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# FCAI submission to the Productivity Commission's Inquiry into Australia's Intellectual Property Arrangements

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## EXECUTIVE SUMMARY

The Federal Chamber of Automotive Industries (FCAI) is the peak industry organisation representing the manufacturers and importers of passenger vehicles, light commercial vehicles and motorcycles in Australia.

On 7 October 2015 the Productivity Commission released an issues paper to assist stakeholders in preparing submissions to the public inquiry into Intellectual Property Arrangements. The issues paper outlines a range of issues about which the Commission is seeking comment on.

In considering the issue of intellectual property arrangements and their impact on the Australian economy, the PC has been asked to examine existing arrangements with a view to ensuring that the intellectual property system provides appropriate incentives for innovation, investment and the production of creative works while also ensuring it does not unreasonably impede further innovation, competition, investment and access to goods and services.

For the purposes of this inquiry, the FCAI is limiting its comments to the negative consequences on intellectual property rights and basic equity arising from the introduction of grey and parallel vehicle import arrangements and parallel/aftermarket parts in the automotive industry.

## MOTOR VEHICLE COMPETITIVENESS AND PARALLEL IMPORTS

The matter of parallel import arrangements for the motor vehicle industry has previously been canvassed by the Productivity Commission in its Australian automotive manufacturing inquiry in 2014, and again when the Department of Infrastructure was specifically tasked with exploring whether or not parallel imports of new and 'quality' second-hand motor vehicles should be considered as part of the MVSA Review.

Australia has one of the most competitive new car markets in the world, delivering a wide range of consumer choice both within brands, and between brands. Competition between brands is delivering more affordable motor vehicles, with higher levels of specification and features. This has been to the benefit of both consumers and the broader community.

The main argument in support of permitting parallel imports is to arbitrage away international price discrimination. The FCAI has presented evidence to the Motor Vehicle Standards Act review (attached to this submission) that demonstrates there is little evidence to suggest that Australian consumers are at risk of any widespread international price discrimination in relation to passenger vehicles. This was a view also supported by the Productivity Commission in its final report to the Australian automotive industry, which concluded in relation to the global automotive industry that:

*Competition within the global automotive industry is intense...*

*As a result of this competition, especially amongst the lower-priced, high-volume vehicle models, there is limited ability for producers to raise their prices ...*

*The limited scope for producers to raise their selling prices within particular vehicle market segments has resulted in cost pressures throughout the automotive supply chain.<sup>1</sup>*

Specifically in relation to Australia, the Productivity Commission concluded at the time:

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<sup>1</sup> [http://www.pc.gov.au/data/assets/pdf\\_file/0020/135218/automotive.pdf](http://www.pc.gov.au/data/assets/pdf_file/0020/135218/automotive.pdf), p48-49

*The Australian market for new motor vehicles is small in global terms. At the same time, due to a high level of import penetration (with few barriers to those imports), the Australian automotive market is highly fragmented, and appears to have become more so over the past decade...<sup>2</sup>*

Australian consumers benefit from this highly competitive new vehicle market. They have greater choice, and competition encourages lower prices, improved vehicle quality and more extras for a new vehicle in a particular market segment.

According to the Productivity Commission:

*The highly competitive Australian automotive market limits the scope for all sellers of cars in Australia to increase the selling price of their vehicles.<sup>3</sup>*

Given that the Australian market is already experiencing a very high level of inter-brand competition, to adequately consider this issue the FCAI commissioned economic analysis by Pegasus Economics to look at the complications and some of the unintended consequences that can arise in a situation where parallel imports are allowed. The full report is attached.

Central to any consideration of this matter must be the investment made by an established brand in the product development, intellectual capital, its dealer network and associated supply infrastructure in the product it has developed for a specific market. This includes servicing, supply of parts and training. Parallel imports undermine this investment by encouraging a 'free rider' to import a good without the authorization or consent of the trade mark owner (in this case, the automotive brands in question).

A free rider is someone who enjoys the benefits of someone else's investment without having to pay compensation for that benefit. As the Pegasus report finds, free-riding on someone else's trade mark will, at little cost, capture some of the profits associated with a strong trade mark because some consumers will assume (at least in the short run) that the free rider's and the original trade mark holder's brands are identical. Free riding occurs in the context of parallel imports because unauthorised distributors obtain goods at prices that do not properly reflect the legitimate costs imposed on authorised distributors at various points in the distribution chain, such as pre-sale marketing and post-sale services costs that are paid in full by authorised dealers.

