Most-Favored-Customer Clause (MFC)

- A MFC guarantees a customer the best price the company gives to anyone.
- MFCs are very common in business-to-business contracts.
- They sound like a good deal for your customers, indeed the main effect is to shift the balance in favor of the seller.

MFC: Example

In 1971 members of the American Congress figured that they should find a way to lower campaign expenses. Thus, the politicians voted themselves an MFC for television spots.

The law didn't quite have the desired effect. Knowing that, in an election year, politicians are going to purchase significant chunks of airtime, the networks want to get as much as they can for these spots. So with an election coming up, how will a network respond when a commercial customer comes to negotiate the rate for an ad spot? It will be very though on price. Giving a concession is extremely costly, since any discount must be extended to all the politicians buying spots. The network would likely end up losing more from the lower price paid by all politicians than it would gain from getting some extra business.

One result of the law was that the networks ended up making more money than before.

MFC: the seller's perspective

Pros

1. Makes you a thouger negotiator.
   ("I'd love to give you a better price, but I can't afford to.")
2. Reduces your customers' incentive to bargain.
   (The customer is guaranteed that no one else can get a better price, even if he does no negotiating at all.)

Cons

1. Makes it easier for a rival to target one of your customers.
2. Makes it harder for you to target one of your rival's customers.

MFC: the customer's perspective

Pros

1. Allows you to benefit from any better deal subsequently offered to other customers.
2. Ensures you that you're not at a cost disadvantage relative to rivals.
3. Eliminates the risk of looking bad if other customers strike better deals.

Cons

1. When others have MFCs, it's harder for you to get a "special" deal.

Meet-the-Competition Clauses (MCC)

- An MCC is a contractual arrangement between company and customer that gives the company an option to retain the customer's business by meeting any rival bids.
- An MCC doesn't force you to meet the competition. It simply rewards you, if you do so, with the assurance of the customer's continued business.

MCC: Example

In January 1994 the Miami Dolphins football team was sold for $138 million to H.W. Huizenga. A pretty good buy - almost a steal.
When Dolphins owner J. Robbie died in 1990, the team was passed to his nine children. Following the death of their father, the Robbies sold Huizenga a 15 percent stake together with a **right of first refusal** (the buyer's counterpart to an MCC) on any future sale. Thus, the Robbie children couldn't sell the team without first giving Huizenga an opportunity to match the best offer.
Put yourself in the shoes of a prospective bidder. You invest time, effort and money lining up financing. Will you be able to outbid Huizenga? Doubtful. If it make sense for you to acquire the team at a certain price, it will make sense for Huizenga, too. The best offer was the $138-million bid that Huizenga matched when he bought the team.

What should the Robbie children have done?

MCC: Pros and Cons

Pros

1. Reduces the incentive for competitors to bid.

   (You can undercut any rival bid as far as it's a good deal.)

2. Takes the guesswork out of bidding - you know what you have to beat.
3. Lets you decide whether to keep the customer.

Cons

1. Allows competitors to bid without having to deliver.
   (Your rival can make a low bid, fully expecting that you will match and lowers your profit without having to put himself on the line.)

Minimum-price guarantees

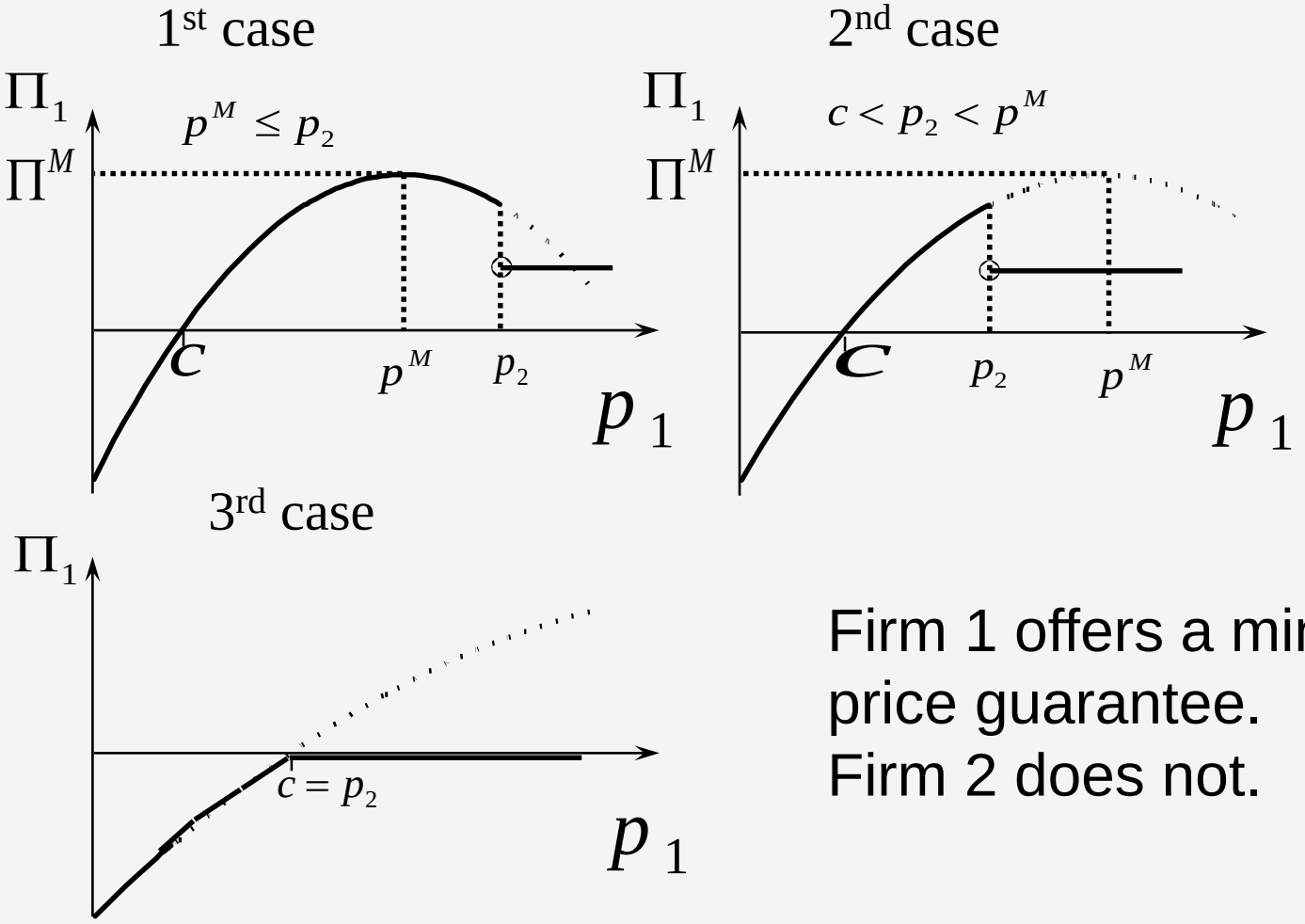
- Minimum-price guarantees assure consumers the lowest price charged by any firm.
- If firm 1 offers a minimum-price guarantee, its actual price will be equal to the minimum of the prices charged by the two firms:

