The law and economics of pass-on in price fixing cases

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ABSTRACT

Sainsbury's Supermarkets v. MasterCard establishes the pass-on "defence" in English law. The Competition Appeal Tribunal set out a two-part test which it erroneously distinguished from the economists' notion of pass-on. It then went on the develop key elements of legal pass-on in price fixing cases. This article critically assesses the Tribunal's judgment within a law and economics framework. It provides a rounded interpretation of pass-on as both a defence and offence, the different evidentiary standards and principles used, and the potential for consistency which could see defendants liable to claims more than the overcharges.

Keywords; price fixing, pass-on, overcharge, causation, counterfactuals, unjust enrichment, credit cards, interchange fees, illegal taxes, MasterCard, EU Damages Directive.

JEL: D4; K0; K21; L1; L4; L11; L12; L13; K14; L41; L44; N60.

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Sainsbury's Supermarkets v MasterCard[1] is the first definitive judicial decision that establishes the pass-on "defence" in English competition law. Despite this welcome clarification, the Competition Appeal Tribunal's (CAT) reasoning is far from clear and has led to confusion. This article clarifies the Tribunal's legal test, apart from incorrectly distinguishing economic and legal pass-on, only applies when pass-on is pleaded as a "defence". It is expressly not applicable when pass-on is used by indirect purchaser to support an action for damages. The differing evidentiary standards adopted by the Tribunal led it to reject MasterCard's pass-on defence while accepting that 50% of the same overcharge had been passed on to Sainsbury's customers when awarding interest. While there may be good legal and procedural grounds for adopting this bifurcated approach; it also lacks coherence since it exposes MasterCard to potential damages 1.5 times greater than the overcharge.

Background

Sainsbury's is a standalone action by an indirect purchaser alleging that MasterCard infringed Chapter I of the UK *Competition Act 1998* and/or Article 101TFEU. The Tribunal in a landmark 300-page judgment considered the law on competition damages and pass-on. It found MasterCard had set excessive default interchange fees on its credit and debit cards, known as multilateral

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[1] *Sainsbury's Supermarkets v. MasterCard* (Case No 1241/5/7/15) [2016] CAT 11; [2016] CompAR 33, CAT.

interchange fees (MIFs). These fees are paid by the card acquirer to the card issuer as a wholesale charge. The card acquirer then marks-up the MIF with its costs and margin which the retailer pays as a merchant service charge (MSC) expressed as a percentage of the value of the goods or services purchased using the credit card.

Central to Sainsbury's damage claim was the issue of pass-on. Pass-on is where a firm adjusts its prices in response to a change in its costs. In a cartel context, it is where the purchaser of an over-priced cartelised product or service increases its prices to cover part or all of the illegal overcharge.

The Tribunal considered three pass-on issues – the pass-on of MasterCard's MIFs by card acquirers to merchants; the pass-on of the MSC by Sainsbury's in higher retail prices; and pass-on when awarding pre-judgment interest. The Tribunal found that same overcharge had been fully, not, and half passed-on respectively. The key pass-on issue considered by the Tribunal was MasterCard's claim that Sainsbury's passed-on the entire MIF overcharge to its customers in higher prices and therefore suffered no loss. This was hotly contested by Sainsbury's, and the defence rejected by the Tribunal because of lack of evidence.

Why is Pass-on Allowed

The law allows any individual the right to claim full compensation "where there is a causal relationship between the harm and agreement or practice prohibited" "provided that the principles of equivalence and effectiveness are observed".[2] Pass-on is key to facilitating this compensatory objective. Pass-on ensures that claimants along the supply chain are only awarded their losses and not part of the overcharge pass-on in higher charges to their customers. To quote the EU Damages Directive 2014/104/EU[3] (Article 12(2)):

> In order to avoid overcompensation, Member States shall lay down procedural rules appropriate to ensure that compensation for actual loss at any level of the supply chain does not exceed the overcharge harm suffered at that level.

Pass-on plays a critical role in ensuring full compensation, avoiding over-compensation, and protecting the defendant from paying excessive compensation.

Pass-on does this in two ways – as a "defence" or "offence"; or more prosaically as a shield or a sword. It is available to a defendant to reduce or eliminate the damage claim by showing that the claimants did not bear the overcharge but passed it on to their customers in higher prices. *Sainsbury's* was concerned with the pass-on as such a "defence", with MasterCard pleading that the MIF was fully passed on by Sainsbury's in higher retail prices. As a sword pass-on gives indirect purchasers the right to claim compensation by showing that the overcharge was borne by them

[2] Case C–295/04 *Manfredi v Lloyd Adriatico Assicurazioni SpA* [2006] ECR I–6619.

[3] *Directive 2014/104/EU of the European Parliament and of the Council of 26 November 2014 on certain rules governing actions for damages under national law for infringements of the competition law provisions of the Member States and of the European Union*, OJ L 349, 5.12.2014, pp. 1–19.

rather than intermediate upstream suppliers from which they purchased the good. Without pass-on indirect purchasers, such as Sainsbury's, they would not have a claim for damages.

Pass-on Before *Sainsbury's*

Prior to *Sainsbury's* pass-on has been extensively considered by the European Courts in tax cases, and set out in the EU Damages Directive. Both are briefly referred to in the Tribunal's judgment largely to dismiss their relevance or to highlight the difficulties of proving pass-on. Here their relevance to and consistency with the position taken by the Tribunal are briefly considered.

