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The legal aspects of hotel rate parity

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Abstract

This research note delineates the conflict of hotel rate parity and key clauses of competition laws in both Europe and the U.S. We trace the origin of hotel rate parity to the principle of most favored nation (MFN) in international trade agreements. We show that rate parity challenges two pillars of competition law. Under rate parity agreements, it is travel intermediaries—not hotels—that demand rate parity, which comes down to the dominance of travel intermediaries over small and independent hotels. The courts view MFN status as a hindrance to competition and therefore in violation of competition law. The trend and message in Europe are clear: the clause is most likely to be judged as not complying with EU competition law and its national equivalents. In the U.S. though, a lack of case decisions precludes us from reaching any conclusion about the fate of the MFN clause.

Keywords

hotel rate parity, most favorable nation, competition law, monopoly, online travel agencies

What is hotel rate parity?

Hotel rate parity is a situation in hotel distribution where a hotel's room rates are identical across distribution channels. Under hotel rate parity, hotels must guarantee the same room rate to all travel intermediaries through which hotel rooms are sold. In some cases, a hotel is not only prohibited from setting different room rates to different intermediaries, regardless of the commissions it pays, but the rate must be the same even if rooms are sold via its own distribution channels, such as its own website, telephone booking, and so on.

The origin of rate parity is the status of *most favored nation* in international trade agreements (Baker and Scott, 2018). However, using this principle to justify rate parity can be called into question. In this research note, we delineate the conflict between hotel rate parity and key clauses of competition laws in both Europe and the U.S. We aim to show that anti-competitive conduct that

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competition law has long been regulating is not compatible with hotel rate parity. Hence, there is a need for the shift of the focus on legislation, at least in the hotel sector or the tourism and hospitality industry. We also call for empirical research on the loss of consumer surplus caused by hotel rate parity because hotel rate parity is likely to be exempt from competition law if empirical evidence shows the opposite.

Competition laws in Europe and the U.S.

What does competition law regulate?

Competition law tackles anti-competitive practices in three categories:

- Agreements between companies that restrict competition in the market;
- Abuse of a dominant position by companies to the detriment of consumers; and
- Mergers and acquisitions that restrict competition in the market.

In the European Union (EU), the first two categories are incorporated in Articles 101 and 102 of the *Treaty on the Functioning of the European Union* (TFEU), respectively (see appendix 1). In EU competition law, the first category incorporates all formal or informal agreements and concerted actions between firms that either impede or aim at impeding competition. In the second category, defining what constitutes a dominant position of a firm is left to case law.

The equivalent of EU competition law is the U.S. antitrust law, which went into effect with the Sherman Act in 1890. Sections 1 and 2 of the Sherman Act correspond to Articles 101 and 102 of the TFEU, respectively. Section 1 stipulates agreements in various forms, such as formal contracts, trust, and conspiracy, that restrain free trade either among U.S. states or between the U.S. and foreign nations. Unlike EU competition law, which sanctions a firm's abuse of its dominant position, Section 2 punishes the very *creation* of a monopoly through a firm's anti-competitive behavior (Martenet and Heinemann, 2021). Hence, Section 2 applies as long as a firm holds, or is likely to acquire, monopoly power.

Exemptions

Exemptions are granted by both EU competition law and U.S. antitrust law. In EU competition law, two justifications for exemptions known as *by individual* and *per category* apply. An agreement between firms is considered an individual exemption, if it helps generate benefits to society or is deemed necessary in the sense that it does not aim to impede competition (Jones et al., 2019; Martenet and Heinemann, 2021). In *per category* justifications, agreements that are part of an industry's existing regulations are automatically exempt from competition law, even if those regulations happen to deter competition.

Since the enactment of the Sherman Act, the U.S. has adopted two approaches to granting exemptions, namely, *rule of reason* and *per se interdiction*. In the 1970s, the Supreme Court returned to the *rule of reason* by considering consumer welfare in the verdicts, which has become the main reference since 1977 for interpreting the Sherman Act.

Hotel rate parity and competition law

Why is rate parity anti-competitive?

First, hotel rate parity falls into the first category of competition law. It restricts hotels' freedom of choice to set rates based on demand and supply. Insofar as distribution is concerned, hotel rates differ because hotels incur different sales expenses that depend on the distribution channel they use. Hotels and intermediaries are likely to attract different consumers with different willingness to pay. Hence, the rates of the same rooms on a hotel's website are likely to differ than those on the website of an intermediary.

Second, not only may rate parity be an abuse of market power by online travel agencies, but it also reinforces their dominant position. Rate parity is demanded by online travel agencies unilaterally due to their dominance over hotels in the supply chain. So, room rates end up reflecting the market power of intermediaries instead of the cost of hotels.

Third, rate parity may not only preclude the entry of other intermediaries but also limit hotels' choice of alternative distribution channels. Under rate parity, the resulting room rates are more likely to reflect the market power of the most dominant online travel agencies. Not only is rate parity a coercion of dominant intermediaries over small intermediaries and hotels as suppliers, but it also deters competition in the travel intermediation market. As a result, rate parity reinforces market concentration in the hotel distribution market.

Do exemptions apply to rate parity?

