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13 September 2021

Small and Family Business Division
The Treasury
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By email: smallbusinessfranchising@treasury.gov.au

Dear Treasury

Automotive Franchising, Discussion Paper, August 2021

In response to the recently released Automotive Franchising Discussion Paper please find attached the response from the Federal Chamber of Automotive Industries (FCAI).

If you have any questions or require clarification on any of the attached, please do not hesitate to contact me.

Yours sincerely

Tony Weber
Chief Executive

FEDERAL
CHAMBER OF
AUTOMOTIVE
INDUSTRIES

FEDERAL CHAMBER OF AUTOMOTIVE INDUSTRIES RESPONSE TO THE AUTOMOTIVE FRANCHISING DISCUSSION PAPER

13 September 2021

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1. EXECUTIVE SUMMARY

The significant and comprehensive reviews of the Franchising Code, and in particular the new motor vehicle sector, over recent years has provided the regulatory framework for a new degree of disclosure and cooperation between distributors and dealers.

The major component of these changes was passed by the Parliament in June 2021. However, the actual implications of the changes will not fully flow through to the market until the existing dealership agreements expire and a new agreement is negotiated.

The Government is in the enviable position of having already legislated significant reform and can now observe the results of those reforms spread through the wider franchising sector over the next few years.

> As with any new policy and regulatory arrangements, observation of the actual impact in the market compared to the legislative intent is critical to good governance and the maintenance of positive consumer outcomes

In the case of the new motor vehicle industry and their dealership agreements, a focused review following a suitable period of in-market operation, in three or five years' time, will meet that governance test.

FCAI is confident that this proposed review will, if implemented, support our position that:

- There is no need for the introduction of a stand-alone code which would come at a significant cost to the industry, and ultimately the consumer;
- There is no evidence that the automotive specific reforms introduced over the past few years through the annex to the Franchising Code need to be extended to the motorcycle and/or all-terrain vehicle (ATVs) sectors
- The notion of pre-contractual arbitration is not well placed to assist the new vehicle sector nor the consumer and would in fact counter the many positive influences embedded in the recent changes.

2. INTRODUCTION

The Federal Chamber of Automotive Industries (FCAI) is the peak industry body for the Australian importers and distributors of passenger motor vehicles, SUVs, and light commercial vehicles, along with motorcycles and ATVs.

FCAI member supply over 99% of new vehicles to the Australian market each year. Our members are listed at https://www.fcai.com.au/about/members.

New motor vehicle distributors and dealers provide the one million Australians who buy a new car each year with access to more than 50 brands from which to choose from. This competition has evolved over time into a framework that provides a mix of retail solutions meets consumer demands and will keep evolving over time. History has shown that no matter the sector, disruption occurs, and change is certain. New motor vehicle sales and service is no exception. The challenge is to ensure that the drivers of change are not artificially constrained or distorted which will inevitably lead to worse outcomes for consumers.

3. THE FRANCHISING CODE AND RECENT AMENDMENTS

The Franchising Code of Conduct has been subjected to significant Government and Parliamentary consideration over the past ten years. These inquiries and reviews have led to improvements in transparency and understanding for franchisees (referred to as dealers in this submission) and franchisors (referred to as distributors in this submission).

The amendments include:

- 12 months' notice of intention to renew or not to renew with the latter requiring a statement of reasons
- Pre-contractual disclosure of capital expenditure requirements
- An improved dispute resolution process and the added capacity for conciliation as well as mediation and voluntary mandatory binding arbitration
- Multi-party Alternative Dispute Resolution procedures
- A requirement for more information to be provided to prospective franchisees at least 14 days before entering into an agreement
- The development and provision of a Key Facts Sheet, in addition to the disclosure document, to be provided to the prospective, renewing or transferring franchisee at least 14 days prior to any agreement
- Additional information to be provided in the disclosure document including whether the agreement provides for arbitration of disputes and also the franchisee's rights to any goodwill they have generated
- Significantly greater degree of discussion and disclosure of any capital expenditure requirements
- From November 2021 the inclusion of any earnings information with, or attached to, the disclosure document

- Extended the cooling off period to 14 days
- Adding a cooling off period for transfer of agreements
- The Franchisee can propose early termination of the agreement
- The Franchisor must give 7 days' notice of the proposed termination of the agreement on particular grounds, and the franchisee can dispute the termination in which case the Franchisor cannot terminate the agreement within 28 days
- For new motor vehicle dealership agreements, the previous voluntary best practice principles introduced in June 2020 are mandatory from 1 July 2021. These include:
    - Agreements must provide provisions for fair and reasonable compensation for franchisees in the event of early termination due to the brand leaving the market, significant rationalisation of the dealership network, or a change in the distribution model
    - Agreements should not include provisions that exclude compensation
    - Fair and Reasonable compensation in the event of a change referred to in the first dot point above should include appropriate allowance for:
        - Lost profit from direct and indirect revenue
        - Unrecovered capital expenditure where required by the franchisor
        - Lost opportunity in selling established good will
        - Wind up costs
    - Agreements should provide a fair and reasonable opportunity to secure a return on the investment required by the franchisor
    - Agreements should include provisions for buy back of inventory and special tools where an agreement is subject to non-renewal, or an event mentioned in dot point one above occurs
    - Agreements should include provisions for timely commercial settlement and dispute resolution.
- Agency model has been specifically referenced as included under the Code.

By any stretch, these are significant and recent changes that in many instances will come into effect (in practice) over the next few years as existing agreements run their course.

The FCAI is firmly of the view that to consider yet further changes, in light of the lack of observation of the impact of the above improvements, is not only premature but clearly is not driven by any evidence of market failure.

In addition to the above the Government has recently passed the Treasury Laws Amendment Act (No. 6) 2021 through the Federal Parliament. This Act imposes significant increases in penalties for "wilful, egregious and systemic breaches" of the provisions of the Franchising Code. Further comment regarding penalties is included at Section 6.

4. INDUSTRY COVERAGE

The FCAI cannot comment on the need to extend coverage of the automotive specific provisions of the Franchising Code to sectors such as agricultural machinery.

However, in respect of motorcycles and ATVs, the distributors of these products are members of the FCAI. It is our observation that there is no evidence of the need to extend beyond the 1 July amendments for these sectors (let alone for the light vehicle sector). Apart from the ongoing observations and discussions with members where the issue of franchising is rarely raised as a matter that demands particular focus, the FCAI notes there has to our knowledge never been a regulatory impact assessment process applied to the motorcycle and ATV sectors to determine if there is indeed any market failure demanding a regulatory response.

FCAI is firmly of the view that to simply transition major policy and legal changes across different market segments without thorough policy consideration and a public inquiry process is inappropriate. Added to this, in our experience the motorcycle and ATV sector have a great deal of difference to the new passenger and light commercial vehicle markets. The consideration of the consumer impacts of any proposed change would, likewise, require close and considered study which as noted has not been undertaken.

5. CONSUMER FOCUS

Regardless of the focus of any regulatory review there is an over-riding demand that must underpin any recommendations – consumer benefit.

> Australians have choice in how they buy clothes, electronics and even real estate and want the same choice when buying a new car. They also recognise that limiting these options has only one outcome – higher prices, or in economic terms a reduction in consumer surplus.

FCAI has commissioned an economic analysis of the new passenger and light vehicle sector taking into account the recent changes to the Franchising Code and the potential impacts of yet more reform. It is attached to this paper. As can be seen, there are very significant consequences if the Government moves to introduce further unwarranted protections to new motor vehicle dealers. The report acknowledges that the amendments to the Code to date have been about better ensuring the value proposition for automotive dealers, however some of the more extraordinary demands, from the AADA in particular, would simply serve to limit competition in the market and increase prices. Findings of the report include:

- The changes made to the Code in 2021 in response to a large brand leaving the market and the resultant early termination of dealer agreements have addressed the consequences of this extraordinary event

- Any further increase in protection of the traditional dealership model will lead to an increase in costs to consumers
- Further restrictions risk stalling the flexibility necessary in a rapidly changing market trying to match consumer expectations.

The report carefully considers the recent changes to the Franchising Code of Conduct and the rhetoric around the apparent desire for yet more protection, and concludes that:

"…..any further restrictions on whether franchisors can treat freely in the market would reduce the pool of potential franchisees, protecting dealers, but inevitably leading to higher new vehicle costs in Australia."[1]

And:

"Restrictions such as minimum terms will reduce the flexibility of a rapidly evolving industry needing to meet consumer expectations of innovation not only in product lines, but in models of consumption. This will come at a cost to consumers, but potentially also to dealers and manufacturers, who will lack the capacity to respond to new market entrants and emerging trends"[2]

When considering consumer benefit, it is of equal note to consider the wider economy and the innovation and changes taking place.

There is change in all sectors, including the new motor vehicle sector, yet it would appear that the new motor vehicle dealers are trying to position themselves as a protected species beyond the reach of innovation and change in the market, including change driven by consumers.

The Australian Government has for many years noted the benefits of change and actively promoted innovative manufacturing and service delivery. The economic efficiencies that have consistently increased the national product through a focus on releasing, not constraining, market forces should not end here.

While clearly there is a role for regulation in respect of, for example, community safety, there is no evidence supporting a major shift in policy driven regulatory development, and yet more change would simply extend the already significant protections available to all franchisees through the Franchising Code, and in particular new motor vehicle dealers with the additional annex.

[1] Federal Chamber of Automotive Industries: Economics of Automotive Franchising in Australia Prepared by Evaluate, 9 September 2021 page 13

[2] Ibid, page 3

6. IMPACT ON THE CONSUMER OF OVER REGULATION

The FCAI believes any proposed new additional regulations will benefit one component of the supply chain over the Australian consumer.

The economic report by Evaluate states that the Australian Government has already found an appropriate balance between ensuring the capacity for a fair return on a motor vehicle franchise and allowing the market to operate competitively for consumer benefit. Franchise Code changes made earlier this year provided further protections and it is important that they be given time – and their impact better understood – before any further changes are contemplated.

The automotive retail environment is changing, consumers are changing but some large corporate dealer networks seem to be seeking to entrench the traditional auto dealer model through further regulation that would subsequently increase barriers to retail innovation and change and ultimately increases costs to consumers.

With choice comes the ability for consumers to pick brands that best cater to their preference, whether it be to purchase directly from manufacturers or through dealers. As in other retail sectors customers are spending more time than ever online prior to arriving at the dealership and have often narrowed selection down to a handful of cars and want to test drive prior to deciding.

Original Equipment Manufacturers (OEMs) and dealers that innovate to cater to spending more time with each customer compared to traditional approaches will have advantage here. Research indicates that young people are happier not to negotiate on price and will make decisions based on other factors (experience, specifications, loyalty, social media, etc.).

Regardless, dealers will remain an important point of contact for consumers, including for after sales services in which they earn much of their profit.

SELLING GROSS PROFIT ORIENTATION - 2019	
New Cars	4%
Used Cars	8%
Finance and Insurance	20%
Parts	22%
Service	45%

Source: Based on the 2020 Deloitte Motor Industry Services Dealership Benchmarks for the Australian car market.

Taken to its extreme, over regulation in favour of dealers will lead to perverse consumer outcomes such in the United States where many states have franchise laws requiring that new cars be sold only by independent dealers. This means that it is illegal to buy a car from Tesla in person in Texas. As a result of these laws residents of Texas have to purchase a Tesla vehicle outside of the state and then have it shipped back to Texas.

While we note that the discussion paper is not considering regulations that mirror exactly those of Texas it is an important illustration of over regulation in favour of dealers at the expense of consumers.

Further, any proposal to introduce further regulation flies directly in the face of the Treasury's stated objectives in the delivery of the economic agenda which expressly provides that "*Our legislation program is managed efficiently to reflect the Government's priorities and the laws we prepare are legally robust, and we have a low tolerance for creating unnecessary burdens on, or creating uncertainty for, regulators, industry and consumers*."[3]

To better understand Australians' views on the relationship these issues, the FCAI commissioned JWS Research to explore the views of new car buyers in metropolitan and regional areas and their attitudes towards further regulation of the car purchasing process.

Australians have become accustomed, even expectant, of having choice when purchasing goods and services. The way we buy products and services has evolved considerably over the past decade, from online shopping and different payment options, to increased choice of purchase channel or method, such as through the introduction of platforms such as Uber and Airbnb.

Consumers, and particularly younger consumers, recognise the many advantages of this evolution, with the top benefits resulting from the changes to the shopping experience over the past decade identified as:

- Choice of products / services
- Ability to get the best product for your needs
- Choice of providers
- Access to product / service information
- Easy, 'hassle-free' shopping experiences; and
- Competitive pricing.

The comment below is a clear reflection of the consumer's perspective on regulating choice of retail model:

[3] The Treasury Corporate Plan 2021- 2022 at page 11.

"It's anti-competitive, plus also almost all industries are going through their shake-ups right now. You have Airbnb shaking up the traditional hotel models, Afterpay shaking up the banking credit card models. Why should car sales not be open to that kind of shake up as well? Everything is going through a shake up right now, why should we stifle one area where the consumer could possibly benefit?" (Metropolitan New Car buyer)

Overall, Australians are relatively comfortable and satisfied with the current way of purchasing new cars through the traditional dealership model, however there is interest in and support for alternative sales models they have, in most cases, yet to experience.

Most Australians support car makers choosing the sales method they use to sell cars, allowing them to adapt to changing economic conditions and consumer preferences, rather than having the Government regulate which sales method car makers can use.

For the most part, customers do not support the idea of locking in one sales model; immediate reactions are that doing so would be anti-competitive and diminish consumer choice. It is recognised that many similar industries have evolved in ways that seek to benefit consumers and regulating the car industry from doing so would be unnecessarily limiting. If dealerships and OEMs are allowed to evolve, then this a natural part of being in an innovative industry in the modern market.

