Senate Economic Reference Committee Inquiry into the effectiveness of the Trade Practices Act 1974 in protecting small business

Submission by the Federal Chamber of Automotive Industries

8 September 2003

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LAWYERS

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Executive summary

1.1 The Federal Chamber of Automotive Industries ('**FCAI**') is the peak industry organisation representing the automotive distributors in Australia. The FCAI's membership comprises the four passenger motor vehicle manufacturers in Australia and the companies which import and distribute all of the new passenger, light-commercial and four wheel-drive vehicles and motor cycles in Australia.

1.2 FCAI submits that the Senate Economic Reference Committee ('**the Committee**') should only make recommendations to further regulate the relationship between large and small businesses if:

(a) the *Trade Practices Act 1974* (Cth) ('**TPA**') regime, including the Franchising Code of Conduct ('**Code**')[1] is proved to be inadequate; and

(b) the benefits of any further regulation can clearly be demonstrated to outweigh the costs.

1.3 When this test is applied to the motor vehicle sales industry there is no reason for any changes to be made to the existing regime.

1.4 Some dealer bodies have suggested that their members (the dealers) are small businesses and need special protection from the distributors. This is demonstrably incorrect.

1.5 The facts are that:

(a) most dealers are not 'small businesses' but are sophisticated operations often turning over tens of millions of dollars. Some dealers are larger than some of the distributors;

(b) the overwhelming majority of motor vehicle distributors have strong, stable and mutually beneficial relationships with their dealers;

(c) disputes between distributors and dealers are low by any standards and existing provisions in the TPA and the Code adequately address any possible problems that might arise; and

(d) further regulation would lead to inefficiencies and costs which would be to the ultimate disadvantage of consumers and the competitive process.

1.6 Some dealer bodies seem to be suggesting that if a dealer agreement is validly terminated or not renewed, the dealer should be compensated for the goodwill they have 'lost'. This misconceives the nature of goodwill and the relationship between distributors and dealers. Goodwill in the brand belongs to the distributor. If a dealer no longer has a right to be a representative of that distributor, the dealer cannot benefit from the goodwill which vests in the brand.

1.7 Motor vehicle dealers have no excuse for not entering into dealer agreements fully knowing and appreciating the terms of the agreement. The Code requires complete disclosure and the dealer is given every opportunity to obtain independent advice before entering into a dealer agreement. It is a transparent commercial arrangement conducted by parties of equal bargaining strength.

1.8 Distributors and dealers face a common challenge to maximise the commercial success of their particular brand of vehicle. The market is extremely competitive and it is in the mutual best interests of both parties to utilise each others' strengths. In the vast majority of cases this is done and distributors and dealers enjoy a close and mutually beneficial relationship. In the very few cases where there are issues which need to be resolved, the existing regime does this more than adequately.

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[1] *The Trade Practices (Industry Codes - Franchising) Regulations 1998* (Cth).

2 Introduction

1.1 This submission is made by the FCAI on behalf of its members.

1.2 The FCAI is the peak industry organisation representing the automotive distributors in Australia. The FCAI's membership comprises the four passenger motor vehicle manufacturers in Australia and the companies which import and distribute all of the new passenger, light-commercial and four-wheel drive vehicles and motor cycles in Australia.

1.3 While many of the arguments raised in this submission apply across a range of industries, this submission discusses the arguments in the context of the relationship between motor vehicle distributors and dealers.

1.4 FCAI submits that Committee should only make recommendations to further regulate the relationship between large and small businesses if:

(a) the TPA regime is proved to be inadequate; and

(b) the benefits of any further regulation can clearly be demonstrated to outweigh the costs.

1.5 When this test is applied, there is no basis for any changes to be made to the existing TPA regime. This submission demonstrates that:

(a) the overwhelming majority of motor vehicle distributors have strong, stable and mutually beneficial relationships with their dealers;

(b) disputation between distributors and dealers is low by any standards. This is demonstrated by the virtual absence of legal proceedings taken by dealers against distributors;

(c) the regulatory provisions contained in section 46, and Parts IVA and B of the TPA, and the Code, adequately address any possible problems that might arise; and

(d) further regulation of the distributor/dealer relationship would impose significant costs on the industry to the disadvantage of consumers and the competitive process.

1.6 As part of preparing this submission the FCAI surveyed its members about their relationships with dealers. Annexure 1 contains this commercially sensitive information. The FCAI requests that the Committee treats this submission as strictly confidential, and not disclosed to any person without the consent of the FCAI. Questions regarding this submission should be addressed to:

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1.7 This submission is divided into three parts. Firstly, it sets out relevant background to the industry and the relationship between automotive distributors and dealers. Secondly, each of the terms of reference for the inquiry are addressed. Thirdly, general insights into the relationship between distributors and dealers are presented to correct what FCAI considers to be false and misleading statements being made by a minority of vehicle dealers.

1.8 In the process of developing this submission the FCAI commissioned Network Economics Consulting Group (**NECG**) to prepare an economic analysis of the relationship between motor vehicle distributors and dealers, including the economics of exclusive distribution. That report is provided as Annexure 2 of this submission.

3 Industry Background

3.12 Approximately 900,000 new motor vehicles are expected to be sold in Australia this year with about 400,000 of those being vehicles produced domestically.

3.13 The automotive sector is much larger than traditional data suggests, contributing over $27 billion to the Australian economy per year.[2] Approximately 55,000 people are directly employed in automotive manufacturing and about 60,000 people are employed in about 3,000 automotive franchise dealers.

Industry structure and size

3.14 In general, motor vehicles are manufactured or imported by motor vehicle distributors (distributors) and then sold wholesale to motor vehicle dealers (dealers). Dealers sell motor vehicles directly to individuals and fleets.

3.15 Motor vehicle distributors own very few dealers. In general, they develop specialist dealer networks to represent them in the retail vehicle market. The vast majority of dealers operate as independent businesses under a 'dealer agreement' with a distributor. Evidence of this was found in the survey of FCAI members for this submission. Only 16 of more than 2000 motor vehicle dealer agreements accounted for in the survey results were with subsidiaries of motor vehicle distributors.

3.16 The nature of the dealer's commercial enterprise varies. Some dealers operate from a single location, many dealers operate at a number of locations. Although it is often argued by dealers that distributors require exclusivity, typically dealers are not restricted to an exclusive relationship with a distributor and are free to develop arrangements with a number of distributors. Our survey data revealed that only 2 of 21 respondents require an exclusive commitment to their brand.

3.17 The relationship between distributors and dealers is explicitly brought within the Code. However, FCAI considers that the relationship between distributors and dealers is somewhere between a wholesale distribution agreement and a 'true' franchise. Dealers provide the conduit between the distributor and the vehicle customer in the retail market.

3.18 The motor vehicle sales industry is fiercely competitive. Competition takes place between approximately 40 vehicle brands (**inter-brand competition**) and for individual sales within brands (**intra-brand competition**). Distributors compete vigorously to achieve market share for particular brands and dealers compete for individual retail sales.

3.19 The FCAI collects and reports statistics on retail sales of new motor vehicles by all member companies in its **VFACTS,** or vehicle facts, database. VFACTS data is regarded as authoritative throughout the automotive industry.

3.20 VFACTS statistics reveal that:

(a) for the 2001 calendar year, there were 773,000 retail sales of new motor vehicles representing approximately $23 billion of revenue for dealers; and

(b) for the 2002 calendar year, there were 824,310 retail sales of new motor vehicles representing approximately $25 billion of revenue for dealers.

3.21 This does not include the parts and services and used vehicles sold by dealers, which represent a significant portion of their business.

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[2] Australian Industry Group (2002) 'Review of Automotive Industry: Progress Report' http://www.aigroup.asn.au/aigroup/pdf/publications/factsheets

3.22 Dealers vary in size from single site dealerships (generally, but not necessarily, sole franchises) to larger multiple site dealerships representing multiple brands (multiple franchises). A number of dealers operate as part of a large corporate group, and there are some that are public companies. A number of dealers have dealerships in several states.

3.23 The variation in the size, location and branding of each dealership makes it difficult to accurately calculate the revenue, including parts and service, of an average dealer. However, in general terms, it can be said that the range is as follows:

(a) for a single site rural dealer, annual revenues up to $5 million;

(b) for a single site regional dealer, annual revenues of between $5 million to $10 million;

(c) for a single site city dealer, annual revenues of between $15 million to $80 million; and

(d) for a large corporate group operating 5-10 sites, annual revenues of between $30 million to more than $750 million.

Conclusion on industry structure and size

3.24 Given the structure and size of the industry, FCAI considers that the proper characterisation of motor vehicle dealers is that they are generally substantial and sophisticated businesses. Indeed, for some vehicle brands the largest dealer groups are bigger businesses, in terms of turnover, than the Australian distributor.

3.25 FCAI submits that the committee should reject assertions by dealer representative groups, such as the Motor Traders Association of New South Wales (**MTA**), that motor vehicle dealers represent small business. This is clearly unsustainable.

