FEDERAL TRADE COMMISSION
Washington, DC 20530

DEPARTMENT OF JUSTICE
Washington, DC 20580

March 14, 2019

The Honorable Tony Vargas
Room #1000
Nebraska Legislature
P.O. Box 94604
Lincoln, NE 68509

The Honorable Brett Lindstrom
Room #2015
Nebraska Legislature
P.O. Box 94604
Lincoln, NE 68509

Dear Senator Vargas and Senator Lindstrom,

The Federal Trade Commission's (the "FTC" or "Commission") Office of Policy Planning and the Antitrust Division of the U.S. Department of Justice (the "Division") (together, the "Agencies") appreciate your invitations[1] to comment on Nebraska Legislative Bill 51 ("LB 51" or "the Bill").[2] It appears that the Bill is intended to remove the requirement that automobile manufacturers use independent, franchised dealers to sell and service new motor vehicles, but only for manufacturers that have not previously used such dealers in Nebraska.

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[1] Letter from Tony Vargas, Sen., Neb. Leg., & Brett Lindstrom, Sen., Neb. Leg., to Matthew Mandelberg, Att'y, Competition Pol'y & Advocacy Sec., Antitrust Div., U.S. Dep't of Justice (Mar. 1, 2019); Letter from Tony Vargas, Sen., Neb. Leg., & Brett Lindstrom, Sen., Neb. Leg., to Bilal Sayyed, Dir., Off. Pol'y Plan., Fed. Trade Comm'n (Mar. 12, 2019).

[2] L.B. 51, 106th Leg., 1st Sess. (Neb. 2019) (as introduced, January 10, 2019).

We understand that the opportunity for LB 51 to be voted out of Committee on a priority basis is closing shortly. Under the time constraints presented by the legislative schedule, we regret that we are unable to submit a detailed comment analyzing this Bill at this time. We hope, however, that the Agencies' prior examination of competition in the sale of motor vehicles may be of use to you in your deliberations.

Over the years, the Agencies have developed considerable expertise in examining markets for the sale of motor vehicles and related products. For instance, the sales of automobiles, auto parts, auto dealer software solutions, and related industries have been the subject of the Agencies' antitrust enforcement efforts.[3] Additionally, the Agencies and their staff have studied the economic effects of state restrictions on the retail distribution of motor vehicles.[4]

Of particular relevance here, FTC staff has previously commented on bills in Michigan, New Jersey, and Missouri that involved similar issues to those raised by LB 51.[5] Those comments are attached, and to the extent that LB 51 seeks to afford

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[3] *See e.g.*, Press Release, Dep't of Justice, Japanese Auto Parts Company Pleads Guilty to Antitrust Conspiracy Involving Steel Tubes (May 31, 2018), https://www.justice.gov/opa/pr/japanese-auto-parts-company-pleads-guilty-antitrust-conspiracy-involving-steel-tubes ("The Antitrust Division's prosecution of widespread collusion in the auto parts industry has yielded more than $2.9 billion in fines and convictions of 46 corporations and 32 executives."); Competitive Impact Statement, United States v. Cox Enterprises, Inc., No. 1:15-CV-01583 (D.D.C. Sept. 29, 2015) (the Division challenged a merger and obtained a divestiture to preserve competition to develop and sell full-featured "inventory management solutions" to automotive dealers); Competitive Impact Statement, United States v. Nat'l Auto. Dealers Ass'n, No. 1:95-CV-01804 (D.D.C. Sept. 20, 1995) (the Division obtained a consent decree after challenging the National Automobile Dealers Association ("NADA") for collusion in the retail automobile industry to reduce discounts, restrict inventories, limit advertising, and boycott brokers); Detroit Auto. Ass'n v. FTC, 955 F.2d 457 (6th Cir. 1992) (affirming the FTC's final order that several motor vehicle dealerships in the Detroit area and the Detroit Auto Dealers Association ("DADA") had entered into anticompetitive and illegal agreements restricting hours of operation); General Motors Corp., 103 F.T.C. 374 (1984) (FTC order imposing conditions intended to guard against possible anticompetitive conduct in a joint venture between General Motors and Toyota).

[4] *See e.g.*, *Auto Distribution: Current Issues & Future Trends*, FED. TRADE COMM'N, https://www.ftc.gov/news-events/events-calendar/2016/01/auto-distribution-current-issues-future-trends (FTC public workshop held on Jan. 16, 2016); Gerald R. Bodisch, *Economic Effects of State Bans on Direct Manufacturer Sales to Car Buyers* (U.S. Dep't of Justice, May 2009), https://www.justice.gov/atr/economic-effects-state-bans-direct-manufacturer-sales-car-buyers (Economic Analysis Group Competition Advocacy Papers reflect the independent research and views of staff economists); ROBERT P. ROGERS, BUREAU OF ECON., FED. TRADE COMM'N, THE EFFECT OF STATE ENTRY REGULATION ON RETAIL AUTOMOBILE MARKETS (1986), http://www.ftc.gov/sites/default/files/documents/reports/effect-state-entry-regulation-retail-automobile-markets/231955.pdf.

[5] Letter from FTC Staff to Darwin L. Booher, Sen., Mich. Senate (May 7, 2015), https://www.ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-regarding-michigan-senate-bill-268-which-would-create-limited-exception-current/150511michiganautocycle.pdf [hereinafter Michigan Letter]; Letter from FTC Staff to Paul D. Moriarty, Assemb., N.J. Gen. Assemb.

manufacturers the option to engage in direct-to-consumer sales, much of the same reasoning contained in those previous comments may be relevant here.

As you will see from the analysis contained in the prior FTC staff comments, as a general matter, "vigorous competition among sellers in an open marketplace gives consumers the benefit of lower prices, higher quality products and services, and greater innovation."[6] Additionally when firms are deciding how to distribute their products, usually, "the competitive process effectively aligns the interests of firms and consumers on the issue of distribution method."[7] "In order to make their product as attractive as possible, firms choose the distribution method that can bring their product to market as effectively and efficiently as possible."[8] In the case of automobile distribution, restrictions on manufacturers' ability to choose their distribution method interfere with this process and can discourage innovation and new forms of competition.[9] Furthermore, the justifications offered in defense of these prohibitions generally appear to be contrary to a significant amount of economic study and Agency experience.[10]

(May 16, 2014), https://www.ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-new-jersey-general-assembly-regarding-assembly-bills-2986-3096-3041-3216-which/140516nj-autoadvocacy.pdf [hereinafter New Jersey Letter]; Letter from FTC Staff to Michael J. Colona, Rep., Mo. House of Reps. (May 15, 2014), https://www.ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-missouri-house-representatives-regarding-house-bill-1124-which-would-expand/140515mo-autoadvocacy.pdf [hereinafter Missouri Letter].

[6] Missouri Letter, *supra* note 5, at 3 (citing Nat'l Soc'y of Prof'l Eng'rs v. United States, 435 U.S. 679, 695 (1978); Standard Oil Co. v. FTC, 340 U.S. 231, 248 (1951)); *see also* Press Release, Dep't of Justice, Justice Department Charges National Automobile Dealers Association with Limiting Price Competition in Car Sales to Consumers (Sept. 20, 1995), https://www.justice.gov/archive/opa/pr/Pre_96/September95/494.txt.html (dealer efforts to lessen price competition among auto dealers and manufacturers "could have substantially driven up the cost of new cars to consumers").

[7] Missouri Letter, *supra* note 5, at 6.

[8] *Id.* at 6. In these comments, "FTC staff offer[ed] no opinion on the question of whether motor vehicle manufacturers would be best served by selling their products directly or through independent distributors." Michigan Letter, *supra* note 5, at 8.

[9] Missouri Letter, *supra* note 5, at 2; *see e.g.*, Competitive Impact Statement, *Nat'l Auto. Dealers Ass'n*, *supra* note 3, at 3-5 (dealers objected to and tried to stop various practices where manufacturers offered discounts such as "fleet subsidies" and "consumer rebates" because they increased competition with new vehicle sales and induced dealers to offer their own rebates).

[10] Missouri Letter, *supra* note 5, at 9; *see also* U.S. DEP'T OF JUSTICE, ROUNDTABLE DISCUSSION SERIES ON COMPETITION & DEREGULATION 176-177 (2018) (Remarks of Makan Delrahim, Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice) (citing, *e.g.*, Francine Lafontaine & Fiona Scott Morton, *State Franchise Laws, Dealer Terminations, and the Auto Crisis*, 24 J. ECON. PERSP. 233 (2010)), http://www.justice.gov/atr/compreg/report (research has shown that state legal protections from competition for franchised car dealers can "cause higher retail prices and higher distribution costs, at the expense of both consumers and manufacturers — particularly U.S. carmakers").

For these reasons, absent "supportable public policy considerations,"[11] the prior comments have advocated that "the law should permit automobile manufacturers to choose their distribution method to be responsive to the desires of car buyers."[12] The Michigan and New Jersey letters, in particular, concluded their analyses of similar partial repeal bills by explaining that a full repeal of the direct sales bans in those states would be of even greater benefit to competition and consumers than would a partial repeal of direct sales bans.[13]

Although our prior work does not directly address LB 51, we hope that it will nonetheless be of some help to the Nebraska State Legislature as it considers changes to its motor vehicle distribution laws. Please feel free to contact the staff listed below if you have questions about the attached materials, or if new questions arise during your legislative session or during further study of these issues.[14]

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[11] Missouri Letter, *supra* note 5, at 2.

[12] Missouri Letter, *supra* note 5, at 2.

[13] *See e.g.*, Michigan Letter, *supra* note 5, at 1 ("Michigan's consumers would more fully benefit from a complete repeal of the prohibitions on direct sales by all manufacturers, rather than the enactment of any limited, selective set of exceptions."); New Jersey Letter, *supra* note 5, at 14 ("in lieu of any of the currently pending bills, we urge the legislature instead to consider abandoning New Jersey's existing law, interpreted as a blanket ban on direct manufacture-to-consumer sales, and instead permit manufacturers and consumers to reengage the normal competitive process that prevails in most other industries.") Nevertheless, the FTC found that the partial repeals under consideration were "likely to promote competition and benefit consumers, compared to a blanket ban on direct manufacturer sales to consumers." Michigan Letter, at 1; *see also* New Jersey Letter, at 1 (reaching a similar conclusion "relative to a blanket ban").

[14] Staff contacts are Ellen Connelly (econnelly@ftc.gov) and James Frost (jfrost@ftc.gov), Off. Pol'y Plan., Fed. Trade Comm'n, and Matthew C. Mandelberg (matthew.mandelberg@usdoj.gov), Competition Pol'y & Advocacy Sec., Antitrust Div., U.S. Dep't of Justice.

Respectfully submitted,

Bilal Sayyed, Director
Office of Policy Planning
Federal Trade Commission

Daniel E. Haar, Acting Chief
Competition Policy & Advocacy Section
Antitrust Division
U.S. Department of Justice

UNITED STATES OF AMERICA
Federal Trade Commission
WASHINGTON, D.C. 20580

Office of Policy Planning
Bureau of Competition
Bureau of Economics

May 7, 2015

Senator Darwin L. Booher
35th Senate District
P.O. Box 30038
Lansing, Michigan 48909-7538

Dear Senator Booher:

Thank you for requesting comments from the Federal Trade Commission ("FTC") staff[1] regarding Senate Bill 268 pending in the Michigan legislature and relating to the sale and servicing of automobiles. This bill would create a limited exception to current provisions of Michigan law that have been interpreted to prohibit automobile manufacturers from selling new motor vehicles to consumers except through independent franchised dealers. In our view, current provisions operate as a special protection for dealers—a protection that is likely harming both competition and consumers. We therefore appreciate this opportunity to provide our views as to the probable impact of the proposed legislation on competition and consumers.

As we discuss below, FTC staff view Senate Bill 268 as likely to promote competition and benefit consumers, compared to a blanket ban on direct manufacturer sales to consumers. The bill would permit manufacturers of a category of vehicles known as "autocycles," under limited circumstances, the flexibility to choose whether to sell such vehicles directly to consumers, through dealers, or through some combination of the two. In our view, however, the bill does not go far enough. Rather, the narrow scope of the bill would largely perpetuate the current law's protectionism for independent franchised dealers, to the detriment of Michigan car buyers. FTC staff believe Michigan's consumers would more fully benefit from a complete repeal of the prohibition on direct sales by all manufacturers, rather than the enactment of any limited, selective set of exceptions.[2]

FTC staff offer no opinion on whether automobile distribution through independent dealerships is superior or inferior to direct distribution by manufacturers. Rather, staff's principal observation is that consumers are the ones best situated to choose for themselves both the

[1] This staff letter expresses the views of the Federal Trade Commission's Office of Policy Planning, Bureau of Competition, and Bureau of Economics. The letter does not necessarily represent the views of the Federal Trade Commission or of any individual Commissioner. The Commission, however, has voted to authorize staff to submit these comments.

