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Foerster & Hayes LTD

Certified Public Accountants

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To Whom It May Concern:

My name is John Hayes. I am a CPA and am a long-standing member of the AutoCPA Group. I have worked with auto dealerships for roughly twenty-five years.

As I understand it, the FTC is considering structural changes to the auto distribution system or "franchise" system based on two factors:

1. Dealer groups are larger than they've ever been, and therefore no longer need franchise laws to protect them
2. The franchise system is inefficient and anti-consumer

Dealer Groups Are Larger, Therefore Franchise Laws Are Unnecessary?

I find this first point to be more than surprising. Manufacturers or "factories" have many pressure points in their relationship with their dealer network; points for which factories have all the leverage. Absent the protection of state franchise laws, factories can take advantage of dealerships through any or all of these pressure points. In my experience with auto dealerships I've seen many examples of factories abusing this leverage to dealerships' detriment. I would like to share some of these with you.

Before doing so, I will point out that the manufacturers themselves do not agree with this first point! They have taken steps to guard against dealer groups getting too big to threaten the manufacturers' leverage advantage. Substantially all factories have some version of what is generally termed a "platform agreement" or "framework agreement" with any large dealership groups that sell the factories' products. What is a framework agreement?

It wasn't that long ago that all vehicle manufacturers specifically banned public companies from owning dealerships. The first transaction in which a public company successfully acquired a U.S. dealership occurred in 1996. The subject Ford / Lincoln stores were in south Florida and right here in northeast Ohio.

Generally, factories had banned public ownership for two reasons. First, they wanted a specific, experienced individual to be the "dealer of record" as party to the franchise agreement. This individual must be an owner with "skin in the game", to be accountable for following all the terms of the franchise agreement. Second, they wanted to limit the number of dealerships owned by any single dealer group.

8225 Brecksville Road, Suite 3, Brecksville, OH 44141
telephone 440-526-9800 ● *facsimile* 440-526-9869

While larger dealer groups were common at the time, none of the groups had grown to the size they could threaten the leverage that factories had over their dealer network. Dealership operations are capital intensive, and it would take access to public capital for a dealership group to grow to that degree.

To allay factory fears on this front, public acquirers agreed to limit the number of dealerships they could own as part of the terms of a framework agreement.

Up to now, the factories have deliberately contracted with their dealer network to prevent dealership groups from owning too many stores. There is no reason to expect that factories won't continue to use framework agreements to maintain the upper hand with their dealer networks.

As mentioned previously, I know of numerous pressure points that manufacturers use in dealership relations. Among these are image programs, adjudication and administration of warranty claims, assessments of sales effectiveness and customer satisfaction, "stair step" incentives, audits of incentives and / or warranty submissions, and vehicle allocation.

Image Programs

Substantially all factories have their version of what is generally termed an "image program". Typically these programs are part carrot and part stick. The carrot: if the dealership makes the facility investment it will receive additional cash from the factory. This is usually a defined percentage or amount per vehicle sold and can be up to $1,000 or more per vehicle. The stick: if the dealership does not make the investment, competing same-make dealerships that made the investment will have a significant price advantage.

There are several issues associated with many image programs that are problematic to dealerships:

- The multi-million dollar cost of these renovations and expansions required by the factory is frequently much greater than can be justified by investment analysis.
- This significant capital outlay is a significant increase in fixed costs, which results in greater risk in the dealership investment.
- Program requirements frequently require the use of vendors and contractors selected by the factory. This eliminates the dealership's ability to manage the cost and service provided by such vendors. Further, the dealership must now explain to local vendors, with whom they are likely to have relationships due to their involvement in the community, why the local vendor was denied an opportunity.

Even with the protection of franchise laws, dealerships can be very much at the mercy of their manufacturer in the process of implementing an image program. This is best illustrated by a recent, high profile case.

A large dealership group (#27 on the *Automotive News* "Top 150 Dealership Groups" list) was implementing General Motors' "Essential Brand Elements" (EBE) image program on a Cadillac store it owned in Florida. The program required the use of a specific building material. The existing dealership facility did not accommodate the use of this building material and would have to be demolished. The dealership group identified a substitute material which would be virtually identical, and would allow the existing building to continue to be used. GM refused to accommodate the substitution.

