



**Is There a Rationale for**  
**Warranty Reimbursement Laws?**

**David Sappington,**  
**Professor of Economics**  
**University of Florida**



# **View of a Regulatory Economist**

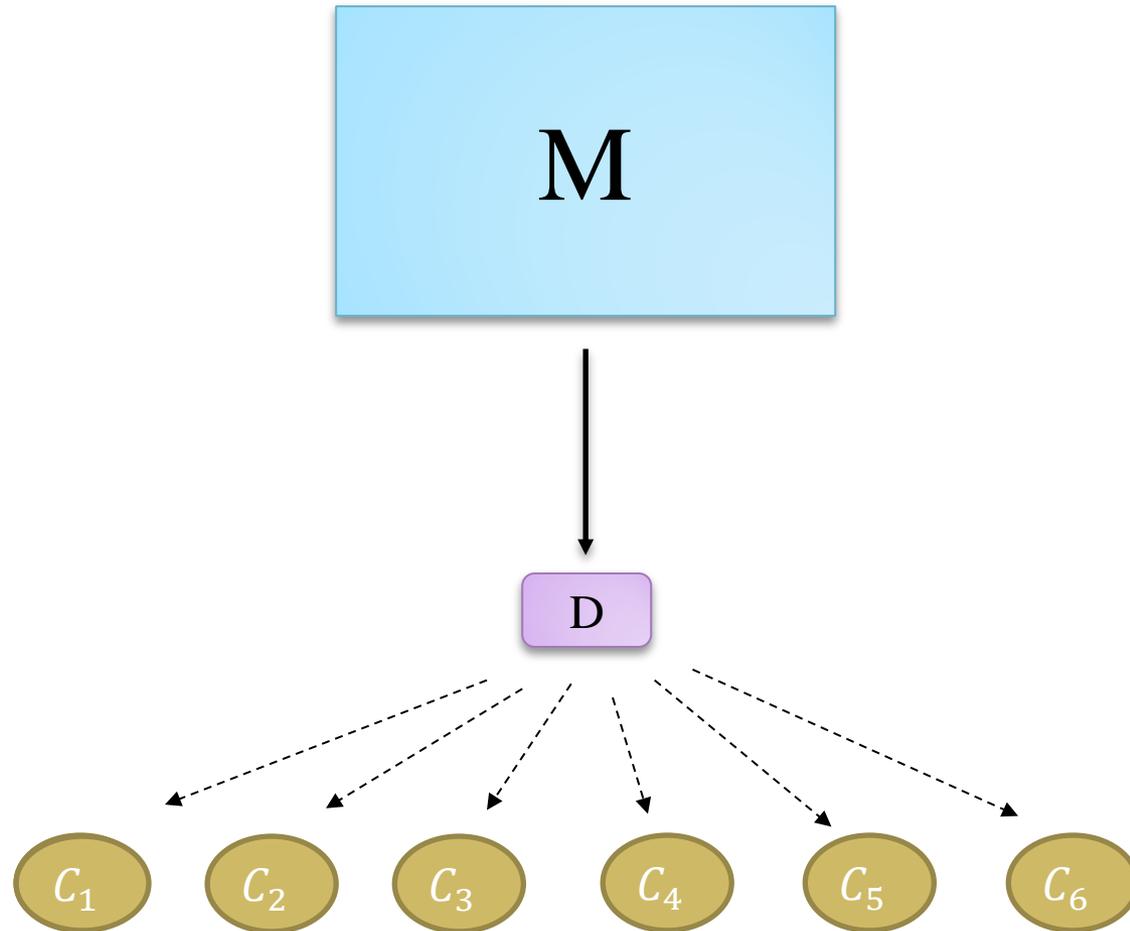
- 1. Competition is the ideal form of consumer protection.**
- 2. Government intervention is appropriate only in the presence of a significant failure of competition to protect consumers.**
  - Regulation is costly and unavoidably imperfect.**
  - Legislation often is even more imperfect because legislators cannot be experts on all matters.**



# **Fundamental Question**

**What is the source of the market failure that warrants government regulation of the interaction between automobile manufacturers and automobile dealers?**

