RBB | Economics

Online Hotel Booking Case

Yan Yu

Yan.yu@rbbecon.com

19 March, 2014

Outline

1. General background of the OFT hotel booking case
2. A brief review of relevant economic theory
3. Competition concerns in the hotel booking cases
4. Concluding remarks

General background of the OFT hotel booking case

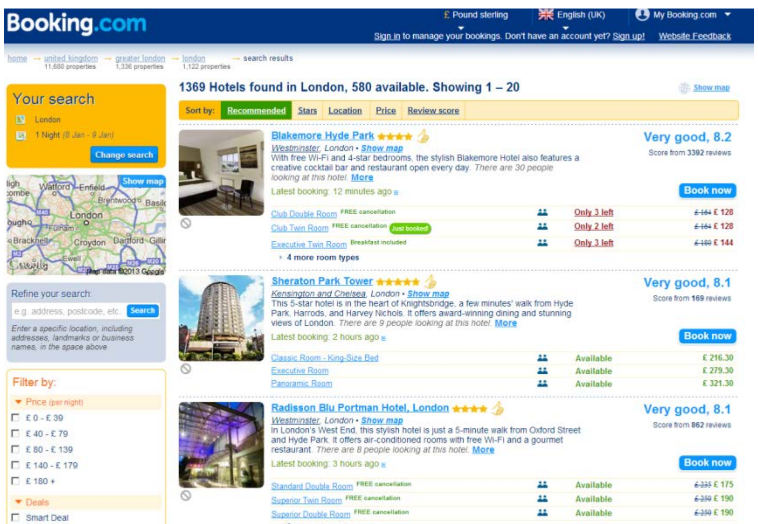
OFT hotel booking case: Timeline

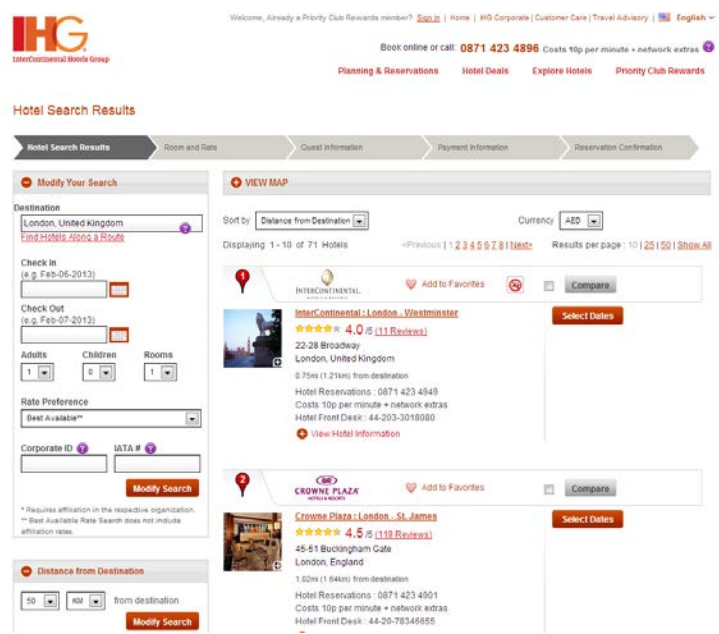
- 10 September 2010: the OFT launched a formal investigation into the specific vertical arrangements between hotels and Online Travel Agents (OTAs)
- 31 July 2012: the OFT issued a Statement of Objections alleging the parties infringed UK and EU competition law in relation to the online offering of room only hotel accommodation bookings by OTAs
- 9 August 2013: the OFT issued a Notice of intention to accept binding commitments and opened a consultation of the proposed commitments
- 20 December 2013: the OFT opened a consultation of the revised commitments
- 31 January 2014: the OFT accepted formal commitments from all parties
  - No assumption should be made that there has been an infringement of competition law

Online hotel bookings

Two channels through which hotels sell their rooms online

- Online Travel Agents (OTAs) – Booking.com, Expedia, hotels.com...
- Own websites – Brand.com (InterContinental Hotels Group plc)





