

# Regulation Impact Statement

Franchise relationships between car manufacturers and new car dealers

December 2018

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# 1. Introduction

In its 2017 market study of new car retailing (market study), the Australian Competition and Consumer Commission (ACCC)<sup>1</sup> made a number of recommendations aimed at addressing concerns within the new car retailing market which were leading to suboptimal outcomes for consumers and hindering effective competition.

As part of its market study, the ACCC examined the interrelationships between the three key groups of entities in the car retailing supply chain – large multi-national car manufacturers (who are often represented by locally based distributors); new car dealers; and independent businesses that service and repair cars (the Australian car retailing industry is further discussed at Appendix 1).<sup>2</sup> The ACCC noted that some of the competition concerns within the new car retailing market stem from the power imbalance in the commercial relationships between the large car manufacturers and the other two groups of entities – new car dealers and independent repairers.<sup>3</sup>

Firstly, while voluntary commitments had been made by car manufacturers to provide independent repairers with the same technical information to repair and service new cars that they provide to their dealers, there are problems with the breadth, depth and timeliness of the information offered.<sup>4</sup> Given this, the ACCC supported a mandatory scheme to compel car manufacturers to provide independent repairers equivalent service and repair information (mandatory information sharing).<sup>5</sup>

Secondly, while the Australian Consumer Law (ACL) provides protections to consumers through the consumer guarantees provisions, there are a number of systemic problems in the new car industry preventing consumers from obtaining the remedies to which they are entitled.<sup>6</sup> One of which is the power imbalance between car manufacturers and their dealers, in favour of the car manufacturer, which means that car manufacturers are able to impose commercial terms on dealers which make it difficult for dealers to provide satisfactory outcomes for consumers.<sup>7</sup> The ACCC also recommended that other issues raised by dealers

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<sup>1</sup> Australian Competition and Consumer Commission, [New car retailing industry market study - final report](#), ACCC.

<sup>2</sup> ACCC (Ibid footnote 1).

<sup>3</sup> ACCC (Ibid footnote 1).

<sup>4</sup> ACCC, p. 10 (Ibid footnote 1).

<sup>5</sup> ACCC, p. 12 (Ibid footnote 1).

<sup>6</sup> ACCC, pp. 4-9 (Ibid footnote 1).

<sup>7</sup> ACCC, p. 8 (Ibid footnote 1).

relating to the imbalance of power in their commercial arrangements with manufacturers, such as insecure tenure and significant capital outlays expected of dealers, be examined further.<sup>8</sup>

In line with the ACCC's findings, the Government has committed to a mandatory information sharing between car manufacturers and independent repairers, with Treasury leading the process. The Government has also been consulting with the sector on how best to address power imbalance concerns with the commercial relationships between car manufacturers, as franchisors and new car dealers, as franchisees. While there are other franchise arrangements in the automotive sector, for example, some service and repair brands operate under franchise arrangements, only the arrangements between new car dealers and manufacturers are being considered in this Regulation Impact Statement (RIS). The scope of the coverage of the franchising arrangements within the automotive sector is discussed further at Chapter 8.

The franchising relationship between car manufacturers and dealers is subject to the Franchising Code<sup>9</sup>, a mandatory code under the *Competition and Consumer Act 2010* (CCA). The Parliamentary Joint Committee on Corporations and Financial Services is currently undertaking an Inquiry into the operation and effectiveness of the Franchising Code with a report due on 14 February 2019 (PJC Inquiry). The PJC Inquiry received submissions and heard from automotive industry stakeholders so may make recommendations relevant to the issues covered in this RIS.

If a separate Automotive Code is implemented to govern franchising relationships between car manufacturers and new car dealers, then the Franchising Code would cease to apply to dealings between car manufacturers and new car dealers since the Franchising Code only operates where an industry-specific mandatory code does not exist.

This RIS identifies four options as having a positive net benefit, which together are likely to address the identified problems in the new car retailing sector:

- Option 2A – requiring manufacturers to provide at least 12 months' notice when not renewing a dealer agreement.
- Option 2B – requiring manufacturers to provide a statement to a dealer whose agreement is not being renewed outlining why the agreement is not being renewed.
- Option 2D – requiring pre-contractual disclosure of significant capital expenditure to have a greater degree of specificity.
- Option 2F – enabling multi franchise mediation.

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<sup>8</sup> ACCC, p. 9 (Ibid footnote 1).

<sup>9</sup> *Competition and Consumer (Industry Codes—Franchising) Regulation 2014*, Schedule 1.

The cumulative average annual regulatory burden for the above four recommended options is about \$1 million identified in the table on page 37.

Other options which are also canvassed include:

- Option 1 – Maintaining the status quo.
- Option 2C – Mandating that manufacturers buy back stock when an agreement is not renewed.
- Option 3B – Minimum five year terms with right of renewal.
- Option 4 – Voluntary Code of Conduct.

## 2. Overview of this Regulation Impact Statement

This RIS has been developed to inform Government decision making and provide an evidence base. This is consistent with the Government's commitment to improving the quality of regulation, including minimising the burden of regulation on businesses, community organisations and individuals. The Government's regulatory policy frameworks assist in keeping the Australian economy as efficient, flexible and responsive as possible. Under the Government's Regulatory Impact Analysis system, every policy proposal designed to introduce or abolish regulation must be accompanied by a RIS.

While the ACCC noted new car dealers' concerns with the power imbalance in their franchising relationship with new car manufacturers, it recommended Government further consider dealers' specific concerns.<sup>10</sup> In addition, industry submissions to the PJC Inquiry indicate that while there may be some agreement on key concerns for dealers, as franchisees, in their dealings with car manufacturers, as franchisors, there is no firm agreement on the best way to address dealers' concerns – whether through amendments to the Franchising Code or specific provisions within a standalone Automotive Code. Therefore, this RIS has been developed to clearly articulate dealers' concerns, define the policy problems to be addressed and canvass possible policy options, including net benefits of policy responses, to address those problems.

It should also be noted that in submissions to the PJC Inquiry new car dealer representatives, the Motor Trades Association of Australia (MTAA) and the Australian Automotive Dealer

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<sup>10</sup> ACCC, p. 9 (Ibid footnote 1).

Association (AADA), have canvassed issues which are being considered as part of other Government processes or are the subject of ACCC action, including unfair contract terms, indemnification of dealers for consumer warranty claims and the mandatory information sharing provisions. These matters are highlighted at Box 1 below and are being considered separately. The substance of the discussion within this RIS focuses on possible policy responses to specific dealer concerns categorised into three themes as follows:

- (1) End of term arrangements contained in dealership agreements including:
  - (a) Insufficient notice periods for non-renewal of dealership agreements;
  - (b) Franchisors providing reasons for non-renewal; and
  - (c) Stock buy-back arrangements when dealership agreements are not renewed;
- (2) Ability to recoup capital expenditure during the term of the dealership agreement:
  - (a) enhanced disclosure requirements;
  - (b) minimum tenure with right of renewal for the dealer; and
- (3) Improving the effectiveness of dispute resolution.

## 3. Background

### **Business model: car dealerships**

The main revenue streams for dealers include the new car department, used car department; parts, accessory and aftermarket sales; service workshop sales; and finance and insurance commissions. Estimated gross profit margins from the revenue streams vary but industry estimates place gross profit margins from the new car department at around 7 per cent while gross profit margin from the service department is estimated at around 64 per cent.<sup>11</sup>

Traditionally, motor vehicle dealership agreements were often evergreen with no fixed terms, but over time these agreements have been replaced with fixed term agreements, some of which are as short as 12 months in duration.<sup>12</sup> It has been suggested that on average, around 50 per cent of total dealer margin is now paid in the form of post-facto bonuses tied to a combination of key performance indicators but always with a heavy emphasis on the Consumer Satisfaction Index.<sup>13</sup> Deloitte profit benchmarks suggest that for a profitable dealership, incentive payments are equal to around 20 per cent of gross profit.<sup>14</sup> The AADA

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<sup>11</sup> ACCC p. 34 (Ibid footnote 1).

<sup>12</sup> Mr Alan Wein, [Review of the Franchising Code of Conduct: Report to the Hon Gary Gray AO MP, Minister for Small Business, and the Hon Bernie Ripoll MP, Parliamentary Secretary for Small Business](#), 30 April 2013, p. 152.

<sup>13</sup> Australian Automotive Dealer Association, [AADA 2017-18 Pre-budget Submission](#), AADA, 19 January 2017, p 4.

<sup>14</sup> Deloitte, [2018 Dealership Benchmarks: Motor Industry Services](#), 2018, pp. 4, 14 and 24.

has submitted that competitive pressures for new car dealers have increased significantly over time, challenging all aspects of a dealership's revenue streams.

Recent regulatory action by the Australian Securities and Investments Commission to address flex commissions and add on insurance practices has also placed downward pressure on car dealer revenue.<sup>15</sup> Analysis prepared by the advisory firm BDO for the AADA suggests that over time, once the market adjusts, additional revenue will be found to replace the missing finance and insurance income, however, it is not clear whether this will come from increased margins on new vehicle sales or increased incentive based income or another source entirely.<sup>16</sup>

### **What is franchising?**

Franchising is a relationship between two separate commercial parties, a franchisor and a franchisee, for a defined term as outlined in their franchise agreement. The franchising relationship is based on a prescribed business model which is offered by the franchisor and carried out under their guidance and oversight by franchise owners (franchisees). For franchisees, the appeal of a franchise is the potential benefits of being able to conduct a business under an established brand name using tested operational systems.<sup>17</sup> In turn, franchisors are able to grow their business by allowing others to use the model they have developed, within an agreement that allows them to retain substantial control over its use but without the financial risks of significant capital expenditure.<sup>18</sup>

Franchisors are expected to offer an appropriate level of support, guidance and advice to franchisees on using their business model; maintain support through advertising and marketing; provide inputs and equipment of an agreed standard; and update the model when business conditions demand it.<sup>19</sup> In return, franchisees are expected to pay agreed fees and royalties and execute the business model as prescribed by the franchisor, to a standard that maintains the reputation of the franchise network as a whole.<sup>20</sup> The success of a franchise model depends on the provision of a consistent, quality product or service to consumers, who

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<sup>15</sup> Acting ASIC Chairman, Peter Kell, [Add-on insurance and flex commission practices](#), Australian Securities & Investments Commissions.

