Organisation for Economic Co-operation and Development

DAF/COMP/M(2016)2/ANN5

Unclassified English - Or. English

9 February 2018

DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

Executive Summary of the Roundtable on Price Discrimination

Annex to the Summary Record of the 126th meeting of the Competition Committee

29-30 November 2016

This Executive Summary by the OECD Secretariat contains the key findings from the discussion held under Item 7 of the 126th Meeting of the Competition Committee on 29-30 November 2016.

More documents related to this discussion can be found at

www.oecd.org/daf/competition/price-discrimination.htm

JT03426503

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Executive Summary of the Roundtable on Price Discrimination held at the 126th meeting of the Competition Committee of the OECD

By the Secretariat[1]

From the discussion at the roundtable, the delegates' and experts' written submissions, several key points emerged:

1. From an economic perspective, price discrimination is when two similar products, which have the same marginal cost to produce, are sold by a firm at different prices. While price discrimination can be frustrating for the purchaser and feel unfair, these are not reasons to use competition law to address it. It is better to use other tools to address cases that policymakers decide require fixing.

From an economic perspective, price discrimination is when two *similar* products, which have the same marginal cost to produce, are sold by a firm at different prices. A key characteristic is that the price that is charged is based partly on the value of the good to the customer, rather than just on the cost of producing the good. There are a number of different ways that firms can price discriminate, for example it can be based on the characteristics of the buyer (referred to as group pricing or third-degree discrimination), the behaviour of the buyer (behaviour-based discrimination), or the characteristics of the product (versioning or second-degree discrimination).

Buyers can often feel that price discrimination is frustrating and unfair, particularly when it is clear that they are paying a higher price than others. Policymakers can address those cases that they consider unfair using anti-discrimination or consumer protection laws. For example, anti-discrimination laws often specify that discrimination on the grounds of gender, race, age, or disability is prohibited. Similarly, in some jurisdictions, preventing price discrimination on products or services sold in different geographic regions is a distinct policy objective.

In contrast, competition law focuses on the impact on consumers. Price discrimination can benefit consumers by reducing prices for some and by increasing the number of consumers that are served. However, it can also have an adverse impact on consumers. For clarity of enforcement of competition law, it is useful to distinguish three different effects: a) it can exclude rivals and thereby lead to the exploitation of consumers; b) it can exploit consumers, and, c) in upstream markets, it can exploit intermediate customers and create distortionary effects that harm consumers in downstream markets. In each case, it is the effect on consumers, and not the fairness of the discrimination, that determines the acceptability of the discrimination.

[1] This Executive Summary does not necessarily represent the consensus view of the Competition Committee. It does, however, encapsulate key points from the discussion at the roundtable, the delegates' written submissions, the panellists' presentations and the Secretariat's background note.

2. If competition authorities find that a price discrimination scheme is exploitative and has an adverse effect on consumers, they should first consider whether the market is likely to solve the problem. If not, and the problem is persistent, the discrimination might be a good indication that the market is not functioning effectively, and a market study may help identify the features of the market that cause this harm. Where an authority believes the cause is a firm's restrictive conduct, it might want to investigate whether the conduct constitutes an abuse of dominance. In any case, the dynamic effects of the discrimination need to be considered.

Price discrimination can be harmful if it is costly to impose and reduces consumer surplus in the short run without a sufficient compensating effect. Such compensating effects might include expanding the market, intensifying competition, preventing commitment to maintain high prices, or incentivising innovation. However, authorities should not intervene in such cases unless they are confident that the market itself will not resolve the problem, for example, through a small or new firm undermining the discrimination by offering lower prices to those are willing to pay more.

If on the other hand price discrimination is persistently harmful and unlikely to be resolved by the market then this might be a symptom of a malfunctioning market. In these circumstances, a market study can provide a comprehensive and holistic examination of the market, the different reasons why the market is not working effectively, and the relative magnitude of those different problems. For example, these may include problems of excessive concentration, tacit coordination, barriers to entry, behavioural biases on the demand side, and regulatory restrictions. Abuse by a dominant firm would therefore be just one of the possible causes and perhaps a rare one.

Evidence of exploitative discrimination would need to include not just market power and a lack of output expansion, though these would suggest that the discrimination is harmful to static welfare. It would also need to address the impact of the discrimination on dynamic welfare. For example, did the prospect of future profits earned through price discrimination incentivise sunk investment or innovation to earn market power (e.g. pharmaceutical firms might expect in business cases for R&D to be able to charge different prices in different countries for the products of their research) or did it lead to rent-seeking investments. Finally, it would need to establish that it was the firm's market power, and not another common factor that creates the discrimination. If, for example, non-dominant firms in the market are also price discriminating, this might suggest that the discrimination is in fact determined by a third factor rather than specifically resulting from the firm's market power.

3. Where price discrimination occurs in upstream markets, it can exploit intermediate customers and, in certain circumstances, create distortionary effects that harm consumers in downstream markets. However, the circumstances in which it will do so are narrow and can only be identified through a distinct test that differs from those that apply to exploitive and exclusionary price discrimination. Authorities will therefore want to specify what kind of price discrimination is being investigated - exploitative, exclusionary, or distortionary - since that will determine the test that should be used.