"I don't think that the status quo needs to remain just because that's been the status quo. If there's a little shake up to the industry because that's what consumers want, then surely the consumers are the ones who dictate how that proceeds because they're the ones buying the products. So, you can't tell me how I want to buy something. Suck it up." (Metropolitan new car buyer)

Furthermore, the consumer research found that the co-existence of sales models offers real choice to Australian consumers and these consumers do not support regulation that locks or inhibits innovation to the detriment of the consumer:

- the most important benefit of car makers being able to choose which sales model they use will be providing choice to Australian consumers (63% total Agreement)
- consumers also support choice of sales model for car makers, because they agree that competition between car makers will keep Australian car prices competitive, regardless of the sales method allowed (61% total agreement) and because the presence of different sales methods (e.g., traditional, agency and direct) will create better competition in the market and therefore lower pricing for customers (53 % agree)

- There is low agreement that dealers offer consumers the best available price (35% total agreement)

The concern of OEMs is that the potential for over-regulation from a standalone code and pre-contractual arbitration is real. Further regulation risks creating a two tier regulatory system. The first, with a higher regulatory burden, would use traditional sales models. Due to the significant compliance costs which have come with the over-regulation of franchising, the second would incentivise companies to use a range of other sales models.

This has already occurred in the USA as companies look to find ways of competing and innovating to meet the needs of consumers outside the dead hand of unnecessary and inefficient regulation which rewards dealers over consumers.

7. PENALTIES

Penalties help encourage behaviour that is in line with the law.

Legislation recently passed by the Parliament proposes a 600 point penalty for a breach of the Franchising Code. Introducing fines of $10 million or more for administrative matters, such as not providing the disclosure document within 14 days, is outrageous.

An even greater over-reach is the proposal to apply penalties that are akin to a breach of the collusive conduct provisions of the Competition and Consumer Act (CCA) to instances where there is a subjective assessment of whether or not one party has acted in good faith. How is there a valid comparative between these two extremes? Further, under the confidential Exposure Draft Legislation a franchisor who operates a franchise site could face a $10M penalty if they do not pay marketing fees on the same basis across all franchisees.

In short, the FCAI is of the view that there is no basis for increasing the penalties for breaches of the Code. There is no evidence to suggest that there have been breaches of the Code where an increased penalty would have acted as a greater deterrent and prevented the breach from occurring. In fact, there have been very few breaches of the Code by the automotive sector that have attracted penalties anywhere near 300 penalty units.

These breaches are not in the same league as the other breaches of the CCA which have the same penalties: for example, cartel conduct as touched on above. In cases of cartel conduct the wrongful activity is often consciously planned and invariably has an extensive impact across a wide sector of the community. Contrast this with the two examples where the impact is confined to no more than a small number of people and will often be inadvertent.

The prospect of a $10M fine (or more) is particularly concerning in the context of automotive specific instances, most notably section 46B which provides that:

> *A franchisor must not enter into a franchise agreement unless there is a reasonable opportunity for the franchisee to make a return on the investment required by the franchisor during the term.*

The FCAI strongly disagrees with the proposition that there should be any penalty for a breach of this clause – let alone a penalty of $10M. The breach affects one person or entity – the dealer – and the impact on that person can easily be quantified in dollars. Therefore, the more appropriate 'punishment' is for the franchisor to be required to pay the dealer the amount of the loss. The dealer is compensated, and the franchisor is punished. A fine (or penalty) is appropriate when there is a requirement for a deterrent and the impact of the breach is on the community (e.g., cartel conduct) or the damage suffered by the wronged person is not an adequate deterrent (e.g., an assault).

There might be a view that establishing a breach of s 46B for the purposes of a penalty will be easier than in a damages case by the dealer. That will not be so. In both cases, virtually the same evidence will need to be called.

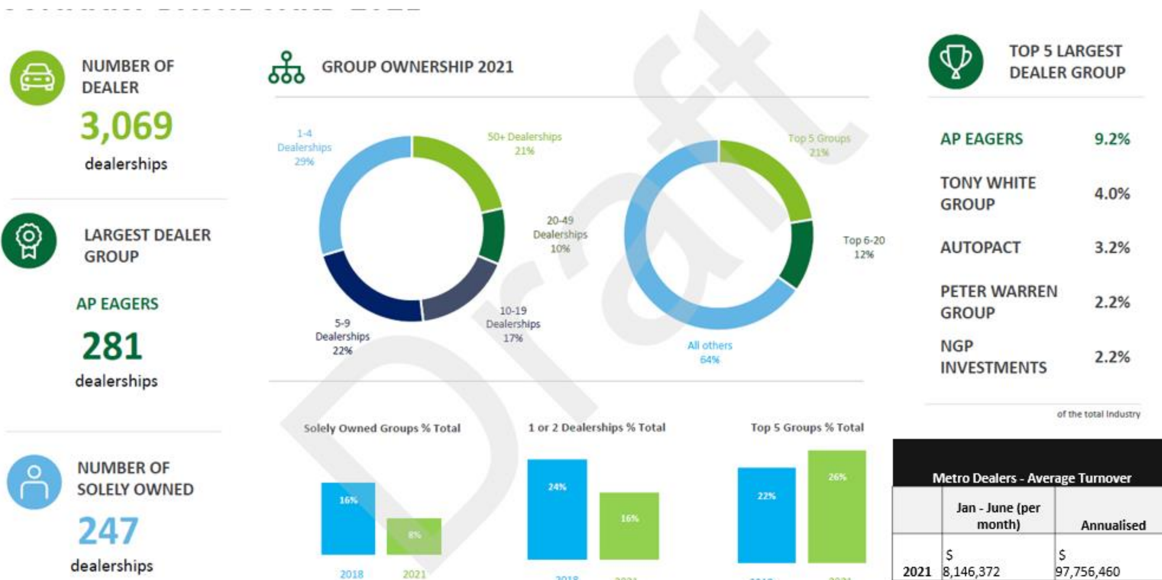
While appropriate penalties are acceptable, the fact is that within the automotive sector there is a real potential to develop a two class system – a very punitive system for those distributors that operate under the Franchising Code, and a consumer driven direct to customer model that is outside the reach of the Franchising Code. In designing any penalties for this sector the degree of difference becomes a real factor to consider – what level of penalty will achieve the desired behaviour as opposed to an exodus from the franchising model?

8. THE AUTOMOTIVE RETAILING SECTOR IN DETAIL

All too often those who seek to promote the need for an entrenched right to a dealership agreement use emotive – even folksy – terms to describe Australian dealerships, e.g. small business, family owned. In truth, dealerships are far from simple small businesses often associate with the Franchising sector. Dealership ownership is becoming more concentrated and increasingly dominated by sophisticated investors, whether they be family owned conglomerates or, as is the case more and more recently, listed companies. These investors are rapidly purchasing dealerships across the country and have turnovers dwarfing many of the FCAI members.

If it is the intention of the Government to embed protection for multi-million, if not billion, dollar family-owned businesses, and multi-billion-dollar listed companies, then that should be made clear to the public. Our data shows that the industry is concentrated to the extent that the notion of a single site or small family business is slowly succumbing to the bidding of cashed-up sophisticated investors, usually other dealership groups. Our latest research, conducted on behalf of the FCAI by Deloitte, indicates the current make-up of the industry, as reflected in the graphic below.[4]

[4] Source: FCAI Dealer Ownership Summary PPP, May 2021



What this table shows is:

- There are fewer and fewer single site dealers as the big groups buy them and consolidate the market.
- There is an overall trend to corporatisation, and this trend is accelerating.
- The average turnover of an urban dealer is over $97m a year.
- As noted in the Evaluate paper, "If anything, small businesses are on the decline, with market share of 1-2 dealerships declining from 24 to 16 percent over the past three years. On the whole, the industry has become increasingly corporatized and consolidated."[5]

FCAI has additional data on the actual make-up and concentration of the dealership network and can provide that if it would be of assistance. It goes a long way to debunking the 'family owned business' myth.

9. A STANDALONE AUTOMOTIVE FRANCHISING CODE

Question 1 - What are the key problems or issues being faced by the automotive sector that you believe have not adequately been addressed by the Government's recent reforms?

The FCAI's response can be simply stated: there were no significant problems or issues being faced by the automotive sector prior to the Government's recent reforms, but if there is any doubt about this, those doubts were more than adequately addressed it by the recent reforms and those being proposed by the Government[6].

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[5] Evaluate, ibid, page 12

[6] Increasing the penalties for breaches of the Code and increasing the reach of the small business unfair contracts regime

The suggestion that there were problems stems from a proposition that there is an inequality of bargaining power between the manufacturers and dealers which is unfairly exploited by the manufacturers.

First, there is no inequality of bargaining power. The FCAI made this point in its submission to the Parliamentary Inquiry into the Operation and Effectiveness of the Franchising Code of Conduct. A copy is attached for your reference. Since that submission, the FCAI has sought further advice on the actual ownership structures and conglomeration of dealerships. It indicates that dealer consolidation is rife with fewer than 16% owned and operated as a single new motor vehicle dealership.

The market is dominated by new vehicle dealers that own five or more new car dealerships. The concept of a one sided or unfair arrangement, as perpetuated by repeated references to "family" businesses, is far from the norm for the sector. These 'family' businesses are often substantial businesses; take the Sutton Group for example, which has a turnover in excess of $1billion.

Even at its most basic, a motor vehicle dealership is substantially more complex than a "standard" franchise and requires a more sophisticated person to run and manage it. A motor vehicle dealership is multi-dimensional: there is the purchase and sale of new and used vehicles, providing finance and insurance to customers, servicing and repairing vehicles, and selling parts, salespeople and technicians need to be employed and managed, stock inventory needs to be controlled. Most franchises are one dimensional: selling the goods or services provided by, or licensed to, the franchisee. Motor vehicle dealers must possess business acumen and experience to manage their sophisticated operations. As such, they are more than able to look after themselves when dealing with the manufacturers.

In fact, the recent Productivity Commission Draft Report on The Right to Repair[7] made a similar observation when considering the potential need to revisit the definition of consumer under the Australian Consumer Law. It concluded that large private enterprises are more than capable of accessing the expertise necessary to manage the complex range of challenges in running a small business, and if considering purchasing a $600,000 new machine for a large farming enterprise they would conduct their own due-diligence. FCAI sees no reason to release new motor vehicle dealers from a similar obligation.

If there was any doubt about there being an inequality of bargaining position, this was laid to rest by the ACCC authorising a class exemption from 3 June 2021. This improves and simplifies access to collective bargaining for franchisees when negotiating with franchisors.

Second, there is no unfair exploitation of dealers by manufacturers. Putting to one side the lack of any credible evidence which demonstrates this, it is just not in the interests of a manufacturer to do so. The Australian automotive market is one of the most competitive in the world and the manufacturers need a strong and viable dealer network to compete.

[7] Productivity Commission, Right to Repair, Draft Report, June 2021, p79.

Finally, if there was ever any doubt about manufacturers exploiting their dealers surely it has been addressed by the many reviews that have been conducted into the Australian automotive industry. Every conceivable issue has been examined and reviewed, often multiple times. In the past 15 months there has been:

- the introduction of an automotive part of the franchising code on 1 June 2020;
- the best practice automotive principles in December 2020; and
- the introduction of a new mandatory scheme for the provision of motor vehicle service and repair information.

There are also two draft bills that will affect the automotive industry as they will:

- significantly increase the penalties for breaches of the Code (in some instances to $10 million); and
- increase the reach of the small business unfair contracts regime.

And on top of all of this has been the recent significant amendments to the Code that specifically relate to new vehicle dealer agreements effective from 1 July 2021. Without going through these amendments in detail it is worth making one point: in what other industry is a party to a contract required to actively look after the interests of the other party (who is entering into the contract willingly) or face the prospect of a fine of more than $60,000 - as is the case in the new section 46B of the Code? The answer is none.

Question 2 – What evidence can you provide about the magnitude of the problem?

The FCAI does not believe there is a problem. Current regulations and provisions should be given the opportunity to be fully tested before introducing new and potentially unnecessary regulation.

Question 3- Which option do you consider to be the most effective solution and why?

The discussion paper refers to two options:

1) amending the Franchising Code and its automotive specific provisions when required; or
2) establishing a standalone automotive franchising code.

There is, of course, a third option – do nothing. For the reasons outlined above, the FCAI strongly favours this third option. There is no reason for any further steps to be taken because, on any objective view, there is no issue or problem.

The FCAI would like to make the following comments on the second option .

The Industry Codes of Conduct Policy Framework (2017) sets out the requirements that need to be satisfied for an industry code to be enacted:

'It is important that the Government applies a robust decision-making process to allow all relevant factors to be properly considered.'[8]

The framework identifies five criteria that need to be satisfied:

- A clearly identified market failure.

[8] P 11

- A problem that can't be addressed using existing regulation.
- Self-regulation has been attempted and failed.
- Evidence that a code is the most effective solution.
- Public benefits that outweigh the costs of regulation.

None of these are satisfied.

Rather than there being a clearly identified market failure, there is no evidence of market failure. The retail market for new vehicles is, as previously mentioned, one of the most competitive markets in the world. At the wholesale/dealer level, there is no shortage of people wanting to become dealers. And at the manufacturer level, most of the manufacturers in the world are represented in Australia.

As explained above, there is no problem that needs to be addressed, but even if one could be found, it could easily be addressed by using existing regulations (i.e., amending the Code).

Similarly, there is no evidence that a separate automotive specific code is the most effective solution.

Finally, rather than benefiting the public, further limitations and impositions on manufacturers will lead to a public detriment. Customers are, rightly, very demanding and the industry needs to be able to adapt to meet their demands. Placing further restrictions on manufacturers, will stifle the ability of the industry to innovate to meet these demands.

10. QUESTION: COULD PRE-CONTRACTUAL MANDATORY ARBITRATION ENABLE BETTER ACCESS TO JUSTICE FOR DEALERS IN RELATION TO RESOLVING DISPUTES?

The suggestion that there be compulsory pre-contractual arbitration is concerning. The fundamental principle which operates within our commercial and economic system is that of 'freedom of contract' - parties are free to choose whether or not they enter into a contract. This is subject to very few exceptions and in these circumstances the aggrieved party has a range of remedies available to them to avoid the contract.

