CEG COMPETITION ECONOMISTS GROUP

COMPETITION CONDUCT

# How close is too close? Effective delineation under dual role agency

Elisa Flecken

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# 1 What is a dual role agency

1. During the 2022 revision of the Guidelines on Vertical Restraints[1] (henceforth "VGL"), which explains under which conditions vertical agreements may be exempt from Article 101(1) TFEU, several companies sought guidance with respect to so-called dual role agency. A traditional agency agreement is a concept in which an actor (a principal) empowers another actor (an agent) to negotiate and/or conclude contracts on their behalf.[2] If the agent bears no significant financial or commercial risks in relation to these contracts, the agent does not act as an independent economic operator. In this case, the agency agreement would fall outside the scope of Article 101(1) TFEU.[3] As a consequence, the principal is free to determine the commercial strategy for the products in question relating to, e.g. where the agent may sell the products (territory), who the agent may sell the products to (customers), and the prices and conditions at which the products must be sold.[4]

2. To fall outside the scope of Article 101(1) TFEU, the principal must cover all financial and commercial 'risks' that are associated with the agency agreement.[5] The coverage of the risk can take various forms, i.e. cost coverage (i.e. covering all costs the agent occurred acting for the principal), a fixed lump sum payment, or a fixed percentage of the revenues generated by the sale of goods or services under the agency agreement.[6,7]

3. Dual role agency describes a situation in which a downstream reseller acts as an agent for one product of a producer and as an independent distributor for another product of the same producer (henceforth "dual role agent"). Reportedly, several large car manufacturers are nowadays shifting their distribution model from a traditional distribution model to an agency or dual role agency model, and the EC reports that interest is also shown in consumer goods markets.[8] According to the EC, suppliers envisaging the use of dual role agency have thus far distributed differentiated products and consider distributing a limited number of specific products under an agency agreement, typically products with higher quality or with novel features.[9]

[1] European Commission (2022), Guidelines on Vertical Restraints, 2022/C 248/01 ("VGL").

[2] VGL, paragraph. 29.

[3] VGL, paragraph. 30.

[4] VGL, paragraph. 41.

[5] These include **Contract-specific risk**. Costs related to the fulfilment of the contract, such as the acquisition of the property or the financing of stocks; **Risks related to market-specific investments**. Costs related to performing the activities needed to operate, such as investments in equipment and training of personnel; and **Risk related to other activities**. Costs related to adjacent activities which are imposed by the contract but not directly related to the contract product. VGL, paragraph. 31, 33.

[6] VGL, paragraph 35.

[7] An example of an agency agreement can be found in DaimlerChrysler v Commission where it is described that the dealers in Germany acted as agents for the principal DaimlerChrysler. In this case, the dealer would negotiate sales with end consumers on behalf of DaimlerChrysler and would upon finalising of the sale order the vehicle from DaimlerChrysler – thereby, among other things, not carrying inventory and hence not being subject to economic risk with respect to these sales (Court of First Instance of the European Communities, DaimlerChrysler v Commission, Case T-325/01, September 2005, paragraph 10, 93).

[8] EC Working paper: Distributors that also act as agents for certain products for the same supplier, paragraph 1; Podcast by Linklaters, VBER 3.0: the questions we're still asking one year on, available under https://linklaters.mediaplatform.com/#!/video/14870/VBER+3.0:+the+questions+we%E2%80%99re+still+asking+one+year+on.

[9] EC Working paper: Distributors that also act as agents for certain products for the same supplier, paragraph 3.

4. The VGL specifies that products distributed under dual role agency agreements must be effectively delineated. While providing some more elaboration, there are still several uncertainties with respect to what this means in practice. This article aims to discuss the condition of effective delineation for the dual role agency to fall outside the scope of Article 101(1) TFEU and to assess whether this is a reasonable condition from an economic point of view.[10]

5. For a dual role agency agreement to fall outside the scope of Article 101(1) TFEU, the VGL adds two further conditions to those of 'standard' agency agreements: 1) the independent distributor must be **free to enter into the agency agreement**; and 2) the activities and risks covered by the agency agreement can be **effectively delineated**.[11] These conditions appear to follow from the need for clarity expressed by stakeholders during the consultation process prior to the 2022 VGL being published.

