Auto Distribution: Current Issues and Future Trends
Workshop hosted by the Federal Trade Commission
January 19, 2016
Part 2 of 4
Full Transcript available on workshop webpage: https://www. Panelists:

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AN WILSON: Good morning. My name is Nathan Wilson, and I'm a staff economist
TC. Along with my colleague James Frost, an attorney in our Office of Policy and
, I will be moderating today's panel on warranty reimbursement regulation. To
uce this topic, all automobile manufacturers offer warranties to consumers when
ew car or truck. The states have historically regulated how repairs provided—
overed by these warranties are provided. Many states' laws allow only new car
selves to perform warranty repairs.

states also regulate how the dealers are reimbursed for the warranty service they
ome cases, tetail rates. Where such retail
ent laws are in force, dealers have the option, but not the obligation, to submit
pricing for their non-warranty work, in order to set the warranty reimbursement

automakers, so dealers and manufacturers must negotiate out in the open where decisions that affect the public and consumer interest are made by democratically elected state representatives, and that's a good thing. The second reason, without state franchise laws, dealers and consumers would be at the mercy of powerful automakers. And no business person in their right mind would ever invest the millions it takes to open a new car dealership.

Public policy in 50 states is designed, not to protect dealers, but to foster investment in the franchise system of neighborhood new car dealerships, because this system promotes competition between and among brands. And not just for new and used car sales, but also for vehicle financing, customer paid service, and even for manufacture paid warranty repairs. Consumers benefit from this competition. Better hours of operation, pleasant customer waiting areas, courtesy transportation, and, of course, cost. Even the dealers' well-documented, charitable, and civic involvement is driven by competition for sales and service, regardless of whether it's customer paid, or warranty work paid by the manufacturer.

That's why the courts and elected legislatures have consistently recognized that the extensive network of 17,000 franchised new car dealers all across the U.S. serves the public interest, promotes competition, and gives consumers ready access to warranty service from skilled technicians working out of properly equipped, conveniently located service facilities. The fact that these dealerships are independently owned, and that the dealers must be paid fairly, ensures that consumers will be treated fairly.

Understand this very important point. When automakers see warranty, they see expense. And experience tells us they will try to reduce that expense by shifting costs to consumers or to dealers. But when a new car dealer sees warranty, they see revenue, and, therefore, an opportunity to serve, to act as an advocate, to ensure their customer gets the full value of the warranty they've already paid for. Now let's talk about how the warranty business works, in the real world.

Study a dealership financial statement. You'll see that dealers make nothing, or often lose money on new car sales. They make two to 3% on used,

example, and here's what you'll find. $0.66 goes right back out the door to the manufacturer to pay for parts and the cost of goods sold. $0.16 goes to personnel expenses, $0.05 goes to variable expenses, $0.07 goes to fixed expenses, and that leaves just $0.06 as net profit before taxes in the dealer. Manufacturers mandate facilities, special tools, equipment, and training to carry out warranty repairs, which cost a lot of money, but that investment benefits consumers because neighborhood new car dealers are standing by to fulfill the warranty promises made by manufacturers, promises that the consumers have already paid for.

So when manufacturers don't pay retail on warranty parts—or warranty repairs to the dealers—they're not just cheating the dealers, they're cheating the consumers too. We surveyed New Jersey GM dealers and found that about 35% of all repairs are warranty. That is free to the customer and paid by the manufacturer. So when GM underpays their dealers on 35% of their parts and service work, the dealers take a loss where they must shift costs to the remaining 65% customer pay jobs. By unilaterally mandating a discount, manufacturers place a financial burden on dealers that inevitably results in losses for the dealer, or higher prices for everyone else.

So how did the reimbursement methodology used in many states to calculate retail come about in the first place? State laws requiring automakers to pay retail on warranty date back to 1977 in New Jersey, but it wasn't until 1991 that Bob and Elaine Robertazzi, the courageous mom and pop owners of Liberty Lincoln in Clifton, New Jersey, challenged Ford Motor Company and eventually proved the powerful automaker was underpaying dealers and shifting cost to consumers in what federal district court Judge Maryanne Trump Barry called a shell game. Still, dealers were frustrated. Automakers continued to devise burdensome reimbursement procedures in order to thwart dealer demands for fair compensation. And by the late 1990s and early 2000s, many legislatures were fed up too. They arrived at this hundred consecutive repair orders methodology, mostly out of frustration with automakers, who were quick to say what retail wasn't, but never offered a reasonable formula to meet their obligations under the law. So here we are, almost 40 years later, retail reimbursement laws were first enacted in 20 years since the courts, and many state legislatures started to try to force compliance. And the sad truth is that automakers continue to game the system because

they know that every penny saved on the warranty, is a penny earned at the expense of consumers and car dealers.

