Agenda

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Pass it on: the draft EU guidelines on pass-on and volume effects

On 5 July 2018 the European Commission published draft guidelines to help national courts estimate the share of overcharges 'passed on' to indirect purchasers and final consumers of goods affected by a cartel. The guidelines also cover estimation of volume effects, which are the natural counterpart to pass-on. How helpful are these draft guidelines, and how could they potentially be improved?

This article is based on Oxera's response to the Commission's consultation on its draft guidelines.

Pass-on is an important element in the calculation of claims for damages. It is recognised as a complex issue in which it is difficult to arrive at precise answers. The Commission's draft guidelines[1] note that national courts are required to 'strive for an approximation of the amount or share of passing-on which is plausible…In practice, national courts will have to rely on assumptions.' (para. 39) Reference is made to the idea of using a 'best fit' approach in Dutch cases, and the concept of the 'broad axe' in UK case law.[2] According to the draft guidelines, national courts 'cannot reject submissions on passing-on because a party is unable to precisely quantify the passing on effects'. (para. 38)

As documented in a 2009 Oxera study for the Commission, the economics literature provides helpful insight into the main drivers of pass-on, and this forms the starting point for the conceptual framework for pass-on analysis.[3] One of the most important insights is that the degree of pass-on is closely linked to the nature of competition in the downstream market. In perfect competition, pass-on equals 100% if the cost increase is uniform among all competitors. This gives rise to a useful (if perhaps counterintuitive) rule of thumb that pass-on tends to be high in competitive markets. This theoretical finding has been corroborated in empirical studies.[4] Another theoretical insight is that a textbook monopolist (facing linear demand and constant marginal costs) passes on 50% of any increase in marginal costs, and in some oligopoly models the rate of pass-on increases with the number of competitors in the market (it is closer to 50% where there are few competitors, and closer to 100% where there are many competitors).

Could a court rely on assumptions alone? Beyond rules of thumb, the answer is probably 'no'. As is well documented, a pass-on rate can depend on many factors: market structure, product differentiation, price-setting behaviour, menu costs, whether an overcharge applies to a variable or a fixed cost, whether it applies industry-wide or affects only a subset of the industry, and so on.

In any case, it is plain from the guidelines that claiming that pass-on is 'too difficult' is not an option for national courts—this would be inimical to the right to full compensation for the victims of a competition law infringement.

Quantitative evidence for pass-on

The draft guidelines recognise that economics theory alone may be insufficient to quantify pass-on:[5]

> in order to be able to construct a counterfactual and control for different factors affecting passing-on, in most cases the parties need quantitative evidence (para. 79)

This quantitative evidence refers to data on actual prices, costs and margins, and *adjustments* to observed data to account for changes in price that are not caused by cartel overcharge. In some cases these 'adjustments' might be 'simple' (para. 107). However, where they are not, econometric analysis is likely to be required, even though such analysis can 'entail considerable costs' (para. 111).

While pass-on might be estimated using granular data and sophisticated econometric techniques, the costs of such an exercise may be prohibitive in the context of a small claim. The class certification case before the UK Competition Appeal Tribunal (CAT) in *Merricks* confirms that, for a major damages claim, one would not want to compromise on pass-on analysis: 'Given the massive size of the claim [£14bn], a difference of even 10% in the average pass-through rate makes a very substantial difference in financial terms.'[6] What is less clear is the acceptable standard of proof for pass-on in a case that is very much smaller.

The draft guidelines have identified a technically preferred technique—multivariate regression analysis. However, this technique relies on the availability of reliable data. It is not uncommon in a follow-on damages case that a harm is claimed for that occurred many years ago. Accordingly, data is normally incomplete, with the quality of data decaying over time, and with its veracity or relevance possibly subject to factual dispute between the parties. Before undertaking quantitative work, it is therefore sensible first to ask whether the right data is available, and what assumptions are required where data is missing (for follow-on cases, missing data is a frequent issue due to the passage of time).[7] Data issues aside, it is not clear from the guidelines when courts can consider such analysis to be disproportionate to the value of a claim.

In light of this, it may be helpful to draw a parallel with the Commission's case practice in mergers (and indeed that of other leading competition authorities). In a large Phase 2 merger investigation, it is not uncommon to see parties, and the Commission, engaging in 'merger simulation'. This is an economics exercise not unlike analysing pass-on, using data on prices, margins and elasticities to estimate the hypothetical price effects of a merger. However, the simulation technique is not normally employed for small-scale mergers and those that are reviewed only at Phase 1, mainly because it is costly and time-intensive; nor would the Commission normally rely on a merger simulation alone to come to its overall assessment of a merger.[8] Rather, the quantitative results will be integrated with the qualitative evidence on the likely effects of the merger (e.g. from a review of internal documents) and be read in conjunction with this evidence.

