Well past its sell-by date
A critical review of the car sales and service sector

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WE BEGIN WITH AN UNDERSTANDING

54 PLAINWOOD CLOSE, CHICHESTER,
WEST SUSSEX PO19 15YB, ENGLAND
TELEPHONE: +44.1243.78.00.36
FAX: + 44.1243.53.38.55
MOBILE: +44.7710.064.890
E-MAIL: jwormald@autopolis.com

9 HEYSEN CLOSE,
PYMBLE, 2073, NSW, AUSTRALIA
TELEPHONE: +61.2.9402.5748
FAX: +61.2.9402.9014
MOBILE: +61.403.078.794
E-MAIL: krennick@autopolis.com

Website: www.autopolis.com

The downstream sector of the automotive industry is somewhat of a living fossil

The upstream sectors – components and vehicle development and production – have undergone massive changes over the last 50 years, with greatly increased technology content, the pursuit of minimum cost through maximum scale, and a redefinition of how responsibilities are shared out. In sharp contrast, the whole downstream sector has changed little in over 50 years. The only notable exception to this has been the emergence – decades ago now – of the Fast Fit and Auto Centre sectors, focused on simpler repairs/replacement (tyres, exhausts, glass) and on the retailing of parts and accessories. This is true right across all the developed automotive markets, with minor local variations.

The automotive downstream sector is large and complex, made up of multiple sub-sectors

- Vehicle manufacturers, or their local importers (whether subsidiaries or independent companies)
- Vehicle retailers:
    - Single-brand and multiple-brand franchised dealers, and dealer groups, for new vehicles;
    - The above players plus individual used car traders plus used car groups;
    - The role of the auction houses (such as Manheim) in used and de-fleeted vehicle remarketing.
- The fleet, leasing and vehicle sales finance sectors.
- Mechanical/electrical/electronic service and repair:
    - Franchised dealers' workshops;
    - The classic all-purpose/all-makes independent garages;
    - Auto centres, and fast fit and tyre chains;
    - Technical specialists (electrical, diesel, aircon, etc);
    - Road-side rescue services.
- Spare parts distribution:
    - Franchised dealers in the OES chains;
    - Independent parts distributors;
    - Parts distribution groups;
    - Tyre and battery wholesalers.
- Smash repair:
    - Individual smash repairers – independent and dealer-owned;
    - A limited number of groups and chains;
    - Insurer evaluation centres and repair shops;
    - Parts distribution;
    - Insurers and insurance brokers.
- In fuel distribution:
    - Independent filling stations;
    - Oil company franchisees;
    - Supermarket-linked operations.

Franchised dealers are not on the side of the consumer, a huge anomaly compared to most retail sectors

- MVPs' franchised dealers, mainly tied to a single brand, enjoy the exclusive right to retail new cars
- Dealers are not independent retailers, as the industry claims, but in effect factory outlets, whose primary role is to push the output of the assembly plants into their local markets
- They cannot pick and choose which models they sell, based on their local market knowledge - they must represent the full range and sell the market failures as well as models in high demand, based on allocations to them by the MVPs
- Their gross margins on new cars (and on spare parts, which they source almost wholly from their MVP franchisors) are strictly limited by the MVPs, to try to limit their discounting to end customers. Dealers cannot negotiate quantity discounts and are rewarded by ex-post-facto bonuses for meeting their sales targets

This has serious negative consequences for the supply side

- There is no-one with market power to "talk back" to the manufacturers, notably about markets and products
    - The dealers are in effect offshoots of the MVPs
    - There are (officially at least) no independent new car wholesalers who might fulfil this role
- The tied distribution and retailing channels are a major brake on market share change – it is hard for a new entrant to put together a dealer network
- They are a major factor in the endemically weak profitability of the new car business of the volume MVPs
    - There is no effective restraint on over-competition between MVPs through the excessive proliferation of their product offerings, which are often virtually indistinguishable between the volume brands, and which hugely bloats investment and fixed costs throughout the manufacturing and supply chains
    - Nor is there any effective opposition to the premature replacement of models, which crashes the residual value of their predecessors, which translates into consumer demands for higher discounts
- Thus volume manufacturers' new car margins are too low, and their fixed costs and breakeven points too high, which forces them into pursuing volume at all costs, in mainly saturated markets – which in turn reinforces their tendency to proliferate products and replace them too early

