ESSAY

WHY INTRA-BRAND DEALER COMPETITION IS IRRELEVANT TO THE PRICE EFFECTS OF TESLA'S VERTICAL INTEGRATION

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In recent years, Tesla Motors (recently renamed Tesla) has been engaged in a state-by-state ground war for the right to distribute its all-electric vehicles directly to consumers.[1] The car dealers' lobby, with the political backing of General Motors, has fiercely battled back, relying on decades-old state dealer protection laws to argue that Tesla is legally bound to distribute through franchised dealers.[2] Through a combination of favorable state legislative and judicial decisions, Tesla has won the right to distribute directly in many states, but remains categorically barred from direct distribution in important states like Michigan and Texas—and hence all direct distribution given its business model.[3] While Tesla has taken the lead in fighting the issue, many other new entrants to the automobile market, such as Elio Motors, are closely watching the issue, hoping that Tesla's success will free up access to the heavily regulated U.S. automobile market.

The dealers and their allies enjoy the tremendous advantage of incumbency, both politically and legally, but can count few other assets. The

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1 *See generally* Daniel A. Crane, *Tesla, Dealer Franchise Laws, and the Politics of Crony Capitalism*, 101 IOWA L. REV. 573 (2016).

2 *Id.* at 582-89.

3 Robert T. Garrett, *Texas Auto Dealers Receive Tesla-Sized Dent from State GOP*, DALL. NEWS (May 20, 2016), http://www.dallasnews.com/news/politics/2016/05/20/texas-auto-dealers-receive-tesla-sized-dent-from-state-gop [https://perma.cc/J4MU-BT63]; Michael Wayland, *Michigan Denies Tesla Dealership License*, DETROIT NEWS (Sept. 15, 2016), http://www.detroitnews.com/story/business/autos/2016/09/15/michigan-denies-tesla-dealership-license/90427216/ [https://perma.cc/W8YM-4X6N]. For the present, Tesla is pursuing a distribution model of selling directly to consumers through online sales and company-owned retail stores rather than through dealers.

dealer protection laws on which the dealers rely were explicitly instituted for the purpose of protecting them from exploitation by the Detroit Big Three (General Motors, Ford, and Chrysler), not for the purpose of protecting consumers.[4] Today, however, many dealers are no longer mom-and-pop organizations but multi-billion dollar enterprises and the automobile manufacturing market has become much more competitive than it was forty or fifty years ago.[5] So the dealers have attempted to recast the state dealer protection laws as *consumer* protection laws, arguing that direct distribution is harmful to consumers.[6]

This shift toward a consumer protection justification has met a significant roadblock: major pro-consumer organizations, including the Federal Trade Commission, Consumer Federation of America, Consumer Action, and Consumers for Auto Reliability and Safety have taken the opposite view, arguing that direct distribution by manufacturers is good for consumer choice, price competition, and innovation, and that dealer protection laws are for the sole benefit of the car dealers.[7] The United States Justice Department quoted a study suggesting that direct distribution could save consumers up to 8% on new vehicle purchases.[8] Virtually every economist and law professor who has weighed in on the issue—from the right to the left—has taken the view that dealer protection laws benefit dealers and incumbent car companies seeking to stifle competition by raising rivals' costs, and harm consumers and

4 *See supra* note 1, at 579 ("The legislative concern reflected in these statutes is that if a manufacturer integrated forward into distribution, it might compete unfairly with its own franchised dealers by undercutting them on price.").

5 *See id.* at 600 (noting that while small dealers remain in rural areas, in urban and suburban areas it has become a big business); *see also Competition Gap Among Top US OEMs Shrinks, Nameplate Count Grows, According to IHS Study*, IHS MARKIT (Dec. 24, 2014), https://www.ihs.com/country-industry-forecasting.html?ID=1065997715 [https://perma.cc/R7VX-4ZXS] (reporting that the U.S. automobile industry is more competitive than at any other time, with close parity in market shares among the top eight automotive groups).

