

The Natural Link between Sales and Service

**An investigation for the Competition Directorate-General
of the European Commission**

November 2000

autopolis

WE BEGIN WITH AN UNDERSTANDING
EXPERIENCE ET SAVOIR FAIRE

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1. Foreword

autopolis is a strategy consulting firm specialising in the automotive industry and founded in 1993. The partners and associates have senior consulting and management experience with leading international firms both within the automotive sector and beyond.

The firm has worked with clients large and small from all sectors of the industry, throughout the world: vehicle manufacturers, systems and components suppliers, vehicle and parts distributors, service chains, financial institutions, governments and consumer associations. We are based in France, the UK and the US, and also work extensively in Asia-Pacific.

We are independent. Through the combination of the analytical disciplines of leading consultancies and of industry knowledge and experience, we create objective, in-depth appraisals of true industry dynamics, starting from the market backwards.

In tackling this assignment, we have simply looked at how the existing business system functions, at what advantages and disadvantages it has for its different stakeholders, and what alternatives already exist.

This report expresses our own considered view of the current system and of the sales/service link.

John Wormald and Vicky Gardner
Co-authors.

2. Introduction

As Regulation 1475.95 approaches the end of its life, the European Commission is examining whether and how to replace it. As part of its preparations, the Directorate-General for Competition asked autopolis to help deepen its understanding of one of the foundations of the current Selective and Exclusive Distribution System (SED). This is the claim that there is a natural link between the selling and the servicing (taken to include necessary repairs) of road vehicles.

Recital 4 to Regulation 1475.95 states:

The exclusive and selective distribution clauses can be regarded as indispensable measures of rationalisation in the motor vehicle industry, because motor vehicles are consumer durables which at both regular and irregular intervals require expert maintenance and repair, not always in the same place. Motor vehicle manufacturers cooperate with the selected dealers and repairers in order to provide specialised servicing for the product. On grounds of capacity and efficiency alone, such a form of cooperation cannot be extended to an unlimited number of dealers and repairers. The linking of servicing and distribution must be regarded as more efficient than a separation between a distribution organisation for new vehicles on the one hand and a servicing organisation which would also distribute spare parts on the other, particularly as, before a new vehicle is delivered to the final consumer, the undertaking within the distribution system must give it a technical inspection according to the manufacturer's specification.

The link between sales and service is an important aspect of the system by which vehicles are sold and supported in service. But it is only one aspect of that system and must be viewed in the context of the whole system, under all its aspects. This can be seen in the arguments put forward by the industry for the maintenance of the current system, which have been summarised as follows:¹

- Automotive goods are unique
- A free-for-all in distribution is unsuitable
- The Selective and Exclusive Distribution systems best benefits consumers, because: access is secured to highly-qualified, specialist dealers; consumer choice is the biggest in Europe; inter-brand competition in Europe is probably the strongest in the world; intra-brand competition is strong; and motor vehicle distribution in Europe is one of the most efficient in the world
- The basic elements of motor vehicle distribution and service are: qualitative selection of dealers; quantitative selection of dealers; combined sales and

¹ "ACEA's position on motor vehicle distribution in the European Union, A system of selective and exclusive distribution and servicing is the best option for consumers dealers and manufacturers"; "ACEA position paper regarding the European Commission's questionnaire on the application of the Automotive Block Exemption", October 2000

service; no sales to resellers not part of the network; brand exclusivity at the point of sale; limited territorial exclusivity for dealers; and direct access to the consumer

- The industry has been one of the earliest adopters of e-commerce but it is not intended to cut out the dealer
- Price competition is strong and national price differences are caused by differences in taxation and currency fluctuations, not the SED, and are less than in other consumer goods sectors. A free-for-all distribution system will not abolish them and SED is in fact the system most conducive to satisfactory alignment of prices
- These statements are broadly supported by various recent studies, undertaken by some of the best-known academic experts on the automotive sector^{2 3 4 5 6}

We set out to evaluate the nature of the sales/service link by performing four tasks:

- Examining the historical and current structures and functioning of the sales and service markets in Europe. The purpose is to place the link in the broader context of the multiple sectors that constitute vehicle distribution and retailing, and the aftermarket (the market for services and parts, once the vehicle is in operation)
- Identifying the forces acting upon these sectors and how they may change market and competitive structures. These include the composition of the vehicle parc; technologies incorporated into vehicles (notably on-board electronic systems); the effects of the improved quality and durability of components; electronic means of communication (including the Internet); the attitudes and expectations of consumers; and the activities of specific categories of participants in the market
- Following a vehicle through its life, from initial shopping by consumers, through ordering, delivery, warranty and non-warranty service and repair interventions, part-exchange and reselling, and the end of the vehicle's life. We identify the sub-components of economic activity and examine how and why they are (or are not) interrelated. The objective is to establish which of these links are natural, which are in some way forced by interested parties, and how indispensable they in fact are

² "Die Bedeutung von Vertriebsbindungsystmen in den Europäischen Automobilmärkten", Professor F. Dudenhöffer, University of Applied Sciences, Gelsenkirchen, Germany, September 2000

³ "Selective and Exclusive Distribution System: "How it Benefits the Consumer", Professor D.G. Rhys, Centre of Automotive Industry Research, Cardiff Business School, UK, August 2000

⁴ "Views on competitive mechanisms in the automobile industry, with specific focus on the selective and exclusive distribution system", Professor G. Volpatto, Ca' Foscari University of Venice, Italy

⁵ "Pricing in Euroland", Lehman Brothers, July 1998

⁶ "Road work ahead", Glenn Mercer, McKinsey & Company, Automotive World Opinion, June-July 2000

- Drawing some conclusions about the nature of the allegedly natural link between sales and service: whether it is necessary and justified, as it currently exists; what issues are raised by the impact of new technologies (notably the spread of on-board electronics and the associated diagnostic systems, and the Internet); and whether satisfactory alternative structures are available, or could reasonably be introduced, which would satisfy consumer demand.

This analysis was performed in a relatively short space of time, September and October 2000. We have relied on three main sources of information:

- Existing material available to the European Commission and ourselves, which documents market structures and functioning
- The relevant parts of responses to the Commission's questionnaire about the SED system, widely circulated within the European automotive industry in September 1999
- Responses from the industry to a further set of questions put to participants by the Commission in August 2000 as part of this analysis.

3. The sales/service link must be seen in the broader context of how SED operates

3.1 The sales-service link is a major support of the vehicle industry's way of operating

The question we are examining is, in effect, whether the sale of new vehicles naturally drives everything that happens in the service markets (the automotive aftermarket) thereafter. We are looking in this analysis at the whole downstream area of the automotive industry, "beyond the factory gate", the whole of user experience with vehicles, and the involvement of a large and varied set of participants in the delivery of vehicles, services and parts. One must therefore also look beyond the new vehicle ownership cycle into the subsequent cycles, when it becomes a used vehicle, of increasing age, until it is retired from service.

But the issues are even broader. The sales-service link is a fundamental structural and operating premise of the automotive industry. Its visible manifestation to the consumer is the combination of sales and service outlets within the franchised dealer format. Yet it goes much further and deeper than that:

- Only 20-25% of spare parts are produced by the vehicle manufacturers, while 75-80% are bought in from suppliers. The vehicle manufacturers act as range assemblers and distributors to the dealers. They have invested heavily in very sophisticated and efficient parts procurement, warehousing, logistics, cataloguing and IT systems for this purpose. They take a considerable gross margin on the parts, often in the 60-65% range. The spare parts business typically makes a large contribution to their profitability. As this is generally low (see the McKinsey study⁷), spare parts business frequently subsidises marginal profits or losses on vehicle operations
- The same generally applies to those component suppliers for whose parts there is an aftermarket (the term used in the industry to describe demand for parts and services that arises after the vehicle is first put into service). They are put under severe price pressure by their vehicle manufacturer customers in original equipment (OE) business, i.e. the supply of systems and components to the vehicle assembly lines. They often have to make up for these low margins by obtaining higher ones for aftermarket business. These suppliers are therefore understandably extremely concerned about the protection of their right to sell their OE parts through all possible channels into the aftermarket

⁷ "Road work ahead", Glenn Mercer, McKinsey & Company, Automotive World Opinion, June-July 2000

- Within the dealership, parts and service revenues cross-subsidise new vehicle sales. This is generally recognised and indeed promoted by the industry as a positive virtue
- For the consumer, there is an evident element of comfort and security in dealing with one organisation, which supplies the new vehicle, offers a complete set of services to support it in operation, and is set up to take the vehicle back in part exchange for a new one, if desired.

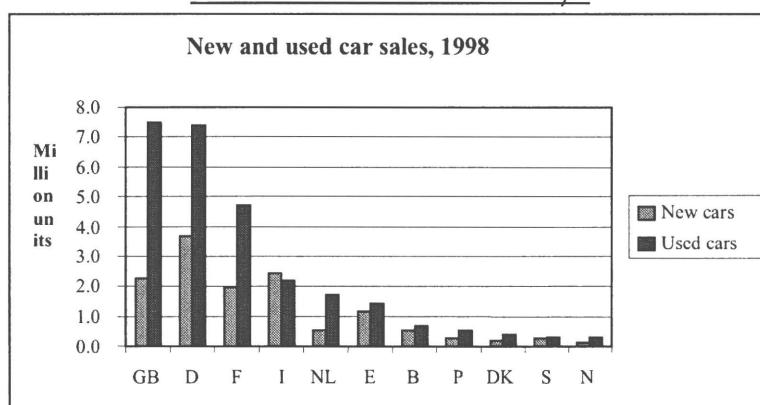
Further arguments are produced in support of the existing SED system, which are presumed not to be available in a “free-for-all” distribution situation:

- Network coverage is assured, even in less populated areas
- All elements of service and repair are available everywhere, even if the more complex repairs are not naturally profitable in all outlets
- The full range of vehicles is made available for sale and supported with full service everywhere
- A close relationship with selected, exclusive dealers is essential to ensuring the range and quality of both sales and service functions
- A strong brand identity is vital to the manufacturer’s survival and a close relationship with selected, exclusive dealers is essential to preserving it.

3.2 SED only operates in part of the sales and service market

A fundamental point to appreciate is that the SED system, although covering 100% of new car sales in Europe, is in fact a minority phenomenon, in terms of overall car sales. As Exhibit 3.2.1, shows, the great majority of car sales transactions concern used cars, rather than new cars. This is no surprise, in a mature and essentially saturated car market. Averaging across Europe, SED concerns only one-third of car sales.

*Exhibit 3.2.1
Used and new car sales in Europe*



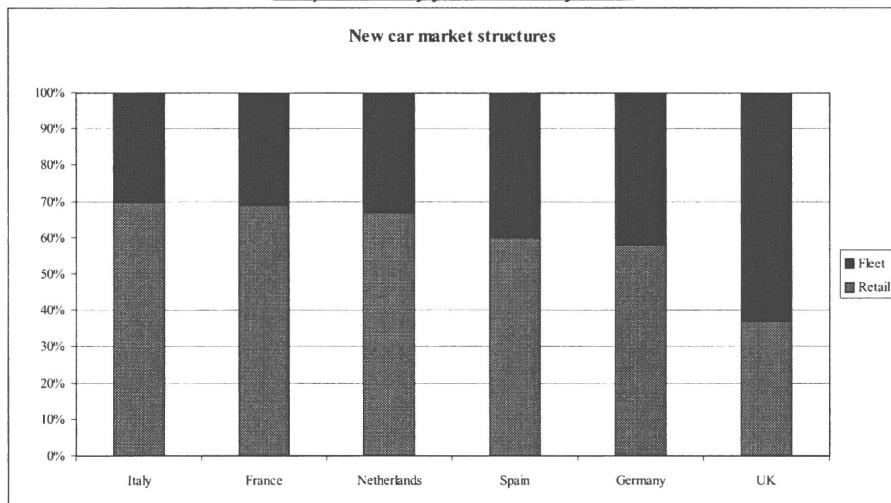
Source: Car Market, BCA, 1999⁸

⁸ Data from SMMT. Quoted in UK Competition Commission, New cars: A report on the supply of new motor cars in the UK. 2000. The Italian ratio is distorted by scrappage incentives

3.3 New car markets are far from uniform across Europe

A second key point is that the structure of new car markets varies between countries. The majority of new cars are sold by franchise dealers to private individuals (the “retail” sector in Exhibit 3.3.1). But there is also a significant “fleet” sector, which is growing. The term “fleet” covers not only genuine operators of vehicle fleets (rental companies, public administrations, service and utility companies’ vehicles, company salespeople, etc) but also purchases by professional leasing and contract hire companies, on behalf of individuals, notably company executives and self-employed professionals. The unusually large fleet sector in the UK is the result of an historical anomaly in personal taxation, which gave a strong incentive for the provision of company cars. Even though the tax incentive is now largely gone, the habit and the attachment to the convenience have stuck.

*Exhibit 3.3.1
Proportion of fleet sales of cars*



Source: autopolis calculations ⁹

3.4 Growing fleet sales weaken the sales/service link

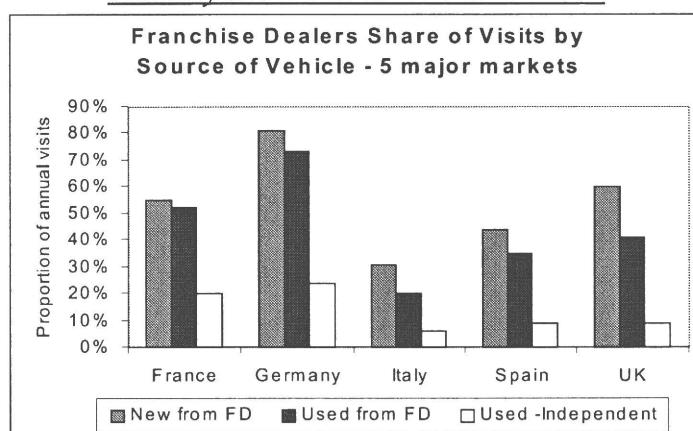
The relative size of the fleet market has a major effect on how cars reaching the end of their first cycle of ownership enter the second hand car market. The greater the share of fleets in the new car market, the more strongly structured are the wholesale and retail markets for reselling them. Although franchised dealers may be nominally involved in the sale of new cars to fleets, these cars often move away from the “supplying” dealer. The sales/service link is then often broken from the outset. Even some new fleet cars never see the dealership for service, and there is generally a heavy drop in service retention by dealership networks when a car enters the second hand market. Dealers can choose simply to resell those used cars they receive as trade-ins against

⁹ Based on ICDP research paper 10/98, Fleet and Direct Sales in Europe, plus industry interviews.

sales of new cars, although this tends to produce a weakly-profitable used car business for them. Or they can quickly dispose of unattractive trade-ins into the wholesale trade channels and actively stock up with saleable cars from those channels, offering a fuller range to purchasers suited to local and regional tastes. By reproducing the buy/maintain/exchange sequence in the second ownership cycle, these dealers can achieve quite high service retention for these vehicles and thus a good level of profitability. There are in fact three car market sectors: new cars, for which sales and service are forcibly bundled together through the SED system; dealer-supplied used cars, in which the bundling is achieved by the dealer in a free market; and used cars from other sources, for which sales and service are largely disconnected (few independent used car traders offer directly connected service facilities).

Exhibit 3.4.1 illustrates this. It also shows the differences in national propensities to have recourse to franchised dealers for service in any of the three car market sectors. These are rooted in long-established traditions. Combined with the differences in the structures of the new car markets, this results in very large differences in overall retention of service business by dealers for the vehicles of their make in the national parc. At one extreme, dealers in Germany typically achieve 65-70% retention, those in the UK 30-35%. There are of course further variations by brand, with upline and Japanese makes usually achieving higher retention than volume makes.

*Exhibit 3.4.1
Source of cars and dealer service retention*



Source: Polk Automotive Intelligence¹⁰

3.5 There are major structural differences between national franchise dealer networks

As Exhibit 3.5.1 shows, there are considerable structural differences between the franchised networks themselves from one European country to another. In the southern European countries, there are extensive networks of service-only sub-dealers (or agents), who may also receive a commission for introducing

¹⁰ Autofocus: European Aftersales Market Sizing Research – 1998 survey of 30,000 motorists

new car customers to the main dealers. This approach also allows greater concentration and higher new car throughputs for the main dealers.

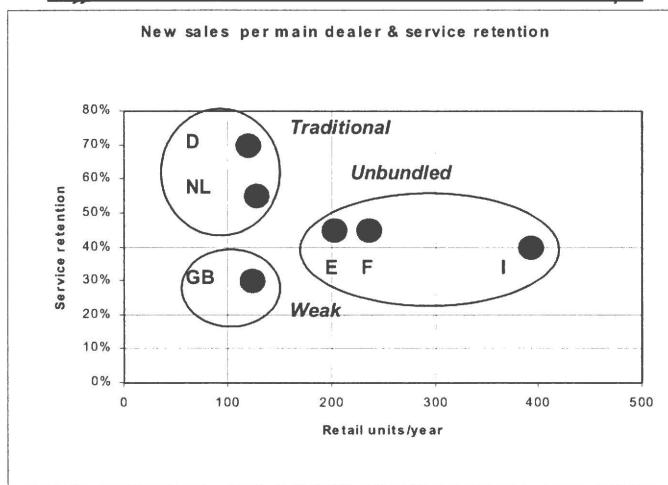
*Exhibit 3.5.1
Dealer networks in Europe*

Country	1997 Volume (thousand)	Retail Market %	Main Dealers	Sub Dealers	Retail Volume per Main Dealer
Germany	3528	58%	17000	8000	120
France	1713	69%	5000	18000	236
Italy	2412	70%	4300	9100	393
Netherlands	478	67%	2500	500	128
Spain	1012	60%	3000	6300	202
UK	2171	37%	6500	800	124

Source: autopolis submission to House of Commons Trade and Industry Committee, 1998

This responds to the need for different network densities for occasional sales of cars and the much more frequent performance of routine service and repair operations. It therefore partly removes sales/service link at the local level, while maintaining it within the national SED network.

