Comments Submitted by the National Automobile Dealers Association Regarding ecompetition

Introduction

Except for some industries, such as the auto industry discussed in this paper, producers have historically had the option to sell directly to consumers via the phone, mail (catalogue) or outlet store. These sales channels, however, are not necessarily the most efficient and thus are not widely utilized. Generally, it is more lucrative for producers to utilize middlemen or retailers to get their products to consumers. The advent of the Internet in recent years has presented producers with an enhanced method of direct access to their final customers. Indeed, producers saw the opportunity to increase control of their brand image, compile data on buying habits and improve profitability.

As the Internet blossomed throughout the late 80's and 90's from a simple tool to exchange information to a new medium of commerce, traditional middlemen of all types – travel agents, music retailers, personal computer retailers, insurance agents, clothing retailers and home improvement stores to name a few – became targets of disintermediation[1]. Consumer advocates and others insisted that shoppers would gain substantial savings, bypassing traditional retailers of goods and services, and transacting online directly with producers.

Clearly, many computer-savvy consumers have managed to save on certain goods, such as personal computers and airline tickets by making purchases via the producer's website. But not all manufacturers or service providers have rushed to sell their products online directly to consumers. A quick visit to a few manufacturers' websites shows just how many are not selling their wares via their corporate sites. The primary reason: sales channel conflict.

Sales channel conflict is not a new phenomenon, but has been exacerbated by the evolution of e-commerce. Although it has made great strides in recent years, the Internet is still in its infancy as a facilitator of commerce. Producers are still largely reliant on traditional resellers for revenue. Understanding this, many resellers fought back when producers established their own e-stores.

The extent that producers establish their own e-commerce capabilities largely depends on the structure and dynamics of their particular market and the specific attributes of the product. Ernst and Young reported in 2000 that the top five Internet purchase categories in the U.S. were: books, computers, CD's, apparel and tickets/reservations.[2] The sale of airline tickets over the Internet, for example, has been widely accepted by the general public. Producers in other industries, such as home appliances, tend to rely heavily on their brick-and-mortar resellers. Many now pursue e-commerce strategies that benefit both

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[1] Disintermediation is the elimination of intermediaries in the supply chain, also known as "cutting out the middleman", enabling a direct path from producer to consumer.

[2] Dell computer, famous for selling directly to consumers, recently announced that it will begin recruiting dealers to sell its computers. See *Chicago Tribune*, September 10, 2002, Business section, page 7.

online and traditional sales. Whirlpool Corp., for example, initiated its "e-Partners" retailing program that endeavors to blur the line between Whirlpool and its resellers.

So where does this leave consumers? In terms of the ability to purchase products online, consumers are better off. The number and quality of Internet storefronts (most of which are middlemen themselves or "cybermediaries") are improving every day. Still, buyers do not necessarily receive the lowest possible price for many goods. It is possible that consumers could receive a better price by purchasing direct from producers, although the amount of savings depends on the market conditions for the good or service. Consumer advocates blame retaliating retailers and legislation or regulations that protect them for hampering producers' efforts to sell direct. But, the blame is wrongly placed, since it is the consumer that wields the power. If enough consumers decided that they preferred to purchase online – directly from producers – then producers would have enough economic clout to develop their own e-commerce sites.

In its September 2001 survey, the U.S. Department of Commerce found that just 21 percent of the U.S. population made an online purchase in 2001 and 39 percent of Internet users bought online. Fifty-three percent of Internet users age 25 to 34 shopped online while the figure was 51 percent for users age 35 to 44. Thus, a large segment of consumers continue to shop in the traditional fashion.

Undoubtedly, the percentage of consumers purchasing online will grow. Many, however, will still prefer to shop at brick and mortar stores, and still more will like to have the option of both Internet and traditional sales channels. This outcome demands that producers and retailers in many industries learn to coexist. Consumers may not receive the lowest possible price for goods and services, but they are the ones who are choosing to pay more for both the added value that traditional retailers bring to the transaction (inventory, personal service, handling of returns, product recalls, etc.) and the opportunity to choose among sales channels. Furthermore, producers may not wish to internalize the services that middlemen provide to them, such as the distribution of product information, management of consumer fraud and the influence on consumers' buying decisions. Middlemen who do not add value to the transaction will be the ones that become disintermediated.

The Case of the Auto Industry

The franchised new car dealer has long been a primary target for disintermediation by consumer advocates. The protection awarded to dealers in the form of state franchise laws, they say, inhibits free and open competition in the e-commerce environment and restricts consumer choice and the potential for savings when purchasing an automobile. The fact that some components of dealer franchise laws inhibit pure short-term competition is plausible. But, when contemplating the removal of those components, a fair assessment of the costs and benefits must include other factors beyond the impact on consumers. Government intervenes in a market when the market fails to serve what the public deems to be in its long-term best interest. In other words, the benefit gained to the public over the long haul by the restriction or regulation of a market outweighs the resulting higher cost to consumers in the short-term.

