Annex 1

Compass Lexecon comments on Provisional Decision on Remedies dated 8 July 2014

COMPASS LEXECON

Private Motor Insurance Market Investigation

Comments on the Provisional decision on remedies

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8 July 2014

Introduction

1. The Competition and Markets Authority ('CMA') published its Provisional Decision on Remedies ('PDR') in the private motor market investigation on 12 June 2014. Remedy 1(c) proposed by the CMA would impose a cap on the rates that can be charged for the provision of temporary replacement vehicles ('TRVs') to the at-fault insurer. The rate cap does not apply if non-fault drivers organise the hire of TRVs themselves.[1]

2. We have been instructed by Accident Exchange ('AX') to provide comments on the proposed Remedy 1(c) in relation to (i) how and whether the remedy would address the adverse effect on competition ('AEC'), and (ii) the remedy's expected impact on non-fault drivers' realisation of their legal entitlement to a TRV.

3. We understand that AX considers that the CMA's proposal for a price cap[2] is unclear in its intended operation, is based on an incorrect view as to how credit hire works and leaves a large number of important details unaddressed. We understand that AX has identified those points in its submission in response to the PDR and we have not addressed these issues in our report. In this report, we assess the proposed remedy's economic impact disregarding any legal issues related to the design and implementation of the price cap.

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[1] PDR, para. 2.59: "We do not propose that the remedy be extended to cover replacement vehicle claims charged to at-fault insurers directly by non-fault claimants who have organised the hire of a replacement vehicle directly themselves, without the assistance of an insurer, broker, CMC or CHC (ie the self-provision of replacement vehicles by non-fault claimants)."

[2] Throughout this report we refer to 'price' simply as a convenient short-hand for the recoverable amount.

4. For the purposes of this report, we take the key features of the price cap to be that (i) there is a low rate cap which applies if the at-fault insurer admits liability within three days of being informed that a TRV was provided, and which the CMA intends to set at a level to cover the costs of providing TRVs including certain administrative and upfront costs but excluding the cost of establishing liability, and (ii) there is a high rate cap which applies if the at-fault insurer does not admit liability within three days, and which will be set as a multiple of the low rate cap.[3]

Background

5. Under tort law, the non-fault victim of an accident has a legal entitlement to be put back in the position in which he/she would have been but for the accident, and to be able to choose whether to use assistance in this process and, if so, from whom. The CMA could have chosen to make recommendations to the Government to change the law if it believed that tort law, as it has developed for TRVs, leads to an AEC but it has decided not to pursue that path. Instead, the CMA has stated that it is not seeking to challenge non-fault drivers' legal entitlement.[4]

6. This is of fundamental importance to the assessment of remedies. It means that remedies can only be considered in so far as they would lead to non-fault drivers realising their legal rights at least to the same extent as at present.

7. It is common cause that the non-fault victims of motor accidents acting as individuals do not generally exercise their legal rights and obtain their legal entitlement without the assistance of some third party.[5] This is partly because of ignorance of their rights and of the process for realising those rights, and partly because of private frictional costs and risks (it is time-consuming and involves the risk that the at-fault insurer challenges the bill and the consumer may not get compensated for the costs incurred). As a result, non-fault drivers historically (before the advent of credit hire) did not obtain TRVs following an accident and were left without mobility.

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[3] PDR, paras. 2.68, 2.78 and 2.92.

[4] PDR, para. 2.244: "it is not our intention to prevent non-fault claimants from obtaining their legal entitlement under tort law".

[5] See, for example, PDR, para. 2.60: "self-provision of replacement vehicles by non-fault claimants does not currently occur on a significant scale [...] There is significant risk for individuals in assuming responsibility for the management of their claim".

8. Credit hire emerged as a response to non-fault drivers' needs for TRVs and to assist them in pursuing their legal entitlement. Whereas consumers did not pursue their legal entitlement by themselves due to ignorance and/or frictional costs and risk, credit hire companies ('CHCs') became familiar with the law and were able to assist claimants to pursue claims at a lower cost than individuals acting in their own capacity through administering a large number of claims and through developing methods and processes to assist claimants to deal with insurers.[6]

9. Since the emergence of CHCs about 30 years ago, the case law has evolved to specify what can be recovered if a TRV is provided on a credit hire basis and this has influenced how these transactions are structured. As set out in AX's response to the PDR the law provides that the consumer (and therefore the CHC) can recover the basic hire rate, which is essentially what the consumer would need to pay if she decided to hire a car herself at a traditional car hire company. This is the cost that a consumer acting alone would impose, which is established in law as the measure for the recovery of damages for the loss of use of a vehicle (also recognised by the CMA as a valid basis for recovering damages where that consumer acts alone).

10. Clearly CHCs did not start providing TRVs (and have not continued to do so) without a profit motive. The legal framework that exists now is one which provides CHCs with the incentives to provide non-fault drivers with TRVs. This is so because the amount that is recoverable under law exceeds CHCs' costs which consist not only of the costs of supplying TRVs but also other elements, including the cost of liability assessments that CHCs need to carry out in order to establish whether the claimant (and therefore the CHC) may recover any costs at all.[7]

11. The difference between the CHCs' costs (including a normal level of profits) and what they recover is paid out to insurers (and to a smaller extent to other entities such as car dealers) in the form of referral fees. Paying referral fees is the means through which CHCs obtain business as non-fault insurers refer non-fault drivers to CHCs in exchange for the payment of the referral fee. The CMA itself has acknowledged that CHCs do not earn more than normal profit precisely because the margin they make is dissipated in the form of referral fees that flow back to insurers.[8]

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[6] In this note, we use the term CHC to mean standalone entities (not insurers) that provide TRVs to non-fault drivers on a credit hire basis.