*Exhibit 3.5.2
Different dealer network structures within Europe*



Source: ibid.

When the annual retail new car throughputs are combined with service retention levels, as shown in Exhibit 3.5.2, the dramatic difference between national networks emerges. Germany has a large number of dealers, selling relatively few new cars per outlet. By achieving high service retention, however, they are able to survive financially. UK dealers, who have sometimes been portrayed as exceptionally large and powerful¹¹ are in fact doubly disadvantaged by the large share of fleet sales and its consequence of poor service retention. The southern European approach may in fact be the

¹¹ See, for example, "Winning tomorrow's customers", ICDP

better compromise. Again, it achieves coverage of rural areas with low population density by accepting a partial weakening of the local sales/service link.

3.6 Franchised dealers are far from the only serious providers of service

It is also very important to understand that good maintenance and repair service is not the exclusive province of the franchise dealer sector. The industry frequently states that dealers alone can offer the full range of services, while conceding that fast fit specialists can work on simple tasks, such as changing tyres and exhausts cost-effectively.

- We are not capturing data for independent repairers. We would, however, expect independent repair outlets to focus their work on light maintenance jobs like oil & filter changes (i.e. not the full routine maintenance in line with our recommendations as defined for each vehicle derivative), light repairs and a limited range of collision and glass repairs. The above repair jobs would only require limited technical skills and training. In general, no special equipment will be required to carry out these less complex repair jobs. (*Vehicle Manufacturer*)¹²

Reality is more complex than this “it’s us or nothing” portrayal. This is in fact also conceded even by dealers, who seem to take an interestingly different stance in their submissions from the one they adopt in public:

- The quality of work performed shows no difference between franchised garages and independent workshops. (They) Like franchised garages are specialising in some makes, independent garages are more and more concentrating either on the maintenance and repair of a small number of makes, or on some specific jobs like brakes, shock absorbers, exhaust and body repair. Independent workshops cannot run unless their work is carried out by specialised well-equipped and trained persons. In some countries there are differences between dealers and independent repairer relating to the ability of independent repairers to compete with dealers due to lack of access to technical information on the one hand and warranty work on the other hand. Warranty work is mostly carried out by franchised dealers. Most consumers cannot appreciate if a repair job is complicated or not, or has been done properly or not and they often prefer to pay a higher price to the franchised dealer because of the support given by the vehicle manufacturer. Another point is the publicity given to the existence of the franchise networks by the manufacturer/importer of the make, which has a great influence on customers to the detriment of independent garages. CECRA (B) (12)
- “It is not possible to identify quality differences between franchised and independent workshops, within the scope of their normal service offerings. This is attributable to the German legal requirement that every workshop be managed by a qualified automotive master mechanic. This requires 3.5 years training as an automotive mechanic or electrician, plus at least 1 year’s experience. It ensures that only competent workshops carry out service and repair. Independent workshops need the same technical equipment as franchised workshops. The make - or model - specific element of special tools amounts to 15-35% of total investment, depending on the size and nature of the workshop (higher for commercial vehicles and body repair). Excluding technical training, workshop investment is about DM300,000, of which 20% is product-specific. Some low-volume specialised repair is sub-contracted, e.g. paint, air conditioning, injection pumps. There is an increasing tendency for vehicle manufacturers to shift responsibility for investment onto

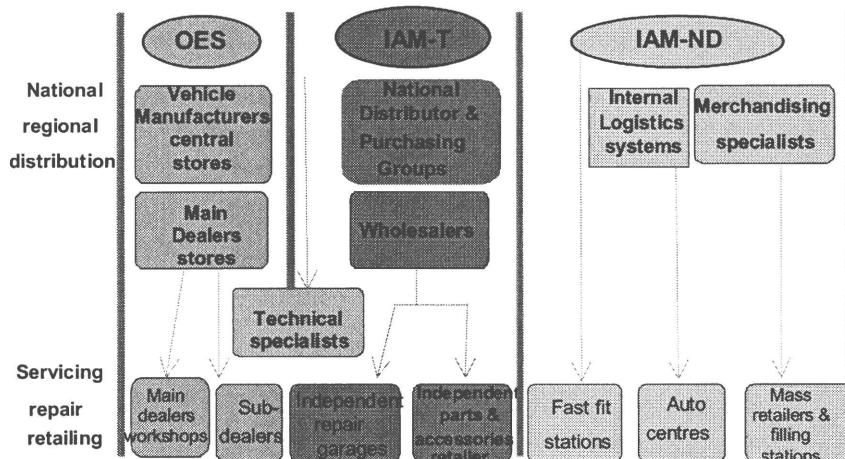
¹² Responses To European Commission questionnaire, August 2000. All further quotations in this document taken from the responses are identified by (12).

the dealers, notably with respect to charging for training. The ZDK has set up a DIN-EN-ISO 9000 accreditation scheme applicable to both franchised dealer workshops (31% penetration so far) and independents (5% penetration)" *ZDK (D)*(12)

- "Vehicle manufacturers strongly support quality assurance procedures in dealer workshops, including ISO 9002 certification. Nothing similar has yet happened for independent workshops, other than in the body repair sector, through the insurance companies. About 50% of bodyshops are in the franchised sector and 50% independent. There are some problems for the independents of access to diagnostic equipment reserved for the franchised sector" *GNCR (F)* (12)
- "In the first 8 months of 2000, we received 140 complaints about repairs (64 relating to franchised dealers, 65 to independent garages, 11 to fast fitters)" *ANWB (NL)* (12)

Exhibit 3.6.1 summarises the structures of service and parts aftermarkets in Europe. The three main sectors appear in all national aftermarkets, although

*Exhibit 3.6.1
European aftermarket structures*



Source: autopolis

in very different proportions:

- The OES (Original Equipment Spares) sector contains the channels organised and managed by the vehicle manufacturers, through their franchise dealers. Its strengths are the brand associations with the vehicle manufacturers, tightly organised logistics and full availability of service and parts ranges within each brand. Its weaknesses are the duplication of networks, caused by brand exclusivity, and the high service prices charged to consumers as a result of the underlying cross-subsidies
- IAM-T (Independent Aftermarket, Traditional) is the sector in which independent repair garages service and repair cars, supported by independent parts distributors. Contrary to vehicle manufacturers' statements, this sector is not simply limited to routine tasks. It supports a large proportion of the vehicle parc and tries to offer a full range of services, although this is becoming more difficult within the sector, because of the growing role of on-board electronic control systems and of

diagnostics equipment (see Section 4). Its strengths are: independence of vehicle brand, local presence and entrepreneurship, and flexibility. Its weaknesses are: internal fragmentation, excessive complexity in the logistics chains, and problems with access to systems and diagnostic technologies kept proprietary by the vehicle manufacturers

- The IAM-ND (Independent Aftermarket, New Distribution) sector covers the large-scale chained and branded independent service, repair and retailing networks, which offer narrow ranges of simplified services in specialised outlets with a more flexible response and lower costs than the traditional channels (OES and IAM-T). They have made considerable inroads, within limited ranges of service, although to different degrees in different national markets. Characteristic examples in the Fast Fit category are the tyre service outlets of the major tyre companies and the major independent chains, such as Midas or KwikFit Euro/Speedy (both of which have partly achieved Europe-wide penetration), or Autoglass-Carglass in glass repair (which is virtually pan-European). There are major independent parts and accessories retailing chains, which also often provide service bays for fast fit and current maintenance and repair. Leading examples are Norauto (France, Spain, Belgium), ATU (300 outlets throughout Germany) and Halfords (UK). These ND players are very large organisations, with strong brand images of their own. Vehicle manufacturers have tried to reproduce fast fit formats within their dealer service networks but with only limited success – the two businesses are too different, in terms of customer groups addressed, premises and staff resources required, and management approaches. The acquisition of KwikFit by Ford and of Midas by Magneti Marelli (Fiat Group) come over almost as admissions of failure
- In addition, technical specialists back up the generalist workshops of both the OES and IAM sectors, for work requiring equipment and training beyond their means. Characteristic examples of these are diesel injection specialists, engine rebuilders and bodywork repairers, and new and growing groups of air-conditioning specialists.

- “Recourse to outside specialists:
 1. Engine: 100% of engine rebuild, 60% of cylinder head rebuild
 2. Diesel: 100% of repair of pumps and injectors
 3. Fuel injection: 60% of clean and check injectors, 100% of ECU repair
 4. Steering: 90% of repair of power steering, 100% for steering pump, 90% for steering box
 5. Air conditioning: 100% for repair and cleaning
 6. Glass: 100% for laminated pieces
 7. Brakes: 100% of mastervac repair
 8. CV joints: 100% of remanufacturing
 9. Automatic and manual gearboxes: 100% of remanufacturing”

RACC (E)(12)

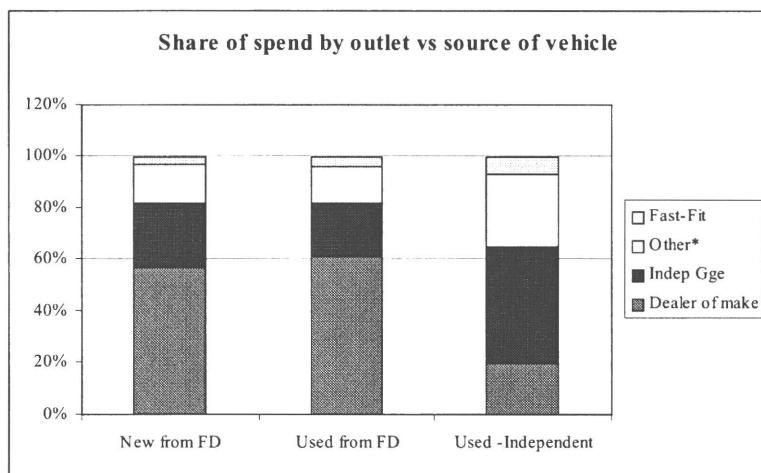
- This long-standing phenomenon is a challenge to the vehicle industry's assertion that only the SED system can provide the full range of high-technology services. An increasing proportion of the technological content

of modern vehicles comes from the systems and components industry, whose members supply systems and components to a range of vehicle manufacturers.

3.7 For older cars, consumers desert the franchise networks and the sales/service link

The older the car gets, the more likely its owner is to purchase service and parts from independent providers. Exhibit 3.7.1 shows data for the split of

Exhibit 3.7.1
Share of service spend by source of vehicle

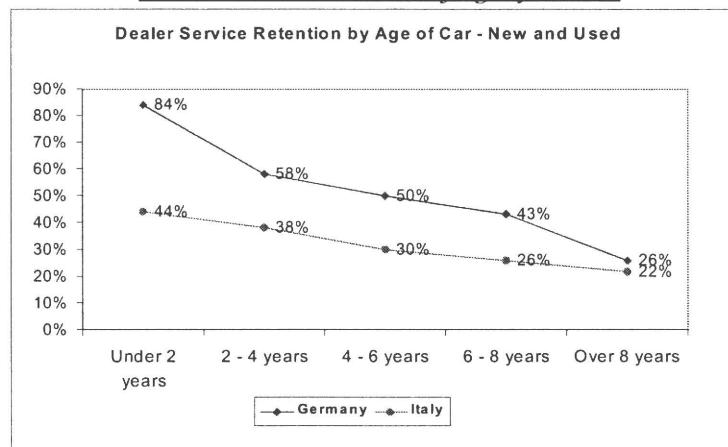


Source: Polk Automotive Intelligence (op. cit.)

service spend, for the top five markets in Europe (Germany, France, Italy, UK and Spain). OES service retention is highest for new cars but equally high for used cars sourced from a franchised dealer – in both cases, it is possible for the dealer to maintain the sale/service/exchange cycle. When the car comes from an independent source, however, the link collapses. There are, however, huge variations in these structures from country to country – with the highest OES shares in the first two columns being achieved in Germany and the lowest in Italy.

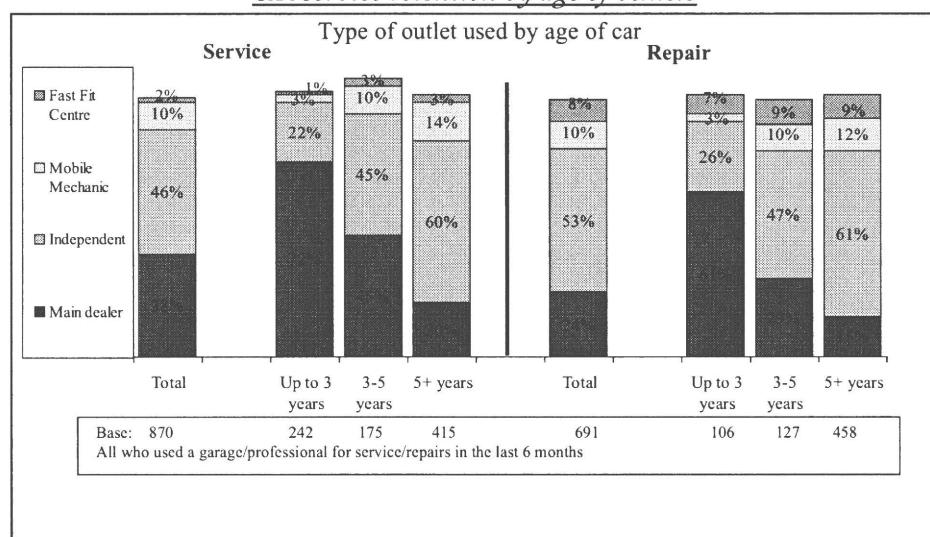
Exhibit 3.7.2 shows dealer service retention profiles for Germany and Italy. Even in Germany, where franchise dealer service retention is probably higher than anywhere else in the world, there is a perceptible fall-off in loyalty after the first ownership cycle. In Italy, at the other extreme, the franchise networks never even capture half the market from the beginning of the vehicle's life. The UK lies somewhere in the middle, with high loyalty during the new car ownership cycle (largely dominated by corporate ownership) but a steep fall-off thereafter (Exhibit 3.7.3), because fleet vehicles entering the second-hand car market are mainly cut off from their supplying dealers.

Exhibit 3.7.2
Dealer service retention by age of vehicle



Source: ICDP, Research Paper 2/97, *Aftersales in Europe*

Exhibit 3.7.3
UK service retention by age of vehicle

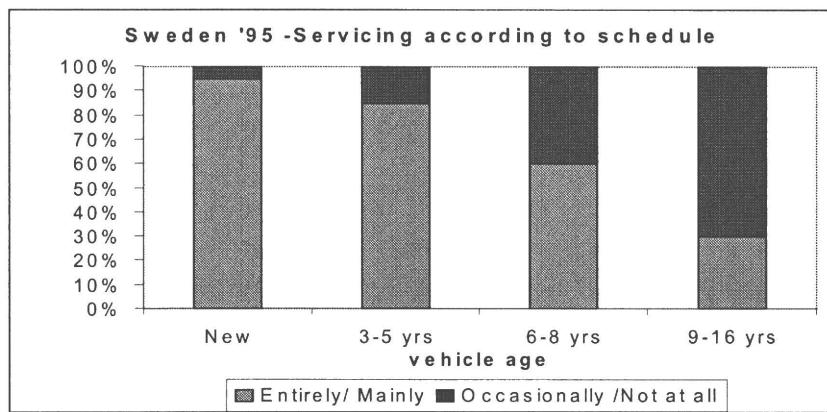


Source: T.N. Harris survey¹³

Drivers of older vehicles are also less likely to adhere to fixed interval service schedules. Exhibit 3.7.4 shows some Swedish survey data, which reveals a dramatic drop in adherence once the vehicle passes the 5-year mark, i.e. when it enters the second-hand car sector. Again, this reflects a flight from the dealer at this stage in the vehicle's life. Sweden has a relatively old parc of vehicles in use. Swedish drivers apparently manage to keep their vehicles on the road a long time, without recourse to the franchise networks – this in a country with very high safety standards. The greatly improved quality of vehicles and components has clearly helped in this.

