"Christopher Yukins"
<cyukins@law.gwu.edu>
05/05/2008 05:11 PM

To mas.advisorypanel@gsa.gov
cc sschooner@law.gwu.edu
bcc
Subject Re: GSA MAS Panel - Literature on Most Favored Customer Clauses

Dear Ms. :

During our discussion today, the Commission asked for citations to the literature discussing the impact of most favored customer clauses in buoying prices in the commercial marketplace. Below are some of those references.

As the literature cited below reflects, economists generally assume that most-favored customer clauses help oligopolists enforce inflated price schemes.

The impact of Price Reductions clause (GSA's "most favored customer clause") in the GSA schedule contracts need not be so pernicious. Instead, even without any collusion, vendors may -- and do -- simply decide not to reduce prices in the commercial market, because doing so will trigger price reductions in the government market. Thus, the Price Reductions clause in effect discourages price reductions in the commercial market, when a vendor straddles between the GSA schedule and the commercial market. I am not aware of any empirical studies of this phenomenon in the GSA schedule submarket, but the Commission's speakers should be able to confirm this, anecdotally or otherwise. I know that I have seen it on a number of occasions, in practice. This phenomenon means, in effect, that GSA is arguably "externalizing" the costs of its most favored customer (Price Reduction) clause, which reduces prices in the GSA submarket, but in effect may cause higher prices in the commercial marketplace.

The Rand Journal of Economics published a piece by Fionna Scott Morton, "The Strategic Response by Pharmaceutical Firms to the Medicaid Most Favored Customer Rules," Vol. 28, No. 2, pp. 269-290 (1997), and I am waiting for an electronic copy of that from Rand.

In the meantime, for a gathering of citations to the literature on a most-favored customer clause, see Cindy R. Alexander, "The Economics of Regulatory Reform: Termination of Airline Computer Reservation Rules," 21 Yale J. Reg. 369, 422 n.167 (2004):

On the merits of most-favored customer clauses, see David Besanko & Thomas P. Lyon, Equilibrium Incentives for Most-Favored Customer Clauses in an Oligopolistic Industry, 11 Int'l J. Indus. Org. 347, 347-67 (1993); Thomas E. Cooper, Most-Favored- Customer Pricing and Tacit Collusion, 17 RAND J. Econ. 377, 377-88 (1986); Patrick J. DeGraba, The Effects of Price Restrictions on Competition Between National and Local Firms, 18 RAND J. Econ. 333, 333-47 (1987); and Charles A. Holt & David T. Scheffman, Facilitating Practices: The Effects of Advance Notice and Best-Price Policies, 18 RAND J. Econ. 187, 187-97 (1987). A popular survey of a portion of this literature can be found in Steven C. Salop, Prices that (Credibly) Facilitate Oligopoly Coordination, in Joseph E. Stiglitz, New Developments in the Analysis of Market Structure 265 (1986).

For a theoretical discussion of how MFC clauses dampen competition:

Jonathan B. Baker, "Vertical Restraints with Horizontal Consequences: Competitive Effects of 'Most Favored Customer' Clauses," 64 Antitrust L.J. 517, 529 (1996):

Most-favored-customer clauses can dampen competition by making firms less aggressive in settings in which rivals will respond by becoming less aggressive as well. [FN48] A firm that introduces a most-favored-customer clause commits to being less aggressive by obligating itself to pay a substantial penalty if it lowers price to any individual customer. The reason: if it lowers price to one, it must lower prices to all its customers. And if its rivals would respond by becoming less aggressive themselves, some firms will find it profitable to make this commitment. [FN49] This dynamic may be most likely, and the resulting price increase may likely be the greatest, when the number of firms is small, when higher prices would not lead to new entry, [FN50] and when exogenous shifts in cost or demand that would tend to lead to lower prices are unlikely. [FN51]

On the way that MFC clauses (also known as "most-favored nation" or "MFN" clauses) may facilitate collusion:

Thomas Piraino, Jr., Regulating Oligopoly Conduct Under the Antitrust Laws, 89 Minn. L. Rev. 9 (2004):

An industry-wide agreement to adopt "most-favored-customer" clauses may also facilitate tacit coordination. Such clauses guarantee that a buyer will receive the lowest price granted by its supplier to any other customer. [FN226] In certain cases, such a provision may be retroactive, requiring a supplier to provide a rebate to a buyer if another customer is offered a lower price. [FN227] It is not in individual firms' interests to enter into most-favored-customer clauses, unless such provisions are demanded by their customers. Without receiving some consideration from a customer, a firm should have no legitimate reason to guarantee that the customer will receive the lowest price granted to any other buyer. Most-favored-customer clauses reduce the advantages of price-cutting because a firm must offer *65 the lower price to pre-existing customers. For sellers subject to such clauses, the increased volume resulting from a lower price will be offset by the requirement to lower their prices across-the-board.