EU Wrongful Tax Cases

The pass-on defence is well-established in actions to reclaim wrongfully imposed taxes. These cases arise where a national tax authority is found to have imposed an illegal tax and faces a claim to repay the tax from those taxed. The national tax authorities have routinely sought to invoke the "unjust enrichment" doctrine as a defence arguing that the claimant passed-on the tax in higher prices to its customers and therefore suffered no loss that the tax authority is required to repay. Unjust enrichment is simply pass-on by another name.

The European courts have said that the defence of unjust enrichment, based on Roman law, was "alien" to the laws of the Member States.[4] For this reason, and because pass-on is a restriction on a claimant's legal right to receive compensation for harm suffered from a breach of EU law[5], the courts have taken a restrictive view – there is no presumption of pass-on and the defendant has the burden of proof.[6] These are unexceptional propositions in English law and ones adopted by the Tribunal in *Sainsbury's.*

Weber's Wine World (excise duty on beverages) distils the established principles of when and how the defence of unjust enrichment or pass-on operates in tax cases:

- It is only an absolute defence if the entire tax is passed on to someone other than the taxable person; [7]
- It is to be interpreted restrictively, in particular because even the full pass-on of a charge to consumers does not necessarily neutralise the economic effects of the tax on the taxable person.[8]

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[4] "On the basis of the foregoing information, it requires only a short step to say that, with the exception of Denmark, passing on is alien to the legal experience of the Member States. And a permissive attitude with regard to alien concepts must not be allowed". *Amministrazione delle finanze dello Stato v. San Giorgio,* EU:C:1983:318, para 14, page 10.

[5] *Weber's Wine World & Ors v Abgabenburufungskommission*, C-147/01, EU:C:2003:533, para 95; *Comateb & Ors v. Directeur général des douanes and droits indirects*, EU:C:1997:12, para 25.

[6] *San Giorgio,* para 14; *Kapniki Michaïlidis AE v Idryma Koinonikon Asfaliseon (IKA),* EU:C:2000:479, para 36; *Weber's Wine World,* para 111.

[7] *Weber's Wine World,* para 94.

[8] *Weber's Wine World,* para 95.

- Even where the charge is wholly incorporated in the price "the taxable person may suffer as a result of a fall in the volume of sales".[9]
- It is not to be assumed if the law requires the charge to be passed-on to final consumers that it is in practice.[10]
- Even where it is established that the charge has not been passed on in part or whole to third parties repayment to the trader of the amount thus passed-on does not constitute unjust enrichment.[11]

The European Court have applied the principle of effectiveness[12] and held *inter alia* that:

- Procedural rules governing repayment must "not render impossible in practice or excessively difficult the exercise of rights conferred by the Community legal order (principle of effectiveness)"[13]
- Requiring "negative proof" from the taxable person or a presumption of pass-on are not consistent with community law [14]
- Assuming pass-on simply because the price invoiced to consumers includes the duty would render repayment impossible or excessively difficult (para 113).

As explained below the Tribunal's "legal test" for pass-on as a "defence" conforms to the restrictive approach taken in these tax cases.

There are several aspects of these tax cases that have a direct relevance to the *Sainsbury's* decision:

- The Courts have consistently held that the "degree of unjust enrichment … can be established only following an economic analysis in which all the relevant circumstances are taken into account"[15] This draws on the economists' analysis of tax incidence which is perhaps as old as economics itself. This uses standard economic theory to determine how a tax is likely to be shifted from the party or parties legally liable to pay the tax to others (buyer, seller or both; and others), who ultimately bears the tax; and its effects in terms of reduced output, investment, labour effort and so on.[16] In this regard the courts have generally shown a good understanding of the economics of tax incidence such as shown in the UK case *Berkshire Golf Club v HMRC*.[17] This economics has direct relevance to pass-on as the MIF being charged as a per centage of the value of the retailers' sales is equivalent an *ad valorem* tax.

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[9] *Weber's Wine World,* para 99.
[10] *Weber's Wine World* para 96.
[11] *Weber's Wine World, para*
[12] For an extensive discussion of pass-on in different legal areas see Magnus Strand, *The Passing-On Problem in Damages and Restitution under EU Law*, Edward Elgar, 2017, Chap 2.
[13] *Weber's Wine World,* para 103.
[14] *Weber's Wine World,* para 102 & 111.
[15] *Weber's Wine World*, para 100.
[16] Lawrence Kotlikoff and Laurence Summers, "The Theory of Tax Incidence," in Alan J. Auerbach and Martin Feldstein, eds, *Handbook of Public Economics* Vol II, 1987, Chap 16; Joseph E Stiglitz, *Economics of the Public Sector*, 2nd edn, Norton, 1988, Part 4.
[17] *The Berkshire Golf Club & Ors v. HMRC* [2015] UKFTT 627, 7 December 2015. Also, Amanda Brown and Karen Killington, "Berkshire Golf Club and the Economics of Unjust Enrichment", *Tax Journal,* 22 January 2016, pp. 14-15.

- There is no presumption of unjust enrichment even when the taxable entity has invoiced the tax to its customers, mark-up pricing is used, or it can be shown that it has been fully passed on. In these situations, the overall price may fall to offset part of the tax and/or as a result of pass-on the taxable entity suffers reduced sales and consequent lost profits.

- There is a major difference distinguishing tax and cartel damage cases. In tax cases the "overcharge" is known – the illegal tax - whereas in a cartel case the overcharge must be estimated using a counterfactual assessment which is typically problematic, difficult and contentious. Thus a cartel case is bound to be more complex, straining normal evidentiary requirements.

