Platform Competition With User Rebates Under No Surcharge Rules

Marius Schwartz *
and
Daniel R. Vincent **

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Abstract

We analyze competing strategic platforms setting fees to a local monopolist merchant and rebates to end users, when the merchant is prevented from surcharging platforms customers, as frequently occurs with credit cards. Each platform has an incentive to gain transactions by increasing the spread between its merchant fee and user rebate above its rival’s spread. This incentive yields non-existence of pure strategy equilibrium in many natural environments. In some circumstances, there is a mixed strategy equilibrium where platforms choose fee structures that induce the merchant to accept only one platform with equal probability, a form of monopolistic market allocation.

Keywords: Platform price competition; rebates; no surcharge; payment networks; credit cards.

JEL Codes: L13, L41, L42, D43.
1 Introduction

In prominent sectors of the economy, platforms intermediate transactions between end users and merchants. Sometimes, as with search engines, the platform charges only one side (advertisers) and has no financial interactions with users. In other cases, notably payment cards, the platform sets fees also to users, often negative in the form of cash-back rebates or other rewards. Under certain conditions only the sum of platform fees matters, not its division between the two sides, a property known as neutrality of the pricing structure (Carlton and Frankel, 1995; Rochet and Tirole, 2002; Gans and King, 2003). Neutrality is absent, however, when a merchant cannot freely adjust its price(s) in response to platform fees. This rigidity can be due to transaction costs of setting different prices across user groups, such as to card versus cash users (‘price coherence’), or a no-surcharge rule (NSR) imposed by the platform that bars a merchant from charging a higher price to platform users than to other customers. Such restrictions have long been used in credit card networks, and more recently in ‘new economy’ sectors, for example, online travel booking sites, triggering extensive regulatory and antitrust scrutiny (Bender and Fairless, 2014; Assaf and Moskowitz, 2015; Gonzales-Diaz and Bennett, 2015).

An inability to surcharge, for whatever reason, dampens the merchant’s price response to a rise in the platform’s fee, because any price increase must extend to other transactions for which the merchant’s cost is unchanged. In turn, the merchant’s dampened pass-through renders demand for platform transactions less elastic with respect to the platform fee, inducing the platform to raise its fee. This force underlies regulatory concerns that fees charged to merchants for certain payment cards under a NSR are excessive, and harm non-card customers such as cash users (Katz, 2001; Farrell, 2006; Schwartz and Vincent, 2006). It also permeates antitrust concerns that no-surcharge rules adopted by competing platforms more generally will induce anti-competitively high fees, as each platform recognizes that increasing its fee will raise a merchant’s price rise also for users of rival platforms (Boik and Corts, 2016; Carlton and Winter, 2017).

This one-sided reasoning is correct as far as it goes, but yields an incomplete understanding of equilibrium pricing under a (merchant-side) NSR when competing platforms set fees also to end users. Yet the issue is important for both economic theory and public policy. For example, the one-sided logic and concern underlay the U.S. district court’s important decision in United States v. American Express (2015). The decision prohibited nondiscriminatory provisions, including a NSR, imposed by
Amex that prevented merchants from offering customers inducements to use competing cards (with potentially lower merchant fees), arguing that such ‘no-steering’ provisions anti-competitively induce higher fees to merchants and ultimately harm card users as well.\(^1\) In overturning this decision, the appellate court wrote: “The District Court erred in concluding that ‘increases in merchant pricing are properly viewed as changes to the net price charged across Amex’s integrated platform,’ [...] because merchant pricing is only one half of the pertinent equation.” The appellate court added: “Because the two sides of the platform cannot be considered in isolation, it was error for the District Court to discard evidence [of ‘two-sided price’ calculations]” (United States v. Amex, 2016, p. 49).\(^2\)

This paper analyzes the two-sided pricing incentives created by no-surcharge rules in the case of competing strategic platforms, explicitly incorporating per-unit fees also to end users. We show that, in many plausible environments, a NSR destroys the possibility for pure strategy equilibrium outcomes. In some cases, the restraint allows otherwise strongly competing platforms to avoid competition by inducing a merchant to probabilistically participate with only one of them.

A useful starting point for grasping the pricing incentives is Schwartz and Vincent (2006), who consider a monopoly card platform facing a merchant that serves card and cash customers, with both groups exhibiting elastic demand for transactions. By raising its merchant fee and cutting the user fee – or increasing the rebate – equally, the platform can maintain its margin and profitably boost transactions volume since the merchant will raise price by less than the upward shift in card users’ demand, as it would absent the NSR. With multiple strategic platforms (instead of a ‘passive’

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\(^1\)“By suppressing the incentives of its network rivals to offer merchants, and by extension their customers, lower priced payment options at the point of sale [...] American Express’s merchant restraints harm interbrand competition.” (pp. 100-101.) “American Express’s merchant restraints have allowed all four networks to raise their swipe fees more easily and more profitably than would have been possible were merchants permitted to influence their customers’ payment decisions.” (p. 111.) The nondiscriminatory provisions are framed broadly to include various merchant conduct that would discourage payments via Amex credit or charge cards. Most relevant for our purposes, the merchant may not “impose any restrictions, conditions, disadvantages or fees [...] that are not imposed equally on all Other Payment Products, except for electronic funds transfer, or cash and check” (Id., pp. 25-26, emphasis added).

\(^2\)Economically, the impact of such provisions on the fee to card users is clearly relevant for a full welfare analysis. We take no position on the overall merits of the appellate court’s decision, which raises also legal issues such as evidential considerations and the appropriate burden of proof. For a critique of the appellate court’s position see Carlton and Winter (2017). In October 2017, the U.S. Supreme Court agreed to hear an appeal of the Second Circuit’s decision.
payment mode, cash), a similar logic implies that each platform wishes to increase the spread between its merchant fee and its end-user rebate. However, since each platform vies to have a greater spread between its fees than the other platform, the implications for equilibrium are subtle and require a more thorough analysis.

Our model has two symmetric platforms offering intermediary services viewed by end users as differentiated substitutes. We set aside potential efficiency roles of a NSR, such as preventing free riding or hold-up problems (e.g., Wright, 2003), and abstract from downstream competition by assuming a local monopolist merchant. Each platform (card network for concreteness) sets per-transaction fees to the merchant and to its end users (cardholders) along with any pricing restraints. The merchant determines whether to accept the contractual terms and then sets price(s) for the customers who use platforms. If both platforms impose a NSR and the merchant accepts both, the merchant must set a uniform price. If only one platform imposes a NSR, the constraint is one-sided. We examine two timing structures. In the first, both platforms simultaneously set merchant and cardholder fees and, each may require a NSR; the merchant accepts the offers from both platforms, one, or none; and lastly, the merchant sets its price(s). Partly as a robustness check, we consider an alternative timing: cardholder terms are set after the merchant decides whether to accept platforms. Under both scenarios, the conclusions are similar: NSR pricing restraints create such strong incentives for each competing platform to persistently outdo its rival in offering rebates to cardholders and funding them with fees to merchants that stable (equilibrium) outcomes in the sense of deterministic prices are not achievable.

The economic intuition for this result is the following. Whenever a NSR binds on the merchant (i.e., its preferred prices for transactions on the two platforms differ), two properties will hold. First, conditional on merchant acceptance, either platform gains by raising its merchant fee and cutting its user fee equally, thereby boosting its transactions as explained earlier. Second, such an increase in the spread between a platform’s fees raises the merchant’s preferred price for that platform’s transactions and, hence, mitigates the NSR constraint if (and only if) the merchant initially preferred to charge a lower price for that platform than for the other. It follows that in any pure-strategy equilibrium a NSR cannot bind on the merchant; if it did, the lower-spread platform could profitably increase its spread while also benefitting the merchant. But from any such candidate equilibrium with a NSR in force yet not locally binding, either platform could profitably deviate by offering a pair of fees that induce preferred prices for the merchant at which the NSR binds only slightly. The merchant would not drop that platform since differentiation implies some profitable
incremental sales from accepting both platforms rather than one.

