

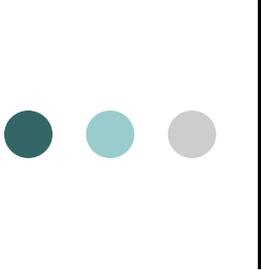


# Efficiencies from MFNs: Economic Theories

Judith A. Chevalier  
Yale School of Management

Prepared for the DOJ/FTC Workshop on  
Most-Favored-Nations Clauses and Antitrust Enforcement  
and Policy

September 10, 2012

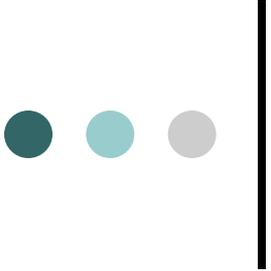


# MFNs Have Many Flavors (for example)

- Adoption
  - Explicit contractual provision
    - Product of bilateral negotiations
    - Part of long term contract
  - Unilaterally announced policy
- Timing of comparison
  - Contemporaneous vs. Retroactive
- Type of seller
  - Retailer
  - Intermediate good supplier



Note: I will often discuss a “buyer” and a “seller” but in most of my examples, the buyer and seller could be switched.

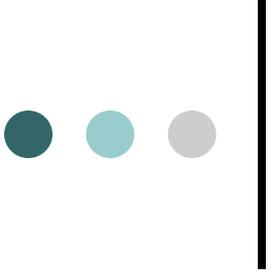


# MFNs Have Many Flavors (in addition)

- 2PMFN: Governs prices for the contractual buyer and seller.
  - Most common- buyer must get the “best” price that the seller has given to any buyer
- 3PMFN: Governs prices that, in theory, can be obtained from every possible seller or buyer
  - 3<sup>rd</sup>-party MFN are essentially equivalent to a meeting competition clause



Scope of MFN often limited by market area, platform, customer type, etc.

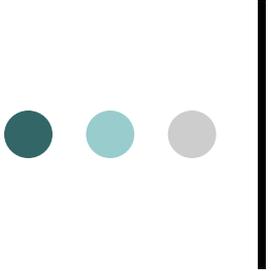


# Potential Efficiencies from MFNs

- Opportunism
  - Hold-up on relationship-specific investments
  - Contractual rigidity
- Transaction cost reduction
  - Switching/information costs
- Time inconsistency
- Quality commitment
- Risk reduction/distribution

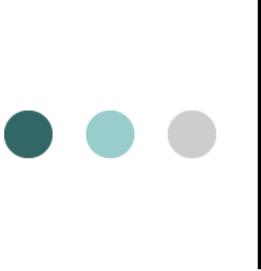


Efficiencies can manifest differently in across types of MFNs, markets, industries, etc.



# Opportunism

- Relationship-Specific Investments:
  - Investments made to support a specific transaction, but where resulting assets cannot be readily deployed elsewhere (i.e., next-best use is a poor alternative)
    - Site specificity
    - Physical asset specificity
    - Dedicated assets (including capacity)
    - Human capital specificity
  - Risk of exploitation may frustrate transactions, and contractual terms may be employed to address hold-up potential

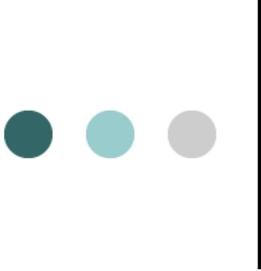


# Opportunism and MFNs

- Hold-up (Marx and Shaffer, 2003)
  - A downstream firm must make relationship-specific investments to transact with an upstream firm.
  - The upstream firm may exploit investments made downstream by selling to other customers at a lower price.
    - Ex. Higher fixed fee, lower marginal price.
  - MFN allows upstream firm to commit not to expropriate the downstream firms investments.
  - May allow efficient investments to be made.



MFN Functions like a weak form of Exclusive Territory/  
non-encroachment contract.



