IFAMD Market Commentary 08/2017

- Does the best price clause offered by hotel portals distort competition? -

Abstract

The 'best price clause' employed by major hotel portals remains controversial, and is currently, as of summer 2017, being contested before a German court. While some aim for consumer protection, others are more concerned about the owners of small hotels. Yet what is the true effect of such a clause, who stands to benefit from it, and what is the optimal response for consumers and hotels if the clause ultimately proves to be admissible? Independently of the pending court decision, this Market Commentary analyses the situation from a game-theoretic perspective.

Hotel prices – this topic stirs interest both privately and in a business sense. The transparency afforded by the internet has long had a strong impact on the mechanisms of price formation in this market, too. What is particularly interesting about this market, besides the presence of very large numbers of both buyers and sellers, is the fact that the individual business relationships – each act of booking – take place within a concrete submarket that is relatively small owing to its geographical constraints. This is what makes hotel portals to immensely valuable for both sides: On the one hand, they allow the consumer the comfort, which would not be available without the internet, of being able to compare hotel offers from around the globe without ever leaving their living rooms. On the other hand, such portals afford hotel owners the previously unheard of opportunity to reach potential customers globally. And yet the formation of prices according to supply and demand is driven by the situation in the concrete individual submarket – when there's a trade fair in town, even the hotel portals will have very few rooms left to offer, and at surreal prices.

Of course the internet also allows for such matching of supply and demand even without a proper portal, as it connects all participants with each other, at least in theory. Yet we know, not least since the success story of Facebook, how important the bundling of information in suitable portals is also within the internet. At the end of this Commentary, we will briefly address the struggle for dominance between pure search engines, best price crawlers and proper (hotel) portals – this is a discussion in its own right.

But let us return to the hotels. Today, you simply and conveniently book a 'hot deal' through a hotel portal and have nothing much left to worry about – a travel agent or an assistant who books your business travel, those are institutions of the past. Then, having arrived at your travel destination, you are told, by the way, that you could have had the same room for much less if you had placed your booking directly with the hotel. A discussion ensues with the lady at the reception desk: Is it justifiable, on legal, moral, economic or whatever grounds, to cancel the deal with the hotel portal and to book the same room directly with the hotel instead? That clearly depends on the individual situation at hand – and on the level of local negotiation skills. Fees

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that are due to the hotel portal play a role here, as does loyalty vis-à-vis the portal, which has already provided a service to both sides.

The question is: How is a customer supposed to feel if, having made a bargain on the hotel portal, he encounters a much lower price locally? As game-theorists, we are of course concerned not so much with the customer's feelings. Instead, we are simply interested in whether the customer will return to the hotel portal for his next booking or, as consumer protection advocates are already advising, he will use the portal only for his search and then contact the hotel directly for the actual booking. This latter behaviour is exactly what hotel portals are trying to protect themselves against by means of a best price clause – legitimately or as an expression of their 'market power'?

Let us first discuss best price clauses in general terms. Recall that game theory knows two variants: the 'meet-the-competition clause' (i.e. we'll match any lower price that the competition may offer) and the 'most-favoured-customer clause' (i.e. we promise not to give a lower price to any other customer). At a second glance, we see that in each case, the effect of the clauses is the exact opposite of what one might expect at first glance.

Many consumers are familiar with the 'meet-the-competition clause' from advertising. A DIY store, a shoe shop or a chain of petrol stations call out into the market and reinforce their call with the best price clause: "We'll match the competition if anyone offers a lower price." At first glance, the customer will be pleased because his supplier is guaranteed to be the cheapest one – this sounds like tough competition. And yet game theorists have long known: The clause actually reflects reduced competition, because once the competitors have anticipated the behaviour of the supplier who made the promise – and thanks to the clause, such anticipation is not difficult because the supplier has made a legally binding promise – none of them will compete with a lower price. This holds unless the supplier who made the promise is too small a player in the relevant market, in which case it will be easy for the competitors to price him out of the market, as happened a few years ago to a German chain of DIY stores. However, if the supplier has sufficient weight in the market, he may use the best price clause to thwart any competition, in which case the competition authorities should take an interest.

