



ESMT CA
Executive
Summary

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

Executive Summary, 12 June 2009

“This Report was commissioned by Daimler with the intention to obtain and present for public debate an objective analysis of a series of economic issues of relevance for the play of competition in the organisation of motor vehicle distribution, repair and servicing. The conclusions are the results of ESMT Competition Analysis’ (“ESMT CA”) best professional judgment. ESMT CA accepts no duty of care or liability for damages suffered by Daimler or any third party as a result of decisions made or actions taken based on this document.”

1. Executive summary

The current motor vehicle block exemption regulation (MVBBER) is due to expire in May 2010. In May 2008, the Directorate General Competition has issued an evaluation report on the operation of the MVBBER. The report suggests that a specific regulation in the automotive sector might no longer be appropriate and that a “*more effects-based and flexible approach would deliver better results for consumers*”.¹ While car manufacturers generally support the European Commission’s findings and views, there are several market participants who have been contesting its view. They argue that the MVBBER has met most of its objectives and improved competition concluding that it should stay in place.

This study concentrates on the issues of competition in the passenger car sector. It analyses the potential economic effects of moving from the MVBBER to the vertical block exemption regulation (VBER) with a focus on the interaction between non-compete clauses, restrictive contractual arrangements and entry in the European car market. One element of particular importance in this context is that such a move shifts the choice on multi-branding of competing brands in the same showroom from the dealer to the manufacturer. Focusing on those cases where interests between dealers and manufacturers may conflict, this report attempts to contribute to the current debate on the MVBBER by analysing the following issues: (1) Is the observed increase in competition due to MVBBER-measures or other reasons? In particular, to what extent have the multi-branding provisions fostered entry and thereby increased consumer welfare? and (2) What are the costs of such multi-branding provisions to consumers?

Overall, we find that the MVBBER is unlikely to have played a significant role in fostering competition. There is good evidence that many of the market developments which have enhanced competition in the past years are independent of the MVBBER. Furthermore, with regards to multi-branding in particular, we estimate an upper bound on the potential entry enhancing effects that the regulation could have had in the past by identifying the countries where specific brands may have significantly expanded market shares due to multi-branding. We estimate an upper bound of cars sold due to the MVBBER at 1% of the total volume of cars sold in the EU in 2008. Even when taking this upper bound at face value, the effects on the relevant concentration ratios in the affected countries are small and concentration is generally low. Moreover, the true number may well have been close to zero as entrants could have entered without using multi-branding - an option chosen frequently. Thus, we conclude that the entry enhancing effect has had at most a negligible positive impact on competition.

At the same time, we identify several costs inherent to multi-branding. These costs can take a number of forms, among others, costs through brand dilution, higher *brand specific* investment of manufacturer, higher *brand-specific* investments of dealers at the point of sale, reduction in the geographic representation of brands and lower *non-brand specific* investment of the manufacturer. Some of these costs arise as the manufacturers strategically adjust the organisation of their retail networks to avoid brand dilution and free-riding of rivals. While there

¹ Commission Evaluation Report on the Operation of Regulation (EC) No. 1400/2002 concerning motor vehicle distribution and servicing, page 12.

is no sufficient data to precisely estimate the magnitude of these costs, the available evidence indicates that all of these costs are present and significant in comparison to potential benefits.

Based on this evidence, this report finds that multi-branding provisions of the MVBBER inadvertently and unnecessarily limit manufacturers' flexibility to enter into efficient relationships with their dealers. Thus, multi-branding provisions should not serve as an argument to maintain the MVBBER in its current form.

The report also discusses other provisions of the MVBBER that have featured in the current political debate. It appears that in many instances dropping the MVBBER and moving to the VBER will not induce a major change. In other cases, regulation seems required, but there is an ongoing legal debate as to the appropriate form. Relying on the European Commission's assessment that these matters can be appropriately addressed by other means, we find that there is no need for the MVBBER in its current restrictive form.

The remainder of the executive summary explains the approach and the main findings in more detail.

