

Consumer Rights Directive:

Allowing contingent or ancillary charges to be assessed for unfairness

OFT response to BIS call for evidence

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1 EXECUTIVE SUMMARY

- 1.1 The Office of Fair Trading (OFT) is the UK's competition and consumer authority. Our mission is to make markets work well for consumers. Our goal is for competitive, efficient, innovative markets where standards of consumer care are high, consumers are empowered and confident about making choices and where businesses comply with consumer and competition laws but are not overburdened by regulation.
- 1.2 The OFT has supported the development of the Consumer Rights Directive (CRD) to date while expressing concern about certain issues in relation to the draft proposal. Those issues are not the subject of this call for evidence.
- 1.3 We believe it is important to seek greater clarity on issues of principle in the drafting of the CRD following the Supreme Court's interpretation of the Unfair Terms in Consumer Contracts Regulations (UTCCRs)¹ in order that the CRD's aims are more easily understood. Unless legislation is clarified there is a risk of uncertainty on the application of the UTCCRs (and in due course the CRD) to contingent or ancillary charging terms.
- 1.4 The key issue is transparency, understood in a broader sense than just plain and intelligible language, and whether charges are likely to be noticed and understood by consumers at the time of entering the contract. In our view this is more important than deciding whether they fall into particular descriptive categories such as 'contingent' or 'ancillary'.
- 1.5 Charges which are not transparent, whether they are triggered by remote contingencies or where their wording is unclear, may harm consumers by making them pay more than they expected. They may not have entered the bargain had they known about the charges and been able to correctly anticipate the likelihood of the need to pay them. Such

¹ The Office of Fair Trading (Respondents) v Abbey National plc & Others (Appellants) [2009] UKSC 6.

charges can reduce the beneficial effects of competition on price because consumers cannot easily compare prices, thereby reducing businesses' incentives to offer low overall prices.

- 1.6 However, if contingent and other ancillary charges are used in a transparent way, they can in principle actually help activate competition by simplifying headline contractual offers to what is essential for many consumers, leaving charges for more detailed services that only suit some consumers in the background. These types of charges do not necessarily mean that consumers always end up paying more overall. In the right market conditions, gains made via such charges may be 'competed away', that is, used to reduce the headline contractual offers on which suppliers do compete. But market conditions are rarely ideal, and this effect cannot be relied on generally to guarantee either economic efficiency or fairness. In particular, contingent charges at levels above cost often result in cross subsidisations from customers who incur the charges to those customers who do not. Such cross subsidisations can involve perceived unfairness, particularly (for instance) where vulnerable consumers cross subsidise those in a stronger bargaining position.
- 1.7 If such charges are sufficiently transparent in the contract, and ordinary consumers can in fact consider the total cost of the product or service they are purchasing, they should be able to avoid incurring any adverse effects by 'switching away', that is, buying a competing product on terms they prefer. The issue is whether typical consumers actually do assess the risks and act accordingly.
- 1.8 In OFT's view the contracts with contingent fees which are more likely to cause concern are those where:
 - i. the fees become payable, if at all, at a time remote from the original time of entering into the contract, or
 - ii. the incidence of fees depends on factors whose impact it is impossible or difficult in practice for consumers to assess at the time of making the contract

- iii. the fee structure lacks transparency, for instance because it is complex

1.9 The key principles we would want the CRD to put beyond doubt are:

- i. The price exemption should focus on 'core' pricing issues. It should only cover as much of the price as forms part of the essential bargain between the parties.
- ii. The interpretation of what is the essential bargain should also be about more than plain and intelligible language. Even if all remuneration terms meet transparency requirements and consumers read such terms, it will not necessarily follow that consumers will consider all detailed payments.
- iii. The interpretation of what is the essential bargain must incorporate and reflect the consumer's perspective.
- iv. Ancillary price terms, and essentially those payable on a contingency not likely to be foreseen by the consumer, should not benefit from the exemption.