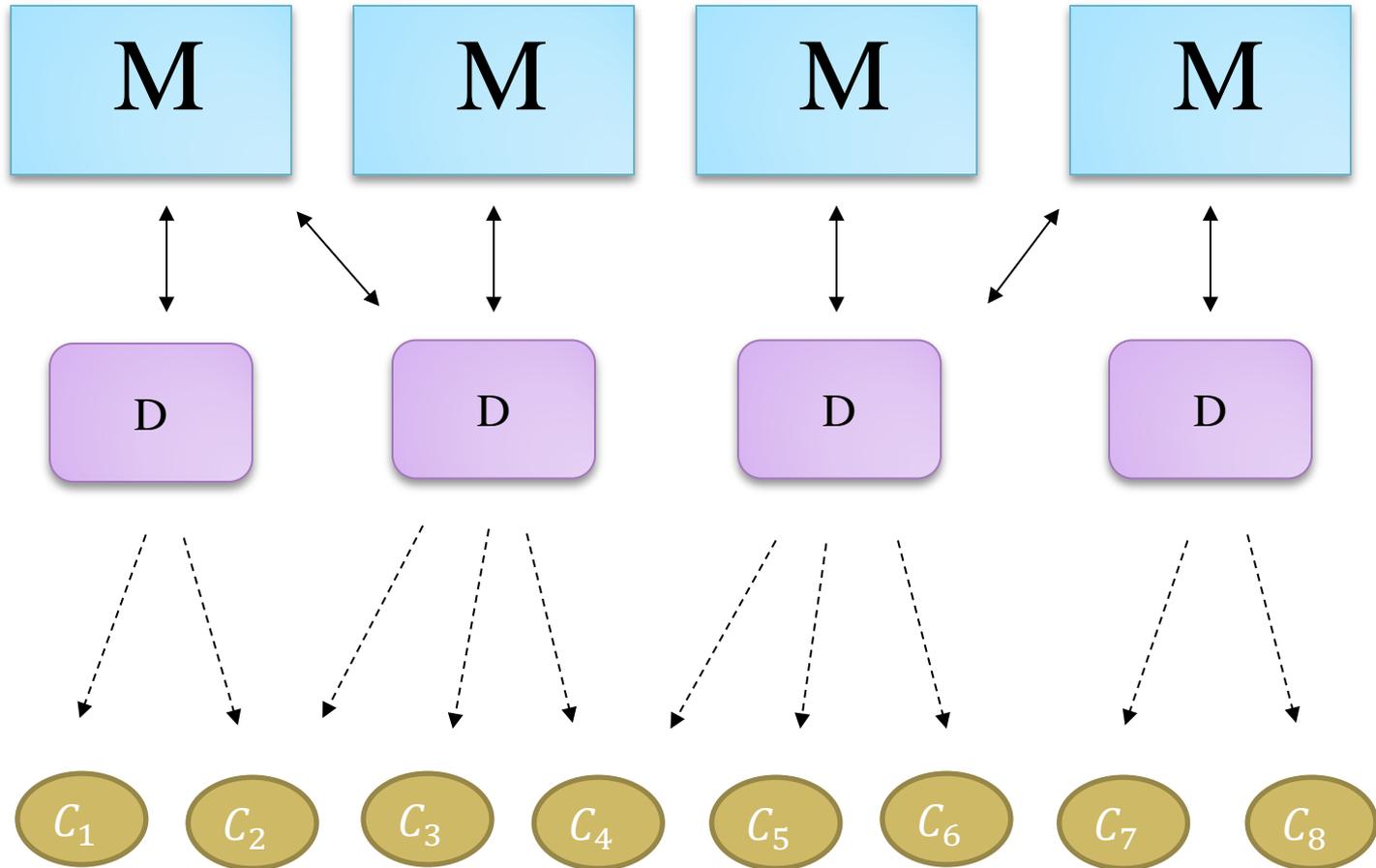
# Hypothetical Setting



# Elements of Hypothetical Setting

- **Large, powerful, monopoly M.**
- **Small, powerless D.**
- **M exploits D by paying D too little to perform warranty maintenance.**
- **Consumers are harmed by the resulting under-supply of warranty services.**

# More Realistic Setting



# **Elements of More Realistic Setting**

- **Several M-D teams compete against each other for customer patronage.**
- **Each M-D team must pursue the best interests of consumers if the team is to be successful.**
- **M-D teams that under-supply warranty service will lose customers to M-D teams that do not under-supply the service.**

# **Elements of More Realistic Setting**

- **Warranty service is one component of a bundle of services that M-D teams sell to customers.**
- **Just as a M does not wish to sell a product with major defects, it does not wish to sell a product that will not be repaired quickly and reliably should a problem arise.**