EU Damages Directive

The EU Damages Directive 2014/104/EU[18], which was not English law at the time of the *Sainsbury's* judgment, establishes a new legal framework for pass-on in cartel cases to come [which came] into force in 27 December 2016 **(??)**.

The Damages Directive seeks to, in effect, codify and unify part of the law on pass-on to be applied by EU national courts in cartel cases. It sets out a rebuttable presumption that a cartel infringement causes harm (Article 17), and that the purpose of damages is "full compensation" and no more to each party harmed (Article 4), irrespective of whether they are direct or indirect purchasers (Article 12). It confirms that there is a pass-on defence with the burden of proof on the defendant (Article 13), establishes a legal presumption of pass-on for indirect purchasers subject to certain conditions (Article 14), seeks to ensure that direct and indirect purchaser claims are rendered coherent so that a defendant does not end up paying more than the harm it has inflicted (Article 15).[19]

The Directive also provides that national courts should be able to estimate pass-on (Article 17) and that the European Commission issue guidelines to the national courts on how this is to be done (Article 16). After the *Sainsbury's* judgment was handed down the European Commission published an external consultant's report ("Pass-on Study" [20]) as a precursor to the Commission meeting its Article 16 obligation.

The Damages Directive affects the law in several key respects. Its major innovation is to reverse the burden, and to some degree standard of proof, by creating a rebuttable presumption of harm and a

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[18] *Directive 2014/104/EU of the European Parliament and of the Council of 26 November 2014 on certain rules governing actions for damages under national law for infringements of the competition law provisions of the Member States and of the European Union*, OJ L 349, 5.12.2014, pp. 1–19.

[19] The Damages Directive also strengthens pre-trial disclosure rules which is not likely to have much of an impact on UK private actions where the disclosure requirements are generally greater than in other EU countries.

[20] *Study on the Pass-on of Overcharges* prepared for the European Commission by RBB and Cautrecasa, Goncalves Periera, 2016 ("Pass-on Study").

rebuttable presumption of pass-on where indirect purchasers use pass-on to mount a claim for damages. The practical effect of this is unclear as the claimant must still prove causation, quantum, and the pass-on rate and amount. The other innovation is that the courts should have more powers to estimate damages where the evidentiary obstacles prove difficult or intractable.

The Damages Directive tempers the substantive and procedural requirements of national courts by the principles of "effectiveness and equivalence" as set out in Article 17 (1) (and generally in Article 4.):

> Member States shall ensure that neither the burden nor the standard of proof required for the quantification of harm renders the exercise of the right to damages practically impossible or excessively difficult. Member States shall ensure that the national courts are empowered, in accordance with national procedures, to estimate the amount of harm if it is established that a claimant suffered harm but it is practically impossible or excessively difficult precisely to quantify the harm suffered on the basis of the evidence available.

The *Sainsbury's* Legal Test for the Pass-on "Defence"

Sainsbury's provides a comprehensive review and clarification of the English law of competition damages and pass-on.

The Tribunal rejected "unjust enrichment" as a basis for the defence of pass-on. This was because unlike a tax reclaim, damages in competition cases where not claims in restitution but competition. Interestingly, the Damages Directive makes no mention of unjust enrichment.[21]

The Tribunal (para 484(3)) also stated: "The pass-on is not a defence but it simply reflects the need to ensure that a claimant is sufficiently compensated, and not over-compensated, by a defendant". It is one element in the general assessment of the claimant's harm and quantum. While this may be true as a matter of law, it is nonetheless also true that the Tribunal did treat pass-on as a defence as it placed the burden of proof on the defendant, which would not be the case if it were merely an aspect of establishing quantum.

The CAT (para 484) then went on to set out its "legal test" for pass-on as a "defence" in the process of distinguishing it from "economic pass-on":

> (4) … whilst the notion of passing-on a cost is a very familiar one to an economist, an economist is concerned with how an enterprise recovers its costs, whereas a lawyer is concerned with whether a specific claim is or is not well-founded. We consider that the legal definition of a passed-on cost differs from that of the economist in two respects:
>
> (i) First, whereas an economist might well define pass-on more widely (i.e. to include cost savings and reduced expenditure), the pass-on defence is only concerned with identifiable increases in prices by a firm to its customers.
>
> (ii) Secondly, the increase in price must be causally connected with the overcharge, and demonstrably so. There is danger in presuming pass-on of costs to indirect purchasers (*pace*

[21] It does however receive brief mention in the European Commission's 2008 Damages White Paper –

Article 14 of the Damages Directive), because of the risk that any potential claim becomes either so fragmented or else so impossible to prove that the end result is that the defendant retains the overcharge in default of a successful claimant or group of claimants. This risk of under-compensation, we consider, to be as great as the risk of overcompensation, and it informs the legal (as opposed to the economic) approach. It would also run counter to the EU principle of effectiveness in cases with an EU law element, as it would render recovery of compensation "impossible or excessively difficult".

(5) Given these factors, we consider that the pass-on "defence" ought only to succeed where, on the balance of probabilities, the defendant has shown that there exists another class of claimant, downstream of the claimant(s) in the action, to whom the overcharge has been passed on. Unless the defendant (and we stress that the burden is on the defendant) demonstrates the existence of such a class, we consider that a claimant's recovery of the overcharge incurred by it should not be reduced or defeated on this ground.

Sainsbury's can be read as setting out a two-part legal test for the pass-on defence. For the defendant to succeed it must prove that there is:

1. an "identifiable" increase in the purchasers' prices causally connected with the overcharge; and

2. a class of the downstream claimants' who paid the higher prices.

