ESMT Competition Analysis

Do we need a Motor Vehicle Block Exemption?

An economic perspective with a focus on the interaction between non-compete clauses, restrictive contractual arrangements and entry in the European car market

Symposium on the future of the MVBER
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Editorial note:
ESMT Competition Analysis has been renamed to E.CA Economics

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Our task: Evaluate the effects of moving from the MVBER to the general VBER

- Focus on distribution of passenger cars and multi-branding provisions, in particular:
  - To what extent have the multi-branding provisions fostered entry and thereby increased consumer welfare?
  - What are the costs of such multi-branding provisions to consumers?
- Other related issues:
  - Shifting bargaining power between dealers and manufacturers.
  - Unbundling sales and services.
- Current VBER as relevant counterfactual:
  - VBER due to expire in May 2010, currently under revision.
  - Likely to keep its current approach with regard to an assessment of a move from the MVBER to the future VBER.

→ We assume that VBER remains essentially unchanged post May 2010.

Main conclusions

- The potential entry enhancing effect of the multi-branding provisions is limited to specific countries and brands.
- The potential beneficial effect on enhanced competition in such countries appears small.
- The multi-branding provisions induce costs, most of which will impact all brands and all countries.
- Shifting bargaining power to dealers and reducing the contractual flexibility of manufacturers by not allowing sales contracts which are conditional on servicing may entail on balance negative effects for consumers.

Conclusions in line with the analysis of the Commission:

"[M]ore effects-based and flexible approach would deliver better results for consumers."

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Focus of the study and relevant counterfactual

- Topics covered:
  - Exclusive dealing and multi-branding: The competitive effects of less restrictive rules on multi-branding are the focus of this report.
  - Provisions strengthening dealers: Briefly discussed, but not analysed in detail.
  - Separation of sales and services: Briefly discussed, but not analysed in detail.
- Topics not covered:
  - Safe harbours: Only minor changes expected.
  - Provisions affecting parallel trade: Only the location clause is not covered in the relevant counterfactual. However, most dealers did not take advantage of the location clause.
  - Provisions promoting competition between authorised and independent repairers: For most of the specific clauses no change with a move to the VBER/relevant counterfactual is expected.
  - Spare parts: Mainly of a legal nature.

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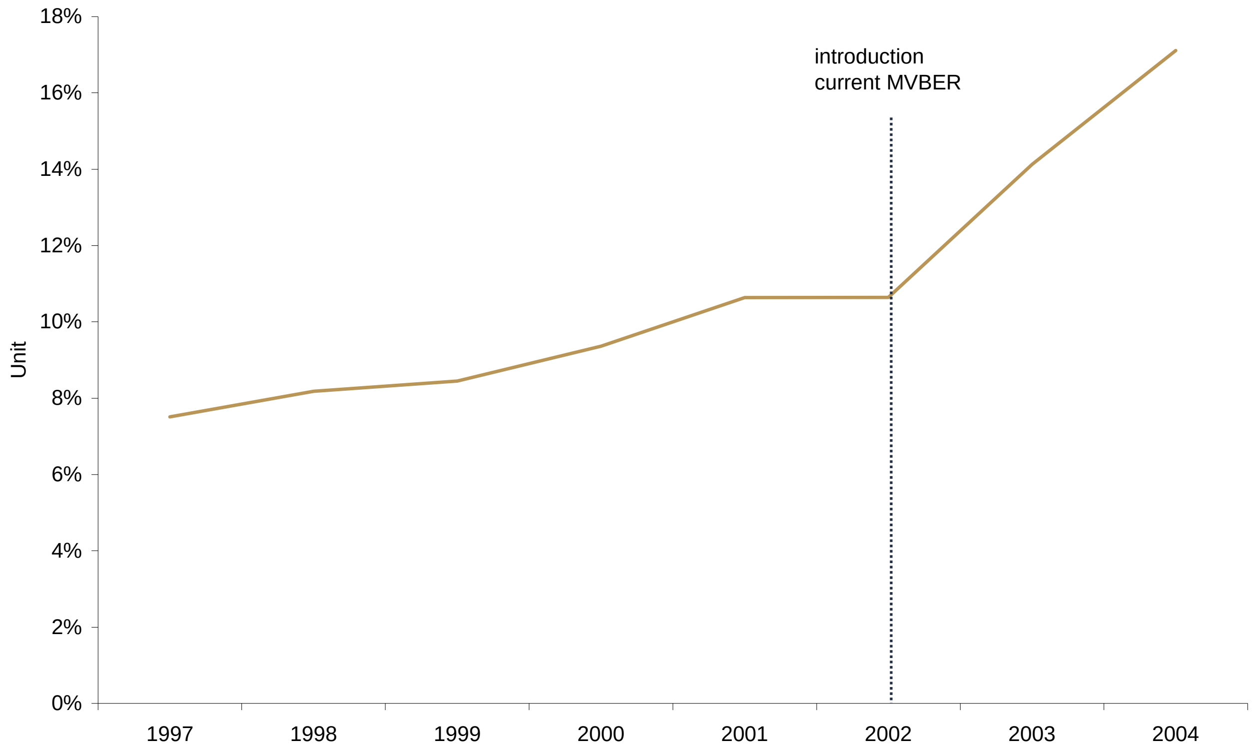
Trends in multi-branding (1/3)

