



March 4, 2016

Via Web

Federal Trade Commission
Office of the Secretary
600 Pennsylvania Avenue, NW
Suite CC-5610 (Annex B)
Washington, DC 20580

Re: Auto Distribution Workshop — NADA Comments
Project No. P131202

Dear Secretary:

The National Automobile Dealers Association (NADA)¹ submits the following comments in response to both (1) the Notice entitled “Auto Distribution: Current Issues and Future Trends/A Federal Trade Commission Workshop” (Notice) that the Federal Trade Commission (FTC or Commission) released in the above captioned matter² and (2) the workshop that was conducted in this matter on January 19, 2016 (Workshop).

Introduction

NADA has a long history of working with federal regulatory agencies, including the FTC, to promote improvements to the auto distribution system in the United States. Accordingly, NADA welcomes the opportunity to work with the Commission and members of the public to further advance these efforts in response to the FTC initiative announced in the Notice and carried out through the Workshop. However, NADA strongly objects to what appears to be the imbalanced and predetermined manner in which this project has proceeded to date. When undertaking inquiries into consumer markets, an independent agency of the government like the FTC should employ an approach that reflects an objective and impartial review of the subject at hand. Unfortunately, as explained below, the process that has been followed thus far does not appear to have comported with this imperative. We ask the FTC to address this shortcoming as it proceeds in this matter.

¹ NADA represents more than 16,000 franchised dealers in all 50 states who sell, lease, and finance the sale of new and used cars and trucks and engage in service, repair, and parts sales. Our members collectively employ over one million people nationwide. Most of our members are small businesses as defined by the Small Business Administration.

² The Notice can be found at <https://www.ftc.gov/system/files/attachments/press-releases/ftc-host-public-workshop-examining-u.s.auto-distribution-system/151215autodistributionnotice.pdf>

Notwithstanding our process concerns, we wish to assist the Commission and the public in better understanding the realities of the auto retailing marketplace and to help establish a fact-based record in this matter. To that end, in the balance of this submission, NADA provides a thorough set of comments on the U.S. auto franchise system and the questions that the FTC has asked about it. Among other things, these comments explain (1) how the auto franchise system benefits consumers, (2) the important role that the states play under our federal system in governing markets like the one for retail autos, and (3) why the laws that have been duly enacted by the 50 state legislatures to address the profusion of overreach that has resulted from the manufacturers' superior economic position remain necessary and prudent. We address these issues both generally and with respect to each of the specific areas into which the FTC has inquired. Finally, throughout these comments, we explain why many of the statements of the "experts" that the FTC invited to speak against the existing system fail to reflect what actually occurs in the market and were otherwise misguided. Taken as a whole, the comments that follow demonstrate that (1) the existing system of auto distribution in the U.S. is both consumer friendly and highly efficient and (2) the state legislatures – government entities duly authorized to write rules in this area – have gotten the regulatory structure right.

Process Concerns

The manner in which this initiative has been put together to date suggests that it has been structured to reach a particular conclusion. To be sure, representatives of the dealer perspective were included in all of the Workshop panels, but in three out of those four panels the dealer representatives were outnumbered by voices from the other side. Some of these opposing voices were representatives of the manufacturers who could be expected to provide a viewpoint that differs from that of the dealers. Presumably, however, the academics that the FTC staff asked to participate were invited to provide a more detached view – what Professor Schneider referred to as an "outsider's perspective as an economist on these issues." Transcript of the Workshop, Segment I at page 21.³ Indeed, one would think that, for these roles, the FTC staff would seek out scholars whose minds were truly open. Sadly, however, this does not appear to have been the case. Most, if not all, of the people chosen had already extensively commented in the public record in ways that were hostile to the current system of auto retailing or the regulatory structure that governs it,⁴ and these speakers certainly manifested those predispositions at the

³ The Transcript of the Workshop is set out in four segments on the FTC's website. For example, the transcript for the first segment is available at https://www.ftc.gov/system/files/documents/videos/auto-distribution-current-issues-future-trends-part-1/ftc_auto_distribution_workshop_-_transcript_segment_1.pdf. For ease of reference, the transcript will be cited in these comments in the following format: "TR. I; 21." In this format, the Roman numeral refers to one of the four segments and the Arabic numeral refers to a page within that segment.

⁴ Professors Lafontaine and Scott Morton have collaborated on such an article. Lafontaine, Francine and Fiona Scott Morton. (2010) "State Franchise Laws, Dealer Terminations, and the Auto Crisis" *Journal of Economic Perspectives* 24(3) 233-50. Professor Crane has also been prodigious in his writing against the current dealer laws Crane, Daniel. (2015) "Tesla, Dealer Franchise Laws, and the Politics of Crony Capitalism" *Iowa Law Review*, Forthcoming; Crane, Daniel. (2014) "Tesla and the Car Dealers Lobby" *Regulation* 37(2) 10-14. Professor Schneider has written critically of the auto buying process. Murray, Charles and Schneider, Henry S. (2016) "The Economics of Retail Markets for New and Used Cars" Handbook on the Economics of Retail and Distribution,

Workshop.⁵ The FTC should have invited a more independent set of outside academics to round out its panels,⁶ and should ensure that it seeks out those voices in the future.

Perhaps the greatest example of the predetermination of the Workshop was found in the existence and composition of the third panel (which was dedicated to discussing state laws that limit vertical integration in auto retailing). In his introductory remarks for that panel, one of the FTC attorneys candidly acknowledged that the FTC staff not only already had views on the topic but that it already had publicly expressed them, and they were completely opposed to the type of laws that were to be discussed. If the FTC staff had already determined what the correct answer was in this area, then why have the panel at all? And if the purpose of the panel was, as this attorney suggested, “to listen, to ask questions, and to learn from the discussion,” TR. III; 9, then why stack it with people whose views and analyses were already well known to the FTC – representatives from the two companies whose cause the FTC had already taken up in letters to state legislatures and Professor Crane? Why not ask people with different views – like Dr. George Ford from the Phoenix Center and/or Steven Szakaly, NADA’s Chief Economist – to present and be challenged through questions? Again, the predisposition displayed at the Workshop saps it of its ability to meaningfully contribute to a dialogue on these issues.

Finally, beyond predisposition, the Workshop process has suffered from its failure to ensure that all the people allowed to speak had views that, regardless of their nature, were grounded in an accurate understanding of the marketplace under discussion. Any attempt to determine whether the laws at issue are necessary and/or prudent needs to be so based. It should not be founded on anecdotal reports, conjecture, or theoretical arguments that do not manifest themselves in the market. But, again, a number of the people given the microphone during the Workshop did not meet this test. A few examples follow:

Forthcoming. And Professor Carlton, while not opining about the auto retailing industry specifically, has criticized the state action doctrine, upon which the state franchise laws proceed. Carlton, Dennis W. 2007 “Does Antitrust Need to be Modernized?” *Economic Analysis Group Discussion Paper*, 21(3) 155-176.

⁵ A subtle but clear example of this predisposition was found in Professor Scott Morton’s comments on panel four. There, at the beginning of what appeared to be a long prepared statement, she said that “this morning what we discussed is that the laws surrounding auto distribution in the United States are largely frozen **and prohibit innovation.**” TR. IV; 13 (emphasis added). This statement plainly ignored many of the earlier comments that were directly on point. For example, Mr. Jacoby, during panel one, stated that “[t]he innovations that are happening in the industry – internet sales, direct sales, just as examples, autonomous vehicles – those are things that are not truly covered by a lot of the existing regulations.” TR. I; 25. Similarly, it was conceded by Tesla General Counsel Todd Maron that even the most salient “innovation” discussed at the workshop – Tesla’s desire to vertically integrate its product distribution – was restricted in only a tiny minority of the states. TR. III; 13. Putting aside that Messrs. Jacoby and Maron were correct in their statements, Professor Scott Morton’s categorical characterization of the earlier discussions, without even an acknowledgment that contrary points had been raised, manifests the type of problematic predisposition we have identified.

⁶ We are aware that the FTC staff asserts that it could not find any such academics or economists. However, this ignores the fact that NADA identified for the FTC one such economist – Dr. George S. Ford, the Chief Economist at the Phoenix Center – who was both (1) qualified – Dr. Ford authored the only empirical study of which we are aware that seeks to measure the impact of intra-brand competition on consumer prices in the auto retailing industry – and (2) available. (The Phoenix Center study authored by Dr. Ford is discussed in section III.C., below.) In fact, NADA provided Dr. Ford’s contact information to the FTC by email on October 14, 2015.

- Professor Lafontaine stated that state relevant market area (RMA) laws “create exclusive territories around the dealerships.” TR. I; 5. But Messrs. Jacoby and Roesner explained that this was an inaccurate characterization of the laws. TR. I; 15; 18-19. They clarified that far from granting dealers exclusive rights, these laws merely provide governmental oversight, oversight which applies only to business-to-business transactions between manufacturers and dealers.⁷ Furthermore, this government oversight inevitably involves consideration of the public interest. These differences should be significant in any discussion of the prudence of these laws.⁸
- Similarly, Professor Scott Morton stated that “[a] single franchise dealer that owns the car has market power in its local area, and it will set a stiff retail market,” TR. IV; 24, and Professor Schneider spoke of dealers “having some market or monopoly power in their local area” as a result of franchise regulation, TR. I; 22. Again, these comments reveal a fundamental misunderstanding of the new vehicle market. Consumers are not only free to shop nationally on the internet, they also might receive active solicitations from competing dealers even while closing a sale inside a dealership. No law grants market exclusivity to dealers for any vehicle, and no law prevents any consumer from shopping at any dealer at any point in time. As noted above, RMA laws exist as a means to regulate commerce and business-to-business transactions between a manufacturer and a dealer. They are completely invisible to consumers, who are free to shop at any dealership no matter where they live or work.
- Professor Sappington stated that “teams” of dealers are able to negotiate with manufacturers over contract terms and that, as a result, state legislative involvement is unnecessary.⁹ This ignores the reality that the exercise of collective economic power by dealers against a manufacturer does not occur because it would constitute a federal antitrust violation. Dealers cannot (and do not) cooperate in this manner, let alone form negotiation “teams.”¹⁰

⁷ More particularly, the RMA laws (1) specify a set geographic area surrounding a dealership and (2) provide that dealer the opportunity to argue that a proposed manufacturer action – such as the establishment or relocation of a competing dealership of the same brand – taking place within that geographic area does not meet certain substantive criteria. Thus, the statutes do not allow dealers to protest the proposed action for any reason whatsoever; they merely give the dealer the right to argue that the proposed action does not satisfy the specific evaluative standards established by the legislature. In this connection, it is also important to note that auto manufacturers do not provide their franchisees with exclusive market territories via their franchise agreements. Quite to the contrary, those franchise agreements typically specify that the dealer’s primary area of responsibility is non-exclusive.

⁸ Professor Lafontaine also professed confusion over the number of dealerships that exist in the country, stating that NADA’s data differed from that of the Census Bureau. (The NADA data is drawn from primary sources and is accurate.) Although the dealer count is not the most important data point involved, one would hope that someone who has focused on auto retailing as much as Professor Lafontaine would resolve this factual question about the market as part of her work.

⁹ In particular, Professor Sappington stated that “in my view, it is not apparent that we really need government intervention here to force these manufacturer and dealer teams to agree upon warranty terms that will serve consumers.” TR. II; 9-10.

¹⁰ This is not to say that a manufacturer and its dealers do not together compete against manufacturers and dealers representing other brands; of course, they do. But when it comes to establishing the terms of the relationship

- Ms. Keller, in her comments during panel three, explained a number of ways in which the writings of Professors Lafontaine and Scott Morton and some of the sources they cite fail to appreciate the market realities of auto manufacturing and retailing. TR. III; 17.

For all of the foregoing reasons, NADA remains quite concerned about the process that has apparently been employed in organizing and putting on the Workshop to date. It is our hope that, going forward, the FTC will work to ensure that greater balance is incorporated into the record and that such balance will be reflected in the Commission's deliberations based on that record. And NADA stands ready to assist the FTC in developing such a balanced record and product.

Substantive Analysis

As noted, despite our concerns about process, NADA is providing a thorough analysis of the subject matter of the Workshop to assist in establishing a common and better understanding of the realities of the auto retailing marketplace and to help ensure that the record in this matter is fact-based and accurate.

I. The Proper Role of the FTC in the Context of Federalism

As a preliminary matter, in connection with any discussion of the questions that the FTC has asked, we believe that it is important to be mindful of the limited role that the FTC has here. Ours is a federal system of government, and one of the important aspects of that system is that the states retain the authority to determine what level of regulation is appropriate for a given market within their borders.¹¹ The approach our system establishes is a prudent one. In such a large and diverse country, many things vary from state to state: the needs, wants, and habits of consumers; political philosophies; the nature of the markets and the market participants themselves; prevalent market behaviors; and the list goes on and on. On many matters, one size does not fit all.

Auto retailing is a good example. There are significant variations among the states on a host of issues addressed by the state franchise laws. Take the controversial subject of vertical integration and direct manufacturer sales for example. To read many media accounts, one would conclude that vertical integration in the distribution of automobiles is prohibited in every state. Nothing could be further from the truth; the laws vary tremendously.¹² But this is a good thing. Some states have determined that vertical integration is fine for their constituent consumers and

between a manufacturer and its in-brand dealers, there is little meaningful negotiation that can lawfully occur outside of the legislative process.

¹¹ The federal government is one of limited powers – those expressly given to it by the Constitution – with the rest being reserved to the states and ultimately to the people.

¹² Indeed, Tesla's General Counsel himself acknowledged, "it's a very, very small minority of states that restrict [Tesla's] ability to sell directly." TR. III; 13. And there are states – including the largest, California – that allow even manufacturers who already have franchised dealers to sell direct, as long as their outlets do not unfairly compete with the independent dealers they have previously authorized within their relevant market areas.

their local markets while others have concluded the opposite.¹³ The fundamental point is that these are decisions that are the duly elected state legislatures' to make. Those legislatures are closer and more politically accountable to the people of their states than is the FTC. That is why the state legislatures are best positioned to determine what approach to, and level of, market regulation is appropriate for their citizenries.¹⁴

At the same time, although there are variations among the states in the specific franchise law provisions that have been enacted, it should also be significant to the FTC that, at a higher level of abstraction, there is no disagreement among the states that some form of regulation of this market is needed. All fifty states have enacted auto distribution franchise laws. This includes both states that are big and those that are small, those that are rural and those that are urban, and those that are politically liberal and those that are conservative. The fact that the bodies to whom this decision has been committed – bodies that on many other matters may come out very differently – have unanimously determined that regulation is required speaks volumes about the appropriateness of these laws from a consumer and public interest perspective.

Our federal system empowers the elected state legislatures to exercise regulatory oversight over markets such as the one for auto retailing, and all fifty of them have determined that some legislative activity in this arena is necessary and appropriate. This does not mean that anyone, including the FTC, needs to agree with every decision that has been made to date or that no prior decision should be revisited. It does mean, however, that the FTC should be mindful that the state legislatures play a primary role in considering what is right for a given state's residents and should not try to usurp that role for itself.

II. The Value and Importance of the Dealer Franchise System and the Laws that Support It

Automobiles are sold through franchised dealers in the United States because that method of distribution is a good model for everyone involved, most notably consumers. And the laws that the 50 state legislatures have enacted to regulate this market reflect prudent public policy choices that help ensure that consumers get the full benefit of this system. Those laws also serve to level the playing field between auto manufacturers and auto dealers that is otherwise tilted decidedly in favor of the manufacturers as a result of unique market structures and public policy choices that have been made by the U.S. Congress.

A. The Franchise System and the Laws that Support It Benefit Consumers

An automobile is often a person's second largest purchase, in dollar terms, after a home. Moreover, the automobile is a complex piece of machinery that (1) consumers typically own for extended periods and rely on heavily for many aspects of their daily existence, (2) will usually require regular maintenance and repair servicing, and (3) has tremendous personal and public safety implications. Given the centrality of the automobile to the lives of so many Americans, it

¹³ We will explain below why a state legislature could prudently come to this conclusion.

¹⁴ In this regard, Professor Carlton's suggestion that state economic legislation (like the state franchise laws) is the product of "corruption," TR. III; 3, 6, is particularly troubling. This assertion unjustifiably impugns the integrity of an entire class of government officials in all 50 states, and the FTC should not credit it in the slightest.

should come as no surprise that state legislatures have determined that the auto retailing and servicing markets require regulation.¹⁵

The laws that these legislatures have adopted directly benefit consumers.¹⁶ The following is just a partial list of the myriad ways in which this consumer-friendly dynamic plays out:

- **Franchise laws help ensure that a healthy level of competition exists in all facets of auto retailing.** Of course, these laws promote vehicle sales price competition among dealers. And the price competition that is fostered is both inter-brand and intra-brand. In fact, the most intense competition is intra-brand – it is often said that the strongest competitor to a Ford dealer is the nearest Ford dealer.¹⁷ But the franchise laws foster competition on more than just price; they also support competition in other key areas such as trade-in valuations, vehicle service and repair, financing, and customer sales and service experiences.

¹⁵ It should be noted that Congress has concluded that these markets require significant federal regulatory oversight as well. Examples include the Truth in Lending and Truth in Leasing Acts, 15 U.S.C. §§ 1601, et seq.; the Federal Odometer Act, 49 U.S.C. §§ 32701, et seq.; the Automobile Dealer Day in Court Act (ADDCA), 15 U.S.C §§ 1222, et seq.; the Motor Vehicle Franchise Contract Arbitration Fairness Act, 15 U.S.C § 1226; the National Motor Vehicle Title Information Act, 49 U.S.C §§ 30501, et seq.; and the FTC Act itself, 15 U.S.C §§ 41, et seq., just to name a few.

¹⁶ Indeed, as a review of the preambles of the state franchise laws reveals, consumer protection is often the legislature’s primary motivation in enacting these provisions. For example, the California legislature, in passing its dealer franchise law in 2013, included the following among its legislative findings:

The new motor vehicle franchise system, which operates within a strictly defined and highly regulated statutory scheme, assures the consuming public of a well-organized distribution system for the availability and sale of new motor vehicles throughout the state, provides a network of quality warranty recall and repair facilities to maintain those vehicles, and creates a cost-effective method for the state to police those systems through the licensing and regulation of private sector franchisers and franchisees.

Sen. Bill 155, 2013-2014 Reg. Sess., ch. 512, 2013 Cal. Stat. Similar statements can be found in the laws of Mississippi (Mississippi Code § 63-17-53), Nebraska (Nebraska Revised Statutes § 60-1401.01), Oklahoma (Oklahoma Statutes § 561), and Washington (Revised Code of Washington § 46.96.010), among many others.

¹⁷ That intra-brand competition between dealers benefits consumers by lowering prices was empirically demonstrated in the recent study by the Phoenix Center which is discussed in Section III.C., below. But this reality is also evidenced by the findings of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) July 19, 2010 report on the dealer closings in the GM and Chrysler bankruptcies. *Factors Affecting the Decisions of General Motors and Chrysler to Reduce their Dealership Networks*, Office of the Special Inspector General for the Troubled Assets Relief Program, U.S. Treasury Department, SIGTARP-10-008, July 19, 2010 (the SIGTARP Report). The SIGTARP Report can be found at https://www.sigtar.gov/Audit%20Reports/Factors%20Affecting%20the%20Decisions%20of%20General%20Motors%20and%20Chrysler%20to%20Reduce%20Their%20Dealership%20Networks%207_19_2010.pdf.