6 Crane, *supra* note 1, at 593-99.

7 *See* Sign-on Statement to State Gov't Leaders About the Anti-Consumer Effects of Laws Prohibiting Direct Distrib. of Autos. (Feb. 16, 2015), http://www.autonews.com/assets/PDF/CA98362217.PDF) [https://perma.cc/LC7Y-UUFA] ("In short, we oppose efforts by state legislatures or regulatory commissions to forbid car manufacturers from opening their own stores or service centers in order to deal directly with consumers."); *see also* Marina Lao, Debbie Feinstein & Francine Lafontaine, *Direct-to-Consumer Auto Sales: It's Not Just About Tesla*, FTC COMPETITION MATTERS BLOG (May 11, 2015, 11:00 AM), https://www.ftc.gov/news-events/blogs/competition-matters/2015/05/direct-consumer-auto-sales-its-not-just-about-tesla [https://perma.cc/BK84-U3PD] ("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.").

8 *See* Gerald R. Bodish, *Economic Effects of State Bans on Direct Manufacturer Sales to Car Buyers*, ECON. ANALYSIS GROUP COMPETITION ADVOC. PAPER 4 (May,2009),https://www.justice.gov/sites/default/files/atr/legacy/2009/05/28/246374.pdf [https://perma.cc/2LMP-25XW] (estimating based on a Goldman Sachs's projected cost differential between order to delivery from build to order).

innovation.[9] To boot, a strange coalition of bedfellows, including free market, environmentalist, pro-technology, pro-consumer, and pro-competition organizations—including such unusual allies as the Sierra Club and the Koch Brothers—have come out in favor of direct distribution.[10] Against this backdrop, the dealers' consumer protection arguments seem increasingly self-serving and illogical.

Nonetheless, the dealership lobby persists in arguing that forbidding consumers from choosing to buy directly from a manufacturer is pro-consumer. From the beginning of the public debate on direct distribution, circa 2014, the dealers' lobby has advanced one principal consumer protection argument—that mandating dealer distribution leads to intra-brand price competition that reduces prices to consumers.[11] Recently, the National Automobile Dealers Association (NADA) has begun to advance this argument more formally in economic policy papers it has commissioned for release[12] by the Phoenix

9 *See generally* Letter from Int'l Ctr. for Law & Econ., to Chris Christie, Governor of New Jersey (Mar. 26, 2014), http://laweconcenter.org/images/articles/tesla_letter_icle.pdf [https://perma.cc/U5FT-H29Y] (noting "the regulations in question are motivated by economic protectionism that favors dealers at the expense of consumers and innovative technologies").

10 Sign-on Statement, *supra* note 7.

11 *See, e.g.*, Jonathan Collegio, *Reply to OurEnergyPolicy.org*, OURENERGYPOLICY.ORG (Oct. 27, 2014, 3:23 PM), http://www.ourenergypolicy.org/should-tesla-and-other-auto-manufacturers-be-able-to-sell-cars-directly-to-consumers/#comments [https://perma.cc/X5HV-Z9XW] (noting that car companies "would not have the same set of incentives to keep costs down that dealers have, because they would not have competitors within the same brand. (E.g. two Chevy stores owned by GM can't really compete with each other in the same way as two business owners with skin in the game.)"); Michael Martinez & Michael Wayland, *Snyder Weighs Pulling Plug on Direct Tesla Sales*, DETROIT NEWS, (Oct. 16, 2014), http://www.detroitnews.com/story/business/autos/2014/10/16/tesla-faces-direct-sales-ban-michigan/17359253/ [https://perma.cc/Q7JV-YJTA] (quoting the spokesman for the National Automobile Dealers Association as saying, "[f]or consumers buying a new car today, the fierce competition between local dealers in any given market drives down prices both in and across brands . . . . If a factory owned all of its stores, it could set prices and buyers would lose virtually all bargaining power"); Interview by Erik Schatzker with James Appleton, President, N.J. Coal. of Auto. Retailers, and Daniel Crane, Professor, Univ. of Mich. Law School, on Bloomberg Television *Market Makers* (Mar. 12, 2014), https://www.bloomberg.com/news/videos/b/53f689ff-ac01-4dff-b2c6-12c927679073 [https://perma.cc/CC4C-YWUQ] (asserting that dealer protection laws in fact protect consumers against a "monopoly" in retail distribution); *see also* Jeff Cobb, *Why Auto Dealers Associations Oppose Tesla*, HYBRIDCARS (May 21, 2013), http://www.hybridcars.com/why-auto-dealer-associations-oppose-tesla/ [https://perma.cc/7R7J-2NCB] (quoting Texas Auto Dealers Association President Bill Wolters, "Now to me fewer dealers drives the price up. . . . The price doesn't go down when they have fewer outlets. And when they talk about the manufacturer being able to save more selling direct, there's nothing that says they pass that along to the customer").