$$p_1^{eff} = \min(p_1, p_2)$$

Exercise (Bauhaus)

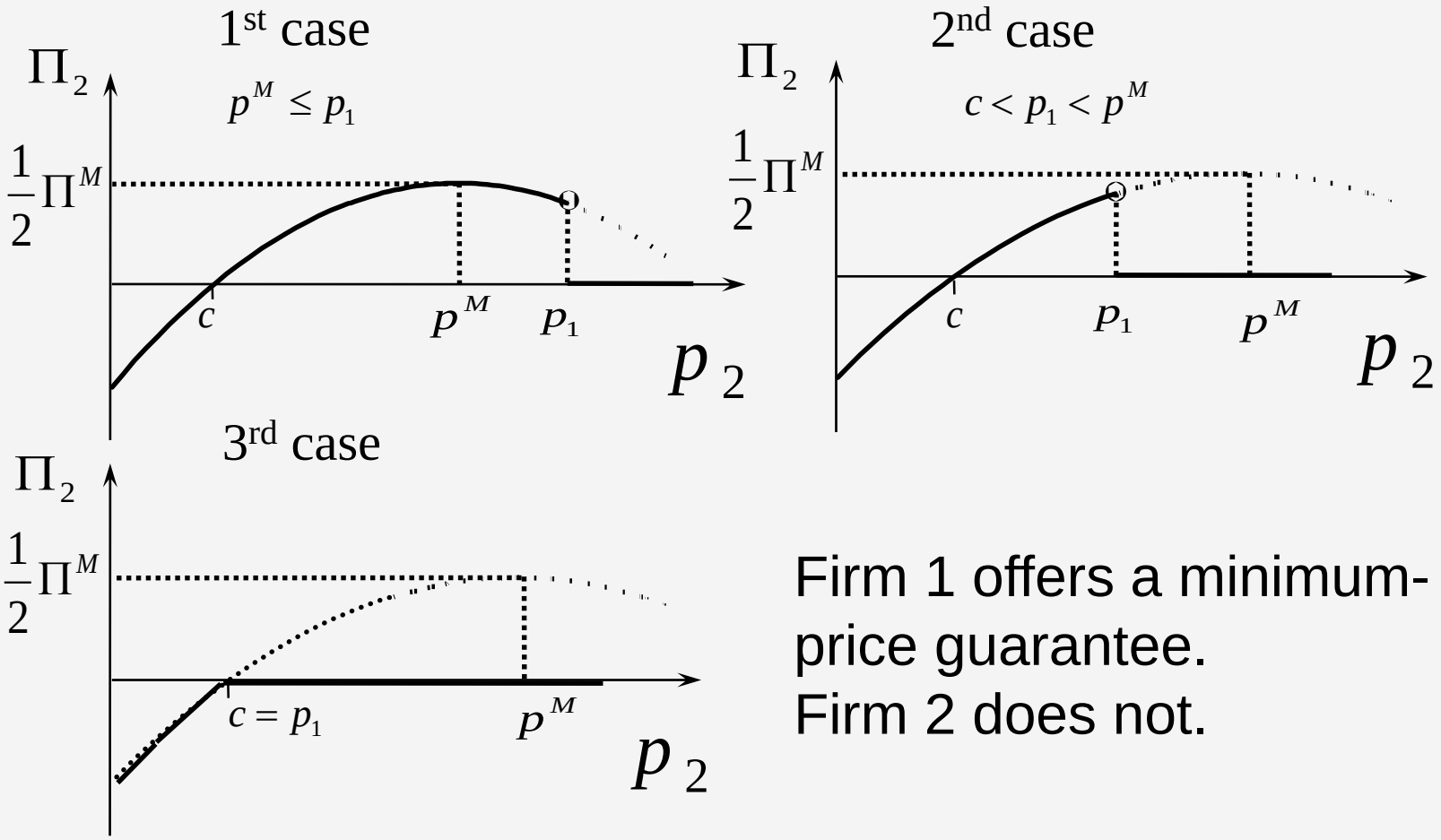
- “If within 14 days of your purchase date, you should find an identical product cheaper somewhere else, we offer you a 12 % discount on the price of the competitor.“
- $p_1^{eff}(p_1, p_2)$?