Qualitative evidence on pass-on

Theory and quantitative evidence should be supplemented by what the Commission terms 'qualitative evidence', and which many courts may term 'factual evidence'—that is, evidence from business witnesses, and from the review of disclosure, including management accounts and internal reports on pricing (board minutes, strategy papers, etc.). The idea here is not necessarily to find a 'smoking gun' statement of the form 'Dear CEO, we have noticed a 10% increase in the price of input x, and we will pass this cost increase on to our customers in full at the next price review, due in three months' time.' It is to find out where the relevant business fits in the economic framework for passing-on. Are prices spot prices, or fixed by long-term contract? Is there a form of cost-plus pricing? Was the cartelised input a variable cost or a fixed cost? Does the firm compete with others that did not use the cartelised input and yet competed in the same downstream market?

In this sense the qualitative evidence is arguably a vital complement to 'quantitative' evidence, and will provide information to enhance the quantitative evidence by contributing knowledge where assumptions would otherwise be necessary.

It is useful to retain the nomenclature of the draft guidelines—referring to 'quantitative' and 'qualitative', rather than 'economic' and 'factual' evidence—because there is a subtle but important difference between a commercial opinion and an economics interpretation of the facts. Consider by analogy cases involving market definition, where 'there is no reason to expect that the concept of market employed by business executives…would be the same as the concept of an "antitrust market" or "relevant market" defined for the purpose of antitrust analysis.'[9] As market definition is about consumer responses to a hypothetical price increase for a (typically) hypothetical bundle of products, it turns out that the legal and economic definition of a relevant market does not correspond to what might be termed a 'market' by those intimately involved in the industry.[10]

Similarly, as noted above, if disclosure or witnesses on pass-on speak about a market that is so competitive that input cost increases are impossible to pass on through prices, it would seem at first glance that the qualitative evidence has confirmed zero pass-on. However, this requires a more subtle interpretation for the legal and economic definition of pass-on, where an industry-wide increase in input costs will be largely or fully passed on where markets are perfectively competitive. A similar distinction can be drawn in relation to buyer power. Evidence suggesting that buyer power prohibited any cost pass-on must be considered in light of the expected competitive dynamics where buyer power is strong (and therefore seller power is weak).

Perhaps a more intuitive example is that pass-on may be low where cartelists are vertically integrated into the downstream market. Claimants may have paid a supra-normal price for the relevant input, but did the cartelists set their internal transfer price at the same level? The latter had an option to win downstream market share through a form of margin squeeze. Whether they exercised that option may be a contested topic. Here qualitative evidence about price-setting might need disclosure from the defendants, even though the topic of interest is whether the claimants adjusted their own pricing.

Evidence of lost profits from volume effects

Volume losses are said to arise where the passing-on of any overcharge by a claimant in the form of an increase in the downstream price itself gives rise to a loss of profit due to a reduced volume of downstream sales. This is based on the assumption that there is an inverse relationship between price and demand in any claimant's end market, where 'end market' can refer to either the final consumer or a further layer of the supply chain. Any volume effects will depend on conditions in these markets—in particular, the elasticity of demand with respect to price.

It might be hoped that a firm would be intimately familiar with its own-price elasticities, and the cross-price elasticities with respect to competing products, and how these factors evolve over time. But as competition lawyers and economists know well from merger cases, this is rarely true. In the real world, the data is simply not available 'off the shelf': 'some of the data used for [merger simulation models], such as pre-merger prices and market shares, is often readily available, but parameters such as the elasticity of demand will usually need to be estimated.'[11] Recall also that in a cartel damages case the relevant data is not current business data, but rather historical data, and therefore often incomplete, inconsistent and in general far from perfect.

Despite these concerns, as with pass-on, saying that volume effects are 'too difficult' will not satisfy the principles of the Commission's guidelines; nor should the problem be seen as intractable. In this respect the requirements set out for economic analysis in the draft guidelines are too ambitious in places. For example, the guidelines state:

> [T]he magnitude of the loss in volume will require an assessment of how the passing-on has affected prices of all competitors in the market, as well as the sensitivity of demand to those price changes. (para. 148)

As discussed above for pass-on, volume loss quantification could not be at this level of sophistication for smaller cases. If it were, the costs for legal and economic expertise might surpass what is considered reasonable. Simpler approaches, such as multiplying an average price increase by a rough approximation of a market elasticity, may be called for in these circumstances.

Conclusion

The draft guidelines are based on sound economic principles. They recognise the main economic factors influencing pass-on, and the interaction between pass-on and volume effects. Yet there are places where the guidelines are perhaps too optimistic about the extent to which quantitative analysis can be carried out without significantly raising the costs of bringing and defending a damages action. They may also place insufficient weight on the importance of factual evidence to complement and inform the economic analysis.

