Competitive Effects of Vertical Most Favored Nation Clauses

The aim of this white paper is to describe a vertical pricing practice called vertical most-favored-nation (VMFN) clause which prohibits retailers from charging more for one supplier's product than for rivals' products. Antitrust implications of VFMN clauses are discussed using examples from the cigarette and soft drink industries and the discussion is extended to recently litigated purchasing parity clauses commonly used by travel platforms.

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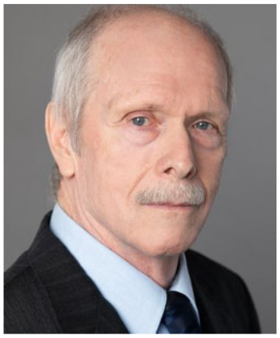

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I describe a vertical pricing practice, which I call a vertical most favored nation clause ("VMFN"). In various contexts, similar practices are called Parity Pricing Clauses ("PPCs") and Platform MFNs. Formal economic analysis of VMFNs is relatively recent. I am unaware of any U.S. court decision that has yet ruled on the specific economic features of these practices.[1]

These pricing arrangements have been used in a number of industries: cigarettes, soft drinks, online travel platforms, and online music and video

[1] There have been U.S. cases where one party employed a VMFN, but in which the VMFN was not the focus of the litigation. See Online Travel Company Hotel Booking Antitrust Litigation, 3:12-cv-3515-B (N.D. Texas 2/18/14), which focused on conspiracy claims. However, VMFNs were present as part of the defendants' conduct.

services, among others. A practice similar, though not identical, to VMFNs, was litigated in the Apple e-books case.[2] In Europe, VMFNs have been the subject of extensive litigation in online travel industries. In Canada, the legality of VMFNs in credit cards has been litigated at least once.[3] Economic literature that analyzes the competitive effects of these vertical pricing arrangements is found in Liu, Sibley, and Zhao (2017) and Boik and Corts (2016).[4]

Below, I describe the economics of VMFNs and their antitrust implications. I describe the anticompetitive effects that are inherent to VMFNs, as well as pro-competitive effects that may exist in particular cases. For expositional purposes, I use a hypothetical example involving competing sellers of cigarettes.

To begin with, VMFNs are unlike the standard MFNs which have been litigated for many years. A standard MFN clause is part of a sales contract in which the seller represents to the buyer that no other buyer is paying the seller less for the product in question.[5] For example, a soft drink manufacturer with an MFN may be required to sell to all its retailers at the same wholesale price.

In the VMFN setting, the seller has no such arrangement with its own customers (retailers), who sell to their own retail customers. The VMFN concerns the prices set by these retailers, not the wholesale prices that the seller charges them. This distinguishes them from ordinary MFNs.

In the case of soft drinks, if a manufacturer has a VMFN agreement with retailers, the manufacturer may require that those retailers charge no more for that manufacturer's soft drink at retail than the retailer charges for certain competing soft drinks. Again, this is quite different from a standard MFN, which concerns the wholesale prices charged by the soft drink manufacturer to those retailers.

1. Starting Point: The Manufacturer-Retailer Relationship Without a VMFN

[2] In Apple's e-book initiative, Apple took a share of the retailer's revenues. Publishers of e-books agreed to a retail MFN clause in which they agreed to set the same retail price on any retail platform that used Apple's e-book format.

[3] Commissioner of Competition v. Visa Canada Corp. 2013 Comp. Trib.10 (Canada).

[4] See Liu, F., D. Sibley, and W. Zhao (2017), "Vertical Contracts that Reference Rivals," *Review of Industrial Organization*, 56(381-407, and Boik, A. and K. Corts (2016), "The Effects of Most-Favored Nation Clauses on Competition and Entry," *Journal of Law and Economics* 59(1).

[5] See Carlton and Perloff, MODERN INDUSTRIAL ORGANIZATION, Pearson, 4th Edition, p. 141.

