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Cost benefit analysis of regulation

When reviewing the costs and benefits of sector specific block exemptions, the European Commission and other evaluating bodies often face the problem of quantifying the costs resulting from the responses of market participants to changes in the legal framework. However, cost quantification can be avoided if there is convincing evidence that the pro-competitive effects are limited. This note proposes a simple technique to identify such evidence in the context of multi-branding in the distribution of vehicles (Motor Vehicle Block Exemption Regulation).

Sector-specific block exemptions are means to take particularities of a sector into account and provide regulatory certainty to market participants. Some of these "exemptions" define specific restrictive rules to protect one side of the market. Thus, they are watched carefully by market participants, who adapt their behaviour in response to such rules.

The case in point is the Motor Vehicle Block Exemption Regulation (MVBER, Regulation 1400/2002). In 2008 the Directorate General for Competition issued an evaluation report on the operation of the MVBER suggesting that a specific regulation in the automotive sector might no longer be appropriate and that a "more effects-based and flexible approach would deliver better results for consumers".[1] One such option was to rely exclusively on the more flexible Vertical Block Exemption Regulation (VBER).

Take the following element of the regulation: Under the MVBER the decision to offer cars of multiple brands rested solely with the dealer (because according to the MVBER no manufacturer could require that sales of his brand accounted for more than 30% of the dealer's turnover); under a more general VBER regulation the manufacturers would have more freedom to require exclusivity from their dealers.

Potential costs and benefits of multi-branding

In theory, multi-branding can lead to both positive and negative welfare effects:

- On the positive side, multi-branding can allow entrants easier access to existing distribution networks, thus lowering their costs of entry and preventing foreclosure. It has also been argued that multi-branding is beneficial by lowering consumer search costs and by reducing overhead costs through economies of scale and/or scope. Analysis of the industry reports have led to the conclusion that only preventing foreclosure is likely to have a measurable positive effect.
- On the negative side, there are several possible sources of costs inherent to multi-branding, including costs through brand dilution, higher brand-specific investment of manufacturer, higher brand-specific investments of dealers at the point of sale, reduction in the geographic representation of brands and lower non-brand specific investment of the manufacturer.

There is evidence that the costs induced by the MVBER regulation are relevant and caused harm. Car manufacturers reacted to potential brand and corporate image dilution by increasing the level of brand-specific investments required from the dealers. Manufacturers also started to contribute less to dealers' investment costs to avoid free-riding by other manufacturers. As a result, the

[1] Commission Evaluation Report on the Operation of Regulation (EC) No. 1400/2002 concerning motor vehicle distribution and servicing, page 12.

distribution costs, which account for about a third of the total cost of a new car, went substantially up.

Measurement

While it seems likely that these additional costs are significant, it appears difficult to put an exact number on the harm to consumers. Does this imply that we cannot perform a meaningful cost-benefit analysis of the regulation? One way out is to quantify the upper bound of the potential benefits of the regulation.

A recent study evaluating the use of the MVBER gives one example of how such an analysis can be implemented.[2] A simple three-step evaluation of 34 car brands in 22 different EU countries (for a total of 748 brand/country combinations) identified all instances in which the availability of multi-branding might have helped with entry or expansion.

In Step 1, the brand/country pairs where entry (initial market share below 2% in 2002) or expansion (gain of at least 1% market share from 2002 to 2007) took place were identified.

In Step 2, instances in which entry/expansion took place without expanding the existing dealer network were eliminated.

In Step 3, the instances where entry/expansion took place via an expansion of exclusive dealer outlets were ruled out.

Altogether, as shown in the table, of the 748 brand/country pairs in total, only 73 remained after Step 1, only 62 remained after Step 2 and only 50 remained after Step 3.

Relatively small national markets of new EU member states such as Estonia, Latvia, Lithuania and Slovakia accounted jointly for 27 of the 50 (i.e. 54%) identified events where multi-branding could play a role. In contrast, in some of the largest and most mature national markets such as Germany, France, Italy or the UK not a single event was identified for which all three criteria for entry or expansion had been met. Overall, the 50 instances satisfying all three filtering criteria accounted for only 1% of the total volume of cars sold in the EU in 2008, which can be interpreted as an upper bound of volume of cars sold due to the multi-branding provisions of the MVBER.

Illustration of three-step evaluation

Country	Step 1	Step 2	Step 3
Estonia	11	8	7
Latvia	11	10	8
Lithuania	8	8	7
Slovakia	7	6	5
Finland	5	3	3
Greece	5	3	1
Denmark	4	4	4
Poland	4	4	2
Slovenia	4	3	3
Austria	2	2	2
Czech Republic	2	2	2
Hungary	2	2	0
Ireland	2	2	2
Sweden	2	1	1
Belgium	1	1	1
Netherlands	1	1	1
Portugal	1	1	1
Spain	1	1	0
Total	73	62	50

Source: E.CA calculations based on HWB International data.

Further evidence

Further evidence can be taken into account to evaluate the likelihood of a beneficial effect. For example, one can take the identified upper bound at face value and evaluate the change in market concentration. Moreover, there may be evidence showing ways to enter the market successfully without making use of the rights as-signed by the regulation.

In the case at hand we found that the effects on the market concentration in the affected countries based on the upper bound are small and identified alternative options to enter. This evidence supports a conclusion that the MVBER is unlikely to have played a significant role in fostering competition in new-car retailing in the automotive sector.

[2] ESMT Competition Analysis (now E.CA Economics), “Do we need a Motor Vehicle Block Exemption? An economic perspective with a focus on the interaction between non-compete clauses, restrictive contractual arrangements and entry in the European car market”, 12 June 2009, available online at: http://www.e-ca.com/sixcms/media.php/689/2009_Final_Report_MVBER_12_ June_09_web.pdf

Given such limited benefits it suffices to observe qualitative evidence of significant costs to conclude that the latter likely outweighs the former.

Postscript

In May 2010 the European Commission adopted new competition rules for vertical agreements in the motor vehicle sector (Regulation 461/2010). The new rules regarding new vehicle sales will come into force on 1 June, 2013, at which time current multi-branding MVBER rules will be repealed and car manufacturers will regain more flexibility to organise their distribution networks and, in particular, to find optimum compromise between single and multi-brand dealerships pursuant to newly modified VBER rules (Regulation 330/2010).