NATIONAL AUTOMOBILE DEALERS ASSOCIATION
8400 Westpark Drive • McLean, VA 22102
703.821.7040 • 703.821.7041

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Andrew I. Gavil, Director, Office of Policy Planning
Deborah Feinstein, Director, Bureau of Competition
Martin S. Gaynor, Director, Bureau of Economics
Federal Trade Commission
600 Pennsylvania Avenue, N.W.
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.

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[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

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[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]

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[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

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[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.

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[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.

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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

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[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 consequences[20] 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,

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[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. <u>There are strong policy reasons that warrant restricting direct manufacturer-to-consumer sales whether or not a manufacturer has existing dealers.</u>

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. <u>Independent franchised dealers foster price competition which lowers prices for consumers.</u>

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

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[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.

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[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

					Dealer Count Based on OEM Website by Zip Code			
Rank	Market Area	Zip	TV Homes	% USA	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

	New Car Department Only		
	Revenue	Profit (incl. F&I) - See Note	
Year	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.

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[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

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[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 <u>any</u> 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 <u>acting as a group</u>, 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.

<u>CONCLUSION</u>

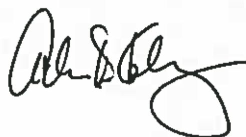
The long-term consequences of allowing manufacturer-controlled stores are not benign. It is true that, as a theoretical matter, there will be times when the introduction of vertical integration into a market offers improvements in economic efficiency and provides other clear benefits to consumers. However, 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

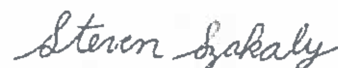
of auto retailing reveals that vertical integration of the distribution channel could very possibly harm consumers, including in unintended and unforeseen ways. The lack of empirical evidence of benefits, the inability to find any industry parallels, and the high probability of negative unforeseen consequences 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 akoblenz@nada.org.

Respectfully submitted,





Peter K. Welch
President

Andrew D. Koblenz
Executive Vice President,
Legal and Regulatory Affairs

Steven Szakaly
Chief Economist