2 INTRODUCTION

- 2.1 The OFT believes that markets work well when there are efficient interactions on both the demand (consumer) side and the supply (business) side. On the demand side, confident consumers activate competition by making well-informed and well-reasoned decisions which reward those businesses who best satisfy their needs. On the supply side, vigorous competition provides businesses with incentives to deliver what consumers want as efficiently and innovatively as possible. When both sides function well, a virtuous circle is created between consumers and competition.
- 2.2 In order for consumers to drive competition they ideally need to **access** information about the various offers available in the market, **assess** these offers in a well-reasoned way, and **act** on this information and analysis by purchasing the good or service that offers the best value to the customer.
- 2.3 The ability of consumers to access, assess and act in order to make well reasoned decisions may be particularly sensitive to what information they have. Small changes in the way information is presented may result in significant changes in their behaviour and hence their ability to discipline the market. This is important when looking at contingent charges and the effect they have in the market.
- 2.4 Consumers' ability to access, assess and act on the best offers cannot therefore be taken for granted. Issues such as search or switching costs can generate barriers to the virtuous circle described above.² Consumer behavioural biases may hamper the virtuous circle at each step:
- **Accessing** offers: Behavioural biases may exacerbate existing problems for consumers in accessing information. For example,

² For example, the key role of search costs in obstructing consumers' ability to access information, and the impact this has on competition, was shown nearly forty years ago by Diamond in his paradox of many firms in a market but all charging monopoly prices. P. Diamond, (1971), A Model of Price Adjustment, J. Econ. Theory, 3(2), 156-58

consumers tend to look at relative costs rather than absolute search costs.³

- **Assessing** offers. Behavioural biases may create or exacerbate consumers' difficulties in assessing the best deal. For example, consumers' ability to assess which product would suit them best may be impaired by incorrectly anticipating risk, underestimating or overestimating future use, or overweighting the present. Consumers may also fail to anticipate add-ons and search only on headline price, or consumers may forget previous experiences. When faced with more information than can be easily analysed, they may only look at a sub-set of information and use rules of thumb to assess the information. Finally they may be distracted by the way in which information is framed and presented.
- **Acting** on information and analysis. Behavioural biases may give rise to, or exacerbate, consumers' difficulty in acting to get the best deals. For example, if consumers have overconfidence in their ability to act in the future, this can create inertia and a tendency to fail to act today.

2.5 If contingent charges are sufficiently transparent in the contract, and ordinary consumers can in fact consider the total cost of the product or service they are purchasing, they should be able to avoid incurring any adverse effects by 'switching away' – that is, buying a competing product on terms they prefer. The issue is whether typical consumers actually do assess the risks and act accordingly. If consumers are made aware, and have a realistic choice at the relevant time then there is less of a problem. Where contingent charges are involved, this might be after the time of the main purchase, at the point when the contingency potentially gives rise to a charge.

³ By way of example, a consumer may be willing to travel an hour across town for a half price offer on a £20 pen, but would not travel an hour across town for £10 off of a £500 television even though the amount saved (£10) would be the same. This may imply that search costs are more prevalent on large ticket items than small ticket items.

2.6 However, if there is a lack of transparency or the costs of termination or switching are excessive it may be that consumers cannot take action to prevent themselves from suffering detriment. This makes a strong case for intervention, and it follows that the law should not artificially restrict scope for such intervention.

3 RESPONSE TO QUESTIONS

Q1. Do you agree with the government premise that because charges are contingent, ancillary or not transparent, or otherwise not part of what a typical consumer would understand as the 'essential bargain', competition may not drive down the level of such charges as it ordinarily would?

3.1 We broadly agree.

3.2 In our view the question is whether the charges are likely to be noticed and understood by consumers at the time of contracting rather than whether they fall into particular descriptive categories. In other words, the key issue is transparency, understood in a broader sense than just plain and intelligible language, rather than whether terms are contingent or ancillary as such. It concerns economic cause and effect rather than where and how the line should be drawn between terms assessable and not assessable for fairness. Charges which are not transparent, whether they are triggered by remote contingencies or where their wording is unclear, may harm consumers by making them pay more than they expected. They may not have entered the bargain had they known about the charges and been able to correctly anticipate the likelihood of the need to pay them. Such charges can reduce the beneficial effects of competition on price because consumers cannot easily compare prices, reducing businesses' incentives to offer low overall prices.

