DIRECT LINE INSURANCE GROUP PLC

PRIVATE MOTOR INSURANCE MARKET INVESTIGATION

RESPONSE TO THE COMPETITION COMMISSION'S ANNOTATED ISSUES STATEMENT AND WORKING PAPERS

1. INTRODUCTION AND EXECUTIVE SUMMARY

1.1 DLG's comments on the CC's Annotated Issues Statement (**AIS**) and Working Papers (**WPs**) can be summarised in the following key points.

1.2 Firstly, unlike most of the markets that end up being referred to the Competition Commission (the **CC**), the private motor insurance (**PMI**) market is highly competitive. While the operation of the PMI market as a whole is certainly not perfect, there are many aspects of it that deliver good outcomes for consumers. The level of concentration in the market is generally low, there is intense rivalry between insurers, customers shop around before buying and, as the CC recognises, switching rates are very high, indeed much higher than in many other retail markets.

1.3 Consumers are the principal beneficiaries of these market features, both in terms of the prices charged for insurance and in terms of quality of service. The biggest driver of premium inflation in recent years has been claims for whiplash injuries, which the Ministry of Justice has sought to address by its recent reforms. Recent data from the AA Insurance Shoparound Survey shows that motor insurance premiums fell by approximately 10 per cent in the second quarter of 2013 as compared to the same period last year, which the AA has attributed to the impact of legal reforms relating to whiplash, and competition between insurers.[1] Notwithstanding the limitations of the CC's consumer survey report (and specifically the very low response rate of policyholders willing to take part in the telephone interview), DLG is pleased to see positive evidence from the survey that customers are happy with the quality of repairs and the provision of temporary replacement vehicles (**TRVs**), as this shows that the PMI market is in many respects delivering value for customers.

1.4 That said, DLG recognises that the separation of cost liability and cost control (the CC's first theory of harm (**ToH**)) does lead to market dysfunction. Accordingly, DLG supports the CC's investigation of this area. Specifically, DLG accepts that the misalignment of incentives that this produces can increase costs for fault insurers, particularly where claims are handled by claims management companies (**CMCs**) / credit hire companies (**CHCs**) and TRVs are provided under credit hire arrangements.

1.5 There are case law precedents which establish the right of CMCs/CHCs to recover above-cost and to generate a profit (albeit the CC has found that this can lead to inflated costs and longer hire periods). DLG and other insurers have sought to challenge this principle, but have consistently failed. There is no justification for the excessive levels of credit hire charges currently being applied by CMCs/CHCs and DLG would support measures aimed at reducing these charges. But the problem will not be solved simply by banning referral fees without also seeking to reduce the level of credit hire charges; as the CC acknowledges, those referral fees are a way for insurers to capture the (excess) profits being earned by CMCs/CHCs.[2]

1 See: http://www.theaa.com/newsroom/bipi/201307-bipi.pdf.

2 WP1, paragraph 62.

1.6 Further, although ToH1 can be viewed as a natural consequence of the third party liability model, any reform of that model would carry a high risk of unintended consequences. DLG therefore strongly believes that any changes that the CC might be contemplating in this area should be very carefully considered, and be underpinned by a full cost/benefit analysis and a broad review of anticipated consequences before any decision is taken.

1.7 Notwithstanding the constraints of the current tortious liability system, DLG does nonetheless seek to control costs through the use of its network of approved repairers, and by the negotiation of discounts and referral fees from input suppliers. This is beneficial to consumers and enables it to offer more competitive premiums. However, it is DLG's view that in the highly competitive environment in which it operates, DLG (and not its less efficient competitors) should be able to benefit from the cost savings which it is able to generate through the centralised procurement of inputs such as parts and paint. This results in a benefit to DLG's own customers, in the form of more competitive PMI premiums. The CC argues that the practice by non-fault insurers, of not sharing referral fees from input suppliers with fault insurers, is part of the moral hazard problem. DLG does not agree, but rather sees a moral hazard in not permitting insurers to benefit appropriately from efficient procurement arrangements with input suppliers; without the ability to keep those benefits, insurers will have less incentive to generate the efficiencies in the first place. There is no rational basis for requiring such rebates to be shared with rival insurers and DLG cannot think of any other competitive market in the UK where suppliers are required to share with their competitors the cost savings achieved from negotiations with input suppliers.

1.8 Secondly, it is important that insurers such as DLG should not be dis-incentivised from investing in their own repair networks and earning a return on that investment. The ability to channel repair work through DLG's network of wholly-owned repairers (**UKAARCs**) and approved third party repairers (**Tier A repairers**) enables it better to control the cost of repairs and to ensure a consistently high quality service. It provides a mechanism for mitigating the separation of cost liability and cost control that is the basis of ToH 1, as the evidence shows that where customers arrange for repairs to be carried out by a garage of their own choice, the cost is often significantly higher.[3]

1.9 Thirdly, DLG believes the CC should be focusing more attention on the market power enjoyed by price comparison websites (**PCWs**). The CC is right to say that so-called 'wide' MFN clauses (which prohibit lower pricing across multiple sales channels) are anti-competitive. However, DLG disagrees with the CC's view that 'narrow' MFN clauses (which prohibit lower pricing on an insurer's own website) are unproblematic. DLG's strong view is that narrow MFNs can be anti-competitive, effectively creating a price 'floor' and dampening price competition between PCWs.

1.10 PCWs have considerable bargaining strength relative to insurers: insurers do not have much leverage when it comes to negotiating commission rates with PCWs. The threat to de-list a brand from a PCW does not carry much weight because of the large number of competing brands that are typically carried by any individual PCW. The CC suggests that costs per acquisition (**CPAs**) may be constrained by the fact that the majority of consumers shop around and can be reached by PMI providers on many alternative sales routes; consistent with this, the CC says it has been told that CPAs have increased at near or below inflation rates.[4] **[CONFIDENTIAL]**.

1.11 Fourthly, the issue of add-ons is currently under review by the Financial Conduct Authority (**FCA**) and DLG considers that the FCA is best placed to address this.

1.12 Fifthly, DLG is surprised at the CC's observations in the AIS on certain contracts between insurers and paint manufacturers.[5] DLG's own contractual arrangements with Akzo Nobel are clearly

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[3] Table 6 of DLG's claims cost data submitted to the CC on 18 July 2013.
[4] AIS, paragraph 48; WP8, paragraph 91.
[5] AIS, paragraphs 87-88.

efficiency-enhancing and DLG does not believe they result in higher paint costs for repairers or cost inflation for other insurers. DLG is pleased to see that the CC now appears to agree with this assessment in the Working Paper (**WP**) on vertical agreements for the supply of paint (excluding foreclosure).[6]

1.13 The remainder of this response enlarges on these themes and is structured as follows:

(a) Sections 2 - 6 discuss the CC's analysis of the various ToHs as set out in the AIS; and

(b) Annexes 1 - 6 comment on the following WPs:

- Annex 1: WP2 (overcosting and overprovision of repairs);
- Annex 2: WP3 (overcosting and overprovision of TRVs);
- Annex 3: WP 6 (vehicle write-offs);
- Annex 4: WP 14 (add-ons);
- Annex 5: WP 17 (vertical agreements for supply of paint);
- Annex 6: WP16 (impact of MFN clauses: note that this is a paper produced by Oxera on behalf of DLG).

DLG has only commented on those WPs where it has specific comments that it wishes to bring to the CC's attention. However, in relation to those WPs where DLG has not commented, it should not be assumed that DLG necessarily agrees with the CC's analysis. Additionally, it should be noted that the order of DLG's response is driven by the order in which issues are discussed in the AIS.

6 WP14, paragraph 78.

2. TOH 1

Vehicle Repairs

2.1 DLG agrees with the CC's findings that credit repairs do appear to increase the cost of non-fault repairs and is not surprised that credit repairs can be more expensive than repairs controlled by the fault insurer.[7] (As noted in previous submissions, DLG does not refer customers or third parties to credit repairers.)

2.2 DLG acknowledges that, on a market-wide basis, repair costs can often be more expensive where the repair is handled by the non-fault insurer as compared to when the same repair is captured by the fault insurer. This is reflected in the evidence found by the CC to-date that, on average, repair bills are £200 more expensive if the repair is handled by the non-fault insurer.[8]

2.3 On the other hand, it is too simplistic to ascribe this difference entirely to the separation of cost control and cost liability that forms the basis of ToH1. DLG's experience is that where a vehicle sustains more severe damage, the customer is more likely to contact his or her own insurer relatively quickly for assistance, as the car may not be driveable, or the customer may have concerns about whether it can safely be driven.

