THE PROHIBITION OF PRICE PARITY CLAUSES AND THE DIGITAL MARKETS ACT

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Platforms have imposed price parity clauses on sellers, which restrict how sellers can set retail prices. These clauses have been found to be anti-competitive in a number of recent abuse cases in and outside Europe. In particular, leading hotel booking platforms had to drop these clauses. The proposed Digital Markets Act prohibits the use of such price parity clauses for gatekeeper platforms that are addressees of the Act. I explore the economic rationale of such a prohibition and point to possible responses by gatekeeper platforms. This raises issues, which are of relevance more broadly for competition policy and the regulation of platforms.

01

INTRODUCTION

Price parity clauses stipulate that sellers on a platform cannot set higher retail prices on this platform than in a certain set of alternative sales channels. This may include certain direct sales channels or other indirect sales channels provided by competing platforms. So-called wide price parity clauses stipulate that sellers must not offer a lower price through any other channel (including direct and indirect channels), while narrow price parity clauses stipulate that sellers must not offer a lower price in the direct sales channel but are allowed to set lower prices on other platforms. Wide-price parity clauses are widely seen as anti-competitive, while there is substantial disagreement about the likely effects of narrow-price parity clauses. Practitioners and academics often call price parity clauses most-favored-customer clauses or "MFNs" (standing for most-favored-nation clauses). This is unfortunate and possibly misleading. Most-favored-customer clauses traditionally stipulate that a seller cannot set different prices to different consumers or different prices over time. Price parity clauses do not contain such restrictions, but impose restrictions concerning prices faced by a given consumer across different distribution channels.

Price parity clauses have been imposed by several large platforms in the past. This includes hotel booking platforms such as Booking, which has led to abuse cases in several jurisdictions in the 2010s. It also includes Amazon with its general pricing rule. Amazon addressed the sellers on its platform as follows: "you must always ensure that the item price and total price of an item you list on Amazon.com are at or below the item price and total price at which you offer and/or sell the item via any other online sales channel." After the competition authorities initiated investigations, Amazon removed price parity clauses in Europe in 2013,[1] but continued to impose the clause in the U.S. In 2019, it then apparently removed the clause also in the U.S.; however, the clause was replaced by a similar "fair pricing policy."[2]

Another example is that Apple obliged publishers to set e-books prices in Apple's iBookstore at the lowest retail price available in the market. Apple abandoned its practice.[3] In August 2015, Booking removed its wide price parity clauses across all European Markets.[4] This led various NCAs, for example the CMA, to close its investigation against Booking.[5] Further, in Germany, Booking stopped using narrow price parity clauses in 2016. This came after the Bundeskartellamt found in 2015 that Booking's narrow price-parity clause is anti-competitive. [6] Booking challenged that the decision, first successfully at the Higher Regional Court in Düsseldorf in 2019.[7] However, the BGH, Germany's highest court, sided with the Bundeskartellamt in 2021.[8] End of story?

02

THE PROHIBITION OF PRICE PARITY CLAUSES IN THE DMA

The *German Booking* case shows that competition law can deal with price parity clauses. The Bundeskartellamt is not

1 See press release of the Bundeskartellamt of November 26, 2013 "Amazon abandons price parity clauses for good" https://www.bundeskartellamt.de/SharedDocs/Meldung/EN/Meldungen%20News%20Karussell/26_11_2013_Amazon.html.

2 In May 2021, the District of Columbia filed a complaint against Amazon at the Superior Court of the District of Columbia that contains more details on the contractual clauses imposed by Amazon.

3 See European Commission, July 25, 2013, Case AT.39847 – E-Books, Annex I, Final Commitments – Apple, p. 4 ("Apple will not include in its new agreements with the 5 Publishers or in any new agreements with any other publisher a Retail Price MFN.") https://ec.europa.eu/competition/antitrust/cases/dec_docs/39847/39847_26805_4.pdf.

4 In April 2015, the Swedish, French, and Italian competition authorities accepted a commitment by Booking.com to reduce its wide parity clause a narrow parity clause. See L'Autorità Garante della Concorrenza e del Mercato April 21, 2015 https://www.agcm.it/media/comunicati-stampa/2015/4/alias-7623.

