

Price Parity clauses: Setting a new legal standard

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Abstract

Under the context of digital platforms who act as an intermediary between consumers and sellers, Price Parity Clauses (PPCs) is a contractual restriction for the seller not to sell at a lower price through any other channel (the so-called wide PPCs), or only in its own channel (narrow PPCs). These clauses present a trade-off between efficiencies and anticompetitive effects. On one side, PPCs act as a committing device of the seller to solve the show-rooming effect suffered by platforms (a particular form of free-riding), at the same time that it ensures platforms viability and enhances its incentives to invest and innovate. On the other side, PPCs allow platforms to charge higher fees, and lead to foreclosure of the market. Currently, neither the EC nor NCAs have set a clear guidance on how to assess these clauses. The main contribution of this paper is to set a legal standard for both wide and narrow PPCs using the cost-error analysis. The conclusions we arrived to are that wide PPCs should be *per se* illegal; and narrow PPCs should be presumed legal unless proven otherwise, except if narrow PPCs are eliminating the competitive restraints of the platform, in which case the standard should be that of rebuttable presumption of illegality.

Contents

1	Introduction	2
2	Framework of Analysis	3
2.1	What is a Digital platform?	3
2.2	What are PPCs?	4
2.2.1	Agency vs Merchant model	5
2.2.2	Types of PPCs	7
2.3	What are the effects of PPCs?	7
2.4	Why do platforms want PPCs?	8
2.5	Why do hotels need platforms?	10
3	Where are we now?	11
3.1	PPCs under article 101 TFEU	12
3.2	Previous cases	13
4	Cost-error analysis	18
4.1	Legal standard for Wide PPCs	20
4.1.1	Cost of Type I	20
4.1.2	Cost of Type II	21
4.1.3	Assessment of Wide PPCs	21
4.2	Legal standard for Narrow PPCs	23
4.2.1	Cost of Type I	23
4.2.2	Cost of Type II	23
4.2.3	Assessment of Narrow PPCs	24
5	References	27
	Figures	28

1 Introduction

”E-commerce will undoubtedly change the way business is done. But as we have said elsewhere, technology changes, economic laws do not. Despite the changes introduced by e-commerce, many of the fundamental principles of competition will still be relevant” Hal R. Varian (1999)

As traditional markets have been displaced by digital platforms and e-commerce, firms have adapted traditional economic practices to their new business model. In this context, new issues regarding possible anti-competitive practices are gaining relevance with different competition agencies around the major jurisdictions.

In particular, digital platforms such as Booking.com, Amazon, and Expedia are increasingly using Price Parity Clauses (PPCs). This type of clauses is a particular type of vertical restraints that restricts the seller from selling at any alternative platform at a lower price.¹

PPCs as such are not new. Traditionally, PPCs or Most Favored Nation (MFN) clauses, their traditional denomination have been used by the buyer to limit the ability of the seller to offer selective discounts to certain buyers, and thus solve the commitment or hold-up problem faced by the seller or manufacturer. But sellers have been prone to use other vertical restraints, such as retail price maintenance, territorial protection or selective distribution.

Recently, however there has been several antitrust cases surrounding PPCs in digital platforms, where competition authorities across Europe are failing to take a uniform approach. Since the existing economic literature on this matter has a theoretical approach, there is a need to create a practical framework, to set a legal standard to solve this complex issue.

This thesis will discuss the effects of the PPCs in the context of the Digital Economy. Also, we will discuss some of the most relevant cases in the EU concerning the impact of PPCs in the competitive process under the light of article 101 of the Treaty of Functioning of the European Union (TFEU).

¹Boik, A., and Corts, K. S. (2016) ”The effects of platform MFNs on competition and entry.” *Journal of Law and Economics*, 59.1, pp. 105-134.

Our goal is to develop a framework to analyze this type of clauses in the context of digital economy, and accordingly, propose the appropriate legal standard that should be adopted. Using the cost-error analysis, the legal standard should minimize the economic costs of type I and type II errors regarding the PPCs.

The structure of this thesis is as follows: first we will define what is digital economy and digital platforms. Next, we will explain the role of PPCs in the context of digital platforms and its rationale. Then, we will explain the effects of these types of clauses on market competition, followed by a presentation of the case law in the different jurisdictions in Europe. Finally, we will define a cost-error analysis to analyze these cases and we will propose a new legal standard.

2 Framework of Analysis

2.1 What is a Digital platform?

The rapid spread of internet, computers, and IT in homes, schools, and firms has led to a revolution in the way business is conducted,² to the point that some even call it the Fourth Industrial Revolution.³ The backbone of the digital economy is hyperconnectivity which means growing interconnectedness of people, organizations, and machines that results from the Internet, mobile technology and the internet of things.⁴

The enabler of these new market structures are digital platforms, who act as an online intermediary between consumers and sellers, reducing significantly the search costs for the former. In this context, platforms such as Amazon, Google, Facebook, Booking or Uber are conquering the economic landscape.

²Brynjolfsson, E. and Kahin, B. *Understanding the Digital Economy: Data, Tools, and Research* (2010), ed. MIT Press

³Shwab, K. M. World Economic Forum.

⁴Deloitte. "What is digital economy? Unicorns, transformation and the internet of things" (available at: <https://www2.deloitte.com/mt/en/pages/technology/articles/mt-what-is-digital-economy.html>)

The key features of this platform ecosystem are that (i) firms set prices on the platforms; (ii) consumers search for firms and complete their purchases through the platforms; and (iii) when consumers complete their purchase through a platform, firms pay a commission fee to the platform.⁵

Usually digital platforms compete with the (i) traditional distribution channels (i.e. offline), and (ii) with the own channels of distributions of the seller (i.e. off- and online). This feature is key for understanding the rationale behind using the PPCs.