This logic holds under both of our timing structures. However, in the case where platforms set cardholder terms after merchant acceptance decisions, and if the platforms are sufficiently close substitutes, we show there exists an interesting *mixed strategy* equilibrium. Platforms offer a NSR and sufficiently different merchant fees and cardholder rebates, and the merchant accepts only one platform with equal probabilities. Viewed in this light, setting sufficiently disparate merchant fees along with a NSR can serve as a profitable mechanism to achieve probabilistic market allocation among platforms. There is some anecdotal evidence consistent with this type of outcome. The major retailing club, Costco, historically accepted only a single card. Originally, it exclusively accepted Discover, then, prior to 2014 it accepted only American Express. More recently, Costco only accepted Visa. Another major retailer, Walmart Canada, exclusively accepts American Express.\(^3\)

Our paper is related to two broad literatures: on two-sided markets and Most Favored Nation (MFN) clauses. Our analysis is two-sided in the key sense that a platform’s pricing structure matters, but we ignore other central issues in the two-sided markets literature, such as the role of platform fees in attracting participation on both sides and the use of fixed fees as well as usage fees (e.g., Armstrong, 2006; Rochet and Tirole, 2006; Rysman, 2009). That literature has not encountered our non-existence of equilibrium under a NSR and competing platforms. Rochet and Tirole (2002) analyze a NSR with a monopoly card platform. Competing platforms are analyzed by Rochet and Tirole (2003), Guthrie and Wright (2007), and Edelman and Wright (2015) but in those models there is an upper limit on the spread for various reasons between a platform’s merchant fee and user fee.\(^4\) In Rochet and Tirole (2003), merchants’ decisions to accept a payment card depend solely on the card network’s merchant fee and is unaffected by the fee to cardholders, so raising the former while lowering the latter equally will cause some merchants to refuse the card and platform transactions will not necessarily rise. Networks therefore lack the

\(^3\)Prior to 2011, Neiman Marcus accepted only American Express of the four major card platforms.\(<http://www.wsj.com/articles/SB10001424052970204505304577000103355671444>\). The Second Circuit Court opinion noted that almost one-third of all merchants that accept cards do not accept American Express. Details on these single-homing examples can be found at \(<https://consumerist.com/2014/11/06/costco-may-finally-start-accepting-something-other-than-american-express/>\) and \(<http://www.usatoday.com/story/money/2016/06/13/walmart-canada-will-stop-accepting-visa-cards/85826704/>\).

\(^4\)Caillaud and Julien (2003), another pioneering article on platform competition, assumes that a platform can only charge a total fee, not separate fees to each side.
persistent incentive to increase their fee spread that arises in our model. In Guthrie
and Wright (2007), merchants internalize buyers’ benefits from card use, which does
create a bias for platforms to tilt the fee structure against merchants. However, there
is an endogenous limit on the maximal rebate to card users because the merchant must
charge the same price to cash users and card users, whereas in our model the NSR
applies only across cards (we discuss this issue further in Section 3). Edelman and
Wright (2015) assume that increased expenditure by a competing platform delivers
benefits to its users at a diminishing rate, which caps the benefit offered to users (and
the fee to merchants) but this assumption rules out cash-back rebates as they point
out.

MFN clauses, such as the NSR, are contractual provisions that specify ‘non-
discriminatory’ terms between various agents, often uniform pricing. A large lit-
erature shows that MFN clauses can arise in diverse settings and perform efficiency
roles (e.g., reduce transaction costs or delays in purchasing) or soften competition
(e.g., prevent sellers from offering selective discounts to divert sales). For a com-
prehensive survey see LEAR (2012). That literature mostly considers retail MFNs,
involving a firm and its direct customers. There is little formal work on MFNs im-
posed by firms at different vertical stages. Carlton and Winter (2017) show in several
models how such vertical MFNs can induce higher prices to downstream merchants.
They characterize no-surcharge rules imposed by payment networks as playing this
role, and provide policy arguments why the two-sided nature of those markets does
not warrant more lenient antitrust treatment of such restrictions. However, their
model of competing platforms does not consider user rebates, leaving the existence of
equilibrium when this option is available as an open question. To our knowledge, the
only analysis of competing platforms setting linear fees to merchants and users under
a NSR is a brief treatment by Boik and Corts (2016). Like us, they consider differen-
tiated platforms facing a monopolist merchant. In the bulk of their paper, platforms
set fees only to the merchant, a simplification that lets them tackle a rich set of issues
we ignore, including the impact of a NSR on entry by a lower-quality, lower-priced
platform. In an appendix, however, they provide a linear demand example where
platforms offer rebates to their end users, and posit that a pure-strategy equilibrium
does not exist, for the same basic force we identify: each platform vies to increase the
spread between its merchant fee and user rebate above the other platform’s spread.
We prove the non-existence result in a more general environment, show it is robust to
alternative timing, and incorporate the merchant’s acceptance behavior. Explicitly
incorporating this strategic choice by the merchant is important for a more complete
understanding of such markets. Merchant acceptance behavior also underpins our second main result, on the mixed-strategy equilibrium under sequential timing.

The remainder of the paper is organized as follows. Section 2 describes the setting. Section 3 analyzes the effect of a NSR when each network sets its fees to the merchant and card users simultaneously and proves that pure strategy equilibria cannot exist. Section 4 shows the same result in the alternative case where merchant fees are set first and user fees are set after the merchant sets its price(s). It also characterizes a mixed-strategy equilibrium with probabilistic market allocation. The Appendix contains all the proofs.

2 The Setting: Agents, Prices and Payoffs

We examine an economic environment with complements exhibiting these salient features: two classes of products are required in fixed proportions (here, one to one for each transaction) to generate a good for final consumption; the providers interact with each other through pricing; and each provider also interacts with the end-users through pricing. The application we maintain throughout is to payment systems. The credit card sector is an enormous component of the world economy, accounting in 2015 for almost 11 trillion dollars of sales globally (Carlton and Winter, 2017). In order for a retailer to complete a transaction, it often must combine its services with a payment mechanism such as a credit card. We consider a market structure in which one product class (the payment platform) is composed of two differentiated competitors while the other class (the merchant) is represented as a local monopolist. Other papers, such as Rochet and Tirole (2003), assume a continuum of merchants (and uniform pricing by platforms to merchants) while Guthrie and Wright (2007) assume duopoly merchants. Our market structure lets us focus on strategic interaction between platforms while abstracting from strategic interaction among downstream merchants who, nevertheless, possess some power over price. Our assumption that platform fees are specific to an individual merchant is consistent with the fact that card companies negotiate customized agreements with certain large merchants (see, e.g., U.S. v. Amex, 2015, p. 27).

