EU Guidelines on passing-on of overcharges

In August 2019, the European Commission issued guidelines on how to estimate the share of cartel overcharges that was passed on to indirect purchasers.[1)] The guidelines discuss passing-on in two scenarios:

- An infringer invokes the passing-on of overcharges in its defence against damages claims. This is a **shield** to a direct purchaser's claim.
- Indirect purchasers may base their damages actions on the argument that the direct purchasers of the infringers have passed on (parts of) the overcharge to them and that they have therefore suffered harm. This passing-on scenario is called **sword**.

The aim of the guidelines is to provide practical guidance in these two scenarios by reference to the relevant economic theory and the quantification methods in the specific passing-on context. These aspects and a few practical examples are discussed in the following.

Economic theory on passing-on

The simple logic is that passing-on of overcharges and the associated price and volume effects arise because of a firm's potential incentive to respond to increases in its costs by raising prices. On the other hand, the assessment is complex since passing-on of overcharges may occur at different levels of the supply chain. Each level is exposed to different competitive forces. Moreover, the existence and the magnitude of passing-on effects are determined by a range of factors that affect the outcome of a passing-on scenario simultaneously. That is why the actual determination of passing-on effects is a challenge in every case.

- Input costs and their effect on pricing decisions

In traditional markets, variable/marginal costs[3)] determine short run price formation whereas fixed costs affect the long run strategic decisions of firms. The starting point for an assessment is the impact of the overcharge on the purchaser's marginal or variable costs.

The qualification as fixed or variable costs are also of importance when the volume effect is estimated, as the estimation of this effect requires an assessment of the profit margins of the firm. A firm will adjust prices only where this will increase profits. In order to receive a higher price, a firm will usually have to accept reduced sales. The assessment of the trade-off between increased profit from higher prices and decreased profit from reduced sales is important.

- Characteristics of demand and links to prices

To assess passing-on, the relationship between demand[4)] and the price level is important. Economic theory in traditional markets suggests that the higher the price level the lower the aggregate quantity purchasers are willing to buy.

The strength of the relationship between price and demand is determined by the price sensitivity of demand.[5)]

1) European Commission 2019 (2019/C 267/07), Guidelines for national courts on how to estimate the share of overcharge which was passed on to the indirect purchaser
2) 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.
3) i.e. the cost increment incurred when purchasing one additional input
4) In any market, demand is referred to as the quantity of the good or service in question that purchasers on this market would buy at a given price level.
5) If, for example, an increase in price of EUR 1 is associated with a significant reduction in the quantity purchased, demand is said to be more price-sensitive than if the purchase quantity reduction is less important for the same EUR 1 price increase.

- The curvature of demand is the rate at which the responsiveness of demand to price-changes varies as price or output changes. There are different shapes of demand curves affecting passing-on.
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    - Different shapes of demand curves

A standard demand curve is an inverse downward sloping one. When the demand curve is linear, it has no curvature. In the case of a convex demand curve, the demand becomes less sensitive to price changes as the price increases (Example: demand for drinking water in the desert). If the demand curve is concave the demand becomes more sensitive to price changes as the price increases (Example: product substitutes are available). The curvature of the demand curve has an impact on the passing-on of overcharges.

- Intensity of competition

In theory, there are two extreme cases: (1) a firm is a monopolist or (2) acts as a price-taker (i.e. perfect competition). These two textbook examples just facilitate our understanding of how markets function. In reality, in between these two extreme cases lies a broad range of intermediary scenarios. To assess these "in-between" scenarios of the textbook-cases a market structure analysis (MSA) upfront is necessary.

- Pricing decisions

A firms' pricing decisions are sometimes not consistent with the predictions on the basis of economic theory. Firms may sell multiple products as in grocery retail markets. In such markets, products are interrelated through their demand, for instance if a retailer sells competing brands of many product categories. Possible feedback effects need to be considered in a passing-on analysis. Another example is related to the existence of so-called 'psychological pricing' (i.e. € 99). A direct purchaser may choose not to pass on an overcharge, as passing an important psychological price data point would lead to a significant drop in the direct purchaser's demand.

- Industry-wide vs. firm-specific overcharge

If only one purchaser is affected, i.e. the overcharge is firm-specific indicating that the passing-on effects could be rather limited. Conversely, where all the undertakings in a market are affected by a cartel/ an overcharge, all of the undertakings will face higher input costs.

Quantification Methods

Three components relate to the harm for which a direct or indirect purchaser may claim compensation, namely (1) the overcharge, the (2) the passing-on related <u>price</u> effect and (3) the passing-on related <u>volume</u> effect.

The methods most widely used to estimate the initial overcharge are the so-called comparator-based methods. For the determination of the passing-on related effects, both for price and volume, similar methods are used. In practice, the market simulation approach that accounts simultaneously for passing-on related price and volume effects is a popular one.

