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Crime and Punishment (and Deterrence) – the role of private cartel damages actions

Private actions for cartel damages have become an increasingly common feature in Europe. This Brief discusses, in light of the EC Commission's White Paper on private actions, the role that damages claims can play in protecting competition and consumer interests in horizontal cartel cases.[1]

The role of private actions for damages

Claims for cartel damages generally arise as a follow-on action after the Commission (or national authority) has completed an investigation and issued a decision against a cartel infringement. The Commission has power to levy substantial fines of up to 10% of a cartel member's global turnover, and has shown an increasing propensity to use these powers to punish cartel behaviour.[2] However, such fines play no role in compensating the victims of the misconduct, and that is where the scope for private damages comes in to the policy equation. To understand how private damages and authority fines should fit together, it is necessary to consider the two distinct policy objectives that underlie much of the policy debate in this area: deterrence and compensation.

Deterrence

In an ideal cartels regime, financial penalties levied on cartelists would provide economic incentives that deterred firms from engaging in cartel activity. Success in pursuing this objective would provide the best long term protection for consumers against the effects of unlawful cartel activity.

The economic principle of optimal deterrence defines an overall penalty that takes account of both the expected commercial gains from a successful cartel conspiracy and the risk of detection. By way of illustration, if a firm expects to gain €100m in additional profits from joining a cartel, and the risk of detection was 33%, the optimal penalty would be at least €300m.[3] Any penalty below this level would make involvement in the cartel look like a sound business proposition.[4]

In a scenario where a Commission decision and fine is followed by private actions for damages, an attempt by the Commission to achieve optimal deterrence would rest on some complex calculations and assessments. First, in setting the fine the Commission would need to assess the likely gains from the cartel infringement and the likelihood of detection. Second, it would need to net off from the fine some adjustment for the expected value of private damages claims. In the illustration above, if the firm's customers would successfully claim €100m in cartel damages once a cartel was detected, the fine should be set at €200m so as to achieve the overall optimal aggregate penalty of €300m.[5]

There is, however, no evidence that the Commission takes the likely value of private damages into account when setting fines, and there is certainly no sign of such considerations in the fining guidelines. Indeed, although those guidelines suggest fines should be related to the overall value of the European sales affected by the cartel, there is no explicit requirement for the Commission to assess the economic effect of cartels in reaching its conclusions on fines, except for a rather general indication that fines will depend on the "gravity" of the infringement. When it comes to Commission cartel decisions, despite the volume of economic data collected during a cartel investigation, there is seldom any serious attempt to quantify the impact of the infringement on prices or profits of the firms involved.

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"White Paper on Damages actions for breach of the EC antitrust rules", EC Commission, 2 April 2008. See also the Commission Staff Working Paper on this subject, issued at the same time. Relevant documents available from http://ec.europa.eu/competition/antitrust/actionsdamages/documents.html#link1

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See, for example, the decision to levy aggregate fines of almost €1.4bn on four car glass producers in November 2008: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1685&format=HTML&aged=0&language=EN&guiLanguage=en

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In this calculation, the €100m gain from involvement in the cartel needs to be multiplied by a factor of 3 to reflect the assumption that 2 out of every 3 cartels remained undetected. This illustration assumes firms have a neutral attitude to risk.

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This abstracts from other costs associated with being caught, both financial (e.g. the costs of fighting the Commission decision) and non-financial such as the adverse effects from bad publicity and/or any personal risk of criminal sanctions to which business managers might be exposed.

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The leniency regime is another relevant practical factor here. Immunity and/or discounts from Commission fines are justified by the impact that leniency incentives have in increasing the probability of detection. But if leniency applicants remain subject to private damage claims that will tend to reduce their incentive to apply.

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See "Guidelines on the setting of fines imposed pursuant to Article 23(2)(a) of Regulation No 1/2003", September 2006.

Compensation

The second major policy objective is the desire to compensate victims of cartels. The Commission's White Paper is clear that its initiatives on private damages are motivated by this objective:

> "The **primary objective** of this White Paper is to improve the legal conditions for victims to exercise their right under the Treaty to reparation of all damage suffered as a result of a breach of the EC antitrust rules. **Full compensation** is, therefore, the first and foremost guiding principle." (page 3, original emphasis)

Compensation requires that the economic effects on competition of a cartel are identified, and that those effects are properly allocated to the various affected parties. Neither of these steps is straightforward. Moreover, this desire to compensate cartel victims is very different from the desire to deter cartel behaviour. For example, a cartel that proved to be hopelessly ineffective *ex post* would not give rise to any need for compensation to its customers, yet the *ex ante* prospect of such activity having an adverse effect could well justify a penalty against the cartel members in order to deter more successful attempts to cartelise in future cases.[7]

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More generally, damages based on compensation will never provide sufficient financial incentives to create deterrence. This is one reason why treble damages are employed in the US system.