MVPs and their franchised dealers are under immense pressure to make up for the lack of profits in new cars by abuse of power in the aftermarket

- MVPs seek monopoly rents in the sales of spare parts and finance products through their tied retailers
- Franchised dealers make up the shortfall through exorbitant hourly charge-out rates for their workshop labour
- Both exploit the vulnerability of consumers at the point of sale
- This is reinforced in the dealer aftermarket through threats of warranty invalidation, should the consumer use an independent workshop, and specious claims that only "original" parts (i.e. those distributed by the MVPs under their own brand, although very largely made by independent suppliers) are reliable, durable and safe
- The abuse is most pronounced in smash repair parts, where MVPs are the producers of large body panels, which require a huge investment in very expensive tooling

Franchised dealer networks are inefficient, costly and disliked

- Despite MVPs' rationalization of their dealer networks (mainly to restrain competition between neighbouring dealers in new car sales), single-branded showrooms are extremely unproductive. Distribution and retailing make up 30 to 40% of the pre-tax price of a new car, a situation that would never be tolerated in most retail sectors
- There is a huge pressure on dealers to "shift the iron" and consumers generally loathe the process of haggling with them over the price of new cars and what they get for trade-ins
- The growth of fleet sales in many countries has increased the downward pressure on prices, created a major flow of relatively young cars into the second hand market, and thereby induced many retail customers to forgo buying new cars
- The more dealer networks are thinned out, the fewer dealer workshops there are, rendering them even more remote from where car owners live and work. It's OK to wait 45 minutes at a remote location while tyres or a windscreen are replaced but not for 4 or 8 hours for a service or routine repair. The thinness of the dealer workshop networks is made very much worse by single-branding, although this has some advantages in terms of product knowledge
- Once cars are out of their first ownership cycle and warranty period, their owners mainly flee the franchised dealer networks and rely on local all-makes independent workshops, which offer lower costs (no showroom to cross-subsidize) and far greater proximity. This pressure is particularly great in areas of low population density, such as rural Australia, much of the US and Scandinavia
- While the MVPs spare parts distribution networks are individually vertically efficient, they suffer badly from structural inefficiency at the local level, again because of reduncancy caused by single-branding

The aftermarket is arbitrarily split into dealer and independent sectors, which do not fully compete against each other

- Used cars make up some 75% of sales transactions in a mature market. This sector is dominated by person-to-person sales and independent traders. It can be a profitable business for dealers who take it seriously (no MVP margin controls) but they are not helped by lack of trust
- Dealer workshops mainly support cars in their first ownership cycles, the independents are increasingly strong in the later cycles. Their all-makes coverage hugely increases their accessibility. They are typically 25-35% cheaper on hourly labour rates
- But they are also isolated and leaderless (there are very few organised chains of any solidity), with little to reassure customers about their capabilities
- Independent parts distributors, who supply the independent garages, have lived under the MVPs' parts price umbrellas for decades, relying too much on push strategies, which overserve the independent garages through a plethora of local parts stocks, with little pressure to tighten up the distribution chains

Technical progress has been and remains a double-edged sword

- The quality and durability of vehicles and components have improved dramatically over the years, while service intervals have lengthened. This has considerably reduced the consumption of workshop hours and largely reduced routine service parts to engine oil, filters and wearing brake components, thereby putting a further pressure on dealer workshops to increase hourly rates, and reducing dealers' opportunities for contacts with their customers
- Huge progress has been made in fuel economy and CO_2 emissions, the control of toxic emissions and crash avoidance through the use of electronic control systems. But they create a perpetual temptation for MVPs to try to shut out the independent aftermarket, for example
    - In the past, restricting the access of workshops to diagnostic equipment and reset codes
    - More recently, removing diagnostic plugs from vehicles and replacing paper service books by electronic ones, both only accessible only via the MVPs' intranets
    - Using remote diagnostics and vehicle-to-vehicle and vehicle-to-infrastructure communications to force access through their own proprietary systems
- Normally, MVPs should support the independent sector in the maintenance and repair of their products, accepting that dealers can't access the whole market but this consideration gets driven out by the need to grab revenues to ensure their own financial survival. Thus the 2014 voluntary agreement between the AAAA and the FAIC failed, with the latter reneging on its promises