¹³ in: Office of Fair Trading, *Car Servicing and Repair*, August 2000

Exhibit 3.7.4
Swedish compliance with service schedules

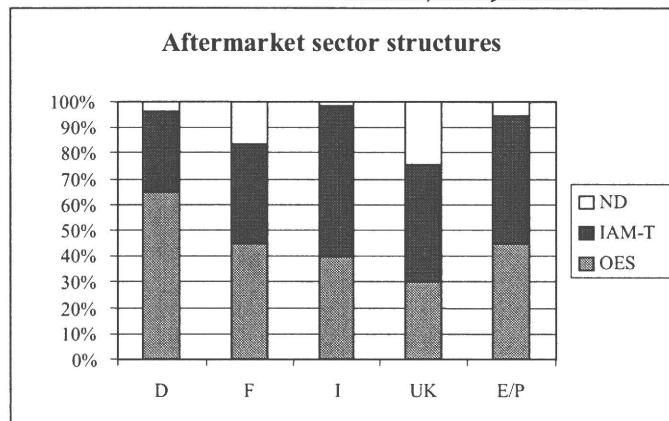


Source: ICDP survey¹⁴, autopolis calculations

3.8 The unregulated independent sector is as large as the franchise sector

The shares of the three main sectors within different national aftermarkets (based on parts flows) is shown in Exhibit 3.8.1, overleaf. At the one extreme, Germany is strongly OES-dominated, while the IAM is much stronger in the UK. On average across Europe, half the aftermarket is OES and half is IAM. The ND formats have achieved considerable penetration in France and the UK but not elsewhere yet. This split at the aggregate level (all parts moving through channels) is the reflection of consumers' choice of service and retail outlets.

Exhibit 3.8.1
Sector structures, based on parts flows¹⁵

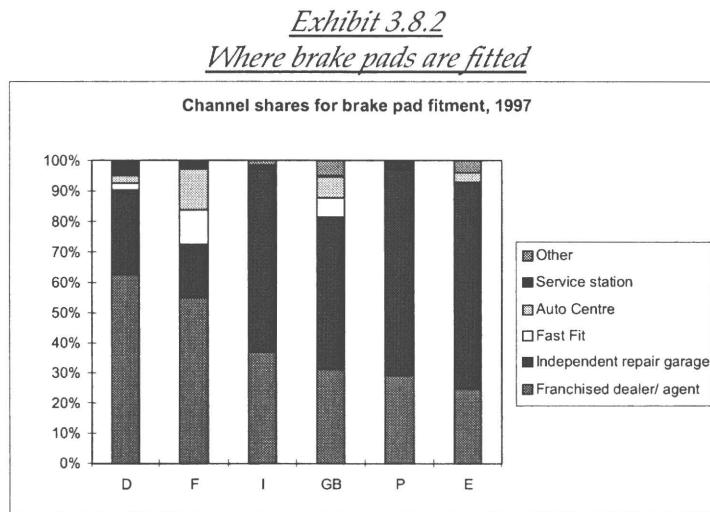


Source: autopolis, from industry sources and interviews

¹⁴ Research Paper 6/98, Impact of technology, quality and reliability on aftersales operations

¹⁵ Excluding tyres and lubricants

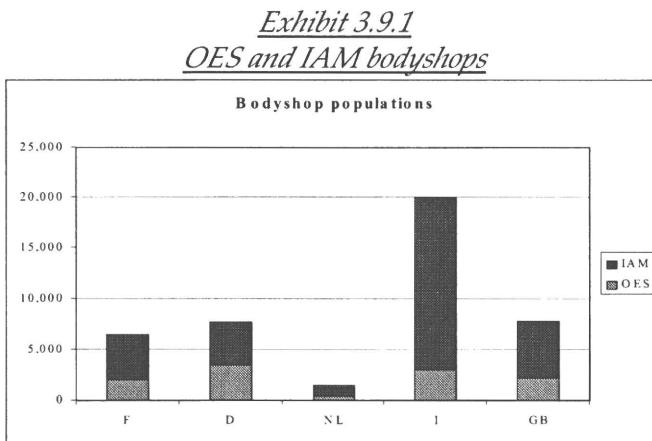
This is also true at the level of specific jobs, as shown for one of the most common (and safety-related, although simple) service jobs, changing brake pads, in Exhibit 3.8.2. Again, this demonstrates that the market split is not simply between OES and ND. Traditional independent service and repair garages in the IAM-T sector still command a large market share.



Source: autopolis client analysis

3.9 Highly technical repairs are not dominated by the OES sector

The technical specialist service and repair sectors are by no means wholly tied to vehicle sales. The two major diesel service networks have always operated under the Bosch and Lucas (now Delphi) brands, these being the two leading suppliers of diesel injection systems. These are major independent systems and components supply groups, which serve multiple vehicle manufacturer customers. Radiator suppliers, such as Valeo, Behr and Serck-Marston have long operated all-makes specialist service networks, now extending into the growing market for air-conditioning maintenance and repair.



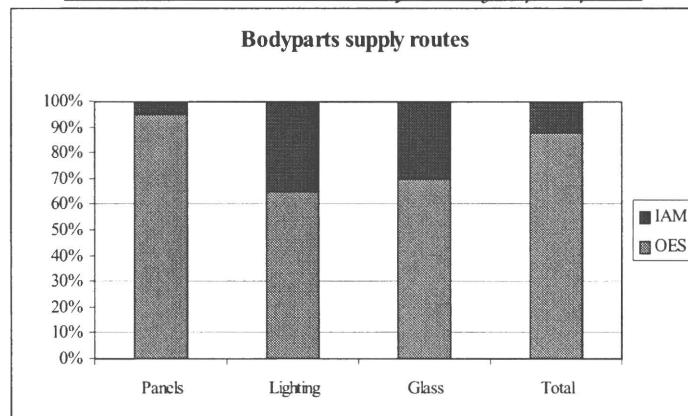
Source: autopolis, based on data from the Association Internationale des Réparateurs en Carrosserie (AIRC)

Body repair is a major technical activity, involving substantial investments in equipment and training. Yet the bodyshop profession is numerically dominated by independent shops (see Exhibit 3.9.1).

- "70% of bodywork repairs are conducted by independent bodyshops. 1050 of the total 1500 all-makes bodyshops are independent, 450 belonging to franchised dealers. There are some problems with equipment only being available to the franchised sector. Of the 1 million repair jobs per year, 50% involve manufacturers' warranties" FOCWA (NL)(12)
- "Although half or more of these are on vehicles that are within the warranty period, 75% are actually performed by independent shops. Nevertheless, the manufacturers, each in their own way, try to get owners to commit to the dealership. They issue repair insurance policies, which require return to the dealership, at non-economic prices. There are threats of warranty invalidation if work is conducted in non-franchised shops. The work of independent body shops is denigrated to customers who have made use of them, although most of our affiliated shops use fully trained personnel and OE parts. Two certification systems are in operation: Eurogarant, an all-makes warranty, and ISO 9002" - Febelcar (B) (12)

While some of the larger bodyshops are dealer-controlled, the independents are able to obtain both vehicle manufacturer and insurer approvals. The physical and training investments required for body repair is generally not specific to vehicle makes or models. There are, however, some links where mechanical or electrical/electronic re-assembly is required. There also appears to be a distortion of parts supply into the bodyshops, with OES channels dominating, particularly through vehicle manufacturers' hold on the supply of bodyparts (Exhibit 3.9.2).

*Exhibit 3.9.2
Distribution channel shares for body repair parts*



Source: ECAR¹⁶

¹⁶ European Campaign for Automotive Repair

One key difference between the bodyshop sector and the rest of the vehicle repair sector is the nature of the customer. Insurance companies pay for the majority of body repairs, which makes the insurance company, not the vehicle user, the buyer of services. Insurance companies will usually direct the customer to their own approved, local body repairer – regardless of whether this is an independent or a franchised outlet. They can exercise considerable purchasing leverage, unlike individual retail customers.

3.10 In the US, the sales/service link is extremely weak

The vehicle industry claims that the US approach to automotive sales and service is similar to that used in Europe. The only difference is supposed to be that the US is a single market, with little government interference, while Europe is a fragmented set of national markets with interference. “A system that works perfectly well in the US is controversial in the EU. The reason is not the system but the context in which it works: the EU”¹⁷

The US SED system is held in place by tough dealership laws. These have been separately negotiated in each state of the Union and vary from one state to another. Attachment to states’ rights is strong in the US. This makes these laws extremely difficult to attack in aggregate. They were originally instituted to protect consumers but now in effect protect dealers against excessive exercises of power by the manufacturers. Dealers are licensed annually by mixed private/public commissions in each state. The balance of power swung in favour dealers in the US in the 1980s, although there has been some partial reversal since.¹⁸ Dealers as a group are far more powerful vis-à-vis both vehicle manufacturers and legislators in the US than in Europe.

A major difference compared to Europe is that the dealer population is far more concentrated. There are one-third as many dealerships as in Europe. The top 25 dealers sell 1.3 million new cars per year, controlling over 7% of the whole market. AutoNation Inc, the largest dealer group, sells almost half a million vehicles, through 290 outlets, i.e. over 1600 per outlet. Behind the shelter of the protective laws and commissions, much more concentration has taken place.

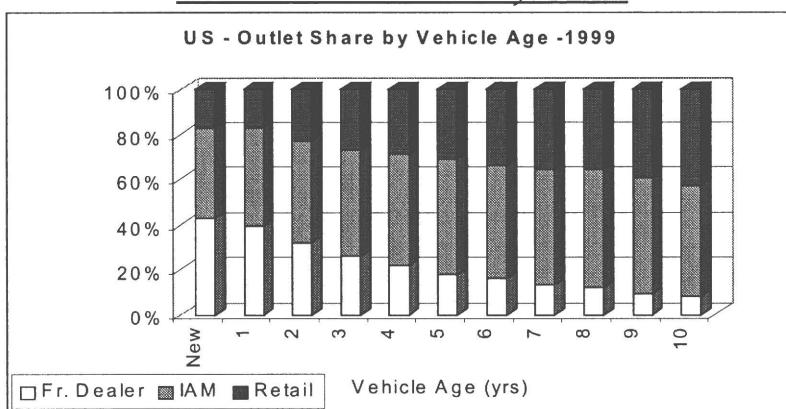
As a result of the different balance of power, US dealers are less constrained in their commercial dealings. They aggressively discount models in stock. The majority of vehicle advertising in the US is local dealer advertising in the press, based on product and price. But they also charge considerable premiums over list price for “hot” models, which is very rare in Europe. They appear to achieve much better profitability on new vehicle sales than their European counterparts, suggesting that a more liberal régime may actually be healthier for dealers than a very controlled one.

¹⁷ ACEA, position on motor vehicle distribution in the European Union (op.cit.)

¹⁸ Dossier: la distribution automobile aux Etats-Unis, La Lettre de l’Automobile, juillet/août 2000

Another very significant difference is that the US has a much stronger independent service sector, including 'do-it-yourself' (DIY), and different attitudes of the public to car ownership and use. In the US definition, the independent aftermarket (IAM) includes both generalist and specialist repair shops. Exhibit 3.10.1 illustrates the respective shares of the different outlet types for 'regular maintenance' – which includes tune-ups, headlamps, air filters, oil changes and batteries. Franchise dealers retain only 40% of this market, even when the vehicle is new. Over the whole life of the vehicle, retention is barely 20% Thus the world's single largest and most mature car market shows the most extensive disconnection between sales and service.

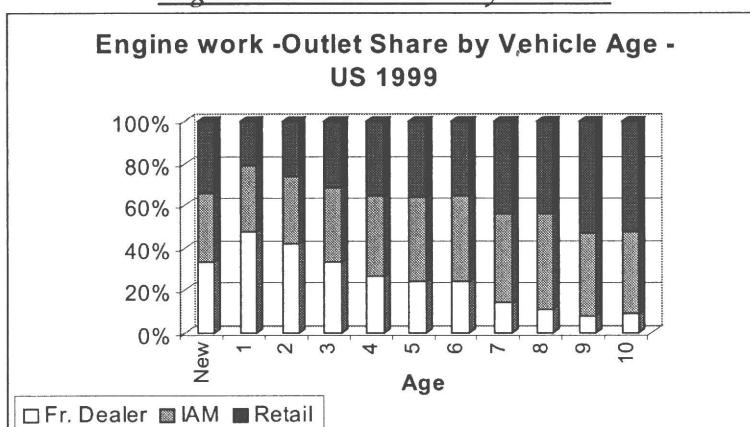
*Exhibit 3.10.1
Routine maintenance share of channel*



Source: *Automotive Industry Statistics Report, 1999, MEMA* ¹⁹

"Regular maintenance" means in the main relatively simple jobs, which would explain the volume of retail, which in the US is either the 'do-it-yourself' market, or where a customer buys the parts for someone else to install.

*Exhibit 3.10.2
Engine maintenance share of channels*



Source: *MEMA (op. cit.)*

¹⁹ Motor Equipment Manufacturers Association (USA)

One might expect greater retention by the franchised dealer for more complicated maintenance or repair jobs, including engine overhauls, fuel pumps, starters and transmission. In fact, as Exhibit 3.10.2 shows, the US market is extensively unbundled even for the more technical jobs.

3.11 It is by no means evident from the market structures that the sales/service link is a wholly natural one

The vehicle manufacturers try to convey the impression that the only serious proposition is SED and the sales/service link, with some grudging recognition of the New Distribution sector. The real picture is significantly different:

- Averaged across countries, half of current service, repair and parts sales in Europe takes place in the independent aftermarket sector, including safety-critical work
- By the manufacturers' reasoning²⁰ therefore either half of the cars on European roads are unsafe, or their presumption that only franchised dealer workshops are competent is false
- By that same logic, either half of car owners are irresponsible, or half the market has good reasons for disagreeing with the proposition that the vehicle manufacturers' system of the sales/service link is the only valid proposition
- There already is an extensive disconnection between sales and servicing of cars, through the existence of an IAM, as large as OES
- The OES sector has no monopoly of the more complex, technical repairs. Some of the most technical service and repair interventions are referred to specialist workshop networks that depend not on vehicle manufacturers but on specialised component suppliers.
- An even more pronounced disconnection is evident in the US, for both routine and complex servicing and repair. Contrary to some public pretensions, vehicle distribution is significantly different in the US, compared to Europe.

All this suggests that the sales/service link is not a wholly natural one, that it may be forced under some circumstances, and that at least some alternatives exist.

²⁰ ACEA -CECRA Press Release 25th October 2000, p.1 following a review of the functioning of distribution of new motor vehicles and automotive after sales services.

4. There are significant forces and trends that threaten a destabilisation of the current system

4.1 Car sales now contribute little to the profitability of dealerships

Vehicle manufacturers regularly collect extensive information about the operations and financial performance of their dealership networks (the so-called dealer composites). This is highly confidential information that is not in the public domain. There are, however, indications available about how important aftercare business is to dealerships. This is illustrated in Exhibit 4.1.1, which shows the contribution of the main departments of dealerships to gross profit for the business as a whole. While there are differences between countries, the overall pattern is there. The analysis is disappointing, in that it does not go beyond gross margins to net departmental contributions, nor to the financial balance of the dealership as a whole.

*Exhibit 4.1.1
Gross profit contributions within dealerships in Europe*

Country	Labour	Parts	Total After-Sales
France	31%	18%	49%
Germany	35%	24%	59%
Italy (estimate)	6%	16%	22%
UK	44%	16%	60%

Source: ICDP (op. cit.)

The remaining gross profit contributions in franchise dealers are obtained through sales of new and used cars, finance and insurance packages, extended warranty sales etc. More detailed published figures have become available, through work conducted for the UK Competition Commission. As the data is for a sample of UK dealers only, care must be taken not to extrapolate all the details and conclusions to the rest of Europe. Nevertheless, some of the conclusions that can be drawn from Exhibit 4.1.2 are interesting.

*Exhibit 4.1.2
Financial structure of a dealer business*

	Sales £ mio	Gross Profit £ mio	Department Profit £ mio	Department Overhead £ mio	Net Profit £ mio	Net Margin % of Sales	% of NP Net Profit	Department Overhead % of Sales
New cars	4.3	0.20	0.17	0.03	0.07	0.02	26%	0.7%
Used cars	3.3	0.19	0.06	0.13	-0.02	-0.01	-6%	4.0%
Car parts	0.9	0.18	0.10	0.08	0.08	0.09	28%	9.7%
Workshop and servicing	0.5	0.29	0.13	0.16	0.12	0.26	43%	35.1%
Bodyshop	0.2	0.08	0.03	0.05	0.03	0.17	10%	32.3%
Forecourt	0.2	0.01	0.00	0.01	0.00	0.00	0%	2.8%
Other	0.1	0.01	0.00	0.01	0.00	-0.01	0%	14.3%
Total	9.4	0.96	0.49	0.48	0.28	0.03	100%	

Source: calculated from data in UK Competition Commission report, "New Cars", 2000²¹

²¹ Based on a survey of 123 UK dealers

As an average across this sample of dealers, the data show that car sales (used and new) contribute 80% of sales but only 40% of the total of departmental gross profits (sales less the cost of goods sold); 50% of departmental profit (gross profit less departmental overheads); and 20% of net profit for the dealership as a whole (the sum of departmental profits, less the central overhead).