Two platforms, 1 and 2, offer differentiated payment services to a single downstream merchant. Let $P_i$ be the total per unit price paid by a consumer for a purchase via platform $i$. Demand for sales made on platform $i$, $D^i(P_1, P_2)$, is twice continuously
differentiable and satisfies the properties:
\[
\frac{\partial D^i(P_1, P_2)}{\partial P_i} < 0,
\]
\[
\frac{\partial D^i(P_1, P_2)}{\partial P_j} \geq 0,
\]
\[
D^1(x, y) = D^2(y, x).
\]

The second condition implies that the two platforms are (imperfect) gross substitutes. The final condition indicates that we restrict attention to symmetric platforms. This representation of demand is a ‘reduced form’ characterization in that we do not focus on the micro-structure that underlies the choice of means of payment by consumers. It allows for consumers to utilize other payment methods such as cash; however, when we later consider the effects of pricing restrictions, we do not assume any similar restrictions on the cash price.\(^5\)

We assume for every price, \(P_1\), there is a choke price, \(P_2(P_1)\) such that \(D^2(P_1, P_2(P_1)) = 0\).

Symmetry implies a similar property for platform 2. The assumption of gross substitutes implies that \(P_2(\cdot)\) is weakly increasing. Define
\[
\bar{D}^1(P_1) \equiv D^1(P_1, P_2(P_1))
\]
to be the demand for platform 1 sales when platform 2 is not available. Gross substitutes implies that for all \((P_1, P_2)\) such that \(D^2(P_1, P_2) > 0\),
\[
\bar{D}^1(P_1) > D^1(P_1, P_2)
\]
and similarly for platform 2.

Each platform \(i\) sets a per transaction fee \(f_i\) to cardholders (typically negative, i.e., rebates) and \(m_i\) to the merchant.\(^6\) If the merchant accepts a platform, the merchant sets a price \(p_i\) for a purchase through that platform and the cardholder total price is
\[
P_i = p_i + f_i.
\]

Define platform \(i\)'s total fee as
\[
t_i \equiv f_i + m_i.
\]

\(^5\)This is consistent with policies of card networks in the U.S. that typically exempt cash from their contractual restrictions on merchants. (See e.g., fn. 1 above.)

\(^6\)In the literature on payment systems, the merchant fee is often termed ‘the merchant discount’.
Platform profits are
\[(f_i + m_i - C)q_i = (t_i - C)q_i\]
where \(C\) is the marginal cost of each platform. The monopolist merchant has marginal cost \(c\) for each unit sold.

The merchant’s outside option – its profit from carrying no platform – is normalized to zero. Assuming the merchant adopts both platforms, using \(m_i = t_i - f_i\), merchant profits can be expressed in terms of \((t_1, t_2)\) and total cardholder fees, \((P_1, P_2)\):

\[
\Pi(P_1, P_2; t_1, t_2) = (p_1 - m_1 - c)D^1(p_1 + f_1, p_2 + f_2) + (p_2 - m_2 - c)D^2(p_1 + f_1, p_2 + f_2)
= (p_1 + f_1 - (m_1 + f_1) - c)D^1(P_1, P_2) + (p_2 + f_2 - (f_2 + m_2) - c)D^2(P_1, P_2)
= (P_1 - t_1 - c)D^1(P_1, P_2) + (P_2 - t_2 - c)D^2(P_1, P_2).
\]

\[1\]

3 Simultaneous Platform Pricing

3.1 The Model With Unrestricted Merchant Pricing

Consider the following price-setting game:

*Simultaneous Platform Pricing*

1) Both platforms simultaneously select cardholder and merchant fees, \((f_i, m_i)\).

2) The merchant observes both pairs of prices and accepts both platforms, one or neither.

3) For each accepted platform, \(i\), the merchant sets a price, \(p_i\), potentially subject to restrictions, for its product and the cardholder’s price is \(P_i = p_i + f_i\).

4) For each accepted platform, \(i\), consumers observe \((f_i, p_i)\): If both platforms are accepted, transactions via platform \(i\) are given by \(D^i(p_1 + f_1, p_2 + f_2)\); If only platform \(i\) is accepted, transactions via platform \(i\) are given by \(\bar{D}^i(p_i + f_i)\) and no transactions occur via platform \(j\); If no platform is accepted, no card transactions occur.

This timing captures a sense in which a merchant is able to change its consumer prices more rapidly than platforms can alter their fees either to merchants or consumers. In Section 4 we examine an alternative timing where platforms set cardholder fees after merchants set consumer prices to check if our non-existence result is sensitive to this feature.
Using (1), the merchant’s profit maximization problem can be equivalently expressed as, given platform fees, selecting total cardholder prices, \((P_1, P_2)\), rather than merchant prices, \((p_1, p_2)\). This representation illustrates the well-known ‘neutrality’ property that, with no restriction on merchant pricing (including no NSR), equilibrium cardholder prices, \(P_i\), depend solely on total fees, \((t_1, t_2)\), and are independent of the split between cardholder fees and merchant fees. The merchant’s optimal prices \(P_i(\cdot, \cdot)\), therefore, depend solely on \(t_i\) as do the optimal quantities:

\[ q_i(t_1, t_2) \equiv D_i(P_1(t_1, t_2), P_2(t_1, t_2)). \]

Since platform \(i\)’s profit margin depends only on \(t_i\) and not on \(f_i, m_i\) separately, neutrality in the division of merchant and cardholder fees follows.

Neutrality thus implies that, with no pricing constraints on the merchant, rival platforms can be thought of as playing a strategic game solely in total fees, \((t_1, t_2)\). For a platform \(i\), define an induced best response function from the neutrality environment as

\[ r^i(t_j) \equiv \arg\max_{t_i} (t_i - C) q_i(t_1, t_2), \]

and denote the partial derivatives of the merchant’s profit function with respect to price as

\[ \Pi_i \equiv \frac{\partial \Pi}{\partial P_i}, \quad \Pi_{ij} \equiv \frac{\partial \Pi_i}{\partial P_j}. \]

For the remainder of this Section, we assume:

A1) Platform profits are strictly quasi-concave in \(t_i\) for all \(t_j\) and smoothly supermodular in \((t_1, t_2)\), and \(r^i(t_j)\) is continuously differentiable with \(r^{iii}(t_j) \in [0, 1)\).

A2) For all \(t_1, t_2\), \(\Pi\) is strictly quasi-concave in \((P_1, P_2)\) and there is a unique \((\bar{P}_1(t_1, t_2), \bar{P}_2(t_1, t_2))\) such that \(\Pi_i(\bar{P}_1(t_1, t_2), \bar{P}_2(t_1, t_2)) = 0, i = 1, 2\).

A3) For all \(t_1, t_2, P_1, P_2\), \(\Pi_{ii} + \Pi_{ij} < 0\).

A4) For any fixed \((t_1, t_2)\), if a merchant accepts only one platform, that platform’s sales are (weakly) higher than its sales when the merchant accepts both platforms.\(^7\)

\(^7\)Chen and Riordan (2015) prove that a similar property holds quite generally when demand is generated by a discrete choice model.
Assumption A1) implies that this is a game in strategic complements and there is a unique equilibrium in $t_1, t_2$ (see Vives, 2001, p. 47). The remaining assumptions allow us to focus primarily on first order conditions to conduct the proofs.

