

Extended warranties on domestic electrical goods

A report on the supply of extended warranties
on domestic electrical goods within the UK

Volume 1: Summary and Conclusions



COMPETITION COMMISSION

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Trade and Industry by Command of Her Majesty
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Members of the Competition Commission as at 30 September 2003

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¹These members formed the Group which was responsible for this report under the Chairmanship of Sir Derek Morris.

Note by the Department of Trade and Industry

In accordance with section 83(3) and (3A) of the Fair Trading Act 1973, the Secretary of State has excluded from the copies of the report, as laid before Parliament and as published, certain matters, publication of which appears to the Secretary of State to be against the public interest, or which she considers would not be in the public interest to disclose and which, in her opinion, would seriously and prejudicially affect certain interests.

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Part I

Summary and Conclusions

1 Summary

Introduction

1.1. On 2 July 2002 we were asked to investigate and report on the existence or possible existence of a monopoly situation in relation to the supply of extended warranties (EWs) for domestic electrical goods (DEGs) in the UK. The reference followed a market investigation by the Office of Fair Trading (OFT), which identified a number of areas of concern in the provision of EWs, and put forward the hypothesis that ‘there is insufficient competition and information to ensure that consumers get good value, and that many electrical retailers may make considerable profits on the sale of EWs’.

Extended warranties

1.2. EWs are contracts which extend the manufacturer’s guarantee on DEGs. They cover repair and replacement of DEGs if they break down, and may also provide cover against other risks such as accidental damage and, in a few cases, loss or theft. They may also provide helpline support, for example on personal computers (PCs). There are a number of different types of EW, some to a greater or lesser extent combined with other types of service. We concluded that for our purposes they included EWs supplied free, renewals and those covering multiple appliances, but not general household insurance or service arrangements for central heating or alarm systems.

The DEG and EW markets

1.3. The total size of the DEG market in the UK is between £15 billion and £20 billion annually. Almost three-quarters of this market is accounted for by white goods (just over 20 per cent of the market by value); brown goods (nearly 30 per cent of the market by value); and home computing and telecommunications (over 20 per cent of the market by value). The balance comprises small appliances (kettles, toasters etc), electronic games and photographic equipment. About one-third of the market for DEGs is supplied by the three main electrical retailers, Dixons (through its Dixons and Currys stores), Comet and Powerhouse (which is now under new ownership following administrative receivership in the latter stages of this inquiry), a further quarter by independent electrical retailers, 10 to 15 per cent by specialist product retailers (for example, those selling PCs or mobile phones), and the remainder by department stores, mail order, catalogue and online retailers.

1.4. Around 18.5 million EWs were supplied in 2001 (the last year for which we have comprehensive, reliable data), with a total value of nearly £900 million (including a valuation of free EWs). EWs are provided by most electrical retailers (including mail order and Internet sellers), by manufacturers, some insurance companies, and to a lesser extent by some utility companies, credit card companies and banks. Most EWs (81 per cent of new EWs by value, 69 per cent if renewals are included in the total) are provided by retailers at the point of sale (POS) of the associated DEG. Many of the larger retailers sell their own EWs (technically, they act as agent for either a service provider or an insurance company, which will have the contract

with the consumer). Smaller retailers (of which about four out of five sell less than £10,000 worth of EWs each year) generally sell EWs as agents of insurers. Manufacturers' sales of EWs (around 12 per cent of the total by value) generally follow from sales of DEGs directly to consumers or depend on consumers returning guarantee cards after purchase of the DEG. Insurers mostly sell EWs through retailers and manufacturers, but some also sell directly to consumers.

