Part III

VERTICAL RESTRAINTS
PRIVATE LABELS, DUAL DISTRIBUTION, 
AND VERTICAL RESTRAINTS—AN 
ANALYSIS OF THE COMPETITIVE EFFECTS

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A. Introduction

This chapter explores how participation of a retailer in the supplier’s market via a private label and participation of a supplier in the retail market via dual distribution impacts on the anticompetitive effects of vertical restraints.

The existence of a private label can impact on the anticompetitive effect of vertical restraints in two principle ways. On one hand, the private label often constitutes presence of the retailer in the supplier’s market, thereby creating horizontal competition between the retailer and the supplier in the supplier’s market. Restraints limiting the retailer’s operation of the private label, therefore, resemble horizontal restraints among competitors and deserve harsher antitrust treatment than purely vertical restraints. On the other hand, as this chapter shows, if a retailer and a supplier adopt vertical restraints that do not limit the retailer’s ability to operate his private label, the existence of the private label could actually weaken the anticompetitive effect of all vertical restraints but for exclusive distribution.

Interestingly, in contrast to this latter finding, the EC Commission Block Exemption for Vertical Restraints treats most vertical restraints in the presence of a private label as horizontal in nature, thereby, for the most part, disqualifying them from the exemption. Accordingly, a change in the EC block exemption’s application is warranted.

On the other hand, as this chapter shows, the block exemption’s treatment of dual distribution cases, in which the supplier party to a vertical restraint also controls a distribution outlet, is too lenient with respect to certain types of vertical restraints. In particular, restraints that eliminate competition between the supplier’s retail outlet and competing retailers may harm competition more than similar vertical restraints absent dual distribution. This is particularly shown to be the case when the supplier’s profits stem from charging an above-cost price per unit. Similarly, with regard to non-compete clauses and price matching policies, account should be taken of the supplier’s retail unit when calculating the percentage of the retail market that is foreclosed from competing suppliers. In fact, exclusive distribution is the only vertical restraint in which the presence of dual distribution warrants a more lenient treatment of the vertical restraint.

B. Why are Vertical Restraints Treated Less Harshly than Horizontal Restraints?

As mentioned in the introduction, one important feature of private labels and dual distribution is that they could turn a supplier and a retailer into competitors...
in the supplier’s or retailer’s market, thereby making some of the restraints in their contract ‘horizontal’ in nature. Accordingly, in order to better understand the way private labels or dual distribution affect the anticompetitive nature of vertical restraints, it should be made clear why vertical restraints deserve a more lenient treatment than horizontal restraints. There are two main reasons for this difference in treatment.

First, when there is a vertical relationship between a supplier and a retailer, the parties can use the legitimate terms of their contract to achieve anticompetitive effects even in the absence of vertical restraints. To illustrate, if a supplier has the power to raise prices and is interested in a high retail price, he can induce retailers buying from him to raise their retail price even without restraints forcing them to do so. All the supplier needs to do is elevate the wholesale price he charges his retailers. This would inflate their marginal costs, thereby compelling them to raise the retail price. Similarly, such a supplier could simply sell his retailers smaller quantities, thereby compelling them to reduce the quantity of the supplier’s brand they sell, even absent a vertical restraint imposing maximum quantities upon retailers. This point is especially relevant when the supplier and retailer’s contract includes not only a wholesale price per unit but also a fixed fee. In such a case, it is not obvious, for example, that a vertical restraint eliminating competition between retailers, such as dictation of the retail price, or division of retailers into exclusive territories, will raise the retail price. This is because if competition between retailers is eliminated, the supplier is expected to lower his wholesale price per unit, so as to maximize retailers’ expected profits. This would enable the supplier to collect a higher fixed fee. Absent the vertical restraint eliminating competition among retailers, retailers do not expect to make substantial profits, and the fixed fee they are willing to pay the supplier goes down. Here, the supplier’s profits must stem from an inflated wholesale price. An inflated wholesale price inflates the retailers’ marginal costs, and, moreover, creates double marginalization, that typically cause the retail price to be even higher than with the vertical restraint.\footnote{For more details about this point see Section F below and the literature cited there.}

The ability to achieve anticompetitive outcomes through legitimate parameters of the agreement such as the wholesale price charged by the supplier and the quantity he sells does not exist with regard to pure competitors. Competitors generally have no such legitimate mechanism that could be used to achieve anti-competitive outcomes. They need explicit restraints, such as cartels, market division, practices facilitating cartels, etc., in order to achieve such outcomes.
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This is one explanation why horizontal restraints deserve more scrutiny: without them, it would be difficult for the parties to harm competition.

The second reason for treating vertical restraints more leniently is that when the supplier derives profits from the wholesale price he charges retailers (i.e., a profit per each unit sold), profit maximization on his part requires him to insist on as much competition as possible among retailers. This is because such competition would increase the number of units sold, thereby elevating the supplier’s profits. Similarly, such a supplier would be interested in the retailers providing optimal services (at least from the point of view of the marginal customer—i.e., the first customer to stop purchasing the product if the price were to go up slightly). As for the retailer, since his profits are typically rising when the supplier’s power to raise prices is limited, the retailer too would not want to engage in a restraint which enhances the supplier’s market power.

