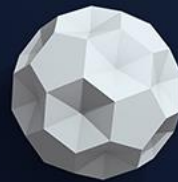


# Economic analysis of “Narrow MFN Clauses”

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# Background: MFNs protect risky investments by OTAs and have a strong economic rationale - prevention of free riding

- Before OTAs, the process of searching and booking a hotel was very cumbersome and non-transparent
- OTAs have revolutionised the market by **making search efficient**
  - Example: A Japanese tourist looking for a 3-star hotel with a nice view in Siracusa (South-East Sicily) today vs 20 years ago
- These benefits come at a **cost** (IT, local managers, selection of info, hotel description, payment processing, etc.)
- MFNs are in place to prevent **free riding** by hotels and low-cost plat.
- **Searching** and **booking** are two separate activities - hotels want to have visibility on OTAs but want customers to book on the hotel site

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# Background: Wide vs. Narrow MFNs

Competition Authorities have argued that wide MFNs might:

1. Reduce competition between platforms: could prevent platforms from competing by offering lower compensation rates
2. Increase barriers to entry: “low cost” competitors cannot offer lower room prices

In order to balance between *efficiency* and (possible) *harm*, narrow MFNs have been suggested as a solution.

But, do narrow MFNs simply replicate the effects of wide MFNs and/or soften competition from the direct channel?

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# Theory of Harm, Narrow MFN

ToH about narrow MFNs restricting competition via following logic:

- Given narrow MFNs, hotels will not discount on OTA websites below the price they set on their own websites for fear of **cannibalising** their sales.
- If hotels will not discount OTA websites below their own, and the Narrow MFN prevent hotels own websites from being below OTA's, then there will be no differentiation between prices on OTA websites.
- As such lifting of wide MFNs will have no change on OTA pricing.

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# No presumption of a concern with narrow MFNs

The narrow MFN theory of harm rests on a number of assumptions which can be tested empirically.

**First**, chain of logic assumes that hotels' own websites and OTAs compete for exactly the same travellers (and therefore are **perfect substitutes**).

- Assumes hotel will not discount below OTA due to **cannibalisation**.
- However, this assumes perfect substitutes, if OTAs can get additional demand then hotels will have an incentive to lower prices on OTA.
- Indeed if a sale by the OTA was exactly a lost sale for hotel own website, **why use OTA at all?**
- The greater the number of consumers who use OTAs but not hotel websites, the lower any cannibalisation will be – and therefore the higher the incentive of hotels to discount on the OTA relative to its own website. OTAs expand the market.

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# No presumption of a concern with vertical MFNs

**Second**, chain of logic also doesn't take into account that removing wide MFNs creates additional incentives for OTAs to undercut each other on rate of compensation asked from hotels.

- If original MFN theory of harm was correct, removal of OTA MFNs provide incentives for OTAs to undercut each other to encourage lower hotel prices.
- Hotels thus have an incentive to differentiate between different OTAs sites.
- This incentive to differentiate OTA price needs to be weighted up against any reluctance to differentiate OTA prices due to the hotel's reluctance to cannibalise themselves and therefore is an empirical question.
- If the share of hotel's own bookings is small relative to that of a given OTA's, then hotel will pass through any reduction in OTA's rate into the prices it sets on that OTA.
- A complete analysis shows that an OTA's incentive to offer a reduction in its compensation rate increases the smaller it is relative to its rival OTAs.

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# Testable propositions in 'Narrow MFN theory'

The direct implication is that with differing OTA sizes, OTAs' optimal compensation rates will also be different and so will the optimal price the hotel makes available through the OTA.

Thus we would predict differences between both hotel own sites and OTAs, and differences in prices across OTAs, regardless of whether there are narrow MFNs.

This creates an opposing set of testable hypothesis between a theory that Narrow MFNs will remove OTA competition, and the theory that Narrow MFNs cannot be presumed to remove OTA competition.

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# Main empirical conclusions

- **First**, contrary to theory of Narrow MFN harm, there is no evidence that, in the presence of narrow MFNs, hotel operators always refuse to discount OTAs below the price level of their own direct channels. Pricing analysis shows that hotels regularly can and do price OTAs at a lower price than their own channel.
- **Second**, no evidence that the narrow MFNs have resulted in hotel pricing being identical across OTAs. Pricing analysis shows that in the face of narrow MFNs, hotels can and do price their hotels at different levels on different OTAs.



