

# 6 Selective and exclusive distribution

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## Introduction

6.1. In the UK, as in the rest of the EC and many other countries, new cars are distributed and sold through networks of specialized retailers known as dealers. In this chapter we describe the way that suppliers use this system to distribute new cars. First, in paragraphs 6.2 to 6.13, we outline the regulatory framework within which this distribution system is operated. In paragraphs 6.14 to 6.48, we summarize the background to the SED system. We then outline the nature of the franchised dealer networks operating in the UK in paragraphs 6.49 to 6.72 and we describe the provisions of the legal agreements between suppliers and their dealers in paragraphs 6.73 to 6.140. Next, we consider Daewoo's alternative approach to distributing its cars in paragraphs 6.141 to 6.143. Finally, we outline possible future developments in paragraphs 6.144 to 6.162.

## The regulation of new car distribution

6.2. The most important legal aspects of the way SED in the car industry is operated in the UK derive from EC law. We set out a detailed account of the relevant EC legislation in Appendix 6.1. In the following paragraphs, we outline the key provisions.

## **The Treaty of Rome**

6.3. The foundations of EC competition law are Articles 81 and 82 of the Treaty of Rome (the EC Treaty).<sup>1</sup> The more relevant of these in the present context is Article 81. Article 81(1) of the EC Treaty prohibits agreements that may affect trade between EC member states and have the object or effect of preventing, restricting or distorting competition within the EC. Article 81(2) declares that any such agreements are automatically void. The European Commission has the power to impose heavy fines for infringements of Article 81(1).

6.4. Article 81(3), however, allows particular agreements or categories of agreements to be declared exempt from Article 81(1). Exemptions of categories of agreements are known as 'block exemptions'. Block exemptions have been made for exclusive distribution agreements, exclusive purchase agreements and franchise agreements. These three block exemptions are due to expire on 1 June 2000, when a new, more general block exemption for vertical agreements will replace them<sup>2</sup> (see paragraphs 6.12 and 6.13).

## **The Block Exemption for car distribution**

6.5. In 1984, the European Commission adopted EC Regulation 123/85 ('the first block exemption') which exempted motor vehicle distribution agreements throughout the EC from the application of Article 81(1). In 1995, the European Commission adopted EC Regulation 1475/95 ('the Block Exemption') which renewed the first block exemption in amended form until 30 September 2002.

6.6. The European Commission's main reasons for adopting the Block Exemption are set out in Appendix 6.1, which also includes the full text of the Block Exemption and a description of the large number of conditions that suppliers and dealers have to satisfy if they are to benefit from it. The Block Exemption specifies in considerable detail the potentially restrictive clauses that are legally permitted to be included. It also lists 'black clauses' and 'black practices' that prevent the exemption from applying.

6.7. The Block Exemption deals not only with the supply of new cars but also with servicing and spare parts. As the single market requires that consumers should be able to buy cars wherever prices and quality are most advantageous, the Block Exemption is conditional on manufacturers not impeding parallel imports or exports. It also has a provision that is intended to prevent manufacturers using product differentiation to partition the market.<sup>3</sup> Another objective of the Block Exemption is to ensure that, irrespective of where a car was purchased in the EC, customers can have access to servicing and repairs, including vehicle recall work and any promised free servicing, and will have their guarantees honoured.

6.8. In brief, the Block Exemption allows suppliers to supply only selected dealers, to grant exclusive territories to them, to require them not to sell any other brand of new cars from the same premises and to require them to provide servicing facilities. There are no controls on how suppliers may select their dealers and they are free to select any number. Suppliers may require their dealers to use their best endeavours to meet sales targets, to be determined by an independent expert in the event of disagreement over what the level of targets should be. They may also impose standards that a dealer must meet. Suppliers may reserve the right to sell direct to final customers. They are, however, required to supply a dealer with any car requested by a customer that is similar to those covered by the dealer's contract and that their manufacturer markets within the member state where the car is to be registered. Suppliers are not permitted to prevent their dealers from advertising outside their territories by other than personalized means. They must permit dealers to sell the cars of other manufacturers, provided that this is done in separate premises, under separate management, in the form of a distinct legal entity and in a manner that avoids confusion between the makes.

## ***Changes made in the Block Exemption of 1995***

6.9. When the Commission reported on the supply of new cars in 1992 (see Chapter 3), it recommended a number of changes to the first block exemption that were intended to enhance competition. Most of these recommendations were adopted by the European Commission in the 1995 Block

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<sup>1</sup>Formerly Articles 85 and 86, before the renumbering resulting from the Treaty of Amsterdam.

<sup>2</sup>The new block exemption for vertical agreements was adopted on 22 December 1999.

<sup>3</sup>See Recitals 16 and 26 of the Block Exemption.

Exemption. These changes had the aim of changing the balance between the diverse interests in the industry and, in particular:

- (a) giving dealers greater security and commercial independence in relation to suppliers;
- (b) giving independent spare part manufacturers and distributors better access to the outlets provided by the car suppliers' networks;
- (c) improving the position of consumers; and
- (d) making the dividing line between acceptable and unacceptable agreements clearer.

6.10. The main modifications made to achieve these aims were that suppliers and manufacturers had to:

- (a) permit dealers to sell the cars of other manufacturers, provided that this was done on separate premises, under separate management, in the form of a distinct legal entity and in a manner that avoided confusion between the makes;
- (b) permit dealers to maintain and repair cars of different makes in the same workshop, provided that the dealer did not allow third parties to benefit unduly from investment made by the supplier;
- (c) permit dealers to engage in any types of transaction for new cars (other than supplying resellers who were not part of the network or supplying via intermediaries unless authorized in writing by final customer);
- (d) only set targets for dealers' sales of new cars, stocking levels and numbers of demonstration cars that had been jointly agreed by both parties or determined by an independent expert;
- (e) extend the minimum duration of fixed-term agreements from four to five years, with six months' minimum notice of intention not to renew;
- (f) extend the minimum period of notice for terminating open-ended dealer agreements without cause, and without compensation, from one to two years (with a one-year period for new entrants to the network and in cases of network reorganization);
- (g) provide better market access to independent suppliers of spare parts by permitting dealers to use spare parts from any source, provided that these were of equivalent quality to the suppliers' own spare parts (suppliers could, however, still insist on dealers using their parts for warranty work, recall work or free servicing);
- (h) provide the technical information needed to carry out repairs and maintenance of cars to independent repairers, unless this information was covered by an intellectual property right or constituted secret know-how;
- (i) permit dealers to advertise outside their territories, so long as they did not use personalized advertising (including direct mail, doorstep canvassing and unsolicited telecommunications); and
- (j) give up any practices designed to hinder parallel imports.

### ***The EC review of the Block Exemption***

6.11. The Block Exemption is due to expire on 30 September 2002. Article 11 requires the European Commission to evaluate its application on a regular basis. It has to take particular account of the impact of the exempted distribution system on price differentials between different member states and on the quality of service to final users. The European Commission is now gathering evidence and the opinions of interested parties, their associations, experts and consumer organizations before reviewing the position and drawing up a report on its evaluation of the Block Exemption by 31 December 2000.

## Other proposed changes to EC law

6.12. In January 1997, the European Commission published a green paper on vertical restraints<sup>1</sup> (see Appendix 6.1). This was followed by the publication of a draft block exemption, together with guidance notes, in September 1999. The green paper started from the premise that vertical restraints are generally benign in the absence of market power. The proposed new block exemption was adopted by the European Commission on 22 December 1999. It extends the operation of the block exemptions for exclusive distribution agreements, exclusive purchase agreements and franchise agreements (see paragraph 6.4) that were due to expire on 31 December 1999 until 31 May 2000. With effect from 1 June 2000 it replaces them with a single block exemption which will apply to almost all types of vertical agreements apart from vertical agreements whose subject matter falls within the scope of another block exemption (see Appendix 6.1). Agreements involving suppliers<sup>2</sup> with market shares above 30 per cent will not be covered. Certain practices, including imposing fixed or minimum resale prices and some forms of territorial protection, will be black-listed. The new block exemption states that, where parallel networks of similar vertical restraints cover more than 50 per cent of a market, the European Commission may by regulation disapply the block exemption in that market.

6.13. As stated in paragraph 6.12, the block exemption for vertical agreements does not apply to vertical agreements whose subject matter falls within the scope of another block exemption. However, if the cars Block Exemption were to be allowed to expire in 2002 without any replacement provisions, it is possible that it would be open to the industry to rely on the block exemption for vertical agreements. If that happened, many features of the present SED system could probably continue. Significant changes might, however, have to be made to the system.

## Background to selective and exclusive distribution

6.14. Car distribution is both a selective and an exclusive distribution system. It is also a form of franchise system. Before considering the way that it is applied, we first outline the chief characteristics of the most general forms of selective distribution, exclusive distribution and franchise networks.

### Selectivity

6.15. In the most general form of selective distribution system, a supplier appoints retailers who may resell its products to end-users without restraint. The supplier normally supplies only its approved retailers and may undertake not to sell to non-approved retailers or to the general public. Thus, selective distribution almost invariably produces a closed network of trading outlets. Before the supplier appoints a retailer, it usually requires to be convinced that the potential retailer can satisfy its standards in such areas as management skills, technical expertise, financial resources and quality of premises (depending on the nature of the product). If the selective system is not also exclusive, the supplier is generally free to appoint any number of additional retailers, even where these are close to its existing retailers, and the retailers are free to retail other products, including competing brands.

6.16. The ECJ has accepted that selective distribution systems are not necessarily restrictive of competition and that such a system can be compatible with Article 81(1) if the certain conditions are met. These can be broadly summarized as follows:<sup>3</sup>

- (a) the product merits a form of selective distribution;
- (b) resellers are chosen on the basis of objective criteria of a qualitative nature which are laid down uniformly for all potential resellers and are not applied in a discriminatory fashion;

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<sup>1</sup>Vertical Restraints in EC Competition Policy.

<sup>2</sup>'Suppliers' as defined in the block exemption, not as defined in the glossary to this report.

<sup>3</sup>See the European Court of First Instance case *Groupement d'Achat Édouard Leclerc v European Commission* (1997) 4 CMLR p995 at page 1025.

- (c) the system in question seeks to achieve a result which enhances competition and thus counterbalances the restriction of competition inherent in selective distribution systems, in particular as regards price; and
- (d) the criteria laid down do not go further than necessary.

However, the ECJ has held that with selective distribution systems that meet these requirements there may nevertheless be a restriction of competition where the existence of a number of such systems leaves no room for other forms of distribution.<sup>1</sup>

## **Exclusivity**

6.17. Two types of exclusivity may commonly be involved in distribution systems: territorial exclusivity and product exclusivity.

6.18. In the most general form of territorially exclusive distribution system, a supplier agrees to supply specified products to only one retailer in a designated area. This is usually referred to as a 'territory' although some distribution systems use other terminology with the same effect. (For convenience, we use the term 'territory' throughout this report.) The retailer is then intended to concentrate on promoting sales in the territory. Usually, the supplier has no direct sales force of its own in the territory and relies entirely on the retailer to achieve sales penetration there. The retailer is free to choose its customers, who may (in the most general case) include end-users and resellers. The supplier may seek to prevent or control the retailer's sales to resellers or to customers who do not reside in its territory.

6.19. Within the EC, bans on active selling outside the territory (for example, advertising in other territories) are permitted under the exclusive distribution block exemption (see paragraph 6.4). Bans on responding to unsolicited approaches from customers outside the territory are, however, not allowed.

6.20. In exchange for being granted rights in its territory, the retailer may accept some types of product exclusivity. It may, for example, undertake not to sell competing products at all, not to sell them within its territory, or not to sell them from the outlet concerned.

## **Franchising arrangements**

6.21. Franchised networks are the other type of vertical distribution system that has parallels with the selective and exclusive system used to distribute cars. Franchising agreements normally create a licence to use a predefined business model for the distribution of goods or services. An important part of this is a licence to use intellectual property rights (IPRs) relating to trademarks, signs and know-how. The franchisor that provides the licence is paid a franchise fee or royalty by the franchisee for the use of the IPRs, the particular business concept and often a model business plan. Such franchise agreements provide the franchisor with a low-cost method of establishing a uniform network of outlets for distributing its goods or services. Franchisees of a reputable, well-established franchisor have the advantage of access to a comparatively low-risk and well-tested method of starting a new business. Franchise agreements are frequently combined with vertical restraints that may include non-compete clauses and combinations of elements of selective distribution and exclusive distribution.

6.22. Franchising is frequently applied in retail distribution systems and in fast-food catering. Although car distribution is often described as a form of franchising, it differs significantly from these other types of distribution network. In particular, car dealers do not pay franchise fees and are not totally limited to following a predetermined business model, as are some types of fast-food franchisee. Although car suppliers do not demand franchise fees from their dealers, they expect dealers to make a substantial capital investment to achieve the required standards.