The Guidelines on Vertical Restraints² acknowledge this second reason for treating vertical restraints leniently and stipulate that:

Vertical restraints are generally less harmful than horizontal restraints. The main reason for treating a vertical restraint more leniently than a horizontal restraint lies in the fact that the latter may concern an agreement between competitors producing identical or substitutable goods or services. In such horizontal relationships the exercise of market power by one company (higher price of its product) may benefit competitors. This may provide an incentive to competitors to induce each other to behave anticompetitively. In vertical relationships the product of one is the input for the other. This means that the exercise of market power by either the upstream or downstream company would normally hurt the demand for the product of the other. The companies involved in the agreement therefore usually have an incentive to prevent the exercise of market power by the other.

Accordingly, if such a supplier and retailer agree on vertical restraints, this could be explained by the need to alleviate inefficiencies in distribution or supply, such as free riding,³ hold-out problems, inventory decisions,⁴ information problems,⁵ moral hazard,⁶ or other externalities between the parties causing them to have inadequate incentives to efficiently promote the product absent the vertical

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restraint. Alleviation of such inefficiencies in distribution or supply may well be to the benefit of consumers.

C. Harm to Interbrand versus Intrabrand Competition

As is well known in antitrust policy, vertical restraints that harm interbrand competition—competition between competing brands—should be treated more harshly than restraints that merely harm interbrand competition—competition between competing retailers of the same brand. To be sure, as shown in the economics literature, some limitations on interbrand competition may also cause harm to interbrand competition, as will be highlighted in several of the following sections. Nevertheless, it is undisputed that the stronger interbrand competition is to begin with, the smaller the anticompetitive threat of vertical restraints. In what follows we shall examine the various types of vertical restraints and the way the existence of a private label or dual distribution affects their anticompetitive nature.

D. Limits on the Sale of the Private Label

This section considers the competitive effects generated through limitations on the sale of private label itself, when the retailer controls the supply of his private label. When the retailer agrees with a supplier to limit the retailer’s ability to sell his private label to consumers, the restraint should typically be viewed harshly, as a horizontal rather than a vertical restraint. In essence, such a restraint resembles the commitment on the part of a potential competitor to limit his ability to compete. Such ‘non-competition clauses’ or market divisions among competitors or potential competitors are typically dealt with harshly as horizontal restraints.

Note, however, that in order to analyse restraints limiting the retailer’s ability to sell his private label it is essential to determine what the private label exactly constitutes. If the retailer purchases his ‘private label’ from an independent supplier, but just replaces the supplier’s brand name with his own label name for

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8 See: Commission Guidelines (n 2) para 102.

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the product, then restraints that limit the retailer’s ability to sell his private label are almost purely vertical, rather than horizontal, and generally should be treated with the same scrutiny as vertical restraints limiting the retailer’s ability to buy from an independent supplier. For example, a retailer’s promise to supplier A not to buy from other suppliers (including suppliers who provide the retailer with the product to be branded according to the retailer’s ‘private label’) resembles a so-called vertical non-compete agreement and should be treated as such.\(^{10}\)

The situation is different, however, when the retailer has substantial control over the operations of the facility supplying the product to be privately labelled. In such a case, a commitment on the part of the retailer to refrain from holding the private label resembles a horizontal restraint to limit the retailer’s operation in the supplier’s market. This would be the case whenever the retailer’s efforts are a key to the very existence of an establishment operating in the supplier’s market. From an economic perspective, the retailer’s commitment to limit the sales of his private label, in such a case, also may limit the additional capacity and variety of supplies the retailer could have contributed to the supplier’s market. In other words, in order to analyse the competitive effects of vertical restraints in the presence of a ‘private label’ one must distinguish between two different situations: (a) the retailer purchases the product from an independent supplier already operating in the supply market and sells the product under the retailer’s own label; and (b) the retailer initiates (or is a key factor in) the production process itself. For example, the retailer invests in expansion of a small supplier’s plant so as to accommodate the retailer’s requirements for its own label; or the retailer invests in the construction of a new plant to be used to supply the retailer’s requirements for its own label, and so forth. Another case that could correspond to possibility (b) is that the retailer adds or helps add capacity to the wholesale level, e.g. by investing in supply channels, warehouses, insurance, packaging, and so forth needed in order to add wholesaling capacity that would accommodate the retailer’s need for his own label. The latter type of ‘private label’ is the one I focus upon here.

In the former type of a ‘private label’, which I am not focusing upon in this chapter, the retailer is not a key to the addition of new capacity at the supply level. He simply purchases existing capacity from an independent supplier. Presumably, before the creation of the retailer’s private label, this independent supplier used its capacity for other channels in the supply market of the product, such as the sale of the product in the branded sector. Once the independent supplier, instead, routes some or all of its capacity to sales ending up as the retailer’s private label,\(^{10}\) Such a vertical restraint may, according to Article 5(a) of the Block Exemption Regulation (n 7), enjoy the exemption defined by the regulation if it is limited to a five-year period.
his relationship with the retailer is purely vertical and restraints between them, or between this retailer and other suppliers, should be analysed in a similar way to any other vertical restraint. Of course, the fact that the product is sold under the retailer's own label may bear on the analysis of these vertical restraints. For example, to the extent that the retailer’s profits from selling his own label are higher than its profits from selling branded goods, the retailer may have an incentive to give more shelf space to his private label and less shelf space to the branded goods.