2.4 By contrast, customers with less severe accident damage are less likely to have made arrangements with their own insurer when the accident is first reported to the fault insurer, and are therefore more likely to be captured by the fault insurer. This is discussed in greater detail in Annex 1.

2.5 **[CONFIDENTIAL]**.

2.6 DLG notes the CC's observation[9] that "when an insurer is in the non-fault position, the referral fees it receives from input suppliers are not typically passed on to the rival fault insurer, which effectively increases the repair costs charged to the fault insurer. This effect is part of the moral hazard problem and included in the estimated overcosting set out in paragraph 12." DLG does not agree with the characterisation of such payments as "part of the moral hazard problem" or the implicit suggestion that it would be better if such payments were used to reduce repair costs charged to at-fault insurers. Larger insurers such as DLG, using centralised procurement strategies and negotiating on behalf of their repairer networks, may well be able to secure better buying terms than smaller, less efficient, competitors who lack comparable scale. But to suggest that DLG's procurement efficiencies should be shared with rival insurers would allow those firms to free-ride off the investments that DLG has made in the establishment and operation of its repair network. The referral fees, discounts and rebates that DLG is able to secure are a result of DLG's purchasing power over its suppliers; a position that has been gained over time through competition on the merits, with many vehicle drivers choosing DLG as their insurer. It is entirely reasonable for DLG to pass on the resulting benefits to these vehicle drivers, i.e. to DLG's own policyholders, rather than other insurers' policyholders. This practice enables DLG to be competitive in the premiums it offers to its customers and provides an appropriate incentive for DLG to optimise the efficiency of its procurement arrangements with input suppliers.

2.7 DLG cannot comment on the arrangements that other insurers have with salvage companies but is surprised by the CC's finding that commission payments and referral fees indicate overcosting of up to around £200 per non-fault written-off vehicle.[10] As explained to the CC **[CONFIDENTIAL]**.[11]

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7 AIS, paragraph 12.
8 AIS, paragraph 12.
9 AIS, paragraph 13.
10 AIS, paragraph 14.
11 **[CONFIDENTIAL]**

As explained in more detail in Annex 3, the difference in the write-off costs identified by the CC between third party non-fault captured claims and first party non-fault claims[12] can to some extent be expected to reflect differences in the average severity of damage. This may also have implications for the related CC estimate of salvage referral fees of £200, if those referral fees are in part explained by differences in salvage value at write-off due to differences in the average severity of damage.

2.8 DLG is pleased to see the CC's findings (in its survey report) that the majority (89 per cent) of respondents were very or fairly satisfied with the repair service they received, with three out of five respondents being very satisfied.[13] Providing customers with a high quality repair service is crucial to DLG's brand equity and DLG invests heavily in its approved repair network to achieve this (e.g. DLG offers customers a five year guarantee on repairs, which is significantly longer than the warranty period offered by most non-approved repairers and indeed by most manufacturers).[14] The provision of such an extensive guarantee is a clear consumer benefit, which DLG would be unable to offer if it did not have an approved repair network.

2.9 In summary, therefore, DLG does not believe any form of intervention by the CC is necessary to address issues relating to vehicle repairs.

TRVs

2.10 On the other hand, there is a strong case for intervention to address the excess profits being earned by the credit hire industry. DLG agrees with the CC's findings that credit hire leads to excessive daily hire rates and hire durations. In DLG's view this phenomenon is mainly due to overcosting, but with an element of overprovision also being likely, notwithstanding the fact that CMCs/CHCs do incur additional costs in the form of frictional costs and referral fees. This is a problem caused by the separation of cost liability and cost control. It also reflects the fact that credit hire rates set under the GTA have been fixed at too high a level. CMCs/CHCs have a very strong negotiating position vis-à-vis insurers, which is a direct result of CMCs/CHCs having the 'outside option' of charging vehicle hire rates in line with case law, which in practice are likely to be even higher than the GTA rates. The GTA was the industry's attempt to address the issue of excessive credit hire charges, but has significant limitations and is no longer fit for purpose (see further Annex 2).

2.11 DLG actively seeks to mitigate this cost inflation in circumstances where it is responsible for the costs of a credit hire vehicle provided to a non-fault party: its arrangements with **[CONFIDENTIAL]**.[15] It may be tempting to assume that referral fees are part of the problem of overcosting. However, this would be too simplistic: as the CC itself acknowledges, referral fees are a way for insurers to capture the (excess) profits generated by CMCs/CHCs.[16] If insurers were not able to generate income from referral fees this would increase the profits of CMCs/CHCs, leaving insurers facing higher costs, and leading to higher premiums. DLG does not therefore believe that the answer lies in only banning referral fees (i.e. as a standalone measure), as referral fees represent both a symptom of, and a means of mitigating costs associated with, the current system.

2.12 In conclusion, this is a highly complex area where the rights of the non-fault party and CMCs/CHCs have been clearly (and repeatedly) upheld in numerous court decisions. Insurers, including DLG, have repeatedly sought to challenge these inflated costs in the courts but have failed. There is no justification for the excessive levels of credit hire charges currently being applied by CMCs/CHCs and DLG would support measures aimed at reducing these charges. However, any changes contemplated by the CC (in particular any changes directed towards reform of the third party liability

12 WP4, paragraph 30.
13 Survey report, page 78.
14 The guarantee is for five years or the balance of the manufacturer's warranty period, whichever is longer.
15 **[CONFIDENTIAL]**
16 WP1, paragraph 62 ("It appears to us that the result of this market structure is that referral fees represent a method by which non-fault insurers and brokers can extract the profits generated by CMCs/CHCs in the provision of credit hire (and other) services.")

model) must be carefully considered and a full cost/benefit analysis undertaken. These issues are further discussed at Annex 2.

3. TOH 2

3.1 DLG agrees with the CC's current thinking that ToH 2 does not create any material consumer detriment.

3.2 Although DLG obviously cannot comment in detail on how other insurers manage their repair processes, as a general matter DLG is not aware of systematic instances of underprovision in relation to repairs managed by insurers. As regards DLG's own approach, as set out in paragraph 2.8 above, DLG invests heavily in its approved repair network to ensure that it provides customers with a high quality repair service whilst ensuring that it can control costs. DLG believes that its ability to own its own repairers (namely, the UKAARCs) and control its approved network of third party repairers (i.e. the Tier A repairers) provides significant benefits to customers. As to the submissions received by the CC[17] "suggesting that the repair quality of insurer-managed repairs is often poor", DLG is confident that any such criticisms in relation to DLG-managed repairs would be entirely unjustified. It also looks forward to reviewing the results of the work being undertaken by MSXI in due course.

3.3 In relation to TRVs, DLG does not believe that the current system of tortious liability, under which non-fault claimants are entitled to a like-for-like replacement vehicle on a credit hire basis, leads to underprovision, although some element of overprovision (at least in terms of credit hire duration) seems likely. The fact that 85 per cent of non-fault claimants who received a TRV said that it met or exceeded their needs is compelling evidence that underprovision of TRVs is not a problem.

3.4 DLG also agrees with the CC that customers do not suffer material harm in relation to the value they receive when their vehicle is written-off because of their ability to challenge vehicle valuations and the option to keep the written-off vehicle.

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17 AIS, paragraph 32; WP5, paragraph 3.

4. TOH 3

Northern Ireland

4.1 DLG has a limited presence in Northern Ireland, and as a result is not best placed to comment in detail on this subject. However, at a high level, it disagrees with a number of contentions that the CC makes.

(i) Undue emphasis placed on HHI measures of concentration

4.2 Notwithstanding the seemingly high HHI levels cited by the CC in its working paper on horizontal concentration of PMI providers in Northern Ireland (**WP7**),[18] DLG does not agree with the CC's contention that the provision of PMI in Northern Ireland should be characterised as 'highly concentrated'. According to the CC's own findings, there are at least 18 insurers active in Northern Ireland, which would suggest a relatively fragmented market.[19] The HHI levels observed by the CC are due mainly to the large market share of AXA (the CC mentions a figure of 30-40 per cent, which alone would give an HHI of 900-1600),[20] and are not necessarily indicative of a lack of competition.