[7] Closely linked to the liability assessments, CHCs also incur the cost of persuading the fault driver to accept liability, e.g. by taking witness statements or proving that the fault driver's story is inconsistent.

[8] Provisional Findings, para. 6.17: "We note that we have not seen evidence that CHCs earn more than normal profits. Indeed, as we found that barriers to entry were low and CHCs compete to obtain referrals by offering high referral fees, we consider it unlikely that CHCs earn more than normal profits."

12. It also appears to be common cause that direct hire or intervention, i.e. TRVs provided by the fault insurer to the non-fault driver has emerged as a response to credit hire.[9] In cases where the insurer considers its driver is at fault, it has an incentive to provide direct hire as it is able to do so at a lower cost than what it would have to pay for the credit hire bill. As under intervention the at-fault insurer instructs the direct hire company to provide a TRV, there is very limited scope for frictions between the at-fault insurer and the direct hire company regarding the provision of the TRV. This entails that direct hire rates can be set at a level that does not cover frictional costs.

13. Inherent in the structure of the market is that the at-fault insurer is always liable for the costs incurred by the non-fault driver in so far as they are permissible under the law but that it only manages the provision of TRVs to non-fault drivers under direct hire and not under credit hire. This leads to frictions between at-fault insurers and CHCs and to at-fault insurers challenging the credit hire bills received.

14. Both CHCs and fault insurers have an interest in avoiding frictional costs. Over time, at the request of the courts that were distressed with the volume of litigated cases, the industry has developed the General Terms of Agreement ('GTA') as an arrangement covering a substantial proportion of the market that provides for claims to be settled at a discount in exchange for avoiding the costs of challenging credit hire bills, i.e. with the aim of minimising frictional costs for both insurers and CHCs to the extent possible.

15. The CMA recognises that at least some proportion of the frictional costs in the current setup is the inevitable consequence of separation between who pays the bill and who arranges the TRV.[10] The CMA also recognises that the GTA provides an efficient framework for negotiation and settlements of claims.[11]

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9 Provisional Findings, para. 3.73: "CMCs/CHCs told us that, in the past, when insurers paid directly for the services they provided to non-fault claimants (ie under the old 'knock-for-knock' regime), the provision of replacement car services to claimants was poor and often below a claimant's legal entitlement. CMCs/CHCs said that the emergence of credit hire had improved replacement car services significantly for consumers. We did not hear views to the contrary [...]"

10 PDR, para. 2.281: "some transactional/frictional costs are an inevitable result of separation".

11 Provisional Findings, Appendix 6.1, para. 66: "although the GTA is not binding and is open to interpretation, it does provide a framework for the efficient negotiation and settlement of credit hire claims".

16. The CMA's case is that frictional costs currently in the system are excessive, i.e. that there are some frictional costs that are above the inevitable frictional costs of separation and which have not been fully addressed by the GTA. This is the CMA's AEC finding that it intends to address *inter alia* by a price cap.[12]

Whether the remedy addresses the AEC

17. In this section, we assess how and whether Remedy 1(c) would address the AEC identified by the CMA. As we set out below, even on the CMA's own assessment of the proposed remedy there is only an "indirect" link between the remedy and the AEC. Also on the CMA's own assessment, an insufficient reduction in the price level may have no effect on frictional costs and therefore no effect on the AEC. Further, the CMA has not shown that a significant reduction in the price level would reduce frictional costs (and thus address the AEC) so long as entities other than insurers provided TRVs.

"Indirect" relationship between the AEC and the remedy

18. The price control is an unusual one because its objective does not relate to the level of prices *per se*. Rather, the purpose of the price control is to reduce frictional costs. A price control at the level proposed by the CMA therefore only makes sense if by regulating prices at that level frictional costs would fall. In economic terms, the remedy crucially depends on there being a significant negative elasticity of frictional costs with respect to the regulated price level.

19. The CMA has stated that there is an "indirect" relationship between rates and frictional costs such that lower rates lead to fewer disputes and therefore less frictional costs.

[12] The CMA is also of the view that the market features described above lead to insurance premium for risky drivers being too high and insurance premium for less risky drivers being too low as insurers' revenues from referral fees are passed on evenly across all drivers whereas credit hire bills are born disproportionately by risky drivers (PDR, para. 2.6). However, the CMA has not quantified the detriment (if any) in relation to the asymmetry of pass-on of referral fees and credit hire bills to different groups of drivers, and as such, it is not in a position to carry out a proportionality analysis of imposing a price cap to remedy this alleged detriment. We therefore do not address this rationale for Remedy 1(c) in this note.

20. In particular, the CMA suggests that a price cap will reduce frictional costs as at lower price levels insurers will have fewer incentives to challenge credit hire bills as follows: "The intention of this remedy is to reduce the cost of replacement vehicle provision to non-fault claimants without compromising claimants' tortious entitlements by: [...] reducing the administrative and frictional costs arising in relation to the provision of replacement vehicles both directly (eg through making the administration of claims more efficient) and indirectly (through lower replacement vehicle claims costs leading to fewer disputes)."[13] [emphasis added]

No impact on the AEC of an insufficient reduction in price

21. The CMA has indicated that for insufficient price reductions below present levels, the indirect relationship above may not apply at all (i.e. there would be no effect of reducing prices on frictional costs).