These, however, are not the type of concerns this chapter focuses on. In essence, when the retailer buys the 'private label' from an independent supplier, and is not a key to the addition of capacity to the supply market due to the private label, it cannot be said that the retailer is really operating in the supply market, and that its relationship with other suppliers is horizontal.

A commitment not to hold a private label

If a retailer commits to the supplier that he will not have a private label, the question is if such a restraint should be treated as a horizontal non-competition clause or a vertical restraint similar to a non-compete clause. Naturally, if the retailer promises not to enter the supplier’s market, the restraint resembles a horizontal non-competition clause. The restraint prevents the entry of an additional supplier (namely, the retailer) into the supplier’s market. Even though this new supplier (the supplier of the private label) may have been focused on selling exclusively to this retailer, interbrand competition is harmed. Suppose, for example, that there are two suppliers, supplier A and supplier B, in the relevant supplying market, and two retailers, retailer A and retailer B, in the relevant retailing market. If retailer A holds his own private label, in addition to supplier A and B’s brands, interbrand competition between the different suppliers would intensify, even if the third brand could be found only in retailer A’s outlet. Thus, a commitment on the part of the retailer not to hold his own private label potentially harms interbrand competition in a way similar in spirit to a commitment on the part of a potential entrant into the suppliers’ market not to enter.

To be sure, when the retailer enters the supplier market with his own label, vertical integration between this retailer and its supply outlet is created. As is well known, vertical integration can at times foreclose competitors.11 In particular, the retailer will naturally want to dedicate more of its shelf space to its own label, leaving less of its shelf space to other suppliers. When the retailer controls a large

portion of retail facilities in the relevant market, this could cause other suppliers to shrink, or at times even exit the market. In the long run, interbrand competition could be harmed, since fewer significant suppliers would be present, despite the new entry of the retailer’s private label. On the other hand, vertical integration has its virtues. Because the retailer will purchase the private label at cost, its entry into the supply market eliminates double margins and tends to lower retail prices charged for the private label. Other economic theories show that the presence of the private label (particularly of poor perceived quality) could actually induce branded suppliers to raise their prices.12

Entry of the retailer into the suppliers’ market, by the introduction of his private label, creates vertical integration. A commitment on the part of the retailer not to introduce a private label prevents such vertical integration. Hence, if we believe the disadvantages of vertical integration outweigh its advantages in a particular case, this factor could work in favour of a commitment on the part of the retailer not to create a private label. Still, such a commitment is horizontal in nature. Absent the commitment, there would have been more brands competing with each other in the supply market. This is why close scrutiny of such a commitment, resembling that of horizontal restraints, is in place.

Financial incentives to sell less of the private label

If the contract between the retailer and a supplier incentivizes the retailer to sell less of the private label (and more of the supplier’s brand) this too is quite similar to a horizontal restraint inducing a competitor of the supplier to partially withdraw from the supplier’s market. Suppose, for example, that the supplier of a ‘must stock brand’ offers the retailer bonuses that hinge upon the retailer purchasing a substantial percentage (e.g., above 50 per cent) of his needs in a certain category of products from the supplier. In such a case, the retailer’s incentives to distribute his private label are harmed. The effect is similar to a competing supplier receiving a bonus from the supplier for mitigating his sales in competition with the supplier’s brand. Such restraints, accordingly, should be treated harshly, as horizontal in nature.

Limitation of shelf space devoted to the private label

A similar result would evolve if the retailer agrees not to devote shelf space above a certain threshold to his private label or devote inferior shelf space to his

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12 See: T S Gabrielson and L Sogard, ‘Private Labels, Price Rivalry, and Public Policy’ [2007] 51 European Economic Review 403, (showing that under certain conditions branded goods are priced at a higher level in the presence of a private label of lower quality.)
private label. Such a commitment limits the quantity sold of the private label in a way that also limits its ability to restrain anticompetitive pricing or behaviour by the suppliers of the other brands. It, too, should be treated as harshly as an ordinary horizontal restraint in which a competing supplier agrees to limit his sales in competition with the supplier’s brand. On the other hand, the foreclosing effects inherent in the existence of the private brand would also be mitigated by such a commitment. The latter factor could mitigate the potential anticompetitive effect.

Commitment to a minimum price or maximum quantity of the private label

Similarly, if the retailer commits not to charge a price for its private label below a certain floor, or sell quantities of its private label above a certain ceiling, this harms the private label’s potential for restraining anticompetitive pricing or quality on the part of competing brands and therefore harms interbrand competition in a way similar to a horizontal price fixing or quantity fixing agreement.

Territorial division with regard to the private label

In the same vein, when a retailer agrees with a supplier to sell his private label only in certain territories and not in others, interbrand competition in the territory in which the private label will not exist due to the restraint may be harmed. In particular, if this territory constitutes a relevant geographic market, consumers in this market find other territories as not interchangeable with this territory. They will enjoy less intense interbrand competition due to the restraint. Such a restraint is similar in nature and effect to a horizontal market division agreement among competing suppliers, which, of course is treated harshly by antitrust law. Again, since such a restraint mitigates the presence of the private label in certain areas, the harsh effects of vertical integration, to the extent they exist, would also be mitigated. This could alleviate at least part of the anticompetitive concerns.

E. Vertical Restraints Not Concerned
With the Private Label

The analysis is substantially different when the retailer does not limit its behaviour with regard to its own label but rather engages in vertical restraints not

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13 See text above accompanying n 11.
14 See text above accompanying n 11.
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connected to the private label, while holding its own label. The way the analysis changes depends on the type of restraint, as the following paragraphs reveals.

