FTC Workshop on Auto Distribution: State Regulation of Dealer Networks

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Henry Schneider
Cornell University

Dealers have some legitimate concerns

Carmakers have some power over dealers due to relationship-specific nature of dealer investments

Dealers invest in showrooms, advertising, repair facilities, etc.

- Relationship-specific in the sense that value of investment derives from carmaker-dealer relationship
- If carmaker adds new franchise nearby or terminates franchise, the investment isn’t easily repurposed and loses value
- Without protections, dealers might underinvest

So in this sense regulations have some value

But …

Not clear why long-term contracts can’t (mostly) address this issue

- Including continuing to use exclusive territories, perhaps in more flexible / efficient way

And reputational concerns for ongoing carmaker-dealer relationship should help

- Except during periods of extreme stress, when short-term considerations dominate

Serious costs of regulations

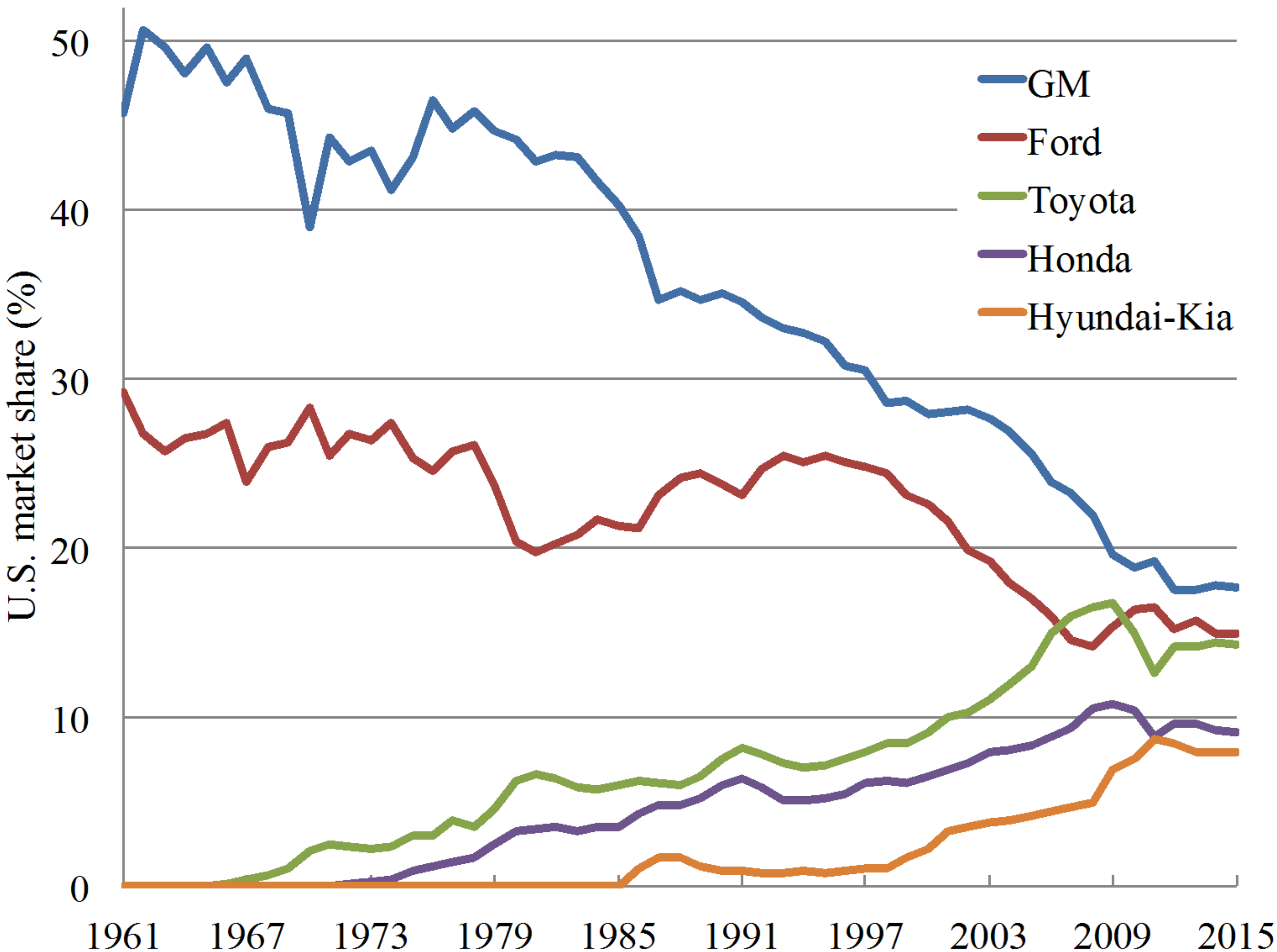
Makes it much harder for carmakers to do the following