In order to employ this market simulation method, an economic expert needs to develop a model of competition at the stage of the distribution chain where the claimant is active and simulate the effect of the relevant overcharge on the claimant's profit during the infringement period. The economic expert also must test how different curvatures of the demand curve may affect the degree of passing-on. Based on the specifications of the demand side and the supply side, the equilibrium prices in the relevant market can be calculated with the support of econometric tools.

Practical passing-on examples

Shield

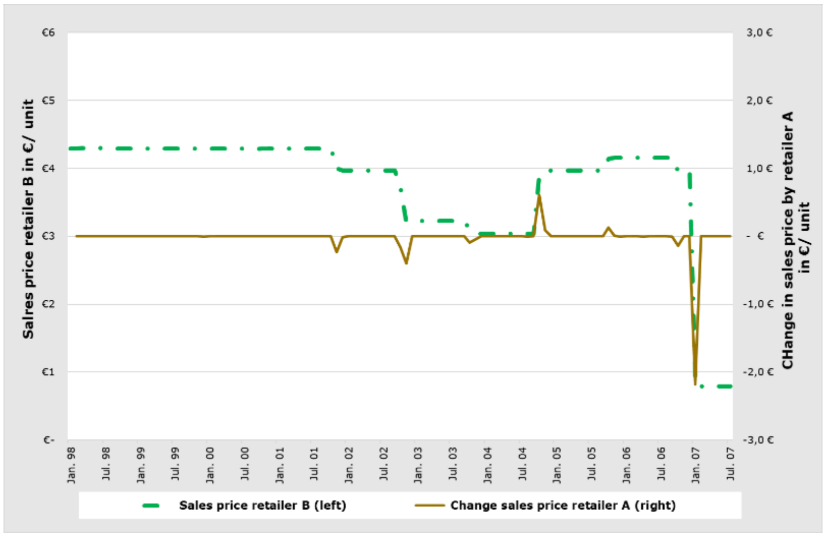
An infringer invokes the passing-on of overcharges in its defence against damages claims by arguing that the purchaser has passed on the overcharge, entirely or in part, to its own customers. This situation is a shield and a quite popular argument in cartel cases when the claimant is a retailer.

As elaborated above, a range of factors may affect the outcome of a passing-on scenario simultaneously. That is why in theory an estimation of the actual passing-on of overcharges according to economic theories and quantification methods might become a demanding task.

Nevertheless, sometimes the introduction of simplicity or common sense helps. The economic expert for example may analyse a potential passing-on by assessing quantitative data without the use of regression analysis and by taking into consideration at the same time qualitative evidence about the market at stake. By using such a simple approach, EE&MC assessed a potential shield in the German grocery retail market.

For illustration, the following graph shows the price developments of retailer B and the price changes of retailer A in the period 1998-2007.

Figure 1: Sales price development retailer B and change in sales prices of retailer A (01/1998-07/2007, in €)



Common sense is that in Germany some retailers are price-makers. Assume that retailer A changes a product price. The product at stake is such a popular one that every consumer has a specific price data point of that specific product in his mind (e.g. coffee or a crate of beer). Experience shows that all other German retailers need to adapt their prices for that specific product, as well, within a few days. Otherwise they risk losing sales.

The cartel period was 2000-2004. The product affected by the cartel was a grocery product. The infringer tries to use a shield against damage claims by a grocery retailer by arguing that overcharges were passed-on to end-consumers. Retailer B suffered from the cartel whereas retailer A did not.

The graph illustrates a pattern namely that retailer B changes product prices in coherence with price changes done by retailer A. A more detailed analysis of the price data reveals that retailer B changed price changes three working days after retailer A has changed its prices.

The observed pattern is consistent within the cartel and the competition period. This suggests that the pricing of retailer B depends on the pricing pattern of retailer A. The shield is broken: observed price changes are not caused by a passing on of the cartel overcharge.

Sword

Indirect purchasers may base their damages actions on the argument that direct purchasers of the infringers have passed on (parts of) the overcharge to them. In such a scenario, passing-on is a sword.

The ORWI-case (Federal Court of Justice, KZR 75/10) is a leading German case in this respect. The injured party purchased carbonless paper from an wholesaler of the infringer. From an economic perspective, the sword-argument depends on the assessment of whether the direct purchaser is a subsidiary with the group of the infringer or an economically independent company.

In the case of group companies, a vertical integrated wholesaler/ subsidiary would not recover damages against the producing parent company. Thus, in fact the indirect purchaser is the first economic direct purchaser outside the cartel.

About EE&MC

EE&MC with offices in Brussels, Düsseldorf, Maastricht, Paris and Vienna is a competition economic consulting firm that performs economic analyses in all antitrust matters for more than 25 years. Managing Partner of EE&MC is Prof. Dr. Dr. Doris Hildebrand. The manifold experiences of EE&MC are documented on the firm’s website www.ee-mc.com. With respect to cartel damage claims EE&MC has a solid record of 15 different cartel complexes serving more than 200 clients in that field.