1.5. Until 1997, most EWs were essentially insurance products, with retailers acting as agents for insurance companies. Since then, most EW providers have developed service-backed schemes that have given their providers tax advantages. The major exception is Comet, whose EWs are still insured. In the case of both insured and service-backed EWs, the provider of the EW will usually insure, or reinsure, itself against its liabilities under the EW, though a substantial part of the risk may reside with an insurance company in the same group as the retailer. In the case of service-backed EWs, the retailer will act as the agent for a service provider which will arrange administration and repairs. Several parties are therefore involved in, or stand behind, the provision of an EW to a consumer; there may be a retailer, an insurer, a reinsurer, and one or more service providers (for example, repair or claims administration companies) in different combinations. The nature and scope of cover provided by different types of EW varies (but this is not always obvious to the consumer).

1.6. Many EWs now extend beyond repair or replacement of the DEG in the event of breakdown (which continues to account for the great majority of claims) to cover (for example) accidental damage, loss or theft, or the availability of helpline services. This is partly in response to the sharp rise in sales of PCs and mobile phones, which have particular risk features which drive the need for different types of EW cover. Consumers generally require helpline services to a greater extent for PCs than for other DEGs; for mobile phone buyers the risks of accidental damage, loss or theft (and associated stolen airtime) may be the most important. Although the risks for consumers vary by type of DEG and by manufacturer, most EWs are offered as relatively similar packages for which the consumer contracts to pay in full, in advance. They are generally offered for a period of either three or five years including the one year of the manufacturer's initial guarantee. They are marketed on the basis that they provide general peace of mind across a range of possible risks, rather than cover tailored to individual risks.

1.7. We recognize that EWs provide a valuable service, and satisfy a genuine demand from many customers who want to cover themselves against relevant risks and who may also require customer support services. Nonetheless, EWs are bought by only a minority of DEG purchasers (only one-third of households that bought a DEG costing more than £50 also bought an EW, according to our NOP survey) and sold on a minority of DEGs (one in five in 2000/01 according to the OFT survey). The decision whether to purchase an EW depends on whether customers wish to commit to pay in advance to cover themselves against a particular class of potential future cost, and is influenced both by customers' assessment of specific costs and risks, and by their general attitudes to risk and their past experience. Most customers shop around for DEGs; the retail price is a major factor in their choice. However, EW buyers do not often plan to buy an EW (less than half of consumers who bought an EW said that they had planned to do so before they went into the store), and many are unaware of the existence of alternatives to taking the EW offered at POS. The main reason given by consumers who do not buy EWs is that they are too expensive, but those who do purchase them are relatively insensitive to their price.

1.8. There is general agreement among retailers and consumers that it is convenient for EW consumers to be able to purchase EWs at the POS of the DEG. This is a reasonable time to consider the need for an EW. Finding alternatives at a later date can be time-consuming; and those using credit agreements can use them for purchasing both the DEG and the accompanying EW. Most of those who purchase EWs say they do not regret buying an EW and are happy with the cover provided, although there is a significant minority who are not. However, the general experience of DEG purchasers has been that they have had little or no hard information at POS

(for example, on reliability or repair costs, or the availability of EWs from suppliers other than the retailer) against which to judge whether they need the EW they are being offered, or whether it represents good value for money. Despite efforts by retailers to control poor sales practices, there remains evidence that a fairly small minority of customers feel pressured to buy EWs at POS. Few consumers appear aware of their rights to cancel EWs within a specified period, and few do so.

1.9. Some retailers confirmed that EWs were a secondary product, complementing the purchase of a DEG and only of any value with a DEG. In such circumstances, they argued that the pricing of EWs and analysis of competition for EWs could be properly understood only by treating EWs and DEGs together as, in effect, part of a single market. However, in assessing the relevant market for the purposes of this reference, we concluded that EWs should not be analysed in this way. Most DEG purchasers do not buy EWs. Moreover, many secondary products are provided under competitive conditions. The close link for many retailers between DEGs and EWs in part reflects the lack of a ready alternative for consumers buying at POS, and this largely arises from the particular way most EWs are currently sold.

