Notes on The Block Exemption Regulations

Author: Diadrom Systems AB
Date: 10/5/2005
Version: A

1 Table of content

2 Introduction

Every other volume vehicle manufacturer is facing inadequate profit figures and dropping sales. For example, GM’s European operations lost $742 million in 2004, the fifth straight annual loss, and lost $1.1 billion during the first quarter of 2005. Manufacturers that are making decent results (such as Volvo Cars) are nevertheless concerned about the market. There are a number of threatening factors, such as environmental regulations, the oil price, and the increasing competition from offensive Asian manufacturers.

If GM relied on just building and selling cars, they would be doing substantially worse than they are. In the fourth quarter of 2004, GM’s financing arm had a profit that almost tripled the result of the company's car operations. In fact, the largest element of the vehicle manufacturers’ profits has traditionally come from “peripheral” activities such as vehicle finance. For manufacturers such as GM and Ford, profits from their finance arms have been absolutely vital to solvency in recent years. While Ford is struggling to make money selling cars and trucks, the profit from financing is growing strong.

Another collateral business for the vehicle manufacturers is aftermarket activities such as service. The gross margin for service is about 50%, compared to the 7% average margin for new cars1. Hence, service is regarded as an important and profitable business for the vehicle manufacturers.

The automotive industry is not only composed of the vehicle manufacturers, but of players such as franchised dealers and independent garages. Since the aftermarket is a key to the profitability for vehicle manufacturers, they are repositioning themselves in the value chain in order to tap into new revenue streams.

From a customer perspective, competition on repair and maintenance is as important as competition on sales and distribution. The purchase price and the cost of repairing and maintaining a car each account for approximately 40% of the total cost of vehicle ownership.

To facilitate this competition, the European Commission (EC) has presented a treaty legislation that aim to open up the market to more competition.

This report will introduce the EC treaty regulation that applies to the vechicle industry, with the following main components:

- an introduction to the competition-regulating Article 81, and how to be excluded from this regulation
- a presentation of the treaty regulations for the vehicle industry
- a brief concluding discussion

For more comprehensive information, please see the applicable EC documents available for download at http://europa.eu.int/comm/competition/car_sector/.

3 The EC Article 81 Treaty and Block Exemption

[1] US figures

The EC Treaty Article 81 states that it is incompatible with the common market to make agreements that prevents, restricts or distorts competition in a way that affects trade between EU member states. The first condition for Article 81 to apply is thus that the agreement can have an appreciable effect on trade between member states (which usually is the case if a network extends across the whole territory of a member state).

The agreements can however be *exempted* under Article 81, if measures are taken to outweigh the agreements' anti-competitive effects – provided that the consumers receive a fair share of the benefits. It often depends on the market structure whether an agreement actually restricts competition and whether, in that case, the benefits outweigh the anti-competitive effects. It requires an individual assessment.

The EC can also grant exemptions for whole categories of agreements. Such regulations are commonly referred to as *Block Exemption regulations*.

The EC Block Exemption regulation no 2790/1999 is a regulation exempting certain categories of vertical[2] agreements from Article 81. The vertical agreements that regulation no 2790/1999 exempts are the supply and distribution agreements concerning final and intermediate goods as well as services, provided that the combined market share of the concerned parties does not exceed 30% of the market. Serious restraints on competition (such as price fixing and limits on production) are however still prohibited.

Regulation 2790/1999 does not apply to vertical agreements whose subject matter falls within the scope of any other Block Exemption regulation – it is general. The following section will outline a regulation that used to be applicable on the vehicle industry.

4 The 1475/95 Regulation

In the early 80:ies, the EC emphasized the consumers' freedom to purchase new motor cars anywhere within the EG and to obtain ancillary back-up services, including warranty services. The objective was to enable consumers to purchase vehicles anywhere in the EG on the most competitive terms.

The intra-EG car price differentials charged by car manufacturers in the member states was taken as evidence that the single market of new motor vehicles was dysfunctional (even though different national taxation systems and currency differentials were the major components of new car price differentials). The EC monitored the car price differentials between the EG member states and concluded that economically unjustifiable differentials and price discrimination existed. The ability to cross borders and purchase vehicles in other member states with low pre-tax prices was not enough to achieve full price harmonization.