<sup>16</sup> Matthew Cutt, [The Changing Landscape of an Automotive Dealership's Profitability](#), Automotive Dealer Magazine: The Official Publication of the AADA.

<sup>17</sup> Parliamentary Joint Committee on Corporations and Financial Services 2008, [Opportunity not opportunism: improving conduct in Australian franchising](#), December 2008, pp 5-7.

<sup>18</sup> Parliamentary Joint Committee on Corporations and Financial Services (Ibid footnote 17).

<sup>19</sup> Parliamentary Joint Committee on Corporations and Financial Services (Ibid footnote 17).

<sup>20</sup> Parliamentary Joint Committee on Corporations and Financial Services (Ibid footnote 17).

generally view the brand as a homogenous entity and exercise their spending preferences accordingly.<sup>21</sup>

The franchising model is necessarily predicated on franchisor control over the use of its brand, allowing it to impose terms and conditions on the way franchisees operate their franchise business.<sup>22</sup> Standard form contracts specify the beginning of a franchising relationship but, as allowed for in the contracts, the operations manual and other communications or directions from the franchisor form the basis of daily operations.<sup>23</sup>

Unlike other commercial relationships, the franchising parties' contractual obligations are variable and based on a symbiotic relationship.<sup>24</sup> The obligations do not involve discrete, one-off exchanges between parties on clearly defined terms that characterise ordinary contractual agreements.<sup>25</sup> Franchising agreements are drafted to allow flexibility of terms so that the franchise system is able to adapt to constantly changing business conditions.<sup>26</sup> Contracts between franchisees and franchisors therefore need continuing cooperation and agreement.<sup>27</sup>

In line with the Government's Policy Guidelines for Codes of Conduct, the Franchising Code does not seek to restrict competition or unduly interfere with the two commercial parties' freedom to contract. Rather, in recognition of the information asymmetry that can exist between franchisors and franchisees, the Franchising Code requires that a disclosure statement be provided to prospective franchisees so they can make a reasonably informed decision about entering into a franchise agreement.

### **Automotive franchising agreements**

Franchising arrangements between car manufacturer franchisors, as represented by distributors within Australia, and Australian car dealerships, as franchisees, are subject to the Franchising Code. However, automotive franchise agreements tend to differ from typical franchise agreements in two key ways:

- New car dealers do not pay fees or royalties to car manufacturers for the use of their brand.<sup>28</sup> The only payments that car dealers typically make to manufacturers are

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<sup>21</sup> Parliamentary Joint Committee on Corporations and Financial Services (Ibid footnote 17).

<sup>22</sup> Parliamentary Joint Committee on Corporations and Financial Services (Ibid footnote 17).

<sup>23</sup> Parliamentary Joint Committee on Corporations and Financial Services (Ibid footnote 17).

<sup>24</sup> Parliamentary Joint Committee on Corporations and Financial Services (Ibid footnote 17); Federal Chamber of Automotive Industries 2018, Submission to Parliamentary Joint Committee on the operation and effectiveness of the Franchising Code of Conduct, FCAI, May 2018, p. 5.

<sup>25</sup> Parliamentary Joint Committee on Corporations and Financial Services (Ibid footnote 17).

<sup>26</sup> Parliamentary Joint Committee on Corporations and Financial Services (Ibid footnote 17).

<sup>27</sup> Parliamentary Joint Committee on Corporations and Financial Services (Ibid footnote 17).

<sup>28</sup> FCAI 2018, p. 3 (Ibid footnote 24).

contributions to co-operative marketing funds and payments for purchasing vehicles, parts, accessories and tools.

- New car dealers typically control the location of the franchise and many own the land on which the dealership is located.<sup>29</sup> In other franchise systems, it is more common for the franchisor to control the location of the franchisee.

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### *Box 1: Related Government processes*

#### **Franchising Inquiry**

On 22 March 2018, the Senate referred an inquiry into the operation and effectiveness of the Franchising Code of Conduct to the Parliamentary Joint Committee on Corporations and Financial Services (PJC Inquiry). Its Terms of Reference include: the effectiveness of the disclosure requirements, dispute resolution procedures and termination provisions in the Franchising Code, whether the provisions of other mandatory codes of conduct contain advantages or disadvantages in comparison with the Franchising Code, the imposition of restraints of trade on former franchisees following the termination of an agreement and the enforcement of breaches of the Franchising Code. The PJC Inquiry is scheduled to report on 14 February 2019.

#### **Supplier indemnification**

In its market study, the ACCC identified that dealers were encountering difficulties with claiming the costs associated with remedying manufacturing defects to which they are entitled. The ACCC has taken a range of enforcement actions against car manufacturers to improve their compliance with the ACL and called for manufacturers to review their dealer agreements, policies and procedures to ensure that these commercial arrangements do not contain unfair contract terms that go beyond what is reasonably necessary to protect their legitimate interests.

At the October 2018 Consumer Affairs Ministers meeting, Ministers directed Consumer Affairs Australia and New Zealand officials to undertake work on improving the supplier indemnification provisions in the ACL. This work will go towards ensuring that suppliers are supported by manufacturers in carrying out their refund obligations.

#### **Unfair Contract Terms Review**

On 12 November 2016, a new law to protect small businesses from unfair terms in business to business standard form contracts came into effect. The unfair contract terms provisions apply to businesses with less than 20 employees and where the upfront price payable is no more than \$300,000 or \$1 million if the contract is for more than 12 months. There have been some calls from industry to extend the application of these provisions to larger car dealers, which often do not meet the definition of small business. The unfair contract terms provisions are being reviewed by Treasury, with the review commencing in November 2018 and reporting in February 2019.

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<sup>29</sup> FCAI 2018, p. 4 (Ibid footnote 24).

The law sets out examples of terms that may be unfair, including: terms that enable one party (but not another) to avoid or limit their obligations under the contract; terms that enable one party (but not another) to terminate the contract; terms that penalise one party (but not another) for breaching or terminating the contract; terms that enable one party (but not another) to vary the terms of the contract. Such contract terms are not prohibited outright. However, if a court or tribunal finds that a term is 'unfair', the term will be void – this means it is not binding on the parties. The rest of the contract will continue to bind the parties to the extent it is capable of operating without the unfair term.

\* ACCC, 2018, Media Release: Court orders Ford to pay \$10 million penalty for unconscionable conduct; <https://www.accc.gov.au/publications/motor-vehicle-sales-repairs-an-industry-guide-to-the-australian-consumer-law>; and

<https://www.accc.gov.au/media-release/volkswagen-undertakes-to-fix-consumer-guarantees-approach>

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## 4. What is the problem?

In franchising there is typically a power imbalance between franchisees and franchisors, this is also true for dealings between car dealers, as franchisees and car manufacturers, as franchisors, within new car retailing. Motor vehicle dealerships are highly fragmented with many privately owned and operating only a single dealership.<sup>30</sup> The industry has a couple of major players with the Automotive Holdings Group Limited (AHG) and A P Eagers Limited, Australian publicly listed companies, holding 8.5 and 6 per cent market share respectively.<sup>31</sup> The AADA in its submission to the PJC Inquiry states that around 85 per cent of dealerships or about 1275 are owned and operated by individuals or are family businesses.<sup>32</sup>

Australia has one of the most open and competitive car retailing markets with strong price competition across all three levels of the supply chain, car manufacturing, wholesaling and retailing, with decreased profit margins over the past five years.<sup>33</sup> While there is fierce competition between dealerships, the franchising related concerns identified within the ACCC market study stem from the power imbalance in the relationship between car manufacturers and new car dealers. Recent media coverage, submissions to the 2018 Franchising Inquiry, and anecdotal evidence presented to DIIS in its one on one consultations have suggested that in response to increased competition car manufacturers have made the decision to reduce their footprint in some areas of Australia with some regional areas particularly affected. Non-renewal of dealership agreements in regional areas has meant that consumers will not be able to have their car serviced locally or will need to travel further to buy a new car.<sup>34</sup> While larger players within the industry have been able to benefit through acquiring existing dealerships, these acquisitions tend to be in larger regional hubs or cities.<sup>35</sup> Further background on the new car retailing industry is at Appendix 1.

### *Franchising power imbalance and new car dealers*

Franchising by definition involves a franchisor granting a franchisee a right to carry on the business under a franchise business model offered and controlled by the franchisor for a specified period of time. A franchisee invests in the business and bears the majority of the

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<sup>30</sup> IBISWorld Industry Report G3911, *Motor Vehicle Dealers in Australia*, April 2018, p. 24.

<sup>31</sup> IBISWorld Industry Report (Ibid footnote 30).

<sup>32</sup> AADA 2018, Inquiry into the operation & effectiveness of the Franchising Code of Conduct, AADA, May 2018, p. 7.

<sup>33</sup> IBISWorld Industry Report, p. 7 (Ibid footnote 30).

<sup>34</sup> Turnbull, Samantha, MacKenzie, Bruce, Shoebridge, Joanne 2017, [Holden cuts dealership franchises across Australia](#), ABC, 17 August 2017.

<sup>35</sup> AP Eagers, *About Us*, AP Eagers, viewed 19 November 2018, <<https://www.apeagers.com.au/apeagers-company-info/>>

risk associated with the operation of a particular outlet, while the franchisor maintains control over the design of the overall system and the quality of the output. In addition, apart from this power imbalance stemming from franchisor control over the franchise model, there can be an information imbalance since the franchisor has full access to information pertinent to the operation of the entire franchise system and controls its disclosure to franchisees.