The SIGTARP Report found that the Department of Treasury’s auto task force wanted to rapidly reduce the dealership networks of GM and Chrysler because having fewer dealerships would reduce “internecine” (or, in other words, intra-brand) competition and thereby enable manufacturers and dealers to retain higher margins.

- **Lawmakers recognize that it is best to have dealer owners with local knowledge, ties, and interests.** When the going gets tough, a large manufacturer can simply close up a local outlet and go away. For the local business person, when the going gets tough, closing the doors and moving on is often not a realistic option. And the franchise laws present the best opportunity to ensure local ownership and operation of dealerships.
- **Franchise laws promote price transparency.** The sale of all motor vehicles involve distribution costs; as a result, by definition, there is a retail margin in the price of all motor vehicles. There are a number of internet sites and other sources from which a customer can learn the difference between the invoice price on a vehicle and the manufacturer's suggested retail price. This assists consumers in seeking out the most competitive price for the vehicle. It would be virtually impossible to so deconstruct a manufacturer's price to determine its retail margin.
- **Franchise laws operate to ensure that there is a healthy economic alignment between those that advocate for and perform warranty work and the consumer.** New car warranties are a key component to vehicle ownership. However, manufacturers see warranty work as a cost while dealers view warranty repairs as an opportunity to perform remunerative work and deliver customer satisfaction. This puts dealers firmly on the side of the consumer. Many of these laws also require that manufacturers file the details of their warranty coverage with the state and ensure that manufacturers and dealers perform their warranty obligations. Finally, a number of states also require manufactures to discharge fully their obligations regarding motor vehicles that are recalled due to product defects.
- **Franchise laws protect consumers through licensure and other related requirements.** The franchise laws ensure that dealers are not only governed by their private franchise agreements, but are also regulated in great detail as to such things as their selling and service responsibilities and advertising content. All of these provisions focus on protecting the public from the unscrupulous.
- **As explained in more detail below, state legislatures understand that the franchised dealership is one of the most powerful economic engines ever created.** The franchise system directly produces jobs for more than one million Americans and indirectly supports many more.

In addition to the foregoing, one often overlooked consumer benefit of the franchise laws is the stability that they bring to dealership operations and the impact that such stability has on dealerships' cost of capital. The franchise laws, especially those that were explored during the first panel at the Workshop, protect dealers against both arbitrary terminations by manufacturers and the unjustified and unsustainable addition of nearby competitors. As such, these laws lower the risk of investing in a dealership. Lower investment risk means a lower cost of capital, and the highly competitive nature of the auto retailing market ensures that this cost savings is pushed

all the way through to the end purchaser of the dealerships' sales and service offerings – the consumer.

Evidence of this impact on dealers' cost of capital can be found in the securities law disclosures made by the publicly-traded dealer groups. Under the guidelines of the Securities and Exchange Commission (SEC), publicly-traded companies need to disclose to the public "information about the most significant risks that apply to the company or to its securities."¹⁸ Virtually all of these groups list elimination of the state franchise laws as one of their key risk factors. For example, the most recent disclosure document for Sonic Automotive, a publicly-traded auto retailing group headquartered in North Carolina, states as a risk factor the following:

"If state dealer laws are repealed or weakened, our dealerships will be more susceptible to termination, non-renewal or renegotiation of their franchise and dealer agreements."¹⁹

If elimination of the franchise laws increases the risk of termination or non-renewal, then retention of those laws reduces that risk. As risk decreases, so does the return on investment demanded by and paid to investors.²⁰ And, while the existence of the franchise laws lowers the amount that dealerships have to pay for their capital, dealers are not the beneficiaries as intense price competition pushes these cost savings all the way to the consumer.

When considering consumer benefits, the economic contribution of motor vehicle dealers should also not be underestimated or dismissed with theoretical statements about market efficiency. The facts are that light-duty vehicle dealers directly employ nearly 1.1 million individuals with average salaries over \$50,000. In total, more than 2.2 million American jobs depend on franchised car dealers in some way. Furthermore, dealers often represent "anchor tenants" in many cities and towns where most other locally owned and operated businesses have left. It is often the case that the local dealership is the last remaining retail outlet providing both local property tax revenue and jobs. Unfortunately, some of the speakers at the Workshop would cast aside these economic contributions and claim that the benefits these jobs provide to their local communities are inconsequential when compared to certain ethereal and purely theoretical benefits for consumers, of which not a single dollar of value to consumers has yet been concretely illustrated.

In a world in which states actively compete for investment and employment and billions of dollars are spent on attracting automotive investment,²¹ it is obvious that state legislators and

¹⁸ <http://www.sec.gov/answers/reada10k.htm>

¹⁹ Sonic Automotive Inc, 2015 Annual Report (10-K) at 12 (February 26, 2016).

²⁰ And this is not a phenomenon that solely affects public companies. The risks described in the public disclosures are common to all dealerships (including those that are privately capitalized) and are similarly known to the capital sources that private capital dealers access – for example, banks and other lenders. In other words, the working capital loans that private dealers have carry lower interest rates as a result of the franchise laws. And, again, competition causes these cost savings to flow all the way through to consumers.

²¹ For example, two tax incentive plans were offered to Volkswagen in connection with the building of its manufacturing facility in Chattanooga, Tennessee: one in 2008 worth \$577 million and another in 2014 worth \$165 million. Boucher, Dave. (2015) "Volkswagen Chattanooga Tax Credits May Be Safe" Feb. 19, 2016. <http://www.usatoday.com/story/money/cars/2015/10/06/tennessee-volkswagen-chattanooga-plant-tax->

governors have a vested interest in ensuring that their states are competitive and able to retain employment. Few businesses employ so many individuals in such high paying jobs as automotive retailing. These realities rebut the theoretical arguments that these individuals will simply find other jobs, and the fact remains that that state legislators have a clear and valid social interest in pursuing policies that promote their state as being friendly to employers. Employment in good paying jobs is clearly in the public interest. Why else would states spend billions of dollars attracting employers? Few laws have such clear and resounding economic benefits in the form of jobs, income, and taxes and yet have effectively no tangible cost to the state or to market efficiency.

Finally, there is one recurring canard with regard to the impact of franchise laws on consumers that must be addressed. One of the greatest misconceptions held by critics of the dealer franchise system is that dealers add costs to the distribution chain. Nothing could be further from the truth. If a manufacturer owns a dealership, it still must invest millions on which its shareholders will expect a return; hire and compensate personnel; pay for rent, utilities, taxes, facility maintenance, local marketing, etc.; and cover the costs for everything else required to operate the business. What's more, warranty services, customer relations efforts, and vehicle repair and maintenance capabilities will still have to be provided. If anything, outsourcing these inevitable distribution costs to dealers saves money in the system. Operations by large, remote corporations would likely raise the costs of doing business over those of local dealers who understand their local markets implicitly and know best how to efficiently control expenses in them.²² Moreover, dealers provide an immediate outlet for vehicles and parts by paying for them before they even arrive at the dealership. Manufacturers do not have to carry the costs of inventories of vehicles and parts on their books. Thus, far from injecting additional costs, dealers typically represent an overall cost savings.

As the foregoing establishes, the state franchise laws operate directly to the benefit of consumers. State legislatures recognize this, and that is why they pass these laws.²³

[incentives/73451136/](http://www.incentives/73451136/) Similarly, in connection with Nissan's plant in Canton, Mississippi, a total of \$1.25 billion in tax incentives was provide: \$850 million in tax breaks spread out over a 30-year period and \$400 million in cash aid. Gibson, C. R. (2014) "Mississippi Cuts \$1.3 Billion From Schools, Gives \$1.3 billion to Nissan" Feb. 19, 2016.

http://www.huffingtonpost.com/carl-gibson/mississippi-cuts-13-billi_b_5614243.html

²² As Ms. Keller explained during panel three, Ford discovered this during its failed experiment with manufacturer-owned stores in the late 1990s. Specifically, she noted that "because of its size and structure, Ford's approach actually ended up increasing its overall distribution costs." TR. III; 17.

²³ During the Workshop, at least two participants observed that none of the so-called consumer advocacy groups were defending the state franchise laws against the attacks leveled by the Workshop speakers and concluded from this that the laws themselves did not benefit consumers. Apart from the fact that it is far from clear that these "consumer" groups always pursue policy outcomes that actually benefit the largest number of consumers in the long run, this argument ungraciously ignores both the important role of state legislatures in this process and the fact that these laws almost universally regulate the commerce between businesses and not consumers. State legislatures are the only actors who are truly accountable to consumers writ large. If the actions of state legislators dramatically depart from the interests of their constituents, those constituents can vote their legislators out at the next election. In our experience, as both Mr. Jacoby TR. I; 5, and Mr. Appleton, TR. II; 11, explained, these legislators are always focused on the impact on consumers when considering whether to enact these laws. Whether a so-called consumer group supports a particular public policy is not a proxy for whether that policy is good for consumers. Analysis

B. The Franchise Laws Seek to Level the Playing Field Between Manufacturers and Dealers

In addition to benefitting consumers, the franchise laws that the state legislatures have enacted level what is otherwise a very imbalanced economic playing field between auto dealers and manufacturers. Despite a number of assertions at the Workshop to the contrary, the simple fact is that auto manufacturers retain to this day a massive economic power advantage over their franchised dealers, resulting from both market structure, manufacturer behavior, and intrusion in the market by the federal antitrust statutes. And manufacturers often use this excess power to overreach and act opportunistically in their relationships with their dealers, to the detriment of dealers and ultimately consumers. The state franchise laws that have been enacted operate to counteract these anomalies and to afford the dealers a reasonable opportunity to negotiate their economic relationships.

The structural economic imbalance between auto manufacturers and dealers is extensive. One key manifestation of the uneven relationship between manufacturers and dealers can be seen in the various franchise contracts. These agreements are not negotiated; they are contracts of adhesion that are presented to the dealer on a “take it or leave it” basis. And any movement to change those terms emanates from the manufacturer in the form of either unilateral amendments to existing agreements or replacement agreements, both of which almost always contain terms that are more onerous from the dealer perspective than what existed before. Frequently supplementing these agreements are controversial programs designed to control dealer behavior, often developed with little or no meaningful dealer input.²⁴

There is also a significant existing asymmetry of information between dealers and manufacturers. This exists not only during the exploratory and purchase phase but also during the operational life of the dealership. The manufacturer knows the full details of a dealer’s operations, including its customer information, its finances, the disposition of its assets, and its succession plans. Conversely, a dealer has no such insight into its manufacturer beyond public documents and SEC filings. Meanwhile, the manufacturer heavily vets any dealer principal and has minimum requirements for assets and investment and continuing access to a dealer’s books and records.

And there’s more. As a result of the internet, everyone knows the dealer’s invoice price for vehicles; these are transparent. Similarly, retail prices for vehicles are also transparent. What

must be had of the content of the policy itself and the underlying legislative intent and, against those measures, the state franchise laws acquit themselves quite well.

²⁴ Indeed, there are many examples where a manufacturer has implemented amendments to its franchise agreement via “click-through” protocols on online portals. There are also instances where dealers unwittingly “agree” to such amendments via participation in a manufacturer program or similar behavior. Such “agreements” are clearly non-negotiable. What’s more, while many dealers may “agree” to these amendments because they feel they have no choice, those few dealers who challenge the fairness or even the legality of the amendments are often faced with the following “choice:” sign the agreement (like the majority of other dealers) or be ineligible (or render their customers ineligible) for a manufacturer incentive program. This is an impossible choice for any dealer; in reality, it is no choice at all.

is not available to anyone – not the dealer and not the consumer – is the margin from the manufacturer. This kind of opacity can only hinder the ability of a dealer to make appropriate business decisions.²⁵

The important role of the dealers’ barriers to exit. In light of the foregoing, a question that clearly arises is why does a dealer remain in such a one-sided contractual relationship if and when its manufacturer starts using its superior bargaining power opportunistically. Stated differently, the question is why can’t dealers protect themselves like participants in other markets simply by walking away and dealing with other vendors. The short answer is that, once a dealer has signed onto a franchise agreement and has made the required investments in the franchise,²⁶ that dealer faces significant barriers to exit.

First and foremost among these barriers is the previously mentioned sizeable economic difference and informational asymmetry between dealers and manufacturers. That dissonance impairs the dealer’s ability to make reasonable decisions about the future. A dealer cannot know the future state of the manufacturer or its products and, furthermore, cannot judge the success those products will have in the market. Indeed, the normal response from a merchant to such uncertainty is to have multiple product lines from multiple sources, thus allowing the merchant to hedge its risks. In the auto retailing arena, however, this effort to respond by stocking new or different products is restricted by the manufacturers.²⁷

This then also creates a second barrier to exit. Once personally invested in a business, a dealer facing a problematic or failing product line or manufacturer has few viable alternatives for disposal. After all, who makes an offer for a multi-million dollar business with high fixed costs and little control over what products can be stocked when that business is troubled or failing?

But there are other barriers as well. Dealerships require sizeable investments; millions of dollars are needed to fund working capital, inventory financing, and investment in facilities and other property. In addition, most capital lenders, especially when dealing with smaller dealerships, require some form of personal guarantees for these investments. And, while financial assistance is sometimes available from manufacturers, this additional incentive is at the discretion of the manufacturer providing it and is guided by opaque processes and decisions invisible to the dealer.²⁸ Moreover, these investments in fixed property, inventory, and unique, often single-use facilities have very high capital costs. The fact that dealers are contractually obligated to invest in these facilities makes it difficult for them to exit without leaving behind significant stranded assets.

²⁵ In this connection, it is important again to recognize that what the franchise laws are regulating is these business-to-business dealings.

²⁶ In general, the franchise agreements and related side agreements require the dealer to make continuing investments in land, buildings, equipment, computers, tools, personnel, training, advertising, and promotions.

²⁷ Most manufacturers have strict rules against selling and servicing another manufacturer’s products at the same location.

²⁸ In this way, these incentives are yet another example of the paucity of information to which dealers have access in making business decisions.

A further barrier to exit is inherent in the design of the retail relationship. We noted elsewhere that dealers frequently operate single product stores carrying only the merchandise of one manufacturer. As such, dealers have no ability to switch products or brands and cannot source independently. This makes it virtually impossible for a dealer to terminate a relationship with a manufacturer, because the dealer would find that it no longer had any products to sell. This is one of the few, if not the only, retail businesses where the merchant has little control over what products will be stocked, when they arrive, how they will be initially priced, and what the terms of payment for that merchandise will be. And this outcome is exacerbated by the facility requirements that most manufacturers impose on their dealers. These requirements, which often can cost several million dollars to meet, typically result in single-purpose facilities that cannot easily be converted to meet another manufacturer's requirements. For example, it would be enormously expensive for a Honda dealer to convert its Honda compliant facility to meet the facility requirements of Chevrolet.

Finally, selling a dealership is also a process fraught with delays and contractual obligations demanded by manufacturers. One simply cannot sell a dealership to anyone; there is an extensive vetting process, and the new buyer must provide significant capital and meet other requirements established by the manufacturer. This process can be time-consuming, and delaying a transaction inherently increases the probability that a sale will fail to be consummated and that the existing dealer will be stranded without a qualified buyer.

Due to the manufacturers' many points of leverage, the economic imbalance will continue indefinitely. During the Workshop, a number of the speakers asserted that whatever imbalance in bargaining power that may have justified the franchise laws in the past no longer exists and that the manufacturers and dealers of today are effectively economic equals.²⁹ Accordingly, this argument proceeded, the proper way for the relational disputes between the dealers and the manufacturers to be resolved is through normal contract negotiations in the

²⁹ See, for example, the following comments of Messrs. Chiapa and Goldberg and Professor Sappington: "[I]f we look back on the rationale of the statutes, . . . in effect there was an unequal bargaining power, [but] Warren Buffett is a different player than a mom-and-pop store from the 1950s." (Mr. Chiapa, TR. I; 30.) "There's been some reference already to the historic unequal bargaining power and some reference to the size of auto dealerships. To put a little bit of a finer point on that, average dealerships in the country now generate \$50 million of revenue a year, are profitable, and the Fortune 500 dealer entities now generate billions of dollars. On average, the six largest dealer groups generate over \$10 billion of revenues a year. . . [Small dealers] get a free ride[] on the negotiating power of these enormous dealer groups." (Mr. Goldberg, TR. II; 7.) "[A]s we've heard a bit this morning, I think the basic story that tries to justify these regulations is that . . . we have a setting where there's a huge dominant manufacturer and a small dealer who is beholden to the manufacturer . . . Now, that's a story that one might tell, but that's not the way I perceive the industry, and I think a more realistic depiction of today's industry is that in fact we have many manufacturers competing against one another to reach customers. They do so through their dealers, but those dealers, notice now in this new picture, are not tiny little entities. As Dan [Crane] has mentioned, they are in fact major players, major economic entities." (Professor Sappington, TR. II; 9.)

marketplace.³⁰ Thus, this line of argument concluded, there is no longer any need for intervention by state legislatures.³¹

Notwithstanding the constant refrain from the franchise law opponents on this point, repeating it does not make it so. The purported predicate of this argument – that dealers now have sufficient bargaining power to protect their interests at the negotiation table – simply does not reflect reality. To the contrary, dealers across the spectrum remain quite small relative to the manufacturers. Most dealers are still small, family owned and operated businesses. The typical dealer principal owns just over two stores and more than 7,500 own three or fewer stores. Indeed the vast majority of dealer principals own only a single retail outlet tied to one manufacturer. And this applies to the volume of vehicles sold as well. 39% of NADA’s members sell fewer than 300 new vehicles per year. The significance of these realities can be seen even more starkly by looking at the magnitude of the economic disparity between dealers and their manufacturers. For example, the average dealership, which is tied to just one manufacturer, has annual revenue of \$52 million; in contrast, GM, by itself, has revenue of \$152 billion and is more than 2,900 times larger.

Indeed, even the large dealer groups do not possess the bargaining power that the Workshop presenters would impute to them. The manufacturers work very hard to ensure that no dealer group achieves ownership of a large portion of their dealerships.³² Every public dealership group and the largest private groups operate under what are known as “framework” agreements. Among other things, the manufacturers use these agreements to constrain the number of dealerships of a particular brand that the signatory group may own. And these efforts are on-going. For example, as recently as last fall, *Automotive News* reported that “Mercedes-Benz USA is talking to its retailers about putting a cap on the number of stores any single dealership group will be allowed to own.”³³

The manufacturers’ efforts to limit the bargaining power of the major groups has been successful. Those groups rarely own more than a very small percentage of a brand’s stores. For example, a review of the SEC Form 10-Ks of the publicly-traded dealership groups reveals that even AutoNation, which is the largest dealer group in the U.S., is still only a small part of any single manufacturer’s franchised network. Following on with our GM example above, AutoNation owns less than 1% of the total GM franchises in the United States. And collectively, the public groups own just over 3% of the franchises nationwide. This is another example of what a highly fragmented industry this remains.³⁴

³⁰ For example, Professor Schneider stated that “it’s not clear to me why . . . long-term contracts can’t address” the issues governed by the state franchise laws. TR. I; 21.

³¹ See Professor Crane’s article “Tesla and the Car Dealers Lobby” *Regulation* 37(2) at page 14 (“Many dealerships are no longer small mom-and-pop organizations but large multi-location and even multi-state ventures. The dealers should protect their interests through contractual negotiations rather than through protectionist legislation.”)

³² Of course, such ownership would go a long way toward giving the larger dealer groups some modicum of bargaining power.

³³ “M-B Looks To Cap Number Of Stores Per Group,” *Automotive News* (October 12, 2015, page 1).