6.23. Within the EC, franchising networks are regulated through the block exemption for franchise agreements (Commission Regulation 4087/88/EC).

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<sup>1</sup>See *Metro SB-Grossmärkte GmbH v European Commission* (1987) 1 CMLR p118 at paragraph 40.

# Selective and exclusive distribution as applied to cars

## Origins

6.24. We set out in Chapter 3 the car industry's generally accepted account of the reasons for the development of the SED system in the early period of the motor industry. In brief, in the earliest days of the motor industry, many methods of distribution were tried. From the 1920s, however, a system of distribution based on direct links between each manufacturer and dealers specializing in its make of car became increasingly prevalent.

6.25. As early cars required frequent servicing and repair, car manufacturers found that their reputation and that of their products depended heavily on the quality of their dealers. In response, they developed a selective approach to appointing them. Since the need to transfer up-to-date technical expertise to their dealers reduced the time they could devote to designing and producing their cars, early manufacturers believed that there was a limit to the number of dealerships that they could support effectively. As a result, they usually constrained each dealer to concentrate on a particular area, rather than spreading its efforts over a wider region that included areas covered by other dealers. This was partly a response to dealer requests for some protection against competition and partly to ensure that the limited number of dealers provided national coverage.

6.26. Car distribution thus evolved into a system with a complex interdependent relationship between each supplier and its dealers. The resulting distribution structure combined many features of both selective and exclusive distribution systems. Similar systems developed in nearly all the major industrialized market economies. (The most significant exception is Japan, where widespread use is still made of door-to-door selling.<sup>1</sup>)

## The present UK car distribution system

6.27. In the UK car distribution system suppliers distribute and sell new cars to the general public through networks of dealers. Although some suppliers have dealer subsidiaries, few retail outlets are actually owned by suppliers. Suppliers enter into SED agreements with their dealers. Nearly all dealerships operate within the framework of a separate legal agreement ('the dealer agreement') with a single supplier of new cars. The agreements each allocate a single territory to the dealer. (A dealership is either a single outlet or a small group of outlets—still within a single territory—covered by a single dealer agreement (see paragraph 6.73).) The other distribution channels used for consumer durables, such as multi-brand retail outlets, supermarkets, department stores and mail order, are very rarely used for new cars.

6.28. Figure 6.1 sets out a schematic representation of the way that a typical car supplier operates its distribution system in the UK. All but a few suppliers have independent franchised dealer networks conforming broadly to this pattern. The exceptions are mostly very small-scale specialist operations, such as that of Lamborghini, whose combined UK importer/retailer sells cars direct to retail customers. All the recent entrants into the UK car market, other than Daewoo, have chosen to use dealer networks based on SED, even where they had no previous links with distributors or dealers in the UK. Daewoo is the only supplier of volume cars not to operate an SED system. It owns its retail outlets and contracts out most servicing work to Halfords. We set out Daewoo's stated reasons for adopting a different approach in paragraph 6.141.

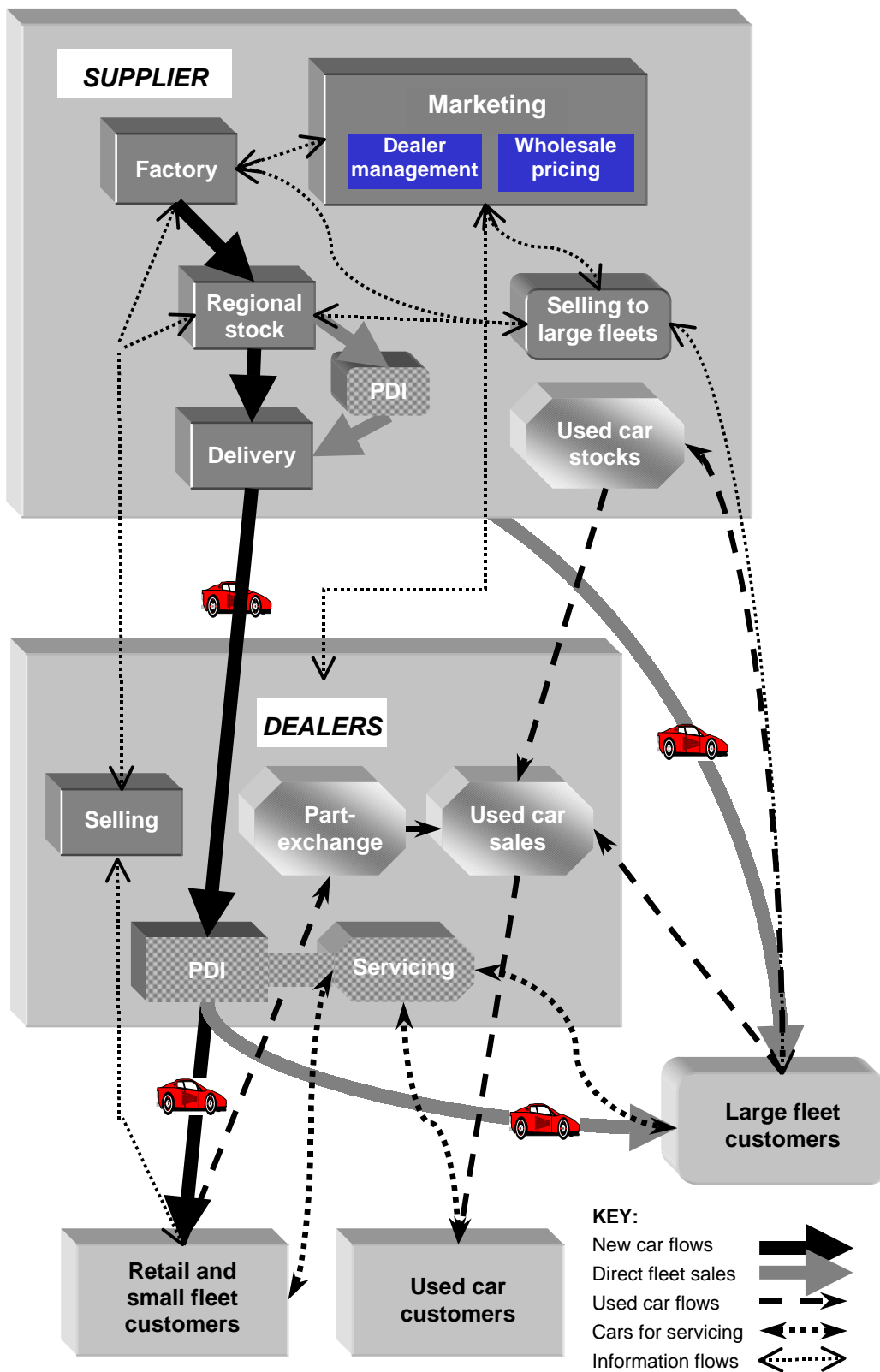
6.29. There are minor variations between suppliers in the details of how this system is operated. For example, some suppliers hold new car stocks entirely at the port of entry or at their dealerships, rather than at regional stocking centres. Many suppliers rely entirely on their dealers to carry out PDIs on cars intended for large fleet customers; others are contemplating concentrating much of this activity centrally for all customers' cars, leaving only a limited inspection to be carried out by dealers. Many suppliers do not hold stocks of used cars repurchased from large fleet buyers and leave all aspects of used car trading to their dealers. Despite these minor differences, all major suppliers' distribution systems are fundamentally similar.

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<sup>1</sup>The Economics of the Car Distribution System, November 1995, International Car Distribution Programme Research Paper Number 1/96, Professor Jonathon Brown.

FIGURE 6.1

The new car distribution system



Source: Commission.

## **The relationship between suppliers and dealers**

6.30. Before considering the legal basis for the relationship between car suppliers and their dealers in detail (see paragraphs 6.73 to 6.140), we first outline its essentials. The connection is much closer than that between suppliers of most other products and the independent retailers they use to distribute them. The selective element of the car distribution system normally gives a supplier complete discretion in selecting its dealers. Suppliers set standards and criteria that each dealer must meet. They are not, however, obliged to appoint any applicants that can meet these standards as dealers. Each dealer is granted an exclusive territory in which it can operate with moderated competition from other dealers in the same franchise.

6.31. Nearly all franchised car dealers have to enter into an exclusive medium- to long-term commitment to a single main supplier in respect of each dealership. Once appointed, individual dealerships are thus dependent on a single supplier for their main products. The relationship is normally open-ended but both the supplier and the dealer are free to terminate it, without cause, by giving two years' notice. As a result, each supplier is in a strong position in its relationship with its dealers. This supplier strength is regulated by the legal framework established in the Block Exemption, which safeguards the rights of dealers in the important areas that we have discussed. In addition, dealer groups are able to reduce their dependence on any individual supplier by operating a mix of franchises in different premises. (A dealer group is any dealer with two or more dealerships.) Suppliers have also made arrangements to consult dealers collectively (see paragraph 6.34).

6.32. The exclusive nature of a dealer's position may be qualified. For example, most suppliers reserve the right to sell direct to fleet customers and some agreements provide for the supplier to continue to supply other existing dealers within the dealer's territory. We were told that this provision was usually used to permit suppliers to carry on supplying existing specialized after-sales outlets, such as body shops and paint shops.

6.33. The relationship between each car dealer and its supplier is formally set out in a dealer agreement and supplemented by the regular flow of franchise standards, policy documents and correspondence that suppliers typically send to their dealers. For convenience, we refer to these documents collectively as the 'dealer agreement' and outline their typical provisions in paragraphs 6.73 to 6.135. We carried out two surveys of franchised car dealers to explore their views about different aspects of their relationships with their suppliers. The main results are described in Appendix 6.2 and we draw on them in the following paragraphs.

### ***Dealer councils***

6.34. Most suppliers have established dealer councils or similar bodies to provide a forum for discussions with representatives of their dealers. We have examined the minutes of many dealer council meetings. Their main role is to discuss developments such as the state of the market, new models, the availability of cars from the supplier, dealer standards or changes to the way that the network is run. Dealer councils also provide a framework for spreading best practice within the franchise. The subject of dealer profitability often features in the minutes of meetings that we studied, normally because dealers were concerned that it was too low.

6.35. Several suppliers stressed the input provided by their dealer councils when new dealer agreements were drafted. Some suppliers added that their dealer councils had taken independent legal advice and proposed a number of amendments that had been accepted. Over half the dealers responding to our survey considered that their dealer council could negotiate the terms of their agreement to a small degree (see Appendix 6.2). However, only 13 per cent of the dealers considered that their dealer council was able to negotiate the terms of the agreement fully or to a substantial degree.

### ***Comparison with distribution systems for other products***

6.36. The position of a franchised car dealer has some similarity with that of a franchised retailer or fast-food outlet, which is constrained to follow a predetermined business model and to take its supplies

from its franchisor. In the same way, car dealers are expected to provide a guaranteed 'route to market' for new cars that their suppliers have invested heavily in developing. Car distribution is, however, unusual in that suppliers representing the great majority of the market operate similar parallel franchised distribution systems. Potential customers of franchise systems in other markets can often choose between a wide range of alternative products or services that are distributed in other ways.

6.37. Many other types of independent retailer or retail group are in a much stronger position in relation to their main supplier or suppliers. A typical retailer of consumer durables or groceries is free to select the products it stocks from the full range available from many suppliers. In extreme cases, such retailers may become 'gatekeepers' that are able to decide which products can reach the market. Large retailers are consequently able to demand keen, volume-related, prices and advantageous terms from their suppliers. In some cases, they do not need to enter into any commitment to continue to buy from the same supplier.

6.38. Even motorcycle dealers, which are also part of selective (but not exclusive) franchised networks, are considered to be in a stronger position than car dealers in their relationships with their suppliers. The Motorcycle Industry Association told the Trade and Industry Committee<sup>1</sup> in October 1998 that this was because each motorcycle dealership was permitted to represent several makes, rather than one per set of premises. This view was also supported by evidence we received from Dixon Motors PLC, a large dealer in both cars and motorcycles (see Chapter 8).

6.39. Car dealers do, however, have a significant advantage over most types of retailer in that they do not have to purchase most of their stock until they have customer orders for it (see paragraph 6.125).

### *The views of suppliers*

6.40. The arguments advanced by the suppliers in favour of SED are set out in Chapter 9. In summary, they take the view that the restrictive effects of SED, as currently permitted under EC law, are outweighed by benefits to consumers. In support of this view, they drew our attention to the Recitals to the Block Exemption (see Appendix 6.1 and its annex). Many suppliers argued that the increasing technical complexity of cars, as well as the need to protect the financial interests of suppliers and customers, required that they continue to select suitable dealers according to qualitative criteria.