What is unclear is whether the second-part of the test is simply a reiteration of the need for the defendant to establish causation and proof of pass-on subject to the principle of effectiveness, or a separate requirement that the claimant's customers are likely to mount their own damage claim.

Do legal and economic pass-on differ?

The CAT's view that the economist's concept of pass-on differs from that in law is misconceived. Put bluntly, it mistakes the economists' analysis of a cost incidence with the narrower concept of pass-on.

An economist asked to address whether prices have increased as a result of an overcharge would address that specific issue. Pass-on means pass-on in higher than otherwise prices (but not as we shall see below necessarily higher absolute prices).

The Tribunal's (para 432) view of the economics of pass-on drew on the somewhat confused cross-examination of MasterCard's economics expert which it quoted at length. Sainsbury's Counsel posited the hypothetical example of a sweet shop faced with a 10 pence increase in the wholesale price of confectionary. Consider, asked Counsel, if the sweet shop decides to absorb the cost by reducing its marketing budget rather than make children pay more – is that cost savings pass-on or not? The expert appeared at times to accept that it was. As the questioning of MasterCard's economics expert continued the Tribunal Members' clarified what Counsel was assuming – an offsetting cost reduction such as cutting workers' wages. Having nearly clarified the concept the

Chairman concluded by asking: "The only thing that's not a pass-on, which is true absorption, is if it actually comes out of the [profit] margin?"; to which the expert replied "Yes, indeed".

The Tribunal's focus on the above cross examination muddied the waters on the pass-on issue. This needs to be swiftly corrected. The confectionary example was not an instance of pass-on but "pass-back" of the cost increase. The economist confused the shifting and incidence of the cost increase with the net burden borne by the confectionary shop on its profit margin. Ironically, the Tribunal went on to treat the confectioner's response neither as pass-on or pass-back but mitigation (see further below). Secondly, the economist was wrong to agree with the Chairman's statement that "The only thing that's not a pass-on, which is true absorption, is if it actually comes out of the [profit] margin?". As the tax cases and the economics of pass-on shows, full pass-on of a cost increase generates a lost profit claim in respect of reduced counterfactual sales. So you can have full pass-on with reduced net profits or "true absorption".

The Tribunal (para 433) appreciated that what is being discussed was the economics of cost incidence not exclusively pass-on:

> As this exchange illustrates, the notion of "passing-on" of a cost is a familiar concept in economics but that what is less clear is its practical implications. It will depend on conditions in both the demand for the product or service and the supply of inputs in its production. What this interchange is about is the practical issue of incidence: which party or parties bear the burden of absorbing the cost increase. Given that an efficient firm must – in order to turn a profit – pass its costs (one way or another) on to its consumers or else go out of business, pass-on might be said to be a fact of economic life (at least over time), occurring in relation to each and every cost, including an illegitimate or illegal overcharge like the UK MIF.

The Tribunal (para 434 and 455) went on to use the above exchange to examine in more detail the possible responses to an unavoidable cost increase:

> When faced with an unavoidable increase in cost, a firm can do one or more of four things:
>
> (1) It can make less profit (or incur a loss or, if loss making, a greater loss).
>
> (2) It can cut back on what it spends money on – reducing, for example, its marketing budget; or cutting back on advertising; or deciding not to make a capital investment (like a new factory or machine); or shedding staff.
>
> (3) It can reduce its costs by negotiating with its own suppliers and/or employees to persuade them to accept less in payment for the same services.
>
> (4) It can increase its own prices, and so pass the increased cost on to its purchasers.

These responses require further clarification (also see Table 1 below).

As stated above Responses (1) is not a response as such but the outcome of the various responses, and a measure of the net loss suffered by the claimant. Making less profits - "absorption" of the cost increase - is the consequence of both passing-on and not passing on the cost increase. The inability to fully pass-on a cost increase reduces profits on the sales made as the purchaser bears part of the increased costs, and is typically measured by the overcharge damages. But pass-on also increases lost profits by reducing counterfactual sales. This latter effect was ignored by the Tribunal but is alluded to in different terms in its discussion of Response (2)[22].

"Spending less" (Response (2)) is defined by the Tribunal to include reductions in marketing, advertising, capital expenditure and/or shedding staff. These responses would lead to a contraction of the firm, reduce its output and sales, and real losses to the claimant. The Tribunal accepted what it later termed "cutting back on expenditure" "is a case where Sainsbury's business may suffer real harm". While not considered by the Tribunal, these effects would be compensable as a lost profit claim by the purchaser because it spelt out lost counterfactual sales.

Reducing suppliers' or other input prices (Response (3)) is not, as already discussed, pass-on but "pass-back". Pass-back, such as when a supermarket pays dairy farmers less for their milk, should be offset against the claimant's damages, and gives farmers a separate claim in damages as difficult as this may seem. Interestingly the Tribunal saw a sharp distinction between this pass-back and Response (2); and treated it (Response (3)) not as pass-on but mitigation (see below).

Increasing the purchasers' product prices (Response 4) is pass-on. It reduces the overcharge damages on actual sales, but increases lost profits by causing the purchasers' customers to buy less of its now more expensive products. This decline in counterfactual sales gives rise to an additional lost profits claim; measure by the quantity of the reduced output times the pre-infringement margin. This aspect of pass-on was not pleased by Sainsbury or considered by the Tribunal.

Table 1: Response of purchasers to costs increases.

