

Public Submission to the Treasury of the Australian Government for the Review of the Franchising Code of Conduct

Adiba Fattah, PhD candidate at University of the Sunshine Coast, School of Business and Creative Industries

Introduction

- I am grateful for the opportunity to submit my research to the Treasury of the Australian Government for the purpose of reviewing the Franchising Code of Conduct. I am a doctoral candidate at the University of the Sunshine Coast, School of Business and Creative Industries, where my research evaluates the franchising model in the Australian automotive industry.
- The relational nature of franchising in the Australian automotive industry (AAI) has experienced significant disruption in recent years. Allegations of power abuse and questionable control mechanisms have been raised by franchised dealers and their representatives, leading to intense public scrutiny of car manufacturers. While two car manufacturers have transitioned to a novel distribution model, the agent model, the remaining car manufacturers continue to rely on traditional franchising as the primary marketing channel for distributing their products and services to consumers.
- The research examines (1) the exercise of sources of power and control mechanisms by franchisors over their dealer network in the AAI, (2) evaluates stakeholders' perceptions of the franchising regulatory framework in overseeing the commercial relationships in the AAI, and (3) analyses the contractual arrangements between car manufacturers and their dealer network. Specifically, the research investigates how issues related to these three research inquiries are experienced differently by dealership groups based on their group size, dealership location, and market share of the brand(s) they are selling.
- The PhD thesis will be submitted as soon as the examination process is concluded.

Extension of regulatory to truck, motorcycle, and farm machinery. YES

- During the initial exploratory research phase, I conducted interviews with a diverse range of motor vehicle franchise dealerships, including motorcycle dealer principals. This extensive examination revealed that similar issues to those uncovered within new car dealership franchises are also prevalent in motorcycle franchises.
- Specifically, the data shows a prevalence of excessive exercise of coercive and non-coercive sources of power and unsustainable control mechanisms within motorcycle franchises. Additionally, it is noteworthy that the Franchising Code of Conduct, prior to its review in 2021, fell short in addressing the specific challenges inherent to the automotive sector. Moreover, the interviews conducted have revealed substantial congruence between motor vehicle and motorcycle dealerships in terms of operational, contractual, and regulatory issues within the franchising landscape. Specifically, these challenges pertain to warranty procedures, reimbursement and underpayment issues,

sales targets, Key Performance Indicator (KPI) bonuses, step programs, corporate identity and capital expenditure, stock and excess of stock accessibility, aftermath of non-renewal and termination, complications with dealer brand councils, and dispute resolution mechanisms.

- **Consequently, I propose an expansion of current and future regulations for motor vehicle dealerships to encompass the entire spectrum of the automotive industry, including new cars, trucks, motorcycles, and farms machinery.**

Service and repair work included in the franchise Code. YES

- In essence, the definition of a motor vehicle dealership as stipulated in the Franchising Code of Conduct imposes certain limitations on the regulatory framework, hindering its capacity to effectively address and adapt to the swift and transformative changes taking place within the automotive industry. To illustrate, in scenarios where an automotive manufacturer discontinues the sale of tangible products (i.e., new cars) through dealerships within a specific geographical region but continues to provide intangible products (such as servicing and repairs) via dealerships, this arrangement should still be recognised as a distribution arrangement. It is imperative to acknowledge that within the franchise sector, there exist numerous industries, including but not limited to financial services, healthcare services, education services, as well as beauty and personal care services, which primarily offer intangible products and heavily rely on the franchising model for both national and international expansion endeavours.
- Nevertheless, the current definition within the Code restricts motor vehicle dealerships solely to the "sale of motor vehicles," thereby falling short in its ability to adapt and safeguard franchisees against potential (1) future market withdrawals or (2) significant disruptions in the distribution of new vehicles.
- Expanding the scope of the motor vehicle dealership definition represents a critical proactive measure to effectively address forthcoming strategic shifts in distribution methods by automotive manufacturers, especially in light of the emergence of electric vehicles (EVs). This broader definition will play a pivotal role in mitigating the ramifications of separating the distribution of tangible and intangible products during the initial stages of EV expansion within the Australian market. It is foreseeable that certain car manufacturers may opt for diverse distribution models for future EVs. These models may include agency arrangements, online omnichannel platforms, company-owned channels, or a hybrid combination, all while retaining responsibility for servicing and repair operations within the framework of the dealer network. A shift in distribution channels within the traditional internal combustion engine (ICE) market can also be reasonably anticipated as ICE production phases out.
- **Amending the definition of motor vehicle dealerships will empower the regulatory framework to proactively respond to any future disruptions in the distribution channels within the Australian automotive industry.**

