



AUSTRALIAN
AUTOMOTIVE
DEALER
ASSOCIATION

SUBMISSION: FRANCHISING SECTOR REFORMS REGULATION IMPACT STATEMENT

6 DECEMBER 2019



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FOREWORD

AADA is pleased to make this submission to the Franchising Sector Reforms – Regulatory Impact Statement (RIS). We welcome the release of this document and the opportunity to participate in the consultation process.

While the RIS is, by its very design, required to manage competing tensions across quite diverse business models we would like to make some comments about its overall likely impact on the automotive distribution business. We do this, aware that the Government is currently intending to regulate the automotive franchising industry through a schedule to the Franchising Code of Conduct, and thus the reformed Code as a whole will form the framework upon which specific regulation of our industry will be built.

Of course, many Dealers have excellent relationships with their Manufacturer partners, but just like other franchisees, Dealers are still subject to unfortunate or unconscionable behaviours by some franchisors. The power imbalance is clear as even the biggest Dealer groups in Australia are relatively small when compared to the offshore multinational car Manufacturers, which are typically 'Fortune 100' companies.

While the size of new car dealerships, and the complex and interlocked relationships they maintain with their franchisors, differentiate automotive franchising from the bulk of the franchisee population there are some commonalities. These include the lack of transparency of information on which decisions are made and the issue of dispute resolution. This last issue being particularly difficult when multiple franchisees face common disputes with their franchisor. In our view, all these issues would be best dealt by an informed, independent body conducting dispute resolution and able to apply substantial penalties for wilful breaches of the letter and intent of the Franchising Code.

At this point we would sound a note of caution. While the RIS makes it clear that it seeks (and expects) an honourable commitment from all parties to ethical and fair relations, our experience is that some overseas vehicle Manufacturers cannot be relied on to do so. The behaviour of some Manufacturers with respect to their compliance with various Australian laws, such as Australian Consumer Law and emissions regulations are examples of the difficulty of ensuring that large offshore multi-nationals play by the rules. The Franchising Code needs to be properly enforced and supported through a penalty regime appropriate for the size of the franchisor. In short, it needs to have teeth, a feature that various iterations of the Franchising Code have lacked.

Franchising and Co-Investment in the Automotive Industry

The AADA has always maintained that the automotive industry should have a separate legal regime that regulates the relationship between new car Dealers and the Manufacturers to which they are franchised. We are encouraged that work is underway on automotive-specific protections, but we have a strong interest that franchising laws in Australia are fundamentally reformed because the system in its current form is broken.

The Franchising Code has existed for over 20 years and there have been a number of iterations which have all failed franchisees. Good franchise relations have largely resulted from the culture and values of specific franchisors, but bad, exploitative relationships have been allowed to endure due to a toothless regulatory regime. The question needs to be asked whether a Code prescribed under the Competition and Consumer Act remains appropriate.

We believe the Government should give strong consideration to a complete overhaul of the regulatory regime governing franchising and consider the establishment of new legislation.

The consultations of the Parliamentary Joint Committee and the recent Taskforce issues paper has flushed out a number of perspectives. One such perspective is to think of franchising as a co-investment model. In the automotive sector, Dealers benefit from the Manufacturers brand and sophisticated product. However, in the retail and servicing aspect of the business it is the Dealer which takes on the lion's share of the risk by investing the overwhelming majority of the capital to build facilities, purchase stock and equipment and adequately train and employ staff. These are not all of the costs.

There are many other expenses which typically run into the millions of dollars for establishing a franchise, and tens of millions of dollars for a Dealer who has held the franchise for generations. Automotive Manufacturers and many other successful franchisors have in effect expanded their footprint, not through their own capital, but by drawing on the capital, skills and effort of their franchisees. This model is unique and has served many businesses – both franchisor and franchisee – well over the years. But the uniqueness of the franchising model requires a unique solution.

As others who have participated in this process have also commented, AADA believes that the Government should give strong consideration to legislation that takes account of this co-investment view of franchising.

Our organisation is committed to an effective framework that serves both franchisors and franchisees for the long haul and is deeply invested in a mutually beneficial future with the Manufacturers who are our partners in the industry. Our submission reflects the discussions we've had with our members.