The counterfactual without the MVBBER

Should the sector specific regulation be abolished, the more flexible VBER would take its place. Although the VBER is going to expire at the same time as the MVBBER and the evaluation process on the future definition of the VBER is ongoing, we understand that the general consensus is that the VBER is likely to be extended without major changes. Therefore, in order to assess the case for a removal of the sector specific regulation a comparison between the current MVBBER and the current VBER appears reasonable. Comparing the MVBBER with the current VBER, we identify a number of provisions that differ within the two legal frameworks. A key aspect that is both of interest in the current debate on the future of the MVBBER and relevant for economic analyses is the effect of changes relating to multi-branding and exclusive dealing.

With regard to multi-branding and exclusive dealing, the move from the current MVBBER to the VBER can be thought of as shifting certain decision rights over multi-branding from dealers to manufacturers. Due to the 30% maximum obligation threshold, under the MVBBER each dealer has an option to source his supplies from at least three different suppliers, hence the decision whether to multi-brand resides with the dealer. In contrast, under the VBER the manufacturers are able to negotiate a binding contract with a high 80% minimum obligation requirement with their dealers, assuming that this is accepted by the dealer. For simplicity, we will abstract from the negotiation process and assume that under the VBER the decision whether to allow multi-branding or not resides with the manufacturers.

Our task

This report attempts to complement and deepen the analysis regarding the arguments for and against the MVBBER. In particular, this study covers the effects of a move to the VBER in relation to the following provisions:

- **Exclusive dealing and multi-branding in relation to new car distribution:** The competitive effects of less restrictive rules on multi-branding are the focus of this report. A detailed assessment is provided in Sections 4, 5, 6 and 7.

- **Provisions strengthening dealers:** Potential effects resulting from the removal of particular clauses strengthening the bargaining power of dealers are briefly discussed in Section 8.1, but not analysed in detail.
- **Separation of sales and services:** Potential effects resulting from the ability to combine sales and service contracts are briefly discussed in Section 8.2, but not analysed in detail.

In contrast, this study does not cover the effects of a move to the VBER in relation to the following provisions:

- **Safe harbours:** Market share thresholds for quantitative selective distribution are lower in the VBER than in the MVBBER. This may induce changes in how dealer and service networks are organised. It is not a focus in this report as there are indications that expected changes are likely to be minor.
- **Provisions affecting parallel trade:** For most of the specific clauses no change with a move to the VBER is expected. Only the location clause does not seem to have a counterpart within the relevant counterfactual. However, for various reasons dealers did not find the option to open secondary outlets economically attractive and as a result very few of them took advantage of the opportunities afforded in 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:** The changes with respect to the relevant counterfactual in relation to provisions on spare parts appear to be relatively minor and mainly of a legal nature.

When does dealers' choice differ from manufacturers' choice

Although generally dealers are likely to implement multi-branding more frequently than manufacturers, there are a number of circumstances in which both dealers and manufacturers consider multi-branding as their optimal choice. So, other things equal, we expect an overall decrease in multi-branding, but not its complete elimination, when shifting certain decision rights over multi-branding from the dealer to the manufacturer.

In particular, the likelihood of identical decisions between manufacturers varies with the extent of capacity utilisation in the short run: with low levels of spare capacity, both manufacturer and dealer are likely to abstain from multi-branding; while with very high levels of spare capacity both would choose to introduce multi-branding in order to increase overall profitability of the dealer. It is the intermediate range of capacity utilisation where a conflict of interest appears most likely. Theoretically, the ability of dealers to multi-brand might foster capacity expansion in the longer run. So far however, we have not seen any clear evidence that capacity expansion is driven by the ability to engage in multi-branding. This lack of evidence itself could be an indication that the ability to multi-brand is not the ultimate driver for capacity expansion.

There are several types of multi-branding: multi-branding from the same showroom, multi-branding from different showrooms within the same location and multi-branding in different

locations. The MVBBER in comparison to the preceding sector regulation stipulates same showroom multi-branding (of brands from different manufacturers). Thus, when assessing the changes that the current MVBBER introduced, we concentrate on the changes in same showroom multi-branding. The hypothesis that there is a subset of situations where the multi-branding decision of the manufacturer and the dealer coincide is supported by evidence prior to the MVBBER: same showroom multi-branding is likely to have existed to a significant extent prior to the MVBBER. Therefore, we expect limited changes from a move of the current MVBBER to the VBER.