Florida state law and the federal Robinson-Patman Act gave the dealership group legal standing to sue GM. Absent this protection, this large group would have been at the mercy of the manufacturer. (See this link for Automotive News' coverage of the lawsuit.[1])

Adjudication and Administration of Warranty Claims

The question of whether a vehicle repair is covered under a factory warranty is not always a simple one. Dealerships advocate for their customers for repairs to be covered or allowed as warranty exceptions. As it is, in many cases there are long delays in getting factory representatives to meet with consumers to address these instances, and dealerships can force the issue to have the customer's concerns addressed.

This benefit of dealer advocacy becomes more critical when extreme circumstances arise. The recent airbag recall is a prime example. It was determined that airbags supplied by Japanese manufacturer Takata were defective and at risk of shooting shrapnel into vehicle occupants. Over 30 million vehicles among 24 brands were affected. Dealerships served as local resources to make sure the necessary repairs were performed quickly and with minimal inconvenience, and to apply pressure to expedite production of the replacement airbags.

Dealerships' Market Area - Sales Effectiveness and Customer Satisfaction

Factories judge the performance of dealerships on their sales effectiveness in their market area. Sales effectiveness is measured by comparing the brand's market share in the dealership's market to the brand's statewide market share. This appears reasonable on the surface, but applying this standard can result in clear inequities.

The determination of a dealership's market can be problematic. The dealership's assigned market might include territory that, due to traffic patterns or geographical features, makes the dealership more difficult for consumers in that territory to reach. So even though the dealership may be closest to the territory as the crow flies, a competing dealership is better positioned to serve that territory. Attempts to redefine the dealership's market area to take such factors into consideration are usually fruitless. I recently heard from a Chevrolet dealer that stated "the appeal process is both cumbersome and completely inflexible".

Additionally, specific characteristics of the dealership's market are frequently ignored. For example, a Ford dealership may have a Chevrolet assembly plant in its market. Therefore the dealership market has a concentration of Chevrolet employees that are strongly incentivized to purchase Chevrolet products. Clearly it's not reasonable to expect this Ford dealership to achieve the same market share as the state average.

[1] http://www.autonews.com/article/20120312/RETAIL07/303129948/facilities-fight-goes-federal

Manufacturers use some form of surveys to determine a dealership's Customer Satisfaction Index ("CSI") for both vehicle sales and repair services. Dealerships are compared to each other to judge their performance. Specifically those dealerships with below average scores are considered underperforming. the flaw in this approach is clear. It's a mathematical certainty that, at any point in time, half of all dealerships are underperforming.

"Stair Step" Incentives

Several manufacturers have structured certain dealership vehicle incentives based on quotas. Measurement periods can vary; often they are monthly and quarterly. If the dealership meets its quota, it receives a stated amount or percentage of the invoice for every vehicle sold during that period. This can amount to $500 or more per vehicle. If it does not meet its quota, it receives nothing.

This presents significant challenges for dealerships. Profit margins on new vehicles are very thin. Stiff competition leads to dealerships counting on this incentive money as it prices vehicles for sale. If the dealership is short of the quota as the end of the quota period nears, it must price these month-end vehicle sales at a loss to reach the quota.

The most troubling part of this circumstance is the ill will and mistrust this fosters with dealership customers. Imagine the repeat dealership customer that buys a vehicle on the 10th of the month. It is the fourth vehicle he's bought from the dealership. He gets a good price and the dealership makes a modest profit. Three weeks later his neighbor tells him about his month-end vehicle purchase at the same dealership. It is his first purchase from that store, and he paid thousands less than the longstanding customer because the dealership was forced to sell at a loss to meet its quota. Certainly it would be difficult for the first customer to trust the dealership and come back to purchase a fifth vehicle.

Another troubling aspect of stair step incentives is the way quotas are determined. Each dealership's quota is specific to that store. The dealership knows little about how the quota is determined, other than it always increases and it's based on the dealership's sales history. Neighboring dealerships have very different quotas to the extent their past sales volumes differ. Furthermore, it's very difficult for a dealership to decide that a quota is too high to attain and not pursue it. Sales would likely drop off dramatically as competing dealerships now have a price advantage; the dealership is positioned (sales staff, inventory levels, etc.) to sell at the higher volume.