Economic characteristics of the distributor / dealer relationship

3.26 A range of characteristics of the motor vehicle sales industry mean that, for a given brand, distributors and dealers share a common interest.

Mutual Dependence

3.27 There is very little evidence of unequal bargaining power between distributors and dealers. In fact, to present the relationship as a competition between distributors and dealers is to misunderstand it. Distributors and dealers are jointly engaged in the real competition in the motor vehicle sales industry, which is between competing vehicle brands.

3.28 In the vast majority of situations, the current business model used for a successful vehicle brand requires a combined effort between the distributor and the dealer. This is demonstrated by the low incidence of vertical integration by distributors. Typically, distributors and dealers rely on the economic benefits of the specialised roles each of them perform. FCAI submits the way in which the Australian industry is currently structured means that the *true* characterisation of the relationship is one of mutual economic interests.

Dealer Councils

3.29 Most dealer networks have dealer councils, which are normally elected by the dealers, to facilitate the relationship between dealers and distributors. Our survey of members indicates that dealer councils are regularly consulted by the distributors about the terms of dealer agreements, marketing campaigns, dealer development, administrative procedures, product selection and other issues impacting on the distributor/dealer relationship.

3.30 The distributors, for their part, work actively with dealer councils to develop their dealer networks and promote their brands. Combined with the relative size of the average dealer, the fact that

dealers are represented in strategic issues by elected councils is further evidence of their sophistication as an industry group.

Not a 'Real' Franchise

3.31 As alluded to above, the relationship between distributors and dealers does not have the orthodox characteristics of a small business franchise. To begin with, dealer networks are often considerably larger than most retail franchises in other industries. In addition, the revenue typically generated by a motor vehicle dealership will be considerably larger than most other franchises.

3.32 Significantly, distributors do not charge a franchise fee to dealers. By contrast with other franchises that require the franchisee to purchase good will and branding from the franchisor (and often to pay significant 'transfer fees' upon a sale of the franchised business), the only investment made by a dealer will generally be in the land and facilities on which to run their franchise. These investments accrue directly to the dealer and because of the nature of the business have an intrinsic value separate from the particular brand of vehicle sold at the site.

Dealer Financial Support

3.33 In recognition of the mutual interests of distributors and dealers, most distributors contribute significant funds to assist dealers with their business (eg facility upgrade assistance, IT infrastructure, advertising etc).

3.34 In some instances, distributors wholly fund these costs. In almost all other situations distributors heavily subsidise the investments made by dealers. For example, where a distributor has an associated finance company (eg General Motors Acceptance Corporation) a dealer may be able to secure capital for fixed investments on favourable commercial terms in circumstances where the required funds could not be sourced from the general commercial market.

3.35 The economic impact of this is a level of support from distributors, and in some cases associated finance companies, that enables dealers to enter and compete in the motor vehicle sales industry in circumstances where that opportunity might not otherwise be available.

4 Adequacy of section 46 of the TPA

4.12 The first of the Terms of Reference (**TOR**) for the inquiry asks:

(a) whether section 46 of the TPA deals effectively with abuses of market power by big businesses;

(b) if it does not effectively deal with abuses of market power by big businesses, what are the implications of the inadequacies of section 46 for:

(i) small businesses:

(i) consumers; and

(ii) the competitive process.

Does section 46 deal effectively with abuses of market power by big businesses ?

4.13 Section 46 is one of the central elements in the TPA for regulating market conduct. It prohibits corporations with a substantial degree of market power from taking advantage of that power for the purpose of:

(a) eliminating or substantially damaging a competitor

(b) preventing the entry of a person into any market, or

(c) deterring or preventing a person from engaging in competitive conduct.

4.14 Examples of such conduct can include:

(a) predatory conduct such as pricing;

(b) refusing to supply for an anti-competitive purpose; and

(c) illegitimately taking advantage of market power in one market to reduce competition in another market.

4.15 Section 46 is indifferent to factors such as the relative size of businesses. Section 46 addresses the influence a business has in a market, what it does with that influence and for what purpose. A contravention of section 46 comes about through the conduct of a business, irrespective of size.

4.16 In the FCAI's view, section 46 operates effectively in its current form. Advocating change to section 46 for the purpose of altering the relationship between small and big businesses confuses the purpose of the provision. Advocates of change misunderstand the objective of section 46; mistaking an interest in conduct between competitors with a predetermined view about the relative merits of small and big businesses.

4.17 Section 46 certainly has an interest in the competitors, or possible competitors, towards which conduct is directed. But that interest is focussed on the conduct directed at competitors, not the competitors themselves. It follows from this that section 46 is about protecting the process of competition, not particular competitors. As described recently by the Chairman of the ACCC:

> *'It is an inevitable part of competition that some firms will be damaged. Some firms will prosper. Others will be forced to close because they are not able to compete. This is a normal feature of a vigorous, competitive market and is an important part of achieving the most efficient use of the nation's resources. Of course, the misuse of market power provisions in s.46 are not intended to hamper such competition.*

These provisions are meant to deal with the situation where a firm with substantial market power uses that power to damage a competitor or potential competitor and thereby damages the competitive process'.[3]

Perceived inadequacies in relation to section 46

Implications for motor vehicle dealers

4.18 FCAI understands that certain groups, including some motor vehicle dealer representative groups, argue that market power is conferred on automotive distributors by virtue of the industry structure and that this is not currently addressed by section 46. This argument proceeds on the basis that once a distributor enters into an agreement with a dealer, the distributor has market power automatically. This is clearly misconceived and misunderstands the relevant market in which to assess competitive conduct.

4.19 FCAI submits that the appropriate markets for the Committee to focus on for the purposes of this inquiry are the wholesale and retail markets for vehicle sales. No distributor has market power in these markets.

4.20 Even if the committee was to conclude that there does exist a separate market for vehicle dealer agreements, section 46 currently regulates conduct in that market. The reality is that distributors would have no power in that market. Where a dealer already owned a site, the barriers to entry into the agreement market are minimal, or non-existent. In fact, dealers are offered inducements to enter that market. Most signage and capital is provided on favourable terms by the vehicle distributor, and no franchise fee is payable for use of the distributor's intellectual property. In addition, dealers themselves often have a significant degree of power, particularly where they are located in high profile vehicle retailing areas such as Parramatta Road in Sydney, Nepean Highway in Melbourne and Breakfast Creek Road in Brisbane.

Implications for consumers

4.21 A consideration for the Committee should be whether the perceived inadequacies of section 46 have any implications for consumers. For this to be the case, the Committee will have to be satisfied that the relevant market (which the FCAI submits is the retail vehicle sales market) is not competitive.

4.22 Even a cursory analysis reveals that the market for retail vehicle sales is aggressively competitive. Driven in part by the government's policy of lowering import tariffs, and by aggressive marketing by distributors, vehicle sales have grown significantly and real prices have decreased. Since 1996, the Consumer Price Index for motor vehicles has declined by 20 per cent, while average weekly earnings have increased by 15 per cent. Based on average total weekly earnings, purchasing a Ford Falcon currently takes 38 weeks' work compared with 44 weeks in 1995. A Magna V6 sedan now takes 35.2 weeks, down from 41.5 weeks.

4.23 FCAI submits that market conduct would adversely affect consumers only if exclusive distribution channels were used (or able to be used) to manipulate prices in a manner that led to them being maintained at a higher level than they otherwise would be. This could theoretically happen in two ways:

(a) a strategy of total vertical integration might allow a distributor to manage the price at which vehicles are sold by also being the exclusive vehicle dealer for its own brand; or

[3] ACCC (2003) *'The Big Issues and the Big Ideas'* Speech to the Australian Industry Group National Industry Forum Parliament House, Canberra, 11 August 2003, page 6.

(b) if particular dealers were perceived to be discounting too deeply, terminations (or non-renewals) could take place as part of a strategy for sustaining price co-ordination between the remaining dealers. (No examples of this conduct can be found in the vehicle sales industry).

4.24 There are three problems with any such argument.

4.25 First, the incidence of vertical integration among FCAI members is low. It could hardly be said that distributors are vertically integrating to try and manage prices. In any event, even if this was true, in a competitive market of about 40 competing brands no distributor can justify a price above what is reasonable for the standard of the vehicle being offered. Buyers simply go elsewhere.

4.26 Second, as to the use of dealer terminations as part of a price maintenance strategy, FCAI's survey results do not support such an argument. Terminations are statistically few and unlikely to influence retail vehicle prices.

4.27 Finally, a strategy such as that outlined in 3.12(b) would, in all likelihood, be in breach of section 48 of the TPA.

Implications for the competitive process

4.28 The adequacy of section 46 as a means of regulating possible abuses of market power has recently been considered in detail as part of the 'Dawson Report'.[4] Amongst other issues, the Dawson Report commented specifically on whether section 46 should be confined to the regulation of market conduct, or seen as a mechanism for industry regulation.