Even if the change in observed multi-branding (in the same showroom as well as in different showrooms) is likely to be limited - what are the welfare implications of this change? This issue is picked up in the following sections which report our findings on the benefits and costs of multi-branding provisions.

Benefits linked to multi-branding provisions

Among the potential benefits of the multi-branding provisions in the MVBBER we have identified a reduced risk of foreclosure, a reduction in consumers' search costs and a reduction in dealers' operating costs due to economies of scope. The report focuses on the effects of the multi-branding provisions on foreclosure. It appears that both the reduction in consumers' search costs and in dealers' operating costs are negligible.

In relation to foreclosure, the first set of questions is whether manufacturers' have the ability and incentive to foreclose. The report finds:

- **Limited ability:** on a national level no market participant has a market share large enough to be able to foreclose unilaterally. Foreclosure can only potentially be achieved through cumulative action of multiple participants.
- **Limited incentive:** inter-brand competition in the automotive industry is high, which implies that manufacturers have rather limited incentives to foreclose.

These conclusions are based on a number of indicators on the current level of inter-brand competition:

- Overall, the industry concentration as measured by the concentration ratio HHI is moderate. The HHI is a concentration measure of the industry that takes into account the relative size of the individual market participants. The weighted average over the HHIs in 27 countries amounted to 1,398 in 2008, representing a slight drop since 2002 when the same index stood at about 1,451. This compares to a weighted average HHI at the level of national car segments in 2008 of 1,849. Computations on pan-European levels decrease the level of concentration only slightly.
- The industry is characterised by a fairly high volatility of market shares: national industry market shares on average differ by about 13% from their long run mean. In comparison, the weighted average coefficient on the level of national segments is equal to 25%. Coefficients are reduced when the geographic scope of the market is broadened to the European level.

- There is no evidence of long-run excess profits. Instead, we observe relatively stable dealership profitability at a relatively low level (~1%) and a higher volatility of manufacturers' margins at a slightly higher level.
- There exist significant levels of excess capacity within the industry.

These arguments suggest that foreclosure in the absence of the MVBBER is unlikely. However, the assessment can be informed by identifying an upper bound on the potential negative effect on consumers. In order to do so, we identified events in which a brand entered or expanded significantly on a national market and where multi-branding could have played some positive role. We then computed the share of those events on total volume sales in Europe. We find that the **upper bound on the volume** directly affected by multi-branding is therefore **slightly above 1%** of total volume sales throughout Europe in 2008.

Furthermore, the low end segments of the market are likely to be more affected than the high end segments since most brands that have potentially expanded through multi-branding are concentrated in those segments: Kia is the brand that has likely benefited most from multi-branding. This brand operates mostly in the low end car segments (A, B and C) and MPV and SUV segments. This implies that the upper bound in terms of value directly affected by multi-branding is likely lower than 1%.

To further quantify the potential impact of multi-branding on competition, we performed additional calculations of concentration indices. Specifically, for each country we have calculated the hypothetical change in HHI at the brand level that would take place absent multi-branding. This hypothetical change can be thought of as a proxy for the upper bound of the impact that exclusivity might have had on foreclosure. Not surprisingly, the hypothetical impact on the concentration index is the largest in those countries for which most entry/expansion events were identified (Latvia, Estonia, Lithuania, Slovakia). In order to take into account the relative importance of different sales volumes, we have calculated the overall impact of multi-branding by weighting the average of the hypothetical HHI changes using sales volumes. The overall impact of multi-branding measured this way is **equivalent to lowering the average HHI concentration measure by 19 points or 1.3%**. In addition, we approximate the hypothetical change in HHI on a segment basis also showing a limited effect on consumers (average decrease in the HHI of 38 points or 2%).

Furthermore, we find that the MVBBER multi-branding provisions are unlikely to have had any significant effect on facilitating entry or expansion in any of the **largest and most mature markets** in the European Union, such as Germany, France, Italy or the UK. Therefore, removing the non-compete obligations from the regulation will most likely only have a minimal impact on foreclosure in these markets. In relation to **smaller markets**, positive effects of the multi-branding provisions are likely to be further limited due to the following factors:

- **Multi-branding may prevail:** 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.
- **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 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.