As a response to the dysfunctional motor vehicle market, the manufacturers and the distributors was given a special industry-specific Block Exemption. It was introduced in 1985 to be in effect for a period of 10 years. 1995, it was replaced by Block Exemption regulation no 1475/95[3], "applying to certain categories of motor vehicle distribution and servicing agreements", aiming to give new car dealers more protection and further freedom of operation.

The 1475/95 Block Exemption regulation contained several adjustments to:

- stimulate competition in the vehicle sector,

[2] Vertical agreement = agreement between parties operating at different levels of the production / distribution chain. The vehicle distribution/repair networks consist of bundles of agreements between the manufacturer and the individual distributors or repairers. These agreements are referred to as vertical, as the manufacturer and distributor or repairer each operate at different levels of the production or distribution chain.

[3] http://europa.eu.int/comm/competition/car_sector/distribution/#reg_1475_95

- enable a single vehicle market,
- balance the different interests in the market,
- improve the position of consumers,
- give dealers greater commercial independence against the manufacturers,
- give independent spare-part manufacturers and distributors easier access to the various markets (in particular the outlets provided by the car manufacturers' networks),
- make the dividing line between acceptable and unacceptable agreements and behavior more clear, and
- protected new motor vehicle dealers from pressure from manufacturers to ignore cross-border vehicle purchase orders.

However, 1475/95 did not fully achieve the stated goals. A number of EC decisions imposing substantial penalties upon for example Volkswagen demonstrated that some motor manufacturers were non-compliant. Rather than enforcing the 1475/95 regulation, the EC decided to introduce a new regulation.

5 The 1400/2002 Regulation

5.1 Introduction

1 October 2002, a new Block Exemption regulation came into force – "Commission Regulation No 1400/2002 of 31 July 2002 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices in the motor vehicle sector"[4].

This regulation introduced substantial changes to the exemption of distribution agreements for new motor vehicles and spare parts. It also introduced major changes to the exemption of agreements for the provision of repair and maintenance services by authorized and independent repairers and other independent operators (e.g. on-road assistance providers, spare part distributors and training providers).

The new regulation was designed to increase competition and bring tangible benefits to European consumers, enabling the greater use of new distribution concepts such as Internet sales and multi-brand dealerships. The new regulation was expected to lead to greater competition between dealers, make cross-border purchases of new vehicles easier, and lead to greater price competition. The customers were expected to be able to choose from a greater variety of repair shops and spare parts stores.

5.2 Scope

The 1400/2002 regulation applies to vertical agreements in the motor vehicle sector at all levels of trade – from the sales of a new motor vehicle by its manufacturer to the final resale to the last customer, and from the first supply of spare parts by the manufacturer to the provision of service and repair to the customers.