6.41. The suppliers considered it important that consumers should have ready access to expert advice about the many model ranges and variants available, regardless of where they lived, and suggested that an SED system was needed to ensure that such comprehensive coverage was available. As suppliers considered that consumers did not distinguish between a manufacturer and its dealerships when forming their opinions of brands, they regarded their dealership networks as their public faces. In support of minimum franchise standards, suppliers contended that, if some dealers did not have to invest in high-quality facilities, staff training and providing demonstrator cars, they would be able to 'free-ride' by obtaining part of the benefit of the investments made by other dealers and by suppliers.

6.42. Suppliers believed that high-quality sales and servicing facilities were an essential part of this process that was expected by customers. They also considered that customers needed to be confident that servicing and repair would be carried out to the same high standards in all the dealers in a particular franchise.

6.43. Many suppliers told us that the SED system ensured that suitably equipped servicing outlets with fully trained technical staff were available evenly throughout the EC. They thought that this degree of coverage would not be possible under any easily realizable alternative system. They argued that the quality of dealers' PDIs, warranty repairs, servicing and general repairs was central to customers' perception of the reliability of their cars and therefore contributed to their loyalty both to the supplier's brand and the dealership. Suppliers also regarded the provision of these services within their franchised networks as being an essential safety measure.

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<sup>1</sup>House of Commons, Trade and Industry Committee, First Report, *Vehicle Pricing*, The Stationery Office, HC 64, 2.12.98.

6.44. Several suppliers believed that allocating dealers a territory helped them to give dealers appropriate incentives and to attract new dealers. Many suppliers considered that territories increased dealers' commitment, as each dealer could be confident that its efforts would be more likely to increase its own sales than those of other dealers in the same franchise. The suppliers added that the partial territorial protection provided by the present system helped each dealership to achieve the level of turnover needed to provide a return on the investment required to meet the franchise standards for premises and other matters, such as staff training and specialist equipment. They considered that the partial nature of the territorial protection nevertheless enabled consumers to benefit from intra-brand competition between dealers with adjacent territories.

6.45. Many suppliers argued that product exclusivity avoided customer confusion and ensured that expert advice on all a supplier's models was available from its dealers. They also considered that dealers selling several marques might not provide objective advice, as they would be tempted to promote the models that provided the largest margins and incentives for dealers. Even if this were not the case, these suppliers felt that customers would have less confidence in advice from multi-brand dealers.

6.46. Some suppliers that had previously sold two of their brands through a common network told us that they had improved the effectiveness of their distribution systems by creating separate exclusive networks for each brand. They added that this enhanced brand focus was found to increase the sales and profitability of both the supplier and the dealers.

6.47. Finally, some suppliers felt that the restrictions inherent in SED did not affect competition between brands in the market for new cars. The suppliers considered that, as there was strong inter-brand competition, the restrictions on intra-brand competition should not raise serious competition policy concerns. On the contrary, as the dealership system provided a guaranteed route to market for new models, this certainty encouraged investment and innovation by manufacturers leading to more competition between new models.

### ***The views of dealers***

6.48. The views put to us by dealers, and their representative bodies, on the SED system are described in Chapter 8. In brief, although most dealers supported various aspects of the system, many of them were critical of the degree of power that it gave the suppliers to determine the detailed way that dealerships were run. We summarize their particular concerns about aspects of dealer agreements in paragraph 6.136.

### **The main UK franchised dealership networks**

6.49. We consider the main UK suppliers' brand dealership networks below. (Other aspects of the suppliers' businesses are discussed in Chapter 4.) As Table 6.1 shows, there is a large variation in the size of these distribution networks.

TABLE 6.1 Distribution networks of UK car suppliers on 1 January 1999

Brand	Percentage market share in 1999	UK dealership sales outlets	Percentage of UK dealership sales outlets	Share of market divided by share of outlets	Membership of groups and alliances
Ford	17.65	769	12.2	1.45	Ford
Vauxhall	13.27	523	8.3	1.60	GM
Peugeot	8.22	367	5.8	1.41	Peugeot
Renault	7.51	318	5.0	1.49	Linked with Nissan
Volkswagen	7.04	312	4.9	1.42	Volkswagen
Rover	5.01	353	5.6	0.90	BMW
Nissan	4.32	263	4.2	1.04	Linked with Renault
Toyota	3.54	229	3.6	0.98	Toyota
Fiat	3.51	189	3.0	1.17	Fiat
Citroën	3.29	249	3.9	0.83	Peugeot
BMW	3.23	156	2.5	1.31	BMW
Honda	2.97	177	2.8	1.06	Honda
Mercedes-Benz	2.84	153	2.4	1.17	DaimlerChrysler
Audi	1.85	134	2.1	0.87	Volkswagen
Volvo	1.78	181	2.9	0.62	Ford
Land Rover	1.51	130	2.1	0.73	BMW
Daewoo	1.48	N/A	N/A	N/A	Daewoo
Hyundai	1.28	159	2.5	0.51	Hyundai owns Kia
Mazda	1.12	149	2.4	0.47	Linked with Ford
Suzuki	1.00	132	2.1	0.48	Suzuki
Skoda	0.99	194	3.1	0.32	Volkswagen
Seat	0.79	115	1.8	0.43	Volkswagen
Saab	0.77	97	1.5	0.50	GM
Jaguar/Daimler*	0.70	94	1.5	0.47	Ford
Chrysler Jeep†	0.62	106	1.7	0.37	DaimlerChrysler
Alfa Romeo	0.45	90	1.4	0.32	Fiat
Others	3.24	675	10.7	0.30	
Total	100.00	6,314	100.0	1.00	

Source: Sewells International with adjustments by some suppliers.

\*Jaguar distributes the Daimler brand in the UK.

†Includes Chrysler and Jeep brands.

6.50. Market share alone does not determine the size of a supplier's network: some suppliers with small market shares have large networks. Column 5 of Table 6.1, which shows market shares divided by shares of outlets, provides a rough indication of the relative throughput per dealership achieved by the distribution networks. (It is not an exact measure as suppliers themselves, rather than dealers, negotiate a significant number of sales to large fleets.) This measure suggests a wide variation in throughput per dealership between the networks for both volume marques and prestige marques. Typically, smaller suppliers achieve less throughput per dealership. This may result in a high unit distribution cost per car sold, reflecting the burden of combining widespread coverage with limited sales. The variation in throughput per dealership could, however, be partly offset by differences in the cost per outlet or revenue per sale as some small suppliers operate low-cost, low-volume dealerships, share dealerships with other small suppliers or sell high-value cars.

6.51. Although all the main suppliers operate a broadly similar SED system, there are significant differences in the ways that they structure their dealership networks. Some suppliers, notably Ford and Renault, operate a two-tier dealership network with main dealer points accompanied by either satellite branch outlets owned by the local main dealer or separately-owned 'retail' dealers who may be appointed by the relevant main dealer. Table 6.2 illustrates these differences in approach for the main UK suppliers' brand dealership networks. It also shows the number of open points, which are territories where a supplier currently has a vacancy for an additional dealer, in each supplier's network.

TABLE 6.2 Structure of dealership networks of UK car suppliers on 1 January 1999

<i>Brand</i>	<i>Main dealers selling new cars</i>	<i>Satellite sales outlets*</i>	<i>Retail dealers/branch outlets</i>	<i>Total dealer sales outlets</i>	<i>Of which: supplier-owned dealerships</i>	<i>Additional service-only outlets</i>	<i>Open points</i>
Ford	262	-	507‡	769	1	-	-
Vauxhall	405	113	5	523	-	-	-
Peugeot	367	-	-	367	31	-	-
Renault	209	29	80	318	17	-	-
Volkswagen	312	-	-	312	-	5	5
Rover	353	-	-	353	-	7	-
Nissan	263	-	-	263	15†	-	20
Toyota	217	-	12	229	-	-	3
Fiat	181	8	-	189	-	33	8
Citroën	249	-	-	249	6	8	-
BMW	156	-	-	156	-	-	-
Honda	177	-	-	177	-	-	-
Mercedes-Benz	138	15	-	153	3	2	-
Audi	134	-	-	134	-	3	-
Volvo	181	-	-	181	-	6	-
Land Rover	130	-	-	130	-	5	-
Hyundai	159	-	-	159	7	-	20
Mazda	143	6	-	149	2	-	6
Suzuki	132	-	-	132	-	-	20
Skoda	194	-	-	194	-	-	-
Seat	114	1	-	115	-	7	66
Saab	97	-	-	97	7	-	4
Jaguar/Daimler	91	3	-	94	-	-	-
Chrysler Jeep	101	5	-	106	-	-	2
Alfa Romeo	90	-	-	90	-	13	6

*Source:* Sewells International with adjustments by some suppliers.

\*Secondary full-service sites owned by a main dealer within its territory.

†Including cases where Nissan only owns the properties occupied by the dealers.

‡The Ford network had 177 branch outlets and 330 retail dealerships as at 1 January 1999.

*Note:* See also footnotes to Table 6.1.

6.52. A few suppliers own some of their own dealerships. In most cases, this is a response to problems experienced with the viability of dealerships in high-cost locations, such as central London. Peugeot has had a sizeable dealer subsidiary for many years: in 1998 this accounted for 16 per cent of its sales of new cars. Renault also has a sizeable dealer subsidiary, which accounted for 20 per cent of its new car sales in 1998. Renault told us that it owned these dealerships only as a last resort and did not aim to own a large proportion of its outlets. It owned dealerships only where independent dealers had been unable to commit the necessary investment and it was essential for Renault to guarantee continuity of representation. Ford participates in two joint venture dealer groups that are discussed in paragraph 6.67. Vauxhall operates a scheme to provide venture capital to help new dealers to start up. It aims for them to become fully independent as quickly as possible. Through this scheme, Vauxhall currently holds minority shareholdings in 48 dealers.

## Changes in dealership networks

### *Reorganization*

6.53. Since the 1992 report, there have been a number of significant changes in the brand dealership networks. Many of these have been responses to changes in market share. Renault, Honda and Mercedes-Benz have significantly expanded their dealership networks and a new dealership network has been established by Chrysler. (Both Mercedes-Benz and Chrysler are now part of DaimlerChrysler.) By contrast, Ford, Vauxhall, Rover, Nissan, Fiat and Volvo have significantly reduced the size of their dealership networks and the dealership networks previously run by Lada, Lancia, FSO and Yugo no longer exist as separate operations. Table 6.3 shows the changes in the main suppliers' dealership networks since the 1992 report.

TABLE 6.3 Changes in the dealership networks of UK car suppliers since the 1992 report

Brand	Number of sales outlets on 1 January			Percentage change between 1991 and 1999
	1982	1991	1999	
Ford	1,216	998	769	(22.9)
Vauxhall	695	601	523	(13.0)
Peugeot	647	400	367	(8.3)
Renault	441	264	318	20.5
Volkswagen	381	331	312	(5.7)
Rover	1,725	789	353	(55.3)
Nissan	415	361	263	(27.1)
Toyota	213	218	229	5.0
Fiat	340	269	189	(29.7)
Citroën	251	231	249	7.8
BMW	143	162	156	(3.7)
Honda	208	152	177	16.4
Mercedes-Benz	98	126	153	21.4
Audi*	0	0	134	N/A
Volvo	258	264	181	(31.4)
Land Rover†	0	129	130	0.8
Hyundai	0	215	159	(26.0)
Mazda	217	174	149	(14.4)
Suzuki	45	110	132	20.0
Skoda	230	280	194	(30.7)
Seat	0	148	115	(22.3)
Saab	178	109	97	(11.0)
Jaguar/Daimler	0	102	94	(7.8)
Chrysler Jeep	0	0	106	N/A
Alfa Romeo	109	71	90	26.8
Others	887	1,233	675	(45.2)
Total	8,697	7,737	6,314	(18.4)

Source: 1992 report and Sewells International with adjustments by some suppliers.

\*The Audi brand was previously distributed through the Volkswagen network.

†The Land Rover brand was previously distributed through the Rover network.

Note: See also footnotes to Table 6.1.

6.54. Many suppliers have restructured their distribution networks by changing the number of territories and redrawing their boundaries. In several cases, the number of dealerships has been reduced in response to a declining market share. If large, such reductions may be difficult to accommodate within an established system of territories. The result may be a series of regional or national reorganizations and unease among the remaining dealers. The largest fall in the number of outlets has occurred in Rover's dealership network, which has declined from 944 outlets in 1988 to 353 outlets in 1999.<sup>1</sup> Rover told us that the removal of a second tier of retail dealers accounted for most of the reduction in its number of dealerships in the last five years. Consequently, the effect on main dealer territories had been smaller than might have been expected.