Under mild conditions, assumptions A1)-A4) are satisfied for two commonly used demand systems:

**Linear-Quadratic (LQ):** Consumer preferences are quasi-linear and given by

$$u(q_1, q_2, M) = q_1 + q_2 - (q_1^2 + 2\gamma q_1 q_2 + q_2^2)/2 + M, \quad \gamma \in [0, 1),$$

where $\gamma = 0$ implies demand for transactions on one platform is unrelated to transactions on the other and $\gamma > 0$ corresponds to platforms as imperfect substitutes. This formulation leads to the standard linear demand system of differentiated products with demand for platform 1 given by

$$D^1(P_1, P_2) = \frac{1 - \gamma - P_1 + \gamma P_2}{1 - \gamma^2}, \quad (2)$$

and symmetrically for platform 2. In the **LQ** case, $\Pi$ is strictly concave and

$$\Pi_{ii} + \Pi_{ij} = -\frac{2}{1 - \gamma^2} + \frac{2\gamma}{1 - \gamma^2} < 0$$

since we assume $\gamma < 1$, so assumptions A1)-A3) are satisfied. To see that A4) holds, observe that for any $(t_1, t_2)$, equilibrium output of platform $i$ with two platforms is $\frac{1 - \gamma - t_i + \gamma t_j}{2(1 - \gamma^2)}$ while with a single platform it is $\frac{1 - t_i}{2}$. Subtracting the first from the second yields

$$\frac{\gamma}{2(1 - \gamma^2)} (1 - \gamma - t_j + \gamma t_i) = \gamma q_j(t_1, t_2) \geq 0.$$

**Independent Demands (ID):** Consumer preferences are quasi-linear

$$u(q_1, q_2, y) = V(q_1) + V(q_2) + y, \quad V' > 0, V'' < 0,$$

Demand for transactions on each platform are given by

$$D^i(P_1, P_2) = V'^{-1}(P_1).$$

In the **ID** case, if merchant profits are concave in prices for each platform use, then A2) is satisfied and, since $\Pi_{ij} = 0$, A3) is also satisfied. Since $r''(t_j) = 0$, A1) holds trivially. A4) also holds trivially since demand for good $i$ is unaffected by good $j$.

A variant of the **ID** case corresponds to a model examined in Schwartz and Vincent (2006) where one platform is interpreted as cash and its corresponding fees are fixed.
at 0 (so one platform is non-strategic). They examine the fee-setting behavior of the other (card) platform when the merchant must charge equal prices for both means of payments. In the next section, we examine the effects of a similar constraint where both platforms can set fees, to the merchant and to consumers.

### 3.2 No Surcharges Rules

We now examine the impact of platform restrictions on merchant pricing. If the merchant accepts both platforms and the no-surcharge rule applies to both platforms, the merchant’s prices for purchases on either platform must be equal, \( p_1 = p_2 \). We assume this restriction to be exogenous to the environment. It only has force if a merchant accepts both platforms. Later in this section we consider a NSR imposed only by a single platform, \( i \), so the restriction is tantamount to the inequality, \( p_i \leq p_j \).

Fix any \( f_1, f_2 \). Given \( p_1 = p_2 \), total consumer prices can differ solely because of different platform fees to consumers:

\[
P_2 = P_1 + f_2 - f_1. \tag{3}
\]

Since \( m_i = t_i - f_i \), we can represent the strategic choice of a platform equivalently as setting \( (f_i, m_i) \) or setting \( (f_i, t_i) \). In what follows, we use the latter representation.

Under a NSR, the merchant’s profit maximization problem can be expressed as the constrained problem (CP)

\[
\max_{P_1, P_2} \quad \Pi(P_1, P_2; t_1, t_2) \tag{CP}
\]

\[
s.t. \quad P_1 + f_2 - f_1 - P_2 = 0,
\]

where \( \Pi(P_1, P_2; t_1, t_2) \) is defined in (1). Let the lagrangian associated with (CP) be

\[
L(P_1, P_2, \lambda; t_1, t_2, f_1, f_2) = \Pi(P_1, P_2; t_1, t_2) + \lambda(P_1 + f_2 - f_1 - P_2) \tag{4}
\]

and denote the solution to (CP) (including the associated lagrange multiplier on the constraint) by \( (\hat{P}_1, \hat{P}_2, \hat{\lambda}) \). Since the NSR here is an equality constraint, the lagrange multiplier can take either sign.\(^9\) In the formulation above, \( \hat{\lambda} > 0 \) implies that, (locally) given \( (t_1, t_2, f_1, f_2) \), the merchant would prefer to charge a higher total

\(^8\)That model is not exactly nested in this one, though, since the quantity of cash sales at equal prices is not required to equal those of the other platform, that is, demands can be asymmetric.

\(^9\)Since the constraint is linear, the usual constraint qualification in the Lagrange Theorem is satisfied.
price for platform 2 but is prevented from doing so by the NSR.\textsuperscript{10} When fees are such that $\hat{\lambda} > 0$, Lemma 1 exploits the envelope theorem to show that, holding $t_1, t_2, f_2$ fixed, merchant profits increase as $f_1$ falls. Intuitively, with $t_1$ fixed, a fall in cardholder fee $f_1$ requires an equal rise in merchant fee $m_1$. These changes imply both a rise in demand for and in marginal cost of transactions on platform 1 and, thus, a rise in the merchant’s unconstrained optimal price for platform 1. This change relaxes the effect of the constraint and therefore benefits the merchant. The same logic implies that a fall in cardholder fee and rise in merchant fee of platform 2 exacerbate the constraint on the merchant.

\textbf{Lemma 1.} \textit{Suppose $\hat{\lambda}$ is strictly positive (at current fees, the merchant prefers to charge a higher price to platform 2). Holding $(t_1, t_2, f_2)$ fixed, merchant profits increase as $f_1$ falls. Holding $(t_1, f_1, t_2)$ fixed, merchant profits decrease as $f_2$ falls.}

\textit{(All proofs are in the Appendix.)}

Assumptions A2) and A3) on the merchant’s profit function can now be used to derive the impact of cardholder fees on platform sales given a NSR. As long as the merchant continues to accept both platforms, an increase in spread between a platform’s cardholder and merchant fees, holding the total fee constant, will increase that platform’s sales.

\textbf{Lemma 2.} \textit{If Platform 1 lowers $f_1$ by (small) $\delta > 0$ holding $t_1$ fixed and the merchant accepts the NSR, then sales on platform 1 rise and sales on platform 2 fall.}

For a given profile of fees, $(t_1, t_2, f_1, f_2)$, if a merchant accepts only a single platform $i$, a NSR has no force and neutrality implies that the merchant’s maximal profit is given by

$$\Pi^S(t_i) \equiv \max_P (P - t_i - c)\bar{D}^i(P).$$  \hspace{1cm} (5)

The envelope theorem implies that stand-alone profits are decreasing in $t_i$, therefore, if a merchant avoids a NSR by accepting only one platform, it will accept the platform with the lower total fee. Thus, when offered fees $(t_1, t_2, f_1, f_2)$ and a NSR, the merchant’s best alternative to accepting both platforms is either its outside option, 0, or $\Pi^S(\min\{t_1, t_2\})$. This feature along with Lemmas 1 and 2 imply that at any pure strategy equilibrium where the NSR is accepted, the NSR cannot bind on the merchant:

\textsuperscript{10}Strict quasi-concavity of $\Pi$, from assumption A2) also implies the merchant’s optimal $p_2$ without the NSR is strictly higher than the constrained merchant price, $\hat{P}_2 - f_2$. 

12
Lemma 3. In a pure strategy equilibrium in platform fees when the merchant accepts a NSR from both platforms, the lagrange multiplier in the solution to (CP) satisfies \( \hat{\lambda} = 0 \).