As it follows from the above definition, digital platforms act in two-sided markets, that is, markets where two distinct sides - consumers and sellers - ultimate benefit from interacting through a common platform.⁶

Because two-sided platforms are subject to network effects, the markets in which they operate tend to be highly concentrated, and with high barriers to entry, as newcomers cannot easily build a network. Thus, PPCs negotiated between suppliers and intermediary platform providers are potentially more complex than those in traditional markets and require careful examination.

2.2 What are PPCs?

PPCs are a type of contractual agreement whereby the seller commits to not offering better conditions to any other buyer.⁷ In the context of digital platforms, the seller would be the provider of a service or manufacturer, and the buyer would be the digital platform, who in turn would sell to consumers. Hence, the provider of the service cannot offer better conditions to any other platform or wholesaler than the digital platform with which it signs a PPC.

⁵Wang, C., and Wright, J. (2016) "Search platforms: showrooming and price parity clauses". Working paper.

⁶Rochet, JC and Tirole, J. (2003) "Platform competition in two-sided markets", *Journal of the European Economic Association*, MIT Press, vol. 1(4), pages 990-1029.

⁷Among many others, see Gonzalez-Daz, F., and Bennett, C. (2015). The law and economics of most favored nation clauses, *Competition Law and Policy Debate*, Vol. 1, issue 3, pp. 26-42.

2.2.1 Agency vs Merchant model

Merchant model the buyer acquires the products from the manufacturer, and sells them to consumers, bearing the risk. Under this model, consumers pay a retail price p to the wholesaler or buyer, and this one pays a wholesale price w to the manufacturer. Note that the price borne by consumers here is decided by the buyer.

Agency Model the seller, or principal in this case, sells to consumers through the agent or buyer who acts on behalf of the principal -, who earns a percentage fee α of the price p . In this model, is the manufacturer or principal who sets the final price, and who bears the commercial risk associated to the demand uncertainty.

According to section 2.2, digital platforms act as an intermediary between consumers and manufacturers or service providers, earning a percentage fee of the retail price set by the seller. Consequently, the business model of platforms can be modelled according to the agency model above explained.⁸

Under a merchant model, PPCs were a vertical restraint devised to avoid the hold-up problem (or Coase problem) by a manufacturer: through PPCs, the seller commits not to price discriminate among the buyers, ensuring that any discount to a buyer would trigger the same discount to all the other buyers.^{9 10}

For a better understanding of this difference, we will be following throughout the whole thesis the example of hotels reservations. Nowadays, in this market, hotels rent their rooms through two main channels: (i) digital platforms which are Online Travel Agents (OTA), mainly Expedia and Booking.com; and (ii) their own distribution channel (own website, telephone or walk-in).

⁸The ongoing discussion regarding the responsibility of platforms with respect to the service provided is out of the scope of this thesis.

⁹Boik, A., and Corts, K. S. (2016). "The effects of platform MFNs on competition and entry." *Journal of Law and Economics*, 59.1, pp. 105-134

¹⁰Note for this mechanism to hold, it is required a market with perfect information and transparency. See Motta, M. (2004) *Competition Policy: Theory and Practice*. Cambridge University Press, p. 343

For the time being, to explain the difference between the two models, we will let the own-distribution channel of the hotel aside. In the merchant model, Booking.com and Expedia would actually do the reservation to the hotel, and pay the wholesale price w_i to the hotel, while offering the room to consumers at price p_i . Given a PPC, the hotel would be obliged to offer the same wholesale price w to both Expedia and Booking.com; this is why PPCs in this setting are referred to as wholesale PPCs.

In the agency model, the OTAs would not be acquiring the reservation of the room but would simply display the availability of the room to consumers, at the price p_i set by the hotel. Only when the consumer makes the reservation of the room through the platform would the OTA earn a percentage fee a_i of the price p_i . The PPC in this case would act in the retail price p_i set by the hotel but displayed through the OTAs: the hotel commits not to offer a different price through the other platform.

