The European Commission Study on Quantifying Damages and Indirect Purchasers

By: Henry B. McFarland, Economists Inc.

The brief discussion of indirect purchaser damages in the European Commission's recent study on "Quantifying Antitrust Damages" provides a useful introduction to the subject.[1] Indirect purchaser damages have received increased attention in a number of jurisdictions lately. Canadian courts certified classes including indirect purchasers in two recent decisions.[2] Moreover, while U.S. federal antitrust law does not allow indirect purchasers to collect damages, indirect purchasers recently have had success under certain state laws.[3] Estimating such damages, however, involves a number of complications not encountered when estimating damages for direct purchasers.

Quantifying indirect purchaser damages is difficult because it requires considering the interactions of two separate economic markets: the upstream market where the antitrust violation occurred and the downstream market where some of the effects might have been felt. The central question is the extent to which the effects of the violation in one market are passed through to the customers in the second market. A variety of factors will affect the extent of pass-through.

The study focuses largely on one of these factors, the structure of the downstream market. Theory indicates that if suppliers in the downstream market are perfectly competitive, suppliers will pass-through 100% of any increase in their marginal cost, the cost of producing an additional unit of output. By comparison, a monopolist in the downstream market will pass-through only 50% of an increase in its marginal costs, if those costs are constant with output and if demand is linear. Different oligopoly models suggest pass-through rates between 50% and 100%. These statements concerning the relationship between industry structure and pass-through, however, all assume that marginal costs do not increase with output. That assumption implies a very elastic supply; there is a relatively large increase in the amount the downstream industry supplies in response to the price it receives. That in turn suggests that the suppliers' response will dominate the extent of pass-through. If marginal costs are increasing, then supply will be less elastic, and the reactions of consumers to higher prices, an issue the report only briefly touches on, will also affect the extent of pass-through.

The need to consider consumer reactions may greatly complicate the pass-through analysis, particularly if the violation affects more than one downstream industry. The consumers of different downstream industries may differ significantly in their ability to turn to alternative products and thus in their reaction to a price increase. Thus, different downstream industries may have very different pass-through rates and require separate analyses. For example, the plaintiffs' expert in one of the Canadian cases differentiated purchasers of hydrogen peroxide in the pulp and paper industry from those in water treatment.[4]

Another important issue affecting pass-through rates is whether the antitrust violation affects all or only some of the competitors in the downstream market. The report describes cases where, because not all suppliers are affected by the violation, the pass-through rate is zero. The extent to which unaffected suppliers prevent pass-through, however, depends on their share of the market and their elasticity of supply. Unless the supply of the unaffected suppliers is infinitely elastic, some pass-through will

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1 "Quantifying antitrust damages. Towards non-binding guidance for courts," study prepared for the European Commission, December 2009, available at ec.europa.eu/competition/antitrust/actionsdamages/. The study does not represent an official position of the European Commission.

2 *Irving Paper Limited et al. v. Atofina Chemicals Inc. et al.* (*Irving Paper)* [2009] O.J. 4051 (S.C.J.) (hereafter "Irving Paper") and *Pro-Sys Consultants Ltd. v. Infineon Technologies AG,* 2009 BCCA 503.

3 For an example of a case in which substantial damages were awarded to indirect purchasers based on the antitrust laws of several states, see Shannon Henson, "Hydrogen Peroxide Indirect Purchasers Win $4.2M Deal," *Law360, June 10, 2010, competition.law360.com/articles/174223. See also* Order Granting IP Plaintiffs' Motion for Class Certification and Denying Motions to Exclude Expert Opinions, *In Re: Static Random Access Memory (SRAM) Antitrust Litig.* (N.D. Cal. Nov. 25, 2009).

4 *Irving Paper* at ¶ 134.

probably occur. Suppose, for example, a price fixing conspiracy raises the costs of a domestic industry that competes with imports but does not affect the costs of the importers. The downstream domestic industry will likely respond to the higher costs by reducing its output. The effect on the consumers downstream will depend on how readily imports expand to replace the reduction in domestic output. If importers require significantly higher prices to increase their sales in the country, then pass-through may be substantial.

Timing is also an important issue when considering pass-through. Price increases in the downstream market may not take place until well after the antitrust violation in the upstream market. As the report notes, the violation may only affect downstream industry costs that are fixed in the short-run. Violations that only affect fixed costs are at first unlikely to affect the downstream industry's price. Over time, however, fixed costs may become variable costs, and thus begin to influence pricing. For example, suppose price fixing increases the cost of an industry's equipment. At first, there will be no downstream price effect, and thus no pass-through, as that industry continues to use the equipment that it already has on hand. Eventually, however, that equipment will wear out. While investments in that equipment may have made an adequate return at the lower price, such investments may not be profitable now that the equipment is more expensive. Thus, the downstream industry may reduce capacity, and as a result its output will fall and its price will rise.

Other factors may affect the timing of pass-through. In some industries, pass-through may be delayed by the existence of long term contracts that do not have escalator clauses. In that case, the timing of pass though may be different for customers whose contracts expire at different times. Moreover, if price increases are costly, for example because they require revising and reissuing a substantial volume of sales literature, then suppliers in the downstream market may delay passing though a cost increase until they determine how long it will last.

As is evident from even this article's brief survey of the topic, accurately calculating indirect purchaser antitrust damages is a highly complicated endeavour requiring exhaustive industry and consumer analysis. There is no default, off-the-shelf model for calculating such damages. For example, if the consumer response in the downstream industry is likely to affect the extent of pass-through, a model of indirect damages may have to take account of factors that influence that response, such as the prices of substitutes. Similarly, in cases where the violation does not affect all downstream suppliers, a model of indirect damages will have to consider how the response of the unaffected suppliers affects pass-through.

Considerations involving the timing of pass-through also have important implications for attempts to quantify damages. If the effects of the violation in the downstream market are likely to lag behind its effects in the upstream market, then the model of indirect purchaser damages will have to account for that possibility. Using a model that assumes that pass-though happens either more or less quickly than is the case can lead to seriously biased estimates of damages.

As courts hear more and more indirect purchaser suits, and as parties gain experience in shaping discovery, expert analysis, trial hearings, and settlement negotiations with respect to calculation of indirect purchaser damages, the economic nuances of such calculations will increasingly become part of the standard repertoire of the antitrust practitioner.