Different pricing strategies for hotel accommodation

- Room-Only Rate
  - Rate set by hotels for hotel room only, i.e. not offered with other travel products e.g. car hire and/or airfare
  - Can include certain ancillary non-travel products e.g. breakfast
- Package Rate
  - A rate made available by hotel to an OTA for the purpose of offering hotel accommodations as part of a package (i.e. together with other travel products e.g. car hire and/or airfare)
  - OTAs determine the overall rate of the package
  - End-users could only observe the rate for the whole package
- Opaque Rate
  - Rate for hotel accommodation where the identity of the hotel is not disclosed until the end-user completes the booking
  - OTA determines Room-Only rates if offered on an opaque basis
  - End users cannot compare an opaque Room-Only rate with a normal Room-Only rate
- OFT’s investigation focus on Room-Only rates as OTAs can independently set prices under other rate types

Distribution models adopted by hotels

- Merchant model
  - OTA offers a hotel accommodation rate online at a mark-up against the "net rate" paid by OTA to hotels
  - OTA does not take title to the room
  - OTA is the merchant of record and end-users typically pay the OTA directly at the point in time the booking is made
  - Example: Expedia.com (*recently introduced the Traveller Preference program so that end-uses can choose to pay directly to the hotel*)

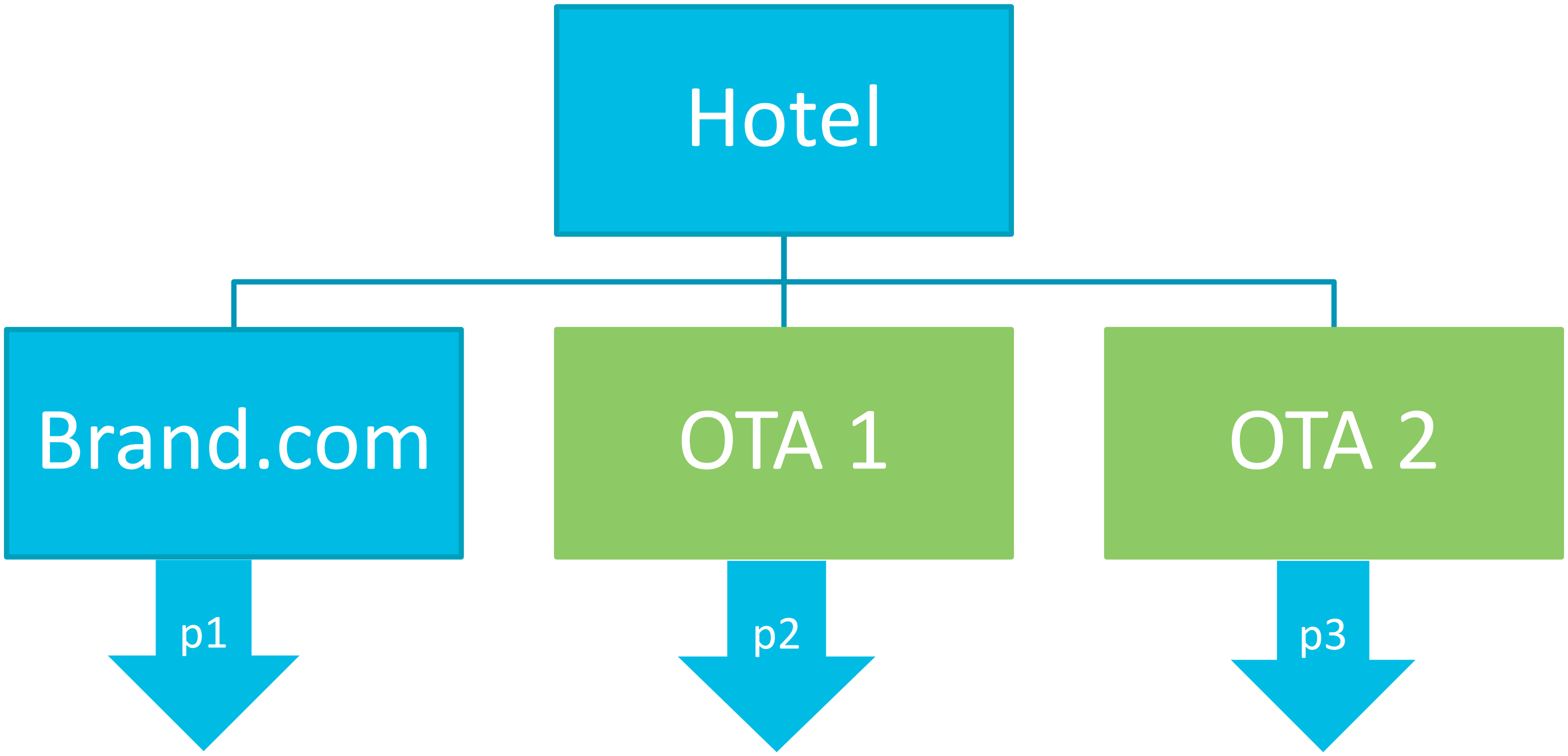
- Commission model
  - The hotel is the merchant of record and end-users pay the hotel directly
  - The hotel pays the OTA a commission for each booking
  - Example: Booking.com