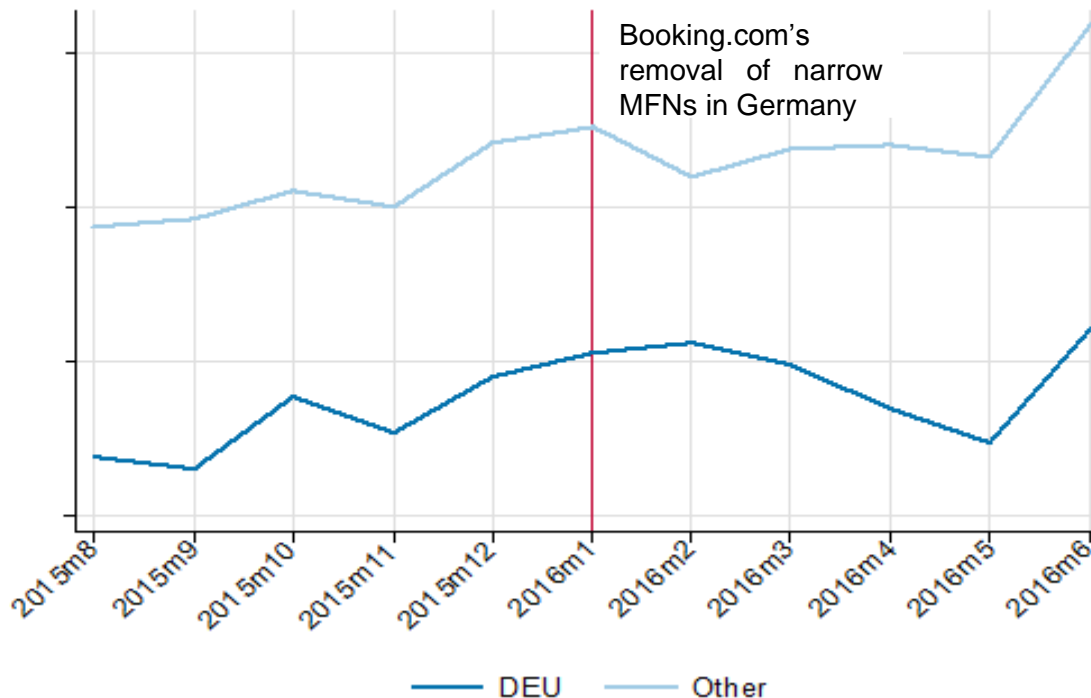
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## Main empirical conclusions (cont.)

- **Third**, no evidence that countries without narrow MFNs have higher degrees of price differentiation than countries with narrow MFNs. Germany has one of the lowest levels of price differentiation in Europe even though, unlike other countries, there were no narrow MFNs for the two largest OTAs.
- **Finally**, no evidence that removing the narrow MFNs has made a significant difference to the degree of price differentiation in Germany compared to the rest of Europe. On average EU countries with Narrow MFNs saw a greater increase in OTA price dispersion than Germany.

# Natural Experiment: Removal of Narrow MFNs had no impact on OTA price differentiation (cross time & country)

Percentage of comparisons in which two large OTAs had different prices for Germany, versus other EU countries with no MFN changes



Evolution in OTA price dispersion over time between Germany, and other countries where narrow MFNs were still in place, are no different – showing no causal link

Other countries includes Austria, Belgium, the Czech Republic, Germany, Hungary, Ireland, Italy, the Netherlands, Sweden and the United Kingdom. France has been excluded as it did not have any enforced MFNs during this period.

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# Assessment of CMA's econometric analysis

- The CMA estimated the impact of wide MFNs on commission rates in the motor insurance market between 2010 and 2016
  - Using a DCT-brand and year fixed-effects model they estimate that commissions are 3-4% higher if wide MFNs are in place
1. Economic vs statistical significance: average commission not disclosed, but likely ~15%, this implies economic impact of  $4\% * 15\% = 0.6\%$ , meaningful?
  2. The choice of using log(commission) not justified (is the distribution of commissions skewed? If yes why? Outcome using levels?)
  3. It would be very useful to show a graph of com over time and distrib.
  4. General trend of commissions decreasing over time confounding

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# Conclusion

- **First**, contrary to theory of Narrow MFN harm, there is no evidence that, in the presence of narrow MFNs, hotel operators always refuse to discount OTAs below the price level of their own direct channels. Pricing analysis shows that hotels regularly can and do price OTAs at a lower price than their own channel.
- **Second**, no evidence that the narrow MFNs have resulted in hotel pricing being identical across OTAs. Pricing analysis shows that in the face of narrow MFNs, hotels can and do price their hotels at different levels on different OTAs.
- **Third**, no evidence that countries without narrow MFNs have higher degrees of price differentiation than countries with narrow MFNs. Germany has one of the lowest levels of price differentiation in Europe even though, unlike other countries, there were no narrow MFNs for the two largest OTAs.
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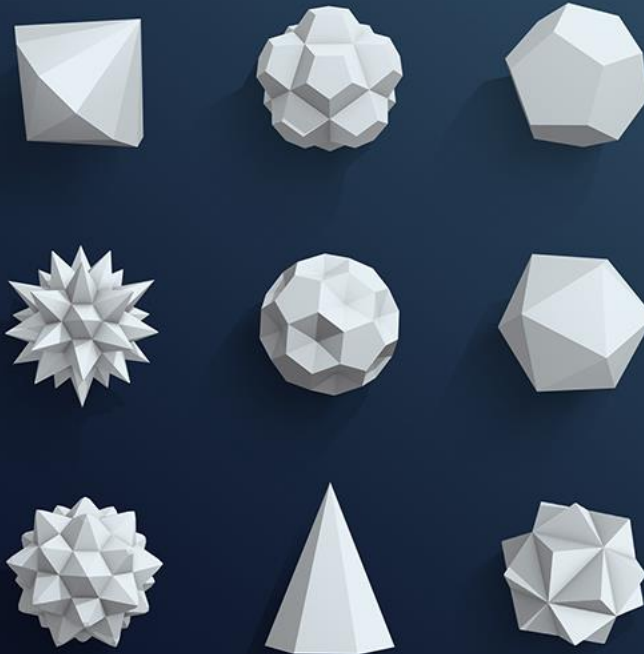
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