Minimum-price guarantees, graphically - firm 1's profit function



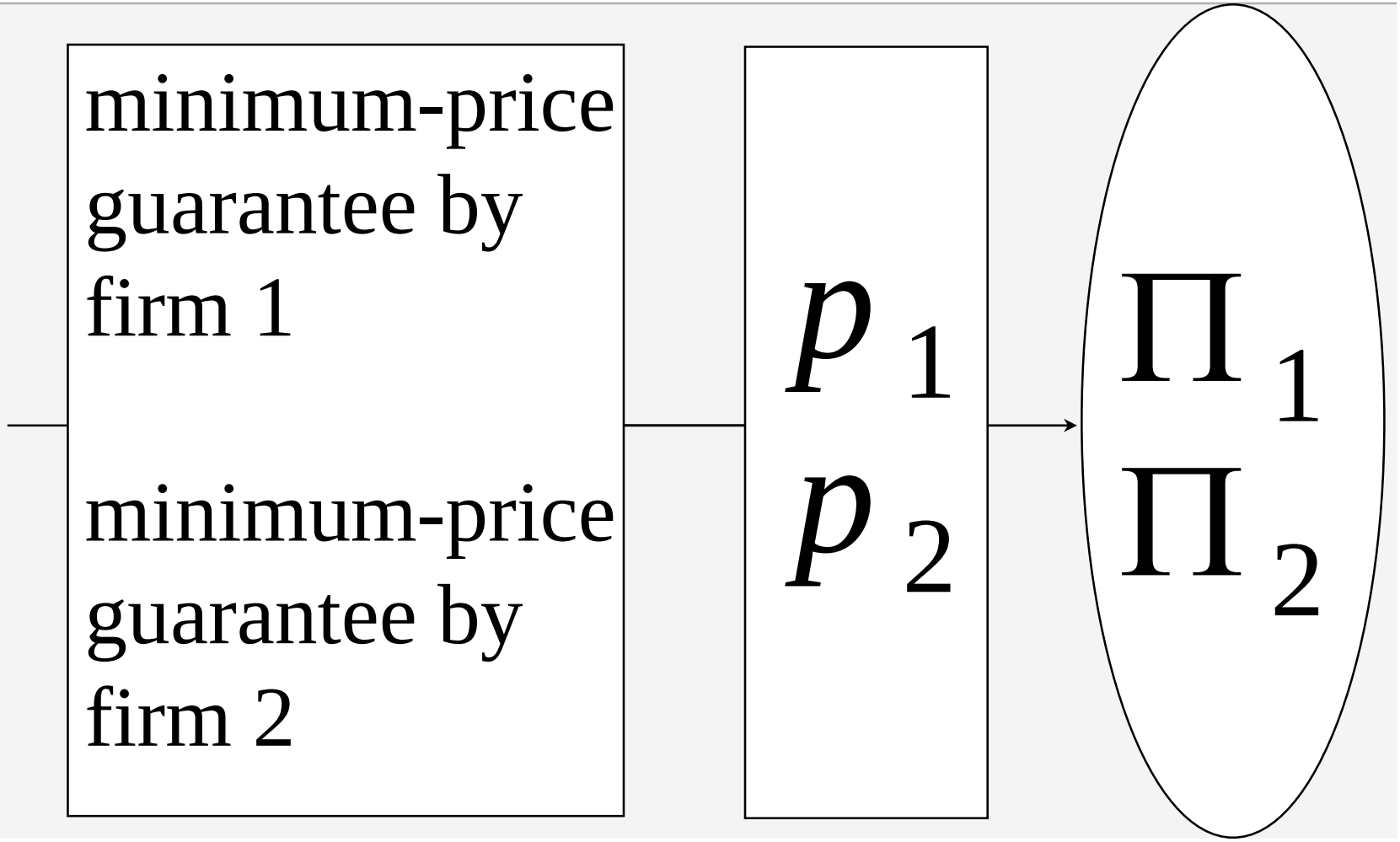
Firm 1 offers a minimum-price guarantee.
Firm 2 does not.

Minimum-price guarantees, graphically - firm 2's profit function



Firm 1 offers a minimum-price guarantee.
Firm 2 does not.