1. **Restructure dealer networks to match long-run changes in demand, car-selling business model (e.g., Internet), etc.**

2. **Consolidate dealers to achieve economies of scale**

3. **Limit dealer market power**

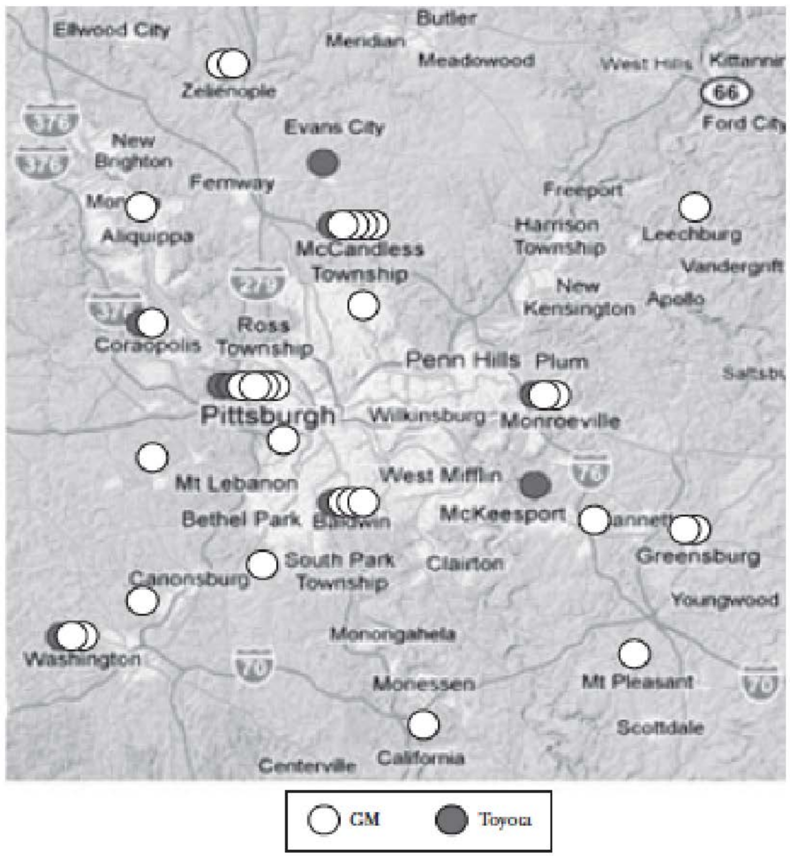
Long-run changes in demand



Source: WardsAuto.com and Edmunds.com

Dealer networks have been slow to adjust

GM and Toyota Dealerships in the Pittsburgh Area



Source: Lafontaine and Scott Morton (2010)