6. While the condition of freedom to enter seems to be more easily graspable (i.e. the agent cannot be forced or coerced into accepting the role) and likely does not require any economic input, the concept of effective delineation appears less straightforward. In particular, in our view it is unclear why this delineation is important and whether this rule reasonably considers the competition risks in a dual role agency.

# 2 How to assess effective delineation in dual role agency scenarios

7. The VGL explains that if a distributor is active both as an agent for one product, and as an independent distributor for another product of the same supplier, there is a risk that "*the obligations imposed on the agent in relation to its agency activity will influence its incentives and limits its decision-making independence when it sells products as an independent activity*", in particular with respect to the pricing policy.[12] The EC thus identifies the risk that the price determined by the supplier for the agent product will influence the price set by the distributor for the product distributed independently. The EC notes that anti-competitive concerns are less likely to arise when the relevant products are in different relevant markets, or in general the less interchangeable the products.[13]

8. As an example of products where activities and risks can be effectively delineated, the VGL mentions products "*with additional functionalities or new features*". However, where objective differences (such as higher quality or new features) are "*insignificant*", pricing decisions for the product distributed independently might be influenced by the agency product.[14]

9. But how does product differentiation in the context of dual role agency actually impact competitive outcomes? Typically, economists expect a product to have a larger impact on another

[10] For ease of argumentation, we limit this article to agency agreements covering B2C products.

[11] VGL, paragraph 36.

[12] VGL, paragraph 37.

[13] VGL, paragraph 38. This is substantiated by reference to DaimlerChrysler v Commission, paragraph 113, which does not concern a dual role agency, but the EC questioned whether the obligation of the agents to carry out repair work (in return for a guarantee payment) would undermine the agency.

[14] VGL, paragraph 36, 38.

product's pricing decision the closer the substitute. Thus, in order to evaluate whether a set of products would fulfil the condition to be allowed to be distributed under a dual role agency, it is therefore relevant to assess whether and/or how interchangeable the products in question distributed by the supplier are. This essentially relates to the concept of closeness of competition, for which economists have several tools (some of which are used in the assessment of relevant product markets), which could be adapted to gain an understanding of substitutability in the market in question.

10. The most useful concept in this context is the assessment of demand substitutability, which entails understanding which products consumers consider interchangeable. This is likely to be the determining influence on whether two products are close competitors. Demand substitutability can be assessed in several ways.

11. One type of tool for assessing demand substitutability includes surveys of consumer sentiment and an assessment of the user cases of two products (i.e. could the product fill the same need for the consumer). Survey data is of course subject to limitations but many issues can be mitigated by following best practices in terms of survey and question design (e.g. avoiding hypothetical questions, and asking people questions as they are exiting a store). Moreover, a survey needs to reach a sufficient number of people as to ensure that inferences can be drawn from the survey answers to the wider population.[15]

12. Another type of tool for assessing demand substitutability includes estimating cross-price elasticities, which is an estimate of the change in the demand of a competing product B in case of a price change for product A. In practice, estimating cross-price elasticities is a data-intensive exercise and is more complex when one product is new on the market. For new products or characteristics cross-price elasticities can be estimated through a hedonic pricing regression (in case similar features are already present in the market) or through a conjoint analysis following a consumer survey (in case similar features are not already present in the market). Both approaches use appropriate demand estimation models to derive cross-price elasticities. Going into detail on these models is beyond the scope of this article, and there exists substantial literature on the topic. However, common for these types of models is that the estimation is almost certain to be data-intensive, potentially burdensome, and may come with limitations.[16]

13. Having estimated demand responses for the products in question, the next step is to assess how close substitutes the products in question are. In the context of cross-price elasticities, a larger value indicates that the products in question are considered more interchangeable by consumers, and as the elasticity grows, the consumer response increases, and the products in question move towards perfect substitutability. Such products would not fulfil the condition of effective delineation as described by the EC. In contrast, the lower the cross-price elasticity, the less substitutable the products are from the perspective of the consumer, and hence the more likely the condition of effective delineation is fulfilled.[17]

[15] See, for example, "Good practice in the design and presentation of customer survey evidence in merger cases", Competition and Markets Authority.

[16] The former example can be thought of as asking the question 'what do people think', whereas the latter example can be thought of as asking the question 'what would people think'.

