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Lear Competition Note

PRICE RELATIONSHIP AGREEMENTS: ECONOMIC ANALYSIS AND IMPLICATIONS FOR COMPETITION

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Price Relationship Agreements (PRAs) are those pricing policies in which the price paid to a seller, for a good or service, is directly related to another price charged for the same or similar competing products. These agreements are somehow in contrast with the typical pricing that would be expected in competitive markets. Indeed, by adopting PRAs sellers do not simply consider and react to the prices of their rivals, they limit their pricing strategy as they link their effective price to other prices.

Typical examples of PRAs are `price-match' or `price-beat' guarantees, whereby one seller promises to match or beat other sellers' prices, for the same good or for other competing products; other examples are `most favourite nation' guarantees whereby a customer, that enters a commercial agreement, is offered the best price offered to any other customers, for the same or similar competing product, in a defined period of time.

Firms offer many types of PRAs that vary along many dimensions. Taking into account the main relevant features it is possible to group them in the following categories (see Figure 1 for an illustration of this classification):

- Across-Seller PRAs - by which a seller promises to its customers that, if a customer finds the same product offered by a competitor at a lower price, it will match or lower its price. Such a promise might be part of a formal contract (especially in purchasing agreements between firms) or simply advertised (typically when consumers are the final buyers).
- Across- Customers PRAs - where a seller and a buyer agree on a contractual obligation whereby the seller offers to the buyer the best price it offers to any other customer within a predefined period of time. These agreements are typically known as `most favoured customer clauses' (MFCCs) and are usually signed between firms.
- Third party PRAs – where a seller agrees with the upstream manufacturer or a retail platform, that the final retail price should be related to some other price (usually the price of a competing product offered by the same seller, or the price offered by the same seller for the same product in a different platform). Notably, in

this type of agreements the final buyer is not a party of the PRA, and she does not have any enforceable right on the terms of the agreement.

Firms adopt PRAs for many different reasons and the competitive effects of these arrangements may vary substantially. PRAs are used by firms to signal private information to buyers (e.g. low prices, or high quality), or to mitigate incomplete contracts problems (especially in long term contracts). Further, these agreements might allow/prevent firms to price discriminate. However, PRAs might also soften competition, facilitate collusion or foreclose entry in a market. The assessment of the effects of these guarantees on consumer welfare is indeed complex. Nevertheless, a relatively wide body of economic literature has provided some solid results that might be helpful in guiding competition authorities and firms. Lear's report published by the OFT provides an in-depth analysis of the existing economic literature and gives some detailed policy conclusions.[1] This note summarizes the main findings of the report.

Determinants for Competitive Assessment

The existing evidence, both from the economic and marketing literature, suggests that firms adopt PRAs for different reasons. PRAs might be offered to signal high quality or low cost, hence to provide information to buyers, with the welfare improving effect of enhancing their ability to choose. Further, these agreements might increase welfare by fostering investments, as they mitigate the risks of incomplete contracts stipulated between firms. PRAs might also be adopted to prevent or allow price discrimination, or to improve the bargaining position of sellers, which in some cases might improve consumer welfare depending on specific conditions. At the same time, PRAs can lead to a reduction in consumer welfare when they soften competition, facilitate collusion or prevent the entry of new competitors.

The assessment of the competitive effects of PRAs might be complex as these guarantees differ under different dimensions, and the effects they produce depend on the interplay with other external factors (e.g. the conditions of demand, the level of competition). Moreover, the same PRAs, at the same time, might produce, different effects and the assessment of the impact on consumer welfare needs to balance the welfare reducing and the welfare improving aspects. For these reasons the assessment of the effects of PRAs requires careful and case-specific economic analysis.

