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The EU Commission's Proposals for Regulating New Car Sales: Article 101 meets Economics 1.01

In December 2009, the EU Commission published its proposals for the new European regime to regulate vertical restraints in the motor vehicles sector under Article 101 (formerly Article 81).[1] The plans involve the continuation of the old sector-specific Motor Vehicles Block Exemption Regulation ("MVBER") for new car sales until 2013 after which time the general Block Exemption Regulation ("BER") for vertical agreements will apply and the sector-specific rules will cease to exist.[2]

In an industry that contains tens of thousands of vertical agreements that benefit from the MVBER, there was widespread support for the continuation of the legal certainty that it has provided. However, the Commission's review reveals some interesting conflicts between the BER approach and the wider move to apply a more economic effects-based approach to vertical restraints. This Brief assesses the proposals, and how they relate to the economic principles behind an effects-based approach to vertical restraints.

Background

The BERs evolved historically as a response to an unduly formalistic view on when a contractual restriction was deemed to be a "restriction of competition". The Commission created broad BER safe harbours in order to avoid the chaotic scenario in which thousands of contracts were deemed unlawful and required prior notification to the relevant competition authorities.

The logical starting point under an effects-based regime is to consider whether a restriction significantly impedes competition. It is only when that question is answered in the affirmative that exemption criteria (whether block or individual) should come in to the reckoning. If a more effects-based analysis is employed to the interpretation of Article 101(1), the very rationale for BERs becomes open to question.[3]

Where inter-brand competition is highly effective, basic economic theory dictates that vertical agreements are very unlikely to result in significant restrictions of competition. In this respect, the Commission rightly acknowledges that the European car industry operates under highly competitive conditions with low levels of concentration, evident industry dynamism and a clear track record for innovation, ever-lower prices and successful recent entry. At an EU level no single manufacturer has a share above 20%, and even at a national level there are just a few instances where a national supplier accounts for much more than 30% of sales. Moreover, this situation has scarcely changed over at least the last decade.[4]

Vertical restraints in the distribution of new cars

The Commission's review addresses two main sets of vertical restraints: restrictions on multi-brand dealers, and selective distribution. In both areas, the Commission's assessment is undertaken within an effects-based framework that starts by identifying the theory of harm that could arise from such restrictions, and then evaluates the concern.

Restrictions on multi-brand dealers

Under Article 5 of the current MVBER, if a manufacturer wishes to benefit from the safe harbour it must provide each retailer a clear right to sell 3 or more different car brands from the same showroom. As the Commission itself candidly accepts, however,

1
See http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1984&format=HTML&aged=0&language=EN&guiLanguage=en for the December 2009 consultation including the proposed Draft Regulation. Earlier documents published on this topic including the July 2009 Commission Staff Working Paper containing its Impact Assessment ("the Impact Assessment") are available at http://ec.europa.eu/competition/sectors/motor_vehicles/block_exemption.html

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In contrast, for motor vehicles aftermarkets the Commission proposes to implement a new sector-specific MVBER.

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The European Court has endorsed a more robust effects-based analysis to Article 101(1) in a number of cases. See European Night Services v Commission, September 1998, Joined Cases T-374/94, T-375/94, T-384/94 and T-388/94.

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Para 6 of the Impact Assessment asserted that "Pressure on real consumer prices exerted by inter-brand competition ... was lower [in 2000] than today." However, there is no evidence to support this contention, other than a reference to the fact that consumer organisations in the UK and Germany were vocal in their dislike of inter-state price differentials that applied in 2000. Para 41 of the same document notes that this decline in real prices was an established trend at least as far back as 1996.

this policy of actively encouraging multi-brand car dealers has been conspicuously unsuccessful on at least three counts.