To overturn such a fundamental principle in an industry which is so competitive and commercial would require there to be a major problem that needs to be solved. This is not the case. There is no need for pre-contractual arbitration because there is no evidence of there being disputes that could have been avoided by pre-contractual arbitration. Of course, there are some disputes that arise from time to time between dealers and manufacturers but given the size and complexity of the industry, these are inconsequential in number. As pointed out in the Automotive Franchising Discussion Paper:

‘In the majority of cases, franchising parties have successfully utilised mediation under the Franchising Code with a high degree of disputes resolved in good faith, facilitated through ASBFEO and state and territory small business commissioners ‘.[9]

The two examples referred to in the paper – the Media Bargaining Code and the Sugar Code[10] – have extremely limited and specific application and should not be used as any sort of precedent for the automotive industry. The Media Bargaining Code is limited to disputes about the remuneration which is to be paid by one party to the other where the arbitrator can only take into consideration a specific set of factors. Other than the price for vehicles and parts, there is no payments made by dealers to the manufacturers.

The Sugar Code was enacted urgently in 2017 in light of a three-year dispute over selling agreements between a sugar mill (Wilmar) and growers represented by Queensland Sugar Ltd. It was seen as a crisis which was having consequences not just for the growers but for the State of Queensland and the country as a whole.

In the sugar industry, growers are ‘locked into’ the industry and have no alternative but to sell their cane to the mills to be processed. This is not the case in the automotive industry.

In the sugar industry, the relationship between the parties is extremely simple: the cane growers grow sugar cane which they have to sell to the sugar mills. There are only three variables that can be in dispute – the price of the sugar cane, the term of the contract and the quantity of the sugar cane to be purchased. This is fundamentally different to the automotive industry. If the dealer is meant to be equivalent to the grower, it is not compelled to sell anything to the manufacturer (the mill owner in the context of the sugar Code). Rather, the dealer is buying vehicles and parts from the manufacturer and is under no compulsion to do so.

In addition, the relationship between dealers and manufacturers is orders of magnitude more complex than between a cane grower and a sugar mill. Dealers are authorised to represent the manufacturer’s brand, they sell new and used vehicles and parts and accessories, they provide service, they carry out warranty work on behalf of the manufacturers and they directly deal with consumers. The number of possible variables in that relationship is vastly more than three.

In considering the concept of pre-contractual arbitration it appears to the FCAI that, particularly with the sophistication of the arrangements in a new motor vehicle agreement, that contract negotiation and consideration would be subject to an enormous and unhelpful degree of uncertainty under this scenario. This uncertainty would lead to significant delays which in turn adds cost. If you consider the potential parties to a new motor vehicle dealership agreement, there are two sophisticated and well-resourced parties vying for the best outcome in the contract discussions. The idea that a third party can come into play and somehow (we still do not understand how) designate one contract term or the other is to be included/excluded, must simply lead to a recommencement of the contract negotiations. Quite often there might be give and take across related (or unrelated) terms within a contract, and if a particular term or condition is mandated, somehow, then that will impact other terms.

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[9] Page 10

[10] Competition and Consumer (Industry Code – Sugar) Regulations 2017 (Cth) Sch 1

Arbitration is an alternative means of resolving legal disputes that is chosen by the parties. What is proposed is that an arbitrator somehow is asked to rule on commercial issues, not legal disputes.

Arbitration is also subject to an international convention concerning enforcement of arbitral awards (among other things). Those conventions rely on consistency in the application of arbitration in signatory countries. The proposed pre-contractual arbitration could well breach existing conventions that Australia has signed.

Option three in the Paper is 'industry-led improvements to dispute resolution'. The industry is in discussions about the possibility of introducing an arbitration scheme similar to the Canadian National Automobile Dealer Arbitration Program (NADAP). As pointed out in the Paper, there are limitations in NADAP, but the FCAI is hopeful that industry discussions will lead to an outcome that will satisfy all parties.

In fact, recent amendments to the Franchising Code provide for a dispute resolution procedure that mirrors much of the Canadian automotive system, with the added protection that the Australian requirements are a statutory requirement. FCAI is in discussions with the industry bodies representing the dealers and has suggested testing industry support such that the current voluntary arbitration provisions within the recently amended code should be mandatory when an agreement is terminated early, and compensation is due because of:

- Withdrawal from the Australian market
- Rationalisation of dealer networks in Australia
- Change to the distribution models in Australia.

The other industry bodies are yet to provide feedback, however further engagement with them is anticipated in coming weeks.

11. CONCLUSION

It is vital that Australia's automotive retail sector operates within a regulatory environment that fosters competition and innovation while ensuring consumers can purchase the best possible vehicles at the best possible prices and have the best possible experience.

However, as has been demonstrated in other jurisdictions, this won't happen if the relationship between manufacturers and independent dealers is overregulated.

The ink has hardly dried on far-reaching changes to automotive franchising regulations. These significant reforms must be given the chance to be bedded down (this can take 3 – 5 years) before additional regulations are even contemplated.

The discussion paper has not established the costs and benefits of the proposed additional reforms nor has this been established by dealer representatives who seek to further protect their business model at the expense of all others – most notably Australian consumers.

In response to the specific reforms canvassed in the discussion paper there is no justification for a separate code for the automotive sector. There is also no justification for an experimental pre-

contractual arbitration scheme that would set a precedent for the rest of the economy – way beyond the automotive sector – on how contracts are negotiated.

Before any consideration is given to implementing a precontractual arbitration system the Productivity Commission must complete a cost benefit analysis on the impact such reforms would have to consumers in the automotive sector and across the broader economy.

In relation to expanding the scope of regulations covering the motorcycle and ATV there has been no evidence of significant market failure to justify further protections for dealers beyond the standard, yet substantial, provisions of the Franchising Code.

Finally, with no clearly identified market failure, no problem that can't be addressed using existing regulation, no self-regulation has been attempted and failed and no evidence that a code is the most effective solution it is the FCAI's firm view that there is no need for an industry code.

EVALUATE

Economics. Policy. Strategy.

Economics of Automotive Franchising in Australia

Federal Chamber of Automotive Industries

7 September 2021

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Executive Summary

This paper looks at the economic structure of new car retailing in Australia, to explain the implications of franchising models, and looks particularly at the impact of both recent actual changes and proposals floated to increase the level of protection for franchisee car dealers.

This paper was commissioned by the Federated Chamber of Automotive Industries in July 2021. It seeks to address a broad range of interrelated issues. Where this is used as part of the ongoing consultation on motor vehicle franchising, Evaluate would be pleased to provide Treasury and other Government agencies with further comment as required.

The broad conclusions of this paper are:

- Whereas the changes to the Franchise Code made earlier in 2021 may have been justified by the need for greater certainty as to the value of a franchise in the wake of the GM departure, proposals for further restraints on trade between franchisors and franchisees are not supported by repetition of the same argument. Underlying this is the observation that termination of a franchise before its expiry is fundamentally different from a franchisor declining to issue a new franchise;
- The recent changes are highly effective in improving transparency and ensuring franchisees can fully consider the expected return on any investment made during the term of the franchise;
- Any increase in the level of market protection to car dealerships will increase costs to consumers;
- They further risk fundamentally undermining the principle of franchising, by transferring intellectual property rights from their originators to distributors (dealers), which in turn is inconsistent with Australia's trade liberalisation commitments;
- While Evaluate does not contest the AADA's assessment of the market footprint of car retailing in Australia, it is found that very little if any of this is actually at risk to justify additional protectionist measures;
- Restrictions such as minimum terms will reduce the flexibility of a rapidly evolving industry needing to meet consumer expectations of innovation not only in product lines, but in models of consumption. This will come at a cost to consumers, but potentially also to dealers and manufacturers, who will lack the capacity to respond to new market entrants and emerging trends;
- Any shift from a wholesale to an agency model is not a threat to dealers, and should increase consumer surplus without reducing revenues. It is not a zero-sum game;
- The agency model will simultaneously reduce dealers' costs, and will shift sales emphasis from price-negotiation to quality of experience, which is a win-win for both sellers and consumers;
- Market competition will mean that the mean price of vehicle purchase will be the same, so there is no transfer of financial surplus from dealers to consumers (if anything, dealers should be better off

under an agency model that generates similar revenue levels at lower cost and risk), and nor is there an increased margin to manufacturers;

- Agency models will be particularly beneficial to smaller dealers and dealers in regional areas, who will no longer lose sales because of limited floorstock;
- The prospect of online sales is a different issue from agency, and should be dealt with transparently in new franchise agreements;
- Concerns about the tax effects of direct manufacturer sales are best dealt with via measures other than market constraint and reduction of consumer choice. In practice, they would in no way differ from concerns about foreign investment in car dealerships, or any other Australian business;
- The proposal of a standalone code is not justified by market tests of information asymmetry or imperfect competition;
- Mandatory arbitration appears to offer more costs than benefits, and is presupposed on addressing an alleged power imbalance (when there is a dispute) for which there is little evidence;
- The arguments for pre-contractual bargaining in the sugar, wheat and media codes are based on radically different products and markets, and do not argue for similar provisions in the Franchising Code; and,
- With respect to non-passenger vehicle categories, there are different economic consequences, which require investigation beyond the scope of the current consultation.

In conclusion, Evaluate is of the view that the Australian Government has already found an appropriate balance between ensuring the capacity for a fair return on a motor vehicle franchise investment, and allowing the market to operate competitively for consumer benefit.

Further restrictions would reduce these benefits, with no evidence that there would be broader economic gains. Unlike the GM departure, which has led to measures aimed at guaranteeing value in the event of early termination, there is no present manufacturer behaviour to justify further reduction in the freedom to negotiate franchises.

As an illustration of the current balance, it is clearly illogical to on one hand have introduced regulations which ensure an opportunity for a reasonable return on capital invested during the term of a franchise, and to then ask for tenure, so a further return can be guaranteed on that already-realised investment. From a regulatory perspective, it is double-dipping at best. Equally, to insist that franchisees have the opportunity to earn out required investments during the term of the franchise and to simultaneously claim residual goodwill at the expiry of a franchise is an unsupportable ambit claim. This is not to suggest that dealer businesses may not have goodwill. They certainly might, and many do, but its existence bears no relationship to the terms and conditions of its franchise arrangements with one or more manufacturers.

It is Evaluate's assessment that the recent amendments are adequate in delivering a balanced relationship in passenger vehicle franchising, and that there are no obvious immediate threats to the sector. It is therefore recommended that the Code be allowed to operate in its current form, with the processes of mediation and arbitration delivering much less cost to consumers than further formal restrictions. Permitting a reasonable period during which to reflect on the impact and adequacy of the recent updates will also provide an incentive to act in good faith by all parties.

Introduction: Sustainability with Consumer Choice

This note is provided as a general commentary to support the FCAI's engagement with Treasury's July 2021 *Automotive franchising: Discussion* paper (the consultation).[1] It also takes into account other proposals or issues which have emerged in the current debate between the Federal Chamber of Automotive Industries (FCAI), the Motor Trades Association of Australia (MTAA) and the Australian Automobile Dealers Association (AADA). It also takes into account the July 2021 changes to the Franchising Code of Conduct (the Code).

The following sections consider current and alternative settings which are suggested by various parties involved in Australian motor vehicle franchising. In particular, Evaluate has considered questions associated with:

- Mandatory binding arbitration and pre-contractual arbitration;
- The need for and implications of a standalone code;
- Wholesale v. agency platforms for franchising agreements;
- Termination questions;
- Issues of competition; and,
- The value proposition for Australian consumers.

The last of these is particularly important. It is understood that the conditions under which cars are sold are likely to evolve in coming years to meet shifting consumer preferences, particularly:

- The growth of online sales as a percentage of new car purchases, with new entrants such as Tesla and BYD entering the market with online-only or OEM-only sales channels;
- New leasing options at both the consumer and corporate level, including pay-for-use and shared ownership models.

Consumers are increasingly accustomed to multiple delivery channels for their purchases, both domestically and internationally. This paper focuses only on domestic distribution questions

[1] Australian Government Treasury, "Automotive franchising: Discussion paper", Canberra, 10 August 2021 https://treasury.gov.au/consultation/c2021-194199 Accessed August 2021

The AADA claims that the industry it represents employs close to 56,000 Australians, with 4,463 apprentices, and makes a total economic contribution of $12.76 billion.[2] This would represent around 0.65% of GDP,[3] delivered by 0.42% of the national workforce.[4]

The key question which should be asked when looking at franchising rules, is not the scale of the industry's footprint, but the extent to which any of this is genuinely at risk from either change in franchisees or the rules of individual franchising agreements. This is particularly important given the short time frame since the most recent changes to the Code: many of which are specifically aimed at better assuring the value proposition for automotive dealers.

Accordingly, the remainder of this paper looks at the various questions relating to Australian motor vehicle franchising from the perspective of benefits to the consumer, while acknowledging the economic importance of industry sustainability.

[2] https://www.aada.asn.au/wp-content/uploads/2020.11.06-AADA-Submission-Dealer-Manufacturer-Senate-Inquiry-web.pdf
[3] GDP is approximately $1.97 trillion
[4] https://www.abs.gov.au/statistics/labour/employment-and-unemployment/labour-force-australia/latest-release Accessed July 2021

What Is a Franchise?

Fundamental Nature

At the outset, it is important to clarify what is a franchise, in order to provide a foundation for economic considerations. The substantive definition under the *Competition and Consumer (Industry Codes – Franchising) Regulation 2014* is given in Clause 5 as:[5]

(1) A ***franchise agreement*** is an agreement:

(a) that takes the form, in whole or part, of any of the following:

(i) a written agreement;

(ii) an oral agreement;

(iii) an implied agreement; and

(b) in which a person (the ***franchisor***) grants to another person (the ***franchisee***) the right to carry on the business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor; and

(c) under which the operation of the business will be substantially or materially associated with a trademark, advertising or a commercial symbol

This is extended in the remainder of clause 5 to clarify matters of financial consideration, and to exclude forms of contract or association regulated under alternative legislation. It explicitly includes a motor vehicle dealership agreement.[6] Clause 6 then establishes the balance between an expectation of good faith by both franchisors and franchisees, and the right to protect their respective commercial interests.

From an economic perspective, there are three elements to the definition above. A *franchise* is an *agreement* involving a *grant from the franchisor to the franchisee* to operate a business utilising *intellectual property of the franchisor*.

An agreement is distinct from a sale insofar as it is time-limited, which is the case with all franchises and master franchises. It confers no rights outside the franchise agreement.

Further, as it involves intellectual property (IP: in this case trademarked goods) it is an agreement for a temporary licence to carry out business under a brand which remains owned by the franchisor. There is no permanent transfer of rights to that brand, and franchises are typically highly explicit regarding the use of trademarks and other IP.