1.10. The most significant distinction within the EW market is between the provision of EWs at the POS of the DEG, and away from the POS of the DEG. Selling an EW at POS of the DEG provides a significant competitive advantage; the EW can be sold as an immediate and relevant secondary purchase at a convenient moment for the customer. Thus non-POS providers have much less opportunity to sell EWs, and POS providers enjoy a significant advantage. Standard tests indicate substantial power to raise prices profitably at the POS. We nonetheless concluded that both POS and non-POS provision should be regarded as being part of the same market, because POS provision of EWs appears to provide a significant competitive constraint on non-POS provision even though, given the POS advantage, the reverse is not true. We also concluded that there was sufficient substitutability of renewals and free EWs for new and paid EWs for us to regard them as part of the same market.

1.11. We concluded that all the EWs defined as part of the reference services (including both POS-sold and non-POS-sold EWs, renewals, free EWs, EWs on different categories of DEG and different categories of risk, but not broader home insurance or EWs on central heating systems and alarms) are in the same market, and that the geographic dimension of the relevant market is the UK as a whole. The threat of new entry has to date exercised little competitive constraint on POS sales or pricing. Whilst it is relatively easy for a firm which is not selling DEGs to acquire many of the assets and capabilities which are needed to enter the market (for example, administration capability and access to repair and servicing facilities), the difficulty in accessing customers at the point when they are most likely to want an EW makes it hard to compete effectively.

EW pricing and profitability

1.12. The DEG retail market appears to be characterized by vigorous price competition. By contrast, there is relatively little competition on the pricing of EWs. Retailers compete for DEG business, treating the EW sale as secondary. EWs are usually priced by retailers in relation to the price band of the DEG. Customers appear to decide whether to buy an EW in part by assessing the cost of the EW against the potential cost of replacing the DEG. Prices set by POS retailers appear to be set to a considerable extent at levels that consumers will bear rather than in the light of competition from readily available alternatives. Prices do not appear to reflect variations in underlying costs or risks. Most manufacturers do not actively promote their own EWs, nor do they compete with retailers to supply EWs at the POS.

1.13. We examined whether the characteristics of the market we have identified enable EW providers to charge excessive prices by looking at the profitability of EWs to the various providers. In order to assess the reasonableness of the returns earned from EWs, we sought to

compare the returns on the capital employed in the EW business with the companies' cost of capital. The analysis was complicated by the differences in business models between companies, and by differences in accounting practices. However, we concluded that larger retailers' returns on capital on EWs persistently and substantially exceed their cost of capital. This indicates that EW prices are generally higher than necessary to cover costs and generate an adequate return. The same appears to be the case for many of those medium-sized retailers whose business was not purely, or predominantly, free EWs, and for some manufacturers selling direct to consumers. There is insufficient data to be able to reach the same conclusion for small retailers. We estimated that the top five EW retailers (accounting for 80 per cent of paid EW sales at POS) have, over the five years which we analysed, collectively earned, on average, between £116 million and £152 million more profit each year than they would have earned if their return equalled their cost of capital. Put another way, were this market fully competitive such that the top five EW retailers' returns were no greater than their cost of capital, we estimate that EW prices would have been, on average, up to one-third lower (though it is not possible to extrapolate from these figures to the rest of the market).

Conclusions on monopoly situations

1.14. We identified a complex monopoly situation in the market for EWs sold at POS, under section 7 of the Fair Trading Act. This complex monopoly situation results from the fact that those that sell EWs at POS have a competitive advantage, and so all those that are involved in selling EWs at POS are part of the complex monopoly situation. They comprise all retailers selling EWs at POS in stores, or through catalogues, mail order, telephone sales or the Internet, all manufacturers selling paid EWs with DEGs sold directly to consumers, all insurers underwriting paid EWs sold through retailers, and all service companies contracted with retailers, manufacturers, or insurers. This includes all those involved in the provision of EWs at POS, but no others. We also identified that a scale monopoly exists in the supply of EWs by Dixons Group PLC as an agent of Appliance Serviceplan Ltd and Allianz Cornhill Insurance plc, amounting to around [redacted] per cent (by value) of the relevant market, but we did not identify any ways in which these companies benefited from that situation, as opposed to their benefiting from participation in the complex monopoly situation.