- IHG's hotel operation models: franchise and management agreement with IHG
  - Room-Only rates are set by each individual IHG-branded hotel

- All covered by umbrella distribution agreement: Hotels load room rates onto an automated interface – then accessed by OTAs

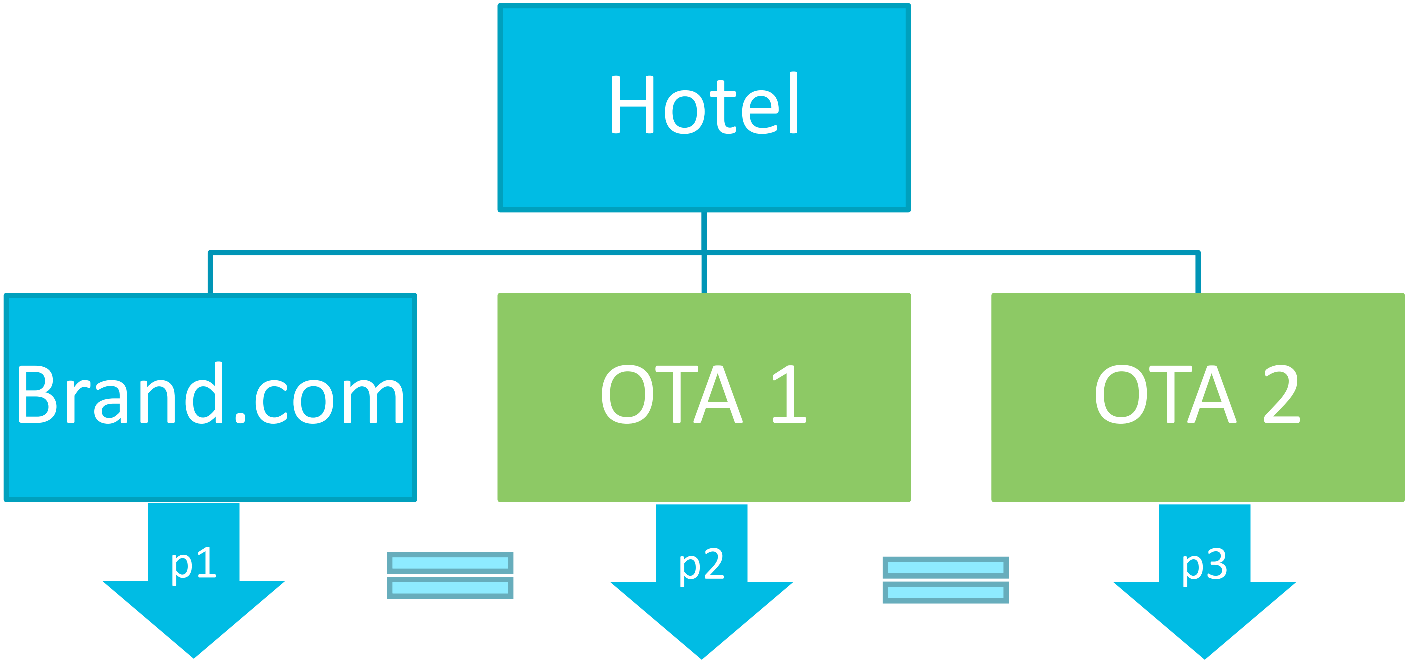
Price agreements - RPM

Hotel sets all retail Room-Only rates – OTAs cannot offer a lower rate by sharing margins or commissions



MFNs - Rate Parity

Hotels have to give each OTA a retail price at least as cheap as a) any other OTA and b) the price set on Brand.com



Overlapping MFNs mean that all prices end up the same, this affects changes in OTA commissions feeding directly through into changes in hotel prices

Legal framework

- RPM is a ‘hardcore’ restriction in UK/EU law – OFT doesn’t need to prove anti-competitive effects, just that the agreements constitute RPM