What Constitutes Good Faith?

The *Australian Competition and Consumer Commission* (ACCC) notes that good faith is a matter best understood within the common law (historical judgments), and which may be summarised as:[7]

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[5] https://www.legislation.gov.au/Details/F2017C00182 Accessed July 2021

[6] Clause 5.2(c)

[7] https://www.accc.gov.au/business/industry-codes/franchising-code-of-conduct/acting-in-good-faith Accessed July 2021

Under common law, good faith requires parties to an agreement to exercise their powers reasonably and not arbitrarily or for some irrelevant purpose. Certain conduct may lack good faith if one party acts dishonestly, or fails to have regard to the legitimate interests of the other party.

For the most part, this governs behaviour by the parties to a franchise agreement during the term of the franchise. However, it may also govern issues which arise at the end of a contract, including its termination.

For the motor vehicle sector, the question of good faith has most recently come to the fore in relation to the shutdown of General Motors' businesses in Australia, which included the early termination of multiple franchisee agreements.

It is Evaluate's understanding that concerns about termination of the GM franchises fall into three categories, viz.:

1. Whether reasonable notice was given?;
2. Whether franchisees were encouraged or induced to enter into capital expenditure and other financial commitments when General Motors was internally aware that it would likely terminate franchises early?; and,
3. Whether appropriate compensation was paid to terminated franchisees?

These may be subsumed within the overall question as to whether good faith was exercised. This has been considered elsewhere, including via a Parliamentary Inquiry, and has resulted in changes to the Franchising Code which are discussed below.

It should be noted that the GM withdrawal was a complex event, which was in the main an artefact of the closure of the last passenger vehicle manufacturing plant in Australia. The issue here remains one of appropriate compensation for the remaining franchise term, which is what the most recent amendments to the Code seek to deliver.

Changes to the Code

As noted in the prior section, recent changes to the Code are essentially changes which anticipate potential breaches of good faith, and provide clarity to both franchisees and franchisors.

The key changes are:

1. Within the Competition and Consumer (Industry Codes—Franchising) Amendment (New Vehicle Dealership Agreements) Regulations 2020[8] and specific to automotive dealer franchises:
    a. A requirement for twelve months' notice of intention to renew or not renew a franchise, with the latter option requiring a statement explaining the franchisor's decision;

[8] https://www.legislation.gov.au/Details/F2020L00636/Explanatory%20Statement/Text Accessed July 2021

b. Pre-contractual disclosure of significant capital expenditure, so this is clear to all parties;

c. Capacity for multi-franchisee dispute resolution; and,

d. Within the Appendix, recognition of the likelihood of moving to an agency model for automotive franchising, following New Zealand and other countries.

2. In the new Automotive Schedule under S.46 of the amended Code, formalisation of what was previously reflected in best practice principles:[9]

    a. Compensation for early termination, regardless of whether this is for market exit, rationalisation of dealer networks or other reasons. This cannot be excluded in a franchise agreement. Compensation should include:

        i. Lost profit from direct and indirect revenue;

        ii. Unrecovered expenditure and unamortised capital expenditure where requested by the franchisor;

        iii. Loss of opportunity in selling established goodwill;

        iv. Wind up costs;

        v. Buy-back of unsold stock and tools.

    b. The franchise agreement must provide a reasonable opportunity for return on the franchisee's investment, which particularly requires that the term of the agreement must be adequate to cover any expected capital expenditure. This intersects with the pre-contractual disclosure noted above, which must be discussed with reference to the adequacy of the franchise term. This is described throughout this document as the opportunity to 'earn out' the investment involved in a franchise during its term;[10]

3. More generally within the Code:

    a. Increases in fines to $10 million;

    b. Extension of the dispute handling process to include conciliation and voluntary binding arbitration; and,

    c. Addition of a 'key facts sheet' to provide plain English clarification of the franchisor disclosure document.

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[9] See: https://www.industry.gov.au/policies-and-initiatives/supporting-australias-franchising-sector/principles-for-new-car-dealership-agreements

[10] Importantly, this is a reasonable opportunity back by detailed disclosure. It is not a guaranteed return, as this would provide perverse incentives to some dealers

Generally speaking, these amendments increase the certainty of the franchisee, and therefore reduce risk, with attendant benefits such as potential reduction in cost of capital. Alongside this, the requirements for adequate compensation and appropriate time for 'earn-out' mean that dealers' expected returns are substantively protected.

Compensation can now be established both directly, or within various forms of arbitration and mediation, none of which restricts appeals to authorities such as the Australian Competition and Consumer Commission (ACCC) or appropriate courts. The substantial penalties are also a significant deterrent to breaches of good faith.

These changes reflect an appropriate balance insofar as they protect the investment of dealers, without decreasing consumer surplus. This balance is discussed further below.

What About Market Power?

Part of the argument for both the recent amendments and any further regulation of motor vehicle franchising is that there is an inherent imbalance of market power between manufacturers (franchisors) and franchise dealers.[11]

This argument may be predicated on the assumption that international licensors of intellectual property are all alike in market power, drawing on the specific experience of the relationship between international online platforms and Australian media content originators.

Here, Evaluate would identify some key differences which distinguish between the two cases:

- This is a market for physical goods, which bears no resemblance to online content;
- The originator of the property involved is the overseas manufacturer, not the Australian dealer; and,
- There is a franchising model in place, governed by the Code, as opposed to the media experience where there was no formal regulation.

Beyond these, it is notable that Australian automotive franchisees are universally at the 'sophisticated investor' end of the franchise market. They are not operators of comparatively low-capital businesses such as coffee or baking franchises, and many are listed companies. They are not without substantial countervailing market power themselves.

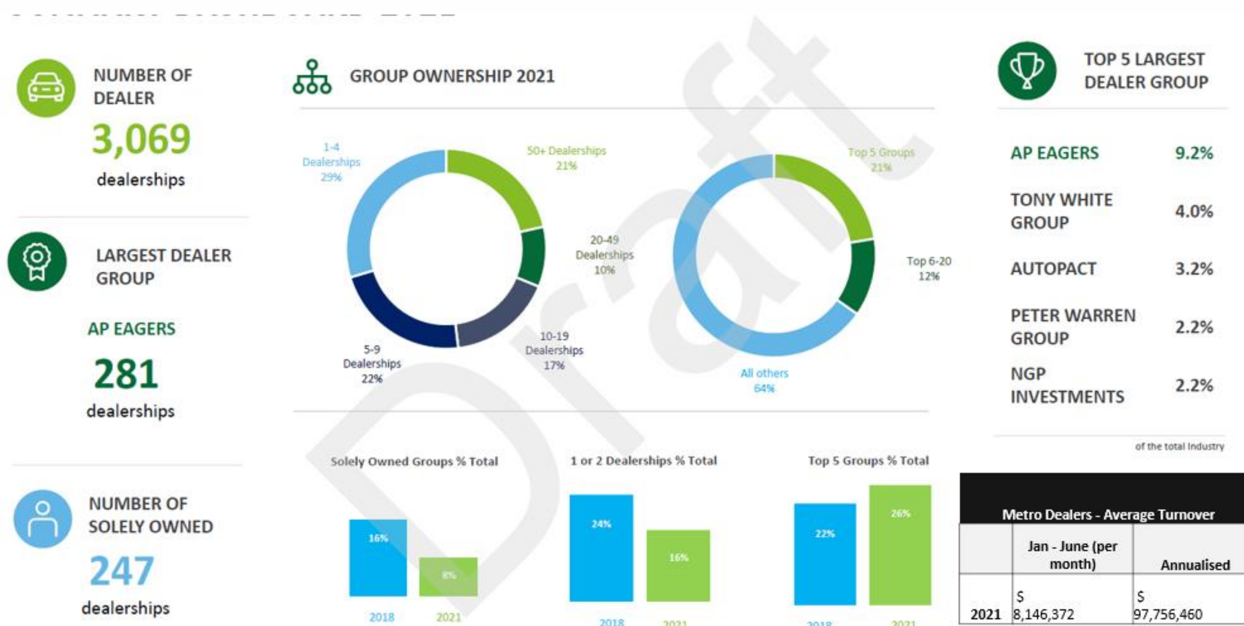
Evaluate is not of the view that there is any imbalance of market power between parties to dealership franchises in Australia, but if there were, the amended version of the Code is adequate in its good faith and compensation clauses to address this issue.

It is notable here that there is no similar level of concern raised in public debate about the substantial market power dealers have over consumers, given the lack of transparency of pricing in traditional

[11] See for illustrative commentary: https://hwlebsworth.com.au/landmark-reforms-to-automotive-franchising/ Accessed July 2021

franchise retail models. As an example of concentration, the 2019 takeover of AHG by AP Eagers showed a prospective consolidated market share of 11.9%.[12] This does not suggest a vulnerable business in need of increased protection.

On this point, and while it is not formally part of the consultation, Evaluate notes that the Government's concern in announcing the consultation relates to 'family-owned automotive businesses'.[13] It is not clear whether there is an intention to distinguish between the market power of authentic family-owned businesses, and multi-billion-dollar listed companies. Such distinctions are typically viewed as pivotal to considerations of exemption from normal market competition, and are particularly pertinent given the current make-up of the industry, as reflected in the graphic below.[14]



This is not an industry characterised predominantly by 'family-owned automotive businesses'. If anything, small businesses are on the decline, with market share of 1-2 dealerships declining from 24 to 16 percent over the past 3 years. On the whole, the industry has become increasingly corporatized and consolidated. The top 5 largest dealer groups account for 21 percent of market share; the largest of these, AP Eagers, with 281 dealerships, is listed on the ASX.

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[12] https://www.accc.gov.au/system/files/public-registers/documents/AP%20Eagers%20Limited%20proposed%20acquisition%20of%20Automotive%20Holdings%20Group%20Limited%20-%20Application%20-%20Annex%208.4.1%20Market%20Share%20Tables%20-%2029.04.19%20-%20PR.pdf p.2. Accessed July 2021

[13] https://ministers.dese.gov.au/robert/delivering-franchise-reforms-morrison-government-releases-automotive-franchising-discussion

[14] Source: FCAI Dealer Ownership Summary PPP, May 2021

Further, it might be usefully considered that increased protection of new car businesses gives them substantial competitive advantage over standalone used vehicle sellers, a market which is contrastingly characterised by small or 'family-owned' businesses.

Complementing the amended Code, the question of misuse of market power is formally established as an authority of the ACCC.[15] This test is focused on misuse of market power to reduce competition: it is notable that further restriction on the capacity of franchisors to enter openly into contracts would restrict competition to the benefit of dealers at a cost to consumers. In particular, any further restrictions on whether franchisors can treat freely in the market would reduce the pool of potential franchisees, protecting dealers, but inevitably leading to higher new vehicle costs in Australia.

What About Goodwill?

Evaluate is not of the view that goodwill exists in principle within franchising. The time-limited licensing nature of franchises means that any value associated with the intellectual property remains with the owner (the franchisor). To argue otherwise would mean that the intellectual property had in part transferred to the franchisee who has some novel right to resell it back to the franchisor.

The essence of goodwill is trust in the seller, which may be expressed as trust in the brand. In this sense, a distinction must be drawn between the franchisor's brand (the vehicle marque) and the branding of the car dealership. As a thought exercise, this may be understood in the consumer mind as:

1. Having a view about the individual vehicle and brand of car purchased, which may be reflected in marque and model loyalty, and which is part of the goodwill of the manufacturer; and,

2. Having a separate view about the experience of purchasing the vehicle, which may be reflected in willingness to buy a future vehicle from that dealer and which is part of the goodwill of that company. This may include goodwill associated with vehicle servicing and the used car market, which are independent of the franchise arrangement.

This is best imagined in the circumstance that a consumer buys a car from their preferred or local dealer, and may choose between multiple marques, including both new and second-hand cars. In this case, there is certainly dealer goodwill, but it is not something which may be levied against an individual franchisor.

The Code as amended does appear to address the different species of goodwill in S46A(b)(iii) which notes the requirement for a franchise agreement to specifically address the question of goodwill lost from early termination. As this is not paralleled with a requirement to address goodwill in the event of non-renewal, Evaluate understands it as relating to a reduction in the capacity to trade an ongoing business, which is potentially a diminution of dealer goodwill, separately from marque goodwill.

Given the codification of a requirement for dealers to have a reasonable opportunity to earn back capital expenditure, the regulatory construction of a goodwill claim by dealers against manufacturers where no new franchise agreement is offered is not only double-dipping, but would be nothing more than a

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[15] https://www.accc.gov.au/business/anti-competitive-behaviour/misuse-of-market-power Accessed July 2021

reallocation of unearned money from one party to another. This appears to be addressed In S.18(fa) of Annexure 1 to the Code, which seeks clarification at the commencement of new franchises as to whether franchisees will establish the type of goodwill for which the franchisor may be liable.

This is particularly unjust in motor vehicle franchising, which predominantly operates on a wholesale margin-only basis, without a new franchise purchase fee. Accordingly, a dealer is not purchasing anything other than a time-limited opportunity in which to make a return on investment: there is no asset purchase other than stock, so no transaction upon which goodwill might be notionally levied.

Should There Be a Minimum Term?

Evaluate is aware that there is a view that – given the extensive capital requirements associated with motor vehicle dealerships – there should be a minimum term for franchises. There are good reasons why franchisors may wish to issue relatively short terms for some franchises, including: a desire to bring all franchisees to a common renewal date; and a desire for flexibility in a rapidly-evolving motor vehicle market. The latter is important: minimum terms may actually increase the risk to dealers, if for example they are committed to a fixed arrangement where the market moves more quickly than expected to online sales or non-franchised vehicles.

The amendments to the Code which cover the requirement to disclose and provide the opportunity to earn out investment within the term of a franchise appear by proxy to address any concerns which might be otherwise allayed by minimum terms. Importantly, this is not equivalent to termination, where there may be a question as to whether franchisees are due appropriate compensation. Where the term is shorter, it would be anticipated that either:

1. There would be substantially less requirement for new capital investment than might occur in the case of a longer franchise so that it might still be earned out; and/or,

2. The wholesale margin (or under agency the commission rate) would be higher to permit earn-out over a shorter period.

The proposal for fixed minimum terms is a restriction on flexibility, which will be a cost to both franchisors and consumers. It is unnecessary, and will raise prices.