Resale price maintenance and exclusive territories

Suppose a retailer is subject to a supplier's dictations as to the resale price or the geographic area (or consumer segment, etc.) in which the supplier's brand is sold by the retailer while, at the same time, the retailer also sells his own private label. How does the fact the retailer holds a private label affect the anticompetitive effect of these vertical restraints?

A formalistic view might treat such restraints more harshly than absent a private label, because the private label supposedly turns the retailer into the supplier's competitor, making agreements between them 'horizontal' in nature rather than vertical. This is a view that classifies a restraint as 'horizontal' or 'vertical' according to the nature of the parties rather than the nature of the restraint; since the parties compete (in the sense that the retailer also operates in the supplier's market by owning the private label) the formalistic view sees the agreement as horizontal, thereby deserving strict review.

I wish to forward, however, a more substantive view, based on the economic analysis of the situation. When the retailer holds a private label, interbrand competition is by definition more fierce than when the retailer does not hold a private label. Hence, the existence of a private label can only weaken the harm to competition involved in these vertical restraints.

In particular, when the supplier dictates the territory or minimum price in which the retailer may sell the supplier's brand, this could at times cause the price of the supplier's brand (and possibly competing brands) to go up, either because competition among suppliers will be softened due to the elimination of competition among the supplier's retailers, or because the elimination of competition among the supplier's retailers helps the supplier commit to charging higher wholesale prices. But the more fierce interbrand competition is to begin with, the weaker are these price-raising effects and hence the weaker the harm to competition.

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As before, the type of 'private label' I am focusing upon throughout is where the retailer is a key player in the supply market with respect to the private label. As noted above, vertical restraints in the presence of the other type of 'private label'—that purchased from an independent supplier and simply 'stamped' by the retailer as his own—are, from an economic perspective, very similar to regular vertical restraints.


See e.g.: D Gilo, 'Retail Competition Percolating Through to Suppliers, and Using Vertical Integration, Vertical Restraints and Tying to Stop It' [2003] 20 Yale Journal on Regulation 25, 57–81.
This is why the existence of the private label is likely to weaken the anticompetitive effect.

Non-compete clauses

Suppose now that a retailer holding a private label promises a supplier that, apart from the supplier’s brand and the private label, the retailer will refrain from holding competing brands. Here, again, either a formalistic or substantive view may be applied. According to the formalistic view, the retailer and supplier are competitors on account of the retailer’s private label. Hence the agreement between them is between competitors and should be treated harshly, in a way similar to the treatment of horizontal restraints. According to the substantive view, however, which I support, the existence of the private label should generally have an opposite effect on the legal treatment of the restraint.

Absent a private label, the non-compete agreement demands that the retailer hold only the supplier’s brand. Hence consumers located in the geographic market or markets in which the retailer operates, particularly those who prefer this retailer over other retailers, will have no choice of brands other than the supplier’s brand. Moreover, if the retailer is an important distribution channel for competing suppliers, they might be induced to shrink or exit the market.

With a private label, both these anticompetitive effects are mitigated. Consumers in the retailer’s geographic market will have more variety, they can choose between the supplier’s brand and the retailer’s private label. Also, even if competing suppliers are foreclosed from the supplier’s market, at least the private label is not.

The preceding paragraphs have compared the effects of a non-compete agreement without a private label to those with a private label. Another type of agreement that the non-compete agreement with a private label could be compared to is a promise to a supplier to grant him a substantial (although not total) percentage of the retailer’s shelf space. Without the private label, when a retailer commits a certain percentage of shelf space to a particular supplier, at least the rest of the retailer’s shelf space is open to competing suppliers. If the retailer owns a large percentage of retail outlets in the relevant market, this available shelf space is often important for the viability of competing suppliers. When, on the other hand, the retailer has a private label, a substantial portion of his shelf space would naturally be devoted to the private label. This would leave less shelf space available to other suppliers compared to a retailer that does not own a private label. This factor should be taken into account when assessing such an agreement in the presence of a private label. Still, the point made in the preceding paragraphs is still in tact: The non-compete agreement is still less harmful than a full exclusivity non-compete agreement absent a private label. In the latter case, all of
the retailer’s shelf space is dedicated to a single supplier. With a private label, on the other hand, some of the shelf space is dedicated to an independent supplier, and another supplier has access to the retailer’s shelf space, namely, the private label, thereby increasing interbrand competition.

**Exclusive distribution**

Unlike the previous vertical restraints in this section, where the existence of the private label actually mitigated the anticompetitive threat, the anticompetitive effect of an exclusive distribution agreement may be exacerbated with a private label. In an exclusive distribution agreement, the supplier commits to sell his brand solely to the retailer, who also holds a private label. Since this retailer will then be the only retailer pricing and selling the supplier’s brand, the retailer is likely to eliminate price competition between the supplier’s brand and the private label. In the case of this particular restraint, the horizontal relationship between the supplier and the retailer (in his role as supplier of his private label) is more than a formality. The retailer actually acts as an entity setting retail prices among two rivals in the suppliers’ market, and this particular case should be treated with high scrutiny, as other horizontal pricing restraints between suppliers are treated.