In line with the on-going, variable and symbiotic nature of the franchising relationship, the Franchising Code provides that parties to a franchising agreement must act in good faith towards one another.<sup>36</sup> As such, although car dealers enter into agreements that provide substantial power to the manufacturer, they have a reasonable expectation that the manufacturer will have regard to the legitimate interests of franchisees and the franchise system when exercising their rights under the agreement. It should be noted that while good faith requires a party to have due regard to the rights and interests of the other party, it does not require a party to act in the interests of the other party.<sup>37</sup> Neither does it prevent either a manufacturer or a dealer from acting in their own legitimate commercial interests.<sup>38</sup>

The good faith obligations are relevant to car dealers who make significant capital outlays on shop fit-outs and equipment towards the end of a franchise agreement. The Department of Industry, Innovation and Science (DIIS) consultations with industry stakeholders, submissions to the 2013 Review of the Franchising Code of Conduct conducted by Mr Alan Wein (Wein Review), and the current PJC Inquiry indicate that dealers would be undertaking those investments with the expectation of renewal of the dealership agreement.

A break down in this relationship can have a particularly large impact on new car dealers, given the scale of investment required to operate a new car dealership, with estimates provided in the range of \$6 to \$20 million, depending on the size and location of the dealership.<sup>39</sup> A break down in a franchising relationship can have negative impacts not only on the dealer, but also on staff, who may lose their jobs, and consumers, who may no longer be able to return to the dealership to have their car serviced.

The Franchising Code mandates disclosure so that prospective franchisees can understand the nature of the relationship they are entering into and the accompanying risks. Disclosure in itself may not be sufficient if the disclosure is not targeted and meaningful. Even where a franchisee is well advised and understands the agreement, as is often the case for new car dealers, they accede to the terms of a dealership agreement and undertake capital

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<sup>36</sup> *Competition and Consumer (Industry Codes—Franchising) Regulation 2014*, clause 6 (Ibid footnote 9).

<sup>37</sup> Australian Competition and Consumer Commission, *Acting in good faith*, accessed 21 November 2018 <<https://www.accc.gov.au/business/industry-codes/franchising-code-of-conduct/acting-in-good-faith>>

<sup>38</sup> ACCC (Ibid footnote 37).

<sup>39</sup> ACCC, p. 79 (Ibid footnote 1).

expenditure in accordance with the franchisor's directions because of the significant sunk costs of having aligned themselves with one brand.

Consistent anecdotal evidence indicates that there are three main problems in the context of dealer agreements – negotiating end of term arrangements, the capacity to recoup capital expenditure and dispute resolution. An important factor that drives these problems in the new car retailing industry is the significant upfront capital investment involved in establishing new dealership facilities.

#### *End of term arrangements*

Under the Franchising Code, a franchisor must provide at least six months' notice if it intends to not renew the agreement. Given the scale of investment involved in establishing a dealership, 12 months' notice is suggested by dealer representatives as a more adequate period of notice rather than six months' notice<sup>40</sup> for a car dealer to manage the non-renewal of its agreement. For example, a dealer may find it difficult to repurpose its facilities or find an alternate franchise in this time.

While statistics on the number of agreements not being renewed are unavailable, media reporting of Holden's decision to not renew up to 30 dealer agreements suggests that not renewing 30 agreements is not a regular occurrence and tends to be precipitated by strategic reviews undertaken by car manufacturers. Given this, the number of dealer agreements not renewed annually is fairly low (noting that there are over 1500 car dealers in Australia).<sup>41</sup> However, whilst the number of agreements not renewed may be low, the impact on those dealers whose agreements are not renewed is likely to be significant. There are also significant impacts within regional areas where dealerships contribute to employment and ensure consumers' access to local services.

Car dealers, through the industry representative the AADA, have also expressed concern that there is an increasing trend of manufacturers issuing non-renewal notices to dealers that have met or exceeded their performance targets and are not in breach of the dealer agreement.<sup>42</sup> Unlike termination for breach, a manufacturer is not required by the Franchising Code to provide a dealer with reasons for issuing a non-renewal notice. Non-renewal without cause is of particular concern for dealers who have undertaken capital expenditure towards the end of a franchise agreement. Non-renewal without being provided a reason (which is allowed under

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<sup>40</sup> AADA 2018, p. 4 (Ibid footnote 32), MTAA 2018, Submission to the PJC Inquiry, p.19.

<sup>41</sup> Turnbull, Samantha; MacKenzie, Bruce; Shoebridge, Joanne (Ibid footnote 34); AADA 2018, p. 3 (Ibid footnote 32).

<sup>42</sup> ACCC, p. 80 (Ibid footnote 1).

the Franchising Code) makes it more difficult for a dealer to assess whether the manufacturer has exercised its right to issue a non-renewal notice in good faith, as required by the Franchising Code.<sup>43</sup>

### *Capital expenditure*

The Franchising Code places restrictions on when a franchisor can require a franchisee to undertake significant capital expenditure. Capital expenditure can only be required of franchisees if:

- it is disclosed through the regular disclosure process;
- if it is agreed to, or approved by, the majority of franchisees;
- the expenditure is required to comply with legal obligations; or
- the franchisor considers the expenditure necessary and can be justified by a rationale for the investment, an explanation of the amount of the expenditure, the anticipated outcomes and benefits and the expected risks for making the investment.

Dealers' concerns with disclosure of capital expenditure is twofold. Firstly, both the AADA and the ACCC in submissions to PJC Inquiry note franchisors are disclosing very broad ranges of estimated expenditure. \$50 000 to \$50 000 000 in the case of car manufacturer franchisors and \$5000 to \$350 000 in the case of a franchisor subject to a compliance check by the ACCC. Secondly, as noted in the AADA's submissions, dealers have a propensity to accede to car manufacturers' request to undertake capital expenditure even if there is doubt as to whether that outlay can be recouped during the term of a dealership agreement because of an expectation that the dealer may be offered another term. This expectation may also arise given the relational and ongoing nature of the franchising relationship. The ACCC in its submission to the Wein Review also outlined a scenario where a franchisee may undertake an expensive shop fit-out towards the end of a dealership agreement in the expectation of renewal but the agreement is then not renewed.<sup>44</sup> While there are existing provisions within the CCA to which the franchisee may have recourse, such as unconscionable conduct, pursuing a remedy through dispute resolution or litigation is expensive.

### *Dispute resolution*

The Franchising Code enables either party to an agreement to initiate mediation, which is an informal dispute resolution mechanism. While this mechanism is available, some dealers are

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<sup>43</sup> ACCC, p. 80 (Ibid footnote 1).

<sup>44</sup> Australian Competition and Consumer Commission 2013, [2013 Review of the Franchising Code of Conduct: Supplementary information to ACCC submission](#), 8 March 2013, p. 2.

hesitant to utilise these provisions for fear of commercial retaliation by car manufacturers. For example, the Office of the NSW Small Business Commissioner (OSBC)<sup>45</sup>, has stated that '[f]ear of retaliatory action has been cited...by many dealers as a deterrent in proceeding to formalise their complaints and seek remedies for unfair contracts and unjust conduct in relation to manufacturers' supply contracts under the' *Motor Dealers and Repairers Act 2013* (NSW) (MDRA). This fear would similarly apply to matters governed under the Franchising Code.

The Franchising Code does not expressly state that mediators may undertake multi-franchisee mediation when disputes of a similar nature arise within a franchise system. At present, multi-franchisee mediation is possible under the Franchising Code with the agreement of the franchisor – unless this would be seen to be anti-competitive. A lack of an express statement within the Franchising Code allowing multi-franchisee mediation could be limiting car dealers' ability to collectively initiate mediation with car manufacturers, which is one way to limit the impacts of the power imbalance between dealers and manufacturers when resolving disputes.

## 5. Why is Government Action needed?

### Existing coverage of motor vehicle dealers by franchising regulation

The operation of the franchising sector and the high level of disputation between the parties to a franchise agreement has been a concern for successive Governments since the mid-1970's. Independent research commissioned by the Franchise Code Council in 1996 indicated 13 per cent of franchisors were in litigation or had a court action in place with one of its franchisees.

In 1998, the Government introduced the Franchising Code of Conduct as a mandatory code, enforceable under the then *Trade Practices Act 1974* (now the *Competition and Consumer Act 2010*). In introducing the Franchising Code, it was noted that the high levels of disputation and litigation in the sector arise from the fundamental nature of franchising arrangements, which differ significantly from other business ventures. As discussed above, the nature of franchising means that the power imbalance favours the franchisor, as does the information asymmetry.

While some common features of franchising may be missing within automotive franchising, such as payment of royalties, motor vehicle dealers are covered by the Franchising Code

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<sup>45</sup> Office of the NSW Small Business Commissioner 2016, [Submission to the ACCC's October 2016 New Car Retailing Industry Market Study \(Issues Paper\)](#), OSBC, 22 November 2016, p. 1.

since it is recognised that dealership agreements and the relationship between dealers and car manufacturers were characterised by other features common within franchising, namely the power imbalance and information asymmetry which favours franchisors.<sup>46</sup>

Car manufacturers are able to stipulate capital outlays, for example shop fit-out requirements and equipment to be held by car dealers. In addition, there are information asymmetries between car manufacturers and new car dealers with car manufacturers typically holding greater information about the long term strategy for the brand and the overall health of the entire dealer network. For example, an individual dealer may consider that its performance is sound, but from the manufacturer's perspective, the dealer may be the weakest link in an at risk market that may require downsizing in order to ensure the health of the overall network. This information asymmetry can have adverse effects on dealers, particularly when they undertake significant capital expenditure, such as purpose built facilities to showcase cars in line with the manufacturer's preference.

### Ongoing issues for car dealers

Although it has been a longstanding intent of the Franchising Code to address issues in automotive franchising, many of the problems identified within the 1997 Report are recurrent in subsequent inquiries. The Wein Review specifically canvassed franchising issues for automotive dealers and recommended an analysis of the impact of a minimum term and standard contractual terms for motor vehicle agreements prior to a future review of the Franchising Code. The ACCC in its market study also recommended issues raised by dealers relating to the imbalance of power in their commercial arrangements with manufacturers, such as insecure tenure and significant capital outlays expected of dealers, be examined further. As the existing provisions of the Franchising Code and industry action to date have not been able to address matters over insecurity of tenure, end of term arrangements when dealership agreements are not renewed and dispute resolution over end of term arrangements, further government action is warranted.