- Multi-branding appears on the rise.

Proportion of multi-branding dealerships (excluding intra-branding, 1997-2004)

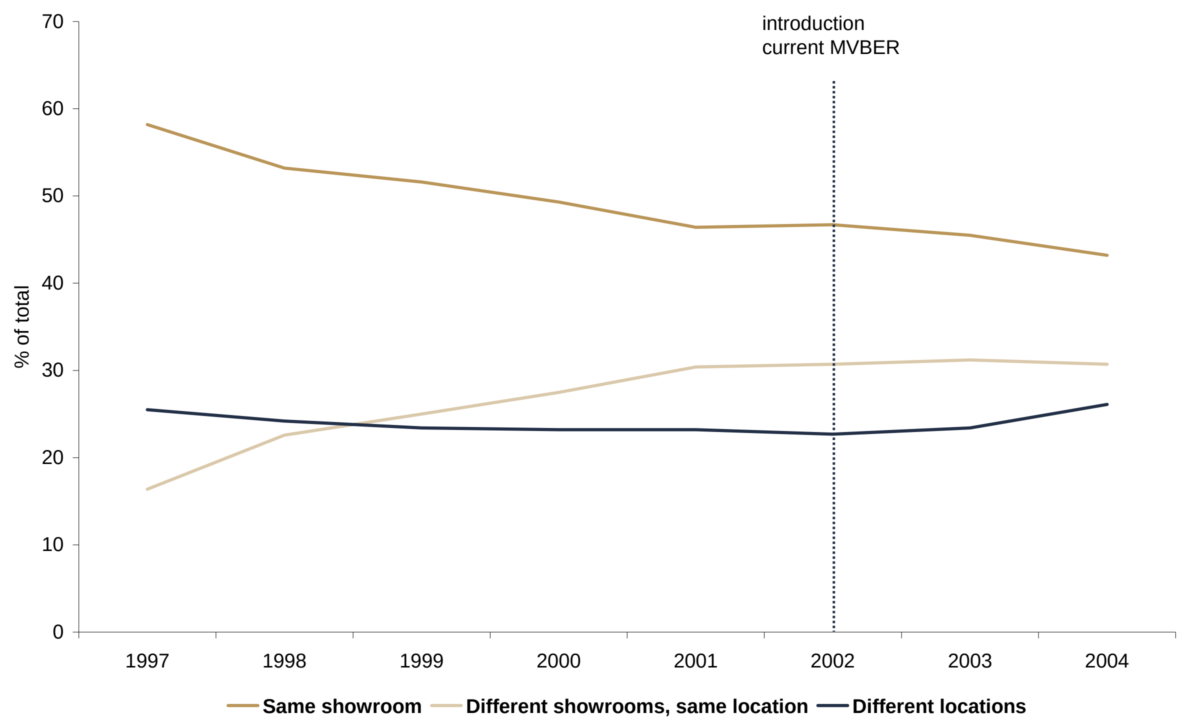


Source: based on LE report (2006)

Trends in multi-branding (2/3)

- Multi-branding:
  - Same showroom,
  - Different showroom same location,
  - Different showroom different location.
- Proportionately, the importance of same showroom multi-branding appears to be decreasing (caveat: data includes intra-branding, i.e. multi-branding with brands of the same manufacturer).
- This is despite the fact that current MVBER explicitly fosters same showroom multi-branding.

Development of different types of multi-branding (incl. intra-branding, 1997-2004)



Note: includes intra-branding (i.e. selling different brands of the same manufacturer) .

Source: LE report (2006), Figure 48 based on dealer survey.

→ Indication that impact of MVBER is limited.