6.55. Some suppliers have chosen to combine a reorganization with a change in the way that the dealership network is operated. In a number of cases, notably including Ford, this change has led to the development of main dealer points and the downgrading of other outlets to become satellite or secondary locations. Under the plan that Ford is implementing, the UK has been divided into a number of large territories, called customer marketing areas (CMAs). The size of these depends on the nature of the location. Each CMA is to be controlled by a single dealer group, which will run a main central outlet and a number of satellite dealerships. Ford has identified a number of dealers as preferred partners for running the CMAs. In many cases, the dealer responsible for the CMA will have to negotiate the acquisition of other dealerships, which will become satellite operations within its CMA.

6.56. Even some suppliers with increasing market shares have chosen to reorganize their dealership networks. Nearly all importers of cars are now in the same corporate group as their manufacturer. The Volkswagen AG group has, for example, acquired control of the UK importer for the Volkswagen and Audi brands and has divided the former combined dealership network into two discrete networks. Renault is reducing its number of main dealerships but increasing its number of satellite outlets.

<sup>1</sup>Source: Franchise Networks, 1999, Sewells International.

### ***Costs of holding new car stocks***

6.57. Methods of holding and financing new car stocks have also changed since the 1992 report. Many suppliers now hold national or regional stocks (sometimes described as 'secondary stock'), which have reduced the need for dealers to acquire large premises to hold their own stocks of new cars. These suppliers' dealers have made further consequential savings as the suppliers bear the cost of insuring and providing security for their secondary stocks. The level of stock that dealers are expected to hold (sometimes described as 'primary stock') consequently varies between franchises. Although one supplier expects its dealers to hold a new car stock level of only 5 per cent of their annual sales targets, other suppliers expect dealers to hold higher stock levels. One supplier told us that it expected its dealers to hold a new car stock level of 16 per cent of their annual sales targets. Another said that its equivalent stock level was 12.5 per cent.

6.58. The majority of suppliers offer their dealers a free credit period of between 30 and 360 days, which removes the need for dealers to finance most of their stocks of new cars. Most new cars are supplied to dealers on a sale-or-return basis. A number of suppliers told us that such terms were not offered to dealers in other EC member states. The suppliers added that the sale-or-return system allowed dealers to exhibit a wide range of models, improving customer choice, without exposing dealers to high working capital requirements or a high degree of financial risk.

### ***Dealership efficiency***

6.59. We analysed the data from our surveys of dealers to estimate the degree of variation in the efficiency of dealerships (see Appendix 6.3). To do this, a number of statistical models relating the staffing levels and costs of dealerships to measures of their size, such as new car sales, used car sales and servicing turnover, were developed. For dealerships of any particular size and business mix, our analysis suggested that there was a wide variation in the staffing and costs of dealerships around the levels predicted by the models. This would imply that there could be substantial scope for savings in distribution costs if the less efficient dealerships were to achieve the average level of efficiency shown by comparable dealerships.

6.60. Other non-size-related factors (such as dealerships providing additional types of customer service) may, however, add to some dealerships' costs. Any such activities that do not generate compensating turnover would cause these dealerships to appear inefficient. If these activities are justified on another basis, our models would overestimate the scope for efficiency gains. However, these activities are of a much smaller scale than the dealerships' main activities of new car sales, used car sales, servicing and repairs, which are fully allowed for in our models. Other activities are, consequently, unlikely to account for a large proportion of the apparent efficiency variation.

6.61. Some suppliers commented that they had a strong interest in the efficiency of their dealerships and provided assistance to help dealers to improve their management. They added that, because of the lower population density, rural dealerships could appear to be less efficient than those in cities. Finally, they felt that 'snapshot' assessments of efficiency could be misleading where changes were taking place. They also criticized detailed aspects of our statistical models, which are discussed in Appendix 6.3.

### **Comparison with car distribution systems in other EC countries**

6.62. Given that the Block Exemption applies to all EC member states, we would expect their selective and exclusive car distribution systems to be similar. Although investigating car distribution in other countries is outside our terms of reference, we have examined the readily available data to see whether this is the case. Table 6.4 shows a broad-brush comparison of the overall composition of the dealer networks in several EC countries. Differences in population density, the number of cars sold per head and land values may account for some of the differences. Nonetheless, the table suggests both that SED is operated in a different manner in different countries and that car dealerships may be more efficient in the UK than in some other EC countries. The ICDP, an organization which carries out research into car distribution with support from the car industry and others (including governments), confirmed this impression by telling us that UK dealers were more efficient than those in most other European countries, where the dealer sector was highly fragmented with many small, family-owned outlets.

TABLE 6.4 Comparison of EC car distribution systems as at 1 January 1998

Country	New vehicles sold in 1998* '000	Numbers of sales outlets			New vehicles sold per main dealer outlet	New vehicles sold per dealer outlet
		Main dealers	Sub-dealers	Total dealers		
UK	2,456	6,308	487	6,795	389	361
Germany	3,828	20,285	6,988	27,273	189	140
France	2,298	6,605	15,307	21,912	348	105
Italy	2,521	5,898	6,178	12,076	427	209
Spain	1,424	3,739	4,700	8,439	381	169
Netherlands	646	3,587	609	4,196	180	154

Source: Commission calculations based on data from Harbour Wade Brown.

\*Adjusted by Harbour Wade Brown on to a comparable basis.

6.63. Autopolis told us, in a paper prepared for CA (see Chapter 8), that greater use was made of sub-dealers in southern European countries; a paper<sup>1</sup> submitted by the ICDP confirmed this. Both attributed it to the presence there of sub-dealers and independent service garages, repairing several makes of car, that act in a reduced role compared with main dealers.

6.64. The ICDP paper commented that in France and Germany there were significant proportions of supplier-owned dealers. It added that cultural and branding differences between countries resulted in differing scales of dealer operations. There were also differences in the degree of development of the used car market and in the sales of financial services.

## Dealer groups

6.65. Many parties told us that the prevalence of large dealer groups in UK car distribution did not occur in other countries. Sewells International has estimated that the number of dealer groups in the UK has increased from 363 in 1994 to 553<sup>2</sup> in 1998. Sewells International has also estimated that the proportion of all franchised new car distribution points owned by dealer groups has increased from 37 to 58 per cent over the same period. Table 6.5 shows the proportion of the main suppliers' distribution networks that are operated by dealer groups.

<sup>1</sup>*Beyond the Block Exemption—An Analysis of Vertical Restraints and Retail Competition in the European Car Industry*, Dr A Tongue and Professor J Brown, ICDP Research Report 4/98.

<sup>2</sup>Source: Franchise Networks, 1999, Sewells International.

TABLE 6.5 Proportion of UK car suppliers' distribution networks operated by dealer groups in December 1998

<i>Brand</i>	<i>Percentage of franchise outlets operated by dealer groups</i>	<i>Percentage of franchise outlets operated by the 20 largest dealer groups</i>
Ford	55.0	18.5
Vauxhall	53.7	19.1
Peugeot	60.2	18.9
Renault	50.0	17.3
Volkswagen	69.4	19.4
Rover	71.1	25.5
Nissan	66.5	15.6
Toyota	57.0	20.6
Fiat	66.7	32.3
Citroë	55.8	14.9
BMW	71.2	16.0
Honda	66.1	14.7
Mercedes-Benz	65.8	18.7
Audi	79.3	26.7
Volvo	79.1	23.0
Land Rover	73.1	30.0
Hyundai	35.2	1.9
Mazda	51.7	8.1
Suzuki	31.8	3.0
Skoda	12.4	0.0
Seat	48.1	7.0
Saab	52.6	18.5
Jaguar/Daimler	89.4	48.8
Chrysler Jeep	72.6	8.5
Alfa Romeo	79.3	44.4
Total	57.5	18.0

Source: Sewells International with some adjustments by suppliers.

6.66. As large dealer groups usually assemble a broad portfolio of different suppliers' dealerships, they are able to limit their exposure to the fortunes of any individual supplier. Table 6.6 sets out the ten largest dealer groups by turnover in 1994 and 1999. The position is fluid with many mergers and other changes since 1994.

TABLE 6.6 Largest ten dealer groups in 1994 and 1999

<i>Largest dealer groups in 1994</i>		<i>Largest dealer groups in 1999</i>	
<i>Group</i>	<i>Turnover £m*</i>	<i>Group</i>	<i>Turnover £m*</i>
Lex Retail Group	1,300†	Pendragon	1,978
Inchcape	975	Lancaster	1,850
Hartwells	774	Reg Vardy	1,200
Cowie Group	518	Inchcape	847
Appleyard Group	490	Sanderson Bramall	800
Sanderson Bramall	420	Hartwells	762
Evans Halshaw	404	Arriva	745
Lookers	363	Renault Retail	655
Bristol Street Motors	360	Lex Retail Group	560†
Henly Group	345	Arnold Clark	643

Source: KPMG Automotive Practice with adjustments by some dealer groups.

\*Results for the latest available financial year.

†Includes truck dealerships.

6.67. Several large groups have grown recently. A number of these, including Inchcape, Lancaster and Arriva (which now incorporates dealerships formerly part of the Cowie Group), are part of corporate groups with other major activities. Pendragon, which has recently acquired Evans Halshaw, has been described as the UK's first 'mega-group'. It has around 180 franchises, representing 23 different car suppliers, at about 150 locations. Even so, Pendragon accounts for only about 3 per cent of UK franchised new car sales outlets. Reg Vardy expanded rapidly in 1998 and now holds 81 franchises. Jardine Matheson, which owns Lancaster, has acquired Appleyard. It has also formed a joint venture with Ford,

through its Polar Motor Group (Polar) subsidiary, to operate Ford dealerships. This joint venture subsequently acquired Dagenham Motors. Pendragon then formed a separate joint venture with Ford to operate its Ford dealerships. As a result of this consolidation of the large groups, Sewells International estimates that the average number of sites operated by each of the 20 largest dealer groups increased from 38 in 1994 to 45 in 1998.

6.68. On the other hand Lex, which held 105 car dealerships in 1995, has decided to reduce its involvement in car dealing to concentrate on other activities.

## **Suppliers' restrictions on the number and clustering of dealerships in single ownership**

6.69. Suppliers require each dealer group to enter into a separate dealer agreement for each dealership (and thus each territory) allocated to it within a particular franchised network. Although most dealerships consist of a single outlet, some suppliers will enter into agreements that cover a main dealership with a small number of branch outlets in the allocated territory. Dealers are generally not permitted to open additional branch outlets without their supplier's consent.

6.70. A few major suppliers told us that they restricted the number of their dealerships that could be held by a single dealer or dealer group; others said that they issued guidelines on this. Some of these suppliers told us that they wanted to limit their vulnerability to the withdrawal, or failure, of any particular dealer group by not granting further dealerships to those with more than a certain share of their sales. A small number of suppliers prefer to appoint small private companies that own only a few dealerships.

6.71. Several suppliers seek to maintain diversity and competition in each geographic area by limiting the number of adjacent territories under the control of a single dealer group. These policies may also take the form of internal guidelines. Conversely, other suppliers are moving towards an approach in which a number of large market areas are each operated by a single dealer group (see paragraph 6.55). The suppliers' reasons for their policies on the number and location of their dealerships that may be held under a single ownership are to be found in Chapter 9.

6.72. Appendix 6.4 sets out a list of major suppliers and indicates whether, and to what extent, they apply such restrictions. Several of these suppliers told us that they had a flexible attitude, and regarded their restrictions as guidelines rather than hard and fast limits. These guidelines may be formally put to the dealers in writing, spread by word of mouth or only disclosed when the occasion arises. Financial strength and satisfactory performance within existing dealerships are also key factors taken into account in deciding whether an additional dealership may be granted.

## **Dealer agreements**

6.73. Appendix 6.5 is a review of UK dealer agreements, based on an analysis of the agreements and associated documents submitted to us by 17 suppliers. It sets out the major contractual obligations and restrictions included in the main suppliers' dealer agreements. We outline the most significant points below and illustrate how suppliers use many of the powers provided to them in the agreements.

### **General**

#### ***Nature of dealer agreements***

6.74. A dealer agreement is the contract entered into by a dealer and a supplier in respect of each individual dealership (see paragraph 6.27). Nearly all dealer agreements are open-ended rather than of fixed-term duration. Where there is a fixed term it must be at least five years. In response to our surveys (see Appendix 6.2), the vast majority of dealers told us that they had little or no influence over the terms of their agreements with their suppliers. Only 6 per cent of dealers said that they were able to negotiate the terms and conditions of their agreements with their suppliers to any significant degree. Three-quarters

of dealers were, nonetheless, satisfied with their relationship with their supplier. One supplier commented that opportunities for negotiation were limited, as many aspects of its dealer agreement were constrained by the provisions of the Block Exemption.

6.75. The contract normally comprises a series of standard documents and forms drawn up by the supplier, completed by the addition of details of the prospective dealer's business and supplemented by further circulars and other correspondence.

