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Representations on Case EC/02UB
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To reduce the Competition Commission's risk of becoming a collusive device for car sellers in Hong Kong, I'm writing to suggest accepting and actively enforcing the 7 car distributors' proposed commitment to:

Clarify to car buyers what is and is not voiding warranty.

That's it. Nothing else the Competition Commission should accept nor enforce. The following is the reason why.

First, the Competition Commission makes a huge mistake of separating the maintenance and repair services from the car market in general. This is based on an unfounded assumption that "*This is because purchasers of new passenger cars typically do not engage in whole life costing i.e. factor in the subsequent cost of maintenance and repair services at the time of purchase of a new car.*"[1] In plain language, it means when we buy a car, we don't think about the maintenance. Why? How can that be the case? Why do car buyers care much about future resale values but not on-going maintenance? Is there any proof that they ignore maintenance when buying a car? An ill-defined market, once exposed, will turn the entire anti-competitive allegation upside-down. But that can be exactly what the 7 distributors want.

It will help to reconsider the background. We can buy a new car from either of the 7 distributors or from smaller fringe sellers. But that doesn't mean competition cannot go beyond these new car sellers. We can always consider buying a second-hand car instead from the thousands of small individual and larger company sellers, some come with the original warranties while others come with none. The outside option is not to have one and rely on other means like carpool or public transportation. They are all available choices that consumers consider with reference to the upfront price, the on-going expenses (of fuel, parking, maintenance, etc.), and the future resale values. To isolate the new car market out of this huge market is to deny at least some consumers will take other choices if the new car sellers offer worse deals.

Choosing the terms and conditions of their warranty is one of many margins new car sellers, including the 7 distributors, compete not only among themselves but also against all second-hand car sellers. Other competitive margins include trying to outsmart others by predicting what models and features consumers will like, importing these car models and features (through managing their relations with manufacturers), and setting the prices and non-price services (convenience of sales locations, knowledge, financing-arrangement, customization, etc.). The focus of the Car Warranties Case (EC/02UB) is the warranty conditions. Specifically, new car sellers try to offer warranty that create consumer value beyond their increased cost. To compete, sometimes the warranty should go unconditional, and other times with restrictive conditions attached depending on a variety of factors.

The anti-competitive allegation is that if warranty is voided if a car buyer services

[1] (Paragraph 34(a) of Commission's Proposal to Accept Commitments in the Car Warranties Case (EC/02UB))

his/her car elsewhere, the car buyer gets "locked-in." Other than vaguely suggesting that such a conditional warranty hurts consumers in the Commission's documents because some can service their cars cheaper elsewhere, there is no specific proof on the claim that a conditional warranty indeed hurts consumers.[2]

Why a conditional warranty that gets car buyers "locked-in" doesn't necessarily hurt consumers? A conditional warranty is like iPhone-users getting "locked-in" for not being able to side-load apps outside of Apple-regulated App Store. But customers aren't stupid. They factor in the expectation that if they buy an iPhone, they will be "locked-in." Irrespective of whether more or fewer customers like being "locked-in" or not, the price of iPhone must reflect such an expectation. Analogously, customers buying a car from a distributor offering a conditional warranty will expect being "locked-in," and takes this into consideration when they purchase the car. If a distributor offering a warranty that comes with a restrictive condition doesn't make customers think it is a better deal, they risk losing the customers to either another new car seller or the thousands of second-hand cars sellers. This is no difference from Apple losing a customer who doesn't like being "locked-in" to Android sellers who won't "lock-in" users. Whether distributors offer an unconditional or conditional warranty, the price must reflect that. Some iPhone users indeed think being "locked-in" benefits them. They are reassured that apps there are compatible with their phone and OS system and they don't have to worry about searching for unauthorized apps that can be trusted. By the same token, we can't rule out the possibility that enough customers will think searching around for cheaper garages to fix cars hurts them, while it is reassuring to exclusively go to the few authorized garages.

The Commission's documents do not rule out the following alternative pro-competitive explanation of a conditional warranty that "lock-in" car buyers to a few authorized garages: reducing information asymmetry. Through reducing information asymmetry, a conditional warranty benefits consumers in two ways.

First, second-hand car is subject to information asymmetry: sellers know more about their own cars than potential buyers.[3] Suppose a distributor offers a conditional warranty, it makes it more credible for its car buyers, when selling their cars in the future, to tell those interested in buying their cars where they have serviced their cars. A car that can be proven credibly that it has all along been exclusively serviced at authorized garages commands a higher resale value than an otherwise equivalent car without such a credible proof. There is no fundamental difference between increasing their own cars' resale value through restricting their car buyers to only service their cars in authorized garages and increasing their own cars' resale value through making their cars more durable. If making cars more durable benefits consumers, why then would restricting warranty to increase their own cars' resale value hurt consumers?