Trends in multi-branding (3/3)

- Multi-branding existed prior to the current MVBER
  - indications that same showroom multi-branding existed prior to the current MVBER
  - Manufacturers have an interest in multi-branding in order to keep dealers in the market.
    - Dealers carrying a single brand in rural areas might not be profitable.
    - Dealers carrying weak brands might not be profitable.

→ Thus, we expect to observe multi-branding even when manufacturers are allowed to contractually restrict the level of multi-branding.

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Pro-competitive effects of MVBER multi-branding provisions

- Three potential benefits of the multi-branding provisions are:
  - Preventing foreclosure of competing car manufacturers,
  - Reduction in consumer search costs: search costs are minimal in relation to the price of new cars.
  - Economies of scope: little evidence that significant economies of scale exist.

→ Focus on prevention of foreclosure

Preventing foreclosure

- Analysis of foreclosure involves the following steps:
  - Ability: significant degree of market power.
  - Incentive: profitability of foreclosure depends on the level of inter-brand competition.
  - Effect: approximation of potential effect of multi-branding on entry and expansion.
- No detailed market definition, instead adoption of market definition in case precedent:
  - Product market: no segmentation.
  - Geographic scope: national markets.
- Robustness checks with more narrowly defined markets.

Ability to foreclose

- Guidelines on Vertical Restraints:
  - Unilateral effect: market share of largest competitor >30%.
  - Cumulative effect: market share of largest competitor <30%, but CR5 > 50%.
- Unilateral effect (2008):
  - weighted average market share (volume) of the largest manufacturer (national level): 26.8%.
  - highest market share: 40.4% for VW in the Czech Republic.
  - weighted average market share of the largest manufacturer on country/segment level: 31%.

→ Unilateral foreclosure unlikely.

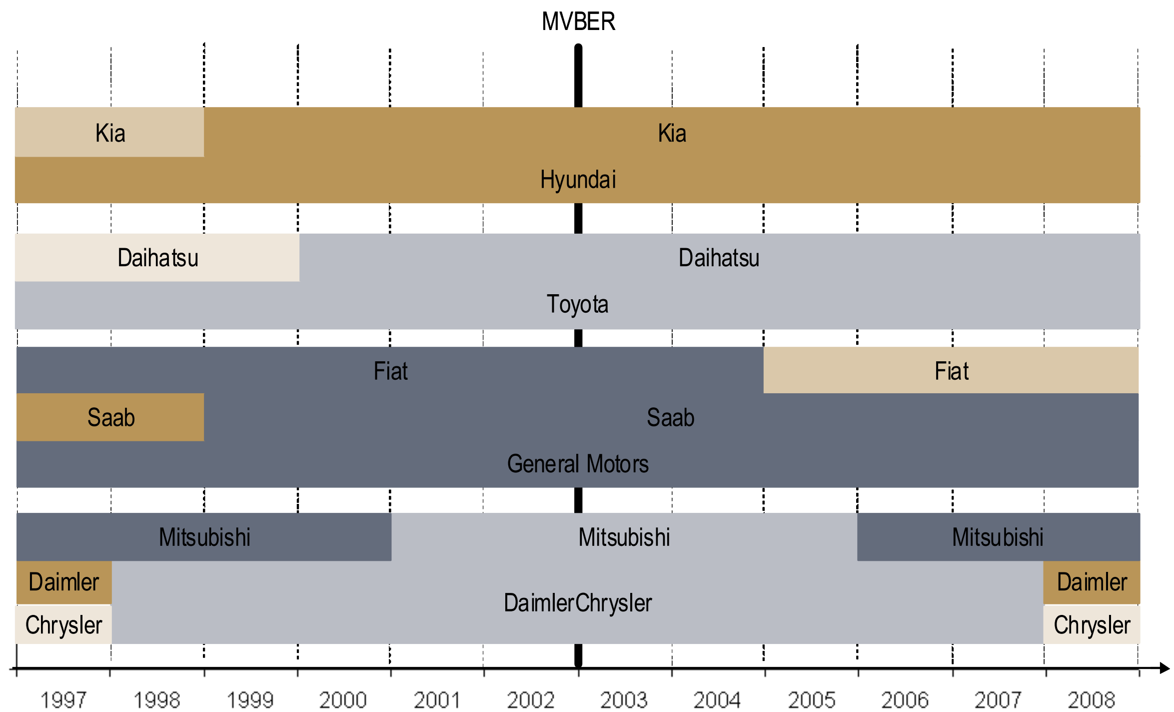
- Cumulative effect (2008):
  - weighted average CR5: 69.8%.
  - highest concentration: 81.6% in Malta.
  - weighted average CR5 on country/segment level: 78.9%.

