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HEARING ON ACROSS PLATFORM PARITY AGREEMENTS

-- Note by Sweden --

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"HEARING ON ACROSS PLATFORM PARITY AGREEMENTS"- COMPETITION COMMITTEE – A CONTRIBUTION FROM SWEDEN

MFNS AND FREE-RIDING ON ONLINE PLATFORMS

-- Sweden --

1. Introduction

1. Online platforms that provide search and comparison services bring together buyers and sellers who, once matched in an online environment, can conclude their transactions on alternative venues. This leads to a potential for free-riding, where the parties search and find each other without paying for the search services. In this contribution, we discuss how free-riding can affect platforms as well as arrangements to mitigate the problem, including the use of Most Favoured Nation clauses (MFNs), also known as Across Platform Parity Agreements (APPAs). Several of these arrangements give rise to antitrust concerns. Since the anti-competitive mechanisms are fairly well-known, including for MFNs, the focus of this contribution will be on the free-riding aspect itself.

2. Many of the features of free-riding discussed here are based on the Swedish Competition Authority's (the SCA's) experience from investigating the online hotel booking sector, which will be referred to in this contribution, and in particular the investigation into *Booking.com*'s application of MFNs, which resulted in commitments by Booking.com, also described below.[1]

2. Platform investments

3. Online platforms for search and comparison make fixed cost investments in quality, e.g. improving algorithms and rankings, as well as various investments aimed at bringing the parties to the platform (attracting the different *sides* to the platform).

4. In the case of online hotel bookings, the platforms, known as Online Travel Agents (OTAs), make investments to connect and display hotels, as well as investments in marketing to attract consumers to the platform. OTAs market themselves both offline and online. An important type of online marketing is so called pay-per-click advertising, where advertisers bid on search words, e.g. Google Adwords. For hotels, using OTAs can be compared to outsourcing parts of their online marketing. Due to the OTAs ability to offer consumers a wide range of different hotels, OTAs are in a position to utilise pay-per-click advertising more cost-efficiently than individual hotels are. Take the search term "hotels in Stockholm". For a hotel, recoupment of pay-per-click advertisement depends on consumers booking a room on that specific hotel after having clicked on a sponsored link paid for by the hotel, so called *conversion* (from "looking to booking"). For an OTA, it suffices if the consumer books any hotel connected to the platform. An OTA can therefore in general achieve a much higher conversion ratio from bidding on search terms

[1] Case number 596/2013.English translation of the decision available at http://www.konkurrensverket.se/en/news/commitments-given-by-booking-com-benefit-consumers/ . These commitments were also offered to and accepted by the French and the Italian competition authorities. The three authorities coordinated their investigations assisted by the European Commission.

such as “hotels in Stockholm”, than any individual hotel. OTAs spend less on pay-per-click advertisement per completed booking than individual hotels do. Nevertheless, marketing to attract consumers to the platforms constitutes substantial investments for OTAs.

3. The commission-based business model

5. The two-sided nature of many online platforms, where users on each side benefit from a large number of users on the other side, renders it crucial for platforms to use a business model which attracts as many sellers and buyers as possible to the platform. A common business model online allows sellers to connect to the platform and post their own prices, and consumers to use the platform’s search and comparison services, without either party paying any fixed fees. Instead, the platform charges a transaction-based fee - a commission - on the transactions completed on the platform.

6. With this business model, platform revenue is dependent on whether the sellers and buyers complete the transaction on the platform after they locate each other, or whether they go elsewhere to transact. The investments made, e.g. the marketing to attract consumers to the platform, are only recouped for transactions completed on the platform. If many platform visitors continue on to other venues to conclude their transactions after finding the right match on the platform, thus lowering the platform’s conversion ratio, the transacting parties can be said to be free-riding on the platform’s investments.

