

with no activity, may close automatically. The intended result is that our reserving will reflect a much more accurate picture of the claims in process situation.

General Claims Memo #362 stresses the importance of uniformity. We want to re-emphasize that importance here.

This is an important transitional period. A "count" will be given for every exposure which legitimately deserves a count. Precautions have been taken to see to it that reserves do not accumulate unnecessarily. We urge you to review General Claims Memo #362 and to follow the recommendations.

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Bob Mecherle's Third Quarter Travel Schedule

I-CAR Annual Meeting
July 21-25, 1986
Writers Manor
Denver, Colorado

Michigan Claim Conference
September 10-12, 1986
Marriott Hotel
Grand Rapids, Michigan

Agency Convention
September 16-19, 1986
Las Vegas, Nevada

Agency Convention
September 30 - October 3, 1986
Las Vegas, Nevada

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G. Robert Mecherle
Claims Vice President

Star Wars — Aftermarket Style

We are in a war. The cause of the war is aftermarket body parts. On one side are the automobile manufacturers and on the other side are insurance companies. The bodyshops and automobile manufacturers are trying to convince the public that insurance companies should not specify the use of cheaper non-original equipment aftermarket parts because the quality of these "counterfeit" parts is poor. Although quality is hailed as the reason non-OEM body parts should not be used — and it is true there are some poor quality non-OEM parts — make no mistake that the real issues involved here are primarily economic. The automobile manufacturers have had a virtual monopoly on crash parts and as a result enjoyed the profits of inflated prices.

Since the repairer makes a profit on the parts he buys and installs, and that profit is based on the retail price, he would obviously prefer to use the more expensive parts. The repairer makes a profit from the use of non-OEM parts, as well, and the percentage of "mark-up" is about the same as that offered by the OEM supplier. However, since the overall cost is less, the dollar profit for the repairer is often times less.

You can begin to see the economic issues involved; the OE manufacturers realize greatest profits in a situation where there is limited competition; the repairers realize their greatest profits when parts prices are highest.

State Farm has an economic interest, as well. We are trying to encourage competition in the crash parts business so that our policyholders can benefit from lower repair costs.

History

As far back as 1972 Ford Motor Company entered into a joint venture with a Taiwanese manufacturer, Lio Ho, for the production of car parts. When mandated gas mileage regulations were introduced it became necessary for Detroit to down-size their cars and go with the unibody construction. This represented a tremendous capital investment for the automobile manufacturers and as a result longer model year runs were made (as contrasted to yearly cosmetic changes) in order to get the most from their capital investment. With more common parts being used by the big three and with longer model year runs, some of the manufacturers who had been supplying Detroit with "original equipment parts" began to consider utilizing their skills for aftermarket parts.

First efforts to market aftermarket parts in the late 1970s were largely unsuccessful due to quality problems and their marketing efforts were unsophisticated. However, by 1982 quality had been improved and direct sales through automotive suppliers flourished. The car makers began to take notice. Distribution systems were set up and marketing was begun through bodyshop expositions and trade shows. By 1984 non-OEM parts accounted for nearly 10% of the crash parts market and represented an \$800 million annual business. The year 1984 also marked the time when the original equipment people responded by cutting their crash parts prices.

In the meantime, Audatex offered to develop a data base which included the inventories of vendors of high quality aftermarket crash parts. State Farm agreed to test the product and did so in three service centers during 1984 and 1985. The PAL system — which stands for Parts and Assembly Locator — would automatically search a data base for the availability of the non-OEM equivalent of an OEM part. The system would compare prices and incorporate the lowest priced part into the finished estimate. Later State Farm voluntarily changed our use of PAL to the lowest price plus 5% in order to give the bodyshops more sources to choose from. If a non-OEM part (aftermarket part) was listed it was identified along with the names and addresses of the suppliers who offered that part at, or below, the price shown on our estimate.

The intent of Audatex was to market PAL throughout the insurance industry. Testing by State Farm was widely publicized at trade association meetings. While the PAL system did perform as promised in the test sites, its universal effectiveness was less dramatic. The PAL system has actually been implemented in only about 100 State Farm claim offices. Where results were unsatisfactory (local distributors not furnishing quality parts or local distributors unable to deliver parts within 48 hours) local management discontinued its use. However, in most instances it proved effective as an aid in locating and pricing parts.