5 Competition and Markets Authority September 16, 2015, Press Release "CMA Closes Hotel Online Booking Investigation," https://www.gov.uk/government/news/cma-closes-hotel-onlinebooking-investigation.

6 Bundeskartellamt December 22, 2015, B9-121/13, Booking.com.

7 OLG Düsseldorf June 4, 2019, Kart 2/16(V), *Booking.com ("Enge Bestpreisklausel II").*

8 BGH May 19, 2021, KVR 54/20, *Booking.com*.

alone; other competition authorities and courts[9] in Europe and beyond intervened by prohibiting wide and sometimes narrow price parity clauses.

> ***Price parity clauses stipulate that sellers on a platform cannot set higher retail prices on this platform than in a certain set of alternative sales channels***

Thus, at first glance, it may look surprising that the prohibition of price parity clauses is included in the Digital Markets Act ("DMA"). Several possible explanations come to mind. While competition law can deal with such cases, it may take too long to decide such a case. By explicitly prohibiting price parity clauses in the DMA, it will arguably be much easier to avoid that they arise in the first place and fewer public resources will be needed to go after those gatekeepers employing them. The fact that European Union Member States treat narrow price parity clauses differently (because of different decisions based on competition law or because of interventions of national legislatures as in Austria, Belgium, France, and Italy[10] in case of hotel booking platforms[11]) suggests that there may be a lack of coherence across the European Union. By including a prohibition of price parity clauses, the DMA removes incoherence whenever gatekeeper platforms are involved. Price parity clauses may also be seen as particularly problematic when invoked by gatekeeper platforms as addressed by the DMA and thus justifying a *per se* approach for those platforms.

The DMA deals with price parity clauses in Recital 37 and Article 5(b). The prohibition of price parity clauses follows from Article 5(b). In the proposal by the European Commission (DMA, COM(2020) 842 final, p. 39) it says, "In respect of each of its core platform services …, a gatekeeper shall ... allow business users to offer the same products or services to end users through third party online intermediation services at prices or conditions that are different from those offered through the online intermediation services of the gatekeeper," which in the draft proposed by the European Parliament (A9-0332/2021, p. 65) becomes: "refrain from applying contractual obligations that prevent business users from offering the same products or services to end users through third party online intermediation services or through their own direct online sales channel at prices or conditions that are different from those offered through the online intermediation services of the gatekeeper."[12]

While the original version by the European Commission may be interpreted as a prohibition of wide price parity clauses only, the revised draft by the European Parliament states explicitly that the prohibition of price parity clauses also applies with respect to (online) direct distribution channels.

According to the Draft European Parliament Legislative Resolution (A9-0332/2021), published 30 November 2021, Recital 37 provides some reasoning:

> Because of their position, gatekeepers might in certain cases, through the imposition of contractual terms and conditions, restrict the ability of business users of their online intermediation services to offer their goods or services to end users under more favourable conditions, including price, through other online intermediation services or through direct business channels. Such restrictions have a significant deterrent effect on the business users of gatekeepers in terms of their use of alternative online intermediation services or direct distribution channels, limiting inter-platform contestability, which in turn limits choice of alternative online intermediation channels for end users. To ensure that business users of online intermediation services of gatekeepers can freely choose alternative online intermediation services or other direct distribution channels and differentiate the conditions under which they offer their products or services to their end users, it should not be accepted that gatekeepers limit business users from choosing to differentiate commercial conditions, including price.

The underlined words have been added by the Committee on the Internal Market and Consumer Protection to the

9 Notably in Sweden, after in July 2018 the Stockholms Tingsrätt had ordered Booking.com to remove narrow parity clauses from its contract terms (PMT 13013-16, *Visita /Booking.com*), the Patent and Market Court of Appeal overturned this ruling, finding that the plaintiff, a tourist services industry association, had not sufficiently demonstrated an anti-competitive effect. Svea hovraätt, Patent- och marknadso¨verdomstolen May 9, 2019, PMT 7779-18, *Booking.com.*

10 European Commission, Impact Assessment Report, SWD(2020) 363 final, Part 2/2, p. 111. For an overview over these legislative interventions and their motivations see Franck and Stock (2020), What is 'Competition Law'? – Measuring EU Member States' Leeway to Regulate Platform-to-Business Agreements, *Yearbook of European Law* 39, 320, 362–370.