4.2 Workshops are the economic and relationship heart of the dealer business

One of the most interesting set of figures in Exhibit 4.1.1 is the last column on the right, departmental overhead as a percentage of departmental sales. It is an indication of the relative depth of investment in each of the dealership's sub-businesses:

- New car sales requires initial investment in the showroom and signage, although there is a trend to reduce the size and cost of showrooms. The new vehicle stock is financed by the vehicle manufacturer, normally for a sufficient period of time for the vehicles to sell. Staff costs are low, relative to the value of sales. Gross margins are held very low, reducing the dealer's ability to discount. The whole sub-business is in effect run by the vehicle manufacturer, with the help of ex-post-facto bonus payments and the provision of incentives to dealers and end customers, such as low-cost or no-cost finance and free insurance. The dealer's main role is to round up customers in the allocated sales territory
- Used car sales require the dealer to maintain a stock of vehicles for sale – hence the higher overhead. This requires astute purchasing and active management, without which hard-to-sell trade-ins remain on the books for long periods and attractive vehicles are not there to draw customers. The lack of profit in the sample confirms that not all dealers manage this sub-business successfully and profitably. This is a free and open business, open to competition from independent used car traders, large and small, and from sales between individuals
- The parts business requires financing an initial stock, refreshing that stock, and a dedicated staff, plus parts identification and communication systems. This business is also quite strictly controlled by the vehicle manufacturer, including bonuses related to parts sales, which can also be linked to and affect vehicle sales bonuses. Maximising returns often means proactive sales into the independent aftermarket - therefore many dealers operate as local OES-branded distributors with a fleet of delivery vehicles.
- The service + workshop and bodyshop are the most heavily invested and most profitable businesses. In fact, they are the economic heart of the dealership. They are also the key to building the relationship with the consumer and keeping his or her loyalty to the dealership
- The forecourt (fuel sales) and other businesses (carwash, rental, etc) are marginal profit contributors

Thus the contribution to profit, reputation and brand image of parts sales, workshop and servicing, bodyshop and the rest greatly outweigh that from vehicle sales, with the proportion having generally increased over recent years. Aftermarket operations subsidise vehicle sales (particularly sales of new vehicles), both financially and in building the relationship with customers.

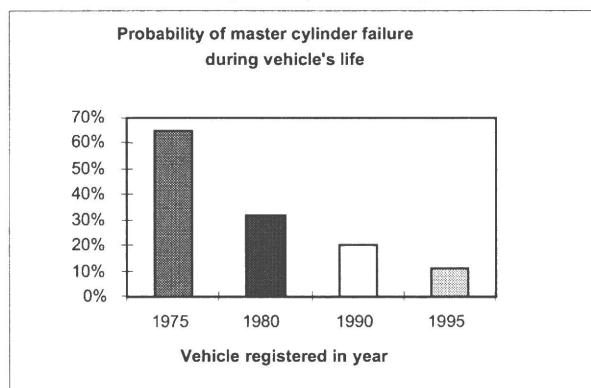
4.3 Focused, scale-driven competitors are able to attack the dealership in each of its constituent businesses

The challenge to these locally bundled sub-businesses is that each of them is increasingly exposed to focused, scale-driven competitors:

- New car sales by direct sales from vehicle manufacturers to fleets, which later generate flows of 6-month to 3-year old used cars back into the marketplace
- Used car sales by a growing breed of used car supermarkets, with a much greater ability to display and maintain a wide range of cars, as well as the traditional local independent traders
- Service and workshop activities by independent garages, at least for routine service and repairs, offering lower labour rates (often 30% lower), and by chained service specialists for the routine tasks such as tyre, exhaust and glass repair, which do not need qualified mechanics and fit well into multi-bay, service-while-you-wait outlet formats
- Body repair by independent bodyshops, as there is no restrictive franchise in this sector
- Other services, notably financial, by a plethora of independent agencies
- Technical repairs by specialists, such as diesel fuel injection workshops

4.4 Improvements in quality continue to undermine the cross-subsidy mechanism within dealerships

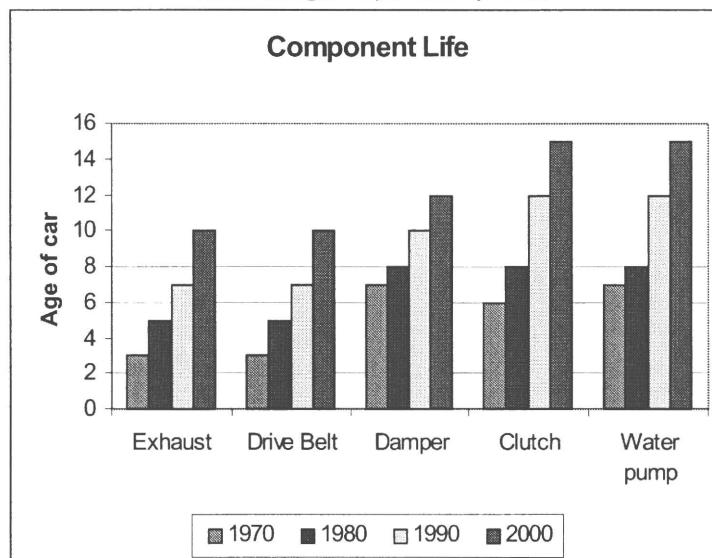
Exhibit 4.4.1
Increasing component life



Source: autopolis client analysis

The automotive industry in Europe has achieved dramatic improvements in the quality of vehicles and in the reliability and durability of their constituent systems and parts. Exhibits 4.4.1 and 4.4.2 illustrate the impact of this achievement on the aftermarket.

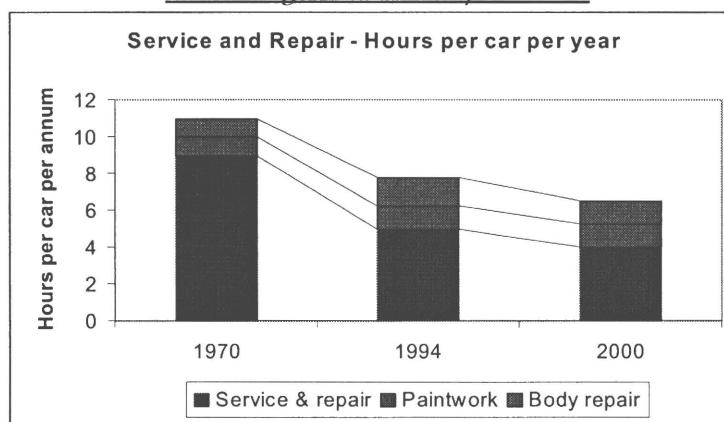
*Exhibit 4.4.2
Increasing component life (2)*



Source: ICDP sponsor, quoted in Research Paper 6/98 (op. Cit.)

The effect is to depress the whole of the aftermarket, at least for conventional mechanical and electrical repairs, as Exhibit 4.4.3 shows. Paint and body repairs, however, are holding up. Even if accident rates have been falling in Europe, the increased complexity of body structures and thus of repairs to them has maintained the overall expenditure of repair hours in this sector.

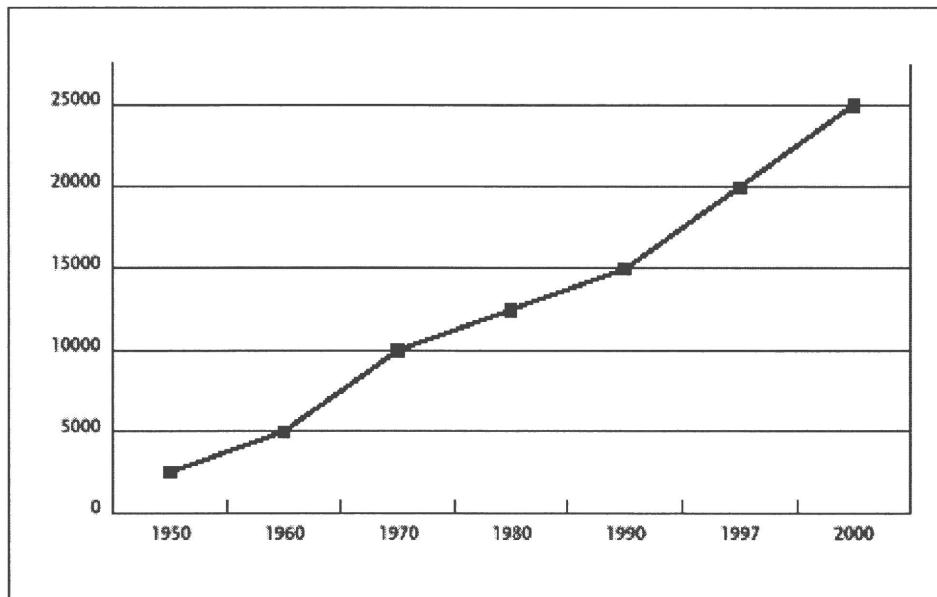
*Exhibit 4.4.3
Decreasing service and repair hours*



Source: AHM Hamburg in ICDP, Research Paper 2/97 (op. cit.)

Manufacturers' recommended service intervals continue to lengthen, as Exhibit 4.4.4 shows.

Exhibit 4.4.4
Lengthening service intervals in Germany



Quelle: Deutsche Veedol GmbH, Hamburg

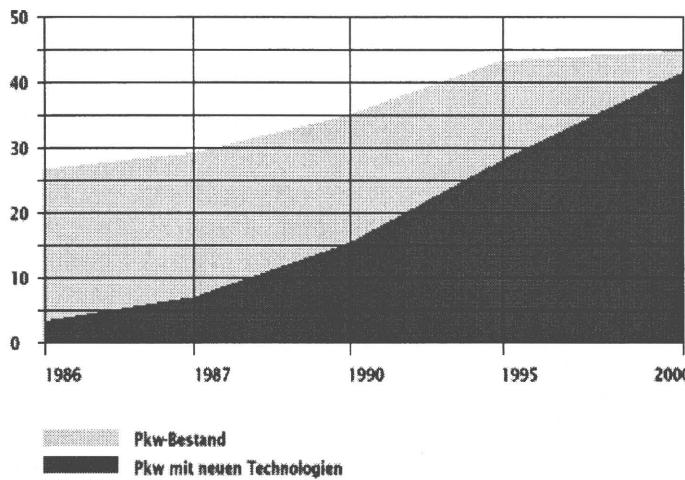
Source: BBE-Branchenreport, der Aftermarket für PkW-Komponenten, 1998

These developments tend to drive the incidence of service and repair further into the later periods of the vehicle's life, when it is least likely to be taken to the franchised dealer. This is increasingly eating into the critical profit streams of the franchised dealers. Conversely, it favours the independent aftermarket, although prices will be severely depressed by the greater price sensitivity of the owners of older vehicles. Many component suppliers and the vehicle manufacturers themselves are offering second ranges of shorter-life components to cater for the needs of this sector

4.5 Conversely, the growth of electronic systems strengthens the position of the dealerships, relative to the IAM-T sector

The increasing complexity of vehicles and the proliferation of on-board electronic systems, required by steadily increasing standards of performance, comfort, safety and environmental protection, increase the opportunities for specialised technical service and repair. The rate of penetration of the new technologies is illustrated in Exhibit 4.5.1 overleaf.

Exhibit 4.5.1
Increasing penetration of new technologies
in the German vehicle fleet



Quelle: Institut für betriebliche Betriebsführung im Handwerk (IBB), Karlsruhe

Source: BBE (op.cit.)

One aspect which remains unclear so far is the extent to which this type of specialist service and repair will be controlled by franchised dealers, thereby increasingly tying the car user to the dealer, or by independent networks, as it has been in the past:

- “Franchised dealer workshops have access to diagnostic systems and data that are not available to the independents. The investments required in make- and model-specific tools are designed by the manufacturers to drive small independent garages out of business. The systems and data updates alone can cost Euro 15,000 – 150,000 per year. Mercedes-Benz updates its access codes every month. Manufacturers have instituted a culture of specificity, which enables them to monopolise the market during the first 2-3 years of the vehicle’s life. They are trying to extend the period further. It’s impossible to get written proof. The equipment and component suppliers no doubt have it but they are frightened of losing their OE business.” *EASRA (12)*
- “The development of all makes diagnostic equipment is an increasingly expensive and difficult activity due to the proliferation of on-board electronic systems and the expanded functionality of such systems. The intellectual property rights (notably copyright in software) of such systems are usually held by the vehicle manufacturers and as such are not available to manufacturers of all-makes diagnostic equipment”. *Major Systems Supplier (12)*

Whatever that ultimate outcome, the new on-board technologies clearly cause problems for traditional independent repair garages. The industry is full of stories of their conducting a service or performing a repair but then having to take the vehicle to the franchised dealer to get the warning light turned off – usually for a fee.²² The vehicle industry clearly states its view that independent

²² Interviews with independent repair garages in the context of this report, September 2000

garages are being disqualified by this trend.²³ There are numerous declarations that support it:

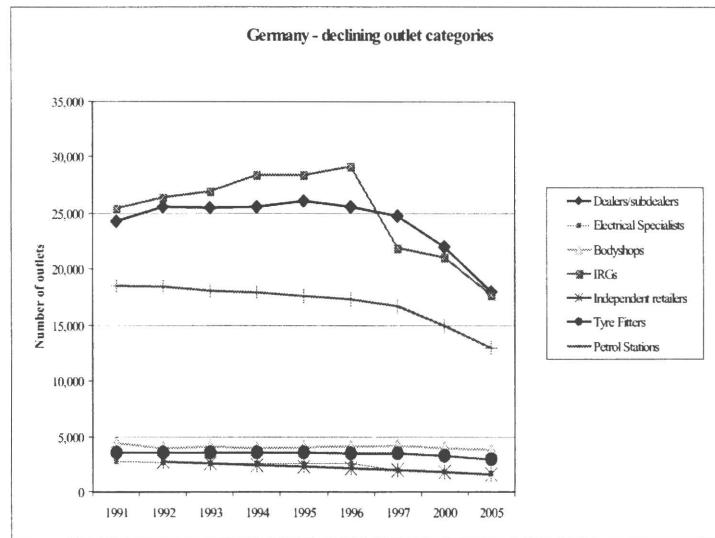
- "For example the following remark "Ah, but! Cars will soon be so complex that customers will have to come to us" was made on more than one occasion during the research, by both dealers and manufacturers." *ICDP, Aftersales in Europe, 1997*
- "Independent repairers are able to repair all vehicle models, but costs for specific equipment for some brands/models is so high that most independent garages cannot afford them. Nowadays there are some models which need special diagnostic equipment and cannot be served at all because failures cannot be diagnosed. Repairs of some newly introduced products require on-line connection to the manufacturer, which is not always made possible for independent repairers." *CECRA (B) (12)*
- "New technologies, such as OBD, are a means of protecting markets. This affects independent garages and distributors, and - above all - consumers". *AK (A) (12)*
- The large number of systems and their specificity requires the development of a particular diagnostic software, so that they can be compatible with overall group standards. This is written with a specific authoring tool and applied through a specific communications electronic board. These are covered by intellectual property rights and software licenses. In addition, safety- and security-related systems require a confidential configuring system. This configuring is carried out by the group's diagnostic system and constitutes confidential know-how. The group does not have diagnostic equipment that can work on vehicles of other makes. Other things being equal, customers are inclined to entrust repairs to the organisation that sold the vehicle. They feel the seller to be responsible for product quality and that they therefore have more influence on a dealer than on an authorised workshop, which only feels responsible for the quality of the repair itself, not of the product as a whole." *Vehicle manufacturer (12)*
- "These (*all makes diagnostic*) products are sold by us only to the independent aftermarket or to smaller vehicle manufacturers without a European dealer network. Those customers do not request us to limit sales to others. It should be noted that the vehicle manufacturers supply dedicated diagnostic equipment to their dealers and provide software upgrades to their dealers only." *Major Systems Supplier. (12)*
- "Due to the large complexity and variety of electrical control units in the various vehicles of the different VM it is simply impossible to develop and produce all-makes testers which cover the makes of all VM. Therefore even the most sophisticated all-makes testers only cover a limited number of the various types of vehicles". *Second Major Systems Supplier (12)*

4.6 Distribution and service networks are changing in a major way

Even in a relatively traditional market such as Germany, traditional outlets are expected to continue to consolidate and reduce in number (Exhibit 4.6.1). There is no sign as yet of the OES sector making significant gains at the expense of the IAM-T sector - but this may be because most of the electronic/diagnostic systems are as yet on cars not old enough to have entered their second and later ownership cycles, and predominantly on up-line cars, for which loyalty to the dealer is greater in any case.

²³ ACEA, position on motor vehicle distribution in the European Union, (op.cit).

Exhibit 4.6.1
Consolidation of traditional outlets in Germany



Data source: BBE (op. cit.)

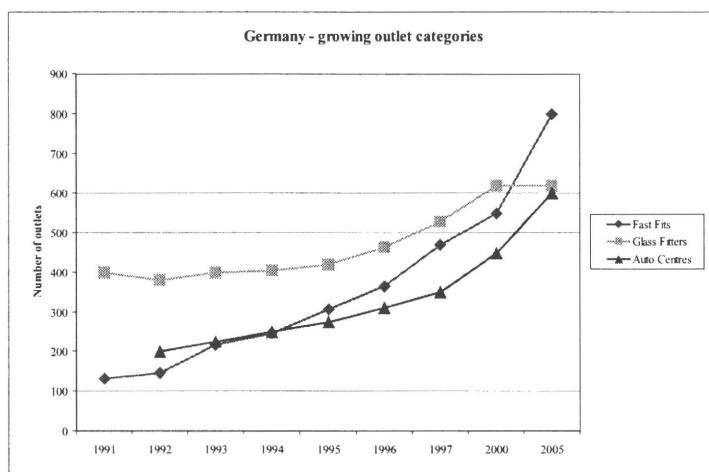
There are signals throughout the industry that vehicle manufacturers intend to restructure their distribution and service networks, consolidating sales points and reducing the number of them, while maintaining extensive networks of local service satellites. In Germany, for example, Ford, Honda and Rover have issued termination notices to a large number of dealers as they restructure their networks in what is viewed as Europe's most important car market. Just as platform strategies preserve economies of scale in underlying components, while allowing the derivation from them of increasing numbers of new vehicle models at acceptable cost, so the sharing of "back office" facilities in the dealer networks allows sharpening of the "front office" brand-specific facilities. Just as tiering has taken place in the upstream components industry, so there will be a more rational deployment of sales and service facilities, including centralisation of heavy repair operations. Investment in diagnostic systems is not only essential for diagnosis and fault-finding in and through the on-board electronic processors: it is also a wonderful way to provide each service point with direct access to very powerful, central, server-based capabilities.