Unfortunately, most consumers will be unaware of this situation. This is because most consumers will focus on the headline price. This situation occurs because many consumers who purchase grey goods mistakenly believe they are purchasing products whose reliability, integrity and service, as symbolised by the trade mark, are maintained and guaranteed by the local trade mark owner. Consumers often make the false assumption that they are receiving the same goods and services by purchasing a grey import that they would receive if they purchased from an authorised seller.

#### **Consumer risk and brand damage caused by free-riding**

One of the common assertions made by proponents of parallel new and second-hand motor vehicle imports is that motor vehicles are cheaper overseas. However, if an imported vehicle is priced lower than a domestic alternative through the authorised channels but lacks the quality, specifications, warranty and support that the authorised product does then much of the benefit of lower prices is illusory.

<sup>2</sup> [http://www.pc.gov.au/data/assets/pdf\\_file/0020/135218/automotive.pdf](http://www.pc.gov.au/data/assets/pdf_file/0020/135218/automotive.pdf), p63-64

<sup>3</sup> [http://www.pc.gov.au/data/assets/pdf\\_file/0020/135218/automotive.pdf](http://www.pc.gov.au/data/assets/pdf_file/0020/135218/automotive.pdf), p67

In the first place, the specification of motor vehicles sold in the domestic market may be entirely different to an imported grey motor vehicle originally destined for an overseas market. In this regard, a brand may position itself in different market segments across countries, and hence the same vehicle model may end with completely different specifications between countries.

Secondly, imported grey motor vehicles are not subject to the inspection, transit or quality controls of the local trade mark owner and their distributors. On the other hand, new motor vehicles imported into Australia through the local trade mark owner and their distributors undergo a rigorous pre-delivery inspection shortly after they land including fitting compliance plates, insertion of log books into the vehicle, removing protective wrapping from vehicles, surveying any vehicle damage, ensuring vehicles are built to specifications, mechanical testing, fitting accessories, cleaning and washing vehicles, and performing any rectification services to repair any damage.

This raises the distinct possibility if not likelihood that imported grey motor vehicles may be of lower quality than those sourced through trade mark holder authorised channels. Indeed, common deficiencies observed in relation to grey goods include foreign-language instruction manuals, ineligibility for factory-authorised warranty service, inadequate warranties and service by grey import distributors and unavailability of replacement parts and inventory.

A consumer may be motivated to purchase an imported grey vehicle import, not just because of perception it is cheaper but also because they think they are obtaining genuine goods of comparable quality and specifications to those offered by authorised distributors. A claim to 'genuineness' of the vehicle in these circumstances will be confusing, if not misleading, where it is of inferior quality and/or has different specifications, or attracts inferior warranty and support in comparison to the authorised vehicle.

This will result in consumer demand being misdirected towards the grey import. The differences between the expectation and performance of the grey import may result in a diminution in consumer welfare. When a consumer purchases an inferior-quality item, their estimate of the brand's quality declines which in turn reduces the goodwill the trade mark owner enjoys and, as a result, the premium the brand can command in the future. Thus, inferior quality goods not only redirect the premium away from the trade mark owner, but also injure the trade mark owner's goodwill, reducing the expected future stream of returns that flow from the trade mark. In turn, they will diminish the incentives to make the kinds of investment required to create goodwill in the first place.

The Pegasus Report notes that free-riding can undermine the value-added services and activities that often lie at the heart of many firms' sources of differentiation and competitive strategy in the marketplace. This is particularly the case in the automotive industry, as an individual or business involved in parallel importing motor vehicles essentially free-rides on the existing domestic reputation of the brand, and on the service offerings that the authorised importer (the trade mark holder) makes to its customers. This is ultimately to the detriment of the brand and the consumer.

This is unsustainable as the full-service retailer (the brand and its dealership network) cannot incur the extra expense of these services and still match the discounter's low price, and must cut back its marketing efforts. This reduction in retail service reduces demand for the manufacturer's product and this produces detrimental consequences for consumers as well as for the manufacturer.<sup>4</sup>

Consequently, permitting parallel importing of motor vehicles promotes unauthorised participants to free ride on a brand's established trade mark and associated reputation, while at the same time

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<sup>4</sup> Pegasus Economics, Implications of Parallel Imports of Passenger Motor Vehicles, p.14

introducing intrabrand competition.<sup>5</sup> Intrabrand competition is essentially a brand competing against itself for the same sale.

