Intra- and inter-brand competition – the public policy debate

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A number of current public policy debates that affect brand owners centre around the distinction between inter- and intra-brand competition. These themes are present, for example, in areas such as trade mark exhaustion, the legality of selective distribution systems, constraints on parallel trade within and beyond the EC, and even in the area of look-alike competition. The sometimes conflicting pressures of intra- and inter-brand competition are not always treated consistently in the public policy discussions.

Why restrict intra-brand competition?

The concept of inter-brand competition is clear and readily explicable. Intra-brand competition, meanwhile, is a more contrived concept – it refers to the competition between rival sellers of a particular brand, for example the rivalry between Tesco and Sainsbury in their efforts to sell Unilever-branded detergents.

At first sight, it is hard to see why manufacturers should restrict intra-brand competition. Suppliers expend great effort in minimising the costs of procurement, manufacturing, logistics and distribution. Since retail margins are effectively one such cost, surely the best way to minimise that cost is to have unrestrained and vigorous competition between competing retailers – intense intra-brand competition.

However, economists have identified a number of potentially legitimate *and consumer-friendly* reasons why it could be in the interests of suppliers to apply a brake on intra-brand competition. The classic textbook illustration concerns the 'free-rider' problem, where retailers provide valuable pre-sales advice or showroom facilities. The provision of such services helps to boost demand for the brand, but it is also costly for the retailer to provide. Even the most efficient retailer will need a higher gross margin to compensate for the extra costs incurred if it is to be worthwhile supplying the pre-sales service.

But what if some retailers adopt a low-cost no-frills business model in which pre-sales service is eliminated and showroom facilities are kept to a minimum (or as with an Internet site, disposed of altogether)? These retailers can easily undercut the prices charged by service-providing retailers. They can also encourage consumers to sample the pre-sales service at the retailers who incur those costs and then make their purchase at a lower price from the no-frills retailer. It is easy to see how this kind of free-riding can undermine the incentives of retailers to invest in sales advice and showrooms, potentially leaving the manufacturer and the consumer worse off.

The applicability of this free-rider rationale for restrictions on intra-brand competition is not limited to goods that require technical pre-sales advice, however, and nor is it restricted to manufacturer–retailer relationships. Consider the position of Whitbread's (historic) position as exclusive UK licensee for Stella Artois beer. Stella is a much loved but distinctly mass market brand in its home market, Belgium, but when Whitbread was appointed UK licensee it invested to promote the brand in the UK as a premium beer, creating a brand with real value to the licensee and to the consumer. It was encouraged to do so by the protection afforded to it under its long-term licence as the exclusive UK producer of the brand – a restraint on intra-brand competition. But the licensee's efforts in creating this valuable brand property in the UK created an incentive for parallel trade from Belgium (where the price of the brand was low) to the UK (where it was high) at the wholesale level. Although this kind of parallel trade offers potential gains to consumers, it also free-rides on the investments and risks that the UK licensee had undertaken in promoting the brand.

Another instance arises where brand owners decide that distribution through up-market retailers helps to promote the image of the brand – fine fragrances and designer jeans are prominent examples. The discount stores who bemoan their inability to sell Chanel perfume and Levi's jeans at lower prices find it easy to portray themselves as consumer champions, but they are seeking to free-ride on the contribution that the approved retailers have made to making those brands what they are.

There are yet other instances where, paradoxically, too much competition between retailers can become dysfunctional from the point of view of manufacturers and consumers. One such case arises from brands that have an impulse appeal to consumers. Manufacturers of such products want the brand to be available in as wide a network of retailers as possible in order to capture discretionary sales opportunities. However, these brands can also be ideal vehicles for loss leading by price-oriented retailers, and this kind of aggressive retail price competition can bid down retail margins so much that smaller retailers choose to stock other brands instead, thus reducing the brand's availability. There are a number of models in the economic literature that point to a welfare trade-off between the lower prices enjoyed by consumers who buy at the outlets that continue to stock the brand, and the resultant non-availability for those who visit other outlets only to find the brand has been de-listed.

These instances where manufacturers restrict intra-brand competition see distribution as one of many inputs that the brand owner relies upon in bringing its product to market. No one criticises Levi's for choosing to make its jeans from higher-quality denim, even though cheaper denim grades are no doubt available. We recognise that this choice of more expensive material will, other things equal, tend to make Levi's jeans more expensive, but we do not accuse that choice of being anti-competitive or anti-consumer. It is just one of the factors that defines the brand. The choices made by brand owners when selecting how their products should be presented to the consumer at retail level are really no different.