Economies of scale in dealerships

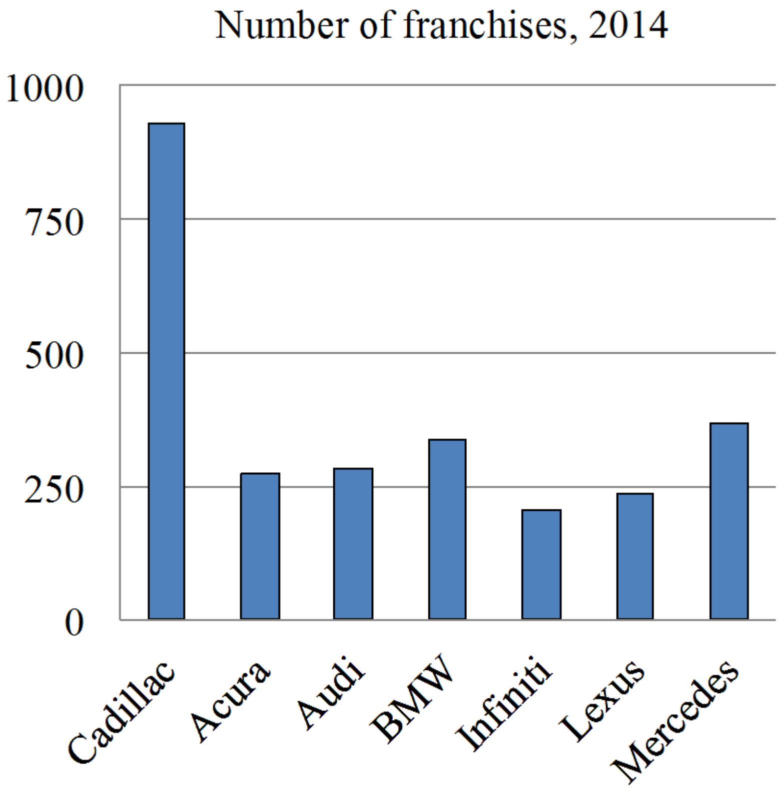
For example

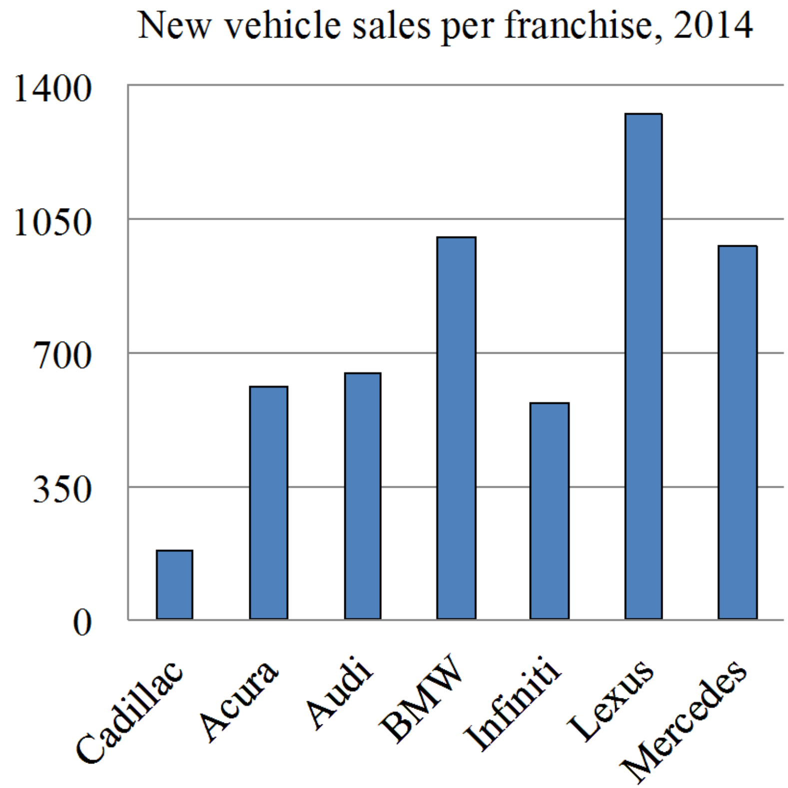
- Larger inventory / variety for customers to choose from
- Back-office costs (e.g., accounting, human resources, IT)
- Savings from purchasing shop supplies in larger quantities
- Better financing terms (e.g., on facility improvements)

Regulations make it harder to consolidate dealers for efficiency

(Some caveats: See Appendix)

Regulations increase costs of adjusting





Source: Automotive News Data Center, http://www.autonews.com/assets/PDF/CA9866239.PDF (accessed January 10, 2016).