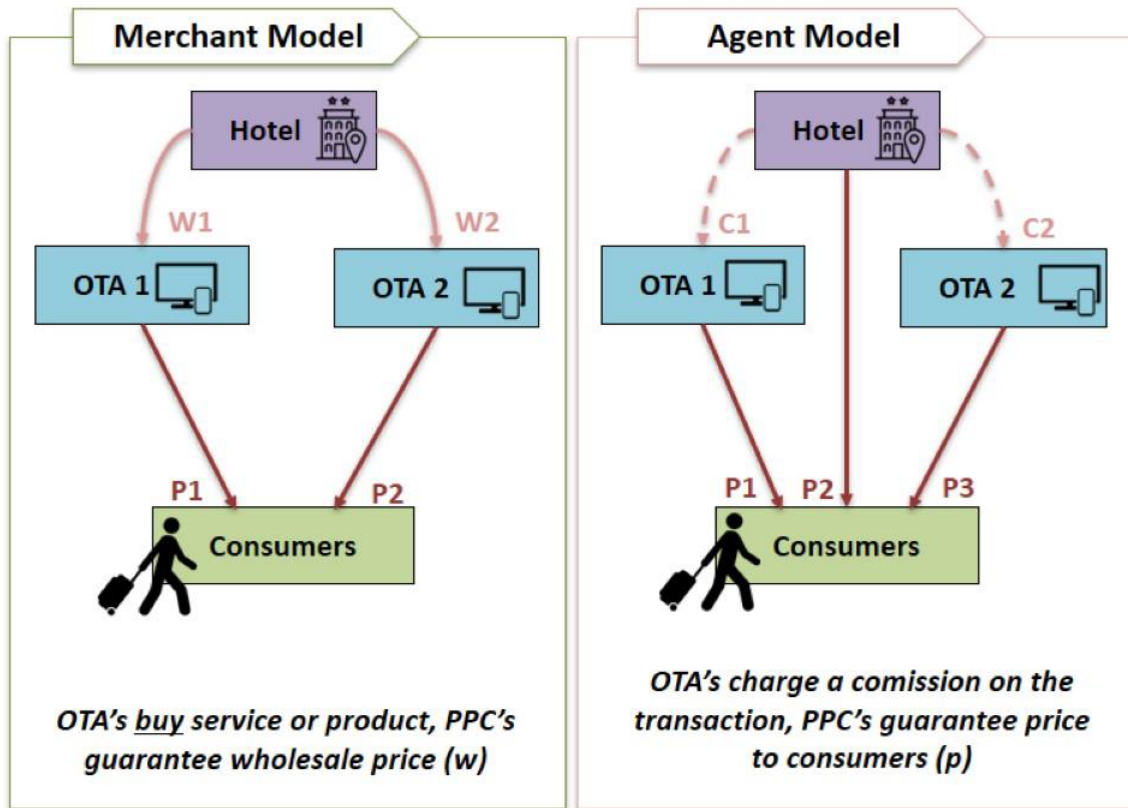


Figure 1: PPCs under merchand and agent model

2.2.2 Types of PPCs

Wide PPCs The seller commits not to offer better conditions to consumers through any other channel, be it another buyer or its own channel, on- or offline.

Narrow PPCs The seller commits not to offer better conditions to consumers through its own channel, be it on- or offline. In this case, the seller could offer better conditions to other buyers.

Other types or classifications of PPC are possible, although less relevant in practical terms. For instance, PPCs are contemporaneous if they enforce the obligation of not offering better conditions in the present time, but retroactive if it also refers to previous periods.¹¹

Going back to the example of the hotel, Booking.com and Expedia, each OTA would enter into a wide PPC-type agreement, by which the hotel commits to make available through the Booking.com, for instance, room rates, terms and conditions for consumers that are no less favorable than those offered through Expedia or their own channels, be it on- or offline.¹² Under a narrow PPC, the hotel would be able to offer better conditions through Expedia than the ones offered through Booking.com, but not on their own channels.

2.3 What are the effects of PPCs?

In this section we will describe the effects of PPCs in the market that explain why platforms as well as service or product providers are interested in them. First, we will look into the effects that interest the platforms; next, we will present the effects that explain why hotels are interested in PPCs as well.

¹¹Motta, M. (2004) *Competition Policy: Theory and Practice*. Cambridge University Press

¹²Padilla, J. and Prasad, K. (2018). "The competitive and consumer welfare implications of narrow MFN clauses in the hotel industry." Working paper.

2.4 Why do platforms want PPCs?

Platforms claim that PPCs are essential in order to be profitable and remain in business. This is because PPCs reduce competition between the different distribution channels of a same manufacturer or seller. In other words, it reduces intra-brand competition. This reduction of competition leads to the following effects:

(i) Prevention of show rooming

Given the agency model, digital platforms only make a profit when consumers purchase the goods or services through their platform. That is, Expedia or Booking.com will only receive the percentage fee of the final price when consumers buy through their platform.

The rationale of PPCs are to avoid that the seller undercuts the prices displayed on the platform. The goal is to prevent consumers from using the platforms to compare different service providers or manufacturers but do the actual purchase through the own distribution channel of the seller. In other words, it forbids an opportunistic behavior by the seller, who would be misappropriating the benefits of the platforms investment. Hence, PPCs protect and incentivize investment by the platforms.

Following the previous example of the hotels and the OTAs, what PPCs are preventing is the situation where a consumer, after checking the price of a hotel on Booking.com, is able to get a better deal either in the hotels own site or on Expedia. Faced with the impossibility of getting a better deal elsewhere, the consumer might as well make the reservation through Booking.com, who would then earn the corresponding fee.

(ii) Foreclosure: barriers to entry

Another effect stemming from the use of PPCs is the creation of barriers to entry.¹³ New entrants cannot pass-on a hypothetical reduction in the fees into the prices displayed. This

¹³Baker, J.B. and Chevalier, J.A. (2013) "The Competitive Consequences of Most-Favored Nation Provisions". *Antitrust*, Vol. 27, No. 2.; Aguzzoni, L. et al. (2012). "Can fair prices be unfair? A review of price relationship agreements," *L.E.A.R. (Laboratorio di economia, antitrust, regolamentazione)* (available at http://www.offt.gov.uk/shared_offt/research/OFT1438.pdf)

is particularly important in the context of digital platforms, where network externalities play a crucial role in the success of a given platform. Without the ability to undercut prices, new entrants cannot build a network to compete with the incumbent platforms.¹⁴

Barriers to entry are particularly strong under wide PPCs, where the incumbent is guaranteed to have the lowest price for a given service provider or manufacturer, perfectly foreclosing any potential entrant. Under narrow PPCs, potential entrants could undercut the prices displayed in other platforms. However, the more spread narrow PPCs are across the different platforms and the more concentrated the market, the higher the foreclosure for potential entrants, given the network effect of these clauses, similar to the effect of wide PPCs.

In the hotels example, let's imagine that a new platform offers lower commission fees to the hotel, and the reduction of fees is passed onto a lower price of the room displayed in this new entrant. If Booking.com has a wide PPC with the hotel, the lower price offered in the new entrants page will be displayed as well on Booking.com, curtailing the competitive advantage of the former. Moreover, note that the discount triggered on Booking.com would come exclusively from the hotels margin, and not on the fee of Booking.com.