Two-stage model



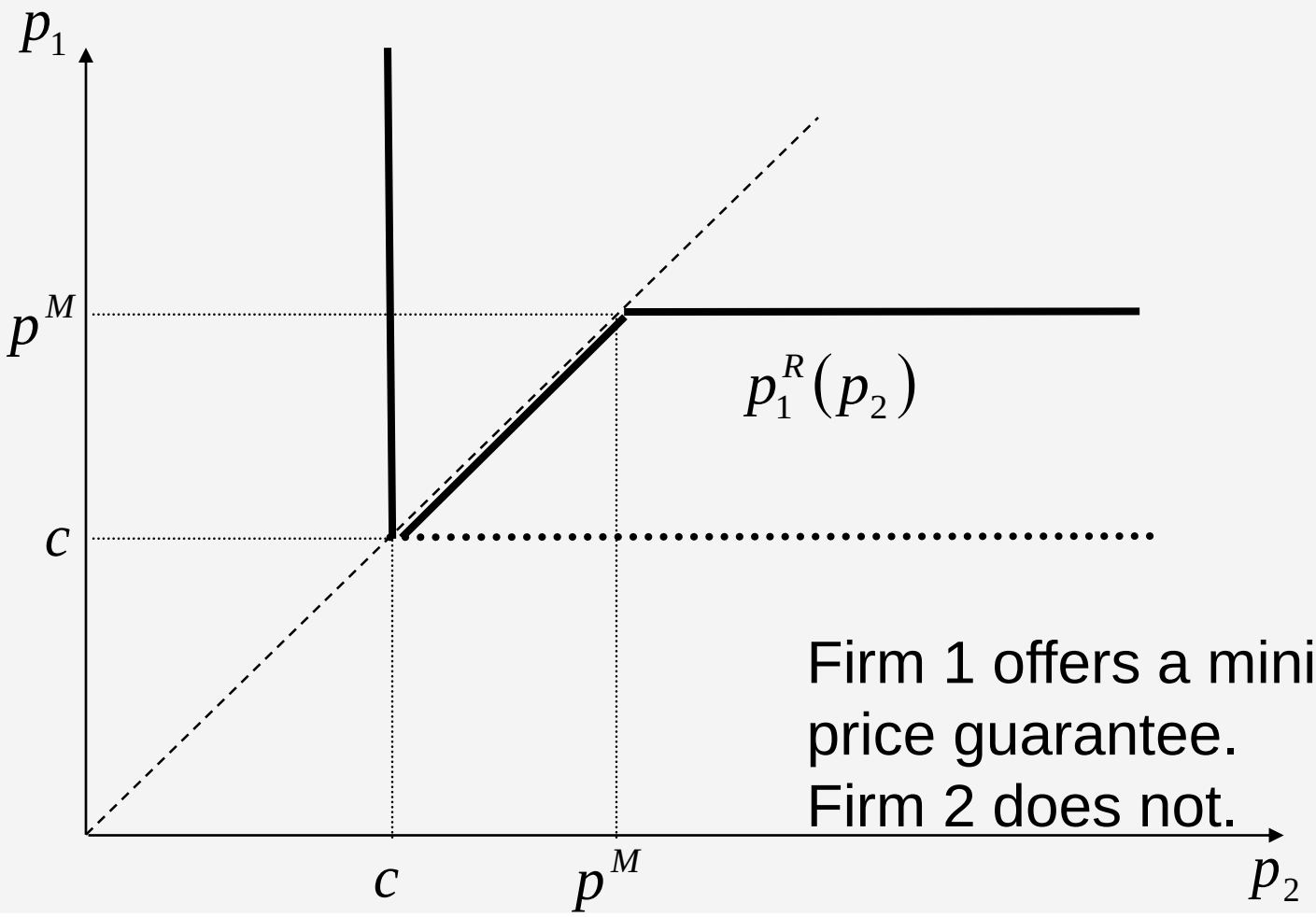
Four possibilities

- Neither firm 1 nor firm 2 offers a minimum-price guarantee:
  Bertrand paradox
- Only firm 1 offers a minimum-price guarantee.
- Only firm 2 offers a minimum-price guarantee.
- Both firms offer a minimum-price guarantee.