4.29 The report of the Dawson Inquiry stated that:

> *'Submissions were made to the Committee calling for additional regulation in certain areas, particularly where there was a high degree of market concentration. Whilst it is appropriate for the ACCC to scrutinise conduct in such areas carefully, the Committee considers that competition measures which are specific to particular industries should be avoided.* ***The competition provisions should protect the competitive process rather than particular competitors.*** *They should not be seen as a means of achieving social outcomes unrelated to the encouragement of competition or as a means of preserving corporations that are not able to withstand competitive forces.*

4.30 The Commonwealth Government in its response to the Dawson Inquiry accepted these recommendations.[5]

4.31 FCAI submits that the Dawson Report, and the Government's response, are correct in their assessment of the efficacy of section 46. As a mechanism to prevent the abuse of market power, section 46 needs no modification.

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[4] *Review of the Competition Provisions of the Trade Practices Act,* Dawson Committee of Inquiry, January 2003.
[5] Ibid pages 1 and 2.

5 Does Part IVA of the TPA deal effectively with unconscionable or unfair conduct in business transactions?

5.12 The second term of reference for the inquiry asks the Committee to consider whether Part IVA of the Act deals effectively with unconscionable or unfair conduct in business transactions. In addressing this question, the FCAI focuses on section 51AC, which regulates unconscionable conduct in business transactions.

5.13 Section 51AC was introduced as part of the Government's response to the report of the fair trading inquiry of the House of Representatives Standing Committee on Industry, Science and Technology entitled 'Finding a balance—Towards fair trading in Australia'.[6] The particular purpose of section 51AC was described in the Second Reading Speech as:

> *'This bill will provide a new substantive legal remedy for small business against unconscionable conduct in the Trade Practices Act. The government has accepted the principle that small business people are entitled to a legal protection against unconscionable conduct which is comparable to that accorded to consumers. ...*
>
> *Accordingly, the government will mirror for small business consumers, in a new section of the Trade Practices Act, the legal rights available to consumers in section 51AB, and incorporate a range of additional matters ....*
>
> *Business conduct which is unconscionable, having regard to the enumerated factors, will be prohibited by the act and give rise to a broad range of remedies under the act. This new provision will extend the common law doctrine of unconscionability expressed in the existing section 51AA of the act'.*[7]

5.14 The financial threshold for 'supply of goods' that fall within the unconscionable conduct guidelines was subsequently raised from $1 to $3 million in 2001[8] and a range of other amendments introduced to 'clarify and expand the sanctions a court may impose where the Trade Practices Act has been breached'.[9] In his second reading speech introducing the amendments, Minister Hockey said:

> *'This bill is about consumer sovereignty. It is about promoting competition, ensuring fair outcomes in the marketplace, and about benefiting the Australian community'.*[10]

5.15 FCAI submits that the objectives for section 51AC in Minister Hockey's Second Reading Speech have been achieved. The arrangements in Part IVA work adequately in their present form. Some dealer groups have argued that the small number of proceedings instituted against distributors under section 51AC demonstrates the fact that this section is not effective. The FCAI submits that the more likely explanation is that there is very little conflict between distributors and dealers and to the extent to which there might be a temptation for distributors to act inappropriately,

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[6] *Trade Practices Amendment (Fair Trading) Act 1998* (Cth), Schedule 2, section 2.
[7] Reith, Peter, MP (Flinders, Workplace Relations and Small Business, LP, Government), House of Representatives Hansard, 30 September 1997, page 8799.
[8] *Trade Practices Amendment (No. 1) Act 2001* (Cth) Schedule 1 section 2.
[9] Hockey, Joe, MP (North Sydney, Minister for Financial Services and Regulation, LP, Government), House of Representatives Hansard, 29 June 2000. page 18578.
[10] Ibid.

section 51AC acts as an effective deterrent to distributors engaging in conduct which could be unconscionable or unfair.

5.16 It could not be argued that a lack of proceedings is due to a lack of resources available to bring proceedings. Dealers are typically large enough to be self funded litigants, the Motor Trades Association of Australia (MTAA) has a 'fighting fund' and the ACCC has a 'war chest' to bring proceedings under section 51AC.

5.17 The standard argument presented by the dealer organisations is that distributors invariably act unconscionably when they terminate, or fail to renew, dealer agreements.

5.18 FCAI submits that, rather than being an example of unconscionable conduct, the few terminations that occur are completely consistent with the existing legal regime. Termination only occurs where there are sound commercial reasons for doing so. It is not in the interest of distributors to have no product representatives or to change them for no reason.

5.19 Whether termination on the terms of a dealer agreement was unconscionable was considered in the recent case of Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd.[11] In that decision, Finkelstein J observed the central importance of the relationship between distributor and dealer, noting that once that relationship had collapsed, it was entirely within the rights of a distributor to terminate a dealer agreement:

> *'Further, I do not regard the refusal by the first respondent to withdraw its notice of termination as unconscionable conduct. I take as the measure of unconscionability, conduct that might be described as unfair. In the present circumstances I do not believe that the first respondent has acted unfairly in not wishing to reinstate the applicant as a dealer. The applicant had been a dealer for seven or eight years. Whilst it was not obliged to adopt the Six-Star Program, that is, it was not contractually obliged to do so, its failure to adopt the program and its criticism of certain aspects of the program, could reasonably be regarded by the first respondent as an indication that the applicant was not willing to act in the best interests of the first respondent and of the dealership group as a whole. No doubt this led to a loss of confidence in the applicant. That loss of confidence would not necessarily be overcome by a change in attitude on the part of the applicant. Many relationships can only operate satisfactorily if there is mutual confidence and trust. Once that confidence and trust has broken down the position is not easily restored. It is not unconscionable to terminate a relationship where that trust and confidence has been undermined.'* [12]

5.20 The argument that terminations are unconscionable amounts to nothing more than rhetoric from certain dealers, intended to procure for them a better commercial outcome. But it seeks to do so by transferring the costs of changed arrangements onto the distributor. This would be inconsistent with the commercial reality of the industry whereby dealers freely enter agreements with distributors in full knowledge of the terms. Motor vehicle sales agreements disclose the relationship between the parties in fulsome detail, including the term of the agreement and the performance standards against which the dealer will be assessed. A Disclosure Document is a requirement of the Code, as is a requirement to obtain legal advice. Dealers enter agreements in full knowledge of their contents, with no one pointing a gun at their head. It would be unethical, uneconomic, and against current commercial practice if distributors should have to fund a divergence from those terms.

5.21 The expectation regarding the term of the agreement and the likely commercial rewards that can be achieved over that term are factored into the initial price. If a dealer enters an agreement with

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[11] [1999] FCA 903.
[12] Ibid, at paragraph 46.

a different expectation, then it is economically appropriate that they bear the risk of that expectation. It would be economically inefficient if distributors were made to carry the risk associated with dealers' divergent expectations that they have no means of managing. Eventually these risks will be reflected in an increase in vehicle prices which will be detrimental to consumer welfare.

6 Whether Part IVB of the TPA operates effectively to promote better standards of business conduct

6.12 The third term of reference asks whether Part IVB of the Act operates effectively to promote better standards of business conduct, and, if not, what further use of it could be made in raising standards of business conduct through industry codes of conduct.

6.13 The second part of this question, relating to Industry Codes of Conduct, is treated together with the fourth term of reference below.

Does the Franchising Code of Conduct operate effectively to promote better standards of business conduct?

6.14 Under section 4(2) of the Code a dealer agreement is deemed to be a franchise agreement. This provides dealers with all of the protections and remedies proscribed by the Code, including:

(a) the obligation on distributors to provide dealers (and potential dealers) with a comprehensive disclosure document to facilitate informed decision making regarding the business;

(b) the requirement that dealers obtain independent advice regarding the dealer agreement;

(c) the requirement that a distributor must not unreasonably withhold consent to the assignment of a dealer agreement (clause 20(2));

(d) the obligation on distributors to give reasonable notice and provide reasons to dealers if the distributor proposes to terminate a dealer agreement;

(e) limitations on a distributor's right to terminate a dealer agreement for breach; and

(f) the dispute resolution and mediation procedures detailed in the Code.

6.15 A contravention of the Code attracts a range of sanctions under the TPA, including injunctive relief and damages. Distributors regard compliance with the Code as extremely important.

6.16 In addition to the commitment of industry participants, compliance with the Code is taken very seriously by the ACCC. This point was made by its Chairman in a recent Press Release relating to a breach of the Code:

> *'The judgement sends another clear message to the franchise industry that franchisors have an obligation to deal fairly and honestly with their franchisees. ...It also indicates that ACCC continues to make it a priority to enhance the business community's understanding of this legislation and the rights and obligations of all parties involved.'*[13]

6.17 FCAI considers that the Code operates effectively. Arguments challenging the efficacy of the Code in relation to the motor vehicle sales industry are misplaced. The relationship between distributors and dealers is not typical of a franchise arrangement, but a decision was taken in 1998 to include motor vehicle dealerships as franchises. Given this decision, dealership agreements are, and should be, treated the same as other franchises.