### *Side letters, operating standards and correspondence*

6.76. Other documents, which often exercise detailed control over many aspects of the conduct of each dealer's business, accompany the main legal agreement. Taken together the documentation generally falls into five distinct parts:

- (a) appointment forms or letters relating to the individual dealership with details of ownership, management, location, premises, the territory and other dealerships held;
- (b) a standard contract that sets out the dealer's and supplier's rights and obligations with regard to the territory, ordering, prices, targets, servicing, warranties, trade marks, and other matters (see paragraph 6.79);
- (c) a set of conditions covering the consignment terms for supplying new cars;
- (d) manuals, guides and booklets providing general information and supplementing the standard agreement in such areas as technical standards, operating standards and bonus schemes; and
- (e) bulletins and notices about specific events, such as recalls, technical announcements, list price changes, promotions and special offers.

6.77. Apart from the appointment letter, these documents are standard for all dealers in a supplier's distribution network and, where appropriate, for second-tier dealers and dealers that handle only a specialized product range.

### **Subjects covered by dealer agreements**

6.78. In this section, we deal with the main restrictions and obligations normally found in dealer agreements, unusual features of these contracts and the types of contractual support provided by suppliers.

6.79. Agreements between suppliers and their dealers cover more than the terms and conditions for the sale and purchase of new cars and car parts. Because of the nature of the distribution system and the product, the contractual relationship between a supplier and a dealer is considerably more complex than that between a normal independent buyer and seller. The extent to which dealer agreements enable suppliers to become involved in the conduct of their dealers' businesses is shown by the following list of matters that suppliers frequently either determine or require their dealers to refer to them for approval:

<i>Physical</i>	Territory	— boundaries
	Premises	— location
		— size
		— layout
		— appearance (signs, decor)
		— cleanliness
		— equipment, tools
		— opening hours
	Supply of cars	— model ranges
		— stock levels
— number of demonstrator cars		
— delivery		

<i>Management</i>	Corporate	— ownership — directors, managers
	Organization and personnel	— structure and staffing — dress — training — computer systems
	Planning	— business plans — performance measures
<i>Finance</i>	Operating	— accounting systems — performance reports — liquidity and credit — payment systems
	Capital	— asset acquisition — asset disposal
<i>Trading</i>	Sales	— targets, promotion — recommended prices — channels of trade — customer records — customer service standards — margins/bonuses/penalties
	Development	— additional franchises — other suppliers' franchises — expansion of premises

6.80. In addition, suppliers audit their dealers' operations by means such as field staff inspections, customer surveys, 'mystery shopping' and monitoring trading performance. Despite this degree of supplier influence, the dealer contracts with its customers as a principal. Dealer agreements usually prohibit dealers from purporting to act as their supplier's agents. Suppliers reinforce this by controlling the use that dealers are permitted to make of their trade names and trademarks.

## **Key features of dealer agreements**

6.81. We set out below the key features of dealer agreements. Nearly all agreements follow the provisions of the Block Exemption closely in the areas that it covers. Where we have not discussed any matter covered by the Block Exemption below or in Appendix 6.5, all the agreements that we have examined reflect its relevant provisions. Many of the other standard provisions in dealer agreements are common to numerous other types of agreement for the sale and purchase of goods. Where such features follow normal commercial practice, we do not describe them below. We focus on the selective and exclusive elements of the agreements, particularly those that potentially prevent, restrict or distort competition in the supply of new cars.

### ***Dealer selection***

#### *Supplier prerogative*

6.82. Suppliers have complete freedom to appoint any company, partnership or individual as one of their dealers. Although they normally seek to apply objective tests of potential dealers' suitability, the choice may ultimately be influenced by subjective considerations, especially where there are only limited opportunities for new appointments. The territory for which a new dealer can be appointed will be constrained by previous appointments. If there is a suitable open point, the new dealer can be appointed to fill it. If, however, there are no suitable open points, new dealers can only be appointed by terminating existing dealerships (see paragraph 6.118) or reorganizing the network.

### *Transfers of ownership*

6.83. The contract is typically between the supplier and a named dealer that may be a company, a partnership or a sole trader. Details of the management and ownership of the dealership are specified as part of the contract. A change in ownership or control of the dealer without the supplier's consent is expressly made a cause for termination. There is also usually a prohibition on assigning the benefits of the agreement without the supplier's prior consent. A transfer of ownership of the dealership, or a change in control of the company holding the dealership, does not therefore guarantee the transfer of the dealer agreement to the new owner. Some suppliers, however, qualify their right to terminate on change of ownership or control of the dealer: for example, they may give an undertaking not to withhold consent unless their interests are materially affected or, alternatively, undertake that consent will not be unreasonably withheld.

### ***Restrictions imposed by suppliers***

#### *Territory*

6.84. As a rule, the supplier agrees not to sell to any other dealer within the dealer's territory. However, a number of agreements reserve the supplier's right to sell to other established dealers in the territory that are listed in a schedule. Nearly all suppliers reserve the right to sell in the territory themselves. Many of them use this right for sales to special categories of customer, such as the suppliers' own staff, but several major suppliers also sell direct to large fleet buyers.

6.85. Approaches to planning the organization and size of territories differ widely. The Block Exemption does not permit agreements that allow suppliers to change the size of a dealer's territory or to establish other dealerships within it unilaterally. In some dealer agreements, suppliers agree only to do so with the dealer's consent but require the dealer not to withhold its consent unreasonably, where the changes are supported by an objective market study and do not threaten the dealer's fundamental viability.

#### *Restrictions on activities outside the territory*

6.86. In many cases, the rights of dealers within their territories are reinforced by provisions designed to limit encroachment by other dealers. Specific constraints may, therefore, be imposed on each dealer's activities outside its territory. For example, dealers are prevented from setting up branches themselves, or from arranging for a third party to carry on dealership operations on their behalf, outside their own territories, without the supplier's consent. Dealers are, however, always permitted to respond to approaches from customers living outside their territories. Typically, about half of dealers' sales are made to customers residing outside their territories (see paragraph 5.29).

#### *Restrictions on promoting sales outside the territory*

6.87. Most agreements preclude the dealer from using personalized advertising, such as mail shots and doorstep or telephone canvassing, outside its territory. Following the changes introduced by the 1995 Block Exemption, the agreements do not prevent the dealer from seeking buyers in the territories of other dealers using general advertising.

#### *Limitations on resale*

6.88. Nearly all agreements underpin the selectivity of the supplier's dealer network by preventing the dealer from selling the supplier's new cars to resellers that are not part of the network. One supplier told us that this restriction was needed to prevent such resellers from benefiting from the investment made by franchised dealers, when they had not invested in services, equipment and training. A sale via an intermediary is permitted only if the intermediary can supply a written authority from a final customer to buy a vehicle on his or her behalf. We received evidence that this condition is sometimes rigorously enforced, even where dealers have sold cars to car brokers in the belief that they were end-users or genuine intermediaries.

### *Controls on dealing in competing products*

6.89. Nearly all agreements require the dealer to obtain the supplier's consent before it is permitted to sell other suppliers' new cars from the same premises. In line with the Block Exemption, such consent is not required if the dealer avoids confusion between brands and intends to operate the two franchises in separate premises, which are separately managed and operated by distinct legal entities. Some agreements also contain provisions preventing the dealer from concluding dealer agreements to sell other cars from different premises without giving details to the supplier. In practice, however, many dealer groups operate separate franchises for numerous suppliers and a sizeable number of dealers operate multiple franchises from distinct, but adjacent, premises. A few small suppliers show further flexibility in operating these restrictions and permit some competing products to be sold from the same premises. These competing products are, however, often limited to other brands within the same group or brands that are complementary to the main supplier's brand.

### ***Dealers' obligations***

#### *Combined sales and servicing facilities*

6.90. All agreements contain obligations on the dealer to provide facilities for servicing and repairing the supplier's cars. Dealers are expected to perform PDIs before releasing cars to buyers. They must also carry out any work required under warranty on cars that have been sold by any of the manufacturer's dealers in the EC. Dealers also have to keep detailed customer records for use in recall programmes. The supplier reimburses the dealer for carrying out warranty and recall work; agreements often include relevant details such as the rate to be charged for labour, times allowed for jobs and prices of parts.

#### *Minimum or uniform franchise standards*

6.91. All suppliers give franchise operating standards a great deal of attention. Franchise standards are designed to ensure that performance in many areas attains or exceeds a minimum specified standard or, in some areas such as computing and stock control, that a uniform level of performance is achieved. We were told that the investment required to establish a dealership that met a typical supplier's standards usually exceeded £1 million and sometimes exceeded £2 million. Suppliers seek to maintain standards in such areas as:

- (a) the dealer's premises, including precise details of their size, layout and decor;
- (b) the dealer's organization and staff levels;
- (c) technical training, service facilities and equipment;
- (d) customer service;
- (e) accounting and stocking systems; and
- (f) advertising and sales promotion.

A considerable number of clauses are devoted to this subject in the agreements and there are often supplementary documents on particular types of standard. In addition, suppliers use field personnel and mystery shoppers to monitor performance against these standards.

6.92. Every supplier is concerned to ensure that work done by any sub-dealers or specialist servicing subcontractors that its dealers appoint achieves its minimum standards. Their agreements often contain one or more provisions that would enable them to achieve this by a variety of means. These may include such measures as bans on the appointment of sub-dealers; requirements for any appointments of sub-dealers or servicing subcontractors to be approved by the supplier; requirements for business plans setting out servicing arrangements to be approved by the supplier; and the application of franchise standards to the quality of work done by any subcontractors.

- *Premises*

6.93. All suppliers set quality standards that have to be met by the dealer's premises. In most cases these are very detailed and usually specify such matters as signage, colour schemes and the layout of the main facilities. Often the precise decor that must be used is specified and sometimes a particular nominated supplier, or list of suppliers, has to be used. Some dealers commented to us that these requirements caused the cost of setting up their premises to be higher than they thought necessary.

- *Servicing facilities, technical training and equipment*

6.94. All suppliers set standards for their dealers' servicing departments. These specify details of the servicing department including the specialist tools and equipment that must be used. All suppliers expect the dealer's technical staff to attend specialist training programmes. Visits from the supplier's field staff monitor the quality of servicing achieved. Many suppliers commented that the link between sales and servicing was essential to maintain the nationwide availability of high-quality servicing outlets. We discuss the limited available evidence on the quality of servicing and repairs in Appendix 6.6.

- *Advertising*

6.95. Dealer agreements often require dealers to undertake at least a minimum level of local advertising. Suppliers' advertising standards specify the format and style of presentation of dealers' locally-placed advertising. Dealer advertisements commonly concentrate on the prices of used cars and often do not mention new car prices. Thus, although the standards do not require that cars should not be advertised at prices below RRP, in most franchises the advertising of prices below RRP is comparatively unusual.

6.96. Suppliers generally denied that they discouraged their dealers from advertising new cars at prices below RRP. Several suppliers also showed us examples of their dealers advertising cars at reduced prices, sometimes comparing the prices offered with the RRP or with higher prices previously offered. In some cases, however, such advertisements were promoting offers funded by the suppliers and cannot, therefore, be taken as evidence of dealers spontaneously engaging in price promotions. It is clear that some suppliers are relaxed about such advertising by their dealers. Others, however, were unable to provide examples of this kind.

6.97. Many of the main suppliers require or expect their dealers to contribute towards the costs of non-local advertising. This contribution is usually an amount per new car sold or a percentage of new car sales turnover. In the case of one supplier, dealers are expected to join collective regional dealer advertising agencies, which carry out regionally-based advertising. Each dealer pays a fee to its regional dealer advertising agency, which decides the price at which new cars should be advertised in its region. These prices are often below RRP and, as the dealers themselves have advertised them collectively, they effectively act as a maximum retail price in the region. Dealers are, however, able to give further discounts from these prices to secure sales.

6.98. 41 per cent of dealers responding to our survey (see Appendix 6.2) said that their supplier imposed restrictions on the way they promoted sales of its new cars. In some cases, the restrictions included setting a maximum discount that could be advertised, whether expressed as a percentage or an absolute amount of money. Unusually, about 13 per cent of respondents (33 dealers) added comments to their questionnaire responses to the effect that their suppliers prevented them from advertising at prices below list price. These comments ranged from 'advertisements must meet "brand value" standards and do not contain reductions in retail price' to 'total ban on advertising below list price'.

### *Sales and other targets*

6.99. The Block Exemption requires that any new car sales targets should be agreed between the supplier and the dealer (see Appendix 6.1). For each dealership, separate annual sales targets are usually set for every model range within the dealer's contract range. Thus, dealers are effectively required to sell all their supplier's model ranges. Table 6.7 shows the proportions of dealers which told us in response to

our surveys (see Appendix 6.2) that they were set targets for new car sales, used car sales, selling financial packages (see paragraph 6.110) or selling extended warranties.