22. In particular, the CMA recognises that an insufficient price reduction may be ineffective to reduce frictions: "If we set a rate cap that is not low enough, there is a risk that we only reduce referral fees and do little to reduce the incentives for parties to dispute the cost of replacement vehicles, maintaining frictional costs. This could have little effect in reducing the net detriment we have identified."[14]

23. This statement suggests that while the CMA has not analysed the elasticity of the number of disputes with respect to price level, it clearly believes that only a substantial reduction in rates will have an impact on frictional costs. However, as we discuss in the next sections, there is insufficient evidence that a substantial reduction in the price level would reduce frictional cost while it would likely to lead to unintended consequences causing significant harm to consumers.

No evidence that a substantial reduction in price will reduce frictional costs

24. There is also no evidence that a substantial reduction in the price level as proposed by the CMA would operate indirectly to reduce frictional costs.

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[13] PDR, para. 2.50. To the extent that the CMA's view is that a price cap will also reduce frictional costs *directly* because it will lead to fewer disputes around the price level itself, we note that for this to apply there is no reason for the price level to be set lower than it is currently as long as the price level is fixed. In other words, if the CMA believes that the source of disputes is that insurers and CHCs cannot agree on the price to pay, it could set the regulated rate at *any* level (including at the level of current credit hire rates) and would not need to reduce the price in order to remove frictions.

[14] PDR, para. 2.65.

25. The CMA supports its view that there would be no friction if the price was set at direct hire rates using two examples: "We would not expect undue frictional costs (eg beyond those already reflected in direct hire rates) under the low rate cap, where liability is agreed. We noted, for example: (a) Enterprise provides credit hire under its subscriber model (ie when the at-fault insurer accepts liability) effectively at direct hire rates; and (b) bilateral agreements between insurers provide for subrogation at the cost of direct hire without any addition to allow for frictional costs".[15]

26. However, neither of these examples shows that if the CMA set the regulated rate at direct hire level, frictional costs would be removed.

27. Regarding point (a), the CMA appears to be inconsistent as based on its own evidence Enterprise cannot provide credit hire at effectively direct hire rates. The CMA sets out that Enterprise provides credit hire "at direct hire rate plus referral fee and FNOL fee".[16] Given that the CMA estimated the average direct hire bill at around £540 and the average referral fee at around £330,[17] the "direct hire rate plus referral fee" is not "effectively" the direct hire rate but more than 50% higher (even without considering the FNOL fee). As such, the CMA cannot argue that frictional costs are low under Enterprise's subscriber model as a result of Enterprise charging direct hire rates for credit hire.

28. Regarding point (b), the CMA is wrong to assume that there are no frictions under bilateral agreements because the price is low. The at-fault insurer has incentives not to challenge the non-fault insurer's claim because on another occasion their roles will reverse and it can expect the same behaviour from the other insurer. As long as the TRV is provided by a third party (i.e. not an insurer), the at-fault insurer's incentives to challenge claims will be maintained. The CMA's evidence is subject to an identification problem because it conflates low price levels and insurer-to-insurer agreements.

29. We also note that the elasticity of frictional costs with respect to the price cap would be zero if frictional costs were driven by other factors. We note from its response to PDRs that AX expects that even under Remedy 1(c) insurers could and would continue to challenge on need and hire duration (while avoiding the risk of having to pay the high rate cap as the high rate cap only applies if the insurer disputes liability).[18] Remedy 1(f) and the components of Remedy 1(c) dealing with duration will not alter these disputes as they do not remove the incentive of insurers to challenge these aspects of a claim.[19]

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15 PDR, para. 2.80.

16 PDR, para. 2.80, footnote 31.

17 WP23, para. 117 and Table 12.

18 AX's Response to the CMA's PDR, para. 6.25.

19 AX's Response to the CMA's PDR, paras. 6.27-6.28.

Conclusion on whether the remedy addresses the AEC

30. Insofar as the remedy is aimed to tackle frictional costs, this is an extremely unusual price control because the connection between the level and the harm is "indirect". The nature of that indirect linkage is unclear and not properly evidenced by the CMA. In any event, a large reduction in prices (which the CMA considers necessary for the remedy to have any effect on the AEC) is likely to lead to unintended consequences causing non-fault drivers not to realise their legal entitlement. We discuss this unintended consequence in the next section.

Consequences of Remedy 1(c)

31. As noted above, the CMA takes non-fault drivers' legal entitlement as given and does not intend to challenge or change it. Thus, any remedy that reduced consumers' realisation of their legal entitlement compared to the *status quo* would be inconsistent with the premise of the CMA's approach. However, as we show below, it is likely to be the case that Remedy 1(c) leads to a lower realisation of consumers' legal entitlement but the CMA has failed to consider this risk as it has not carried out a proper analysis of insurers' incentives to provide TRVs post-remedy.

Elimination of credit hire

32. Remedy 1(c) has fundamental implications on the functioning of the market, including that it is very likely to eliminate credit hire as an industry for a number of reasons.

Reduction in / elimination of referral fees

33. As the CMA has set out in the PDR under Remedy 1(c) CHCs will no longer be able to pay significant referral fees to insurers and thus insurers may decide not to refer non-fault claimants to CHCs.[20] Thus, the primary means of CHCs to get to non-fault claimants (see paragraph 11 above) will be substantially reduced if not eliminated, which implies that CHCs will be unable to obtain business.

34. The CMA's view that the reduction in referral fees may require some other marketing costs to be incurred[21] is obviously misplaced as if CHCs cannot afford to pay referral fees they will also be unable to afford other marketing expenses to get to the customer.