12 NADA's sponsorship of the Phoenix Center's work is not disclosed in the policy papers or on NADA or the Phoenix Center's websites, as far as I can discern. However, according to a *USA Today* article, which quotes the President of NADA, the Phoenix Center report was commissioned by NADA. Brent Snavely, *Auto Dealer Chief Warns of Tesla Direct Sales Model*, USA TODAY (Oct. 6, 2016), http://www.usatoday.com/story/money/cars/2016/10/06/auto-dealers-chief-warns-teslas-direct-sales-model/91649750/ [https://perma.cc/U4FA-4ZZ9] (reporting that the Phoenix Center study was commissioned by NADA).

Center for Advanced Legal & Economic Public Policy Studies, a Washington think tank.[13] In short, NADA and the Phoenix Center argue that empirical evidence shows that consumer prices fall when intra-brand dealer competition intensifies.[14] It follows, argues the Phoenix Center, that the elimination of inter-brand dealer competition altogether through manufacturer vertical integration would lead to higher prices to consumers.[15] According to NADA and the Phoenix Center, this evidence supports state legislation prohibiting direct sales.

That argument is specious, and this essay rebuts it.

I. Economic Fundamentals of Integration Forward Into Distribution

For a manufacturing firm, retail distribution is just another cost of doing business. As Ronald Coase observed in *The Nature of the Firm*, whether a firm decides to perform any particular commercial function, including distribution in-house or to buy that service on the market, is in large part a function of the respective transaction costs of the two choices.[16] Firms are generally free to integrate forward into distribution,[17] and will exercise that choice if they are more efficient at performing it than retailers. Conversely, when retailers are more efficient than manufacturers, the manufacturer increases its profits by outsourcing the function and buying distribution from retailers. There are circumstances where a manufacturer can obtain monopoly rents through vertical integration, but those only arise where the vertical integration forecloses a rival's access to a needed input (either upstream, as with respect to

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13 *See generally* T. Randolph Beard & George S. Ford, *State Automobile Franchise Laws: Public or Private Interests?,* PHX. CTR. FOR ADVANCED LEGAL & ECON. PUB. POL'Y STUD. (July 12, 2016), http://www.phoenix-center.org/perspectives/Perspective16-06Final.pdf [https://perma.cc/PU5P-V5R2]; T. Randolph Beard, George S. Ford & Lawrence J. Spiwak, *The Price Effects of Intra-Brand Competition in the Automobile Industry: An Econometric Analysis,* PHX. CTR. FOR ADVANCED LEGAL & ECON. PUB. POL'Y STUD. (Mar. 2015), http://www.phoenix-center.org/pcpp/PCPP48Final.pdf [https://perma.cc/S4XR-VNEV]. The Phoenix Center describes itself as a think tank with a "mission to provide independent assessments of the economic and material implications of regulatory and economic policy in the U.S. and abroad." *About the Phoenix Center,* PHX. CTR. FOR ADVANCED LEGAL & ECON. PUB. POL'Y STUD. http://www.phoenix-center.org/pcau.html [https://perma.cc/F43E-2L8L].

14 Beard, Ford & Spiwak, *supra* note 13, at 22 (reporting "relatively strong" negative price effect from geographic proximity of additional dealers in the same brand).