# Opportunism and MFNs

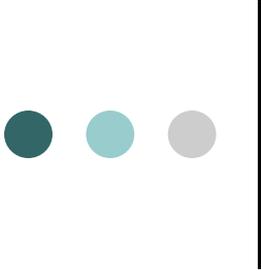
- Rigidities in long-term contracts (Goldberg, 1991; Crocker and Lyon, 1994)
  - Upstream firm must make relationship-specific investment in downstream firm
  - Long term contract (such as a requirements contract) entered into to avoid expropriation
  - Long term contract creates too much rigidity in price
  - Downstream firm receives MFN agreement from upstream firm to reduce price rigidity
  - Often a 3PMFN/Meeting Competition agreement



Examples in the literature (International Salt, Natural Gas) are ones where the transactions costs in finding an alternative partner to trigger the MFN are substantial.



In that case, MFN functions like a gross inequity clause.

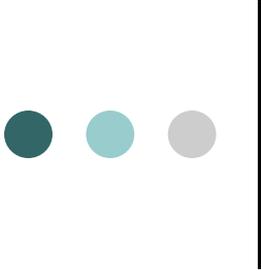


# Transaction costs

- There may be high transaction costs associated with price discovery and/or constant negotiation
- Seller can agree to a “placeholder” price, but an MFN ensures that the seller will not be disadvantaged in the long-run
- MFN sellers essentially free-riding on the non-MFN seller’s price discovery efforts.
- Can we claim this efficiency if every seller has an MFN? If the largest seller has an MFN?

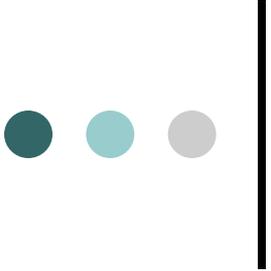


Problem: large seller and buyer have a big incentive to collude against the small sellers over terms not covered by the contract.



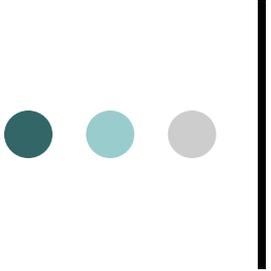
# Transactions Costs

- The transaction cost argument may reverberate down the chain
- Platform provider's MFN with an input provider certifies the platform provider's competitiveness to an end buyer
  - Example: Company contracting with a PBM doesn't know the prices of all drugs its employees may use
  - MFNs between the PBM and the pharmaceutical firms could certify PBM's competitiveness



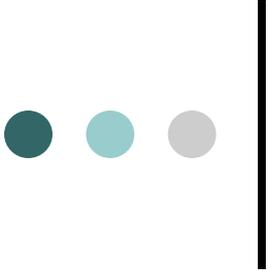
# Time inconsistency

- Butz (1990): MFNs solve the Coase durable goods problem for the seller
  - Usually bad for consumers, *unless* the Coasian outcome would eliminate trade
  - MFN as a commitment not to lower price in the future
- Png (1991): MFNs allow sellers facing uncertain demand to encourage buyers not to gamble on future price declines caused by weak demand
  - MFN alternative to price discrimination across periods



# Other possible efficiencies

- Quality commitment: Extension to a model of price as a signal of quality (Wolinsky, 1983)
  - Seller wants to convince buyers that an experience good is high quality
  - Consumers know that high price cannot be sustained if good develops a reputation for low quality
  - MFN provides a commitment on the part of the seller that the good will not be perceived as low quality in the future
- Risk reduction: MacAvoy (1962) argues that MFN can serve to allocate risk efficiently
  - Shifts price uncertainty from the beneficiary of the MFN to the benefactor

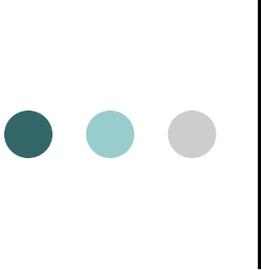


# Potential Efficiencies from MFNs

- Opportunism
  - Hold-up on relationship-specific investments
  - Contractual rigidity
- Transaction cost reduction
  - Switching/information costs
- Time inconsistency
- Quality commitment
- Risk reduction/distribution



Efficiencies can manifest differently in across types of MFNs, markets, industries, etc.



# The Effects of MFNs

- MFNs may be hard to enforce in practice
  - Especially when contracts are multi-dimensional and include non-price terms.
- MFNs may be enforced even when they are not written down.
  - Disadvantaging one buyer over another may be a bad long term strategy.
  - Robinson Patman