³⁴ What’s more, contrary to one of the assertions made at the Workshop, even if a few of the larger dealer groups were to have sufficient economic power to protect their own interests, this would not solve the problem for all dealers. During panel two, Mr. Goldberg claimed that some of the top dealer groups were large enough to bargain

Clearly, dealers – even the largest ones – do not individually have the bargaining power to negotiate effectively with their manufacturers. Moreover, dealers are also precluded by the federal antitrust laws from getting together and using their collective economic power for this purpose. The federal antitrust laws significantly constrain collective dealer activities. Individual dealers may complain, criticize, second-guess, and vent about their manufacturers. Acting as a group, however, dealers are subject to extensive restrictions on their activities. Dealer groups may not, for example, agree to refuse to sell an unpopular car or decline to participate in an exploitative manufacturer program. Dealer groups may not require better financial arrangements as a condition of using a manufacturer’s captive finance company. And, perhaps most importantly, no group of dealers may jointly refuse to accept a manufacturer’s unilateral revisions to its franchise agreement. Unlike unions, dealers have no exemption under the federal antitrust laws to engage in collective bargaining with the manufacturers. If these restrictions did not exist, dealers would be in a position to exercise collective economic self-help in response to manufacturer behavior. The world would be a different place indeed if dealers could threaten to stop buying cars from a given manufacturer unless that manufacturer dropped a pernicious program that it had proposed. But exercising collective economic power in this manner would be illegal and is therefore not an available option for dealers.³⁵

The combination of a lack of individual bargaining power, the prohibitions in the federal antitrust laws against the exercise of collective economic power, and significant barriers to exit leaves auto dealers especially vulnerable to manufacturer overreach. And, unfortunately, manufacturers have a long history of taking advantage of that superior position and behaving opportunistically relative to their dealers. Example abound, including (1) threats of termination or a shorter term franchise agreement on renewal based on a dealer’s failure to meet sales performance targets that were not realistically attainable, (2) pressure to upgrade facilities without any evidence of a positive return on investment, (3) pressure to accept slow-moving inventory, (4) requiring a dealer to compete when other dealers in the same market are given preferential pricing (“two-tiered pricing”), (5) requiring a dealer to join, and contribute financially to, a cooperative advertising association even when the advertising is of little or no benefit in the dealer’s market, and (6) pressure to accept unordered parts and essential special tools whether needed or not. And the list expands each year due to the creative efforts of the manufacturers to outsource more and more costs.

effectively on their own and that small dealers “get a free ride[] on the negotiating power of these enormous groups.” TR. II; 7. As we have explained, Mr. Goldberg was wrong about the negotiating power of the large dealer groups. But even if he was right, the scale, multi-brand nature, and other attributes of those groups make them an insufficient bargaining proxy for the more numerous smaller dealers.

³⁵ In another manifestation of their lack of understanding of the auto retailing marketplace, some of the Workshop participants were apparently unaware of these limitations. Professor Sappington argued that, in lieu of seeking resort in the state legislatures, “dealer teams” can (and should) work together with their manufacturers to work out a relationship package that will best position that brand to compete with other brands. TR. II; 9. But Professor Sappington’s idyllic view of the world ignores the fact that, because of the federal antitrust laws, dealers cannot engage in those negotiations as a team and that, as individuals, they lack the bargaining power to achieve an appropriate outcome.

In light of their limited ability to protect themselves through normal market channels, dealers have been left with no viable option but to seek redress through their state legislatures. Professor Schneider framed the issue quite nicely when he said, during panel one, that the question that the franchise laws present is whether “you want to give dealers equal bargaining power with manufacturers?” TR. I; 27. This is, in fact, the question that state legislatures have been called upon to answer; and because of the structure of the relationship, the history of manufacturer behavior, and the reduction in dealer negotiating power resulting from the federal antitrust laws, they have generally and legitimately answered that question in the affirmative.³⁶

Importantly, this engagement with the state legislatures was initially, and still is today, a negotiation. The manufacturers are entitled to be (and are) full participants in the legislative process, as are other related constituencies such as consumer groups, safety advocates, municipalities, other auto industry stakeholders, and other business organizations. Over the years, these public sector negotiations on motor vehicle laws and the resulting implementing regulations have resulted in a process that has fairly balanced a variety of competing economic and political interests. Notably, the end result serves the public interest far more than would be the case if private contractual negotiations between the dealers as a group and the manufacturers were permitted under federal antitrust laws. In this sense, the enactment of state franchise laws governing the sale of motor vehicles was the natural economic response to the absence of a free market: a dysfunctional market marked by (1) constrained dealer advocacy with threats of antitrust sanctions from the federal government and (2) actual harm from oppressive, unilateral actions from the manufacturers. In the future, the degradation of these laws would replicate the same dysfunctional market, while the retention of the statutes will replicate the same beneficial stakeholder negotiations inherent in the public policy process.

C. The Economic Arguments Made at the Workshop In Opposition to the Franchise System Were Not Well Founded

At their core, the arguments presented against the franchise laws by various panelists at the Workshop boil down to a simple disagreement between theory and reality. These panelists constructed a marvelous theoretical world, one in which all parties in an economic relationship have equal information, representation, and economic power. This hypothetical world also operates with completely fluid markets in which all individuals and firms act rationally, thinking only of their economic interests and nothing more.

Unfortunately, dealers do not operate in such a world. They deal with individuals whose decisions are clouded by personal bias, irrational expectations, or short-term financial and

³⁶ While theory might suggest that any manufacturer that undermines the financial viability of its franchisors would soon face ruin, reality has unfortunately proven otherwise. The state franchise laws have been enacted to regulate this opportunistic behavior by manufacturers. Indeed, when dealers support the enactment of these laws, they are simply reacting to manufacturer overreach. A manufacturer can push cost and obligations onto dealers with little or no accountability. Therefore, it is perfectly understandable why dealers feel it necessary to petition their state governments. Absent these pressures from the manufacturers, NADA has little doubt that the state laws would be considerably less extensive than they necessarily are today

economic objectives that often do not align with an economically-rational long-term outcome.³⁷ In addition, as noted above, dealers suffer from a large disparity not only in economic power but also in information. Add into this mix high barriers to exit and it soon becomes very clear that it is these inherent disparities in the real interactions between dealers and manufacturers, and not theoretical constructs, that should inform state legislatures regarding the need for and appropriateness of dealer franchise laws.

Setting aside theory and focusing on reality, we can examine in more detail the primary economic arguments proffered at the Workshop for eliminating state franchise laws: that the vertical integration of auto retailing will lead to costs savings; that RMA laws result in dealers having market power in retail distribution; that the current distribution system denies consumers the benefits of e-commerce and manufacturers the benefits of a build-to-order system; and, finally, that RMA laws also increase prices.

NADA substantively addressed all of these issues when we wrote to the FTC staff regarding its position on direct sales legislation in 2014. See NADA's letter to Andrew I. Gavil, et al., dated July 17, 2014 ("NADA's 2014 Letter").³⁸ None of the points in support of the franchise laws raised by NADA's 2014 Letter were addressed by any of the Workshop panelists. The unanswered points include the questions we raised regarding the academic studies used by many in opposition to the franchise laws, nearly all of which suffer from serious econometric or factual issues. More importantly, not a single piece of new econometric evidence was presented to justify any of the arguments against these laws.

Turning to some of the assertions made at the Workshop, we start with the RMA laws. Most importantly, these laws must be seen for what they are – a business-to-business regulation. They create a process of review whereby independent third parties are allowed to examine a manufacturer's choice of placing a new retail outlet into a same brand dealer's current area. These laws do not impact consumers and, in fact, are wholly invisible to any new vehicle purchaser. RMA laws simply do not grant any market power. In fact, we are unaware of any dealer with market power sufficient to charge monopoly rents.

We also remain unaware of any empirical evidence that illustrates that any franchise law results in double marginalization or excessive rents. In fact, quite the contrary is the case. The most recent study we have found shows that RMA laws may actually *reduce* prices in some cases. Walden (2005)³⁹ This study, which uses price data collected from individual Honda dealers across the United States for a new vehicle with the same options, finds no positive price

³⁷ For example, just in 2015, a regional executive at one of the auto manufacturers demanded that dealers answer independent surveys from NADA with only positive ratings, thereby impairing the quality and candidness of the dealers' operational feedback that they were otherwise able to give. Many of the affected dealers had no real ability to resist this pressure because they were single point stores tied only to that manufacturer. While there was no clear motive for the employee's behavior, it appeared that this was being done so managers would receive positive short-term performance reviews. To be sure, this issue was positively resolved; however, problems like this are not rare, and it is one more example why franchise laws are needed.

³⁸ For the FTC's convenience, a copy of NADA's 2014 Letter is attached hereto as Attachment A.

³⁹ Walden, Michael L. (2005) "Do Geographic Entry Restrictions Increase Car Prices?" *The Review of Regional Studies* 35(2) 231-245.

effect from dealer entry restrictions. In fact, the two dealer entry restriction variables included in the analysis actually had negative effects on price. Furthermore, as mentioned, the findings on the interaction of RMA laws with population density is contrary to the findings of Rogers (1986).⁴⁰ And Walden actually found that, in areas of higher population density, RMA laws may lead to lower prices for consumers. Walden also finds that the use of the internet in car shopping can yield lower prices for consumers, which is consistent with later research done by Scott Morton et al. (2011).⁴¹ It is estimated that buyers shopping online receive an average price discount of \$429.

Finally, we want to underscore an important point regarding the new vehicle market that we made in NADA's 2014 Letter. Simply put, in a workable competitive market for motor vehicles, we would expect that (1) the demand for individual automobile product lines would be more elastic than is the case for automobiles as a whole, and (2) if the demand for a motor vehicle is highly elastic, then a small reduction in price would capture a proportionally larger increase in market share. This would render unviable any attempt by an individual dealer to exploit a ban on direct manufacturing sales in order to extract higher prices.

Empirical evidence confirms these observations. The elasticity of demand for new motor vehicles in the U.S. is estimated to be -0.87 by McCarthy (1990) and -1.0 by Bordley (2006). Product line elasticities are reported for the U.S. by Bordley (2006) and for Spain by Jaumandrou and Moral (2001). The results are reasonably consistent across the two studies in terms of the estimate range of elasticities by product line. The elasticities for individual product ranges is generally three- to four-fold higher than for the overall market. It is therefore difficult to see how in a market with a large number of auto dealers, any kind of sustainable rents could be achieved. Furthermore, it is impossible for us to understand how such a competitive market could be aided by vertical integration, and the Workshop panelists provided no evidence that would clearly illustrate any consumer benefits to ending current restrictions on auto manufacturers from selling directly to the public.

Since there are clear and marked differences in economic power between dealers and manufacturers that can only be remedied through the action of state legislatures and these actions cause no quantifiable harm to consumers, what then is the economic justification for eliminating these duly enacted laws?⁴² There certainly is no econometric evidence. Meanwhile, states receive the benefit of additional tax revenue and employment; other consumer and ancillary societal benefits are achieved; and an artificially tilted playing field is leveled. Simply put, these laws serve the public interest.

⁴⁰ Rogers, R.P. (1986) "The Effect of State Entry Regulation on Retail Automobile Markets." Bureau of Economics Staff Report. Federal Trade Commission: Washington, D.C.

⁴¹ Scott Morton, Fiona, Florian Zettelmeyer, and Jorge Silva-Risso (2011) "What Matters in a Price Negotiation: Evidence from the US Auto Retailing Industry," *Quantitative Marketing and Economics*: 9:365-402. Ms. Keller highlighted this interesting conclusion from Professor Scott Morton's research during panel three. TR. III; 18.

⁴² In this regard, Professor Carlton asked a very interesting question: "[w]hat is the evidence that consumers are harmed?" TR. III; 8. Clearly, he was questioning the need for franchise laws, yet we ask this same question: *what is the evidence that consumers are harmed by dealer franchise laws?*

III. The Value and Importance of the Specific Laws About Which the FTC Has Inquired

The foregoing points about the value and importance of the state franchise laws apply with particular force to the three sets of laws specifically discussed at the Workshop – laws relating to (1) dealer terminations and additions, (2) warranty reimbursement, and (3) direct sales. As we demonstrate below, the concerns of some of the presenters about these particular laws were unfounded. These laws represent prudent and appropriate policy decisions of the state legislatures that adopted them.

A. Dealer Terminations and Additions

The underlying public policy rationale for the state regulation of dealer networks by each of the 50 states is as viable to today as when these laws were first enacted. More than 100 years ago, the auto manufacturers established a dealer network comprised of independent entrepreneurs to outsource the costs associated with the distribution, sales, and servicing of their products. Since its inception, the franchise system has provided an efficient and cost-effective method for selling and servicing vehicles. However, also since the inception of the franchised system, a severe economic imbalance between the manufacturer and the dealer has existed and, as explained in detail above, that imbalance still exists today. It is that imbalance and the advantage of it that many manufacturers have taken (and continue to take) that has led state legislatures to enact the types of laws that were discussed during panel one of the Workshop.

Prior to the enactment of the statutory provisions relating to dealer networks, existing dealers faced several types of pressure from the manufacturers, including the threat of a unilateral termination without cause and the threat that the manufacturer would seek to oust them by establishing additional competing dealerships with the same brand nearby the original dealer. Moreover, in an attempt to indirectly achieve the same ends, the manufacturers became particularly adept at transferring every conceivable cost (direct and indirect) from the manufacturer to the dealers, thereby imposing an involuntary cost structure upon the entire dealer body.⁴³ And, as explained above, in the face of these oppressive unilateral actions by the

⁴³ Some of the typical ways that manufacturers continue unilaterally to impose costs on dealers are as follows:

- Pressure the dealer to take excess or undesirable new inventory or used inventory coming off lease as a condition of obtaining desired new inventory;
- Unreasonably chargeback warranty work;
- Impose exorbitant signage obligations and/or sign rental fees;
- Establish sales percentage metrics that are mathematically unattainable;
- Create complex sales incentives that alter wholesale pricing retroactively;
- Bill a dealer for unordered and excessive tools via an open account between the manufacturer and dealer;
- Pressure the dealer to take excess parts inventory;
- Require redundant dealership employee training;
- Require facility upgrades with payments insufficient relative to the anticipated return on investment;
- During facility upgrades, require the use of specific vendors that are less competitive than local vendors and/or materials that may not be suited for the local market;
- Unreasonably deny dealership succession plans; and

manufacturers, the dealers were powerless due to the federal antitrust laws to join together to fight back. So, lacking sufficient individual negotiating power and being precluded from exercising collective power, dealers sought redress from their state governments. Key elements of the enactments that resulted were the dealer network provisions of these laws – most notably, the franchise law provisions that address arbitrary dealer terminations and those that regulate the arbitrary placement of new dealerships in the immediate physical proximity of existing dealers. For example, the very first state franchise law, passed in Wisconsin in 1937, prohibited a manufacturer from terminating a dealer “without due regard to the equities of said dealer and without just provocation.”⁴⁴

The state franchise laws relating to dealer networks do not confer monopoly power on incumbent dealers. At the Workshop, the provisions of the state franchise laws that regulate RMAs or preclude unfair terminations or denials of succession were criticized in theory for undermining competitive markets.⁴⁵ As we demonstrated in NADA’s 2014 Letter, there is no statistical evidence to support such claims. These laws, which only regulate business-to-business transactions, simply inject balance into the otherwise inherently imbalanced manufacturer-dealer relationship while ensuring that the public interest is considered as well.

The typical RMA statute defines the regulated market area to be within 7 to 10 miles of an existing store. However, as explained by both Mr. Jacoby and Mr. Roesner, TR. I; 15, 18-19, not a single state RMA provision grants an incumbent dealer the right to veto a new store within an RMA. Rather, the RMA provisions merely provide incumbent dealers with a right to protest a new store as part of a proceeding that balances the interests of the dealer, the manufacturer, and the public. Generally speaking, if the manufacturer can demonstrate that it makes economic sense for both consumers and dealers to add a new dealer in a specific market, that point will be added. In this regard, as Mr. Jacoby explained, TR. I; 29, it is important to note that the protesting dealers usually lose the cases brought under the RMA laws and, in the vast majority of settlements in these cases, new dealer points are added.⁴⁶ Indeed, due to internet-driven price

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- Impose extensive cross-default clauses in the various required contracts (franchise agreement and related documents incorporated by reference, various personal guarantees, financing documents, etc.)

The manufacturers derive the power to do this from several sources. The owners of many smaller dealerships have too much of their total personal wealth tied up in the dealership to challenge the manufacturer. The owners of many larger dealership chains have too much corporate exposure to challenge the manufacturer. Moreover, the franchised dealer’s business model is disproportionately capital intensive. As a result, dealers, even the largest ones, are heavily credit dependent (the economies of scale for larger dealers are not manifested in reduced credit dependency). Additionally, this business model has disproportionately more frozen capital (large, single-purpose real property) for large and small dealers alike.

⁴⁴ 1937 Wis Laws, chs 377; 378. And the states were not alone in addressing these issues. In the 1950s, Congress considered and, in 1956, enacted the ADDCA. Significantly, however, the ADDCA generally does not preempt state dealer franchise laws.

⁴⁵ For example, in his comments on panel one, Professor Schneider suggested this when he spoke of dealers “having some market or monopoly power in their local area.” TR. I; 22. See also Professor Scott Morton’s comments during panel four to the effect that “[a] single franchise dealer that owns the car has market power in its local area, and it will set a stiff retail market.” TR. IV; 24.

⁴⁶ As Mr. Jacoby also explained, TR. I; 29, the fact that the protesting dealer usually loses when protests are litigated also fully addresses and negates the complaints that were made at the Workshop by Mr. Chiapa and one of the

information, geographically-defined RMAs are less relevant in defining actual and potential markets. However, as Mr. Roesner explained, one salutary impact of these laws is that they prompt manufacturers to “look long and hard at terminations and additional points,” TR. I; 19, rather than to make those decisions precipitously. Thus, the RMA statutes do not dictate outcomes, but instead simply ensure that when dealer network decisions are made, there is an appropriate balancing, administered by an independent fact finder, of the public interest (including the impact on competition) along with the economic interests of the various market participants.⁴⁷

Similarly, the state law provisions governing unfair termination or denial of succession do not vest dealers with veto rights over a manufacturer’s decision. Instead, the typical provision requires a manufacturer to show good cause prior to terminating a dealer agreement and provides a framework for determining a fair value of the terminated franchise.⁴⁸ A dealer facing a precipitous termination can file a protest before an independent board or commission. In rendering a decision, the administrative hearing officer balances the interest of the individual dealer and the manufacturer, but also weighs other broader effects such as the impact on future market participants if an unwarranted termination were to be sustained. As in the case of the RMA decisions, these laws often trigger negotiations that, in turn, lead to settlements that reflect a dealer’s economic harm resulting from the closure. However, in practice, the amount of money that the dealer is awarded in an administrative proceeding or receives in the context of a settlement usually does not fully mirror the actual amount of harm sustained.

The state franchise laws relating to dealer networks have not prevented the “rationalization” of those networks. There were a number of comments at the Workshop

public questioners, TR. I; 28, that the presence of dealers on the motor vehicle boards that consider these cases is problematic and otherwise deprives those boards of objectivity.

