December 4, 2014

Dear Governor-Elect Abbott, Lieutenant Governor-Elect Patrick, Speaker Straus and Members of the Texas Legislature:

We, the signatories of this letter, are professors of law, business, economics, and public policy with expertise in industrial organization, distribution, competition, intellectual property, and related fields at various institutions of higher learning in the State of Texas. We write to express our strong support for legislative efforts to modernize laws governing motor vehicle distribution to permit car companies like Tesla Motors to open up their own showrooms and service centers in Texas.

For the last several years, Tesla has been fighting on a state-by-state basis for the right to distribute its electric vehicles directly to consumers. In many states, it faces regulatory restrictions based on decades-old laws that were intended to protect franchisees from inequitable practices by manufacturers, but were never intended to prevent a car company from deciding to distribute its cars without using dealers. Under the current Texas law, Tesla cannot open its own showrooms or service centers. It can only have “galleries” where its staff is prohibited from even quoting a price to a potential customer.

There is no justification on any rational economic or public policy grounds for such a restraint of commerce. Rather, the upshot of the regulation is to reduce competition in Texas’s automobile market to the detriment of consumers. It is protectionism for auto dealers, pure and simple. And while the immediate target of such laws may be Tesla, it would apply equally to any other new entrant trying to bring an innovative new product to market.

We feel it is important to stress that we don’t have a stake in either side of this dispute. The value of our contribution arises from the independence of our position and our specialized knowledge, not about Tesla or Texas’s automotive market in particular, but about the way firms are organized, the way markets work and the economic consequences of the regulatory structure in which they operate. As we explain below, it is evident to us that the public interest is harmed by the regulatory prohibition on direct distribution of automobiles.

Our starting point is some basic observations on the economics of retail distribution. As a general matter, manufacturers face a decision about whether to distribute their goods through specialized retailers or directly to consumers. The superiority of either option for a particular manufacturer depends on a variety of idiosyncratic factors, and neither consumers, nor manufacturers, nor the economy as a whole is necessarily made better off in the abstract by one system or the other.
Some manufacturers choose to distribute through dealers because doing so is simply more efficient. The use of specialized dealers may enable a manufacturer to play to its comparative advantages in other areas, allowing it to achieve economies of scale or scope, diversify risk, or benefit from dealers’ local knowledge and relationships.

But for differently situated manufacturers, these advantages of the specialized dealer may be less significant, and they may be predominated by other issues that recommend direct distribution instead. Most significant among these, a manufacturer may determine that dealers will pay insufficient attention to service or promotion of the manufacturer’s long-term brand equity. Particularly in a case like Tesla’s, where the company is introducing a disruptive and unfamiliar technology, the incentives of the manufacturer and dealers may be difficult to align. While the manufacturer may need to make costly, upfront investments in time and money that will expand the new technology’s long-term acceptance, independent dealers may be ill-positioned to either assess or bear such a business strategy, and may be more focused on maximizing short-run sales. At the same time, the new technology may cannibalize revenues earned from sales of dealers’ other brands, exacerbating the costs to dealers of the manufacturer’s preferred business model and further diminishing their incentives to promote the new brand aggressively.

We pass no judgment on whether Tesla’s decision to bypass dealers and distribute directly is actually the best business decision for its particular circumstances. In fact, the essence of our concern with the current Texas regulation is our certainty that neither we nor the government is well positioned to make such a decision. Rather, it is a decision that Tesla is best-situated to make. And ultimately it is consumers who should decide whether they are happy doing business with a company that bypasses dealers or whether they would prefer to buy automobiles from established dealer networks. That is the way that markets are supposed to work.

Nevertheless, there is room for well-considered judgment that some regulatory constraint is likely necessary to protect consumers. And we have heard many arguments by the car dealers’ lobby about why the protection of consumer welfare requires that direct distribution be prohibited. But dealers, as well, are poorly-positioned to make such a determination – all the more so, in fact, because they are decidedly not impartial and their own interests are seemingly opposed to Tesla’s. It is perhaps not surprising, then, that every argument we have heard is unconvincing and inconsistent with our understanding of the economics of distribution.

First, the dealers claim that the direct distribution ban is necessary to break up a “monopoly” and to create price competition. This argument is absurd on its face. The automotive market in the United States (and Texas is no exception) is competitive; no manufacturer has anything like a monopoly. Tesla in particular, as an upstart new entrant, has nothing like a monopoly.

But even if Tesla did have a degree of market power sufficient to extract monopoly prices, prohibiting direct distribution would not be likely to introduce more competition or lower
average prices. A hypothetical monopolist Tesla could still fully exploit its market power because it would still set the wholesale price. At the same time, the company would have no greater ability to increase its profits by charging a retail monopoly mark-up, whether distributing its cars directly or via specialized dealers. In fact, doing so would actually reduce Tesla’s sales and profits. Instead, Tesla’s incentives would be to obtain the most cost-efficient form of distribution, which would increase the sales of Tesla’s cars and hence Tesla’s profits. Thus, as the Supreme Court has repeatedly explained, the interests of consumers and manufacturers are aligned on the question of whether goods should be given a monopoly mark-up at retail. Such a mark-up may be in the interests of the dealers, but not the manufacturer or consumers. Thus, if there is any public policy concern here, it should be directed at dealers attempting to use regulations to carve out the ability to restrict competition despite manufacturers’ incentives to ensure that retail prices remain competitive.

We would also note that the dealers’ argument here is contrary to economic studies and the dealers’ own admissions. In a 2009 study, the Justice Department found that direct distribution could save consumers over $2,200 per vehicle on average. And when the dealers have brought court actions against Tesla in other states, they have argued that they have legal standing because the prices a directly distributing car manufacturer would charge at retail are too low, not too high.

Second, the dealers have argued that the ban is necessary to ensure that car buyers receive adequate levels of service in aftermarkets. This argument is similarly unfounded. Automobile manufacturers make considerably greater investments in their brands than do individual dealers. As a result, manufacturers have considerably greater incentives to preserve their brands’ long-term reputation, including by offering appropriate aftermarket service. Tesla is investing billions of dollars not only in car technologies, but also in battery-swap and charging infrastructure. It will never be able to recover those investments if customers receive sub-par service and fail to become loyal to its brand and technologies. Tesla needs no coercive intervention by the government to make adequate arrangements for aftermarket service.

Third, and finally, dealers have argued that the ban is necessary for consumer safety, because dealers have unique incentives to service safety recalls. They argue that safety recalls are a cost to the manufacturer but a revenue opportunity for dealers, and hence that dealers will be more amenable to servicing safety recalls. But this argument is also unfounded, because dealers don’t make the decision to issue safety recalls. That decision is made by the manufacturer and the National Highway Traffic Safety Administration. Once the decision is made, the manufacturer has as much incentive to provide service to comply with recalls as dealers do. The dealers have pointed to recent recall failures with respect to GM, but those events do not support the dealers’ argument, since all of those failures occurred in circumstances where GM was distributing through dealers.
In sum, we have not heard a single argument for a direct distribution ban that makes any sense. To the contrary, these arguments simply bolster our belief that the regulations in question are motivated by economic protectionism that favors dealers at the expense of consumers and new technologies. It is discouraging to see this ban being used to stifle innovation and block investment in the State of Texas. We strongly encourage you to repeal it by new legislation.

Very truly yours,

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