When an oligopolist obligates itself to a most-favored-customer clause, it can signal its rivals that it favors a particular consensus price. As Hay has pointed out, such an oligopolist may persuade "its rivals that it will not initiate a price cut," thereby "establishing the mutual confidence necessary to launch a period of noncompetitive pricing." [FN228] Oligopolists' most-favored-customer contracts are particularly suspect when they do not receive substantial consideration from their customers (such as a commitment to increase purchases) in return for an agreement to provide the customers with the lowest available prices. When one firm initiates such a clause, it encourages its rivals to take a similar risk in order to cement a tacit arrangement of price coordination; if all or most of the firms in the market respond to the initial firm's invitation without receiving some compensating consideration from their customers, the courts need inquire no further before inferring a tacit price-fixing arrangement.

And:

Mark T.L. Sargent, Economics Upside-Down: Low-Price Guarantees as Mechanisms for Facilitating Tacit Collusion, 141 U. Pa. L. Rev. 2055, 2068-69 (1993):

4. Most-Favored-Nation Clauses

Under an MFN, a seller guarantees that a buyer will be charged a price no higher than the lowest price the seller charges any other customer. [FN62] A seller might extend MFNs to all of its customers or just to a select few. These policies are usually inserted as clauses in purchasing contracts, making them legally binding. [FN63] The attraction such policies hold for buyers is obvious. Most-favored-nation clauses guarantee to buyers that they will pay no more than their rivals, and thereby ensure that they will not be at a cost disadvantage in their industry.

There are two types of MFNs: contemporaneous and retroactive. [FN64] Under a contemporaneous MFN, a buyer is guaranteed a price no greater than the price paid by any other customer for the same product at the time of purchase. [FN65] A retroactive MFN, in contrast, promises that the buyer will receive the benefit of any price cuts that occur during a specified period of time after each sale. [FN66] The collusive implications of these two types of MFNs are similar. Essentially, MFNs change the incentive structure of the firms offering the policies. These firms are penalized for cutting prices, since a price cut extended to one buyer also must be extended to all other customers covered by the MFN. This can significantly raise the costs of price cutting, particularly in the case of retroactive MFNs. As a result, firms following these types of pricing policies tend to avoid lowering their prices. When many *2069 firms in an industry offer MFNs, price competition can decrease or disappear. [FN67]

Of the three tasks required of any cartel for successful collusion, MFNs facilitate the third task-maintaining the collusive equilibrium. If each firm in a silent conspiracy adopted MFNs with all of its customers, the incentive to cheat by lowering prices from their collusive equilibrium would be greatly reduced. Most-favored-nation clauses do not, however, help to accomplish the second task needed for successful cartelization-moving prices from competitive to collusive levels. In fact, if firms introduce retroactive MFNs while prices are at competitive levels, a failed attempt to raise prices to supracompetitive levels becomes extremely expensive given the penalty imposed by the MFNs. [FN68] In industries where costs decrease with the passage of time, [FN69] however, MFNs can fix prices and prevent decreases in production costs from being passed on to buyers.

I should stress, again, that none of this should be read to suggest that there is oligipolistic behavior in the GSA schedule market; indeed, for the reasons we discussed, the "always open" GSA schedules actually discourage olipolistic behavior. What the literature instead highlights is economists' continuing concerns that most-favored customer clauses, such as the Price Reductions clause, can have unforeseen impacts in dampening competition and increasing prices. This suggests, in turn, that GSA should carefully consider the collateral (and sometimes almost invisible) impacts of its pricing policies.

Thank you, again, for the opportunity to contribute to the work of the Commission.

With best regards,

Chris Yukins

---- Original message ----
>Date: Fri, 25 Apr 2008 14:50:55 -0400
>From: mas.advisorypanel@gsa.gov
>Subject: Re: GSA MAS Panel - Offer to Present

> Would like for you to do your presentation on 5 May.
> The agenda is still evolving so please give me a
> call to discuss a time frame for the presentation.
>
> Thanks much.
>
> Pat
> 703 605-3406
>
> "Christopher Yukins" To mas.advisorypanel@gsa.gov
> <cyukins@law.gwu.edu> cc sschooner@law.gwu.edu
> Subject GSA MAS Panel - Offer to
> 04/18/2008 09:51 AM Present
>
>
> Dear Ms. Brooks:
>
> I'd be glad to present to the panel, on either of
> the available dates (May 5 or May 22) noted in
> Wednesday's Federal Register announcement (73 FR
> 20675). I would plan to offer a brief distillation
> of the attached draft article (which is in "galleys"
> at the publisher).
>
> Thanks, and all the best.
>
> Chris Yukins
>
> Christopher R. Yukins
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> Co-Director, Government Procurement Law Program,
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>07_Yukins ABA Galleys - Are IDIQS Inefficent.pdf (226k bytes)

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>
>   Chris,