Where an upstream firm (e.g. a manufacturer) profit-maximises it may charge different prices to different downstream buyers (e.g. retailers) without seeking to exclude an upstream rival. The different prices may simply reflect the downstream buyers' different valuation of the good or service (or differing levels of buyer power). However, in certain

circumstances, the difference may nevertheless distort competition between retailers in the downstream market, and this may have an adverse effect on consumers. For example, if a more efficient retailer has less elastic demand for an input they might be charged a higher price by a manufacturer with market power than other less efficient rivals. This may increase its costs, and lead it to produce less than it otherwise would, or even to exit.

A manufacturer might be relied upon to guard against discriminating in a way that increases its average margin but reduces downstream volumes to such a degree that it reduces its profits. For example, it typically benefits upstream firms to have a competitive downstream market. However, where it can increase its margin by discriminating without losing much volume downstream it may be indifferent to the downstream distortion that is created. Alternatively, there might be a non-financial explanation, such as the nationality of the favoured buyer. To identify a harmful distortion would therefore require an explanation of the manufacturers reasoning. It would also require that the un-favoured retailer would otherwise have imposed a competitive constraint upon the favoured retailer. For instance, if despite the distortion, the downstream market remains competitive then no such competitive constraint will have been lost. Therefore, perhaps counterintuitively, where a specific retailer out of a competitive field is ‘unfairly picked upon’ by a manufacturer this is unlikely to harm consumers and so unlikely to merit action by an authority. Finally, an effects-based test for distortionary discrimination does not necessarily require specific evidence of injury to un-favoured retailers (e.g. evidence of sales lost to favoured rivals); rather it requires evidence of damage to the competitive constraints that would otherwise be found in the market, and hence harm to consumers. For example, there might be evidence that the risk of switching had deteriorated. It may therefore be useful to clarify that the focus of laws governing distortionary price discrimination is on the effect on consumers.

Given the narrow circumstances in which distortionary price discrimination can be harmful for consumers there are perhaps a surprising number of cases. Non-financial payoffs to an upstream firm from favouring firms of one nationality over another appear to be one factor that has led to harmful distortions. In others, the concern sometimes appears to be exclusionary in nature, in which case a test for exclusionary effects would be more appropriate.

4. Exclusionary price discrimination is widely accepted as having the potential to harm consumers and is therefore a priority for many competition authorities. Such cases require careful analysis to distinguish between those in which the firm has an interest in, and an ability to exclude rivals, and those in which the same form of conduct delivers efficiencies. Cases in which price discrimination depends upon the buyers’ purchases from rivals are a particular concern.

Price discrimination can be used to execute a range of exclusionary practices. These include predation, where discrimination can reduce the profit that is sacrificed during the predatory stage. They also include margin squeeze cases where discrimination can allow a vertically integrated firm to foreclose downstream rivals and hence protect its upstream market power, or to price discriminate in the downstream market. Second-degree price discrimination is integral to fidelity rebates, which offer a range of different prices depending on the quantity purchased or the proportion of purchases that the buyer makes from the seller. These pricing schemes require particular close examination when the price is contingent on the buyer’s purchases from rivals. However, price discrimination can often be a competitive strategy. For example, it enables firms to reduce the price they charge their rival’s customers and hence to poach customers that would otherwise

purchase from a rival. Therefore, price discrimination will often make life difficult for rivals. Of course, whenever a firm cuts price, it creates difficulty for rivals since they make fewer sales. Therefore, the effect on rivals is not a useful test of the effect on consumers.

5. The scope for price discrimination in the digital economy is expanding as firms increase the accuracy with which they can predict an individual's willingness to pay. This raises the stakes on exploitative price discrimination, and there are particular reasons to worry that price discrimination in digital markets will be harmful. However, the principles of the analysis remain the same; markets may resolve the problem themselves, or with a little help, for example, mandating transparency on the use of personalised pricing, or providing greater clarity on the allocation of property rights to data.

The growth in data they hold on consumers allows firms to use increasingly sophisticated analytical tools to model and predict each consumer's willingness to pay with increasing accuracy, and hence allows them to set personalised prices that increase the rent that they extract from consumers. This seems unlikely to affect distortionary or exclusionary price discrimination cases since these predominantly occur in upstream markets. However, it increases the potential harm in exploitative price discrimination cases. In addition, in digital markets consumers may be unaware that the price for a given product on their screen is different from the price for the same product that is displayed for another consumer. This may prevent them from choosing between buying from firms that set personalised prices and those that do not. Personalised price discrimination is also costly to carry out, since data must be updated improved algorithms developed, and analytics re-run to maintain the accuracy of the estimates. Where firms hold market power the costs of this rent-seeking may be passed onto consumers. Taken together, these characteristics mean that digital price discrimination might be more likely to be harmful for consumers both from a static and dynamic perspective. As technological capability develops, it may therefore change the risk calculus for competition authorities considering whether to conduct such cases.

However, the principles for analysing exploitative price discrimination remain the same in digital markets as in traditional markets. Interventions through competition law should not address matters of fairness or other policy goals. Market studies remain a more effective tool for examining potentially harmful price discrimination, whether it be digital or not. Indeed, in these fast-evolving markets it is particularly important to consider whether the market will resolve the problem, as consumers may quickly learn more sophisticated online behaviour, and low barriers to entry may allow new entrants to destabilise these pricing strategies. However, a helping hand may be required in order for markets to solve the problem. For example, regulations that require sellers to identify to a buyer whether a price is personalised or not. Assigning property rights over purchasing history and online behaviour to the consumer might also be helpful since it allows them to sell that information to third parties and thereby earn back the value of that information, or to withhold that information.