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20 PDR, para. 2.98: "At the rates we propose [...], we would not expect replacement vehicle providers to be able to pay significant referral fees. Consequently, insurers (and brokers, dealers, repairers, etc) would have less incentive to refer non-fault claimants to a CHC/CMC."

21 PDR, para. 2.98: "We recognise that reductions in the level of referral fees paid by replacement vehicle providers to insurers and brokers could require some other marketing costs to be incurred by replacement vehicle providers."

35. Further, the CMA's intention to gather data during its periodic price reviews on "the extent of referral fees being paid, as an indicator of the difference remaining between the costs incurred by a provider of replacement vehicles to non-fault claimants and the costs charged to at-fault insurers"[22] suggests that to the extent CHCs were able to pay referral fees following the implementation of the price cap, the CMA may further reduce the regulated rate to eliminate this "difference" between costs and prices.

No allowance to recover the cost of establishing liability

36. The CMA's intention is to set the regulated price level "slightly" above the cost of providing TRVs[23] and not to allow the TRV provider to recover the cost of determining whether the driver is at fault or not (see paragraph 4 above), which will lead to CHCs being loss-making in expected terms.[24]

37. The CMA is unclear on whether it expects the TRV provider to carry out its own liability assessment or not. When considering the TRV provider's incentives to provide a TRV, the CMA explicitly refers to the TRV provider's own assessment of liability.[25] Elsewhere, the CMA appears to suggest that the TRV provider is supposed to rely on the insurers' initial liability assessment when making the decision whether and to whom to provide a TRV.[26]

38. However, in either case, the result is that CHCs are likely to be loss-making or may not even have the opportunity to offer TRVs to non-fault drivers.[27]

39. First, given that CHCs would be unable to recover the costs incurred in assessing liability, they would likely to be loss-making if they were to carry out their own assessment.

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[22] PDR, para. 2.69(b).

[23] PDR, para. 2.66: "we believe that a cap slightly above the level of cost efficiently incurred in providing a replacement vehicle is likely to provide the best balance of incentives."

[24] We understand that AX considers that there are other costs the regulated rate is ought to cover but which the CMA has failed to consider (AX's Response to the CMA's PDR, paras. 6.56-6.58, 6.60 and 6.63).

[25] PDR, para. 2.88: "On the second issue, we noted that the replacement vehicle provider's incentives would depend on: (a) Its own assessment of the likelihood of the claimant being non-fault."

[26] PDR, para. 2.77: "Insurers told us that they made an assessment of fault at FNOL but in some cases fault was undetermined and in some cases the initial assessment changed. This uncertainty has implications for the incentives to provide replacement vehicles. If, to take a simple example, the initial assessment at FNOL is that a claim is non-fault but there is a 20% chance it will turn out to be at fault, and if the provision of replacement vehicles is charged at cost, the expected recovery is 80% of the costs incurred. In this scenario, the party taking the risk (ie the replacement vehicle provider) must expect to incur a loss of 20% of its costs."

[27] For a simplified model formalising the expected profitability of CHCs under these conditions, see Annex A.

40. Second, if CHCs were to rely on insurers' assessment, it is unclear what incentives if any insurers would have to reveal the results of their assessment to the CHCs. In particular, if an insurer finds that its policyholder was at fault, it could offer a TRV to the non-fault driver before the CHC could be informed about the outcome of the liability assessments.

41. Third, the CHC would obviously not risk offering a TRV to a driver randomly without having a view on whether the driver is non-fault, in particular if the rate cap is set only "slightly" above costs.

Daily rate set at direct hire rates

42. The CMA intends to define the variable element of the rate cap based on current direct hire rates. We understand from AX that direct hire rates are set on the basis of zero risk of non-payment and under-recovery. However, CHCs would face some risk of non-payment or under-recovery even if Remedy 1(c) would result in reduced frictions. For instance, CHCs may be unable to recover costs of providing the TRV if their initial assessment of liability or need was erroneous. Given that under direct hire the insurer carries out the liability assessment itself and instructs the direct hire provider to provide a TRV, direct hire rates do not reflect such risks. As such, to the extent that the fixed element of the rate cap does not have an allowance for these risks (and there is no indication in the PDR that it would do so), the CMA's price cap would make CHCs loss-making in expected terms.[28]

Conclusion on the elimination of credit hire

43. We note that it appears from the PDR that the CMA itself anticipates that its remedy would lead to the elimination of CHCs and that it is agnostic about such a consequence: "Another consequence of lower referral fees could be that insurers (and others) seek a different way in which to provide replacement vehicles to potential non-fault claimants. One option is that they would make the provision themselves, subrogating the claim to the fault insurer, and not referring the claimant to a CHC/CMC. Other options could also emerge. However, we are not concerned with the specific type of contractual arrangements which might arise under our proposed remedy."[29]

44. Thus, CHCs will not be able to operate profitably if Remedy 1(c) is implemented and the CMA appears to be aware of this at least as a possible, if not inevitable, consequence. However, despite apparently being aware of the likely elimination of credit hire, the CMA has not assessed the potential impacts of this on non-fault drivers' realisation of their legal entitlement. As we discuss in the next section, the elimination of credit hire is likely to have a negative impact on the realisation of consumers' legal entitlement.

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[28] We also note that while a conventional price control would be set with reference to costs, the proposed Remedy 1(c) would be set with reference to prices at what the CMA refers to as the direct hire market (PDR, para. 2.70), but which are highly influenced by one large player's, Enterprise's, rates and therefore are vulnerable to specificities of Enterprise's business model, as well as to potential manipulation by Enterprise.

[29] PDR, para. 2.99.