The second variant of the best price clause, the 'most-favoured-customer clause', also has a counterintuitive effect. This one, too, is liable to restricting competition. A seller who invokes the clause promises his customer not to offer a better price to any other customers. This variant is hardly conceivable in the consumer goods business but in fact quite common in industrial goods markets. In the auto industry, for example, customers will often demand that clause to ensure that no competitor receives a better offer from a particular supplier. The questions as to who benefits from the clause and whether competition is distorted again strongly depend on the market power of the relevant players, and competition law may come into play here, too. The clause may also benefit the supplier if he can use it to argue for higher prices for his other customers – at least the best price clause serves as lower price bound for them. However, this effect of the clause presupposes price transparency, which is often lacking in purely private-economy industrial goods markets.

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So what are we really looking at in the case of hotel portals? At first glance, we see a 'most-favoured-customer clause' in a market with price transparency and with powerful hotel portals facing a large number of mostly very small hotels. It was arguably this simple view of the situation which induced the competition authorities to ban the best price clause. But is this view indeed correct? After all, the hotel portals are not the customers but rather the intermediaries who stand between the suppliers and the customers. The portals do not engage in trade in the sense of buying, reselling and retaining a margin; they are mere agents who receive a fee for facilitating the business. Thus, a best price clause vis-à-vis the hotels is at best a 'most-favoured-sales-channel clause' (a concept just coined for this purpose) – and as is often the case in game theory: The small difference makes all the difference. So long as the customer has free access to all of the hotel's sales channels, there can be no talk of the portal exploiting any market power based on its size. Instead, the best price clause provides the only guarantee for the portal that the deal it helped to create actually goes through and that the portal actually reaps the brokerage fee, which is collected as part of the room price.

From the customers' perspective, the best price clause has no drawbacks: Those who use the portal get to enjoy the best prices, and those who do not use it are free to change their minds and begin using it. The question remains whether this clause, too, has a systematic effect of helping to keep prices high, as with the two classical best price clauses. The price transparency afforded by the portal could indeed facilitate the hotel owners' coordination to achieve a higher common price. This will work all the better if each owner can be sure that all the other hotels are likewise committed, via the best price clause, to the prices they publish on the portal and that apply even outside of the portal. Interestingly though, the best price clause in the context of hotel portals is discussed in this sense neither by the public nor by the competition authorities. Indeed, such subtle game-theoretic effects are only rarely observed in practice – it is virtually impossible for all hotel owners in a given region to take part in such collusion.

Or could the best price clause actually hurt hotel owners, in that through the portals, the customers create excessive competitive pressure and succeed in driving down the prices? Well, price transparency as such is not due solely to the hotel portal; if the competitive pressure is so strong locally that rooms can only be sold by cutting the price, then why not just use the portal? The alleged 'volume bundling' that takes place on the portals and that seems to suggest that the portals hold 'market power' does not constitute bundling in the proper sense. Actual bundling involves the bundling of purchase decisions. Yet precisely these decisions are not made by the portal but rather by the individual customers. Thus, the portal is but a driver of outreach and price transparency – and each hotel owner may decide whether to enjoy these benefits.

Though we are arguing in favour of the best price clause for hotel portals, we must bear in mind that the court's decision is still pending and one must therefore be prepared for both possible outcomes: What to do in case the clause is upheld, and what to do otherwise?

If the best price clause for hotel portals should become admissible once again, many hotels will have to fundamentally rethink their pricing strategy. Of course price discrimination must remain possible, so that as much as possible of the customers' willingness to pay can be extracted. Yet then price discrimination cannot occur via the portal price, but rather via the individual price that is realised on the basis of special offers, additional services, bigger rooms, more flexibility

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regarding cancellations, etc. A hotel portal may then be used strategically to fill vacancies at short notice and low prices – or to send a price-quality-signal at a high level to the market, and this signal becomes truly credible only thanks to the best price clause.

If, conversely, the ban on best price clauses remains in force, hotel portals will have to fundamentally redevelop their business model, from intermediaries to pure information portals whose fees are based not on the deals made but already on the mere posting of an offer, on the clicks that the offers receive, or such like. This means that hotel portals will have a much harder time holding their ground against pure search engines, arguably entailing a step backwards regarding the two main benefits of hotel portals: outreach for the suppliers and price transparency for all consumers.

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