15 Beard & Ford, *State Automobile Franchise Laws*, *supra* note 13, at 2,9 (arguing that laws prohibiting vertical integration into distribution by car manufacturers reflect a "consumer motivation" based on the effects of intrabrand price competition in lowering consumer prices).

16 *See generally* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

17 Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 56 (1977) (noting that manufacturers would like to minimize the cost of distribution—the difference between the wholesale and retail price).

raw materials, or downstream, as with respect to critical distribution channels).[18] Such circumstances have nothing to do with the debate over direct automobile distribution, since there is no suggestion that Tesla or any other firm is hindering inter-brand competition by creating its own critical automobile distribution outlets. Conversely, a manufacturer cannot obtain monopoly profits by integrating forward into distribution and then charging customers an above-market retail distribution margin. This is because a manufacturer that has market power in its brand is already charging a monopoly mark-up at the wholesale level.[19] A further retail mark-up would decrease its profits because it would cause the manufacturer to exceed the profit-maximizing price for its product.

To illustrate concretely, suppose Tesla had market power in its brand of electric vehicles that enabled the company to charge a twenty-percent market power premium over the idealized competitive price. Suppose that company executives were considering the choice of selling through retailers or opening Tesla's own showrooms and selling directly to consumers. Among the many considerations that drive this analysis, one of them would *not* be the possibility of increasing the hypothetical market power premium above twenty percent by controlling retail distribution and charging an additional monopoly retail mark-up. The market power premium was twenty percent and not higher because any increase of the wholesale price above twenty percent would have diminished sales more than it would have increased profits as downstream consumers substituted other vehicles. Hence, by extracting a new monopoly rent by charging an above-market-power retail mark-up, Tesla would sell fewer cars, cannibalize its hypothetical wholesale monopoly rents, and earn less profit.

It is for this reason that the Supreme Court has correctly observed that the interests of consumers and manufacturers are aligned on the question of whether retailers should have market power.[20] Retailer market power leads to higher prices for consumers, but it also leads to diminished manufacturer profits since the manufacturers make fewer wholesale sales as retail prices rise. If there are monopoly rents to be extracted from its brand, the manufacturer would like to extract them all for its own benefit. The

18 *See* U.S. DEP'T OF JUSTICE, NON-HORIZONTAL MERGER GUIDELINES n.29 (June 25, 2015), https://www.justice.gov/atr/non-horizontal-merger-guidelines [https://perma.cc/9F82-JUDK].

19 *See* F.M. SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 541-42 (3d ed. 1990) (explaining that an upstream monopolist would prefer to sell to a downstream competitive firm); *see also* Port Dock & Stone Corp. v. Oldcastle Ne., Inc., 507 F.3d 117, 124 (2d Cir. 2007) ("[A] monopolist can only extract one monopoly profit on a product; once it enjoys a monopoly at one level of the product's market, there is no further monopoly profit to be had from its expansion vertically.").

20 As the Supreme Court recognized in the vertical restraints context, the interests of consumers and of manufacturers are aligned against retailers having market power. *See* Leegin Creative Leather Prods. v. PSKS, Inc., 551 U.S. 877, 896 (2007) ("[T]he interests of manufacturers and consumers are aligned with respect to retailer profit margins.").

manufacturer's profits increase when it can obtain distribution services at the lowest possible cost, whether from itself or by purchasing distribution from independent retailers.

II. IRRELEVANCE OF INTRA-BRAND DEALER COMPETITION

The principal thrust of the Phoenix Center study and policy paper is that intra-brand price competition between dealers selling the same brands of cars reduces prices to consumers.[21] Specifically, the Center's econometric study finds that moving an intra-brand dealer one mile closer to another dealer leads to an equivalent decrease in price as a similar move by thirty-five inter-brand rivals.[22] This may all be true, but it is irrelevant to price effects of vertical integration.

It is no surprise that intra-brand competition can reduce consumer prices. Over the last century, one of the leading controverted questions in antitrust policy has been the treatment of manufacturer efforts to control the downstream prices charged by retailers.[23] On the one hand, manufacturers sometimes wish to set minimum resale prices to incentivize retailers to make beneficial investments in local brand promotion.[24] On the other hand, manufacturers sometimes worry that retailers may face too little intra-brand competition and impose an above-competitive retail mark-up. In such cases, the manufacturer may impose maximum resale prices on its retailers, essentially vertical price controls, to cabin the exercise of retailer market power.[25] Manufacturers try to control supracompetitive retail pricing because it reduces their profits.