[2] Our opinion is limited to bills addressing blanket restrictions on manufacturer sales and service to consumers. We do not attempt to comment or review the myriad additional provisions of Michigan law that regulate the relationship between automobile manufacturers and their independent dealers.

vehicles they want to buy and how they want to buy them. Automobile manufacturers have an economic incentive to respond to consumer preferences by choosing the most effective distribution method for their vehicle brands. Absent supportable public policy considerations, the law should permit automobile manufacturers to choose their distribution method to be responsive to the desires of motor vehicle buyers.

I. Interest and Experience of the Federal Trade Commission

The FTC is an independent administrative agency charged with working to protect consumers by preventing anticompetitive, deceptive, and unfair business practices, enhancing informed consumer choice and public understanding of the competitive process, and accomplishing this without unduly burdening legitimate business activity.[3] To secure these goals, the FTC has played a significant role in promoting competition and consumer protection law and policy through law enforcement, the study of industries and business practices, and through competition advocacy, which may include specific comments to legislators or regulators concerned about the likely competitive impact of pending legislative or regulatory measures.[4]

Competition is at the core of America's economy, and vigorous competition among sellers in an open marketplace gives consumers the benefits of lower prices, higher quality products and services, and greater innovation.[5] The goal of our advocacy program is to enhance understanding of the competitive process and provide a framework for thinking about public policy issues from a competition and consumer protection perspective. We urge decision makers to consider: (1) the likely competitive impact of proposed legislation or regulations; (2) how they might affect consumers; (3) what justifications might exist for any restrictions on competition; and (4) whether less restrictive alternatives would fulfill public policy goals while adequately protecting consumers. These considerations can be especially important when heavily regulated industries encounter new or disruptive products, services, and methods of sale.[6]

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[3] *See* Federal Trade Commission Act, 15 U.S.C. § 45.

[4] Sections 6(a) and (f) of the FTC Act authorize the FTC "[t]o gather and compile information concerning, and to investigate from time to time the organization, business, conduct, practices, and management of any person, partnership, or corporation engaged in or whose business affects commerce," and "[t]o make public from time to time such portions of the information obtained by it hereunder as are in the public interest …." 15 U.S.C. § 46(a), (f).

[5] *See Nat'l Soc'y of Prof'l Eng'rs v. United States*, 435 U.S. 679, 695 (1978) ("The assumption that competition is the best method of allocating resources in a free market recognizes that all elements of a bargain—quality, service, safety, and durability—and not just the immediate cost, are favorably affected by the free opportunity to select among alternative offers."); *Standard Oil Co. v. FTC*, 340 U.S. 231, 248 (1951) ("The heart of our national economic policy long has been faith in the value of competition.").

[6] *See, e.g.*, Comment from FTC Staff to Brendan Reilly, Alderman, City Council, City of Chicago (Apr. 21, 2014), *available at* http://www.ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-honorable-brendan-reilly-concerning-chicago-proposed-ordinance-o2014-1367/140421chicagoridesharing.pdf; FTC Staff Comments Before the District of Columbia Taxicab Commission Concerning Proposed Rulemakings on Passenger Motor Vehicle Transportation Services (June 7, 2013), *available at* http://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comments-district-columbia-taxicab-commission-concerning-proposed-rulemakings-passenger/130612dctaxicab.pdf.

In carrying out its mission, the Commission has developed considerable expertise in analyzing markets for the sale of motor vehicles. For example, in 1988 and again 2014, FTC staff submitted advocacy letters opposing limitations imposed by Illinois law on the hours of operation of auto dealerships.[7] The FTC also used its enforcement authority to protect competition in motor vehicle sales in the late 1980s, when it issued a complaint against several motor vehicle dealerships in the Detroit area and the Detroit Auto Dealers Association ("DADA") for imposing anticompetitive restrictions on hours of operation.[8]

In 1986, the FTC's Bureau of Economics issued a report on the effect of state regulations in retail motor vehicle markets that restrict the establishment of new motor vehicle dealerships near existing dealers selling cars of the same make.[9] The report found that these state laws harmed consumers because they caused motor vehicle prices to rise. In addition, in 2001, then-Commissioner Thomas Leary expressed concern about the same kind of decades-old state laws now at issue in Michigan—laws that insulate motor vehicle dealers from competition from automotive manufacturers. While dealers at one time tended to be small businesses, he observed, in 2001 they were frequently much larger entities, and the once highly concentrated motor vehicle manufacturing industry had become far more competitive. Commissioner Leary questioned, therefore, whether this kind of regulatory protection for dealers could still be justified, especially because it tended to interfere with the development of new and potentially more efficient methods of motor vehicle distribution, such as e-commerce.[10]

More recently, in 2014, FTC staff submitted comments in connection with proposed bills in Missouri and New Jersey addressing restrictions on manufacturers' direct distribution of motor vehicles in those states.[11] This comment echoes the views expressed in those comments.

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[7] Comment from FTC Staff to James Oberweis, State Senator of Illinois (March 26, 2014), *available at* http://www.ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-illinois-state-senate-regarding-senate-bill-2629-which-would-repeal-certain/140327illinoisautostaffcomment.pdf; Comment from FTC Staff to James R. Thompson, Governor of Illinois (Dec. 22, 1988), *available at* http://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comment-governor-james-r.thompson-concerning-s.b.1870-limit-auto-base-rental-charges-alter-allocation-costs-and-risks-damage-or-theft-and-ban-long/v890008.pdf.

[8] These dealers had reached an agreement, orchestrated by the DADA, to limit the number of hours that they would be open for business. The FTC concluded that the agreement was anticompetitive, a conclusion that was later affirmed by the U.S. Court of Appeals for the Sixth Circuit. *See Detroit Auto Dealers Ass'n v. FTC*, 955 F.2d 457 (6th Cir. 1992).

[9] Robert P. Rogers, Bureau of Econ., Fed. Trade Comm'n, THE EFFECT OF STATE ENTRY REGULATION ON RETAIL AUTOMOBILE MARKETS (1986) [hereinafter "Bureau of Economics Staff Report"], *available at* http://www.ftc.gov/sites/default/files/documents/reports/effect-state-entry-regulation-retail-automobile-markets/231955.pdf.

[10] Thomas B. Leary, Comm'r, Fed. Trade Comm'n, State Auto Dealer Regulation: One Man's Preliminary View, Speech at The International Franchise Association 34th Annual Legal Symposium (May 8, 2001), *available at* http://www.ftc.gov/public-statements/2001/05/state-auto-dealer-regulation-one-mans-preliminary-view.

[11] Comment from FTC Staff to Rep. Michael J. Colona, Missouri House of Representatives (May 15, 2014), *available at* http://www.ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-missouri-house-representatives-regarding-house-bill-1124-which-would-expand/140515mo-autoadvocacy.pdf; Comment from FTC Staff to Assemblyman Paul D. Moriarty, General Assembly, State of New Jersey (May 16, 2014), *available*

II. Discussion and Analysis of the Pending Bill

A. Michigan's Ban on Direct Manufacturer Sales

The Office of the Attorney General of Michigan has interpreted current Michigan law to prohibit automobile manufacturers from selling their products directly to consumers. These activities, it is maintained, can be carried out only through independent franchised dealers.[12] In October 2014, the legislature passed and the governor signed legislation that made wording changes to strengthen Michigan's statutory prohibitions on manufacturer direct sales to consumers. At that time, however, the governor said that "[a] healthy, open discussion can and should be had over whether the current business model in Michigan should be changed" and encouraged the legislature to engage in such debate.[13]

A blanket prohibition on manufacturer sales to consumers is an anomaly within the larger economy. Most manufacturers and suppliers in other industries compete with each other not only on the price, quality, and features of their products and services, but also on the cost, speed, service and efficiency of their sales and distribution systems. These manufacturers make decisions about how to design their distribution systems based on their own business considerations and in response to consumer demand. If a manufacturer concludes that using independent distributors to sell its products will best serve consumers and its own needs, it is free to contract for those services. On the other hand, if it decides that direct sales work better for its products, it can deal with consumers directly. Many manufacturers choose some combination of direct sales and sales through independent retailers.[14] The competitive process gives the manufacturer the incentive to pick the distribution option that it believes will be the most responsive to consumers. Typically, no government intervention is required to augment or alter these competitive dynamics—to the extent a manufacturer faces robust competition from other manufacturers, the market weeds out inefficient, unresponsive, or otherwise inadequate distribution practices on its own.

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at http://www.ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-new-jersey-general-assembly-regarding-assembly-bills-2986-3096-3041-3216-which/140516nj-autoadvocacy.pdf.

[12] Letter from Matthew Schneider, Chief Legal Counsel, Dep't of Att'y Gen., to Hon. Richard D. Snyder, Governor of Michigan (Oct. 21, 2014), *available at* http://www.michigan.gov/documents/snyder/HB_5606_Signing_Letter_472039_7.pdf. In Michigan, with limited exceptions, a manufacturer cannot directly or indirectly own, operate, or control a new motor vehicle dealer (Mich. Comp. Laws § 445.1574.14(1)(h)), or sell any new motor vehicle directly to a retail customer other than through franchised dealers (*id.* at § 445.1574.14(1)(i)). In addition, with limited exceptions, a manufacturer cannot own a motor vehicle service and repair facility, or authorize a motor vehicle service and repair facility to perform motor vehicle warranty repairs and recall work. Mich. Comp. Laws § 445.1574.14(1)(p), -(q). The latter prohibition does not apply to a motor vehicle dealer performing service or repair work on motor vehicles under the terms of a dealer agreement. *See* Mich. Comp. Laws § 445.1564.4(4).

[13] Letter from Governor Rick Snyder to Michigan Legislature (Oct. 21, 2014), *available at* http://michigan.gov/documents/snyder/HB_5606_Signing_Letter_472039_7.pdf.

[14] Computer manufacturers are one example of this hybrid distribution system, and popular clothing brands are another, but there are many more.

Economists have long been interested in why firms choose to sell their products through a network of independent entities, to "vertically integrate" (engage in retail sales themselves), or to do some combination of the two.[15] A large body of literature has shown that the decision is very context specific. In some circumstances, such as when local sales and promotional efforts are hard to measure but important for the firm's success, a firm may conclude that it is desirable to use highly incentivized independent representatives.[16] In others, however, reliance on independent dealers may fail to achieve the best outcome for either the upstream producer or the consuming public. The vast majority of existing work by economists suggests that allowing firms in competitive marketplaces to make the decision for themselves leads to better outcomes for consumers.[17]

When manufacturers respond to competitive pressure by choosing to vertically integrate, consumers usually benefit through lower prices and/or higher quality.[18] In contrast, when the government intervenes and outlaws vertical integration, consumers often experience worse service and higher prices.[19] It is not that vertical integration is always superior. Preventing firms

[15] One of the first papers focusing on this "make or buy" decision was Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937). The literature has since expanded dramatically. Recent surveys touching on both theory and empirical evidence include Francine Lafontaine & Margaret Slade, *Vertical Integration and Firm Boundaries: The Evidence*, 45 J. ECON. LIT. 629–85 (2007); and Timothy Bresnahan & Jonathan Levin, *Vertical Integration and Market Structure*, in HANDBOOK OF ORGANIZATIONAL ECONOMICS 85 (R. Gibbons & D.J. Roberts, eds., 2012).

[16] A book-length treatment of the theory explaining why can be found in Jean-Jacques Laffont & David Martimort, THE THEORY OF INCENTIVES: THE PRINCIPAL-AGENT MODEL (2009).

[17] This conclusion was reached in two separate recent surveys of the literature: Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy*, in HANDBOOK OF ANTITRUST ECONOMICS (Paolo Buccirossi, ed., 2008); and James C. Cooper, Luke M. Froeb, Dan O'Brien, & Michael G. Vita, *Vertical Antitrust Policy as a Problem of Inference*, 23 INT'L J. INDUS. ORG. 639–64 (2005).

[18] This is not to suggest that vertical integration can never harm competition, as may be the case where it is used to impair competition from rival suppliers or customers.

[19] Efficient vertical integration by upstream manufacturers can benefit consumers in a variety of ways. First, it can remove the incentive for a manufacturer as well as a dealer to each mark up the price of the product on its way to the consumer. This results in lower prices and increased sales to consumers. Discussion and details are available in Dennis W. Carlton & Jeffrey M. Perloff, MODERN INDUSTRIAL ORGANIZATION 523–27 (2d ed. 1994).