(iii) Increase in fees

Another main incentive for the platforms is the reduction of intra-brand competition between rival platforms, that allows platforms to increase the fees they charge to the buyer. That is, the existence of PPCs relaxes the platforms incentives to lower their prices, which will most likely end up in a reduction of the sellers margin and higher prices for consumers.¹⁵

In our example, let's assume that both OTAs are charging a 20% commission fee to the hotels; let's also assume that Booking.com has a wide PPC. If Expedia decides to lower its fee to 15%, in order to display lower room rates and increase its demand, by virtue of the wide PPC, the lower room rates would as well be displayed on Booking.com, who would still

¹⁴Oxera 2014

¹⁵Among others, see Boik, A. and Corts, K. S. "The Effects of Platforms MFNs on Competition and Entry". Working paper, University of Toronto.

earn a 20% commission fee. Hence, the 5% reduction by Expedia is not profitable, which means that neither OTA will have incentives to lower its fee.

There is no doubt that these effects ensure the market power that platforms have in the market, which is detrimental for consumer welfare, especially in digital markets where concentration is high due to network externalities. This effect is more evident when platforms have certain degree of market power, since the dominant platforms would increase fees without the fear of losing market share.

On the other hand, platforms claim that without PPCs, their business model would no longer be profitable. The next question, then, is why competition policy should be interested in guaranteeing the viability of digital platforms. We will now discuss, then, what are the efficiencies that the existence of platforms brings to the table, and by extension, the efficiencies of PPCs, to the extent that those are needed to make platforms viable.¹⁶

2.5 Why do hotels need platforms?

(i) Reduction of search costs

In two-sided markets, the intermediary platform performs a coordinating role between the users on both sides of the markets, reducing the search costs. This is because the presence of the PPCs facilitates information flow because the platforms aggregate quantitative and qualitative information about the suppliers. Platforms also, provide the information in multiple languages making it easier for consumers, retailers and suppliers to interact. Additionally, the price transparency offered by platforms makes it easier for consumers to compare different options and get the best price deals.¹⁷

The decrease in search costs is notoriously higher in the presence of wide PPCs, these is because the consumer does not need to search in more than one platform in order to get the

¹⁶The discussion of the viability of platforms without PPCs is dealt with in section 4.

¹⁷Ezrachi, A. (2015). The competitive effects of parity clauses on online commerce. *European Competition Journal*, 11:2-3, 488-519, page 5

better deal, in the case of narrow PPCs, this might not necessarily hold. In the presence of wide PPCs the platform takes the role of one-stop shop.

Also, the attempt of suppliers to overcomplicate their offering in order to increase information costs is deterred by the comparison tools and reviews that the platforms provide.¹⁸

(ii) Effects on investment and advertisement

Upstream suppliers would engage on these types of clauses to mitigate costs and reduce risk associated with online advertising and commerce. It is especially relevant when the cost to operate the supplier online channel is higher than the cost of being in the platform. For instance, the suppliers may lack economies of scale to achieve return on investment in online advertising, but the platform will since it not only invests on promoting one specific product but those of a range of suppliers.¹⁹

However, the extent to which a seller benefits from the platform investment in advertisement depends largely on the strength of the brand of the seller. The stronger the brand of a seller displayed in the platform, the more it will benefit from higher advertisement and higher traffic in the platform, as consumers will lean towards the stronger brands.

3 Where are we now?

So far we have presented the rationale and the effects of PPCs. In this section we will dive into the legal enforcement of the PPC clauses. First, we will analyze what should the enforcement be under the current legal framework. Second, we will dissect the cases in the most notable jurisdictions of the EU to have a better understanding of the current situation.

¹⁸Ezrachi, A. (2015). The competitive effects of parity clauses on online commerce. *European Competition Journal*, 11:2-3, 488-519, page 5.

¹⁹Ezrachi, A. (2015). The competitive effects of parity clauses on online commerce. *European Competition Journal*, 11:2-3, 488-519, page 5.

3.1 PPCs under article 101 TFEU

Vertical agreements fall within the scope of article 101 TFEU. This article presents a two-step assessment to determine the compatibility of an agreement with EU Competition Law:

- (1) Article 101(1) TFEU sets that any agreements between undertakings which has as its object or effect the prevention, restriction or distortion of competition will be deemed illegal and, therefore, void.
- (2) According to article 101(3) TFEU, any agreement considered illegal ex article 101(1) TFEU shall be exempted from the aforementioned rules if it meets cumulatively the following conditions: (i) creates efficiencies (in terms of production, distribution or any other source of quantifiable efficiency); (ii) the efficiencies are passed on to consumers; (iii) the restriction or distortion of competition is indispensable in order to obtain the efficiencies; and (iv) the agreement does not eliminate completely the competition in the market.

For the sake of legal certainty and guidance for undertakings, there exists the so-called block exemption regulations, which apply only to specific set of agreements. These regulations lay the conditions under which these agreements are presumed to be exempted ex article 101(3) TFEU.

The relevant regulation for vertical agreements is the Vertical Block Exemption Regulation²⁰

(VBER). In order to be exempted (i) both of the companies entering into an agreement need not have a market share higher than 30%; and (ii) it must not be one of the hardcore restrictions. When we project these conditions to PPCs in digital platforms, there are two relevant comments.

²⁰Commission Regulation (EU) No 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices, OJ L 102 of 23.04.2010.

First, as we mentioned in section 2.1, network externalities lead to a high concentration in the world of digital platforms. The definition of the relevant market becomes instrumental, given that the narrower the product market definition, the higher the likelihood of the threshold to be met. The question that national competition authorities (NCAs) have to answer is whether platforms are in the same product market as the own-distribution channel of the seller, or if the market is defined only as the intermediation services.

We understand that there is no specific answer to this question, as it depends on the demand-side substitutability which needs to be assessed case by case. However, given the nature of the markets in play - and the fact that narrow PPCs exist, one could argue - for a market definition including the own-distribution channels as well as the platforms. In this event, the threshold is harder to meet.