Nevertheless, some general policy considerations can be drawn from the relevant body of established economic literature that studies PRAs under different perspectives: theoretical, empirical and experimental. This literature has indeed developed an in-depth understanding of two types of PRAs, namely across-customers and across-sellers, that can provide valuable policy indications to competition authorities and firms, interested in the welfare assessment of PRAs. On the contrary, the literature on third party agreements is less developed and for this type of PRAs it is only possible to provide some preliminary considerations.

The main factors to consider in the assessment of PRAs are the following:

Market characteristics

- Degree of concentration.
- Heterogeneity of buyers and sellers.
- Barriers to entry.
- Type of contracts (e.g. long term contracts).

Characteristics of Sellers adopting PRAs

- Degree of market power.
- Level of prices.
- Number and type of sellers adopting the PRAs.

Characteristics of the PRAs

- Level of hassle-cost (to exercise/enforce the PRAs).
- Contemporaneous or retroactive.
- Part of a long term contract.

Other factors

- Nature of buyers (consumers, firms).
- The side who asks for the PRA.

On the basis of the above elements Figure 2 and Figure 3 present two screening devices to preliminary assess across-customers and across-sellers PRAs.

Across-Sellers Agreements

Within this type of agreements we can distinguish between `low price guarantees' as those promises made by a seller to its customers, and `meeting competition clauses' as those guarantees embedded in long term contracts. Customers might be attracted by these offers as they may believe to find low prices at the retailers offering the guarantees, and save in their search cost. Also, buyers might be reassured, by high quality sellers, that the higher quality does not come at an extra cost. Further, downstream firms might be attracted by such agreements, in particular when entering long term purchasing contracts, as to avoid to be locked in unfavourable terms, especially when the clause is coupled with the option to be released.

Despite these policies seem to offer very good value to buyers, it has been showed that they might not be a truly good deal. For instance, firms offering PRAs might make it very difficult for buyers to redeem the guarantee. Hence, firms might unduly attract customers without actually offering low prices, and this type of concerns should be properly addressed through consumer law. Further, in relation to competition law, across-sellers PRAs, under some conditions, might raise the following concerns:

- Softening of competition: in concentrated markets, where many sellers adopt the same policy, price reductions become less attractive, hence there is a reduced incentive to cut prices, the same happens if the PRAs reduce buyers activity to look for lower prices.
- Facilitate collusion: collusive strategies are sustainable if firms are able to detect and punish deviations. The reciprocal offer of PRAs, by colluding firms, might enhance the monitoring of each other's prices and facilitate collusion, especially in concentrated markets.
- Foreclose entry: large incumbent firms, enjoying a dominant position, might offer PRAs to discourage entry in their markets. Across-sellers PRAs act as a credible commitment to match any low price offered by new entrants. Entry is then made less viable as it will be more difficult to attract customers.

Despite the above concerns, across-sellers agreements do not seem to raise competitive concerns and might be welfare enhancing when:

- PRAs are used to price discriminate and the market is expanded.
- PRAs are offered in fragmented markets.
- Only small players adopt PRAs;
- PRAs are offered by the truly low priced retailers.
- In long term contracts PRAs mitigate price rigidity.

Across-Customers Agreements

These price guarantees (i.e. MFCCs) are often included in contracts between input suppliers and downstream firms. Indeed, buyers might favour the inclusion of these guarantees as to link the price that they pay to the price that also other buyers pay or will pay in the future. Indeed, this implies that if other buyers will be offered more favourable terms, also the buyer that is part of the agreement will benefit. However, MFCCs might have different effects on consumer welfare.

Indeed, as with across-sellers agreements, also across-customers policies might raise, although to a lesser extent, similarly important competition law concerns:

- Softening of competition: when the upstream seller offers a MFCCs it will have a reduced incentive to lower prices to any of its buyers, with the likely result that the downstream firms will all pay the same higher price (higher than the average price that would have prevailed absent the MFCCs). This, in turn, implies that also downstream competition will be affected and final consumers will likely experience higher prices;
- Facilitate collusion: these agreements could sustain collusion as they prevent firms from offering selective discounts, However they also increase the cost of punishing other firms' deviations, as any price cut will have to be extended to all contracts covered by the MFCCs. Indeed, the final effect might be ambiguous.
- Foreclose entry in downstream market: downstream firms might have an incentive to ask for the adoption of MFCCs as to prevent that new downstream competitors enter the market and secure lower input prices This might happen when the upstream and downstream markets are concentrated or there is a dominant vertically integrated firm that offers the agreement.