- Following the comprehensive review of the Code in 2021, a discussion paper was initiated to explore the issue of warranty and recall processes, as well as subsequent reimbursement within the Australian Automotive Industry (AAI). Regrettably, no substantial progress has been made in addressing this matter. Given the ongoing disruptions in distribution channels and impending changes to service arrangements, **it is imperative that regulators devote further regulatory attention to matters concerning traditional warranty repairs, product defects, recalls, and service-related issues within the broader automotive sector.**
- Despite the fact that dealers possess statutory right to seek reimbursement from car manufacturers for repairs pertaining to consumer guarantees, including warranty repairs, product defects, and recalls, important challenges in this domain persist. Empirical data from the research underscores the prevalence of problematic practices such as warranty extrapolation, substantive delays to source parts from car manufacturers, and underpayment of warranty repairs within the industry.
- Warranty extrapolation entails the withholding or denial of reimbursement to dealers for warranty-related repairs if they fail to adhere to the stringent warranty process requirements. Certain franchisors have gained notoriety for creating obstacles that hinder dealers from obtaining rightful compensation for warranty-related work, thereby fostering a climate where dealers may feel apprehensive about pursuing reimbursement for such activities due to concerns of potential retaliation. **The incorporation of provisions to ensure fair compensation for warranty, product defect, and recall reimbursements is not only a concern for consumers but also a critical aspect of franchisees' financial sustainability.**

Significant investments in capital expenditure and recoupment

- In the research, a comprehensive assessment of stakeholders' perspectives on the Code, both prior to and following its review in 2021, was conducted. This evaluation specifically focuses on the contentious operational facets of franchising within the AAI. Stakeholders have expressed a favourable perception of the existing regulatory framework concerning contract terms, which is designed to allow dealers reasonable time to recover their investments in capital expenditure. In summary, the ability to recover investments towards Corporate Identity is intricately linked to the profitability of dealerships. Over the past few years, dealership groups have experienced advantageous profit margins on new car sales, primarily attributable to pandemic-driven disruptions of the automotive worldwide supply chain. However, it is anticipated that these profit margins will revert to their customary range as the disruption eases. As a result, contracts may require adjustments to acknowledge these disparities and consider prevailing market conditions, ensuring the adequate recoupment of investments in capital expenditure.

Suppliers constraints

- Regarding franchisors' financial contributions to Corporate Identity initiatives, it is evident that their involvement primarily pertains to brand-related components. This

primarily covers signage costs, for which franchisors may share up to 50% of the expenses, which may or may not include installation costs. Some car manufacturers may also extend their contributions to cover aspects of interior decor such as tiles and furniture. However, it is noteworthy that certain car manufacturers impose a predefined cap on their contributions, typically up to 25% of the total cost, up to a specified threshold. Any expenses exceeding this capped value are the sole responsibility of the dealer. The study has classified car manufacturers into three distinct categories based on their Corporate Identity requirements and the extent of financial support, where applicable.