James Voortman
Chief Executive Officer



THE AADA SUBMISSION

The AADA understands that the Department is particularly interested in our response to the key questions outlined in the RIS. However, we believe that the questions do not allow for specific responses to the various options listed as part of the solution space for the problems listed in the document. Consequently, we have listed below our preferred option for each of the policy problems as well as some brief comments. Specific responses to the questions in the RIS are included further below in this document.

Problem 1.1: Disclosure can be hard to comprehend; critical information may be hidden in detail and some information is not provided

- *Option 1.1.2 (c) Increased and formal financial disclosure:*

The AADA supports the proposal for increased formal financial disclosure but notes that such disclosure must be relevant to the decision of whether to take up the franchise, and that the franchisor must be able to be held accountable for its veracity and completeness.

Problem 1.2: The reliability of information provided to prospective franchisees may be difficult to assess

- *Option 1.2.2 Requiring franchisors to verify financial statements and introducing a national franchise register:*

The AADA supports increased franchisor accountability and the creation of a comprehensive national franchise register along the lines of the current, but voluntary, Australian Franchise Register.

Problem 1.3: Information gaps – a potential franchisee might be unaware of which types of information are materially relevant to inform their decision to enter an agreement

- *Option 1.3.3 Mandate all prospective franchisees receive legal and financial advice before entering into a franchising agreement:*

The AADA supports this option in principle but submits that it must include the opportunity to waive the requirement.

Problem 2.1: Cooling off rights may expire before franchisees and franchisors have adequate time to appropriately reflect on their business arrangements after entering the agreement

- Nil response.

Problem 2.2: Cooling off rights may expire before lease arrangements are finalised

- Nil response.

Problem 2.3: Cooling off rights in transfers, extensions and renewals can be unclear, including with respect to franchisee to franchisee sales

- Nil response.

Section 2

Problem 3.1: Marketing funds are not always transparent

- *Option 3.1.3 Increase awareness and provide guidance around existing legal obligations:*

Please see our response to Q7 below. The AADA would be happy to brief the Taskforce on the way that marketing funds are normally handled in the franchised new car Dealer sector.

Problem 4.1: Supplier rebates can lead to conflicts of interest

- *Option 4.1.2 Address conflicts of interest in the handling of supplier rebates to franchisors by requiring increased disclosure:*

While we support this option in principle, the AADA would highlight the role of franchisor-mandated suppliers for tools, parts or services. While increased disclosure is a step in the right direction to address issues relating to supplier rebates it does not, by itself, address franchisor reliance on supplier rebates as an ongoing revenue stream. Please see our response to Q9.

Problem 4.2: Conflicts of interest in the context of capital expenditure

- *Option 4.2.2 Modify the Franchising Code to define significant capital expenditure and provide rights for franchisees to recoup the value of significant capital expenditure:*

AADA strongly supports this option.

The right to not only recoup one's investment but make a reasonable profit from that investment is one of the most important principles for automotive franchisees. This is particularly pertinent in the current environment where shorter terms are being offered to car Dealers despite significant investment requirements.

It is important to note that, with the exception of a small number of company-owned stores, the overwhelming bulk of the investment in new vehicle distribution in Australia is provided by the franchised new car Dealers.

The AADA has consistently argued that the best way of dealing with significant capital expenditure is to link it explicitly to term offered for the franchise agreement. Please see our response to Q10.

Section 2

Problem 4.3: Unilateral variations can lead to conflicts of interest and exploitation

- *Option 4.3.2 Banning or limiting the circumstances in which franchisors can unilaterally vary franchise agreements:*

AADA strongly supports this option.

The AADA submits that the overwhelming majority of Dealership Agreements we have seen include clauses allowing for unilateral changes to the Agreement and, more importantly, subsidiary documents such as Operations and Warranty Manuals, by simple notification by letter.

This is of overwhelming concern because such unilateral variations are used to change practices and procedures that functionally determine Dealership profitability. It is our submission that unilateral changes to franchise agreements, or to subsidiary documents should not be possible without consultation and the agreement of the affected franchisees.

Problem 5.1: Some disputes are not being resolved in a fair, timely and cost-effective manner

- *Option 5.1.2 Expand options for dispute resolution, and streamline mediation procedures and services:*

The AADA notes the high level of disputes mentioned in the RIS, and submits that, in our experience, mediation by itself is rarely a lasting solution.

Experience in the US demonstrates that third-party bodies, constituted with suitable technical, legal and procedural expertise, and structured within a suitable organisation such as an Ombudsman's Office are a workable solution to the issue of dispute resolution. Please see our response to Q12 and Q13.