Incentives to provide consumers' legal entitlement

The identity of TRV providers post-remedy

45. If CHCs withdraw from the market, the question arises which other organisations could provide TRVs and whether these organisations would have incentives to do so.[30]

46. When discussing the post-remedy outcomes, the CMA refers to "replacement vehicle providers" in general without specifying which market participants would continue (or start) to provide TRVs.[31] However, the CMA's view that "[t]he replacement vehicle provider and the at-fault insurer have to determine liability irrespective of whether a replacement vehicle is provided"[32] suggests that the CMA is envisaging that TRVs would be provided by insurers (given that no other market participant needs to / would determine liability if it does not intend to provide a TRV).

47. We thus understand that the CMA intends to create a world through Remedy 1(c) in which TRVs are only provided either by the non-fault insurer or, to the extent direct hire continues, by the fault insurer. Viewed in a historical context, this is striking given that consumers only began to receive their legal entitlement with the emergence of CHCs, as described above. However, aside from history, there are other serious reasons to doubt whether in a world where the only possible providers of TRVs are insurers consumers would receive their legal entitlement.

Insurers' unilateral incentives to provide a TRV post-remedy

48. The CMA's intention is to set the rate cap slightly above the level of costs incurred in the provision of TRVs in order to allow for some profit and maintain (insurers') incentives to provide TRVs.[33] The CMA has pointed out that a consequence of rates capped at a low level is that at-fault insurers' incentives to provide TRVs to non-fault drivers will decrease.[34,35]

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[30] In this report, we only discuss unintended consequences of the remedy regarding the provision of TRVs. We understand that the elimination of credit hire would result in consumer detriment given the advocacy / claims handling services CHCs currently provide (AX's Response to the CMA's PDR, para. 5.1).

[31] See, for example, PDR para. 2.46 where the CMA sets out in a footnote in very general terms that it means by replacement vehicle provider "the company that bills the at-fault insurer for the replacement vehicle".

[32] PDR, para. 2.68.

[33] PDR, para. 2.66: "we believe that a cap slightly above the level of cost efficiently incurred in providing a replacement vehicle is likely to provide the best balance of incentives." This implies that non-fault insurers' unilateral incentives to provide a TRV will be significantly reduced.

[34] PDR, para. 2.121: "once our remedy is implemented, we would expect that the reduced hire rates imposed by the cap would reduce the incentive of at-fault insurers to capture non-fault claims in order to provide them with a replacement vehicle."

49. However, beyond these statements, the PDR contains little discussion or analysis of insurers' incentives to provide consumers' legal entitlement in the post-remedy world.[36] This is striking in light of the CMA's intention not to alter the delivery of non-fault drivers' legal entitlement.

Increased risk of (tacit) collusion

50. The CMA has not considered coordinated effects apart from a short discussion on potential tacit collusion between direct hire providers.[37] This is despite recognising the risk of coordinated effects in its Working Paper on the AEC where it acknowledged that while insurers individually may not have incentives to under-provide under the *status quo*, "if both parties to a bilateral agree to reduce provision, they can both gain through lower costs".[38]

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[35] See also PDR, para. 2.91, footnote 39: "We are proposing that the variable element of the low rate cap would be set close to cost, implying that replacement vehicle providers would not gain much from unduly lengthening hire periods or by providing a more expensive car than the non-fault claimant needs." The CMA aims to maintain incentives to provide TRVs but it intends to set this incentive at a low level so that TRV providers would not want to lengthen hire periods. However, a TRV provider either has an incentive to provide a TRV or not. If it does, it has an incentive to provide a TRV for an additional day, so it is unclear at what profit range TRV providers would have the incentives the CMA aims to create. However, even if it was possible in theory to set prices that meet these criteria, this would require a very sophisticated price control and a level of "fine-tuning" that may be difficult if not impossible to implement in practice.

[36] In para. 2.101 of the PDR the CMA explains that some non-fault insurers manage the claims of non-fault drivers as if those claims were made under their PMI policy, so that these drivers obtain less than their entitlement under tort law, and that there is a concern that this practice may continue under Remedy 1(c). While the PDR is not entirely clear on this, we understand that this is a practice that insurers follow under bilateral agreements (given that otherwise they would have no incentive to let drivers claim against their own policy). Despite the fact that this concern is discussed as part of the "unintended consequences" of the remedy, the CMA does not set out the relationship between its remedy and the concern. Thus, we understand that this practice is either (i) not a consequence of the remedy or (ii) would become a more serious concern under the remedy. If (i) applies, this should be a separate theory of harm and dealt with separately. If (ii) applies, the CMA appears to implicitly acknowledge the increased risk of tacit collusion under Remedy 1(c) – see paras. 50-58 below.

[37] PDR, para. 2.104: "The only way in which competition would be affected would be if our remedy led to tacit coordination on price by direct hire companies. However, we note that direct hire is provided under contract to insurance companies so it is the insurers which control the bidding process, and this would be likely to limit the ability of direct hire companies to effect tacit price coordination. In addition, we note that our remedy uses a competitive market price as a benchmark (ie the direct hire rate), which means that many of the usual concerns with market distortions arising from price caps are further reduced."

[38] WP23, para. 104.

51. As AX has set out in its submission to the CMA on the Notice of possible remedies,[39] a market where only insurers are capable of / entitled to provide TRVs is extremely prone to collusion. Given that this is exactly the situation to which Remedy 1(c) would lead, and given that the CMA has not made any reference to AX's previous submission or indeed to the risk of collusion between insurers at all, we repeat and expand on AX's previous submissions here.