- The first category encompasses high-volume brands, characterised by well-defined identity standards that are updated approximately every decade. These brands also demonstrate consistent contributions to capital expenditures, typically ranging from 15% to 25%. The second category comprises aspirational brands that aspire to expand their market presence. These brands implement more frequent updates to their identity programs, occurring every 3 to 5 years. Their identity requirements are generally less stringent, and they provide varying degrees of support for capital expenditures. The third category pertains to low-volume brands that introduce more costly identity programs but offer limited financial support for capital expenditures.
- During the exploratory phase of this study, significant concerns were unearthed concerning the stringent supplier requirements imposed by franchisors with respect to Corporate Identity elements. **A critical issue arises from the absence of viable alternatives presented by car manufacturers to their dealers in the selection of material suppliers. This circumstance has the adverse effect of stifling pricing competition and subsequently leading to increased expenditures for material procurement.** It is also pertinent to note that car manufacturers frequently mandate dealers to engage overseas suppliers from the manufacturer's country of origin, further complicating the procurement process and cost dynamics.
- In order to address these issues, **I recommend that franchisors be mandated to provide dealers with access to a comprehensive range of suppliers, encompassing both local and international options, for their Corporate Identity materials.** This requirement would complement the existing legal obligation, as per the 2021 amendments to the Code, for franchisors to transparently disclose any rebates or financial incentives they receive from suppliers. This approach has the potential to effectively alleviate pricing challenges and empower franchisees to capitalise on a competitive marketplace environment.
- The disparities in Corporate Identity requirements and support among manufacturers underscore the necessity for regulatory measures aimed at safeguarding dealers and their substantial investments in franchisors' Corporate Identity programs. These regulations should be structured around the establishment of reasonable contractual terms, directly tied to dealers' profit margins.

Withhold of margin and future capital expenditure

- Research findings also shed light on the funding sources for capital expenditures, often referred to as redevelopment funds. These funds are typically generated through "margin repatriation" or "withhold margin" practices. The latter involves withholding a portion of dealers' earnings, often based on factors like the number of cars sold (volume-based), which is then reserved for future Corporate Identity requirements. Essentially, when capital expenditure becomes necessary, dealers already have a reserve they can tap into to partially finance these investments. The remaining capital is typically secured through finance companies, with dealers generally obtaining funding for capital expenditures from their chosen floorplan finance providers.
- It is critical to highlight that the practice of withholding margins for future program requirements has raised significant concerns, particularly with the introduction of Electric Vehicles (EVs) into the Australian market. International examples indicate that car manufacturers often use margin repatriation to shift the financial burden of costly new infrastructure required for EV sales and service onto dealerships. **Changes in distribution channels that impact dealers' profitability and ownership of their businesses, coupled with heightened dealer contributions towards EV infrastructure, are poised to create substantial challenges within the automotive industry.** A U.S. court case¹ from September 2023 reflects early stages of this pattern, underscoring the urgency of proactive regulatory efforts in Australia to mitigate these risks and ensure reasonable requirements towards capital expenditure of the automotive sector.

Regulatory standards relating to unilateral variations

During the Senate inquiry into the regulation of the relationship between car manufacturers and car dealers in Australia (formerly General Motors Holden Operations in Australia), extensive deliberations have focused on dealer agreements. Regrettably, the significance of the operations manual, also referred to as the dealer's manual or policy and procedures manual, has been somewhat overlooked in recent legislative amendments. In light of this, I respectfully propose that the forthcoming review of the Code incorporates provisions that encompass both dealer agreements and operations manuals. While the Code has commendably instituted enhanced regulations to address concerns related to unilateral retrospective modifications of franchise agreements, it regrettably neglects to address the matter of unilateral changes to the operations manual.