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...continued from page 4

A common public policy theme – conflict between dynamic and static efficiency

These tensions between intra- and inter-brand competition have parallels in a number of other public policy areas in which static incentives clash with the objective of promoting dynamic competition. The basis for patent protection is a case in point. Competition between branded and generic pharmaceuticals is a kind of intra-brand competition. It can be extremely effective in driving down prices of existing products (i.e. in promoting 'static efficiency') to the benefit of consumers. However, the law grants patent rights to research-based firms that allow some respite from generic competition in order to preserve their incentives to invest for future generations of breakthrough medicines (i.e. promoting 'dynamic efficiency').

There is no definitive 'right' balance to be struck between static and dynamic efficiency in patent rights. However, two guiding principles do help the choices. First, where there is a clear opportunity for other innovators to make a better patented product, any detriment to consumers caused by the patent right 'monopoly' can be guaranteed to be temporary. Second, the benefits to consumers and economic growth from encouraging the development of new products are potentially far greater than the benefits from making existing products available at lower prices.

When it comes to restrictions of intra-brand competition, the same tensions are evident in the policy debate, but recently there has been a welcome shift towards a more permissive view on intra-brand restrictions. In 2000 the EC Commission produced a new set of enforcement guidelines on vertical (i.e. manufacturer–retailer) restraints that struck a more liberal stance than the traditional European policy, and the new UK competition law regime has declared vertical restraints per se legal (with a few exceptions) as long as there is inter-brand competition. Another significant move in this direction came with the *Davidoff/Levi Strauss* case in which the ECJ ruled in favour of brand owners' rights to restrict parallel trade from outside the EU.[1]

Inter-brand competition is critical

Discussion of restrictions on intra-brand competition often takes place without reference to the nature of inter-brand competition and the role it plays in protecting consumer interests. Yet in most markets where these restraints arise there is vibrant inter-brand competition and a very wide range of choice available to the consumer.

Where inter-brand competition is healthy, concerns about the effects on consumers of reduced intra-brand competition can generally be dismissed. This proposition is neatly encapsulated in the Levi's example. Parallel traders ask why consumers should be denied the choice of buying cheap jeans from a no-frills retailer, and instead have to buy their 501s at a higher price from a Levi's-approved high-margin outlet. But in reality consumers are presented with a wide choice of inexpensive jeans, available from outlets varying from high-street boutiques to market stalls.

The only 'freedom' consumers are denied is the freedom to buy Levi's jeans from the low - cost outlets. However, if Levi's are correct in their marketing judgment that the (relatively expensive) up-market retail presentation of their brand is an integral part of the brand's appeal of their jeans, that would be a false choice. And if Levi's have made a commercial misjudgment on the value that up-market retailing adds to the appeal of their product, we can rely on the effectiveness of inter-brand competition to ensure they will be punished in lower sales and shrinking market share to rival brands that make full use of lower-cost retail distribution.

Significantly, however, the discount retailers involved in the parallel trade disputes specifically want to sell Levi's jeans. This fact alone betrays the fact that the appeal of the brand has some additional and enduring value over and above its tangible attributes. Levi's is taking a risk in restricting the points of retail access for its brand, and paying its approved retailers higher margins than the minimum necessary to distribute the product to the consumer. If the brand owner in a competitive market believes that the way the product is presented in approved retail outlets helps to create that value, it should have the right to protect it by excluding low-cost retailers. If it gets this judgement wrong (as many do) it will be punished through inter-brand competition by rivals who do select the right mix.

It is all too easy for the consumerist argument to fall on the side of discount stores and parallel traders, and against the brand owners who impose restrictions on intra-brand competition. However, the true interests of consumers lie in some more complex trade-offs. Often, any harm caused by some suppression of intra-brand competition is more than compensated by the benefits consumers derive when, because of these same restrictions, more effective inter-brand rivalry is generated. Policy makers increasingly recognise the importance of this trade-off, and of allowing inter-brand competition to flourish. In the end, effective inter-brand competition provides all the necessary safeguards to protect and promote consumer interests.

[1] *European Court of Justice, Judgement of the Court, 20 November 2001, Joined Cases:* Zino Davidoff v A&G Imports C-414/99, Levi Strauss v Tesco C-415/99 *and* Levi Strauss v Costco Wholesale C-416/99.

Tougher sentences for pirates

In July, The Copyright and Trade Marks (Offences and Enforcement) Bill received Royal Assent. Introduced as a Private Member's Bill by Dr Vince Cable MP, this legislation will mean tougher sentences for counterfeiters and pirates and gives greater powers to investigators. Penalties for copyright theft are increased (from 2 to 10 years), search warrant provisions are strengthened and powers of forfeiture of counterfeit goods are increased. The Bill was strongly supported by the Alliance against Counterfeiting and Piracy.