The credit given to State Farm by Audatex for assistance in the development of the PAL system served a purpose in giving credibility to the product. However, this same credit was perceived by automobile makers as an effort by State Farm to use automation to disrupt their virtual monopoly on crash parts. It was seen by many bodyshop owners as an effort to remove their freedom of choice as to parts selection, supplier, and usage. As a result State Farm has been the target of criticism by both factions.

State Farm visited Taiwan to inspect their manufacturing facilities and impress upon them the need for quality parts and our willingness to pay for that quality. Some OEM manufacturers are referring to these parts as "counterfeit" or "imitation" as if there is some intent to pass off these parts as OEM. There never has been such an intent by the aftermarket people.

State Farm is certainly sensitive to the quality issue. That is why we made sure Audatex required the distributors using its system to warrant their parts the same as OEM parts are warranted. Mostly that is a 90 day warranty. Keystone offers a lifetime warranty and the Aftermarket Body Parts Association is working on a five year parts warranty. At any rate, Audatex is pledged to enforce this requirement so that we know we get good quality parts.

Therefore it is important if we receive a complaint from a policyholder or bodyshop that the part specified by the PAL system is a poor quality part, we must check it out. The fact that much of this is a smoke screen to mask the

economic issue is supported by two examples that we actually experienced. We were told that we were forcing bodyshops to use inferior aftermarket parts in a geographic area where we had not even turned on the PAL system as yet. In a second instance a complaint was made about the quality of an aftermarket part specified and when our property superintendent went to check the claim he found the aftermarket part had not even been taken out of the carton. We should be able to tell immediately whether the fit and finish is OEM quality just by a careful inspection. Note well, however, that if the automobile has not been brought back into proper body alignment not even an OEM part will fit properly. The corrosion issue is a different matter and although a limited study involving aftermarket repairs that took place in 1983, tended to show no difference between aftermarket and OEM crash parts, this was a very limited study. Generally it is too early to tell and that is why we are insisting that the non-OEM supplier's guarantee of his part to be the same as OEM.

What we do know, however, is that non-OEM competition has been successful in lowering the OEM price for crash parts. Although price decreases started in 1984, as late as February 24, 1986 Nissan announced the following price changes: front bumper cover on 300ZX went from \$462.17 to \$225.00; a rear bumper cover on the same car went from \$383.25 to \$241.67. Price decreases were announced on 19 other Nissan parts at the same time.

State Farm does not purchase parts. We specify competitive prices of quality parts in our appraisals. The following corporate guidelines were published February 14, 1986 to all Regional Vice Presidents and on February 21, 1986 in General Claims Memo #430:

1. Aftermarket parts must be of OEM quality; that quality must be guaranteed by the supplier;

Salvage parts must be of equal, or better, quality compared to the parts being replaced;

2. No unusual delay must occur as a result of selecting other than new, OEM parts for use in repairs;

3. The vehicle owner should know that other than new OEM parts are to be used in repairs; (a stamp is being devised and will be in your hands shortly to be put on any estimate which contains other than new, OEM parts.)
4. There should be a reasonable profit for the repairer when other than new, OEM parts are to be used in repairs; (for example, we refused to use a part where the low price was achieved by cutting the profit margin of the bodyshop to \$4.00);
5. There should be an economic incentive for State Farm, relative to the cost of new, OEM parts, when other than new, OEM parts are to be used in repairs.

In the meantime the war goes on. GM and Ford have taken out ads attacking the quality of non-OEM parts. Ford has even singled out State Farm by running full-page ads of a State Farm insured who found out that their estimate called for other than Ford parts. But remember, we feel we have an answer to the quality issue. We are only dealing with aftermarket people who will give an OEM guarantee with their parts. In addition, if there is a complaint of fit or finish we promise to check that claim and if we find that there is a continuing problem with fit and finish or that any one of the above five guidelines cannot be followed, we will turn off the PAL system in the area affected. This certainly gets the attention of Audatex for we pay them \$5.00 for every aftermarket hit that we get and non-usage encourages them to repair their system.

The latest attack, however, is directly on the economic issue. Toyota has actually put dealers on the PAL system with competitively priced OEM parts. Ford is now doing the same thing in Texas and Oklahoma only they are coming in at an OE price substantially under that of the non-OEM competition. We have been advised they plan to expand this to the metro Los Angeles and metro New York areas. It looks like the second front is about to open up into an all-out price war. I promise to keep you posted as this saga unfolds.