Tribunal category	Label	Description	Effect
Response (1) Make less profits	Absorption	Not an independent response but the outcome of the reactions to an unavoidable cost increase	Compensable as overcharge damages plus separate head of lost profit damages from reduced (counterfactual) sales.
Response (2) Spend less	Volume effect	Reducing marketing budget; advertising; capital investment or shedding staff imply	Lost profit on reduced (future) counterfactual sales

[22] The interrelationship between lost profits and pass-on has been stressed in the European Commission's Practical Guide and at length in the Pass-on Study but largely ignored in the Damages Directive, although clearly covered by Articles 3(2) and 12(3). See Cento Veljanovski, "Volume Effect Damages in Cartel Cases - Why pass-on gives rise to offsetting lost volume damages" *Casenote* March 2015 online at http://www.casecon.com/wp-content/uploads/Casenote-Passing-and-Lost-volume-March-20151.pdf.

		reduction in counterfactual sales/output	
Response (3) Reduce supplier costs	Pass-back	Tribunal treats as mitigation	Offset against overcharge damages
Response (4) Increased prices	Pass-on	Lost counterfactual sales due to pass-on ignored by Tribunal	Offset against overcharge claim (plus an additional claim for lost profits at pre-infringement margins on counterfactual sales)
Shrinkflation	Pass-on	Periodic size and package reduced while maintaining nominal prices	

If the above responses are casually related to the overcharge, then the claimant would be entitled to damages as follows:

Damages = Overcharge – Pass-on – Pass-back + Lost Profits

or simplified:

$$\textit{Damages} = (1-\alpha-\beta)\ \textit{Overcharge} + \textit{Lost Profits}$$

where α and *β* are the pass-on and pass-back rates respectively; and *Lost Profits* are the lost profits on counterfactual sales.

Under the compensatory principle pass-on and pass-back would be subtracted from the overcharge damages, so that *(1-α-β)* gives the discount on the overcharge estimate.

Does Pass-on Mean Higher Prices?

There is another amendment to the Tribunal's definition of what constitutes pass-on. Pass-on does not require an increase in absolute retail prices. It is consistent with increasing, constant and falling prices. This is so for at least two reasons:

- The "re-engineering" of products by decreasing their size and/or shrinking packet sizes but charging the same price – so called "shrinkflation"; and/or
- Reacting to a decline in costs where a cartel seeks to arrest the decline in its prices.

Pass-on can happen when prices are unchanged but the purchasers respond by reducing product weight, quality or pack size. In these cases the customer is paying the same for less. Product "re-engineering" appears a common response to rapid costs increases in the fast-moving grocery sector, and has been reported widely in 2016 as confectionary companies respond to the stronger US dollar and higher input costs.[23] Where a supplier or supermarket reduces product and/or packet

[23] This has been observed by the Bank of England's *Agents' summary of business conditions 2016 Q3*, p. 5.

sizes, but maintains the retail price then this is equivalent to a quality or quantity adjusted price increase, and is pass-on. For example, the recent reduction in Terry's Chocolate Orange from 175g to 157g while for the same retail price amount to a 10% increase in the weight-adjusted price of the product.

Pass-on is also consistent with the purchaser's price declining or remaining the same. Many cartels respond to and seek to arrest the decline in prices triggered by price wars, excess capacity and/or the entry of a new firm or imports which expand production and depress prices. These cartels slowdown the speed and extent of price declines so that the actual reduction in prices is less than would the decline in counterfactual prices. Thus pass-on of an overcharge when costs are falling is consistent with falling purchaser prices.

Mitigation

The Tribunal (para 472-478) dealt with the cost-saving Response (3) as "mitigation" and not as pass-on. Mitigation is where the claimant takes an action which reduces costs with the consequent cost reduction treated as "benefit" to be deducted from its claimed losses.[24] The Tribunal (para 475) commented that mitigation as "akin to one of causation".

Mitigation plays a key role in tort. In the typical tort case the claimant has a duty to take reasonable steps to reduce the harm it has suffered. He cannot leave a burst pipe unattended because it was caused by the negligence of his plumber. He must take reasonable steps to stem the flow, and is entitled only to the loss that would have resulted had he taken reasonable steps to mitigate the loss plus the cost of the remedial action.

The judgment is not always clear by what it means by "cost savings". It refers generally to the annual cost savings which the evidence indicated was a firm fixture of Sainsbury's annual budgetary efforts. But the judgment then confines "cost savings" to Response (3) which I have defined as pass-back.

The Tribunal rejected that any cost savings by Sainsbury's could be treated as mitigation. It (para 478(1)) found that because Sainsbury's was a rational cost-minimising business, any reduction in costs was not causally related to the overcharge and therefore could "not be regarded as a "benefit" to be set off against the overcharge":

> Most fundamentally, any costs savings sought and achieved by Sainsbury's would have been sought and would have been achieved whatever the level of the MIF. As a rational and efficient firm in a highly competitive market, Sainsbury's would be (and, as a matter of fact was) concerned to ensure that its costs were, year-on-year, as low as possible. That approach was a fundamental (but unsurprising) part of Sainsbury's business model and we consider that

[24] For recent restatement of the doctrine of mitigation in English law see *Fulton Shipping Inc v Globalia Business Travel SAU* [2014] EWHC 1547 (Comm).

this approach would have pertained whether the overcharge had been made or whether it had not been made.

The Tribunal concluded that whether there were any causally related cost-savings was “unknowable” and hence mitigation failed on this count alone.