The development of best practice in quantifying pass-on and (even more so) volume effects is at an early stage relative to quantifying overcharges. As the draft guidelines recognise, there is a tension between the principle of effectiveness and the standard of proof: '[Courts] must apply rules on the burden and standard of proof so that the full effectiveness of Article 101 TFEU is not put at risk.'[12] (The principle of effectiveness means that courts 'must apply national rules in such a way that the application does not render practically impossible or excessively difficult the exercise of the right to full compensation for harm caused by an infringement of EU competition law'.[13]) In order to achieve 'effectiveness', pass-on and volume effect analysis will need to remain tractable, and therefore relatively crude (or 'broad axe'), at least for smaller claims.

This is not an impossible balance to strike, as can be seen from the area of merger control. Here, advanced and data-intensive economic techniques are usually employed only for the largest cases, and even then the results of such techniques are normally interpreted in conjunction with less technical evidence.

Finally, thus far pass-on has always meant an increase in prices paid by the claimants' customers.[14] Future cartel damages actions may be more complex in a world where Internet services are often free at the point of use. The Sisyphean task of calculating non-price pass-on is not covered in the Commission's guidelines. That remains a topic for future research.

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[1] European Commission (2018), 'Guidelines for national courts on how to estimate the share of overcharge which was passed on to the indirect purchaser', Communication from the Commission, draft, https://bit.ly/2KKurd3, accessed 3 October 2018.

[2] References are given at European Commission (2018), op. cit., p. 11, footnote 40. The footnote states: 'E.g. in the United Kingdom national courts quantify harm "by the exercise of a sound imagination and the practice of the broad axe" (*Gibson v Pride Mobility Products Ltd* [2017] CAT 9), in the Netherlands the national court awarding damages quantifies the amount of the harm to the extent that this is possible (see Article 612 Wetboek van Burgerlijke Rechtsvordering) and estimates it in the manner that is the best fit for the characteristics of the harm (see Article 6:97 Burgerlijk Wetboek).'

[3] Oxera and a multi-jurisdictional team of lawyers led by Dr Assimakis Komninos (2009), 'Quantifying antitrust damages: towards non-binding guidance for courts', study prepared for the European Commission Directorate General for Competition, December. See also European Commission (2013), 'Practical guide: quantifying harm in actions for damages based on breaches of Article 101 or 102 of the Treaty on the Functioning of the European Union', Commission staff working document, SWD(2013) 205, 11 June.

[4] See Niels, G., Jenkins, H. and Kavanagh, J. (2016), *Economics for Competition Lawyers*, second edition, Oxford University Press, paras 9.125 to 9.128.

[5] The guidelines explain that 'parties may generally base their analysis on economic theory and quantitative economics' but that supporting evidence 'will depend to a great extent on the economic method used' (para. 32). The 'guiding economic principle' (para. 76) is to compare the actual scenario with what would have occurred absent the infringement—i.e. the counterfactual. To be able to construct a counterfactual, 'in most cases the parties need quantitative evidence' (para. 79).

[6] Competition Appeal Tribunal (2017), *Walter Hugh Merricks CBE v MasterCard Incorporated and Others*, Judgment (Application for a Collective Proceedings Order), [2017] CAT 16, 21 July, para. 77.

[7] For example, in the US courts, the question of available data for regression analysis may be addressed at the class certification stage: 'Dr Netz has successfully explained how to assign numerical values to all factors relevant to her regression analysis and has identified obtainable data to be used with her four approaches later.' United States District Court, Northern District of California, San Francisco Division (2013), *In re: Cathode Ray Tube (CRT) Antitrust Litigation*, Report and Recommendation regarding Indirect Purchaser Plaintiff's Motion for Class Certification, p. 36, footnote 23.

[8] Buettner, T., Federico, G. and Lorincz, S. (2016), 'The Use of Quantitative Economic Techniques in EU Merger Control', MPRA Paper No. 76384, posted 25 January 2017, p. 3.

[9] Reference is to Baker, J. (2007), 'Market Definition: An Analytical Overview', *Antitrust Law Journal*, **74**:129, at p. 139.

[10] A similar point can be made about the relevance of disclosure on intentions in Article 102 predatory pricing cases. See Niels, G., Jenkins, H. and Kavanagh, J. (2016), *Economics for Competition Lawyers*, second edition, Oxford University Press, paras 4.71 to 4.72.

[11] Niels, G., Jenkins, H., and Kavanagh, J. (2016), *Economics for Competition Lawyers*, second edition, Oxford University Press, para. 7.78. Note the similarity: 'While potentially generating more robust results than the approaches discussed above, full merger simulation is not very common because of its complexity and data requirements.'

[12] European Commission (2018), op. cit., para. 36.

[13] European Commission (2018), op. cit., para. 9.

[14] See CAT and Court of Appeal judgments in *Sainsburys v MasterCard*: 'the pass-on defence is only concerned with identifiable increases in prices paid by the claimants' customers.' Court of Appeal (2018), *Sainsburys v MasterCard; AAM v MasterCard; Sainsbury's v Visa*, [2018] EWCA 1536 (Civ), 4 July, para. 340.