→ Collective foreclosure cannot be excluded entirely.

Incentive to foreclose

- Industry concentration:
  - weighted average concentration measure HHI decreased from 1,451 in 2000 to 1,398 in 2008.
  - Highest HHI in 2008: 1,994 in the Czech Republic.
  - weighted average HHI on country/segment level: decrease from 2,003 in 2000 to 1,849 in 2008.
- Volatility of market shares:
  - weighted average coefficient of variation of market shares: 12%.
  - weighted average coefficient of variation of market shares on country/segment level: 25%.
- Further indicators for competitive industry: Price convergence in Europe, Product portfolio expansion (market entry in new segments), Low and stable margins for dealers, Significant excess production capacity.
- Divestitures: Consolidation trend prior to introduction of MVBER, partly reversed.

Timeline of consolidation and divestiture (1997-2008)



Source: Internet resources, ESMT CA

→ Incentives to foreclose are likely small.

Effect of potential foreclosure: Identification of instances (1/3)

- On the assumption that the multi-branding provisions fostered entry and expansion, we assess the "*upper bound*" effect on consumers.
- 748 brand/country pairs in our data (Source: European Car Distributions Handbooks)
- First step - entry: identification of "successful" entry in a country.
  - Condition 1: initial market share below 2% in 2002 - excludes established brands.
    - 476 instances (~64%).
  - Condition 2: gained at least 1% market share from 2002 to 2007 - excludes brands that did not expand post MVBER.
    - 125 instances (~17%).
  - 73 brand/country pairs satisfy both conditions (~10%)

Effect of potential foreclosure: Identification of instances (2/3)

- Second step – expansion strategy: In order to identify whether a brand increased its sales in a particular country via expanding its sales outlets or via increasing the volume sold per outlet, we compared the number of sales outlets in 2002 and 2007 for the 73 brand/country pairs identified in the first step.
  - In 11 out of 73 there is no increase in outlets. This leaves us with 62 instances.

    [Note: increase by one outlet: 10 more of 62]

- Third step - non-exclusive outlets: In order to approximate the percentage of multi-branding outlets within a dealer network, we used information on exclusivity data (available only for 2007). Of the remaining 62 identified events we exclude brands for which the exclusivity ratio within the country exceeds 90%.
  - The ratio of brand-exclusive outlets is above 90% in 12 out of the 62 events. This leaves us with 50 instances

    [If the ratio of brand-exclusive outlets is very high, it implies that the multi-branding ratio must be very low, and hence multi-branding cannot have been a significant factor in the expansion.]

    [However, the reverse is not true: If the ratio of brand-exclusive outlets is very low, it does not imply that multi-branding must be high as this could reflect intra-branding.]

→ 50 out of 748 brand/country pairs where multi-branding might have helped entry or expansion.

Effect of potential foreclosure: Identification of instances (3/3)

Brand/ Country	Denmark	Estonia	Finland	Latvia	Lithuania	Slovakia	Slovenia	EU
BMW				x		x	x	4
Daewoo	x		x	x				3
Ford		x		x	x	x		4
Hyundai			x			x		5
Kia	x	x	x	x	x	x	x	13
Mitsubishi		x		x	x			3
Peugeot		x		x	x			3
Subaru		x		x	x			3

Effect of potential foreclosure: Quantification (1/2)

- 50 out of 748 brand/country pairs are less than 7%.
- About 1% of the total number of cars sold in 2008 in EU (small country effect)
- Instances are concentrated in lower value segments → value of cars sold is likely below 1%.
- 50 out of 748 brand/country pairs imply an average decrease in HHI of less than 19 points or about 1.3%

  [country/segment level: decrease in the HHI of 38 points (about 2%).]

→ “Upper Bound” effect of potential foreclosure is small

Effect of potential foreclosure: Quantification (2/2)

Foreclosure effect is an upper bound due to the following factors:

(1) Multi-branding would happen anyways: the identified smaller markets could be exactly those regions where a higher level of multi-branding would have arisen regardless of the regulation as both dealers and manufacturers prefer multi-branding to single-branding in those regions. Some of the demographics of these markets seem to suggest this (Estonia or Finland).