TABLE 6.7 Proportions of dealers set targets by their suppliers

<i>Target</i>	<i>Proportions of dealers set targets</i>
Sales of new cars	97
Sales of used cars	25
Sales of financial packages	41
Sales of extended warranties	29

*Source:* Commission survey.

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6.100. All dealer agreements include the Block Exemption requirement that, in the absence of agreement between the supplier and the dealer, any sales targets for new cars that the dealer has to endeavour to meet must be set by an independent expert. In practice, such expert determination is very rarely used. The agreements of nearly all suppliers provide that failing to endeavour to meet, repeated failure to meet, or failure to meet a proportion of new car sales targets can be a specific cause for termination (see paragraph 6.122). (Which of these provisions are applied and the form they take vary from supplier to supplier.) Some of these suppliers told us that they used this option only as a last resort, after additional assistance and motivation from their field support staff had proved unsuccessful. They added that failures to meet targets were usually accompanied by failures to achieve service standards.

6.101. We analysed data submitted by five of the largest six suppliers to see what proportions of their dealers met or exceeded their sales targets in 1998. These data showed that the proportions averaged 50 per cent and varied from 25 to 81 per cent depending on the franchise concerned.

- *Demonstrator cars and stocks of new cars*

6.102. Most suppliers may oblige their dealers to hold agreed levels of stock related to the sales targets. As part of a move towards improving efficiency by adopting ‘lean distribution’ methods, several major suppliers have introduced regional stocking centres in the last few years (see paragraph 6.57). The requirement for their dealers to hold stocks of cars has, consequently, been greatly reduced. The agreements also enable suppliers to require dealers to have agreed numbers of demonstrator cars available. In the event of failure to agree the necessary stock levels or numbers of demonstrator cars, these may be determined by an independent expert.

### *Supply of information*

6.103. Dealers are required to keep full records of their dealings with customers, of their financial transactions and of their own credit position. These have to be available for inspection by the supplier. 56 per cent of the dealers which responded to our survey (see Appendix 6.2) told us that their main supplier was able to require the provision of information concerning individual sales of new cars. 72 per cent of them said that their main supplier could require them to provide general financial information about their business.

6.104. The supplier usually reviews the dealership’s full trading results. The management accounting systems to be used are often specified by the supplier to assist the aggregation of composite results from the entire network (see Chapter 4). The resulting composite results are disseminated to provide dealers with a benchmark against which they can assess their performance. They also show the average gross and net margins for similar dealers in the network, which enable dealers to make rough estimates of how the discounts they are giving compare with those of other dealers. The accuracy of such comparisons is, however, affected by dealers’ different sales mixes within model ranges and by differences in the treatment of part-exchanges and supplier-financed incentive programmes in dealers’ management accounts. Although most agreements give suppliers the right to see individual dealers’ returns, the suppliers told us that they used third party agents to assemble the data and normally saw only the aggregated results themselves.

## ***Financial rewards***

### *Wholesale and retail pricing and dealer margins*

6.105. List prices (RRPs, sometimes also described as base prices) are set and published by each supplier. The wholesale prices payable by dealers are usually established by setting a percentage dealer margin that is to be deducted from the list prices. These margins typically range from 5 to 10 per cent. A few suppliers set wholesale prices with no stated link to list prices.

6.106. Several of the main suppliers set percentage dealer margins that vary with the model. Larger margins may be offered to dealers when a supplier is making a special promotion, for example to reduce stock levels in advance of the launch of a replacement model. Alternatively, such promotions may take the form of offers to customers that are directly financed by the supplier without affecting the dealer margin.

6.107. The prices needed to secure sales to some large fleet customers may be unattainable within the normal margin and bonuses available to dealers. In such cases, suppliers either negotiate the entire sale centrally or offer the customer discounts that are additional to any discounts the customer may negotiate with a dealer. In the former case, the supplier is the seller and may either make its own arrangements for carrying out PDIs and delivering the cars to the customer or pay one or more dealers a commission for doing so. In the latter case, the dealer is the seller of the car and the supplier arranges for the extra discount to be passed to the customer.

### *Bonus schemes*

6.108. Many suppliers operate bonus (or award) schemes that result in the effective dealer margin being increased if the dealer achieves specified performance targets. These schemes are typically set out in separate documents that may be revised one or more times each year. Suppliers told us that their purpose was to give dealers an incentive to increase sales and to maximize customers' satisfaction with the sales and after-sales service they received. The maximum total bonuses attainable by dealers typically range from 2 to 8 per cent of list price. Most suppliers give bonuses for meeting agreed sales targets and franchise standards. Often the element of bonus linked to franchise standards is conditional on at least a minimum level of performance against the main service standards being achieved. There is a tendency among suppliers to have incremental bonus payments for various elements of achievement, such as meeting performance targets set out in a business plan that has been developed jointly by the supplier and dealer. In response to our survey (see Appendix 6.2) nearly all dealers said that they could receive bonuses linked to achieving targets for sales of new cars.

6.109. These schemes are generally the only way that dealers can achieve a lower effective wholesale price by selling more new cars. Unlike conventional volume discounts, the sales levels required for a lower effective price to be offered vary from buyer to buyer: a large dealer will need to sell more cars than a small dealer to meet its target. One supplier commented that, as large dealers did not commit themselves in advance to taking specified numbers of cars, suppliers did not receive any production planning advantages in supplying them rather than small dealers.

6.110. In many schemes points are awarded for meeting sales targets for new cars (see paragraph 6.99), targets for sales of parts and extended warranties and for achieving a defined percentage of sales of new cars financed through the supplier's sponsored credit sale scheme. Nearly half the dealers responding to our survey said that they could receive bonuses for meeting targets for sales of financial packages and over a third of them could receive bonuses linked to sales of extended warranties.

6.111. The reward for achieving an appropriate total number of points for all available categories is often assessed over a given time period, for example a quarter or a whole year. Satisfactory performance may then effectively result in an additional percentage discount on the wholesale price of all new cars sold during that same period of time. Such schemes can thus encourage dealers that are close to achieving the relevant sales target to offer larger discounts towards the end of a period. As sales are usually measured in terms of the numbers of cars registered, these schemes may also provide an incentive for dealers to pre-register unsold cars, particularly where an enhanced registration bonus has been offered for a limited period.

6.112. Bonuses often also depend on the achievement of customer service standards that are frequently measured by means of customer surveys. Service-related bonuses are often linked to such measures as staff training courses attended and the views of customers and mystery shoppers on the quality of service provided. Some of these factors are subjective: over a quarter of dealers responding to our survey (see Appendix 6.2) considered that their supplier had a significant element of discretion in deciding what level of bonus to award. Some suppliers told us that the elements of their bonus schemes contingent on objective criteria were significantly larger than those with an element of subjectivity. They added that subjective assessment systems, such as mystery shopping reports, were designed in such a way that they were as objective as possible.

6.113. Bonus schemes are also liable to change in line with suppliers' overall marketing priorities: a third of the dealers responding to our survey said that their bonus scheme had changed in the last year and, in a few cases, there had been several changes. Some of these changes are specific incentives to sell particular models. Several suppliers commented that these campaigns gave them the flexibility to respond to market conditions and could provide dealers with substantial rewards.

6.114. Given the potential for subjectivity and change, it might be expected that dealers would find bonuses difficult to predict. Nevertheless, two-thirds of the dealers told us that they were able to take bonuses into account when assessing the level of discount that they could afford to offer customers.

6.115. Table 6.8 shows a summary of the various elements of the main suppliers' dealer margins and bonus schemes. This summary is a simplification of complex schemes, which include many different types of bonus, and is intended to provide an indication of the general approaches. In many suppliers' reward systems, margins and bonuses differ for individual models or model ranges. In some cases, even the overall shape of the supplier's reward system may differ from model to model. Different models may thus have their main potential sources of reward attached to different categories of margin or bonus. Bonuses that can be awarded for one model may not be available for others. For these reasons, the summarized bonuses in Table 6.8 are not always additive. Short-term tactical bonuses are not included. Only Ford treats its dealers' contributions to advertising campaigns as negative bonus payments; some other suppliers expect similar payments that are not shown in this analysis.

### *Increasing importance of bonus payments*

6.116. In its 1992 report, the Commission noted that most suppliers gave bonuses. It commented that some suppliers were beginning to reduce the common dealer margin of about 17 per cent, requiring dealers to cover the difference through bonuses linked to sales targets (see paragraph 6.57 of the 1992 report). Since then, many suppliers have continued to reduce their dealer margins (see Table 6.8) but have increased the bonuses available to dealers. Vauxhall told us that it took the lead in making a significant cut in dealer margins between 1991 and 1993 (see Chapter 9). It added that it had held wholesale prices to the dealer constant and reduced its list prices. This cut its dealer margin from 17 per cent in 1991 to 13.5 per cent in 1993. As wholesale prices remained the same, dealers had not had to change their transaction prices. Vauxhall added that bonuses had not been changed at that time. Other suppliers said that any absolute reduction in dealer remuneration had in many cases been accompanied by the removal of an element of dealers' costs, such as stocking costs or marketing levies.

6.117. Over half the dealers who responded to our survey (see Appendix 6.2) felt that their bonus system had increased in importance over the previous five years, relative to other parts of the overall financial returns offered by their franchise.

### *Termination arrangements*

#### *Open-ended agreements*

6.118. About 20 per cent of the dealerships of the six largest suppliers had their contracts terminated over the period from January 1994 to December 1998. Dealer agreements are normally of indefinite duration. Upon termination of such open-ended contracts, dealers are normally required to return to their supplier any saleable cars that are held on consignment terms. Although, with one exception, no compensation is payable, dealers are normally given the option to return saleable parts to the supplier in

TABLE 6.8 Dealer margins and bonuses for the six largest suppliers in 1999

*Maximum bonuses or other payments related to percentage of pre-tax list price*

	<i>For model with highest or lowest margin or bonus</i>	<i>Dealer margin</i>	<i>Supplementary margin or discretionary bonus</i>	<i>New car sales and/or registrations</i>	<i>Other sales</i>	<i>Standards</i>	<i>Less contribution towards advertising</i>	<i>Maximum total bonus</i>	<i>Highest attainable margin and bonuses</i>	<i>Minimum possible net payment to dealer</i>
[ ]		8.5		5.3		2.8		7.1	15.7	7.5
[ ]	Highest	10.0		2.6		3.5	-1.0	6.1	14.1*	10.0
	Lowest	5.0		0.0		1.5		1.5	6.5	5.0
	Average†	7.5		1.3		2.5		3.8	10.3	7.5
[ ]	Highest	8.0		1.5		6.2		7.7	12.7*	8.0
	Lowest	5.0		1.5		3.2		4.7	9.7	5.0
	Average‡	6.1		1.5		4.6		6.1	12.3	6.1
[ ]	Highest	9.0	3.0§	2.1	0.8	2.4		8.3	16.4*	9.0
	Lowest	5.4	0.0§	0.8	0.3	0.9		4.5¶	10.0	5.4
	Average‡	7.5	2.8§	1.4	0.6	1.6		6.4	13.9	7.5
[ ]	Highest	10.5	0.5	□	1.3	5.2		7.0	13.0*	10.5
	Lowest	5.0	0.5	□	0.4	1.6		2.5	6.0	5.0
	Average‡	7.8	0.5	□	0.9	3.4		4.8	9.5	7.8
[ ]		8.0	2.0#			3.8		5.8	13.8	8.0
	Overall average	7.6	0.9	1.6	0.2	3.1	-0.2	5.7	12.6	7.4

Source: Suppliers.

\*The highest attainable figure may combine high margins or bonuses in some areas with lower payments in other areas.

†Unweighted average of models with highest and lowest rates.

‡Unweighted average of all models.

§[ ]

¶Some models with low maximum bonuses in one category can attract high bonuses in another.

□During the course of 1999, [ ] adopted a number of tactical bonus schemes, under which a fixed sum was paid to dealers in respect of cars of a given model sold by them during a particular period. [ ] told us that the great variety of these schemes made it impossible to produce simple figures for inclusion in this column. By way of example, the bonuses payable on [ ] and [ ] models under such schemes had typically been between 5 and 10 per cent of the relevant list price.

#Discretionary bonus related to such matters as building new showrooms, fleet sales and achieving Motability first-class status.

Note: Not all figures are additive. For example, some suppliers have models that combine high margins with low bonuses and others that combine low margins with high bonuses.

exchange for the price they originally paid, less an administration charge. Special tools are usually returnable at current market value. In many agreements, however, these provisions are subject to the consent of the supplier. The following three classes of termination are provided for.

- *Termination without cause*

6.119. Most terminations take place under the ‘without cause’ provisions of the Block Exemption, which give suppliers the right to terminate a dealer’s agreement at two years’ notice, even where performance has been satisfactory. With the exceptions set out below, nearly all the open-ended agreements consequently allow either party to terminate them at any time by giving two years’ prior notice. Where the dealer is a new entrant to the network or where compensation is payable by law or by agreement, the Block Exemption allows the notice period under the agreement to be reduced to one year. Some agreements therefore provide for only one year’s notice to be given to new entrants; one supplier’s agreements provide for its dealers to be given one year’s notice and to receive compensation.

