

The European Commission publishes a study on the Passing-on of Overcharges

November 2016

On 25 October 2016, the European Commission published a Study on the Passing-on of Overcharges (the “Study”). Written by economists with assistance from lawyers across the EU, it is intended to provide judges, practitioners and economic experts with practical guidance on how to assess the pass-on of overcharges in the context of competition law infringements. The Study will also be used by the European Commission to assist with its drafting of pass-on guidelines.

This Briefing Note considers the increasing importance of pass-on in competition damages actions and provides an overview of the Study’s findings and its key implications for clients either bringing, or defending, competition damages actions.

Why is pass-on important?

The assessment of pass-on is often one of the most complicated aspects of competition damages claims across Europe. Much debate has previously been had across different European jurisdictions as to whether the passing-on defence should apply and, if so, how pass-on should be quantified.

Under English law, the passing-on defence is considered to flow from the compensatory principle of damages: that damages ought to place a claimant in the position it would have been in had the infringement of competition law not occurred. It follows that, where the claimant has reduced its loss by passing price increases down the supply chain, the claimant should not be able to recover those losses from the defendant. Although the existence of the passing-on defence had never been fully articulated in the English common law until the recent judgment in *Sainsbury’s v MasterCard*² (see further below), the English courts had proceeded in previous cases on the basis that it was available.

As yet, there has been no case under English law substantively dealing with the pass-on defence, although the existence of the defence has been recognised on a number of occasions

Competition Appeal Tribunal in *Sainsbury’s Supermarkets v MasterCard*

Nevertheless, there remain evidential difficulties with proving pass-on: it can be very difficult to prove that a business passed on an overcharge, especially when the product concerned has been ‘transformed’ (that is, the product for which the business has been overcharged has subsequently been incorporated into a more complex product). This was demonstrated in the recent judgment of the Competition Appeal Tribunal (“CAT”) in the *Sainsbury’s v MasterCard* case, which was the first English law judgment to give detailed consideration

¹ The Study is available here: <http://ec.europa.eu/competition/antitrust/actionsdamages/>

² *Sainsbury’s Supermarkets Ltd v MasterCard Incorporated and Others* [2016] CAT 11

to the pass-on defence. The CAT held that the passing-on defence failed because it was impossible to determine what proportion of the overcharge was passed on in the form of higher prices, as opposed to paid out of cost-savings or paid for by reducing expenditure and therefore service levels. In addition, the CAT held that the passing-on defence is only available where, on the balance of probabilities, the defendant can establish the existence of another class of claimant (downstream of the claimant in the action) to whom the overcharge was passed on, which MasterCard could not do in this case.

However, if the evidential hurdles can be overcome, the passing-on defence has the potential to make a huge difference - economic analysis suggests that businesses typically pass on between 50% and 100% of any overcharge to the next level of the supply chain (and this will be closer to 100% in highly competitive markets). Therefore, a defendant that successfully adduces the passing-on defence could reduce its liability to direct customers very significantly, or even entirely.

Pass-on can also facilitate indirect purchaser claims, in which a claimant will allege that it has suffered loss caused by the infringement of competition law due to pass-on by the direct purchaser. The use of pass-on in this way allows indirect purchasers to claim damages in respect of infringements that have not affected them directly. Such indirect purchaser claims are permitted under English law, though they have been less common than direct purchaser claims.

Impact of the EU's Damages Directive (2014/104)

Pass-on will soon be brought into sharper focus as a result of the imminent implementation of the Damages Directive (which is due to be implemented by EU Member States by 27 December 2016). The Damages Directive³ provides for full compensation to anyone harmed by anti-competitive conduct, including direct and indirect purchasers. It also requires that EU Member States make the passing-on defence available to defendants. Pass-on will therefore become increasingly important in Europe and European national courts will be required to understand and assess pass-on analyses in order to decide cases relating to competition law infringements. For the UK, this means proceeding down the same path on which it has already started; for some other EU Member States, these changes are likely to have a more significant impact on the way that pass-on is dealt with. See Figure 1 for a summary of the changes.

Against this back-drop, the Study was commissioned to help judges and practitioners (who are unlikely to be economists) to evaluate pass-on claims and to provide practical guidance on the economic questions which need to be addressed when assessing pass-on.

³ See our client briefing note on the Damages Directive ("*UK Government consults on implementation of the Damages Directive*", February 2016) here: <https://www.slaughterandmay.com/what-we-do/publications-and-seminars/publications/newsletters-and-briefings/2016/uk-government-consults-on-implementation-of-the-damages-directive/>

The Study has also been prepared to assist the European Commission draft guidelines for national courts on how to estimate the share of the overcharge which was passed on to the indirect purchaser, as required under Article 16 of the Damages Directive. Those guidelines are intended to aid national courts in deciding cases involving pass-on, and will complement the existing European Commission's Practical Guide on Quantifying Harm⁴, which includes a short section on pass-on.