(ii) Market shares in Northern Ireland are not static

4.3 The CC has found that AXA Northern Ireland has substantially increased its market share in Northern Ireland in recent years.[21] The reasons for AXA's growth appear to be due in large part to competition on the merits, suggesting that the market in Northern Ireland is dynamic, and that insurers who are willing to invest and offer low prices will be rewarded with a larger share of the market at the expense of less competitive players.[22] This suggests that less emphasis should be placed on HHIs and market shares as these may be subject to change over time.

(iii) Lower claims ratios do not indicate higher profitability

4.4 The CC has found that claims ratios are somewhat lower in Northern Ireland than in the rest of the UK. However, this does not necessarily indicate higher profitability. Distribution costs are likely to be higher in Northern Ireland than in the rest of the UK, due to the use of brokers as the main distribution channel. The appropriate measure of profitability is the combined operating ratio (**COR**). **[CONFIDENTIAL]**. In addition, uncertainty over claims costs means that there may be a greater requirement for capital to fund potential liabilities.

(iv) No evidence that lower claims ratios are due to lack of competition

4.5 In Appendix 1 to the Working Paper, the CC identifies three reasons why claims ratios are lower in Northern Ireland than in Great Britain. None of these reasons is related to a lack of competition. In its conclusion the CC notes that: "it did not appear to us that these reasons were likely to explain all of the ten percentage point difference we observed." The CC does not present any evidence to support this statement. Furthermore, the CC does not give a give a view on what proportion of the ten percentage point difference is likely to be accounted for by these reasons.

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18 WP7, paragraph 26.
19 WP7, Table 1.
20 WP7, paragraph 23.
21 WP7, paragraphs 46-51.
22 WP7, paragraph 51.

(v) Other factors influence pricing

4.6 The CC asserts that premiums in Northern Ireland are higher than in the rest of the UK. However, there may be a number of reasons for this. As the CC recognises in its Working Paper, the OFT, in its summary of evidence received following its call for evidence in relation to PMI, identified a number of reasons why premiums may be higher including:[23]

(a) higher costs as a result of both higher compensation levels for personal injury in Northern Ireland as compared to the rest of the UK and differences in the legal processes (in particular, the absence of a compulsory pre-action protocol in Northern Ireland may make litigation more prevalent); and

(b) the fact that statistically, Northern Ireland has more accidents per capita and per vehicle.[24]

[23] WP7, paragraph 20.

[24] OFT's Private Motor Insurance, Summary of Responses to Call for Evidence, paragraph 5.6.

PCWs

4.7 PCWs are the major and growing sales channel through which PMI is increasingly sold. DLG estimates that in 2012 PCWs had a share of **[CONFIDENTIAL]** per cent of new PMI policies.[25] Given their crucial importance as a sales channel for insurers, DLG agrees with the CC that the four large PCWs do have bargaining power when negotiating with insurers and that the threat of de-listing even a major brand carries only very limited weight (given the significant loss of sales that the insurer would suffer).

4.8 **[CONFIDENTIAL]**.[26]

Cost estimation systems

4.9 DLG agrees with the CC's current findings that harm is unlikely to arise as a result of horizontal concentration in repair cost estimation systems.

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25 **[CONFIDENTIAL]**

26 **[CONFIDENTIAL]**

5. TOH 4

Transparency and complexity of add-ons

5.1 The FCA is conducting an on-going investigation into add-ons, and recently issued a call for evidence.[27] DLG is actively working with the FCA on this project. Given this parallel investigation and the FCA's remit, DLG believes that the FCA is best placed to assess the issues identified in the CC's survey report.

5.2 DLG believes that customers are generally able to compare the add-on policy options available to them and agrees with the findings of the consumer survey[28] that customers prefer PMI policies which they can tailor themselves. DLG also believes that the PMI market is sufficiently transparent for consumers to shop around to find the add-ons most appropriate to their needs.

5.3 DLG seeks to ensure that its customers fully understand the add-on products they purchase (e.g. through its policy booklets and call centre scripts). However, DLG shares the CC's concern about the level of customer understanding in relation to certain add-ons and recognises that the industry has a responsibility to address this.[29] DLG will continue to work to improve the clarity of communication to customers (as with all of the products and services DLG sells).

5.4 As regards NCB protection, where the CC's survey report identifies a possible lack of customer understanding as to what the product entails (albeit, as explained in Annex 4 below, the interpretation of this data is not necessarily as straightforward as the CC suggests). The fact remains that this product does provide considerable value and reassurance to customers, protecting them from a loss of NCB in the event of a claim.

Potential obstacles to switching

5.5 As the CC's working paper on obstacles to switching (**WP11**) highlights[30] "there is clear evidence that switching levels for PMI are high relative to comparable products." DLG agrees with this assessment. In DLG's view, this is clear evidence of a competitive market.

5.6 DLG also agrees with the CC that automatic renewals and cancellation fees are not obstacles to customer switching.

(a) Automatic renewal represents a critical consumer protection, given that driving without insurance constitutes a criminal offence.

(b) The cancellation process for a customer with a policy that is set to automatically renew is simple and there is no cancellation charge for these DLG customers. A significant proportion of customers with policies that are set to automatically renew also shop around either before switching or choosing to stay with their existing insurer.

(c) Although mid-term cancellation fees vary across the market, the relatively high level of mid-term cancellations demonstrates that these do not represent a material barrier to switching **[CONFIDENTIAL]**.

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27 See: http://www.fca.org.uk/static/documents/general-insurance-add-on-market-study.pdf. The FCA states (page 5) that it is testing whether prices are excessive for a given quality, and whether quality is often not what consumers reasonably expect.

28 AIS, paragraph 56.

29 For completeness, it should be noted that DLG does not offer certain of the add-ons featured in the CC's customer survey where the level of customer understanding seems to have been a particular issue, specifically key loss cover and foreign use cover.

30 WP11, paragraph 2.

5.7 Nor does DLG believe that NCB protection operates as an obstacle to switching; indeed it can be argued that it actually enhances a customer's ability to switch, as it enables the customer to keep the benefit of his or her current level of NCB following a claim.

5.8 On the specific point about the interpretation of the survey results relating to customers' understanding of NCB protection, DLG agrees with the CC that some survey respondents may have confused NCB and NCB protection. But this may be because the questionnaire did not make it sufficiently clear that the question was specifically asking about NCB protection, i.e. NCB protection as a policy enhancement or add-on, rather than the NCB itself. DLG therefore believes that the survey does not provide a sufficient basis to draw any reliable conclusions about whether NCB protection or the NCB itself forms an obstacle to switching. More generally, DLG would welcome the creation of a level playing field to ensure that any potential barriers to switching are avoided; as noted in paragraph 5.1 above, the FCA is conducting an on-going investigation into add-ons to establish if there are better ways to help customers understand the products they are purchasing (and DLG is actively working with the FCA on this project).

6. TOH 5

Ownership of PCWs

6.1 Although in theory there is a risk that an insurer-owned PCW could manipulate rivals' quotes on their PCW, DLG agrees with the CC that in practice there seems to be no evidence that this has actually occurred. If it were to occur, however, the CC is right to observe[31] that the threat of de-listing is very much a last resort, and would be an unattractive option for any insurer given the importance of PCWs as a sales channel.

MFNs

6.2 The use of MFNs by PCWs is, however, a more immediate issue and DLG is surprised that the CC is so sanguine about the competitive impact of 'narrow' or 'own-website' MFNs. For a brand that wishes to distribute direct as well as on PCWs, DLG's view is that there is little difference between the effects of a 'wide' MFN and a 'narrow' MFN. A narrow MFN means that the price in the insurer's own channel (i.e. on its own website) cannot be lower than the price quoted on the PCW. But in practice, it is unlikely that an insurer would want to be so constrained: it would be unattractive to an insurer for the price in its own channel to be higher than on other PCWs, so the practical effect of a narrow MFN is to lead to price harmonisation across all channels and all PCWs. This is the same as the effect of a wide MFN, albeit via a less direct mechanism**.**

6.3 This is a particular cause for concern in light of the current stage of evolution of the PCW sector. The PCW industry is entering a transitional phase between growth and maturity, and is now at the point where **[CONFIDENTIAL]**. If a PCW believes that its competitive position in the market is completely unaffected by the commissions it charges, it can raise them with impunity, with the costs spread across all distribution channels, resulting in widespread CPA inflation and, ultimately, consumer detriment. If a PCW increases its commissions, an insurer either has to absorb the cost (which may be unsustainable in a market as competitive as PMI), pass it on by increasing premiums, or de-list (which, to DLG's knowledge, has never happened) and sacrifice significant volume. Assuming that insurers are effectively forced to pass on the increased CPA costs by raising premium rates, the effect of a narrow PCW will be an increase in price across all channels and all PCWs. These themes are further explored in the Oxera paper which is included at Annex 6.

