axiom FORENSICS

Anti-competitive behaviour:

Assessing damages using residual income

Abstract

In February 2015 the Australian Competition and Consumer Commission (ACCC) Chairman Rod Sims released the ACCC's Compliance and Enforcement Policy, which outlines the organisation's current priorities. The policy provides that there are *"some forms of conduct that are so detrimental to consumer welfare and the competitive process that the ACCC will always regard them as a priority".*

Anti-competitive agreements and practices such as price-fixing are one such form of conduct.

One effective way to evaluate allegations of price-fixing involves the economic theory known as residual income. Residual income is a transparent, easy-to-understand method for identifying price-fixing behaviour and quantifying the damage suffered as a result of this anti-competitive behaviour.

Anti-competitive behaviour: "detrimental to consumer welfare and the competitive process".

Introduction

Over the past decade the ACCC has increased investigations into alleged anti-competitive behaviour.

Anti-competitive behaviour, including price-fixing, is also of interest to plaintiff law firms investigating potential class actions.

As such, it is relevant to examine avenues through which price-fixing can both be identified and damages quantified.

Overview of residual income

Residual income is an economic theory that relies on commonly available accounting information. In the context of allegations of price-fixing, residual income theory can be adapted both to demonstrate price-fixing behaviour and to quantify damage arising from price-fixing.

Applied in this context, the theory of residual income states that individual product prices should, at a minimum, seek to recover:

- Production costs, being those costs associated with producing the product that is the subject of the enquiry; and
- Stay-in-business costs.

'Stay in business costs' reflect the return that the owners of the business require on the capital that they have invested in the business.

If a company were to price its goods so that in the long run those prices did not recover all production costs and the capital return required by shareholders, the company will likely fail.

A business does not need to generate residual income to survive; rather, a business that earns a rate of return that satisfies both production costs and stay in business costs is performing in accordance with expectations.

Residual income is an economic theory that uses accounting information already commonly used in industry to evaluate a business' pricing policy.

Indeed, a business that generates residual income is, in essence, earning an 'abnormal' rate of return. In a competitive market where a business does not hold an enduring competitive advantage (such as unique intellectual property), it would be unusual for a business to generate residual income for extended periods of time.

Identification of price fixing and assessing damages

Where it has been alleged that price-fixing arrangements between competitors have been entered into, the theory underpinning residual income can be applied to both quantitively identify instances of price-fixing and to assess the damage suffered as a result of any price-fixing activity.

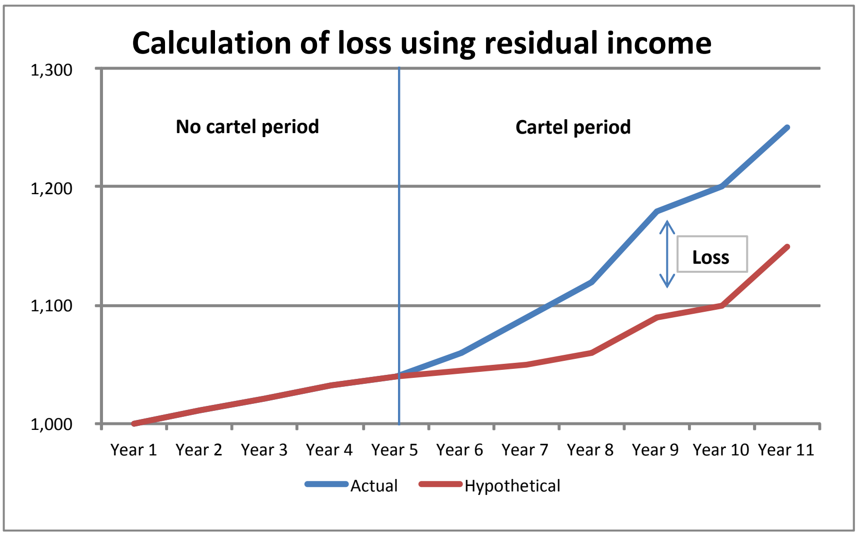
Axiom has been involved in matters where price-fixing has been alleged.

Axiom's analysis showed that while prior to the commencement of the alleged price-fixing period the business did not earn residual income, following the commencement of the alleged price-fixing period the business commenced earning residual income. Relevantly there were no changes in the business over this period.

The fact that the business started earning residual income from the time in which the price-fixing arrangement was alleged to have commenced, supported the contention that the business had engaged in price-fixing.

The residual income generated during the price-fixing period reflected the excess price that the business charged to customers as a result of the price-fixing agreement, and therefore reflected the damage that had been suffered by those customers.

A simple illustration of a residual income calculation in the context of price-fixing is as follows:



In relation to the above, the following should be noted:

- Prior to the cartel period the business achieved its required rate of return; that is, no residual income was earned;
- From year 5 onwards, however, with no changes to operations, the business began earning residual income;
- The period of residual income coincided with the period over which it was alleged that a price-fixing cartel operated.

By utilising residual income theory, Axiom was able to both identify the period of alleged price-fixing and to quantify the damage suffered as a result of this alleged price-fixing.

Conclusion

Axiom believes that residual income theory is a transparent, easy-to-understand method for both exposing price-fixing behaviour and quantifying the damage suffered by customers as a result of price-fixing behaviour.

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