Is There an Argument for Tenure?

The companion argument to minimum terms and goodwill appears to be a proposal for tenure: that franchisees should either:

1. Have an automatic expectation of franchise renewal; or,

2. Be compensated as if a franchise were terminated.

This is again entirely antithetical to the notion of a franchise, and transfers intellectual property rights from a manufacturer to a franchisee. It is entirely inconsistent with all the recent argument around compensation, which is focused on the question of a reasonable chance to earn out investment. It raises the spectre that a franchisor would be simultaneously liable for such value to both a new franchisor, and one whose contract has expired.

To expand on this point, Evaluate notes that much of what has been done in the recent amendments to the Code is focused on ensuring adequate compensation where a franchise is terminated early, and explicitly equates the earn-out period with the term of the franchise: a unilateral reduction in the franchise term obviously limits the earn-out capacity of the dealer. There is not a logical argument which treats a decision not to offer a new franchise on expiry in the same manner. In fact, it may reasonably be argued that the earn-out provision explicitly rules out any requirement for automatic renewal. On what economic basis would it be warranted, since the dealer has had the opportunity to be reasonably compensated for any investment made under the previous, now expired franchise?

Equally, it is entirely unnecessary given recent changes to the code. From a policy perspective, the question must be asked as to what were the arguments for these amendments if the ultimate aim is to place this straitjacket on manufacturers and importers. Where the earlier amendments reflect a desire for balance between manufacturer and dealer interests, this type of change is simply a reallocation of property rights.

There is a logic gap in any proposal which simultaneously seeks protections associated with term completion, and asks that franchise terms be rendered irrelevant, as the model in Australia would be reversed. In the latter case dealers would obtain a perpetual right to exploit the relevant intellectual property and would then be able to set the terms on which manufacturers were able to enter or remain in the Australian market.

From an economic perspective, this is nothing more than a proposal for a new barrier to entry, and one which is proposed for an already protected market with high costs of new entry. The costs of this would need to be passed on to consumers.

Further, from a game theory perspective, the more the impediment to reasonable termination is increased, the lower the incentive becomes for franchisees to comply with contracts or to protect the intellectual property rights of franchisors.

Evaluate also notes that such restrictions are inconsistent with Australia's active pursuit of free trade under our commitment to WTO liberalisation of trade in services, which includes distribution services, and which has the goal of reducing costs and removing barriers to consumer access at reasonable prices.[16] Notably, Australia's 2005 Revised Offer under the WTO General Agreement on Trade in Services specifically excludes any restrictions on franchising.[17]

[16] https://www.wto.org/english/tratop_e/serv_e/distribution_e/distribution_e.htm Accessed July 2021
[17] https://www.dfat.gov.au/trade/services-and-digital-trade/services-trade-and-the-wto/Pages/services-trade-and-the-wto Accessed July 2021

With respect to trade regulation, Evaluate is not of the view that recent Code updates have had similar effects, as they are more focused on ensuring appropriate value within the term of a franchise. However, this goal is now exhausted, and further proposals have the character of protection and value transfer, not balance.

The Economic Interests of Franchisors and Franchisees

Shared Interests

There has been a tendency in recent years to characterise the relationship between franchisors and franchisees as antagonistic. In practice – and outside the arena of regulatory advocacy – it is a highly cooperative and constructive form of licensing. This is even more true in the motor vehicle sector, where high barriers to entry (particularly land) mean it is difficult to replace dealers. While there are new models of direct retailing for electric vehicles in particular, it is notable that 99% of cars sold use traditional fuels.[18]

The following describes the symbiotic relationship between franchisors and franchisees in Australian automotive retailing, and how this delivers the scale of car retailing in Australia:

1. The economic footprint of car retailing in Australia is a function of two principal factors, viz.:

    a. The number of cars sold, which provides for a certain level of economic activity and taxation;

    b. Whether those cars are sold through a dealership model, or via online sales, which is pertinent to the level of employment, marketing investment, land development and other activities to promote sales;

2. There are four maximisation goals shared by OEMs and dealers, viz.:

    a. Maximising the total number of vehicles sold;

    b. Maximising the aggregate sales margin over total vehicles sold;[19]

    c. Ensuring the dealer business model is sustainable, which means maximising not only dealer margins, but also the percentage of sales which proceed through dealerships rather than online. This is important to manufacturers because dealers will remain a significant sales channel into the foreseeable future, and because the after-sales experience remains important, including with online sales;

    d. Maximising customer satisfaction, which adds value simultaneously to the marque (franchisor) and the vendor (franchisee), increasing the probability of future sales;

3. The principal limits on the numbers of cars sold in a given year are:

    a. General economic circumstances (consumer confidence, cost of finance and economic capacity to purchase a new vehicle);

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[18] https://www.eagersautomotive.com.au/wp-content/uploads/2021/04/Annual-Report-2020.pdf p.14. Accessed July 2021

[19] There is some competition between the first two goals, as there is a point where discounting will lead to higher sales volume, but lower aggregate margin. This is a strategic question, choosing between market share and profitability. As a strategic question, and given that dealer income is a function of overall sales income, the incentive is aligned.

b. The availability of new vehicles (currently constricted)[20]; and,

c. The relative price differences between new and used vehicles.

This is a simple model, but one which allows interrogation of the impact of likely variations to traditional franchise models. The main two of these are: agency models; and, direct online sales.

Impact on Economic Footprint

Evaluate has not undertaken a comparable assessment to the AADA calculation of economic footprint for the Australian car industry, which leads to the claim of a $12.76 billion footprint. It is not entirely clear how the multipliers are calculated, or how much of the industry is included. It is noted that by including apprentices in employment data, this is likely to include the service component, which seems independent of the franchising question, and also competes with non-franchise businesses. It may also include finance and used car businesses which also compete in broader markets.

While the modelling remains unclear, the question is not how large is the industry, but how much of that footprint is at stake due to any change in franchising arrangements or due to replacement of one franchisee with another.

The shared maximisation goals outlined above are important here: franchisors/manufacturers are not interested in models where fewer vehicles are sold or market share is attenuated. While as noted there may be some strategic interplay at the margin between volume of sales and prices, this should not affect the overall scale of the industry.

An important principle here is that – with the exception of the extreme high end of the market, all motor vehicles have multiple close substitutes. This is to say that:

- The consumer decision to purchase a new car – whether private or corporate – may have initial marque and dealer preferences based on perceptions or experience, but are also highly price elastic and open to persuasion and the influence of good service;
- Consequently, there is no coherent argument that the total number of vehicles sold is somehow related to the franchise conditions under which dealers contract with manufacturers; so,
- The economic footprint is not at stake from any fanciful notion of a reduction in the number of new cars sold.

What restrictions on franchise arrangements – particularly ambit claims such as tenure, which remove the prospect of competition for franchises – would do is reduce the level of market competition, particularly for large multi-brand dealers, at the expense of consumers.

[20] By factors ranging from global transistor shortages, through the Suez blockage, to COVID-related increases in shipping costs

At the same time, there is no evidence that demand for used vehicles, light commercial vehicles or vehicle finance would be reduced by changes in franchising conditions.

Deadweight Losses

It is universally accepted that there are economic costs of increased regulation. These are the costs of distortions to the market, which direct capital flows away from normal equilibrium, and are generally known as deadweight losses. Increased protection of one retail sector (in this case new car sales) will make investment in this sector more attractive than other more productive industries, which creates a loss to the economy as a whole.[21]

This is inefficient, and is beneficial to neither the consumer, nor to the Australian workforce. In practice it creates a rent, which will inevitably be at cost to the consumer via higher retail prices.

The Agency Model

For the purposes of this paper, Evaluate takes the fundamental nature of the agency model to include four common elements:

1. The prices of individual vehicles would be set by the manufacturer/franchisor and would be independent of which dealer sold the vehicle;
2. All stock, whether or not it is on an individual dealer's floor, would be owned by the franchisor, and would no longer be wholesaled to dealers for resale;
3. Consequently, any vehicle, whether allocated to an individual dealer's showroom floor would be available for sale by any dealer anywhere in Australia; and,
4. Franchisors will no longer require marketing spend by dealers, but will undertake all marketing centrally, in consultation with their franchisee network.

There are likely to be individual variations to this model, including detailed questions such as treatment of demonstrator stock, and how costs of delivery are managed.

The issue of marketing spend is an example of alignment between franchisors and franchisees, as the maximisation goal around number of cars sold is common to both parties.

Benefits to Consumers

The agency model is consistent with emerging practice in multiple product markets, including whitegoods and electronic devices, where there is a single price regardless of sales channel. It is a model developed to meet the preferences of consumers, who are well-aware that vendors have more information than them.

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[21] This is economically distorting for the dealer, who faces a lower opportunity cost from alternative investments because protection measures reduce competitive risks in the automotive market

As a signal, it allows consumers to properly distinguish between different products on the basis of quality relative to price because:

- Price is no longer a variable; and,
- The value for money equation is consequently more linear and less confusing.

The interest of the manufacturer in a market with multiple close substitutes is to match price to value, and to compete for market share, which obviates the risk of economic rents. In practice, the manufacturer's equilibrium strategic position is to set the price of a vehicle at the mean real sales price currently prevailing for vehicles of that marque and class across the market.

Anchoring the manufacturer-set price to the mean sales price which would otherwise prevail means that there is no change in the price component of aggregate consumer surplus. Where the changes do occur is in reassurance, and the broader car-buying experience, which are sources of consumer utility.

The term 'mean sales price' is used because of the problem of market asymmetry. While this is less significant in the new car market than the used car market because quality is clearer,[22] there is little capacity for the average consumer to discern the true price of a vehicle. This is due to three factors, viz.:

1. The absence of a clear market price, which a manufacturer price under an agency model would establish;
2. The complexity of understanding the relative value of variations, including engine type and capacity, and different packages of appointments for a common vehicle platform; and,
3. The particular ambiguity which emerges with trade-ins, where asymmetry is magnified by consumers' simultaneous lack of knowledge of either: the value of the trade-in vehicle; or the price of the new vehicle.

The last issue is particularly fraught. While most dealers also operate a profitable used car business, only a small share of that potential profit will be passed on to consumers in the trade-in value. This is an additional source of industry surplus, in part guaranteed by the distaste most consumers have for selling a car privately.

In the agency model, consumers know both the total price and the value of their trade-in, as the latter is simply the difference between the manufacturer price for that vehicle, and the amount paid by the consumer.

For many consumers, this is a source of utility, removing the doubt that they have paid more than market value for their new vehicle, or that they have been insufficiently credited for their trade-in. For these consumers, the asymmetric wholesale model is a discount to consumer surplus. An important observation

[22] For the seminal commentary on this issue see: George Akerlof, "The market for lemons: quality uncertainty and the market mechanism", *The Quarterly Journal of Economics*, 1970

here is that there is room – in improving the purchase experience – to increase consumer surplus while making no reduction in aggregate seller surplus. This is not a zero-sum game.

Evaluate notes that there may also be a group of consumers who enjoy the game of matching wits with car dealers. However, the decision by any given manufacturer to move to any agency model will take this into account, and will only make sense where maximisation goals are supported by the move: this would imply that for the given marque, a majority of consumers would prefer the new single-price approach. Otherwise, manufacturers should prefer to stay with a wholesale model.

As a note here, consumers who believe their negotiating capabilities give them the edge over the vendor are deluding themselves. Capacity to negotiate is first and foremost a function of information, and it would be a unique consumer who is better informed than dealership staff regarding the price at which a vehicle is available.

Consumers also benefit under agency from access to a greater range of vehicles. This is particularly significant for those who live in less population-dense regional areas, and who currently need to shop out of area to obtain the specific vehicle they prefer, or otherwise settle for an imperfect substitute.

For those regional consumers, there is the attendant benefit that their dealer will now also be their service agent, which should lead to relationship benefits and preferential service pricing.

The ultimate consequence of this shift is that dealers will now compete for custom not principally on price, but on service, and any included extras. This is a consumer benefit in that it will radically improve the buying experience, reducing pressure and uncertainty, and the stress of negotiation.

Effects on Dealers

The principal concern amongst dealers in relation to the agency model is in direct conflict with the attainment of consumer benefit: there is a view that the part of profit which derives from information asymmetry and the profession of negotiation will be reduced.

In economic terms this is a rent which comes from information asymmetry. It is not an overall economic benefit, and any restriction on agency models justified by this argument would be protecting suppliers to the cost of their customers. It is also a source of deadweight loss, as it is inefficiently redirecting some share of consumer expenditure from other productive economic activity toward this rent.

However, the nett outcome if agency commission rates are simply mean wholesale margins discounted by reduced costs should be the same, as the fixed price will approximate the mean real price. To this extent, it is only the double-asymmetry which comes from simultaneous ambiguity of the sticker price and the trade-in price which is removed.

The most important benefit which is shared between dealers and consumers is the levelling of a competitive playing field by introducing access to the full range of available stock. This is again particularly important to dealers in rural and regional markets who will no longer see such a large proportion of local customers purchase new cars from capital city dealers, simply because they offer a broader range.

Again, it is notable that this has no impact on the total economic footprint of sales, but will likely increase the share of that footprint which occurs outside the major centres.

This still leaves room for selling outside a dealer's local area: improved service and relationship management should be effective in attracting more distant customers, particularly repeat customers; and the scale benefits associated with capital city dealerships should still mean better offers for trade-ins, as they have access to larger markets for used vehicles.

The context for any change from current wholesale arrangements to an agency model is important. Motor vehicle industry profitability in Australia has been on a steady decline for several years; specifically, while services & parts and used car profits have been trending upwards, these have been offset by steady declines in new car profitability. This is caused by changes in demand and levels of competition.

The other important context is that most agency models will only apply to new passenger vehicle and light commercial sales, where the likely impact on a dealer's overall profitability will be small, primarily because the contribution made to a dealership's profitability by the sale of new cars is small. In 2019, for example, for the 30% of the best dealers in Australia it was 4%.[23]

Selling gross Profit Orientation - 2019	
New Cars	4%
Used cars	8%
Finance and Insurance	20%
Parts	22%
Service	45%

Finally, arguably the most important context is that under an agency model, manufacturers only set the price for new cars: they do not determine the price for a trade-in; nor for insurance, finance or accessories not supplied by the manufacturer. This suggests that dealers are likely to continue to yield a substantial amount of flexibility in deciding the nett price to offer a potential customer.