# **Implications**

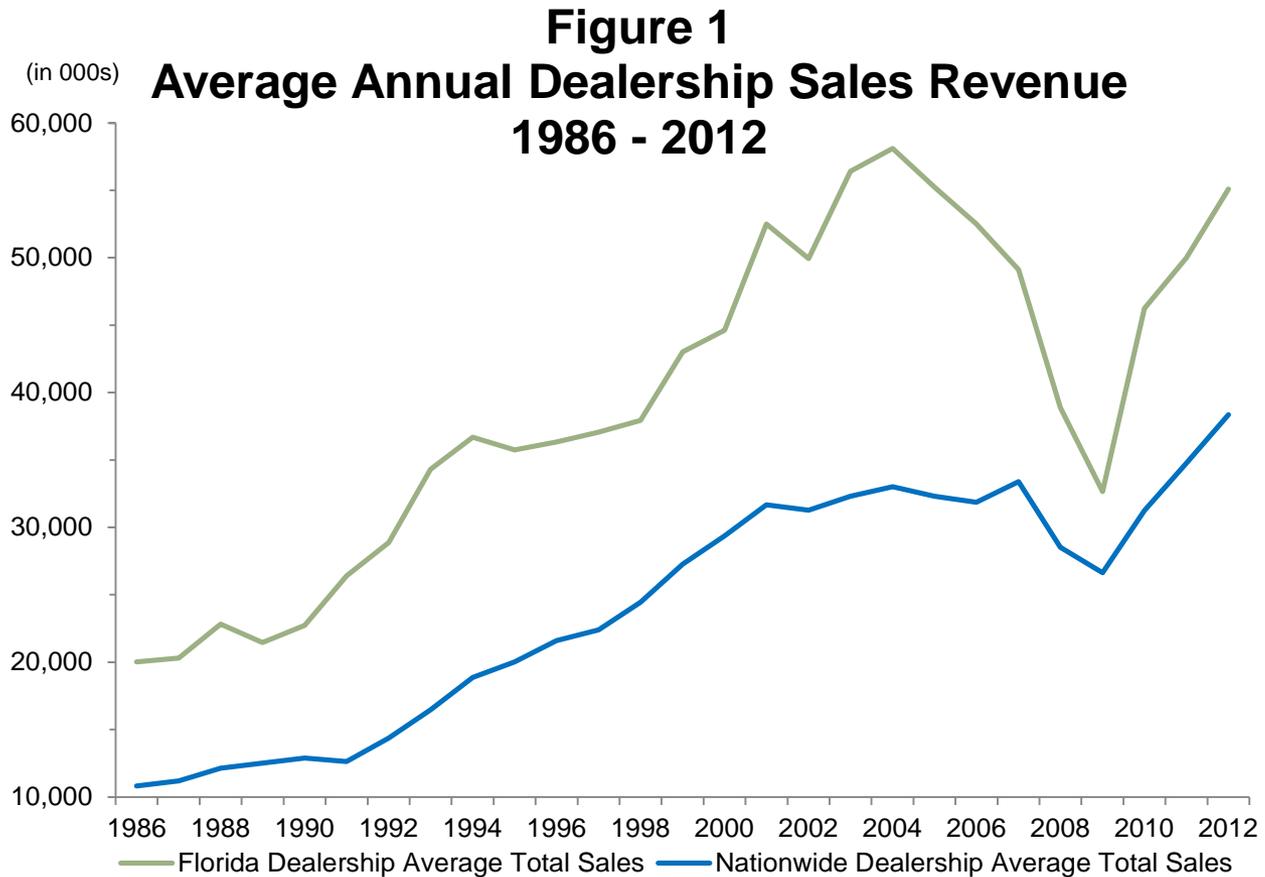
- 1. The automobile industry is characterized by substantial competition today.**
- 2. Competition seems likely to motivate M-D teams to agree upon warranty reimbursement terms that will result in warranty service that serves the best interests of consumers.**

# **Implications**

- 3. Consequently, it is not apparent that government intervention is needed to force M-D teams to adopt warranty reimbursement rules that best serve customers.**

# Implications

4. **It is also not apparent that dealers need protection against exploitation by manufacturers.**
- **Manufacturers compete for the best dealers.**
  - **Today's dealers often are powerful economic entities.**
  - **Today's dealers often are not beholden to a single manufacturer.**



Sources: 1987 - 2012 "NADA Data" Reports from NADA Industry Analysis Division at NADA.org; WardsAuto Group report "U.S. Vehicle Sales Market Share by Company, 1961-2012" from [www.wardsauto.com](http://www.wardsauto.com)

**Table 2**  
**Average U.S. Dealership**  
**Sales, Revenue, and Profit**

	1965	1986	2012
New-Vehicle Sales	331	649	838
Total Sales Revenue	na	\$10,821,331	\$18,297,687
Net Pre-Tax Profit	na	\$233,741	\$402,443

Notes: New-Vehicle Sales are in units. Sales revenue and net pre-tax profit are in 1986 dollars. Net pre-tax profit is the difference between gross profit and operating expense. Revenue and net pre-tax profit data were not available for 1965. Sales revenue and net pre-tax profit for 2012 in nominal dollars were \$38.4 million and \$0.844 million, respectively.

