

March 26, 2014

Governor Chris Christie
Office of the Governor
PO Box 001
Trenton, NJ 08625

Dear Governor Christie,

We, the signatories of this letter, are professors and scholars of law, business, economics, and public policy with expertise in industrial organization, distribution, competition, intellectual property, innovation and related fields. We write to express our concerns regarding the recent decision of the New Jersey Motor Vehicle Commission to prohibit direct distribution of automobiles by manufacturers.

The Motor Vehicle Commission's regulation was aimed specifically at stopping one company, Tesla Motors, from directly distributing its electric cars. But the regulation would apply equally to any other innovative manufacturer trying to bring a new automobile to market, as well. 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 New Jersey's automobile market for the benefit of its auto dealers and to the detriment of its consumers. It is protectionism for auto dealers, pure and simple.

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 New Jersey'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 Motor Vehicle Commission's regulation is our certainty that neither *we nor they* are well-positioned to make such a determination. 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 New Jersey is no exception) is competitive; no manufacturer has anything like a monopoly. Tesla in particular, as an upstart new entrant, has a market share in New Jersey of less than one percent.

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.

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 related, 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.

Finally, the dealers have argued that they are specially deserving of protection because they are unique bastions of philanthropy in local communities. While we have no doubt that many automobile dealers make important contributions to their local communities, this is a terrible justification for stifling innovation and making automobile markets less competitive through protectionist regulation. There is no evidence that auto dealers make better philanthropic citizens than would any other economic special interest granted a protected position. If the goal is to encourage local philanthropy, there are many better ways than blocking efficient distribution methods to the detriment of consumers.

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 innovative technologies. It is discouraging to see this ban being used to block a company that is bringing dynamic and environmentally friendly products to market. We strongly encourage you to repeal it, by new legislation if necessary.

Very truly yours,

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