Figure 1 Changes to pass-on under the Damages Directive

Member States will need to ensure that:

- Direct and indirect purchasers from an infringer must be able to claim full compensation for harm.
- National courts have the power to estimate the share of any overcharge that was passed on.
- A defendant may use pass-on as a defence, arguing that the claimant passed on some of the overcharge and therefore suffered less harm. The burden of proof will be on the defendant.
- Indirect purchasers may bring a claim based on the pass-on of costs down the chain. Where certain minimum conditions are met, there will be a presumption of pass-on to indirect purchasers, which should make indirect claims easier.

Overview of the Study

The Study is divided into six key sections:

- (i) an introduction to pass-on and its effects,
- (ii) an analysis of case law and the legal framework governing pass-on,
- (iii) an overview of economic theory of pass-on,
- (iv) an analysis of the quantification of pass-on and volume effects,
- (v) guidance for judges on assessing evidence on pass-on, and
- (vi) a 39 step check-list for judges.

Case law of national courts across the EU

The Study's analysis of the existing case law demonstrates that national courts and competition tribunals in the EU are relatively inexperienced at handling pass-on claims. The limited case law

demonstrates that they will often consider a range of factors (such as the market structure, buying power of the purchaser and supply and demand elasticities), but quantitative analysis is rarely carried out by the parties. Consequently, pass-on has often been rejected on the basis that insufficient evidence has been advanced to prove the causal link between the alleged infringement and the passing-on of any overcharge. After the Damages Directive has been implemented, national courts and competition tribunals may need to reconsider their approaches, particularly regarding legal presumptions and burdens of proof.

The economic theory of pass-on

The Study focuses on the key elements comprising harm suffered in competition damages claims.

These three elements are:

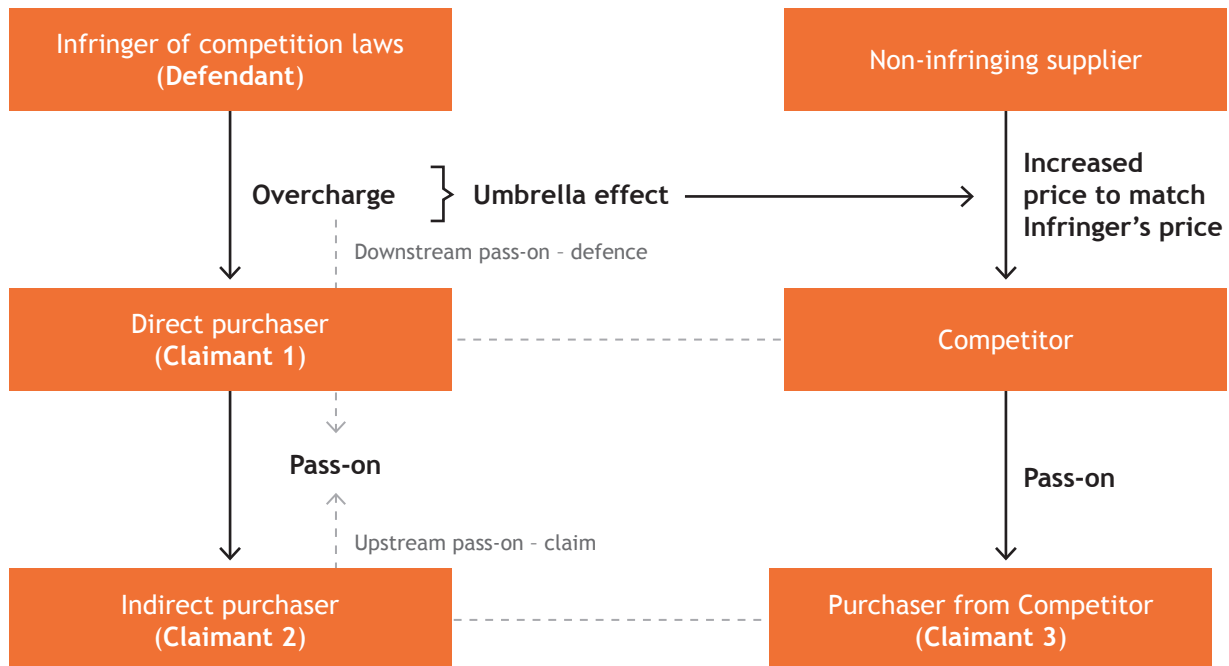
Damage = overcharge effect - pass on effect + volume effect