Second, integration by a manufacturer into distribution can enable manufacturers to better match their products with the preferences of consumers. For example, although manufacturers have an incentive to increase overall sales of their products, particular dealers may be most interested in making sales from their inventory, which may cause consumers to have to visit multiple dealerships to establish what product best fits their needs, resulting in relatively high search costs. When consumers' search costs are a large determinant of their purchasing patterns, a manufacturer can have a strong incentive to make direct sales so that it is simpler for consumers to find what they want. *See* Comment from FTC Staff to James Oberweis, State Senator of Illinois 5 (March 26, 2014), *available at* http://www.ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-illinois-state-senate-regarding-senate-bill-2629-which-would-repeal-certain/140327illinoisautostaffcomment.pdf (discussing and summarizing literature on the impact of search costs). For some empirical evidence on the importance of search costs in the automotive industry, *see* Fiona Scott Morton, et al., *What Matters in a Price Negotiation: Evidence from the U.S. Auto Retailing Industry*, 9 QUANTITATIVE MARKETING & ECON. 365–402 (2011). For a more general review of the economic theory and evidence connecting search costs to prices, *see* Michael Baye, et al., *Information, Search, and Price Dispersion*, in HANDBOOK ON ECONOMICS AND INFORMATION SYSTEMS 323 (T. Hendershott, ed., 2005).

from using independent retail networks, when that is what they want to do, also can have negative competitive consequences. The common message in both situations is that the competitive process effectively aligns the interests of firms and consumers on the issue of distribution method. In order to make their product as attractive as possible, firms choose the distribution method that can bring their product to market as efficiently as possible.

Specific evidence to support these views can be found in many industries, including retail automotive markets and industries like gasoline retailing. Past studies by both academic researchers and FTC staff have concluded that state-imposed restrictions on automobile manufacturers' ability to negotiate with their dealers increased the prices paid by consumers without leading to notable improvements in service quality.[20] Similarly, studies have found a causal link between laws that inhibit gasoline refiners' ability to operate or own retail stations, and higher prices.[21] In our view, the well-developed body of research on these issues strongly suggests that government restrictions on distribution are rarely desirable for consumers. When they are adopted, at a minimum, such restrictions should be clearly linked to specific policy objectives that the legislature believes warrant deviation from the beneficial pressures of competition, and should be no broader than necessary to achieve those objectives.[22]

Those who support a blanket prohibition on direct manufacturer sales have made a number of arguments that FTC staff find unpersuasive. Perhaps the central concern reflected in the current laws regulating the manufacturer-dealer relationship is that government intervention is required to protect independent dealers from abusive behavior by their suppliers. But a blanket prohibition of direct manufacturer sales is not a narrowly crafted provision to protect franchised

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Third, past work by economists has shown that vertical integration can aid firms in responding to uncertainty or evolving business environments by establishing clear lines of authority between their manufacturing and sales personnel, especially when new firms are attempting to enter an established market. A survey of the theoretical motivations for vertical integration can be found in Timothy Bresnahan & Jonathan Levin, *Vertical Integration and Market Structure*, in HANDBOOK OF ORGANIZATIONAL ECONOMICS (R. Gibbons & D.J. Roberts, eds., 2012). Empirical evidence of integration's impact on firms' ability to respond to events can be seen in recent studies such as Sharon Novak & Scott Stern, *Complementarity among Vertical Integration Decisions: Evidence from Automobile Product Development*, 55 MANAGEMENT SCIENCE 311–32 (2009); and Silke Forbes & Mara Lederman, *Does Vertical Integration Affect Firm Performance? Evidence from the Airline Industry*, 41 RAND J. ECON. 765–90 (2012).

[20] In particular, *see,* E. Woodrow Eckard, Jr., *The Effects of State Automobile Dealer Entry Regulation on New Car Prices*, 24 ECON. INQUIRY 223–42 (1985); and FTC Bureau of Economics Staff Report, *supra* note 9.

[21] J.M. Barron & J.R. Umbeck, *The Effects of Different Contractual Arrangements: The Case of Retail Gasoline*, 27 J.L. & ECON., 313–28 (1984); Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. REG. ECON. 217–33 (2000); and A.A. Blass & Dennis Carlton, *The Choice of Organizational Form in Gasoline Retailing and the Cost of Laws that Limit that Choice*, 44 J.L. & ECON. 511–24 (2001).

[22] Our comments here echo prior comments discussing similar issues. FTC Staff Comments Before the District of Columbia Taxicab Commission Concerning Proposed Rulemakings on Passenger Motor Vehicle Transportation Services (June 7, 2013), *available at* http://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comments-district-columbia-taxicab-commission-concerning-proposed-rulemakings-passenger/130612dctaxicab.pdf (discussing taxicab rules and suggesting that "any restrictions on competition that are implemented should be no broader than necessary to address legitimate subjects of regulation, such as safety and consumer protection, and narrowly crafted to minimize any potential anticompetitive impact.")

dealers from abuse in their franchise relationships. Such a prohibition is categorical, going well beyond the many other statutory provisions that protect dealers from such abuse. It extends to every entity engaged in manufacturing, assembling, or distributing new motor vehicles, even a manufacturer that has never entered into a franchise agreement.

Advocates for existing dealers also argue that manufacturers that sell directly to consumers will not provide them with adequate service. This argument presupposes that automobile manufacturers in a competitive environment will act contrary to their economic self-interest. If consumers greatly value post-sale service and would be unlikely to purchase or recommend any automobile without a reasonable assurance of quality future service, then any manufacturer will have an incentive to supply such service or else see its sales decline to the benefit of its rivals. This competitive pressure is a strong motivation for manufacturers to either provide good service themselves or continue to contract with an independent service provider, such as a dealer, to do so.

Finally, advocates for a categorical ban on direct sales argue that direct-selling manufacturers would charge higher prices to consumers. In their view, consumers benefit from the "intrabrand" competition between dealers of the same brand of vehicle. In other words, rival dealers in the same area that sell the same make and model of car compete for business and competition between them can lower prices for car buyers. Manufacturers, they maintain, would not be subject to the same competitive pressures.

This view is inconsistent with modern economic learning and with the Supreme Court's widely accepted observation that strong "interbrand" competition—competition between rival manufacturers—can suffice as a source of downward pressure on price.[23] Manufacturers in a competitive market face acute pressure to keep prices low to keep buyers from shifting their purchases to a competing manufacturer's product. Thus, forcing firms to use inefficient distribution methods can result in higher prices and other forms of consumer harm. As described above, this is not merely a theoretical possibility. Statistical evidence shows that states that have placed strong limitations on gasoline refiners' ability to operate their own retail outlets tend to have higher prices than those that allow refiners to use whatever combination of dealer and company-operated stations they prefer.[24]

A continuing ban on direct sales by manufacturers perpetuates the current closed system of motor vehicle sales in Michigan. The system limits competition among existing, well-established manufacturers, all of whom must sell through the established network of independent auto dealers. A direct sales ban deters experimentation with new and different methods of sales

[23] *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 52 n.19 (1977) ("Interbrand competition is the competition among the manufacturers of the same generic product […] and is the primary concern of antitrust law. […] In contrast, intrabrand competition is the competition between the distributors, wholesale or retail, of the product of a particular manufacturer. […] [W]hen interbrand competition exists, […] it provides a significant check on the exploitation of intrabrand market power because of the ability of consumers to substitute a different brand of the same product.").

[24] Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. REG. ECON. 217–33 (2000).

by current auto manufacturers, and also by future entrants to the market. Michigan's consumers are paying the price of such a dictate. The essential mechanism that drives markets—the interaction between the supply by manufacturers and the demands of consumers—is being curbed. The market is less responsive to consumer preferences and less innovative in anticipating their evolving needs.

Again, FTC staff offer no opinion on the question of whether motor vehicle manufacturers would be best served by selling their products directly or through independent distributors. Nor do we express a view as to whether any particular motor vehicle manufacturer should succeed or fail. Our principal point is this: absent some legitimate public purpose, consumers would be better served if the choice of distribution method were left to motor vehicle manufacturers and the consumers to whom they sell their products.

B. Proposed Bill to Ease a Manufacturer Sales Ban

Your request for the FTC's views and comments refers to Senate Bill 268 in the Michigan legislature. This pending bill would not remove what has been interpreted as a categorical manufacturer direct sales ban. Instead, the bill would carve out a limited exception to the current law's prohibitions for a defined category of motor vehicles. In our view, this bill (as indeed any effort to loosen or reduce the blanket prohibition) is a step in the right direction for competition and consumers.

1. The Proposed Bill

Senate Bill 268 would apply to the category of motor vehicles known as "autocycles," which are defined under existing law[25] as follows:

> "Autocycle" means an enclosed motorcycle that is equipped with safety belts, rollbar, windshield, wipers, steering wheel, and equipment otherwise required on a motorcycle, and which has not more than 3 wheels in contact with the roadway at any 1 time.

The operative language of Senate Bill 268 would add a new subsection (4) to Mich. Comp. Laws § 445.1574 that would expressly permit manufacturers of autocycles to engage in sales and service of these products in Michigan:

> The manufacturer of new or used autocycles may engage in the direct retail sale, purchase or exchange of, or deal in or make repairs to, those autocycles. As used in this subsection, "repairs" includes general repairs, warranty work or repairs, or recall work or repairs.

In addition, the bill would modify several prohibitions under existing law:

[25] Mich. Comp. Laws § 257.25a.

- The current prohibition against a manufacturer directly owning, operating or controlling a new motor vehicle dealer[26] would be modified to permit "the ownership, operation or control by a manufacturer of autocycles of a new motor vehicle dealer or a used motor vehicle dealer that is engaged in purchasing, selling, exchanging, or dealing in autocycles manufactured or assembled by that manufacturer."

- The current prohibition against a manufacturer selling a new motor vehicle directly to a retail customer other than through franchised dealers[27] would be made subject to the new subsection (4) above.

- The current prohibition against a manufacturer authorizing a non-franchised motor vehicle service and repair facility to perform motor vehicle warranty repairs and recall work[28] would be modified to permit "work on an autocycle that was manufactured or assembled by the manufacturer."

2. Benefits of the Proposed Bill

Removing the direct sales and service ban for the autocycle motor vehicle category would eliminate an obstacle to market entry in Michigan by a new manufacturer. Elio Motors has announced plans to manufacture an innovative low-cost, high-mileage, enclosed three-wheeled vehicle. The firm plans to manufacture the vehicles at a facility in Shreveport, Louisiana, beginning in 2016. As of March 29, 2015, it had accepted more than 41,000 reservations for the vehicles. Elio Motors does not intend to establish an independent dealer network. Warranty service will be provided through the Pep Boys auto service chain.[29]

Distribution of Elio products is planned through a series of company-owned retail sales centers and a smaller number of regional company-owned "Marshaling Centers." Customers will place orders at the retail centers and the orders will be filled overnight from the Marshaling Centers that will maintain product inventory. Basic models of the Elio vehicles stored at the Marshaling Centers will be configured with optional equipment selected by the customer and then delivered to the retail center for pickup by the customer. This distribution method, which maintains product inventory at locations away from the sales outlets, and tailors final product assembly to the configuration chosen by the customer, is an important part of the firm's business plans to drive down the consumer price of its products. By fitting cars with only those options that the customer chooses, Elio plans to avoid charging for options "packages" containing costly items that customers neither need nor want.[30]

[26] *Id.*, § 445.1574(1)(h).

[27] *Id.*, § 445.1574(1)(i).

[28] *Id.*, § 445.1574(1)(p)(iv).

[29] Elio Motors, http://www.eliomotors.com (last visited March 30, 2015). *See* Elio One-Page Specs Sheet, http://www.eliomotors.com/One_Page_Specs_Sheet.pdf.

[30] Tech Talk v60 – The Elio Customization Process (March 18, 2015), http://www.eliomotors.com/tech-talk-v60-the-elio-customization-process/ (last visited March 30, 2015). CEO Paul Elio has explained that he sees packages of options as bad for the interests of consumers: "As a customer, if I want the leather seats, I have to buy the fancy radio and the fancy wheels whether I want to or not. And if you look in your vehicle right now, there's several

The proposed bill would help clear the way for an innovative product and distribution method not yet available to Michigan consumers. Moreover, the bill is not specific to Elio Motors; it would also permit other manufacturers of autocycles to reach customers directly in the event consumer demand grows in this market segment. The proposed bill, therefore, would enhance competition in a new product category and would provide tangible benefits for Michigan consumers.

III. Conclusion

Although Senate Bill 268 would likely facilitate innovation in new products and distribution methods in the autocycle category of motor vehicles, it would leave in place existing law for other forms of motor vehicles. In other words, a blanket ban on direct manufacturer sales would remain in effect for the products that make up the vast majority of motor vehicles sold in Michigan today. FTC staff believe that current law, interpreted to ban direct manufacturer sales of motor vehicles, is very likely anticompetitive and harmful to consumers. Its breadth cannot be justified as a way to protect franchised dealers from abuse in their franchise relationships, and the other arguments offered in its defense appear to be contrary to a significant body of economic study and FTC experience.