The Tribunal’s assumption of cost efficiency is insufficient to dismiss mitigation. That Sainsbury’s did and would have acted to reduce costs in both counterfactual and factual situations is simply to assume it was an efficient profit-maximising entity consistent with the economist’s and Tribunal’s competitive market model. This does not rule out that a firm would seek further reductions when faced by an increase in its unavoidable costs. If this were not the case the courts would be drawn to the erroneous conclusion that an efficient firm would never pass-back a cost increase.

Summary

1. There is no difference between legal and economic pass-on.

2. Pass-on is consistent with direct and indirect purchaser prices increasing, remaining the same and/or falling over the infringement period.

1. Full pass-on cannot be equated to no impact on the purchaser’s profit margins. Pass-on implies reduced counterfactual sales and hence a lost profit claim.

2. Reducing capital expenditure and staff (Response (2)) implies reduced counterfactual sales and a lost profits claim.

3. Reducing supplier costs is “pass back”, or mitigation, and should be deducted from the claimants’ damages.

4. The factual and counterfactual that Sainsbury’s was a cost-minimising purchaser does not imply that an overcharge has not been passed-back or “mitigated”.

THE SECOND LIMB OF THE *SAINSBURY’S* TEST

The Tribunal (para 484(4)(ii)) further distinguished legal and economic pass-on by asserting that the former balances the risks of under-compensation and over-compensation of claimants.

This attempted distinction has little to do with the economics of pass-on. The Tribunal was addressing the evidentiary concern of whether when faced with uncertainty it should pay more attention to a Type I (undercompensating the claimant) than Type II (overcompensating the claimant) error. This must be the case since if the Tribunal knew the pass-on rate, there would be no need for the second limb of its legal test.

Expressed in this way the Tribunal seemed to be arguing that the risk of under-compensation trumps the prospect that the claimant may be over-compensated. In doing so, on one view, it could be seen as coming close to distorting the compensatory objective of damages by transposing full compensation to the claimants with the notion of full compensation paid by the Defendant.[25]

In the author's view the Tribunal confused the issue. The Tribunal's test does no more than reiterate and apply the restrictive approach of the EU Courts in tax cases and the Damages Directive when pass-on is pleaded as a "defence". In all three areas the Claimants' right to compensation is not to be easily compromised, and hence the law is applied restrictively requiring the Defendant to offer strong proof of pass-on.

The Tribunal's other requirement – that the defendant establish the existence of the class of downstream claimants to which the overcharge had been passed-on was poorly expressed. If this was a reiteration of the need to establish a causal link between the overcharge and the prices charged to Sainsbury's customers, then there is no issue. But paragraph 484(5) reads as if the defendant must establish that there was a realistic prospect that Sainsbury's customers would bring their own actions for compensation. This seems an unnecessary requirement reinforcing the criticism in the previous paragraph. Notwithstanding this, the irony was that just as the ink was drying on the Tribunal's judgment, a collective proceeding (*Walter Merricks v MasterCard*)[26] was launched in the CAT under the *Consumer Rights Act 2015* against MasterCard representing all downstream consumers premised on a high pass-on rate from retailers such as Sainsbury's.

This brings us to the main point. The Tribunal's test only applied when passing-on is used as a defence; even though the Tribunal denies that there was a passing on "defence". The judgment read in its entirety shows the Tribunal adumbrating a wider asymmetric or bifurcated legal test for pass-on. Where pass-on is raised as a "defence" the defendant cannot expect to deny the claimant compensation by default, mere assertion, and/or economic and empirical generalities. The defendant must prove pass-on to the civil standard of more likely than less. Where pass-on is used to mount an indirect purchasers' claim a more permissive approach is to be taken. Then the pleading runs with the grain of the right to compensation for an illegal act causing harm. In these cases, indirect economic and commercial evidence including economic theory may be sufficient to estimate the pass-on rate and quantum. The "principle of effectiveness" acts to modify the standard of proof, if not the type of evidence which can be used, to ensure that the "right to damages is not practically impossible and excessively difficult".

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[25] The European Commission's Proposal for a Damages Directive (para 30) did consider this (but was omitted from the final version): "in a situation where the overcharge is passed on to persons who are legally unable to claim compensation, it is not appropriate for the infringing undertaking to invoke the passing on defence, as this would render it free of liability for harm which it has caused". A Dutch lower court (District Court of Gelderland, *TenneT v. Alstom*, 10 June 2015 (ECLI:NL:RBGEL:2015:3713), para 2(29). http://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:RBGEL:2015:3713) denied the passing-on because it would unjustly enrich Alstom (a member of the Gas Insulated Switchgear cartel) as TenneT's purchasers faced "diabolical evidentiary problems, issues regarding limitation and other procedural complications, compared with their relatively small and scattered losses" which meant little prospect they would sue.

[26] CAT, *Notice of an Application to Commence Collective Proceedings under Section 47b of the Competition Act 1998* Case No. 1266/7/7/16.

This interpretation is supported by the way the Tribunal treated pass-on in the award of interest. Having comprehensively rejected MasterCard's pass-on defence, the Tribunal then found that half the overcharge had been passed-on to Sainsbury's customers when awarding interest. In a terse, abrupt and largely unsupported passage the Tribunal (para 525 – my emphasis) found:

> Sainsbury's would have sought to pass the cost of its UK MIF on to its customers. Although Sainsbury's would not have been unconstrained in its ability to pass this cost on, because the UK MIF was a cost common to Sainsbury's and its supermarket rivals, **<u>we consider that a substantial amount of the UK MIF – 50% – would have been passed-on (albeit not in a manner which would have amounted to a "defence" of pass-on</u>**, for the reasons given at paragraphs 484 to 485). It follows that had the overcharge not been made, Sainsbury's would not have received any interest: it would simply have not passed on the overcharge.