The principle underlying exemptions from competition law is that any agreement should not undermine, at the very least, consumer welfare and, at the same time, maintain a certain degree of competition. Many hotels, especially independent hotels, have no choice but to accept rate parity. Edelman and Wright's (2015) study, if it were applied in hotel distribution, would show that competition between intermediaries can, counterintuitively, push up room rates. This is because travel intermediaries will focus on competing for consumers by providing them with more yet unnecessary benefits while the costs are borne by hotels. This leads to consumers' excessive use of intermediation services, thereby pushing up hotel rates on all platforms. So, direct booking becomes less favorable to consumers.

Case law on online travel agencies

Because competition law is generic, case-based verdicts on hotel rate parity provide legislators with guidance regarding how to interpret and enforce the law. In hotel distribution, there have been seven cases pertaining to the infringement of competition law in Europe and the U.S. (see appendix 2). We summarize below the key antitrust enforcement measures that have been undertaken by national antitrust authorities.

The first case involved HRS, a top hotel reservation portal in Europe specialized in hotel distribution in the business travel market. The German antitrust authority condemned HRS for the infringement of Article 101 (1) of the TFEU on the grounds that the most favored nation clause constitutes collusive behavior (Thuen-Paulsen, 2016). The authority concluded that the clause is comparable to a hardcore clause, that is, it is illegal in its own right. This decision implies that any most favored nation clause infringes competition law in Germany.

The Office of Fair Trading (OFT) in the U.K. opened an investigation in 2014 into the distribution of hotel rooms of IHG on Booking.com and Expedia (see e.g., Haynes and Egan, 2015). The OFT accepted the commitments of the two online travel agencies that they would modify their distribution by offering price discounts for certain rooms. Note that the U.K. decision contradicts, to some degree, the German precedent that treated the most favored nation clause as a hardcore clause. The U.K. decision seems to suggest that improved efficiency can justify the most favored nation clause and hence an exemption can be granted.

The European Commission added an extra element to judicially distinguish between narrow and wide most favored nation clauses. In 2015, France, Italy, and Sweden, under the coordination of the Commission, investigated the most favored nation clause of Booking.com. They jointly accepted the commitment of Booking.com, which agreed to change its wide most favored nation clause to a narrow one. However, the agreement did not last long as Booking.com was banned by German antitrust authorities in 2015. This led Austria, France, and Italy to change their antitrust legislation accordingly.

Note that case law does not provide a one-size-fits-all answer as to whether most favored nation clauses comply with EU competition law. European authorities and courts seem to concur that both narrow and wide most favored nation clauses are hardcore clauses, and hence they infringe on Article 101 TFEU. This is even truer now that the only court that has declined to label a most favored nation clause a hardcore clause (and thus potentially eligible for exemption according to Article 101 (3) TFEU) is no longer bound by the TFEU after Brexit.

A full picture of case-based verdicts in the U.S. is less clear. There is only one incidence so far, and it was dismissed by the U.S. Supreme Court, because the plaintiff, according to the Supreme Court, did not allege the fact sufficiently that the online travel agencies conducted price fixing in the hotel market (Baker and Scott, 2018). There are no further indications of whether most favored nation clauses could be tolerated by U.S. authorities.

Discussion ad conclusion

The legal issues of hotel rate parity entail a new understanding of anti-competitive conduct and its ramifications. In a generic context, anti-competitive conduct arises in two fundamental ways, one being horizontal collusion, such as price agreement, between firms in the same sector and one being vertical integration of firms in the supply chain. Neither causes a big concern about anti-competition in the hotel sector. In fact, the hotel sector is highly competitive. Even Marriott's $13 billion acquisition of Starwood in 2016, the largest hotel acquisition ever, did not raise concern of regulators about the reduced competition in the hotel sector. The hotel sector has become increasingly competitive due to the entry of Airbnb and other lodging firms. On the other hand, there is no evidence that online travel agencies are interested in pursuing any vertical integration of hotels in the supply chain.

It becomes clear that reduced competition in the hotel sector is not on the supply or production side, which competition law has long been targeting. It comes down to online travel agencies that monopolize the *transaction* between consumers and producers (i.e., hotels). Hotel rate parity is, but not the only, one manifestation that online travel agencies abuse their dominance to monopolize transaction. In fact, online or traditional intermediaries used to be instrumental in reducing transaction costs in the tourism market, thereby scaling up the size of the tourism economy. This was achieved through intermediaries diversifying options of transaction. Not only would hotels compete with each other by providing better accommodation services to guests, but they would also compete for providing better and more efficient transaction options, which drives down transaction costs.

Under hotel rate parity, online travel agencies artificially increase transaction costs and hence hinder competition because consumer choice of transaction is restricted. Despite competition existing between hotels that aim at providing better accommodation services, there is little or even no competition for transaction. Namely, anti-competition is shifted from production to transaction which online travel agencies dominate. This is a new type of anti-competition that becomes increasingly evident in the hotel sector but beyond the reach of competition law. So, economic analysis of competition law should focus on transaction instead of production.

There is a series of studies suggesting that the ban of rate parity in Europe increased hotel performance while reducing the market share of online travel agencies in hotel distribution (Nicolau and Sharma, 2019; Sharma and Nicolau, 2019). However, note that the overriding goal of competition law is to protect consumers through increasing competition. Edelman and Wright (2015) have shown in theory that rate parity reduces consumer surplus, yet no empirical research has been done to estimate the size of the loss of consumer surplus. If the increase in producer surplus for travel intermediaries exceeds the loss in consumer surplus and if the net surplus can be transferred to consumers in one way or another, then hotel rate parity can be exempt. These questions remain open and warrant further research.

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