An important consideration in formulation of possible policy responses to identified concerns is the existing policy framework for the Franchising Code which provides for disclosure to assist franchisees but does not dictate how the dealership agreement must end or what will happen when it does. This is in keeping with some basic principles of contract law – firstly, that a franchise agreement is a contract between two parties; secondly, that the parties to any contract are, by-and-large, free to negotiate the terms of the agreement themselves; and, thirdly, that the law will not force parties to engage in contractual relations against their will.

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<sup>46</sup> See the House Standing Committee on Industry, Science and Resources, *Finding a balance: Towards fair trading in Australia*, May 1997.

The policy underpinning the Franchising Code has been reiterated in Government responses to previous inquiries and reviews of the Franchising Code. Any policy responses discussed below which may be contrary to the existing policy framework of the Franchising Code or contrary to the competition principles underpinning the CCA are flagged as such.

## 6. Options

### 1 – Status Quo

Under this option, no regulatory changes would be made and new car dealers and car manufacturers would continue to be subject to the existing provisions in the Franchising Code (which are summarised in Appendix 2). If any amendments were made to the Franchising Code in response to the PJC Inquiry, those amendments would also apply to dealer agreements.

Unless any Government response to the PJC Inquiry were to address the identified problems, without further action car dealers would continue to face problems negotiating end of term arrangements, in gaining meaningful disclosure on, and recouping, capital expenditure and dispute resolution on end of term arrangements.

#### *Net benefits*

While this option would have no regulatory impact, it is not the preferred option as it would not address the problems identified in this RIS.

### 2 – Regulatory Intervention

Under this option, the Government would make regulatory changes to address the issues identified in the problem section of the RIS. The regulations would be mandatory, applying to all car manufacturers and new car dealers. Different ways of implementing these options are discussed in Chapter 8 which includes amendments to the Franchising Code or through a standalone code of conduct for the automotive industry. This chapter includes a number of sub-options, each of which are considered individually, but if chosen, would be implemented via Government action.

#### **Option 2A – 12 month notice periods**

Under the Franchising Code, if a franchisee intends to not renew the agreement they must provide the franchisee notice of their intention to not renew at least six months prior to the end of the agreement.

To provide new car dealers with time to consider how to manage their affairs at the end of their agreement, this option would require 12 months' notice be provided, rather than six months. The new obligation would only apply to an agreement with a term greater than 24 months. In its consultations, DIIS heard anecdotally that automotive industry practice might be for nine months' notice prior to non-renewal. The MTAA supported 12 months' notice in its submission to the PJC Inquiry.

#### *Impact on car dealers*

Requiring longer notice periods for non-renewal would provide car dealers with more time to arrange their affairs in the event their agreement is not renewed. For example, it would provide dealers with additional time to:

- search for a new franchisor;
- sell the site; or
- where they operate multi franchise arrangements, reconfigure their site to focus on their remaining brands after the agreement expires.

It would also provide staff opportunities to look for alternative sources of employment where the end of the agreement causes the dealership to close down and it would provide time for the dealer to contact consumers to inform them that the dealership can no longer service their vehicle (where this is the case).

Having longer notice periods will also reduce the likelihood that dealers will undertake capital expenditure that they are unable to recoup, as a car dealer is unlikely to undertake capital expenditure during the 12 month period where they know the agreement will not be renewed. Alternatively, where a dealer decides upon receiving the notice of non-renewal to switch to another franchise at the end of the agreement, they may be able to undertake the capital expenditure in a way that means that the new facilities can be more easily repurposed to be used for another brand.

More broadly, even if an agreement is eventually renewed, the uncertainty inherent in short notice periods for non-renewal could affect the decision making of new car dealers in running their business. For example, a car dealer may choose to invest further in the business if it has certainty that the car manufacturer will not issue a non-renewal notice six months after a major outlay of capital.

### *Impact on manufacturers*

Having longer notice periods will require manufacturers to make decisions regarding whether to renew an agreement earlier, potentially reducing their flexibility to not renew an agreement. Manufacturers will also find it more difficult to require a dealer to undertake capital expenditure during the period between 12 months and six months out from the end of the agreement when they intend not to renew the agreement. Manufacturers would still have the ability to set the terms of a new agreement or not renew the agreement.

### *Net benefit*

This option would provide car dealers with additional certainty and, where an agreement is not being renewed, provide them with more time to prepare for the end of the agreement. Whilst car manufacturers would have less flexibility and have to make decisions at an earlier point in time, they would still have the ability to not renew an agreement. The cost incurred by new car dealers, in terms of winding down a business or negotiating a new dealership agreement (particularly if there is a gap between agreements), would outweigh the business costs incurred by car manufacturers. As such, this option is expected to have a positive net benefit.

### *Regulatory burden*

<b>Total Option 2A Costs - Average annual regulatory costs (ten years)</b>				
Change in costs (\$ million)	Business	Community organisations	Individuals	Total change in cost
Total, by sector	\$0.18			\$0.18

Regulatory burden would be incurred by manufacturers who would need to draft new terms into agreements entered after the commencement of this option.

The regulatory burden calculation assumes that it would take a lawyer one hour to draft a clause in new dealer agreements at a cost of \$500 per hour. This cost would be incurred for all 3500 dealerships once.

The regulatory burden calculation assumes that:

- it would take a lawyer one hour to draft a new clause for each dealer agreement;
- each agreement for all 3500 dealerships would need to be updated; and
- the cost would be incurred once.

Question for stakeholders:

1. What is standard industry practice for non-renewal, is it longer than the minimum six months required under the Franchising Code?
2. How long does it take to negotiate new franchise arrangements with a different car manufacturer?
3. It has been put to us that 12 months is considered to be a more adequate length of notice for non-renewal. Is this optimal or is there a more optimal period of notice for non-renewal?
4. Would the benefit to car dealers of an extra six months' notice outweigh the costs to manufacturers of having to make business decisions further out than the prescribed six months? Why/Why not?
5. Would increased education and awareness of existing pre-disclosure and notice periods for non-renewal support dealers undertake their due diligence and highlight the risks of non-renewal?

### **Option 2B – Franchisors to provide reasons for non-renewal**

Unlike termination for breach, a manufacturer is not required by the Franchising Code to provide a dealer with reasons for issuing a non-renewal notice. To support the existing obligation under the Franchising Code for parties to a franchise agreement to behave in good faith, this option would involve amending the Franchising Code to provide that franchisors must provide reasons for non-renewal.

#### *Impact on car dealers*

This option would make it easier for a dealer to assess whether the manufacturer has exercised its right to issue a non-renewal notice in good faith, with a duty of good faith being an existing requirement under the Franchising Code.

While this option by itself would not address the other issues faced by dealers upon non-renewal, such as organising their affairs and looking for alternative dealership agreements, it would be conducive to building a better dialogue between the parties to the franchise agreement to enable dispute resolution on end of term arrangements.

#### *Impact on manufacturers*

This option would hold manufacturers to greater legal account on their decision to not renew franchise agreements, which may lead them to incur compliance costs if they are found to be acting contrary to their legal obligations. However, providing reasons may also benefit them if it results in speedier dispute resolution through a better dialogue with their franchisees.

#### *Net benefit*

This option would provide car dealers with additional certainty about good faith dealings by their franchisors and could assist with dispute resolution where an agreement is not being renewed. Car manufacturers would be held to greater legal account and would need to take time, and incur costs, to provide reasons for non-renewal. However, a manufacturer would still be able to not renew a contract and the benefit to the car dealer in gaining assurance that the car manufacturer has exercised its decision in good faith would likely outweigh the possible detriment to the manufacturer. As such, this option is expected to have a positive net benefit.

### *Regulatory burden*

<b>Total Option 2B Costs - Average annual regulatory costs (ten years)</b>				
Change in costs (\$ million)	Business	Community organisations	Individuals	Total change in cost
Total, by sector	\$0.00*			\$0.00*

\*Figure rounds to zero. Actual amount is \$5,000 per year.

Regulatory burden would be incurred by manufacturers who would need to allocate time and communicate through writing to car dealers on reasons for non-renewal.

The regulatory burden calculation assumes that:

- it would take a lawyer two hours to draft a non-renewal notice each time an agreement is not renewed at cost of \$500 per hour;
- that five agreements are not renewed annually; and
- that car manufacturers would already undertake an assessment as to why a dealership is not being renewed, so the information in the notice would already be prepared in the absence of the obligation to provide a notice to the dealer.

Questions for stakeholders:

6. Is it common practice for car manufacturers to explain to dealers why their agreements are not being renewed?

### **Option 2C – Stock buy-backs**

Under this option dealer agreements would be required to include a stock buy-back provision in the context of non-renewal of dealer agreements. The provision would provide that the price of the stock would, in the first instance, be agreed between the manufacturer and the new car

dealer. It is intended that the price of the stock would be negotiated by the parties after the notice of non-renewal is served. Noting that parties would still be obliged to act in good faith during negotiations. If an agreed price cannot be reached, then the value will be determined by a valuer, appointed by the parties.

Car dealers amass stock worth significant monetary amounts and have highlighted the importance of dealer agreements providing for end of term arrangements that allow them to recoup their investments. This stock includes new cars and demonstrators, as well as parts and special tools.

Currently, the Franchising Code does not specify the end of term arrangements that should apply between dealers and car manufacturers. In line with the general principles of contract law, the Franchising Code allows distributors and dealers to negotiate terms that best suit their circumstances. This includes making provisions for the buy-back of stock.

Some existing dealer agreements do require manufacturers to buy back stock when an agreement expires or terminates, however, not all agreements contain these provisions. According to the AADA, typically the manufacturer has discretion as to whether these buy back provisions are exercised.<sup>47</sup>

Given that currently manufacturers must provide at least six months' notice before not renewing an agreement, car dealers may also have an opportunity to run down their stock. However, dealers also have obligations to actively sell vehicles and maintain levels of stock. Dealers will also have special tools and equipment for servicing particular types of vehicles. Given the ongoing concerns associated with stock buy backs, it appears that car dealers are unable to run down stock when an agreement is not being renewed, even if notice is given.