It appears that the same economic theory that the Tribunal rejected when considering the pass-on "defence" was here sufficient to establish it as an "offence" which in principle would see Sainsbury's customers awarded half of its damages. Why half is not explained.[27]

The coherence of this dual approach is problematic. Suppose that there are two private actions - one by a direct purchaser and the other by an indirect purchaser. The Defendant pleads a pass-on defence and the court takes a hard-line that it must prove identifiable price increases linked to the overcharge. If it cannot establish this, the defence fails and the direct purchaser gets full compensation. At the same or later date the direct purchaser's customers claim that they bore the bulk of the overcharge in increased prices. The court then relaxes the standard of proof according to the principle of effectiveness, and their claim for partial pass-on is successful. The defendant now confronts total damages greater than the overcharge. This is not a hypothetical example but implicit in the Tribunal's own findings - it fully compensated Sainsbury's while accepting that 50% of the overcharge was passed on to Sainsbury's customers. If this interpretation is accepted, MasterCard is exposed to potential damages 1.5 times the overcharge.

PROVING PASS-ON

Sainsbury's also suggests that different evidentiary standards can be used to assess damages which range from stringent when pass-on is used as a defence to theory when used by indirect purchasers (see summary Table 2 below).

A central premise of the law and economics of cartel damages is that quantifying harm is a difficult, uncertain, crude if not at times impossible. The Damages Directive (Recital (45)) states:

> Quantifying harm in competition law cases is a very fact-intensive process and may require the application of complex economic models. This is often very costly, and claimants have difficulties in obtaining the data necessary to substantiate their claims. The quantification of

[27] The Tribunal accepted that the market was competitive and that Sainsbury's would have passed-on most of the overcharge. The only theory which supports 50% pass-on is if it were assumed that Sainsbury's was a monopolist with linear demand and constant marginal costs.

> harm in competition law cases can thus constitute a substantial barrier preventing effective claims for compensation.

The Tribunal (para 434) similarly accepts that: "The problem is that it can be very difficult to ascertain whether and, if so, how, a given cost has been passed-on". It quotes White J's US Supreme Court judgment in *Hanover Shoe*[28] which stressed the "insuperable difficulty" of establishing the "unascertainable figures" required for pass-on so that the task would "normally prove insurmountable". *Hanover Shoe* resolved these evidentiary problems by rejecting the pass-on defence in US Federal antitrust law.[29] *Illinois Brick*[30] cemented this by refusing standing to indirect purchasers under US Federal law. This is not the approach in European and UK laws which permit pass-on as a defence and as the foundation for indirect purchasers' right to compensation.

Despite these concerns the CAT took a strict approach to proof of pass-on as "concerned with identifiable increases in prices by a firm to its customers" which "must be casually connected with the overcharge, and demonstrably so", the latter on the balance of probabilities. The Tribunal wanted evidence that the overcharge affected the price of every individual product line sold by Sainsbury. This was hardly an accommodation to the difficulties of proof.

MasterCard was not able to offer direct evidence establishing an identifiable link between the MIF overcharge on Sainsbury's retail prices. Its experts offered theory, quotations from various regulatory bodies and the courts, examples and research of the way similar industries passed-on cost increases.[31] The Tribunal ignored this evidence. The Tribunal (para 469) rejected what it admitted was a caricature of MasterCard's case:

> It is quite simply impossible to say that of the price for Sainsbury's Loose Fairtrade Bananas – which at the time of this Judgment sell for 68p per kilogram – 0.1p (or any other amount) is attributable to the UK MIF and is the means by which Sainsbury's recovers the cost of the UK MIF. Given the manner in which Sainsbury's does business, the proposition that such a nexus exists would be a frankly absurd one.

The Tribunal relied on evidence given by senior executives of Sainsbury's on how they budgeted costs and set their prices. This, the Tribunal said, showed a "detachment" between costs and prices, and that product prices which were determined by competitive pressures rather than costs. This

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[28] *Hanover Shoe Inc v. United States Machinery Corp.* 392 US 481, at 491-494. White J focus was on the deterrence role of private actions in US antitrust stating that they would be "more effectively enforced by concentrating the full recovery for the overcharge in the direct purchasers rather than by allowing every plaintiff potentially affected by the overcharge to sue for only the amount it could show was absorbed by it."

[29] This has been proposed for EU law. Bernard Rudden and William M Bishop, "Gritz and Quellmehl: Passing it on" *European Law Review*, [1981] Vol. 6, pp. 243-[].

[30] *Illinois Brick Co. v. Illinois* 431 U.S. 720 (1977) 735.

[31] The Pass-on Study's (Chap xx) indicates that this approach has been most common in the pass-on cases it reviewed: "Where experts have intervened, they have generally relied on insights from economic theory to argue for or against the existence and extent of pass-on and have sought to support their contentions with publicly available documentation such as market study reports and the particular characteristics of the market in question."

applied to all costs not just the overcharge – the price of bananas did not necessarily reflect the cost of bananas. The Tribunal (para 464/5) found that how Sainsbury's had reacted to the overcharge was as a matter of evidence "unknowable", and that the pass-on defence failed.