Sources: "NADA Data" Reports from NADA Industry Analysis Division at NADA.org; Wards AutoGroup Report "U.S. Car and Truck Sales, 1931-2012" from WardAuto.com

**Table 3**  
**Automobile Dealer Firms in the Fortune 500**

Firm	Fortune 500 Rank	Gross U.S. Revenues	Number of U.S. New Vehicle Dealerships
AutoNation	177	\$15,668,800,000	221
Penske Automotive Group	203	\$8,403,151,000	145
Sonic Automotive	307	\$8,365,500,000	111
Group 1 Automotive	343	\$6,954,000,000	111

Notes: Fortune 500 rank as of May 2013. Asbury Automotive Group ranks just outside the top 500, at number 506. It reported gross U.S. revenue of \$4,640,300,000 for 2012 and currently has 77 U.S. new vehicle dealerships.

Source: Company SEC Form 10-K filings for the fiscal year ended 12-31-2012; www.hoovers.com; [http://money.cnn.com/magazines/fortune/fortune500/2013/full\\_list/index.html?iid=F500\\_sp\\_full](http://money.cnn.com/magazines/fortune/fortune500/2013/full_list/index.html?iid=F500_sp_full)

**Table 4**  
**Dealer Chains and the Brands They Sell in the U.S.**

Dealer Chain	Brands Sold by the Dealer Chain
AutoNation	Acura, Audi, Bentley, BMW, Buick, Cadillac, Chevrolet, Chrysler, Dodge, Fiat, Ford, GMC, Honda, Hyundai, Infiniti, Jeep, Land Rover, Lexus, Lincoln, Mazda, Mercedes-Benz, Mini, Mitsubishi, Nissan, Porsche, Ram, Scion, smart, Subaru, Toyota, Volkswagen, Volvo
Penske Automotive Group	Acura, Aston Martin, Audi, Bentley, BMW, Bugatti, Cadillac, Chevrolet, Chrysler, Dodge, Ferrari, Fiat, Fisker, Ford, Honda, Hyundai, Infiniti, Jaguar, Jeep, Lamborghini, Land Rover, Lexus, Lotus, Maserati, Maybach, Mazda, Mercedes-Benz, Mini, Nissan, Porsche, Rolls Royce, Scion, smart, Sprinter, Suzuki, Toyota, Volkswagen
Sonic Automotive	Acura, Audi, BMW, Buick, Cadillac, Chevrolet, Ford, GMC, Honda, Hummer, Hyundai, Infiniti, Jaguar, Kia, Land Rover, Lexus, Mercedes-Benz, Mini, Nissan, Porsche, Saab, Scion, smart, Subaru, Toyota, Volkswagen, Volvo
Group 1 Automotive	Acura, Audi, BMW, Buick, Cadillac, Chevrolet, Chrysler, Dodge, Fiat, Ford, GMC, Honda, Hyundai, Infiniti, Jeep, Kia, Lexus, Lincoln, Maybach, Mazda, Mercedes-Benz, Mini, Nissan, Porsche, Ram, Scion, smart, Sprinter, Subaru, Toyota, Volkswagen, Volvo