Furthermore, potential entrants and expansion candidates do not uniformly express the opinion that the ability to multi-brand is essential to their entry and expansion plans. For example, the Spanish brand Seat which is strong on the home market, but not in other European countries, prefers exclusive dealerships for its expansion plans. As another example, Korean automobile manufacturers have put forward contradicting statements: on the one hand, the industry association voices the opinion that the possibility of dealers to sell brands of competing manufacturers within the same showroom is a vital element for foreign manufacturers. On the other hand, Hyundai stated that it prefers to work with dealers that sell only the Hyundai brand, but that multi-brand dealers offer the manufacturer a chance to be represented in countries with lower local potential, such as Switzerland and Scandinavia.

All these findings suggest that from a competition policy perspective the specific and general regulation of multi-branding in the MVBBER is not required. This conclusion is reinforced when considering the costs linked to the multi-branding provisions.

Costs linked to the multi-branding provisions

The multi-branding provisions of the MVBBER also come with costs: vertical restraints can often have positive effects. Appropriately structured vertical contracts can enable suppliers to increase their efficiency by optimising their manufacturing or distribution processes. The potential scope of the benefits of such optimisation in the automotive industry is significant, because distribution costs account for about 30% of the total cost of a new car. As recently summarised by Commissioner Kroes:

[T]here were certain overly restrictive sector-specific provisions regarding the sale of new cars, which, while not necessary for safeguarding competition, could in fact be hampering the flexible and efficient adjustment of car manufacturers' networks to changing market conditions. This may be having a significant impact on the competitiveness of the European car industry, particularly in the current economic climate. The resulting inefficiencies would add to the industry's distribution costs, which would imply higher prices for consumers.²

Costs inherent to multi-branding are difficult to measure precisely. Some arise as manufacturers strategically adjust the organisation of their retail networks to the constrained "second best". Others may reflect negative effects on manufacturers that are not fully internalised by dealers. In other words, the efficiency of manufacturers' networks with forced multi-branding is lower than if they did not face this constraint. These efficiency costs can take a number of forms, among others:

- **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

² Answer to question P-1363/09, 1 April 2009.

maintaining strong brand image -and not foreclosure- are primarily responsible for exclusivity policies.

- **Higher brand specific investment of manufacturer (overinvestment):** in order to avoid brand dilution, manufacturers invest more in their brands than without 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:** in order to avoid brand dilution, manufacturers ask for higher brand specific investment of the dealers in order to differentiate brands more clearly. These costs are quite universal. The establishment or increase in the minimum number of models requested on display per outlet is a special form of higher brand-specific investments which is more likely to affect smaller dealers.
- **Lower non-brand specific investment of the manufacturer (underinvestment):** due to free-riding effects of another manufacturer's brands also displayed within a single dealership, the manufacturer is less inclined to engage in non-brand specific investment (e.g. events at a certain dealership). These costs are likely to apply only to areas where dealers engage in multi-branding.

While there is no sufficient data to precisely estimate the magnitude of these costs, the available information indicates that all of these costs are to some extent empirically present. In particular, vertical integration has increased and so has manufacturers' brand specific investment requirements.

Balancing of costs and benefits

Overall, we identified only very limited positive effects of the multi-branding provisions of the MVBBER. In particular, those effects are restricted to certain regions and certain segments. In contrast, many costs associated with the provisions apply quite generally and the provisions appear to have had appreciable negative effects. We conclude that the multi-branding provisions unduly restrict manufacturers' flexibility to enter into efficient relationships with their dealers.

Shift of bargaining power

As pointed out above, moving from the MVBBER to the VBER gives manufacturers more leeway in preventing multi-branding of any type resulting in a general shift of bargaining power to manufacturers. This and other provisions in the MVBBER, like the right to sell their franchise (and contract with the manufacturer) without consent of the manufacturer, may shift the bargaining power from dealers to manufacturers. A shift in bargaining power implies foremost a change in the distribution of rents between manufacturers and dealers. From an efficiency and consumer perspective, changes in bargaining power only matter if it impacts the efficiency of the vertical relationship.