Textbook examples of this are government regulations on the emission of pollutants. In most cases, pollutant emission controls result in higher prices to consumers. Yet society (voiced through elected representatives) has deemed that to be an acceptable cost so that we may enjoy a clean environment. In the agriculture and steel industries (among others), government regulation in the form of tariffs on imported goods have the effect of raising prices to U.S. consumers. Again, the public (voiced through elected representatives) has determined that protecting farmers and the steel industry outweighs the higher prices we pay for food and goods made with steel (such as automobiles).

What are the costs and benefits of the components of state franchise laws that mandate franchised dealers to be the exclusive outlet for new vehicle sales? The costs are embodied in the savings consumers could potentially gain if they could purchase directly from auto manufacturers or their websites. Taking the extreme scenario where all consumers purchase direct via the Internet and franchised dealerships were eliminated, the potential savings could include: the retail gross margin that dealers receive on new vehicle sales and any margin dealers receive to arrange financing, insurance and/or service contracts. Savings might include the reduction in costs incurred by manufacturers resulting from the elimination of the franchise system.

In 2001, the average retail gross profit (sales price less cost of goods sold) for the franchised dealer on new vehicle sales was 6% of the vehicle's sales price. Income dealers receive from providing consumers immediate and "one-stop" access to financing, insurance and extended service contracts is 1.5% of the vehicle's price. The dealer total is thus 7.5%, or about $1,900 for the average new unit. For manufacturers, savings would come from the elimination of franchise support staff and overhead, and a possible reduction in freight costs resulting from fewer shipping destinations.

A closer look at the infrastructure that will realistically be required by manufacturers to distribute their vehicles shows that a significant portion of the potential savings to consumers will evaporate. The product is not a simple product, like a compact disc, nor is the transaction. Automakers will require strategically located distribution outlets since automobiles cannot be shipped to consumers' doorsteps in a small box via UPS or Federal Express. While the number of outlets may be fewer than the number of franchised dealer outlets, they must be staffed with personnel that handle the transfer of vehicles, and duties such as cleaning the vehicle, adding gasoline, attaching temporary tags, etc. The potential savings to consumers will thus be lowered as a result[3].

With fewer distribution points, the cost of picking up new vehicles will rise for many consumers since they will be required to travel further to get them. Alternatively, the cost of delivering a new vehicle to a consumer's home would also increase as a result of the greater distance. Savings may be gained by

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[3] For comparative purposes, rent and equivalent at the typical franchised dealership accounts for about 1.5% of a new vehicle's price.

operating fewer distribution points compared to the number of dealer stores. But that savings is diminished by either the inconvenience (cost) to the consumer of driving further to pick up a vehicle, or the higher cost associated with traveling further to deliver the vehicle to the consumer's home.

It is also highly unlikely that everyone will boot-up their PC's and buy online – without as much as a test-drive. Less than 10 percent of new light vehicle sales are currently made online. That percentage will likely increase in the future, but it is widely agreed that a dominant segment of the car-buying public will wish to physically see what they are buying. As Robertson Stevens noted, *"we are not convinced that the majority of people will purchase a product averaging more than $20,000 without at least taking it for a test drive."*

For online buyers, the distribution outlet serves simply as a place to pick up their vehicle or the place where new vehicles are prepped and then delivered to consumers' homes. But for traditional buyers, the outlet would serve as a test-drive facility, requiring that a small inventory be on hand. This, too, would significantly lower savings to the consumer.

Indeed, maintaining a minimal inventory is a primary source of savings envisioned by champions of Internet-based vehicle sales. Consumers can go on-line, choose their vehicle with specific options and colors, and have it delivered. Minimizing production time is essential to make this option appealing, however, and the concept of a two-week order-to-delivery schedule is far from reality. In fact, the time period from order to delivery is on the rise. It has increased in the past year to 53 days from 47 days.[4] Many consumers will still prefer to have the ability to purchase a new vehicle from inventory and drive it off the lot on the same day – particularly those who urgently need a new vehicle as a result of accident or theft. This need for inventory also serves to lower the potential savings to consumers.

Another potential and significant decline in savings to the consumer could result from automakers' return policy for Internet sales. An enticing aspect to making a large purchase on the Internet is the ability to return the merchandise after a nominal period of time (two weeks, for example) if one doesn't like the product or if it is flawed. If the auto manufacturers implemented such a policy, they would have to absorb the cost of either receiving the vehicle at a facility and/or pay the costs of transporting the vehicle to that facility or a repair shop. Additionally, the vehicle would now be used, and worth substantially less than its original value.