- MFNs may have some similar *effects* to RPM but but that does not necessarily make them anti-competitve in effect, so OFT would need to undertake a detailed investigation of effects in order to find an infringement

- The main concern seems to be rate parity agreements (MFNs), but OFT only makes a finding based on RPM

A brief review of relevant economic theory

Impact of online retailing on price and non-price competition

- Price competition may intensify *vs.* a reduced incentive to invest in product quality / service
  - More pricing transparency and lower consumer searching costs
  - Lower distribution costs (?): Reduced supplier chain or added intermediation
  - Information asymmetry between seller and end-customers: harder for brand equity building online; consumers cannot physically inspect and test the goods before purchase (adverse selection)

- Increase in product range offerings although consumers may be indifferent
  - Physical inventory is less a concern
  - Higher incentive to carry long-tail products
  - How much is too much?

Impact of online retailing on market definition

- A wider geographic market?
  - Internet may allow business to reach out to further regions and reduce cost of supplying
  - But, it could also raise new barriers to entry/expansion
    - Network effects
    - Regulatory constraints

- Impact on the market defintion based on sales channels
  - Would online and offline sales channels fall into the same relevant market?

Impact of online retailing on business operation

- Challenge on conventional distribution model
  - An increasing importance of online sales may distress the conventional manufacturer and distributor relationship
  - Raise the question of the need for re-optimisation of channel strategies
  - May lead to pro-competitive rationales for manufacturer to gain control over online retail pricing *e.g manufacturers might legitimately want to protect physical retailers if they consider that physical retailers help to contribute towards the appeal of the product including brand image, physical demonstration etc.*

- May stimulate certain types of price related vertical restraints
  - *MFNs*: a MFN clause prevents a seller from price-discriminating between customers
  - *Rate parity agreements:* overlapping MFNs may lead to rate parity across customers
  - *Other pricing restrictions:* e.g. restriction on retailers' ability to price discriminate online vs. offline, or dual pricing

MFNs and rate parity

- A MFN is a form of *vertical* restraint: Most-favoured-nation clauses / most-favoured-customer clauses
  - Under a MFN clause, a seller commits not to offer worse terms to one customer than are offered to other customers
  - MFNs constrain sellers' ability to price discriminate between customers, at the extreme, *multiple MFNs* may lead to "*rate parity*" across customers

- *Often extracted by buyers with strong negotiating power, but can be initiated by sellers*

- Complications come in different ways
  - Cotemporaneous or retroactive
  - Retail vs. wholesale MFNs
  - Scope of the MFNs: firm wide or industry wide? All products or some products? Terms and conditions?

- MFNs *vs.* CRR (Contract that Reference Rivals)
  - MFNs compare retail price across direct customers, related to one seller
  - Whilst a CRR (e.g. lowest-price guarantee) compares prices across sellers

MFNs can give rise to both efficiencies and anticompetitive effects

- The nature of MFNs differ case-by-case
  - Scope of MFNs varies e.g. firm specific *vs* industry wide; all products *vs* selected products
  - May be subject to different time-dimensions e.g. contemporaneous *vs* retroactive
  - May occur at the different levels of a supply chain
  - May intertwine with other contractual terms and conditions

- MFNs may lead to pro-competitive efficiencies, but competition concerns could also arise due to the reduction of seller's incentive to lower price to others

- *Evaluating the competitive effect of MFN clauses requires a case-by-case analysis!*

RBB | Economics

Likely pro-competitive efficiencies from MFNs

Vertical restraints are subject to inherent efficiencies

- Possible efficiencies:
  - Prevent investment hold-up problem
    - particularly when relationship specific investments are required for transaction to occur
    - To avoid opportunities for upstream firm to exploit downstream investment
    - To achieve efficient investment
  - Cost efficiencies
    - Reduce transaction costs arising from frequent price negotiations
    - Reduce searching costs
  - Others: quality commitment; efficient risk allocation

Likely anti-competitive harm from MFNs: foreclosure

Key concern: may raise rivals' costs, thus reduce rivals' competitiveness

- Firms with substantial buyer power may use MFNs to harm competition by raising the cost of rival retailers

- If a seller is not able to offer other buyers a lower price, this may weaken the competitiveness of other buyers in constraining the dominant buyer → foreclosure may occur

- Key questions to consider
  - Does the buyer have substantial market power in the downstream market (an essential gateway to consumers)?
  - Could other buyers obtain the same product or similar products from other sellers at a competitive price?