The proposed bill carves out a limited exception to current law. In FTC staff's view, any effort to loosen or reduce a blanket prohibition on direct manufacturer sales may prove beneficial. However, we note that innovations in distribution methods (including the kind planned by Elio Motors) could be undertaken for a much broader range of motor vehicle products than just autocycles.

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thousands of dollars of stuff you neither need nor want." Tavarish, Interview with CEO Paul Elio, http://carbuying.jalopnik.com/elios-ceo-explains-how-he-can-sell-an-84-mpg-car-for-6-1677743693 (last visited March 30, 2015). *See also* New York International Auto Show: Elio Press Conference, https://www.youtube.com/watch?v=RJUXhK4pHx8&feature=youtu.be (published April 2, 2015) at 11:25 – 14:15.

We urge the legislature to consider abandoning the direct sales prohibition in Michigan's existing law, and instead permit manufacturers and consumers to reengage the normal competitive process that prevails in most other industries. Such a change would facilitate the development of new methods of distribution, benefitting the motor vehicle buyers of Michigan.

Respectfully submitted,

Marina Lao, Director
Office of Policy Planning

Deborah Feinstein, Director
Bureau of Competition

Francine Lafontaine, Director
Bureau of Economics

UNITED STATES OF AMERICA
Federal Trade Commission
WASHINGTON, D.C. 20580

Office of Policy Planning
Bureau of Competition
Bureau of Economics

May 16, 2014

Assemblyman Paul D. Moriarty
Chair, Consumer Affairs Committee
General Assembly
State of New Jersey
125 West State Street
Trenton, NJ 08625

Dear Assemblyman Moriarty:

Thank you for requesting comments from the Federal Trade Commission ("FTC") staff[1] regarding several bills pending in the New Jersey legislature that relate to the sale of automobiles. In different ways and to differing degrees, each of these bills would create limited exceptions to current provisions of New Jersey law that have been interpreted to prohibit automobile manufacturers from selling new motor vehicles to consumers except through independent auto dealers. These laws operate as a special protection for these dealers—a protection that is likely harming both competition and consumers. We therefore appreciate this opportunity to provide our views as to the probable impact of the proposed legislation on competition and consumers.

As we discuss below, FTC staff view all of the bills as likely to promote competition and benefit consumers, relative to a blanket ban on direct manufacturer sales to consumers. Each bill would permit some manufacturers, under limited circumstances, the flexibility to choose whether to sell cars directly to consumers, through dealers, or through some combination of the two. In our view, however, the bills do not go far enough. Rather, the narrow scope of the bills will largely perpetuate the current law's protectionism for independent franchised dealers, to the detriment of New Jersey car buyers. FTC staff believe New Jersey's consumers would more fully benefit from a complete repeal of the prohibition on direct sales by all manufacturers, rather than any limited, selective set of exceptions.[2]

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[1] This staff letter expresses the views of the Federal Trade Commission's Office of Policy Planning, Bureau of Competition, and Bureau of Economics. The letter does not necessarily represent the views of the Federal Trade Commission or of any individual Commissioner. The Commission, however, has voted to authorize staff to submit these comments.

[2] Our opinion is limited to bills addressing a blanket restriction on manufacturer sales. We do not attempt to comment or review the myriad additional provisions of New Jersey law that regulate the relationship between automobile manufacturers and their independent dealers.

FTC staff offer no opinion on whether automobile distribution through independent dealerships is superior or inferior to direct distribution by manufacturers. Rather, staff's principal observation is that consumers are the ones best situated to choose for themselves both the cars they want to buy and how they want to buy them. Automobile manufacturers have the incentive to respond to consumer preferences and choose the most effective distribution method for their vehicle brands. Absent supportable public policy considerations, the law should permit automobile manufacturers to choose their distribution method to be responsive to the desires of car buyers.

I. Interest and Experience of the Federal Trade Commission

The FTC is an independent administrative agency charged with working to protect consumers by preventing anticompetitive, deceptive, and unfair business practices, enhancing informed consumer choice and public understanding of the competitive process, and accomplishing this without unduly burdening legitimate business activity.[3] To secure these goals, the FTC has played a significant role in promoting competition and consumer protection law and policy through law enforcement, the study of industries and business practices, and through competition advocacy, which may include specific comments to legislators or regulators concerned about the likely competitive impact of pending legislative or regulatory measures.[4]

Competition is at the core of America's economy, and vigorous competition among sellers in an open marketplace gives consumers the benefits of lower prices, higher quality products and services, and greater innovation.[5] The goal of our advocacy program is to enhance understanding of the competitive process and provide a framework for thinking about public policy issues from a competition and consumer protection perspective. We urge decision makers to consider (1) the likely competitive impact of proposed legislation or regulations; (2) how they might affect consumers; (3) what justifications might exist for any restrictions on competition; and (4) whether less restrictive alternatives would fulfill public policy goals while adequately protecting consumers. These considerations can be especially important when heavily regulated industries face new and disruptive products, services, and methods of sale.[6]

[3] Federal Trade Commission Act, 15 U.S.C. § 45.

[4] Sections 6(a) and (f) of the FTC Act authorize the FTC "[t]o gather and compile information concerning, and to investigate from time to time the organization, business, conduct, practices, and management of any person, partnership, or corporation engaged in or whose business affects commerce," and "[t]o make public from time to time such portions of the information obtained by it hereunder as are in the public interest …." 15 U.S.C. § 46(a), (f).

[5] *See* Nat'l Soc'y of Prof'l Eng'rs v. United States, 435 U.S. 679, 695 (1978) ("The assumption that competition is the best method of allocating resources in a free market recognizes that all elements of a bargain—quality, service, safety, and durability—and not just the immediate cost, are favorably affected by the free opportunity to select among alternative offers."); Standard Oil Co. v. FTC, 340 U.S. 231, 248 (1951) ("The heart of our national economic policy long has been faith in the value of competition.").

[6] *See, e.g.*, Comment from FTC Staff to Brendan Reilly, Alderman, City Council, City of Chicago (April 21, 2014), *available at* http://www.ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-honorable-brendan-reilly-concerning-chicago-proposed-ordinance-o2014-1367/140421chicagoridesharing.pdf; FTC Staff Comments Before the District of Columbia Taxicab Commission Concerning Proposed Rulemakings on Passenger Motor Vehicle Transportation Services (June 7, 2013), *available at*

In carrying out its mission, the Commission has developed considerable expertise in analyzing markets for the sale of motor vehicles. For example, in 1988 and again earlier this year, FTC staff submitted advocacy letters opposing limitations imposed by Illinois law on the hours of operation of auto dealerships.[7] The FTC also used its enforcement authority to protect competition in motor vehicle sales in the late 1980s, when it issued a complaint against several motor vehicle dealerships in the Detroit area and the Detroit Auto Dealers Association ("DADA") for imposing anticompetitive restrictions on hours of operation.[8]

In 1986, the FTC's Bureau of Economics issued a report on the effect of state regulations in retail motor vehicle markets that restrict the establishment of new motor vehicle dealerships near existing dealers selling cars of the same make.[9] The report found that these state laws harmed consumers because they caused motor vehicle prices to rise. In addition, in 2001, then-Commissioner Thomas Leary expressed concern about the same kind of decades-old state laws now at issue in New Jersey--laws that insulate motor vehicle dealers from competition from automotive manufacturers. While dealers at one time tended to be small businesses, he observed, in 2001 they were frequently much larger entities, and the once highly concentrated motor vehicle manufacturing industry had become far more competitive. Commissioner Leary questioned, therefore, whether this kind of regulatory protection for dealers could still be justified, especially because it tended to interfere with the development of new and potentially more efficient methods of motor vehicle distribution, such as e-commerce.[10]

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http://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comments-district-columbia-taxicab-commission-concerning-proposed-rulemakings-passenger/130612dctaxicab.pdf.

[7] Comment from FTC Staff to James Oberweis, State Senator of Illinois (March 26, 2014), *available at* http://www.ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-illinois-state-senate-regarding-senate-bill-2629-which-would-repeal-certain/140327illinoisautostaffcomment.pdf; Comment from FTC Staff to James R. Thompson, Governor of Illinois (Dec. 22, 1988), *available at* http://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comment-governor-james-r.thompson-concerning-s.b.1870-limit-auto-base-rental-charges-alter-allocation-costs-and-risks-damage-or-theft-and-ban-long/v890008.pdf.

[8] These dealers had reached an agreement, orchestrated by the DADA, to limit the number of hours that they would be open for business. The FTC concluded that the agreement was anticompetitive, a conclusion that was later affirmed by the U.S. Court of Appeals for the Sixth Circuit. *See* Detroit Auto. Ass'n v. FTC, 955 F.2d 457 (6th Cir. 1992).

[9] ROBERT P. ROGERS, BUREAU OF ECON., FED. TRADE COMM'N, THE EFFECT OF STATE ENTRY REGULATION ON RETAIL AUTOMOBILE MARKETS (1986) (Bureau of Economics Staff Report), *available at* http://www.ftc.gov/sites/default/files/documents/reports/effect-state-entry-regulation-retail-automobile-markets/231955.pdf.

[10] Thomas B. Leary, Comm'r, Fed. Trade Comm'n, State Auto Dealer Regulation: One Man's Preliminary View, Speech at The International Franchise Association 34th Annual Legal Symposium (May 8, 2001), *available at* http://www.ftc.gov/public-statements/2001/05/state-auto-dealer-regulation-one-mans-preliminary-view.

II. Discussion and Analysis of the Pending Bills

A. New Jersey's Ban on Direct Manufacturer Sales

Current New Jersey law has been interpreted by the New Jersey Motor Vehicle Commission ("NJMVC") to prohibit automobile manufacturers from selling their products directly to consumers. These activities, it is maintained, can be carried out only through independent franchised dealers.[11]

Such a blanket prohibition on manufacturer sales to consumers is an anomaly within the larger economy. Most manufacturers and suppliers in other industries compete with each other on not only the price, quality, and features of their products and services, but also on the cost, speed, service and efficiency of their sales and distribution systems. These manufacturers make decisions about how to design their distribution systems based on their own business considerations and in response to consumer demand. If a manufacturer concludes that using independent distributors to sell its products will best serve consumers and its own needs, it is free to contract for those services. On the other hand, if it decides that direct sales work better for its products, it can pursue sales directly. Many manufacturers choose some combination of direct sales and sales through independent retailers.[12] The competitive process gives the manufacturer the incentive to pick the distribution option that it believes will be the most responsive to consumers. Typically, no government intervention is required to augment or alter these competitive dynamics – to the extent a manufacturer faces robust competition from other manufacturers, the market polices inefficient, unresponsive, or otherwise inadequate distribution practices on its own.

Economists have long been interested in why firms choose to sell their products through a network of independent entities, to "vertically integrate" (engage in retail sales themselves), or to do some combination of the two.[13] A large body of literature has shown that the decision is very context specific. In some circumstances, such as when local sales and promotional effort is hard to measure but important for the firm's success, a firm may conclude that it is desirable to use

[11] In New Jersey, with limited exceptions, a "motor vehicle franchisor" cannot directly or indirectly sell or offer to sell motor vehicles to consumers, other than through a franchised dealer. *See* N.J.S.A. 56:10-27. In addition, with limited exceptions, a "motor vehicle franchisor" cannot own or operate, or enter into an agreement with any person other than a franchised dealer to operate, a retail service facility authorized to perform warranty services on its vehicles. *See* N.J.S.A. 56:10-7.4(e). The term "motor vehicle franchisor" is defined to include any entity engaged in manufacturing, assembling or distributing new motor vehicles, whether or not it has entered into a franchise agreement with a franchised dealer. *See* N.J.S.A. 56:10-26(e).

[12] Computer manufacturers are one example of this hybrid distribution system, and popular clothing brands are another, but there are many more.

[13] One of the first papers focusing on this "make or buy" decision was Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937). The literature has since expanded dramatically. Recent surveys touching on both theory and empirical evidence include Francine Lafontaine & Margaret Slade, *Vertical Integration and Firm Boundaries: The Evidence*, 45 J. ECON. LIT. 629-685 (2007); and Timothy Bresnahan & Jonathan Levin, *Vertical Integration and Market Structure*, in HANDBOOK OF ORGANIZATIONAL ECONOMICS 85 (R. Gibbons & D.J. Roberts, eds., 2012).

highly incentivized independent representatives.[14] In others, however, reliance on independent dealers may fail to achieve the best outcome for either the upstream producer or the consuming public. The vast majority of existing work by economists suggests that allowing firms in competitive marketplaces to make the decision for themselves leads to better outcomes for consumers.[15]

When manufacturers respond to competitive pressure by choosing to vertically integrate, consumers usually benefit through lower prices and/or higher quality.[16] In contrast, when the government intervenes and outlaws vertical integration, consumers often experience worse service and higher prices.[17] It is not that vertical integration is always superior. Preventing firms from using independent retail networks, when that is what they want to do, also can have negative competitive consequences. The common message in both situations is that the

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[14] A book-length treatment of the theory explaining why can be found in Jean-Jacques Laffont & David Martimort, THE THEORY OF INCENTIVES: THE PRINCIPAL-AGENT MODEL (2009).

