence since fewer parties will be involved in the proceedings. This may increase the chance of the direct purchaser claiming the damages successfully, and the damages payment would be more likely to reflect the overall losses caused by the overcharge. This option is more likely to be an effective deterrent against anticompetitive behaviour than Option 21.

The downside of this option is that it may result in a loss of equity for the indirect purchasers. If the downstream industry is very competitive then, as shown in the discussion above, the indirect purchasers would incur considerable losses because a large proportion of the overcharge would be passed on to them. Thus, if the indirect purchasers are denied the opportunity to claim compensation for their damages, a redistribution of wealth from indirect purchasers to direct purchasers is likely to occur.

– **Option 23: the passing-on defence is excluded and both direct and indirect purchasers can sue the infringer.**

Under Option 23, if damages actions from both direct and indirect purchasers are successful, the collective damages claim may be higher than the losses caused by the defendant's anticompetitive actions. As a result, the deterrent effect against anticompetitive behaviour if Option 23 is chosen would be stronger than under Options 21 and 22. Indeed, this option could be considered a possible alternative to awarding multiple damages in antitrust cases, at least to the extent that damages paid may exceed the gain to the firm infringing the laws.

Furthermore, if the actions of both direct and indirect purchasers are successful, all affected parties have the potential to be compensated. Thus, the equity objective could potentially be achieved under this option.

Due to the exclusion of the passing-on defence, the legal proceedings should be less complicated and possibly less costly than under Option 21. However, if both direct and indirect purchasers are engaging in legal action, some of the costs may still be duplicated. Furthermore, the indirect purchasers would have to prove that the damages were passed down the supply chain, which could increase the costs of the proceedings.

Finally, the incentive for the direct purchaser to engage in a private action should be similar to that under Option 22 because the direct purchasers can potentially extract a damages payment which is higher than the damages incurred. Although, the indirect purchasers are given legal standing under Option 23, the incentives for indirect purchasers to engage in legal action are lower than for the direct purchasers. This is due to the cost of legal action compared with the damages awarded and the burden of proving that the indirect purchaser suffered losses as result of the defendant's anticompetitive conduct.

– **Option 24: a two-step procedure, in which the passing-on defence is excluded, the infringer can be sued by any victim and, in a second step, the overcharge is distributed between all the parties that have suffered a loss.**

Option 24 appears to maximise the equity aspect because if the damages claim is successful at the first stage, all concerned parties could be compensated for the incurred losses at the second stage. Furthermore, the costs of legal proceedings under this option should be relatively low, since only a single party needs to engage in the private action, which enhances the efficiency of the outcome.

The downside of this option is that the incentive to engage in the private action is weaker than under Options 22 and 23. This is because if the case is won, the firm taking action will not receive all of the damages, since the overcharge will need to be shared among the indirect purchasers. However, if the case is lost, all the costs are likely to fall on the party initiating the action, so fewer actions may be launched.

Conclusion

The economic principles demonstrate that the extent of passing on is determined by the number of firms in the downstream market. A monopoly downstream firm will not pass the entire overcharge on to the final consumer, whereas an industry with a large number of firms is more likely to raise the market price to reflect the full amount of the overcharge, and hence would be entitled to lower damages under the passing-on defence.

This has implications for the legal standing of indirect purchasers. By allowing only direct purchasers to claim damages, a redistribution of wealth from direct to indirect purchasers will be encouraged. Thus, in order to enhance equity within the economy, a mechanism for compensating the indirect purchasers may need to be considered.

The legal position of the passing-on defence is of key importance. If it is permitted, the incentive for direct purchasers to engage in private actions is, on balance, reduced and the cost of legal proceedings may be increased. Thus, if the competition authorities' objective is to encourage private actions, it may be worth examining those options that exclude the passing-on defence.

[1] Office of Fair Trading (2007), 'Private Actions in Competition Law: Effective Redress for Consumers and Business', Discussion Paper, April.
[2] *Hanover Shoe, Inc. v United Shoe Machinery Corporation*, U.S. Supreme Court, 392 U.S. 481 (1968).
[3] *Illinois Brick Co. v Illinois*, U.S. Supreme Court 431 U.S. 720 (1977).
[4] Source: www.amc.gov/report_recommendation/toc.htm.
[5] Waelbroeck, D., Slater, D. and Even-Shoshan, G. (2004), 'Study on the Conditions of Claims for Damages in Case of Infringement of EC Competition Rules', Ashurst.
[6] European Commission (2005), 'Damages Actions for Breach of the EC Antitrust Rules', Green Paper, December.
[7] If the demand curve is defined as P = a – bQ, total revenue is PQ = aQ – bQ^2. The marginal revenue is then P = a – 2bQ. Thus, the demand curve has slope b, while the marginal revenue curve has slope 2b.
[8] If the demand is convex instead of linear (starts steep to the left and becomes flatter to the right), the pass-through ratio will be greater than 0.5. If the demand curve is concave (starts flat to the left and then becomes steeper to the right), the pass-through ratio is smaller than 0.5.
[9] Ten Kate, A. and Niels, G. (2005), 'To What Extent are Cost Savings Passed on to Consumers? An Oligopoly Approach', *European Journal of Law and Economics*, **20**, 323–37.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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