MFCCs might also be used to prevent inter-temporal price discrimination and to solve some investment hold-up problems. This is the case when a firm has to undergo a substantial fixed investment to produce a durable good and faces consumers with different willingness to pay. For the firm would be optimal to ask a higher price at the beginning, and then lower the price in subsequent periods. But if this is anticipated, nobody will accept the higher price in the first period and all consumers would want to wait for the lower price, making the investment not viable. By adopting a retroactive MFCC a firm might credibly commit to charge the same price for all periods and the investment might become viable.

Third Party Agreements

The distinctive feature of third party agreements is that the buyer of the good, or service object of the agreement, is not a party to the agreement. Indeed, these PRAs, despite having as object the final retail price of the seller, are usually stipulated between a seller and a manufacturer or a seller and a platform (online or physical platforms, like websites and shopping centres).

Given their nature, these PRAs, under some conditions, might affect competition both at the level of platforms/manufacturers and at the level of sellers. Further, they might raise competition law concerns similar to the ones identified for across-sellers PRAs:

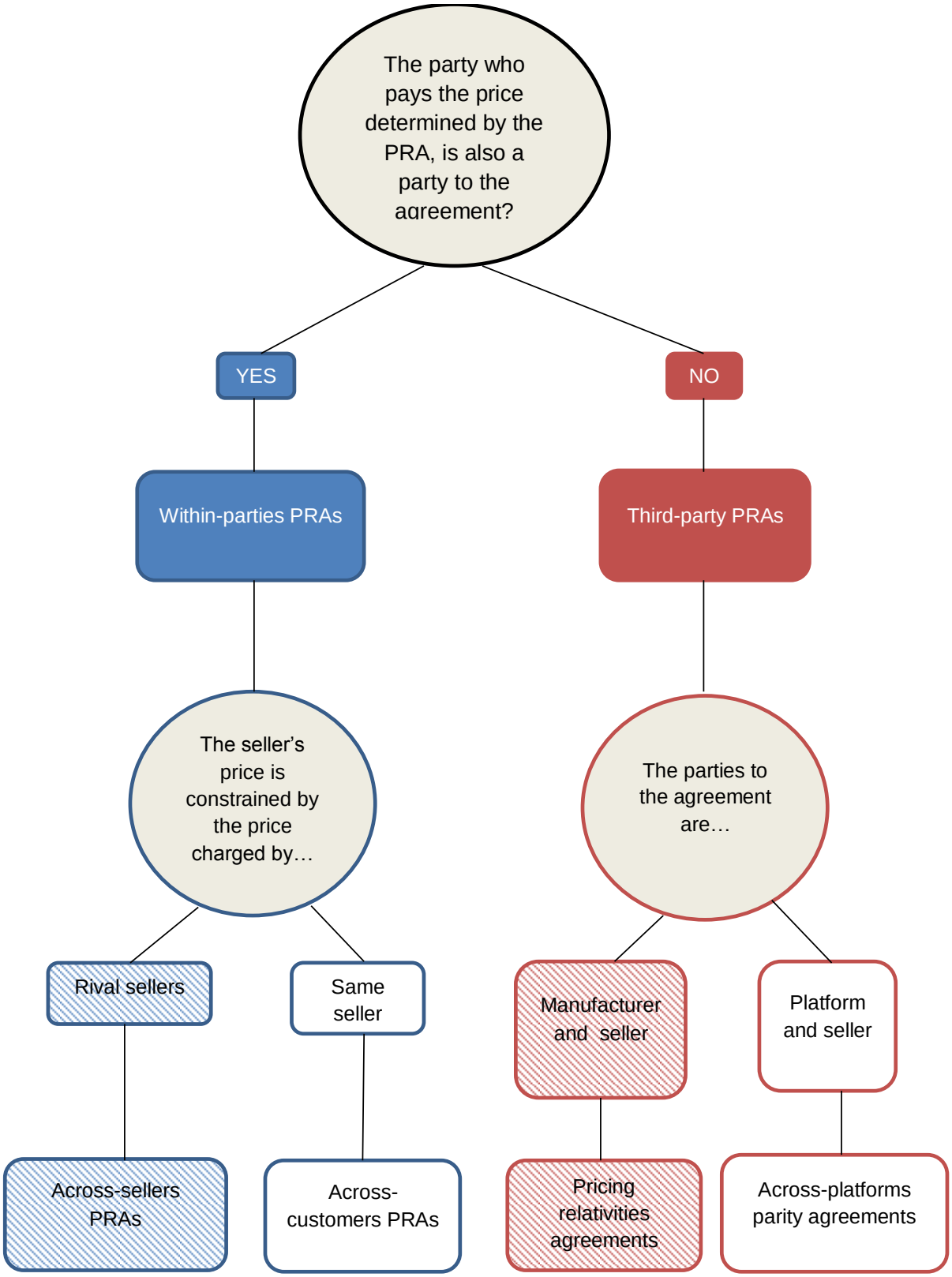
- Softening of competition: the adoption of these PRAs reduces the incentive for the seller to lower its final prices (respectively across the products of different manufacturers or across platforms). At the same time also manufacturers have a lower incentive to lower their prices, given that cost reductions are less likely to be passed to final prices and expand output. For the same reasons, also the competition between platforms is softened as there will be a reduced incentive to lower the cost of the seller (i.e. the platform fee).
- Facilitate collusion: in particular, in the case of third party agreements between sellers and manufacturers, these policies might increase price transparency and facilitate collusion between manufacturers.
- Foreclose entry: new manufacturers might not be able to effectively compete on prices if other manufacturers ask sellers to match or to keep fixed differentials on other competing products. Differently, when platforms sign third party agreements with a substantial share of sellers, other new platforms might find it difficult to attract buyers, as sellers are forced to offer the same prices across platforms.