11 In the case of Italy, the provision applies not only with regard to online platforms but also to offline travel agencies. *Id*. at 367.

12 The European Parliament adopted this amendment on December 15, 2021.

European Commission's original draft and this amendment has been adopted by the European Parliament on December 15, 2021.

Price parity clauses when used by gatekeeper platforms and applied in the context of core platform services are seen as harmful to consumers (and businesses). Where does the harm stem from?

03

THEORIES OF HARM

The basic argument by which price parity clauses are anti-competitive is straightforward. Consider first a single platform that charges fees on the seller side and competes against the direct sales channel. If the platform obliges sellers on its platforms not to offer a lower price in the direct channel, consumers are not inclined to use the direct channel if the platform offers some convenience benefit. The platform will then set a high fee and extract a large fraction of seller profits if many consumers do not check for products in the direct sales channel when the product is not visible on the platform (more on "showrooming" below). If price parity clauses were prohibited the platform's fee setting would be constrained because the sellers would serve consumers in the direct channel if the fee were too high. The idea here is that once consumers find a product they like on the platform they are inclined to check for this product outside the platform. This is a powerful argument against narrow and wide price parity clauses.

> ***Another example is that Apple obliged publishers to set e-books prices in Apple's iBookstore at the lowest retail price available in the market***

If there are competing platforms the argument extends to wide price parity clauses. Since the sellers' retail prices must be the same across the competing platform under wide price parity, a seller cannot serve more consumers on a platform that lowers its fee. This reduces the incentive of a platform to offer a reduced fee. This means that wide price parity clauses can be used as a facilitating device to soften platform competition. At the same time, consumers have little reasons to try out new look-alike platforms and, thus, barriers to entry are higher with such clauses being in place.

One criticism to the above arguments may be that quality competition is neglected: With price parity in place, platforms may have strong incentive to increase service quality offered to consumers to attract them to their platform. Economic theory predicts that, accounting for such costly quality provision, will lead to socially excessive investments in service quality (which benefits consumers), but overall consumers will be harmed because the consumer surplus gain from higher service quality is more than offset by higher retail prices.[13]

Another criticism is that one should not neglect the investments by platforms that allow consumers to easily collect and process information about various offers on the platform. Absent price parity, consumers would continue to find this service useful but, with lower retail prices elsewhere, desert the platform and finalize the transaction elsewhere, depriving the platform of revenues. Platforms would receive no compensation for such showrooming services, which may depress their incentive to provide such a useful service to consumers. Price parity clauses make seller free-riding unlikely since consumers cannot find lower prices elsewhere.

Absent price parity, consumers search on the platform and will not transact via the platform if the price differential between price on the platform and price on the direct distribution channel exceeds convenience benefit from transacting on the platform. Sellers will want to set low prices in the direct channel that induce consumers to switch only if fees exceed convenience benefits by a sufficient amount. This constrains the platform's fee setting since the platform will want to avoid free-riding. Economic theory predicts that consumers are better off when price parity clauses are prohibited in such a context.[14]

With competing platforms and showrooming, wide price parity clauses continue to be consumer welfare decreasing. Results regarding narrow price parity clauses are less clear-cut. If narrow price parity is needed for the viability of platforms and platform competition is sufficiently intense,

13 This argument is developed and formalized by Edelman & Wright (2015), Price Coherence and Excessive Intermediation, *Quarterly Journal of Economics* 130, 1283-1328.