[15] This conclusion was reached in two separate recent surveys of the literature: Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy*, in HANDBOOK OF ANTITRUST ECONOMICS (Paolo Buccirossi, ed., 2008); and James C. Cooper, Luke M. Froeb, Dan O'Brien, & Michael G. Vita, *Vertical Antitrust Policy as a Problem of Inference*, 23 INT'L J. INDUS. ORG. 639-64 (2005).

[16] This is not to suggest that vertical integration can never harm competition, as may be the case where it is used to impair competition from rival suppliers or customers.

[17] Efficient vertical integration by upstream manufacturers can benefit consumers in a variety of ways. First, it can remove the incentive for a manufacturer as well as a dealer to each mark up the price of the product on its way to the consumer. This results in lower prices and increased sales to consumers. Discussion and details are available in Dennis W. Carlton & Jeffrey M. Perloff, MODERN INDUSTRIAL ORGANIZATION 523-527 (2nd ed. 1994).

Second, integration by a manufacturer into distribution can enable manufacturers to better match their products with the preferences of consumers. For example, though manufacturers have an incentive to increase overall sales of their products, particular dealers may be most interested in making sales from their inventory, which may cause consumers to have to visit multiple dealerships to establish what product best fits their needs, resulting in relatively high search costs. When consumers' search costs are a large determinant of their purchasing patterns, a manufacturer can have a strong incentive to make direct sales so that it is simpler for consumers to find what they want. *See* Comment from FTC Staff to James Oberweis, State Senator of Illinois 5 (March 26, 2014), *available at* http://www.ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-illinois-state-senate-regarding-senate-bill-2629-which-would-repeal-certain/140327illinoisautostaffcomment.pdf (discussing and summarizing literature on the impact of search costs). For some empirical evidence on the importance of search costs in the automotive industry, *see* Fiona Scott Morton, et al., *What Matters in a Price Negotiation: Evidence from the U.S. Auto Retailing Industry*, 9 QUANTITATIVE MARKETING & ECON. 365-402 (2011). For a more general review of the economic theory and evidence connecting search costs to prices, *see* Michael Baye, et al., *Information, Search, and Price Dispersion*, in HANDBOOK ON ECONOMICS AND INFORMATION SYSTEMS 323 (T. Hendershott, ed., 2005).

Third, past work by economists has shown that vertical integration can aid firms in responding to uncertainty or evolving business environments by establishing clear lines of authority between its manufacturing and sales personnel, especially when new firms are attempting to enter an established market. A survey of the theoretical motivations for vertical integration can be found in Timothy Bresnahan & Jonathan Levin, *Vertical Integration and Market Structure*, in HANDBOOK OF ORGANIZATIONAL ECONOMICS (R. Gibbons & D.J. Roberts, eds., 2012). Empirical evidence of integration's impact on firms' ability to respond to events can be seen in recent studies such as Sharon Novak & Scott Stern, *Complementarity among Vertical Integration Decisions: Evidence from Automobile Product Development*, 55 MANAGEMENT SCIENCE 311-332 (2009); and Silke Forbes & Mara Lederman, *Does Vertical Integration Affect Firm Performance? Evidence from the Airline Industry*, 41 RAND J. ECON. 765-90 (2012).

competitive process effectively aligns the interests of firms and consumers on the issue of distribution method. In order to make their product as attractive as possible, firms choose the distribution method that can bring their product to market as efficiently as possible.

Specific evidence to support these views can be found in many industries, including retail automotive markets and industries like gasoline retailing. Past studies by both academic researchers and FTC staff have concluded that state-imposed restrictions on automobile manufacturers' ability to negotiate with their dealers increased the prices paid by consumers without leading to notable improvements in service quality.[18] Similarly, studies have found a causal link between laws that inhibit gasoline refiners' ability to operate or own retail stations, and higher prices.[19] In our view, the well-developed body of research on these issues strongly suggests that government restrictions on distribution are rarely desirable for consumers. When they are adopted, at a minimum, such restrictions should be clearly linked to specific policy objectives that the legislature believes warrant deviation from the beneficial pressures of competition, and should be no broader than necessary to achieve those objectives.[20]

Those who support a blanket prohibition on direct manufacturer sales in New Jersey have made a number of arguments that FTC staff find unpersuasive. Perhaps the central concern reflected in the current laws regulating the manufacturer-dealer relationship is that government intervention is required to protect independent dealers from abusive behavior by their suppliers. But a blanket prohibition of direct manufacturer sales is not a narrowly crafted provision to protect franchised dealers from abuse in their franchise relationships. Such a prohibition is categorical, going well beyond the many other statutory provisions of New Jersey law that protect dealers from such abuse. It extends to every entity engaged in manufacturing, assembling or distributing new motor vehicles, even a manufacturer that has never entered into a franchise agreement.

Advocates for existing dealers also argue that manufacturers that sell directly to consumers will not provide them with adequate service. This argument presupposes that auto manufacturers in a competitive environment will act contrary to their economic self-interest. If consumers greatly value post-sale service and would be unlikely to purchase or recommend any

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[18] In particular, *see*, E. Woodrow Eckard, Jr., *The Effects of State Automobile Dealer Entry Regulation on New Car Prices*, 24 ECON. INQUIRY 223-42 (1985); and ROBERT P. ROGERS, THE EFFECT OF STATE ENTRY REGULATION ON RETAIL AUTOMOBILE MARKETS (1986) (FTC Bureau of Economics Staff Report, *supra* note 9).

[19] J.M. Barron & J.R. Umbeck, *The Effects of Different Contractual Arrangements: The Case of Retail Gasoline*, 27 J.L. & ECON., 313-328 (1984); Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. REG. ECON. 217-33 (2000); and A.A. Blass & Dennis Carlton, *The Choice of Organizational Form in Gasoline Retailing and the Cost of Laws that Limit that Choice*, 44 J. LAW & ECON. 511-24 (2001).

[20] Our comments here echo prior comments discussing similar issues. FTC Staff Comments Before the District of Columbia Taxicab Commission Concerning Proposed Rulemakings on Passenger Motor Vehicle Transportation Services (June 7, 2013), *available at* http://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comments-district-columbia-taxicab-commission-concerning-proposed-rulemakings-passenger/130612dctaxicab.pdf (discussing taxicab rules and suggesting that "any restrictions on competition that are implemented should be no broader than necessary to address legitimate subjects of regulation, such as safety and consumer protection, and narrowly crafted to minimize any potential anticompetitive impact.")

automobile without a reasonable assurance of quality future service, then any manufacturer will have an incentive to supply such service or would see its sales decline to the benefit of its rivals. This competitive pressure is a strong motivation for manufacturers to either provide good service themselves or continue to contract with an independent service provider, such as a dealer, to do so.

Finally, advocates for a categorical ban on direct sales argue that direct-selling manufacturers would charge higher prices to consumers. In their view, consumers benefit from the "intrabrand" competition between dealers of the same brand of vehicle. In other words, rival dealers in the same area that sell the same make and model of car compete for business and competition between them can lower prices for car buyers. Manufacturers, they maintain, would not be subject to the same competitive pressures.

This view is inconsistent with modern economic learning and with the Supreme Court's widely accepted observation that strong "interbrand" competition—competition between rival manufacturers—can suffice as a source of downward pressure on price.[21] Manufacturers in a competitive market face acute pressure to keep prices low to keep buyers from shifting their purchases to a competing manufacturer's product. Thus, forcing firms to use inefficient distribution methods can result in higher prices and other forms of consumer harm. As described above, this is not merely a theoretical possibility. Statistical evidence shows that states that have placed strong limitations on gasoline refiners' ability to operate their own retail outlets tend to have higher prices than those that allow refiners to use whatever combination of dealer and company-operated stations they prefer.[22]

Unlike the purported benefits of a manufacturer sales ban, which are questionable, the anticompetitive effects of such a ban are immediately visible in the circumstances that have led to the introduction of the pending bills. Tesla Motors is a relatively new entrant into the business of motor vehicle manufacturing and sale, with an innovative new product and a distinctive method of selling it.[23] However, it is no longer permitted to operate direct sales outlets in New

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[21] Continental T. V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 52 n.19 (1977) ("Interbrand competition is the competition among the manufacturers of the same generic product […] and is the primary concern of antitrust law. […] In contrast, intrabrand competition is the competition between the distributors, wholesale or retail, of the product of a particular manufacturer. […] [W]hen interbrand competition exists, […] it provides a significant check on the exploitation of intrabrand market power because of the ability of consumers to substitute a different brand of the same product.").

[22] Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. REG. ECON. 217-33 (2000).

[23] Tesla has described the reasons for its direct-to-consumer sales model as follows:

> We believe that by owning our own sales and service network we can offer a compelling customer experience while achieving operating efficiencies and capturing sales and service revenues incumbent automobile manufacturers do not enjoy in the traditional franchised distribution and service model. Our customers deal directly with our own Tesla-employed sales and service staff, creating what we believe is a differentiated buying experience from the buying experience consumers have with franchised automobile dealers and service centers. We believe we will also be able to better control costs of inventory, manage warranty service and pricing, maintain and strengthen the Tesla brand, and obtain rapid customer feedback. Further, we believe that by owning our sales network we will avoid the conflict of interest in the traditional dealership structure inherent

Jersey. Tesla must engage in inefficient procedures to ensure that any sale to a willing buyer from New Jersey does not occur within the state. New Jersey residents who wish to purchase Tesla vehicles must now undertake for themselves some of the purchase-related services that could be provided by a dealership, such as some steps to register and title their cars in New Jersey. New Jersey residents are no longer eligible for financing through Tesla, and may be unable to take advantage of some tax incentives for electric car purchases. As a result, Tesla cars may become less attractive to New Jersey consumers, weakening Tesla as a competitor and reducing the pro-competitive impact its entry might otherwise have on rival brands. New Jersey customers would have to incur additional time and expense to purchase a Tesla car and are deprived of the option they may prefer—purchasing directly from Tesla in New Jersey.

Beyond the immediate effects for Tesla, a continuing ban on direct sales by manufacturers will perpetuate the current closed system of motor vehicle sales in New Jersey. The system limits competition among existing, well-established manufacturers, all of whom must sell through the established network of independent auto dealers. A direct sales ban deters experimentation with new and different methods of sales by current auto manufacturers, and also by other future entrants to the market. New Jersey's consumers will ultimately pay the price of such a dictate. The essential mechanism that drives markets—the interaction between the supply by manufacturers and the demands of consumers—is being curbed. The market is less responsive to consumer preferences and less innovative in anticipating their evolving needs.

FTC staff offer no opinion on the question of whether Tesla or other manufacturers would be best served by selling their products directly or through independent distributors. Nor do we express a view as to whether any particular motor vehicle manufacturer should succeed or fail. Our principal point is this: absent some legitimate public purpose, consumers would be better served if the choice of distribution method is left to motor vehicle manufacturers and the consumers to whom they sell their products.

B. Proposed Bills to Ease a Manufacturer Sales Ban

Your request for the FTC's views and comments refers to several pending bills in the New Jersey legislature. None of the various pending bills would remove what has been interpreted as a categorical manufacturer direct sales ban. Rather, each one would carve out limited and varying exceptions to the current law's prohibition. In our view, any effort to loosen or reduce a blanket prohibition is a step in the right direction for competition and consumers. However, New Jersey's consumers would ultimately benefit far more from reforms that unambiguously permit all manufacturers to choose their methods of sale, including direct sales to consumers.

<u>Electric Vehicles Exception</u>. Assembly Bill A.2986 (and identical companion bill S.1898) would amend current law to allow manufacturers of electric motor vehicles to directly

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to most incumbent automobile manufacturers where the sale of warranty parts and repairs by a dealer are a key source of revenue and profit for the dealer but often are an expense for the vehicle manufacturer.

TESLA MOTORS, INC., ANNUAL REPORT ON FORM 10-K (Filed Feb. 26, 2014) at 11.

sell, offer to sell, or deal an electric motor vehicle to consumers. The operative language of the bill would add a new statutory provision stating:

> Notwithstanding the provisions of any law, rule or regulation to the contrary, a motor vehicle franchisor who manufactures electric motor vehicles may directly buy an electric motor vehicle from a consumer and may directly sell, offer to sell, or deal an electric motor vehicle directly to a consumer if the franchisor is licensed pursuant to R.S.39:10-19.