Likely anti-competitive harm from MFNs: facilitating collusion

Key concern: may increase the sustainability of a tacit agreement

- Market outcomes consistent with tacit collusion are also consistent with competition
  - Market structure matters: the market structure is such that firms are able to reach and sustain a tacit understanding?
  - Need a credible theory of harm: focal point, deviation detective mechanism, punishment mechanism…

- MFNs ***may*** be used as a way to facilitate tacit collusion among suppliers
  - MFNs reduce the incentive to deviate from any tacitly agreed equilibrium
  - But, it also renders a higher cost of retaliation, i.e. punishment becomes more costly

  → ***Net effect is unclear!***

- Concern related to collusion among retailers needs to factor in that upstream suppliers have no incentive to encourage their retailers to engage in collusion, so need to address the question why manufacturers allow retailers to behave in such fashion

Likely anti-competitive harm from MFNs: softening competition

Key concern: reduce rival's unilateral incentive to compete

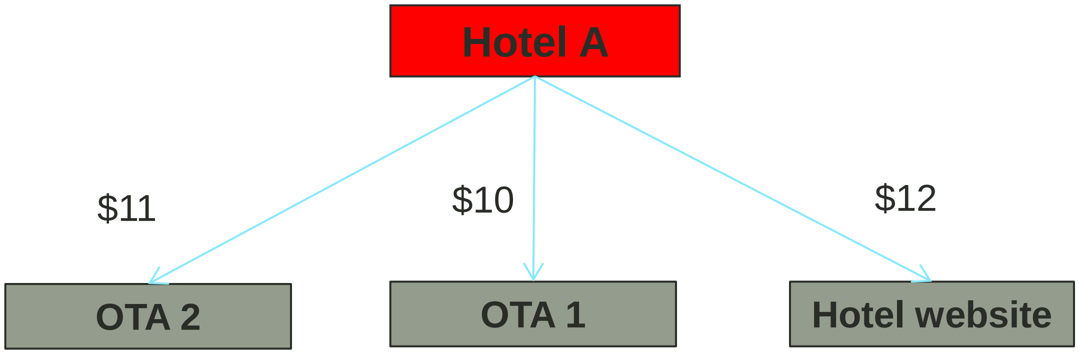
- In a concentrated market, MFNs may soften competition between sellers even without tacit collusion
  - Signal to rivals that it will compete less aggressively
  - Rivals may find it unilaterally profitable to increase their prices

- Unlikely to be credible in markets where entry is a real threat

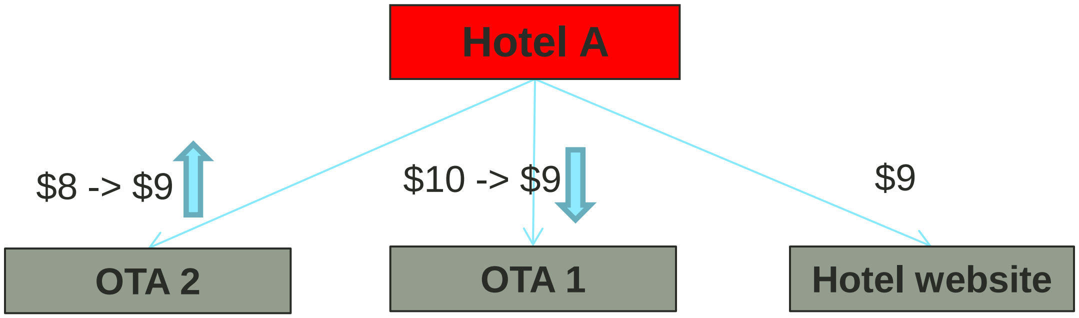
- Resemblance to the TOH under RPM: a reduction of intra-brand competition
  - MFN may reduce buyers' incentive to negotiate a better offer as that may benefit other retailers
  - RPM may reduce the sellers' incentive to lower the price charged to retailers as they are unable to pass on the price decrease to end customers

A stylised example: Would a MFN lead to higher prices?