### *Impact on car dealers*

This option would reduce the costs to car dealers of an agreement expiring potentially increasing their bargaining power with manufacturers.

For example the MTAA<sup>48</sup> asserts that, even when amicable, end of contract events can result in significant disadvantage to new car dealers which impact closing profits across new car

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<sup>47</sup> AADA 2017, [Australian Automotive Dealer Association submission to the ACCC issues paper](#), AADA, 19 October 2017, p. 3.

<sup>48</sup> Motor Trades Association of Australia 2018, *MTAA Limited Submission to the Parliamentary Joint Committee on Corporations and Financial Services on the operation and effectiveness of the Franchising Code of Conduct*, May, MTAA, p 18.

dealership operations. Aside from its vehicles, the MTAA<sup>49</sup> noted that a dealer may have over a million dollars of parts in stock, which are needed for: counter sales to members of the public; account sales (to, for example, independent repairers); and as workshop/service stock. The MTAA<sup>50</sup> also identifies that larger dealerships will have much larger stock holdings, and may also supply parts to smaller dealerships.

The MTAA<sup>51</sup> also explained that in the servicing area of the business, the dealer is required to purchase a range of specialist equipment and tools as specified by the car manufacturer. In particular, car dealers in regional areas will be affected as many may not need to use the specialist equipment due to the type of cars typically sold in those areas.<sup>52</sup> As these tools are owned by the dealer, they are usually not part of end of term arrangements.<sup>53</sup>

#### *Impact on car manufacturers*

Mandated buy-back of stock arrangements may negatively affect a car manufacturer's ability to control its network and respond to changing economic conditions due to increased end of term costs placed on the car manufacturer.

While there would be costs associated with buying back stock, this would be offset by manufacturers' ability to re-sell the stock. Given that the majority of the stock would be new vehicles that have not yet been driven, if the manufacturer were to repurchase the stock at the price paid by the dealer, they would likely be able to sell the stock for the same price to another dealership or to fleet buyers.

#### *Net benefit*

This option would be contrary to the existing policy framework for the Franchising Code, competition principles underpinning the CCA and general principles of contract law since it would be seeking to impose particular commercial terms on two parties to a contract rather than let the parties to the contract or the franchise agreement determine the terms that best suit them.

This option would reduce the commercial pressure and risk on new car dealers, however, it would greatly increase the costs of compliance for car manufacturers, which may have flow on pricing increases for car dealers and consumers. This may prolong contract negotiations

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<sup>49</sup> MTAA 2018 (Ibid footnote 48).

<sup>50</sup> MTAA 2018 (Ibid footnote 48).

<sup>51</sup> MTAA 2018 (Ibid footnote 48).

<sup>52</sup> MTAA 2018 (Ibid footnote 48).

<sup>53</sup> MTAA 2018 (Ibid footnote 48).

and restrict the ability of both parties to enter into contracts with terms that would adequately meet both parties' needs.

As a result, it is likely that this option would not have a positive net benefit.

### *Regulatory burden*

<b>Total Option 2C Costs - Average annual regulatory costs (ten years)</b>				
Change in costs (\$ million)	Business	Community organisations	Individuals	Total change in cost
Total, by sector	\$10.5			\$10.5

Regulatory burden would be incurred by car manufacturers who would be required to buy back stock they would not otherwise be required to purchase. In practice, some of this burden would be offset to the extent that the manufacturer is able to re-sell the stock it has bought from the dealer. This offset has not been included when calculating the regulatory burden.

The regulatory burden calculation assumes that:

- the average dealership has around \$2.1 million in stock and equipment remaining at the end of an agreement.<sup>54</sup>

Questions for stakeholders:

7. Are car dealers able to run down their stock when they know an agreement is not being renewed?
8. How much stock would a dealer typically have remaining when an agreement is not renewed?
9. In what circumstances do buy-back arrangements generally apply in current agreements (for example, at non-renewal, termination by agreement)?
10. To what extent do dealerships trade stock with other dealership businesses to address the issue of excess stock upon cessation of a franchise agreement?
11. To what extent do manufacturers buy-back stock upon the conclusion of a dealership agreement?
12. To what extent would mandating buy-back options deter manufacturers from signing dealership agreements?

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<sup>54</sup> Estimate based on new car sales data provided by FCAI, industry stakeholder estimates of 65 as the average number of days new car stock is held and 3500 dealerships.

## **Option 2D – Enhanced capital expenditure disclosure**

Under the Franchising Code, a franchisor is only able to require a franchisee to undertake significant capital expenditure in limited circumstances. One of those circumstances is where the expenditure was disclosed prior to entering into the franchise agreement (see Appendix 2 for a complete list of circumstances). DIIS has heard that some manufacturers can disclose extreme ranges of capital expenditure that may be required (e.g. \$50 thousand to \$50 million in establishment costs), making the disclosure effectively meaningless.

Under this option, automotive franchisors would only be able to require significant capital expenditure to be undertaken when that expenditure is disclosed with a high degree of specificity regarding the quantum, size and timing of the expenditure. To ensure the effectiveness of this obligation, a car manufacturer would no longer be able to rely on Clause 30(2)(e) of the Franchising Code, which enables a franchisor to require significant capital expenditure to be undertaken when justified by a written statement including certain information.

As discussed above, there exists an information asymmetry between car manufacturers and new car dealers with car manufacturers typically holding greater information about the long term strategy for the brand and the overall health of the entire dealer network. This information asymmetry has resulted in a market failure leading to sub-optimal outcomes for car dealers, particularly when they undertake significant capital expenditure, such as purpose built facilities to showcase cars in line with the manufacturers' preference. Disclosure of capital expenditure is not specific enough and there is insufficient regard for capital outlays undertaken by dealers which cannot be recouped during the term of the existing dealership agreement.

### *Impact on car dealers*

Short and uncertain tenure and poor disclosure practices provide manufacturers with the ability to apply commercial pressure to new car dealers to incur significant capital expenditure in the form of refurbishments, building new premises or relocating premises, the costs of which may not be able to be recouped during the life of the agreement.

Limiting car manufacturers' ability to require a dealer to undertake capital expenditure unless disclosed prior to entering into the arrangement with greater specificity and agreed to by the dealer will help to ensure that dealers only undertake capital expenditure that they consider to be in their interests. It will also encourage manufacturers to work with their dealer networks to develop capital expenditure plans that both parties support.

While manufacturers would not be able to force dealers to undertake capital expenditure, dealers may still feel compelled to undertake capital expenditure even if it cannot be recouped during the term of their agreement as a way of ensuring renewal of the franchise agreement. Thus, while this option may reduce the commercial pressure applied to car dealers to undertake capital expenditure, it would not eliminate it entirely.

#### *Impact on manufacturers*

Manufacturers would have reduced flexibility and requiring car dealers to undertake significant capital expenditure would require better planning, as they will have to provide a narrower indicator of range when it comes to capital expenditure. Under this option, manufacturers may need to plan significant capital expenditure programs either well in advance (so that they can be included in the relevant disclosure material) or in a way that gains dealers support for the proposed expenditure.

Importantly, as currently allowed under the Franchising Code, even where the expenditure is not disclosed, manufacturers would still be able to require significant capital expenditure to be undertaken where the expenditure will be incurred by a majority of franchisees and a majority of franchisees approve the expense. As such, a minority group of dealers will not be able to prevent expenditure that has the support of the majority of the dealer network.

#### *Net benefit*

This option would benefit car dealers by reducing the likelihood that they will be required to incur significant capital expenditure for which they have not planned. While manufacturers would find it more difficult to compel dealers to undertake significant capital expenditure through prior disclosure, they would still have a number of avenues to do so:

- the manufacturer could gain the dealer's support for the expenditure;
- the manufacturer could include the detailed disclosure when the agreement is renewed and require the expenditure to be undertaken early in the agreement; or
- if all franchisees are being required to undertake the expenditure, the manufacturer could seek to gain the support of the majority of franchisees.

Given that this option would benefit dealers but still provide a range of mechanisms via which manufacturers can require significant capital expenditure to be undertaken that they consider necessary, this option is likely to have a positive net benefit.

## Regulatory burden

Total Option 2D Costs - Average annual regulatory costs (ten years)				
Change in costs (\$ million)	Business	Community organisations	Individuals	Total change in cost
Total, by sector	\$0.70			\$0.70

Regulatory burden would be incurred by firms as new terms in dealership agreements would need to be drafted when dealership agreements are renewed. The regulatory impact would be incurred each time a dealer agreement is renewed, as required capital expenditure is likely to vary for each agreement.

The regulatory burden calculation assumes that:

- it would take a lawyer two hours to draft the capital expenditure disclosure part of an agreement each time an agreement is renewed.
- that on average dealership agreements last for five years (so all 3500 agreements would need to be renewed twice over a 10 year period).

Questions for stakeholders:

13. Do manufacturers typically determine what significant capital expenditure will be required prior to an agreement being entered into or is this a decision that is ordinarily made during the life of the agreement?
14. Generally, what is the monetary range for expenditure disclosed to car dealers? How common are wide expenditure ranges in disclosure documents? If wide expenditure ranges are provided, why are they provided?
15. What level of support and education is provided to dealers when entering into franchising agreements and during the contract, regarding capital expenditure requirements?
16. Are you aware of instances where dealers have expended significant capital expenditure towards the end of a dealer agreement which is in accordance with their agreement, but which they anticipate cannot be recouped? How far out from the end of the agreement are they undertaking this capital expenditure?
17. Can dealers undertake capital investments, for example build a showroom, so that it can be repurposed to suit another distributor's brand if their existing dealership agreement ends?
18. To what extent do the other provisions of the CCA, such as the unconscionable conduct provisions, provide remedies for dealers in situations where they have to outlay capital which cannot be recouped during the term of the dealership agreement?