First, the policy has failed completely in its objective of encouraging multi-brand outlets. Despite the fact that almost all retail agreements sign up to the MVBER terms, only 1% of car sales throughout Europe take place from multi-brand showrooms, and even these instances (which apply mainly in very sparsely populated areas such as parts of the Nordic region) have probably not been influenced by the MVBER.[5]

Second, despite this absence of multi-brand outlets, the Commission recognises that the main market failure that could justify forcing manufacturers to open up their retail arrangements to rival brands – the possibility of foreclosure if new suppliers find themselves unable to gain access to effective retail distribution – has not come to pass. It is plausible to construct such theories of harm in industries where smaller suppliers need to be stocked alongside established rivals and to gain distribution across a high share of the available outlets in order to compete viably, but these concerns clearly fail to apply to the sale of new cars. There already exists a wide choice of existing brands, many of them with very low brand shares, which operate on the basis of single brand retailers. Indeed, the Commission notes that recent entry by new car brands (notably Kia and Hyundai) has occurred successfully within a system of single-brand retailing.[6]

Third, and quite apart from the fact that its intervention has done no good, the attempt to encourage multi-brand retailing appears to have done serious damage to the efficiency of distribution in the motor vehicles sector.[7] The Commission reports that fear of other manufacturers free-riding on retail level investments has caused manufacturers to over-specify the investments that retailers must undertake in order to sell their brand. One trade association estimated that this had resulted in dealer fixed costs being some 20% above the level they ought to be in a competitive environment. The Commission's review provides insufficient evidence to substantiate this estimate, but if it is even half true it would suggest that the MVBER has resulted in a huge regulatory deadweight loss that consumers will ultimately have had to suffer.

Restricting intra-brand competition through selective distribution

The MVBER exempts quantitative selective distribution systems provided the manufacturer's market share is below 40%. Most car manufacturers have taken advantage of this safe harbour by directly limiting the number of new car dealers selling their brand. However, in order to comply with the MVBER, manufacturers have been obliged to remove any restrictions preventing dealers from opening new outlets, even if they are close to existing dealers of the same brand.[8]

Plainly, when a manufacturer restricts the number of retailers selling its brand, it will shelter those retailers from an element of direct competition they would otherwise have faced from rival retailers of that same brand. This protection would give rise to consumer harm if it allowed the retailers in question to sustain their margins above competitive levels.[9] However, manufacturers have a strong incentive not to provide retailers with more protection than is required to finance the optimal level of pre-sales service. Any manufacturer who misjudges this equation will make the consumer price for its brand higher than it needs to be without any benefit to the manufacturer. As such, inter-brand competition controls this problem and there is no need to employ competition law intervention to impose a regulatory solution.[10]

There is also a clear pro-competitive efficiency rationale for providing retailers some protection. Retailers need incentives to invest in pre-sales service amenities such as physical showroom facilities and the option to test drive cars. Whilst these investments are potentially beneficial for both manufacturers and consumers, they also pose a clear risk of free-riding from other retailers who could adopt a strategy of failing to provide such services but instead compete on price to undercut the retailers who do incur these

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Ironically, where multi-brand dealers do exist in these remote areas, they raise potentially serious issues of suppression of inter-brand competition, since a single seller can become responsible for the retail pricing decisions across a number of what would otherwise be competing brands of car. The 1% figure cited for multi-brand retailers relates to dealers selling multiple brands from a single showroom. It is much more common for dealer groups to sell multiple brands through separate showroom outlets.

6
In its evidence to the Commission, the Korean Hyundai-Kia Automotive Group did express the view that multi-brand retailing is important for new entrants, but the Commission noted that its two brands have both achieved successful market penetration despite the fact that they have chosen a sales strategy in which each brand has its own dedicated showrooms in Europe.

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Para 95 of the Commission's Impact Assessment comments that: "Experience has shown that attempts to regulate complex issues through hardcore provisions all too often lead to counter-strategies aimed at circumventing those provisions."

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Such black-listed restrictions are termed "location clauses".

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There is also at least a theoretical risk that by making the retail distribution more orderly, manufacturers can use selective distribution as a way to facilitate inter-brand collusion, but given the evidence on vigorous inter-brand competition and differentiation in the market the Commission dismisses this hypothetical concern.

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This proposition remains valid unless inter-brand collusion concerns, or some valid post-Chicago theory of harm, applied. But the Commission's assessment does not identify these as serious concerns in the new cars sector.

investment costs. Any consumer benefit that arises from lower prices based on free riding is an unsustainable one, and it is widely accepted that offering retailers a degree of protection from intra-brand competition is justified by the need to avoid such individually profitable, but collectively harmful, retailer behaviour.