**Most favoured customer clauses**

A most favoured customer clause is a commitment on the part of the supplier not to discriminate against the retailer, i.e., not to grant competing retailers better terms than those of the retailer. This too is a vertical restraint. As the economics literature shows,\(^\text{18}\) the anticompetitive threat from such restraints lies in the fear that the supplier will be less inclined to cut prices due to the most favoured customer clause. This may produce both unilateral anticompetitive effects (i.e., prices might rise even absent ongoing collusion) and coordinated anticompetitive effects (i.e., ongoing collusion is liable to be more stable).

The so-called unilateral effects may arise when the most favoured customer clause is retroactive in application, and competition among suppliers is imperfect.\(^\text{19}\) By ‘retroactive’ application it is meant that the supplier promises a retailer (say, ‘retailer A’) that if at a certain point another retailer receives better terms

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\(^{19}\) See: Cooper (n 18).
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than retailer A, retailer A will not only receive these terms from then on but will also be compensated retroactively for his previous purchases. By ‘imperfect competition’ among suppliers it is meant that there are only a few suppliers in the relevant market and price, even absent ongoing collusion, does not go all the way down to marginal cost, despite competition, due to market imperfections such as product differentiation, capacity constraints, and so forth.

The coordinated effects of most favoured customer clauses may arise even when they are not retroactive in nature. This is because such clauses could make price-cuts by the supplier more transparent to his rivals, or make price cutting less profitable in other ways, including the prevention of selective price cuts made only to new customers, and so forth.

How does the existence of a private label affect the anticompetitive effects of most favoured customer clauses? Similarly to the vertical restraints discussed in the previous paragraphs, these anticompetitive effects could in fact be mitigated when a private label exists. As explained above, these anticompetitive effects hinge on the imperfect nature of interbrand competition in the supplier’s market. The more numerous are substantial competing brands, the weaker the potential price rise within the above-mentioned unilateral effect, and the less likely collusion is to be stable under the coordinated effect. Since the existence of the private label enhances interbrand competition, the above-mentioned competitive threats stemming from most-favoured customer clauses are mitigated.

Price matching

Another type of vertical restraint that deserves consideration is price matching, where the supplier promises the retailer that he will match price-cuts made by competing suppliers. This restraint too may possess both unilateral and coordinated effects. The unilateral effects stem from the fact that the supplier could use price matching in order to grant price concessions and competitive prices only to informed buyers, who ‘shop around’ for competing offers and utilize the price matching guarantee. This induces the supplier to raise the price it charges uninformed buyers, who do not seek offers from competing suppliers. The coordinated effect of price matching restraints stems from the fact that the supplier’s rivals may find deviation from a collusive scheme less profitable, since stealing the supplier’s informed buyers would be more difficult. A related threat

21 Ibid, ch 5.
22 See: Baker (n 18), Edlin (n 18).
23 Edlin (n 18).
24 Edlin (n 18).
to competition is that the supplier’s rivals may be foreclosed from the market by the price matching guarantee, given that many retailers would be induced to stick with the supplier and not transfer their purchases to the competing suppliers.

Again, all of these anticompetitive effects are weaker the fiercer is interbrand competition. Since the existence of a private label intensifies interbrand competition, it can only help alleviate the anticompetitive effect of price matching. Still, when the concern is of suppliers’ foreclosure, one should take into account that, in addition to the price matching supplier, to whom the retailer might wish to stick, the retailer is also inclined to devote the rest of his shelf space to his private label. But note that the foreclosing effect is not greater than the one that exists without a private label. Absent a private label, a supplier’s price matching guarantee could induce the retailer to devote all or almost all of his shelf space to this supplier, and foreclosure of other suppliers is as likely.

F. Dual Distribution

Dual distribution takes place when a supplier operates a retail outlet in competition with the retailer. As in the case of a private label, the existence of dual distribution affects the analysis of different vertical restraints in different ways. Let us separate, therefore, the different vertical restraints.

Restraints eliminating or restricting interbrand competition

With regard to vertical restraints that eliminate or limit competition among retailers, the existence of dual distribution could intensify the anticompetitive effect. This is because when the supplier is also a retailer his incentives are changed in a way that favours less competitive pricing and behaviour on the part of retailers than when the supplier does not operate a retail outlet.

This is not to say that the anticompetitive effect of eliminating interbrand competition is the same with dual distribution as with a purely horizontal restraint. Still, in certain cases, this anticompetitive effect is stronger than that of purely vertical restraints. To see why, recall the two reasons for treating vertical restraints more leniently. The first reason was that when the supplier’s contract with his retailers includes a fixed fee and a wholesale price per unit, then absent the vertical restraint, the supplier often can and will cause the retail price to be even higher than with the vertical restraint.

The second reason, which is of particular interest in the current context, was that when the supplier’s profits rely on the wholesale price per unit it charges retailers, the supplier should normally not be interested in eliminating competition among
his retailers, because this will reduce the number of units sold and harm the supplier’s profits. In such a case, as the argument goes, if the supplier did eliminate competition between retailers, it is likely to be due to the supplier’s incentive to solve imperfections in distribution, such as retailers’ free-rider problem or their lack of sufficient incentives to grant services that consumers want. This latter incentive may at times coincide with consumers’ preferences. But it is this second consideration favouring a lenient treatment of vertical restraints that becomes weaker when the supplier also operates his own retail outlet. In such a case, there is another reason the supplier may want to eliminate competition among retailers other than solving imperfections in distribution: his willingness to raise the profits of his retail outlet. The extent to which the second consideration becomes weaker in the presence of dual distribution, however, depends on the circumstances of each case. In particular, the consideration becomes of less weight the more the supplier’s profits depend on the wholesale price per unit and the less they depend on the fixed fee. Let us analyse this last point in more detail below.