Vehicle repairs are another major issue. Without franchised dealers, where would consumers go to have their vehicles repaired under warranty? Manufacturers must maintain their own service facilities, and/or license independent repair shops to perform the work. Repair shops would be required to invest in training and equipment to repair today's sophisticated vehicles. They must also add staff and overhead

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[4] Jim Mateja, "GM Program about Content or Discontent," Chicago Tribune (KRT), September 16, 2002, http://www.auto.com/industry/content14_20020914.htm

to process warranty claims.

It should also be noted that manufacturers' reliance upon independent repair shops lessens their control over consumers' experience during their span of ownership and, consequently, the potential for repeat customers. For example, a Ford owner who experienced superior warranty service at a Ford-owned facility would more likely purchase another Ford compared to another Ford owner who experienced good warranty service at Joe's Auto Repair who happens to do warranty work on both Ford and GM vehicles.

The head of Ford's e-commerce unit stated in 2000, *"If Ford's 6,000 dealers were suddenly wiped out tomorrow, what would we do? Well, we'd have lots of unhappy customers. We'd have to go out and build service centers to provide maintenance service and parts. We'd also have to put up showrooms around the country. It begins to look a bit familiar."* Robertson Stevens added: *"We believe that most manufacturers, even if starting from scratch, would implement a dealership franchise system for distribution rather than rely exclusively on the Internet."*

The Development of the Franchise System

We should not overlook the fact that we are examining a distribution system that will deliver more than 16.8 million new vehicles to consumers during 2002. Franchised dealers will also process nearly 10 million trade-in vehicles. The fact that this accomplishment is taken for granted illustrates the business acumen of franchised motor vehicle dealers. Indeed, dealers have made the business look "easy."

The purchase of a motor vehicle, either new or used, is actually a series of transactions. With a new car, a trade-in is often involved. This requires an individual to examine the trade-in and determine its value. This cannot be done over the Internet. Ancillary issues such as verifying the accuracy of the odometer reading, whether the vehicle is paid off, its accident and repair history (has it ever been branded as a "lemon" or a salvaged or flood damaged vehicle?) abound. What will be the reconditioning costs to make the trade in attractive to the public? These are just a few of the functions carried out by new car dealers.

The purchase of a new car in this country is highly regulated. In order to sell a new vehicle it is common for states to require that a dealer be licensed, have an established place of business, be bonded, and employ salespeople that often times must be licensed by the state. The regulation is pervasive. It is an exercise of the police power of the state to protect the public. Consumers are required to title a vehicle, buy license plates, and obtain insurance. Dealers often handle many of these tasks for consumers and the state. Sales tax must be collected. Plus, information must be sent by dealers to manufacturers so that safety and recall notices can be handled to protect the public.

The franchise system, as the preferred business model to sell and deliver new vehicles to the public, dates back to the 1920s. Initially, manufacturers sold directly to the public. As the demand for vehicles increased, manufacturers determined that it was in their best interest to move to a vertical distribution system, with a dealer acting as the middleman between the maker of the vehicle and consumers. Besides helping to meet consumer demand, manufacturers also realized enormous cost savings by not having to invest in the real estate, personnel, equipment and other costs of "doing business" to sell new cars.[5]

Dealers operate under what is now called a "Dealer Sales and Service Agreement" with manufacturers. A major part of this document includes strict requirements which dealers must follow to ensure that each vehicle is free from defects before a consumer drives it off the lot. The Agreement further mandates that dealers properly perform warranty and service work thereafter. If a safety recall is announced, it is the dealer who fixes it.

Wisconsin, in 1937, was the first state to enact a law designed to curb arbitrary actions by the automobile manufacturers against dealers. That law contained the modest requirement that a manufacturer have "cause" to cancel a franchise agreement with a dealer. A quote from a case during that period is helpful:

> While there is a natural impulse to be impatient with a form of contract which places the comparably helpless dealer at the mercy of the manufacturer, we cannot make contracts for parties or protect them from the provisions of contracts which they have made for themselves. Dealers doubtless accept these one-sided contracts because they think that the right to deal in the product of the manufacturer, even on his terms, is valuable to them; but, after they have made such contracts, relying upon the good faith of the manufacturer for the protection which the contracts do not give, they cannot, when they get into trouble, expect the courts to place in the contract the protection which they themselves have failed to insert.[6]

This result was fairly typical of cases during that time. The courts were not willing to aid dealers because they viewed the franchise agreement as an ordinary contract between ordinary contracting parties. The fact is the courts did not look at the disparity in bargaining power and dealers were left hoping to convince a court to "imply" some duty of good faith or good cause on the part of a manufacturer.

Dealers tried other avenues to find relief from one-sided agreements and arbitrary actions by manufacturers. The antitrust laws, for example, were invoked, but proved of little use in stopping some manufacturers from putting a same brand dealer on every corner. Ultimately, dealers lobbied Congress and this led to enactment in 1956 of the Dealer Day in Court Act which dealers thought would help.[7] That law

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[5] See Scott Fuller, The Federal Dealer Day in Court Act, A misnomer, Ohio Northern University Law Review, 1986. Article covers the evolution on the franchise system and the weakness of Dealer Day in Court Act.