The underlying economic forces at work in Lemmas 2 and 3 are as follows. Whenever a NSR binds on the merchant, two properties will hold. First, conditional on merchant acceptance, either platform gains by raising its merchant fee and cutting its user fee equally. With this change, platform \( i \)’s total fee remains constant, but expanding the spread \( (m_i - f_i) \) increases transactions on platform \( i \): its users’ willingness to pay increases by the cut in \( f_i \) whereas the merchant raises price by less since the price rise must apply also to the other platform’s users. Second, expanding the spread will raise the merchant’s preferred price for \( i \)’s transactions and, hence, mitigate the NSR constraint if and only if the merchant initially preferred to charge a lower price for \( i \) than for the other platform (at the initial fees, the NSR binds on transactions with \( i \)’s rival) because the merchant’s preferred prices would move closer. The merchant therefore benefits from an increase in the fee spread of platform \( i \) because the impact of the NSR constraint is reduced. It follows that in any pure-strategy equilibrium a NSR cannot bind; if it did, platform \( i \) could profitably deviate by increasing its fee spread while retaining merchant acceptance.

Lemmas 1 through 3 can now be combined to obtain our main result.

Proposition 1. In the Simultaneous Pricing Game under Assumptions A1) through A4), if both platforms impose a NSR, there is no equilibrium in pure strategies.

The logic is as follows. Start from a candidate equilibrium with the NSR non-binding on the merchant (by Lemma 3) and equal total platform fees. Since the platforms are symmetric and imperfect substitutes, the merchant strictly prefers to accept both than just one. Thus, either platform could profitably deviate by raising its fee spread slightly so the NSR starts to bind without being dropped by the merchant, breaking the candidate equilibrium.

Next, consider unequal total fees, say \( t_2 > t_1 \) so \((t_1, t_2)\) must be above the line \( t_1 = t_2 \) (see Figure 1). With a non-binding NSR, the neutrality property applies – all profits depend solely on total platform fees (not on their fee structure). The lower-fee platform could always profitably raise its fee and retain merchant acceptance, but must prefer not to in a candidate equilibrium. This implies that any platform’s equilibrium total fee is higher than its best response to the other platform’s fee (to the right of the line \( r_1(t_2) \)). But in this case, the platform with the higher fee must then
be strictly above its no-NSR best response, \( t_2 > r_2(t_1) \) and \( t_2 > t_1 \), i.e., in region \( E \) implying it could profitably deviate by reducing its fee if the merchant accepted (by Assumption A1). And the merchant would accept, since its profits rise when a platform cuts its total fee and the NSR does not bind.

![Figure 1: Illustration of Proof of Proposition 1 – Unequal Total Fees](image)

To this point, we assumed both platforms impose a NSR. Suppose instead only one platform, say platform 2, imposes a NSR. The merchant’s profit maximization problem is an obvious modification of (CP) where the constraint becomes the inequality constraint:

\[
P_2 \leq P_1 + f_2 - f_1
\]

and the lagrange multiplier in (4) must be non-negative. Proposition 2 demonstrates that with a single NSR, equilibrium existence continues to fail.

**Proposition 2.** *In the Simultaneous Pricing Game under Assumptions A1) through A4), if one platform imposes a NSR, there is no equilibrium in pure strategies.*

The argument is similar to the logic underlying Proposition 1. If a NSR binds in equilibrium, it must clearly bind on the price of the platform that imposes the NSR, say, platform 2. Platform 1 then has the incentive described by Lemma 2 to increase
the spread of fees and thereby increase transactions, and the merchant would accept such a change using the same logic as in Lemma 1. Once again, this leads to the conclusion that the NSR cannot bind in equilibrium and the proof from Proposition 1 now proceeds in the same fashion.

Propositions 1 and 2 show that pricing restraints such as no surcharge rules raise important questions about the stability of a pricing game with competing platforms. The driving force lies in the feature that with the NSR, no matter the size of the gap between merchant and cardholder fees, if competing platforms have equal gaps (so the NSR is not locally binding) each has an incentive to increase its gap and steal sales from the rival. This persistent incentive highlights an important difference between our framework and that of Guthrie and Wright (2007) and the nature of contractual restrictions. In their model, increased sales are obtained by drawing more customers out of the cash market and into the cardusing market. If the merchant is forced to charge the same price not only to all card users but to cash users as well, it becomes more costly to draw in cash users (who are heterogeneous in their value of card use) and simultaneously more costly to induce merchants to raise the common price to its remaining cash customers. When the constraint on the merchant lies only on the prices charged to users of the same class of means of payment (cards) leaving the merchant free to charge separate prices to users of other means of payment, this limiting effect is absent and the source of our non-existence issue emerges.¹¹

One candidate explanation for non-existence of pure strategy equilibrium is that the strategic structure has been misspecified. In the next section, we explore this possibility by considering a related game where the timing is modified so that platforms set prices to card-holders after coming to an agreement with a merchant. The underlying logic is robust to this new specification. In this new game, the incentive remains for each platform to exploit a NSR by shifting transactions to itself and non-existence of pure strategy equilibrium persists. However, we also demonstrate that an equilibrium can exist where the merchant single-homes but randomizes over which platform it accepts.

¹¹Recall that in the Amex case, the contractual restrictions exempted “electronic funds transfer, or cash and check”. (See Footnote 1.) An equivalent result would arise if there were only card users in the market.
4 Sequential Platform Pricing

Beyond providing a robustness check on the results of Section 3, an alternative timing structure where platforms respond with cardholder fees after the merchant sets its price may better reflect certain economic situations. When platforms interact with many (locally monopolistic) merchants and must service many cardholders nationwide, the timing structure of Section 3 where both $f_i$ and $m_i$ are committed to first before any merchant decision is a plausible modeling assumption. For example, if contracts between platforms and merchants and platforms and consumers are relatively long-term, de facto or de jure, while merchant prices can be altered more quickly and easily, the simultaneous pricing game may be a close representation of the interactions among agents. In other circumstances, however, contracts between merchants and platforms may extend over a longer period than contracts between platforms and cardholders and, furthermore, the true fees between cardholders and platforms are not likely to be known (and credibly committed) to merchants before they set their prices. If so, then any initial cardholder fees are not generally sequentially rational.

The timing structure in the following game more accurately captures these features:

*Sequential Platform Pricing*

1) Both platforms simultaneously select merchant fees, $m_i$.

2) The merchant observes both fees and accepts both, one or neither platform.

3) For each accepted platform, $i$, the merchant sets a price, $p_i$, potentially subject to restrictions.

4) Merchant price(s) are observed and each accepted platform, $i$, sets cardholder fee, $f_i$.

5) For each accepted platform, $i$, consumers observe $(f_i, p_i)$: If both platforms are accepted, transactions via platform $i$ are given by $D^i(p_1 + f_1, p_2 + f_2)$; If only platform $i$ is accepted, transactions via platform $i$ are given by $\bar{D}^i(p_i + f_i)$ and no transactions occur via platform $j$; If no platform is accepted, no card transactions occur.

The timing structure of this alternative pricing game implies that given the merchant fees set by the platform and the subsequent merchant prices, the two platforms
play a subgame in cardholder fees, $f_1, f_2$. In order to apply the natural solution concept, subgame perfection, we need to determine how the equilibria of these subgames vary with the the prior selected fees and prices, $(m_1, m_2)$ and $(p_1, p_2)$. This requirement restricts our ability to provide general results; however, the linear-quadratic preference (LQ) case is tractable and offers useful insights. In particular, merchant and platform best responses with a NSR mirror in many ways those of the simultaneous structure and indicate that the leapfrogging incentive for increasing the gap between merchant discounts and cardholder fees that leads to non-existence is present in a sequential game as well.

4.1 Equilibrium Behavior in the Continuation Game

With or without the NSR, the subgame perfect equilibrium is obtained by first finding the equilibrium of the subgame where platforms select cardholder fees given merchant prices and merchant fees, $(m_1, m_2)$. Anticipating these equilibrium fees and given any pair of merchant fees: if there is no NSR and both platforms are accepted, the merchant then selects $(p_1, p_2)$; if there is an NSR and both platforms are accepted, the merchant selects a single price, $p$; if the merchant accepts only a single platform, $i$, the merchant selects $p_i$. Anticipating this behavior, the platforms select $(m_1, m_2)$.