Ideally, a supplier that eliminates competition among his retailers would maximize his profits by charging retailers a fixed fee that is based on their expected profits, while reducing the wholesale price per unit to the supplier’s marginal costs. This would eliminate problems of so-called ‘double marginalization’ that harm the supplier’s and retailers’ joint profits. In such an ideal case, the second above-mentioned consideration in favour of treating vertical restraints leniently is irrelevant. Here only the first consideration in favour of the lenient treatment holds. Dual distribution would not change the economic analysis, as will be explained below.

At times, however, due to insufficient information, retailers are not willing to pay a large fixed fee even when competition among retailers is eliminated. For example, a retailer that does not know in advance how high his profits will be may prefer paying the supplier an above-cost wholesale price per unit and a relatively small fixed fee. As mentioned, the more the supplier’s profits depend on the above-cost wholesale price per unit and the less they depend on fixed fees, the stronger is the second argument mentioned above in favour of treating vertical restraints leniently. Recall that this argument is based on the fact that such a supplier would not be interested in eliminating competition among retailers, and if he does so, it must be to solve distortions in distribution, such as free riding. But, as noted, this second argument is weakened when the supplier is also a retailer, because in his capacity as a retailer the supplier would be interested in eliminating retailer competition.

On the other hand, the less the supplier relies on the wholesale price for his profits vis-a-vis the retailer, the weaker is the second above-mentioned consideration in
favour of a lenient treatment for vertical restraints. For example, suppose that
with a restraint eliminating interbrand competition the supplier sells to the
retailer for a price per unit equal to the supplier’s marginal costs of production
and derives his profits only from fixed payments (that do not depend on retailer’s
actual sales) the supplier receives from retailers. In such a case, even without dual
distribution, the supplier would want minimal competition and maximum prof-
its on the part of retailers. This is because the higher retailers’ profits are, the
higher are the fixed fees retailers would be willing to pay the supplier.\(^{25}\)

The foregoing paragraphs imply that the presence of dual distribution does not
affect the economic analysis of restraints eliminating competition among retail-
ers when the supplier’s profits stem only from fixed fees. On the other hand, when
the supplier’s profits stem only from the wholesale price per unit, the presence of
dual distribution exacerbates the anticompetitive effect of such restraints.
Intermediary cases are also possible, where some of the supplier’s profits stem
from fixed fees and some from the wholesale price per unit. The more they depend
on the wholesale price per unit, the more the presence of dual distribution inten-
sifies the anticompetitive effect.

To make things more concrete, let us examine these points with regard to mini-
mum resale price maintenance and exclusive territories separately below.

**Minimum resale price maintenance**

Suppose that while using minimum resale price maintenance, the supplier relies
on an above-cost wholesale price in order to make his profits rather than on a
franchise fee. Absent dual distribution, elimination of price competition among
retailers by the supplier would have seemed puzzling. Since the supplier makes
profits in this example solely from the price per unit he charges retailers, one
would expect him not to block competition among retailers so as to maximize
the number of units sold. Hence it could be claimed in such a case that elimina-
tion of competition among retailers is needed in order to avoid inefficiencies

\(^{25}\) Here, it is the first above-mentioned consideration justifying lenient treatment of vertical
restraints which becomes more pronounced: even without elimination of interbrand competition,
the retail price could be equally high, or even higher. This is because with interbrand competition,
retailers’ expected profits are low, and so are the fixed fees the supplier can collect from them.
Accordingly, the supplier is expected to use its market power in order to raise the wholesale price.
This will raise retailers’ marginal costs and raise the retail price, notwithstanding competition
between them. Since retailers too are expected to have a profit margin (assuming competition among
them does not drive the retail prices all the way down to their marginal costs), consumers may suffer
from a higher price than would be charged absent retail competition, due to double marginalization
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in distribution. Moreover, due to the supplier’s incentive to maximize the number of units, it could be claimed that the dictated minimum resale price is not equal to the cartel-like retail price retailers would prefer, but rather equal to a lower price—the lowest retail price that keeps in tact retailers’ incentives to distribute the supplier’s product efficiently.

But when the supplier is also a retailer, the profits he makes on account of his retail outlet are those of a retailer. These profits are maximized when the retail price is equal to the cartel price among retailers. This factor could partly offset the supplier’s ordinary incentives to keep the retail price as low as possible, so as to maximize the profits of his supplying outlet. The retail price dictated could be higher than the one a supplier not engaged in dual distribution would dictate. Moreover, the restraint may well be motivated by the supplier’s eagerness to eliminate retail competition so as to raise the profits of his retail outlet. It is no longer the case, as absent dual distribution, that the restraint could be explained only by the need to improve the efficiency of distribution.