There are also signs of the OES distribution structures being used to attack the IAM parts market, through all-makes programmes – a revival of an old idea. Reciprocally, vehicle manufacturers are required by Regulation 1475.95 to allow their dealers to purchase equivalent quality parts from the IAM sector. While there is no documentary proof of intent or obstruction, there is anecdotal evidence of informal pressure brought to bear on dealers not to source these parts (see Section 5).

In the face of all this, the IAM-T sector remains very dispersed, although major international purchasing groups are gaining increasing power and influence in the distribution of spare parts, led by AutoDistribution International, Temot

International, Groupe Auto Union and Auto Teile Ring. The major groups all have chains of soft-franchised independent garages but these do not yet provide networks as tightly controlled or as well equipped as those in the OES sector. There is a plethora of "concepts", involving independent repair garages becoming appointed centres for various component suppliers. These do not appear to have had a serious impact – it is hard to imagine a multi-purpose garage being appointed by different suppliers in all the different components areas. Thus the sector still calls out for consolidation, rationalisation and general improvement of performance – but under whose leadership ?

*Exhibit 4.6.2
Growth of ND outlets in Germany*



Data source: BBE (op.cit.)

There is a constant undercurrent of fear in the IAM-T sector that it will be crushed between the OES and ND sectors, if it does not restructure itself.²⁴ The components industry is extremely concerned at the risk of losing access to the OES sector and of that sector launching a general assault on the IAM-T markets.²⁵ But it is virtually impossible to obtain public testimony on these issues, because of the nature of suppliers' relationships with their vehicle manufacturer customers.

Conversely, a continued rapid expansion of the New Distribution formats is expected (Exhibit 4.6.2). While the penetration of these is already high in the UK and France (and possibly reaching its limits there), it is now clearly underway in Germany, which was a latecomer to the sector, has started in Spain and is in its infancy in Italy. While there is little room for these formats to widen the scope of their operations, as only a limited set of interventions lend themselves to their approach, there is plenty of room for geographical

²⁴ Source: confidential client survey of component suppliers' opinions, July 1999

²⁵ Source: **auto**POLIS client assignments; submissions from independent aftermarket federations and component suppliers, August 2000 (72)

extension. The ND sector is in general concentrated in the hands of a small number of financially powerful players, who can strongly brand their chains and exercise considerable purchasing power in sourcing spare parts.

4.7 The Internet may be less controllable than the vehicle industry likes to think

The vehicle industry's position so far has been that the Internet creates huge cost saving opportunities, both in B2B relationships with suppliers and in B2C relationships with customers.²⁶ In B2C, the hope is to use the Internet to support a generalised move away from selling completed vehicles from stock to assembling vehicles only to real end customer order, with considerable benefits to the running of the whole supply chain. But the stated intention is not to eliminate the dealer from the sales process through direct ordering by retail customers.

The Internet facilitates comparisons of products and prices, although vehicle manufacturers have not yet allowed actual purchasing of new cars through it. At present, therefore, the Internet acts only as an additional shop front into the franchise dealer system for new vehicles. E-commerce ventures, such as JamJar, Virgin and OneSwoop, in fact have to source new vehicles from franchised dealers. Their business is in fact the old one of an intermediary acting on behalf of end customers, arbitraging price differences between national markets (mostly the UK versus continental Europe), with a more modern user interface. The situation in the US is not fundamentally different, with vehicle manufacturers and dealer associations fighting incursions by would-be 3rd party distributors, whether based on e-commerce or not. Mary-Ann Keller's resignation from a leading e-commerce enterprise in the US, on the grounds that Internet-based sales of new cars are not taking place to a significant degree and may never do so, is an interesting indication of the realities of B2C in car retailing.²⁷

For the moment, therefore, the impact of the Internet remains limited. The principal external braking factors are: general lack of familiarity with B2C e-commerce in Europe; concerns about the security of the Internet for large purchases; variable rates of PC penetration, lower on average across Europe than in the US; and attachment to the habit of seeing and trying out the product. Behind this stand the more fundamental barriers of vehicle manufacturers' and dealers' resistance to direct ordering, by-passing the dealer, and the much deeper threat which the Internet carries of unbundling the whole distribution system.

This is clearly identified by Evans and Wurster of the Boston Consulting Group, who view the Internet as a powerful dissolver of the glues that hold together bundled businesses, and who are sceptical about the future of the

²⁶ ACEA, reference 1 footnote 1 page 5

²⁷ Wall Street Journal, 7th November 2000

dealer system.²⁸ It would certainly be interesting to see large purchasers of vehicles, such as the short-term rental fleets, large utility companies, or government bodies conduct B2B Internet procurement auctions, thereby emulating the vehicle manufacturers' actions in parts sourcing. For retail customers, the movement could well first gather momentum in the second-hand car sector and in the retailing of pre-registered vehicles, which do not have to be retailed through franchised dealers. The whole e-commerce phenomenon could prove to be far less controllable than the vehicle industry imagines.

4.8 An overall assessment

Yesterday's framework is not automatically the best for tomorrow's circumstances:

- 20 years ago, we lived in an era in which vehicles were indeed unreliable and potentially dangerous because of failures caused by inferior maintenance and repair. The concerns of that era were reflected in Regulation 123.85, which first formally exempted the vehicle industry and its franchised networks from the common restrictions on vertical links
- Thanks to the great improvements in quality, reliability and durability, consumers became more used to dealing with unbundled sales and service propositions - as they have in other sectors. The independent aftermarket has flourished under these conditions, notably its ND sector
- Regulation 1475.95, however, appears virtually to have reproduced the assumptions about the unquestioned need for SED, with only minor concessions to opening up the market
- We are now into the early stages of a new cycle, in which on-board electronics have introduced new complexities and new diagnostic tools into the service market. The vehicle industry appears intent upon using them to build proprietary barriers to entry, which will reduce the role of the IAM-T sector. It is in general seeking to tighten its control over sales and service in its franchise channels

The "natural" sales/service link in particular requires closer examination.

²⁸ "Blown to Bits", P. Evans and T.S. Wurster, Harvard Business School Press, 2000

5. The sales/service link needs closer examination

5.1 The sales/service link needs to be reviewed against the whole spectrum of distribution activities

In order to understand fully the nature of the link between sales and service, it is necessary to identify all the activities which impact upon it and are affected by it. At first sight, some of these may not seem to have a bearing on the sales-service link. They do, however, have an important indirect influence on it, because they are part of a complex set of linkages which underpin the functioning of the current distribution and service system. They also illustrate the culture of command-and-control of which the sales-service link is part.

We examine the following stages in the ownership cycle:

- Search and selection: how customers obtain information about products, prices and availability, in order to preselect the products they are interested in; bundling of benefits, in products and services; how they are able to test drive vehicles; and how they make their selection
- Negotiation and ordering: who has what power and stands on whose side
- The ownership cycle: PDI and handover; warranty claims and other service and repair; recalls; trade-ins and scrappage

A useful comparison is the nearest approximation in this sector to a 'free' market – the sales and servicing of used cars – and where appropriate we draw comparisons between the new and used car markets.

5.2 Search and selection in new vehicles is not made more open by the sales/service link

5.2.1 Product evaluation is mainly an open information market but service evaluation is difficult

There is an open market in information about the characteristics of vehicles, through the various media. The Internet reinforces it further. Conversely, the role of the franchise network as a source of information for evaluation may actually be declining. "As a provider of unbiased product information, its value added is negative"²⁹ The selective and exclusive distribution system militates against dealer new car salespeople providing unbiased comparisons of products to benefit the consumer.

Conversely, there is a major gap in information about the service side of the ownership experience. There is no 'Guide Michelin' for service and repair in Europe. Public comparative information about product quality and safety and about the cost and quality of service and repair has historically been extremely limited. In the US, JD Power have for many years surveyed the US vehicle

²⁹ Evans and Wurster, op. cit.

market in terms of the ownership experience of vehicles. The survey does not look solely at the product, but also compares the aftersales experiences offered by the franchise networks. In general, the owners of volume manufacturers' cars fare far worse than the niche, specialists or upline producers in all respects. Such has become the power and acceptability of this annual survey, that the organisation has introduced a 'Retail Certification' programme, which accredits dealers who meet certain service quality standards. Public comparative data of this kind is hard to find in Europe. The fragmentation into national markets does not help. Vehicle manufacturers conduct co-operative comparative surveys but the results are kept private.

The sales/service link brings few benefits to consumers with respect to buying cars and none with respect to freedom of choice in service

5.2.2 Control over new car transaction prices is indirectly facilitated by the link

The UK Competition Commission's investigation ³⁰ clearly identified how vehicle manufacturers use their control over dealers within SED to control transaction prices for retail customers. Dealer margins have been reduced, in order to lessen their ability to grant discounts independently of the manufacturer. Consumers' ability to shop around on price within a brand (intra-brand competition) will clearly be further reduced by the granting of exclusivity within enlarged dealer territories ("market areas").

In the US pricing information is more open - although there are some individual states which protect dealers' exclusive advertising territories. US dealers have significantly greater commercial freedom than their European counterparts. They are less dependent on financial cross-subsidy of car sales by service and repair. They constantly advertise price deals in the local media. Use of the Internet for price shopping is more developed in the US, which has more of a national market than Europe. Another critical difference between Europe and the US is the access to information on the manufacturers' invoice prices to dealers, plus their incentives and vehicle finance, through Internet sites such as Edmunds.com. This allows consumers to estimate the dealer's potential profit on a vehicle, and hence their room for manoeuvre in negotiating.

Another key area of obscurity in pricing information is the practice of bundling of 'benefits' - free or low cost finance, insurance, extended warranties, and free servicing packages. 'Special edition' models are a further device for obscuring the price of the base vehicle and of options.

The non-transparency of new car pricing is not itself a result of the sales/service link. But the practice of transaction price control on new car sales through very low dealer gross margins is clearly enabled by the internal

³⁰ Op.cit.. Despite its UK focus, the Commission's detailed and thorough report should be required reading for all those concerned with automotive distribution issues.

cross-subsidy within dealerships, which is itself made possible by the sales/service link.

5.2.3 The link does nothing to support freedom of choice in new car outlets

Under SED, there is no choice of source of new cars for retail customers. The franchised network is the only set of approved retail outlets. Shopping around within the network within a country is being made more difficult. The theoretical right to shop in another country, under 1475.95, is hopelessly inconvenient for all but a tiny minority of consumers. It has also been widely obstructed in practice. E-commerce intermediaries have to source from franchised dealers in other countries. The industry is keeping a very tight rein on this phenomenon. Would-be new entrants such as mass retailers are equally constrained.

For used vehicle purchasers, the market is more open. Most used car dealers are multi-marque, allowing interbrand comparisons and considerably more choice of vendor within a local geographic area, facilitating the sourcing process.

The non-availability of truly competing outlets in sourcing new vehicles is forced by the vehicle manufacturers. It is emphatically not the result of natural market forces. Other than the fact that franchise dealers are obliged to have service facilities, there is no correlation with the sales/service link.

5.2.4 Test drives are being separated from the service location

Test drives are presently only available through the franchise network, as dealers have demonstration vehicles for this purpose. The vehicle manufacturers themselves are looking to alternative methods of facilitating test drives, as they restructure their dealer networks to cut out cost. Some have proposed having a limited set of demonstration centres in populated areas, in order to centralise the test drive process. This further weakens the link between sales and service. The growth of the fleet market in Europe has also been working against the dealer in this respect. Drivers of executive cars (who are not the economic purchasers of vehicles) are increasingly using dealerships to test drive vehicles at a location convenient to them. Rental companies in effect offer test drives of different vehicles and brands to business travellers.

As test drives are purely an aspect of sales promotion, there is no relationship between test drives and the linking of sales and service.

5.2.5 New car selection is still heavily influenced by producer push, which is indirectly facilitated by the link

Selection is highly biased by producer push, i.e. the need to keep factories producing to pre-determined schedules. Vehicles are allocated to dealers to sell, rather than chosen by dealers. Full range forcing across the product range (the contractual obligation to sell all of the product line) is a standard part of this process. Vehicle manufacturers use their power to require dealers to take less attractive models along with the more desirable ones. The supply of the popular products is made contingent on acceptance of the less popular. The dealer then has to try to force the selection into the local market. In spite of overcapacity, evidence given at the UK Competition Commission enquiry³¹ suggested that at least 23% of consumers do not get their first choice of vehicle. Instead, they are encouraged to buy what the franchise dealer has in stock, i.e. the vehicles that have been allocated to the franchise dealer by the producer. The industry is attempting to move to building cars to customer order only. Time will tell how well this will work, with factories no longer shielded from real demand by a compliant dealer channel.

The relationship to the sales/service link is an indirect one. The internal cross-subsidy may enable dealers to continue manufacturer-financed full range forcing and the stocking of slow movers. The dealer is not required to act as a viable independent business in new car sales. This places the dealership firmly on the side of the supplier, not of the consumer.

In the used car market, customers can select from a wider variety of vehicles, and used car traders will usually stock vehicles they believe to be appropriate to customer tastes in the local market area. They will 'trade on' to other dealers or through auctions those vehicles they do not believe they can readily sell. The need to bundle additional packages to the product, in order to make it attractive, is also not such an imperative for the used car dealer – who is free to determine his/her own business with or without service facilities.

5.3 Negotiation is also highly constrained for the retail customer and the dealer

Retail customers for new cars have no option but to buy from the franchised dealer. They therefore have only limited latitude in negotiation, which is often obscured by trade-in values and other bundled-in benefits. The franchise dealer has limited ability to negotiate with the private buyer, because of the small gross margins granted by vehicle manufacturers on new car sales. There is no opportunity to negotiate the terms of aftersales service.

In the fleet business, the franchise dealer is further disadvantaged when the negotiations take place directly between the fleet operator and the vehicle manufacturers. Under these circumstances, dealers effectively enter an 'auction' to become the supplying dealer – or are appointed as specialist fleet

³¹. Op.cit.

dealers by the vehicle manufacturer. One reward for the dealer is the retrospective bonus given by the suppliers for achieving sales targets. The other is the promise of guaranteed service revenues from fleet owners. However, these are subject to negotiation on price, to outsourcing to third parties, or to the vehicle simply disappearing into another territory.

Thus the retail buyer negotiates on car price and accepts the service offering. The retail buyer is given no opportunity to break open the sales/service link by negotiating on service. The fleet buyer can explicitly negotiate both, thereby breaking the link (notably through threatening to take service business elsewhere). The second hand car customer may go through a similar process to the new customer when buying from a franchise dealer but also has the option to go to the independent sector.

5.4. Finance is frequently used as a means of locking sales and service together

Selling finance and insurance packages (on new or used vehicles) is a key method for dealers' new car sales departments to gain revenue to offset the small margins on new car sales. It is also a means by which the customer can be retained within the network for service.

All vehicle manufacturers have branded finance packages available for end customers to facilitate the purchase of new vehicles. Franchise dealers are not free to source alternative forms of finance for the customer (unless the captive finance company does not wish cover the risk on a particular customer). Customers who arrange their own finance are in many ways less attractive: they have more negotiating ability and present fewer additional profit opportunities with which to support the dealer's small new car margin.

The obligation to have vehicles serviced in the dealer network is explicit, when lease or contract hire packages are provided by the dealer. When they are provided by independent third parties, the lock-in becomes part of the negotiation on prices and conditions for the sale of vehicles to those third parties. A general expectation is created that service and repair by a franchise dealer will enhance residual values, thereby drawing the customer into the franchise sector for aftersales.

In the used vehicle market, finance packages are also available from the dealer, but without the necessary tie into the aftercare network. Consumers are more used to unbundling of products and services in the used car market. They will in many cases make independent finance arrangements to pay for the vehicle.

This is clearly another forcing of the link by vehicle manufacturers, inhibiting true transparency and freedom of choice for the consumer.

5.5 Insurance appears to be independent of the sales/service link

Insurance provision is a profit opportunity for both new and used dealers, as previously discussed in the effects of bundling. There is usually nothing in insurance which ties the customer to the vehicle seller for service.

5.6 The sale of extended warranties props up the sales/service link

Consumers are greatly reassured by the provision of warranty on high-value items. All new vehicles sold in the European Union through authorised dealers have a manufacturer's warranty. In general this is for one year for European and US manufacturers. In some countries, as an additional marketing tool, manufacturers will extend the warranty to three years (this appears most prevalent in the UK and Swedish markets). Japanese manufacturers routinely cover vehicles with a three-year warranty in all EC countries, with Toyota extending this to six years in Greece. Interestingly, their service retention is also higher. Most manufacturers also make provision for "goodwill", which is rectification of potentially embarrassing defects arising outside the warranty period.