Source: Company SEC Form 10-K filings for the fiscal year ended 12-31-2012

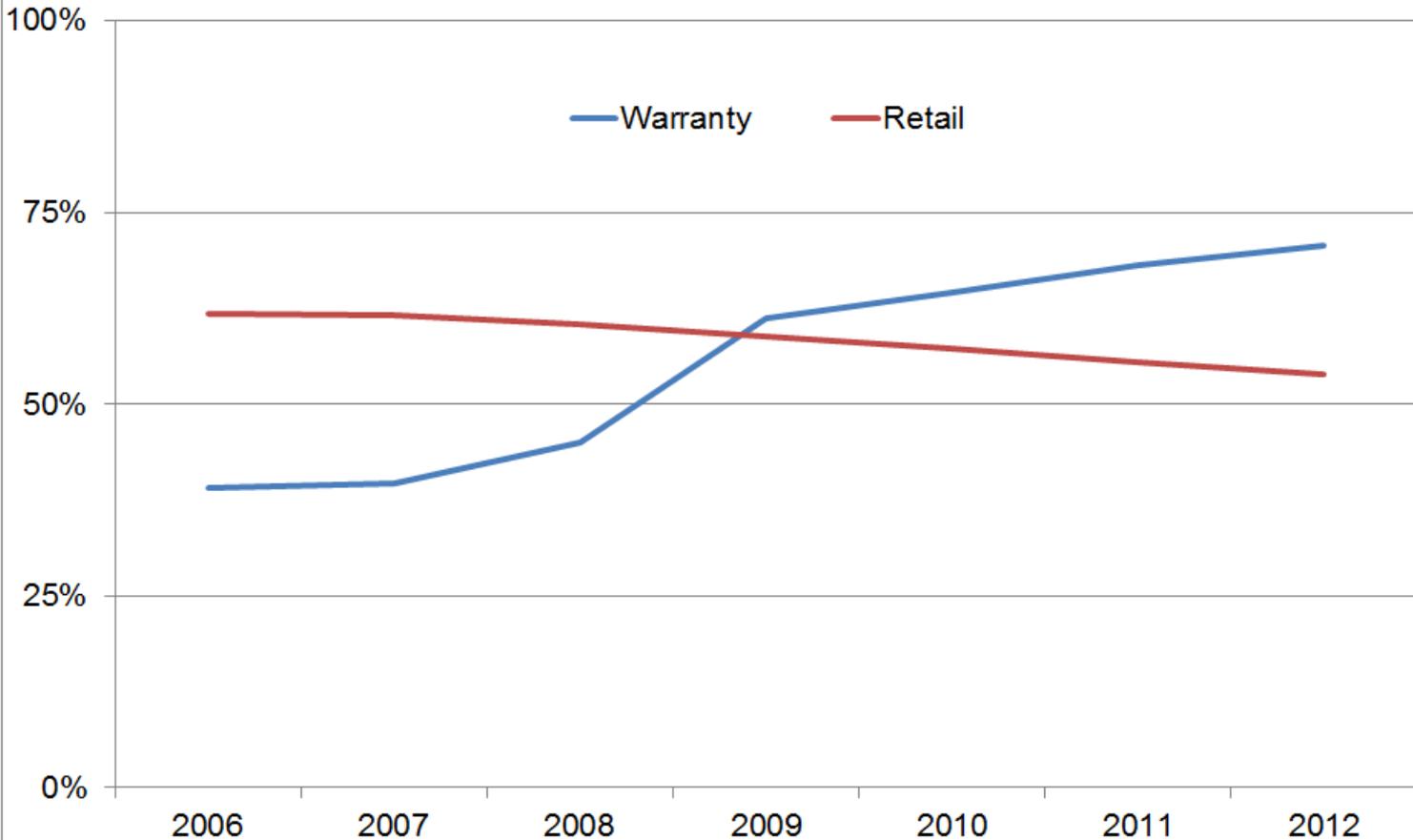
# **Government Intervention** **Can Cause Problems**

- 1. Is compensation for non-warranty work the proper benchmark for warranty work?**
  - Perhaps dealers should offer manufacturers a discount on warranty work, much as they offer discounts to other “large” customers.**

# **Problems**

- 2. Laws intended to equate dealer reimbursement for warranty and non-warranty repairs may fail to do so.**
  - Exempting “discounts” and “sales” when calculating non-warranty reimbursement rates can cause charges for warranty work to exceed charges for non-warranty work.**