⁴⁷ It is significant that the courts that have reviewed these laws have found them to be appropriate exercises of legislative authority. The United States Supreme Court upheld the constitutionality of California’s RMA law based on the following rationale:

“The disparity in bargaining power between automobile manufacturers and their dealers prompted Congress and some 25 states [now all 50] 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 manufacturers from adding dealerships to the market areas of its existing franchises where the effect of such intrabrand competition would be injurious to the existing franchisees *and to the public interest.*”⁴⁷

New Motor Vehicle Board v. Orrin W. Fox Co., 439 U.S. 96, 100-102 (1978) (emphasis added). Similarly, a California appellate court upheld the same provision, concluding that it was supported by the legislative intent 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. Piano v. State of California ex rel New Motor Vehicle Board, 103 Cal.App.3d 413 (1980). See also 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).

⁴⁸ Some of these laws go further and actually define in the statute what constitutes good cause. The granularity in these latter statutes was often enacted in response to attempts by manufacturers to classify as constituting “good cause” facts and circumstances that no reasonable person would agree did so.

about the impediments that the dealer network laws supposedly place in the way of updating a manufacturer's representation in a given market. But for more than 60 years, the number of dealerships in the United States has been shrinking consistently, despite the enactment of the allegedly anti-competitive, market-limiting state franchise laws in every state during the very same time frame.

In reality, the decline in the number of dealerships has reflected market conditions. The number of dealership peaked in the 1950s at about 50,000 dealerships and by 1970 had declined to 30,800. In 1987, there were 25,150 new-car dealerships; by the end of 2015 there were only 16,545.⁴⁹ Dealerships, like all economic firms, respond to market conditions and economic cycles. State franchise laws, which have been in existence throughout this period of dealership count decline, have never impeded the natural market forces of growth or decline; rather, they have simply provided for oversight of a divisive and often imbalanced process.

Perhaps one of the clearest examples of successful consolidation activity led by a manufacturer occurred with Ford Motor Company in the years leading up to and following the great recession of 2008-09. While GM and Chrysler executives relied on bankruptcy to reduce their dealer networks,⁵⁰ Ford executives avoided bankruptcy and yet still adjusted the Ford dealer network in proportional numbers. They did so by analyzing local markets and working with existing dealers to create mutually-beneficial arrangements that still served the consumers in those markets. And this was all achieved within the framework of the existing franchise laws. In this way, it can be seen that the existence of the dealer network statutes creates an incentive for a manufacturer to enter into good faith negotiations with its dealers when a market restructuring is planned rather than to act precipitously or arbitrarily.

Additionally, the existence of franchise laws has never interfered with the establishment of new brands or the entry of new manufacturers. Product failures aside, every manufacturer that has chosen to operate within the established guidelines has successfully launched and established a retail dealer network. No manufacturer has ever failed because of franchise laws. During the past 20 years, individual dealers have been much more likely to invest capital in multiple dealerships of different brands. Market incumbents reaping monopoly rents have an incentive not to diversify. Yet, today, a multi-point dealer is just as likely to have a domestic and an

⁴⁹ Interestingly, during the period in which the number of retail dealerships has been cut in half, the U.S. vehicle population that these dealers sell and service has more than doubled – from 125 million vehicles in 1976 to approximately 260 million vehicles today.

⁵⁰ The dealer terminations in the GM and Chrysler bankruptcies were very controversial and, in many respects, misguided. Indeed, although saving money was one of the reasons offered to justify the dealer closures effected through the GM and Chrysler bankruptcies, SIGTARP failed to identify any such “savings” from those closures. See SIGTARP, Quarterly Report to Congress (October 26, 2010) at 22. (This quarterly report is available at https://www.sig tarp.gov/Quarterly%20Reports/October2010_Quarterly_Report_to_Congress.pdf.) And the reason that there were no savings from these closures was because dealers simply do not cost the manufacturers anything to operate. See *The Franchised Automobile Dealer: The Automaker's Lifeline* (Casesa Shapiro Group, November 26, 2008), a copy of which is available [here](#). The primary conclusion of the Casesa Shapiro Group report was that “[f]ar from being a burden to the manufacturer it represents, the automobile dealer supports the manufacturer's efforts by providing a vast distribution channel that allows for efficient flow of the manufacturer's product to the public *at virtually no cost to the manufacturer.*” (Emphasis added).

international brand, rather than just domestic or just international brands. Indeed, over this period, the establishment of new dealerships has likely been aided by franchise laws that help assure potential investors of the safety of their investment. The recruitment of dealers, particularly for a new entrant, is made far easier with the presence of franchise laws than without.

And this brand diversity benefits consumers as well. Indeed, at one time, the federal government scrutinized manufacturer restrictions on dealers representing more than one manufacturer (so-called “dualing arrangements”). It did so presumably because of concerns that dualing prohibitions limited competition that otherwise benefitted consumers. Having dealers representing multiple brands is good for competition. It certainly allows consumers to compare vehicles much more easily.

State franchise laws relating to dealer networks have not prevented the automakers from reorganizing or eliminating brands. Notwithstanding the existing state franchise laws, the domestic manufacturers have been able to institute “channeling” arrangements which involve the combination of multiple brands within one dealership. For example, Chrysler (now FCA) has moved aggressively to set up the Jeep, Chrysler, and Dodge configuration for many of its locations. Similar activity has occurred with GM brands. This process, often implemented at the expense of the dealers involved, has enabled the domestic manufacturers to package several brands under one dealership roof.

Similarly, the state franchise laws have not prevented manufacturers from terminating or eliminating brands entirely. Saturn, Oldsmobile, Mercury, Pontiac, and Plymouth dealers did not have any veto rights over the elimination of these brands. Rather, as with individual terminations, the state dealer network laws in those instances simply accounted for the fact that the dealer body had assumed a significant cost by establishing and maintaining the manufacturer’s retailing network over the years and operated to inject a modicum of good faith into the manufacturer’s plan to restructure.

The shuttering of the one hundred year old Oldsmobile brand is a case in point. In this connection, we need to re-emphasize that dealers have only a single source for their products and cannot stock their shelves with merchandise from other manufacturers. It is also critical to remember that dealers have no control over the product they sell, as research, development, and design all occur within the manufacturer. So when GM made the announcement in December 2000 that Oldsmobile would be eliminated, it came as a surprise to many dealers.⁵¹ Note that these dealers had already suffered declining investment by GM in Oldsmobile products, advertising, and even quality. This had reduced the value of Oldsmobile franchises and made them virtually impossible to sell. Indeed, when the announcement came, the affected dealers’ only recourse was found in the state franchise laws. GM, undoubtedly prompted by the presence of these laws, offered a “buyout” package to its Olds dealers which included a payout of cash based on a stated recent sales formula and certain other provisions. Although the average

⁵¹ Indeed, this announcement came less than a month and a half after new, five year franchise agreements between GM and its Oldsmobile dealers became effective.

payment offered (approximately \$360,000⁵²) was well below the actual injury the dealers had sustained, the vast majority of Oldsmobile dealers took the package and eschewed the courtroom. In the final analysis, while the state franchise laws did result in some compensation to GM's loyal Oldsmobile dealer body, those laws neither precluded GM from terminating the brand nor provided an unjust enrichment to the dealer body.

In light of the ongoing overreach and opportunism by manufacturers and the magnitude of the salutary dealership investments that dealers make, the various states have put into place a series of well-structured laws concerning dealer networks. The laws that have been adopted do not prevent manufacturers from adjusting their market representation, but do encourage thoughtfulness and fairness in the process and ensure that any adjustments that are made take into account the public interest. As such, these laws reflect a prudent exercise of state legislative authority.

B. Warranty Reimbursement

In his introductory remarks to panel two on warranty reimbursement, the FTC moderator stated that the inquiry into the warranty reimbursement laws presents the question of whether or not "such direct regulation ultimately is in the interest of U.S. consumers." TR. II; 1. The answer to this question is unequivocally yes.

State laws regulating manufacturer reimbursement rates for dealer-performed warranty work have been enacted in virtually every state because they prevent manufacturers from exploiting their superior market position to undercompensate dealers and to deprive consumers of the full benefit of the vehicle they purchased. Although the details vary, the majority of such laws peg the reimbursement rates for warranty repairs to the prices associated with comparable non-warranty repairs. Problematically, however, the same market power and economic incentives that caused dealers to be undercompensated for warranty repairs in the first place give manufacturers incentives to circumvent these state laws by attempting to recoup money paid for warranty repairs through other mechanisms.⁵³ Several states have responded to such circumvention efforts by enacting "recoupment bars" (which expressly stop manufacturers from recouping warranty-related reimbursement costs from dealers) and laws that permit dealers to resubmit claims that have been rejected due to "clerical" mistakes in the original submission.

As noted above, the relationship between an auto dealer and its manufacturer is governed by a written franchise agreement. These agreements cover a broad range of subjects, including how manufacturers and dealers implement and execute manufacturer-backed warranties on new

⁵² "Most Suzuki Dealers Take Buyouts," *Automotive News* (December 10, 2012) ("GM said it cost \$1 billion to wind down about 2,800 Oldsmobile stores."); "New GM CEO Henderson Lays Out Survival Plan," *Automotive News* (April 13, 2009) (quoting GM CEO Fritz Henderson as saying that the cost of eliminating the Oldsmobile dealers was \$1 billion).

⁵³ Means of such circumvention included surcharges on new automobiles and audits that penalize dealers not because warranty repairs were not performed and compensation was therefore not owed but because dealers find it difficult at times to perfectly comply with the extremely complex rules and regulations manufacturers have imposed for processing warranty claim submissions. In the latter case, this results in mistakes in submission of warranty claims that are commonly described by dealers as "clerical" mistakes.

automobiles. Standard franchise agreements mandate that dealers perform warranty repair work irrespective of whether a dealer sold the vehicle to be serviced. In turn, manufacturers promise to reimburse dealers for their warranty work.

The vast majority of states have regulated this aspect of the manufacturer-dealer relationship for decades. Several states simply require that a manufacturer's compensation for warranty work be "reasonable," "adequate," or "fair."⁵⁴ The bulk of the states, however, require that manufacturers tether their warranty work reimbursement rates to the retail price of similar non-warranty work. North Carolina, for example, mandates that dealer compensation for warranty work will "under no circumstances . . . be in an amount less than the dealer's current retail labor rate and the amount charged to retail customers for the manufacturer's or distributor's original parts for nonwarranty work of like kind, provided such amount is competitive with the retail rates charged for parts and labor by other franchised dealers within the dealer's market." N.C. Gen. Stat. Ann. § 20-305.1.⁵⁵

In response to state laws tying reimbursement for warranty work to retail rates, some manufacturers have attempted to recoup the costs imposed by those laws by instituting "warranty

⁵⁴ See, e.g., Cal. Veh. Code § 3065 ("The warranty reimbursement schedule or formula shall be reasonable with respect to the time and compensation allowed to the franchisee for the warranty diagnostics, repair, and servicing, and all other conditions of the obligation."); Kan. Stat. Ann. § 8-2415 ("manufacturer or distributor shall pay reasonable compensation to any authorized new vehicle dealer") (original statute enacted in 1980); R.I. Gen. Laws Ann. § 31-5.1-6 ("Every manufacturer shall properly fulfill any warranty agreement and adequately and fairly compensate each of its motor vehicle dealers for labor and parts.") (original statute enacted in 1974); S.C. Code Ann. § 56-15-60 ("Every manufacturer, distributor, wholesaler, distributor branch or division, factory branch or division, or wholesale branch or division must fulfill properly a warranty agreement and compensate adequately and fairly each of its motor vehicle dealers for labor and parts.") (original statute enacted in 1962); Wyo. Stat. Ann. § 31-16-117 ("No schedule of compensation shall fail to include reasonable compensation for diagnostic work, repair service and labor.") (original statute enacted in 1988).

⁵⁵ See also Ala. Code § 8-20-7 (original statute enacted in 1981); Del. Code Ann. tit. 6, § 4903 ("With respect to parts and labor warranty reimbursement, reasonable compensation shall not be less than the rate charged by such dealer for like services to nonwarranty customers for nonwarranty parts, service and repairs, provided such rate is reasonable.") (original statute enacted in 1983); Idaho Code Ann. § 49-1626 ("The schedule of compensation for warranty parts and labor shall not be less than the rates charged by the dealer for similar service to retail customers for nonwarranty parts and labor") (original statute enacted in 1988); Minn. Stat. Ann. § 80E.04 ("The hourly labor rate paid to and the reimbursement for parts purchased by a dealer for warranty services shall not be less than the rate charged by the dealer for like service to nonwarranty customers for nonwarranty service and repairs.") (original statute enacted in 1981); Nev. Rev. Stat. Ann. § 482.36385 ("The dealer's compensation for parts and labor to satisfy a warranty must not be less than the amount of money charged to its various retail customers for parts and labor that are not covered by a warranty.") (original statute enacted in 1977); S.D. Codified Laws § 32-6B-61 ("The hourly labor rate paid to the dealer for warranty services may not be less than the rate charged by the dealer for like service to nonwarranty customers for nonwarranty service. Reimbursement for parts used in the performance of warranty repair may not be less than the current retail rate customarily charged by the vehicle dealer for such parts.") (original statute enacted in 1990); Va. Code Ann. § 46.2-1571 ("Compensation of a dealer for warranty parts, service and diagnostic work shall not be less than the amounts charged by the dealer for the manufacturer's or distributor's original parts, service and diagnostic work to retail customers for nonwarranty service, parts and diagnostic work installed or performed in the dealer's service department unless the amounts are not reasonable.") (original statute enacted in 1989); W. Va. Code Ann. § 17A-6A-13 ("in no event may the compensation of a dealer for warranty labor and parts be less than the rates charged by the dealer for like service to retail customers for nonwarranty service and repairs") (original statute enacted 1982).

parity surcharges.” In Maine, that surcharge took the form of a \$500 price adjustment on each new car sold to Maine dealers. Several states have responded to such manufacturer attempts to pass on the costs of warranty work by enacting “recoupment bars” as was discussed during panel two at the Workshop. These provisions unequivocally prohibit manufacturers from recovering from the dealers the costs associated with reimbursing dealers for warranty-related parts and labor.⁵⁶

The rate of reimbursement for warranty-related parts and labor has typically been governed by the franchise agreement. To understand why nearly every state has deemed it necessary and in the public interest to regulate this area, it is important to appreciate how this type of regulation has evolved. Historically, manufacturers preferred to reimburse dealers for parts used in warranty work at a national rate of cost plus x%. Because the cost of labor varies considerably across the U.S., however, the treatment for labor cost reimbursement has been different. Regarding these latter reimbursements, adjustments were made based on where the dealer was located with the calculation being roughly tied to local market conditions affecting the rates dealers charge for labor. Nonetheless, what was and remains uniform in the context of reimbursement for warranty labor is that manufacturer unilaterally determines the number of hours or units of time that a particular warranty repair will take. In this regard, it needs to be stressed that, absent state regulation in this area, a so-called “free market” approach would mean that manufacturers would have absolute discretion in determining what compensation dealers would receive for the warranty work they are contractually required to perform under the terms of their franchise agreements. Failure to do these repairs is grounds for termination in most, if not all, of these agreements. While, clearly, manufacturers have an interest in seeing that this work is done properly for customer retention and satisfaction reasons, it is also obvious that, as we explain below, manufacturers will spend the absolute minimum required because manufacturers naturally view warranty as an expense.

Several decades ago, the state legislatures began to identify a significant market failure when it came to manufacturers fulfilling the warranty commitments and other similar promises they had made to the consumers that bought their products. The first so-called “lemon law” was passed in Connecticut in 1982. Today, every state has some form of similar law that provides consumers with the right to receive a refund or replacement vehicle if a manufacturer could not remedy a covered defect during a certain time period or after a specified number of unsuccessful

⁵⁶ See, e.g., Conn. Gen. Stat. Ann. § 42-133s (“A manufacturer or distributor may not otherwise recover its costs from dealers within this state”) (original statute enacted in 1982); Fla. Stat. Ann. § 686.405 (“A licensee shall not recover or attempt to recover, directly or indirectly, any of its costs for compensating a motor vehicle dealer under this section.”) (original statute enacted in 1970); Haw. Rev. Stat. § 437-56; Me. Rev. Stat. tit. 10, § 1176 (“A manufacturer or distributor may not recover, or attempt to recover, from dealers its cost for reimbursing a dealer for warranty work as required by this section.”) (original statute enacted in 1975); Me. Rev. Stat. tit. 10, § 1176 (“A franchisor may not otherwise recover its costs for reimbursing a franchisee for parts and labor pursuant to this section.”); N.M. Stat. Ann. § 57-16-7 (“A manufacturer may not otherwise recover all or any portion of its costs for compensating its dealers licensed in this state for warranty parts and service either by reduction in the amount due to the dealer or by separate charge, surcharge or other imposition.”) (original statute enacted in 1973); Wash. Rev. Code Ann. § 46.96.105 (“A manufacturer may not otherwise recover all or any portion of its costs for compensating its dealers licensed in this state for warranty parts and service either by reduction in the amount due to the dealer or by separate charge, surcharge, or other imposition.”).

repair attempts. This state intervention into the free marketplace is an example of the type of regulation that the states found necessary when it comes to ensuring that consumers receive what they were promised in the warranty on the vehicle. And the state legislatures have made a similar judgement in enacting laws that ensure dealers receive reasonable compensation for warranty work.

As was made clear during panel two by Messrs. Appleton and Sox, TR. II; 2-4, decades of allowing the manufacturer to dictate unilaterally the amount to be paid for warranty parts and labor resulted in dealers being undercompensated for warranty work. Lacking the ability to negotiate collectively over the rates paid to them, dealers turned to the only viable option open to them – petitioning the state legislatures. It was not lost on these legislatures that one outcome of this “free market” approach to warranty work was the very real possibility that dealers were unwillingly (and perhaps even unknowingly) subsidizing manufacturers by permitting them to recoup, through underpayment, a portion of the cost of the warranty coverage they used to market their vehicles to consumers.

Dealers are required to invest substantial sums in service facilities that meet the specifications set by the manufacturers. For example, there are requirements as to the number of square feet dedicated to this purpose, the number of individual service bays, and the size and characteristics of customer reception and waiting areas. In addition, the manufacturers mandate the training required for technicians. Dealers must also employ other service-related employees, purchase and stock special tools and an inventory of parts so that warranty work can be done on an expedient basis, and incur myriad other expenses in providing warranty repair services to their customers. Manufacturers understandably are very specific on how these repairs are to be carried out, and these requirements often are spelled out in ever-changing warranty and policy procedure manuals that can easily run into hundreds of pages.

Dealers also incur other costs connected with warranty repairs which are not readily apparent to casual observers. For example, some manufacturers require dealers to provide (1) loaner vehicles or shuttle service for service customers who leave their vehicles for repair, (2) complimentary car washes, and (3) other amenities in the service department waiting room such as food and beverage service. These services and amenities benefit consumers to be sure, but providing them represents an expense to dealers that must be paid. Dealers are also required to return failed parts to the manufacturer as part of the warranty process. While these requirements will vary by manufacturer, it cannot be disputed that dealers incur significant costs associated with performing warranty service, not of all of which is reimbursed as part of the payment from the manufacturer.⁵⁷

It was stated during the panel two discussion that most dealers are receiving cost plus 40% for parts used in warranty repairs. Indeed, it is our understanding that this figure represents the amount that many, if not most, manufacturers believe is the appropriate figure for dealers nationally, and this is the amount most dealers have typically received in recent years absent the

⁵⁷ Of course, dealers are fully supportive of warranty work. Indeed, they consider it to be a critical customer care function of the dealership. However, it still must be noted that these costs are unavoidable.

state laws regulating this area.⁵⁸ Professor Sappington stated that he had estimated that the increased cost to four manufacturers over a five-year period of complying with Florida's warranty reimbursement law was over \$80 million. TR. II; 10.⁵⁹ In other words, Professor Sappington explained that, absent the law in Florida, these manufacturers would not have incurred this expense. However, simply describing the amount of reimbursement the Florida law requires does not provide a credible argument that the Florida legislature got it wrong or any rebuttal to the point that the manufacturers had been for years enjoying discounted pricing for warranty work performed by dealers.