As in other consumer goods sectors, dealers (of new or used vehicles) can sell extended warranty insurance to purchasers (coverage beyond the normal one-year manufacturer-financed warranty period). Despite industry folk-wisdom that claims are increasing, there is no real evidence for this, except for specific temporary problems. The great majority of claims arise during the first year of the new vehicle's life and the normal warranty system appears to be efficient in detecting and remedying these problems. There is a sharp drop-off in warranty claims thereafter. The reduced probability of encountering a problem over the extended time period is not explained to the customer. Extended warranties on new vehicles therefore provide a lucrative profit opportunity for dealers in both sales and service. It is common knowledge that dealers can earn 30% gross profit on the sale of warranties (sales staff are incentivised to sell them), and the consumer may also be more inclined to use the dealer's workshop for service during the extended warranty period. There is usually no incentive given to the consumer to look around for an independent source of warranty insurance.

In the used car sector, warranties are offered which do not require the vehicle to be serviced by a particular outlet – although they do require a competent repairer carry out the task. These warranties are provided by insurance companies, and will cover all makes and models of vehicle (of a certain standard) and have national coverage – allowing the consumer more choice. Warranty providers, i.e. insurance companies, may also accredit certain repair outlets – franchise and non-franchise - that have the requisite facilities.

When a repair under warranty is required, the most important element to the consumer is the first-time rectification of the fault. In this sense it is natural for

the owner to seek repair and redress through the authorised agent of the producer, or in the used car market, the authorised agent of the warranty provider.

With new vehicles, unlike new appliances or equipment, there is in effect less consumer choice of the outlet to which to return the vehicle for repair, and extended warranties exacerbate this effect.

The warranty system as a whole is clearly used as part of forcing the sales /service link.

5.7 Trade-ins are sometimes used to force the sales/service link

Exhibit 5.7.1 shows the percentage of sales of new vehicles to private customers that involve trade-ins. Trading-in is a well-established practice and a major part of the full-service expectation on the part of consumers.

*Exhibit 5.7.1
Transactions involving trade-in vehicles*

Proportion of sales to private customers which involve 'trade-ins'	
<u>Country</u>	<u>Average %*</u>
UK	75
Germany	75
Spain	61
France	58
Italy	54

* 1997 - 1999

Source: UK Competition Commission

It is generally recognised that vehicles with fully documented service records are more saleable to second or third buyers. Franchise dealers sometimes imply that a non-franchise service record is of less value than service from dealer of the marque, even though a reputable independent garage may have serviced the vehicle professionally and to the manufacturer's service specification. This is another means of coercing the customer back into the franchise network.

Independent used vehicle traders also value a full service record from a qualified reputable garage, implicitly using original or equivalent quality parts. Whether the servicing garage is franchised or non-franchised is less important. Most independent used vehicle traders do not have service facilities. There is therefore no correlation between the trade in of cars and the sales/service link in the independent used car business.

5.8 Pre-Delivery Inspection (PDI) is not a justification for the sales/service link

Currently the large majority (90%) of PDIs take place at the franchise dealer, although for high volume fleet sales, PDI is increasingly conducted by third parties, such as logistics companies.³² There are also variations in this process between manufacturers, depending on the source and destination of the vehicles. Some manufacturers operate import centres, which have facilities for rectification and the majority of the elements of PDI, leaving the dealer with a final vehicle preparation prior to hand-over, which includes cleaning, visual inspection and activation of codes. The growth of vehicle manufacturers' use of PDI centres allows them to control costs more effectively through economies of scale, and can be expected to increase in the drive for increased profitability. This weakens the notion of an absolute, safety-related link between PDI and the franchise dealer outlet.

- "PDI is carried out by the dealer or logistics company for each category of customer (*retail or fleet*). Dealers carry out PDI for the vast majority of retail customers, and logistics companies for the majority of large fleet customers. They have the advantage of economies of scale but the dealer has the ultimate responsibility for the condition of the vehicle at hand-over to their customers. Dealers do however use logistics companies for PDI when their service workshops are full and may continue using them due to economics. RMIF (GB) (12)

"Before a new vehicle is delivered to the final consumer, the undertaking within the distribution system must give it a technical inspection, according to the manufacturer's specification".³³ This statement appears to imply a process of a highly technical nature, very specific to the product and brand. In fact, PDI is not usually a lengthy process (normally 2 to 3 hours). Nor, historically, has it been a very technical one. The elements normally included are:

- Deprotection/cleaning
- Visual inspection for body/paintwork damage
- Mechanical checking/test drive
- Function checking (lights, etc)
- Code enabling
- Accessory fitment
- Final cleaning and valeting

As such, many non-franchise operators could conduct the PDI process. One aspect is changing, however. This is the appearance of instructions to clear error codes, conduct a test drive and clear error codes again. This requires access to specialised diagnostic equipment, which is generally brand-specific. The process is evidently becoming more exclusive to the brand, insofar as the brand is putting up more proprietary barriers to entry in diagnostics. This forces PDI closer to the franchised workshop (wherever and whatever it is) but

³² See, for example, "Logistics boss says dealer system may go", Automotive News Europe, November 6, 2000, p. 16.

³³ Regulation 1475.95, Recital 4.

actually says nothing about the sales/service link itself. Therefore, apart from the use of specialised diagnostic equipment, there is nothing inherent to the PDI process that underpins the sales/service link.

5.9 Delivery/collection & hand-over are not directly related to the sales/service link

This aspect is an important second opportunity, after the actual sale, for the dealer to establish a relationship with the private buyer. It should also be the time for introducing the customer to the service facility of the dealership, to reinforce the tie between sales and service in the customer's mind, and generally to strengthen their loyalty to the brand. Where the dealer service agent arranges the purchase of the new vehicle from the main dealer (common in southern European countries, especially in rural areas), the link between sales and service takes a different form, centred around the service end of the business. In fleet sales the whole linkage is much less strong, because of the disconnection between purchasers and users of vehicles. Many used vehicle dealers do not have service facilities, although they may recommend a service outlet.

In the context of this process, the sales/service link is therefore a relative concept, whose form and strength depends on the particular vehicle sales sector.

Some vehicle manufacturers in Europe seem to be moving towards integrated regional networks on a hub-and-spoke model, with service points clustered around a salespoint. The initial sale and subsequent trade-in could happen either at the centre or by delegation to a service point. The service relationship in the period between will be led from the service satellite. With proper handover procedures in both directions, there is no reason for this change to harm relationships with customers. It might in fact reinforce them, as the workshop is the closer and more "solid" entity. Again, we have here the beginnings of a separation of sales from service.

5.10 The effects of tying warranty to the franchise network

Warranty work is almost wholly conducted by franchised dealers or their sub-dealers/agents. The only exceptions to this appear to be where fleet owners have their own workshops, which some suppliers have authorised to conduct simpler warranty repairs, under close supervision, in a very limited number of instances. Increasingly, vehicle manufacturers are using some form of 'intranet' system to process warranty claims from their dealer networks. It would indeed be highly costly to widen this facility to the general aftermarket.

Dealers are generally authorised to carry out repairs, without referral, up to a certain value. Thereafter they have to seek the supplier's approval. All repairs have to use original equipment parts.

- It is a common view held by the majority of motorists that the main dealer must complete warranty work. We have experienced a number of cases where dealers consider aftermarket components, despite being manufactured by the same supplier, to be sub-standard and, when asked, comment that the part fitted was not a 'pattern part' as supplied by the vehicle manufacturer (*sic*). *Kwik Fit (GB) (12)*

For the franchise dealer warranty work is often not attractive in comparison to private retail work. Many vehicle manufacturers reimburse labour at a lower rate than charges to retail customers. Hourly charge-out rates are typically 85-100% of those for retail work. Some dealers complain that there is no compensation for additional fault-finding or administrative time. Margins on parts used in warranty are often considerably curtailed, sometimes down to dealer's net purchase cost plus a handling fee. In addition, these margins vary considerably between brands and within them between European Member States, for reasons which are unclear.

- "Quality has improved but complexity has gone up (electronics, airbags, ABS, etc) and product ranges have been extended (although common platforms compensate for that to some extent). The number of warranty claims has trended upwards. 10-30% of dealer workshop turnover is for warranty work, depending on make, with some special cases of much higher incidences, especially for heavy trucks. Labour hours are normally reimbursed to the dealer at the retail tariff, parts at prices varying between recommended retail price and purchase price + handling charge. But the standard hours prescribed do not adequately compensate for the extra diagnostic and administrative work involved, while parts rates are below normal. In practice, warranty work is exclusively conducted in franchised workshops, on legal and contractual grounds. Fundamentally, franchised dealers are free in their parts sourcing. However, the use of OE parts is prescribed for warranty work" *ZDK (D) (12)*
- "Warranty work does not seem to have diminished in volume. For one brand, it went up from 10% of dealer workshop activity in 1999 to 12% in the first half of 2000. Most makes now reimburse dealer warranty hours at the full tariff but parts are generally reimbursed at cost, plus an extra percentage for some makes – which is not always satisfactory for dealers" *FEDERAUTO (B) (12)*
- 20-25% of activity in dealer workshops is warranty work. Volumes vary considerably between brands and dealers. Parts are reimbursed at cost for warranty work, there is no margin on them - *FACONAUTO (E) (12)*

A workshop full of warranty work may therefore be uneconomic for the dealer, in comparison to one filled with paid retail customer work. Yet the protection of the warranty is a key element in the service decision choices of a consumer, while good execution of warranty work can do wonders to restore damaged relationships with consumers.

Warranty is a natural extension of the supplier's new product obligations. Free rectification of problems helps create a genuine bond of the customer to the brand. As manufacturers pay for the parts and labour, they are entitled to insist on them coming from their own sources. But there is an element of forcing. Evidence exists³⁴ that consumers are sometimes not informed of their right to have non-warranty servicing and repair work undertaken outside the franchise network during the warranty period. Fleet companies are more

³⁴ UK OFT Report Car Service and Repair, August 2000

aware of this dynamic - and some have the added advantage of an approval system for garages, whether franchised or independent. They are more able than the general public to assess the general competence of repairers. It is also very noticeable how service retention by dealer workshops falls off, once the warranty expires.

- The manufacturer refuses to independent garages their legitimate right to carry out service and repair during the warranty period Consumers are led to believe that they are obliged to go to the franchised dealer workshop during the warranty period. OBD systems drive motorists to the dealer workshop - *EASRA* (12)
- Independent garages cannot perform warranty work, as the manufacturers refuse to reimburse the labour hours. Warranties should be supplied by independent insurance providers, so that the customer has freedom of choice - *VKW(D)* (12)

Warranty is not only a means of keeping customers satisfied. Conducted within a selective and exclusive network, it is also a way of catching remaining quality problems after the factory gate and keeping the incidence of the problems quiet. This is one reason for which warranty statistics are treated as highly confidential.

Most used vehicle warranty providers allow the consumer to take the vehicle to a VAT registered independent garage of their choice for servicing, although some will stipulate that the first service after acquisition should be conducted at the franchise dealer. These providers need access to information on failure incidence rates, in order to set their premiums.

In conclusion, warranty covers product obligations on the part of the vehicle manufacturers. They are entitled to prescribe where and how warranty work is conducted. However, implying that normal servicing and repair carried out outside the franchise network will invalidate warranties is an unnatural forcing of the sales/service link.

5.11 Apart from safety related issues, recalls can relate to simple quality problems

Recalls are initiated when there is an identified problem with a model of vehicle - it is another form of post-factory rectification. All manufacturers have similar procedures, although they may execute them somewhat differently.

The identification of problems is mainly made through the vehicle manufacturers' service, manufacturing and engineering functions, and through the dealer workshop network. In a few instances the problems are notified by outside bodies, such as safety inspectorates.

The affected vehicles are identified by their chassis numbers. If the vehicle is in the early stages of its life, then dealers' customer files may be sufficient to ensure that most customers are contacted. Manufacturers may, however, also have to involve state vehicle licensing authorities to obtain the name and

address of the current owner, particularly for older vehicles and/or used cars, which no longer return to the selling dealer for service. Manufacturers will also in certain cases use national media advertising for a recall when there is need to inform the public quickly. In this sense this is no different from food safety related recalls.

It is understandable that for safety, speed and cost effectiveness, repairs are conducted by supplier-approved agents, in order that they can easily monitor the number of affected vehicles which have been repaired. Many national licensing authorities also require confirmation that vehicles have been rectified. Vehicle manufacturers organise the mass provision of replacement parts into the dealer network through their sophisticated distribution systems.

Safety-related recalls are always notified to the relevant public authority and vehicles are repaired as soon as possible. However, licensing authorities in some European countries will not make such information available to third parties, which seems an obstruction of actions for public safety.

- "For legally prescribed (i.e. safety related) recalls, owners are contacted by the manufacturer or importer. There are also "silent recalls", which affect comfort and convenience, and which are exclusively handled through the dealer network. Dealers are able to contact owners through their IT systems" *ZDK (D)* (12)
- "There are two kinds of recall. Safety related recalls are widely publicised, through the media and organisations such as ANWB. Other recalls are handled when the vehicle is next in the workshop. There is no public information" *ANWB (NL)* (12)

Non-safety-related recalls are not so advertised ('silent recalls') and rectification is usually conducted in the franchise network when the vehicle is next presented for service. Indeed vehicle manufacturers usually identify them differently, using titles such as 'Product Update' and 'Customer Satisfaction' campaigns. Having selective and exclusive dealer partners makes it easier to prevent information about non-safety recalls leaking out. While a well-organised recall can have a beneficial influence on brand image, it is nevertheless also an admission of a quality problem.

- "A manufacturer's willingness to recall a product is also influenced by the fact that recalls have lately often generated a rather negative reaction in the media and the product quality was doubted. Especially if recalls accumulate, the manufacturer will tend to have additional defects rectified in the framework of maintenance services, or at least not communicate the recall through the media." *ADAC (D)* (12)
- "The number of cases where manufacturers delay recall actions even if safety-related defects are involved has not decreased. While the manufacturers' fear of damage to their image and pressure by the public or the automobile clubs plays an important role, experience shows that they delay a recall action in at least 1/3 of the cases, rather showing an upward trend. We understand that the general increase in recall actions is to some extent due to deterioration in quality. Even family cars and small cars are fitted with even more technical extras. To reduce the costs, low-quality products are used." *ADAC (D)* (12)
- "Recalls in Germany are virtually all conducted under the responsibility of the manufacturers. There are therefore no official statistics on them, only what can be gleaned from the press. A tightening up would be desirable in this area" *TÜV (D)* (12)

The issue with recalls is not whether the franchise dealer network should be responsible for carrying out the recall and rectification – this is a normal part of the manufacturer accepting responsibility for rectifying defects, free of charge. Where the rectification is carried out – by the dealer, sub dealer or factory – is up to the manufacturer. The use of certified independent workshops may sometimes be appropriate. The problem is more lack of transparency about quality problems, in cases where no public notification is made. A cynic might take the view that the sales/service link is used to keep the bad news within the family. Although the right to return defective goods exists in some countries, Europe has no direct equivalent of the US Lemon Laws, applied in many States.

5.12 Maintenance and repair and the sales/service link

5.12.1 Consumers in different sectors of the market make different trade-offs in selecting providers of service

*Exhibit 5.12.1
Distance to service provision*

<u>Maximum distance prepared to go to service car</u>	
<u>Maximum travel distance (miles)</u>	<u>% Drivers</u>
up to 3	30%
3 to 6	31%
6 to 9	14%
9 to 12	8%
12 to 15	5%
15 to 18	3%
Over 18	9%

Source ICDP / Lex 1998

Proximity to the consumer is one of the key decision points for choosing a service provider. Over 60%³⁵ of motorists do not wish to travel more than 10 kms to have their vehicle serviced, as Exhibit 5.12.1 shows. Service is an integral part of the product ownership experience for vehicles and does therefore directly affect the image of the product brand, insofar as sales and service are strongly linked in the SED system. Serviceability is linked to the reputation for reliability and durability, as well as cost of ownership. An ICDP³⁶ study of German motorists found that the principal components of the serviceability part of the brand image included:

- Technical complexity

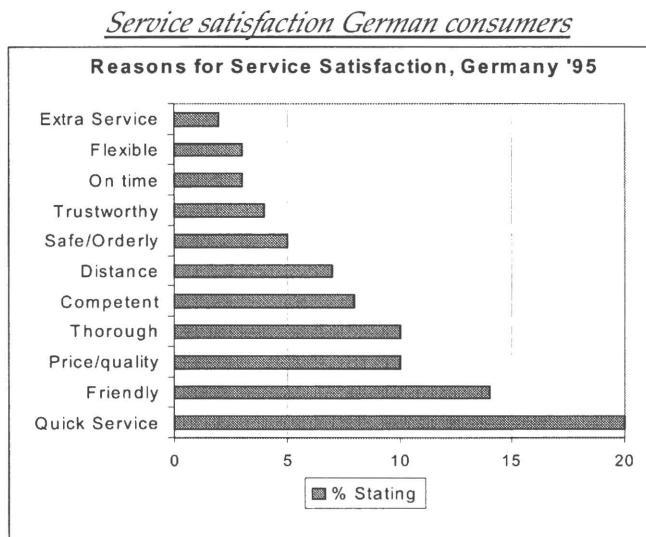
³⁵ ICDP:Future Directions for European Car Distribution Evolution or Revolution? 9/98

³⁶ Aftersales in Europe, Research Paper 2/97

- Availability and cost of parts
- Amount of servicing (intervals, length, cost)
- Convenience of servicing (location)
- Quality of service

Satisfaction with service is a function of multiple factors, led by quick service, friendliness and price/quality, as Exhibit 5.12.2 shows.

