The Agency Model and MFN Clauses

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An agency model combined with most-favored-nation clauses were implemented by Apple and Amazon for e-book sales.

- Similar models used in other markets.

The US sued, alleging collusion in the sale of books. Settlements have largely been reached.

How do agency models and MFNs work? Was the correct decision made?
Two distinct sales models:
  - Wholesale—very traditional
  - Agency—suppliers set final retail prices, and split profits

Most-favored-nation (MFN) clauses—restrict suppliers to charge the same price to different retailers
  - Frequently considered anti-competitive
Background Facts—the e-book market

- Amazon—the larger player and first mover
- Apple—entered the market at the same time it released the iPad
- Apple and Amazon standards are incompatible
- Apple demanded publishers move to the agency model (with an MFN) as a condition of entry
- Book prices increased significantly
1. Is the agency model an anticompetitive tool?
2. Are MFNs anticompetitive tools?
3. Is the fact that prices went up in the e-book market substantial evidence that consumers were harmed?
Answers to Key Questions

1. Is the agency model an anticompetitive tool? **Possibly**
2. Are MFNs anticompetitive tools? **Maybe Not**
3. Does the fact that prices went up in the e-book market solid evidence that consumers were harmed? **Definitely Not**
Sketch of Model

- Imperfectly competitive upstream and downstream markets
- Each supplier sells to all retailers
- Under the agency model, suppliers set retail prices and receive share $r$ of generated profit
- The wholesale model works in the typical fashion
Agency eliminates double markup and lowers retail prices
- (Under certain complementarity assumptions on prices)
- Industry profits could go up or down
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  (Under certain complementarity assumptions on prices)
  Industry profits could go up or down

What happens if revenues rather than profits are shared? Each supplier $i$ with marginal cost $c > 0$ maximizes

$$rp_iD_i(p_i, p_{-i}) - cD_i(p_i, p_{-i}) = r \left( p_i - \frac{c}{r} \right) D_i(p_i, p_{-i})$$

$$\cong \left( p_i - \frac{c}{r} \right) D_i(p_i, p_{-i})$$
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$$\approx \left( p_i - \frac{c}{r} \right) D_i(p_i, p_{-i})$$

Because $r < 1$, $\frac{c}{r} > c \Rightarrow$ Agency can raise retail prices
There is an incumbent \((I)\) and a potential entrant \((E)\)

Suppose that life is very bad for suppliers if no entry occurs

Suppliers want entry but face a “problem” convincing \(E\) to enter
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- Suppose that life is very bad for suppliers if no entry occurs
- Suppliers want entry but face a “problem” convincing \(E\) to enter
- MFNs provide a solution \(\Rightarrow\) MFNs can be pro-competitive
- This may explain why Apple demanded the agency model, along with an MFN, prior to entering the e-book market
Goal: understand observed price increases in the e-book market
Goal: understand welfare implications
Remember: Apple and Amazon have incompatible e-book standards
Model change: two periods with consumer lock-in, set marginal costs $c = 0$
Main Results

- The agency model raises first-period prices but lowers second-period prices

Consumers prefer the agency model, hence cannot conclude consumers were harmed.
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- Consumers prefer the agency model
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- The agency model raises first-period prices but lowers second-period prices.
- Consumers prefer the agency model.
- Hence, cannot conclude consumers were harmed.
Agency eliminates the double markup and can (but need not) lower retail prices
MFNs can encourage retail entry under the agency model
In dynamic models, initial price increases are not solid evidence that consumers are harmed
Final thoughts on the e-book case...
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