The bill also would add the following definition to N.J.S.A. 56:10-26:

> "Electric motor vehicle" means a motor vehicle that uses a battery to store the electrical energy to power the vehicle's motor, including a battery electric vehicle, and that is charged or recharged from an external source of electricity, such as by plugging the vehicle into an electric power source. An electric motor vehicle shall not include a hybrid electric vehicle.

The bill addresses a specific narrow category of products, including Tesla products, and current and future electric vehicles of other manufacturers. It is framed to include not only automobiles, but all vehicles falling within the definition of "motor vehicles" as defined by N.J.S.A. 56:10-26, including electric motorcycles. It would relax the existing direct sales prohibition and would permit electric vehicle manufacturers to exercise direct control over the sales efforts for their products.

The bill is likely to increase competition and benefit New Jersey consumers. It would permit manufacturers to have direct control over the sales process and to incentivize efforts by salespeople to educate potential purchasers about the new technology.[24] Permitting direct manufacturer sales of electric vehicles might help to stimulate future consumer demand for such products.

Although the bill would likely facilitate innovation in products and distribution methods within a prescribed range of firms and products, it would leave in place existing law for internal combustion and hybrid-powered motor vehicles. In other words, a blanket ban would remain in effect for the products that make up the vast majority of motor vehicle sales in New Jersey today. For the reasons discussed earlier, we see no public interest justification for continuing any existing direct sales restriction for this broad category of vehicles. We also note that the rationale for loosening the restriction for novel technologies might also be applicable for new technology

[24] Consumer Reports made a recent study of auto dealerships to gauge sales people's knowledge of electric cars. It sent nineteen secret shoppers to eighty-five dealerships in four states, making anonymous visits between December, 2013 and March, 2014. The secret shoppers asked a number of specific questions about the vehicles. Consumer Reports discovered several very knowledgeable salespeople at some dealerships, but concluded that few provided accurate and specific answers about batter life and battery warranties. Many salespeople seemed to lack a solid understanding of electric-car tax breaks and other incentives, or of charging needs and costs. *See* CONSUMERREPORTS.ORG, DEALERS NOT ALWAYS PLUGGED IN ABOUT ELECTRIC CARS, CONSUMER REPORTS' STUDY REVEALS (April 22, 2014), *available at* http://www.consumerreports.org/cro/news/2014/04/dealers-not-always-plugged-in-about-electric-cars-secret-shopper-study-reveals/index htm.

beyond just electric motor vehicles.[25] Permitting multiple manufacturers of electric vehicles to experiment in their methods for selling directly to consumers could lead to some degree of competition in distribution methods in this product category, but the beneficial consumer effects of the bill will be limited and the existing protectionist laws will largely remain intact.

Temporary Exception for Zero-Emission Vehicles. Assembly Bill A.3096 would amend existing law to permit manufacturers to make direct sales of zero-emission vehicles, but would reinstate a direct sales ban in the event sales of these vehicles exceed four percent of overall vehicle sales in New Jersey. The operative language of the bill would add a new statutory provision stating:

> a. Notwithstanding the provisions of any law, rule or regulation to the contrary, a motor vehicle franchisor who exclusively manufactures zero emission vehicles may directly buy from and directly sell, offer to sell, or deal to a consumer a zero emission vehicle if the franchisor is licensed pursuant to R.S.39:10-19 and the total number of zero emission vehicles sold is less than four percent of all vehicles sold Statewide in each calendar year.
>
> b. Within 365 days after the number of zero emission vehicles sold in this State in any calendar year equals four percent or more of all the motor vehicles sold, all manufacturers of zero emission vehicles in the State shall comply with the provisions of P.L.1985, c.361 (C.56:10-26 et seq.), and any rules and regulations adopted pursuant thereto.

The bill also would add the following definition to N.J.S.A. 56:10-26:

> "Zero emission vehicle" means a motor vehicle certified as a zero emission vehicle pursuant to the California Air Resources Board zero emission vehicle standards for the applicable model year, but shall not include an advanced technology partial zero emission vehicle, a partial zero emission vehicle, or a hybrid electric vehicle.

Our comments above respecting the "electric motor vehicles" bill are also pertinent with respect to this bill. It could in theory give flexibility to multiple manufacturers with present or future products falling within the defined category of "zero-emission vehicles." It would likely facilitate competition for new and innovative products, by among other things enabling manufacturers to directly control sales efforts for their zero-emission vehicle products and incentivize salespeople to educate potential purchasers about their features. Like Assembly Bill A.2986, this bill could, therefore, improve competitive conditions in New Jersey to some degree.

However, staff question whether there is a public interest basis either for limiting the scope of the bill to manufacturers that "exclusively" manufacture zero-emission vehicles, or for restoring a ban on direct sales if sales of zero-emission vehicles reach the specified threshold of four percent of vehicle sales in New Jersey. Reinstating a direct sales ban in this way could

[25] The bill explicitly would not permit manufacturer direct sales of hybrid vehicles, for example, and it is not clear that it would permit direct sales of motor vehicles using other innovative technologies like natural gas or fuel cells.

operate as a penalty for successful innovation in product distribution, and could introduce perverse incentives. As aggregate industry sales grow nearer the threshold, some manufacturers could be motivated to be less innovative in their sales methods, for fear that they would lose the flexibility to make direct sales to consumers. Framing the threshold for reinstating a ban in terms of industry-wide sales also could result in differing treatment of zero-emission vehicle manufacturers. The industry-wide threshold could reward early entrants with greater autonomy in designing their distribution methods, but punish later ones, who would no longer be eligible to use direct distribution, even if they deem it to be the most effective way to promote their vehicles. And it could deter entry by later-entering firms that do not want to utilize independent dealers.

In addition to possible practical difficulties in assessing and administering a calculation of aggregate New Jersey industry sales of zero-emission vehicles,[26] the market share threshold imposed by this bill does not appear to be justified by any identifiable public interest. It would not protect dealers from abuses in the franchise relationship. Instead, it would establish a hard limit on the scope of competition once the four percent threshold is met. We also note more generally that, like the electric vehicles bill, this bill would leave in place a manufacturer direct sales ban for internal combustion and hybrid-powered motor vehicles—products that make up the vast majority of current vehicle sales in New Jersey.

Low Volume Exception. Assembly Bill A.3041 would amend current law to allow the NJMVC to license a manufacturer making sales of no more than 500 vehicles per year to sell directly, but for no more than five consecutive years. The operative language would add a new statutory provision stating:

> Notwithstanding the provisions of any law, rule or regulation to the contrary, a motor vehicle franchisor who is a manufacturer may directly buy from and directly sell, offer to sell, or deal to a consumer a motor vehicle if the franchisor:
>
> a. is licensed pursuant to R.S.39:10-19; and
>
> b. sells no more than 500 motor vehicles in each calendar year.
>
> The Chief Administrator of the New Jersey Motor Vehicle Commission shall not license a franchisor as a dealer, pursuant to 46 R.S.39:10-19, for more than five consecutive years in total.

Unlike the electric vehicles bill and zero-emissions vehicles bill discussed above, this bill would not relax a direct sales prohibition for a defined category of products across multiple manufacturers. Instead, it would permit direct distribution by only the smallest of firms, and for a limited period of time. It would leave intact the existing law for electric cars manufactured by

[26] Administering such a bill would seem to require identifying vehicle makes/models within the product category, monitoring the sales volumes of these products and overall New Jersey vehicle sales, establishing an administrative procedure to determine whether and when the threshold is reached, and dealing with disruptions caused by a change in status for previously-licensed direct sales outlets.

firms such as General Motors, Toyota and Nissan, all of which sell many more than 500 motor vehicles each calendar year.

The sales volume of 500 units specified in the bill is miniscule in comparison to the existing pattern of motor vehicle distribution in New Jersey, where 513,551 new vehicles were registered in 2012.[27] Indeed, it is not apparent that the low sales volumes set in the bill would be sufficient, as a matter of economics, to justify the establishment of a direct sales mechanism in New Jersey, so it could have no effect at all. A small new manufacturer that adopts a direct-sales method would exceed the statutory threshold by selling the same number of new vehicles as the average single dealership in the United States.[28]

Even if a higher sales volume were specified in the bill, the approach set out in the bill presents difficulties from the perspective of competition and consumers. Like the market share cap in the zero-emission vehicles bill discussed above, the sales volume limitation would operate as a rigid limit on competition and could introduce perverse incentives. As a manufacturer's sales grow nearer the specified volume, it could be motivated to be less competitive and innovative in its methods of distribution, for fear that it would lose the flexibility to make direct sales of its products, even as part of a distribution plan mixing direct and dealer sales.

While a bill permitting temporary direct sales by small-volume manufacturers is preferable to a blanket prohibition of manufacturer direct sales, it is a very small step in loosening the statutory ban. The low volume levels set in the bill, its inapplicability to existing manufacturers with competing innovative products, and the disincentives to competition embodied in the bill's structure, all make A.3041 unlikely to significantly promote competition and consumer welfare.

<u>Limited Outlets for Zero-Emission Vehicles</u>. Assembly Bill A.3216 would amend existing law to permit manufacturers to make direct sales of zero-emission vehicles through a limited number of outlets. The operative language of the bill would add a new statutory provision stating:

> Notwithstanding the provisions of any law, rule or regulation to the contrary, a motor vehicle franchisor licensed pursuant to R.S.39:10-19 on or prior to January 1, 2014 and exclusively manufacturing zero emission vehicles may buy from and sell, offer to sell, or deal to a consumer a zero emission vehicle, provided that the franchisor owns or operates, directly or indirectly:
>
> > (1) no more than four places of business in the State; and
> >
> > (2) at least one retail facility for the servicing, including warranty servicing, of zero emission vehicles sold, offered for sale,

[27] *See* NATIONAL AUTOMOBILE DEALERS ASS'N, NADA DATA, STATE-OF-THE-INDUSTRY REPORT 2013, at 17.

[28] *Id.* at 9 (table of national average number of new vehicles sold per dealership, 2002-2012; range from a low of 563 in 2009 to a high of 819 in 2012).

> > or otherwise distributed in this State. This facility shall be furnished with all the equipment required to service a zero emission vehicle.
>
> A franchisor shall not be required to establish or operate a place of business at a retail facility for the servicing of zero emission vehicles.

The bill also would add a new statutory provision requiring the reporting of annual sales of zero-emissions vehicles eligible for New Jersey's sales tax exemption, and would add the following definitions to N.J.S.A. 56:10-26:

> "Place of business" means a fixed geographical location at which the motor vehicle franchisor's motor vehicles are offered for sale and sold, but shall not include an office, a warehouse, a place of storage, a residence or a vehicle.
>
> "Zero emission vehicle" means a motor vehicle certified as a zero emission vehicle pursuant to the California Air Resources Board zero emission vehicle standards for the applicable model year, but shall not include an advanced technology partial zero emission vehicle, a partial zero emission vehicle, or a hybrid.

From the perspective of competition and consumer interests, this bill would be preferable to continuing a categorical ban on all direct manufacturer sales. It would permit a manufacturer to engage in the direct sale of zero-emission vehicles through up to four outlets in New Jersey. In contrast to current law that prohibits a manufacturer from operating its own service facility, it also requires them to have at least one in the state.

But the bill is extremely narrow in scope. Like A.3096, it would apply only to a manufacturer that "exclusively" manufactures zero-emission vehicles. It adds the further requirement that the manufacturer must have been licensed as a dealer on or before January 30, 2014. These qualifications appear to make the bill apply only to Tesla, so its possible procompetitive effects will be very limited.

Although the bill would not lead to the perverse incentives discussed above in connection with A.3096's threshold for revoking the direct sales permission, like A.3041, which would cap sales at 500 units, it would effectively restrict the supply of Tesla vehicles in New Jersey. Any competitive benefits to be gained from loosening the current blanket ban on direct manufacturer sales will be marginal, therefore, and the bill will hinder Tesla's ability to respond to consumer demand and changing market circumstances. So far as we can tell, New Jersey law does not similarly fix the number of outlets available to manufacturers who distribute their products through independent dealers, and there is no apparent public policy justification to support a fixed limit on sales outlets for zero-emission vehicle manufacturers such as Tesla.

III. Conclusion

FTC staff believe that current New Jersey law, interpreted to ban direct manufacturer sales of motor vehicles, is very likely anticompetitive and harmful to consumers. It cannot be justified as a way to protect franchised dealers from abuse in their franchise relationships, and the other arguments that have been offered in its defense appear to be contrary to a significant body of economic study and FTC experience.

The various bills carve out only limited exceptions to current law. In staff's view, any effort to loosen or reduce a blanket prohibition on direct manufacturer sales may prove beneficial to competition and consumers. However, staff's view is that the limitations in each of the bills will diminish their procompetitive potential and appear to lack any public policy rationale. Staff notes that Assembly Bill A.2986 seems likely to facilitate the broadest range of competitive benefits among these alternative approaches now pending before the legislature.