So yes, inter-brand competition can lower prices to consumers in some circumstances. But it does not follow that a vertically integrated manufacturer's retail prices would be higher than those set by dealers in a competitive environment. The increase in dealer prices in noncompetitive environments arises because dealers maximize their profits by charging a supracompetitive retail mark-up. As already established, however, a manufacturer cannot similarly increase its profits by charging a supracompetitive retail mark-up. Hence, the competitive price reduction effect described in the Phoenix Study

21 *See* Beard & Ford, *State Automobile Franchise Laws*, *supra* note 13, at 2 ("[W]e find that there are consumer benefits of state laws requiring independent sales of automobiles—primarily, lower prices for consumers. Indeed, we find that a consumer-motivation for these laws has good support and appears to be most consistent with the available evidence.").

22 Beard, Ford & Spiwak, *supra* note 13, at 1.

23 *See* DANIEL A. CRANE, ANTITRUST 80-83 (2014) (walking through the history of jurisprudence on downstream price manipulation).

24 *See* Leegin, 551 U.S. at 897 ("The antitrust laws do not require manufacturers to produce generic goods that consumers do not know about or want. The manufacturer strives to improve its product quality or to promote its brand because it believes this conduct will lead to increased demand despite higher prices.").

25 *See* State Oil Co. v. Khan, 522 U.S. 3, 22 (1997) (holding that manufacturer's maximum resale price setting was subject to the antitrust rule of reason rather than per se illegality).

should similarly be observed with vertical integration, since the manufacturer would maximize its profits by embedding a competitive retail mark-up (essentially, its cost of distribution) into the retail price.

If the assumption of the Phoenix Center paper were true, it would mean that vertical integration of most kinds would lead to higher retail prices, since it eliminates the opportunity for competition among input suppliers. It would imply, for example, that a company that previously hired a janitorial service company operating in a competitive market would increase the price of its products if it moved the janitorial function in-house, since it would no longer be buying that function in a competitive market but instead "monopolizing" it. Similarly, it would imply that the car dealers themselves be ordered to vertically disintegrate, for example by putting out all servicing for competitive bidding, since that would lower service prices to consumers. Taken to its logical conclusion, this argument would destroy the very idea of a firm and insist on a world of atomistic competition among sole proprietors.

An important caveat: a manufacturer's vertical integration into retailing could increase consumer prices, but not for the reason identified in the Phoenix Center study. If a manufacturer were less efficient at distribution than its retailers operating in a competitive intra-brand environment, then taking the distribution function in-house would lead to a retail price increase. But, since the manufacturer would also lower its profits with that gambit, it would not be in the manufacturer's self-interest to make that choice.

To be sure, a manufacturer could vertically integrate under the mistaken belief that it will be more efficient than retailers in performing the distribution function. The dealers have argued that Tesla is making such a mistake in thinking that it can distribute cars more efficiently than franchised dealers.[26] It is impossible to know whether Tesla or the dealers are right without testing the effects of vertical integration in the market. But, if Tesla is wrong and the dealers are right, legislation prohibiting direct distribution is unnecessary. In that hypothetical case, Tesla will suffer a competitive disadvantage by distributing inefficiently, will lose money, and will be sufficiently incentivized to switch to the more efficient dealer distribution model. There is no need for the law to tell car manufacturers to do what is in their own best interest.

The dealers' arguments as to the effects of intra-brand competition are wholly off the mark. They have completely failed to present the necessary empirical evidence of prices with and without vertical integration.

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26 Maryann Keller, *Tesla's Flawed Defense of Direct Sales*, AUTOMOTIVE NEWS (Oct. 24, 2016), http://www.autonews.com/article/20161024/RETAIL01/310249997/teslas-flawed-defense-of-direct-sales [https://perma.cc/BMD4-6KSL].