Public authorities all over the world have struggled with the downstream sector

- The federal government in the US effectively cannot touch the franchised dealer system, as it is protected by state dealer laws that protect its monopoly of new car sales, reflecting the influence of the dealers in state legislatures. MVP attempts to sell direct via the Internet have been vigorously resisted in the courts. There is only a limited fleet sector
- The European Commission is in theory all-powerful in this matter, as exclusive vertical agreements are banned by the Treaty of Rome, the EU's founding constitutional document. The franchised dealership system therefore has therefore had to be exempted from its provisions, via successive automotive Block Exemption Regulations.
- The Directorate General for Competition, which is a powerful anti-trust authority, was highly skeptical about the franchised dealership system in the run-up to the new 2002 BER but had to water down its ambitions in the face of intense lobbying from the European automotive industry and the German one in particular
- At the 2010 renewal, it gave up on its 2002 attempt to redress the balance between MVPs and their dealers in the matter of sales. But it maintained its stance of ensuring the survival of the independent aftermarket, to avoid the suppression of consumer choice in service and repair
- Ensuring equitable access to technical information for the independents has not been easy, not only because of MVP resistance but also because of the technical difficulty of creating portals spanning the incompatible systems of the various MVPs. Such access was made a mandatory in the European Union as part of Euro6 vehicle homologation. But this has once again been potentially invalidated by the otherwise sensible moves from local diagnosis in the workshop to remote condition monitoring. Job-by-job access is now seen as inadequate, with the independent sector needing preliminary access to bulk data, so that it can develop its own diagnostic techniques and solutions

With automotive manufacturing largely ending in Australia, this is a good time to look at its downstream sector

But the same problems are in evidence everywhere – in the US, in Europe, in Brazil, in South Africa, in Australia. The Chinese government has recently supported the creation of the Chinese Automobile Maintenance Association, in order to bring some structure into the independent aftermarket, as a response to over-pricing in the authorised service sector. Australia has a mature automotive economy, with a sizeable new and used car market, and a large automotive aftermarket. It is not clear that it operates in the interests of consumers or the national economy, because of the MVPs individual distribution and retailing monopolies, exercised through the franchised dealer system. It looks suspiciously as though a Complex Monopoly is in operation in the pricing of luxury cars, which is very much higher in Australia than in comparable developed country markets. Vehicle manufacturers and franchised dealers have usually fought to prevent change in the downstream sector, pleading that it risks damaging the industry. Now that the Australian manufacturing industry is largely disappearing, this claim is essentially voided. This is therefore indeed a good time to take a fresh and critical look at the whole Australian automotive downstream sector.

The ACCC's market study of the New Car Retailing Industry is to be welcomed, although there are some peculiarities to it

The Background section of its Issues Paper reads:

The ACCC has received a large number of complaints from consumers relating to new cars. Other relevant agencies and complaint handling bodies also report a growing number of complaints from consumers and industry. The purpose of this study is to gain a better understanding of how the new car retailing industry operates, while focusing on key issues that have come to the ACCC's attention.

This market study will examine whether industry practices are consistent with what we would expect from a competitive market. In particular, practices relating to:

- Consumer guarantees, warranties and new cars
- Fuel consumption, carbon dioxide (CO_2) and noxious emissions, and car performance
- Post-sale service arrangements
- Access to repair and service information and data.