52. The *status quo* is an 'open system' in which anyone (including CHCs) can offer TRVs to non-fault drivers. CHCs have no interest in colluding with insurers with a view to denying the victim of an accident his/her legal entitlement to a TRV.

53. However, after the elimination of credit hire, this would transform into a 'closed system' in which only insurers provide TRVs to non-fault drivers. In this closed system, all insurers will in some cases find themselves on the non-fault side providing the TRV and incurring the cost of provision and in other cases find themselves on the fault side paying the regulated rate as compensation for the TRV provision. This means that insurers would frequently interact with each other but having alternating roles (i.e. sometimes as non-fault insurer and sometimes as fault insurer) in these interactions.

54. As set out in the CMA's market investigation guidelines, reciprocal relationships between firms may facilitate coordination.[40] In addition, interactions on different markets make it easier to respond to deviations from the collusive behaviour by "punishing" deviating players[41] and thereby provide incentives not to deviate.

55. The alternating roles of insurers in a closed system (i.e. when no third party can or would provide TRVs) resembles the situations described by the CMA in its market investigation guidelines in which firms have reciprocal relationships or interact in several markets. Remedy 1(c) would make it significantly easier compared to the *status quo* for insurers to coordinate in avoiding the costs of providing TRVs.

56. There are many dimensions on which coordination could occur, since TRVs are a complex product. These dimensions include liability resolution, grade of car, duration of hire, other features of the car, collection and delivery, and collision damage waiver. Collusion in respect of any dimension of provision, where that denies non-fault drivers their legal entitlement, would violate the principle of designing a remedy that does not seek to challenge the law.

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[39] AX Further Submission on Notice of Possible Remedies, 13 May 2014.

[40] Guidelines for Market Investigation CC3 (Revised), April 2013, para. 252(e): "Firms [...] in reciprocal supplier/buyer relationships may also find it easier to reach an understanding."

[41] Guidelines for Market Investigation CC3 (Revised), April 2013, para. 254(d): "Factors that make it easier to respond quickly to deviation from a coordinated outcome may make coordination easier to sustain. [...] a response to a perceived deviation from a coordinated outcome need not necessarily take place in the same market as the deviation; if coordinating firms have commercial interactions in several markets, these may offer various ways of responding to deviations [...]"

57. For instance, in this type of collusive market context, insurers would be more likely (at least tacitly) to reach an agreement that whenever possible they would not establish liability, which would then allow them to avoid having to provide a TRV. This is much less likely in the *status quo* given that CHCs have the incentive and the expertise to establish liability in all cases.

58. The CMA will need to consider every dimension of TRV provision provided by law and explain why consumers' realisation of their legal entitlement will not be jeopardised by collusion.

The planned measures are insufficient to prevent tacit collusion

59. The CMA intends to monitor liability assessment of insurers by looking at insurers' aggregated liability assessment reports to identify those insurers that do not establish liability or conclude that liability was split in a high proportion of cases.[42] However, the CMA has not set out what it would consider a "high" proportion of split or undetermined liability assessments and what consequences (if any) it would lead to if an insurer appears to have reached this "high" proportion. Further, monitoring on an aggregated basis is unlikely to impose a credible threat that any tacit or explicit agreement between insurers would be detected. We note that the PDR is unclear about the frequency of monitoring.[43] It is thus extremely unclear how the CMA's planned measures would prevent insurers from using liability assessments to collude.

60. Further, insurers would have incentives and means (tacitly) to agree on other aspects of the TRV provision including those set out above, e.g. providing lower quality cars and for shorter period than what the consumer would be entitled to, or providing inferior collection and delivery arrangements. The CMA does not intend to monitor any of these aspects, and as such, there is almost zero chance that collusion on these aspects would be detected. In any event, it is far from clear how regulation could ever be an effective substitute for the present market mechanism under which CHCs are incentivised to provide non-fault drivers' with their legal entitlement.

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[42] PDR, para. 2.102: "Each insurer's aggregate data on liability assessments would be monitored. [...] The purpose of this information would be to identify those insurers which, in a high proportion of cases, make an assessment of 'split liability' or 'impossible to determine fault' which is subsequently changed into a non-fault assessment."

[43] PDR, para. 2.147: "We do not believe that there will be a significant ongoing monitoring and enforcement requirement between these reviews [i.e. in the first two years and subsequently in three-year periods between the reviews]. This is because any breach of the hire rate caps would be transparent to insurers and could be enforced through the courts. However, we note that **some** monitoring by the CMA would be required of insurers' aggregate data on liability assessments (see paragraph 2.102)." [emphasis added]

61. We note that the CMA has found that insurers currently use bilateral agreements explicitly to agree not to refer claims to CHCs, to arrange direct hire instead, and to bill at costs lower than the reasonable levels recoverable under tort law.[44] While bilateral agreements are insurers' response to credit hire and therefore they would not necessarily apply in an environment from which credit hire is eliminated, this heightens the concern that if the conditions in the market allow, insurers would be likely to attempt to reach an agreement which would result in consumers receiving less than their legal entitlement.

62. We note also that in cases where the same insurer has both the non-fault and fault driver as its customers, it has no incentive to resolve liability (this problem arises without collusion). "Collusion" is effectively automatic as the non-fault and fault insurer are one and the same, and in a closed system CHCs are not present to ensure non-fault drivers receive their legal entitlement.