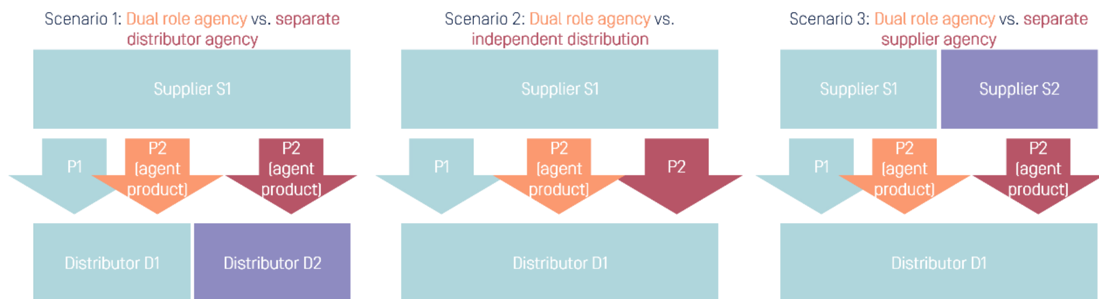
[17] For example, products from different relevant product markets would likely exhibit low cross-price elasticities, and thus likely fulfil this condition.

14. In a market definition context, the results using the tools above can be interpreted using a SSNIP test.[18] This tests whether a 5-10% price increase for a candidate set of products is profitable, thereby indicating the scope of the product market. However, in the context of effective delineation, it is unclear whether the threshold for product market definition would be the same as for the question of whether two products are sufficiently delineated. In fact, it might be more narrow as the example given by the EC in paragraph 40 of the VGL concerns products in the same product market. In practice, the threshold should thus be determined on a case-by-case basis.

# 3 Potential competition risks - Examples

15. In cases where it cannot be shown that the products in question are sufficiently delineated, it is worth considering whether there is a competition risk. A way to examine potential competition risks is by looking at different possible dual agency scenarios and compare them with other scenarios, which the EC considers unproblematic. As the VGL description of potential competition risks is vague, we consider the main risk scenarios we have identified below. We also present a graphic representation of these scenarios in Figure 1.

**Figure 1: Presentation of different dual role agency scenarios.**




*Source: CEG presentation.*

## 3.1 Scenario 1: Dual role agency vs. separate distributor agency

16. Consider a scenario in which a distributor D1 is independently distributing a product P1 from supplier S1. Supplier S1 introduces a new product P2 which is in the same relevant product market as P1 but has additional features (e.g. a new model of a car series). Supplier S1 prefers using an agency model for product P2 in order to have a higher degree of control of the distribution process of this novel product. Supplier S1 can then decide whether to (i) contract distributor D1 with the distribution of the product (i.e. adopt a dual role agency model), or (ii) contract distributor D2 who is not yet active in the same product market for supplier S1 (i.e. a separate distributor agency) (see Scenario 1 in Figure 1). While for option (i) the products need to be effectively delineated to fall outside the scope of Article 101(1) TFEU, option (ii) could be implemented without any compliance risk.

17. What difference in competition risk might the EC identify based on the choice of distributor? In the separate distributor agency situation, the distributor D1 does not have information on the price of the product P2 and hence sets the price for product P1 absent precise information on P2. In the dual role agency situation, distributor D1 can take into account the current and future price

[18] Small but significant and non-transitory increase in price.

determined by supplier S1 for the agent product P2 when determining the price for the non-agent product P1.

18. The dual role agency situation may thus share similarities to a one-sided information exchange on current/future prices in the separate agency situation from distributor D2 to D1 regarding product P2 because it provides information on pricing. It is well known that under certain circumstances, information exchange can be considered harmful and lead to inflated prices.[19] This could also apply in the case of unilateral information exchanges which serve as a focal point.[20]

19. These effects materialising of course hinges on the assumption that the products are sufficiently substitutable, and it is unclear what the predictions of the theory are when, for example, the number of products sold by distributor D1 is large and the marginal relevance of product P2 to the pricing decision of the retailer is smaller.

## 3.2 Scenario 2: Dual role agency vs. independent distribution

20. Another potential scenario is one where the decision for the supplier is not with respect to which distributor to use for the agency product, but rather which distribution model to use, given that he wants to use distributor D1 with whom it is already working and has an established business relationship with. Supplier S1 can either distribute product P2 through D1 as an independent distributor (as for P1), which is not considered problematic by the EC, or contract D1 as an agent (dual role agency) where the agency agreement falling outside the scope of Article 101(1) TFEU hinges on the fact that the products can be effectively delineated (see Scenario 2 in Figure 1).