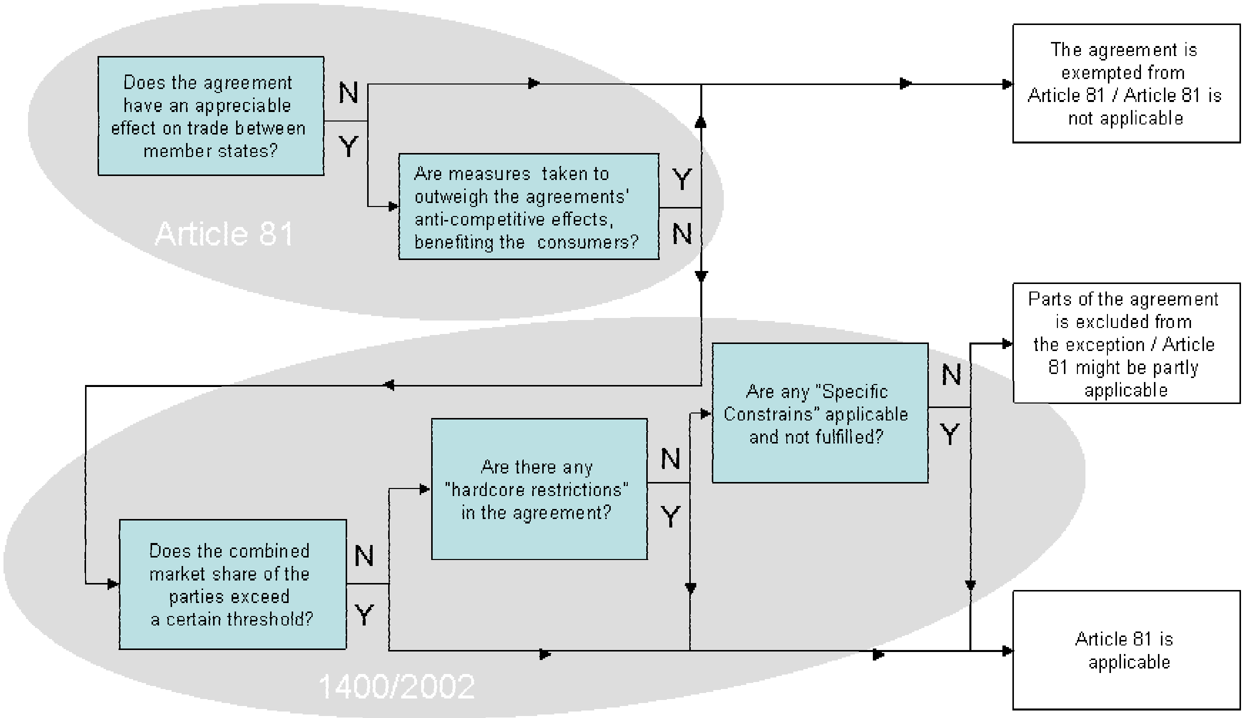
The regulation concerns motor vehicles and spare parts. In this context, "motor vehicle" is a self-propelled vehicle intended for use on public roads, having three or more road wheels. "Spare parts" refers to goods to be installed in or upon a motor vehicle to replace components of that vehicle, including goods (such as lubricants) which are necessary for the use of a motor vehicle. Fuel is not included.

---

[4] http://europa.eu.int/comm/competition/car_sector/distribution/#final_reg

The regulation applies for example on an association between a vehicle manufacturer and an authorized dealers, or between a manufacturer and a group of independent dealers who jointly buy vehicles – but only if none of the individual members of the association have a total annual turnover exceeding EUR 50 million. Agreements can only benefit from the Block Exemption when certain market share thresholds are not exceeded. The threshold is 30%, but 40% for quantitative selective distribution agreements for vehicle sales. To calculate its market share, a company has to take all its connected undertakings into account.

The official EC document contains a more comprehensive listing of the categories of agreements that fall within the scope of the regulation. The scope of the regulation can, however, outlined as follows:



The picture[5] outlines when an agreement is subject by Article 81 regulation, and when it can be exempted as part of a block. Please note that it is a simplified picture presenting the main approach – there can still be exceptions from the standard path.

5.3 Regulation Principles

5.3.1 Principles regarding the distribution of new motor vehicles

Regulation 1400/2002 sets up a regime which aims to stimulate the development of innovative distribution methods, thereby enhancing competition. The regulation is based upon the following principles:

- The combination of selective and exclusive distribution is banned – manufacturers have to choose between selective and exclusive distribution to be exempted from Article 81.

[5] Please note that it is not an official outline, but a self-made interpretation.

- Distribution agreements which restrict passive sales are not exempted.
- Agreements in selective distribution systems which restrict active sales are not exempted.
- "Location clauses" prohibiting dealers in selective distribution systems from establishing additional outlets elsewhere in the EU are not exempted.
- Agreements that do not allow dealers to subcontract servicing and repair to authorized repairers are not exempted. That is, the obligation for a firm to carry out both sales and service is removed.
- Restrictions on sale of vehicles of different brands by one dealer is prohibited, thus facilitating multi-branding (the manufacturers can only require that vehicles of different brands are exhibited in different showroom areas).
- Agreements that limit a dealer's ability to sell cars with specifications different from the standard model are prevented (enabling UK customers to buy new right-hand-drive cars in mainland Europe, for example).
- The consumers' use of intermediaries or purchasing agents is supported.
- The minimum standards of contractual protection (such as minimum notice periods) are strengthened.
- The dealers are given the freedom to sell their businesses to other dealers authorized to sell the same brand.