While the model may be implemented somewhat differently in the arrangements established between different manufacturers and dealers, the benefits to the latter generally are likely to include:

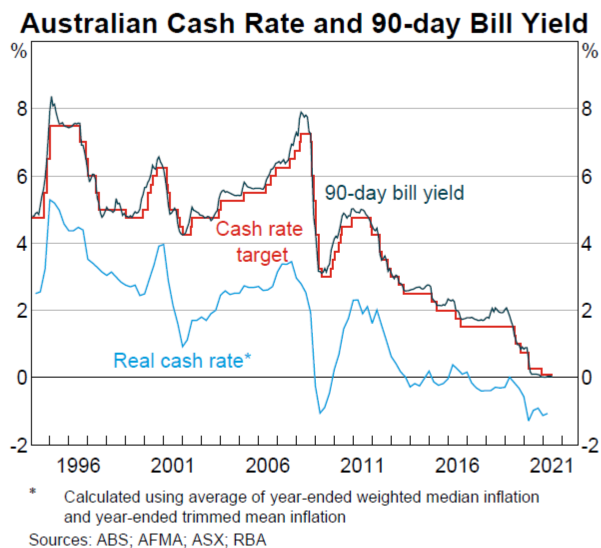
[23] Based on the 2020 Deloitte Motor Industry Services Dealership Benchmarks for the Australian car market.

- Reduced retail costs, including floor plan costs; costs associated with non-showroom stock storage; and costs of owning demonstrator vehicles;
- Elimination of some supply chain duplication, in particular in marketing, business optimization and process improvements, and,
- The transfer of certain risks (and costs) to the manufacturer, including for freight, insurance and finance.

A key cost and risk that is substantially reduced by the shift towards an agency model is the speculative risk associated with attempts to optimise a dealer's floor stock, given that any vehicle—whether or not allocated to that dealer's showroom floor - would be available for sale by that dealer. Inventory management is a key risk for any dealership. A US Federal Reserve Board paper, for example, indicates that since the 1960s, "average inventory holdings at auto dealerships often have exceeded levels consistent with 65 days' supply—and this ratio has changed little, on average, over the past several decades."[24] The inventory-sales ratios observed in the motor vehicle sector are high relative to most other industries in the retail sector. To give a sense of the scale of this at the macro level, the Paper notes that *"inventory investment for new motor vehicles can quite easily subtract more than half a percentage point to the quarterly growth rate of U.S. gross domestic product (GDP)."* Evaluate has not seen evidence of attempts to quantify inventory cost data in Australia, but there is no reason why it might be substantially different from that of other markets.

Similarly, while finance may appear not to be material, at least in the current low interest environment, but it is worth remembering that interest rates have not always been as low as they are currently (as noted in the figure below), and will ultimately return to their long-run trend.

[24] Wendy E. Dunn and Daniel J. Vine, Federal Reserve Board), Why are Inventory-Sales Ratios at U.S. Auto Dealerships so High?, Washington D.C., 2016



Evaluate understands that what economists view as risk, some dealers may see as opportunity, and that the very broad range of weighted average cost of capital (WACC) values for different dealerships makes the current model for some dealers a source of competitive advantage. It is difficult to see how WACC differentials will change under an agency model, but for a given turnover the lower capital requirement for a now less capital-intensive business will increase dealer return on equity (ROE), regardless of capital structure or the cost of capital.

There are likely to be some transitional impacts, that may have a negative short-term effect on profitability. As the agency model impacts the entire sales process, one-time investments in technology, business processes, and organizational structures are likely to be needed. These are not considered to be substantial, however, nor long-lasting. While some inventory management systems may become redundant, for example, these are effectively sunk costs, not forward losses. They require no replacement due to the new model, and are likely to remain useful in any case for second-hand and non-passenger vehicles.

The long-term trend is expected to reverse the short-term effects, resulting in a positive impact on profitability. This is because the model is not only focused on optimizing the cost of retail relative to existing revenue levels across all sales channels, but also because it is expected to enable more effective data-driven decision making to drive increased revenues.

Any suggestion that the long-term trend will result in reduced profitability for agents must presuppose that the new arrangement fundamentally changes the commercial dynamics that enable current wholesale margins to be set. This will include not only the establishment of margins which permit a reasonable expectation of return, but also the inclusion of outperformance incentives to drive and reward exceptional dealer performance.

As mentioned, manufacturers in a market with multiple close substitutes will be compelled to set the price of a vehicle at the mean real sales price currently prevailing for vehicles of that class across the market. Consequently agency commission rates will only vary from mean wholesale margins by the amount of any reduced costs.[25]

There is no reason why manufacturers should increase bargaining power under an agency arrangement, especially in a market with multiple close substitutes, which provides choice to dealers/agents if they are unable to negotiate preferred commercial arrangements with specific manufacturers.

Based on implementation experience elsewhere, Capgemini[26] notes that dealers will ultimately benefit from the new customer insights that become available along the whole sales funnel, in turn helping to expand volume by improving customer satisfaction. They expect more effective data management to yield benefits including optimized sales promotions throughout the entire customer lifecycle and upselling enabled by customer insights realized at multiple points in the lifecycle.

Direct Online Sales

One of the key drivers of manufacturer desire to move to agency arrangements is to improve customer experience, by changing the character of the interaction between consumers and dealers. There is a concomitant benefit to dealers from this as the improved retail experience will limit the growth of alternative channels such as we see in markets such as the United Kingdom.[27]

However, unlike the agency model, the prospect that manufacturers will increase their direct online sales at the same time as agency is introduced, is a real issue related to the value of a franchise.

The argument here is that there is a particular segment of the community who – despite the new experience which comes from agency – will prefer a direct sale to any engagement with a dealer. If this segment grows – as it has for other goods – then the expected share of market for dealers will reduce over the life of the franchise.

At the same time, and looking at the issue from a game theoretic perspective, there could be an incentive for the manufacturer as director of marketing spend to skew trade toward the higher margin online model. While this is constrained by the manufacturer goal of ensuring sustainability of traditional dealer channels, it presents some uncertainty at the margin.

It seems difficult to codify solutions to this problem, and to restrict it would be another discount to consumer surplus. At the same time, if regulation were – for example – to prohibit online sales of marques with franchisees, this would magnify costs by directing the part of the consumer base who prefer online purchase to newer online-only marques.

[25] For example, savings on marketing spend, or the cost of inventory maintenance
[26] Capgemini Invent (2020), Agency Sales Model: Accelerating the future of automotive sales
[27] See for example: www.cars2buy.co.uk Accessed July 2021

From Evaluate's perspective, where this issue intersects with the question of franchise value is in the capacity to realise an appropriate return on expenditure within the term of the franchise. Accordingly, it is best resolved in good faith within franchise agreements, which could specify from the outset:

1. Expected share of customer migration to online channels during the term of the franchise;
2. Under what conditions vehicle delivery will occur (i.e. will it be separate, or via the dealer network);
3. What happens in terms of margin or commission variously with:
    a. Dealer-originated leads who ultimately purchase online (and vice versa);
    b. Margins or commissions associated with dealer delivery;
4. Arrangements to address any perverse marketing incentives (typically a committee involving franchisees as occurs at the moment should resolve this problem); and,
5. In line with the earn-out requirements of the revised Code, clarity as to how this is compensated (or not) where the online share is substantially higher than predicted.

This is consistent with upfront disclosure requirements.

Looking back to the overall economic footprint of motor vehicle sales, the shift to online should be immaterial. If jobs are lost in dealership sales positions, then they will be required elsewhere to satisfy new online sales. The overall number of vehicles sold should be unaffected. And there is no impact on demand for service, finance or used vehicles.

The other prospect if the market is allowed to operate efficiently, is that there will be an increase in consumer surplus which will lead to higher consumption of vehicles over time, which would be economically beneficial for all participants. This allows for simultaneous increases in the aggregate of both seller and consumer surplus.

Tax Considerations

As part of this brief, Evaluate was asked to address the claim in some quarters that online direct sales lead to reduced tax revenues, as tax-planning by overseas manufacturers comes into play.

As a general response, international tax-planning is an issue across multiple industries, and one which has been resolved by Government via legislation, agreements and enforcement. In relation to this, two other cases are noted:

1. The risk and solution would differ in no way from online-only sales businesses, who as noted would be the principal beneficiaries of any online restrictions; and,
2. The argument would be logically extended to prohibit foreign investment in any Australian business, including car dealerships, purely because tax planning is different.

Evaluate does not assume that Australian car dealers are averse to their own tax planning strategies, and anticipates that there is not a concurrent call for extra regulation to address this. Finally, it would make no sense to restrict consumer surplus because of any concern about tax revenues. There are more effective and less costly remedies available.

Specific Proposals in The Consultation

Following from the general review of economic questions, in particular the adequacy of the code as amended, this section comments formally on the proposals to be considered in the consultation.

As a preliminary to this section, it is further noted that the Government's policy interests in raising these questions are to:

- Ensure appropriate protections for automotive dealerships from unfair contract terms in their agreements with manufacturers;
- Consider the merits of a standalone automotive franchising code; and,
- Consider options to achieve mandatory binding arbitration for automotive franchisees.[28]

It is Evaluate's view that the July 2021 amendments to the Code strike a strong balance between the interests of manufacturers, dealers and consumers. It is worth noting that these 2021 amendments themselves followed the introduction of an automotive part to the Franchising Code a year earlier, on 1 June 2020 (the first time a sector specific part of regulations had been included in the Franchising Code), and the announcement of the voluntary best practice automotive principles on 11 December 2020.

It would be both normal and sensible to allow these various amendments to play out in the market to test their effectiveness before rushing to further regulation. To do otherwise would mean no new evidence had been gathered to test the adequacy and effectiveness of the amended regulations. This is not good regulatory practice. Further, the continuing policy interest in this area, as evidenced by the consultation and the Government's public commentary, will be effective in placing manufacturers on notice that it is the spirit, and not just the letter of the Code which should be observed.

A Standalone Code

As noted in the consultation, there is a fivefold test for prescribing industry codes, of which a standalone automotive franchising code would be one. These are:[29]

1. A clearly identified market failure;
2. A problem that can't be addressed using existing regulation;

[28] Consultation paper, p.5
[29] Australian Government Treasury, "Industry Codes of Conduct Policy Framework", Canberra, 2017 https://treasury.gov.au/publication/p2017-t184652 Accessed August 2021

3. Self-regulation has been attempted and failed;
4. Evidence that a code is the most effective solution;
5. Public benefits that outweigh the cost of regulation.

In the *Industry Codes of Conduct Policy Framework* from which these are taken, it is accepted as a general proposition that markets should be allowed as a first principle to operate competitively, both so that capital will flow to the most productive parts of the economy, and to maximise consumer benefit.[30]

In this *Framework*, Treasury further notes that there are two key sources of market failure, viz.:

1. Asymmetric information; and,
2. Imperfect competition.

The first of these appears to be moot. As a specific example of solving an asymmetric information problem, Treasury notes:

"Asymmetric information occurs where market participants do not have access to the same information. This prevents parties from making informed decisions and bargaining on a level playing field. For example, the Franchising Code requires a disclosure statement be provided to prospective franchisees so they can make a reasonably informed decision about entering into a franchise agreement."[31]

This type of pre-disclosure is the soul of fair franchise negotiations, and is now comprehensively addressed in the additional automotive schedule of the Code. Consequently, information asymmetries provide no argument for a standalone code.

On imperfect competition, Treasury believes this occurs where:

"Imperfect competition occurs when there are relatively few producers compared with the number of consumers (or suppliers compared with retailers) in a market, or vice versa. This can result in an imbalance of bargaining power between the parties. Where this occurs parties may be unable to negotiate a fair contract. For example, the Food and Grocery Code of Conduct sets out minimum terms to be included in a grocery supply agreement and requires retailers to adhere to minimum standards of behaviour, such as placing restrictions on the ability to retrospectively or unilaterally vary contracts."[32]

This is highly informative on multiple fronts. First, there is a question of competition which arises from the ratio of prospective sellers (in this case manufacturers) to buyers (dealers). Evaluate is informed that there are 56 separate manufacturers from whom Australian dealers may source vehicles,

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[30] Ibid., p.8
[31] Ibid.
[32] Ibid., p.9

Looking to market breakdown, the principal test of a competitive market is the Herfindahl-Hirschman Index (HHI) which provides a score out of 10,000 (a monopoly) to indicate the level of market share concentration.[33]

Two calculations for HHI have been made, based on actual sales data for 2019,[34] which is the most recent 'normal year':[35]

1. For all passenger vehicles across all marques, the HHI is 1027.9; and,
2. For SUVs, which are the most ubiquitous class of passenger vehicle by number of manufacturers, the HHI is even lower at 782.5.

For a product with such high R&D costs, this is a highly competitive market, both for dealers, and for consumers. This level of competition is particularly important for consumers, because a lower HHI is associated with higher consumer surplus.[36] This intuitively makes sense, as consumer power increases with seller competition.

However, two hypothetical arguments might conceivably be offered in support of greater market restriction, neither of which Evaluate believes is credible.

The first of these is that some franchisees operate only in sub-markets and are therefore more vulnerable. This is in the first case a matter of business strategy and risk management, as the particular vulnerability is more to do with shifting market preferences than supplier arrangements. Further, the market – particularly for larger dealers – is characterised by multi-marque sellers.

In either case, every sub-market has multiple good substitutes. Even at the most rarefied end of the price scale, there are several manufacturers with whom dealers can enter into franchise agreements.

Second, it might be posited that the limited number of franchises available for each marque creates a competitive imbalance. However, this would be an argument for lighter regulation to permit more franchisees, a circumstance which would increase relative consumer power, but would obviously be unattractive to dealers.

In practice, the limited number of franchise spots will likely be guaranteed by the increased requirements to a reasonable expectation of earn-out during the life of the franchise.

The conclusion here is that neither information asymmetry nor imperfect competition indicates the type of market failure which Treasury specifies as the threshold for a standalone industry code.

