

Letter from Deloitte and Touche on the allocation of discounts to extended warranties

The Board of Directors
Dixons Group plc
Dixons House
Maylands Avenue
Hemel Hempstead
Herts
HP2 7TG

12 September 2003

Ladies and Gentlemen

Extended Warranties Inquiry: Allocation of discounts offered on extended warranties

This letter is prepared in accordance with our engagement letter dated 5 September 2003. In the context of your ongoing discussions with the Competition Commission (“the Commission”) in respect of the above inquiry, you have asked Deloitte & Touche LLP (“Deloitte”) to consider whether the approach adopted by Dixons Group plc (“Dixons”) to allocating discounts on revenues received from the sale of products with extended warranties is appropriate and reasonable.

Dixons’ approach

We understand from Dixons that eligible products sold in 2001/2 without a Coverplan agreement had an average unit discount of £[X]¹ while products sold with an agreement had an average discount of £[X]. Dixons has calculated the incremental discount associated with extended warranties to be around £[X]m, arrived at by multiplying £[X], the difference between discounts on products sold with a Coverplan agreement and those sold without one, by around [X] million products sold with an agreement.

Dixons believes that this will in practice be an under-estimate as discounts on products sold without Coverplan agreements are generally offered because the products are (for example) end of line or ex-display stock. The unit discount of £[X] would therefore often not apply to products sold with an agreement. The total unit discount attributable to Coverplan agreements would, on this basis, fall between the £[X] increment and the £[X] total.

Competition Commission approach

We understand from Dixons that the Commission has disputed this approach to calculating the discount allocated to extended warranties on the basis that the approach followed should be “proportionate”—i.e. sourced from a relationship between, for example, sales or costs relating to Coverplan agreements and those relating to other products, in the same way that a proportionate approach was used by Dixons to allocate costs to its Coverplan business. We understand that the Commission therefore intends to allocate less than [X]% of the total discount to Coverplan agreements as it has calculated direct costs associated with Coverplan to be less than [X]% of total direct costs. This gives a discount associated with Coverplan agreements in 2001/2 of around £[X]m.

Assessment of the alternative allocation approaches

We understand that a proportionate approach to the allocation of costs to Coverplan was adopted by Dixons as it considered this to be the most prudent proxy available when making the cost allocation.

¹ This and other monetary amounts shown exclude VAT.

However, given the frequent nature of discounts offered on products bought with Coverplan agreements when compared to products purchased without an agreement, the adoption of a proportionate approach to the allocation of discounts would not appear to be appropriate. If discounts can be allocated using a more direct method, this should be chosen. Where this can be done, to suggest that a proportionate approach should be used for consistency with other allocations would seem neither robust nor reasonable.

If transactions including the sale of a Coverplan agreement are discounted based on the sale of the agreement only, and not on the sale or value of the product to which the agreement applies, the “incremental” method of allocating discounts to Coverplan agreements used by Dixons would appear to be reasonable.

After discussing with Dixons relevant issues regarding the circumstances in which the discounts are offered, the drivers of the size of discounts, and the nature of the [X] million Coverplan transactions relative to the eligible transactions with no Coverplan element, we understand from Dixons that the pattern of discounts stated above does apply. Furthermore, the results of Dixons’ recent analysis of the basis of discretionary discounts given by store managers give further support to the results generated using the incremental method.

On this basis, we consider the incremental approach adopted by Dixons to be an appropriate and reasonable approach to allocating the discounts in question.

Yours faithfully

Paul Rowe
Partner
Deloitte & Touche LLP