- *Reorganization of network*

6.120. Agreements generally allow suppliers wishing to reorganize the whole, or a substantial part, of their dealership network to terminate the affected dealerships by giving one year’s prior notice. Several suppliers told us that they preferred to give their dealers two years’ notice when possible rather than making use of this provision. These suppliers often use the ‘without cause’ provisions even for network reorganizations. One supplier told us that it frequently did this because the definition of what constituted ‘a substantial part of the network’ under the relevant provision of the Block Exemption was uncertain. Other suppliers, however, commented that the one-year termination provisions of the Block Exemption were important because they allowed the development of flexible, efficient distribution structures.

- *Termination with cause*

6.121. Dealer agreements usually include an extensive list of eventualities that would give the supplier grounds either to terminate the contract immediately or to terminate it with up to three months’ prior notice. The most commonly cited causes for immediate termination are:

- (a) the death or incapacity of the dealer;
- (b) the dissolution of the partnership, or winding up procedures against the company, owning the dealership;
- (c) a change in the ownership or management of the dealership without the supplier’s consent (although the supplier’s right to terminate may be qualified);
- (d) disputes between the owners or managers of the dealership that materially affect the supplier’s interests;
- (e) bankruptcy or insolvency, which some agreements define as including an excess of liabilities over assets;
- (f) fraudulent claims or misrepresentation; and
- (g) failure to pay monies due.

6.122. Under some agreements, other types of breaches of the dealer’s basic obligations may result in the supplier terminating the contract after giving a longer period of notice. The most commonly cited causes for termination after giving from one to three months’ prior notice are:

- (a) repeated failure to achieve sales targets;
- (b) repeated failure to achieve agreed customer satisfaction standards;

- (c) repeated sales of cars to unauthorized resellers;
- (d) repeated violation of signage standards or trademark obligations;
- (e) refusal to allow the supplier to audit performance; and
- (f) persistent failure to honour other material obligations.

In some suppliers' agreements, these types of breaches of obligations may also result in immediate termination.

### *Fixed period agreements*

6.123. Only one major supplier at present makes any significant use of fixed period dealer agreements. The Block Exemption requires that such agreements must have a term of at least five years and that each party must give the other at least six months' notice of any intention not to renew the agreement. As with open-ended contracts, such agreements may also set out circumstances under which the contract may be terminated either immediately or after a short period of notice.

### *Dealerships terminated*

6.124. Table 6.9 shows an analysis of the numbers of dealer agreements terminated by the six largest suppliers between January 1994 and December 1998. The categories of termination shown are those set out in the Block Exemption. Terminations during the period covered by the original block exemption are grouped with subsequent terminations of a similar nature, rather than those with the same notice period. The table does not include a large number of formal termination notices associated with issuing new dealer agreements to take account of the new Block Exemption or those served by VW in connection with issuing dealer agreements for the newly separated Volkswagen and Audi brand distribution networks.

TABLE 6.9 Dealer agreements terminated by the six largest suppliers

Supplier	Number of dealerships served with termination notices from January 1994 to December 1998				Total	As a percentage of outlets in December 1994
	Without cause*	For reorganization†	With cause‡	Non- renewal of fixed term§		
⊗	25	0	10	0	35	4.0
	3	0	1	16	20	3.8
	280	0	4	0	284	46.1
	18	23	130	0	171	42.8
	91	0	3	0	94	26.3
	9	13	46	0	68	21.9
Total	426	36	194	16	672	21.8

Source: Suppliers.

\*Notices of termination of types now given a two-year notice period under the provisions of the Block Exemption, excluding those subsequently withdrawn. Includes terminations for reorganization that were made with a two-year notice period.

†Notices of termination of types now given a one-year notice period under provisions of the Block Exemption, excluding those subsequently withdrawn.

‡Notices of termination of types now given less than one year's notice under the provisions of the Block Exemption, excluding those subsequently withdrawn. Includes immediate terminations, eg for insolvency or serious breaches. In the case of [ ⊗ ], terminations where there is a change of ownership within the dealership are included.

§Fixed-term contracts not renewed at the choice of the supplier.

¶[ ⊗ ]'s figures are for dealer agreements that terminated in the period.

## ***Other features of dealer agreements***

### *Terms of consignment and payment*

6.125. As stated in paragraph 6.57, many suppliers now hold most of their new car stocks at regional or national stocking centres. This makes most cars in stock immediately available for supply to any dealer, in contrast to previous systems under which each dealer held a sizeable stock and cars often had to be transferred from one dealer to another. Most dealers consequently have limited numbers of new cars at their showrooms, typically including a number of showroom models and demonstrator cars. Some dealers may also hold stocks of new cars at storage sites, requiring only PDIs before being supplied to customers. Those cars that are kept by dealers, other than demonstrator cars, are often held by them on a sale-or-return basis rather than owned by them outright. This reduces the working capital needed by dealers. Since dealers rarely return cars in practice, the sale-or-return terms effectively amount to deferred purchase.

6.126. A few suppliers may require a dealer to lodge a deposit with them or provide a parent company guarantee. Some of these suppliers told us that they did this only where there were doubts about a dealer's financial status. Alternatively, other financing arrangements that produce a similar result may be used. Where dealers receive their supplier's assistance in funding stocks, they are normally expected to use the associated finance company that is financing their supplier's element of the stock funding.

6.127. Dealers usually receive cars on a consignment basis. Under this arrangement, the dealer normally takes ownership of a car only when it either sells the car to a customer or registers it to buy it for the dealer's own purposes. The supplier pays the financing costs of holding each car for up to a certain maximum period (often set at 90 days). Beyond this time, the dealer becomes responsible for interest costs and may be obliged to purchase the car itself if no buyer has been found.

### *Delivery*

6.128. Most suppliers reserve the right to deliver new cars to their dealers' premises (or to alternative locations nominated by the dealers). Over 90 per cent of dealers in our survey said that their supplier insisted on arranging delivery. Suppliers levy a standard delivery charge (irrespective of distance) that is additional to the wholesale price (see paragraph 6.105). In response to our survey, 82 per cent of dealers said that their supplier determined the delivery charge made to the customer.

### *Unilateral variation*

6.129. A few agreements contain a provision under which the supplier has the unilateral right to vary the terms of the agreement for all dealers. These suppliers told us that such a provision has not been, and would not be, used to make material alterations to the terms of the contract to the detriment of the dealer. Its purpose was claimed to be to give scope for technical amendments that might become necessary as a result, for example, of changes in the law.

## ***Suppliers' obligations to support dealers***

6.130. Dealer agreements often commit the supplier to supporting or assisting the dealer to fulfil its obligations, for example through sales promotions, technical assistance or staff training. Some suppliers levy a charge of as much as 1 per cent of sales for this service. Suppliers often also undertake to monitor and maintain the integrity of the SED system. These support activities require the suppliers to invest in premises, specialized staff and equipment. One large supplier estimated that the cost of providing these services was £8.6 million a year.

### *National advertising and advertising support*

6.131. Suppliers carry out national advertising campaigns, exhibitions and promotions. Besides carrying out national advertising, suppliers often contribute to the costs of dealers' regional and local

advertising. They also provide promotional material to dealers and assist with their local promotions and joint regional promotions. Such support is usually tied to the use of an approved advertising format and artwork produced centrally (see paragraph 6.95).

### *Technical assistance*

6.132. Suppliers regularly provide technical data and service advice to help dealers to service and repair their cars. Specialist personnel are available to resolve unusual or difficult technical problems, for example through telephone helplines or on-line data links.

### *Staff training*

6.133. Suppliers run training courses and seminars for dealers' technical, managerial and sales staff. They told us that these courses were intended to help dealers to provide a better, more efficient and more profitable service to their customers. Management training may be used as a means of spreading best practice or assisting under-performing dealers. Some suppliers told us that their new product training was provided free of charge. Sales and management training courses are often subsidized. Technical and after-sales courses are frequently provided at cost.

### *Business consultancy*

6.134. Most suppliers provide assistance with the design and implementation of business systems for stock control, ordering and accounting. Expertise is also available to assist in organization and staffing and in the design and layout of the dealership premises. Field staff employed by suppliers also assist dealers in their sales activities and in improving customer service. Where a dealer is in danger of losing its franchise, its supplier may expect it to accept management consultancy support.

### *Information*

6.135. In addition to their contractual obligations, suppliers usually provide information on national market trends, competitors' activities and general developments in the retail car market. Information is also disseminated on best practice and on the average benchmark costs of comparable dealers (see paragraph 6.104).

### ***Dealers' views on dealer agreements***

6.136. Dealers' views on the dealer agreements are contained in Chapter 8. In brief, many dealers and their representative bodies, while they broadly supported many other aspects of the system, individually made certain criticisms. Matters objected to in response to our dealer survey included:

- (a) their supplier selling direct to fleet buyers at discounted prices that were not available to dealers;
- (b) low returns and reductions in dealer margins;
- (c) the high cost of investing in franchise standards, which they thought was not related to the likely return;
- (d) high price levels and their supplier's preference for offering bundled financial packages rather than price cuts;
- (e) a dealer agreement that could not be assigned, making it difficult for dealers to sell their businesses;
- (f) their supplier imposing used car warranty schemes on dealers that had better, less expensive schemes;

- (g) excessive control by their supplier and what they considered to be its dictatorial stance;
- (h) restrictions on advertising;
- (i) reductions in the size of dealer networks;
- (j) pressure from their supplier to pre-register cars;
- (k) high new car stock levels and the cost of funding them;
- (l) restrictions on the computer hardware and software that dealers could use;
- (m) lack of two-way communication with their supplier; and
- (n) special deals offered only to large dealer groups (for example, to clear stocks of end-of-life models).

### ***Suppliers' views on dealer agreements***

6.137. Suppliers' views on the dealer agreements are contained in Chapter 9. In summary, suppliers considered that the restrictions and obligations the agreements imposed on their dealers were needed to ensure the ready availability of a full range of high-quality sales and servicing facilities to consumers throughout the UK. A number of suppliers considered that, by creating brand focus and customer satisfaction, the restrictions maximized inter-brand competition and ensured the long-term profitability of dealership networks. They added that current distribution arrangements facilitated suppliers' handling of safety issues, which were of paramount importance.

### ***Relationship of dealer agreements to the UK market***

6.138. Dealer agreements are drafted on the basis that UK dealers sell new cars that they have purchased from their manufacturer's UK distribution company. In practice, dealers are not able to form contractual relationships with the manufacturer's distribution companies in other EC member states, and thus cannot purchase from them. Under the Block Exemption, a dealer may purchase a UK specification car from one of its manufacturer's franchised dealers in another EC country. The purchase would, however, depend on the voluntary cooperation of the overseas dealer.

6.139. The way that the sales of such imported cars are measured by the manufacturer's UK distribution company will determine whether or not they count towards the targets it sets for the UK dealer. One supplier told us that it based its sales count on the UK car registrations made by each dealer. In this case, sales of imported cars would count towards dealers' targets. Some other suppliers told us that such cars would not count towards the UK dealer's targets, although they might count towards any bonus payable to the overseas dealer.

6.140. The agreements cover models and model variants which the suppliers have decided they wish to market in the UK (often referred to as 'the contract programme') and the pricing and other provisions relate only to these cars and their parts. Under the Block Exemption, dealers have to undertake warranty work on cars sold by the manufacturer's dealers anywhere in the EC. A dealer is permitted to sell a car, acquired from its supplier, to a customer (direct or via his or her authorized intermediary) who wishes to register it in another EC member state. Such a sale would usually count towards the dealer's targets set under its dealer agreement. A number of suppliers have provided separate guidance to dealers on consumer rights and the procedures to be followed in such cases.

## **Daewoo: an alternative approach**

6.141. Although Daewoo had a market share of only 1.5 per cent of UK new car registrations in 1999, it provides an interesting example of an alternative approach to the distribution and servicing of

cars. Daewoo entered the UK car market in April 1995 with a target of achieving a 1 per cent market share as quickly as possible. It told us that, after studying the performance of recent entrants into the market, its management decided that the conventional SED system, using franchised dealers, could not achieve its target level of sales quickly enough.

6.142. Daewoo consequently developed a different approach that gave it direct control over its interaction with customers. This is based on wholly-owned sales outlets that sell at fixed prices direct to end-users. Daewoo's personnel are directly employed and do not receive sales-related commissions. In October 1999, it had three types of outlets:

- (a) wholly-owned sales outlets that concentrate exclusively on selling new cars, including:
  - (i) 11 large flagship units in retail parks that display up to 16 cars; and
  - (ii) three smaller outlets, which each display one car, in leased shop units located at three of Sainsbury's Savacentre supermarkets;
- (b) 21 wholly-owned sites that sell cars, provide service support and retail used cars; and
- (c) 95 service sites, 91 of which are located in Halfords garages servicing superstores but staffed by a mixture of Daewoo customer support personnel and Halfords technicians. Twenty-eight of these sites have been upgraded to include new car display areas. Four stand-alone service sites owned by Daewoo have recently supplemented these service sites.