1.15. Four overlapping characteristics of market behaviour suggested that, given the POS advantage, practices that might otherwise be unexceptionable could act to restrict or distort competition:

- (a) Almost all EWs are purchased at POS; few consumers seek information on EWs prior to their purchase; and consumers have little opportunity to consider alternatives to the EW on offer at POS.
- (b) EWs on offer at POS are nearly always all from one provider, usually the retailer (or a third party which is the sole supplier to the retailer).
- (c) There is generally no information available at POS on prices, or terms and conditions, of EWs available from alternative providers (such as manufacturers, insurers, credit card companies or others).
- (d) There is generally no information available on DEG reliability, likely repair costs, or the probability of theft or accidental damage.

Conclusions on the public interest

1.16. In this context, we found that the practices of EW providers at POS restricted or distorted competition, in that the providers limited the choice of product, and limited the provision

of relevant information about that product and alternatives (including price information). In the case of larger, and some medium-sized, retailers, and manufacturers selling direct to consumers, they were able to charge excessive prices, indicated by levels of profits significantly and persistently in excess of their cost of capital. Retailers at POS also limited the choice of cover and time periods, and required consumers to contract, and commit to paying for, EWs substantially in advance of receiving benefits. All those involved in providing paid EWs at POS (collectively accounting for around 56 per cent of the market) engage in practices which restrict or distort competition. We concluded that they all benefit from the complex monopoly situation, and that these practices, and others (including offering some terms which consumers might not expect, nor have the opportunity to compare with others, and employing selling practices which leave customers feeling under unreasonable pressure), maintain or exploit the monopoly.

1.17. Many of the practices that we have identified during the course of our investigation operate or may be expected to operate against the public interest. They result in lack of choice, excessive prices, insufficient information, insufficient competition at POS, limited but not insignificant sales pressure, some terms which could be disadvantageous, and lack of information about the scope of protection under service-backed schemes. They operate on all types of paid EWs, and for all types of POS sales operation, though the effects are less in the case of EWs on mobile phones (because of the prevalence of rolling monthly contracts) and where EWs are provided through catalogue sales, or through the Internet.

Remedies

1.18. Having identified facts which operate, or may be expected to operate, against the public interest, we considered what action should be taken to remedy or prevent them. We considered and consulted on a wide range of possible remedies. Because the adverse effects we have identified arise from the lack of competition in the provision of EWs at POS, we believe it appropriate to remedy the adverse effects by creating the conditions for more competition. In general terms, therefore, we favoured remedies designed to provide consumers with wider opportunities to assess their need for an EW and to choose between EWs, and to provide them with the information necessary to make well-informed decisions regarding their purchase of EWs. We considered, in addition to those discussed below, a number of other remedies including a prohibition on retailers selling their own EWs and remedies designed to control prices or profits directly. However, we rejected these because we believed that there were less intrusive options for dealing with the adverse effects identified.

1.19. Based on our consultation on remedies and our further consideration, we developed two packages of possible remedies.

1.20. Package 1 is founded in three core aspects of our assessment: the need for consumers to know EW prices at the time that they choose the DEG; the need for consumers to have time to compare EWs and to have the opportunity to switch; and the need for consumers to have better information when deciding whether to buy an EW. It comprises:

- (a) the requirement to display the price of an applicable EW alongside a DEG in store and in press advertisements and other publicity;
- (b) cancellation and termination rights, including the right to cancel an EW with a full refund within 45 days from purchase if no claim has been made (and the provision of a written postal reminder of the right to cancel), and the right to terminate an EW and obtain a pro-rata monetary refund at any time;
- (c) the provision of a written quotation in a standard format stating that the EW remains available for 30 days on the same terms (which a customer purchasing an EW must sign

to confirm issue and acceptance), and the requirement that offers of a discount on DEG prices contingent on the purchase of an EW should be available to the consumer for the period of the quotation; and

- (d) the requirement to make available to consumers a standard information leaflet setting out information on statutory rights, on the availability of EWs from other organizations, on the possible relevance of household insurance for some consumers, on cancellation rights and on the nature of the warranty.