19. The Franchising Code also prohibits franchisor imposed capital outlays during the term of the franchising agreement unless specific conditions are satisfied. How are these provisions utilised within the industry?

### **Option 2E – Minimum five year terms with right of renewal**

Under this option all franchise agreements between car manufacturers/distributors and their new car dealers would be required to have a minimum term of five years, with the franchisee having the option to extend the term of the agreement by an additional five years, provided they meet the requirements outlined in the agreement.

The intent of this option would be to provide car dealers with sufficient time to recoup significant capital investments they are required to undertake.

Stakeholder feedback indicates that the majority of dealer agreements currently have five year terms with the franchisor having the option to renew the agreement.<sup>55</sup> This option would be broadly consistent with current industry practice, but would provide the franchisee with the option to renew, rather than the franchisor.

An alternative option, which stakeholders are invited to provide feedback on, would be to link the term of a new agreement to the amount of capital expenditure undertaken.

#### *Impact on car dealers*

This option would reduce the pressure felt by car dealers to undertake capital investment due to fear of non-renewal of their dealership agreement. Further, where capital investment is undertaken, this option would provide car dealers with more opportunities to recoup their investments. Providing greater certainty of tenure would also assist dealers to make informed decisions as to whether to undertake capital expenditure, as they could make an assessment regarding whether they will be able to recoup their investments during the term of the agreement.

Providing longer tenure and a right of renewal would also lessen the commercial pressure on new car dealers to put the interests of manufacturers ahead of consumers in order to maximise the likelihood that their dealer agreement will be renewed.

Although having minimum five year terms with an automatic right of renewal would increase certainty for dealers, it would also lock them into a particular way of doing business. This could

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<sup>55</sup> AADA 2017, p. 2 (Ibid footnote 47).

result in dealers being required to continue to stock a brand that is not in demand due to changes in consumer preferences or technology and may reduce dealers' ability to innovate.

While having minimum tenure requirements may assist car dealers during the term of their agreement, in the transition to implement this option, some manufacturers may elect not to renew an agreement rather than be locked into a 10 year agreement.

For example, a manufacturer that was uncertain about the prospects of a particular dealership may have previously decided to enter into a three year agreement with the intention of reassessing the viability of the dealership at the end of the term. Instead such a manufacturer may decide to not renew an agreement, rather than be locked into what could potentially be a 10 year agreement.

#### *Impact on manufacturers*

As outlined previously, the franchising model is predicated on franchisor control over the use of its brand, including the geographic footprint of the brand. Having minimum five year tenure with an automatic right of renewal would curtail a manufacturer's ability to manage its network to maximise overall profitability of the brand and dealer network.

According to the Federal Chamber of Automotive Industries, the flexibility to manage the size of the overall network plays an important role in securing the health of the overall dealer network and the brands: 'The ability of the Distributor to manage the overall brand footprint in the market is a key to the health of all dealerships and the brand more broadly'.<sup>56</sup>

For example, in an area with 15 dealerships a manufacturer may determine that due to declining market share, it is no longer commercially viable to have more than 12 dealerships. In order to ensure the profitability of the brand and the entire dealership, the manufacturer may seek to reduce the number of franchisees in that area to 12 over time.

The ability to have flexibility in managing networks and in managing relationships with dealers will become increasingly important in the coming years as the new car retailing sector adapts in response to technological improvements and changes in consumer preferences. Having what could effectively be 10 year terms could lock in particular ways of doing business at a time when innovation and change will be required to adjust to changing business conditions.

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<sup>56</sup> FCAI 2018, p. 3 (Ibid footnote 24).

This option could also disadvantage incumbents relative to new entrants, by locking in particular networks of dealers, with new entrants having the flexibility to develop networks to suit the market conditions at the time.

*Net benefit*

Although this option would reduce the commercial pressure on new car dealers, it would restrict manufacturers’ ability to control the size and location of its dealer networks. It would also restrict both parties to enter into contracts with terms that meets their needs. In relation to the automatic right to renewal, this option could also force unwilling parties to enter into a commercial relationship, contrary to the existing principles of the Franchising Code and the CCA. This option could adversely impact consumers by reducing choice and the benefits of price competition. Given that option 3A is expected to address much of the harm associated with car dealers being required to undertake significant capital expenditure without many of the downsides associated with having minimum tenure, option 3B does not have the highest net benefit and is therefore not a recommended option.

*Regulatory burden*

<b>Total Option 2E Costs - Average annual regulatory costs (ten years)</b>				
Change in costs (\$ million)	Business	Community organisations	Individuals	Total change in cost
Total, by sector	\$0.35			\$0.35

This option has a relatively low regulatory burden but potentially has significant economic ramifications as discussed above. Regulatory burden would be incurred by manufacturers who would need to draft new terms in their agreements when the agreements are renewed for the first time following the implementation of this option.

The regulatory burden calculation assumes that:

- it would take a lawyer two hours to draft new provisions in dealer agreements at a cost of \$500 per hour.
- that all 3500 dealer agreements would need to be updated once.

Questions for stakeholders:

20. How would car manufacturers respond to the introduction of minimum terms?
21. Would dealers and manufacturers still have flexibility to respond to developments in technology and changing consumer preferences if agreements had minimum five year terms?

22. What would be the public benefits or detriment of providing minimum tenure and a right of renewal? For example, to what extent might it deter manufacturers signing agreements with dealers or accelerate consolidation of dealerships in particular regions or areas?
23. Would a longer notice period for non-renewal achieve a similar outcome to addressing concerns about minimum tenure and the need for franchisees to have certainty when it comes to business planning?
24. To what extent would minimum terms or a right of renewal prevent manufacturers from responding to changing market conditions and lock the parties into the existing business model?

### **Option 2F – Multi-party dispute resolution**

This option would explicitly allow franchisees to request multi-party mediation and enable mediators to undertake such mediation where multiple franchisees wish to dispute similar issues with a franchisor.

Currently, the Franchising Code provides mechanisms for parties to a dealership agreement to try and resolve disputes in a timely and cost effective manner; however, it does not expressly state that mediators may undertake multi-franchisee mediation when disputes of a similar nature arise within a franchise system.

The two dispute resolution mechanisms in the Franchising Code are that:<sup>57</sup>

- franchisors must have an internal procedure for handling complaints that meets certain standards set out in the code; and
- either party can request mediation which, once requested, becomes mandatory for both parties to attend and genuinely attempt to resolve the dispute.

The mechanisms in the code are a way to bring the two parties together to resolve the dispute in an informal manner. They are not a way to reach a binding solution and they do not affect a party's right to take legal action over a franchising dispute.

The Office of the Franchising Mediation Adviser (OFMA) reported that in the period from 1 January 2017 to 31 December 2017 there were a total of 288 requests for mediation filed with OFMA for which the Adviser appointed a mediator. Of these, mediation had begun in 266 matters and reports had been provided for 180 of these matters that had been completed during this period. In 149 of these matters, Mediators reported that they conducted a mediation, of which 119 were resolved at mediation.

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<sup>57</sup> *Competition and Consumer (Industry Codes—Franchising) Regulation 2014, Part 4.*

As stated previously, the OSBC<sup>58</sup>, has identified that dealers are reluctant to commence legal proceedings against a manufacturer due to concerns that doing so would cause irreparable damage to their commercial relationship, which is the paramount concern for the dealer.<sup>59</sup> By explicitly allowing for multi-franchisee mediation, it could empower new car dealers, through strength in numbers, to formalise their complaint and seek a resolution (particularly if the problem is systemic).

The Victorian Automobile Chamber of Commerce (VACC) compiled survey evidence which indicated that there 'is a perception in the automotive industry that all regulators are powerless or lack the resources to assist franchisees in disputes against large multinational franchisors.'<sup>60</sup> Multi-franchisee mediation may increase the pool of resources available to franchisees and thereby increase their perception of the potential success of mediation.

#### *Impact on car dealers*

This option is likely to benefit new car dealers because it will assist in equalising the imbalance of bargaining power between car manufacturers and new car dealers when resolving disputes and create a more efficient process and use of resources. The introduction of multi-franchise dispute resolution would also assist groups of dealers that are being consolidated due to the franchisor changing their geographic footprint.

Industry stakeholders representing new car dealers have suggested that the dispute resolution procedures set out in the Franchising Code are not working as intended. Industry stakeholders have noted that taking legal action to resolve a dispute can be costly and time consuming and often puts the franchisee at a disadvantage, given the greater resources of the franchisor. Stakeholders note that the costs associated with taking legal action can mean that franchisees do not have access to justice, particularly when the franchisor is unwilling to reach a solution that works for both parties.

Through undertaking multi-franchising mediation, new car dealers will be able to share resourcing and distribute the costs involved in undertaking the mediation. This will assist in making the dispute resolution process more cost effective and accessible, particularly to smaller dealers in regional areas.

#### *Impact on manufacturers*

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<sup>58</sup> Office of the NSW Small Business Commissioner 2017, [Submission on the draft report of the New Car Retailing Industry Market Study](#), OSBC, 6 September 2017, p. 2.

<sup>59</sup> ACCC 2017, p. 87 (Ibid footnote 1).

<sup>60</sup> Victorian Automotive Chamber of Commerce 2018, Submission to Parliamentary Inquiry into the Operation and Effectiveness of the Franchising Code of Conduct, VACC, 4 May 2018, p. 10.

By addressing issues in the one mediation process, it could potentially reduce legal costs and time spent mediating an outcome for car manufacturers. By not undertaking multi-party mediation a car manufacturer would be required to separately resolve each issue with each new car dealer thereby increasing time and costs.

However by increasing the accessibility of dispute resolution, it could increase the number of car dealers becoming involved in mediation which could potentially increase costs (associated with implementing outcomes from the mediation) for car manufacturers.

*Net benefit*

This option would create benefits for both new car dealers and car manufacturers. It would empower car dealers and allow them to share costs and resources, whilst car manufacturers would also have cost and time savings. Any increase in cost to the car manufacturer would be outweighed by the cost and resource savings experienced by the car dealer that is now able to access mediation.