Exhibit 5.12.2



Source: ICDP, Aftersales in Europe

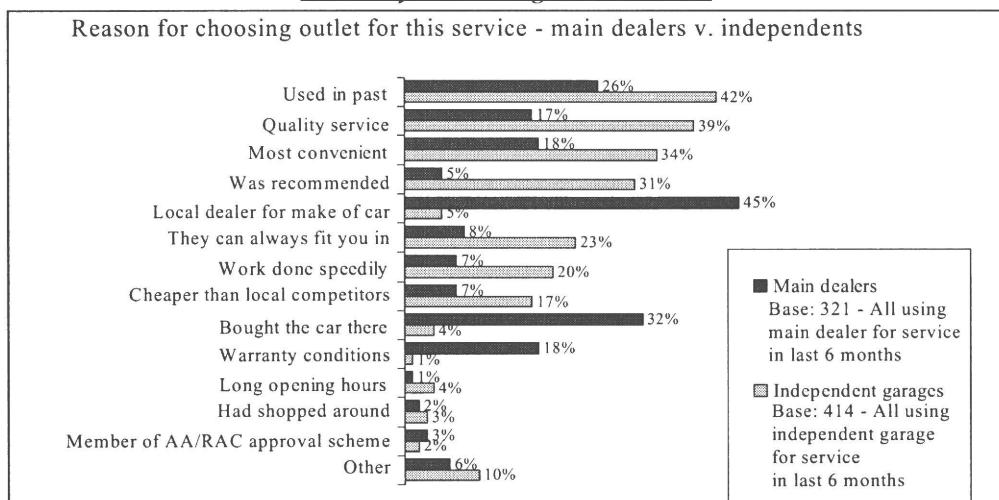
Users of dealer and independent workshops select their service providers based on significantly different criteria. The sales/service link matters to the former but not much to the latter, for whom the relationship with the service outlet itself is most important. Professional (fleet and other) buyers of new cars are also likely to break the sales/service link.

- "Finance and leasing companies have now developed into major distribution players across Europe. They conduct a significant proportion of business sales – they have developed preferred networks of suppliers, working to their own quality standards." *ICDP, Future directions for European Car Distribution, 1998.*

When a new car buyer switches brands, their service loyalty will typically switch to the service outlet of the new brand. Not so for used cars, where the primary relationship stays with the known independent service garage. A British survey of car owners, performed as part of the Office of Fair Trading inquiry into vehicle servicing and repair, illustrates this point (Exhibit 5.12.3)

Exhibit 5.12.3

Reasons for choosing service outlet



Source TNS Harris (*op. cit.*)

Main dealers lead on only three criteria: 'local dealer for make of car'; 'bought the car there'; and 'warranty conditions'. Independent garages lead on everything else, notably: 'used in past'; 'quality of service'; 'most convenient'; and 'was recommended'. Franchise dealerships emphasise the sales/service link, presenting their workshops as an integral part of the product brand image (for better or for worse, depending on the quality of the workshop's performance). Independent garages have only the quality of their service to offer. The good ones focus on their relationships with their customer base.

- "The equipment in independent workshops is more costly, because of having to handle all makes. The reason: there is no device on the market which will communicate with all models. Manufacturers only release the technical data for vehicles over 3 years old. This puts independent repairers and the consumer at huge disadvantage. Consumers are forced into the dealership. Manufacturers refuse to supply error codes for vehicles less than 3 years old. Key functions, such as airbags, immobilisers, error files cannot be accessed, as communication with the processors is impossible. This is demonstrable for Opel, VW, Daimler-Benz, Ford, BMW, etc. However, OBD emissions data is made available, because this is legally required." *VKW (Master Garage Federation - D)* (12)
- "The principal difference in the range and nature of service/repair activities undertaken by franchised and independent repair garages is the fact that franchised garages generally do repair and servicing work as part of the manufacturer's warranty." *AA (UK)* (12)

Franchise dealers do appear to have an initial competitive advantage in consumers' minds in the first ownership cycle. The natural tendency of a large proportion of consumers is to use the service provider of the make. In the first cycle there is an implicit lock in; the second cycle is still a large opportunity for the franchise dealer; but beyond this dealers are often uncompetitive – not just on price but also on flexibility and responsiveness to customers' needs.

In effect, consumers like to have access to a local, 'official' service outlet or network, particularly during the warranty period. Reality shows that outside the warranty period, consumers go to both the franchised dealers and

independents to service their vehicles. Therefore they do not require the network to be solely in the franchise sector, rather it could be another authorised or accredited service point in the independent sector.

5.12.2 Routine maintenance and repair is a shrinking sector, open to competition

First services, at around 1,500 km, are now virtually a thing of the past. Longer service intervals and increasingly component life have pushed more and more routine service and repair activities into the independent sector, as discussed earlier. The consumer has the right to have service performed in a workshop of his or her choice, whether franchise or independent. In the mind of many consumers there is no sales/service link. However, as mentioned above, the franchise sector appears to play on consumers' fears of warranty invalidation and reduced resale value to keep them in its workshops.

It is extremely difficult to find any reliable evidence about whether the franchise or independent workshops provide better or worse service. It is important to distinguish between "equipped to do" and "does well". There is a growing perception that independent garages are shut out of certain areas by lack of proprietary equipment available only to their franchise counterparts. For jobs that both can perform the differences are less evident. In Germany, it is a legal requirement that any garage be run by a qualified Meister. There are some formal requirements in France but much less in southern Europe and the UK.

- Quality assurance can be found only where a competent and well trained person does perform the job. This is more often the case in independent garages, the more so if the owner is a very good specialist. In most EU member countries quality certification systems have been set up (ISO 9000 in Germany, certification in France, BOVAG standard in the Netherlands, etc) tailored to the specific needs of the automotive business. *CECRA (B) (12)*

Complaints about workshops generally seem to be about evenly split between the franchise and independent sectors. Both miss deliberately planted defects in mystery shopping tests in about the same proportions. There is no statistical evidence available about whether one sector or the other causes more accidents through defective work.

There is no obvious technical link of service to the selling outlet. Special tooling (tools, jigs and fixtures specific to one or more models of a given brand) typically only forms 5-10% of the fixed investment in a garage. This does not constitute an insuperable investment obstacle to independent repairers. Vehicle manufacturers concede that they do not ask their dealers to invest in tooling and equipment for a number of low-volume operations in which they are not competent. Thus diesel injection work, engine reconditioning and major crash repair are widely subcontracted to independent, all-makes specialists. On-board electronic and diagnostic systems, however, present a far more serious problem for the independent trade (see below).

Vehicle manufacturers invest huge amounts of time and money in defining and implementing service and repair procedures and standards in their franchise networks. The pity is that this investment is then over-milked within the dealership to support the internal cross-subsidy of vehicle sales. Service department managers are pressured to maximise utilisation of assets, which can endanger the carefully built-up quality approach. Dealers are encouraged to invest in training of service personnel, which is claimed to be highly brand-specific. At the same time, pride is taken in the fact that defecting service personnel form a main source of qualified staff for the all-makes independent sector. This suggests that the real training investment is in basic mechanical and electrical capabilities, which can be applied to servicing and repairing all products of all makes, with only an overlay of brand-specific elements.

All these considerations indicate that there is no fundamental link between current service and repair and the sales of a specific brand.

5.12.3 Electronic and diagnostic systems have the potential to be used as a major new means of shutting out independent all-makes repairers

The ability to interface with, interrogate and act upon the increasing number of on-board electronic systems requires franchise dealer workshops to invest in diagnostic and interface equipment that can cost up to Euro 100,000³⁷. As the hardware and software are almost always specific to a brand, this creates an absolutely prohibitive investment barrier against independent all-makes workshops. In effect, they are rapidly being shut out of this sector of maintenance and repair.

- "A problem for independent garages is the increasing number of electronic transmission and braking-related equipment, e.g. ABS, ASR, ESP, etc, leading to higher qualification requirements for the garage in terms of fault diagnosis and repair. In many cases, an independent garage is unable to provide such service, in view of the considerable investments required for the necessary equipment to cover all vehicle makes." *ADAC (D) (12)*
- "With the advance of technology in component systems and coded electronic systems being fitted to new vehicles, the independent sector is potentially disadvantaged in being able to diagnose faults on a vehicle and consequently effect repair by replacing parts" *Major Systems Supplier. (12)*

Component manufacturers who design the diagnostic equipment on behalf of the vehicle manufacturer are not always free then to distribute the equipment into the independent aftermarket. There are some systems available which carry out the diagnostics on the majority of vehicles but they do not cover all functions. The only major exception is on emissions controls, where there are legal requirements that the systems be made openly accessible.

- "The supply of the necessary technical information to independent repairers is still dragging on in some vehicle makes. This is the reason why Block Exemption Regulation

³⁷ Vehicle manufacturers' responses to Commission questionnaire (12)

should adopt the 3-monthly period for the transmission of technical data to all repair market operators as already provided by the On-Board-Diagnostics (OBD) directive.”
CECRA (B)(12)

- “Often vehicle manufacturers try to compel equipment suppliers to grant them exclusivity rights on equipment for new models. In general equipment manufacturers do not grant such exclusivity rights. If they do so these rights cover a maximum period of one year”.
EGEA (B)(12)

The number of suppliers of processors and of on-board systems is limited. While standardisation of componentry by function and of communications protocols is currently done across vehicle brands belonging to a group, it is supposedly impossible across different groups. The effect of all this is to recreate exclusivity in servicing capability. Whether this is technically necessary or economically justified is unclear. There are suspicions that vehicle manufacturers are deliberately promoting technical differences to support exclusivity in service, exclude independent garage competitors and restore lost parts and service profits to their dealerships. There have been loud calls for standardisation of devices and procedures from independent repairers and much more discreet ones from systems and component suppliers.

We can conclude therefore that both lack of standardisation and new technologies are being used to force the sales/service link

5.13 Safety/emissions inspections are already largely disconnected from the franchise sector

Every European country has a vehicle testing programme, although these are not fully harmonised across Europe. In Germany and the UK the date of the first test is when the vehicle has been licensed for 3 years, in France testing starts at 4 years, and it has come down from 10 years to 4 years in Italy. Increasingly, many vehicles are only repaired or serviced at the time of the annual test in order to ensure that they pass. Testing is obviously important contributor to safety - and also to the size of the aftermarket in Europe.

Testing is not confined to the franchise sector. Accreditation to conduct annual tests is given by a central government authority based on the suitability of premises, equipment and trained personnel, irrespective of whether the outlet is franchised or non-franchised, or whether it has a sales showroom or otherwise. This is an example of an independent, recognised arbiter judging the suitability of the outlet on given criteria, predominantly facilities and training.

5.14 Vehicle recycling is not connected to the sales/service link

Vehicles are usually scrapped when the cost of repair exceeds the value of the vehicle, whatever the age of the vehicle. European legislation³⁸ presently requires that 75% of the vehicle weight must be recycled, this will increase to 85% in 2005 and 95% in 2015. This will become a heavy burden on the vehicle suppliers, on whom the responsibility for recycling rests. By the time most vehicles are scrapped they have long left the franchise network for repair and maintenance. This process is therefore disconnected from either sales or service.

Because of the vast improvements in component quality, some vehicle manufacturers have already started to recycle and resell refurbished parts through their networks, at prices designed to attract users of older vehicles back into their franchise service outlets. As the manufacturers' liability for recycling increases, this market can be expected to increase dramatically.

At present, most stages of this process take place outside the franchise sales/service channels – though waste collection companies, scrap yards, third party re-manufacturers, and parts reconditioners. All aftersales distributors, franchised and independent, will become involved in this market, on account of the volume of recycled parts that will be generated and in order to serve all possible customer segments. This is independent of any sales/service link in the early stages of a vehicle's life.

5.15 Vehicle manufacturers have a major financial interest in the sales-service link

Original equipment replacement parts under the vehicle manufacturer's brand are only available through the franchise network. Equivalent quality parts under the brand of the component supplier are available though independent distributors. Under the provisions of regulation 1475/95, franchise dealer workshops are entitled to use equivalent quality parts, provided they inform the consumer, and distributors are entitled to supply them under their own brand or the component manufacturers brand.

However, it is often implied that equivalent quality parts (even when made by the same component manufacturer as the OE parts) are not original and are therefore inferior, which can be used to influence consumers. Although the consumer in theory has a free choice of sources for equivalent quality parts, in practise there is significant pressure to employ OES parts. Pressure to use parts from OES sources is exercised on dealers through parts consumption objectives and retrospective bonuses, which are also sometimes linked to vehicle sales objectives and bonuses.

- "Many spare parts can only be sourced from franchised dealers. Even current parts, such as disc brake rotors and friction are not released to the independent aftermarket by VW. Up to 60% of parts for vehicles under 3 years old come under such restrictions" *VKW(D)* (12)

³⁸ 75/442/EC End of Vehicle Life Directive, as amended by 2000/53/EC

- "We have no evidence but we received signals that many manufacturers use their intellectual property rights to prevent original equipment parts suppliers from selling body parts to the independent aftermarket sector. These questions have to be asked of parts manufacturers." *CECRA (B)(12)*
- "In the recent past, the terms of the current regulation 1475/95 under which Block Exemption was granted to the European vehicle manufacturers, has not been respected in many cases by some of those manufacturers. In particular I refer to the open and free right to provide products and service into the Independent Aftermarket." *CLEPA (B)(12)*
- "We do not think that 1475.95 adequately protects the dealer's right to use equivalent-quality parts. One can observe a tendency to locking up the parts market. The classic example is design rights. This has a negative impact on independent garages and distributors but, above all, on consumers" *AK (A)(12)*

Independent systems and component suppliers, who are increasingly responsible for the technology and design of their products, produce 70 - 80% of all parts. OES parts supply is a major source of profitability for vehicle manufacturers, who typically take a 60-65% gross margin on them, limiting their franchise dealers to much lower gross margins. The main dealer acting as both wholesaler and workshop has a 40-45% gross margin. A range assembler supplying the independent aftermarket will typically operate on a 20% gross margin on its sales into the independent distribution trade, while the combination of independent distributor and workshop lives on a 55-60% gross margin. This means that there is much tighter control of the value chain in the OES sector.

- "Franchised dealers have the infrastructure and expertise to remain as major competitors in the aftermarket - it is the economic factors that are the barrier to their regaining market share. However there are unlikely to be radical moves in this direction as long as parts profits remain 'ring fenced' within car manufacturers." *ICDP, Future directions for European Car Distribution, 1998*
- "The dealer may be reluctant to purchase parts from sources other than their respective vehicle manufacturers by virtue of their economic dependency on the vehicle manufacturer. Dealers are commonly rewarded by rebates or bonus schemes contingent on achievement of sales targets of the vehicle manufacturers products". *Major Systems Supplier (12)*

In the independent sector, the distributor has to respond to market conditions. In the franchise sector, the distributor is constrained from responding to them - unless the vehicle manufacturer facilitates it. This parallels the margin and price controls that vehicle manufacturers exercise over their distribution channels for vehicles.

- "In our sector, various cases have been reported confidentially to CLEDIPA's distributor members that car manufacturers exert an informal pressure on their franchised dealers and workshops in order to prevent the supply of replacement parts of equivalent (or even superior) quality from entering the independent aftermarket. However no evidence can be provided on our side. Car manufacturers avoid written instruction because this would contravene regulation 1475/95 and endanger their exemption. Pressure is exerted indirectly and subliminally. E.g. on the occasion of contract negotiations (threat not to renew / to cancel the dealers contract) or when representatives of the car manufacturers "visit" the dealers stock." *CLEDIPA (B)(12)*
- "Supply of equivalent quality parts to dealership workshops is inhibited in two principal ways. First, through design rights. Second by manufacturers exercising informal pressure

on dealers, implicitly during contract negotiations and when manufacturers' representatives inspect dealers' parts stores. This cannot be documented but we constantly hear about it informally. There are obviously no written records, as they would contradict 1475.95 and endanger a manufacturer's right to it. Manufacturers exercise similar implicit and informal pressure on component suppliers not to sell into the independent aftermarket. Nobody simply refuses to supply – they invoke manufacturers' patent protection or their ownership of tools and dies. Manufacturers also conduct publicity campaigns to induce consumers only to buy OE parts. Those who believe in this publicity are thereby discouraged from buying equivalent quality parts from OE suppliers in the independent aftermarket. This is not a potential infringement of cartel laws but of those on misleading publicity" *GVA (D) (12)*

- "We have no specific evidence of this, but the vehicle manufacturers will frequently in their standard terms of purchasing or development agreements seek a transfer to them of supplier intellectual property rights created during product development. They may also seek to impose exclusivity of supply contractually or through tooling ownership which, if acceded to, would also effectively restrict or prevent sales of products to third parties (dealers or the independent sector)." *Major Systems Supplier (12)*

Competition in the parts market is effectively constrained. Recommended retail prices for spare parts in both the OES and IAM-T sectors are commonly set by comparison with each other. Liberating this market is a major concern for suppliers operating in both the OES and IAM channels.