[6] Ford Motor Co. v. Kirkmeyer Motor Co., 65 F.2d 1002 (1933).

[7] The FTC had highlighted the heavy handed treatment of dealers by manufacturers as early as 1939. *See* "Report on the Motor Vehicle Industry 1067."

provided dealers with a private right of action against manufacturers who failed to act in "good faith" or who unlawfully terminated a dealer's sales and service agreement.[8] Unfortunately, the law had been weakened by strong lobbying by the manufacturers and the courts construed it in such a way that it quickly proved to be largely ineffective in leveling the playing field between manufacturers and dealers. This led dealers to lobby their state legislatures for relief.

Many of these state laws contain relevant market area provisions (RMA) which permit a dealer to file a protest, often with an administrative agency, when a manufacturer proposes to add an additional dealer within a specified radius of an existing same line-make dealer. A California appellate court concluded that the legislative intent of these provisions was to balance the dealers' interest in maintaining viable businesses, the manufacturers' interest in promoting sales and the public's interest in adequate competition and convenient service.[9] Sometimes an RMA provision is tied to the selling area which a manufacturer unilaterally assigns to a dealer in the franchise agreement. The impact of the RMA provisions has been overstated. An RMA provision does not give a dealer the ability to block the addition of another dealer by a manufacturer. Rather, it requires a manufacturer to show that an additional dealer is justified in the market place.

As hard as it may be for some to believe, manufacturers can behave opportunistically against their dealers. The potential power manufacturers have over dealers has been recognized by the U.S. Supreme Court. In a decision upholding the constitutionality of the California law protecting dealers, the court stated:

> The disparity in bargaining power between automobile manufacturers and their dealers prompted Congress and some 25 states [by 1978] to enact legislation to protect retail car dealers from perceived abusive and oppressive acts by the manufacturers. California's version is its Automobile Franchising Act. Among its other safeguards, the Act protects the equities of existing dealers by prohibiting automobile manufacturers from adding dealerships to the market areas of its existing franchisees where the effect of such intrabrand competition would be injurious to the existing franchisees <u>and to the public interest</u> (emphasis added.).[10]

These laws have been carefully scrutinized since their enactment. For example, numerous challenges to the laws on constitutional grounds have been filed in the courts by manufacturers and distributors. The result has been that the U. S. Supreme Court and state courts have consistently upheld the validity of the

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[8] 15 U.S.C. § 1221 et. seq.

[9] <u>Piano v. State of California ex rel New Motor Vehicle Board</u>, 103 Cal.App.3d 413 (1980), cited in Franchise Protection: Laws Against Termination the Establishment of Additional Franchises. American Bar Association, ABA Monograph 17, pp.90-91, 1990.

[10] <u>New Motor Vehicle Board v. Orrin W. Fox Co.</u>, 439 U.S. 96, 100-102 (1978).

laws. See, e.g., American Motor Sales Corp.v. Division of Motor Vehicles, 592 F.2d. 219 (4th Cir. 1979); Tober Foreign Motors Inc. v. Reiter Oldsmobile, Inc., 381 N.E.2d 908 (Mass.1978); Ford Motor Co. v. Pace, 335 S.W.2d 360 (Tenn. 1960); Forest Home Dodge, Inc. v. Karns, 138 N.W. 2d 214 (Wis. 1965).

It is often claimed that these laws are no longer necessary, that manufacturers no longer behave opportunistically toward dealers. The relationship between dealers and manufacturers has improved. There is a growing awareness that cooperation rather than confrontation is required if both parties are to prosper. This includes cooperation in utilizing the Internet in ways that best serve dealers, manufactures, and the public. Still, overreaching behavior continues to exist. A 1996 decision is but one example which illustrates that these laws continue to be necessary.[11]

The elected state legislatures continue to recognize the continuing need for these laws. In 1986, when the FTC released its study on the impact of the relevant market area (RMA) laws, 36 states had such provisions. Today, the number is 45. Some claim that this is easily explained by the fact that dealers have a lot of political clout in the legislatures. In 2000, South Carolina enacted a RMA provision for the first time. It did so despite the fact that a major manufacturer has a plant located in that state. Michigan, the state with the most significant manufacturers presence, has long had a strong dealer franchise law, including a RMA provision. NADA has confidence that those closer to the action are more likely to get it right. This year, Alaska became the 45th state to enact a RMA provision.

The most significant event which prompted dealers to approach the legislatures the past couple of years was not the Internet. Rather, it was the move by several manufacturers to own and operate brick and mortar dealerships in direct competition with their franchised dealers, independent businesses which are completely dependent on the manufacturer for the products they sell and service. The decision to directly compete with independent franchised dealers had the potential to put many dealers out of business, a result which would wreak havoc on the economy of many communities, and harm consumers as well.