A fundamental fact about warranty work is that it represents an expense to manufacturers. As such, there is an economic disincentive for manufacturers when faced with warranty work. In contrast, dealers are incentivized to want to take care of their customers by performing warranty work. Their interests are perfectly aligned with those of the consumer.⁶⁰ This is not to suggest that manufacturers do not want to satisfy their customers. However, as Mr. Appleton aptly explained in his remarks during the panel discussion, TR. III; 34, the state regulation of warranty service, including making sure that dealers are compensated appropriately, is more than justified and, indeed, is essential in helping to ensure that warranty and non-warranty customers are treated fairly.

Another reason for the recent focus on legislation in this area has been the expansion in the duration of manufacturer warranties. What was once uniformly a one year, twelve thousand mile non-transferrable obligation is now commonly three years or longer in duration, covering thirty-six thousand miles (or more) of operation and passing to the new owner when the car is sold. This has increased the percentage of service work where manufacturers can unilaterally set the compensation that dealers receive. State legislatures have determined that regulation in this area is important to ensure that dealers are not subsidizing the manufacturers.⁶¹

Complaints by auto manufacturers that state warranty reimbursement laws are unfair, lead to higher costs, and are not in the best interest of consumers are disingenuous. Every warranty repair is the result of an auto manufacturer error – that is, a badly designed or

⁵⁸ The reimbursement payments that a dealer receives in excess of the cost of a part, however, should not be confused with the dealer's profit. The "cost plus" figure refers to dealer gross revenue. Only after all direct expenses paid and overhead incurred by the dealer are calculated can what a dealer nets on the reimbursement for warranty work from a manufacturer be calculated. Therefore, a 40% retail margin is *not* a 40% profit. The net profit on a 40% margin is much less. Moreover, as the story that Mr. Appleton told regarding the wholesale price of a replacement fuel tank engine demonstrates, TR. II; 3, the underlying cost figure is subject to manipulation itself.

⁵⁹ The Florida law in question provides for several ways to determine the amount dealers should be reimbursed for warranty work, including a formula providing reimbursement for parts at the "retail" rate or based on a formula roughly approximating the customer pay that dealers receive for the same or similar repairs.

⁶⁰ Further evidence of the alignment between consumer and dealer interests can be seen in the statements made by Tesla Motors in its various securities law filings. There, Tesla candidly acknowledged that manufacturers have a conflict of interest with regard to warranty work because, to the manufacturer, warranty work represents a cost. Tesla Motors Inc., 2014 Annual Report (10-K) at 8 (February 26, 2015). This same provision also appeared in Tesla's 2013 10-K. (Interestingly, this statement has been deleted from Tesla's 2015 10-K which was filed *after* the Workshop at which Ms. Keller noted this admission of conflict. TR. III; 19.)

⁶¹ Moreover, as we discuss below, this trend is likely to continue, and perhaps accelerate, given the likely need to extend warranties on autonomous vehicles.

manufactured part. Federal and state warranty laws are designed to hold manufacturers responsible for, and to make consumers whole in connection with, such mistakes. Dealers are charged with the responsibility and expense of carrying out warranty repairs, and it is well within the purview of state legislatures to make sure that proper warranty repairs are being performed for their residents and that the dealers that perform those repairs are fairly and adequately compensated.⁶²

C. Direct Sales

NADA has previously submitted extensive comments to the FTC explaining why public policy considerations fully justify state determinations to prohibit vertical integration in the sales of motor vehicles. See NADA's 2014 Letter. In particular, NADA's 2014 Letter described in detail the following primary policy considerations that underlie these enactments:

- (1) the promotion of intra-brand price competition;
- (2) the desire to ensure that the economic incentives of the party performing warranty work on a vehicle align with those of the consumer;
- (3) the interjection of additional parties accountable to the consumer in the event a manufacturer departs from the market; and
- (4) the promotion of local economic activity.

As explained in NADA's 2014 Letter, these points apply even where, as is currently the case with Tesla and Elio Motors, the manufacturer does not itself have any franchised dealers. The Letter also explained, in detail, why the public policy justifications for prohibiting direct factory sales are even stronger when a manufacturer does have an established independent franchised dealer network. We will not repeat all of the analysis that is laid out in NADA's 2014 Letter on these subjects. Rather, we incorporate that Letter and the analysis it contains (which, as noted above, is contained in Attachment A hereto) by reference in these comments. The balance of this section sets out certain additional points regarding the state franchise laws relating to direct sales that need to be made in response to statements and assertions that were made by some of the participants at the Workshop.

⁶² In this regard, it is also important for the FTC not to give short shrift to the broad scope of the franchise laws in the warranty arena. This issue is not solely about warranty reimbursement. Rather, these laws also require that manufacturers file the details of their warranty coverage with the state and ensure that manufacturers and dealers perform their warranty obligations. Finally, a number of states also require manufacturers to discharge fully their obligations regarding motor vehicles that are recalled due to product defects. For example, the warranty provisions of Alabama's franchise law provides as follows:

Every manufacturer and new motor vehicle dealer shall fulfill the terms of any express or implied warranty concerning the sale of a new motor vehicle to the public of the line make which is the subject of a contract or franchise agreement between the parties. If it is determined by a court of competent jurisdiction that either the manufacturer or new motor vehicle dealer, or both, have violated an express or implied warranty, the court shall add to any award or relief granted an additional award for reasonable attorney's fees.

Ala. Code § 8-20-8 (Warranty obligations of manufacturers and dealers to consumers). All of these elements of the warranty laws are focused on consumers.

Intra-brand competition benefits consumers. Central to the discussion of direct sales laws is the question of the value and role of intra-brand competition. Despite all of the articulated hostility to laws that prevent vertical integration, some of the presentations at the Workshop actually confirmed that the intra-brand competition those laws engender can be very good for consumers. For example, Mr. Anderson certainly extolled the virtues of intra-brand competition at the beginning of his prepared remarks on panel one.⁶³ Similarly, Professor Schneider explained that “[i]f there were intense competition at sort of the dealer level – either intra-brand or inter-brand – you would see tighter margins and so on.” TR. I; 27.

Perhaps most important, however, is the fact that we no longer need to rely on a debate of competing economic theories to determine whether intra-brand competition operates to benefit consumers. As Ms. Keller pointed out in her opening remarks on panel three, “there is now substantial empirical evidence to confirm [the value of intra-brand competition].” TR. III; 18. A study of hundreds of thousands of transactions, published in 2015 by the Phoenix Center, shows that intra-brand competition in auto retailing lowers prices for consumers significantly.⁶⁴ For example, the Phoenix Center report found that when multiple Honda dealers are present in a market, the prices for the popular Honda Accord model are \$500 lower when compared to markets that have only one Honda dealer. Ms. Keller summarized the significance of this new research as follows: “The Phoenix Center’s comprehensive analysis of the impact on price in markets with multiple same-brand dealers provide[s] evidence [of what] should be obvious. Competition lowers prices.” TR. III; 19.⁶⁵ In light of this new data, it is easy to see why a state legislature would want its constituents to benefit from the costs savings that intra-brand competition delivers.

⁶³ There, Mr. Anderson stated as follows:

In the U.S., virtually all new automobiles are sold through a network of franchised new vehicle dealers. The primary purposes of the dealer networks are to provide consumers a competitive environment in which to shop and convenient access to the product for both sales and service. Manufacturers initially appoint a number of well-located dealerships *to compete with nearby same-brand dealerships on an intra-brand basis* as well as other brand dealerships on an inter-brand basis. . . . When the individual needs of manufacturers, dealers, or consumers are not met, the system fails. Manufacturers and dealers have to make a reasonable return on their investments, and consumers must be provided superior products, a competitive environment in which to shop, and convenient access to the product for both sales and service to have a sustainable system. . . . The franchise system has served manufacturers, dealers, and consumers relatively well.

TR. I; 16 (emphasis added).

⁶⁴ A copy of the Phoenix Center report is available at: <http://www.phoenix-center.org/pcpp/PCPP48Final.pdf>.

⁶⁵ As Ms. Keller also pointed out TR. III; 18, any individual consumer can test the competitive impact of intra-brand competition with a few clicks on the internet. All one has to do is to log on to one of the many vehicle search engines to see the powerful effects of both inter-brand and intra-brand competition. These sites empower consumers to match, for example, similarly-equipped Camrys, Accords, and Malibus. Once the consumer makes a choice among brands, then the real intense competition begins, comparing Camrys to Camrys, Accords to Accords, or Malibus to Malibus. This is facilitated by a wide variety of dealers advertising on the web and in traditional media. Every day, consumers are saving real money on real cars because of real intra-brand competition. See also Scott Morton, Fiona, Florian Zettelmeyer, and Jorge Silva-Risso (2011) “What Matters in a Price Negotiation: Evidence from the US Auto Retailing Industry,” *Quantitative Marketing and Economics*: 9:365-402.

Tesla's arguments mostly relate to issues that could be resolved without vertical integration. At the Workshop, Mr. Maron, Tesla's General Counsel, listed seven reasons why Tesla wishes to sell direct and offered them up as arguments against the state laws that prohibit vertical integration in auto retailing.⁶⁶ But Mr. Maron's arguments entirely miss the mark. He simply gave seven reasons why Tesla does not wish to hire as a dealer any of the 16,000+ retailers who currently sell other motor vehicle brands.⁶⁷ But none of the laws that constrain vertical integration in auto retailing require manufacturers to choose as dealers people or companies who are already engaged in the business for other manufacturers. Tesla could comply with the various bans on direct sales and avoid all of the concerns that Mr. Maron raised at the Workshop simply by engaging persons other than traditional dealers and setting up with those new dealers, through a franchise agreement, the retail model that Tesla wants. No one questions that Tesla has the right to determine the go-to-market strategy that is right for it. For example, if Tesla wants to eschew inventories, advertising, and business lines other than new vehicle sales, it may do so. But there is nothing about such a strategy that inherently requires vertical integration.⁶⁸

More significantly, Mr. Maron's points do not join issue at all with the public policy considerations, laid out in NADA's 2014 Letter and in the foregoing comments, which have led some state legislatures to conclude that vertical integration should be limited in this market. Perhaps most telling is that, with respect to the second of these public interest considerations,

⁶⁶ These seven reasons were as follows:

1. Traditional dealers are, in large part, in unacceptable out-of-the-way locations.
2. Traditional dealers carry large inventories while Tesla does not.
3. Traditional dealers need to work on a high volume, fast paced sales model, while Tesla does not.
4. Traditional dealers earn their profit from operations other than new vehicle sales, operations Tesla does not expect to have in any quantity.
5. Traditional dealers rely on manufacturers to fund advertising, while Tesla does not advertise and would not allow or pay for others to advertise for it.
6. Traditional dealers could not make money selling Teslas because Tesla itself would undercut them with lower online pricing.
7. Traditional dealers rely on selling internal combustion engine (ICE) powered vehicles and therefore have a conflict of interest selling electric vehicles (EVs) which Tesla believes need to replace, and not just complement, ICE vehicles.

TR. III; 11-12.

⁶⁷ It is not clear that all of Mr. Maron's points are correct even as to traditional dealers. For example, in his seventh point, he asserts that dealers who sell ICE vehicles will not be able to effectively sell EVs even at a different store. But dealers are merchants; they sell what the manufacturers build and the consuming public wants. Dealers do not have an *a priori* view as to superiority of one powertrain over another. In reality, point seven is merely an attempt to conflate arguments over the environmental attributes of Tesla's products with distribution channel questions. But those two sets of issues are separate, and they should be treated that way.

⁶⁸ The only one of Mr. Maron's seven points that even approaches the issue of vertical integration is point six relating to Tesla's inevitable undercutting of its putative dealers through direct online sales. But this point seems to proceed on the assumption that Tesla would sell vehicles to its dealers at the same retail price as it sold those same vehicles to the public. Since the dealers in this case would be absorbing some of Tesla's distribution costs, it is hard to understand why Tesla would not simply establish a lower wholesale price for its dealers. This is what every other seller of goods does where dual distribution is allowed and utilized.

Tesla has not only failed to address it, it has taken a position that is entirely inconsistent. Both in NADA's 2104 Letter and in the comments presented at the Workshop by Ms. Keller, TR. III; 19, it was noted that Tesla has stated in its securities law disclosures that one of the reasons it wants to vertically integrate its vehicle distribution is that "by owning [its] sales network [it] will avoid the conflict of interest in the traditional dealership structure inherent to most incumbent automobile manufacturers where the sale of warranty parts and repairs by a dealer are a key source of revenue and profit for the dealer but often are an expense for the vehicle manufacturer."⁶⁹ In other words, one of Tesla's stated goals is to avoid (in the interest of saving money) one of the key consumer benefits that independent dealerships provide and limit the value of the warranty that its customers have already purchased. Indeed, the so-called "conflict of interest" that Tesla wants to eradicate is in reality a consumer-friendly dynamic that franchise laws operate to foment. It is specious to suggest that state legislatures that reject Tesla's self-interested approach and vote to create a healthy economic alignment between the warranty repairer and the consumer are acting in a manner that is anti-consumer and/or the product of "crony capitalism."

Tesla clearly doesn't want to use independent dealers to retail its vehicles. But that preference doesn't necessarily translate into good public policy. And, as we explained here and in NADA's 2014 Letter, there are, in fact, several strong policy reasons that warrant restricting direct manufacturer-to-consumer sales in the auto retailing marketplace. Consequently, a state legislature that opts to limit or prohibit vertical integration in this distribution channel would be well within the exercise of prudent judgment.

IV. Future Trends Will Undoubtedly Require a Dealer Presence in the Evolving Mobility Market

Panel four at the Workshop addressed "Future Trends" in the auto manufacturing and retailing industries. However, this panel's focus on the potential effect of autonomous vehicles and certain "ridesharing" business concepts on the current automotive distribution model largely missed the mark. First, while it may be entertaining to speculate on the impact such changes may have if widely adopted, we do not share in the predictions of imminent widespread adoption, and even when adopted, of any fundamental changes in the way automobiles are consumed or distributed in this country. Second, we believe that rather than focusing on such speculation, the Commission should instead engage its efforts in assisting with the two critical areas that are the most important to consumers, the most closely aligned with the FTC's mission, and the most likely to "make or break" these new technologies: privacy and cybersecurity.

The franchised dealer network will facilitate – not impair – the deployment of autonomous vehicles in the market. Dealers wholeheartedly support the advances in autonomous technology and share the excitement about the safety and efficiency promises such technology holds. Many "driver-assist" and semi-autonomous features are currently in vehicles

⁶⁹ Tesla Motors Inc., 2014 Annual Report (10-K) at 8 (February 26, 2015). This same provision also appeared in Tesla's 2013 10-K. As noted above, it is interesting that this statement was deleted from Tesla's 2015 10-K which was filed *after* the Workshop at which Ms. Keller highlighted this admission of conflict.

on our roads today and will soon be in millions more. Consumers appreciate these features and are often shopping with them in mind. As with any new technology, the ultimate test is and should be consumer acceptance, and we agree that there will be exponential growth in the near term in both vehicle connectivity and semi-autonomous capabilities.

Semi-autonomous features, however, are vastly different from *fully* autonomous vehicles, which are likely to be further away from widespread adoption than many have suggested. In addition to the numerous technical, legal, and practical obstacles that must be overcome, we simply note that the sheer numbers of vehicles involved suggest something more like a minimum 20-25 year timeline for commercial adoption of this technology, rather than the 5-10 year timeline many have suggested.⁷⁰ While the panel discussion assumed a world with full availability and adoption of fully autonomous technology, we believe that such a world is at least a generation away, and that any adjustments to the distribution model needed to adapt to this new technology will have ample time to develop via experimentation and will naturally evolve over that period.⁷¹

If and when the obstacles to full autonomy are overcome, there is little evidence or indication that autonomous capabilities, in and of themselves, will change anything about consumer demand for cars or the new car sales and distribution system. If the technology delivers on its promise, it could certainly have a profound effect on the dealers' business model, but not necessarily on auto ownership or distribution. For example, dealer body shop and parts businesses would be tremendously affected due to the reduction in crashes expected to accompany autonomous technologies. The dealer service business model will also be affected as dealers will face increased costs associated with training, equipment, and cybersecurity investments needed to ensure that they are able to securely and adequately repair increasingly advanced vehicles. The more advanced the vehicle and the greater the autonomous capabilities enabled by the software, the more important it is to have a highly-trained staff ready to repair the vehicle, equipped with the most secure and sophisticated equipment. The nation's dealers will simply evolve to meet these new demands for products and services, as they have many times in the past when faced with comparable technological developments.

Moreover, in a world in which auto manufacturers are likely to face increased liability exposure (including, perhaps, strict liability) with respect to autonomous vehicles, it is difficult to envision a scenario where the warranty coverage for new vehicles is also not greatly increased, perhaps up to a "lifetime" warranty. That is because a manufacturer facing strict liability for autonomous vehicle accidents is likely to seek control over the repair of such vehicles to ensure

⁷⁰With approximately 258 million cars and trucks on U.S. roads and an average of 17 million new vehicles sold each year, even if 100% of all cars produced today were fully autonomous, it would take 15 years to turn over the entire U.S. fleet. With even the most aggressive predictions suggesting at least 5-10 years before widespread availability of fully autonomous vehicles, this suggests a conservative timeline of from 20 to 25 years before we have widespread adoption of fully autonomous vehicles.

⁷¹ Such change is not unheard of in the auto industry. Between 1955 and 1985, thousands of new dealerships opened to facilitate the sale of Japanese- and German-produced vehicles. Even if those cars may seem quaint and antiquated today, they were at the time revolutionary just as autonomous vehicles will be, containing myriad technologies that were then unheard of. Examples included the small displacement four cylinder engine and the four speed front wheel drive automatic. These are both ubiquitous today but were rare in the U.S. market as late as 1972.

that repairs, updates, and modifications are done securely and correctly. This will require even closer coordination between the dealer and the manufacturer to ensure consistency and leadership with respect to the requisite technological expertise and security investment. We are seeing the more forward-thinking manufacturers taking that approach even today.

One example of this expanded involvement is that autonomous vehicles, as essentially “rolling computers,” will increasingly require ongoing software updates for a variety of reasons throughout their operational lives. Several of the panelists on panel four at the Workshop discussed the potential for remote, “over the air” (OTA) software updates. Dealers believe that such OTA updates are likely, and hold tremendous promise, particularly for features not tied to driving functionality, such as navigation or entertainment software. However, OTA updates are not the panacea they are often held out to be for a number of reasons. First, there will always be a large portion of repairs that will need to be done physically.⁷² Second, while many consumers will enjoy the convenience of OTA updates, many others will want to come to the dealership to ensure that the update is completed adequately and correctly, to get an explanation of the process, and to see a demonstration of any new or improved features. Third, and most importantly, any software update that could have any impact on the driving functionality of a vehicle should only be accomplished if it can be done *securely*, and it is far from clear that this is possible today over the air. Certainly, security risks are present in any system, but it is also clear that a system requiring a secure physical touchpoint presents fewer threat vectors and is generally more secure than one that allows remote access.