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[33] The HHI of a market is calculated as the sum of the squares of all market shares by percentage. So: a market with one supplier means 100% share squared = 10,000; whereas a market with 100 suppliers each having an equal share will have an HHI of 100*1% share squared = 100

[34] Data supplied by FCAI

[35] Without COVID, the Suez blockage or the transistor shortage. However 2020 and 2021 are only marginally different.

[36] Yossi Spiegel, "The Herfindahl-Hirschman Index and the distribution of social surplus", SSRN, July 24, 2020

Are there other market peculiarities?

The consultation notes that dealers assert four conditions which profoundly distinguish their operations from other franchisees or traders in Australia, viz.:

1. Association with off-shore multinational corporations;
2. Significant up-front capital investment required for establishing a franchising business;
3. Dealers tending not to pay franchise fees or other financial payments to franchisors; and,
4. Longer-term after-sale interactions with customers.

Given the increasingly limited nature of Australian manufacturing, the first of these does not appear in any way to be a distinguishing feature of the market; on the contrary, it seems no different from a vast array of other Australian resellers of imported products, from fridges to telephones to food products. It is a species of broader arguments against globalisation and free cross-border trade, which are anathema to current Australian Government policy, and would be highly deleterious to Australian exporters.

The issue of up-front capital investment (improvements) required for establishment of a franchising business is well-addressed in the new earn-out requirements. It differs from other franchising businesses only in scale. The amendments also include a clarification that the Franchising Code's protections apply to dealerships operating under agency models. It is therefore not at all clear what residual risk to franchisees remains that warrants further consideration.[37]

The currently dominant model of wholesale purchase and resale by dealers is less common in other franchising models, though it is common outside franchising, for example in whitegoods retailing. It is likely that automotive retailing will follow other technology businesses in a migration toward more common agency models, which attack the problem of dealer-consumer information asymmetry, and this will mean new franchise agreements differ from expired franchises.

However, it is not clear why either model argues for a standalone code. This is a matter of stock management and business risk (which are reduced in agency models), and which is common to all businesses, whether franchises or not.

The final point about long-tail relationships is somewhat ambiguous. It is understood that dealers have an interest in ongoing customer relationships, both for new car sales, and for after-sales activities such as servicing. However:

- These activities are offered in competitive markets. While some servicing may be packaged with a vehicle sold, this is not part of the franchise agreement, so seems irrelevant; and,

[37] Importantly, it should not include either land, which is useful to alternative businesses, nor parts of the business which are not dependent upon specific marque new vehicle sales

- Warranty liabilities accrue to manufacturers, not dealers, which is notably even more clear under the agency model.[38]

While the departure of General Motors is lamentable, it is worth reflecting on this as a model for the longer-tail relationship: any costs to consumers associated with this departure (e.g. from inability to trade within the same marque) are in practice due to the end of manufacture, not the closure of franchises. These issues should be clearly distinguished.

It is not Evaluate's view that the distinct features claimed by the dealer sector justify a standalone code. The maintenance of an automotive schedule into the overall Code seems a more balanced approach. Consequently, Option 1 to amend the relevant schedule of the Code 'as required'[39] is recommended.

Mandatory Binding Arbitration

Evaluate expresses no legal opinion in this paper, but notes that the Franchise Code is frequently tested in the Courts, and sees no reason why there should be any prior mandatory binding arbitration. In saying this, three factors are taken into account:

1. There is now the option of voluntary binding arbitration within the Code, which gives manufacturers and dealers the option of fast resolution for agreed questions;
2. Beyond this, courts will encourage non-judicial solutions to disputes. Creating a quasi-judicial adversarial alternative undermines this; and,
3. Inevitably, any proposed arbitration is only binding to the extent it may then be tested by appeal in the courts. Any attempt to limit this would seem to circumvent the fundamental nature of Australian Government, by violating the separation of powers doctrine. This is noted in the consultation paper. In any case, it is assumed that dealers – like manufacturers – will not want their rights of appeal constrained.

Consequently, this would seem to introduce the prospect of increased legal costs and time to resolution for some problems, and weaken the prospect of goodwill where voluntary arbitration is possible. It will inevitably weaken the relationship between manufacturers and dealers, by making it more adversarial.

It is worth considering what supposed problem mandatory binding arbitration is trying to address. According to the Discussion paper:

- Mandatory binding arbitration for automotive franchises is premised on the need to 'address a power imbalance when there is a dispute'; since,

[38] Currently Australian Consumer Law responsibility falls to dealers, but it is typically indemnified by the manufacturer. This would be simplified under an agency model

[39] Consultation Paper, p.8

- Franchisors are assumed to be able to ‘leverage the power imbalance as part of the mediation process to achieve settlement, knowing the franchisee could not afford a long court process.’

Presupposing a power imbalance makes no sense. If, as suggested before, this has something to do with the relative size of off-shore multinational corporations relative to resellers of imported goods, then why single out automotive manufacturers for special treatment? It is more reasonable to conclude that manufacturers do not have such power, since Australian dealers can source vehicles from a large number of manufacturers. The reliance of longer-standing manufacturers on effective dealer networks is significant, and there is no alternative short-term business model. Thus, any leverage the latter are assumed to have over the former may be illusory.

Pre-Contractual Arbitration

The issue of pre-contractual arbitration is quite separate from mandatory arbitration, as it is proposed as part of the process of negotiating prior to a contract, rather than for resolution of disputes arising from performance within a contract.

The templates for pre-contractual arbitration seems to be of two types:

1. Agricultural products, such as the Sugar and Wheat Codes; and,
2. The treatment of intellectual property in the media bargaining code.

It should be noted from the outset that: none of these involves a franchise; and each of them is about ensuring fair negotiating rights for producers (of grains, sugar and content) against large intermediaries, in circumstances characterised by genuine imbalances of power. This latter point is the exact opposite of the situation imagined here. And with respect to the business model, it is inapposite to equate seasonal supply contracts with multi-year franchise agreements.

However, it is useful to make clearer distinctions on the justifications for different codes. First the *Port Terminal Access (Bulk Wheat) Code of Conduct* has an object of ensuring that owners of monopoly infrastructure allow fair and transparent access by wheat exporters to ports.[40] Monopoly ownership of access infrastructure is the source of power imbalance here. No facet of this is replicated in automotive franchising contract negotiation, as there is no monopoly infrastructure in play.

The objects of the *Competition and Consumer (Industry Code—Sugar) Regulations 2017* are a little broader, regulating contracts with millers and others in the supply chain, but again designed to protect growers.[41]

It requires something of a leap of faith to compare franchise motor vehicle dealers with small primary producers dealing with monopoly infrastructure operators. As discussed at length above, the nature of the firm, the competitive environment and the issues at question are radically different.

[40] https://www.legislation.gov.au/Details/F2014L01250 Schedule 1, Part 1, Section 2 Accessed August 2021
[41] https://www.legislation.gov.au/Details/F2017L00387 Schedule 1, Part 1, Section 2 Accessed August 2021

It is particularly difficult to argue that the type of protection required for growers when they already have a crop which might spoil, is equivalent to pre-franchise bargaining, from which both parties can walk away without loss. The time sensitivity of negotiations is a key source of power imbalance here. It is wholly absent in negotiations between dealers and automotive manufacturers.

Other than their inclusion of pre-contractual arbitration (for industry-specific reasons) these codes are not instructive.

The media bargaining code which comes from the *Treasury Laws Amendment (News Media and Digital Platforms Mandatory Bargaining Code) Act 2021*[42] is a different creature. It is designed to ensure fair value for the reuse of Australian-originated news content by online digital platforms.

In practice, this is a complement to the copyright law. It is necessary because republishers of content – particularly those offshore – are insufficiently threatened by existing Australian copyright law to treat fairly with Australian originators. Previously, the expected costs of breaching Australian copyright were lower than the costs of fair dealing. This mismatch is the source of power imbalance here that warrants regulation.

Copyright is a different form of intellectual property from trademarks, which are licensed in franchising. The former is designed to create rights to what would otherwise be non-rivalrous goods[43] whereas cars are a combination of patents and trademark protection. However, it is notable here that many of these proposals – including apparently pre-contractual arbitration – seek to invert the intent of the media bargaining code: they are designed to increase the power of resellers, in turn diminishing the value of original intellectual property.

What the agricultural and media codes share – and what presumably justifies the requirement for pre-contractual mediation – is that a nominally vulnerable market participant has created a product, and the expectation of reasonable producer surplus is at risk. There is no analogue in the case of a franchise: until a franchise contract is agreed, there is nothing at risk: where both parties may walk away or treat with alternative suppliers, the prospective value of pre-contractual mediation seems unclear.

Extension to Other Vehicle Categories

This is a question which requires extensive modelling beyond the scope of this paper, and Evaluate is unaware of such modelling in the Australian market.

What should be particularly taken into account in answering this question is that regulation of commercial vehicles has a more significant flow-on effect to the general economy: the costs of protecting distributors of passenger vehicles is simply a reduction in consumer surplus to the end-purchaser; whereas increased costs to small trade businesses or large transport businesses are costs which will be passed on and magnified in broader supply chains. This is not to suggest that we should trivialise the economic value of

[42] https://www.legislation.gov.au/Details/C2021A00021 Accessed August 2021
[43] In practice, news content is infinitely replicable at no cost

the reduction in consumer surplus arising from the current regulatory environment, but rather that we should understand fully the consequences of extending it.

Evaluate appreciates that there is overlap here, between larger-capacity passenger and small commercial vehicles and for categories such as dual-cab utes. As a simple observation, what is supplied and sold within a passenger vehicle or light commercial franchise can be easily delineated from a heavy commercial vehicle franchise, and using this delineation should limit any undesirable and unanticipated economic costs.

However, the investigation of this question goes well beyond what is feasible in a 30-day policy consultation. This question would be best referred to the Productivity Commission or a similar competent body.

Conclusion: sustainability for all market participants

This paper supports the view that the most recent changes to the Franchising Code of Conduct are more than adequate to protect the economic interests of both individual dealers, and the overall industry footprint.

The proposed additional changes read as an ambit claim to protect the sales and distribution businesses of the sector from market forces and emerging trends in motor vehicle consumption.

This will inevitably come at cost to the consumer. In the first place, this is because the level of red tape and uncertainty which comes from novel rights for one section of the market is an increased cost to manufacturers, who cannot be expected to absorb it. Consequently, it will have an inflationary effect on the price of new cars, which is a simple cost to consumers and a source of deadweight loss.

Further, by attempting to constrain details of franchise agreements, the desires of consumers to purchase cars with the same level of flexibility that they purchase other goods is restricted, transferring value from buyers to sellers. The particular value of the agency model in reducing information asymmetry and improving consumer surplus is important here: it offers greater satisfaction and customer experience at the same mean price.

Finally, it is worth noting that sound regulatory practice would allow the current changes to play out in the market to test their effectiveness before rushing to further regulation. On the other hand, as the experiences of other sectors, such as energy, have painfully borne out, regulatory uncertainty inhibits long term investment, thereby constraining the sector to adapt to changed circumstances.

This offers some useful parallels here. Consumer requirements are changing – they are increasingly demanding multiple delivery channels for their purchases, both domestically and internationally. Industries that have responded to these customer requirements have benefited: whereas those that have not, have suffered.

Although proposed future vehicle sales models offer both a wide range of potential savings and an effective response to changing customer requirements, they cannot proceed without substantial initial investment in technology, business processes and organisational restructuring. The required investment is unlikely to be

forthcoming, however, in an environment characterised by unsettled and constantly changing rules and regulations.

In short, the motor vehicle sector in Australia can operate with its current economic footprint, with more satisfied customers. Producer and consumer surplus are not zero-sum games, particularly as there are elements of both price and experience in play. Happier consumers are repeat consumers, so ultimately, a more flexible industry should lead to higher average sales over time.

FCAI Submission to Parliamentary Committee on the operation and effectiveness of the Franchising Code of Conduct

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EXECUTIVE SUMMARY

1. This submission is made by the Federal Chamber of Automotive Industries (**FCAI**), on behalf of itself and its members who distribute passenger motor vehicles, light commercial vehicles and SUVs (new motor vehicles), in response to the Parliamentary Joint Committee's inquiry into the operation and effectiveness of the Franchising Code of Conduct (**Code**).

2. The FCAI is the peak industry body for the automotive industry in Australia. Its members include all of the major importers of new vehicles in Australia (**Distributors**).

3. Unlike other franchise models, within the automotive sector there are a number of unique aspects to the relationship between a Distributor and a dealer, which means that it is not a "true" franchise. Motor vehicles dealerships are however included within the definitions of what constitutes a franchise in section 5(2) of the Code. Distributors have accepted the applicability of the Code and have incorporated the requirements outlined in the Code, into their contractual dealings and day to day operations.

4. Whilst the Oil Code of Conduct (**Oil Code**) is not directly relevant to the automotive industry, we acknowledge the similarities between it and the Franchising Code of Conduct; in particular, both codes aim to assist participants to make informed decisions when entering, renewing, or extending dealer/fuel-reselling agreements, amongst other things.

5. Given the complex nature of the relationship between Distributors and dealers, the current legislative framework and the enhanced powers of the ACCC effectively protect the interests of the participants in the automotive industry.

6. The ACCC's newly released market study, into the new car retailing industry, identified the sector as a "significant sector of the Australian economy" not only due to the fact that there are 3500 retail outlets, but that the revenue generated by car dealers in 2016-2017 was estimated to be $64 billion[1]. Any proposed changes to the operation and effectiveness of the Code must also bear in mind the multi-dimensional economic impacts, which may be likely to result.

7. It is also important to note that over the past five years the minimum term applicable to new motor vehicle dealerships have increased to a point where nearly all agreements are for a minimum of five years often with options to renew for a further five. Coupled with a sensible approach to maintenance of the brand image through capital investment, potential dealers have a significant period of time across which to assess the legal and financial opportunities available through the prospective dealership arrangements and make an informed decision on whether or not to agree.

[1] ACCC, *"New Car Retailing Industry – A market study by the ACCC"*, December 2017, page 1.