Car Dealers and the Internet

Proponents of e-commerce envision an Internet-fostered system of free and open competition that has not eliminated the role of the dealer but has greatly changed that role by empowering the consumer. This suggests a pull rather than a push system with manufacturers building vehicles already sold rather than selling vehicles already built.

Many of these benefits are now in place for consumers; and franchised dealers have become actively involved in promoting and selling cars over the Internet. More than 90% of dealers have an

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[11] Bronx Auto Mall, Inc. v. American Honda Company, Inc. 113 F.3d 329 (2nd. Cir. (1997). Termination of dealer's Sales and Service Agreement, citing false reasons for the termination, held to be an unfair business practice.

Internet presence, and many of these sites are interactive. Dealers have embraced the Internet as a way to provide better service and value to consumers. This use of the Internet has also expanded the selling area for each dealer, and thereby increased competition among dealers.

There is an enormous amount of information currently available to consumers on the Internet. The information is located on websites maintained by dealers, manufacturers, third parties, including "dot.coms," and others. The information includes model descriptions, options, colors, pricing (both MSRP and invoice), financing options, insurance, extended warranty and service contracts, and used vehicle valuations. Consumers obtain this information without charge and are much more knowledgeable when entering a dealer's showroom. The dialogue between an Internet-empowered customer and a dealer competing in 21st century e-commerce has changed fundamentally.

However, most consumers will want to include a visit to a dealer in their car buying. They know that there is an enormous difference between the purchase of an automobile and the purchase of a book or compact disc. It's not simply the cost and importance of the vehicle. Consumers want to test drive an actual vehicle, feel the upholstery, and view the colors and accessories. Customers want a convenient location for warranty and safety recall work. These are not concerns when a consumer purchases the latest Harry Potter novel. A book is available in only one color, it never needs warranty service, and it will not be recalled for unsafe tires.

We have also seen the high profile demise of many dot.com businesses. The most vulnerable business has been the "pure-play" Internet operation - a new economy business with few physical assets and a questionable "business model." The most successful companies are a "clicks and bricks" operation that includes elements of both the old and new economies. Franchised dealers use the best features of the Internet, information and communication, while providing old-fashioned face-to-face service for consumers that has and will stand the test of time.

A recent article states a cautionary note about the peril of viewing the Internet as a benign instrument of commerce. The Internet can be a very dangerous place, and some of its ills are becoming better known. An investigation by Business Week led it to estimate "that financial fraud on the NET costs businesses and consumers $22 billion annually, based on law enforcement and analyst projections."[12]

Many websites, both dealer, manufacturer, and third party, include dealer inventories of new vehicles. A consumer can use a "configurator" to add options and choose a color for his or her new car model of choice, and then search local dealers' inventories for that vehicle. This locate-to-order process is not the build-to-order system promised by the Internet, but is an interim step that has great benefits for

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[12] "The Underground Web. Drugs, Gambling, Child Pornography. How the Internet makes any illegal activity more accessible than ever. Business Week, September 2, 2002.

consumers. The delay in implementing build-to-order is due to inefficiencies in the manufacturing process, not dealers' reluctance to embrace new business practices.

As noted previously, automobiles and related products and services have been distributed in the United States through a network of retail dealers franchised by the vehicle manufacturers. The manufacturers required their dealers to make investments in their franchises based on the expected demand for the manufacturer's products in the dealer's assigned territory. These investments have been made in dealership facilities, tools, inventory, advertising and promotions, and good will to meet the dealers' obligations under their franchise agreements. In the absence of the franchised dealer network, the manufacturers would have to make billions of dollars of investments in facilities and other assets. In 2001, franchised new car dealers had an investment of over $140 billion in inventory, land and improvements. Manufacturers would have to incur the risk of losing such an investment, a risk that now falls entirely upon franchised dealers. [13]

In recent years, a decline in gross profits as a percentage of new vehicle selling prices has forced franchised car dealers to rely more heavily on sales of other products and services to obtain a return on their franchise investments. In 1990, the gross profit figure was 7.5%. By 2000, it had declined to 6.1%. Although new vehicle department net profits have rebounded somewhat in recent years, due to record sales, these departments were primarily break-even operations for most of the 1990's. Also, dealer new and used vehicle departments rely on aftermarket (service contract, finance and insurance) sales for a significant portion of their gross profit. Without these sales, new and used vehicle sales by franchised dealers show only marginal profitability.

It is often suggested that significant savings could be realized if the state law were replaced or direct sales by the manufacturer were the norm. The flaw in this analysis is the assumption that franchised dealers can lose the core part of their business (new car sales) to others, operate with little or no protection of their significant investments, and somehow still be able to provide the same level of service as they do today.