As for the second condition, there is no specific mention of PPCs neither in the VBER nor in the Guidelines on Vertical Restraints. Nevertheless, as we pointed out in section 2.4, wide PPCs, or narrow PCCs if there is a network effect, can effectively lead to the same effects as a Resale Price Maintenance clause. Hence, it could be argued that in that particular event, PPCs might constitute a hardcore restriction.

3.2 Previous cases

Both NCAs and the European Commission (EC) have dealt with some cases involving PPCs. Here we will focus in the cases that involve digital platforms,²¹ in order to understand the theories of harm and the findings in every case.

(a) **The e-books investigation**²²

Between 2011 and 2013, the EC investigated the use of PPCs in the market for e-books. In particular it involved the top five publishers²³ (the Five Publishers), who sold their e-

²¹We will not focus in other cases often mentioned by the literature, such as the Hollywood studios case by the European Commission COMP/38427.

²²Case COMP/AT.39847 - *E-Books*

²³Penguin, Simon & Schuster, HarperCollins, Hachette and Holtzbrinck/Macmillan

books through Apple (iBookstore) and Amazon (Kindle). Amazon was the main player in the retail market for e-books, under a wholesale agreement, according to which Amazon set the retail price and paid a wholesale price to the Publishers. The prices set by Amazon for e-books was significantly lower than the prices set by the Five Publishers for their books.

Apple entered the retail market for e-books with an agency agreement with the Five Publishers. Accordingly, retail prices of e-books sold through Apple were set by the Five Publishers. However, Apple introduced a retail PPC by which the retail price sold through Apple had to match the lowest price offered in any other platform i.e. Amazon for a given book. Consequently, Amazon accepted to switch to an agency agreement as well.

In the views of the Commission, the PPCs acted as a commitment device across the Five Publishers to pressure Amazon to switch into an agency model that would net higher retail prices for e-books, given that it would be too expensive for Amazon to continue to sell its e-books at a discounted price with the certainty that Apples e-books would match its price regardless. The Commission then considered that the Five Publishers acted in a coordinated fashion to raise prices.

Nevertheless, investigation ceased pursuant the binding commitments submitted by the Five Publishers between December 2012 and April 2013, that allowed the distributors to discount the retail price set by the Publishers from their own commission. The commitments also placed a five-year ban on the use of PPCs by the Five Publishers.

(b) **Hotel reservations**

Many NCAs across Europe²⁴ have launched investigations in the use of PPCs in the market for hotel reservations, with platforms such as Booking.com and Expedia at the core of the investigations. In what follows we will briefly overview the cases in the most notable jurisdictions.

²⁴Austria, Denmark, France, Germany, Hungary, Ireland, Italy, Sweden, Switzerland and the United Kingdom.

(i) United Kingdom ²⁵

The Office of Fair Trade (OFT) launched an investigation into the vertical agreements in place between the hotels chain InterContinental Hotels GC (IHG) and the OTAs Expedia and Booking.com. According to the OFT, the theories of harm associated to the agreements, and in particular to the use of wide PPCs: (i) price competition between OTAs was limited given that they lost the ability to offer discounts at the retail level; and (ii) increased barriers to entry and expansion to OTAs that may seek to expand its power by offering discounts at the retail level.

The investigation closed following the commitment from the parties that can be summarized as follows: (i) OTAs are free to offer discounts only to consumers who have previously purchased through the platform; and (ii) hotels are free to offer discounts to consumers through their own-distribution channels.

The OFT accepted that there were efficiencies in enabling hotels to have control over the headline rate for their hotel rooms and thus to restrict discounting. In any case, the parties agreed to refrain from using PPCs in the future, even though no decision from the OFT stating that these clauses are incompatible with article 101 TFEU exists.

The Competition Appeals Tribunal (CAT) quashed the OFT's decision claiming that it did not take into account Skyscanners²⁶ arguments with respect to the effect of the commitments in the transparency of prices. In particular, the CAT considered that an increase in opacity means less visibility for platforms, which in turn leads to a diminish in its basis of consumers. By virtue of network externalities, less consumers means less hotels quoting its prices in the platform, and the final outcome is a decrease in competition between hotels. Given that the OFT failed to address this effect, the CAT quashed the decision.

The OFT currently, the Competition and Markets Authority (CMA) announced its decision to reopen the investigation, but no final decision has been yet reached. In July 2015,

²⁵Online hotel booking investigation; available at <https://www.gov.uk/cma-cases/online-hotel-booking>

²⁶Skyscanner is a price comparison website.

Booking.com announced it was dropping all the wide PPCs in all EU markets, including the UK, maintaining nonetheless narrow PPCs, most likely in the light of the Private Motor Insurance Decision by the CMA (*v. infra*).

(ii) Germany ²⁷²⁸

Since 2010, the Bundeskartellamt, Germanys NCA, has started proceedings against the three main hotel reservations online platforms: HRS, Booking.com and Expedia, with the latter still pending for a decision.

The first investigations started in 2010, in relation to the wide PPCs of HRS and Booking.com. Notably, Booking.com decided to change from wide PPCs, to narrow PPCs during the course of the investigation.

Interestingly, the relevant product market comprised the sale of hotel rooms via hotel portals, which includes the functions search, comparison and booking in a bundle of services. Accordingly, the own websites of the hotels are excluded from the relevant market, a decision that makes it easier for the undertakings to have a market share over 30% and thus not qualify for the automatic exemption of the VBER.²⁹

The theories of harm put forward by the Bundeskartellamt are in line with the ones found by the CMA: (i) lessening of competition between platforms which leads to the removal of incentives to reduce fees; and (ii) increased barriers to entry. The authority also took into account the strengthening of these effects by the fact that all three competitors had similar agreements with the hotels.