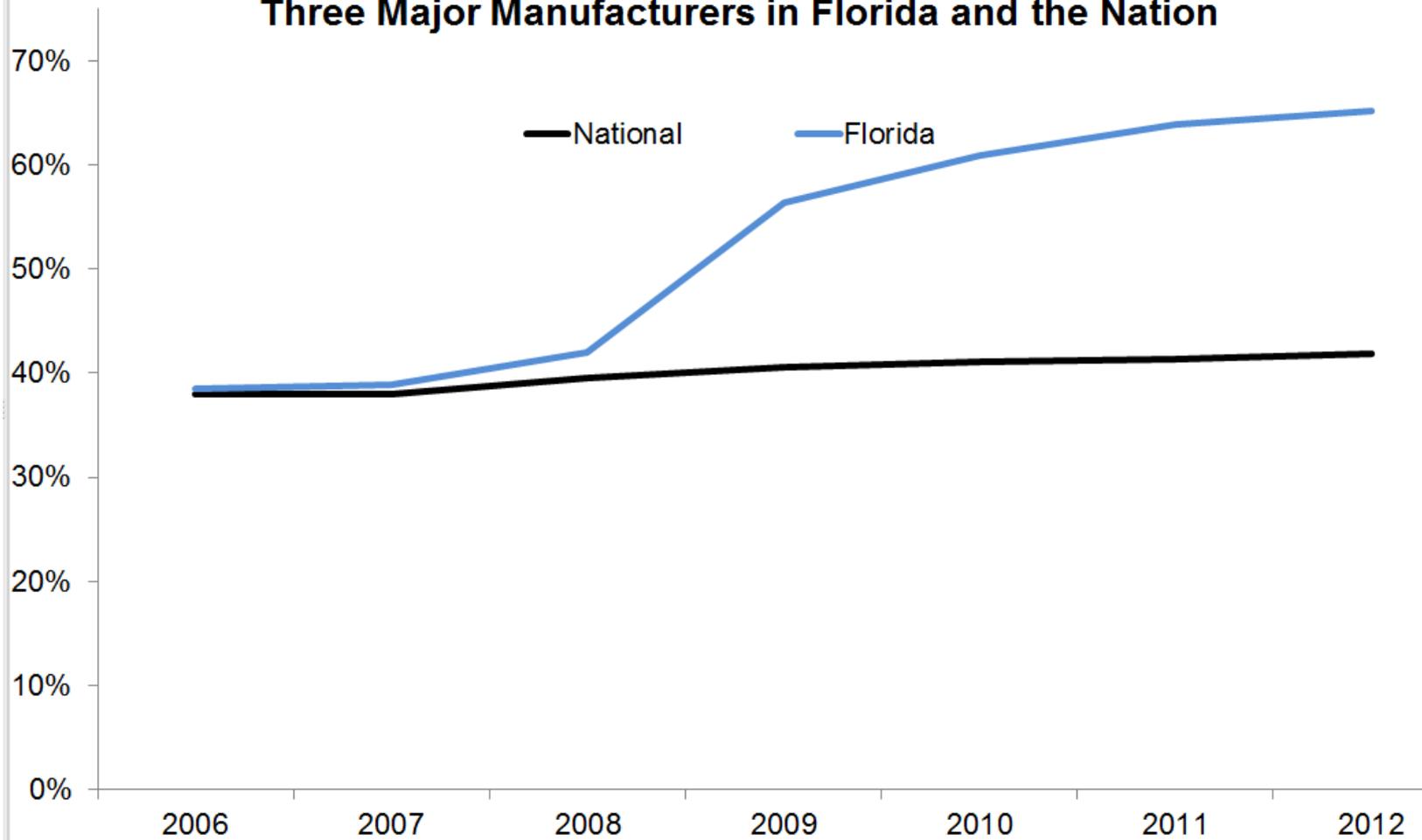
**Figure 3**  
**Average Florida Dealership Mark-ups on Retail and Warranty Parts for Four Major Manufacturers Combined**



Mark-ups calculated as gross profits divided by costs.

Sources: Florida Dealership End-of-Year Financial Reports for Each of the Four Manufacturers

**Figure 4**  
**Average Mark-ups on Warranty Parts for**  
**Three Major Manufacturers in Florida and the Nation**



Sources: Manufacturer Annual Dealership Composite Reports for Florida and the Nation

# **Observations**

- 1. The financial implications of warranty reimbursement laws can be substantial.**
  - Between 2008 and 2012, the Florida laws caused the warranty reimbursement payments of four manufacturers\* to increase by more than \$80 million.**

**\* These manufacturers accounted for just less than 50% of new vehicle sales in Florida.**

- 
- 2. Laws that force warranty reimbursement above appropriate levels can induce manufacturers to reduce warranty coverage and/or increase automobile prices unduly, and thereby harm consumers.**

# Summary

- 1. Market competition is the ideal form of consumer protection.**
- 2. Regulation and legislation are costly and imperfect substitutes for competition.**
- 3. Regulation and legislation should be avoided in the absence of a significant failure of competition to protect consumers.**

# **Summary (Continued)**

- 4. Competition in today's automobile industry appears well equipped to protect consumers.**
- 5. A role for warranty reimbursement laws (other than to transfer wealth from manufacturers to dealers) is not apparent.**
- 6. These laws can distort market outcomes, potentially to the detriment of consumers.**