- **Overcharge** - this is the price increase charged by the infringer to the direct purchaser. It is usually measured by comparing the per unit price of the product before the competition infringement, with the per unit price during the competition infringement.
- **Pass-on effect** - if there is a positive overcharge, the next step is to estimate whether the direct purchaser passed on any of the overcharge to its own customers by increasing its prices and thereby reducing its own losses arising from the competition infringement.
- **Volume effect** - if the direct purchaser did pass on some of the overcharge, its customers (i.e. indirect purchasers) will generally make fewer purchases, leading to a fall in the volume of sales and a corresponding fall in revenue. This fall in sales must be factored back into the damages award because otherwise the risk is a claimant's loss is underestimated.

⁴ Available here: http://ec.europa.eu/competition/antitrust/actionsdamages/quantification_guide_en.pdf

Figure 2 demonstrates these three key elements, and also shows how passing-on can be used as both a claim and a defence.

Figure 2



The extent of the harm suffered will depend on various economic factors. The Study highlights the following, among others:

- **Price-sensitivity of the direct purchaser's customers** (also known as price-elasticity of demand) - if customers (i.e. indirect purchasers) are very sensitive to a price increase, the direct purchaser is less able to pass on the overcharge without a large fall in the volume of the product sold.
- **Market structure** - the level of pass-on will often depend on the market structure in which the direct purchaser operates. For example, if the direct purchaser only has a small market share in a highly competitive market, it will likely be less able to pass on the overcharge because, if it increases prices, it will lose sales to its rivals. Conversely, if the market is dominated by only a few large firms, those firms competing with the direct purchaser may choose to raise prices as well

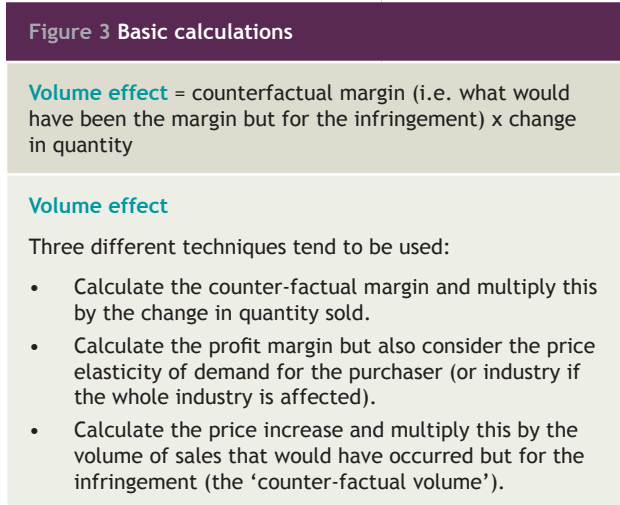
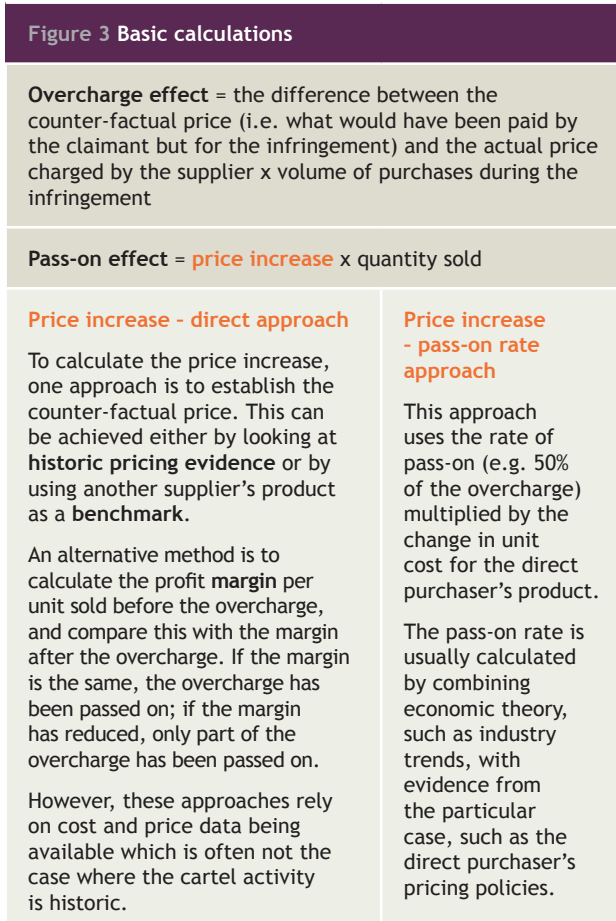
(despite not being affected by the competition infringement), resulting in it being easier for the direct purchaser to pass on the overcharge.