(2) Entrants have other options: many recent entrants have successfully expanded using their own existing network (other brands in the same group) or by setting up a single-brand network. Multi-branding is just one of several options to expand. Therefore, even if multi-branding could have been prevented by manufacturers, recent entrants are likely to have expanded with their own dealer networks – as this was the choice of many manufacturers for many brands in many countries.

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Anti-competitive effects of MVBER multi-branding provisions

- Vertical restraints often have positive effects: vertical contracts enable suppliers to optimize their manufacturing or distribution processes.
- Potential benefits are significant, because distribution costs account for about 30% of the total cost of a new car.
- Costs associated with multi-branding (among others):
  - Brand dilution,
  - Strategic reaction to brand dilution,
  - Under-investment due to free-riding.

Costs linked to multi-branding

- Brand dilution:
  - The strength of a brand might be weakened through the joint display with another brand. This is likely to reduce demand for cars overall.
  - Strategies of multi-brand manufacturers who often avoid mixing their own brands in a single showroom underpin the importance of this factor and indicate that factors such as creating and maintaining strong brand image - and not foreclosure - are primarily responsible for exclusivity policies.
- Higher brand specific investment to avoid brand dilution:
  - Higher brand-specific investments *of manufacturer* because of multi-branding (e.g. advertisement). This type of cost is not restricted to certain geographic areas or consumer types.
  - Higher brand-specific investments *of dealers* at the point of sale: manufacturers ask for higher brand specific investment of the dealers in order to differentiate brands more clearly. These costs are universal.
- Lower non-brand specific investment of the manufacturer:
  - manufacturer are less inclined to engage in non-brand specific investment (e.g. events at a certain dealership) due to free-riding by other manufacturer's brands. These costs are likely to apply only to areas where dealers engage in multi-branding.

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Balancing of pro- and anti-competitive effects

- Pro-competitive effects are small:
  - Indeed, the true impact may well have been close to zero as entrants could have entered without using multi-branding - an option chosen frequently.
  - Upper bound potential effect is small:
    - About 1% of the total number of cars sold in Europe is potentially sold due to multi-branding provisions.
    - The potential effect on enhanced competition appears very small.
- Anti-competitive effects:
  - Costs are universal in the sense that they apply to all segments and all countries.
  - Hard to quantify, but likely to be significant.

→ Multi-branding provisions unduly restrict manufacturers' flexibility to enter into efficient relationships with their dealers (Article 81)

→ VBER should replace the current MVBER

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Provisions strengthening dealers

- Explicit provisions
  - Right to sell the franchise to another business,
  - Requirement of a written cause for termination,
  - Minimum notice periods for termination,
  - Right of either party to call for arbitration.
- Further provisions impacting the distribution of bargaining power (among others):
  - Allocation of decision rights over multi-branding,
  - Prohibition of location clauses.

☞ Generally, competition policy does not regulate the relationship between smaller and larger negotiating partners.

☞ Distribution of bargaining power affects foremost the distribution of rents, not the efficiency of the vertical relationship.

Provisions strengthening dealers

Pro-competitive effects

- Double marginalisation:
- Hold up:

Anti-competitive effects

- Shifting bargaining power to dealers may lead to dealer concentration in relevant anti-trust markets.
- Shifting bargaining power to dealers may prevent the optimisation of dealer networks.

→ Competition policy arguments can therefore not serve as a *per se* justification for "protecting" dealers' bargaining power.

→ Do not need the MVBER

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Separation of sales and services

- Preventing agreements obliging dealers to also repair cars:
  - Not many dealers have taken up the opportunity to become stand-alone dealers; dealers' profits are mainly generated within the repair segment of the market.
  - Ineffective in stipulating multi-branding (freeing-up capacity within the dealership).
- Preventing agreements obliging repairers to also sell cars:
  - Most repair networks are organised under the qualitative selective system. Thus, this provision is effectively redundant as a requirement to sell new cars does not qualify as a qualitative criterion for the selective system.
  - Thus, service contracts conditional on the sales of new cars are also not exempted under the VBER.
  - Moreover, obliging repairers to also sell cars has never been a practical issue.
- Transition from the MVBER to the VBER increases contractual flexibility. There exist business rationales for linking sales and services contracts: bad service can have negative effects on the overall sales of a manufacturer.
- Linking sales and service contracts enables the manufacturer to incentivise dealers in their services such that they take into account the negative reputation effect of bad services on the brand image. By doing so, overall welfare can be increased.

→ Since most dealer outlets currently combine sales and services, the removal of MVBER will not change the number of linked outlets significantly but allow additional efficiencies