14 This result is due to Wang & Wright (2020), Search Platforms: Showrooming and Price Parity Clauses, *Rand Journal of Economics* 51, 32-58.

narrow price parity clauses are in the interest of consumers.[15]

> *With price parity in place, platforms may have strong incentive to increase service quality offered to consumers to attract them to their platform*

Without doing justice to a larger economics literature on price parity clauses, my summary would be that, in the case of B2C platforms, there are strong indications that price parity clauses are detrimental to consumer welfare if competition between platforms is not effective. This is likely to be the case for gatekeeper platforms within the meaning of the DMA. Thus, my reading of the economics literature is that economic theory backs the presumption that price parity clauses are anti-competitive and consumer welfare decreasing when imposed by gatekeeper platform.[16]

Overall, considering the sound theories of harm regarding price parity clauses when one platform is in a strong position, combined with the fact that there is little ambiguity as to whether a contractual restriction constitutes a price parity clause, one may come to the conclusion that the DMA solves the competition problem adequately for gatekeeper platforms (if the proposal by the European Parliament is adopted). Mission accomplished?

04

PLATFORMS' BUSINESS RESPONSES TO PROHIBITING PRICE PARITY CLAUSES AND FOLLOW-UP REGULATORY ISSUES

To forecast the effects of the prohibition, it may be useful to look at what happened due to competition law enforcement after price parity clauses were withdrawn from the contracts between platforms and sellers. The Bundeskartellamt undertook an investigation of the hotel booking sector. It summarizes its main findings as follows:

> *The investigations have shown that ultimately the elimination of the narrow price parity clauses has not harmed Booking.com's market success. Meanwhile Booking.com is by far the leading online hotel platform in Germany, and even without the price parity clause the company has been able to consolidate its market position further and achieve enormous growth rates ... The accommodations use the pricing options now available to them in a diversified sales mix, without neglecting the "hotel booking portal" sales channel ... Most consumers do not compare accommodation prices but book where they first found an accommodation, which rules out any significant redirection/ free-riding activities ... An accommodation's own online direct sales channel is predominantly used by consumers who already knew the accommodation before they made a booking ...*[17]

Regarding hotel pricing, "more than half of the accommodations cooperating with Booking.com actually make use of the options for price differentiation now available between Booking.com and the hotels' own direct online sales." (p. 5) The Bundeskartellamt sees its position confirmed by these findings. Interestingly, the commission rates charged by the platforms to hotels have not changed. The investigation does not contain findings about consumer welfare.

Looking beyond the Bundeskartellamt's investigation, platforms make a number of design decisions that affect the interaction between sellers and buyers on the platform. A crucial role of platforms is to present consumers with an ordered list of recommendations and additional information about the offerings. These recommendations are generated by algorithms that use information available on the platform and possibly elsewhere. In particular, the algorithm may place a hotel high on the list for certain hotel queries if

15 For the economic theory behind this insight, see again Wang & Wright (2020), Search Platforms: Showrooming and Price Parity Clauses, *Rand Journal of Economics* 51, 32-58.

16 A caveat is due. According to economic theory, in some environments price parity may be consumer welfare increasing and beneficial for the platform even if there is a single platform. See Liu, Niu & White (2021), Optional Intermediaries and Pricing Restraints, unpublished manuscript, for such a result when some consumers always use the direct distribution channel, and the other consumers choose between the direct distribution channel and the platform channel – the latter provides a convenience benefit that is not available in the direct distribution channel.

17 Bundeskartellamt (2020), The Effects of Narrow Price Parity Clauses on Online Sales – Investigation Results from the Bundeskartellamt's Booking Proceeding, p.4.

previously that led to a high conversion rate. A high conversion rate may be interpreted as the hotel providing a good match to consumers making certain queries. By contrast, a hotel with a low conversion rate in such a position may receive a less favorable treatment. Low conversion rates are generated if most consumers find things to dislike about the particular hotel and, therefore, decided against booking this hotel. Low conversion rates may also result if consumers do like the particular hotel but find more attractive offers for the same hotel outside the platform.

> ***"Regarding hotel pricing, "more than half of the accommodations cooperating with Booking.com actually make use of the options for price differentiation now available between Booking.com and the hotels' own direct online sales."***

Clearly, the lower the price offered in a different distribution channel, the more likely it is that a consumer books via a different distribution channel and, thus, the lower the conversion rate. The algorithm may use even prices outside the platform as input. Hotels that offer lower prices outside the platform can then be punished directly and immediately. Either way, such recommender systems may "discipline" hotels even in the absence of price parity clauses making sure that no better offers are found elsewhere.[18] All that is needed, are sufficient data and a recommendation algorithm that works in the best interest of the platform. Then, the platform no longer needs price parity clauses and achieves the same or a similar outcome.[19] The prohibition of price parity clauses might therefore turn out to be ineffective.