As for the efficiencies, the Bundeskartellamt refused to acknowledge the merits of the arguments based on the prevention of show-rooming and the incentives to invest. In particular, the authority claims that the investments allegedly protected by the PPCs are not

²⁷Decision B9-66/10, of January 1, 2015, press release available at: https://www.bundeskartellamt.de/SharedDocs/Meldung/EN/Pressemitteilungen/2015/09_01_2015_hrs.html

²⁸Decision B9-121/13, of December 23, 2015, press release available at: https://www.bundeskartellamt.de/SharedDocs/Meldung/EN/Pressemitteilungen/2015/23_12_2015_Booking.com.html

²⁹See section 3.1.

contract-specific, that is, that the investments of the platform are not specific to the hotels bound by the PPC. Even the general investments in the platform are not considered to benefit hotels significantly through the attraction of more customers (i.e. the billboard effect), because most of the hotels are small and medium size hotels.

All in all, the Bundeskartellamt considers that the PPCs of both HRS and Booking.com are contrary to Article 101 TFEU (as well as the equivalent German national law) and imposed a fine to both undertakings. In the case of HRS, the decision has already been confirmed by the Dsseldorf Higher Regional Courts.

(iii) France³⁰ and Italy³¹

The Autorit de la Concurrence ("AdC", the French NCA) and the Autorit Garante della Concorrenza e del Mercato (AGCM, Italian NCA), respectively opened an investigation into online hotel booking platforms. The platforms had been imposing wide PPCs in their contracts with hotels.

Both NCAs identified the same two theories of harm: (i) the increased fees charged by the platforms, as a result from the reduction of competition between platforms; and (ii) foreclosure of any potential platform given the inability to offer discounts or better rates to consumers.

In response of those allegations, Booking.com presented identical commitments by which it changed its wide PPCs to narrow. Additionally, Booking.com would allow the hotels to apply discounts on the rates offered on their platforms to specific categories of clients. The AdC and the ACGM accepted the commitments and closed the investigation on April 2015. Both authorities undertook the commitment to provide quantitative evidence of the effect of these clauses in the market. The decision of the AdC has been appealed, but a decision is still pending.

³⁰Decision no. 15-D-06, of 21st April 2015; available at (in French): <http://www.autoritedelaconcurrence.fr/pdf/avis/15d06.pdf>

³¹Decision of 21st April, 2015; available at (in Italian): http://www.agcm.it/component/joomdoc/allegati-news/I779_chiusura.pdf/download.html.

(c) **Private Motor Insurance**³²

This is a case followed by the CMA which is the British NCA to look into the agreements between the Price Comparison Websites (PCW) and the Private Motor Insurance companies (PMI). PCWs are online platforms that display the prices of PMIs to consumers, who are then able to compare prices and contract the PMI from the PCW. The existence of PPCs was not the sole focus of the investigation, but the analysis undertaken is remarkably thorough.

The agreement between PCWs and PMIs had both narrow and wide PPCs. The main concerns by the CMA were the high fees charged by PCWs, leading to higher insurance prices, the foreclosure of the market of PCWs, and, as a consequence, the lack of incentives to innovate.

The assessment by the CMA distinguishes between the two types of PPCs. On the one hand, the CMA acknowledges the efficiencies brought by the narrow PPCs by preventing the free-riding by the PMIs or by other platforms and concludes that these efficiencies offset the competitive concerns these clauses bring. The lack of a market penetration of the narrow PPCs, coupled with the lack of competitive constraint that the PMIs own channel constitutes for the PCWs, are the reasons underlying the CMA's assessment.

As for the wide PPCs, the CMA considered that the marginal increase in efficiencies with respect to the narrow are not sufficient to compensate for the significant increase in anti-competitive effects they bring. Hence, the decision of the CMA is to allow the narrow PPCs in the market, yet to prohibit the wide PPCs.

4 Cost-error analysis

After defining the digital platform market, the concept and economic rationale of the PPCs and an overview of the current case law on this matter, now we will build the cost-error analysis. The cost-error analysis is a methodology used to set a legal standard that minimizes

³²See *Private Motor insurance market investigation*; available at <https://www.gov.uk/cma-cases/private-motor-insurance-market-investigation>.

total cost. There are five different types of legal standards, going from an interventionist standard to *laissez faire*:

- (i) Per se illegality: the conduct or agreement is prohibited and does not allow evidence to the contrary.
- (ii) Rebuttable presumption of illegality: the conduct or agreement is illegal unless the undertaking provides enough evidence to the contrary.
- (iii) Rule of reason: the conduct or agreement would be assessed on a case-by-case basis.
- (iv) Rebuttable presumption of legality: the conduct or agreement is legal unless the authority provides enough evidence to the contrary.
- (v) Per se legality: the conduct or agreement is permitted and does not allow evidence to the contrary.

Now for each set of conducts or agreements we would select the standard that maximizes long-run expected consumer welfare taking into account the possibility of error. Given the challenges that this assessment presents, Judge Easterbrook³³ proposed a reformulation of this problem. His proposal was to minimize the expected cost of a Type I or Type II error,³⁴ subject to administrability, legal certainty and resource constraints.

Each of the different types of legal standards is associated with a probability of making a Type I and Type II error: the more interventionist the legal standard the less probable to make a Type II error, and conversely, the more *laissez faire* the less probable to make a Type I error.

Therefore, the optimal legal standard will be the one that minimizes the expected total cost of an error, depending on which of the two types is more costly. For instance, in a cartel case the expected cost of the Type II error is significantly higher, thus the optimal legal

³³Easterbrook, F., "Limits of Antitrust," 63 *Texas Law Review* 1 (1984).

³⁴Type I error is when a conduct or agreement is prohibited and should be legal (over enforcement). Type II error is when the conduct or agreement is legal and should be prohibited (under enforcement).

standard is per se illegality. On the other end we find the conduct of above cost predation, which is per se legal in most jurisdictions. The graph below is an illustration of these ideas, where the arrows show the type of error minimized in each end of the possible legal standards.