6.18 Arguments against the adequacy of the Code in regard to dealership agreements claim that there is something *special* about the relationship between distributors and dealers. Therefore it is argued,

[13] ACCC, (2003) *'Federal Court Finds 4WD Franchisor Misled Franchisees'* MR 170/03.

from this, the industry should be subject to specific regulations. However, this argument flies in the face of accepted wisdom regarding regulation. As noted by the Dawson Report, it is generally accepted that competition regulation should be applied universally and consistently to avoid distortions between sectors of the economy. The Dawson Report said:

> *'Consistently with the recommendations of [the Hilmer Committee], Australian Governments should continue to ensure that the competition provisions are applied as broadly as possible across the economy... It is also fundamentally important that the competition provisions be universally applied to avoid distortion of economic activity'.*[14]

6.19 The fact that the level of capital associated with vehicle dealerships is large relative to many other franchises is not relevant to an assessment of the adequacy of the Code. Rather it is a doctrinaire statement reflecting a predetermined view of how industry policy should treat certain businesses by comparison with others.

6.20 Rather than being a *special* relationship due to the relative size of distributors and dealers, if anything, it is a *special* industry because of the high level of interdependence in the relationship. In the vast majority of situations, the distributor has a parallel incentive with the commercial success of the dealer. This is reflected in the fact that few disputes occur. The closeness of the relationship is reinforced by FCAI survey results that indicate dealers are consulted by distributors on most important matters which might affect them, including any changes to Key Performance Indicators and corporate identification requirements.

6.21 Vehicle sales agreements confer on dealers a commercial arrangement that is, in economic terms, no different from the vast majority of other franchise arrangements. Through the appropriate identification of market zones and the allocation of those zones to dealers, the distributor seeks to use the economies of specialisation that accrue to the marketing expertise of dealers to maximise the value of the vehicle brand.

6.22 The fact that motor vehicles are a higher priced item relative to many franchised products, reinforces the interdependence between distributors and dealers as distributors have large amounts of capital at risk through the behaviour of their dealers in the market place.

What further use could be made of Part IVB through Industry Codes of Conduct?

6.23 The second limb of the third term of reference, and the fourth, both raise the issue of Industry Codes of Conduct as a mechanism for enhanced regulation of business conduct between large and small players.

6.24 FCAI agrees with the Dawson Report, as noted in paragraph 5.7, that competition regulation should be applied consistently across the economy.

6.25 The FCAI strongly believes that the existing regulatory environment is adequate and extensive. Industry specific regulation of the motor vehicle industry would be costly and without justification. Moreover, FCAI understands that the proposal of dealer representatives is that industry specific regulation would be *in addition* to the Code. Given this, FCAI submits that the Committee should be cautious in its consideration of Industry Codes as they can result in a divergence from the general principle of consistent regulation. FCAI strongly believes that franchises should be regulated equally.

[14] Dawson Report, above N3, page 6.

6.26 Notwithstanding this, FCAI is committed to best practice regulation. For example, FCAI led a process of developing a voluntary code of practice for motor vehicle advertising. FCAI is aware of recent statements by the Chairman of the ACCC supporting the development of Voluntary Industry Codes of Conduct.[15] FCAI agrees that Voluntary Industry Codes are worth considering if they have the potential to reduce regulatory costs, but otherwise they should not be supported. As noted by the ACCC Chairman the objective must be achieving compliance at lower cost:

> *'This initiative has the potential to provide effective industry codes of conduct that deliver real benefits to businesses and consumers with the least possible compliance cost placed on either.'*[16]

6.27 With a view towards improving the performance of the industry overall, the FCAI suggests that the Committee might want to consider a Voluntary Industry Code that supplemented the existing Code with the following elements:

(a) Industry specific mediation referenced under the Code. Under such an agreement expert mediators would be chosen from a specialist pool. This would enable the mediators to build up a detailed understanding of the relationship between dealers and distributors;

(b) An amendment to the Code (not necessarily industry specific) containing an obligation to attend mediation in *good faith*. Although, under the Code currently, mediation is compulsory, attendance is the only obligation imposed on them. In effect, parties may predetermine their position and attend the mediation as merely a formality. An obligation to participate in good faith may reinforce the existing obligation to attend mediation; and

(c) An amendment to the Code (not necessarily industry specific) to make it compulsory to go through mediation prior to issuing proceedings. Often, once proceedings are issued, the relationship between the parties completely breaks down. Settlements are still possible but extremely difficult. By requiring mediation prior to the issuing of proceedings, all settlement options can be explored in an environment which is hopefully more conducive to an agreed resolution being reached. An exception would need to be made for urgent relief.

6.28 The FCAI would be happy to participate in any process of reform of the Code with a view to establishing a Voluntary Industry Code of Conduct covering the issues raised above.

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[15] See for example, ACCC, (2003), *'ACCC to Endorse High Standard Voluntary Industry Codes of Conduct'* MR 168/03; Fiona Buffini, Mark Skulley and Stephen Wisenthal, (2003) *'Samuel's Grand Vision of Self-regulation'*, AFR 12 August 2003, pages 1 and 4.

[16] Ibid.

7 International approaches

7.12 The TOR for the inquiry are not limited to consideration of the Australian regulatory model. They ask the committee to consider whether approaches adopted in Organisation for Economic Co-operation and Development (OECD) economies could usefully be incorporated into Australian law.

7.13 FCAI has considered North American regulations as well as the European Union framework.

United States of America

7.14 Despite the suggestions by some dealer representatives, FCAI submits that the USA model of regulation of distributor/dealer relationships is not particularly helpful. In the USA, the Federal anti-trust legislation[17] contains similar provisions to section 46 of the TPA relating to the abuse of market power. However, with respect to franchising activity, regulation varies across the 50 US States, following no clearly consistent model.

Canada

7.15 In Canada, conduct of the type being considered by the Committee is regulated by a combination of Federal and Provincial legislation. The central competition law[18] is relatively similar to the TPA with respect to anti-competitive conduct and misuse of market power.

7.16 Significantly, the Canadian approach to regulating unconscionable conduct is quite different. In Canada unconscionable conduct is generally regulated not by statute, but under the existing common law.

7.17 Franchising is predominantly regulated by provincial laws, particularly:

(a) *Franchises Act R.S.A 2000, c.F-23*; and

(b) *Arthur Wishart Act (Franchise Disclosure), 2000S.O. 2000, c.3.*,

7.18 As this legislation is relatively recent, there is not yet much case law to guide its interpretation. However, for the purposes of this inquiry, FCAI considers the Committee should note the following:

(a) Both the Franchises Act Exemption Regulation of Alberta AR312/2000 and Ontario Regulation 9/01 contain an exemption for established franchisors from the requirement to disclose financial statements in a disclosure document. This is effectively a sophisticated investor exemption from franchise regulation acknowledging that sophisticated and established franchisors seldom represent a financial risk to new investors; and

(b) in Canada, since 1996, industry specific mediation and arbitration arrangements have been adopted. More than 90 per cent of dealers have opted into the National Automobile Dealer Arbitration Program, known as NADAP. Under the NADAP framework the objective is to settle disputes between vehicle manufacturers and dealers by mediation and, if necessary, by arbitration.[19] When a manufacturer/dealer dispute arises, NADAP participants must first try and settle it using the manufacturer's dispute resolution process

[17] Although there are a range of pieces of legislation, including administrative legislation that governs anti-trust law in the USA, the relevant legislation for the purpose of comparison with the TPA is the Sherman Antitrust Act, 15 U.S.C. and the Clayton Act, 15 U.S.C.

[18] *Competition Act, [R.S. 1985, c. C-34]* section 50; see also section 61(1) that makes 'price maintenance' illegal.

[19] See for example, CVMA-NADAP http://www.cvma.ca/Programs/NADAP.html

(if one exists) and if that is unsuccessful, go to NADAP mediation and potentially arbitration. Only disputes that do not qualify for NADAP can go to court.

The European Union ('EU')

7.19 In the EU, competition in the car distribution and after-sales service markets (the motor vehicle industry) is regulated by the Motor Vehicle Block Exemption, which derives its basis from Article 81(3) of the EC Treaty (Treaty of Rome, 1957). Article 81 essentially prohibits all agreements which may affect trade between Member States and which restrain or distort competition in the market and declares as void any non-complying agreements. Restrictive agreements that may be declared void under the Article include:

(a) horizontal agreements between competitors, such as mutually controlling the market by acting together in a way that minimises competition (eg price fixing); and

(b) vertical agreements between parties at different levels of the supply chain, for example between distributors and dealers (eg exclusive territorial sales licences that prevent retailers from exporting goods).