To inform the ACCC's understanding of practices in the new car retailing industry, this market study will explore the broad structure and operation of the new car retailing industry, assessing whether market characteristics, including new car buyer behaviours and expectations, are conducive to competition. ***It is already clear from Australian and international evidence (see the discussion above) that the sector suffers from serious lapses from true competitiveness.***

A consumer survey undertaken by Colmar Brunton will also inform the report. ***We do not know the purpose or methodology of this survey but it will presumably relate to the issues listed above and will no doubt provide further evidence of discontent.***

While this study will focus on new cars, it will **not** consider:

- Direct or parallel imports of new cars by individuals
- Car financing and insurance products. ***This is a strange exclusion, given their importance to the profitability of MVPs and their dealers and existing***

evidence of abuse of customers temporarily captive at the point of vehicle sale

- Product safety
- Demonstrator vehicles. ***Also a strange omission, given that it is part of the widespread practice of pre-registering new vehicles and selling them as almost new, in order to boost apparent market shares and shift stock***
- Capped price servicing.

The ACCC also notes a number of other government reviews relating to cars. Where relevant, the ACCC will consider the findings of these reviews as they relate to the key areas of interest to this study.

The exclusion of used cars is bizarre, given that they are the permanent alternative to new cars for consumers, a significant profit opportunity for dealers who take them seriously, and the major source of aftermarket revenues. The scope of the study does, however, include independent service and repair operators, although not parts distribution.

Even very large downstream markets such as the US and Europe are imperfectly described. Dealer populations can easily be accessed but breaking down their turnovers and profits by activity requires analysis of their accounts or of MVPs dealer composites, neither of which are likely to feature in voluntary submissions. The AAAA may have records of independent repairer and distributor populations, which it may provide. No-one actually knows what is bought and sold by whom from and to whom along the chains, often because the data is simply not gathered. Even in the large markets, most information comes from surveys of participants. Very little of this has been done in Australia. Transfer prices and the build-up of costs and margins in new and used car sales, or in service and repair or spare parts businesses are very hard to access.

The proof of the pudding will be the development and evaluation of policy options, which requires targeted economic and financial analysis

The consumer survey and some of the voluntary submissions will underline the nature and scale of consumer and professional discontent with the existing arrangements. Submissions from the MVPs and dealers will surely argue their benefit, as almost axiomatic, without adducing any proof. There will be usual range of bizarre opinions.

All this will not of itself produce answers to what ought to be the hard questions, many of them economic and financial in nature:

- What is the accumulation of costs and margins on the way from the assembly plant to the customer for new cars?

- How are transfer prices set and who is accumulating what profits? How much remains in Australia and how much goes overseas, possibly into tax havens? Particularly for luxury cars
- What is left for the local franchised dealers? Can they survive on this without cross-subsidy from their aftermarket activities?
- What is the breakdown of their turnover and profits?
    - New cars – retail and fleet sales
    - Used cars
    - Sales finance and other add-on products
    - Service and repair workshop hours
    - Spare parts
        - For their own workshops and sold to other workshops
        - Mechanical/electrical, and smash repair
    - Other businesses, such as car rental
- How competitive are they in each of these businesses, compared to independent suppliers? Are consumers (retail and fleet) being overcharged?
- How good is access to diagnostic tools and technical information for independent repairers?
- What is the accumulation of costs and margins along the MVP-dealer and the independent parts distribution chains?
- How do dealer and independent sector parts prices compare? How are they set? How does this vary between competitive and captive (only available through dealers – notably in smash repair) parts?
- How good is geographical coverage in new car sales, used car sales, workshops (authorized and independent, mechanical and smash)?
- What are the policy options and their comparative cost-benefit?
    - Continue as at present
    - Stricter policing, e.g. forcing MVPs to release technical information through the threat of withholding homologation of models. What is feasible at the level of Australia? Which measures would need international cooperation?
    - Break up the franchised dealership system?
        - Unbundle dealerships and reconstitute separate sales, workshop and parts distribution networks
        - Ensure more effective competition in car sales finance and other financial products
        - Remove single-brand limitations, encourage the emergence of truly independent multi-brand importer-distributors
        - Break down the distinction between the dealer and independent aftermarkets