Let's look at two common strategies the automakers use today to shift cost. Surcharges and manipulation of parts pricing and labor times. It's interesting. Thirty-seven states accounting for about 75% of all US auto sales require manufacturers to pay retail, but the manufacturers don't bake that price into the cost of the car. Instead, they up the surcharge dealers only in the states where they actually are forced to comply with the law, effectively charging consumers twice for warranty.

In New Jersey, GM agreed to pay dealers retail, but then turned around and imposed a surcharge on dealer invoice—a GM imposed charge intended to compensate them for what they say is their additional cost of doing business. We estimate GM collected $6.5 million in surcharges in New Jersey in 2014, and paid out just $3.2 million for reimbursement in excess of the 60% mark-w [illegible]

Yet there is no certainty for the dealers as to how many warranty repairs they will be making, and the value of those warranty repairs, or the size of those warranty repairs. The manufacturers do not and cannot guarantee any level of warranty work to their dealers, yet they require all of those overhead costs. There are currently at least 40 states wherein the state legislature has independently determined that manufacturers were not reimbursing dealers for warranty work at rates which were fair and appropriate. Those state legislatures each vetted this issue, independently, and determined that a market driven retail rate was fair and reasonable and in the best interest of consumers. As Mr. Appleton mentioned, after many of these state legislators required manufacturers to reimburse dealers at rates equivalent to retail, manufacturers made it virtually impossible for dealers to obtain an increase in their parts mark-up and labor rate based upon the dealerships customer pay repair work.

So as a result, 22 state legislatures had to include a specific formula in the franchise laws, by which the dealers would submit the equivalent of their retail rates. These formulas vary from state to state, but are generally based upon the dealerships collecting some number of consecutive repair orders—customer pay repair orders—and then taking an average of the parts mark-up and the labor rate for each. In addition, certain non-warranty like repairs, such as fluid and filter changes, are expressly excluded from that calculation as non-warranty like repairs.

Our firm has assisted hundreds of dealers in the submission of warranty reimbursement claims, under these laws. In practice, the dealers submit both the repair orders used in calculating the average parts mark-up and labor rate, along with the intermittent repair orders that didn't apply because they contained non-warranty like repairs. After submission, the manufacturer either accepts the requested increase in reimbursement, or raises questions related to the submission. In many cases, the manufacturers make a counteroffer for a lower reimbursement rate.

Dealers are certainly within their rights to negotiate the parts mark-up increase and the labor rate increase, and often do. Where the dealer and manufacturer cannot agree that the statutory calculation has properly been made, most states provide for administrative appeal to resolve the issue. As was mentioned earlier, some manufacturers have used surcharges to

dealers do a good job on the warranty work. Because manufacturers are dependent on the

I quote from an article by two brilliant people, Francine Lafontaine and Fiona Scott Morton, "The net result of all these laws is to raise profits for car dealers.... Dealers represent an identifiable source of employment and tax revenue, while even large manufacturers can site manufacturing plants in only a limited number of states. The result is that new car dealers have an advantage over auto manufacturers when it comes to political leverage in state legislatures, and thus states enact laws that extract rent from manufacturers and redistribute it to franchise dealers."

Now as I say in addition to that excess cost that it's costing the manufacturers, the manufacturers, in many states, there are now I believe 19 of them that prohibit recoupment in the state. So it's not a question of a dealer saying you owe me an additional $2,000 and the next invoice comes back and they're charged $2,000. It's a question of a manufacturer saying state x, New Jersey, cost me an additional x million dollars a year because it enacted these regulations. So I'd like to put a surcharge on the vehicles and identify it as something, so that when consumers go to buy the car they know that they are paying an extra whatever it is, $125, because of the warranty reimbursement that has been enacted in the state, a simple thing that would allow the voters, those affected by the regulations, to have some political say in the process. But these recoupment bars basically say to the manufacturers you are prohibited from recovering the increased costs caused by the statutes from within our state. And therefore, as David Sappington will address, the enormous costs have to get reflected somewhere else in the system. All of which results in things that are adverse to consumers. I'll stop there. My time is up.

perspective of a regulatory economist. And I think the golden rule for a regulatory economist is that competition is the ideal form of consumer protection. And no matter how well intentioned regulation or legislation might be, it's cumbersome, costly, and subject to error. And I have great respect for regulators. I've had the privilege of serving with regulators, and I have great admiration for them, but their job is just impossible. So whenever possible, it's ideal to rely upon competition to protect consumers rather than turn to regulation or legislation.

So the fundamental question then before us is what is the source of market failure, the lack of competition, that warrants government regulation or legislation in the interaction between automobile manufacturers and automobile dealers.