III. DOUBLE MARGINALIZATION

Far from increasing retail prices, there are strong reasons to believe that vertical integration of automobile manufacturers will lead to *lower* consumer prices, even apart from the many business efficiencies that may arise from direct distribution.[27] The vertically integrated firm's incentive to lower prices would arise from the elimination of double marginalization—price increases to downstream buyers that arise when multiple firms in the chain of production and distribution exercise market power by setting prices above competitive levels.[28]

The Phoenix Center argues, oddly, that vertical integration in car manufacturing will not eliminate double marginalization since double marginalization only occurs when there is significant market power at multiple layers of the distribution chain, and the car dealers have no market power as evidenced by their low sales margins.[29]

There are two fundamental problems with the Center's argument. First, focusing just on the dealer margins in new car sales is misleading, since dealers earn a significantly higher profit margin on servicing vehicles,[30] and the direct distribution debate concerns both sales and service. (More on this in a moment.) Second, and more generally, the dealers' own arguments on the price benefits of intra-brand competition undermine their claim that double marginalization does not occur in automotive retailing. The whole point of the dealers' study on intra-brand competition is that lower prices result from enhanced competition and that higher prices result from reduced competition because of the exercise of market power.[31] The dealers spaced far from other dealers must have market power, or else the Center's argument doesn't hold.

The Phoenix Center paper recognizes the contradictions in its argument, but its effort at rectification only makes matters worse. The paper argues that increased prices for dealers more distant from intra-brand competitors is not the result of the exercise of market power, but instead results from the fact that the higher-charging dealers tend to be located in more remote geographic areas, work on smaller volume, and hence must charge higher prices to cover

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27 For a description of the reasons Tesla has chosen a direct distribution strategy, see Crane, *supra* note 1, at 580, which quotes Elon Musk's explanation that dealerships face a conflict of interest between selling electric and gasoline powered cars.

28 JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION 174-75 (1988); W. KIP VISCUSI, JOHN M. VERNON & JOSEPH E. HARRINGTON, JR., ECONOMICS OF REGULATION AND ANTITRUST 221-23 (3d ed. 2000).

29 Beard & Ford, *State Automobile Franchise Laws, supra* note 13, at 9.

30 Jim Henry, *The Surprising Ways Car Dealers Make the Most Money off You*, FORBES (Feb. 29, 2012), http://www.forbes.com/sites/jimhenry/2012/02/29/the-surprising-ways-car-dealers-make-the-most-money-off-of-you/#4b87cb153ac8 [https://perma.cc/6DJV-TZXG].

31 *See supra* note 11.

their fixed costs.[32] But, if that is true, then the price increases detected in the Phoenix Center report are *not* the result of diminished intra-brand competition but rather of higher operating cost–effects that would continue even in a more competitive environment for dealer operations at the same scale. That might weaken the argument that vertical integration lowers double marginalization, but it would simultaneously destroy the entire thrust of NADA's consumer protection argument—that vertical integration destroys beneficial intra-brand competition.

There is no way out for the dealers. Either there is a problem of dealer market power, which is partially mitigated by intra-brand dealer competition and eliminated by vertical integration, or else there is no problem of dealer market power and hence no evidence that the elimination of dealers will lead to reduced intra-brand competition and higher retail prices. The argument points to direct distribution leading to lower prices for consumers.

IV. Retailers as Product and Service Bundlers

The Phoenix Center policy paper makes one additional argument, that merits a brief rejoinder, as to why mandating dealer distribution advances consumer welfare. It asserts that dealers serve to bundle new car sales with a service component in a way that allows buyers to pay a low initial purchase price for vehicles.[33] Even though customers may effectively pay a higher price for service because of this bundling (as evidenced by the fact that customers are routinely dissatisfied with the service they receive from car dealers), the net effect on consumers is positive, according to the Phoenix Center.[34] This argument misunderstands the nature of dealers in fulfilling manufacturers' warranty and safety recall obligations.