7.20 In recognition that restrictive agreements in the motor vehicle industry may confer economic benefits that outweigh any restrictive or distorting effect on competition, the EU first instituted the Motor Vehicle Block Exemption in 1985. The original exemption allowed distributors to enter into Selective and Exclusive Distribution (SED) systems agreements, which would otherwise be prohibited under Article 81 of the Treaty. The decision to institute an exemption for the industry was based on the view that:

(a) effective competition existed within the motor vehicle industry;

(b) car dealers must also provide after-sales service; and

(c) brand specialists are needed for the repair of motor vehicles.

7.21 The impending expiry of the Block Exemption in September 2002 prompted a review and overhaul of the regulations in 2001-2. In response to concerns over high car prices in the United Kingdom and a perceived lack of competition within the automotive industry, the EU introduced the new Block Exemption, which came into effect on 1 October 2002 (although a one year transitional period applies). The new stricter regulations still allow car distributors to enter into Selective or Exclusive Distribution systems agreements with dealers; however, distributors must choose between either a Selective network or an Exclusive network.

7.22 Most distributors are likely to opt for the Selective Distribution network, as it provides scope to control the size and composition of the network. Under this type of network, distributors retain the right to appoint and select dealers and repairers according to criteria established by the dealers themselves. Although the regulation does not prescribe dealer criteria, 'hardcore' restrictions are imposed by Article 4 which prohibit manufacturers from, among things, establishing criteria that directly or indirectly has the effect of setting a minimum sale price or restricting the territory in which the dealer or repairer can set up shop. As of 1 October 2005, distributors are prohibited from entering into agreements which prevent dealers from establishing additional sales or delivery outlets (known as the 'ban on location' clause).

7.23 The new regulation also opens up the market for after-sales services by facilitating competition between authorised repairers and independent repairers and dealers. Independent repairers are guaranteed access to technical information and training on the same basis as dealers. Moreover, distributors cannot limit the number of authorised repairers who meet their established criteria and cannot designate their location.

7.24 The legal framework provided by the EU Block Exemption on the motor vehicle industry and its objectives have limited application to the Australian context for the following reasons:

(a) the main purpose of the regulation is to facilitate trade between member countries with a view to reducing price differentials between States. This is simply not an issue in the Australian regulatory environment;

(b) high car prices in England (in particular) were a considerable impetus for implementing the new Block Exemption. By contrast, real car prices in Australia have decreased since 1996;

(c) the main measures adopted to facilitate trade include the ban on location clauses, limiting distributors' ability to restrict the appointment and selection of dealers, and prohibiting distributors from requiring that dealers exclusively sell their brands. As indicated previously, typically dealers in Australia are free to enter into arrangements with a number of distributors and only a small number of distributors require an exclusive brand commitment; and

(d) the EU competition regime operates at an industry level and is not aimed at conduct directed at competitors. Such a regime would be inconsistent with the aim of Australian competition law as previously noted.

8 The relationship between distributors and dealers

8.12 Over a sustained period, certain dealer representative groups have been lobbying for changes to the regulation of the relationship between distributors and dealers. Most recently, the MTA has lobbied the New South Wales Government to consider specific legislation to regulate the relationship.

8.13 FCAI denies there is any basis for such legislation. In general, the relationship between distributors is positive, stable, and characterised by a sophisticated understanding of common commercial objectives.

8.14 The positive nature of the relationship between distributors and dealers is supported by the fact that the FCAI's survey results show that only 14 dealers have issued legal proceedings against a distributor in the past five years. This represents less than one per cent of the dealer agreements covered in our survey.

8.15 Lobbying efforts by groups such as the MTA are an ambit claim by certain dealers to enhance their own financial position. As FCAI considers it likely that the same arguments will be presented to the Committee, we include a brief response to the major allegations that have been raised against distributors.

Dealer agreements are terminated by distributors (or not renewed) without just cause.

8.16 For a distributor to remain commercially viable it is imperative that it has a strong and stable dealer network. If a dealer ceases to operate, at least in the short term, it can cause significant financial losses to the distributor. This is exacerbated where the dealer is a critical part of the distributors marketing plan. For this reason, terminations or non-renewals of dealer agreements by distributors only occur where there are sound commercial reasons for doing so and even then as a last resort.

8.17 On the basis of our survey results, terminations or non-renewals generally occur because:

(a) the dealer becomes insolvent and unable to perform its obligations;

(b) there has been persistent underperformance and fundamental breach of the agreement; or

(c) it is part of an effort to improve the commercial performance of a vehicle brand, the distribution system is re-configured, including changes to the number and location of dealers.

8.18 In addition, MTA's position regarding termination overlooks the fact that:

(a) most dealer agreements allow the dealer to terminate the relationship by giving very short notice to the distributor;

(b) the majority of terminations are instigated by dealers; and

(c) even where an agreement contains a *no default* clause, the Code provides that distributors must give reasonable written notice of a proposed 'without cause' termination, and reasons for it, to the dealer.

When dealer agreements are not renewed dealers should be compensated

8.19 Dealer groups have been advocating a position that where fixed term dealer agreements are not renewed, the dealer should be compensated by the distributor for 'good will' the dealer has built up. This misconceives the nature of good will.

8.20 When a dealer enters into a fixed term dealer agreement, it does so in the full knowledge of what the term is for that dealer agreement. As indicated, the Franchising Code ensures that distributors provide a disclosure document to a prospective dealer and there is no excuse for a dealer not knowing the terms of a dealer agreement. If the dealer chooses to enter into the dealer agreement, it pays nothing to the distributor. During the term of the dealer agreement, the dealer can seek to sell its business with the consent of the distributor. The price it receives for the business, over and above the value of its assets, represents the 'good will' the purchaser is prepared to pay. This good will reflects the expected future profit of the business which in part is determined by the likelihood of potential customers coming to the business, notwithstanding that it has been sold. This future profitability can, however, only be for the remaining portion of the dealer agreement. Therefore, any good will paid will be proportional to the remaining length of the term of the agreement.

8.21 At the end of a fixed term dealer agreement, the dealer has no franchise business to sell. There may well be good will that attaches to the distributor, but at the end of a fixed term agreement the distributor is under no obligation to renew that agreement. The distributor's good will does not belong to the dealer and therefore should a distributor validly not renew a dealer, the distributor should not be obliged to pay any compensation to the dealer. The outcome of introducing an obligation to make good will payments is likely to be distributors recovering these inefficient costs by charging a franchise fee.

8.22 It may well be that some good will attaches to the dealer itself, independent of the distributors goodwill. This does belong to the dealer and can be sold by the dealer. It is, however, independent from the distributor's good will.

8.23 The concept of good will has been considered by the Australian Taxation Office in ruling TR1999/16. That ruling demonstrates the complexity of good will as a legal and accounting concept, emphasising the close connection between the *particular* characteristics of the business and the existence of good will. This is emphasised by the description of good will as a "quality or attribute that derives among other things from using other assets of a business". Such assets would include:

(a) a businesses site;

(b) the personality of the staff;

(c) the level of service available; and

(d) its reputation for price.

8.24 At the same time as it demonstrates the complexity of the concept, this ruling demonstrates that good will does not accrue only by virtue of a licence to trade. On that reasoning a motor vehicle dealer agreement alone does not contain good will.

8.25 The consideration of good will by the Australian Taxation Office was influenced by the Full High Courts decision in Murry's case.[20] In that case, the court focused on the idea of good will as reflecting an ability of a business to attract future custom. While the existence of the taxi licence, in that case, was clearly a factor in the businesses ability to attract future custom it was not a

[20] *Commissioner of Taxation v Murry* [1998] HCA 42.

source of good will. Rather the licence was the authority for conducting a business and did not constitute or contain good will.

8.26 Both the ruling of the Australian Taxation Office and the decision in Murry's case are clearly inconsistent with the arguments raised by some dealers that valid terminations or non-renewals of dealer agreements, should attract good will payments. FCAI submits that introducing such a scheme would simply result in windfall gains to dealers for no competitive benefit. Moreover, to the extent that good will payments would be priced into the relationship between distributors and dealers they are likely to increase vehicle prices and be detrimental to consumers.

Unilateral variation of dealer agreements by distributors.

8.27 Dealer agreements do not allow distributors to unilaterally vary material terms or the primary structure of the dealer agreement itself. It would be inconsistent with standard contract law and probably the existing law of unconscionable conduct for a party to unilaterally vary the obligations of the other party under an agreement.

8.28 Rather, some dealer agreements include clauses that allow distributors to notify dealers of revised procedures or processes they are required to comply with (eg warranty procedures) Many of these processes and procedures are required to be responsive to consumer requirements or sentiment, or to a changing regulatory environment (eg the introduction of Privacy legislation). This practice is necessary and practical for both parties, particularly in a dynamic industry such as the motor vehicle industry. The practice is not unique to the motor vehicle industry – it is used as an important and practical contractual tool in most distribution arrangements.

Distributors are unwilling to negotiate the terms of dealer agreements.

8.29 Most distributors have standard procedures for the appointment of a prospective dealer. At least one FCAI member surveyed offers alternate agreements at the election of the dealer. Appointment procedures are clear, concise and pay due regard to both the Code and the TPA.