Relationships with paint manufacturers and distributors: non-foreclosure issues

6.4 The CC suggests in the AIS that contracts under which the insurer recommends a paint brand or manufacturer to its repair network in exchange for a per-repair referral fee, and in some cases an additional fixed fee paid by the manufacturer, reduce competition at the retail level, which may lead to higher paint costs for repairers.[32] DLG is not aware of the details of other insurers' contractual arrangements with paint manufacturers and can therefore only comment in general terms. However, as a point of principle, it would also seem relevant to consider whether the alternative brands of paint that the repairers would otherwise have purchased would match the quality of the paint being recommended by the insurer. It is in DLG's view entirely legitimate for insurers to control the quality of paint used on repair work for which they are ultimately responsible; indeed this is essential where the insurer is also guaranteeing the repair work (as DLG does), as the insurer will then be responsible for making good any rectification claims under the guarantee.

6.5 The CC refers in the AIS to "one specific paint supply contract" which "mandates repairers to use a specific brand for the insurer's repairs and, for some repairers, also mandates the distributor".[33] The

[31] AIS, paragraph 67.
[32] AIS, paragraph 87.
[33] AIS, paragraph 88.

CC suggests that "this exclusivity in conjunction with the fee structure used may provide an incentive to inflate the cost of paint invoiced to insurers which are not a party to the agreement and may generate higher differentials between the paint costs faced by the insurer involved in the contract and other insurers (see ToH 1)." It notes that it intends "to consider the effects of this agreement further".

6.6 **[CONFIDENTIAL]**.

6.7 **[CONFIDENTIAL].** [34] DLG notes the CC's observation in WP14 that "the contracts between paint suppliers and insurers may generate efficiencies along the supply chain … some of which might result in reduced costs to consumers".[35] DLG agrees. **[CONFIDENTIAL]**.

6.8 **[CONFIDENTIAL]**.[36]

6.9 **[CONFIDENTIAL].** [37] The hypothesis underpinning the CC's comment in the AIS seems to be that if repairers were able to buy paint more cheaply, they would charge lower prices back to DLG, but DLG believes this to be unlikely given where the commercial interests of repairers lie. A more plausible scenario is that repairers would simply keep any savings for themselves, and DLG notes with interest the CC's finding in WP14 that cost increases arising from paint supply contracts are small relative to the average repair bill (similar to the level of rebates paid to insurers), and that repairers would be unlikely to pass on fully to insurers any savings made from not having such contracts, which is consistent with DLG's own assessment.[38] The CC is therefore right to conclude that harm to PMI consumers is unlikely to arise directly from such contracts.[39]

6.10 The CC leaves open the possibility that harm to consumers may nonetheless arise indirectly, due to these contracts inflating non-fault repair costs.[40] DLG does not agree with the implicit suggestion underpinning this remark that non-fault insurers should be forced to share with fault insurers the rebates and referral fees that they obtain from input suppliers. These rebates are a source of competitive advantage for an insurer such as DLG, albeit the amounts of money at stake are small relative to the issue of excessive credit hire charges imposed by CMCs/CHCs. There is no rational basis for requiring such rebates to be shared with rival insurers and DLG cannot think of any other competitive market in the UK where suppliers are required to share with their competitors the cost savings achieved from negotiations with input suppliers. Indeed, to impose such a requirement in the case of the PMI market would blunt DLG's incentives to use its purchasing power to drive efficiencies in its procurement; this would ultimately benefit upstream suppliers and lead to higher premiums for policyholders.

6.11 Finally, the CC is right to dismiss the concerns being voiced by RML and the VBRA, which are speculative and uncorroborated, and ultimately irrelevant to the issues in this inquiry.[41] These points are further discussed at Annex 5.

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34 **[CONFIDENTIAL]**
35 WP14, paragraph 62.
36 **[CONFIDENTIAL]**
37 **[CONFIDENTIAL]**
38 WP14, paragraph 63.
39 *Ibid*.
40 WP14, paragraph 63.
41 WP14, paragraphs 78-81.

ANNEX 1

WP2 (OVERCOSTING AND OVERPROVISION OF REPAIRS)

Introduction and summary

1. DLG agrees with the CC's view that credit repairs are more expensive than repairs captured by the fault insurer and believes that credit repairs can contribute to premium inflation.

2. While the separation of cost liability and cost control is likely to be one possible factor behind the higher cost of credit repairs, the £200 difference which the CC has identified between the repair costs incurred by non-fault insurers and the charges they make to fault insurers cannot be attributed entirely to ToH 1 as the CC suggests. DLG's experience (as evidenced below) is that first party repairs controlled by the non-fault insurer typically involve more severe damage to the vehicle than third party repairs captured by the fault insurer, and DLG's data suggests that this explains a significant part of the £200 cost difference.

Credit Repairs

3. DLG agrees with the CC that there is overcosting of credit repairs and is not surprised by the CC's findings that credit repairs can be more expensive than repairs controlled by the fault insurer. However, the precise impact on the cost of repairs may differ from the CC's £300 estimate if the average severity of damage differs relative to repairs conducted by insurers.

Repairs controlled by non-fault insurers

4. The CC's current findings are that the average cost of a non-fault repair for a fault insurer is around £200 more expensive if the non-fault insurer manages the repair rather than if the fault insurer manages the repair itself (comprising an average difference in repair bill of £178 and a further £10 to £20 of commissions or rebates from suppliers).[42]

5. DLG's view is that the separation of cost liability and cost control can impact the incentives of insurers, CMCs, repairers and other parties and is therefore one reason why repairs controlled by a non-fault insurer are more expensive. Applying different charges for the same repair depending on whether it is a fault or non-fault repair, by adding administration or other fees to fault repairs, or by not passing on discounts received from repairers, are direct examples of this.

6. However, DLG believes that ToH 1 is just one of a number of factors why a first party non-fault repair may be more expensive than a third party non-fault captured repair. DLG does not therefore believe that the £200 difference identified by the CC can be attributed entirely to the separation of cost liability and cost control as the CC suggests.

(i) Non-fault controlled repairs are likely to involve more cases of severe damage:

7. DLG's experience is that where a vehicle sustains more severe damage, customers are more likely to contact their own insurer relatively quickly for assistance, whereas customers with less severe accident damage are less likely to have made arrangements with their own insurer when the accident is first reported and are therefore more likely to be captured by a third party insurer. A car with more severe damage is more likely not to be driveable, or the customer may have more concerns about driving it and therefore will notify his own insurer more quickly than where the car sustains less severe damage.

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[42] WP2, paragraph 51.

8. DLG has observed that of its first party non-fault claims settled in 2012, **[CONFIDENTIAL]**.

9. DLG also notes that **[CONFIDENTIAL]**.

10. This difference in the average severity of damage can be seen through an analysis of average costs for repairs undertaken by DLG for its (first party) non-fault customers as the non-fault insurer as compared to those (third party) non-fault repairs captured by DLG as the fault insurer. **[CONFIDENTIAL]**

11. The data that DLG provided to the CC in its response to the claims cost data response of June 2013 shows that repair costs were **[CONFIDENTIAL]** when DLG is the non-fault insurer compared to where the non-fault repairs are captured by DLG as the fault insurer. This would suggest that the difference that the CC has identified can be explained in terms of the differences in severity of damage by DLG's data. This data is summarised in Table A1 below.

Table A1

Comparison of labour, parts and paint costs (2012 data)

	DLG non-fault insurer	**DLG captures non-fault third party**	**Difference**
Labour costs	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**
Parts costs	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**
Paint costs	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**
Sum of costs	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**

Source: Comparison of 2012 results from DLG response claims data tables, comparing category 1b (first party non-fault) with category 1d (non-fault captured). It should be noted that **[CONFIDENTIAL]**.

12. It is therefore important to take account of differences in the average severity of damage before reaching conclusions about the impact that separation of cost liability and cost control may be having on repair costs.