8. The ability of the Distributor to manage the overall brand footprint in the market is a key to the health of all dealerships and the brand more broadly. From time to time, and with the increasing competitiveness of the Australian market, the network of dealers may need to be adjusted to take into account these changing market conditions. This is not only entirely appropriate, it is necessary to ensure maximum potential for overall profitability of the brand and the dealer network. The FCAI fully supports efforts to ensure that the franchise system is fair and balanced but does not support initiatives that seek to remove brand development and network management rights from the Distributor.

9. Overall the FCAI view is that the Code is currently more than adequate to handle the challenges that may arise from time to time across a very diverse set of businesses. To highlight instances of franchisee failures (whether financially or in terms of compliance with workplace laws) is not a reason to demand amendment to the Code. However, it is a reason to demand enforcement of the law as it is written.

10. If the operation of the Code on automotive dealers and Distributors is to be reviewed it would be more appropriate to do so as part of the next proposed review in 2020, as recommended by the Wein Review.

THE DISTRIBUTOR / DEALER RELATIONSHIP

1. In the automotive industry the relationship between a Distributor and its authorised dealers is not a "true" franchisor / franchisee relationship. This is primarily because, unlike "true" franchise systems, dealers in the automotive industry are not required to pay to the Distributor any upfront or ongoing franchise fees. Dealers do not pay an upfront fee to be appointed as a dealer, for the right to use a Distributor's intellectual property, or for access to the substantial goodwill in the Distributor's brand.

2. The fact that the automotive industry is not a "true" franchise is recognised in the Code itself. The general definition of "franchise agreement"[2] in the Code (which sets out the 4 indicia of a "franchise agreement") does not apply to the automotive industry. It is only because a "motor vehicle dealership agreement" is expressly deemed to be a franchise agreement[3] that the Code applies.

3. The reality is that the franchise model in its application to the automotive sector, is more akin to a distribution model, rather than a "pure" franchise.

[2] As set out in clause 5(1)
[3] By clause 5(2)(c)

4. There are also a number of aspects of the relationship between dealers and Distributors that are unique. These include the following:

Distributors have a different level of control over dealers, compared to a pure franchisor/franchisee relationship.

a. In most franchises, the franchisor has a significant degree of control over the operations of their franchisees, with all aspects of their operations prescribed (goods, services, processes, systems, staffing levels and the like) and identical from site to site. This is however, not the case in the automotive industry. Distributors have limited control over the operation of their dealers. They have very little, if any, visibility of the "back office" functions of the dealers and, by and large, dealers alone determine how to operate their dealership, which in most cases is multi-franchised (representation of multiple automotive brands).

Dealers are often large and sophisticated

b. Prospective dealers in the automotive industry do not fit the stereotype of the "mum and dad" franchisee/investor, starting a business for the first time, selling a single product or service. On the contrary, most dealers are operated by experienced commercially minded people and many are large, multi-franchised corporations. For example, AHG Limited, one of the largest dealer groups in Australia is ASX listed, has annual revenue of about $3.7 billion and employs approximately 7,500 people. As such, it is bigger than many of the Distributors with which it engages.

c. Whilst not all dealers are ASX listed companies, even smaller regional and rural dealers are financially and commercially sophisticated on the basis that they are also often multi-franchise entities selling new vehicles, used vehicles and financial and insurance products, and manage a good number of multi-disciplinary employees, from automotive technicians, to financial controllers and business managers.

d. As a result, the power imbalance between Distributor and dealer that may be present in other franchise models, is not a pronounced factor in the context of the automotive industry; in fact, the balance of power at times falls in favour of dealers.

Dealers often own key real estate

a. Unlike in other franchise models, dealers (or entities with whom they are associated) often own the sites from which the dealerships operate. In metropolitan and regional areas, dealerships are often concentrated in key strategic locations, the land holding is extremely valuable and highly sought after for various uses.

b. Unlike other franchise models, Distributors often have no step-in property rights or even rights of first refusal in relation to the sites from which the dealerships operate. In the event that the dealer is terminated, the dealer agreement is not renewed, or

the dealer wishes to surrender the dealer agreement, the Distributor loses a key strategic location which may heavily impact on the success of the brand in a geographic location. This power balance between dealers and Distributors cannot be overlooked.

The relationship is symbiotic

a. Dealers and Distributors need each other equally; without a Distributor, a dealer does not have access to vehicles or parts and without a dealer, the Distributor may not have access to key strategic locations from which its products can be showcased and/or serviced.

b. A strategically placed, well-established and multi-franchised dealer can have a substantial degree of power; if it were to cease being a dealer or did not wish to renew a dealer agreement with a Distributor, then the Distributor would suffer a significant loss in that market from which it could take many years to recover. It is also evident that where a Dealership agreement is not renewed at a particular site the Dealership more often than not quickly establishes a new brand, through a relationship with another Distributor, on that same site.

c. Distributors recognise that the relationship between Distributor and dealer is symbiotic and engage with their dealers accordingly.

d. Distributors work closely with dealer advisory councils, and discuss with matters of key strategic importance, realising that their success is dependent on the buy-in of their dealers. Generally, the dealer advisory councils are comprised of long standing and very experienced dealers, which creates a strong and highly engaged sounding board for Distributors.

FCAI RESPONSE TO MATTERS REFERRED TO JOINT PARLIAMENTARY COMMITTEE

(A) The operation and effectiveness of the Franchising Code of Conduct, including the disclosure document and information statement, and the Oil Code of Conduct, in ensuring full disclosure to potential franchisees of all information necessary to make a fully-informed decision when assessing whether to enter a franchise agreement.

The current disclosure regime is effective in terms of providing potential dealers with the information necessary to make an informed decision about entering into a dealer (franchise) agreement.

As a result of the disclosure and information statement obligations mandated by the Code, potential dealers are provided with a substantial amount of information by the Distributor. Potential dealers are also provided with a copy of the dealer (franchise) agreement. The prospective dealer then has 14 days to consider this information before entering into dealer agreement, or any associated agreement. At this point, the onus is ultimately on the prospective

dealer to read and process this information, and to obtain independent legal and financial advice before entering into the dealer agreement (see clause 10(2) of the Code) and to ask additional questions of the Distributor.

A potential dealer is not obliged, under any circumstances, to sign an agreement with the Distributor and as noted above, many established dealers have significant bargaining power.

Looking at the specific issues raised in the terms of reference, we make the following additional comments:

i. **information on likely financial performance of a franchise and worse-case scenarios:**

The Code has adequate provisions at clauses 17(1) (and clauses 20 and 21 of Annexure 1) requiring disclosure of financial details of the franchise by Distributors. Given the size and history of the Distributors operating in the Australian market, Distributors can and do provide as much information as they can to potential dealers to assist them in their decision to become a dealer.

In the automotive industry, it is extremely rare that an individual or entity would approach a Distributor as a prospective dealer without any prior knowledge or experience of the automotive industry, or without an understanding of the financial performance of the Distributor. On the contrary, potential dealers in the automotive industry often have a better idea of the issues facing the retail market because they invariably already have experience in the automotive market. Even if such information is not known, the fact that Distributors are required to provide the contact details for other dealers provides potential dealers with the opportunity to obtain such information.

Prospective dealers are also able at any time to request additional information from Distributors to support their decision-making processes and this frequently occurs. The information flow is not limited to prospective dealers, but often their representatives (legal and financial) contact Distributors should further clarification be required.

In addition, it is important to remember that a Distributor has limited control over the operations of their dealers. It is largely left to dealers as to how they run their businesses. Successful dealers are well run, dealers that fail are invariably not well run – which comes down to business management. In other words, the likely financial performance of a franchisee will depend much more on the performance of the franchisee itself than the actions of the franchisor.

ii. **information on the contractual rights and obligations of all parties, including termination rights and geographical exclusivity,**

Notwithstanding the fact that the Code currently requires disclosure about the contractual rights of all parties, dealers are also advised and encouraged to obtain legal and financial advice in relation to the terms of the dealer agreement proposed.

Since the introduction of the Code, dealership agreements in the automotive industry have been drafted with the Code in mind and as a result, contractual rights including termination, are aligned with the provisions contained in the Code.

Geographical non-exclusivity is a well understood concept within the automotive sector, in that Distributors generally do not allocate territories, but a local marketing area or prime marketing area (also known as a PMA) within which dealers should focus their marketing efforts. In fact, geographic exclusivity with time has become less relevant to the automotive industry for a number of reasons, including:

- customers have the freedom to obtain multiple quotations from different dealers (and do) and are free to purchase a vehicle from any dealership they wish, irrespective of what geographic boundary may apply to the dealership;
- dealers are increasingly using the Internet to advertise their dealership;
- most Distributors now measure a dealer's performance on total sales, not sales within a geographic area; and
- it is not in the interest of Distributors to have dealerships in close proximity as the market is generally not large enough to sustain a saturation of the same dealership type in close proximity.

iii. information on the leasing arrangements and any limitations of the franchisee's ability to enforce tenants' rights, and

A dealer's leasing arrangements and rights as a tenant are not a relevant consideration as Distributors do not typically control the sites of their authorised dealers, nor do they generally have step in rights. Further, as noted above, many dealers (or entities with whom they are associated) own the sites where their dealerships are located.

iv. information on the expected running costs, including cost of goods required to be purchased through prescribed suppliers;

An automotive dealership is a complex business and there are inherently many relevant variables. Notwithstanding this, the Code requires sufficient disclosure (at clause 14 of Annexure 1 to the Code) of expected running costs and prospective dealers, who are typically experienced in such operations, have a good understanding of what their likely costs might be.

It is common place for Distributors, like other franchisors, to have a panel or a supplier listing from which dealers may source goods and/or services relevant to the operation of the dealership. This fosters efficiencies (both in terms of fiscal and process) and safeguards the Distributor's intellectual property.

Distributor generally go to great lengths to ensure that the suppliers they engage with provide favourable terms, have an emphasis on quality assurance, product and service consistency, and have the capability to support the entire dealer network.

As Distributors are granted distributorships for Australia (amongst other regions), Distributors are generally responsible for the management of intellectual property within the region licenced to them. Consequently, Distributors are required to maintain

tight controls over which suppliers they will engage with, and a dilution of this control may compromise the value of their brand.

Goods or services which may be relevant in this context to the automotive sector may be signage, training support, point of sale displays and the like.

(B) The effectiveness of dispute resolution under the Franchising Code of Conduct and the Oil Code of Conduct;

The FCAI considers the dispute resolution processes under the Code to be effective, in that either party may initiate a formal mediation, without the need to issue legal proceedings. Whilst the process is generally effective, there is always room for improvement.

We are unable to provide meaningful comments on the effectiveness of the Oil Code dispute resolution process, as we are not familiar with the practical operation of that process. Importantly, in the case of the new motor vehicle distributors there is an established and regular pathway to discussion with dealers through the national dealer councils.

(C) The impact of the Australian consumer law unfair contract provisions on new, renewed and terminated franchise agreements entered into since 12 November 2016, including whether changes to standard franchise agreements have resulted;

The extension of the unfair contract provisions under the Australian Consumer Law (**ACL**) to small businesses has had no significant impact on the automotive industry, primarily because most dealers do not fall under the definition of a "small business".

Having said that, even if the unfair contract provisions did apply, it is highly unlikely that any provisions of existing dealer agreements would be considered to be "unfair", as prior to the appointment, the dealer has ample time to review and assess the terms of the dealer agreement, they are afforded an opportunity – and are encouraged - to seek legal advice and raise their concerns with the Distributor. Should the terms of the arrangement offered to prospective dealers not be appealing, the dealer is ultimately not compelled to sign the dealer agreement.

FCAI is strongly of the view that in the case of new motor vehicle dealerships they are business arrangements that are far removed from the original intent of the unfair contract term legislation, which was to protect those that do not have the wherewithal or opportunity to fully consider and appreciate proposed contract terms. This is not the case with new motor vehicle dealerships. Furthermore, dealer agreements are already subject to a number of similar legislative protections including:

- the Code – where a failure to act in good faith can attract a significant penalty;
- the unconscionable conduct provisions of the ACL– a breach of which also attracts a significant penalty;[4] – and

[4] Of up to $1.1million for a corporation – s224 of the ACL

- in NSW, the *Motor Dealers and Repairers Act* 2013.

The introduction of any further protections to dealers must be properly balanced against the right of Distributors to manage their businesses and their dealer networks effectively. If a Distributor is prevented from being able to properly manage its dealer network as a whole, dealers will suffer. It is in dealers' collective commercial interests for the network to provide a high quality, consistent customer experience and for it to be strong and profitable. This might mean that from time to time a Distributor has to make a decision that might impact on one or a small number of dealers in the interests of the balance of the dealer network.

(D) whether the provisions of other mandatory industry codes of conduct, such as the Oil Code, contain advantages or disadvantages relevant to franchising relationships in comparison with terms of the Franchising Code of Conduct;

Yes, it our view, the Oil Code does provider some operational advantages to suppliers within that sector, one of which is described below.

(E) The adequacy and operation of termination provisions in the Franchising Code of Conduct and the Oil Code of Conduct;

In general terms, the termination provisions in the Franchising Code are adequate and operate effectively. That is, agreements can be terminated immediately in limited circumstances, such as for breach provided that the breaching party has been given a reasonable opportunity to rectify the breach and on reasonable notice in the circumstances as outlined in the Code.

Notwithstanding our view that the termination provisions contained in the Franchising Code are adequate, the Oil Code does contain operational advantages, specifically relating to special circumstances whereby a supplier is not required to provide a retailer (in the Oil Code context) with the right to remedy a breach before proceeding to a termination. Whilst most of the special circumstances mirror the Franchising Code, the Oil Code provides suppliers with the ability to terminate a fuel re-selling agreement on the basis that there has been a breach of a provision of the fuel re-selling agreement at least three times.

(F) the imposition of restraints of trade on former franchisees following the termination of a franchise agreement;

The imposition of restraints of trade on former franchisees is not a common practice amongst Distributors in the automotive industry.

(G) The enforcement of breaches of the Franchising Code of Conduct and the Oil Code of Conduct and other applicable laws, such as the *Competition and Consumer Act 2010*, and franchisors; and

The FCAI does not consider there to be any impediment to enforcement of the Code, or other applicable laws. The ACCC is adequately resourced and has all the necessary powers required to enforce the Code, as demonstrated recently by the investigation and enforcement action taken in regard to particular issues within the retail franchise system.