In addition, a substantial portion of dealer aftermarket sales also involve the manufacturer. For example, 34% of new vehicle sales financed by dealers in 2000 were financed through the manufacturers' finance subsidiaries, and 43% of new vehicle leases were made through the manufacturers' finance subsidiaries. Parts and extended service contracts offered by manufacturers through their dealers are also an important part of the dealers' business and profitability. As a result, dealers have become dependent upon the manufacturers and their affiliates for non-vehicle products and services, similar to their dependence for new car sales.

Recently, some manufacturers have begun marketing products and services such as extended

[13] See attachment. The investment by franchised dealers in inventory, parts and real estate leased on year to date average in 2002 is over $137 billion.

service contracts, parts and accessories, and vehicle financing, directly to retail customers in competition with the franchised dealers. The manufacturers desire to compete in retail markets with their own franchised dealers has been driven, in part, by the Internet. Formerly, the only effective way of reaching prospective car buyers was to establish a retail facility close to where the buyer lives. Now, after relying upon and benefitting from their franchised dealers' investments in these facilities, these manufacturers have tried to use the Internet as a way to market directly to retail customers without making their own investments in local facilities. This circumvention of the franchised dealer by manufacturers is unfair, particularly because of the manufacturers' requirement that their dealers investment in facilities be adequate to meet the demand for the manufacturer's products in the dealer's area.

The long term consequences of factory-owned stores are uncertain. One possibility is an oligopoly of factory stores without intrabrand competition. For example, all Ford dealers in a metropolitan area, if factory owned and operated, could charge a single price for each model.[14] The Washington, D.C. area currently has nine Ford dealers competing against each other for Ford customers. Consumers would lose the benefit of the current competition among dealers representing the same manufacturer. A factory-owned dealership network would attain a level of monopoly power and be able to raise prices.

It has been suggested that there have been fundamental changes in the traditional relationship between automobile manufacturers and their dealers, and that manufacturers have perhaps lost bargaining power with their dealers. Two reasons cited include the fact that there are now more manufacturers competing for dealers, and the rise of chain dealerships has increased dealers' bargaining strength.[15] It is certainly correct that the relationships have changed, but the changes have increased, rather than reduced, the need for state franchise laws.

It is simply wrong to suggest that a level playing field exists. It misrepresents current factory-dealer relationships for the vast majority of dealers. The typical franchise contract is not negotiated. It is a "take it or leave it" offer presented by the factories to their dealers. The basic terms of the factory-dealer relationship are thus set by the factories. Any movement to change those terms comes from the factories in the form of unilateral amendments to existing agreements, or replacement agreements, which always contain terms and conditions more onerous than what existed before. Supplementing these agreements, which have been held to be contracts of adhesion, are often controversial and ever-changing programs developed with little or no dealer input.

This is not a "supposed" imbalance in bargaining power. The extent and significance of the existing imbalance in bargaining power is illustrated by a dealer's sole remedy in many situations - a lawsuit. Significantly, dealers may even be denied access to the courts if a manufacturer chooses to amend an

[14] The antitrust laws allow a manufacturer to set uniform prices for its products. Dealers, as a group, are prohibited from setting uniform prices for their manufacturer's products.

[15] "State Auto Dealer Regulation: One Man's Preliminary View." Speech by FTC Commissioner Thomas B. Leary to the International Franchise Association, May 8, 2001.

agreement to require mandatory binding arbitration as the sole mechanism to resolve any disputes which may arise. The Federal Arbitration Act effectively strips dealers of their rights under state laws. Such a clause has been invoked to require a dealer located in Florida to arbitrate a termination action rather than being able to pursue a state law remedy. That dealer's agreement also provided that the arbitration would take place in New York.

Even when not subject to binding arbitration, the reality is that dealers are reluctant to sue their manufacturer. The prospects for an individual dealer's success are poor due to the factory's unlimited budget for litigation and the factory's ability to retaliate outside the courtroom in many ways, both obvious and subtle.

It has also been suggested that the increase in the number and size of chain dealerships has strengthened dealers' positions with manufacturers. While it is true that large dealer chains may have more resources available for dealing with manufacturers, the discrepancy in resources is still overwhelming. Even a large dealer chain will have reservations about litigating against a large multinational corporation, such as General Motors, which had market capitalization of $22 billion as of October, 2002.

The claim has also been made that "in many areas today" consumers no longer enjoy the benefit of a local entrepreneur with hands-on responsibility for the dealership, who has direct contact with customers. This is simply wrong. Most dealerships remain closely tied to the community. Many dealerships remain family-owned and operated, including chain dealerships. The fact remains that for most dealers, it is their personal investment that is on the line.

Another area of criticism is the dealers' legislative activities, and the suggestion that the Supreme Court decisions that allow private interests to petition their state legislatures free of antitrust restraint are ill-advised. These same decisions allow <u>any</u> private group, including manufacturers and consumers, to petition a state legislature. It is the function of each state's elected representatives, not appointed members of a federal agency, to balance the competing interests of their constituents. Ultimately, <u>all</u> regulation of business, (including the statute that created the FTC and the federal antitrust laws), is the result of legislative activity by private interests.