(ii) Repairs undertaken outside of an approved repair network

13. The £200 difference identified by the CC includes repairs undertaken outside of an approved repair network. As the CC recognises, such repairs can be significantly more expensive than repairs undertaken by an insurer's approved network, which is symptomatic of the separation of cost liability and cost control but also reflects the ability of insurers to leverage their scale when procuring repair network capacity.

Commissions/Rebates received from suppliers

14. The CC describes the practice of taking rebates from suppliers (e.g. of parts and paint) which are not passed on to the fault insurer as one of a number of "strategies for gaining value from non-fault repairs."[43] DLG disagrees with this characterisation. DLG uses its centralised procurement of parts and paint both to control repair costs and to ensure quality of paints/parts used in repairs (DLG offers

43 WP2, heading to paragraph 35.

a five year guarantee on all repairs conducted by its approved repair network). DLG believes that this benefits its repairers (which generate discounts from these procurement efficiencies) and its customers (both because DLG is able to control costs, which helps it offer customers competitive premiums and also because it ensures customers' vehicles are repaired with parts and paint of sufficient quality). DLG does not believe that, within the context of the highly competitive PMI market, it should be required to pass on all of its procurement benefits to its less efficient rivals and can think of no other example of a competitive market in the UK where such a requirement exists.

15. In any event, DLG notes the CC's findings that the commissions/rebates received from suppliers amount to only approximately £10 to £20 per repair.[44] Using the OFT estimate of 23 million policies,[45] this would amount to 22 to 43 pence per policy per annum, which would not be material in the context of the average annual premium for a PMI policy.

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44 WP2, paragraph 47.

45 See: Private Motor Insurance: OFT Report on the market study and proposed decision to make a market reference, May 2012 (OFT1422), note 66

ANNEX 2

WP3: OVERCOSTING AND OVERPROVISION OF TRVS

Introduction and summary

1. DLG agrees with the CC's findings that credit hire leads to excessive daily hire rates and hire durations. In DLG's view this phenomenon is mainly due to overcosting but with an element of overprovision also being likely, notwithstanding the fact that CMCs and CHCs do incur additional costs in the form of frictional costs and referral fees. This is a problem caused by the separation of cost liability and cost control. In terms of the relative scale of consumer detriment, this is a much bigger issue than differences between fault and non-fault repair costs.

Credit hire and direct hire

2. The CC's analysis shows that credit hire appears to be more expensive than direct hire, with insurers paying twice as much for credit hire than for direct hire. The CC has found this difference to be driven by a higher daily rate for credit hire (around 50 – 120 per cent more than the average daily rate for direct hire) and longer hire duration (about 3.7 days longer for credit hire than direct hire). DLG is supportive of these findings and has highlighted the excessive credit hire periods and daily rates which CMCs/CHCs use in its previous submissions to the CC.[46] DLG agrees with the CC's conclusion that the reason for third party non-fault claims having significantly higher TRV costs is primarily due to the use of CMCs/CHCs which invoice the cost of a TRV at higher daily rates and often for longer periods of hire.[47]

Car hire duration

3. The CC's findings show that the length of average credit hire is 3.7 days longer than the length of the average direct hire, but that the length of credit hire (and direct hire) is driven by the duration of repair. The CC therefore states that it is not clear from the evidence that non-fault repair durations are longer when a non-fault claimant is provided with TRV services under credit hire than under direct hire. The CC acknowledges that CMCs/CHCs have an incentive and ability to extend hire durations, in particular through their influence over the repair process. However, the CC believes that insurers are able to monitor hire durations and challenge claims, particularly where hire durations are governed by guidelines under the GTA.

4. DLG considers this to be an overly simplistic assessment of the situation, which does not take into account all the relevant variables. The length of credit hire is not only driven by duration of repair. CMCs/CHCs have significant incentives to draw out the length of time for which a TRV is hired out as ultimately they will be able to claim the costs back from the fault insurer. The longer the hire period, the greater their credit hire costs will be, creating inflationary pressures which correspondingly raise costs for insurers.

5. CMCs/CHCs commonly use tactics to extend the duration of the credit hire period, a fact the CC confirms in the Working Paper.[48] DLG does monitor these hire and repair periods, but challenging excessive periods increases insurers' costs further (through frictional costs, discussed below). In addition, the GTA guidelines on hire periods are insufficiently robust to be effective or enforceable across the market.

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46 See DLG's response to question 56 of the CC's 14 December 2012 questionnaire.
47 See DLG's response to question 2(a) of the follow up questions dated 18 July 2013.
48 WP3, paragraph 127.

Additional costs in the provision of credit hire compared with direct hire

(i) Referral fees

6. As the CC acknowledges, referral fees represent a method by which non-fault insurers can extract the excessive profits generated by CMCs/CHCs in the provision of credit hire (and other services).[49] The CC also asserts that the level of referral fees is an indication of the extent of the underlying profitability in credit hire. DLG agrees with this statement. The presence of CHCs/CMCs in the market causes a distortion and referral fees are the means by which insurers seek to correct this.

7. As DLG has emphasised in previous submissions to the CC, referral fees are both a symptom and a necessary means of mitigating costs associated with the current system. **[CONFIDENTIAL]**. It may be tempting to assume that referral fees are part of the problem of overcosting. However, this would be too simplistic: if insurers were not able to generate income from referral fees the result would be that CMCs/CHCs would make more money but insurers would face higher costs, leading to higher premiums. DLG does not therefore believe that the answer lies only in banning referral fees (i.e. as a standalone measure).

(ii) Frictional costs

8. The CC states that frictional costs arise from the administration, management and settlement of non-fault claims and are generated by the fault insurer attempting to minimise the cost of claims passed onto it by a non-fault insurer or CMC/CHC, and by the non-fault insurer or CMC/CHC defending its claim. The CC's findings show that frictional costs incurred by fault insurers and CMCs/CHCs taken together amount to around between £46 million and £186 million. These findings appear reasonable, although in DLG's view the costs are likely to be towards the upper end of the CC's estimate.

9. DLG's own experience is that frictional costs come from setting up and maintaining bilateral agreements, employing staff to capture claims for hire and repair, defending credit hire litigation, checking loss-of-use dates, GTA compliance, the reasonableness of daily hire rates and the quantum of a CMC's/CHC's claim and negotiating settlement.

10. All frictional costs are ultimately paid for by policyholders. In common with other insurers, DLG therefore takes steps to mitigate them. In circumstances where it is responsible for the costs of a credit hire vehicle provided to a non-fault party, **[CONFIDENTIAL]**.[50] However, DLG would be strongly in favour of a more streamlined system for the provision of TRVs to remove unnecessary costs from the process.

The GTA

11. The CC claims that the GTA plays an important role in reducing the level of disputes (and therefore frictional costs) between insurers and CMCs/CHCs. The CC reports significantly lower savings made against GTA claims as compared with non-GTA claims, suggesting the GTA provides an effective framework for ensuring fewer disputes, and that non-GTA claims are subject to increased frictional costs. In DLG's view, the CC's assessment fails to consider in sufficient detail the various limitations of the GTA.

12. The GTA is an effort by the industry to mitigate cost inflation, providing a compromise between insurers and CMCs/CHCs to control the ever escalating credit hire rates. The GTA was established with the intention of removing confrontation, avoiding costly litigation in disputing the cost of credit hire and stimulating collaboration in the management and settlement of credit hire claims. DLG

[49] WP2, paragraph 62.
[50] **[CONFIDENTIAL]**

recognises that the GTA has had some limited success. For example, non-fault policyholders are entitled to a like-for-like vehicle and having the GTA in place provides a benchmark for this entitlement. However, DLG is also acutely aware of the significant limitations of the GTA. DLG therefore supports the industry's current view (as shared by the ABI) that the market has moved on since the GTA's establishment, and that the GTA is no longer fit for purpose.

13. In particular, credit hire rates set under the GTA have been fixed at an unjustifiably high level (relative to direct hire rates), which encourages CMCs/CHCs to enter the market in the knowledge that there are opportunities to earn large profits. In DLG's view, this is not serving the best interests of consumers. CMCs/CHCs have a very strong negotiating position vis-à-vis insurers, which is a direct result of CMCs/CHCs having the 'outside option' of charging vehicle hire rates in line with case law which, in practice, are likely to be even higher than the GTA rates. The GTA is also voluntary. Although signatories are obliged to apply GTA rates once they are signed up, a robust solution to the problem would need to be multilateral and cover the entire market. The GTA guidelines on hire duration are also insufficient to curtail the incentives of CMCs/CHCs to extend hire periods beyond what is reasonable, a practice which has simply led to inflation of insurers' costs.