The Commission's assessment recognises this free-rider rationale for restricting intra-brand competition. It agrees that the presence of effective inter-brand competition is sufficient to prevent manufacturers from allowing prices to be sustained in excess of competitive levels, but it nevertheless cites a fear that vertical restraints could be used by manufacturers to inhibit competitive initiatives by authorised dealers "where such behaviour was against a supplier's wishes".[11] However, having acknowledged the validity of the free rider problem, the Commission also ought to accept that individualistic retailer behaviour is not in the wider interests of economic efficiency or consumers if it involves price competition that undermines the incentives to make such welfare-improving investments. Hence, putting a brake on the freedom of dealers to cut prices is intrinsically part of avoiding the free-rider problem.[12]

Further, the Commission's assessment notes that in order to protect against the free rider concerns that arise from the ban on location clauses, manufacturers have added increasingly onerous qualitative requirements so as to discourage dealers from opening new outlets. As with multi-brand distribution, therefore, the old regime's regulatory constraints on selective distribution appear to have led to wasteful investment requirements, thus harming consumers and the efficiency of distribution for no good reason.

Parallel trade and competition objectives

The most likely explanation for the Commission's underlying unease with manufacturer-imposed controls over retail outlets is the high priority it places on promoting parallel trade in new cars.[13] The Commission has an inherent suspicion that manufacturers will use any influence they enjoy over dealers as a way to discourage them from engaging in parallel trade. However, whilst there is no doubt that the Commission's desire to encourage free movement of goods within the Single Market is a strong policy objective, it is less clear whether competition rules restricting the behaviour of individual firms provides the appropriate instrument for realising that goal.

If one accepts – as the Commission appears to do – that protecting individual dealers from free rider distortions is a valid competition objective, it should be clear that encouraging consumers to benefit from pre-sales services from a local dealer and then to buy the car from a foreign dealer could conflict with the valid objective of providing an appropriate reward for such dealer investments. Such competition between domestic and foreign dealers is not based on the relative efficiency or performance of those dealers, but rather on their opportunities to exploit arbitrage opportunities from ex-manufacturer pre-tax price differentials across different EU member states.

A more considered response to the factors behind parallel trade opportunities would recognise first that arbitrage opportunities frequently arise as a result of distortions created by inconsistent national government interventions such as dramatically different sales tax rates, and second that in any event the interests of overall economic efficiency are unlikely to be served by a slavish assumption that there should be a single ex-manufacturer price level across the EU (even though that outcome would eliminate incentives for parallel trade). Clearly, the Commission's political commitment to encouraging parallel trade will not be abandoned. However, the competition policy debate is made more opaque by the Commission's continued insistence that parallel trade is definitively pro-competitive when both the theory and the evidence show that it is not.

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See para 80 of the Commission's Impact Assessment.

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The provision of pre-sales services such as test drive facilities clearly has the potential to boost demand for a brand. But if the incentive for dealers to provide such service is undermined by free riding, the optimal level of such service will be withheld and the demand boost foregone, reducing the welfare of both consumers and the affected manufacturer.

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This preoccupation is seen in the regular publication by the Commission of a survey on new car prices across the EU, which highlights inter-state price variations. The Commission's assessment notes that ex-manufacturer car price differentials have widened over recent periods but (rightly) ascribes this divergence to the impact of exogenous macro-economic dislocations such as exchange rate shifts rather than to any anti-competitive or exploitative motivation of the car manufacturers.

Conclusions

The Commission proposals for a new Article 101 regime for vertical restraints in new car sales provide an interesting case study on the clash of philosophies between the old form-based and BER-dependent enforcement regime and the new effects-based approach to which the Commission is now committed.

The role for BERs is hugely diminished in an effects-based regime, and the tendency for BERs to force a reversal of the logical order of the competition assessment – by placing questions of exemption before the assessment of whether there is an anti-competitive effect – is clearly inconsistent with an effects-based framework. Moreover, the Commission's review explicitly admits that unnecessarily complex regulation of new car sales through the existing sector-specific BER has been at best fruitless, and at worst positively harmful to competition, efficiency and consumers.

Given the low levels of market concentration and the evident vitality of inter-brand competition in the new cars market, none of the established theories of competition concern from single brand retailing or selective distribution applies. Vertical restraints within the new car sales sector are extremely unlikely to be anti-competitive, so manufacturers should be free to adopt the retail strategies that best suit their needs. The motor industry has probably become too dependent on the BER regime to recognise it, but the underlying message from the Commission's review is that the new cars BER should have become largely redundant because, taking a robust effects-based approach, the restrictions in question should not even caught by Article 101(1).