In the LQ model, platform demand is given by (2). Using $P_i = p_i + f_i$, we can generate platform best responses in $f_i$ as

$$f_i(f_j) = \frac{(1 - \gamma + \gamma p_j - p_i + C - m_i + \gamma f_j)}{2}$$

This is a familiar linear game in strategic complements (see for example Vives, 2001 pp. 159-160) and the equilibrium in cardholder fees satisfies

$$f_i(p_1, p_2, m_1, m_2) = \frac{2A_i + \gamma A_j}{4 - \gamma^2},$$

(6)

where

$$A_i \equiv 1 - \gamma + \gamma p_j - p_i + C - m_i.$$

Setting $p_1 = p_2$ yields the equilibrium cardholder fees with a NSR in place and setting $\gamma = 0$ yields the fees with a single platform. With this equilibrium behavior, a merchant then selects prices to maximize profits. This analysis enables us to characterize the continuation equilibrium in any subgame given merchant fees, $(m_1, m_2)$ and a merchant’s acceptance decision over platforms.
No NSR. In a market with no NSR, neutrality implies that quantities and profits depend only on the total fees, \((t_1, t_2)\). To see this, fix any \(m_1, m_2\). Suppose \(p_1, p_2, f_1, f_2\) are the equilibrium prices that maximize merchant profits given that the subsequent \(f_i\) are determined by (6). The corresponding quantities are \(q_i = D_i(p_1 + f_1, p_2 + f_2)\). Now suppose a different pair of merchant fees, \(\tilde{m}_1, \tilde{m}_2\), are offered. If the merchant sets prices \(\tilde{p}_i = p_i + (\tilde{m}_i - m_i)\) and the platforms each set cardholder fees \(\tilde{f}_i = f_i - (\tilde{m}_i - m_i)\), then quantities and platform and merchant profits are the same as in the original equilibrium and therefore, this new profile of price and fees forms an equilibrium with the same outcome. This implies that even though platforms set merchant fees first, the outcome ultimately mirrors a vertical chain where the merchant acts as an upstream price-setter, setting \(p_1, p_2\) and platforms then react in an imperfectly competitive way. The equilibrium margins and quantities are then\(^{12}\)

\[
p_i - m_i = \frac{1 - c - C}{2}, \quad q_i = \frac{1 - c - C}{2(1 + \gamma)(2 - \gamma)}. \]

The optimal merchant pricing then yields platform margins as

\[
f_i + m_i - C = \frac{1 - \gamma}{2(2 - \gamma)}(1 - c - C). \]

Observe that, consistent with neutrality, platform margins are independent of the initial stage offer of merchant fees, \((m_1, m_2)\), and platform margins vanish as the degree of differentiation between platforms vanishes (\(\gamma\) approaches one).

Single Platform. If the merchant accepts only a single platform \(i\), the NSR is irrelevant and once again neutrality implies that quantities and profits depend only on the total fee, \(t_i\). The resulting game is one with an upstream supplier, in this case, the merchant, and a downstream firm, platform \(i\). This is a familiar vertical chain with linear demand and double marginalization because of linear pricing. The merchant’s subsequent profits are independent of the merchant fee, \(m_i\), agreed to in the first stage. For the linear-quadratic model, merchant profits are

\[
(1 - c - C)^2 / 8 \tag{7}
\]

while the profits of the accepted platform \(i\) are

\[
(1 - c - C)^2 / 16. \]

\(^{12}\)All calculations for this section are available from the authors.
NSR in Force, Two Platforms. The equilibrium of the merchant pricing subgame is computed by setting $p_1 = p_2 = p$, determining equilibrium $f_i$ and solving the merchant’s maximization problem in $p$. This yields an equilibrium common price

$$p(m_1, m_2) = \frac{1 + c - C + m_1 + m_2}{2},$$

and quantity:

$$q_i = \max\{0, \frac{1 - C - c}{2(2 - \gamma)(1 + \gamma)} + \frac{m_i - m_j}{2(2 + \gamma)(1 - \gamma)}\}.$$  

As in the initial game with alternative timing, when a NSR is in place, sales on platform $i$ increase in the difference between platform $i$’s merchant fee and that of its rival (Lemma 2).

The equilibrium prices imply that, under a NSR, merchant profits are decreasing in the difference in merchant fees (by the same logic as in Lemma 1 of Section 3):

$$\frac{(1 - C - c)^2}{2(2 - \gamma)(1 + \gamma)} - \frac{(m_i - m_j)^2}{2(2 + \gamma)(1 - \gamma)}.$$  

Using the equilibrium price and cardholder fees, the profit margin of each platform for a given profile of merchant fees is

$$f_i + m_i - C = (1 - c - C)\frac{1 - \gamma}{2 - \gamma} + (m_i - m_j)\frac{1 + \gamma}{2 + \gamma}.$$  

Platform $i$’s margin and sales increase in $m_i - m_j$, therefore, its profits increase in this difference as well.

4.2 Behavior in the Full Game

These properties of the continuation game immediately imply a result mirroring Proposition 1 in the previous sections.

**Proposition 3.** In the Sequential Pricing Game with LQ preferences, if both platforms impose a NSR, there is no pure strategy equilibrium with the merchant accepting both.

With a single accepted platform, the Sequential Pricing Game collapses to effectively a two-stage pricing game where the merchant sets price and the platform then sets an optimal cardholder fee (and therefore optimal total fee, $t_i$). This structure enables an explicit derivation of a mixed strategy equilibrium in this game. Define
\( \Delta^* \) to be the maximum difference in platform fees to the merchant such that the merchant is just willing to accept both platforms with a NSR compared to accepting a single platform. Using (9) and (7), this implies

\[
\Delta^* = (1 - C - c) \left( (1 - \gamma)(2 + \gamma) - \frac{(1 - \gamma)(2 + \gamma)}{4} \right)^{1/2}
\]

Note that as \( \gamma \) approaches 1 (perfect substitutes), \( \Delta^* \) approaches zero. Economically, as the platforms become closer substitutes, the merchant’s incremental profit from accepting a second platform decreases. Therefore, to maintain the merchant’s willingness to accept a second platform under a binding NSR, the burden of the NSR must be eased, requiring a smaller gap between the platforms’ merchant fees.

The next result shows that, as platforms become close enough substitutes, there is a mixed strategy equilibrium with a NSR such that the merchant accepts only a single platform, each with equal probability. In such an equilibrium, the platforms can exploit the NSR to weaken the strong competition between them by inducing the merchant to single-home.

**Proposition 4.** Suppose \( \hat{m}_i > \hat{m}_j + \Delta^* \). In the Sequential Pricing Game with LQ preferences, as \( \gamma \) approaches 1, it is an equilibrium for platforms to offer \((\hat{m}_1, \hat{m}_2)\) along with a NSR. The merchant adopts a single platform, rejecting each platform with equal probability.