6.143. As all Daewoo's sales outlets are directly owned, they do not need the protection of the Block Exemption or other exemptions on vertical restraints: such exemptions are needed only for agreements between independent parties. Several other suppliers told us that, although they preferred at least for the time being a system based on independent dealers, they had examined the possibility of using vertically integrated distribution. One supplier said that it would seriously consider this alternative if the Block Exemption were not to be renewed.

## Possible developments in car distribution

6.144. Although most experts and commentators on the motor industry agree that substantial changes in car retailing are probable, they are often uncertain about which of the possible changes they envisage are most likely to occur. We have examined a number of expert reports on car distribution including in particular research papers by the ICDP<sup>1</sup> and a report by AT Kearney,<sup>2</sup> one of the leading global automotive consulting firms. We briefly consider possible developments, including some suggested by these reports, below. We have not summarized changes, such as the further development of large dealer groups, which are simply continuations of existing trends that we have already discussed. We outline other possibilities under three headings: measures to improve the efficiency of the existing distribution system, new retail business models and the use of the Internet. We have not, however, attempted to assess the extent to which any of these possibilities may occur.

### Improved efficiency

6.145. Over the last two decades, significant steps have been taken to improve the efficiency and quality of car production.<sup>3</sup> These steps, which built on improvements pioneered by the Japanese motor industry such as just-in-time arrangements with suppliers, have improved the efficiency of product development, component supply and car assembly. They are collectively referred to as 'lean production'

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<sup>1</sup>Particularly *Future Directions for European Car Distribution: Evolution or Revolution?*, M Harbour with Professor J Brown and the ICDP Research Team, September 1998, ICDP Research Paper 11/98.

<sup>2</sup>*The Future of Automotive Distribution, Evolution of Revolution?*, AT Kearney, 1998, FT Automotive, Financial Times Business Ltd.

<sup>3</sup>See *The Machine that Changed the World, the Story of Lean Production*, J P Womack, D Jones and D Roos, 1990, HarperCollins.

techniques. The car industry is increasingly seeking to apply similar approaches to improving the efficiency of car distribution. These are collectively referred to as 'lean distribution' and have been encouraged by collaborative projects such as those initiated through the ICDP.

6.146. The ultimate development in lean distribution would be a move towards building cars to customer orders, which could virtually eliminate the need to hold stocks of new cars, other than for demonstration purposes. It would require a radical change in the motor industry's traditional way of scheduling production on the basis of dealers' demand forecasts. This shift is described as a move from 'product push' to 'demand pull'.

6.147. The ICDP submitted evidence<sup>1</sup> that its work had identified a significant degree of change in both the organization of distribution chains and the value-adding activities conducted within them over the last decade. Although it attributed part of this to changes in the regulatory framework, it added that there was now a feeling that the legislative framework was obstructing the evolution of the sector.

6.148. Among the changes that the ICDP expected to continue were:

- (a) the further development and implementation of lean distribution methods, which would improve dealers' ability to meet customer needs while reducing the levels of stock and fixed assets required;
- (b) further improvements in the quality of cars, such as continuing increases in the use of microprocessors and improved environmental and safety standards; and
- (c) more additions to the product 'bundle' offered by suppliers, including the financial products and other services that increasingly accompany cars.

6.149. Another ICDP paper<sup>2</sup> said in September 1998 that most car makers had yet to introduce 'lean' systems in car supply or after-sales service and that the rationalization of dealer outlets was only just beginning. It added that large financial gains were available from adopting 'build to order' systems for new cars, particularly if they were integrated with pricing and marketing policies. Redesign of the supply chain using a 'customer pull' approach would produce large stock reductions and improved customer service.

## **New retail business models**

6.150. A T Kearney commented<sup>3</sup> that the regulation of car retailing had protected it from change and unwanted newcomers. It expected that a trend towards eliminating restrictive practices would lead to reduced supplier and dealer control over the market, which would both encourage outsiders to enter the market and enable existing players to develop new approaches. A T Kearney suggested that six possible models would emerge:

- (a) *Company stores* controlled by suppliers which would be a further development and expansion of supplier-owned dealerships. These would assist suppliers to experiment with alternative distribution channels, including direct sales via the Internet.
- (b) *Direct sales* in which the suppliers would take the direct approach one stage further by going straight to customers without using the traditional form of dealer. Suppliers would employ a direct sales force, as many already do to sell to large fleet buyers. The sales force would probably make use of the Internet and telephone marketing methods. Retail customers would then be able to negotiate terms direct with suppliers; they would accept delivery either through dealers or by having cars delivered direct to their homes.

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<sup>1</sup>*An Analysis of Vertical Restraints and Retail Competition in the European Car Industry*, Dr A Tongue and Professor J Brown, ICDP Research Report 4/98.

<sup>2</sup>*Future Directions for European Car Distribution: Evolution or Revolution?*, M Harbour with Professor J Brown, P Wade and the ICDP Research Team, ICDP Research Paper 11/98, September 1998.

<sup>3</sup>*Ibid*, page 2.

- (c) *Integrated franchises* which would be an evolutionary development of the existing dealership system. Major changes would occur, including a substantial reduction in the number of dealerships and a consolidation of dealerships into larger dealer groups. A move towards a ‘hub and spoke’ system was likely. In this the ‘hub’ would provide a full-service integrated centre for an enlarged territory and the ‘spokes’ could be service-only outlets; they might also provide limited facilities for new and used car sales, depending on the nature of the local area. Alternatively, these spokes could be outlets for the separate services in the distribution system, franchised in an unbundled form.
- (d) *Business format franchises* which would be unbundled franchises for aspects of distribution, such as servicing, fast-fit repairs or used car sales. These would effectively unbundle the suppliers’ integrated dealer franchises and might enable them to secure representation in areas that did not have enough potential to make an integrated dealership financially viable. A T Kearney felt that, before suppliers could offer unbundled new-car franchises, they would have to take steps to ensure that they would be viable as free-standing businesses.
- (e) *Category management* which would involve retailers selling several brands of car from a single site. These sites could specialize in one type of vehicle (for example, sports cars or small hatchbacks) or could be large sites where cars were divided up by vehicle category, rather than brand. A T Kearney said that its research suggested that 29 per cent of new car buyers would prefer to use a retail outlet that stocked multiple brands of one category of vehicle. New entrants to car retailing might establish these outlets. A T Kearney added that its research in the UK indicated that 53 per cent of car buyers would consider buying a car from Tesco or Sainsbury’s. It considered that the nearest existing parallel was the development of the AutoNation chain of dealerships (formerly known as Republic Industries) in the USA. AutoNation was already large enough to challenge the power of the US car suppliers but had not yet succeeded in securing volume-related discounts or in selling multiple brands from a single site.
- (f) *Independents or brokers* which would be independent specialists in particular unbundled aspects of car distribution. A T Kearney considered that independent fast-fit operations and independent used-car supermarkets were existing examples of this. It also cited online new- and used-car brokers (see paragraph 6.153) as another example.

6.151. The ICDP has also analysed future scenarios for car distribution<sup>1</sup> and proposed four principal scenarios for distribution after 2010. These were:

- (a) *evolved dealer* which was superficially similar to the ‘integrated franchises’ scenario proposed by A T Kearney but envisaged radical changes in dealer processes to take advantage of changes further up the supply chain;
- (b) *dominant retailer* which was a variant of A T Kearney’s ‘category management’ scenario in which large retailers looked for regional domination, succeeded in getting preferential terms from suppliers and might market private-label cars;
- (c) *dominant manufacturer* which resembled A T Kearney’s ‘company store’ scenario; and
- (d) *multiple specialists* which was another variant of A T Kearney’s ‘category management’ scenario with competing types of distribution channels including traditional dealers, multi-brand ‘mega-stores’ and discount specialists selling excess stock.

6.152. The ICDP considered that, although continuing evolutionary progress was likely, revolutionary change might be triggered by external events. One such possibility was declining dealer profits leading to more active supplier intervention in the distribution process. Another was legislation leading to the end of selective or exclusive tied distributors. A third was the entry of a large-scale external investor that could shift the commercial balance between suppliers and dealers. The ICDP felt, however, that it would be difficult for such an investor to succeed.

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<sup>1</sup>Ibid.

## The use of the Internet

6.153. Several parties drew our attention to the rapidly growing use of the Internet in the new car purchasing process in the USA and predicted that similar growth would occur in the UK. A T Kearney said that its research indicated that 36 per cent of car buyers with Internet access would consider buying their next car on-line.<sup>1</sup> They might, however, also make use of other distribution channels. Suppliers said that they believed the Internet would be used primarily as a source of information rather than for actual purchases of new cars. They felt that most customers would still want to view the vehicles they were contemplating buying, and would want to discuss finance terms and the valuation of trade-ins. For these reasons, the suppliers thought the Internet would largely complement, rather than replace, traditional dealers. Our consumer survey, carried out in October 1999, found that only 4 per cent of respondents had used the Internet as a source of information when they were considering buying a new car.

6.154. Several independent Internet-based car brokers have set up in the UK, including Autobytel, New Cars Direct and Totalise; Microsoft CarPoint and the Virgin group have announced the intention to do the same. These brokers usually operate as intermediaries, matching buyers and sellers, the sellers being franchised dealers who pay a fee for inclusion in the broker's list of potential suppliers, although a variety of approaches appears to be opening up.

6.155. Some suppliers do not favour their dealers becoming involved in such third party Internet services either because they fear that these services will tend to undermine the normal operation of their franchised networks or because they intend to establish their own competing Internet-based systems. Indeed VW has made clear to its dealers that it opposes their involvement. Under the Block Exemption, however, and under the terms of the dealer agreements, franchised dealers are permitted to engage in this activity as long as the Internet service operates as an intermediary and not as a reseller.

6.156. In the second half of our inquiry Vauxhall announced that it would sell special editions of its leading models direct to customers through the Internet at prices around £1,000 (7 to 10 per cent) below the list prices of equivalent models sold through its dealers. The cars would be delivered by franchised dealers who would also carry out the usual PDIs. Vauxhall said that the lower prices at which cars would be sold through this service reflected the lower marketing and distribution costs involved. However, a true comparison of the value for money offered by the service would have to take account of the extent to which discounts and financial benefits available to customers buying from dealers offset the lower list prices of the Internet cars.

6.157. The Ford group has also announced initiatives to sell cars direct to private customers over the Internet but not, so far, in the UK.

6.158. Most existing Internet-based systems assist their customer to compare the merits of suitable models and then to specify the details of the model he or she would like to buy. They next price this model using list prices and refer the customer to a dealer, who has paid a fee to be part of the system. The dealer then seeks to complete the sale by providing a test drive, negotiating any trade-in arrangements and making a firm offer.

6.159. Many customers will no doubt prefer to continue buying new cars from retailers with a physical showroom. However, other customers, who do not need face-to-face advice from a dealer and either do not have a car to trade-in or are confident that they can realize its value in another way, may be prepared to complete their purchase on-line. Such customers would expect the prices offered to reflect the cost savings involved, which could potentially be very substantial, compared with the costs of a traditional dealership.

6.160. Such a retailer would not need high-quality accommodation, as customers need never visit its premises. A retailer could, in principle, cover the UK by holding any necessary stock of cars in a small number of large industrial-quality buildings and delivering them direct to the customer for test drives or on the completion of a sale. To avoid the diseconomies and loss of customer choice associated with supplying from stock, the retailer would ideally arrange for as many cars as possible to be built to order. PDIs could be provided by the retailer or by service outlets acting as its contractors.

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<sup>1</sup>Ibid, page 180.

6.161. At present, such a business model would be incompatible with the Block Exemption, unless a supplier agreed to make special arrangements for it.

### **Summary of possible developments**

6.162. It seems likely that customers will have an increased choice of distribution channels for buying new cars, used cars and servicing. A T Kearney felt that consumers might use several channels for a single purchase. It concluded that although change in automotive distribution would be dramatic, it would be evolutionary rather than revolutionary unless factors currently inhibiting change disappeared. A T Kearney considered that there would be a massive reduction in the current number of car dealers and that suppliers would have to develop multi-channel distribution strategies. The ICDP commented that modelling work was needed to assess the impact of multiple distribution channels. It added that it was assessing how effectively such systems would satisfy customer requirements. Although we cannot predict the form that any change will take, we consider that it is likely to be substantial, provided that it is not inhibited by any regulatory constraints.