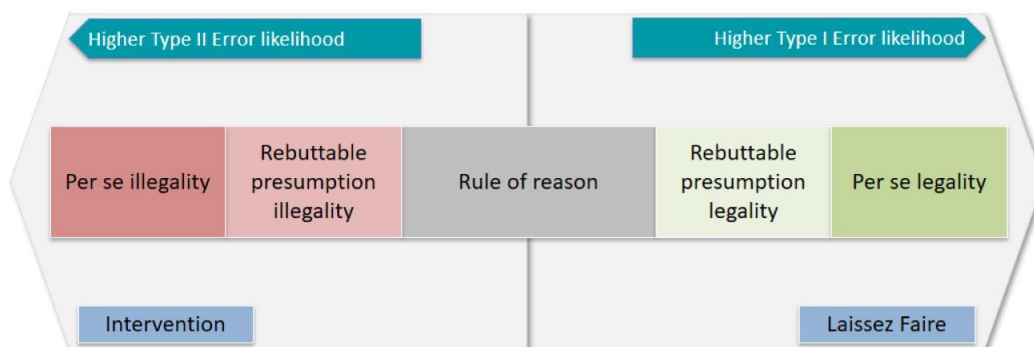


Figure 2: Spectrum of legal standards

As a last remark before starting with the cost analysis, the relevant measure is the expected cost, which takes into account not only the magnitude of the cost, but the probability of the realization of this cost. For the magnitude of each cost, we will base our analysis on the efficiencies and the anticompetitive effects described in Section 2.2.

4.1 Legal standard for Wide PPCs

4.1.1 Cost of Type I

Over-enforcing PPCs means allowing for show-rooming. The main expected cost is the viability of platforms, and hence the elimination of the efficiencies that they bring forward, contingent on the probability that without PPCs, platforms would actually be out of business. As for the efficiencies lost were that the case, first, search costs would increase for consumers since they would need to invest more time and resources to compare prices and look for more options. Second, the inter-brand competition between sellers would decrease

as a result of the increased search costs, and would result in higher prices charged by the sellers.

Lastly, investment (advertisement, building and improvement of own platforms) would be inefficient, since every seller would have to individually invest, instead of the platform centralizing such investment. However, as we saw in section 2.4, this effect is ambiguous given that the benefit on investment will vary depending on the characteristics of the seller.

The magnitude of the above costs relies on the extent to which the platform bound by the wide PPC is a one-stop shop . The rationale is that when consumers rely on one platform to compare and purchase the products the decrease on search costs is higher than when consumers compare various platforms before doing a purchase. Also if a platform is a one-stop-shop, sellers would not invest on advertisement, eliminating duplication, and freeing resources to the sellers to invest on quality.

4.1.2 Cost of Type II

In particular, these costs are associated with the anti-competitive effects of PPCs. First, the existence of contracts allowing wide PPCs does not give incentives to the platforms on decreasing their commission fees, therefore eliminating intra-brand competition. Second, the wide PPCs creates market foreclosure for new entrants and to competitors wishing to expand, therefore innovations incentives are decreased. Third, the risk of collusion is higher since monitoring is less costly.

4.1.3 Assessment of Wide PPCs

On the one hand, the expected cost of Type II errors is high, since the mere presence of a PPCs creates, with all likelihood, the anti-competitive outcomes described above. On the other hand, the efficiencies that a Type I error would eliminate are conditioned on the viability of platforms without the PPCs, that is to say, the extent that the show-rooming effects threatens the profitability of platforms; and to which degree a platform is a one-stop-

shop.

As the viability of platforms without wide PPCs, we deem that platforms would still exist. One piece of evidence is that in Europe, Booking.com unilaterally decided to shift from wide PPCs to narrow PPCs in 2015, and still is one of the main OTAs in the market. Also, in the cases followed before the different NCAs in the market of hotel reservation, platforms have not been able to bring enough evidence to show that show-rooming is a relevant problem, by looking at the ratio of site visitors to actual bookings.

Moreover, literature seems to side this view as well from the theoretical point, showing that there is an equilibrium where consumers and firms trade in the platform even without PPCs; that is, even without PPCs, there are enough incentives in play for sellers not to free-ride, according to this model.³⁵

An explanation for the lack of impact of the show-rooming effect might lie on the existence of switching costs. If consumers face a high cost when switching from a platform to another platform or the own seller, even if these offer a better price, then the free-riding problem does not exist. This means that for the show-rooming to exist, the difference in prices across the different channels should be large enough to compensate for the switching costs. Currently, Booking.com and Expedia offer a loyalty program, that constitute a switching cost for consumers, and it might explain the lack of evidence of the show-rooming effect.

Moreover, the platforms are not the reliable one-stop-shop their claim to be, as even the leading platforms display the products and services according to their own commercial interests. In particular, consumers will visit more than one platform given the lack of trust in the neutrality of the search results.³⁶

³⁵Wang, C. and Wright, J. (2016) "Search platforms: Showrooming and price parity clauses". Working paper.

³⁶Padilla, J. and Prasad, K. (2018). "The competitive and consumer welfare implications of narrow MFN clauses in the hotel industry." Working paper.

4.2 Legal standard for Narrow PPCs

To set a legal standard for narrow PPCs, it is necessary to acknowledge the difference in effects with respect to the wide PPCs. But, in the presence of certain characteristics the effects of the narrow PPCs would be similar as the effects of the wide, namely the degree of one-stop-shop, the existing network of narrow PPCs among competing platforms, the brand positioning of the seller, and the switching costs faced by consumers. Therefore, for the analysis and definition of the legal standard we will only consider the scenario where the effects differ.