1.21. Package 2 is founded on the belief that the POS advantage is so strong that it can only be addressed by delaying the purchase of EWs which provide cover for more than one year. Thus consumers would retain the convenience of being able to purchase an EW (for one year only) at the same time as the DEG, and would then have that one-year period to consider whether they wanted longer-term cover, and to shop around. Other providers would have the opportunity to market their EWs in this period. It comprises:

- (a) a requirement that prevents POS providers selling an EW providing cover for more than one year on the day of sale of the relevant DEG or for 30 days thereafter (but there is no restriction on the POS provider selling a one-year EW at POS, so that consumers that want extended cover for, for example, accidental damage, can obtain it immediately);
- (b) a requirement to display an applicable EW price (the one-year EW) alongside the display of the price of the DEG;
- (c) the same rights to cancel a one-year EW or terminate an EW which may have been purchased after the 30-day prohibition as in package 1; and
- (d) the same requirement for a standard information leaflet as in package 1.

1.22. We considered the likely effectiveness of the two packages in remedying the adverse effects, and the restrictions and costs they would impose on providers and consumers in order to assess the reasonableness both of each individual remedy and of the packages. Both packages would reduce the POS advantage which is at the heart of our adverse public interest finding. However, four of us (the majority) felt that the impact of package 1 would be adequate to remedy the adverse effects and that package 2 would be excessively restrictive. The other member of the Group (the minority) did not believe that package 1 would be sufficiently effective to remedy the adverse effects and concluded that only package 2 was adequate.

1.23. The majority concluded that package 1 would be adequate to remedy the adverse effects identified. The right to terminate makes any DEG purchaser a possible customer for other EW suppliers, increasing those suppliers' opportunity to access consumers, which is currently restricted by the POS advantage. The written quote clarifies that the consumer need not buy an EW at POS and that alternative EWs are available. More, objective information will come to permeate the marketplace through the information leaflet, raising general awareness of alternative providers and of the scope to purchase from them. POS purchases will thus be made in the informed knowledge of available alternatives. The majority envisaged that the scope for consumers to delay, cancel or terminate POS EWs should provide much stronger incentives for other suppliers to sell EWs, which in turn should act as a significant constraint on the price of POS EWs.

1.24. The majority also considered that the adoption of package 2 might have disproportionate effects. Prohibiting consumers from purchasing EWs of more than one year's duration at POS is a substantial restriction on consumers' freedom of action; and survey evidence suggested that the opportunity to buy an EW at POS was one that many consumers value. The majority concluded that the adverse effects could be offset without such a degree of restriction on consumers. Many of the respondents to our remedies consultation (including some that would have much to gain from opening up the market) shared this view. The majority were also

concerned that package 2 might lead to a substantial reduction in demand for EWs—many consumers might not buy EWs which they would otherwise have bought—and that this reduction in sales could be out of proportion to the scale of excessive pricing identified. The majority were also concerned that retailers might be able to undermine the effectiveness of the package in various ways. Finally, the majority were concerned about the practicalities of package 2 in relation to cash sales, which seem more problematic for package 2 than for package 1.