Other than the above competition law concerns, third party agreements might have efficiency justifications when they aim to mitigate free-riding problems on specific services or to protect specific investments. For instance, when a platform offers superior pre-sale services it might be efficient to prevent that buyers free-ride on the pre-sale services and then purchase on another low-services low-prices platform.

Nevertheless, given the limited scope of the economic literature that considers third party PRAs, and their impact on different levels of the value chain, a careful ad-hoc analysis is always advisable for the assessment of these policies.

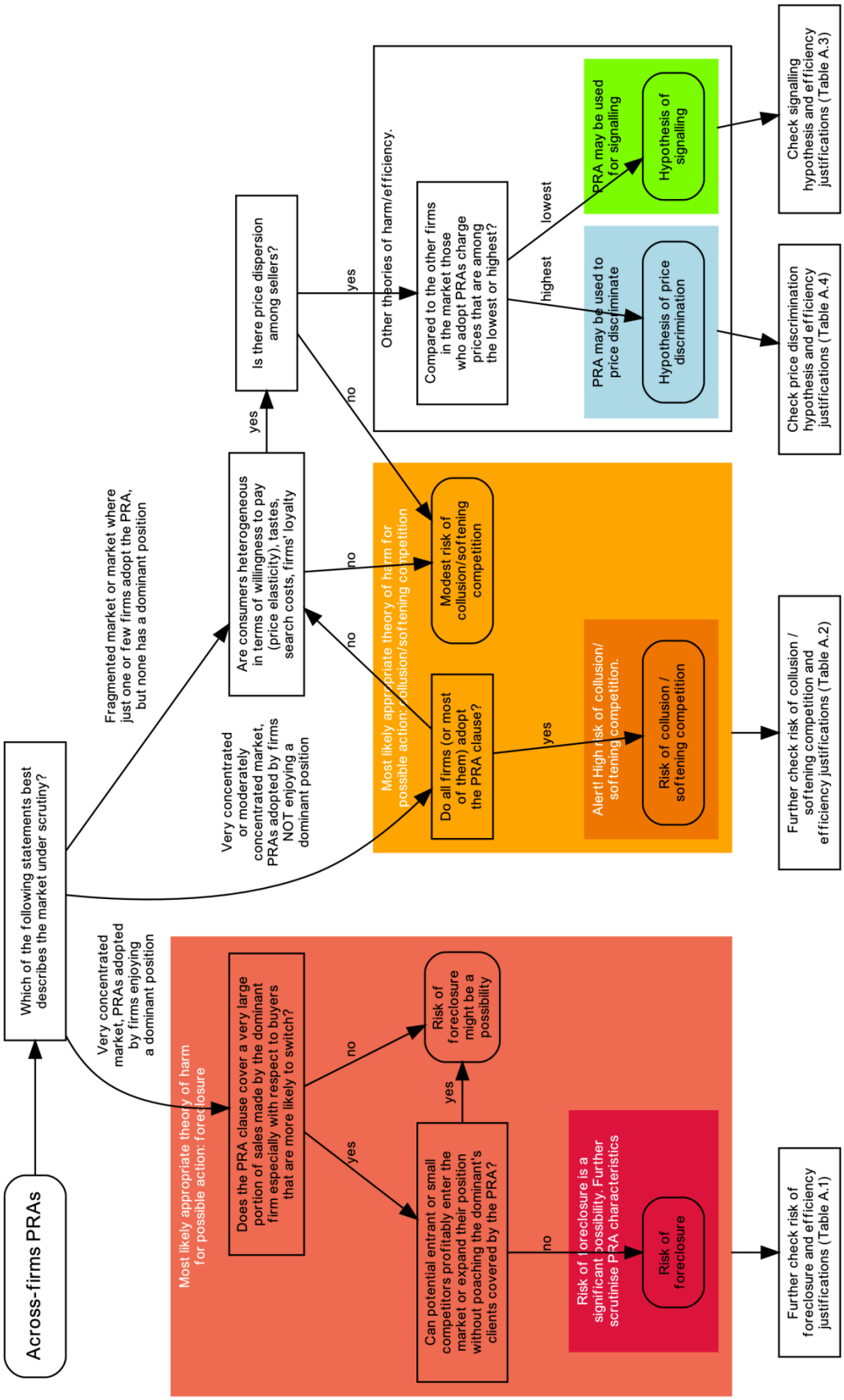
[1] Can "Fair" Prices Be Unfair? A Review of Price Relationship Agreements', a report prepared for the OFT by Lear, September 2012, http://www.learlab.com/pdf/oft1438_1347291420.pdf