For simplicity, suppose that there are two cigarette manufacturers. Label one "Reynolds" and the other "Lowprice." Assume that there is no VMFN in effect in the market. Both manufacturers sell products that are differentiated by features, quality, etc., but which also compete on price at retail. Reynolds and Lowprice both sell to a given retailer at wholesale prices. The retailer then chooses its retail prices for the two products in order to maximize its profits, given the wholesale prices charged by Reynolds and Lowprice.

Both Reynolds and Lowprice can affect retail prices by the wholesale prices that they charge the retailer. If Reynolds raises its wholesale price, the retailer will pass on part of the increase to consumers via an increase in its retail price. This increase in Reynold's price will cause some customers to substitute away from Reynolds to Lowprice. It may also cause some customers to stop buying cigarettes altogether. These effects cause a reduction in units sold by Reynolds. This loss in unit sales disciplines Reynolds in its choice of the profit-maximizing level of its wholesale price. Think of it as consumer pushback.

The same dynamic is true for Lowprice. If Lowprice raises its wholesale price, the retailer will pass some of the increase on to its customers, and some of them will switch to Reynolds, in response. Some may stop smoking altogether. This reduces unit sales by Lowprice to the retailer and disciplines its pricing.[6]

Economists call the loss in unit sales from consumer pushback the "price elasticity of demand". The higher the price elasticity facing Reynolds, the more pushback, the lower is its profit-maximizing wholesale price. The lower the price elasticity, the less pushback and the higher is its wholesale price. The same is true for Lowprice and its wholesale price.

2. How the VMFN Increases Prices

Now suppose that Reynolds requires that the retailer set the retail price of Reynold's cigarettes no higher than the retail price of Lowprice's cigarettes, *i.e.,* Reynolds adopts a VMFN. Described in this way, it makes it appear that Reynold's VMFN is actually procompetitive. However, the VMFN would likely have anticompetitive effects.

To see why, consider why Reynold's would choose to have a VMFN with the retailer. Clearly, if the retail price of Reynold's cigarettes is typically less than

[6] Obviously, this vertical chain described above is simplified. In reality, the manufacturer may sell through several wholesalers to get its product to the retailer. However, as long as these wholesalers are competitive, no serious complications are introduced.

the retail price of Lowprice's cigarettes, there is no need for the VMFN. Therefore, for a VMFN to make sense, it must be that the retail price of Reynold's cigarettes would typically be higher than that of Lowprice's, absent a VMFN. In this case, the VMFN must be constraining, *i.e.,* it causes the price of Reynold's cigarettes to equal those of Lowprice.

How does the retailer comply with the VMFN? One possibility is that the retailer lowers the price of Reynolds' cigarettes to the Lowprice level. The other possibility is that the retailer increases both prices, while keeping them equal to each other. In fact, that is what happens. The economic logic is as follows.

Because the retail prices of Reynolds and Lowprice must be equal, then if the retailer wants to raise the retail price of Reynolds, it must also raise Lowprice's retail price by the same amount, so that both prices remain equal. Thus, consumers no longer have a price-based reason to switch away from Reynolds to Lowprice. Therefore, the initiating increase in Reynolds' wholesale price does not result in as much consumer pushback as it would if there were no VMFN.

This means that Reynold's can profitably set its wholesale price higher than it would without the VMFN. In turn, this causes the retailer to set both retail prices at higher levels than it would without the VMFN.

Interestingly, it is not necessary for both manufacturers to have VMFNs with the retailer in order for both wholesale prices to rise. If Reynolds imposes a VMFN and both retail prices rise, the retailer cannot reduce Lowprice's retail price. Therefore, it makes no economic sense for Lowprice to reduce its wholesale price in order to undercut Reynold's. Lowprice has an economic incentive to go along, just as if it, too, had a VMFN.

It is important to note that no element of conspiracy is required for the VMFN to have anticompetitive effects involving both manufacturers. The two manufacturers are each behaving in their individual self-interest.