There is another aspect to the debated over public policy in this area which NADA believes has not been focused, and that is the other features of antitrust law that restrict dealer activities. Individual dealers may complain, criticize, second-guess, and vent about their manufacturers. Dealers acting <u>as a group</u>, however, are subject to extensive antitrust restrictions on their activities. Dealer groups may not, for example, refuse to sell an unpopular car. Dealer groups may not require better financial arrangements as a condition of using a factory's captive financial services. These same restrictions apply to dealer group actions toward any supplier or vendor. Lastly, and most importantly, no organized group of dealers may refuse to accept a factory's unilateral revisions to its franchise contract.

The "free rider" concern which dealers have is certainly significant. The potential for the Internet to facilitate businesses whose primary focus is to sell products rather than provide the full range of services is a major concern to dealers. Nor is it realistic for dealers to simply rely on manufacturers to take care of this issue. Dealers are extremely vulnerable if manufacturers begin to directly compete with them or if third parties are free to do by taking advantage of the investment dealers are required to make. This is an area where the dealers have little ability to take action.[16]

On the second point, allowing manufacturers the ability to sell direct creates a situation where dealers must compete with their suppliers. As noted in the introduction, this is the case in many unregulated industries. The competitive outcome in those industries, however, would likely not lead to the eventual termination of the retailer. If Black & Decker, for example, decided to exclusively sell directly to consumers, Home Depot would not go out of business. No single supplier to Home Depot has that amount of power. The same is not true for the auto industry. Franchised dealers, especially those with only one franchise, are completely reliant on the automakers for their inventory. Thus, dealers -- in direct competition with their suppliers – would, in the long run, be driven out of business. Factory-owned stores or e-commerce storefronts could not only beat dealers on price, but could also give unfavorable treatment on warranty claims and the allocation of popular vehicles. Automakers could also have access to the financial information of their franchisees, further placing dealers at a competitive disadvantage.

History has shown that manufacturers, even with the enactment of state franchise laws, exert a great deal of power over their dealers – particularly those who hold only one franchise. The 1956 Automobile Dealers Day in Court Act stated: *"Dealers are with few exceptions completely dependent on the manufacturer for their supply of cars. When the dealer has invested to the extent required to secure a franchise, he becomes in a real sense the economic captive of his manufacturer. The substantial investment of his own personal funds by the dealer in the business, the inability to convert easily the facilities to other uses, the dependence upon a single manufacturer for supply of automobiles, and the difficulty of obtaining a franchise from another manufacturer all contribute toward making the dealer an easy prey for domination by the factory. On the other hand, from the standpoint of the automobile manufacturer, any single dealer is expendable. The faults of the factory-dealer system are directly attributable to the superior market position of the manufacturer."*

The power that automakers hold over their dealers remains today. Regarding the bipartisan Motor Vehicle Franchise Contract Arbitration Fairness Act, Senate Majority Leader Tom Daschle said on May 17, 2002 *"Today, large automobile manufacturers are forcing small business automobile dealers to sign away their legal rights as a condition of entering into a franchise agreement. These franchise contracts are presented by the automobile manufacturers as a "take it or leave it" proposition, without any room for good faith negotiations. It is wrong for one party to take advantage of its raw negotiating power to limit the legal rights of another party…. They [dealers] are just small business owners trying to keep their legal rights and make a living. South Dakota automobile dealers tell me they just want to be treated fairly, and they should be treated fairly…. This matter is a matter of basic fairness for thousands of small business owners across the country."*

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[16] *In the Matter of Fair Allocation System, Inc.,* FTC File No. 971-0065 (1998).

Another major benefit of the franchised dealer system is community involvement. Dealers contribute millions of dollars and a great deal of time to local charitable organizations and community development. Critics of state franchise laws speak of the "powerful dealer lobby". The real power of the dealer lobby is their grassroots relationship to the communities that they reside in. As noted by Majority Leader Daschle, your local franchised dealer typically isn't a massive conglomerate. Rather, it's your neighbor down the street who has a great deal invested in his or her business and who is actively involved in your locality's civic organizations.

Does the cost to consumers (savings on new vehicle purchases) of state franchise laws that make franchised dealers the exclusive source of new vehicles outweigh the benefits? In an idealized market, where consumer behavior is significantly different than it is currently, the savings off the price of a vehicle may be sizable. As discussed above, the realistic costs of distributing, maintaining and providing value-added services to today's new car buyers tend to sharply reduce the price savings to consumers. The benefits to the states and their communities, while not necessarily or easily quantifiable in terms of dollars, arguably outweighs the potential consumer savings on new vehicle sales. Indeed, the public of 50 states (voiced through elected representatives) has determined that dealer franchise laws are important and acceptable – in spite of the impact on the market price of new vehicles.