The logic for Proposition 4 is the following. By accepting a single platform, the merchant renders a NSR irrelevant. Moreover, if a single platform is accepted, neutrality implies that only that platform’s total fee matters, and platform symmetry implies the total fee would be the same whichever platform is accepted. (Regardless of a platform’s merchant fee, the platform’s unique equilibrium total fee is determined by its subsequent choice of cardholder fee, set after the merchant’s price to consumers.) Thus, the merchant is indifferent between the platforms, justifying randomization over acceptance. The merchant prefers this to accepting both platforms with a NSR when their merchant fees differ enough, because the merchant’s preferred prices to consumers will then differ sufficiently that satisfying the NSR becomes too onerous. By adopting a NSR with sufficiently disparate merchant fees, the platforms therefore can ensure that only one of them will be accepted. Finally, when platforms are sufficiently close substitutes, their margins will be arbitrarily small if both are accepted, whereas if only one is accepted, its profit is positive and independent of the degree of substitutability.
5 Discussion

In markets such as credit cards, where a platform sets fees both to merchants and its end users who in turn transact with merchants, several authors have noted that restrictions on merchants’ ability to surcharge platform customers will induce the platform to raise its fee to merchants and lower the fee to users or provide cashback rebates. However, the equilibrium implications of this incentive to increase the fee spread have gone virtually unexplored in the case of competing platforms.\textsuperscript{13} We analyze this case under the traditional assumption that rational consumers care about the total cost of purchases – the merchant’s price plus the platform’s fee (or minus its rebate). No-surcharge restrictions transform a broad range of otherwise well-behaved environments into an environment where pure strategy equilibria in platform fees cannot exist. The restrictions persistently induce strategic platforms to compete by trying to outdo each other’s spread between the merchant fee and user rebate, and the only endogenous brake on attempts to increase the spread is the merchant’s option to drop one or both platforms. In some circumstances, we show that platforms’ recognition of the merchant’s option leads to a mixed strategy equilibrium in which platforms offer very disparate merchant fees along with no-surcharge rules and the merchant randomizes over which platform to accept, an outcome with the flavor of probabilistic market allocation by platforms.

What should one make of the non-existence of pure strategy equilibria? For some two-sided market applications, platforms may not interact with consumers at all or there may be exogenous lower bounds on fees that platforms can charge the consumer side of the market (such as zero). With these constraints, equilibria generally emerge. However, for credit cards, cardholder rebates can be paid and very often are paid and once this capability is recognized the main message of our paper is that the incentive to compete in spreads makes deterministic equilibria in fees very difficult if not impossible to achieve. In many game theoretic models, the absence of equilibrium can often be ‘solved’ by extending or modifying the game. We have made some attempts at this by considering a model of fairly general differentiated demand and alternative timing of moves. The non-existence issue remains robust to these extensions. Nevertheless, there could well be other, significant economic forces not captured by our model that would establish the possibility of equilibrium existence.

Alternatively, should we expect pure-strategy equilibria always to exist? Contractual restrictions can have powerful impacts on the strategy sets and payoffs of

\textsuperscript{13}Except for a short treatment in Boik and Corts (2016), as noted in the Introduction.
firms and they may originally emerge for misguided economic motives or for entirely non-economic reasons. It is plausible that agents impose these restrictions without fully understanding their market implications, including their impact on market equilibrium. However, the possibility that disequilibrium is endemic poses a challenge for industrial organization theorists to predict what behavior will be in such markets. Perhaps these markets will exhibit instability in prices and acceptance decisions. If so, however, is not obvious that this has occurred in credit card markets. Even though there exist some instances of single-homing by merchants, many merchants still accept multiple cards. A key force in our model when a merchant accepts both platforms is an incentive for each platform to continually outdo its rival by increasing cardholder rebates funded by increases in merchant fees. While such leapfrogging behavior has occurred to a limited extent, casual observation suggests that fees in this industry are more stable than our model might indicate.

6 Appendix

6.1 Proof of Lemma 1

Proof. Partially differentiate the expression in (4) with respect to $f_1$ and apply the envelope theorem.

6.2 Proof of Lemma 2

Proof. Fix $t_1, t_2, f_1, f_2$. Set $d = f_1 - f_2$ and note from (3) that $(\hat{P}_1, \hat{P}_1 - d)$ are thus the merchant’s optimal price(s) under the NSR at these prices. This pair is unique by A2). By definition,

$$\Pi_1(\hat{P}_1, \hat{P}_1 - d) + \Pi_2(\hat{P}_1, \hat{P}_1 - d) = 0. \tag{11}$$

Now suppose platform 1 changes its cardholder fee to $f_1 - \delta$ and suppose the merchant chose to raise the common price by $\delta$ so that the new cardholder prices become $(\hat{P}_1, \hat{P}_1 - d + \delta)$. That is, the total cardholder price for platform 1 stays constant, while the total price for platform 2 goes up by $\delta$ because the common merchant price is raised by $\delta$. Observe that by the fundamental theorem of calculus,

$$\Pi_1(\hat{P}_1, \hat{P}_1 - d + \delta) = \Pi_1(\hat{P}_1, \hat{P}_1 - d) + \int_0^\delta \Pi_{12}(\hat{P}_1, \hat{P}_1 - d + \tau)d\tau$$

22
and
\[ \Pi_2(\hat{P}_1, \hat{P}_1 - d + \delta) = \Pi_2(\hat{P}_1, \hat{P}_1 - d) + \int_0^\delta \Pi_{22}(\hat{P}_1, \hat{P}_1 - d + \tau)d\tau \]

Summing the two expressions and using the first order conditions from (11) to eliminate the first term on the right side of each equation, gives
\[ \Pi_1(\hat{P}_1, \hat{P}_1 - d + \delta) + \Pi_2(\hat{P}_1, \hat{P}_1 - d + \delta) = \int_0^\delta \Pi_{12}(\hat{P}_1, \hat{P}_1 - d + \tau) + \Pi_{22}(\hat{P}_1, \hat{P}_1 - d + \tau)d\tau. \]

Assumption A3) implies this is negative. Since the left side is the derivative of merchant profits with respect to price, this means the merchant prefers to lower prices from this point.

Consider the price profile, \((\hat{P}_1 - \delta, \hat{P}_1 - d)\) so that the cardholder price for platform 2 remains the same but for platform 1 falls by \(\delta\). A similar argument to above yields
\[ \Pi_1(\hat{P}_1 - \delta, \hat{P}_1 - d) + \Pi_2(\hat{P}_1 - \delta, \hat{P}_1 - d) = \int_0^{-\delta} \Pi_{11}(\hat{P}_1 + \tau, \hat{P}_1 - d) + \Pi_{21}(\hat{P}_1 + \tau, \hat{P}_1 - d)d\tau \]
\[ = -\int_{-\delta}^0 \Pi_{11}(\hat{P}_1 + \tau, \hat{P}_1 - d) + \Pi_{21}(\hat{P}_1 + \tau, \hat{P}_1 - d)d\tau. \]

The second line just changes the direction of integration and therefore is multiplied by \(-1\). Assumption A3) implies this is positive. Since under the NSR, the derivative of merchant profits with respect to \(P_1\) is positive at the lower end of the interval, \([\hat{P}_1 - \delta, \hat{P}_1]\) and negative at the upper end and since strict quasi-concavity implies that the merchant profits are single-peaked along any ray in \((P_1, P_2)\), this implies that the new optimal cardholder fees involve a lower total price for platform 1 and a higher total price for platform 2, so the gross substitutes property implies that platform 1 use rises and platform 2 use falls.

\[ \square \]

6.3 Proof of Lemma 3

Proof. Suppose, for example, \(\hat{\lambda} > 0\). Platform 1 can lower its cardholder fee \(f_1\) while keeping \(t_1\) fixed (that is, raise \(m_1\) by the same amount). This has no effect on the merchant’s outside option, \(\Pi^S(t_i)\), and by Lemma 1, this raises merchant profits, so the merchant would continue to accept both platforms. By Lemma 2, platform 1 profits rise. A parallel argument holds for platform 2 if \(\hat{\lambda} < 0\). \(\square\)
6.4 Proof of Proposition 1

Proof. We first establish an additional lemma showing that if a platform charges strictly lower total fees under a NSR than its rival, the merchant would continue to accept if the platform raised its total fees slightly:

Lemma 4. Suppose the profile of fees \((t_1, t_2, f_1, f_2)\) are such that \(\hat{\lambda} = 0\) and \(t_1 < t_2\). If the merchant accepts the NSR and there are positive sales through both platforms, merchant profits decline in \(t_i\). For a small increase in \(t_1\), the merchant prefers the NSR to rejecting platform 2.