14. DLG would consequently urge the CC to consider alternatives to the GTA that would facilitate a more effective way for insurers to reduce the expense and time involved in settling disputes with CMCs/CHCs. DLG would also encourage the CC to examine mechanisms for reducing the incentives of CMCs/CHCs to offer wasteful credit hire services at inflated prices, while at the same time recognising the rights of non-fault drivers to a like-for-like replacement vehicle.

ANNEX 3

WP4: VEHICLE WRITE-OFFS

Introduction and summary

1. DLG agrees with the CC's view that there is unlikely to be significant overprovision (ToH 1) or underprovision (ToH 2) of services to non-fault customers who have had a vehicle written-off. However, DLG believes that the CC has over-estimated the extent of possible overcosting of services related to vehicle write-offs, for similar reasons that apply to repairs (see Annex 1 above).

2. The CC concludes that "[t]he level of the commission payments and referral fees received by some non-fault insurers and CMCs from salvage companies indicates that the extent of the overcosting is likely to be up to around £200 per non-fault written-off vehicle."[51] However, the following factors should also be taken into account:

   (a) differences in the average severity of damage between situations where the fault insurer captures the non-fault third party and situations where the non-fault insurer is handling a claim by its own policyholder (see Annex 1 above for DLG's evidence); and

   (b) the limited materiality of any salvage referral fees on a per-policy basis.

Differences in the average severity of damage

3. Annex 1 above discusses differences in the average severity of damage between situations where the fault insurer captures the non-fault third party and situations where the non-fault insurer is handling a claim by its own policyholder. Differences in the average severity of damage can be expected to have implications both for the proportion of write-offs (as more severely damaged vehicles are more likely to be written-off) and the value of write-off costs (as severity of damage may affect the salvage value of written-off vehicles).

4. Consequently, the difference in the write-off costs of around £300 identified by the CC between third party captured non-fault claims and first party non-fault claims[52] can to some extent be expected to reflect differences in the average severity of damage. This may also have implications for the related CC estimate of salvage referral fees of £200, if those referral fees are in part explained by differences in salvage value at write-off due to differences in the average severity of damage. DLG has not been able to calculate this potential impact on the true extent of overcosting of non-fault vehicle write-offs, but would encourage the CC to look more closely at this.

5. **[CONFIDENTIAL]**.

6. DLG therefore believes that the CC's estimate of £200 for salvage referral fees may exaggerate the true extent of overcosting of non-fault vehicle write-offs.

Limited materiality of salvage fees

7. Even if one accepts the CC's estimate of salvage referral fees of £200, it remains the case that these referral fees are unlikely to have a material impact on PMI premiums, as the cost of the referral fee per policyholder is small, and there remains an incentive for the value of the referral fees to be competed away by the insurers through lower premiums.

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51 WP4, paragraph 6.
52 WP4, paragraph 30.

8. In addition to the estimate of £200 salvage referral fees, the CC also estimates that there are some 112,000 vehicle write-offs per annum for non-fault claimants managed by non-fault insurers.[53] This would suggest that the total level of referrals is £22.4 million per annum, which equates to approximately £1 per policyholder per annum (using the OFT estimate of 23 million policyholders).

9. An amount of £1 per policyholder is plainly insignificant compared to the average annual PMI premium. Furthermore, as the amount of salvage referral fees received by an insurer is related to the number of non-fault claims it manages, which in turn is directly related to the number of customers it has, the insurer is incentivised (at the margin) to reduce premiums in order to increase the number of customers (and hence referral fees). Consequently, these incentives are likely to result in referral fees being passed back to consumers in terms of lower premiums.

[53] WP4, paragraph 17.

ANNEX 4

WP14: ADD-ONS

1. DLG believes that customers are generally able to compare the add-on policy options available to them and agrees with the findings of the consumer survey[54] that customers prefer PMI policies which they can tailor themselves. DLG also believes that the PMI market is sufficiently transparent for consumers to shop around to find the add-ons most appropriate for their needs.

2. The CC's analysis shows that a relatively high percentage of customers compare add-ons from different insurers,[55] which DLG believes reflects the ease with which customers can access information about add-ons both on insurers' websites and many PCWs. DLG seeks to ensure that its customers fully understand the add-on products they purchase (e.g. through its policy booklets and call centre scripts). However, DLG shares the CC's concern about the level of customer understanding in relation to certain add-ons and recognises that the industry has a responsibility to address this.[56] DLG will continue to work to improve the clarity of communication to customers (as with all of the products and services DLG sells).

3. As regards NCB protection, where the CC's survey report identifies a possible lack of customer understanding as to what the product entails,[57] DLG does not believe the results of the survey necessarily show this. The way in which the question seems to have been put to respondents ("Does the protection prevent your premium going up as a result of a claim?") does not necessarily lend itself to a binary "Yes/No" answer. NCB protection <u>limits</u> the extent of any increase in premium as a result of a claim, so to suggest (as the CC does) that 56 per cent of respondents gave the wrong answer by answering "Yes" is arguably an over-simplification.[58] There is also the point that it is not clear whether this result reflects a misunderstanding of the product or a misunderstanding of the CC's survey question. It is possible, for example, that the survey respondents misunderstood the question as to whether they have 'NCB protection' to be asking whether they benefit (in terms of lower premiums) from having an NCB. In addition, the CC is right to question whether the survey results can be considered representative of all PMI policyholders given the remarkably low response rate (5 per cent) for policyholders who were willing to participate in the telephone interview.[59] However, even assuming a possible lack of understanding on the part of <u>some</u> customers, the fact remains that this product does provide considerable value and reassurance to customers, protecting them from an immediate loss of NCB in the event of a claim.

4. DLG agrees with the CC's recognition of the fact that there are a range of possible explanations for claims ratios being lower for some add-ons than for basic cover. At a general level, premiums for add-on products tend to be materially lower than for the core insurance policy. As such, the expense ratio associated with managing and selling these products (and associated overheads) is likely to be higher. The same is true of claims handling costs (which are generally excluded from the claims costs that DLG has previously provided to the CC). There is also an opportunity cost associated with creating, managing and selling add-ons. Time spent on communicating the benefits of add-ons could equally be spent selling alternative products, or deepening the customer relationship in other ways. If add-ons carried margins that were as low as the core insurance policy (e.g. with a combined ratio of c.95 per cent), this would leave profit margins extremely low (around £1 on an add-on priced at £25, for example).

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54 AIS, paragraph 56.

55 WP14, Table 1.

56 For completeness, it should be noted that DLG does not offer certain of the add-ons featured in the CC's customer survey where the level of customer understanding seems to have been a particular issue, specifically key loss cover and foreign use cover.

57 WP14, paragraph 36.

58 WP14, Table 9.

59 WP14, footnote 12.

5. Such low margins would render the sale of add-ons unsustainable, with the result that either (a) the add-on would be incorporated into the core policy, reducing consumer choice and increasing premiums for customers who have no need of the additional cover provided; or (b) the add-on would be removed from sale altogether, leaving customers who need it under-insured.

6. The FCA is conducting an on-going investigation into add-ons to establish if there are better ways to help customers understand the products they are purchasing and recently issued a call for evidence.[60] DLG is actively working with the FCA on this project. Given this parallel investigation and the FCA's remit, DLG believes that the FCA is best placed to assess the issues identified in the CC's survey report and would therefore encourage the CC to continue to liaise with the FCA on this aspect of its investigation.

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60 See: http://www.fca.org.uk/static/documents/general-insurance-add-on-market-study.pdf. The FCA states (page 5) that it is testing whether prices are excessive for a given quality, and whether quality is often not what consumers reasonably expect.

ANNEX 5

WP14: ANALYSIS OF VERTICAL AGREEMENTS FOR THE SUPPLY OF PAINT

Introduction and summary

1. As the CC acknowledges, the price of automotive refinish paint for use in repairs is determined by complex interactions between paint manufacturers, distributors, repairers, insurers or CMCs and car manufacturers. DLG seeks to ensure the best quality repairs for the ultimate benefit of its policyholders. One way of doing this is through the negotiation of vertical supply contracts with paint manufacturers. DLG is therefore supportive of the CC's overall conclusion that paint supply contracts do not give rise to competition problems for the PMI market.