> ***Clearly, the lower the price offered in a different distribution channel, the more likely it is that a consumer books via a different distribution channel and, thus, the lower the conversion rate***

The European Commission has not been blind to the concern that platforms may have alternative tools to discipline sellers. Indeed, Recital 37 of the Commission's proposed DMA ends with "… it should not be accepted that gatekeepers limit business users from choosing to differentiate commercial conditions, including price. Such a restriction should apply to any measure with equivalent effect, such as for example increased commission rates or de-listing of the offers of business users" (COM(2020) 842 final). When applying Article 5 of the DMA, this statement suggests that the Commission may address unfavorable seller rankings due to lower prices on alternative platforms. More explicitly, the Committee on Economic and Monetary Affairs of the European Parliament had added "less favourable ranking"[20] as another example, which, however, was not included in the Draft European Parliament Legislative Resolution.

As a result, the DMA also addresses practices that serve as substitutes to price parity clauses, but there is uncertainty as to whether a particular design of a recommender system constitutes a non-compliance with Article 5. A particular difficulty arises if a platform cannot monitor whether a transaction was completed elsewhere. It then has a hard time to obtain good estimates of the overall conversion rates of a listing. Such a conversion rate would, however, be an important input for a well-functioning and non-biased recommender system. In a nutshell, when price parity clauses are not available to gatekeeper platforms, other practices that may be seen as substitutes raise important questions about how regulation will affect the overall quality of the platform services that are provided.

Looking beyond the design of recommender systems, a possible response by platforms faced with legal risks when using price parity clauses or substitute practices is to revamp the overall monetization model. As in the case of hotel booking services, platforms relied almost exclusively on transaction fees. It is noteworthy that, for example, Booking recently introduced an ad-funded part to its business: hotels can obtain attractive positions in the ranking and are labeled as "promoted." To list such native ads, hotels place bids that, if successful, determine the cost-per-click ("CPC"). Such native advertising gives the platform a revenue source that does not require the transaction to be completed on the platform.

18 For an empirical analysis that finds lower rankings because of lower prices on other distribution channels, see Hunold, Kesler, & Laitenberger (2020), Rankings of Online Travel Agents, Channel Pricing, and Consumer Protection, *Marketing Science* 39, 92-116. A discussion of the platform's incentives when designing its recommender system is provided, for instance, by Belleflamme & Peitz (2021, chapter 6), *The Economics of Platforms: Concepts and Strategy*, Cambridge University Press.

19 Detecting such behavior may be difficult for the regulator if sellers are hesitant to becoming invisible. The perceived threat to be pushed down in the ranking may be sufficient to discipline sellers and thus distortions in the recommendations may not be observed (using economic jargon, such distortions may occur only off the equilibrium path).

20 Draft European Parliament Legislative Resolution, A9-0332/2021, p. 164.

> *A particular difficulty arises if a platform cannot monitor whether a transaction was completed elsewhere*

Dealing with price parity clauses and other potentially anti-competitive business practices by gatekeeper platforms, the EC has provided a set of prohibitions and obligations. The European Commission did not take the path to enter into price regulation, different from what has happened for example in the case of telecoms. A possible regulatory action against excessive fees stemming from price parity clauses would be to impose a ceiling on those fees. While there are some theoretical merits for such are regulatory intervention,[21] my fear is that it can do a lot of damage in an innovative market environment, especially if a platform may want to provide integrated services.[22] It should be a policy of last resort.

21 For a formal investigation showing advantages of fee regulation compared to banning price parity clauses, see Gomes & Mantovani (2021), Regulating Platform Fees under Price Parity, unpublished manuscript.

22 What is more, a ceiling applied to transaction fees may provide incentives for platforms to move towards the native ad-funded models, which may not lead to better outcomes for consumers or the sellers that use the gatekeeper platform. As mentioned before, while less immediate, a similar concern can be raised against the prohibition of price parity clauses.

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