And as we've heard a bit this morning, I think the basic story that tries to justify these regulations is that if we have a setting where there's a huge dominant manufacturer and a small dealer who is beholden to the manufacturer, it may turn out to be the case that manufacturer would abuse that power, and, in fact, withhold payments for warranty work, for example, from the dealers. And consumers would be harmed in the process, because dealers would not have the proper incentives to do the warranty work properly. Now that's a story that one might tell, but that's not the way I perceive the industry, and I think a more realistic depiction of today's industry is that, in fact, we have many manufacturers competing against one another to reach customers.

They do so through their dealers, but those dealers notice now in this new picture are not tiny little entities, as Dan has mentioned, they are in fact major players, major economic entities. So I think the better way to now view the industry is that we have teams of manufacturers and dealers working together, competing against one another, to attract consumers and make sure they can both sell cars. And so it's in the interests of both manufacturers and dealers to pursue the best interests of consumers. Otherwise, they will lose business to other manufacturer-dealer teams.

So a more realistic picture in my view of today's industry is that we do have substantial competition in the industry and this competition seems very likely to motivate manufacturers and dealers to work together to agree upon warranty reimbursement terms as a part of the

competition. And, therefore, should be avoided whenever there is a reasonable possibility that

I've been involved in four separate different legislative initiatives in the state of New

obligated to pay dealers fairly for that work, they would not be able to make the investment in the community, which state legislatures have insisted –

I know the counselor Goldberg was concerned about the fact that there are so many different state laws and all the rest. Well now we have this pesky 10th Amendment, and this pesky 10th Amendment tells us that the states should be in a position to regulate for the health, safety, and welfare of their citizens, as they see best. And that's what we've seen all across the country. And the implication that somehow dealers have more political influence at the state house—let me tell you something. Last year we had a very vocal, very high profile battle in the state of New Jersey over a franchise bill. Automakers spent $600,000 in paid media and they spent another 400,000 in contract lobbyists. Now the dealer association spent a hell of a lot less than—

DANIEL L. GOLDBERG: Can we get a little equal time here? I thought you said two minutes, Nathan.

NATHAN WILSON: Yeah.

JAMES APPLETON: I'm sorry. I didn't know you were trying to get my attention. I apologize.

DANIEL L. GOLDBERG: Thank you.

RICHARD SOX: We're going down the line?

NATHAN WILSON: Why don't we go back and forth? Dan, do you want to jump in?

DANIEL L. GOLDBERG: And I'll try to keep it to my two minutes. When you look at the legislative process for these statutes, you won't find any consumer groups that were banging on the door of the legislature and say our dealers in this state are not performing warranty well. We need the dealers to perform better warranty, and, therefore, please pay them more. You won't find any history showing that, before and after these retail reimbursement statutes were enacted, that somehow the quality of warranty improved.

And I would warrant that if you tried to do a study between customer satisfaction of warranty in states that did not have retail reimbursement, and states that did, you won't find a

difference. Why not? Because there is a strong aligned view. Manufacturers, as I said earlier,

prices charged for non-warranty work. So, again, it's just another illustration of how regulations, even if they're well intentioned, don't always achieve their standard purpose.

NATHAN WILSON: OK. Dan? We'll do it in the same order. Do you have anything to add?

DANIEL L. GOLDBERG: I think the thing that is unique about the auto industry is what I referred to before, and that is the remarkable political power that the dealers have in every state. And I'll put it this way, if the elevator operators had had the same political power that dealers did, we wouldn't have self-operating elevators.

NATHAN WILSON: OK. Richard? David? Do you know anything to add?

RICHARD SOX: Yeah. I would just emphasize what Jim said in terms of what's one of the very unique things about this industry is that a vehicle is a dangerous instrumentality. It is something that, if it's not repaired correctly, it can cause death. And the state legislators, as Aaron mentioned in the last panel, found that governing that relationship and governing the repairs of those vehicles is critical to the public safety in the state. And I also want to point out that there was mention of price-fixing in one of the opening statements. And, if you read these laws carefully, you will understand this is not price-fixing at all. This is tying the warranty reimbursement to a market-driven rate that is going to be different for every dealer depending on the market, and the cost of doing business in that market, and maintaining facilities, and conducting those repairs in those markets.

NATHAN WILSON: Thanks.

DAVID SAPPINGTON: Nathan, I'll defer to individuals on the panel who are more informed about the details of the auto industry than I am. But my perception is that there really is not something fundamentally different about the auto industry, in terms of basic economic issues. And so I think we would then need to look for other explanations for why we see this large difference in regulation. And I think Dan's suggestion in that regard, the political influences, deserve serious attention.

NATHAN WILSON: Thank you. I'd like to now to turn to a question that we've received from the audience.

JAMES FROST: Multiple times—

NATHAN WILSON: From separate people. It's not just one insistent person. I'd like to hear the panel's thoughts about allowing non-franchised dealers to perform warranty work, perhaps independent mechanics, or chain repair shops. Perhaps two minutes again per person?