7. Online, this type of free-riding can be much more prevalent than in physical marketplaces, since switching costs online are so much lower than in the offline world. Free-riding is often present even when sellers do not undercut platforms on price. If, however, sellers choose to undercut platforms in order to divert visitors from the platforms, free-riding has the potential to reduce conversion even further. Figure 1 shows a situation where conversion is sensitive enough to the price charged by the platform that the platform cannot cover its marginal costs of attracting visitors, resulting in a breakdown of the commission model.[2]

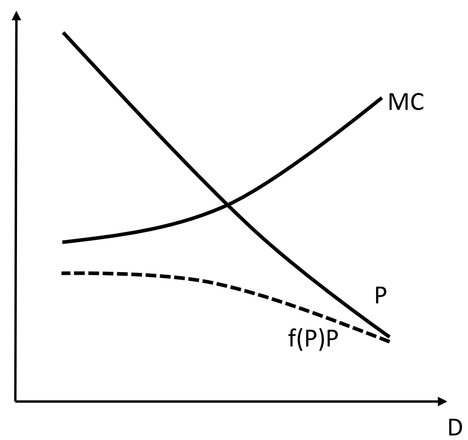

Figure 1. Marginal costs, inverse-demand *P*, and monetized inverse-demand (conversion *f* multiplied by *P*). The latter constitutes the portion of demand that actually generates revenue.

2 Jeanrond, J., M. Mandorff, and J. Selin. (2015). “Free-riding on Online Platforms,” *Mimeo*.

8. In situations where the business model does not break down, free-riding on the platform can nevertheless lead to decreased investments in quality, decreased investments in advertising to attract visitors, and in many circumstances also to higher prices charged by the platform.[3]

9. In the case of online hotel booking, free-riding occurs when consumers choose to divert to hotel websites or to competing platforms instead of completing the booking with the OTA. Free-riding in this context has been the subject of two studies published by the Center for Hospitality Research at Cornell University.[4] These studies show that bookings on hotel websites increase when hotels enlist on OTAs, even in the absence of undercutting by hotels. Hotels thus seem to benefit from the visibility that OTAs provide and from consumers diverting to the hotel websites to complete their bookings. This phenomenon has been termed the *billboard effect*.

10. The billboard effect and the potential for free-riding in online hotel booking was analysed as part of the SCA's investigation into Booking.com. In the course of the investigation, Booking.com conducted surveys in nine European countries among a total of around 2,000 accommodations and 14,000 consumers who had recently completed a booking through Booking.com. The survey measured the extent to which hotels would undercut Booking.com if there were no MFN-obligations, and the extent to which consumers would respond to this pricing by diverting to hotel websites. For Sweden, the results of the survey indicated that around a third of all hotels, and nearly half of chain-hotels, were likely to offer lower prices or special offers in their own channels if there was no price parity. Furthermore, nearly half of consumers booking hotels in Sweden were likely to divert from Booking.com to hotel websites if the price was 5 percent lower there than on Booking.com, and nearly two thirds if the price was 10 percent lower.

4. Alternative business models

4.1 Commission with "wide MFN"

11. When faced with a free-riding problem, one solution a platform may opt for is to impose complete price parity on sellers, requiring that they do not offer prices anywhere that are better than those posted on the platform. This is sometimes called a "wide MFN". The MFN reduces the level of free-riding, and maintains conversion ratios, as consumers learn that there is no use in diverting from the platform once they have located the best seller.

12. The potential for anti-competitive effects from this arrangement primarily derives from the "horizontal MFN" component, constraining sellers to offer no better prices at competing platforms.[5] To understand why, one may consider what happens when a platform increases its commission in a scenario where all platforms impose wide MFNs. Since the seller is bound by the MFN-obligation, it will have to respond to the increase in commission by raising its price not only on the platform itself, but also on the competing platforms.[6] The platform consequently no longer faces any diversion to competing platforms when increasing its commission. This softening of competition will lead to increased commissions and

3 Ibid.

4 See Anderson, C. (2009). "The billboard effect: Online travel agent impact on non-OTA reservation," *Cornell Hospitality Reports, 9*(16), 6-9, and Anderson, C. (2011). "Search, OTAs, and online booking: An expanded analysis of the billboard effect," *Cornell Hospitality Reports, 11*(8), 6-10.

5 See e.g. Boik, A., and K.S. Corts (2013): "The Effects of Platform MFNs on Competition and Entry," *Working Paper*.

6 Note that pass-through from commission to price will be lower than if there was no MFN.

prices, all else being equal, and can even result in commission rates that are above the cartel/monopoly-level.[7] The MFN can also serve as an entry barrier.