Figure 1 Classification of PRAs



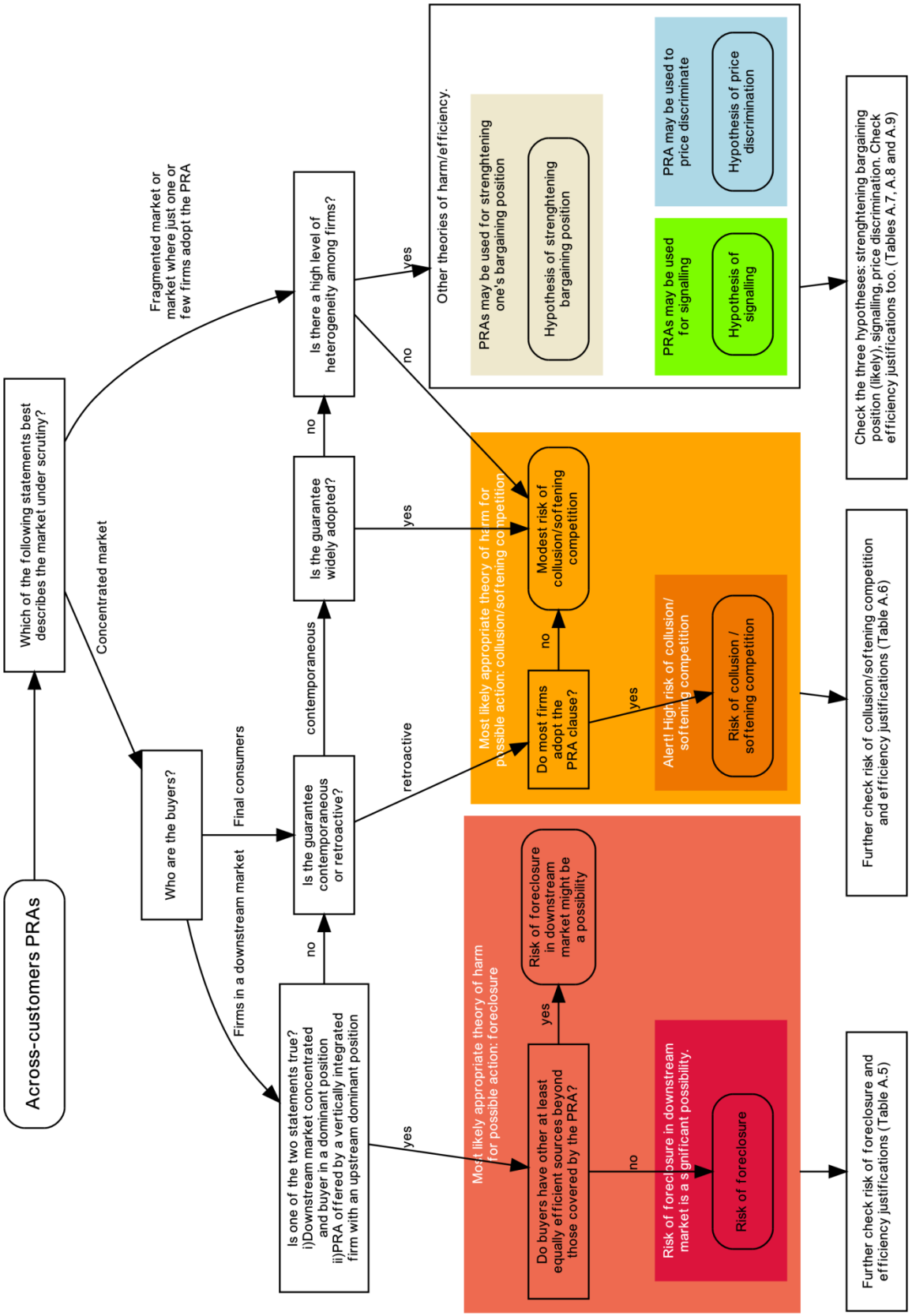
Source: Can "Fair" Prices Be Unfair? A Review of Price Relationship Agreements', a report prepared for the OFT by Lear, September 2012, http://www.learlab.com/pdf/oft1438_1347291420.pdf

Figure 2 Screening device: Across-Sellers PRAs



Source: Can "Fair" Prices Be Unfair? A Review of Price Relationship Agreements', a report prepared for the OFT by Lear, September 2012, http://www.learlab.com/pdf/oft1438_1347291420.pdf

Figure 3 Screening device: Across-Customers PRAs



Source: Can "Fair" Prices Be Unfair? A Review of Price Relationship Agreements', a report prepared for the OFT by Lear, September 2012, http://www.learlab.com/pdf/oft1438_1347291420.pdf