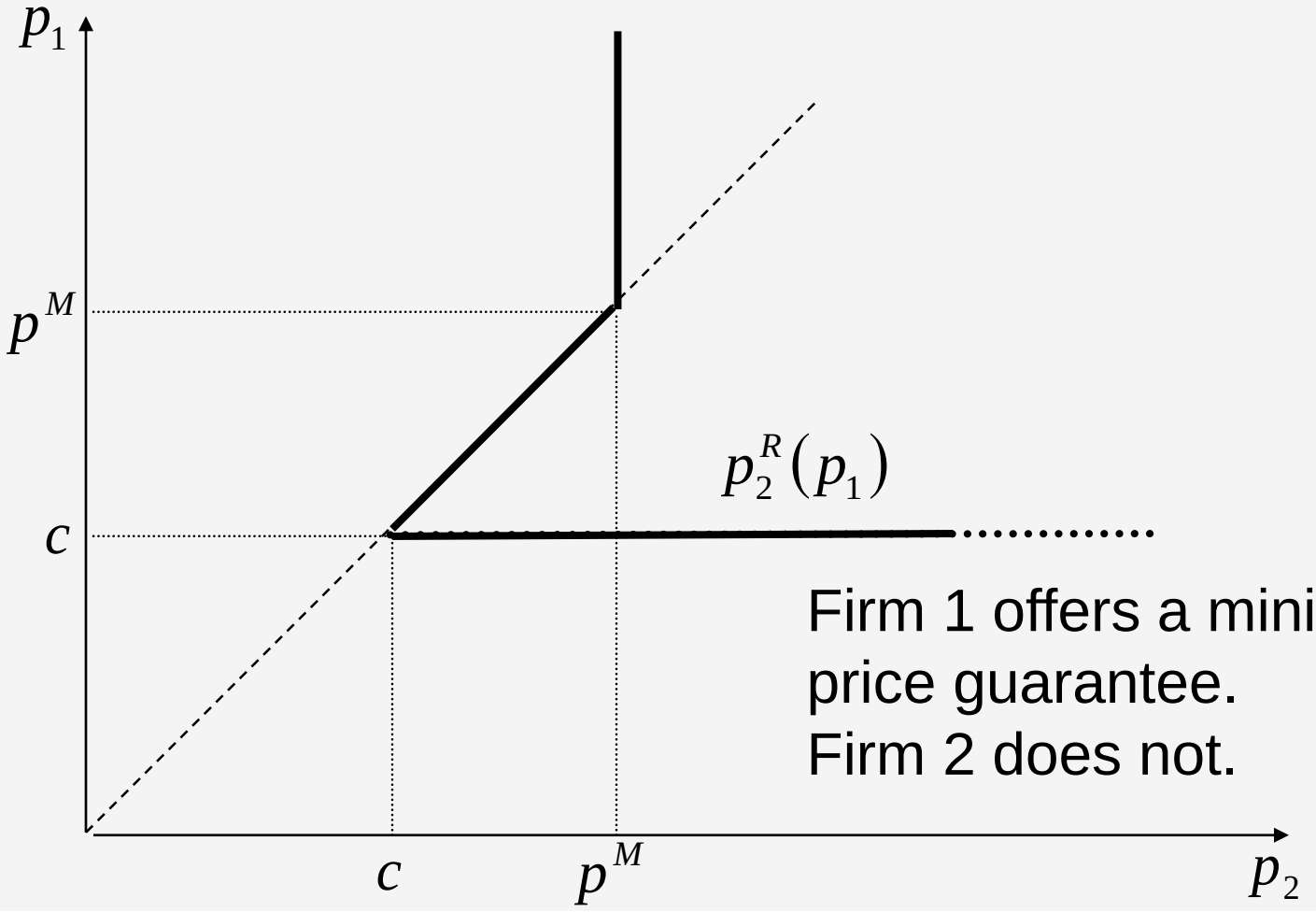
Unilateral minimum-price guarantee (2nd stage)

- (c, c) is a Nash equilibrium.
- (c, c) is the only equilibrium.
  - $(c-\delta, \cdot), (\cdot, c-\delta)$
  - $(c+\delta, c+\delta)$
  - $(c+\delta, c+\gamma)$ *with* $\delta < \gamma$
  - $(c+\gamma, c+\delta)$ *with* $\delta < \gamma$
  - $(c+\delta, c), (c, c+\delta)$
- Uniliteral minimum-price guarantees result in the Bertrand paradox.

Reaction correspondence of firm 1 (2nd stage)



Reaction correspondence of firm 2 (2nd stage)