Suppose now that the supplier imposes a minimum resale price and sells to retailers for a price equal to the supplier’s marginal cost and that the profits the supplier makes are due to fixed franchise fees the retailers pay him. Here, the claim in favour of a lenient treatment of minimum resale price maintenance is that without it, the supplier will not be able to collect sufficient franchise fees and therefore he will be induced to use his market power to raise the wholesale price per unit above his marginal cost. This will inflate retail costs and prices. Due to retailers’ own profit margins, double marginalization could evolve and price could be equal to or even higher than the price with minimum resale price maintenance.

The latter analysis does not change in principle when dual distribution exists. Absent minimum resale price maintenance, the supplier inflates the wholesale price he charges independent retailers and double marginalization evolves. In fact, since the supplier competes with retailers in the retail market, he might even inflate the wholesale price more, in order to grant himself a competitive advantage over independent retailers.26 With minimum resale price maintenance, the supplier can eliminate double marginalization by lowering the wholesale price per unit he charges independent retailers all the way down to his marginal costs. While the retail margin goes up, due to elimination of price

26 Compare Y Yehezkel, ‘Downstream Competition Between an Upstream Supplier and an Independent Downstream Firm’ (working paper, January 2004, on file with author) who shows that a supplier engaged in dual distribution has an incentive to inflate the wholesale price he charges the independent retailer.
competition, the wholesale margin (and retailers’ marginal costs) goes down, so that the retail price may well be lower than without minimum resale price maintenance.

**Exclusive territories**

A similar reasoning suggests that exclusive territories imposed by a supplier engaged in dual distribution could be more anticompetitive than exclusive territories imposed by a supplier who does not operate his own retail outlet, if the supplier’s profits include profits per unit and not only fixed fees. Again, absent dual distribution, and when the supplier makes a profit per each unit sold, such a restraint could be explained mainly by the supplier’s need to solve imperfections in distribution. When the supplier controls a retail outlet, on the other hand, the profits he makes on account of his retail outlet are enhanced when downstream competition is eliminated. Hence his motivation for imposing exclusive territories may well be the reduction of competition rather than efficiencies in distribution. This mixed motivation bears on the rationale for treating such a vertical restraint differently than a horizontal one.

Suppose, on the other hand, that the supplier imposes exclusive territories upon his retailers and lowers the wholesale price all the way down to his marginal cost, while making his earnings from fixed franchise fees. This time, the main rationale for lenient treatment is that absent exclusive territories the supplier would cause retail prices to be high (or even higher) by raising the wholesale price. Here the existence of dual distribution does not justify harsher antitrust treatment. Without exclusive territories, the supplier would still inflate the wholesale price he charges independent retailers (and possibly even more so, in order to grant his retail unit a competitive advantage), inducing retail prices that could even be higher than those that prevail under exclusive territories.

**Restraint’s limiting the supplier’s entry or operation in the retail market**

In the same spirit, any restraints limiting the supplier’s ability or incentive to enter the retail market are actually horizontal in nature. They are similar to a potential retailer committing not to enter or to limit its operations in the retail market and therefore amount to a horizontal restraint similar to a non-competition obligation, which should be viewed harshly.\(^{27}\)

\(^{27}\) See n 9.
Non-compete obligations

If the retailer promises the supplier not to buy from competing suppliers (a non-compete obligation) is the anticompetitive effect stronger in the presence of dual distribution? It could be in the following sense. The supplier’s retail outlet will be inclined itself to buy only from the supplier and not from competing suppliers. Hence it too is under a de facto ‘non-compete obligation’. All this means, however, is that the share of the retail market foreclosed from competing suppliers includes the share of the supplier’s retail outlet, and not only the share of the retailer subject to the non-compete obligation. Moreover, the harm to product variety in the latter retailer’s geographic market should take into account that at least one other retail outlet in the same market, namely, the supplier’s retail outlet, is inclined to hold only the supplier’s brand.

Exclusive distribution

When the supplier commits towards a retailer that he will sell only to him, but for the supplier’s retail outlet, then dual distribution actually mitigates the anticompetitive harm compared to the case of exclusive distribution absent dual distribution. This is because without dual distribution, consumers in the retailer’s geographic market will have access to the supplier’s brand only in the exclusive retailers’ outlet. This is while with dual distribution, consumers can find the supplier’s brand both in the retailer’s outlet and in the supplier’s own outlet.

Most favoured customer clause

Can a most favoured customer clause harm competition more in the presence of dual distribution? Dual distribution does not really have a significant bearing on the anticompetitive effects of most favoured customer clauses. The theories against such clauses hinge on the claim that the supplier will find price cutting less profitable when he has to give the same discount he gives other customers to the customer enjoying the clause. The same theories would exist and be applied similarly when the supplier operates his own retail outlet.

Price matching

The concerns about the anticompetitive effects of price matching are also similar in spirit when the supplier is engaged in dual distribution. These theories hinge on other suppliers hesitating to price cut due to the supplier’s price matching policy, on the fear of discrimination between informed and uninformed consumers, and on exclusion of competing suppliers. The latter effect is similar to that of non-compete clauses: the larger the percentage of retail outlets the supplier controls due to his price matching promise, the stronger the anticompetitive
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effect is. In this context, the supplier’s retail outlet should be considered as part of the retail outlets controlled by the supplier, thereby possibly strengthening the exclusionary effect.