Vertical supply contracts

2. The CC states that vertical supply contracts are not standard practice, but also notes that five of the ten largest insurers (therefore making up a substantial proportion of the PMI market) have these contracts in place,[61] as do some CMCs.[62] The question of whether they are or are not standard practice is perhaps academic, but the fact remains that they are not unusual in the sector.

(i) Efficiencies of vertical supply contracts

3. DLG agrees with the CC's conclusion that contracts between paint suppliers and insurers generate efficiencies along the supply chain, which ultimately result in reduced costs to consumers. As DLG has emphasised to the CC, vertical paint supply contracts enable significant cost savings and ensure the paint used in repairs is of an appropriate quality.

4. In addition, as the CC confirms, the amount by which insurers actually benefit from paint supply contracts is negligible compared to the average billed cost of paint, and even smaller compared to the average total cost of a non-fault repair.

(ii) Exclusive contracts

5. DLG agrees with the CC's assessment that exclusive contracts do not lead to a greater degree of overcosting than non-exclusive paint contracts. The CC characterises exclusive contracts as where an insurer mandates a paint brand to its approved repairers for use on its repairs in return for a rebate. **[CONFIDENTIAL]**.

6. **[CONFIDENTIAL]**.[63] In any event, as the CC rightly observes,[64] any cost increases that may be said to arise from paint supply contracts are small relative to the average repair bill, and it is unlikely that any savings that repairers might make would be passed on fully to insurers. The CC is therefore right to conclude that harm to PMI consumers is unlikely to arise directly from these contracts.

(iii) Effect of contracts on non-fault repair costs

7. The CC nonetheless leaves open the possibility that harm to consumers may arise indirectly from these contracts, due to the inflation of non-fault repair costs. The CC argues this would occur where an insurer receives a rebate from the manufacturer, and achieves the benefit of the rebate in all cases, while only incurring the higher cost when it is liable for the cost of the claim. The CC states this is

61 WP14, paragraph 20.
62 WP14, paragraph 19.
63 **[CONFIDENTIAL]**
64 WP14, paragraph 63.

due to the separation of cost liability and cost control. DLG has acknowledged that the separation of cost liability and cost control is a problem within the current system. However, as DLG has emphasised to the CC, DLG does not believe that non-fault insurers should be forced to share rebates and referral fees that they obtain from input suppliers with fault insurers, as to do so would dis-incentivise DLG from using its purchasing power, which would ultimately benefit upstream suppliers and lead to higher premiums for policyholders.

[CONFIDENTIAL].

8. **[CONFIDENTIAL]**.

9. **[CONFIDENTIAL]**.[65]

10. **[CONFIDENTIAL]**.[66] [67]

11. **[CONFIDENTIAL]**.[68]

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65 **[CONFIDENTIAL]**

66 **[CONFIDENTIAL]**

67 **[CONFIDENTIAL]**

68 **[CONFIDENTIAL]**

ANNEX 6

WP16: IMPACT OF MFN CLAUSES

Comments on the Competition Commission's working papers relating to PCW MFNs

Prepared for the Competition Commission

September 6th 2013

1 Introduction and summary

Direct Line Group (DLG) asked Oxera to provide comments on the Competition Commission's (CC) working papers in relation to the impact of most-favoured nation clauses (MFNs) that are requested by price-comparison websites (PCWs).[1] The main issue raised in this note is the impact of own-website MFNs[2] on competition and consumer harm. The potential benefits of MFNs are also discussed. This paper addresses, in particular, the CC conclusion that: 'It does not appear to us that narrow MFN clauses are likely to be problematic in the same ways [as wide MFNs]'.[3]

Oxera's overall conclusion on own-website MFNs is that they are likely to soften competition between PCWs in the same way as wide MFNs, albeit via an indirect mechanism that has not been explicitly considered by the CC. The potential harm is expected to be greater for providers of personal motor insurance (PMI) that have significant operations in both the direct and indirect (ie, PCW) channels, as they would need to ensure that their direct channel remains competitive.

On the benefits of own-website MFNs, the conclusion is that, while in principle there may be benefits linked to their use, these are likely to be limited. It is also not clear that these benefits would outweigh any harm caused.

[1] Competition Commission (2013), 'Theory of harm 5: Impact of MFN clauses in contracts between PCWs and PMI providers', August; and Competition Commission (2013), 'Theory of harm 3: Horizontal concentration in PCWs', July.

[2] The CC define an own-website MFN to be where a PMI provider may not offer a particular policy on its own website for less than it is advertised on the PCW. The CC define a wide MFN to be where a PMI provider may not offer a particular policy on any online sales channel (or any sales channel of any form) for less than it is advertised on the PCW.

[3] See ToH5 working paper, paragraph 74.

2 Relevant economic literature

There is little economic literature that relates directly to MFNs imposed by online platforms. One relevant source, a recently published research paper commissioned by the UK Office of Fair Trading, sets out the following potential anti-competitive and pro-competitive effects of MFNs agreed between sellers and platforms.[4]

Potential anti-competitive effects:

– foreclosing of rival platforms: wide MFNs that restrict the provider's pricing across platforms can have a foreclosure effect on new platforms or prevent some from taking up a different business model. In some cases, own-website MFNs may have the same ultimate effect, albeit via a less direct mechanism;

– softening of competition: wide MFNs can soften competition between platforms and lead to higher prices for consumers, through the upwards pressure on cost-per-acquisition (CPA) fees;

– facilitating collusion between platforms: a wide MFN may facilitate collusion between platforms by diminishing the incentive for any platforms to deviate from a collusive outcome and enhancing monitoring of the members' behaviour.

Potential pro-competitive effects:

– protecting platforms' investment: both wide and own-website MFNs can help a platform defend its investment in quality. For example, suppose that a high-cost/high-quality platform has invested in the provision of services that help consumers to make an informed choice and/or has invested in vetting the quality/reliability of sellers that use the site. MFNs can help limit sellers from free-riding on the 'advertising' provided and low-cost/low-quality PCWs from attracting customers.

– reducing search costs: economic theory suggests that MFNs can, in some cases, reduce the search costs of consumers. For example, if a platform can signal to potential buyers that they will not find the same product at a lower price through an alternative channel, this could reduce their search-related costs.

These issues are largely addressed in the CC's working paper in relation to Theory of Harm (ToH) 5.

3 Comments on specific issues raised in the working papers

Own-website versus wide MFNs

The CC's four sources of harm in relation to MFNs are as follows:

– MFN clauses may lift constraints on CPA fees, resulting in higher CPA fees and, if these higher fees are passed through by PMI providers, higher PMI premiums;
– MFN clauses may lead to higher PMI prices irrespective of CPA fees because price reductions become more costly to PMI providers;
– MFN clauses may restrict entry and innovation, and therefore choice and price competition, in the provision of PCWs;

[4] OFT (2012), 'Can 'fair' prices be unfair? A review of price relationship agreements', September.

– MFN clauses may shift competition from being based on prices to being based on advertising, leading to excessive advertising, which in turn might raise barriers to entry.

The CC has stated that, 'in the case of an own-website MFN, we do not expect substantial harm from at least three out of the four possible sources of harm.' The CC puts forward the following arguments to support that position.

3.1 CC argument (a)

The CC states that:

> Competition over CPA fees is unlikely to be weakened by own-website MFNs. Other channels, and especially other PCWs, continue to be a source of competition when an own-website MFN is in place. Moreover, our survey of PMI policyholders suggests that most consumers are likely to visit multiple channels, with 63 per cent of those who searched on one PCW visiting more than one PCW (see working paper 'Survey report'). We have no evidence that CPA fees are higher for policies with own-website MFNs than for those with no MFN.

Response: The CC's argument does not appear to take into account the indirect effect that own-website MFNs can have on the insurer's pricing. This indirect effect means that own-website MFNs can potentially have effects similar to wide MFNs in terms of reducing the constraints on CPA inflation. As DLG explained in its response to the CC's July 23rd questions on PCWs: 'the likely result [of own-website MFNs] is that the additional cost from a unilateral increase in commissions ends up being spread across the direct channel, and indirectly across other PCWs, protecting the PCW from the competitive effect of its actions, and leading to premium inflation.'