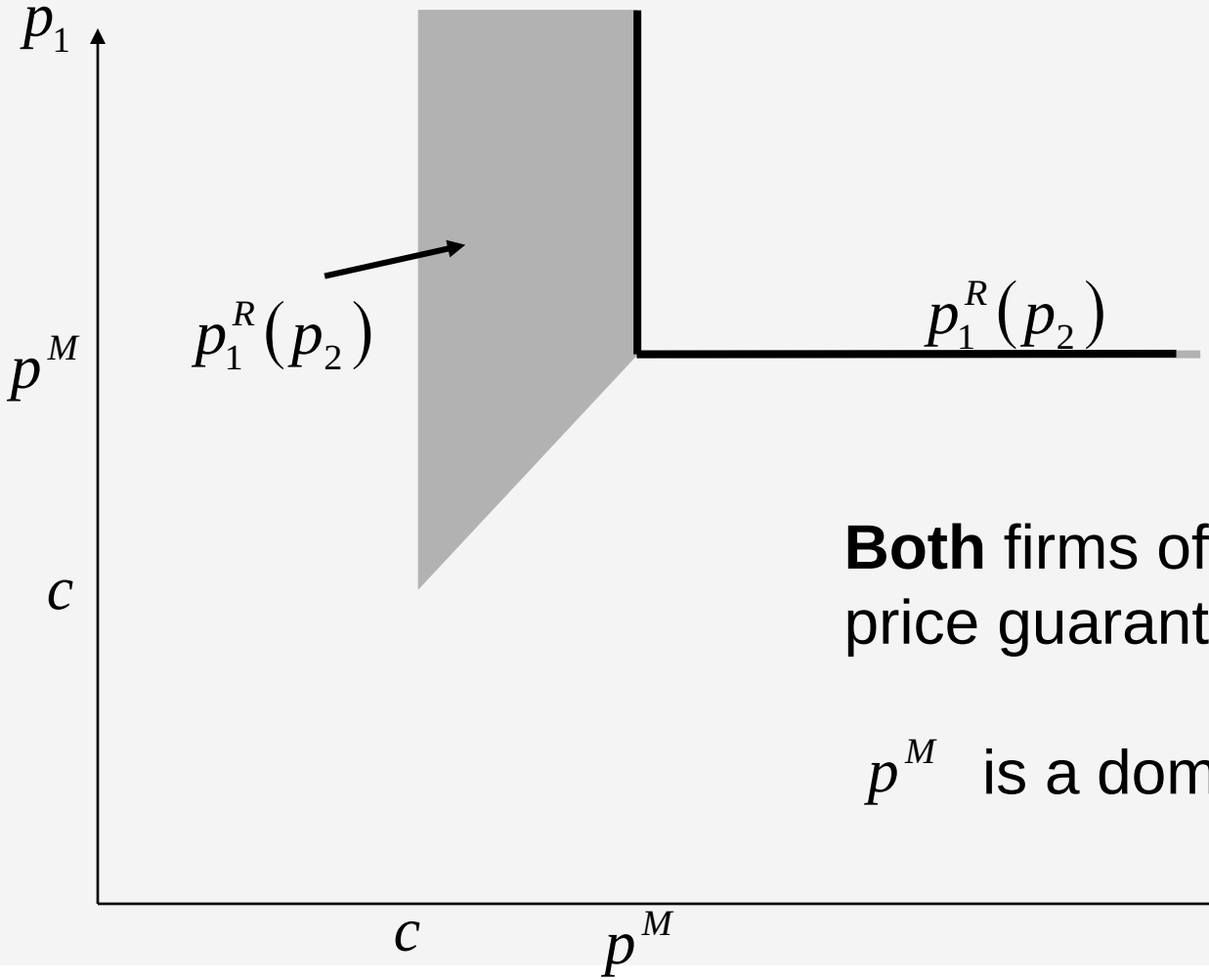


Firm 1 offers a minimum-price guarantee.
Firm 2 does not.

Bilateral minimum-price guarantee (2^{nd} stage)

- (c, c) is a Nash equilibrium.
- (c, c) isn't the only equilibrium.
  - (p^M, p^M)?
  - $(p^M, c+\delta)\ with\ c+\delta \geq p^M$?
  - $(p^M, c+\delta)\ with\ c+\delta < p^M$?
  - $(c+\delta, c+\delta)\ with\ c+\delta \leq p^M$?
- Are there any dominant strategies ?

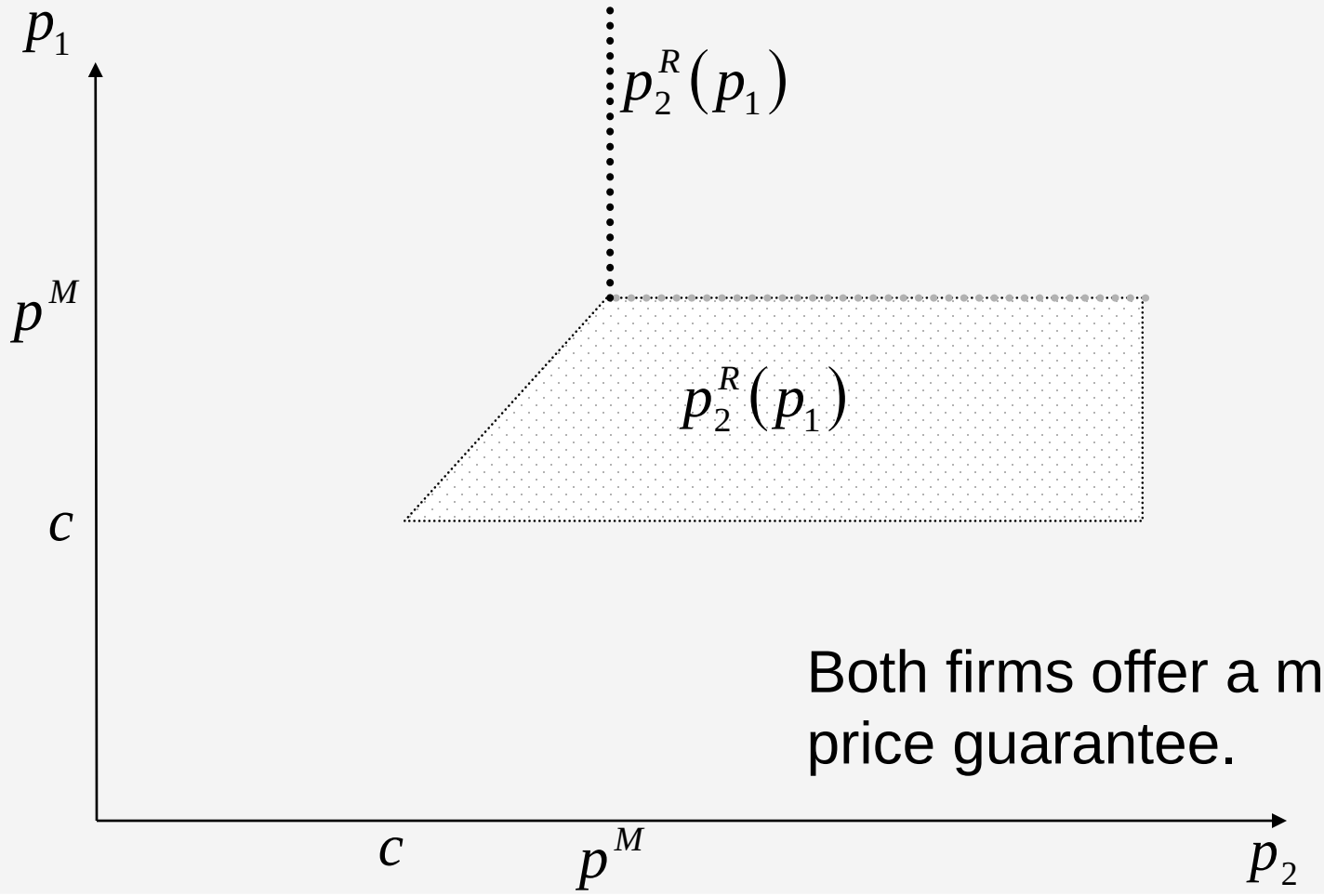
Reaction correspondence of firm 1 (2nd stage)