While perhaps less costly to undertake, OTA updates, particularly those made to central operating systems or other firmware, are difficult and can be complicated, time consuming, and are simply less secure than controlled physical updates. Over just the past several years, the list of technology companies that have either reported security problems with OTA software updates, or have issued updates that have caused system failures or other faults, is lengthy. In fact, it would be easier to name the few that have not had such issues. OTA updates have not been consistently demonstrated to be capable of completion without errors, crashes, or breaches – certainly not to the level of accuracy and security required with self-driving vehicles. It is one thing when such issues occur with phones, computers, or a connected refrigerator; it is quite another altogether when such issues occur with an automobile or a fleet of millions of automobiles, especially automobiles with autonomous/self-driving features that can jeopardize the safety of the drivers, their passengers, and those around them. And these concerns are even *more* critical in a world with V2V and V2X⁷³ technology, where an error or a virus in one vehicle can expose the entire driving public to catastrophic failures.

In this context, security must come first, and vehicles must be designed and repaired with security as a non-negotiable requirement. Indeed, we agree with the Department of Transportation (DOT) and the National Highway Traffic Safety Administration (NHTSA) that autonomous-enabled vehicles require that automobiles and the auto industry be held to the same

⁷² For example, as discussed during panel four, the recently-publicized widespread problems with Takata airbags, the GM ignition switch, and the VW emissions retrofit all require physical repairs. TR. IV; 16. So would braking and powertrain systems, just to name a few.

⁷³ “V2V” refers to “Vehicle to Vehicle” communications; “V2X” refers to “Vehicle to Everything” communications.

safety and security standards as the aviation industry.⁷⁴ Automakers must design vehicles with that high standard in mind, and automakers and regulators alike must remember that standard when balancing convenience and cost savings against safety.

Despite the potential for profound changes outlined above, we do not believe autonomy alone will have any substantial effect on vehicle sales or ownership. There is no simple, linear relationship between the fact that a car can operate without a driver and consumers' need for, and demand for, personally-owned transportation. Whether the car is driver-operated or autonomous, consumers will still have unique and personal needs that can only be filled by owning their own vehicles. To be sure, full autonomy will provide tremendous benefits to many with limited transportation options today, such as the elderly or disabled. It will also likely fill a niche in certain urban and other markets that may reduce personal car ownership demand to a limited degree. Overall, however, it is unlikely that personal ownership demand will decrease materially. Dealers share in the excitement about the safety and efficiency promise of autonomous vehicles. It is clear that they are coming. It is also clear that whatever changes may come, consumers' need for a local dealership will increase, and it is also likely that the relationship and reliance between dealers and their manufacturer partners will also increase.

Franchised dealers sell more EVs today than auto manufacturers sell directly.

While there has been a tremendous resurgence in interest in EVs, EVs themselves are not new.⁷⁵ And, as noted above, any suggestion that franchised auto dealers would be unable or unwilling to sell EVs is completely unfounded and, for some, merely self-serving. Dealers are merchants and are agnostic about the propulsion systems of the vehicles they sell; they want to, and will, sell what consumers want (and what the manufacturers make). This is evidenced by the fact that dealers currently sell many more EVs than any manufacturer selling directly and will continue to do so to the extent that customers demand those products. To date, EVs have been niche products. Although sales are beginning to accelerate, their ultimate success or failure will be determined by the market. If these vehicles meet the needs and/or desires of consumers at an affordable price point, now or in the future, consumers will seek them out and dealers will be there to effectively sell them.⁷⁶

The market penetration of ridesharing has no relationship to the provisions of state franchise laws. The concept of ridesharing itself is also not new. Indeed, car sharing companies

⁷⁴See, e.g., <http://www.freep.com/story/money/cars/2016/02/13/faa-and-nhtsa-using-similar-regulatory-playbooks/79314200/> (noting that “[DOT Secretary] Foxx, who oversees 12 agencies, including NHTSA and the FAA, made it clear in December he wanted automakers to borrow from the aviation playbook”). The aviation industry does not conduct software updates over the air, but only via a secure physical connection performed by an FAA trained technician.

⁷⁵ While some of the battery technologies may be relatively new, the electric car certainly is not. In both 1899 and 1900, the all-electric Columbia captured the annual sales crown and more than 38% of all vehicles sold in 1900 were electric. See also <http://energy.gov/articles/history-electric-car> (“Introduced more than 100 years ago, electric cars are seeing a rise in popularity today for many of the same reasons they were first popular.”)

⁷⁶ There is also no direct connection between EVs and autonomous vehicles or ridesharing. The development and adoption of autonomous technology will proceed independently of EVs. While there may be a case for a model utilizing fully autonomous electric vehicles in combination with fleet ownership as a way to overcome the range limitation problems inherent in today's EVs (because a fleet of autonomous EVs can be recharged remotely, with

have been operating in the U.S. for nearly 100 years.⁷⁷ And various options, including rental cars, public transportation, taxicabs, and shuttles, have existed in full form for decades. To be sure, fully autonomous vehicles may change the economics and scope of ridesharing and make these concepts more efficient. However, the effect this may have on private vehicle ownership will be more muted than some predictions suggest.⁷⁸ First, ridesharing is not and cannot be linear because peak demand for rides will always frustrate peak supply.⁷⁹ Second, the autonomous vehicle ridesharing model is at heart, a more convenient, customized mass transit model, not a competitor to private vehicle ownership.⁸⁰ While this model will certainly have appeal to some, even if it were to become more cost-effective on a per-mile basis, the overwhelming majority of consumers will not wish to sacrifice flexibility and convenience for shared autonomous mobility.

For the Commission, issues of privacy, consumer protection, and potential deception should be the focus in the context of ridesharing. Many ridesharing companies today rely heavily on the ability to gather, compile, and leverage very sensitive personal information about their customers (including information about those customers when they are *not* using the ridesharing service). Indeed, many ridesharing companies are generally considered to be more “data” companies than transportation companies.⁸¹ Reasonable limitations, consumer consent, and consumer protection with respect to this incredibly sensitive information is critical. In addition, many ridesharing business models rely on so-called “dynamic” pricing models that are difficult to predict, adequately disclose, or rely on as a consumer. While there is nothing inherently problematic with such models, to the extent that consumers seek to rely on such ridesharing services as their primary transportation option, the opportunity for unfair or deceptive treatment increases greatly.

The cybersecurity and privacy issues presented by autonomous vehicles and ridesharing are of paramount importance. Overall, we would urge the Commission to

another EV in the fleet always at the ready), that is purely a business case that should not affect policy decisions and will be irrelevant to the vast majority of consumers, who are generally agnostic about power train options. (Mr. Diamond confirmed this consumer powertrain indifference during panel four when he stated that “most people don't care if they fill that up on gasoline, diesel, biofuel, natural gas, electricity, fuel cell. They just don't care. That is I think what we've discovered, for the most part.” TR. IV; 3.)

⁷⁷ See

<https://www.hertz.com/rentacar/abouthertz/index.jsp?targetPage=CorporateProfile.jsp&c=aboutHertzHistoryView> (Noting that the company was founded in 1918).

⁷⁸ See, e.g., 2016 Boston Consulting Group (BCG) study predicting “that car-sharing will cost the industry just 550,000 vehicle sales worldwide in 2021, a year in which global auto sales are expected to approach 100 million vehicles.” (<http://www.cnbc.com/2016/02/23/car-sharing-impact-will-be-limited-despite-a-jump-in-shared-mobility-start-ups-bcg-says.html>) (citing the BCG study).

⁷⁹ A lot of people will want cars during rush hour; very few will want them in the dead of night.

⁸⁰ Indeed, the policy questions with ridesharing will likely center not on how it will compete with private ownership, but on how it will compete with public transportation (and whether large-scale public transportation projects should continue to be funded).

⁸¹ See, e.g., <http://www.forbes.com/sites/ronhirson/2015/03/23/uber-the-big-data-company/>. The same can be said for non-manufacturing, “data” companies who seek to become auto manufacturers. Why would such a company wish to manufacture a car? Presumably because of the value of capturing and controlling the sensitive data emanating from, and related to, that car. The privacy issues arising from such a business model are immense and should also be an area of increased focus by the Commission.

continue to focus its efforts on the truly crucial issues that underpin all of these promising new technologies: cybersecurity and privacy.⁸² With other regulators (including NHTSA, the Department of Homeland Security, and DOT) focused on the technical aspects of cybersecurity, the Commission should continue to work with manufacturers, suppliers, software companies, and dealers to protect consumers by ensuring that privacy and security are at the forefront of all they do.⁸³ Vehicles and related systems need to be designed with privacy and security first, and executed with security as the top priority. We would also urge the Commission to work with other regulators at the federal and state level to establish clear rules regarding liability and consumer protection now, before they are needed. A security problem or a loss of faith in the vital privacy protections in a connected, autonomous vehicle would present both an existential threat to a manufacturer and an impediment to consumer acceptance of these new technologies. Moreover, the cybersecurity bar must be a high one. These issues must be addressed now, and consumers must have reason to trust these systems *before* they are adopted.

The dealership franchise model has a positive effect on “innovation.” Finally, we take issue with the suggestions made by some of the speakers during panel four at the Workshop that the state laws restricting vertical integration in the automotive retail distribution system somehow stifle the ability to “innovate.” In particular, Professor Scott Morton’s suggestion that the state franchise laws are akin to a state law “outlawing internet movie downloads and requiring consumers to visit a video shop and rent a video if they want to watch a movie,” TR. IV; 14, is the flimsiest of straw men. Any consumer in this country can go online and purchase a new car from a dealer today. No state franchise law limits or restricts any ridesharing business model or autonomous driving technology. As outlined above, these laws simply regulate the ownership structure of the retail outlet and the relationship of that outlet to the manufacturer.

So what are the specific innovations that the franchise model allegedly stifles? According to Professor Scott Morton, they are: (a) “remote updates of software”; (b) “just in time manufacturing”; and (c) alternate means for consumers to “to test drive, look at the features of the car, [and] physically touch the car” before purchase.⁸⁴ The first issue is addressed above.

⁸² See Keynote Remarks of Commissioner Terrell McSweeney at the Connected Cars USA Conference 2016 where she stated that “the Federal Trade Commission’s role in all of this [is] . . . to include protecting consumer privacy – and, ultimately, their data security.” She went on to state that “[s]ince becoming an FTC Commissioner, I have become a frequent visitor to the various hacker conferences where car hacking has been prominently featured. Some have dismissed these exploits as stunts. But I think it would be wiser to treat these revelations as an important wake-up call to the auto industry.” See https://www.ftc.gov/system/files/documents/public_statements/913813/mcsweeney_-_connected_cars_usa_2016_2-4-16.pdf at 2-3.

⁸³ While “connected” vehicles were not discussed in any detail on the panel, we believe that the privacy and security issues with connected vehicles will require concerted regulatory and technological efforts over the coming years, and should also be at the center of the Commission’s efforts.

⁸⁴ Id. (“So what would those innovations be? Remote updates of software are an obvious one that Ellen pointed out. This is very handy for the consumer. Saves them lots of time and schedule hassle. And it omits the need for a physical presence in their local area. Efficient manufacturing, just in time manufacturing. So this is the Dell model as it used to be called. I produced a [sic] demand and not inventory. I make cars that people want. In fact, I make cars that people have already paid a deposit on. So I don't even incur the cost for the parts until I have cash in hand. That saves carrying costs for both the manufacturer for parts and the dealer for inventory. Moreover, you're never marking down a car, because every car is already bought. So that, the estimates on the savings of that changing a

The second example is a manufacturer issue, not a dealer issue, and the reasons why just in time (also referred to as build-to-order) manufacturing is inapplicable to the automotive sector have been thoroughly addressed elsewhere.⁸⁵ And the third alleged example of a limitation on innovation is simply mistaken. Dealerships are as flexible and innovative as any retailers in the way they sell their products and services, and the notion that dealers do not or will not exercise any option available in the market reflects a lack of understanding of the business. Dealers innovate all the time. (If they fail to do so, they become former dealers.) In addition to every flavor of online and electronic marketing, dealers display cars at malls, fairs, auto shows, and other venues. And there is a huge number of vendors – many of whom are themselves market disruptors – that find dealers to be among their best customers for cutting edge products and services. If there is an innovative method of selling that will increase sales, dealers will undertake it, and any suggestion to the contrary is unfounded. The bottom line is that there are no facts asserted that legitimately support the argument that dealer franchise laws somehow impede a manufacturer’s ability to “innovate” with respect to the retailing automobiles.

We agree with Commissioner McSweeney who recently stated that “[t]he age of connected cars has begun, and, I believe, will only accelerate from here. The answers for what that means for consumers, for the automotive industry, and for the job market will be shaped by how regulators, enforcers, legislators, and most importantly, the innovators approach issues of safety, security, and privacy.”⁸⁶ For the FTC, that means focusing on “the important role security and privacy play in building [consumer] trust.”⁸⁷ The coming years will be very exciting indeed in the automotive industry; however, no one knows exactly what the future holds and speculation at this early stage is likely to be counterproductive. We would urge the Commission to continue to focus its efforts on those two critical issues – privacy and security – because unless those are assured, the full promise of many of these new technologies will not be met.

V. Conclusion

As we stated at the outset, it is essential that the FTC approach issues pertaining to the state franchise laws in a balanced fashion and that it carefully consider the actual effects that removal of these laws may have on this efficient and consumer-friendly model. And, for all of the reasons that we have explained, a balanced and open review of these laws, informed by market data and not merely hypothetical economic theory, reveals that the existing system of auto distribution in the U.S., in all of its variations, works well for all parties, starting with consumers. In essence, the state legislatures that have considered these issues have gotten it correct, and their regulatory decisions should be respected.

system from producing to inventory to producing to demand are quite large. So then, you don't need a local dealer to hold inventory for you. You do need to test drive, look at the features of the car, physically [sic] touch the car perhaps. There are many interesting ways to organize that. It's not clear that the franchise model would be the one.”)

⁸⁵ See NADA’s 2014 Letter; the comments of Ms. Keller during panel three, TR. III; 17-18; and Maryann Keller and Kenneth Elias, *Consumer Benefits of the Dealer Franchise System*, 2014, a copy of which is available [here](#).

⁸⁶ See Keynote Remarks of Commissioner Terrell McSweeney at the Connected Cars USA Conference 2016 at 1.

⁸⁷ See id. at 5.

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Thank you for the opportunity to comment in this matter. Please contact the undersigned if we can provide you with additional information that would aid the Commission in its consideration of these issues.

Respectfully submitted,


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Executive Vice President,
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Steven Szakaly
Chief Economist

Attachment A



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July 17, 2014

Andrew I. Gavil, Director, Office of Policy Planning
Deborah Feinstein, Director, Bureau of Competition
Martin S. Gaynor, Director, Bureau of Economics
Federal Trade Commission
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Washington, D.C. 20580

Dear Mr. Gavil, Ms. Feinstein, and Mr. Gaynor:

We are writing in response to the blog you posted on April 24, 2014 and the letters you sent to the Missouri and New Jersey legislatures on May 15 and 16, 2014 (collectively, the “FTC writings”), all relating to the varying ways in which the elected state legislatures in the 50 states have opted to structure the marketplace for the sale of new motor vehicles in their respective jurisdictions.¹ Your writings contend that the decisions some of those legislatures have made to restrict the vertical integration of motor vehicle distribution operates to the detriment of consumers. We believe that your analysis misses the mark in a number of ways, including by failing to acknowledge how the franchised dealer network actually benefits car buyers through price competition, safety enhancement, and the creation of economic benefits for local communities. We would very much appreciate the opportunity to meet with you to discuss these matters and to engage in a healthy dialogue about these important consumer issues.

OVERVIEW

As we explain in detail in Section I. below, the economic analysis set out in your writings fails to recognize the highly competitive nature of automobile retailing, the salutary impact of intra-brand competition on auto consumer welfare, and the paucity of applicable research regarding the consumer benefits of vertical integration in our market. In fact, our analysis shows that there is no evidence that vertical integration in retailing, let alone automotive retailing, would provide any benefits to consumers. As such, it is simply not the case that consumers are harmed by a state’s determination to prohibit vertical integration in auto retailing.

¹ The National Automobile Dealers Association (NADA) represents approximately 16,000 franchised automobile and truck dealers who sell new and used motor vehicles and engage in service, repair, and parts sales. Together, our members employ more than 1,000,000 people nationwide, yet a large majority of them are small businesses as defined by the Small Business Administration.

Moreover, there are several strong public policy considerations that, when properly understood, fully support the determination made by several states to restrict direct factory-to-consumer sales of motor vehicles. Indeed, even your writings acknowledge that the presence of such policy considerations would justify the regulation of the motor vehicle distribution channel.² In Section II., we comprehensively lay out the multitude of public policy reasons why these regulations are needed and appropriate.³ As we explain in Section II.B., a number of these reasons (including the promotion of intra-brand competition, the proper alignment of economic interests for the performance of warranty work and safety recalls, the provision of greater long-term accountability, and the creation of extensive local economic benefits) apply whether or not a manufacturer has established independent dealers to sell its products. But the need for the regulation of direct factory sales is even greater when the manufacturer has established an independent dealer network, and in Section II.C. we explain why.⁴

The public policy imperatives that support the enactment of state laws restricting vertical integration of motor vehicle distribution and sales are as valid today as they were when these laws were first enacted. These laws fully benefit consumers by promoting competition, safety, accountability, and economic growth. They also help ensure that consumers' transportation needs are met by legitimate businesses with strong ties to the local community. Any state legislature that adopts such an approach is acting prudently and in the interests of its constituents.

ANALYSIS

I. Proper Economic Analysis Demonstrates That Prohibitions On Vertical Integration In Motor Vehicle Distribution Do Not Harm Consumers

Your writings argue that the elimination of current restrictions on vertical integration in the auto retailing industry would benefit consumers by allowing for greater efficiency and cost

² For example, on page 2 of your letter to the New Jersey legislature, you state that direct factory sales should be allowed, but only if "supportable public policy considerations" that justify regulation are "[a]bsent." And on page 8 of the same letter you reiterate the point by noting that, in your view, consumers would be better served by the availability of direct factory sales, but only "absent some legitimate public purpose" for a prohibition.

³ As a preliminary matter, we describe in Section II.A. why acquiring a car is not like buying any other consumer product. For example, with vehicles you need an operator's license, insurance, and financing; vehicles contain hazardous materials that are themselves regulated; and, if operated incorrectly, vehicles can result in the injury to, or death of, people. These unique attributes explain why regulation of the vehicle distribution channel is warranted in the first place.

⁴ Your letters to the two state legislatures argue that state restraints on vertical integration should be removed even where manufacturers have established dealer networks. However, your letters fail to recognize, let alone address, the myriad of additional policy considerations that are introduced in that context. When those considerations are included in the analysis, it becomes even clearer that state legislative action is warranted.

savings in automobile retailing. But your writings fail both to take into account historical precedent and to recognize the highly competitive nature of today's automotive market. As a consequence, the benefits you claim will follow from the legislative changes you promote will not, in fact, be realized; what's more, those changes would more likely harm consumers in unintended and unforeseen ways. For nearly 40 years, the automotive industry has been in a continuous cycle of dismantling, selling, or shuttering non-core assets and has steadily disintegrated production, logistics, and even engineering and design functions. Your writings fail both to appreciate these industry dynamics and to recognize the very tangible differences between theoretical constructs and market realities. In the sections that follow, we explain in detail why your arguments are flawed.