- **Buyer's power** - if the direct purchaser (or its customer) has a strong negotiating position, it may be able to resist paying an increased price for the product. However, this is not always the case and may depend on the agreed pricing strategy and whether the purchaser has a choice of products from the supplier which will satisfy its need (or whether it is forced to continue purchasing the affected product).
- **Time lag** - there may be a time lag in passing on the overcharge. This may mean that prices charged after the end of the competition infringement are still inflated compared to the prices that would have been charged but for the infringement. The result is that parties need to choose carefully the time period which they use for evidence.

- **Umbrella effect** - if a litigant decides to use a competitor’s product as a benchmark for calculating the pass-on or volume effects, the full supply chain for that product must be considered to check that the illegal price increase has not impacted the competitor’s product, whether directly or as a result of the competitor’s supplier increasing its prices to match the infringing supplier (and benefit from consumers paying more for the product). This umbrella effect is demonstrated in Figure 2.

Quantification of pass-on and volume effects

The Study describes various approaches to calculating pass-on and the challenges to estimating pass-on rates. The main approaches recommended in the Study are summarised in Figure 3.



Guidance on the analysis of pass-on evidence

The Study contains advice to judges on how to approach economic evidence in competition damages cases. It is helpful for litigants and potential clients to understand the following points so that they can predict what evidence of pass-on they will need and how it will be received:

- Economic evidence must always be combined with other factual evidence, such as contracts, financial documentation, internal pricing strategy documents and witness statements, so that the courts apply a *“holistic approach”*. Indeed, the Study accepts that economic evidence needs to be assessed in conjunction with factual evidence as economic evidence is *“often a stylised representation of reality”*.
- In assessing economic evidence, judges must understand the expert’s underlying assumptions and methodologies. As a result, the economic expert needs to be very clear as to their approach.
- Economic evidence should be disclosed to varying extents as the case progresses. Initially, parties need to satisfy a threshold test that their pass-on case is plausible. After that, written proposals should follow, with disclosure in stages and/or sampling.

- Experts should not be surprised if they are cross-examined, ‘hot-tubbed’ (as in the *Streetmap* case⁵), or asked to give the court a basic economic tutorial (a ‘teach-in’ where an independent expert spends time educating the judge on the basic economic concepts as preparation⁶). Moreover, one of the parties may request that the court appoints an independent expert. Court-appointed experts are designed to provide independent advice to the judges and can provide a useful economics tutorial before the hearing. Whilst this procedure is uncommon in the English High Court, a Tribunal hearing cases in the CAT will often include one or more economists.
3. Parties will likely need to obtain far more detailed economic evidence in future if they wish to use pass-on as a defence or as the basis of a claim. Economic evidence will almost certainly become more sophisticated as an increasing number of pass-on cases are decided in the EU.
 4. Litigants should have regard to the Study’s 39 step practical check-list for judges, which presents a list of questions that are intended to assist national courts in assessing economic evidence. The check-list provides a useful tool for parties involved in competition litigation to understand how economic evidence will be approached by the court.

Key takeaways

There are five key points to take from the Study for those who are, or may become, party to competition damages actions:

1. Pass-on is likely to play a far greater role in competition damages cases in the future as the Damages Directive obliges national courts to recognise the passing-on defence, and national courts will need to assess the quantum of any overcharge which has been passed on. Pass-on is already playing an important role in cases currently before the courts. More developed case law will emerge as courts increasingly have to deal with pass-on.
2. There are three components to calculating the harm suffered in a claim for damages from a competition infringement: the overcharge, the pass-on effect and the volume effect. Of these, the volume effect is often neglected.
5. Lastly, it is worth bearing in mind that where parallel proceedings are on foot in different jurisdictions, a decision on pass-on in one jurisdiction could (i) influence how pass-on is determined in another jurisdiction, and (ii) result in an increased (or reduced) risk of indirect purchaser claims in that and other jurisdictions. It is generally prudent (and cost-effective) for a party which is a defendant to competition damages claims in multiple jurisdictions to instruct one economic expert firm to act across all the claims in order to ensure a consistent and streamlined approach.

⁵ *Streetmap.EU Limited v Google Inc. and others* [2016] EWHC 253 (Ch). ‘Hot-tubbing’ is a procedure in which both parties’ experts are questioned in the witness box at the same time, first by the Tribunal and then by each party’s counsel in turn. *Streetmap* is the first competition case in which the court has given a ‘hot-tub’ direction.

⁶ This was used in *Electromagnetic Geoservices ASA v Petroleum Geo-Services* [2016] EWHC 881 (Pat)



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