Both firms offer a minimum-price guarantee.

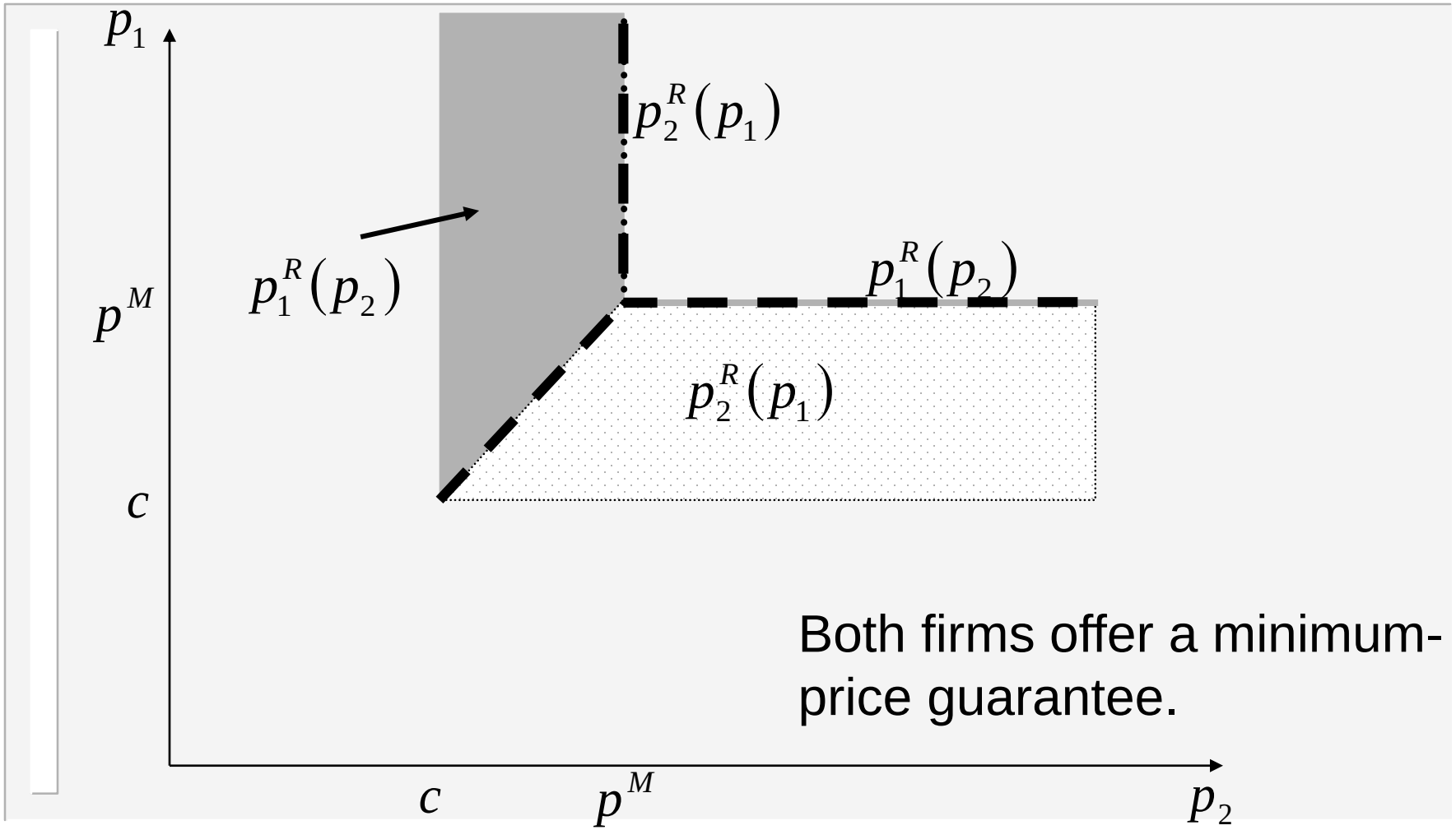
p^M is a dominant strategy.

Reaction correspondence of firm 2 (2nd stage)



Both firms offer a minimum-price guarantee.