Fundamentally, the description of dealers as "bundlers" of products and services for manufacturers is misguided. Dealers play no role in setting the terms of the manufacturer's warranty, which contractually obligates the manufacturer to provide free repair services, nor in determining when the manufacturer must issue safety recalls.[35] Dealers perform those services for the manufacturer, often at reimbursement rates prescribed by state law, but in no way negotiated with customers.[36] Hence, the bundled nature of warranty

32 Beard & Ford, *State Automobile Franchise Laws, supra* note 13, at 9-10.

33 See *id.* at 7 ("The ability of an independent franchise dealer effectively to "bundle" these aspects of the transaction is valuable to consumers. Retail purchasers could not enforce this bundling on their own versus a manufacturer.").

34 *Id.* at 8.

35 Crane, *supra* note 1, at 599.

36 Daniel L. Goldberg & Samuel R. Rowley, State Regulation of Motor Vehicle Warranty Payments: Special Interest Legislation Run Amok, Presentation to Federal Trade Commission (Jan. 19, 2016) https://www.ftc.gov/system/files/documents/public_events/895193/panel_2_-_goldberg.pdf [https://perma.cc/3G5T-3269].

and service recall commitments and new car purchases is not a function of dealer distribution. The same thing happens when customers buy cars directly from Tesla—they bargain over both warranty and recall service and vehicle price simultaneously. (Dealers may set their prices for other kinds of service, but then the customer is not bound to use the dealer at all—it may shop competitively at independent repair shops.)

If anything, the structure of dealer compensation for warranty and recall service suggests just the opposite effect—that it allows the dealers to extract monopoly rents at the expense of consumers. Many states have laws requiring all warranty service to be performed by franchised new car dealers and set minimum reimbursement rates that manufacturers must pay dealers for providing warranty parts and service, often at a premium of thirty to forty percent over the dealer's cost.[37] Consumers do not incur these costs directly since they are paid for by manufacturers at the time of warranty service; however, the manufacturers must recoup this cost so they embed it into the wholesale price of new vehicles. Thus, while dealers generally earn relatively small margins on new car sales, they earn large margins on service paid for by consumers at the moment of new car purchase.[38] Contrary to the dealers' assertions, direct distribution prohibitions are not lowering customers' initial purchase prices, they are increasing them while disguising the dealers' extraction of legislatively empowered monopoly rents within inflated vehicle wholesale prices. In a world of direct distribution, where manufacturers also perform the service component, this price-elevating effect would disappear.

CONCLUSION

The dealers' and Phoenix Center's argument about the consumer welfare effects of intra-brand price competition is a cheap parlor trick. It plays on the correct observation that intra-brand competition can reduce prices in some circumstances to extrapolate that vertical integration must increase prices since it eliminates intra-brand competition and creates a distribution monopoly in the manufacturer. That argument is simply wrong because it completely ignores other necessary factors. If anything, vertical integration leads to lower prices for consumers by eliminating double marginalization. Furthermore, focusing

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37 *See* Transcript of Workshop, Nathan Wilson, Economist, Bureau of Economics, Fed. Trade Comm'n at Auto Distribution: Current and Future Trends (Jan. 16, 2006), https://www.ftc.gov/system/files/documents/public_events/895193/auto_distribution_transcript.pdf [https://perma.cc/F32N-FD2D] ("Starting about a decade ago, however, many states enacted new laws requiring manufacturers to also reimburse their dealers for parts at the retail rates."); *see also* Francine Lafontaine & Fiona Scott Morton, *State Franchise Laws, Dealer Terminations, and the Auto Crisis*, 24 J. ECON. PERSP. 233, 240 (2010) (stating that the "prevailing formula" for reimbursement is thirty to forty percent).

38 *See supra* note 30.

just on the price effects does not reach a significant issue—that Tesla and other new entrants selling disruptive new technologies would be severely disadvantaged if forced to employ century-old distribution methods, and hence that state prohibitions on direct distribution may retard beneficial innovation.[39]

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39 Crane, *supra* note 1 at, 579-80 (discussing the important relationship between innovation in product markets and innovation in distribution methods and how entrenchment in distribution methods can retard product market innovation).