No effect



Ambiguous effect



- Hypothetical setting:
  - If hotel lists on OTA1 at $10
  - OTA1 requires the lowest price compared with hotel's own website and a rival online platform OTA2
  - **Online platforms charge suppliers (or take commission) for access to their platform*
- Would the MFN lead to higher prices?
  - No effect: Hotel A might in any event want same or higher price (e.g. $12) on its own website and/or OTA2
  - Ambiguous effect: Even if the MFN causes the price on OTA2 to increase, it might lower the price on OTA1 relative to the counterfactual of unconstrained pricing

A stylised example: Would MFNs soften price competition?

- MFNs reduce the incentive of OTAs to compete on commissions:
  - Without MFNs, OTA1 could reduce its commission in return for the hotel setting a reduced price → more volume for OTA1
  - With MFNs, cut in commission doesn't pass through into cut in price → no incentive for OTA to cut commission

- However, hotels have other ways to incentivise OTAs to cut commission:
  - Number of rooms made available to OTAs
  - Threat of delisting OTAs: large number of alternatives available including own site
  - Hotels have strong incentive to put pressure on OTA commissions due to high levels of inter-brand competition

- Key question: is there sufficient inter-brand competition?

A stylised example: Would the MFN lead to foreclosure?

- Would the MFN allow OTA1 to raise rivals' costs?
  - If OTA1 is a gateway platform, critical to such a degree that sellers have no choice but to sell through it, OTA1 could (in theory) increase its charge for access
  - If so, OTA1 may force the seller's price up (and hence force prices up on other online channels)
  - But if OTA1 is not the critical gateway to market, then sellers can leave and go elsewhere for lower charges. (OTA1 then has greater incentive to lower costs to attract sellers)

- Before coming to a view on consumer harm, need to assess:
  - OTA1 role as a critical gateway;
  - Access to substitute products for rival online platforms;
  - Alternative choices for consumers;
  - Cross agreements…

Competition concerns in the hotel booking cases

The OFT's competition concerns

- Current restrictions on discounting limit competition on room rates (reduction of intra-brand competition)
  - The restriction requires OTAs not to offer bookings of Room-Only hotel accommodation at a rate lower than that specified by that hotel
  - High degree of price transparency and lower searching cost online, certain OTAs may want the option to offer discounted rates to attract more customers
  - The OTAs have incentive to use discounts, evidenced by the use of voucher schemes by some OTAs and the discounting that has taken place in other rate types offers such as package rate and opaque rate

- Current restrictions on discounting *may* increase barriers to entry
  - Prevent new OTAs from entering and/or achieving sufficient scale by offering discounts
  - New entries with more innovative and efficient business models are unable to pass any efficiencies directly to end consumers
  - But note that upstream suppliers have no desire to suppress downstream innovation

Inter-brand versus intra-brand competition

- OFT claims RPM existed and that intra-brand competition was lost (i.e. restriction of OTAs' ability to discount the ROR)
- But with enough competing hotels, hotels will choose a competitive price anyway (inter-brand competition)
- OTAs can compete on non-price features, or on price where room is bundled with other features such as travel, or room is "opaque"
- Restrictions of intra-brand competition do not matter if inter-brand competition is strong

How would hotels react if OTAs started discounting?

- Can't take 'wholesale prices' as given – if OTAs can choose their mark-up, hotels will have different pricing incentives

- Stylised example: hotel with 50 rooms to sell for a certain date
  - 40 "leisure" consumers who are willing to pay up to £100 for a room and book far in advance;
  - 40 "bargain" consumers who are only willing to pay up to £95 and also book in advance; and
  - 10 "business" consumers who are willing to pay up to £150 for a room but only book in the final week of the booking window

- If hotel has full control, sets price of £100 up till final week, when it raises price to £150. Sells to all leisure and business customers but no bargain customers

- If OTA can discount, it might try and undercut rivals early on. If it cuts price to below £95, it may sell out all rooms before business customers start buying

- Hotel has incentive to prevent this from happening – set higher wholesale price to stop OTA discounts from causing early sell-outs

Pro-competitive rationales

- A number of potential efficiencies were put forward for hotel control of pricing, i.e. restricting OTAs from using their commission rates to lower room only rates:
  - Parties: Yield management given fixed and perishable inventory of rooms. Complex price modelling and optimal price setting over time can be disrupted by OTA discounting. Direct online sales is an important channel with lower costs. OTAs have different incentives and their discounting policies may be hard to predict
  - Expedia/Booking.com: Avoid free-riding on OTA investments
  - IHG: Discounting may undermine brand. Hotels wish to avoid OTA cannibalisation of profitable direct online channel