3. Possible Procompetitive Efficiencies of VMFNs

In some settings, VMFNs may have procompetitive effects. In the GrubHub litigation, plaintiffs claimed that GrubHub's platform MFN causes restaurants with both online and physical presences to raise prices to consumers, whether or not they buy online. GrubHub may argue that such a practice is needed in order to keep sellers from free-riding on value-added features of its website.[7]

[7] Davistashvili et al v. Grubhub, Inc., et al No. 1:20-cv-03000(SDNY, April 13, 2020).

In a manufacturer-retailer setting, one might argue that the presence of the VMFN makes it possible for a manufacturer to provide the retailer with marketing benefits that a manufacturer could not provide without the VMFN.

Depending on the specifics of the case, such defenses may or may not be compelling. In any case, the price-increasing effects of the VMFN are always present. Nonetheless, the existence of effects like those claimed by GrubHub could pose problems for class certification.

4. Industries Where VMFNs Have Been Used

In the cigarette industry, RJ Reynolds ("RJR") has an optional trade program called "Every Day Low Price" ("EDLP").[8] RJR offers retailers various marketing benefits and has a VMFN as part of the EDLP program. The majority of cigarette retailers have selected EDLP. Other cigarette manufacturers do not have VMFNs. This would seem to rule out an argument that the VMFN is required to solve a free rider problem or some other type of market failure. The RJR VMFN was applied to the RJR discount brand, which is Pall Mall. The EDLP contract specifies that the retailer cannot price Pall Mall higher than it prices a specific list of competing discount cigarette brands.

Another example comes from the soft drink industry. Examples are the so-called Calendar Marketing Agreements ("CMA") used by Coke and Pepsi in the 1990s. According to a Texas Supreme Court decision, both Coke and Pepsi had VMFNs as part of their CMAs. In the early 2000s, a Texas Supreme Court decision in an antitrust case involving a Coke bottler described both Coke and Pepsi CMAs as using Royal Crown as the reference price in their respective VMFNs.[9] That is, Coke and Pepsi required that a retailer not charge more for their respective brands than it did for Royal Crown.

In a somewhat different form, VMFNs have been used, and are now being litigated, in platform industries, such as travel platforms. In the platform context, VMFNs are usually referred to as Pricing Parity Clauses ("PPCs").

A PPC is an agreement between a given platform and a seller that, among other things, requires that the seller not charge lower prices on other platforms or on the seller's own website.[10] As with the VMFN between a

[8] See Liu, Sibley and Zhao (2019) at footnote 13.

[9] Coca Cola Company v. Harmar Bottling Company Supreme Court of Texas, The Coca Cola Company, et al, Petitioners v. Harmar Bottling Company, et al, respondents, No. 03-0737. Decided: October 20, 2006.

[10] This is known as a "wide" PPC. A "narrow" PPC is one in which a seller must only keep its prices for direct sales and platform sales the same.

manufacturer and a retailer, this has the potential to inflate platform commissions and seller prices.

To see why, suppose that Platform A increases the commission it charges its sellers. Absent the PPC, the seller would pass some of that increase through to consumers in a higher selling price on Platform A only, rather than on other platforms through which it sells. This might cause buyers to shift to other platforms or to the sellers' own websites. This would reduce the volume of business done on Platform A. This volume reduction would limit Platform A's incentive to increase the commission in the first place.

However, with a PPC in effect, a seller would violate the PPC if it increased its price only on platform A. Therefore, the seller must either absorb the commission increase or else increase its selling price on <u>all</u> other platforms and on its own website. This occurs even though these other platforms may not have increased their commission rates at all. The same will be true for all other sellers on Platform A.

If the sellers on Platform A all absorb the commission increase, this merely incentivizes Platform A to increase its commission further. Therefore, the logical result is that sellers on Platform A will increase their prices on all platforms. Further, since all platforms have the same incentive, all commissions, on all other platforms, will be inflated.

Potential anticompetitive effects exist both upstream and downstream. In the upstream market for platform services, the customers are sellers. The downstream markets consist of the products sold by sellers on that platform. The downstream customers are retail consumers.

Upstream, PPCs inflate commissions. Downstream, the PPC also inflates selling prices to consumers who buy using Platform A or other platforms.