5.3.2 Principles regarding repair and maintenance of motor vehicles

The regulation aims to enable all operators (dealers, authorized repairers, and independent repairers) to offer good quality services and thereby contribute to vehicle safety and reliability. Manufacturers are, however, allowed to set selection criteria for authorized repairers.

The following aims are pursued:

- If a supplier of new motor vehicles sets qualitative criteria for the authorized repairers, all operators who fulfill those criteria must be allowed to join.
- The authorized repairers should have access to spare parts competing with parts sold by the vehicle manufacturer.
- The competitive position of independent repairers is reinforced through ensuring them access to spare parts, technical information, training and tools in line with technical advances (especially in the field of electronic devices and diagnostic equipment).

5.4 The Regulation Restrictions

5.4.1 Hardcore Restrictions

Based on the general principles of the regulation, a set of "hardcore restrictions" has been developed, clarifying what is not normally permitted. Where these restrictions are present, the agreement will no longer benefit from the Block Exemption (and an individual exemption is also unlikely).

The hardcore restrictions prevent for example:

- the restriction of a distributor's / repairer's ability to determine sales price,

- the restriction of the territory into which a distributor / repairer may sell the goods or services,
- the restriction of a distributor's ability to sell any new motor vehicle corresponding to a model within its contract range,
- the restriction of a distributor's ability to subcontract service , repair, and maintenance services to authorized repairers,
- the restriction of a repairer's ability to limit its activities to repair, maintenance and distribution of spare parts, and
- the restriction of sales of spare parts to an independent repairer.

5.4.2 Specific Conditions

The regulation also imposes specific conditions on certain vertical restraints, in particular non-compete obligations and location clauses. When these specific conditions are not fulfilled, these vertical restraints are excluded from the Block Exemption. However, the regulation continues to apply to the rest of a vertical agreement if the remainder of the agreement can operate independently from the non-exempted vertical restraint. The non-exempted vertical restraint will need an individual assessment under Article 81.

5.5 Time Frame

The regulation came into force in October 2002. However, the EC generally allows stakeholders sufficient time to adapt to a new legal framework. Therefore, the 1400/2002 regulation became fully applicable after the end of the transition period. Agreements compatible with the 1475/95 regulation were exempted until 2003/30/9. Dealers of new motor vehicles in a selective distribution system are prohibited from opening additional outlets elsewhere in the EU until 2005/30/9. The regulation expires 2010/31/5.

6 The Block Exemption Effect

Anytime there is a change, there is opportunity. So it is paramount that an organization get energized rather than paralyzed.[6]

From a vehicle sales perspective, the regulation will have the major impact of 1/ enabling delers to market their services and reach customers in different areas or countries, 2/ enabling dealers to sell more than one brand at the same site with fewer restrictions. Internet retailers will find it easier to cooperate with dealers and with individual customers who wish to import cars themselves. This will increase competition in the European vehicle market, giving consumers more choice and a reduction in car prices.

From a service perspective, the regulation will have the major effect of enabling more competition in the servicing and repair market, leading to lower costs and higher standards for consumers. The after-sales market will be opened up, with a change to the rules linking new vehicle sales and servicing. Dealers will still have to ensure that the customers' cars are serviced and repaired to manufacturer-approved standards, but they will no longer have to do it themselves; independent garages and roadside assistance organizations will have much greater access to technical information, including diagnostic equipment and software.

[6] Jack Welch, CEO General Electric

Vehicle manufacturers have to review their supply strategies to increase their competitiveness, since the Block Exemption regulation is opening up for new supply channels. The relationship between the manufacturer and the dealer is important for the compliance with safety and environmental issues and for the pursuit of quality in products and services delivered to consumers. These factors are essential for the conveyance of a good overall service to the consumers, and many manufacturers are expected to try to strengthen this link. Their aim is to improve consumers’ satisfaction, but also to secure a firm foothold in the profitable section of the value chain.