Problem 6.1 Reasonable exit arrangements may not be, or may not be perceived to be, available or accessible for some franchisees

- *Option 6.1.2 Limit termination in circumstances where the franchisee seeks mediation, and/or breaches have occurred for fraud or public health and safety reasons, and introduce statutory termination rights into the Franchising Code:*

The AADA supports this option to limit 'no fault' terminations.

Section 2

Problem 6.2: Excessive restraint of trade clauses may inhibit lawful pursuit of subsequent business interests

- *Option 6.2.3 Codify common law that restraints of trade should go no further than reasonable to protect legitimate interests:*

The AADA submits that restraint of trade clauses should be constrained to the minimum feasible to protect franchisor IP without preventing exiting franchisees from working with alternative Manufacturers.

Problem 6.3: There are different expectations around the treatment of goodwill in franchise arrangements

- *Option 6.3.2 Clarify the franchisees' rights in regard to goodwill, if any, in the franchise agreement:*

The AADA strongly submits that goodwill rights should be mandated in all franchise contracts, and that its calculation should be based on an agreed industry standard formula that recognises the franchisees contribution to goodwill in their area of operations.

Problem 7.1: Some franchisors experience additional regulatory burden from having to comply with both the Franchising Code and the Oil Code

- *Option 7.1.2 Increase the number of common provisions between the Oil and Franchising Codes to reduce the regulatory burden for some franchisors:*

The AADA notes the continuing existence of the Oil Code with industry-specific features and protections. We submit that the Automotive Industry merits a similar approach to its protection.

Problem 7.2: Compliance with the Franchising Code, Oil Code and where relevant the Competition and Consumer Act and the Australian Consumer Law, remains imperfect

- *Option 7.2.2 Application and enhancement of civil penalties to all breaches of the Franchising and Oil Codes:*

The AADA submits that the overwhelming power differentials between automotive franchisor and franchisee is exacerbated when the franchisor is, like most vehicle Manufacturers, among the biggest corporations in the world. Particularly as their local operations are nothing more than wholly-owned subsidiaries of their parent corporation. Consequently, we recommend that breaches of the Franchising and other industry codes should be subject to a scale of penalties similar to those applied for breaches to the ACL.

DRAFT PRINCIPLES AND QUESTIONS

PRINCIPLE 1:

Prospective franchisees should be able to make reasonable assessments of the value (including costs, obligations, benefits and risks) of a franchise before entering into a contract with a franchisor.

Q1 - What are the critical pieces of information that should be contained in a summary document?

Automotive franchising is likely to be among the more complex of the industries that use the franchising model of distribution. Nevertheless, the critical pieces of information that we believe should be included in a disclosure document are straight forward:

- Prospective Capital Expenditure to be undertaken during the term of the agreement. This should be a specific figure, rather than a band of expenditure so broad as to make it meaningless.
- The term offered for the agreement, which should be directly proportional to the capital expenditure expected.
- Disclosure of supplier rebates.
- The amount of sales expected during the agreed term
- The return on sales during the agreed term.

One additional factor that merits disclosure in a summary document relates to the level of incentive payments expected or available during the term of the agreement. The AADA has found that, over time, this source of income has become critical for new car Dealers to sustain viability of their operations.

Q2 - If a national franchise register is established, what information should it contain? What would be the benefits and costs of a national franchise register?

The AADA notes that there is already an Australian Franchise Registry, albeit voluntary in nature, but endorsed by the Franchise Council of Australia¹. The registry requires lodgement of current year Disclosure Documents and Franchise Agreements, and is given a rating on the basis of their:

- System Performance
- Franchisee Financial Performance
- Franchisee Engagement and Satisfaction
- Franchisor Training and Support
- Franchisor Financial Performance
- Lender Relations
- Compliance and Assurance.

The benefits of instituting a comprehensive national franchise registry would be to provide likely franchisees a strong basis on which to compare various franchise platforms and to expose those that fail to provide a system through which both franchisors and franchisees may derive sustainable value. It would also identify to all stakeholders who is operating a business as a franchise and is therefore subject to the Franchising Code of Conduct.

The AADA considers that this registry would form a suitable basis for a mandatory national franchise registry. We further note that the voluntary register's schedule of costs would likely be transferable to a compulsory registry.