3.3 This type of charge does not necessarily mean that consumers end up paying more overall. In the right market conditions, gains made via secondary charges may be 'competed away', that is, used to reduce the headline contractual offers on which suppliers do compete. However, market conditions are rarely ideal, and this effect cannot be relied on generally to guarantee either economic efficiency or fairness. In particular, contingent charges at levels above cost often result in cross subsidisations from customers who incur the charges to those customers who do not. These cross subsidisations may cause allocative inefficiencies. Subsidised consumers consume too much of the good,

whilst exploited consumers consume too little. The net impact of these inefficiencies can be significant. Furthermore, such cross subsidisations can involve perceived unfairness, particularly (for instance) where vulnerable consumers cross subsidise those in a stronger bargaining position.

- 3.4 If contingent and other ancillary charges are used in a transparent way, they can in principle actually help activate competition. Simplifying headline contractual offers to what is essential for many consumers leaves charges for more detailed services that only suit some consumers in the background. If the consumers who incur contingent charges **can and do** assess them then competition can work well. In practice, it is often difficult for consumers who will incur contingent charges to predict that they will, or to assess what they may have to pay. This may not only be because of the behavioural biases as outlined in the call for evidence document but also changing circumstances. Such circumstances may make it difficult for businesses to design contractual offers that inform consumers optimally even if they want to, and easy for less well-intentioned businesses to manipulate consumers if they choose. In some cases businesses may not have an incentive to clarify their contracts, and may positively have incentives to deceive.⁴
- 3.5 Businesses in markets where there is no, or no effective, competition on contingent charges may also exploit consumers further by increasing the charges, and/or introducing new ones.

Q2. Should any exclusion from the price exemption provision in the UTCCRs (paragraph 6(2)) focus on:

- **contingent charges – made only on the occurrence or non-occurrence of a particular event – and/or**

⁴ For a further discussion of this, see M Bennett, J Fingleton, A Fletcher, L Hurley and D Ruck. 'What Does Behavioural Economics Mean for Competition Policy?' OFT Discussion Paper 1224, March 2010. www.offt.gov.uk/OFTwork/publications/publication-categories/reports/Economic-research/oft1224

- **ancillary charges which require the consumer to pay additional sums for matters outside the ordinary and expected performance of the contract – and/or**
- **charges that are not transparent to the consumer for reasons going beyond the clarity of the language used, for instance, in terms of presentation**
- **or all three of the above?**

3.6 Our view is that these are not best treated as three separate types of term. The first two categories overlap, in that ancillary charges can be contingent, and both overlap with the third to the extent that contingent and ancillary charges tend not to be transparent. The exclusion should therefore as far as possible cover all three types of charges, with the principal focus being on the issue of transparency.

3.7 We believe that the key factors to be taken into consideration here are:

- **The remoteness of the charges.** The provisions should be drafted in a way that invites the courts to consider the reality of the situation for consumers. Evidence could be adduced on how far consumers are able and likely in practice to factor the charges into their initial decision to enter the contract. Such evidence shouldn't be compulsory or difficult to avoid, as it won't be necessary in all cases. Otherwise uncertainty will remain as to what charges can be regarded as being remote from the initial purchase decision and may fail to take account of the realities of consumer behaviour.
- **The perspective and circumstances of the typical or average consumer,** and whether, in the context of the ordinary pressures and constraints of modern life, consumers actually do factor these charges into their initial purchase decision.

3.8 In general we consider that the types of contracts with additional fees which are most likely to cause concern are those where:

- the fees become payable, if at all, at a time remote from the original time of entering into the contract, or
- the incidence of fees depends on factors whose impact it is impossible or difficult in practice for consumers to assess at the time of making the contract and are hard to control.
- The fee structure lacks transparency because it is not presented clearly or its impact is hard for the consumer to understand, or it is difficult to understand, for example because it is complex.