G. Implications of the Economic Analysis With Regard to the EC Block Exemption Regulation

Private labels
As shown in Section E above, apart from exclusive distribution, vertical restraints which are not concerned with the private label deserve a more lenient treatment than the same vertical restraints absent the presence of a private label. This implies that EC competition law treats such cases too harshly. In particular, the Block Exemption Regulation28 exempts, under certain conditions, only vertical restraints between a supplier and a buyer that do not operate in the same level of the supply chain. As Article 2.1 of the Block Exemption Regulation puts it:

Pursuant to Article 81(3) of the Treaty and subject to the provisions of this Regulation, it is hereby declared that Article 81(1) shall not apply to agreements or concerted practices entered into between two or more undertakings each of which operates, for the purposes of the agreement, at a different level of the production or distribution chain, and relating to the conditions under which the parties may purchase, sell or resell certain goods or services ('vertical agreements').

Moreover, the first part of Article 2(4) provides that:

The exemption provided for in paragraph 1 shall not apply to vertical agreements entered into between competing undertakings . . .

According to these provisions, when a retailer controlling the supply of a private label operates at the supplier’s level of production or distribution, the parties are not eligible for the exemption. This is despite the fact that, as we have shown, apart from the case of exclusive distribution, the existence of the private label mitigates the anticompetitive threat. If the same agreement, with the same market shares of the parties, is exempt in the absence of a private label, I have shown above that this restraint should a fortiori be exempt in the presence of a private label.

To be sure, under Article 2(4)(a) of the Block Exemption Regulation, even if the retailer competes with the supplier, their vertical restraint would be eligible for exemption under the Block Exemption Regulation if the retailer has a total annual turnover not exceeding EUR100 million. This qualification, however,
does not solve the anomaly described above. On the contrary, the higher the retailer's annual turnover, the more the fact that he operates his private label mitigates the competitive threat of vertical restraints (apart from exclusive distribution). This is because the retailer's private brand acts as an addition to interbrand competition compared to the case without a private label. The larger the retailer's operations, the larger the operations of his private label, hence, the stronger the competing brand the retailer contributes to interbrand competition at the supplier's level.\(^{29}\)

**Dual distribution**

The lack of consideration to the pro-competitive effect of the retailer's private label stands out when compared to the specific consideration given in the block exemption to 'dual distribution' cases. According to Article 2(4)(b) of the Block Exemption Regulation, the vertical restraint is eligible for exemption if 'the supplier is a manufacturer and a distributor of goods, while the buyer is a distributor not manufacturing goods competing with the contract goods'. First, it is surprising that the other form of supplier—retailer competition—of the retailer also operating in the supply market (i.e. holding a private label), is explicitly ruled out (but for the narrow proviso of Article 2(4)(a) mentioned above) while dual distribution is explicitly ruled in. Moreover, the overall eligibility of the 'dual distribution' case for exemption seems to be too broad and lacks fine-tuning.

In particular, as shown in Section F above, restraints that eliminate interbrand competition such as minimum resale price maintenance and exclusive territories may be substantially more anticompetitive when dual distribution exists. This is particularly the case when the supplier’s profits stem from an above-cost wholesale price rather than merely from franchise fees. In such cases, the Block Exemption Regulation should not be available to dual distribution cases, and a case-by-case analysis is warranted. In the case-by-case analysis consideration should be given, among other factors, to whether, and to what extent, the supplier makes his profit from above-cost wholesale prices or rather from fixed fees, or a combination of the two.

As to non-compete obligations, in order to take account of dual distribution, it is important to acknowledge the supplier’s retail outlet as included in the portion of the retail sector foreclosed from other suppliers. The direct implication is that

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\(^{29}\) To be sure, when a retailer is large, concerns such as foreclosure of suppliers that do not gain access to this retailer could arise. Furthermore, the retailer’s possession of a private label constitutes vertical integration that itself could foreclose other suppliers. See n 11 and accompanying text. Still, as shown, except for the case of exclusive distribution, the same vertical restraint is typically less anticompetitive with the presence of the private label than without it.
the Block Exemption Regulation's 30 per cent market share threshold should be calculated after taking into account not only the market share of the retailer that gave the non-compete obligation but also as combined with the market share of the supplier's own retail unit. The same is true with price matching policies, especially when one of the concerns is exclusion of competing suppliers. On the other hand, as shown in Section F above, exclusive distribution actually deserves a more lenient treatment when dual distribution is present than when it is not.

H. Conclusion

When a retailer controls the supply of a private label, the economic analysis of vertical restraints in such cases should distinguish between two categories: The first category consists of restraints that limit the retailer's ability to sell the private label. Such restraints should be treated as harshly as horizontal restraints. The second category consists of restraints that are not related to the sale of the private label. As this chapter reveals, antitrust treatment of vertical restraints of the second category should arguably be more lenient than vertical restraints absent a private label. This conclusion stands in contrast to the Block Exemption Regulation provisions. The Regulation does not apply to vertical restraints when the retailer controls the supply of a private label, either in the first or second category of cases, but for the case where the retailer's turnover is limited. As shown, this narrow proviso misses the point, since the larger the private label's turnover, the more lenient the treatment vertical restraints (but for exclusive distribution) deserve. On the other hand, the Block Exemption Regulation applies to dual distribution cases, despite the fact that when some vertical restraints are coupled with dual distribution, they actually possess stronger anti-competitive effects than absent dual distribution. In particular, restraints eliminating competition among retailers are especially harmful with dual distribution, provided that a large percentage of the supplier's profits are from the wholesale price per unit rather than from fixed fees.