About the operations manual:

- The primary objective of operations manuals is to facilitate the transfer of knowledge and expertise from the franchisor to franchisees, while also establishing control mechanisms to ensure consistent operational practices and conformity within the

¹ A summary of this case is available on the link <https://mailchi.mp/gnyada.com/new-york-states-salary-transparency-law-927420?e=1369fa36d2> . The details of the court case and outcome can be found on https://mcusercontent.com/26aaaa2fc0e8e986dde700fb4/files/0883c696-d28f-b0d3-3032-63f4edbc289b/PREMIER_FORD_v_FORD_MOTOR_COMPANY_DECISION_Sept_2023_.pdf

franchise system. These manuals encompass comprehensive information on product or service offerings, sales and servicing procedures, advertising requirements, employee standards, showroom corporate identity, and other critical details essential for effectively running a franchise business. Their ultimate aim is to maintain uniform quality and value delivery to customers across all franchise units.

- Operations manuals are inherently dynamic, subject to regular updates and revisions within any given franchise system. Frequently, franchise agreements stipulate that franchisees must adhere to the guidelines outlined in these operational documents. However, due to their dynamic nature, these manuals can introduce high degree of uncertainty for franchisees. Consequently, operations manuals are perceived as powerful tools that grant franchisors significant authority, enabling them to exercise control over their franchisees without substantial limitations. **In the context of the AAI, I have observed that franchisors consistently and unilaterally amend operations manuals through bulletins and other online communications throughout the duration of the dealer agreement.**

Impact of changes to the operations manual

- Given the pivotal importance of the stipulations outlined in the operations manual, certain amendments can have a substantial impact on the profitability of dealerships. For example, car manufacturers may alter warranty obligations, audit processes, product and service profit margins, Key Performance Indicator (KPI) and KPI incentives, payment systems, procedures for unloading new inventory, or recruitment quotas. **These modifications can lead to unforeseen increases in operational and overhead costs for dealerships over the course of a contract.** The content of the operations manual plays an integral role in determining the profitability of a franchise business. However, **the current legal framework lacks adequate recognition of the significance of these documents within a franchise system. I propose that the Code should incorporate provisions that prevent essential requirements affecting dealers' commercial livelihood from being shifted from the contract to the operations manual.** Instead, such requirements should be subject to majority consent provisions, providing dealers with an opportunity for productive negotiation with the franchisor.
- Several U.S. states have taken specific measures to safeguard against unilateral changes to operations manuals. Some regulations have introduced thresholds for franchisor standards to ensure good faith in the exercise of operations manuals. Notable examples include the state of Connecticut, as per the General Statutes of Connecticut (Section 42-133), and the state of New Jersey, under the New Jersey Revised Statutes (Section 56:10-7). Meanwhile, in California, franchisees must provide prior consent for changes to be enforced, as outlined in the California Franchise Investment Law (Section 3110). Furthermore, court decisions in South Dakota and Minnesota have ruled against certain modifications to loyalty programs and fee-incurring programs (material changes) through the operations manual, instead mandating their disclosure in the franchise agreement, which inherently lacks dynamic characteristics (Bird Hotel Corp. v. Super 8 Motels, Inc., 2010; Bores v. Domino's Pizza LLC., 2007).

The importance of the dealer brand council

A growing number of franchisors are adopting a "divide and conquer" approach by denying dealers the opportunity to establish Dealer Brand Councils (DBC). DBCs play a pivotal role in enabling dealers to collectively unite and protect their commercial interests. My research reveals that a significant portion of participating dealership groups either lacks established DBCs or has seen their DBCs dismantled due to recent disruptions in the distribution channel, market exits, or the outsourcing of distribution activities to third parties. This trend is primarily attributed to automotive franchisors' reluctance to engage with DBCs, instead favouring one-on-one interactions.

Dealers heavily rely on DBCs to coordinate and facilitate negotiations for improved contractual terms and operational requirements. DBCs also serve as a rapid response platform for addressing concerns that can benefit from collective bargaining. As a unified entity, DBCs provide enhanced resources for negotiations compared to individual businesses. **The establishment of DBCs should not be subject to the approval of car manufacturers; it should be a fundamental right that empowers dealers with greater bargaining leverage against powerful car manufacturers, promoting a more balanced franchising dynamic.**

Adiba Fattah

PhD candidate

University of the Sunshine Coast