However, in lieu of any of the currently pending bills, we urge the legislature instead to consider abandoning New Jersey's existing law, interpreted as a blanket ban on direct manufacturer-to-consumer sales, and instead permit manufacturers and consumers to reengage the normal competitive process that prevails in most other industries. Such a change would facilitate the development of new methods of distribution and possibly accelerate the arrival of new motor vehicle manufacturers, benefitting the motor vehicle buyers of New Jersey.

Respectfully submitted,

Andrew I. Gavil, Director
Office of Policy Planning

Deborah Feinstein, Director
Bureau of Competition

Martin S. Gaynor, Director
Bureau of Economics

UNITED STATES OF AMERICA
Federal Trade Commission
WASHINGTON, D.C. 20580

Office of Policy Planning
Bureau of Competition
Bureau of Economics

May 15, 2014

Rep. Michael J. Colona
Missouri House of Representatives
State Capitol
201 West Capitol Avenue
Jefferson City, MO 65101-6806

Dear Representative Colona:

Thank you for requesting comments from the Federal Trade Commission ("FTC") staff[1] regarding House Bill No. 1124, which is now pending in the Missouri legislature. A portion of that bill would amend Section 407.826.1 of the Motor Vehicle Franchise Practices Act, which currently prohibits franchisors of new motor vehicles from "owning or operating a new motor vehicle dealership" in Missouri.

Under current law in Missouri, an automobile "franchisor" means a person who grants to another person the right to use trademarks and other rights, and shares a community of interests with that person, in connection with the sale of new motor vehicles.[2] The relevant portion of HB 1124 would add a new and different definition of "franchisor" for purposes of the prohibition on owning or operating new vehicle dealerships. Under the change set forth in HB 1124, "franchisor" for these purposes would be broadly defined to "include any manufacturer of new motor vehicles which establishes any business location or facility within the state of Missouri" that allows for the sale of new motor vehicles.

The plain effect of HB 1124, therefore, would be to expand the current prohibition on direct-to-consumer sales. The prohibition would apply not only to franchisors but also to motor vehicle manufacturers who do not use an independent franchise system and instead prefer to sell

[1] This staff letter expresses the views of the Federal Trade Commission's Office of Policy Planning, Bureau of Competition, and Bureau of Economics. The letter does not necessarily represent the views of the Federal Trade Commission or of any individual Commissioner. The Commission, however, has voted to authorize staff to submit these comments.

[2] *See* MO. REV. STAT. § 407.815 (8) (defining "franchise" or "franchise agreement" as "a written arrangement or contract […] in which a person grants to another person a license […] to use, a trade name, trademark, service mark, or related characteristics, in which there is a community of interest in the marketing of goods or services, […] and in which the operation of the franchisee's business […] is substantially reliant on the franchisor for the continued supply of franchised new motor vehicles, parts and accessories […]."); and *id.*, § 407.815 (10) (defining "franchisor" as "a person who grants a franchise to another person").

directly to consumers. All new motor vehicles in Missouri would have to be sold through independent dealers.

Laws such as the existing Section 407.826 operate as a special protection for independent motor vehicle dealers. They restrict automobile manufacturers from selling their products using any method other than through independent auto dealers. This protection limits the ability of auto manufacturers to innovate in their methods of sale in ways that might be more cost-effective and responsive to consumer demand. While it protects the dealers, it is very likely harming both competition and consumers. By expanding the scope of the existing prohibition to include manufacturers that do not currently use, or even desire to sell through independent dealers, HB 1124 would amplify the adverse effects of the current prohibition. It will discourage innovation and new forms of competition, especially from newer auto manufacturers who have no dealer network. We therefore appreciate this opportunity to provide our views as to the probable impact of the proposed legislation on competition and consumers.[3]

FTC staff offer no opinion on whether automobile distribution through independent dealerships is superior or inferior to direct distribution by manufacturers. Rather, as is more fully explained below, staff's principal observation is that consumers are the ones best situated to choose for themselves both the cars they want to buy and how they want to buy them. Automobile manufacturers have the incentive to respond to consumer preferences and choose the most effective distribution method for their vehicle brands. Absent supportable public policy considerations, the law should permit automobile manufacturers to choose their distribution method to be responsive to the desires of car buyers.

I. Interest and Experience of the Federal Trade Commission

The FTC is an independent administrative agency charged with working to protect consumers by preventing anticompetitive, deceptive, and unfair business practices, enhancing informed consumer choice and public understanding of the competitive process, and accomplishing this without unduly burdening legitimate business activity.[4] To secure these goals, the FTC has played a significant role in promoting competition and consumer protection law and policy through law enforcement, the study of industries and business practices, and through competition advocacy, which may include specific comments to legislators or regulators concerned about the likely competitive impact of pending legislative or regulatory measures.[5]

[3] Our opinion is limited to bills addressing a blanket restriction on manufacturer sales. We do not attempt to comment or review the myriad additional provisions of Missouri law that regulate the relationship between automobile manufacturers and their independent dealers.

[4] Federal Trade Commission Act, 15 U.S.C. § 45.

[5] Sections 6(a) and (f) of the FTC Act authorize the FTC "[t]o gather and compile information concerning, and to investigate from time to time the organization, business, conduct, practices, and management of any person, partnership, or corporation engaged in or whose business affects commerce," and "[t]o make public from time to time such portions of the information obtained by it hereunder as are in the public interest …." 15 U.S.C. § 46(a), (f).

Competition is at the core of America's economy, and vigorous competition among sellers in an open marketplace gives consumers the benefits of lower prices, higher quality products and services, and greater innovation.[6] The goal of our advocacy program is to enhance understanding of the competitive process and provide a framework for thinking about public policy issues from a competition and consumer protection perspective. We urge policy makers to consider (1) the likely competitive impact of proposed legislation or regulations; (2) how they might affect consumers; (3) what justifications might exist for any restrictions on competition; and (4) whether less restrictive alternatives would fulfill public policy goals while adequately protecting consumers. These considerations can be especially important when heavily regulated industries face new and disruptive products, services, and methods of sale.[7]

In carrying out its mission, the Commission has developed considerable expertise in analyzing markets for the sale of motor vehicles. For example, in 1988 and again earlier this year, FTC staff submitted advocacy letters opposing limitations imposed by Illinois law on the hours of operation of auto dealerships.[8] The FTC also used its enforcement authority to protect competition in motor vehicle sales in the late 1980s, when it issued a complaint against several motor vehicle dealerships in the Detroit area and the Detroit Auto Dealers Association ("DADA") for imposing anticompetitive restrictions on hours of operation.[9]

In 1986, the FTC's Bureau of Economics issued a report on the effect of state regulations in retail motor vehicle markets that restrict the establishment of new motor vehicle dealerships near existing dealers selling cars of the same make.[10] The report found that these state laws

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6 *See* Nat'l Soc'y of Prof'l Eng'rs v. United States, 435 U.S. 679, 695 (1978) ("The assumption that competition is the best method of allocating resources in a free market recognizes that all elements of a bargain—quality, service, safety, and durability—and not just the immediate cost, are favorably affected by the free opportunity to select among alternative offers."); Standard Oil Co. v. FTC, 340 U.S. 231, 248 (1951) ("The heart of our national economic policy long has been faith in the value of competition.").

7 *See, e.g.*, Comment from FTC Staff to Brendan Reilly, Alderman, City Council, City of Chicago (April 21, 2014), *available at* http://www ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-honorable-brendan-reilly-concerning-chicago-proposed-ordinance-o2014-1367/140421chicagoridesharing.pdf; FTC Staff Comments Before the District of Columbia Taxicab Commission Concerning Proposed Rulemakings on Passenger Motor Vehicle Transportation Services (June 7, 2013), *available at* http://www ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comments-district-columbia-taxicab-commission-concerning-proposed-rulemakings-passenger/130612dctaxicab.pdf.

8 Comment from FTC Staff to James Oberweis, State Senator of Illinois (March 26, 2014), *available at* http://www ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-illinois-state-senate-regarding-senate-bill-2629-which-would-repeal-certain/140327illinoisautostaffcomment.pdf; Comment from FTC Staff to James R. Thompson, Governor of Illinois (Dec. 22, 1988), *available at* http://www ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comment-governor-james-r.thompson-concerning-s.b.1870-limit-auto-base-rental-charges-alter-allocation-costs-and-risks-damage-or-theft-and-ban-long/v890008.pdf.

9 These dealers had reached an agreement, orchestrated by the DADA, to limit the number of hours that they would be open for business. The FTC concluded that the agreement was anticompetitive, a conclusion that was later affirmed by the U.S. Court of Appeals for the Sixth Circuit. *See* Detroit Auto. Ass'n v. FTC, 955 F.2d 457 (6th Cir. 1992).

10 ROBERT P. ROGERS, BUREAU OF ECON., FED. TRADE COMM'N, THE EFFECT OF STATE ENTRY REGULATION ON RETAIL AUTOMOBILE MARKETS (1986) (Bureau of Economics Staff Report), *available at*

harmed consumers because they caused motor vehicle prices to rise. In addition, in 2001, then-Commissioner Thomas Leary expressed concern about the same kind of decades-old state laws now at issue in Missouri, laws that insulate motor vehicle dealers from competition from automotive manufacturers. While dealers at one time tended to be small businesses, he observed, in 2001 they were frequently much larger entities and the once highly concentrated motor vehicle manufacturing industry had become far more competitive. Commissioner Leary questioned, therefore, whether this kind of regulatory protection for dealers could still be justified, especially because it tended to interfere with the development of new and potentially more efficient methods of motor vehicle distribution, such as e-commerce.[11]

II. Discussion and Analysis of HB 1124

Current Missouri law prohibits automobile manufacturers who use franchise systems from owning or operating their own dealerships; sales of new motor vehicles by existing franchisors can be carried out only through independent franchised dealers.[12] Because most current manufacturers utilize a franchise system, the effect of the law on existing manufacturers is to bar alternative means of reaching or responding to consumers.

Such a blanket prohibition on direct manufacturer sales to consumers is an anomaly within the larger economy. Most manufacturers and suppliers in other industries compete with each other on not only the price, quality, and features of their products and services, but also on the cost, speed, service and efficiency of their sales and distribution systems. These manufacturers make decisions about how to design their distribution systems based on their own business considerations and in response to consumer demand. If a manufacturer concludes that using independent distributors to sell its products will best serve consumers and its own needs, it is free to contract for those services. On the other hand, if it decides that direct sales work better for its products, it can pursue sales directly. Many manufacturers choose some combination of direct sales and sales through independent retailers.[13] The competitive process gives the manufacturer the incentive to pick the distribution option that it believes will be the most responsive to consumers. Typically, no government intervention is required to augment or alter these competitive dynamics—the market polices inefficient, unresponsive, or otherwise inadequate distribution practices on its own.

Economists have long been interested in why firms choose to sell their products through a network of independent entities, to "vertically integrate" (engage in retail sales themselves), or to

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http://www ftc.gov/sites/default/files/documents/reports/effect-state-entry-regulation-retail-automobile-markets/231955.pdf.

[11] Thomas B. Leary, Comm'r, Fed. Trade Comm'n, State Auto Dealer Regulation: One Man's Preliminary View, Speech at The International Franchise Association 34th Annual Legal Symposium (May 8, 2001), *available at* http://www ftc.gov/public-statements/2001/05/state-auto-dealer-regulation-one-mans-preliminary-view.

[12] In Missouri, with limited exceptions, a motor vehicle "franchisor" is prohibited from "owning or operating a new motor vehicle dealership." *See* MO. REV. STAT. § 407.826.1.

[13] Computer manufacturers are one example of this hybrid distribution system, and popular clothing brands are another, but there are many more.

do some combination of the two.[14] A large body of literature has shown that the decision is very context specific. In some circumstances, such as when local sales and promotional effort is hard to measure but important for the firm's success, a firm may conclude that it is desirable to use highly incentivized independent representatives.[15] In others, however, reliance on independent dealers may fail to achieve the best outcome for either the upstream producer or the consuming public. The vast majority of existing work by economists suggests that allowing firms in competitive marketplaces to make the decision for themselves leads to better outcomes for consumers.[16]

When manufacturers respond to competitive pressure by choosing to vertically integrate, consumers usually benefit through lower prices and/or higher quality.[17] In contrast, when the government intervenes and outlaws vertical integration, consumers often experience worse service and higher prices.[18] It is not that vertical integration is always superior. Preventing firms

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[14] One of the first papers focusing on this "make or buy" decision was Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937). The literature has since expanded dramatically. Recent surveys touching on both theory and empirical evidence include Francine Lafontaine & Margaret Slade, *Vertical Integration and Firm Boundaries: The Evidence*, 45 J. ECON. LIT. 629-685 (2007); and Timothy Bresnahan & Jonathan Levin, *Vertical Integration and Market Structure*, in HANDBOOK OF ORGANIZATIONAL ECONOMICS 85 (R. Gibbons & D.J. Roberts, eds., 2012).