Proof. Clearly if the merchant were to reject a platform, it would reject the high total fee platform 2. Recall that \((\hat{P}_1, \hat{P}_2, \hat{\lambda})\) is the solution to (CP) using the lagrangian in (4). The assumption that \(\hat{\lambda} = 0\), implies the NSR does not bind and that the derivative of the lagrangian with respect to \(P_i\) at \((\hat{P}_1, \hat{P}_2)\) and must equal zero. Assumption A2) then implies that \((\hat{P}_1, \hat{P}_2)\) also represents the optimal prices given \((t_1, t_2, f_1, f_2)\) under no NSR. The envelope theorem implies that the change in merchant profits with respect to \(t_i\) is (by partially differentiating (4) with respect to \(t_i\))

\[-D^i(\hat{P}_1, \hat{P}_2) < 0.\]

Let \(\tilde{P}_1\) be the optimal price offered by the merchant if it rejected platform 2 and sold only through platform 1. Again, the envelope theorem implies that the change in merchant profits with respect to a small increase in \(t_1\) is

\[-D^1(\tilde{P}_1)\]

Assumption A4) implies that this decline in profits is more than the decline in profits under the NSR, therefore if the low total fee platform 1 raised \(t_1\) slightly (which in this case implies raising \(m_1\) as we are partially differentiating) the merchant would continue to accept both platforms and the NSR instead of accepting only platform 1. \(\square\)

Lemma 3 implies that in any equilibrium, \(\hat{\lambda} = 0\), so the NSR does not bind.

First, suppose \(t_1 = t_2\) in an equilibrium and let \(p\) be the uniform merchant price. Since the NSR does not bind, this must imply \(f_1 = f_2\). Suppose not. Consider the equilibrium prices under no NSR. A2) implies this is unique in \((t_1, t_2)\) and neutrality implies that equilibrium quantities and, therefore, consumer prices depend only \((t_1, t_2)\). Symmetry and the hypothesis that \(t_1 = t_2\) imply that \(p + f_1 = P_1 = P_2 = 24\)
This implies \( f_1 = f_2 \). Since the platforms are not perfect substitutes, then the merchant does strictly better accepting the NSR and both platforms than rejecting one platform. But, then Lemma 2 implies each platform would increase profits by lowering \( f_i \) holding \( t_i \) fixed so this cannot be an equilibrium.

Therefore, suppose \( t_1 < t_2 \) and \( \hat{\lambda} = 0 \). Lemma 2 implies that the merchant’s participation constraint must bind, otherwise, each platform has an incentive to raise \( m_i \) and lower \( f_i \). We show that at least one platform will wish to change its \( t_i \) thus contradicting the assumption of an optimum.

Lemma 4 implies that \( t_1 \geq r^1(t_2) \). To see this, note that if \( t_1 < r^1(t_2) \), Lemma 4 shows that platform 1 can raise \( t_1 \) and the merchant will still accept the NSR. Since platform profits are strictly quasi-concave in \( t_1 \), platform 1 will prefer the higher \( t_1 \) so we cannot be at an equilibrium. Therefore, \( t_1 \geq r^1(t_2) \).

Symmetry and A1) imply that the equilibrium of the platform game with no NSR is symmetric, say \((\hat{t}, \hat{t})\). Assumption A1) implies \( t_2 > t_1 \) and \( t_1 \geq r^1(t_2) \) if and only if \( t_1 > \hat{t} \). This is because the inverse of platform 1’s best response function, \( r^1(\cdot) \) has slope greater than one in \((t_1, t_2)\) space and, so, crosses the line \( t_1 = t_2 \) from below at \( \hat{t} \).

Assumption A1) also implies that \( t_1 \geq \hat{t} \) if and only if \( t_1 \geq r^2(t_1) \) \( (r^2(\cdot)) \) crosses the line \( t_1 = t_2 \) exactly once and does so at \( \hat{t} \) from above since \( r^2(\cdot) < 1 \). Thus, \( t_1 > \hat{t} \) if and only if \( r^2(t_1) < t_1 \). But this then yields, \( t_2 > t_1 \geq r^2(t_1) \).

Since platform 2 profits are strictly quasi-concave, this implies platform 2 would like to lower \( t_2 \) and Lemma 4 implies the merchant would continue to accept the NSR with the lower \( t_2 \) since the merchant’s single-homing option (accepting only platform 1) is unchanged and merchant profits under an NSR increase with a decline in \( t_2 \). \( \square \)

### 6.5 Proof of Proposition 2

**Proof.** Note that the proof of Proposition 1 applies in this case as well if it can be shown that with a single NSR, \( \hat{\lambda} = 0 \) is necessary for a pure strategy equilibrium. Therefore, suppose \( \hat{\lambda} > 0 \) at an equilibrium profile of fees such that the NSR from platform 2 is accepted by the merchant. Lemma 1 implies that merchant profits under an NSR rise as \( f_1 \) falls holding all other fees constant, thus the merchant continues
to accept both platforms (since $t_i$ is held fixed, its outside option has not changed). Lemma 2 implies that since the NSR strictly binds, platform 1 sales rise and platform 2 sales fall as $f_1$ falls. Thus, it is feasible for platform 1 to lower $f_1$ and raise $m_1$, keeping $t_1$ fixed and its profits would rise.

6.6 Proof of Proposition 3

Proof. Equation (8) implies that, assuming the merchant accepts a NSR, profits of platform $i$ increase in $m_i - m_j$. Suppose a NSR equilibrium exists with, say, $m_1 < m_2$. Merchant profits must be weakly greater under the NSR than what could be earned by rejecting one platform, (7). Equation (9) illustrates that merchant profits with a NSR strictly increase if platform 1 raises $m_1$ slightly (and therefore, the merchant would continue to accept the NSR) and equations (10) and (8) show that platform 1 profits rise as well. So $m_1 < m_2$ cannot be a best response. Similarly for the case $m_2 < m_1$. If $m_1 = m_2$, equations (9) and (7) imply that the merchant gets strictly higher profits with both platforms than with one (assuming that the platforms are not perfect substitutes, $\gamma < 1$) so each platform could raise its $m_i$ slightly, increase its profits and still have the merchant accept.

6.7 Proof of Proposition 4

Proof. If the merchant single-homes, neutrality implies that the continuation game is independent of $m_i$ and merchant profits are given by (7) no matter which platform it selects to single-home with. Therefore, (conditional on single-homing) randomizing over platforms is a best response for the merchant. By definition of $\Delta^*$ and equation (9), a merchant will never accept both platforms with this profile of merchant discounts and a NSR. As $\gamma$ approaches 1, (10) shows that platform profits approach zero when a NSR with both platforms is accepted for any $|m_i - m_j| \leq \Delta^*$, while platform profits under single-homing, $(1 - c - C)^2 / 16$, are bounded above zero. The proposed equilibrium, then, offers platforms higher equilibrium profits than either a market with no NSR, or one in which merchant discounts are such that the merchant would accept both platforms and a NSR.
7 References