8.30 In circumstances where a distributor intends to roll out a revised dealer agreement for future use, the following procedures are generally recognised as good practice:

(a) consultation between the distributor and dealer council on the proposed changes;

(b) dealer council seeks external advice and considers the proposed changes (including consultations with individual dealers);

(c) dealer council responds to the distributor in writing and details areas of concern;

(d) distributor seeks external advice regarding the dealer council's response; and

(e) both parties finalise the dealer agreement.

The tenure of dealer agreements is inadequate.

8.31 The bulk of dealer agreements are for fixed terms of either three or five years. Given the requirements for disclosure, and the requirement for the dealer to obtain separate advice, the term of the agreement should have no bearing on the success or otherwise of a dealer. Any rational party entering an agreement will determine their likely commercial returns within those constraints. The dealer is fully informed and makes a commercial decision on that basis.

Distributors impose unreasonable requirements on dealers in order to force them to operate only one franchise or to operate each franchise at separate facilities.

8.32 This assertion is factually incorrect. In general, distributors do not require their dealers to operate as sole franchises. Only two of our members surveyed require exclusivity and one of those has granted a significant notice period to dealers as part of introducing exclusivity.

Distributors unreasonably withholding consent to the assignment of a dealer agreement to a properly credentialed buyer.

8.33 This assertion is inconsistent with the existing regime. Section 20 of the Code provides that:

> *A [distributor] must not unreasonably withhold consent to the transfer [of a dealer agreement].*

8.34 Assuming the assertion was accurate (an assumption FCAI refutes), the aggrieved dealer would have recourse under the existing provisions of the TPA.

9 Anti-competitive & protectionist proposals

9.12 At their heart, submissions seeking specific legislation designed to protect motor vehicle dealers are anti-competitive and protectionist, and show no regard for the likely detriment to consumers.

9.13 The proposal to introduce legislation which mandates indefinite tenure and prohibits termination except in overly narrow circumstances is inherently anti-competitive because:

(a) the effect would be to stifle competition between vehicle brands by depriving distributors of the contractual flexibility to respond to changing consumer choices and demand, which would thereby significantly distort competition in the market; and

(b) such reforms would significantly raise barriers to entry by entrenching existing competitors in the retail market. This would eliminate intra-brand competition by potential entrants.

9.14 The proposal to prohibit distributors operating retail outlets in competition with dealers is also inherently anti-competitive. This suggestion would effectively shelter dealers by limiting their exposure to intra-brand retail competition by eliminating the possible entry of distributors into the retail market. Such a lobbying position is protectionist, rent seeking, behaviour by incumbent players that want to maximise their financial advantage at the expense of competitors and consumers.

9.15 The only beneficiaries of the legislative changes sought by the minority of dealers who are advocating increased regulation are those dealers themselves. FCAI submits that the Committee should reject their assertions as, to do otherwise, would be to fail to recognise the historic efforts of the Australian vehicle industry to become a mature, global player, capable of developing through flexible and stable commercial relationships.

Annexure 2 Network Economics Consulting Group Report

necg

Economic characteristics of the relationship between automobile distributors and dealers

A submission to the Senate Economics Reference Committee
Inquiry into the Trade Practices Act and small business
Prepared for the Federal Chamber of Automotive Industries

September 2003

Executive Summary

There has been suggestion in some quarters of the automobile industry that existing general provisions under the Trade Practices Act ("the Act") are inadequate for the purposes of regulating the automobile industry, in essence, because they permit automobile distributors to exercise bargaining power vis-a-vis franchised motor dealers; and that industry specific amendments are required to remedy these inadequacies. Such remedies would have the effect of substantially increasing the market strength of dealers.

From an economic perspective, the merits of any such claims and proposed remedies should be evaluated against the standard of economic efficiency, which is the overriding objective of the Act; and competition, which is the means to this end. We believe the current provisions of the Act are in fact adequate when measured against these standards, in that they permit arrangements in this industry that generally *enhance* efficiency and *promote* overall competition. In contrast, those remedies proposed would likely have *adverse* impacts on economic efficiency and competition, and instead, are only likely to enhance outcomes for certain firms. Our view is based on a consideration of the underlying economics relevant to the relationship between distributors and dealers in general, and the specific context of the automobile industry.

Our analysis begins by delineating the relevant markets. We do so only to the extent needed for evaluating the distributor dealer relationship. In this respect, the most relevant issue we consider is whether separate functional markets exist for the wholesaling and retailing functions. In short, we believe they do, given the extent to which specific (and value adding) assets are required at each functional level and the observed extent of vertical integration. Having framed the relevant arena of rivalry, we turn next to the more substantive issues, beginning with an examination of the types of distributor-dealer arrangements that exist in this industry.

As we understand it, there is no standard form of agreement that exists in this industry. Some distributors require dealers to stock only their brand, others may not require dealers to stock only their brand though might attach conditions regarding product display, while some may allow dealers to stock other brands without restriction. That said, these agreements do tend to contain some common features. For instance, they tend to obligate the dealer to maximise sales, particularly within some designated sales area; maintain retail premises, display areas and customer service levels to a required standard; and maintain certain standards with respect to servicing and parts functions, as well as the level of staff training. Distributors, on the other hand, are typically obligated to provide dealers with ongoing product support and provide training (perhaps at the dealer's expense). Most importantly, agreements typically obligate distributors to undertake advertising on behalf of the dealer, be it general advertising or specific advertising programs with dealers (in which case, dealers might have to pay the distributor a levy). Distributors typically have a degree of discretion over which of their own product lines a dealer can stock.

What is clear is that key features of this industry are mirrored in many other industries, in particular, other consumer durable goods industries ranging from computers, home entertainment systems, refrigerators, ovens, to pianos. Like these other industries, the automobile industry is characterised by strong mutual dependencies between distributors and dealers. As suggested by provisions contained in distributor-dealer agreements, these arise from the extent of (sunk) relationship-specific assets, the degree of brand technical specialisation required by the retailer, and the high degree of consumer support required in order to sell products. In turn, these factors potentially give rise to 'market failures'. Reflecting this, distributor-dealer arrangements in the automobile industry, like those other industries just noted, contain provisions that seek to negate 'market failures' that would otherwise occur absent these provisions.

Economic analysis shows that such provisions contained in distributor-dealer arrangements in this industry and in many others are likely to be welfare enhancing. Moreover, it is far from clear that the particular circumstances under which such arrangements will lead to adverse effects on competition are found in this industry.

The analysis of distributor-dealer arrangements and their underlying economics, sheds light on the likely bargaining power distributors have vis-à-vis dealers. In particular, regardless of the extent of concentration in automobile distributorship, mutual dependencies between distributor and dealer confer upon each party significant bargaining power. While any distributor has power with respect to its brand, the dealer also has a degree of hold up power associated with relationship specific assets. In summary, therefore, there does not appear to be a fundamental imbalance of bargaining power as between distributors and dealers.

While problems and disputes may arise between distributors and dealers, if these raise any issues of anti-competitive or unconscionable conduct by distributors, there is no reason to believe that the existing provisions of Part IV, particularly s.47, and Part IVA are inadequate to address those issues.

While we believe this to be the case, we turn to proposals to strengthen dealers' positions viz-à-viz distributors through such notions as a prohibition against distributors terminating dealer agreements, mandatory indefinite tenure, and prohibitions against distributors either competing directly with a dealer or introducing new dealers to the area. These proposals are problematic on a number of grounds:

- Most of them invoke legislative powers to modify an existing commercial arrangement in a manner which is very favourable to one party without the other party's consent;
- Some are clearly anticompetitive in that they would prevent a distributor from taking pro-competitive measures;
- More broadly, the proposals would greatly increase the degree of holdup power available to dealers.

In short, the proposed remedies would prevent distributors from offsetting problems relating to externalities and hold up through contractual means, potentially leading to inefficient distribution and dealership arrangements.

Finally, we consider a specific suggestion that upon termination of a dealership agreement, a 'good will' payment should be made by the distributor to the dealer in recognition of the dealer's efforts in promoting the brand. We find the suggestion to be flawed on account of the fact that dealers should have rationally budgeted to recoup all outlays within the initial term of the agreement, and hence, any 'good will' payment would represent a windfall gain above and beyond the recoupment of the dealer's investment. Moreover, there is the presumption that the dealer is primarily responsible for creating good will. On the contrary, the structure of arrangements in this industry suggest that distributors are obligated to undertake significant investments in their own right in advertising, in product quality improvements, in distribution process improvements, and in parts and service capabilities, which confer benefits to dealers to which dealers do not contribute financially. As with those other proposed remedies discussed above, this specific proposed remedy would only serve to increase prospects of particular firms, rather than enhancing competition or social welfare.