*Regulatory burden*

Total Option 2F Costs - Average annual regulatory costs (ten years)				
Change in costs (\$ million)	Business	Community organisations	Individuals	Total change in cost
Total, by sector	Nil			Nil

Since this option involves a regulatory amendment to clarify the existing ability for franchisees to undertake multi-franchisee mediation, it is anticipated that there is no regulatory burden resulting from this change.

Questions for stakeholders:

- 25. Would an ability to enter into multi franchise mediation make car dealers more likely to utilise mediation as a means to resolve disputes?
- 26. Are car dealers generally aware of the existing dispute resolution procedures in the Franchising Code?

### 3 – Voluntary Code of Conduct

Under this option, the preferred proposals in option 2 would be implemented through a voluntary industry code of conduct, rather than by amending the existing Franchising Code or creating a mandatory Automotive Code of Conduct.

As outlined in the Final Report of the Taskforce on Industry Self-Regulation:

“Self-regulatory schemes tend to promote good practice and target specific problems within industries, impose lower compliance costs on business, and offer quick, low cost dispute resolution procedures. Effective self-regulation can also avoid the often overly prescriptive nature of regulation and allow industry the flexibility to provide greater choice for consumers and to be more responsive to changing consumer expectations.”<sup>61</sup>

However, the benefits of self-regulation can only be realised where it is effective at changing the behaviour of industry participants. Previous attempts at addressing the problems identified in this RIS suggest that a voluntary code of conduct is unlikely to be effective.

The mandatory Franchising Code of Conduct already has provisions dealing with end of term arrangements, capital expenditure and dispute resolution – the three key problems identified in this RIS. Despite the Franchising Code being mandatory and seeking to resolve these problems, the issues continues to persist with particularly significant impact on car dealers. Given this, it is unlikely that a voluntary code of conduct would be effective.

#### *Net benefit*

While this options would have a lower regulatory impact than option 2, due to being self-regulatory, given past experience with voluntary approaches to franchising regulation failing, it appears unlikely that Option 3 would effectively address the identified problems.

Question for stakeholders:

27. Would a voluntary code of conduct specific to the automotive industry be effective?

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<sup>61</sup> The Treasury 2000, [Industry Self-Regulation in Consumer Markets – Report prepared by the Taskforce on Industry Self-Regulation – Final Report](#), August 2000, p. 1.

## Regulatory burden summary table

Average annual regulatory costs (ten years)				
Change in costs (\$ million)	Business	Community organisations	Individuals	Total change in cost
Option 2A: 12 month notice period	\$0.18			\$0.18
Option 2B: Non-renewal notice	\$0.00			\$0.00
Option 2C: Stock buy backs	\$10.5			\$10.5
Option 2D – Significant capital expenditure disclosure	\$0.70			\$0.70
Option 2E – Minimum terms	\$0.35			\$0.35
Option 2F – multi party dispute resolution	Nil			Nil

The regulatory burden estimates only consider the costs associated with complying with the reform option and do not include opportunity costs. For example, the regulatory costs for Option 2E account for the costs of updating dealer agreements, but do not include estimates of the costs for manufacturers associated with lost opportunities as a result of an inability to restructure dealer networks. These broader costs and benefits, which are excluded from the regulatory burden estimate, underpin the assessment as to which options are preferred and which are not.

Questions for stakeholders:

28. Are the assumptions that underpin the regulatory costs reasonable?

29. What additional regulatory costs should be included?

## 7. Consultation

DIIS will undertake a public consultation process to explore the issues outlined in this RIS. The objective of the consultation process is to gather additional evidence and data on the extent of the problem and to seek views on the benefits and costs of the potential policy options.

The consultation process will consist of:

- a formal written submission process;
- an industry roundtable with peak bodies; and
- targeted face-to-face and telephone meetings with stakeholders.

DIIS will consult with a broad range of affected stakeholders and will encourage stakeholders to make submissions and share their views on the issues in the RIS. Of note, DIIS has consulted with, and will continue to engage with the Australian Small Business and Family Enterprise Ombudsman in the development of this policy.

Once the consultation process has concluded, a final stage RIS will be prepared prior to decision makers making a final decision.

DIIS may publish submissions on its website, unless the submission is marked as confidential.

## 8. Implementation

Implementation of the options identified in this RIS could be achieved via three methods.

The first method would implement the RIS options by amending the Franchising Code. This method would apply the RIS options to all franchises governed by the Franchising Code to benefit the broader franchising sector. There are approximately 73 000 franchisees and approximately 1180 franchisors in Australia, and an annual turnover in the order of \$131 billion.<sup>62</sup> There would be merits in implementation of the RIS options through this first method given that similar concerns about exit arrangements, capital expenditure and imbalance of power in favour of franchisors in dispute resolution has been raised within the wider franchising context as reflected in submissions to the PJC Inquiry. Notably, of the mediations conducted by OFMA in 2017 around 5 per cent relate to exit arrangements. In

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<sup>62</sup> Griffith University, Asia-Pacific Centre for Franchising Excellence, Franchising Australia 2012 pp 9-12.

addition, the ACCC's submission to the PJC Inquiry called for greater specificity in relation to capital expenditure disclosure by all franchisors, not confined to automotive franchising.

The second method would implement the RIS options as amendments to the Franchising Code and would apply specifically to dealer agreements. However, these amendments would be grouped together under a separate schedule under the title Automotive Code.

The third method would implement an Automotive Code separate from the Franchising Code, which will apply only to dealer agreements between new car dealers and car manufacturers.

Implementing the RIS options as amendments to the Franchising Code would provide for future consistency with the Franchising Code. For example, following the outcome of the Wein Review,<sup>63</sup> the Franchising Code was amended to introduce civil pecuniary penalties for breaching certain provisions of the Franchising Code, such as the then newly introduced good faith provision.<sup>64</sup> However these reforms were not implemented in the Oil Code, creating inconsistency between the two Codes.

### *Scope of the reforms*

The problems identified in this RIS and the evidence that supports the analysis in the options section relates to the relationships between new car dealers and car manufacturers. This is in line with the scope of the ACCC's market study, which looked at sales of new cars, defined as cars sold to Australian consumers that have not previously been registered. This definition includes passenger vehicles, four wheel drive vehicles and vans.

The Franchising Code currently applies to 'motor vehicle dealership agreements'<sup>65</sup> and a motor vehicle dealership is defined, in part as 'a business of buying, selling, exchanging or leasing motor vehicles...'.<sup>66</sup> The Franchising Code provides a broad definition of 'motor vehicle' that encapsulates not just cars but also other vehicles such as motorcycles, motorised farm machinery, aircrafts and motor boats.<sup>67</sup> This definition is significantly broader and the franchise relationships that exist in these other industries have not been assessed as part of this RIS. As such, the reform options outlined in this RIS, if enacted, are proposed to apply to franchise arrangements between manufacturers of new cars and their franchised dealers. The new obligations would only apply to dealer agreements entered into 12 months after the

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<sup>63</sup> Mr Alan Wein 2013, (Ibid footnote 12)

<sup>64</sup> [Explanatory Statement](#), Competition and Consumer (Industry Codes—Franchising) Regulation 2014.

<sup>65</sup> *Competition and Consumer (Industry Codes—Franchising) Regulation 2014*, clause 5(2).

<sup>66</sup> *Competition and Consumer (Industry Codes—Franchising) Regulation 2014*, clause 4(1).

<sup>67</sup> *Competition and Consumer (Industry Codes—Franchising) Regulation 2014*, clause 4(1).

commencement of the reforms. It is intended that the measures will be reviewed following implementation.

Questions:

30. If an automotive code is implemented, should it apply to a broader category of vehicles, rather than just new cars?
31. Are there any practical difficulties associated with only applying an automotive code to new car dealers? For example, are there franchise agreements that cover both new cars and motorcycles?

# Appendix 1: Australian retail automotive industry

The Australian car industry consists of three main sectors:

- Manufacturers (represented by distributors) – import vehicles to distribute to dealers and commercial fleet buyers. Distributors are typically wholly owned subsidiaries of foreign car manufacturers and act as links between foreign manufacturers and Australian dealer networks.
- Dealers – sell new and used cars to consumers and businesses. While large businesses often purchase cars directly from distributors, smaller businesses typically purchase vehicles from dealers. Dealers also provide a range of other services, including servicing and repair, aftermarket sales and finance and insurance services.
- Independent repairers – typically small, independent establishments that service a local area.

Figure 1 shows the supply chain for new car retailing in Australia. Around 1.2 million new cars were sold during 2016–17, including at more than 1500 new car dealers operating more than 3500 retail outlets. The Australian market contains 72 brands and 400 models.<sup>68</sup> Car dealer revenues in 2016–17 are estimated at \$64 billion. Australia is one of the most open, competitive and deregulated car markets in the world.<sup>69</sup> Industry participants face barriers to entry by way of access to capital, infrastructure and having a dealership agreement in place in the case of dealers but they are not generally restricted on the sales channels they employ.

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<sup>68</sup> AADA 2018, pp. 4-5 (Ibid footnote 32).

<sup>69</sup> IBISWorld Industry Report F3501 Motor Vehicle Wholesaling in Australia, May 2018, p. 30.