A. Theory vs. Reality

Although there is a large set of research that illustrates the theoretical benefits of vertical integration resulting in various gains in efficiency, when this analysis is applied to the automobile retail industry there are no clear comparable examples that provide any evidence of benefits to consumers.⁵ Even if we look at the far broader framework of general retailer and manufacturer relationships, the results of empirical studies do not permit any clear conclusions to be drawn.

Overall, it is important to note that the various models of vertical integration represent theoretical depictions of inter-firm relationships that typically contrast outcomes under spot market trades with those under complete vertical integration. The reality is that firms have a myriad of options regarding contractual solutions to issues of transaction costs or incentive problems. Bresnahan & Levin (2012)⁶ These solutions include joint ventures, board seats, shared ownership, and franchising. Indeed, the terms of most franchising arrangements include vertical restraints that are effectively contract clauses imposed by one party in a vertical chain on another, such as those mandating the provision of warranty repair services. These vertical restraints can result in outcomes very similar to what would occur within a vertically integrated setting. Lafontaine & Slade (2013)⁷

⁵ Your letter to the New Jersey legislature states, at page 5, that “[w]hen manufacturers respond to competitive pressure by choosing to vertically integrate, consumers usually benefit through lower prices and/or higher quality.” But your analysis never moves beyond the theoretical to the actual market in which our members operate.

⁶ Timothy F. Bresnahan and Jonathan D. Levin, *Vertical Integration and Market Structure*, No. w17889, National Bureau of Economic Research, 2012.

⁷ Francine Lafontaine and M. Slade, *Franchising and Exclusive Distribution: Adaptation and Antitrust*, Oxford Handbook of International Antitrust, 2013.

In your writings, you offer no specific citation for, nor provide any conclusive research demonstrating that there are, consumer benefits to vertical integration in automotive retailing. You do reference two surveys (the two cited in the previous paragraph), but neither of these provides support for your position that vertical integration would be beneficial to auto consumers.

It is significant to note that Bresnahan & Levin are themselves generally critical of empirical studies of vertical integration, which runs somewhat contrary to a number of your arguments. For example, Bresnahan & Levin cite numerous statistical and methodological challenges that arise from testing. There are three criticisms that Bresnahan & Levin point out that are particularly relevant in this context:

- First, Bresnahan & Levin observe that studies at the firm level tend to assume that the nature of goods and services being contracted on, the contracting environment, and the surrounding market context are the same. This makes it difficult to determine whether the effects can be unambiguously attributed to the integration decision or whether, alternatively, firm specific factors (i.e. financing) or general market factors (i.e. market concentration) are more important.
- Second, they note that theories of vertical integration can only be tested if there are empirical measures of abstract concepts like risk, monitoring costs, and effort. These factors cannot be readily measured and, in fact, are more often completely unobservable. In many cases, it is not clear whether the proxies capture the intended theoretical driver and whether these factors are independent of the factors driving organizational decisions.
- Third, Bresnahan & Levin explain that testing for the effects of vertical integration is complicated by the possibility of a wide range of contractual solutions to a given problem. Most studies simply avoid any distinctions and rely on some sort of binary integrated versus non-integrated classification.

Bresnahan & Levin essentially conclude that it is unclear whether the difference in outcomes between integration and non-integration is important in any economic sense. In the end, they can identify only a handful of industries where there is clear benefit from vertical integration. These industries are (1) bauxite production and alumina smelting, (2) coal mining and coal fired power plants, and (3) the airline and truck transportation industries (where real time scheduling coordination is paramount in responding to changing circumstances within minutes or hours). While we accept that there may be benefits to vertical integration in these instances, there are simply no examples that apply to the general retail sector, let alone to automotive retailing in particular.

You cite the retail gasoline market as an example of one in which vertical integration benefits consumers. We disagree with the comparison based on the crucial fact that gasoline is a highly fungible commodity product that is readily traded on global spot markets, whereas automobiles are a highly differentiated product. Further, a paper recently published by Rand explained that the “Federal Trade Commission and the Department of Justice are the two main agencies in the US in charge of looking for and preventing anticompetitive practices, and a sizable portion of their budgets is allocated to overseeing the gasoline industry.” Jaureguiberry (2010)⁸ This paper goes on to note that the need for this sizeable oversight is because “[e]ven after 40 years of active intervention, much is left to be learned about the main issues affecting the prices in this market, among the most important the underlying pricing strategies behind the retail gasoline market[.]” Jaureguiberry We question the use of a highly substitutable commodity product in comparison to the automotive retailing industry, especially when the gasoline industry requires so much oversight and lacks the pricing transparency available to motor vehicle retail consumers.

B. Market power in retail distribution

You also contend that consumers are affirmatively harmed by state-mandated vertical separation and that the removal of restrictions around vertical integration would allow consumers to benefit from the elimination of double marginalization and a reduction in search costs.⁹ You further argue that if vertical integration were permitted, manufacturers would be better able to match their products to consumer preferences and would be able to respond more rapidly to uncertainty or changing business environments.

We look first at the case of double marginalization. This dynamic only occurs in industries where there are successive stages of monopolistic or oligopolistic firms. We agree that when two monopolistic or oligopolistic firms integrate, mark-ups are eliminated and the prices charged to consumers are reduced. In such a market, vertical integration does clearly benefit consumers. But is auto retailing such an industry? By making the foregoing argument, you imply that both automobile manufacturers and automobile dealers have market power and that, by extension, the resulting mark-ups must be pervasive. However, you present no actual statistical evidence to support these claims of oligopolistic practices by either manufacturers or dealers, and we are not aware of any ourselves.

The second claim you make in this connection is that manufacturers would become more efficient at matching their products to consumer preferences were vertical integration permitted. To begin, this represents a fundamental misunderstanding of product development

⁸ Florencia Jaureguiberry, *An Analysis of Strategic Price Setting in Retail Gasoline Markets*, Rand Corporation 2010.

⁹ Your letter to the New Jersey legislature states, at page 5, that “when the government intervenes and outlaws vertical integration, consumers often experience worse service and higher prices.”

lead times in the automotive industry. Typically, research and development in the automotive industry takes up to 6 years for a completely new vehicle and requires an intensive process involving billions of dollars. Hill, et al. (2007)¹⁰ Even changes to production vehicles (beyond basic trim level mixes) take months of lead time, not because manufacturers do not know consumer preferences but because of organizational, engineering, and manufacturing constraints. Hanawalt & Rouse (2010)¹¹ These factors should not be ignored.¹²

You also suggest that the importance of search costs in automobile transactions leads consumers to visit multiple dealerships. But the facts that motor vehicles represent one of the highest cost purchases for a household, that consumers purchase them relatively rarely, and that they represent a long-term financial investment would naturally lead one to conclude that individuals will spend a fair amount of time seeking out their personal preferences and price points. Once again, you do not present any statistical evidence showing that, in the face of these other factors, current search costs would be reduced through vertical integration. Rather, you simply claim that these search costs may be reduced because dealers prefer to sell out of their inventory and that this preference requires consumers to spend more time than would otherwise be necessary in searching for their preferred model. In our review of Scott Morton, et al. (2011)¹³, we see no evidence for such a conclusion.

More telling, from the papers cited, it is unclear why or how vertical integration would improve upon or change the existing search methods used by automotive retail consumers. Indeed, Scott Morton, et al. suggest that consumers have ready access to comparative price information, and the results of their survey show that 82% obtained information by searching the internet and by obtaining offers from competing dealers. We question how this would change in a market with vertically integrated retail outlets. Most significant, Scott Morton et al. found that buyers who obtained price quotes from multiple dealers secured price reductions. This suggests that intra-brand competition was effective.

¹⁰ Kim Hill, Steven Szakaly, and Morgan Edwards, *How Automakers Plan Their Products: A Primer for Policymakers on Automotive Industry Business Planning*, Center for Automotive Research, 2007.

¹¹ Edward S. Hanawalt and William B. Rouse, *Car Wars: Factors Underlying the Success or Failure of New Car Programs*, *Systems Engineering* 13 no. 4: 389–404, 2010.

¹² The FTC comments submitted to James Oberweis in 2014 relate to the Illinois legislature's consideration of a ban on Sunday auto sales. Although those comments claim that a ban on Sunday sales would impede comparison shopping, would not reflect consumer preferences, and would diminish competition among dealers for automobile repairs and sales, they offer no actual statistical evidence on the number of cars sold or repairs completed on Sunday. Consequently, it is impossible to judge the materiality of a ban on Sunday sales or the relevance of this analysis to current debate on vertical integration regulations.

¹³ Fiona Scott Morton, Jorge Silva-Risso, and Florian Zettelmeyer, *What Matters in a Price Negotiation: Evidence from the U.S. Auto Retailing Industry*, *Quantitative Marketing & Economics* 9, no. 4: 365-402, 2011.

C. Distribution and E-commerce

Your third argument for vertical integration is that vertically integrated firms are able to respond more effectively to uncertainty and changes in the business environment. In addition, you contend that new entrants would benefit from a highly vertically integrated structure as they learn and adapt to their new market.

As discussed above, Bresnahan & Levin note that there are cases where vertical integration will lead a firm to more efficient outcomes. Our issue is that these firms are all in either the mining industry or the transportation/logistics business. We agree that trucking firms and airlines likely benefit from the ability to adjust schedules and remain flexible in light of external factors like weather. However, Bresnahan & Levin offer no opinion on whether vertical integration would solve similar coordination issues in other industries, let alone in automotive retailing. We submit that given the long logistics chains and lead times involved in manufacturing an automobile, any benefits would be virtually non-existent.

In this regard, Novak & Stern (2009)¹⁴ offer insights into automobile manufacturing and the extent to which individual procurement choices are interdependent and need to be coordinated. They note that manufacturers may internally source clusters of components if they foresee difficulties in coordinating design changes that require large scale modifications. It is unclear to us how this research supports your claim that consumers would benefit from automakers vertically integrating into retailing.¹⁵

D. Restrictions and Past Automobile Retailing Studies

You next claim that state restrictions on vertical integration raise prices for consumers without any quality improvements.¹⁶ We would expect such a strong statement to be backed by equally strong empirical arguments and literature. This, however, is not the case. In fact, we note that the FTC studies relating to the automobile industry are outdated and, from our review, appear to suffer from econometric problems. In addition, the other market held out to

¹⁴ S. Novak and S. Stern, *Complementarity Among Vertical Integration Decisions: Evidence from Automobile Product Development*, *Management Science*, 55(2), 311-332, 2009.

¹⁵ The final source to which you cite, Forbes & Lederman (2009), studies the relationship between major U.S. airlines and their regional affiliates. Once again we can see no clear parallels to the automobile industry, and none are mentioned by the authors.

¹⁶ Your letter to the New Jersey legislature states, at page 6, that “past studies by both academic researchers and FTC staff have concluded that state-imposed restrictions on automobile manufacturers’ ability to negotiate with their dealers increased the prices paid by consumers without leading to notable improvements in service quality.”

be the ideal case study for automotive retailing – the retail gasoline market – involves a comparison that we submit is fundamentally flawed, as discussed above.

There is a lack of empirical evidence to support any claims that eliminating vertical integration restrictions in auto retailing would benefit consumers. Both Eckard (1985)¹⁷ and Rogers (1986)¹⁸ are outdated studies, and both suffer from econometric problems.¹⁹ Eckard attempted to use disaggregated data to evaluate relevant market area (RMA) laws. Interestingly, Rogers himself criticizes Eckard as having omitted variables, endogeneity problems, and an inadequate model of supply and demand. The Rogers study is no better. Our review of that paper shows serious econometric flaws that resulted from either poor model specification, poor data, or both. Many of the estimated variables in Rogers have the wrong sign or are insignificant, including those of estimated price elasticities, the coefficients for the impact of labor costs and advertising, and the dummy variables for state laws.

These are weak empirical citations given their age, their lack of econometric integrity, and the widespread technological changes that have occurred since their publication. To rely on these studies as a basis for considering and deciding major regulatory changes is unwarranted. Lawmakers should consider the clear evidence of high levels of competition that exist because of today's regulatory environment to be of much greater importance. It is basic economics that above normal rents are not sustainable in a competitive market unless there are barriers to entry. Our industry is open to competition, and there is no evidence to suggest that there are any material barriers to entry in automotive retailing. It is true that new entrants in automotive retailing must invest in showrooms, repair facilities, and inventory. Nonetheless, new individual dealerships are established all the time. Moreover, other retail sectors have effectively the same requirements of working capital, inventory, land, and facilities. New entrants over the past 50 years have built up franchises and gained market share all relative to incumbents.

* * * * *

There is general agreement that it is possible in some cases for vertical integration to lead to cost savings, even economically material savings. Unfortunately, there is no evidence

¹⁷ E. W. Eckard, Jr., *The Effects of State Automobile Dealer Entry Regulation on New Car Prices*, Economic Inquiry, Volume XXIV, 1985.

¹⁸ Robert P. Rogers, *The Effect of State Entry Regulation on Retail Automobile Markets*, Federal Trade Commission Bureau of Economics, 1986.

¹⁹ We recognize that there is a third study (R.L. Smith (1982)) that is often cited in this regard and that these three papers – Eckard, Rogers, and Smith – largely form the basis of nearly all criticisms of the retail automotive system. However, since Eckard and Rogers cover fundamentally the same topics as Smith, we chose not to review Smith here.

that vertical integration in retailing, let alone automotive retailing, would provide any benefits to consumers. The lack of empirical evidence of benefits, the inability to find any industry parallels, and the high probability of negative unforeseen consequences²⁰ leads to the conclusion that there is, in fact, no benefit to consumers in ending current restrictions on automobile manufacturers from selling directly to the public.

II. Public Policy Considerations Fully Justify State Determinations To Prohibit Vertical Integration In The Sales of Motor Vehicles

Against the foregoing backdrop of economic analysis, it is now appropriate to consider whether there are public policy imperatives which support state laws that limit vertical integration in auto retailing. As noted above, even your writings acknowledge that the presence of such policy considerations would warrant the enactment of those laws. And, upon review, we can see that these policy justifications abound.

A. The unique nature of automobiles justifies state regulation of their distribution.

As a threshold matter, it is important to note that some form of state regulation of the vehicle distribution process is both highly appropriate and desirable. The acquisition of an automobile is a singular experience that is not comparable to the purchase of virtually any other consumer good. The unique nature of an automobile purchase explains the litany of regulations which affect both the vehicle itself and the retail process that accompanies it. All states regulate important retail markets (such as those in the eyewear and real estate industries) to protect consumers. Thus, it should come as no surprise that laws have been enacted to protect consumer interests by addressing the unique facets of car purchasing and ownership.

The purchase of an automobile is often a person's second largest purchase, in dollar terms, after a home. Before even beginning the purchase process, consumers conduct extensive research, including back-to-back vehicle comparisons and test drives at local dealerships. Vehicle acquisition typically requires financing, often taking into account a past loan or the acceptance and valuation of a trade-in vehicle. According to Experian, nearly 85% of all new vehicle transactions are financed, thereby creating the need to identify a competitive financing alternative given family budget and down payment requirements.²¹ Moreover, in excess of 60% of car purchases involve a trade-in, and those trades often carry an outstanding loan balance. This requires the additional step of requiring a payoff of the current loan. Finally,

²⁰ These unintended consequences could include, without limitation, the consolidation of low volume dealerships, loss of employment, decreased consumer convenience, loss of service locations, and increased prices.

²¹ State of the Automotive Finance Market, Experian Automotive, Fourth Quarter 2013 (available [here](#)).

to complete the acquisition process, motor vehicle titling and registration processes must be navigated. This usually requires additional assistance.

An automobile also differs from most consumer products in that ownership presents several ongoing operational requirements throughout its life. These include securing an operator's license, ensuring that one holds all the necessary insurance, and performing regular maintenance and other repairs and/or recall work when needed. (And the latter needs are present regardless of the vehicle's powertrain.)²² Especially in light of the significant investment that consumers make in their vehicles, all of these services are continually required whether or not the vehicle's original manufacturer remains in business.

The acquisition and ownership of a motor vehicle thus involves a fair amount of complexity. For all these reasons, the unique attributes of motor vehicles explain why a state legislature would be justified in deciding to impose a regulatory and licensing scheme on the distribution of vehicles and the companies that participate in that distribution channel.

B. There are strong policy reasons that warrant restricting direct manufacturer-to-consumer sales whether or not a manufacturer has existing dealers.

There are several compelling public policy concerns that fully justify the various states' determinations to build their regulation of vehicle distribution around the limitation or prohibition of vertical integration. The primary benefits of such regulations include the increased intra-brand competition that independent dealers foster, the safety benefits that independent dealers bring by being economically aligned with consumers' interests, the increased long-term accountability that independent dealers provide, and the local economic benefits that independent dealers create.

1. Independent franchised dealers foster price competition which lowers prices for consumers.

Simply put, a non-vertically integrated vehicle distribution system of independently owned, franchised dealers ensures competition both among and within brands, all to the benefit of the consumer. As you note in your writings, "[c]ompetition is at the core of America's economy, and vigorous competition among sellers in an open marketplace gives consumers the benefits of lower prices, higher quality products and services, and greater innovation."²³ We could not agree more with this sentiment, and we fail to see how eliminating thousands of independently owned businesses would positively impact prices or

²² Vehicles also contain hazardous materials that are themselves regulated, and, if operated incorrectly, vehicles can result in the injury to, or death of, people.

²³ Your letter to the New Jersey legislature at page 3.

quality of service. We can, however, quickly ascertain that reducing competition is inherently harmful from an economic perspective and that it is precisely the state franchise laws that you question that best facilitate the “vigorous competition” that you seek for the automobile market.

Market fluctuations, both economy-wide and specifically in the automotive industry, are constant and ever-shifting. A vehicle distribution system of independently owned, franchised dealers ensures that market fluctuations are accurately reflected in the vehicle marketplace.²⁴ Automakers set suggested retail prices (as required by law), but new cars sell most often below the manufacturer suggested retail price (or MSRP). As previously noted, it is simply not possible for dealers to sell vehicles at prices – on average – that are greater than what the market will bear at any point in time. Moreover, the dealer’s current inventory and local market conditions continuously influence price as does competition within a vehicle segment. Auto manufacturers might sponsor regional marketing programs that can temporarily impact demand for a specific model. But rival automakers or their dealers will respond if they lose market share. These forces ensure that consumer pricing is in tune with market demand.

This highlights one of the possible adverse and unintended consequences of removing the current vertical restrictions on manufacturers entering the retail auto market. A manufacturer-controlled system would probably be more averse to changing prices and would certainly be slower in responding, even if such pricing was demanded by local and/or regional market conditions. A manufacturer would thus face increased inventory and carrying costs, which would inevitably be passed on to the consumer.

The same underlying factors that lead to locally adjusted vehicle prices also enable fierce intra-brand competition among dealerships. This intra-brand competition benefits consumers by ensuring that there are multiple retailers of the same brand in the same market facilitating both price competition and superior customer service as they compete for business. Even with the decline in the number of dealerships due to (1) natural consolidation, (2) the elimination of brands, and (3) the dealer and manufacturer bankruptcies that occurred during the 2008-2009 recession, the majority of consumers can do business with more than one dealer of a given brand within their local market. This means that customers have convenient access to a system that supports competition both among same-brand dealers and among those of competing brands. Since many car buyers don't settle on a specific make and model until well into the buying process, competition exists among brands at the dealership level just as it does among the manufacturers.