Second, offering a warranty is costly. To compete, new car sellers do all kinds of things to reduce the costs of offering warranty. Of primary importance is to sell cars unlikely to breakdown during the warranty period. The second is to make sure buyers use their cars in the right way. But it is extremely difficult to monitor how buyers subsequently drive their own cars and how they service them. There's no guarantee that any problems due to the mishandling of the buyers will always be classified as such. Wrongly misclassified as the car sellers' liability is possible. An imperfect way to reduce the frequency of such a misclassification is by restricting buyers to service their cars from authorized garages only. It reduces the chance for car mechanics to re-modify a driver-created issue to look as if it were caused by the car sellers/manufacturer. Reducing the frequency of such a misclassification is reducing sellers' costs of offering warranty. Like reducing any other sellers' costs in any market, it is hard to argue why reducing car sellers' costs of offering warranty hurts consumers.

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[2] See paragraphs 38 and 39 of Commission's Proposal to Accept Commitments in the Car Warranties Case (EC/02UB).

[3] George A. Akerlof received a Nobel Prize for this insight by first articulating the effects of such information asymmetry in his 1970 article: Akerlof, George A. (1970). "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism." *Quarterly Journal of Economics*, 84 (3): 488–500.

I can't say for sure my explanation above is *the* explanation.[4] But neither do the Commission's documents rule out any of the dozen of alternative pro-competitive explanation of a conditional warranty proposed in the literature.[5]

Suppose some pro-competitive explanations, possibly including mine, indeed explain the 7 distributors' offering of conditional warranties. That means to sell cars and offer warranty at the least costs possible, competition compels these distributors to offer conditional warranty. And they benefit consumers in various ways. On the other hand, offering an unconditional warranty isn't what competition is called for. That doesn't mean any of the 7 distributors doesn't want to "unconditionize" their warranties. It is just that given car distributors cannot synchronize such a change simultaneously, a car distributor unilaterally "unconditionizing" its warranty means its costs will go up alone and but not the costs of other car distributors.

What about getting help from the Competition Commission? If the Competition Commission is willing to synchronize for them a ban of conditional warranties at a specific point in time, none will have to worry about just their own costs going up but not those of the others. And this is dangerous. The ban at a specific point in time facilitates a (tacit) collusion by the distributors by giving them a nice focal point. It gives them all a nice excuse to raise their price at a concerted point in time in the future.[6] One can still argue if their overall costs go up by, say 1%, and they only raise price by less than 1%, it wouldn't be all that bad. Not to mention why we risk artificially raising their costs by 1% without a strong reason, how can we rule out the possibility that they raise price by more than 1%? An asynchronized and unilateral price hike is risky to any seller but a synchronized price hike is what sellers dream of. Why give sellers what they dream of?

[4]Except for the few clearly anti-competitive practices, it is standard practice in competition law among the advanced countries that the burden of the proof is on the plaintiff to prove that the defendants' alleged business practice is anti-competitive because its anti-competitive effects outweigh the pro-competitive effects. The Competitition Commission does not indicate this case belongs to the few clearly anti-competitive practices. It merely states it may be anti-competitive: "*Based on its investigation, the Commission is concerned that the Warranty Restrictions contained in Standard Warranties and Complimentary Extended Warranties offered by the Relevant Distributors may give rise to anti-competitive effects in the markets for brand-specific repair and maintenance services in Hong Kong.* (Paragraph 37 of Commission's Proposal to Accept Commitments in the Car Warranties Case (EC/02UB))

[5]The economic and legal literature comes up with dozens of both and pro-competitive and anti-competitive theories for aftermarket monopolization after the U.S. Supreme Court heard *Eastman Kodak Co. v. Image Technical Services* (504 U.S. 451 [1992]). Unlike the Competition Commission, very few of these theories separately look at the aftermarket without simultaneously looking at the product market.

[6]To be specific, when I say price, it is always the adjusted price. The terms and conditions must be taken into account. It can be easy to detect car price changes, but extremely difficult to detect how much deterioration there is for the other terms and conditions. This isn't at all an issue when one buys a pack of papers. But it is when one buys a high ticket-price durable item like a car. The price can remain the same, while the customers can get slightly less customization, slightly fewer choices, slightly longer waiting time, less knowledgeable sales rep, slightly weaker after-sales services, slightly worse financing arrangement, etc. When price increases not by changing the actual transacted price, but by deteriorating these terms and conditions, I don't see how they can be easily detected.