63. Further, Remedy A, i.e. the obligation to provide information on consumers' rights in the motor insurance policy documentation and following an accident, is unlikely to be effective in incentivising insurers to provide TRVs to non-fault drivers. If (as a result of coordinated effects or the fault and the non-fault insurers being the same) neither the non-fault nor the fault insurer has incentives to provide a TRV, non-fault drivers would need to incur large private frictional costs to exercise their rights even if they are aware of these rights. As pointed out by the CMA, self-provision of TRVs does not currently occur at any significant scale given the costs and risks involved.[45] As such (and in particular as credit hire is eliminated), insurers would face no credible threat that the non-fault driver will submit any claims if the insurers themselves do not provide a TRV. The informational remedy is thus ineffective in recreating insurers' incentives. We also note that it would be odd and in our view unsubstantiated to eliminate a market solution (i.e. credit hire) and instead to rely on an informational remedy to improve market outcomes for consumers.

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[44] Provisional Findings, para. 6.10. AX has repeatedly requested that the CMA assesses to what extent insurers use bilateral agreements to agree to provide less than the consumers' legal entitlement. See, for instance, DLA's letters to the CC dated 5 and 14 March 2014.

[45] PDR, para. 2.60: "self-provision of replacement vehicles by non-fault claimants does not currently occur on a significant scale [...] There is significant risk for individuals in assuming responsibility for the management of their claim".

Conclusion on the impact of the remedy

64. In conclusion, it appears clear that Remedy 1(c) will eliminate credit hire and that the CMA is aware of this consequence. However, the CMA has not analysed the incentives of insurers to provide the consumers' legal entitlement absent credit hire. As shown above, in the post-remedy world insurers would face weak unilateral incentives to provide consumers' legal entitlement (given the limited profit incentive the CMA intends to allow for when setting the price cap) and strong incentives to explicitly or tacitly agree not to provide consumers' legal entitlement (given that this would allow them to avoid collectively the cost of TRV provision). The CMA has not considered this risk in its assessment, despite AX's previous submission on the issue and its own acknowledgement regarding insurers' bilateral incentives in the AEC Working Paper.

Conclusion

65. Based on the above, we conclude that:
    - The CMA lacks the evidential basis to set a price cap given that the relationship between the remedy and the harm is only "indirect" and the nature of that indirect linkage is extremely unclear and not evidenced by the CMA;
    - The CMA appears to anticipate that the remedy will eliminate CHCs but has conducted no analysis of the potential consequences; and in particular
    - The CMA has not analysed either insurers' unilateral incentives or the market's obvious vulnerability to (tacit) collusion, leading to an under-provision of consumers' legal entitlement post-remedy.

66. If there is any risk that non-fault drivers would not receive any element of their legal entitlement the CMA cannot view that as a 'cost' to be weighed against benefits. The presence of such a risk means that the remedy could undermine consumers' legal entitlement and as such would be incompatible with the premise of the investigation which is not to challenge consumers' legal entitlement. Any remedy giving rise to such a risk would therefore be inappropriate. In any event, the CMA has not conducted any analysis of consumers' valuation of TRVs and could not assess the materiality of such a cost in consumer welfare terms.

Annex A

Expected profitability of TRV provision

Introduction

A.1 In this appendix, we derive CHCs' expected profitability given the CMA's intention to set the regulated rate such that it does not allow TRV providers to recover the cost of establishing liability. Throughout this discussion, we assume that CHCs cannot rely on insurers' initial liability assessment when making the decision on whether to offer a TRV to a driver or not.[46]

A.2 The assessment below relies on a number of simplifying assumptions in order to focus on the impact of the regulated rate not having an allowance to recover the cost of establishing liability, and as such it is not capable of providing a reliable basis to set the regulated rate.

A.3 We have found that CHCs could only profitably operate if they are not allowed to recover the cost of establishing liability if the profit margin of the regulated rate's daily element was sufficiently large which is contrary to the CMA's intention to set the regulated rate only "slightly" above costs.

Assessment

A.4 When a CHC becomes informed about the accident and it intends to provide a TRV, in principle it has a choice:

i. It does not assess liability and provides a TRV to one of the drivers involved in the accident; or

ii. It incurs the cost of assessing liability and provides a TRV to the driver who it believes to be non-fault.[47]

A.5 Below we derive CHCs' expected profitability in both cases under some simplifying assumptions.

A.6 We use the following notation:

- F: the fixed cost of assessing liability to the CHC;
- v: the daily cost of providing a TRV to the CHC;

[46] As mentioned in para. 40 above, it is unclear that insurers would have any incentive to reveal the results of their assessment to CHCs.

[47] For simplicity, we only discuss those scenarios where only two drivers are involved in an accident and one of them is fault and the other is non-fault.

- t: the number of days for which the TRV is provided;
- q: the probability that if a CHC or an insurer assesses liability, the result of the assessment is incorrect (i.e. the CHC/insurer finds that the driver is non-fault when the court would find that the driver is in fact fault).

A.7 Further, we make the following assumptions:

- Beyond the cost of assessing liability, the CHC does not face any other fixed costs. This is a simplifying assumption that does not alter the assessment as the CMA's intention is to allow TRV providers to recover other fixed costs.
- The regulated low daily rate is set at daily cost of $v + \varepsilon$. This follows from the CMA's intention to set the rate cap "slightly" above the cost of TRV provision.
- The regulated high daily rate is set at $2(v + \varepsilon)$. This follows from the CMA's intention to set the high rate cap twice as high as the low rate cap.
- The insurer always determines liability but does not inform the CHC about the result of its assessment before the CHC provides the TRV to one of the drivers.
- If the insurer finds that its policyholder was non-fault, it will challenge the credit hire bill but if it finds that its policyholder was fault, it will not challenge the credit hire bill.
- If the CHC provides a TRV to one of the drivers involved in the accident without assessing liability, it has 50% chance that the driver is the non-fault driver and 50% chance that the driver is the fault driver.
- $q < 0.5$, i.e. CHCs / insurers are more likely than not to get the liability assessment right.
- Neither insurers, nor CHCs would incur frictional costs when there is a dispute over claims.