Dealer market power

Exclusive territories give dealers some local monopoly power

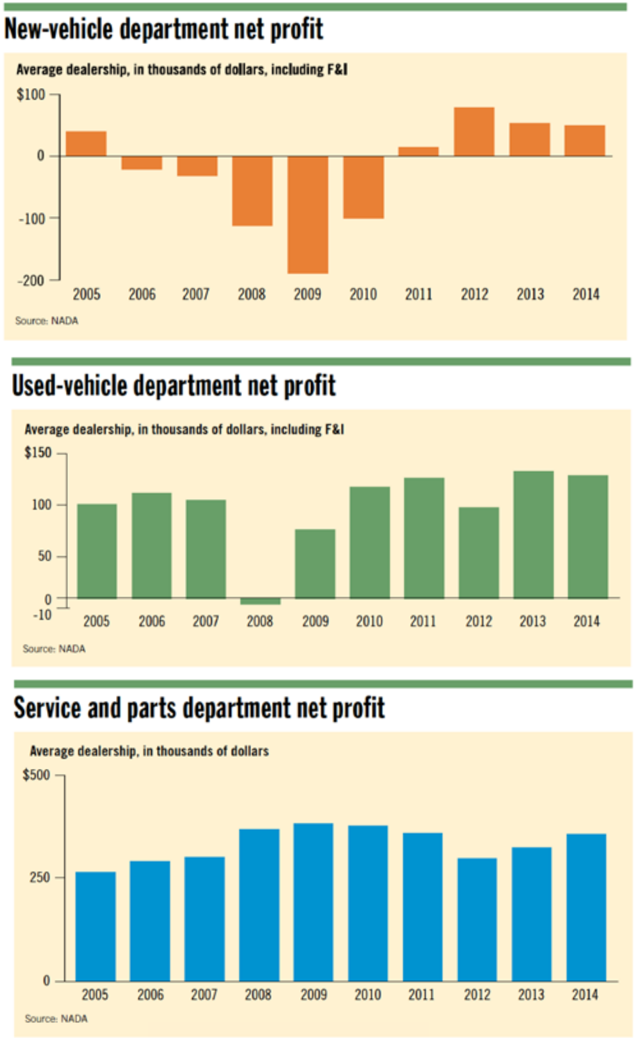
- Prices may be too high / volume too low from welfare perspective

Profit per new car is "only" $1,151 (new-car price is $33,158), but this is very incomplete

New-car sale is package that includes trade-in and future repair service

- Used cars and repairs are highly profitable

Dealership return on investment or return on net assets is generally very good



Source: NADA Data 2014, https://www.nada.org/nadadata/ (accessed January 11, 2016).

Dealer market power

Dealer regulations make it hard for carmakers to address this issue

- Carmakers want dealers to make some profit, but prefer relatively low retail prices (avoid double marginalization problem)

Carmakers could limit dealer market power using:

- Threat of adding new franchises or closing uncooperative franchises
- Direct sales (e.g., via Internet)
- Minimum quantities, price ceilings, etc.

But these are generally prohibited by regulations

Special protections for car dealers?

Franchisors giving exclusive territories and other protections to franchisees is very common

- 73% of franchisors across all industries offer some form of exclusive territories (Lafontaine and Slade 2013)

Evidence indicates that territorial protections are important for survival of young franchisor firm (across all industries) (Azoulay and Shane 2001)

But franchisors sometimes phase out protections over time (e.g., Love 1986)

Special protections for car dealers?

Sometimes argued that car dealers are different because of their size

- ~$700 billion in annual revenue
- ~20% of state sales tax revenue
- ~8% of retail employment

Deserve special protection due to important role in communities

- E.g., Texas Motor Vehicle Commission Code: “distribution and sale of motor vehicles vitally affects the general economy of the State and the public interest and welfare of its citizens.”

But if regulations are used as support for local communities

- Effectively a subsidy paid by carmakers and car buyers filtered through car dealerships
- Inefficient and not particularly fair

Appendix: Economies of scale in dealerships: Caveats

Trade-off between scale and dealer market power

- Inter-brand and intra-brand competition helps reduce market power
- So consolidation somewhat increases market power
- Allowing carmakers to use price and quantity requirements, direct sales, etc. would help address this issue
- Suggests that range of regulatory changes should be considered together in overall package

Consumer search costs to visit dealers are relatively large (e.g., Murry and Zhou 2015), so limiting distance to dealership has value

- Yet larger inventory / variety at dealership benefits consumers
- So there is a balance in how much to consolidate

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