Assessing damages to direct purchasers

The starting point for an assessment of damage from a cartel is to measure the impact on direct purchasers. In the simplest case, how much did a cartel elevate the prices paid by customers compared to the price that would have applied in the absence of the infringement?[8]

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We focus on price, although in principle the cartel may impact on service, quality or even innovation. Other parties may also be directly affected, for example suppliers of inputs to the cartel members who will lose sales from the tendency for the cartel to have restricted output levels in the industry. Less conventional cases may raise other issues, for example if the cartel is aimed at affecting the prices at which the cartel members buy from their suppliers.

A range of tools exists for estimating the effects of cartels on prices. Typically, this estimation will involve a series of benchmark comparisons that seek to assess prices in the absence of the infringement. If there is a clear delineation of the periods before, during and after the cartel period, then a comparison of prices or margins across these periods provides the obvious starting point for this assessment. If some products or customer groups are affected by the cartel but others are not, then a cross-section comparison at any point in time may serve a similar purpose.

Since prices and price changes in an industry will be influenced by many factors, a model that seeks to explain price changes solely be reference to the cartel is likely to be imperfect. Various empirical techniques exist to overcome such imperfection by controlling for other factors. At the extreme, some have advocated simulation models, comparable to those used in merger simulation, which purport to provide a complete explanation of price formation in an industry and then attempt to isolate the impact of cartel behaviour from other factors.[9]

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Cartel simulation models are ambitious, not least because the difference between cartel and non-cartel outcomes tends to involve a shift in the way in which firms compete from coordinated to non-coordinated behaviour rather than a simple adaptation of unilateral conduct to changes in competitive constraints.

An effective approach to estimating the direct impact of a cartel on price should ideally combine a number of different approaches to the assessment of the counterfactual, and where possible ensure that the results can be sense-checked against known industry facts. The task of estimating the effects of a cartel has been criticised for being speculative in nature, and it is undeniable that such estimates require the analyst to piece together the available clues on what would have happened to price had it not been for the infringement. However, that challenge is inherently no more or less difficult than many other competition law assessments, for example the evaluation of the effect that a merger will have on competition.[10] Nor is it necessarily any more complex than other "what if" enquiries about commercial damages suffered from events such as breach of contract, and on which courts are expected to make an assessment.

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Though the result from a merger analysis tends to be a simple yes/no assessment to the relevant question, whereas a cartel damage analysis does need to undertake a more granular assessment of how much damage was caused by the cartel.

As with these other classes of empirical estimation, there will typically be a range of tools available to undertake the analysis, and the degree of sophistication employed in the analysis should depend on the nature of the case, the data (and time) available, and on what is at stake in the dispute.

The Commission's work in this area has shown an interest in methods that might be adopted to simplify the analysis, perhaps by applying simple rules of thumb to ease the burdens on private parties and hence encourage them to engage in private actions for damages.[11] However, in view of the diversity in the form and effectiveness of cartel infringements, it is very unlikely that such simple rules will provide a reliable guide to the actual impact of a cartel, and private actions will not provide fair levels of compensation if they result in damages claims that fail to match the actual economic impact of the infringement.[12]

A more reliable way to improve the quality of the analysis of cartel effects would be for the Commission itself explicitly to address the impact of a cartel on prices when reaching its decisions.[13] At that stage the Commission has access to detailed information on the affected businesses, and would also be able to engage the parties and their advisers in an informed debate on the degree to which the cartel succeeded in its aim to raise prices. This process could provide better and more timely evidence than is available to third parties when making damage claims, many of which arise years after the cartel infringement has ceased.[14]

Requiring the Commission to undertake this additional task would be consistent with the broader moves towards effects-based enforcement of EC competition law and need not be particularly onerous in view of the extensive legal and factual analysis that already surrounds a cartel investigation. It would also provide an opportunity for the Commission to address whether the level of fines imposed for cartel offences bore a reasonable relationship to the economic costs of the behaviour that was being condemned, thus providing greater transparency and predictability than the current system.

Downstream harm and the passing on defence

Of course, even if the initial impact of the cartel is identified, that impact on the prices paid by the immediate customers is just the first round effect. A true inquiry into the damages from a cartel needs to go beyond this first round effect to assess the extent to which primary customers succeeded in passing on the cartel's effects to downstream customers.

Where the cartel affects the per unit price of a cartelised product, economic theory predicts varying degrees of cost pass-through depending on the nature of demand for the product in question and the effectiveness of competition between the suppliers in the downstream market.[15] A per unit increase in a component cost of all the suppliers in a very competitive low margin industry will be expected to result in a very high degree of pass-through. But in a downstream industry where price-cost margins are high and products are highly differentiated, pass-through effects are much harder to assess and can be very low.[16] The empirical assessment of such issues reflects the kinds of analysis that is routinely done to assess the extent to which per unit or *ad valorem* taxes which are levied on suppliers have their effects passed through in customer prices.