²⁴ Maryann Keller and Kenneth Elias, *Consumer Benefits of the Dealer Franchise System*, 2014, at page 13-14. This study, a copy of which is available [here](#), contains a comprehensive analysis of the consumer benefits of the independent franchised dealer system.

As shown in the following chart, data developed among selected dealer marketing areas across the country for Chevrolet, Ford, Toyota, and Honda illustrates just how extensive the intra-brand choices that shoppers have are when they are buying and servicing their cars.

Dealer Counts by Selected Market Areas and Brands

Rank	Market Area	Zip	TV Homes	% USA	Dealer Count Based on OEM Website by Zip Code			
					Chevrolet	Ford	Toyota	Honda
25	Charlotte, NC	28201	1,136,420	0.995%	21	20	9	12
50	Jacksonville, FL	32201	659,170	0.577%	12	10	5	5
75	Omaha, NE	68101	414,060	0.363%	17	15	4	3
100	Greenville - New Bern, NC	27833	303,280	0.266%	13	15	7	5
150	Albany, GA	31701	150,110	0.131%	9	11	2	2
175	Lake Charles, LA	70601	94,610	0.083%	6	6	3	1
200	Ottumwa-Kirksville, IA	52501	46,730	0.041%	5	8	1	0
All US DMA			114,173,690	100.000%				

Nielsen Local Television Market Universe Estimates by DMA as of 1-1-13

210 Total Markets = 100% Coverage of US TV Homes

Dealer counts limited to identified franchises within 50 miles of submitted zip code.

Keller & Elias at page 15-16. These data demonstrate that, even in the 175th largest local market area (which has fewer than 95,000 homes), consumers have multiple same-line dealer choices for many of the major automobile brands.

The studies by Rogers and Eckard are fundamentally flawed, as discussed above. However, if we accept their premises, then the FTC's own research supports the benefits of intra-brand competition. Your writings cite Rogers' criticisms of laws that regulate the "establishment of new motor vehicle dealerships near existing dealers selling cars of the same make."²⁵ In particular, your writings note that Rogers "found that these state laws harmed consumers because they caused motor vehicle prices to rise."²⁶ In other words, limiting the number of independent, same-brand dealerships in a given area increases vehicle prices for consumers by reducing intra-brand competition. But if that is true, the converse must be true as well – namely, that increasing the number of independent, same-brand outlets in a given market will cause prices to fall.²⁷ And this is exactly what the state laws restricting vertical

²⁵ Your letter to the New Jersey legislature at page 3.

²⁶ Id.

²⁷ Other studies illustrate the positive effect of intra-brand competition. First, Scott Morton et al. imply that consumers that visit multiple dealers spend less on their new vehicle than those that visit only one dealer. This would lend support for the value of strong intra-brand competition. Second, studies of elasticities in the automotive market illustrate a strong bias toward healthy competition. McCarthy (1996) estimates U.S. elasticity for new vehicles at -0.87 while Bordley (2006) estimates -1.0. (P.S. McCarthy, *Market Price and Income Elasticities of New Vehicle Demands*, Review Of Economics & Statistics, 78(3), 543-547, 1996; R.F. Bordley, *Estimating Automotive Elasticities From Segment Elasticities and First Choice/Second Choice Data*, originally in

integration are designed to do. Those laws recognize that the intra-brand competition that is inherent in the franchised dealer system benefits the consumer.²⁸

The fact that dealers earn very little on new car sales – or even lose money at certain points in time – reinforces the reality of competition in the marketplace. The chart that follows, which sets out data consolidated from NADA member dealers, shows that (1) over the past 15 years profits on the sale of new cars (including financing revenues) never exceeded one percent of revenues and (2) for several years (surrounding the period of the financial crisis of 2008-2009) dealers lost money in their new car departments. In 2012, the margin increased not because dealers were able to keep more of the spread between wholesale and retail prices but because low interest rates reduced their floorplan inventory carrying expenses while inventory turnover rebounded.

Approximate Average Dealer Profit - New Car Department

Year	New Car Department Only		
	Revenue	Profit (incl. F&I) - See Note	
	PVR	PVR	Margin
1998	\$23,600	\$144	0.61%
1999	24,445	224	0.92%
2000	24,923	115	0.46%
2001	25,797	153	0.59%
2002	26,163	220	0.84%
2003	27,565	189	0.69%
2004	28,060	180	0.64%
2005	28,381	63	0.22%
2006	28,451	-32	-0.11%
2007	28,797	-45	-0.16%
2008	28,350	-212	-0.75%
2009	28,996	-302	-1.04%
2010	29,793	-138	-0.46%
2011	30,659	23	0.08%
2012	30,910	111	0.36%

Note: Profit for new car department is based on average dealer profit including F&I revenue divided by average new vehicles retailed. Profit is pre-tax but after department expenses.

The Review of Economics & Statistics, 455-462, 1993, republished in 2006 at <http://bordley.org/publications/econ/elast10.pdf>) In a competitive market, one would expect elasticities for each vehicle segment to be higher than for the market as a whole. This is indeed the case; elasticities for vehicle segments are three- to four-fold higher for vehicle segments. Bordley (2006) This further evidences the healthy competitive market for new motor vehicles that is supported by intra-brand competition.

²⁸ It should be noted that the RMA laws that were the subject of Rogers' study address arbitrary actions by manufacturers in adding franchises to the market. Importantly, they do not prevent a manufacturer from adding a franchise in a given area; rather, they merely subject a proposed addition to a possible protest where the manufacturer must justify its appointment of a new dealer in order to proceed.

Keller & Elias at page 14. The combination of constantly adjusting local vehicle pricing and robust intra-brand competition creates a pricing structure that is better for consumers than the comparatively more homogenous pricing strategy that manufacturer-controlled dealerships would implement.

2. Independent franchised dealers enhance consumer safety.

The unique relationship that dealerships have with both their customers and their auto manufacturers allow them to play a vital role helping to ensure their customers' safety. Current franchise agreements are structured such that manufacturers compensate dealers for warranty and recall repairs; thus, dealers have an independent financial incentive to do this work which benefits consumers. Additionally, it is in the dealer's interest to ensure that customers remain satisfied with the operation of their vehicles – and this can be achieved, among other ways, by resolving warranty claims and handling recalls and technical service bulletins expeditiously as they arise. Although the higher build quality of today's cars has reduced many warranty claims related to fit and finish issues, dealers still confront the challenges of solving problems which exceed the limits of current diagnostic equipment. Furthermore, vehicle owners often ignore recall notices if they think the repair is not critical; dealers, however, routinely confirm that vehicles brought in to them for service are up-to-date on recall repairs.

In contrast, warranty repairs and recalls represent a cost for the manufacturers. As a result, the manufacturer's economic incentive is to do the minimum (subject to concerns about safety liability and consumer loyalty). Accordingly, the franchised model has a distinct advantage in ensuring the completion of warranty and recall work.

Franchised dealers often advocate for vehicle owners with regard to vehicle-related disputes. In a manufacturer-controlled system, consumers would likely have fewer outlets where they could get service, and the local manager, as an employee of the automaker, would be less likely to advocate on behalf of the customer. This role as an advocate between the customer and the manufacturer is especially important in light of the large volume of recalls that the consolidation of vehicle platform and parts has created. When so many units are recalled at once, they present a challenge that can most effectively be handled by a national network of dealers that is capable of making repairs as soon as the manufacturer provides parts and establishes the repair protocols with the National Highway and Transportation Safety Agency, the agency within the Department of Transportation which has oversight of vehicle safety.

It is precisely this alignment of consumer and dealer interests that a factory direct retail model would eliminate. Even companies like Tesla acknowledge this. In the excerpt from Tesla's 2013 SEC Form 10-K filing that you cite in your writings,²⁹ Tesla emphasizes that "by

²⁹ Your letter to the New Jersey legislature at footnote 23.

owning [its] sales network [it] will avoid the conflict of interest in the traditional dealership structure inherent to most incumbent automobile manufacturers where the sale of warranty parts and repairs by a dealer are a key source of revenue and profit for the dealer but often are an expense for the vehicle manufacturer.”³⁰ In other words, one of Tesla’s stated goals is to avoid (in the interest of saving money) the very consumer benefits that independent dealerships provide. Indeed, the so-called “conflict of interest” that Tesla wants to eradicate is in reality a consumer-friendly dynamic that franchise laws operate to foment.

Tesla’s comments are particularly telling as they highlight that warranty and recall work is seen by factories as “an expense for the vehicle manufacturer.” Tesla’s own emphasis on financial considerations demonstrates how manufacturers have a disincentive when it comes to the completion of warranty and recall work. While there is potential for conflict between the manufacturer and the dealer when dealing with defective products, the safety interests of the consumer always remain paramount. Although Tesla has yet to face a major recall, an independent franchised dealer system would ensure the efficient and properly incentivized completion of recall work as the number of Tesla vehicles on the road increase.

3. Independent franchised dealers provide additional accountability.

In addition to providing essential warranty and recall work throughout the life of a vehicle, independent franchised dealers also service vehicles in the circumstance in which the vehicle’s manufacturer goes out of business. As was witnessed during the 2008-2009 recession, this became a great concern for owners of Saab, Fisker, and Suzuki vehicles, among others. Given the financial investment associated with purchasing a vehicle, it is exceedingly valuable for consumers to have a reliable and efficient source of service for their vehicles.

As a result of these concerns, states require independent franchised dealers because dealers serve as a backstop for customers if their vehicle manufacturer ceases to exist. When this occurs, the dealer is more likely to stay in business and will still be around to perform needed repairs and routine maintenance. Many dealerships sell multiple brands and consequently will have available trained technicians and expertise in both locating parts and servicing vehicles, even if the manufacturer has ceased operation. For example, many former dealers of the shuttered brands mentioned above continue to service their customers’ cars and trucks. Dealers thus ensure the availability of service solutions independent of the manufacturer, providing additional protection to consumers and increasing consumer confidence.

³⁰ Tesla Motors Annual Report, form 10-k, filed Feb. 26, 2014, at page 11.

4. Independent franchised dealers create significant local economic benefits.

Independent franchised dealers fuel local economic activity, creating jobs and economic opportunity for local residents and generating significant tax revenues. Collectively, the nation's more than 17,500 dealers employ over one million people, offering high paying jobs with good benefits and attractive opportunities for personal advancement and professional development. And local dealers hire local people for jobs that cannot be outsourced. When the going gets tough, a vertically integrated manufacturer could opt to close a local retail outlet and move on. This will be significantly less likely with a local dealer.

Independent franchised dealers also drive local revenues by paying billions in state and local taxes. Sales at new vehicle dealerships account for 15% of all retail sales in the U.S. and consequently generate 15% of sales tax revenue. Similarly, unlike the profits earned by a vertically integrated manufacturer, dealer revenues stay in local communities, helping to support other businesses and thereby creating a local "virtuous cycle" that benefits families and other small businesses.

Finally, the local impact that independent franchised dealers have is outsized given the broad distribution of dealers. Dealers are not only located in major urban areas. Rather, they are spread widely around the country. In fact, in many small towns and rural areas they are the primary source of tax revenue, employment, and economic development. Given the history of automotive retailing, it is highly likely that one of the consequences of vertical integration would be the elimination of these local ex-urban and rural dealerships in favor of amalgamation into larger urban markets. Historical precedent would imply that while rural dealers are quite capable of being self-sufficient, as they are today, this would change if they were to become just a small part of a larger corporation. There would be increased pressure on margins, substantively higher requirements for return on investments, and higher overhead costs.

* * * * *

As the foregoing demonstrates, there are several strong policy reasons that warrant restricting direct manufacturer-to-consumer sales in the auto retailing marketplace. Accordingly, far from being absent, the "supportable public policy considerations" that you acknowledge would justify regulation of factory direct sales are very much present in force. Consequently, a state legislature that opts to limit or prohibit vertical integration of this distribution channel would be well within the exercise of prudent judgment.

C. The public policy justifications for prohibiting direct factory sales are even stronger when a manufacturer has an established independent franchised dealer network.

What is particularly problematic about your writings is that you have called not only for the elimination of franchise laws that prohibit or restrict companies like Tesla (which do not

have an existing dealer network) from selling directly to consumers, but also for the repeal of state laws that prohibit manufacturers that have such networks from unfairly competing with their dealers through the establishment of factory-owned stores. Of course, all of the analysis contained in the previous section applies with equal force to this latter recommendation and shows why it is ill-advised. But the public policy justifications for laws prohibiting direct factory sales are much stronger when a manufacturer has established independent franchised dealers.

These laws were not enacted in a vacuum. They were adopted in response to the outrageous behavior of some manufacturers which, after getting their independent dealers to invest billions of dollars in their brands and stores, tried to undercut those dealers by unfairly competing against them with factory outlets. These independent dealers in good faith entered into franchise agreements with manufacturers in reliance on the fact that they would be the retailers of the products they were charged with selling and servicing. The dealers did not make those investments or enter into those franchise agreements with the expectation that they would face direct competition from the very companies that encouraged that investment to represent their brands in the marketplace. The existing prohibitions on manufacturer-controlled stores represent the absolute centerpiece of the protections against manufacturer exploitation that have been enacted.

The power that manufacturers typically possess over dealers, the regulation of which is at the core of these provisions, has been recognized many times over the years – by Congress nearly 60 years ago and more recently by the courts. The Congressional findings that accompanied the enactment of the 1956 Automobile Dealers Day in Court Act stated as follows:

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.³¹

Similarly, in a recent review by a federal appellate court of a state ban on direct selling by automobile manufacturers, the Fifth Circuit Court of Appeals noted that “the legislative history

³¹ S. Rep. No. 84-2073 (1956) at page 2. While the industry is less concentrated today at the manufacturer level, these findings remain accurate in describing the power of a manufacturer over a dealer.

indicates the legislature's intent to prevent manufacturers from utilizing their superior market position to compete against dealers in the retail car market. The legislature's concern was fueled by the recent opening of several dealerships owned by manufacturers and the perceived detriment to the public from vertical integration of the automobile market." Ford Motor Company. v. Texas Department of Transportation, 264 F.3d 493, 500 (5th Cir. 2001).

These analyses are also borne out by the history of actual manufacturer behavior. Experience has shown that when manufacturers control both the production and distribution of new automobiles, they often opt to abuse that position by unfairly obtaining a competitive advantage to the detriment of dealers and consumers.³² Manufacturers who also sell at retail have a massive informational advantage relative to their same-brand dealer competitors in that they receive detailed monthly financial and operational reports from those very dealers. This one-way informational flow allows the manufacturers to further improve their market position based on the fact they know everything about their competition. The end result is likely to be favored treatment by manufacturers of the dealerships that they own, and certainly no cost savings or other benefits would offset the harm caused by permitting direct sales.

Furthermore, manufacturers have historically 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, all to meet the dealers' obligations under their franchise agreements. It is simply not fair for manufacturers who have imposed these requirements to be allowed to enter the market and thereby put the billions that the dealers have invested at their behest in jeopardy.

There also have not been any recent shifts in market structure that might warrant a repeal of these anti-exploitation provisions. In a 2001 speech by former FTC Commissioner Thomas B. Leary (on which you rely in your writings), the former Commissioner suggested that there have been fundamental changes in the traditional relationship between automobile manufacturers and their dealers and that the manufacturers have perhaps lost bargaining power with their dealers. He asserted that the dealers' collective bargaining strength had been increased by two claimed developments: an increase in the number of manufacturers competing for dealers and the rise of chain dealerships.

Former Commissioner Leary was simply wrong on his facts. It is inaccurate to suggest that a level playing field existed in 2001 or exists today. That assertion does not reflect current manufacturer-dealer relationships for the vast majority of dealers. Regardless of the number of manufacturers, the typical franchise contract is not negotiated. It remains a "take it or leave it" offer presented by the manufacturers to their dealers. The basic terms of the manufacturer-dealer relationship are thus set by the manufacturers. Any movement to change those terms

³² Keller & Elias at pages 26-27 (Ford and GM examples).

comes from the manufacturers, in the form of unilateral amendments to existing agreements or replacement agreements which almost always contain terms and conditions more onerous than what existed before. Frequently supplementing these agreements, which have been held to be contracts of adhesion, are controversial programs designed to control dealer behavior, often developed with little or no meaningful dealer input.

The former Commissioner also suggested that “in many areas today” consumers no longer enjoy the benefit of a local entrepreneur with hands-on responsibility for the dealership and who has direct contact with customers. This is also not reflective of the current marketplace. Dealerships remain closely tied to the community. Most are still family-owned and operated, including several of the larger, so-called “chain” dealerships. The fact remains that, for most dealers, their personal investment is on the line.

Finally, former Commissioner Leary was also somewhat critical of dealers’ legislative activities, and he implied that the Supreme Court decisions that allow private interests to petition their state legislatures free of antitrust restraint are ill-advised. But these same decisions allow any private group, including manufacturers and consumers, to petition a state legislature. It is the province of each state’s elected representatives to balance these competing interests and establish prudent transportation and consumer protection policies for the benefit of the residents of their states.

Ironically, the existence of the federal antitrust rules is actually one of the reasons why the state franchise laws are so necessary. The federal antitrust laws significantly constrain collective dealer activities. Individual dealers may complain, criticize, second-guess, and vent about their manufacturers. Dealers acting as a group, however, are subject to extensive antitrust restrictions on their activities. Dealer groups may not, for example, agree to refuse to sell an unpopular car or decline to participate in an exploitative manufacturer program. Dealer groups may not require better financial arrangements as a condition of using a manufacturer’s captive finance company. Lastly, and most importantly, no group of dealers may jointly refuse to accept a manufacturer’s unilateral revisions to its franchise contract. If these restrictions did not exist, dealers would be in a position to exercise collective economic self-help to address manufacturer overreach and abuse. However, they do exist, and dealers are, as a result, often left with seeking redress in their state legislatures as their only viable option.

CONCLUSION

The long-term consequences of allowing manufacturer-controlled stores are not benign. It is true that, as a theoretical matter, there will be times when the introduction of vertical integration into a market offers improvements in economic efficiency and provides other clear benefits to consumers. However, your writings present no evidence that, in the specific case of automotive retailing, consumers, the economy, or even manufacturers would tangibly benefit in any way from vertical integration. Indeed, as we have explained, proper economic analysis

of auto retailing reveals that vertical integration of the distribution channel could very possibly harm consumers, including in unintended and unforeseen ways. The lack of empirical evidence of benefits, the inability to find any industry parallels, and the high probability of negative unforeseen consequences leads to the conclusion that there is in fact no benefit to consumers in ending current restrictions on automobile manufacturers from selling directly to the public. State legislators should not forgo all the tangible benefits that local dealers provide based solely on theoretical claims of consumer advantage that are unsubstantiated in the actual marketplace at issue.

The fact that one cannot articulate with reliable analysis how motor vehicle consumers would specifically benefit from direct manufacturer sales should, in and of itself, give pause to any state legislator considering the drastic regulatory changes you advocate. But in this case there is much more. As we have explained, there are several compelling public policy considerations that fully justify the various state determinations to restrict a manufacturer-controlled motor vehicle distribution system. The primary benefits of such regulations include the increased intra-brand competition that independent dealers foster, the safety benefits that independent dealers bring by being economically aligned with consumers' interests, the increased long-term accountability that independent dealers provide, and the local economic benefits that independent dealers create. The analysis set out in your writings simply fails to recognize this range of public policy reasons why these laws are needed and appropriate and fully benefit consumers.

We would appreciate the opportunity to discuss these matters with you, and we look forward to constructive engagement and a helpful dialogue on these issues. Please feel free to contact us at akoblentz@nada.org.

Respectfully submitted,



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