Table 2: Treatment of evidence by the Tribunal

Evidence	Details	Tribunal conclusion
Mark-up pricing	Uncontested that overcharge reflected in fees to merchants because acquirers used mark-up on costs to set fees	Accepted outright
Economic theory	In a competitive market costs would be largely pass-on	Rejected for pass-on defence but accepted to find 50% pass-on for award of interest
Regulation & competition authority statements	European Commission, OFT, other regulators and European Court stated that the overcharge would be passed-on in higher retail prices	Ignored
Pass-through studies	Reference to studies of cost pass-through in retail and similar sectors	Ignored
Econometric analysis	Not attempted because overcharge small and did not vary over the infringement period	
Claimant's direct evidence	Evidence of claimant's budgeting and pricing showed apparent detachment of prices from specific costs	Evidence accepted - Tribunal finds that how costs were dealt with was "unknowable".
Margins	Sainsbury's profit margins constant (para 463)	Ignored implications that all costs were covered unless assumed 100% pass-back

This approach contrasts markedly with the way the Tribunal treated pass-on when not a defence. When awarding interest the Tribunal (para 468) relied solely on economic theory to conclude that "Sainsbury's and its supermarket rivals … would have been passed-on (albeit not in a manner which would have amounted to a "defence" of pass-on)" half the overcharge. It went further saying that in the commercial environment in which Sainsbury's operated full pass-on was "blindingly obvious" – "If Sainsbury's did not seek to recover the inevitable costs of its business from its customers, it would rapidly lose more than it made, and become an ex-business."

The Tribunal's approach to proof was also in stark contrast to the breezy way it estimated the overcharge. There the Tribunal (para 423(3)) approvingly cited Shaw L's dictum that "when carrying out such an assessment, where there is an element of estimation and assumption – as frequently there will be – restoration by way of compensation is often accomplished by "sound imagination" and a "broad axe".[32] It employed what it described as a "speculative" and "hypothetical" counterfactual analysis.[33] There was no evidence that but for the actions of MasterCard what the interchange fee would have been. The counterfactual interchange fee and the MIF overcharge were simply estimated by the Tribunal based on extracting from past cost studies commissioned by MasterCard those cost items which the Tribunal did not regard as benefiting merchants.

ECONOMISTS' EXPERT EVIDENCE

The Tribunal had some stern words to the parties on the way they should instruct their economic experts.[34] It discounted the economist's expert evidence on the appropriate bilateral counterfactual and the how to measure the overcharge (para 181) because they were not "experts on payment systems". The Tribunal (para 37) noted the economists "expertise was engaged at one remove: it could only be deployed in relation to substantial and complex factual material about which they were not expert". "[i]t was" said the Tribunal (para 38), "incumbent upon the parties to ensure that the experts gave their opinions based upon a common – and if possible, agreed – factual base. It pointed to examples were the experts through no fault of their own were not aware of documents or of the applicable law as there was "in this case, a strong interplay between the legal principles, and the questions the economists were being asked to answer. As a result the Tribunal "placed considerably more weight on the contemporary factual material and the evidence of the witnesses of fact than we have on the experts, mainly because this material was insufficiently considered by them." The Tribunal (para 41) advised prospective litigants:

> For the future, in cases where significant economic evidence is being adduced by economic experts who lack specific expertise in the particular factual field under consideration, we consider that the parties need to be especially assiduous in ensuring that the economic experts are:
> (1) Clearly instructed on the legal principles they are to apply, and in particular any assumptions they are being required to make.
> (2) Absolutely clear as to the factual material on which their reports are to be based.

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32 *Watson Laidlaw & Co Ltd v Pott Cassels &* Williamson [1914] SC(HL) 18, para 29-30. Also cites *Devenish Nutrition Ltd v Sanofi-Aventis SA* [2007] EWHC 2394 (Ch) per Lewison J para 27 - 29 and [2008] EWCA Civ 1086 per Arden LJ para 110 and Longmore LJ at para 159.

33 See European Commission Staff Working Document, *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* {C (2013) 3440} ("Practical Guide"). *Communication from the Commission on Quantifying Harm in Actions for Damages Based on Breaches of Article 101 or 102 of the Treaty on the Functioning of the European Union* (2013/C 167/07).

34 In England the expert rules are set out in Part 35 of the Civil Procedure Rules (CPRs) and the associated Practice Direction; the Civil Justice Council's *Guidance for the Instruction of Experts in Civil Claims 2014;* and the CAT Guide 2015, para 7.65 to 7.69.

This is likely to lead to a more careful consideration as to how experts are instructed and whether they will be required to meet to agree certain common assumptions before trial. Under English procedural rules the experts can be directed by the court to produce a joint report that identifies the areas of agreement, disagreement and reasons for disagreement. In *Sainsbury's* the experts produced multiple reports and responses to one another's reports. In other jurisdiction, such as Australia, the lawyers will typically give their experts a list of factual and legal assumptions on which the expert's report is to be based. This is generally unsatisfactory for two reasons a) if the assumed facts are not the same facts as found by the Court then the expert evidence is weakened or rejected; b) the assumed facts given to an expert often reflect more favourably on the party issuing instructions thus giving rise to partial and/or distorted evidence.[35] After all it places the burden on what are essentially partisan lawyers to set out the facts and law. Even when both sides meet to set out the factual and legal assumptions, one or the other may be asked to agree to certain assumptions at an early stage in the proceedings which turn out to be incorrect or incomplete. Notwithstanding this the Tribunal's advice is well aimed.

[35] Cento Veljanovski, *"Economists in Court - A comparative assessment of procedures and experience in Australia and England & Wales from an economist's perspective"* (2009) Online at http://ssrn.com/abstract=1519952