Q3. Are there matters the government should consider in terms of the interpretation of concepts such as contingent, ancillary, non-transparent terms or 'essential bargain' or other terms which are relevant?

3.9 As already indicated, we think that at this stage the focus needs to be on outcomes rather than technical terms and concepts. We believe enforcers need to be able to deal effectively with charging terms that consumers don't focus on and therefore come as an unwelcome surprise. The OFT questions the fairness of terms which seek to hide extra charges from the consumer at the time of purchase and where they are unable to make a conscious decision regarding payment at the time they need to do so. We do not seek to recommend words for use by the legislative draftsman.

3.10 However we do have the following comments on the terms and concepts mentioned.

3.11 We do not think that the ordinary meaning of the word 'contingent' exactly matches the kind of charging terms that give rise to concern but whose position in relation to the fairness assessment is currently unsatisfactory and/or unclear. It can have a meaning that is too narrow, in that it might be thought to cover only charges which are only a possibility, not certain but remote in other ways (such as time). It can also cover certain other 'conditional fee' charging terms which are not

certain to be paid but are nonetheless clearly likely to be in the forefront of the consumer'

- 3.12 The term 'ancillary' does not give rise to the same problems, and is capable of being used so as to represent a good fit with the language of the House of Lords in the First National case.⁵ Our main concern here is (as generally) that such a term should be used in a way that incorporates the perspective of the ordinary consumer – what is ancillary from his or her point of view – and reflects what consumers can be shown (if necessary by evidence) actually to do, not just what they are legally presumed to be capable of doing. We think it is particularly important that a term should not become exempt from the fairness test solely on the basis that it generates such high levels of profit that it is critical to the business model of the trader. This might be a basis on which many an extremely unfair term could be considered central rather than ancillary to the bargain between the parties.
- 3.13 The term 'non-transparent' fits with the concerns we have been expressing. However, we think something more than just this term would be needed. The risk is that if it is not interpreted too narrowly – as meaning 'in plain and intelligible language', when that issue is already covered by the current legislation – it will be seen as unclear in the limits of its coverage.
- 3.14 The concept of the 'essential bargain' seems to us to offer a good description of what is really intended to be covered by partial exemption created by Article 4(2) of the Unfair Contract Terms Directive. Although it might not immediately draw a line between charging terms that are obviously assessable for fairness and those which are not, a case-by-case context-sensitive approach is consistent with the general approach of this legislation. In our view drafting that reflects such a concept has the potential to lay down principles which will be more useful and workable than either the present legislation or the current draft proposal.

⁵ Director General of Fair Trading v. First National Bank [2001] UKHL 52

Q4. Should all contingent price terms be assessable even where they are likely to be in the forefront of consumer's minds when contracting, for example, estate agency sale fees? If not, what other criteria should be involved?

3.15 It follows from what is said above that the OFT considers that certain terms which might be considered to involve contingent charges, or to have affinities with contingent charges, are unlikely to be a cause for concern, primarily because consumers are generally likely to factor them into their initial purchase decision. Provided it is possible to exempt such terms from assessment without also exempting terms which do give rise to concern, the OFT would be content for them not to be assessable provided they meet plain language requirements. Examples of such terms are as follows:

Estate Agency

3.16 The fee or commission is charged after the service is delivered and is based on a percentage of the value of the property being sold but is contingent on a successful sale and the consumer knows the level of fee when entering into the contract. It is payable for work done and a result achieved by the agent. This is also the 'upfront price' that consumers focus on when entering into the contract and can readily compare with what other agents are charging. There is unlikely to be any other price to which it is secondary, and the contingency is not in any sense remote.