1.25. Overall, therefore, the majority concluded that, whilst either package would be effective in creating the conditions and providing the information necessary for consumers to be able to make informed choices, and for competition to develop in the supply of EWs, for the reasons given they regarded package 2 as going further than was necessary to address the adverse effects on the public interest. Whilst it will clearly take time for trading conditions to change, the majority expected package 1 over time to bring about a substantial change in the way EWs are sold in a reasonable timetable. If, as can be expected, their price falls through time in response to increased competition, then this should lead to an expansion in sales to a competitive level determined by consumer preferences and the underlying costs of providing EWs. Even though we do not expect it, if this should turn out not to be the case, then it will, in the view of us all, be clear that only the block on the sales of EWs beyond one year, as envisaged in package 2, would be capable of addressing the lack of competition in the EW market.

1.26. The minority concluded that the remedies in package 1 would not sufficiently address the adverse effects identified, and that only package 2 would be effective. The minority acknowledged that the remedy prohibiting sales of EWs for more than one year at POS would affect consumers' freedom of choice more directly than package 1, but believed that this would be outweighed by the benefits to consumers of greater competition, and that package 2 was less prescriptive and cumbersome in other ways.

1.27. Package 2 enables consumers to obtain cover for relevant risks at POS for the first year, but not beyond. This would eliminate the requirement for a written quotation and for a written reminder of cancellation rights, reducing the costs and complexities of compliance. It also extends throughout the first year the window for consumers to consider whether to buy a further extension of cover for risks including breakdown, and obliges them to make a positive decision if they wish to do so. POS retailers and other providers may be expected to take advantage of this to market actively and innovatively to target customers in this period, and it is likely that consumers wishing to do so will purchase an extension of cover when the initial EW runs out, in what can be expected to be a competitive market. If EWs continue to be perceived as valuable by a proportion of DEG customers, then demand for them is unlikely to collapse. Consumers will continue to seek out cover which meets their particular needs at the right price (as they do in other insurance markets).

1.28. The minority believed that package 1 relied heavily on cancellation and termination rights, combined with the knowledge and understanding of alternative providers, and on consumers changing their behaviour in the light of these. However, consumers seldom use their cancellation rights, and it is difficult to ensure that they read, understand and act on them given the difficulties of regulating the behaviour of sales staff and the risk that, having left the POS, consumers will give the matter no further attention. Moreover, customers seem unlikely to seek out alternative providers in the period immediately following their purchase of an EW (or subsequently in the absence of a specific trigger) and they will remain difficult for an alternative provider to target. There is therefore a significant risk that package 1 will have little effect on the POS advantage.

1.29. The minority believed that given the risk that package 1 would not satisfactorily address the POS advantage, and bearing in mind the advantages of package 2 to the customer (the retention of convenience of POS purchase and of immediate cover) and to the retailer (the lower costs of compliance associated with the lack of a written quotation and notice of cancellation and termination rights), package 2 was the minimum remedy necessary to address the adverse effects identified.

Recommendations

1.30. The majority recommended that package 1 should be implemented in full. We believe that all the elements of package 1 need to be implemented in order to address the adverse effects. This is because it is only through the combination of the recommended remedies that we believe the adverse effects will be addressed through increased competition. Package 1 consists of requirements on providers of paid EWs at POS to display the price of the EW alongside that of the DEG both in store and in press advertisements; to provide an information leaflet before the sale of the EW; to provide a quotation before the sale of an EW which would remain valid for 30 days; to keep any discounts available during the quotation period; to provide a right for the consumer to cancel the EW with a full refund within 45 days and to terminate it at any time with a pro-rata refund; and to confirm in writing the right to cancel or terminate the EW.

1.31. The minority recommended that package 2 should be implemented in full. Under Package 2, providers of paid EWs at POS may sell EWs at POS if the duration of the EW is up to one year. They may not sell any EW with a duration of more than one year until 30 days after they have sold the DEG to which it relates. They are required to display the price of the one-year EW alongside that of the DEG, both in store and in press advertisements; to provide an information leaflet before the sale of the EW; and to provide a right for the consumer to cancel a one-year EW with a full refund within 45 days, and to terminate an EW with a duration of more than one year at any time with a pro-rata refund.