Nash equilibria (2nd stage)

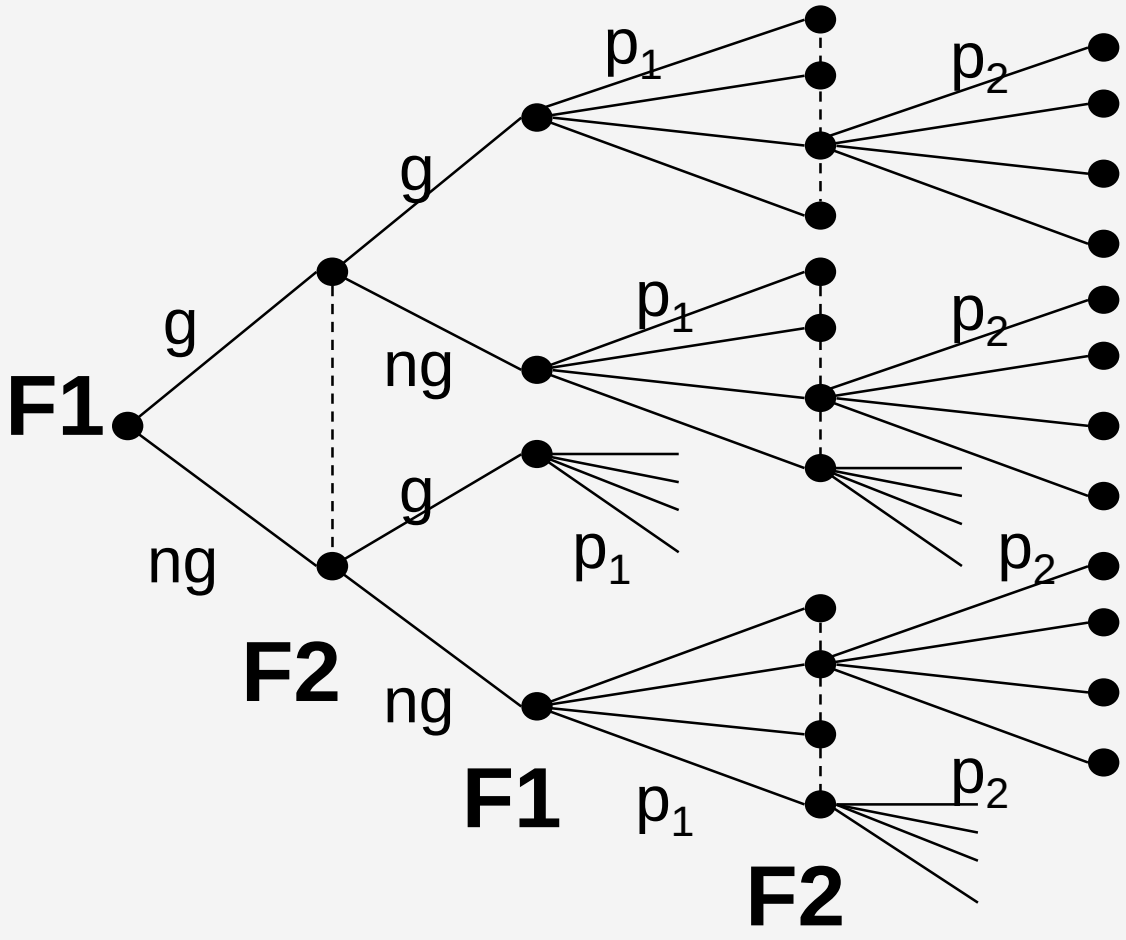


Both firms offer a minimum-price guarantee.

Minimum-price guarantee (1st stage) Payoff matrix

		firm 2	
		with minimum-price guarantee	**without minimum-price guarantee**
firm 1	**with minimum-price guarantee**	$\left(\frac{1}{2}\Pi^M, \frac{1}{2}\Pi^M\right)$	**(0, 0)**
	without minimum-price guarantee	**(0, 0)**	**(0, 0)**

The game in extensive form



A player's strategy:

1. decision for or against a guarantee

2. decision on prices in all 4 possible situations

Equilibria in extensive form games

- A strategy is of the following form:

$$\left(g/ng,\ p_{(g,g)},\ p_{(g,ng)},\ p_{(ng,g)},\ p_{(ng,ng)}\right)$$

- Which of these strategy combinations are equilibria?
  - $((g,p^M,c,c,c),(g,p^M,c,c,c))$?
  - $((g,p^M,c,c,c),(g,p^M,\ p^M\ ,c,c))$?
  - $((\mathrm{n}g,p^M,c,c,c),(\mathrm{n}g,p^M,\ p^M\ ,c,c))$?
  - $((g,p^M,\ p^M,c,c),(\mathrm{n}g,p^M,\ p^M\ ,c,c))$?
  - $((ng,c,c,c,c),(ng,c,c,c,c))$?

Executive summary I

- Homogeneity leads to an aggressive price war suppressing profits.
- In case of equal costs, zero profits (the Bertrand paradox) result. In case of unequal costs, the cost leader will prevail.
- Ways out of the Bertrand paradox:
  - capacity constraints,
  - repeated play,
  - cost leadership, switching costs,
  - price cartel,
  - minimum-price guarantees,
  - product differentiation.

Executive summary II

Minimum-price guarantees

- reduce consumers' uncertainty about fair prices,
- make it impossible to be underbid by the rival,
- discourage entry, and
- may accomplish the monopoly outcome if given by both firms.