Factory Audits

Manufacturers announce incentive programs from time to time, to stimulate sales of certain models as they see fit. Dealerships report the associated vehicle sales to qualify for and receive such incentives. Understandably, manufacturers have the right to audit dealerships' sales records to verify that all paid incentives meet the requirements of the incentive programs. Similarly, dealerships submit claims to their manufacturers to be reimbursed for repairs performed to fulfill the manufacturers' warranty obligations. Likewise, these claims are subject to audit by the manufacturer to determine the repair was covered by the warranty.

The threat of a warranty or incentive audit is another lever used by manufacturers. At a minimum, such audits are time consuming and a distraction. Additionally, dealerships have been charged back for submissions that qualified, but all of the specific, detailed documentation were not available to show the auditor.

Vehicle Allocation

Generally, vehicles are made available for dealerships to purchase based on sales history. That is, the more vehicles sold by a specific dealership, the more vehicles it will have an opportunity to buy going forward. However, when tensions arise in the factory / dealership relationship, it is not uncommon for manufacturers to suggest that future allocations could be lost if the dealership doesn't concede.

On the other end of the spectrum, in times when vehicle production is too far ahead of vehicle sales, factories have been known to coerce dealerships to take delivery of vehicles they don't want. An extreme example of this: it's been reported that Chrysler did this across most of its dealer network prior to its bankruptcy.

The Franchise System is Inefficient and Anti-Consumer?

It appears there is a sentiment that factories should be allowed to sell direct to consumers, and "let consumers' wallets decide" the better way to purchase a car. It's not realistic to expect that, over the long term, consumers will have a choice to purchase from either a dealer or direct from the manufacturer or "factory". Inevitably, factories can undercut dealer pricing and be left as the only means for a consumer to purchase a vehicle. So what happens when a direct purchase from the factory is the only choice for the consumer?

As more fully described below, much of the distribution costs and inefficiencies in today's automobile distribution system could be eliminated if automobiles were distributed using a "pull" system rather than a "push" system.

A "push" system, in the strictest sense, consists of a manufacturer deciding on a fixed number of units to produce and, if necessary, discounting the price to sell all of the produced units. A "pull" system, in the strictest sense, describes a manufacturer that does not produce any stock units but rather builds to order. Today's automobile distribution system is primarily a push system.

This current push system has been much maligned for its inefficiencies. For years, many industry participants and observers have cited the benefits of moving to a pull system. This would benefit the distribution channel with reduced inventory and related holding costs. It would benefit manufacturers with reduced incentive costs, which are often necessary to sell built vehicles that need to be "pushed" to consumers. Additionally, less incentives means improved residual values, which lowers costs of financing for the consumer and reduces risk and losses to the manufacturer's captive lender. These are but a few of the benefits that market participants would enjoy.

All of these longstanding, widely recognized factors have been strong incentives for factories and dealers alike to move to a push system. For the most part, it has not happened. Why not? After all, vehicle shoppers can go to any factory's website today and build their own vehicle. I find it difficult to believe it's because the customer is taking delivery in a showroom owned by a vehicle retailer, and that somehow the answer would be different if the showroom were owned by a vehicle manufacturer. So why don't we have a "pull" system today, with all these compelling economic reasons already in force?

In short, the car business is complicated. On the production side, design and lead times are much longer. Manufacturers must contemplate significant fixed costs such as facilities and tooling in the context of expected sales volumes. On the distribution side, there are over 250 vehicle models on the market today. They cost tens of thousands of dollars. Financing must be arranged. A trade-in or lease turn-in must be handled. Vehicle technology is more robust than ever. You need a license and insurance to operate a vehicle, which must be registered in the state of operation. The tax collection process is unique.

None of these factors are present when it comes to selling computers or smart phones. It's simply not an even comparison to relate the vehicle market to what Dell and Apple are doing. To suggest that allowing manufacturers to own dealerships ignores the root causes as to why today's distribution system is primarily a push system.

Conclusion

Dealerships seek the privilege of representing a manufacturer in the marketplace and selling its products. Dealerships make substantial investments for this privilege. These upfront, fixed costs can only be recovered through future service and sales of the manufacturer's products. In many ways, dealerships fortunes are closely tied to the factories they represent. It is inherent to the factory / dealership relationship that all the leverage is in the factories' favor.

Franchise laws have developed over time to give dealerships protection from unfair exertion of this leverage. While this letter's description of different pressure points within the manufacturer / dealership relationship is not comprehensive, it's intended to be informative and convey the continuing need for the protection that franchise laws provide dealerships.

Sincerely,

John P. Hayes, CPA