4.2.1 Cost of Type I

Similar to the case of wide PPCs, the cost of the Type I error is allowing the show-rooming effect, and consequently the viability of the platform. Nonetheless, because of the nature of the narrow PPCs, the intensity of the efficiencies achieved would vary. First, the reduction of search costs are not as consumer welfare enhancing as in the case of the wide PPCs. This is because consumers could get better prices by checking different platforms.

Second, increase on inter-brand competition is less than wide PPCs because of the decrease of price transparency. Third, narrow PPCs, to the extent that they provide a mild solution to the free-riding problem, also provide a lesser incentive for platforms to innovate. Thus, the cost of a Type I error is reduced from the standpoint of investment.

4.2.2 Cost of Type II

Contrary to the expected cost of Type I error, in this case the expected costs for Type II errors decrease significantly with respect to the wide PPCs. Because platforms are not guaranteed to have the lowest price among its competitors, intra-brand competition will increase. Consequently, platforms will not have an incentive to increase fees, as it would translate into loss of market shares.

Along that line, the market would not be foreclosed, given that any competitor present or

not in the market can undercut prices to expand or enter the market. This leads to a higher pressure to invest in innovation by the market leaders, provided that the market for online platforms will tend to be highly concentrated. Also, many of the platforms are introducing loyalty programs or other competing strategies to induce consumer fidelity, which is creating higher switching costs for consumers, therefore the threat of show-rooming under narrow PPCs is diminished.

Finally, prices may vary across platforms which renders monitoring more costly. Therefore the risks of coordinated effects is reduced, as incentives to deviate will be higher.

4.2.3 Assessment of Narrow PPCs

As mentioned above, narrow PPCs allow for platform competition but prevent competition from the seller directly. Hence, the effects of Narrow PPCs depend on (i) the degree of competition in the market for platforms; and (ii) the competitive constraint that the sellers own channel constitutes for the platform. The elements to look to understand if those two cumulative circumstances happen, are the following:

(i) Lack of competition at the platforms level

- (a) One-stop shop: when a platform is a one stop shop it is de facto acting as the sole undertaking in the market. One of the main reasons for that to happen is in the presence of switching costs: those are the costs of consumers from by-passing the platform will determine the magnitude of the free-riding problem, therefore the intensity of the efficiencies of PPCs. The way in which those are introduced nowadays in the context of platforms is through fidelity or loyalty rewards and programs.
- (b) Network of Narrow PPCs: the majority of the platforms present in a market are bound by a narrow PPC, it might lead to a price-floor effect. If a new entrant or an incumbent platform was to offer lower fees, it would allow a seller to display lower

prices in that platform. Then, the said seller would have incentives to display the same price in its own site, which would trigger a domino effect in all other platforms, thus leading to price uniformity. Hence, a network of narrow PPCs may have the same effect as wide PPCs.

(ii) **Competitive constraint from the seller**

- (a) Brand strength of the seller: the competitive constraint that the own distribution channel of the seller has on the platform is key in the effects of the narrow PPC. The stronger the brand recognition among consumers, the bigger the competitive constraint that the own channel is for the platform. Hence, the anti-competitive effect of narrow PPCs is bigger when the brand of the seller is stronger, provided that the clause will be eliminating the main competition for the platform.

Under a scenario without effective competition between platforms, and where the sellers own channel is the main competitive constraint, the effects of Narrow PPCs and Wide PPCs would be the same. This will be the case when: (i) (a) the platform has a base of locked in consumers; or (b) there is a network of narrow PPCs across platforms; and (ii) when the main competitive constraint for the platform was the sellers own channel, which was restricted through the narrow PPC.

In this case, the legal standard should be rebuttable presumption of illegality. The reason why we consider optimal to allow for an efficiency defense is to avoid the cost of prohibiting those PPCs that, for the very nature of the case, are needed for the viability of the platform.

In the scenario where those conditions are not met, under narrow PPCs, the expected costs for each type of error are the ones explained above. The expected cost of a Type II error is severely diminished, given that there will be effective competition in the market for digital platforms, and lower market power. Meanwhile, the expected cost of Type I error decreases, provided that the efficiencies are less intensive, and less likely.

Hence, the optimal legal standard for narrow PPCs, in the absence of the exceptional

conditions, should be the rebuttable presumption of legality. The authority would then have the chance to prove that the anti-competitive effects overcome the efficiencies in specific cases.

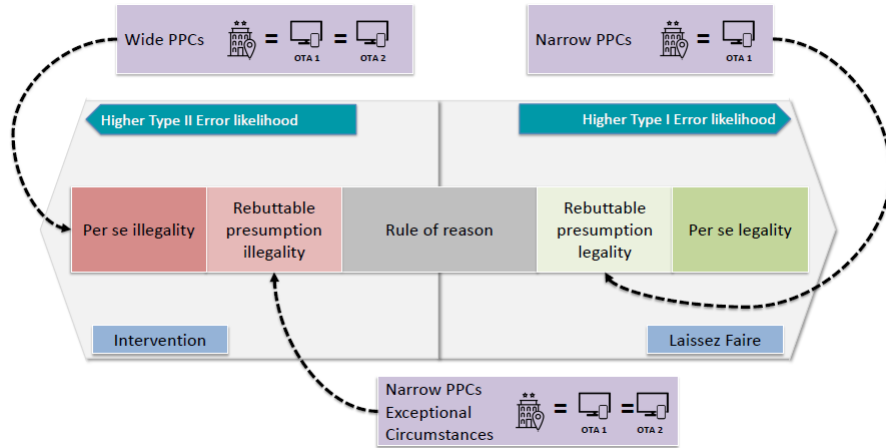


Figure 3: Proposed legal standards

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List of Figures

1	PPCs under merchand and agent model	6
2	Spectrum of legal standards	20
3	Proposed legal standards	26