¹<https://www.thefranchiseregistry.com.au>, accessed 21 November 2019.

Q3 - There are a number of existing educational resources on franchising. What additional education options for prospective franchisees should be made available? If there was an online educational resource which brought together the available franchising education options, what would its costs and benefits be?

Nil response.

PRINCIPLE 2:

Franchisees and franchisors should have 'cooling off' time to consider whether the relationship is right for them after signing.

The AADA submits that franchised new car dealerships are not frequently acquired by newcomers to the industry. Further the complexity of getting a new Dealership off the ground renders the concept of a 'cooling off period' relatively meaningless.

Q4 - What are the practical implications (costs and benefits) for prospective franchisees and franchisors of increasing cooling off or disclosure periods?

Nil response.

Q5 - How easy is it for franchisors to provide reasonable estimates of leasing costs before they are finalised?

Nil response.

Q6 - How often are leasing arrangements finalised after the cooling off period expires? What are the implications of having the cooling off period commence after a lease is finalised?

Nil response.

Section 3

PRINCIPLE 3:

Each party to a franchise agreement should be able to verify the other party is meeting its obligations and is generating value for both parties.

Q7 - What would 'meaningful information' look like in terms of marketing fund disclosure?

The AADA submits that the franchised car Dealer industry has, in the main, an effective model for the use and accountability of marketing funds. In this model, the marketing funds are co-contributed by both the franchisor and the franchisees, and their expenditure and accountability are managed by a "Dealer Council" that brings together all the franchisees in discussion with the franchisor. In this way, the funds are transparently collected, used and accounted for. The AADA further submits that this model could be applicable across all automotive brands and to other franchise systems.

Q8 - How does the benefit of increased frequency of reporting of marketing funds compare to the costs of increased administration?

Nil response.

PRINCIPLE 4:

A healthy franchising model fosters mutually beneficial cooperation between the franchisor and the franchisee, with shared risk and reward, free from exploitation and conflicts of interest.

The AADA endorses this principle as an ethical basis on which to build mutually successful business relationships. However, our experience shows that some powerful franchisors, in our case overseas vehicle Manufacturers, will exploit weaknesses in the system to maximise their profit while externalising risk to their franchisees. Consequently, we would advocate for any changes to the Franchising Code to include robust, low cost, and mandatory dispute resolution arrangements, with the capacity to issue penalties that will be more than mere irritants.

Q9 - What information should franchisors disclose in relation to supplier rebates? Are there any barriers to providing this?

In the automotive distribution sector, it is often the case that the franchisor will mandate the use of specific suppliers for services, tools or parts. While we would not be so naive as to suggest that businesses should not seek volume-based discounts on their purchases, the AADA submits that lack of transparency in their practices make it impossible to gauge the extent to which vehicle Manufacturers use the practice to force payments from Dealers that are well above market expectations.

Section 3

This is evident in the requirements that Manufacturers put to Dealers with respect to fit out of their premises, and the use of specified suppliers for tiles, cladding, desks and EV chargers. AADA submits that where franchisors specify that particular suppliers be used, they should disclose that a rebate applies, and the amount of rebate involved. The question of supplier rebates is also particularly evident in the pricing of specialist tools, where equivalent third-party tools are available in the market at prices that are a fraction of the 'factory brand' that Dealers are obliged to buy.

The AADA would argue that the practice of overly inflating prices for mandated tools, parts, and suppliers, constitute an invisible 'franchising fee' charged to Dealers, contrary to the claims of vehicle Manufacturers.

Q10 - If franchisors are required to ensure franchisees get a return on their significant capital expenditure, how might this be done in practice? ?

AADA has consistently argued that the most effective way of ensuring that franchisees get a return on mandated capital expenditure is to require a specific link between the required expenditure and the term of the franchise agreement, on the basis of how long it will take to recoup the investment and make a reasonable profit at current profit levels.

For example, if income after tax is \$1 million, and the franchisor requires a refurbishment of the facility budgeted at \$5 million, then the franchisor should offer a term (or extension to the current term) of no less than five years.

If the term extension is not agreeable to the franchisor, then the alternative is to restructure incentive payments or other revenue streams to increase income after tax, and thus enable the expenditure to be recouped over a shorter period.

Q11 - If franchisees are given a right to review capital expenditure business cases (which must be presented to franchisees by the franchisor under clause 30(2)(e) of the Franchising Code for expenditure that the franchisor considers is necessary for capital investment), how would this right be exercised?