Dealers Must Continue to Add Value

As mentioned above, middlemen that add little to transactions are the first to fall prey to disintermediation. Consumers voluntarily pay more for value-added services provided by dealers such as help with financing, the ability to test-drive a vehicle, a reliable service facility, handling trade-ins, providing loaner cars and the ability to shop though inventory and drive a vehicle off the lot on the same day. But, the public's support for dealer franchise laws will wane if consumers feel that the benefits and services received when purchasing a new vehicle from their local dealership (or through the dealership website) do not justify the increase in cost versus buying directly from the factory or its website. Dealers clearly understand this. The J.D. Power and Associates 2001 Sales Satisfaction Study showed that "overwhelmingly, and contrary to popular belief, most buyers believe that their selling dealer is honest and courteous". On a scale from 1 to 10, car buyers gave their dealers a score of 8.5, indicating a high level of satisfaction.

Further aiding online consumers is the availability of new vehicle pricing information through several websites, including NADA's DriversSeat.com. Consumers not only have easy access to MSRP's, but also invoice prices paid by dealers. Indeed, new car pricing is transparent. How many other retailers make the price that they paid for their goods known to the general public? Consumers that purchase a TV from WalMart or a refrigerator from Sears are unlikely to be aware of the price those retailers paid (and the gross margin made) to resell those products. Not surprisingly, the retail gross margin made by new vehicle dealers has declined every year since 1998.

Conclusion

E-commerce has added an enhanced sales channel for retail sales. Many producers of goods and services have explored the Internet for direct selling to consumers. For some industries, particularly where middlemen add little value to the transaction, selling direct via the Internet has proved to be viable. In many other industries, a dominant segment of consumers either wish to shop in the traditional manner, or have the opportunity to choose between traditional or Internet shopping. That fact has led to sales channel conflict and an environment where traditional retailers and producers wishing to sell direct must coexist.

Consumers will dictate the evolution of retail sales. Although many could potentially receive a lower price by buying direct from producers, they prefer to pay a higher price for goods and services to take advantage of the value-added services that retailers provide. In other words, consumers are willing to pay a higher price for the ability to choose among sales channels.

As middlemen, franchised new car dealers have been targets of disintermediation. Consumer advocates insist that substantial savings can be gained from the price of a new vehicle by eliminating franchise laws and allowing factories to sell online directly to consumers. These "pie-in-the-sky" savings dwindle as a result of the infrastructure that would be needed by factories to deliver and service vehicles, and the value added services still demanded by most consumers. The removal of state franchise laws will simply allow the replacement of franchised dealers with factory-owned stores.

The benefits of dealer franchise laws to the states and their communities, while not easily quantifiable in economic terms, outweigh the potential consumer savings on new vehicle sales. All of the fifty state legislatures have determined that dealer franchise laws are important and acceptable – in spite of the impact on the market price of new vehicles.

In the 21st century economy, middlemen who add little value to a transaction will be expendable. Franchised dealers realize this, and know that they must earn the protection they receive by continuing to add value to the car-buying experience. To that end, dealers have evolved – embracing technology and improving their operations. As NADA Chairman H. Carter Myers, III noted at NADA's 2002 Annual Convention, the franchise system has grown stronger by meeting the many challenges it has faced, and will continue to thrive in the future. He said, "Today, our franchise system is time-tested, battle-hardened and proven, and I think we can all agree — manufacturer and dealer alike — it is still the best automotive distribution system in the world.

Attachment

For the average dealership, inventory levels:

	1999	2000	2001	2002
Average dealer inventory - New Car	$1,270,254	$1,425,563	$1,627,278	$1,633,688
Average dealer inventory - New Truck	1,015,340	1,302,777	1,671,974	1,644,859
Average dealer inventory - Demo	96,020	111,071	130,866	115,328
Average dealer inventory - Used Car	558,635	559,846	698,682	674,540
Average dealer inventory - Used Truck	309,988	334,686	428,991	442,790
Average dealer inventory - Used vehicles over 30 days	317,562	340,009	429,732	415,796
Average dealer inventory - Parts	213,765	223,507	277,552	267,047
Total Average Monthly Inventory	$3,781,564	$4,297,459	$5,265,075	$5,194,048
Average dealer Land & Improvements, Net	$787,491	$852,720	$1,058,085	$1,116,221

Number of Franchised new-car dealerships	22,400	22,250	22,150	21,800
Total dealer inventory(New & Used Lt.Vehicles, Parts)	$84,707,022,518	$95,618,451,785	$116,621,419,560	$113,230,252,762
Total dealer Land & Improvements, Net	$17,639,794,279	$18,973,027,537	$23,436,586,969	$24,333,616,093

2002 Data based on year-to-date average.

Source: NADA Industry Analysis