Contents

Introduction

The Motor Trades Association of Australia (MTA) seeks legislative intervention in the relationship between franchised motor dealers and their distributors.[21] In effect, the MTA seeks industry-specific amendments to the Trade Practices Act, 1974 (the "Act"), which will affect the character of that relationship. Among other claims, the MTA states that existing protections under the Trade Practices Act are not adequate because:

1. There is an imbalance of negotiating power between dealers and distributors;
2. The Act is uncertain in its application, and only provides redress for the most oppressive form of corporate conduct; and
3. In the absence of effective legal sanctions or remedies, distributors are unwilling to resolve disputes.

The remedies sought by the MTA involve a series of legislative amendments tailored specifically to their industry. These include such proposals as prohibition against distributors terminating dealer agreements other than in exceptional circumstances, provision for indefinite periods of dealer tenure, prohibition on distributors operating retail outlets in competition with dealers, enshrining the right of dealers to sell more than one brand of motor vehicle, and prohibition on distributors appointing other dealers in a dealer's Prime Market Area.

The MTA's submissions on this subject in various fora have raised questions at three distinct levels. First, they invoke questions of legislative principle and interpretation which are best dealt with by lawyers. Second, they raise questions concerning a number of factual matters which are best dealt with by those more familiar with the evidence.[22]

Third, by the nature of their proposals for legislative change, they raise issues on which economics can contribute by providing an understanding of the business environment which gives rise to dealer agreements in their current form. This report sets out these economic issues, and applies economic principles to analyse, not only the possible results of following the MTA's prescriptions, but also, more generally, the likely benefits and costs associated with imposing industry specific legislation, given the underlying economics of distributor-dealer relationships in this industry.

The scheme of this report is as follows. Section 2 delineates the markets relevant to analysing the current arrangements. Section 3 observes and examines the structural characteristics of the industry. The picture that emerges is one of mutual dependencies between dealers and distributors, and where 'market failures' would arise absent the contractual means of mitigating adverse impacts associated with 'externalities' and 'hold up' problems. Section 4 elaborates on the economics underlying these two sources of market failure. In section 5, we address claims regarding the supposed imbalance of power as between distributors and dealers. To the extent that issues of anti-competitive or unconscionable conduct arise, the existing provisions of the Act contain appropriate remedies. For completeness, we consider the types of industry specific remedies in section 6. While prompted by the specific remedies proposed by the MTA, the discussion is broadly applicable to any suggestion to impose industry specific remedies. Finally, in section 7, we evaluate one of the MTA's specific proposals, for 'good will' payments, in light of the economic framework established in earlier sections.

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21 The distributors are the Australian automobile manufacturers and importers, who are the constituents of the Federal Chamber of Automotive Industries (FCAI) on behalf of whom this report has been prepared.

22 That said, we note that the FCAI conducted a questionnaire survey of its members in July 2003, which casts doubt on the MTA's claims of oppressive conduct by distributors.

Relevant markets

Our analysis begins by defining the market(s) relevant to assessing the current market structure. In particular, economic analysis of competitive effects requires an understanding of the field of rivalry, which involves the formal economic discipline of market definition —that is, establishing the boundaries of the field of rivalry. In antitrust cases, this market definition process is often contentious, and therefore involves sophisticated argument and heavy evidentiary support.

For the present purpose, a more simplified market definition analysis will suffice. In particular, it is the delineation of functional markets that is most relevant to our analysis – that is, whether motor vehicle wholesaling takes place in a distinct market from motor vehicle retailing. We believe it does, on account of the following factors (which are evidenced in greater detail in subsequent sections):

1. specific assets, in the form of showrooms, after sales service and maintenance facilities, tools, parts, training, retail-specific IT systems, and advertising, are required for the retailing function which are not required for wholesaling;
2. these assets permit retailers to add value to the product in important ways;
3. vertical integration from wholesaling into retailing is uncommon, and backward integration from retailing into wholesaling is even less common;[23]

Having delineated the relevant markets to the extent necessary, we now consider the more substantive issues, beginning with an analysis of the nature and range of distributor-dealer arrangements exist in this industry.

Nature and range of dealership arrangements

Distributors are either the manufacturers or importers of automobiles. They sell automobiles to motor vehicle dealers, who then sell them to consumers. Some distributors own motor vehicle dealerships, but the vast majority of dealers are independent franchisees who have a dealer agreement with a distributor. Many dealers operate at multiple locations. Many dealers have arrangements with multiple distributors. The Australian industry structure is a common one worldwide.

Approximately 40 separate automobile brands compete in the Australian market. Within brands there is strong competition between dealers. Australia-wide, 824,310 new motor vehicles were sold in the retail market for 2002, representing $25 billion in dealer revenue. In annual revenue terms, individual dealers range in size from $5 million to above $750 million. The largest of these would have greater turnover than some of the distributors.[24]

Various types of distributor-dealer arrangements exist in this industry. As we understand it, no standard form of agreement exists in this industry. For instance, some distributors require dealers to stock only their brand, others may not require dealers to stock only their brand though might attach conditions regarding product display, while some may allow dealers to stock other brands without restriction. That said, these agreements do tend to contain some common features. For instance, they tend to obligate the dealer to maximise sales, particularly within some designated sales area. They also typically require dealers to maintain retail premises, display areas and customer service levels at acceptable standards. Further, such agreements contain provisions regarding minimum levels of servicing and parts functions that dealers must operate, as well as acceptable levels of staff training. Distributors, on the other hand, are typically obligated to provide dealers with ongoing product support and provide training (perhaps at the dealer's expense). Most importantly, agreements typically obligate distributors to undertake advertising on behalf of the dealer, be it general advertising or specific advertising programs with dealers (in which

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23 It is clearly implausible that a large dealer would develop the werewithal to commence manufacturing motor vehicles, but not so unlikely that a large dealer could become an importer.

24 Data sourced from FCAI's VFACTS system.

case, dealers might have to pay the distributor a levy). Distributors typically have a degree of discretion over which of their own product lines a dealer can stock.

What is clear is that key features of this industry are mirrored in many other industries, in particular, other consumer durable goods industries ranging from computers, home entertainment systems, refrigerators, ovens, to pianos. Like these other industries, the automobile industry is characterised by strong mutual dependencies between distributors and dealers. As suggested by provisions contained in distributor-dealer agreements, these arise from the extent of (sunk) relationship-specific assets, the degree of brand technical specialisation required by the retailer, and the high degree of consumer support which must be provided in order to sell products. In turn, these factors potentially give rise to 'market failures'. Reflecting this, like those other industries just noted, distributor-dealer arrangements in the automobile industry contain provisions that seek to negate 'market failures' that would otherwise occur absent these provisions.

In the following section, we elaborate on two particular sources of market failure, and the means by which contractual arrangements, such as those observed in this industry, can alleviate them.

Sources of market failure

Economic analysis shows that the types of arrangements that exist in this industry, including (in the extreme case) exclusive distribution provisions, are typically welfare enhancing. In particular, they can mitigate 'externalities' or 'hold-up' problems, which can lead to 'market failure' – that is, outcomes that are socially suboptimal than those that could otherwise be obtained. Moreover, such arrangements only have harmful effects on competition overall under particular circumstances.

To elaborate, externalities are effects that are not mediated through the price system. If these are not factored into individual decisions, market failure may arise due to the producing of certain activities at levels which are either lower or higher than the socially efficient level, depending on whether the externality is 'positive' or 'negative'. There are two types of 'positive' externality that are especially important in distribution arrangements. *Vertical externalities* may arise from the relationship between distributors and dealers, whereby net benefits are conferred on one group as a result of the other's efforts. *Horizontal externalities* may arise from the interaction between dealers, whereby one dealer confers benefits upon rival dealers. These externalities can be especially great when there is close complementarity between the physical product and dealer input in determining the quality and ultimate competitiveness of the product.

In practice, exclusive dealing arrangements (or other less restrictive arrangements) are a common approach to mitigating these externality related problems. For instance, such arrangements can induce jointly efficient levels of marketing investment, by eliminating spill-over benefits from the promotion efforts of any given distributor or dealer. By optimising locational distribution of dealers, dealer prospects for cost recovery can be maximised, while leading to a denser dealer network for the product than would otherwise occur. By requiring a level of dealer commitment to a particular brand by requiring the dealer to make brand-specific investments in training, parts, signage, etc., such arrangements can ensure the dealer's own good-will is tied up with the brand, thereby preventing brand degradation.

Such arrangements can also alleviate 'hold up' problems. 'Hold-ups' are situations where parties develop *ex post* power relative to each other that they lacked prior to entering into a transaction. They typically arise when distributors must, as a result of the transaction, incur a cost that (1) once incurred is sunk and (2) will only yield a return if the relationship between the parties continues. The hold-up problem may arise for a distributor that has extensively invested in dealer training in non-brand specific skills; or where a dealer has developed an extensive customer list due to a long association with a brand, and it is costly to monitor and/or duplicate this list. Absent contractual arrangements, dealers could extract rents from distributors. The threat of hold-ups – and its associated investment deterring effects – in dealer networks is most acute when dealers, as a result of long association with a brand, acquire some degree of local

market power, enabling them to play off competing distributors. Exclusive distribution arrangements help reduce the likelihood of opportunistic behaviour, by forcing the dealer to incur the costs of shifting away from its current brand – that is, by reducing the transferability of the dealer's good will.