The right to review the business case for specific capital expenditures would require that all materials used to make the business case is also provided for review. The experience of our members is that franchisors consistently refuse them access to the marketing reports and other business intelligence products used to justify requests for capital expenditure.

PRINCIPLE 5:

Where disagreements turn into disputes, there is a resolution process that is fair, timely and cost effective for both parties.

Q12 - A number of stakeholders have told the Taskforce that the cost of arbitration can be comparable to going through the court system, and that conciliation may be a preferable alternative alongside mediation. In what circumstances could conciliation be an effective alternative dispute resolution process?

The AADA submits that experience has shown arbitration, as currently available, is worthless and ineffective, and thus rarely invoked. The US experience is that industry-specific dispute resolution boards are an effective means of providing mandatory conciliation, arbitration and adjudication. Such Boards are best established within a body such as an Ombudsman's Office and staffed with a mixture of senior personnel with both legal and industry experience. Arbitration and adjudication then need to be supported by a regime of penalties in line with the size and financial resources of the litigants. For the Australian context we would note that the penalty regime available under the ACL would be broad enough to meet this requirement.

Q13 - Would you consider including arbitration to resolve disputes in your franchising agreement, if a clear voluntary option were provided?

We would consider a voluntary regime to be meaningless in an environment where vehicle Manufacturers systematically ignore voluntary constraints on their behaviour. Certain global vehicle Manufacturers have demonstrated their disregard for both Australian laws – such as the ACL and emissions regulations - and voluntary codes – such as the current Voluntary Agreement on Access to Service and Repair information.

As per our response to Q12, we consider that any dispute resolution regime needs to be mandatory, enforceable and feature penalties substantial enough to force acquiescence from recalcitrant franchisors.

The AADA submits that a mandatory dispute resolution process must include arbitration backed by the potential for substantial penalties as the culmination point of a process that includes mediation prior to compulsory arbitration. Further, we would add that such arbitration would need to be carried out by an independent body that includes suitable technical, legal and procedural expertise. Experience from the United States shows that such bodies, when properly staffed and constituted within suitable state organisations are an effective means of dispute resolution within the automotive distribution industry.

PRINCIPLE 6:

Franchisees and franchisors should be able to exit in a way that is reasonable to both parties.

Q14 - Under what circumstances should franchisees be allowed a no-fault exit from the franchise system?

The AADA submits that 'no fault exit' is not a significant issue in the new car Dealer franchising sector.

We would note however, that issues exist regarding franchisors improperly vetting proposals for the transfer of the dealership or mandating that it be transferred to a particular entity, even when that entity is not offering the highest price for the business.

Q15 - If goodwill was required to be fully clarified in the franchise agreement, how might this be done in practice? What would be the costs and benefits of this approach?

We would note that the question of 'goodwill' in the automotive franchise sector is fraught. Manufacturers often make the argument that they do not charge 'goodwill' at the commencement of a franchise agreement and thus refuse to consider it when a Dealer exits the franchise. This, of course, ignores the work of the Dealer in building up the business and the OEM's brand in that particular market area over a protracted period. As noted earlier in this submission, we would argue that excessive prices for 'factory branded' tools and parts and specific facilities constitute a de facto franchising fee or 'brand goodwill' price.

Despite this, the calculation of 'goodwill' in the automotive industry is subject to a well-understood and accepted equation: 4 x average earnings before interest, tax, depreciation and amortization (EBITDA). This is for a dealership making an average Return-on-Sales. For operations delivering better results, the multiple can be as much as eight times EBITDA.

Section 3

PRINCIPLE 7:

The framework for industry codes should support regulatory compliance, enforcement and appropriate consistency.

The AADA is concerned that the questions in this section of the RIS seem to suggest a continued distinct approach for the Oil Code separate from the Franchising Code proper. This is particularly relevant when the Government has indicated that a separate Code would not be feasible for the Automotive sector, and that our industry-specific protections would be constructed as a Schedule to the Franchising Code.

Our submission is that this process of updating the Franchising Code should either see all distinct industry Codes, such as the Oil Industry Code, subsumed into the Franchising Code, or that our industry protection also receives the same level of specific support.

CONCLUSION

We would be happy to meet with departmental staff to further discuss the comments above. If you have any questions, please contact me or our Policy Manager Alexander Tewes.

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