Unlike wide MFNs, own-website MFNs do not contractually oblige insurers to increase their prices on third-party PCWs if they increase prices on the PCW that has the MFN in place. However, the own-website MFN does force any increase to be reflected on the insurer's own website. When altering its prices, the insurer must take into account the commercial implications of this action.

By increasing prices on one PCW and its own website, an insurer effectively changes the relative prices between its different sales channels which would lead to an outcome that is not necessarily optimal **[CONFIDENTIAL]**.

[CONFIDENTIAL]

The solution to this problem could be to set a flat price across all online channels. As a result, when faced with an increased CPA from a PCW, its optimal response is to increase prices across multiple channels.[5]

In DLG's case the impact of own-website MFNs is therefore likely to be similar in practice to wide MFNs—price competition between PCWs is softened. Essentially, PCWs can profitably increase CPAs because any pass-through to higher premiums would be spread across direct websites and other PCWs.

As the importance of PCW increases, the effect of own-website MFNs on softening competition, as described above, is expected to become stronger. As PCWs become even

[5] In theory, the optimal response may be for an insurer to de-list itself (or de-list certain brands) from a PCW following a CPA increase. However, according to the CC's own findings, there is little, if any, evidence of insurers de-listing themselves from PCWs **[CONFIDENTIAL]**. See section 3.1.2.

more popular among consumers (they are currently responsible for **[CONFIDENTIAL]** of new sales)[6]:

- their bargaining power over PMI providers will increase; and
- the diversion of customers from the direct channel to PCWs is likely to be larger if there are price differences between the two (eg, due to brand awareness of PCWs).

The following sub-sections examine further the claim that, unlike wide MFNs, own-website MFNs are not expected to reduce competition over CPA levels.

3.1.1 Relationship between CPA levels and PMI premiums

As noted above, the CC argues that, under own-website MFNs, other PCWs continue to be a source of competition for the platform that wishes to increase the CPA fee. The argument suggests that a PCW would not wish to raise the amount it charges PMI providers since this would undermine its attractiveness among other PCWs. Essentially, any higher CPA fees would be passed through to that platform's premiums but not to others', leading to a loss of its market share. This reasoning also rests on the premise that insurers would be willing to pass-on the CPA without substantial adverse consequences to the competitiveness of the direct channel and their overall profitability.

If the above argument is valid, then for an insurer such as DLG **[CONFIDENTIAL]**.

However this does not appear to be true in practice. DLG has informed Oxera that **[CONFIDENTIAL]**.[7] In addition, any increase in the amount charged by a platform is not merely passed on to that platform's premiums. The justification for this, as explained by DLG, is that it is commercially necessary for the premiums at its websites to be competitive when compared to the PCWs.

Therefore, if under own-website MFNs CPA increases from a single platform are in fact, not just spread to the direct channel, but also across other PCWs competition over CPA fees is likely to be weakened. This outcome means that the result from the own-website MFN clauses is equivalent to the result for wide MFN clauses, as has been described by the CC. This reduction in the competitive constraints can be expected to lead to higher CPA prices.[8]

3.1.2 Inflation of CPA levels

If the constraint from other PCWs was substantial, CPA levels would be expected to increase at or below the level of inflation. The CC has argued that 'CPA fees have risen only slightly during recent years, at near or below the rate of general inflation' to support the view that PCWs compete with one another.[9] However, information supplied by DLG indicates **[CONFIDENTIAL]**.[10]

[CONFIDENTIAL]

3.2 CC argument (b)

The CC states that:

> The degree to which an own-website MFN will make it costlier for a PMI provider to reduce its prices depends on the proportion of sales that go through PCWs covered by

[6] **[CONFIDENTIAL]**
[7] **[CONFIDENTIAL]**
[8] See ToH 5 working paper, paragraph 28
[9] See ToH 3 working paper, paragraph 14.
[10] **[CONFIDENTIAL]**

> the MFN compared with the proportion going through the direct channel only. If sales exclusive to the direct channel are a small proportion of total sales, we would expect the own-website MFN to increase significantly the cost of a price reduction on the PMI provider's own website.

Response: The CC is correct to conclude that own-website MFNs make it more costly for insurers to cut their prices and that this cost is greater when the proportion of direct online sales is small compared with PCW sales. However, for insurers with a small proportion of direct sales and which are focused mainly on PCWs, being able to price competitively over the direct channel is less important for their business model **[CONFIDENTIAL]**.[11]

3.3 CC argument (c)

The CC states that:

> Entry to the PCW market could be based on the ability to compete on CPA fees, with the expectation that PMI providers would pass through their lower costs to lower policy prices. An own-website MFN does not hamper this process.

Response: The CC's argument assumes that insurers would always be willing to offer premiums on the new entrant PCW that were lower than on their direct website. As noted above insurers may be reluctant to offer prices on a new PCW that were lower than the prices on their own direct websites, for fear of undermining the competitiveness of the direct channel. Own-website MFNs that prevent insurers reducing their online direct prices could make it more difficult for new PCWs to enter the market with a low-price/low-CPA model.

3.4 CC argument (d)

The CC states that:

> The mechanism by which MFNs might lead to high levels of advertising expenditure is directly related to the degree to which they allow for higher CPA fees. Since we expect CPA-fee competition to be maintained by own-website MFNs, we would not expect them to lead to higher advertising expenditure.

Response: As set out in the response to argument (a), own-website MFNs can have the effect of softening CPA-fee competition. As such, the CC's concern about a lack of price competition driving excessive advertising competition would hold for own-website MFNs as well as for wide MFNs.

4 Benefits of MFNs

4.1 Reducing search costs

The CC states at paragraph 76 of the ToH 5 working paper:

> MFNs may enhance the consumer experience of searching for PMI products by reducing the need for consumers to shop around to find a cheaper price. With an MFN in place, consumers can reasonably infer that they are getting a good deal when the PCW returns its quotes. This reduces the consumer's search time and effort.

[11] **[CONFIDENTIAL]**

Response: MFNs can reduce the search costs of consumers. If a PCW can credibly inform potential buyers that they will not find the same motor insurance cheaper through an alternative channel, this could reduce search-related costs.[12]

However, if MFNs lead to higher prices, it is not obvious that reducing the cost of choosing between the inflated prices would provide a net benefit to consumers, unless the expected level of price inflation were small and the costs of shopping around very substantial. Furthermore, as the CC has recognised, own-website MFNs are likely to have a smaller beneficial impact than wide MFNs (since consumers may still spend time on comparing prices across different platforms).[13]

4.2 Protecting investments in quality made by PCWs

The CC states at paragraph 80 of the ToH 5 working paper:

> MFNs may protect the sunk and fixed cost investments of a PCW. If a PCW invested in offering good-quality search but consumers discovered that the policies offered were cheaper elsewhere, they might use the search but not purchase products through the PCW. The PCW might reduce the quality of its offering and indeed go out of business. As a result, good search solutions might not be offered to consumers.

Response: Protecting sunk investments is a generally accepted potential benefit of many vertical agreements. If a PCW has invested heavily in producing a good-quality service in order to attract customers, it may legitimately want to restrict free-riding by PMIs or other PCWs.

It could be argued, however, that MFNs are not necessarily desirable and/or required to protect those investments. First, since MFNs might lead to harm from price inflation, as noted above, the net benefit to consumers might be small or zero. Second, PCWs may make such investments in any case because, even absent MFNs, the commercial benefits of doing so could outweigh the costs —ie, there could still be a business case for the investment despite some customer leakage. Third, if PCWs provide a service to PMI providers irrespective of the sales they generate (for example, by informing consumers which provider has better customer reviews), providers could pay for this service directly. Lastly, there are alternative ways for PCWs to protect their investments, instead of using MFNs. [14] Hence, it is not clear that MFNs are necessary to prevent free-riding by PMIs.

It appears that the benefits of own-website MFNs are much more limited than those of wider MFNs. In addition, as explained above, there are alternative ways to achieve some of the benefits which do not carry the anti-competitive consequences of own-website MFNs.

[12] The CC has not provided evidence to suggest that, absent MFN clauses, search costs would be substantial, or that shopping around or switching by customers would be substantially reduced.

[13] See ToH 5 working paper, paragraph 18.

[14] The third and last points are reflected in the ToH 5 working paper at paragraph 85.