4.2 Fixed fees for buyers

13. An alternative to the commission model is to have consumers pay a fee for using the platform search services, regardless of whether the consumer transacts on the platform or not. This would indeed solve the free-riding problem, but the model is unusual in the online world and may have problems of commercial viability, for example in convincing consumers to pay upfront before knowing whether the search services are useful or not.

4.3 Fixed fees for sellers

14. A fixed fee for sellers enlisting on the platform would also solve the free-riding issue. However, this model means that sellers have to bear more of the risk of variability in conversion, which is especially hard on smaller, risk-averse sellers. Fixed fees can also make it more difficult for sellers to incentivise the platform to make sufficient efforts to achieve sales.

4.4 Pay per click

15. Pay per click means that sellers have to pay a fee for every consumer's click on the individual seller on the platform. This eliminates free-riding, but again sellers have to bear the risk of conversion, i.e. that clicks transform into actual transactions.

16. In the case of online hotel bookings, the pay per click model is the prevalent business model for so-called meta search sites. However, most hotels, especially smaller ones, do not directly enlist on meta search sites. The meta search sites' customer base instead mainly consists of OTAs.

4.5 Exclusivity

17. Another way to eliminate free-riding is to require exclusivity from the seller, i.e. that the seller only sells through that one platform. This imposes a cost on the seller to the extent that multi-homing is useful for reaching more consumers. Exclusivity can also have the standard anti-competitive effects when covering large portions of the market, preventing the entry and expansion of competing platforms.

4.6 Commission with "Narrow MFN"

18. Finally, to counter free-riding, platforms can use the commission model with MFNs, but tailor these MFNs narrowly. For example, the application of MFNs can be directed only at those distribution channels that generate the majority of free-riding.

4.7 Booking.com's commitments

19. During the course of the SCA´s investigation into Booking.com, the company offered commitments to the authority as well as its French and Italian counterparts to remove Booking.com's wide MFNs. In particular, Booking.com offered to remove its parity vis-à-vis competing platforms, the horizontal parity. However, Booking.com did not offer to remove its vertical parity, but rather wanted to continue to apply a

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7 Note that these effects only apply if the sellers need to multi-home, i.e. sell through more than one platform.

narrow MFN which restrained hotels from undercutting the platform on the hotels' own websites. Booking.com did not consider this restriction anti-competitive, but necessary to prevent free-riding.

20. During the SCA´s market test of Booking.com's proposed commitments, hotels responded that the narrow MFN risked becoming a *de facto* wide MFN, since for hotels to price differentiate between OTAs while constrained by a vertical MFN, they would have to price higher on their own websites than on at least one OTA. Hotels argued that this would prevent them from price differentiating.

21. Following this feedback, Booking.com proposed new commitments that further narrowed their MFNs, removing MFN obligations from all hotel pricing not marketed online to the public. The SCA then analysed the hotels' incentives to price differentiate under these new commitments. The incentives primarily depended on how price changes influenced hotels' total sales, as well as on how these sales were reallocated across different distribution channels.[8] Following this analysis, which was based on economic submissions provided by the various market participants, the SCA concluded that hotels would have sufficient incentives and that the narrow MFN would restore competition between OTAs. In April 2015, the SCA and the French and Italian Competition Authorities accepted the commitments.

4.8 The need for a more flexible approach?

22. The ease with which consumers switch between different venues online reinforces free-riding problems that, while also present offline, often do not reach the same critical scale. Vertical restrictions that can mitigate these problems pose new challenges for competition enforcement, as these restrictions may include both pro- and anti-competitive elements at the same time. The interplay between free-riding problems, business models and restrictions can be highly industry-specific, and at the same time be rapidly evolving as innovations disrupt these marketplaces. This calls for a more flexible approach to the enforcement of competition policy, considering variable conditions, and for a commitment to an in-depth understanding of the logic of the online marketplaces under scrutiny.

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8 When a hotel lowers prices on a single OTA, it will increase its sales in that channel due to customer gains from other sales channels, from other hotels on the same OTA, and from a general increase in demand. Insofar as the hotel´s customer gains derive from less profitable sales channels or constitute new sales, this is to the advantage of the hotel. At the same time the hotel is deprived of revenue insofar as existing consumers switch from a sales channel that is more profitable for the hotel; the latter being in particular consumers switching from the hotel's website. The incentives of hotels to offer lower prices on a single OTA in response to lower commission rates depend on the combined profitability of this flow.