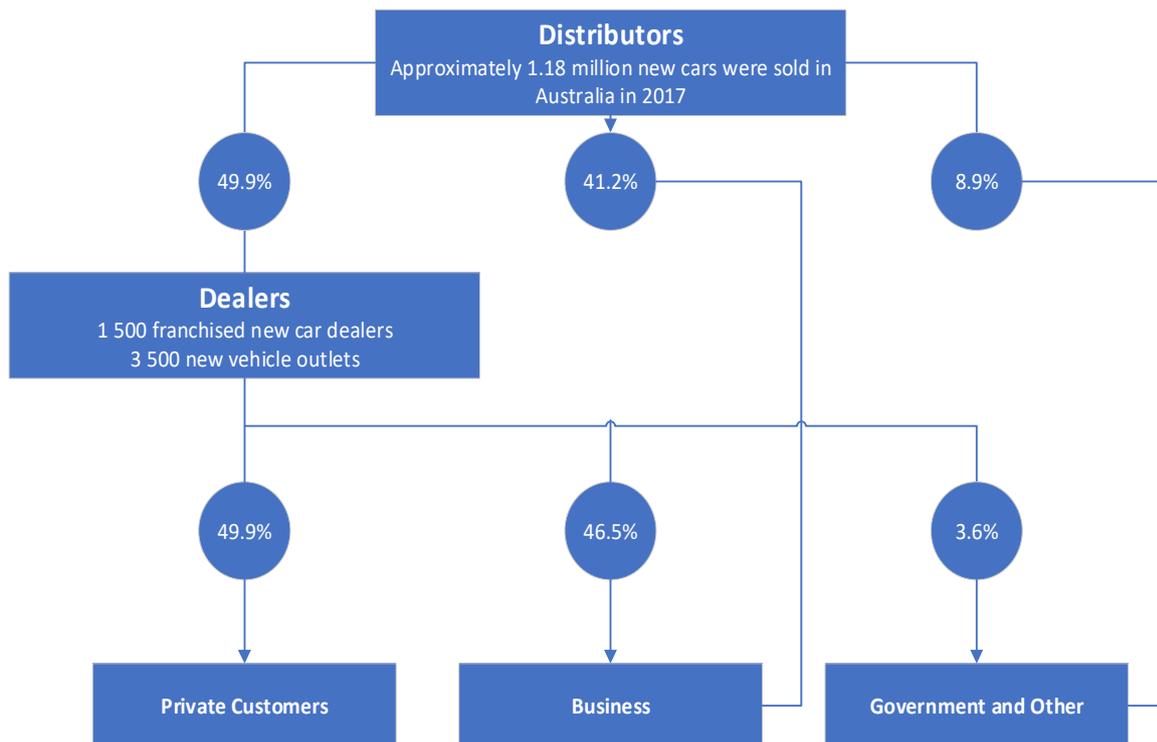


Figure 1: New Car Supply Chain.

Source: FCAI (VFACTS) motor vehicle sales data (as at December 2017); IBISWorld Industry Report F3501 Motor Vehicle Wholesaling in Australia, May 2018; *IBISWorld Industry Report G3911 Motor Vehicle Dealers in Australia*, April 2018.

Industry analysts predict automotive retail will shift from being product-driven to a customer-centric approach with key supply chain participants (manufacturers, dealers and independent repairers) garnering consumer loyalty through responding to consumer behaviour and expectations.<sup>70</sup> The move of Toyota New Zealand away from a traditional dealership to an agency model is illustrative of this shift (**Box 2** refers).<sup>71</sup>

Substantial change is currently underway globally and locally, and further change driven by the following factors is predicted.<sup>72</sup>

- Shifting consumer mobility preferences, such as increased demand for car-sharing services.
- Increased digitalisation, which is changing the way consumers purchase vehicles. Even where a vehicle is purchased at a dealership, much of the consumer's research is taking place online.
- Increased use of data analytics enabling car manufacturers and dealers to respond to changes in demand.

<sup>70</sup> [Innovating automotive retail, Journey towards a customer-centric, multi-format sales and service network](#), McKinsey, 2013; [Future of automotive retail](#), Ernst & Young, 2015.

<sup>71</sup> Maetzig, Rob 2018, [Toyota NZ ditches 'dealerships' for 'stores' in big changes to sales methods](#), Stuff, 29 March 2018.

<sup>72</sup> AADA 2017 p. 4 (Ibid footnote 13).

- Altered supply chains resulting from the cessation of motor vehicle manufacturing in Australia in 2017 and new free trade agreements.
- An increased consumer preference for automated, electric/hybrid vehicles and downsizing of internal combustion engines (ICEs) and increased use of complex computer systems which will change consumer servicing needs. Specialised equipment and new skills are required to service cars with complex computer systems and electric cars have fewer fluids and moving parts and require less servicing.

The MTAA, the national peak body for Australian automotive retail, service, repair and recycling industry states:<sup>73</sup>

*'The retail, service, repair and recycling sectors of the Australian automotive industry are expected to face significant adjustment, or complete restructure, in the short to medium-term. This will profoundly reshape business models, products and service provision and consumer/stakeholder relationships. As a result of this adjustment, some businesses will be forced to exit the industry, while others will need to adapt to seize opportunities for growth and long-term sustainability.'*

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#### *Box 2: Toyota New Zealand (NZ) agency model*

In March 2018 Toyota NZ announced moves away from a dealership model to an agency model where dealers are to become Toyota agents - called Stores - and they will be paid a fee to deal with customers. Vehicles will not carry recommended retail prices, which means there will no longer be any negotiation between dealers and consumers over price. Staff will be salaried product specialists and not commission-focussed sales people.

Toyota NZ intends to also continue to sell cars from dealerships and actually double the number of vehicles on yards but the stock at the stores will be demonstrators, and all cars purchased will then be delivered from one of its three hubs. Toyota states that the move was customer driven – customers can be assured about price transparency, do not have to feel like they have to bargain to get the best deal, recognises that most customers do on-line research before buying cars and expect the widest availability of choice and customisation.

Recent media coverage, submissions to the PJC Inquiry, and anecdotal evidence presented to DIIS in its one on one consultations has suggested that in response to increased competition distributors have made the decision to reduce their footprint in some areas of Australia. This has necessarily resulted in non-renewal of dealership agreements.<sup>74</sup>

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<sup>73</sup> MTAA 2018, [An industry at crossroads: Automotive 2018](#), MTAA, p. 2.

<sup>74</sup> Turnbull, Samantha; MacKenzie, Bruce; Shoebridge, Joanne 2017, (Ibid footnote 34); MTAA 2018 p. 5 (Ibid footnote 48).

# Appendix 2: Franchising Code obligations

## **Rights and obligations of parties under the Franchising Code**

### ***Pre-contractual rights***

#### *Disclosure*

Franchisors are required to disclose certain information and provide specific documents to prospective franchisees. These documents include:

- an information statement on the risks and rewards of franchising;
- a copy of the Franchising Code;
- a disclosure document; and
- a copy of the franchise agreement in its final form.

#### *Cooling off*

A prospective franchisee is entitled to a seven day cooling off period after entering into a new agreement or making any payment under the agreement, whichever occurs earlier. The cooling off period does not apply to transfers, renewals or extensions of an existing agreement.

#### *General obligation to act in good faith*

The Franchising Code contains an obligation for all parties to a franchise agreement to act in good faith towards one another in respect of any matter relating to their agreement or the Franchising Code.

The obligation to act in good faith also applies to parties who propose to enter into a franchise agreement.

### ***Rights and obligations during the agreement***

#### *Marketing fund*

If the franchisor operates a marketing fund, the franchisor must maintain a separate bank account for the fund and contribute to the fund on the same basis as other franchisees for each company owned store that a franchisor operates. Marketing and advertising fees may only be used to meet certain expenses.

If a marketing fund is used, the franchisor must prepare an annual financial statement for the fund. The annual financial statement must set out meaningful information about sources of income and items of expenditure.

The annual financial statement must also be audited by a registered company auditor, unless 75 per cent of the franchisees that contribute to the fund vote not to do so.

#### *General release*

A franchise agreement must not require a franchisee to sign a general release of the franchisor from liability towards the franchisee.

#### *Transfer*

A franchisee that wants to transfer an agreement must seek the franchisor's consent in writing. A franchisor must not unreasonably withhold their consent. The Franchising Code contains a non-exhaustive list of circumstances in which it would be reasonable for a franchisor to withhold consent.

Consent is assumed to be given by the franchisor after 42 days unless the franchisor advises the franchisee in writing that they do not consent.

#### *Restraint of trade*

A restraint of trade clause in a franchise agreement will have no effect when a franchisee has sought to extend their agreement and the franchisor does not agree and the franchisee:

- had sought to extend the agreement on substantially the same terms as those contained in the franchisor's current agreement that applies to other franchisees or would apply to a prospective franchisee; and
- was not in breach of their agreement or any related agreement; and
- had not infringed the intellectual property of the franchisor or breached any confidentiality agreements; and
- received only nominal, and not genuine, compensation for goodwill; or
- the agreement provided no avenue by which to claim compensation in the event it was not extended.

#### *Dispute resolution*

The Franchising Code provides mechanisms for parties to a franchise agreement to try and resolve disputes in a timely and cost-effective manner. The two dispute resolution mechanisms in the code are that:

- franchisors must have an internal procedure for handling complaints that meets certain standards set out in the code; and
- either party can request mediation which, once requested, becomes mandatory for both parties to attend and genuinely attempt to resolve the dispute.

The mechanisms in the code are a way to bring the two parties together to resolve the dispute in an informal manner, they are not a way to reach a binding solution and they do not affect a party's right to take legal action over a franchising dispute.

Parties must pay their own mediation costs and parties split the costs of the mediator equally.

#### *Significant capital expenditure*

A franchisor must not require a franchisee to undertake significant capital expenditure, which is not defined in the Franchising Code. However a franchisor can require franchisees to incur significant capital expenditure where the expenditure:

- was disclosed to the franchise in the disclosure document; or
- will be incurred by a majority of franchisees and a majority of franchisees approve the expense; or
- is necessary to comply with legislative obligations; or
- has been agreed to by the franchisee; or
- is considered necessary by the franchisee as a capital investment in the business, justified by a statement which sets out the:
  - rationale for making the investment;
  - amount of capital expenditure required
  - anticipated outcomes and benefits; and
  - expected risks associated with the investment.

#### *Non-renewal*

The Franchising Code does not require franchisors to renew a franchise agreement once it expires. However, if the term of the agreement is six months or longer, the franchisor must notify the franchisee at least six months before the end of the term of the agreement whether they intend to:

- renew or not renew the franchise agreement; or
- enter into a new agreement.