21. What difference in competition risk might the EC identify based on the choice of distribution model? If product P2 is distributed independently, distributor D1 sets the prices for the two products jointly while in the dual role agency situation, the price of product P2 is given and taken into account, in case the products are sufficiently substitutable.

22. As in the dual role agency situation of Scenario 1, the price for the agent product may serve as a focal point for the determination of the non-agent product. In case both products are independently distributed, the price setting is not influenced by information on price setting by the supplier (apart from indirect influence through the wholesale price). Depending on the price setting of supplier S1 and distributor D1, the EC might see a risk that the price for product P2 is higher in the situation where the products are distributed independently.

## 3.3 Scenario 3: Dual role agency vs. separate supplier agency

23. Another scenario that might evolve in the market is when the product P2 is not introduced by supplier S1 but by supplier S2 and he wants to use the agency model for that product. If supplier S2 uses distributor D1 as an agent, the latter is distributing one product as an independent

[19] Other forms of information exchange may have a neutral or even positive effect on competition.

[20] European Commission (2023), Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal co-operation agreements, 2023/C 259/01, paragraph 378, 385, 394, 396, 398. The German Federal Court of Justice found that there is a high degree of probability in the sense of an empirical principle that information exchanges on current or future prices will lead to higher prices than absent the exchange (German Federal Court of Justice, Schlecker, KZR 42/20, November 2022, paragraph 46).

distributor and another product as an agent. Compared to the dual role agency, the two products are now supplied by different suppliers (i.e. separate supplier agency) (see Scenario 3 in Figure 1). Independent of how close the products are, such a situation is not considered problematic.[21]

24. What is the potential competition risk of the dual role agency compared to the agency with a different supplier? In both cases, distributor D1 can take into account the current and future price for the agent product P2 when determining the price for product P1. Different outcomes in these cases might only arise if (i) the price for the agent product P2 is taken into account differently if it concerns a product by the same supplier, or (ii) the price setting for product P2 differs depending on whether the supplier already contracts the retailer as a distributor (i.e. dual role agency) or not. For the former case, it is not straightforward why a retailer would vary its pricing decisions based on who supplies the product. For the latter case, the price setting might be different if the supplier strategically sets a higher price for the agent product in order to raise the price for the non-agent product. Given the high investments that the supplier needs to make in order to implement a dual role agency, which includes all market-specific investments, it is unclear whether such a strategy would be profitable.

# 4 Conclusion

25. The EC determines in the VGL that for a dual role agency scenario to fall outside the scope of Article 101(1) TFEU the activities and risks covered by the agency agreement must be effectively delineated. This is since the EC sees a risk that the pricing decisions of the product distributed independently are affected by the agency activity. Economists can provide insights on effective delineation by assessing the product differentiation and closeness of competition of the products in question. The precise threshold for effective delineation however remains unclear and will need to be assessed on a case-by-case basis.

26. In case the products cannot be effectively delineated, assessing different dual role agency scenarios and how they compare to other distribution scenarios can provide insights on the competition risk that the EC might see. While one can think of potential channels through which a competition risk in dual role agency scenarios with products that cannot be effectively delineated may arise, these examples show that the difference in potential competition risk compared to other, unproblematic supplier-distributor constellations, is not always clear or does not seem likely to materialise (in particular in Scenario 3).

27. The EC sees an understandable risk that the dual role agency is misused "*in scenarios where the supplier does not actually become active at the retail level via the agency agreement and take all associated commercial decisions and assume all related risks […] but rather uses the agency model as a means to control retail prices for those products that allow high resale margins*".[22] However, that risk depends on the supplier actually covering all the relevant costs and does not hinge on the effective delineation of the products.

[21] This is since single branding provision, prohibiting such a situation, may harm inter-brand competition through foreclosure of suppliers (VGL, paragraph 43).

[22] VGL, paragraph 45.

28. It is therefore not entirely clear what competition risk the EC aims to avoid by introducing the condition of effective delineation for the dual role agency to fall outside the scope of Article 101(1) TFEU. Further guidance in that regard would be helpful in order to ensure correct self-assessment.

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