Intra-brand competition can have the perverse effect of diminishing competition within a market. This is because permitting the unrestricted parallel importation of second-hand motor vehicles will not only subject motor vehicle manufacturers to free riding on their trademarks, it will in turn threaten the goodwill invested in their brands, as well as pose a massive risk for consumers. Left unchecked, at its worst excess there is a risk that intra-brand competition will erode the brand's ability to service its own brand (but unsupported) motor vehicles, and impact on the ability of the brand to support its authorised dealer network. This in turn risks eroding the level of inter-brand competition in the marketplace. This will ultimately leave consumers worse off. This was summarised neatly by Professor Eleanor Fox of New York University, who states:

*There is growing recognition in the world that rivalry between and among competing producers ("interbrand competition") is the essence of competition. It is that interplay that tends to keep prices relatively close to costs, to provide choices for consumers, and to allocate resources to their best use in view of consumer demand. Intrabrand competition – a producer's product competing against itself – cannot do this job.<sup>6</sup>*

### **Future technology, the motor vehicle and the impact of parallel imports**

The FCAI would also add that there is a real opportunity to see major improvements in safety and essential gains in the environmental efficiency of vehicles and infrastructure use through the adoption of Co-operative Intelligent Transport Systems. Cooperative Intelligent Transport Systems (C-ITS) is the term used for advanced applications which provide innovative services relating to transport and traffic management and enable various users to be better informed and make safer, more coordinated and 'smarter' use of transport networks.<sup>7</sup> This comes through vehicle to vehicle and vehicle to infrastructure communication. Many of these benefits would be placed at risk or undermined with the introduction of parallel imports that sit outside the established regulatory framework.

C-ITS holds the prospect of delivering a step-change in the way that travel by motor vehicle is undertaken. It offers enormous opportunities, by making driving easier, improving road safety, reducing emissions through better traffic flow and easing congestion. However, despite the lack of an internationally accepted standard for C-ITS, 12 manufacturers have signed an agreement to begin including cooperative ITS devices from the 2015 model year for use in the European market. The US National Highway Traffic Safety Administration is fast-tracking recommendations for the US domestic market.<sup>8,9</sup> Japan is exploring an altogether different approach. In each of these three significant markets (and dominant sources for motor vehicles sold into the Australian market), there are differences in the allocation of radiofrequency bands for C-ITS operation. In its 2014 submission to the Motor Vehicle Standards Act review, Austroads noted:

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<sup>5</sup> Pegasus Economics, Implications of Parallel Imports of Passenger Motor Vehicles, p.20

<sup>6</sup> See Fox, E. M. (2001). Parallel Imports, The Intrabrand/Interbrand Competition Paradigm, and the Hidden Gap Between Intellectual Property Law and Antitrust. *Fordham International Law Journal*, 25, 982-985.

<sup>7</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:207:0001:0013:EN:PDF>

<sup>8</sup> Australian Cooperative ITS Platform, paper presented to the 26th ARRB Conference – Research driving efficiency, Sydney NSW 2014

<sup>9</sup> US DOT Fact Sheet, July 2015, Planning for the Future of Transportation: Connected Vehicles and ITS, [www.its.dot.gov/its\\_program/its\\_factsheets.htm](http://www.its.dot.gov/its_program/its_factsheets.htm) [accessed 8 July 2015]

*The implications of this are that vehicles transmitting on different frequencies will not be able to communicate with each other, making their C-ITS safety systems ineffectual. Also, some vehicles may include radio communications equipment that is not licensed for use in Australia, and could cause interference to other existing licensed users. Further, it is likely that some emerging safety applications will require satellite positioning and mapping services that are not currently supported in Australia.<sup>10</sup>*

Crucial to the roll-out of a national ITS strategy is agreement on the spectrum allocation. The FCAI supports the adoption of the 5.9 GHz spectrum to align with European channel allocations. As these technologies are integrated into the motor vehicle at its manufacture at the factory, it will be difficult if not impossible to retrofit a different configuration of C-ITS into a vehicle once it is in the marketplace. While limited vehicle to vehicle interface is possible, the step change in safety, environmental and infrastructure efficiency improvements will not be achievable. Importantly, nor will it be anywhere near certain that the automated operation of the vehicle's braking or steering to avoid a crash will operate as designed.

The Government is currently considering the appropriate regulatory model prior to vehicles with these technologies and applications entering the Australian market. This has implications for personal and grey imports of near new vehicles. Motor vehicles in other markets will be built to the regulatory environment in their designated market and will not deliver the achievable improvements in safety, environment and infrastructure efficiency that is envisaged in their design if the bandwidth is not compatible with the Australian bandwidth. In Australia there are other complicating aspects, such as vehicles would be at risk of adversely affecting mobile telephone bandwidth (700 MHz band) and other applications, such as toll road collection (that operate in the 5.8 GHz band).