Overall, the potential efficiency enhancing effects of most forms of dealership agreements, including exclusive dealing, appear compelling. In contrast, the impact of distribution agreements on competition is less clear cut, and is highly sensitive to market circumstances. That said, it is important in any overall assessment that account be taken of the ways in which these arrangements facilitate and encourage investment by distributors and dealers in competitive effort. Broadly, competitive harm can manifest itself in three ways: through unilateral market power, concerted conduct and through increases in entry barriers:

- Exclusive dealing is most likely to increase distributors' unilateral market power when it shelters individual dealers from competitive constraint. Where consumers can substitute between brands, face a range of reasonably widely distributed brands and have incentives to search for 'good deals', the competition-strengthening impacts of addressing the market failures discussed above are likely to outweigh any unilateral effects.
- Exclusive dealing may facilitate concerted conduct, most notably in the form of tacit price coordination. Tacit coordination is unlikely where markets are characterised by a number of competing suppliers, products are highly differentiated and prices are observable.
- Exclusive dealing can increase entry and mobility barriers by increasing the sunk costs, and hence risks, involved in entry. Where there are numerous unaffiliated dealers, covering areas sufficient to allow an efficient entrant to defray its fixed costs, no such foreclosure can occur. Nor can it occur if the fixed costs involved in dealership are low, or alternatively, if there are diseconomies of scope to distribution. Finally, exclusive dealing can reduce entry barriers as well as increasing them, so any claims on this score need to be treated with caution.

Overall, the above discussion suggests that even exclusive dealing is only likely to harm competition in certain circumstances. Importantly, the particular circumstances under which such arrangements will lead to adverse effects on competition are unlikely to exist in this industry. Most relevantly, because the market is not highly concentrated (with approximately 40 competing brands and strong import competition), products are highly differentiated and prices are not transparent, the likelihood of anti-competitive effects appears low.

Bargaining power

The previous sections shed light on the likely bargaining power distributors have vis-à-vis dealers.

Before elaborating on why this is so, we note that the MTA's arguments give central importance to a claim that distributors have market power with respect to dealers and this is the justification for industry-specific legislation. To begin with, the claim that distributors wield market power is unproven at best. Market shares of individual distributors are relatively low and while each distributor has a degree of product differentiation and brand loyalty, most face a number of relatively close competitors. Oligopolistic coordination would be difficult to sustain in an industry with 40 brands and strong import competition.

Turning to the specific issue of relative bargaining power between distributors and dealers, before any proposal for industry-specific legislation could be considered, the proponents would have to provide, at a minimum, a clear exposition of what economic features set the motor vehicle wholesaling market apart from other wholesale markets. The MTA, so far as we are aware, has not articulated these distinguishing features. *Prima facie*, it is entirely unclear what such features might be. As discussed above, most of the features described here: the mutual dependencies between wholesaler and retailer arising from relationship-specific assets, the hold-up risk, the degree of brand technical specialisation required by the

retailer, and the high degree of consumer support which must be provided in order to sell the product are common to wholesale markets for almost all consumer durable goods.

These mutual dependencies give each party significant bargaining power, regardless of the level of market concentration generally. While a distributor has power with respect to its own brand, the dealer typically has bargaining power vis a vis the distributor with respect to relationship specific investments. Additionally, each party has the ability to use holdup threats of various kinds to protect its interests.

Even if, for the sake of developing the argument only, a distributor did have significant bargaining power with respect to its dealers, there would be no justification for industry-specific legislation. While problems and disputes may arise between distributors and dealers, if these raise any issues of anti-competitive or unconscionable conduct by distributors, there is no reason to believe that the existing provisions of Part IV and Part IVA are inadequate to address those issues. Exclusive dealing that has the purpose, effect or likely effect of substantially lessening competition in a market is unlawful under s.47 of the Act, but appropriately can be notified on public benefit (notably efficiency) grounds. S.46 of the Act is generally an inappropriate remedy for resolving issues around the termination of dealerships. Where a firm, such as a motor vehicle distributor, is not vertically integrated, it has no anti-competitive interest in terminating an effective dealer. However, it is vital that it be allowed to terminate ineffective dealers in the interests of promoting inter-brand competition. This is the type of situation dealt with by the High Court in *Melway*, and similar issues have arisen in relation to motor vehicle dealerships, e.g. *Regent's Pty Ltd v. Subaru (Aust) Pty Ltd* No. WAG150 of 1995 FED No. 1122/95 Equity. If the termination of dealerships involves unconscionable conduct, the recently expanded Part IVA of the Act should provide adequate remedies. These provisions are relatively new and untested, so it is too soon to say whether they are appropriate, but there is no reason to think at this stage that they are inadequate.

Proposed remedies generally

The MTA's proposals generally involve a considerable strengthening of each dealer's position vis-à-vis its distributor through such notions as a prohibition against distributors terminating dealer agreements, mandatory indefinite tenure, and prohibitions against distributors either competing directly with a dealer or introducing new dealers to the area. These proposals are problematic on a number of grounds:

- most of them invoke legislative powers to modify an existing commercial arrangement in a manner which is very favourable to one party without the other party's consent;
- some are clearly anticompetitive in that they would prevent a distributor from taking pro-competitive measures;
- more broadly, the proposals would greatly increase the degree of holdup power available to dealers.

As discussed above, features of franchising arrangements are typically driven by externalities and problems with hold up. If this holdup risk were to be amplified by legislative intervention, then distributors would be forced to resort to other, more costly means of protecting their investments in brand equity.[25] Such measures might include a greater degree of vertical integration into dealership, a strategy of relying on a smaller number of larger, more carefully screened dealers, or even a reduction of outlays on appropriable assets such as advertising and dealer training.[26] Ultimately it is quite possible, if not likely, that consumer welfare would suffer in the longer term if the current voluntary agreements between dealer and distributor were distorted by legislative intervention.

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25 Brand equity investments include market research, manufacturing, R&D, and other steps aimed at improving product quality, advertising aimed at publicising product features, and investments in the distribution network's effectiveness.

26 These and other types of measures may involve higher cash costs to distributors, or higher opportunity costs in terms of foregone sales.

'Good will' payments by distributors to dealers

We turn now to consider in more detail a specific suggestion by the MTA that, upon termination of a dealership agreement, a 'good will' payment should be made by the distributor to the dealer in recognition of the dealer's efforts in promoting the brand.

As we understand it, the MTA's argument in favour of 'good will' payments is that dealers make an investment in brand equity building at the local level which is not fully recouped within the term of the dealership agreement. As the distributor benefits from this dealer investment, the distributor should make a payment to compensate the dealer upon termination of the agreement. The fundamental points of this argument, if we have correctly understood it, are that everyone, dealer and distributor, would be better off if 'good will' payments were made because they are necessary to provide incentives for the optimal level of investment by the dealer, which would not be forthcoming otherwise.

The contrary argument is that the dealership agreement is a voluntary contract between commercially sophisticated parties, in which the dealer will have rationally budgeted to recoup all outlays within the initial term of the agreement. After the fact, if a 'good will' payment is made to the dealer, it would represent a windfall gain above and beyond the recoupment of the dealer's investment.

The 'good will' concept appears to presume that it is the efforts of the dealer primarily which create good will, or brand equity, in the dealership territory. However, as described in section 4 above, the distributor makes very substantial investments in its own right in advertising, in product quality improvements, in distribution process improvements, and in parts and service capabilities which create external benefits—environmental features from which the dealer benefits but to which it does not contribute financially. Seen in this light there is a strong argument that the good will for which the *dealer* wants compensation may be generated principally by the investments and activities of the *distributor*.

However that may be, the crucial point is that the current dealership agreements represent a contract freely entered under which each party's rights and obligations are clearly set out and 'priced'. To amend such an agreement after the fact in a manner which is very favourable to one party, by means of compulsory mechanisms such as legislative or regulatory intervention would set a worrying precedent. Such intervention would make distributors far more wary of entering dealership agreements in the future, to the probable detriment of consumer welfare.

Conclusions

In conclusion, the motor vehicle industry shares a number of characteristics which are common to many markets for durable consumer goods. In particular, there are strong mutual dependencies between distributors and dealers arising from relationship specific investments by both parties. These characteristics have the potential to give rise to market failure. The contractual relationships between distributors and dealers respond to these potential problems, by imposing obligations and restrictions on both parties. These relationships are generally efficiency enhancing, particularly given the structure of the motor vehicle industry. If, however, issues of anti-competitive or unconscionable conduct do arise, there is no reason to believe that the existing provisions of the Act, notably s.47 and Part IVA, are inadequate to deal with them. Proposals for industry specific legislation are likely to give rise to more harm than good, preventing efficient contracting to overcome market failure and preventing pro-competitive conduct by distributors.