In relation to pro-competitive effects of strengthening dealers' bargaining power we find that in some industries a shift in bargaining power to retailers or other downstream units may be desirable in order to lower the margins upstream and, hence, unit costs (and ultimately prices). However, there appears little evidence of a lack of competition. Hence, excessive margins at the

manufacturer level seem unlikely. Furthermore, specific contractual rights for the dealer might be justified by the fear that manufacturers may use the right to terminate a contract in order to appropriate the investments of dealers. However, there is empirical evidence that reputation effects are sufficient to keep the contract termination rights of the manufacturer in check. Furthermore, there is evidence that, to the contrary, manufacturers might use the contract termination rights efficiently as an instrument of screening bad dealers out of the network.

At the same time, shifting bargaining power to dealers may also result in consumer harm since it might lead to dealer concentration in relevant anti-trust markets. Additionally, such a shift may also prevent the optimisation of dealer networks as it becomes more difficult to rationalise the network. The optimisation of dealer networks is further hindered by forbidding location clauses in dealer agreements undermining quantitative selection.

Competition policy arguments can therefore not serve as a *general* justification for “protecting” dealers’ bargaining power, even if this may be desirable under specific circumstances.

Unbundling sales and services

This report does not focus in much detail on the potential effects of a transition from the MVBER to the VBER in relation to the provisions on unbundling of sales and services. This is due to the fact that strong effects appear unlikely:

- **Agreements rendering sales conditional on services:** Article 4(1)(g) of the MVBER prevents manufacturers from offering sales contracts conditional on the provision of services. Although this provision has no counterpart within the VBER, the removal of this provision is unlikely to have any negative effects for the following reasons. First, not many dealers have taken up the opportunity to become stand-alone dealers. Since dealers profits are mainly generated within the repair section, this is not a surprising result. Second, it appears that the provision is ineffective in stipulating multi-branding, which it was supposed to do by freeing-up capacity within the dealership.
- **Agreements rendering services conditional on sales:** Article 4(1)(h) of the MVBER prevents manufacturers from offering services contracts conditional on the sale of new cars. Since most repair networks are organised, and have possibly (depending on the definition of the relevant market) to be organised under the qualitative selective system, Article 4(1)(h) is effectively redundant. 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.

While there appear to be no or minimal negative effects, there exist positive effects of a transition from the MVBER to the VBER due to increases in contractual flexibility. In the presence of a positive impact of high service levels on overall brand perception, there exist business rationales for linking sales contracts to services contracts: bad service can negatively affect the overall sales of a manufacturer. Linking sales contracts to 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 are currently combined sales and service outlets, it is likely that significant efficiencies are foregone due to the fact that no linkage is possible.

Conclusion

From a competition policy perspective, the following factors suggest that a move from the MVBER to the VBER will benefit rather than harm consumers:

- (1) The potential entry enhancing effect of the multi-branding provisions is limited to specific countries and brands.
- (2) The potential beneficial effect on enhanced competition in such countries appears very small.
- (3) The multi-branding provisions induce costs, most of which will impact all brands and all countries.
- (4) Overall, 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.

These findings suggest that a specific regulation in the automotive sector might no longer be appropriate and reinforce the European Commission's statement that a "*more effects-based and flexible approach would deliver better results for consumers*".³

³ Commission Evaluation Report on the Operation of Regulation (EC) No. 1400/2002 concerning motor vehicle distribution and servicing, page 12.

About ESMT

ESMT European School of Management and Technology is an international business school based in the heart of Europe in Berlin. The School was founded by 25 globally operating companies and institutions to develop entrepreneurial leaders, who think globally, act responsibly and respect the individual. ESMT offers Full-time MBA and Executive MBA programs, as well as executive education in the form of open enrollment and customized programs. The School also features in-house research-oriented consulting services. ESMT strives to generate relevant and ground-breaking knowledge for managers, business and policy makers through the integration of world-class research with a practice-oriented approach. Members of ESMT's faculty come from a wide variety of international, academic, and professional backgrounds. ESMT's campus is located in the historical center of Berlin, with a second campus in Schloss Gracht near Cologne.

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About ESMT Competition Analysis

ESMT Competition Analysis is working on central topics in the field of competition policy and regulation. These include case-related work on European competition matters, e.g. merger, antitrust or state aid cases, economic analysis within regulatory procedures and studies for international organizations on competition policy issues. ESMT Competition Analysis applies rigorous economic thinking with a unique combination of creativity and robustness, in order to meet the highest quality standards of international clients.

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