The CHC provides a car without assessing liability

A.8 The table below sets out the CHC's costs, revenues and expected profit in all possible scenarios if it decides to provide a TRV to one of the drivers involved in the accident without assessing liability.

Table 1: Payoffs if the CHC provides a TRV without assessing liability

Driver	Insurer	CHC cost	CHC revenue	CHC profit
Non-fault	Disputes	vt	$2(v+\varepsilon)t$	$vt + 2t\varepsilon$
	Does not dispute	vt	$(v+\varepsilon)t$	$t\varepsilon$
Fault	Disputes	vt	0	$-vt$
	Does not dispute	vt	$(v+\varepsilon)t$	$t\varepsilon$

A.9 As shown in Table 1 above, the CHC's cost is the same in all scenarios: the daily cost of

providing the TRV times the number of days of the hire. If the insurer does not dispute the credit hire claim, the CHC's revenue is the same (irrespective of whether the driver was actually fault or non-fault): the regulated rate $(v+\varepsilon)$ times the number of days of the hire. If the insurer disputes the claim and the driver is non-fault, the CHC's revenue is the high rate cap $(2(v + \varepsilon))$ times the number of days of the hire. If the insurer disputes the claim and the driver turns out to be fault, the CHC will not receive any revenues.[48] The CHC's profit is the difference between its revenues and costs in each scenario.

A.10 Thus, the expected profit of the CHC is the following:

$$\mathrm{E}\pi = 0.5 * \{q(vt + 2t\varepsilon) + (1-q)t\varepsilon\} + 0.5 * \{(1-q)(-vt) + qt\varepsilon\} = (q-0.5)vt + (q+0.5)t\varepsilon.$$

A.11 As $q < 0.5$, the first term $(q-0.5)vt$ is negative. The expected profit thus depends on how much profit the CHC can earn above the cost of providing the service (ε) and the ex-ante probability that insurers get the liability assessment wrong (q). The table below shows the critical thresholds for setting ε, for different levels of q, in order to make sure that CHCs are profitable in expected terms.

Table 2: Critical margins given the probability of incorrect liability assessment

Probability of incorrect liability assessment	Critical ε	Margin required
0.1	$2/3v$	40%
0.2	$3/8v$	27%
0.3	$2/7v$	22%
0.4	$1/9v$	10%

A.12 The CMA has used in an example a 20% probability that the initial assessment of liability is incorrect.[49] If the CMA believed that this is a realistic number, the model above suggests that it should allow at least a 27% margin for CHCs to maintain their incentives to provide TRVs. This is in contradiction with the CMA's intention to set regulated rates only "slightly" above costs.

The CHC provides a car after assessing liability

A.13 The table below sets out the CHC's costs, revenues and expected profit in all possible scenarios if it decides to provide a TRV to the drivers it considers non-fault after assessing liability.

[48] We understand from AX that in practice CHCs do not pursue drivers for any costs if their legal claim fails (AX's Response to the CMA's PDR, para. 2.21).

[49] PDR, para. 2.77.

Table 3: Payoffs if the CHC provides a TRV after assessing liability

Driver	Insurer	CHC cost	CHC revenue	CHC profit
Non-fault	Disputes	$F + vt$	$2(v + \varepsilon)t$	$vt + 2t\varepsilon - F$
	Does not dispute	$F + vt$	$(v + \varepsilon)t$	$t\varepsilon - F$
Fault	Disputes	$F + vt$	0	$-vt - F$
	Does not dispute	$F + vt$	$(v + \varepsilon)t$	$t\varepsilon - F$

A.14 The only difference in Table 3 above compared to Table 1 is due to the inclusion of the fixed cost of assessing liability (F) which appears as a cost to the CHC and thus has an impact on the CHC's profit in each scenario.

A.15 Thus, the expected profit of the CHC is the following:

$$\begin{aligned} \mathrm{E}\pi &= (1-\mathrm{q}) * \{q(vt + 2t\varepsilon - F) + (1-q)(t\varepsilon - F)\} + \mathrm{q} * \{(1-q)(-vt - F) + q(t\varepsilon - F)\} \\ &= -F + t\varepsilon. \end{aligned}$$

A.16 In this case, the expected profit does not depend on the probability of getting the liability assessment right as we assume that this probability is the same for insurers and CHCs (and therefore these terms cancel out).[50] The expected profit is the profit the CHC can earn above the cost of providing the service multiplied by the length of the hire ($t\varepsilon$) minus the fixed cost of establishing liability (F). This implies that CHCs would only make positive profits in expected terms if $\varepsilon > F/t$, i.e. the profit allowance was larger than the fixed cost of assessing liability divided by the average length of hire.

Conclusion

A.17 As shown above, CHCs could profitably operate under Remedy 1(c) only if the margin over daily rates is set sufficiently high to meet certain conditions. These conditions (even in the simplified setup we use above) depend on a number of factors, including the cost of establishing liability and the probability that insurers and CHCs get the liability assessment wrong. While this model could not serve as a reliable basis for setting a price cap, it demonstrates that CHCs would likely to be loss-making if the CMA set the regulated rate "slightly" above costs and that setting any price cap involves a number of hard to assess parameters not conventionally found in price controls.

[50] Note that this is a simplifying assumption that we employ as we have no information on the actual proportions of incorrect liability assessments by insurers or CHCs.