While not necessarily an issue directly linked to intellectual property, this issue does highlight the risk of significant public detriment when considering the parallel imports aspect of the Productivity Commission's review.

#### **FCAI position**

There is no compelling public policy case to permit parallel imports as there is evidence of robust interbrand competition in the Australian passenger vehicle market.

The overriding problem with the parallel import of new and second-hand vehicles is the direct link between the trade mark owner's product and the consumer has been broken because some extraneous third party has broken the nexus. As the trade mark owner can no longer guarantee the quality of a parallel imported vehicle, this leaves the consumer vulnerable to the risk of purchasing a 'lemon' or defective vehicle.

Strong intra-brand competition (e.g. via large scale importation of used or near-new vehicles) introduces the risk of reducing competition within the market. The flow-on effect could be an overall reduction in the number of new motor vehicle sales from the brands (used or new-new imports will be substituted for new car sales – see Case Study Scenario below) with a subsequent negative impact on the government policy objectives of community safety, consumer protection as well as competition.

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<sup>10</sup> [https://www.infrastructure.gov.au/vehicles/mv\\_standards\\_act/files/Sub136\\_Austrroads.pdf](https://www.infrastructure.gov.au/vehicles/mv_standards_act/files/Sub136_Austrroads.pdf)

### **Case Study Scenario: Substitution of New Vehicles with Large Scale Imports of Used Vehicles**

If used vehicles or parallel imports are introduced into the market, it is unlikely that there will be an corresponding increase in demand as Australia has one of the highest levels of car ownership (refer to Section 2.3.1). Therefore the increase in supply can be expected to lead to a decrease in price for used vehicles (i.e. higher supply without increased demand) which will then result in an increased 'change-over' price for a consumer upgrading to a new (or newer) vehicle.

If there is a sufficient increase in the change-over price, new car consumers may change their purchasing behaviour and delay their purchase of a new car. If new car consumers delay their purchase by 1 year, a likely impact on the new car industry would be:

- Business buyers move from a 3 year to a 4 year change-over;
- Private buyers move from a 5 year to a 6 year change-over

As new light vehicle purchases were distributed between business and private buyers of 47% to 53% in 2013<sup>11</sup>, the impact on the overall new vehicle market can be calculated as follows:

- Reduction in new vehicle market =  $0.47 \times 3/4 + 0.53 \times 5/6 = 0.79$ .

That is, under this scenario, the new light vehicle market would be expected to fall to 80% of the current sales.

Obviously, this would not be an immediate outcome and would happen over a number of years. This would result in a reduced growth of sales in new vehicles (at best) or even no growth at all as has been the experience in New Zealand. Either way, the outcome is an increasing age of the in-service fleet.

## **SECTION 72 OF THE DESIGNS ACT 2003**

The second area of concern for the FCAI is the provisions of section 72 of the Designs Act which provides (broadly) an exception such that it is not an infringement of a registered design to use or import a spare part which is a component part of a complex product, 'for the purpose of repair of the complex product so as to restore its overall appearance in whole or part'.<sup>12</sup>

The Advisory Council on Intellectual Property 2015 review considered the FCAI position on this particular exception however they did not address the competition anomalies but rather restricted their findings to the essential IP issues. The Council report also noted that the FCAI submission to their review (copy attached) while addressing aspects of the Designs Act also focused on a number of Competition and Consumer Act issues. ACIP was not charged with reporting on issues outside the design laws, hence these interrelations were not specifically addressed.

While the FCAI does not dispute the scope of the ACIP review, the value of that review is severely diminished if they preclude the impact of other Commonwealth laws when assessing the economic impact of the Designs Act provisions. For this reason the FCAI holds that the argument proposed in its submission are still relevant today.

<sup>11</sup> Federal Chamber of Automotive Industries (FCAI), Vfacts National Report, New Vehicle Sales December 2013

<sup>12</sup> Review of the Designs System, Advisory Council on Intellectual Property, Final Report, March 2015

The FCAI submission also refers directly to the legal interpretation of the provisions of the Copyright Act 1968 and the Trade Marks Act 1995 also referred to by the Harper Competition Policy Review and the Productivity Commission scope in this particular inquiry.

The FCAI seeks a further investigation of the provisions of section 72 of the Designs Act.

Please feel free to contact this office for further information as necessary.