[15] A book-length treatment of the theory explaining why can be found in Jean-Jacques Laffont & David Martimort, THE THEORY OF INCENTIVES: THE PRINCIPAL-AGENT MODEL (2009).

[16] This conclusion was reached in two separate recent surveys of the literature: Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy*, in HANDBOOK OF ANTITRUST ECONOMICS (Paolo Buccirossi, ed., 2008); and James C. Cooper, Luke M. Froeb, Dan O'Brien, & Michael G. Vita, *Vertical Antitrust Policy as a Problem of Inference*, 23 INT'L J. INDUS. ORG. 639-64 (2005).

[17] This is not to suggest that vertical integration can never harm competition, as may be the case where it is used to impair competition from rival suppliers or customers.

[18] Efficient vertical integration by upstream manufacturers can benefit consumers in a variety of ways. First, it can remove the incentive for a manufacturer as well as a dealer to each mark up the price of the product on its way to the consumer. This results in lower prices and increased sales to consumers. Discussion and details are available in Dennis W. Carlton & Jeffrey M. Perloff, MODERN INDUSTRIAL ORGANIZATION 523-527 (2nd ed. 1994).

Second, integration by a manufacturer into distribution can enable manufacturers to better match their products with the preferences of consumers. For example, though manufacturers have an incentive to increase overall sales of their products, particular dealers may be most interested in making sales from their inventory, which may cause consumers to have to visit multiple dealerships to establish what product best fits their needs, resulting in relatively high search costs. When consumers' search costs are a large determinant of their purchasing patterns, a manufacturer can have a strong incentive to make direct sales so that it is simpler for consumers to find what they want. *See* Comment from FTC Staff to James Oberweis, State Senator of Illinois 5 (March 26, 2014), *available at* http://www.ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-illinois-state-senate-regarding-senate-bill-2629-which-would-repeal-certain/140327illinoisautostaffcomment.pdf (discussing and summarizing literature on the impact of search costs). For some empirical evidence on the importance of search costs in the automotive industry, *see* Fiona Scott Morton, et al., *What Matters in a Price Negotiation: Evidence from the U.S. Auto Retailing Industry*, 9 QUANTITATIVE MARKETING & ECON. 365-402 (2011). For a more general review of the economic theory and evidence connecting search costs to prices, *see* Michael Baye, et al., *Information, Search, and Price Dispersion*, in HANDBOOK ON ECONOMICS AND INFORMATION SYSTEMS 323 (T. Hendershott, ed., 2005).

Third, past work by economists has shown that vertical integration can aid firms in responding to uncertainty or evolving business environments by establishing clear lines of authority between its manufacturing and sales personnel, especially when new firms are attempting to enter an established market. A survey of the theoretical from using independent retail networks, when that is what they want to do, also can have negative competitive consequences. The common message in both situations is that the competitive process effectively aligns the interests of firms and consumers on the issue of distribution method. In order to make their product as attractive as possible, firms choose the distribution method that can bring their product to market as effectively and efficiently as possible.

Specific evidence to support these views can be found in many industries, including retail automotive markets and industries like gasoline retailing. Past studies by both academic researchers and FTC staff have concluded that state-imposed restrictions on automobile manufacturers' ability to negotiate with their dealers increased the prices paid by consumers without leading to notable improvements in service quality.[19] Similarly, studies have found a causal link between laws that inhibit gasoline refiners' ability to operate or own retail stations, and higher prices.[20] In our view, the well-developed body of research on these issues strongly suggests that government restrictions on distribution are rarely desirable for consumers. When they are adopted, at a minimum such restrictions should be clearly linked to specific policy objectives that the legislature believes warrant deviation from the beneficial pressures of competition, and no broader than necessary to achieve those objectives.[21]

Those who support a blanket prohibition on direct manufacturer sales have made a number of arguments that FTC staff find unpersuasive. Perhaps the central concern reflected in the current laws regulating the manufacturer-dealer relationship is that government intervention is required to protect independent dealers from abusive behavior by their suppliers. But a blanket prohibition of direct manufacturer sales is not a narrowly crafted provision to protect franchised dealers from abuse in their franchise relationships. Such a prohibition is categorical, going well

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motivations for vertical integration can be found in Timothy Bresnahan & Jonathan Levin, *Vertical Integration and Market Structure*, in HANDBOOK OF ORGANIZATIONAL ECONOMICS (R. Gibbons & D.J. Roberts, eds., 2012). Empirical evidence of integration's impact on firms' ability to respond to events can be seen in recent studies such as Sharon Novak & Scott Stern, *Complementarity among Vertical Integration Decisions: Evidence from Automobile Product Development*, 55 MANAGEMENT SCIENCE 311-332 (2009); and Silke Forbes & Mara Lederman, *Does Vertical Integration Affect Firm Performance? Evidence from the Airline Industry*, 41 RAND J. ECON. 765-90 (2012).

[19] In particular, *see*, E. Woodrow Eckard, Jr., *The Effects of State Automobile Dealer Entry Regulation on New Car Prices*, 24 ECON. INQUIRY 223-42 (1985); and ROBERT P. ROGERS, THE EFFECT OF STATE ENTRY REGULATION ON RETAIL AUTOMOBILE MARKETS (1986) (FTC Bureau of Economics Staff Report, *supra* note 9).

[20] J.M. Barron & J.R. Umbeck, *The Effects of Different Contractual Arrangements: The Case of Retail Gasoline*, 27 J.L. & ECON., 313-328 (1984); Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. REG. ECON. 217-33 (2000); and A.A. Blass & Dennis Carlton, *The Choice of Organizational Form in Gasoline Retailing and the Cost of Laws that Limit that Choice*, 44 J. LAW & ECON. 511-24 (2001).

[21] Our comments here echo prior comments discussing similar issues. FTC Staff Comments Before the District of Columbia Taxicab Commission Concerning Proposed Rulemakings on Passenger Motor Vehicle Transportation Services (June 7, 2013), *available at* http://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comments-district-columbia-taxicab-commission-concerning-proposed-rulemakings-passenger/130612dctaxicab.pdf (discussing taxicab rules and suggesting that "any restrictions on competition that are implemented should be no broader than necessary to address legitimate subjects of regulation, such as safety and consumer protection, and narrowly crafted to minimize any potential anticompetitive impact.")

beyond the many other statutory provisions of Missouri law that protect dealers from such abuse. HB 1124 would extend the current restrictions to every entity engaged in manufacturing, assembling or distributing new motor vehicles, even a manufacturer that has never entered into a franchise agreement and has no interest in doing so.

Advocates for existing dealers also argue that manufacturers that sell directly to consumers will not provide them with adequate service. This argument presupposes that auto manufacturers in a competitive environment will act contrary to their economic self-interest. If consumers greatly value post-sale service and would be unlikely to purchase or recommend any automobile without a reasonable assurance of quality future service, then any manufacturer will have an incentive to supply such service or would see its sales decline to the benefit of its rivals. This competitive pressure is a strong motivation for manufacturers to either provide good service themselves or continue to contract with an independent service provider, such as a dealer, to do so.

Finally, some advocates for a categorical ban on direct sales argue that direct-selling manufacturers would charge higher prices to consumers. In their view, consumers benefit from the "intrabrand" competition between dealers of the same brand of vehicle. In other words, rival dealers in the same area that sell the same make and model of car compete for business and competition between them can lower prices for car buyers. Manufacturers, they maintain, would not be subject to the same competitive pressures.

This view is inconsistent with modern economic learning and with the Supreme Court's widely accepted observation that strong "interbrand" competition—competition between rival manufacturers—can suffice as a source of downward pressure on price.[22] Manufacturers in a competitive market face acute pressure to keep prices low to keep buyers from shifting their purchases to a competing manufacturer's product. Thus, forcing firms to use inefficient distribution methods can result in higher prices and other forms of consumer harm. As described above, this is not merely a theoretical possibility. Statistical evidence shows that states that have placed strong limitations on gasoline refiners' ability to operate their own retail outlets tend to have higher prices than those that allow refiners to use whatever combination of dealer and company-operated stations they prefer.[23]

Unlike the purported benefits of a manufacturer sales ban, which are questionable, the anticompetitive effects of such a ban are immediately visible in the circumstances that have led to the introduction of HB 1124. Tesla Motors is a relatively new entrant into the business of motor vehicle manufacturing and sale, with an innovative new product and a distinctive method

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[22] Continental T. V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 52 n.19 (1977) ("Interbrand competition is the competition among the manufacturers of the same generic product […] and is the primary concern of antitrust law. […] In contrast, intrabrand competition is the competition between the distributors, wholesale or retail, of the product of a particular manufacturer. […] [W]hen interbrand competition exists, […] it provides a significant check on the exploitation of intrabrand market power because of the ability of consumers to substitute a different brand of the same product.").

[23] Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. REG. ECON. 217-33 (2000).

of selling it. It has no franchise system and does not use franchised dealers, preferring instead to promote and sell its vehicles on its own. If HB 1124 were to become law, however, Tesla could be forced to enter into franchise relationships with independent dealers in order to sell in Missouri, even though it has concluded that to do so would make it less effective as a competitor.[24] Alternatively, Missouri residents who wish to purchase a Tesla product could be forced to use inefficient procedures to ensure that any sale to a willing buyer from Missouri does not occur within the state. Missouri residents likely would be required to undertake for themselves some of the purchase-related services that could be provided by a dealership, such as some steps to register and title their cars in Missouri. Missouri residents would no longer be eligible for financing through Tesla, and might be unable to take advantage of some tax incentives for electric car purchases.

The current system that mandates use of independent dealers limits competition among existing, well-established manufacturers, all of whom must sell through the established network of independent auto dealers. A direct sales ban deters experimentation with new and different methods of sales by current auto manufacturers, and also by other future entrants to the market, such as Tesla, which might want to use different methods of sale. Missouri's consumers will ultimately pay the price of such a dictate. The essential mechanism that drives markets—the interaction between the supply by manufacturers and the demands of consumers—is being curbed. The market is less responsive to consumer preferences and less innovative in anticipating their evolving needs. HB 1124 would exacerbate this continuing harm to competition and consumers.

As already noted, FTC staff offer no opinion on the question of whether Tesla or other manufacturers would be best served by selling their products directly or through independent distributors. Nor do we express a view as to whether any particular motor vehicle manufacturer should succeed or fail. Our principal point is this: absent some legitimate public purpose, consumers would be better served if the choice of distribution method is left to motor vehicle manufacturers and the consumers to whom they sell their products.

III. Conclusion

FTC staff believe that Missouri's current ban on direct-to-consumer sales by motor vehicle franchisors is very likely anticompetitive and harmful to consumers. It cannot be justified

[24] Tesla has described the reasons for its direct-to-consumer sales model as follows:

> We believe that by owning our own sales and service network we can offer a compelling customer experience while achieving operating efficiencies and capturing sales and service revenues incumbent automobile manufacturers do not enjoy in the traditional franchised distribution and service model. Our customers deal directly with our own Tesla-employed sales and service staff, creating what we believe is a differentiated buying experience from the buying experience consumers have with franchised automobile dealers and service centers. We believe we will also be able to better control costs of inventory, manage warranty service and pricing, maintain and strengthen the Tesla brand, and obtain rapid customer feedback. Further, we believe that by owning our sales network we will avoid the conflict of interest in the traditional dealership structure inherent to most incumbent automobile manufacturers where the sale of warranty parts and repairs by a dealer are a key source of revenue and profit for the dealer but often are an expense for the vehicle manufacturer.

TESLA MOTORS, INC., ANNUAL REPORT ON FORM 10-K (Filed Feb. 26, 2014) at 11.

as a way to protect franchised dealers from abuse in their franchise relationships, and the other arguments that have been offered in its defense appear to be contrary to a significant body of economic study and FTC experience.

HB 1124 would expand the scope of the current prohibition and hence is very likely to further harm competition and consumers. Instead of expanding the reach of the direct sales ban in Section 407.826.1, we urge the Missouri legislature to carefully evaluate repealing it and instead permit manufacturers and consumers to reengage the normal competitive process that prevails in most other industries. Such a change would facilitate the development of new methods of distribution and possibly the arrival of new motor vehicle manufacturers, benefitting the motor vehicle buyers of Missouri.

Respectfully submitted,

Andrew I. Gavil, Director
Office of Policy Planning

Deborah Feinstein, Director
Bureau of Competition

Martin S. Gaynor, Director
Bureau of Economics