"We are concerned that the removal of Regulation 1475/95 would create a less competitive marketplace in which the vehicle manufacturers may be able to impose restrictions on component manufacturers that would then be legitimate under general law (even as recently amended by the Vertical Restraints Legislation). The key principles that we believe must be preserved in any scenario to ensure that the highly competitive marketplace that exists today is maintained are as follows:

1. The vehicle manufacturers must not be able to restrict the component manufacturer from selling to the Independent Aftermarket.
2. There must be no restriction on the component manufacturer selling matching quality parts to dealers or other vehicle manufacturer outlets.
3. There must be no restriction on VM dealers buying parts of matching quality from third parties.
4. There should be no use by the vehicle manufacturers of tooling ownerships / intellectual property rights / branding rights to restrict the component manufacturers or dealers rights listed in points 1 to 3 above.
5. There must be continued rights for the component manufacturer to brand products with its own brand.
6. There must be clarity of use of parts and service descriptions to avoid inconsistent and misleading use of commonly used terms (e.g. 'genuine', 'original').

There must be freedom of access for repairers or associations that collate information on their behalf to technical information required to allow vehicle diagnostic and repairs to take place and competitive prices in the Independent Aftermarket. This issue is of increasing importance and must be addressed to ensure that the consumer has real freedom of choice in preparing and diagnosing increasingly sophisticated inter-dependent and integrated vehicle systems". *Major Systems Supplier (12)*

The vehicle manufacturers have a major financial interest in the continuation of sales/service link. This not only enables the cross subsidy from aftermarket to sales within the dealership. Tied sales of OE parts through dealers also cross subsidise manufacturers' sales of vehicles.

5.16 In summary, the sales/service link is much less natural and much more forced than often appears

The nature and strength of the sales/service link is very much dependent on the context within which it operates, i.e. the type of distribution régime in place:

- Search and selection for new vehicles is primarily based on product characteristics, not on the service experience, which is a post sales activity. The bundling of 'additional' benefits, such as free servicing and extended warranties, forces a link between sales and service. Private consumers can only source new vehicles directly (or indirectly) through channels heavily controlled by the producer. Test drives are a method of sales promotion and are independent of service. The link between sales and service in this context is supplier-forced, not natural
- Negotiation between the private customer and the dealer is constrained by the customer's lack of purchasing power and the dealer's poor sales margins. It is focused solely on the sale of the vehicle, not on service. Fleet customers can negotiate both sales and service prices but are not then constrained to use particular facilities. There is no natural sales/service link in this process
- Many new vehicle finance packages are an explicit attempt to enhance revenue streams for the franchise system by requiring the owner to use the service facilities of the dealer. Used vehicle finance schemes in the independent sector give the consumer freedom of choice of service outlet. The link between new vehicle sales and service is therefore being forced
- Insurance sales are not linked to service
- Extended warranty sales for new vehicles are clearly a means of forcing the sales/service link
- Although trade-in values are influenced by the service record of a vehicle, there is no natural link between this and servicing in the franchise sector
- The link between PDI and franchise dealers has already been broken in many corporate sales, and is therefore no longer a justification for a sales/service link
- Delivery, collection and handover are part of the sales cycle, but not related to aftersales service. Whilst they can be used to introduce the consumer to the service facility, there is no natural link
- The conduct of warranty, as part of the manufacturers' obligations for new product, has a natural link to the manufacturers' appointed service agents. That these have to be brand-exclusive or franchised is not 'proven', although it clearly allows a supplier to control information with regard to quality problems. Warranty work carried out on used vehicles frequently occurs in independent repair garages without sales facilities, and demonstrates that the sales/service link is not driven by the market
- Similarly, the tying of recalls to the franchise sector, although probably the most cost-effective process for the supplier, constrains consumer choice by

forcing vehicles back into the franchise network. Suppliers are only obliged to notify authorities about safety-related recalls. Other quality problems are only addressed if the vehicle returns to the franchise sector for service, and these are not generally publicised. Certified independent workshops could carry out the necessary rectification, if they were informed that a problem existed. However, the majority of recalls are 'silent', so that only vehicles returning to the franchise sector for service will be rectified. This is not therefore proof of a natural link

- Maintenance and repair is not naturally linked to sales, but is increasingly being used to force the sales/service link, in order to make up for the poor profitability of the franchise sales channels. Across Europe, 50% of maintenance and repair is conducted in the independent sector. Lack of component standardisation and new technologies may be used as a major new means of shutting out independent repairers and forcing consumers back into the suppliers' exclusive networks. Yet safety and emissions inspections are already mainly disconnected from the franchise sector. Consumers in different sectors of the market make different trade-offs in selecting providers of service, and given freedom of choice they use service providers *they* find competent – independently of whether they are the suppliers' exclusive outlets or not
- Recycling primarily takes place after the vehicle has left the franchise network and is not connected to the sales/service link
- Vehicle manufacturers and their exclusive dealers have a major financial interest in implicitly and explicitly forcing the sales/service link in the minds of the consumer – their aftersales activities subsidise vehicle sales at all levels of the channels

The sales/service link therefore, although a natural result of market requirements in some cases, is in the main often forced by the interests of suppliers.

6. Conclusions

6.1 The sales/service link is more forced than natural

The structural analysis of the downstream sectors of the industry in Chapter 3 suggests that the sales/service link is far from the only game in town. This link is not a wholly natural one and may be forced under some circumstances. At least some alternatives exist.

The analysis of forces and trends in Chapter 4 indicates that major changes are happening in the distribution environment, including the growth of on-board electronic and diagnostic systems, which operate as new barriers against competition from the independent aftermarket. This has the potential to make the sales/service link even more forced.

From the analysis in the previous sections of Chapter 5, it is clear that the nature and strength of the sales/service link is very much dependent on the context within which it operates, i.e. the type of distribution régime in place. Under current distribution arrangements, it is more producer-driven than market-driven.

In Exhibit 6.1 we have therefore taken each of the elements examined in Chapter 5 and consolidated them into a framework, against the following questions

- “Is this process currently exclusive to franchise dealers?”
- “Is this a natural result of market forces, or is it in any way forced by suppliers?”
- “Are there credible alternatives today, within the SED system?”
- “Could credible alternatives exist tomorrow, in the absence of SED ?”

The term ‘natural’ is used to mean that the link arises in response to genuine market demand. By the term ‘forced’ we mean that the supplier is imposing the link implicitly or explicitly on its partners and the market.

For example: although information on product evaluations is not exclusive to the franchise sector, vehicle manufacturers clearly limit public access to objective comparative information about product safety, quality, reliability and lifecycle costs.³⁹

From Column 2 in the table, we see that about half the activities involved in the relationship of consumers with dealers are kept exclusive to the franchised sector, while the other half are in fact open to some form of competition. From Column 3 we see that most of the exclusive activities are so, not because of some law of business or competitive economics, but because manufacturers

³⁹ Witness, for example, the industry’s hostile reaction to independent crash testing, sponsored by governments and consumer federations.

operating within the SED system have made them so, i.e. they are forced. Column 4 shows that credible alternatives exist today for many of the service functions but not for those directly related to vehicle sales, on which the franchise networks still have an absolute lock – as a direct result of SED and Regulation 1475.95. Column 5 suggests that alternatives could be found for all functions.

Exhibit 6.1
The consolidated picture for the new car sales and service links

<u>Activities</u>	<u>Exclusive to Franchise Dealers?</u>	<u>Natural or Forced by Suppliers?</u>	<u>Credible Alternatives- Today?</u>	<u>Credible Alternatives- Tomorrow?</u>
<i>Information - Product Evaluation</i>	N	F	Y	Y
<i>Information - Pricing</i>	Y	F	Y	Y
<i>Sourcing</i>	Y	F	N	Y
<i>Test Drive</i>	Y	F	N	Y
<i>Selection</i>	Y	F	N	Y
<i>Negotiation</i>	Y	F	N	Y
<i>Ordering</i>	Y	F	N	Y
<i>Finance</i>	N	F	Y	Y
<i>Insurance</i>	N	N	Y	Y
<i>Warranty - Sales</i>	Y	F	Y	Y
<i>Trade-in/Disposal</i>	N	N	Y	Y
<i>PDI/Refurbishment</i>	Y	F	Y	Y
<i>Delivery/Collection/Handover</i>	N	F	Y	Y
<i>Warranty - Conduct</i>	Y	F	Y	Y
<i>Recall</i>	Y	F	Y	Y
<i>Service - Routine</i>	N	F	Y	Y
<i>Repair - Garage Diagnosis</i>	N	F	Y	Y
<i>Safety/Emissions Inspection</i>	N	N	Y	Y
<i>Replacement parts</i>	N	F	Y	Y

Through the disaggregation of the various activities of service and repair, we have sought to show the subtle and artificial links which are used to justify the link between sales and service in the automotive aftermarket. The sales/service link, although natural in some cases, is very often the result of forcing, rather than an independent phenomenon.

6.2 There may be viable alternatives

Forced links and cross-subsidies are often presented by the industry as unquestioned benefits in their own right: service subsidising sales, simple service subsidising complex repair tasks, or urban outlets subsidising rural ones. Correspondingly, competitors who exploit the resulting price umbrellas to establish focused formats with lower costs and prices (and sometimes better service) are derided as “free riders”:

“The independents, particularly the fast fits, concentrate on the higher-volume, less complex jobs, those which provide the highest profit and the lowest risk, leaving the franchised network to carry the responsibility for the lower profit, more complex and less frequent work. The dealer network ensures the full range of services, independent of complexity or profitability, also covering rare models. If

"independents had to cover everything, their costs would rise considerably. Without the dealer network, customers would face an oversupply in current work and a scarcity of supply in complex work. For the most esoteric work and for thinly populated regions, there might be no cover at all. There would be particular problems in safety- and environment-related categories, which require particularly high quality of work and of commercial and moral probity" - Vehicle Manufacturer (12)

In most sectors, businesses linked by cross-subsidy are seen as fair targets for unbundling by focused entrepreneurs, especially in the age of the Internet.⁴⁰ Unbundling has in fact begun to take place within the franchise system, loosening the sales/service link:

- In Southern Europe, through the agent/sub-dealer system
- In areas of low population density, particularly in Scandinavia, where full exclusive facilities would be uneconomic, some vehicle manufacturers sub-contract to independent repairers to 'in-fill' gaps in service availability⁴¹ (12)
- There are incipient moves by the vehicle manufacturers to reduce the role of franchise dealers in new car sales

Alternatives to the franchise system itself do exist, although they are still imperfectly structured. The independent aftermarket sector accounts for 50% of the European service market. The historical conflict between the franchise and independent sectors is arbitrary and wasteful.

Each of these systems, franchised and independent, has deficiencies:

- Quality resources are stretched and scarce. They are inefficiently used in the two competing systems
- Standards of training and monitoring vary widely between different European Member States
- There are no uniform, independent, accreditation systems covering all aspects of service and repair. Instead, there is a plethora of schemes for self-policing run by individual entities with little independent auditing. This leads to the situation in which both sectors are of very variable quality in service delivery
- The new technology 'lock-out' built into on-board and diagnostic systems limits consumer choice and ultimately increases consumer costs
- Franchise dealers are so tightly controlled that they are in continual conflict between the impositions of their 'masters' and the needs of their customers
- The independent sector has not developed to its fullest potential, because of the constraints in the market, plus its own internal fragmentation

Equally, there are very positive elements, in both camps:

⁴⁰ Evans and Wurster, op. cit.

⁴¹ Vehicle manufacturer response to Commission questionnaire August 2000 (12)

- There are independent repair garages who have proved in the eyes of their customers that they are competent and trustworthy
- The same is true for a proportion of franchised garages, regardless of the franchise
- The focused all-makes independent specialists (technical and New Distribution formats) offer competence and cost-effectiveness in their particular disciplines
- Vehicle manufacturers, having a limited number of exclusive sales outlets, have been able to maximise the efficiency of their logistics for parts replacement systems (although the existence of 40-odd parallel brand exclusive retailing channels must itself be of questionable economic value)
- Diagnostic systems, developed by independent suppliers for the manufacturers, can be accessed remotely through computer links, allowing repairers (presently only the franchise sector) to reduce the need for some of the expensive garage based equipment at every outlet. This is a brilliant reconciliation of the need for local presence and for centralised expertise. It is not, however, self-evident that these systems inherently need to be marque-specific.

The sales/service link has lost much of its sense, as an exclusive proposition. There are potential alternative solutions, although the independent aftermarket sector will have to structure and strengthen itself considerably to help make them real.

6.3 The forced sales/service link is not the sole option

In examining the link between sales and service today we are reviewing Recital 4 to Regulation 1475.95 which states:

The exclusive and selective distribution clauses can be regarded as indispensable measures of rationalisation in the motor vehicle industry, because motor vehicles are consumer durables which at both regular and irregular intervals require expert maintenance and repair, not always in the same place. Motor vehicle manufacturers cooperate with the selected dealers and repairers in order to provide specialised servicing for the product. On grounds of capacity and efficiency alone, such a form of cooperation cannot be extended to an unlimited number of dealers and repairers. The linking of servicing and distribution must be regarded as more efficient than a separation between a distribution organisation for new vehicles on the one hand and a servicing organisation which would also distribute spare parts on the other, particularly as, before a new vehicle is delivered to the final consumer, the undertaking within the distribution system must give it a technical inspection according to the manufacturer's specification.

It is still true today that motor vehicles require '*expert maintenance and repair at both regular and irregular intervals*' albeit less so now than in the past. What is clear from our analysis, however, is that this does not necessarily have to be

conducted by a set of brand-exclusive repairers who also sell the vehicles. In half of the European aftermarket there is no such link. As the market and quality of product and service matures, this lack of relationship becomes increasingly evident. Vehicle manufacturers appear to be attempting to use new technology to reverse that situation. The market has become progressively more driven by consumer choice. A proportion of consumers is genuinely using the franchise network as a preference rather than as a felt obligation.

The proposition that '*the linking of servicing and distribution must be regarded as more efficient than a separation between a distribution organisation for new vehicles on the one hand and a servicing organisation which would also distribute spare parts on the other*' has been largely refuted. The growth of new distribution formats and technical specialists is a clear response to a market demand, which has been led by the consumers willingness to unbundle the sales and service offering. Specialisation by function, covering all brands, is more efficient than specialisation by brand, covering all functions – when it is allowed to take place.

With respect to PDI - '*particularly as, before a new vehicle is delivered to the final consumer, the undertaking within the distribution system must give it a technical inspection according to the manufacturer's specification*' - we have shown that the tasks required are mainly simple ones, which could be carried out by any competent service and repair outlet that has access to the required codes and equipment. Vehicle manufacturers themselves, in circumstances of high volume throughput, outsource PDI to third parties. It is strange that such a relatively routine activity should have been given such prominence as an argument in favour of the sales/service link.

For vehicle manufacturers, containing PDI, warranty and non-safety-related recall actions within a selected and brand-exclusive network ensures that knowledge of post-factory-gate quality problems is limited to a selected number of actors, most of whom are under the vehicle manufacturers' direct control.

For consumers who want a 'one-stop shop', there clearly are certain natural links between sales and service. This also provides an 'umbilical cord' to the product manufacturer, which is important to some consumers, in the event that a problem should occur. This is not, however, a reason to regard the sales/service link as a universal truth or axiom.

Regulation 1475/95 has imposed the forcing of a link between sales and service in the franchise sector and inadvertently curtailed the freedom of many of the different actors within the aftermarket. Without this imposition, there might have been more opportunity for innovative offerings from a variety of operators in both the franchise and non-franchise sectors, in response to consumer-driven market requirements.

7. Glossary

ACEA	Association des Constructeurs Européens d'Automobiles
ACI	Association de Carrossiers Indépendants
ADAC	German Automobile Club
Aftermarket	All post sales activities
AK	Bundeskammer für Arbeiter und Angestellte (Austria)
ANWB	Koninklijke Nederlandse Toeristenbond
BBE	BBE-Unternehmensberatung GmbH
CECRA	European Council for Motor Trades and Repairs
CLEPA	European Association of Automotive Suppliers
CLEDIPA	Comité de liaison Européen de la Distribution Indépendante de Pièces de Rechange et Equipements pour Automobiles
DK	Deutsches Kraftfahrzeuggewerbe
EASRA	European Automotive Services and Repairers Federation
ECAR	Campaign against design rights
EGEA	European Garage Equipment Association
FACONAUTO	Federacion de Asociaciones de Concesionarios de la Automocion
FEBELCAR	Koninklijke Belgische Federatie der Rijtuigmakerij
FOCWA	Nederlandse Vereniging van Ondernemers in het Carrosseriebedrijf
GIPA	Groupement Interprofessionnel de l'Automobile
GNCR	Groupement National des Carrossiers Réparateurs
Grey Imports	New cars imported from outside the European Union which have no EC certificate of conformity to vehicle type approval
GVA	Gesamtverband Autoteile-Handel e.V
IAM	Independent Aftermarket
IAM-ND	New Distribution in the independent aftermarket - fast fits; autocentres; glass replacement etc
IAM-T	Traditional independent aftermarket
ICDP	International Car Distribution Programme – a research programme mainly financed by the industry
KBA	Kraftfahrt Bundesamt
MEMA	Motor Equipment Manufacturers Association
OES	Original Equipment Supply
Parallel Imports	Vehicles imported into one Member State from another
PDI	Pre-delivery Inspection
RACC	Spanish Automobile Club
RMIF	Retail Motor Industry Federation
SED	Selective and Exclusive Distribution
TÜV	Technische Ueberwachungs Verein
VKW	Vereinigung Kfz Werkstätten