There are clear practical problems with capturing downstream pass-through effects. First, as the effects pass from one stage of the supply chain to another their estimation becomes more and more complex, depending on actions and reactions to the original upstream price effect. In a context where damage claimants need to satisfy a court of the harm they have suffered this complexity adds to the cost and difficulty of that task. Second, in most markets the customer base becomes more diffuse as the product moves down the supply chain. The effect of a cartel between a few suppliers of an industrial product to a few primary customers could end up in the hands of millions of individual end consumers, each of whom will have suffered only a small loss. These two features have a potentially devastating impact on the ability of downstream customers to make a claim for damages. The complexity factor makes it more costly to establish the impact, and the diffusion factor reduces the expected pay-off for any one claimant. The White Paper acknowledges these problems but its proposed solutions are less than convincing.

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See the conclusion on page 7 of the White Paper under heading 2.5.

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This warning is even more acute in respect of alleged cartel infringements that involve behaviour such as information exchange between rivals, where any link between the behaviour and the alleged effect on competition is (at best) an indirect one.

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Arguably, this assessment could go even further, including consideration of likely pass-through effects or impact on other trading partners of the cartel members.

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The information could be especially valuable in legal regimes where there is no discovery process that allows claimants to obtain date from the cartel members.

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Where the cartel's impact takes the form of a single lump sum effect, however, there may be no such pass-through of the damage. For example, it is plausible that the impact of a bid-rigging conspiracy in local government contracts to build a new school would affect the local government entity but not the eventual users of that building.

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Similarly, pass through could be reduced if the cartel affects only a sub-set of competitors since competition with rivals who do not face the cartel cost penalty may reduce their scope for pass-through.

To reduce the complexity factor it proposes to introduce a rebuttable presumption that the damage from an upstream cartel will be passed through the supply chain in its entirety. Para 2.6 of the White Paper concludes:

> "indirect purchasers should be able to rely on the rebuttable presumption that the illegal overcharge was passed on to them in its entirety."

There are (at least) three problems with this approach. First, the presumption is clearly not valid in most cases, so it is bound to invite robust criticism from defendants in any damages action. Second, it remains uncertain where the pass-through process ends, and the notion that the damage claim belongs to the final link in the supply chain will raise particularly difficult problems in the case of cartel activity that occurs at the top of a long supply chain.[17] Third, by encouraging the notion that cartel damages are passed down the supply chain in this fashion the White paper makes it much harder for immediate customers, who are generally in the best position, to mount a credible claim.[18] Thus, the Commission's desire to encourage downstream customers to claim damages could have the unintended effect of reducing the likelihood of damages claims happening at all.

To address the diffusion problem, the White Paper suggests a need for downstream claimants to have access to class or representative actions whereby they can amalgamate their purchasing power and justify the costs of engaging in litigation. However, these suggestions sound more like wishful thinking than concrete proposals for reform.

Assessment

This Brief has highlighted three main economic and policy issues arising from the White Paper as it relates to cartel damages.

First, there is a clear conceptual distinction between the desire to deter cartel behaviour and the desire to compensate victims. It is important to maintain a clear focus on which of these objectives any public policy instrument is seeking to pursue, but such clarity is not always evident in the White Paper discussion. Ultimately, effective deterrence is the most effective way for the Commission to protect consumers from the adverse effects of cartels. In a legal system in which damages are confined to compensating victims, fines levied on cartel members (perhaps along with other penalties) remain the most effective instrument to achieve that objective.

Second, one of the biggest obstacles to claiming private damages is the difficulty of establishing the impact of the cartel. Since the Commission wishes to encourage customers to use private actions to gain redress, one of the most useful steps it could take would be to ensure that the Commission's extensive data gathering is used to address explicitly the estimated effects of the cartel in cartel infringement decisions. Deterrence objectives could justify the Commission in imposing fines even on cartels that fail in their attempts to raise price, but a fining system that was more closely related to the adverse effects on customers would provide a more robust basis for private actions, and it would also ensure that Commission cartel decisions are more firmly grounded in an effects-based approach.

Third, the Commission needs to think further about the trade-off between its preference to allow end consumers to claim damages from cartels, and the practicalities of establishing a basis for effective private actions. In its populist desire to follow the effects of cartels down the supply chain, the White Paper is in danger of defining private actions out of existence.

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Similarly, indirectly affected parties need not be confined to those downstream of the cartel. It is possible for suppliers and other industry participants to bear some impact, especially if the cartel has had a significant impact on output levels.

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Though even with complete pass-through there will still be some loss to immediate customers due to the reduction in sales volumes they will suffer after being forced to raise their output prices.