- Counterfactual: greater discounting could lead to reduced online availability, e.g. more selective use of OTAs, rationing of rooms sold on OTAs

OFT's views on efficiencies

- OFT acknowledges claimed efficiencies and in particular appears to give weight to yield management efficiency rationale
  - http://www.oft.gov.uk/shared_oft/ca-and-cartels/oft1500.pdf 5.29 et seq

- In particular, it states:

  "*…in the context of strong inter-brand competition and a fixed and perishable stock of hotel rooms, hotels may have a stronger incentive than OTAs to adjust the headline room rates to reflect changes in demand and ensure maximum occupancy levels.*"

- So what was the problem in the first place?
  - Inter-brand competition is "strong"
  - There are incentives to ensure maximum output

The final commitments accepted by the OFT

- Key principles:
  - OTAs will be free to offer reductions off Room-Only headline rates set by the relevant hotel to a “closed group”
    - Eligibility for such discounts is subject to end-users who joined the closed group and had made single one previous booking after the effective date of the final commitments
  - Hotels will be free to offer reductions off their own headline rates to closed group members on the same basis
  - OTAs will be free to publicise information regarding the availability of discounts in a clear and transparent manner; however OTAs cannot publicise information regarding specific level or extend of discounts for any IHG hotel room, or any other information that would allow the discounts to be calculated

- Other restrictions including MFNs are not subject to the commitment unless such restrictions prevent (directly or indirectly) either hotels or OTAs from offering discounts based on the principle above

- Valid for two years on Room-Only rates of hotel rooms in the UK sold to EEA customers

Investigations by other authorities

- The OFT investigation centred on competition concerns involving IHG's restriction on OTA's ability to discount hotel room-only rates, but MFNs still gained attraction in other national investigations

- Germany's Federal Cartel Office vs HRS
  - 20 December 2013: Germany's Federal Cartel Office banned online travel agent Hotel Reservation Service (HRS) from including MFN clauses in its contracts with German hotels, and opened an investigation of Expedia and Booking.com over the same conduct

- French Hotels complain over rate parity
  - July 2013: A number of French hotels registered official complaints with the France's Competition Authority (Autorité de la concurrence) against Bookings.com, Expedia and HRS for requesting their lowest rates, and then barring hotels from offering discounted rates elsewhere, including the hotels' own websites

- Switzerland's Competition Commission vs OTAs
  - 11 December 2012: Switzerland's Competition Commission launched an investigation into the practices of the three largest OTAs that sell hotel rooms in Switzerland on their best price guarantee agreement with hotels

- USA class action suit over price fixing
  - August 2012: A class action suit was filed in a Californian U.S. District Court, against OTA's and Hotels based on allegations that they were involved in a price-fixing scheme that harmed consumers

Concluding remarks

Concluding Remarks

- Take a step back
  - Inter-brand competition versus intra-brand competition
  - What degree of market power exists (up and downstream)?
- What smoke signals has the OFT sent out?
  - Are sellers setting prices on platforms such as eBay engaging in RPM?
- Glass half empty or half full?
  - OFT opens the door for more “shoehorning”?
  - OFT opens the door for more efficiency defences of RPM?
- Policy questions
  - Is it sensible to shoehorn a practice into the object box and avoid analysis of effects?
  - Is this the appropriate way to send out a message or obtain commitments?

Locations and contact

London

The Connection
198 High Holborn
London WC1V 7BD
United Kingdom
T +44 20 7421 2410
E london@rbbecon.com

Brussels

Bastion Tower
Place du Champ de Mars 5
1050 Brussels
Belgium
T +32 2 792 0000
E brussels@rbbecon.com

The Hague

Lange Houtstraat 37-39
2511 CV The Hague
The Netherlands

T +31 70 302 3060
E thehague@rbbecon.com

Madrid

Pinar 5
28006 Madrid
Spain
T +34 91 745 59 34
E madrid@rbbecon.com

Stockholm

Östermalmstorg 1
114 42 Stockholm
Sweden
T +46 8 5025 6680
E stockholm@rbbecon.com

Johannesburg

Augusta House, Inanda Greens
54 Wierda Road West
Sandton, Johannesburg, 2196
South Africa
T +27 11 783 1949
E johannesburg@rbbecon.com

Melbourne

Rialto South Tower, Level 27
525 Collins Street
Melbourne VIC 3000
Australia
T +61 3 9935 2800
E melbourne@rbbecon.com