JAMES APPLETON: Sure. Let me just back up a second on—

So they've incurred the cost, and now, it's easy for the manufacturer to say, well, now

RICHARD SOX: It's just the opposite. I think the question proves what again, courts after looking at lots of evidence and state legislatures have found over long periods of time, that the manufacturers have an economic power over their dealers. And that's why some dealers are afraid to pursue the retail rates, because the manufacturers, in writing, over and over again, have told dealers, don't do this. Don't do this. And so a lot of them are scared to do it. And some of them, as Jim said, stand up for their rights. And they do that.

Now, as it relates to public companies, what's not being mentioned here, and it's important for the record. Every public company is required by manufacturers to sign what's called a framework agreement. Framework agreement limits the amount of business that that public company can do with that manufacturer, so that they are limited in their economic power by virtue of those framework agreements. So they are not all powerful. They don't come close to rising to the power of the manufacturers.

most efficient and most beneficial to the drivers of the vehicle. And I don't think there are any dealers that would object to that approach.

But let's keep in mind that the reason these franchise laws require reimbursement at a retail rate for warranty is because there needs to be investment. And we need to encourage investment in this independent network of franchised new car dealers that sits in the community ready, willing, and able to serve the needs of the consumer. If manufacturers are willing to stand down on what are considered oppressive and over the top facilities demands, as a result of technological changes that may or may not ever take place, then I don't think you'll hear any complaints from the dealer communities about being able to build smaller dealerships, hire fewer people, and engage in less intensive training for their employees. It's about the consumers.

NATHAN WILSON: Thank you.

DANIEL L. GOLDBERG: Well, I agree with part of what Jim said.

JAMES APPLETON: Uh, oh. I must be wrong.

DANIEL L. GOLDBERG: And that is—

So as we look down the road at the ability to do over-the-air repairs, it should be—and this is where Jim and I absolutely agree—it should be what is the most convenient, beneficial, for the consumer. And if the consumer can get it by pushing a button, and not having to drive to a dealership, and not having to absorb either directly or indirectly through the system commissions to the dealer for not doing anything, then we agree. That's how it should happen.

RICHARD SOX: I would just add—I'm aware of that letter as well. And I think you took some of that out of context. I believe NADA's concern, and it would certainly be mine in my own vehicle, is I don't want someone to have access to changing something in my vehicle that could cause harm to the vehicle and cause me harm as the driver. And I think that's the focus, is

And you know, I think when you listen to the panel this morning, and when you listen to this panel, there seems to be some thread running through this that maybe we'd be better off with fewer dealerships? Is this—? I mean, consumers don't see it that way. You know, 17,000 dealers competing across the U.S. for customer business is a better model than 22 manufacturers. Maybe 17,000 isn't the right number, but the marketplace should determine that, with the consumer's best—with the appropriate mechanisms in place to protect the consumer's best interest.

And that's what these warranty laws do, is protect the consumer interest in an extensive network of independent franchisees who stand ready, willing, and able in the community to carry out the promises the manufacturers make, which the consumers have already paid for.

NATHAN WILSON: Thank you. Dan?

DANIEL L. GOLDBERG: Man, I don't know what it would look like in 10 years if these laws were gone with respect to warranty reimbursement. But I think there's a high likelihood it would be different from what it is now. And that difference is going to be driven by the market forces that we've talked about.

In terms of encouraging investments, you know, in every other industry where there's a distribution system and a need by someone down the distribution chain to invest, the marketplace takes care of it. The showrooms for appliances—you can go down all your major consumer goods. And the manufacturers have a strong interest in making sure that there is investment along the distribution chain, because that's how they get their products to consumers.

RICHARD SOX: The premise that this is all based upon a bygone era is false. We all still purchase vehicles. It's the second largest purchase we make in our lives other than our home. It's still something that can kill you and your passengers if it's not repaired properly. That hasn't changed. And that's not going to change.

These costs, again, have to be paid somewhere. And so the answer would be, if you went back to the days of the manufacturer dictating the rates of reimbursement, you would have the cost shift to other customers purchasing products and services from the dealership.

NATHAN WILSON: Thanks. And I guess that means David, you get to sum things up for us.

DAVID SAPPINGTON: I'll do what I can. Again, I think it's extremely difficult to predict exactly what would happen if we took the gloves off and just let the market work for 10 years. But I do think that there is sufficient competition in the industry that the manufacturers and dealers would then have the right incentives to get together and make sure they're doing what is best for consumers.

And I do think that if a manufacturer were foolish enough to try to expropriate the

JAMES FROST: If we could have the panelists down here please for a lunch, and everyone else—

[LUNCH BREAK]