General insurance contract excess fees (for example, car, house insurance etc)

3.17 The insurance excess is payable on the same contingency as the triggering of insurance cover. Consumers buy insurance specifically to cover risks and excesses are a basic and very common feature of all insurance. So it is rarely remote to consumers that some excess may have to be paid in the event that they decide to make a claim. However, when insurance contracts cover many risks, or have exclusions that are hard to interpret or are hidden, specific excesses may be remote to consumers, and could even be designed to catch them out.

3.18 As a matter of contractual analysis, an insurance excess is properly regarded as an exclusion from the main subject matter of the contract not a contingent price term, and is referred to as such in recital 19 of the Unfair Contract Terms Directive.⁶ But it gives rise to similar issues from the average consumer's perspective, and what is said in recital 19 helpfully illustrates points made above about contingent charging terms (note the use of the word 'clearly').

'...in insurance contracts, the terms which clearly define or circumscribe the insured risk and the insurer's liability shall not be subject to ... assessment since these restrictions are taken into account in calculating the premium paid by the consumer'

Gym Contracts (additional charges)

3.19 Membership agreements may allow for the consumer to be charged an additional or higher sum for using the gym during peak hours. Consumers are made aware of the charges in advance and, being aware of their own needs and preferences as regards time of using gyms, can be expected to have the motivation to focus on the issue and the ability to decide when to use the gym and how much they are prepared to pay. Depending on their other commitments they may also be able to avoid them by not using the gym during peak times.

Q5. Would you support a provision which would simply allow charges to be assessed for unfairness if they were not, from the consumer's perspective, part of the 'essential bargain' between the consumer and trader? Would further conditions need to be applied?

3.20 We would strongly support a provision having that effect. We take the view that future legislation via the CRD needs to put beyond doubt that:

⁶ Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts

- The price exemption should focus on 'core' pricing issues. It should cover only as much of the price as forms part of the essential bargain between the parties.
- The interpretation of what is the essential bargain should also be about more than plain and intelligible language and will be capable of taking account where necessary of evidence as stated previously. Even if all remuneration terms meet transparency requirements and consumers read such terms, it will not necessarily follow that consumers will consider all detailed payments.
- The interpretation of what is the essential bargain must incorporate and reflect the consumer's perspective – not **exclusively**, since this legislation is about achieving a fair balance, but **sufficiently** to enable it to give appropriate protection to consumers as they really are and as they really operate in the modern marketplace.
- Ancillary price terms, and especially those payable on a contingency not likely to be foreseen by the consumer, should not benefit from the exemption.

Q6. Do you have any evidence of contingent, ancillary or non-transparent charges arising in other sectors beyond personal current accounts which, in your view, would be assessable for unfairness in relation to the level of the charge if the law was changed?

3.21 The OFT has recently undertaken cases in the residential letting, retirement homes and season tickets sectors which have involved contingent/ancillary charges and it is our view that such charges are assessable for fairness **under the existing legislation**. What we are seeking is clarification and certainty of the relevant provisions within the proposed CRD rather than changes to the law.

Foxtons⁷

3.22 In *The Office of Fair Trading v Foxtons Limited*, the OFT challenged the fairness of terms the agent used in an agreement it used with landlords, particularly one which provided for the payment of a substantial renewal commission to the agent at the end of the initial period of a tenancy if the tenant remains in the property. The renewal commission was in addition to a similar fee payable on the initial tenancy and was payable when the agents did nothing to secure the renewal, did not collect the rent or manage the property. The High Court rejected Foxtons' contention that its renewal commission term was a core pricing term forming part of the remuneration for introducing the tenant to the property. It ruled that Foxtons' terms were not transparent to consumers, so that they represented a trap and were therefore unfair, and ordered that Foxtons may not rely on these terms except where they remain instructed to manage the property.

Retirement homes⁸

3.23 The OFT issued formal written notices to 26 retirement home businesses setting out concerns over fees charged when residents sell or rent their properties. The OFT is concerned in particular about the fairness and clarity of contract terms providing for these so-called 'exit fees', charged to occupants of purpose built retirement homes. The exit fee, often called a 'transfer fee', that the OFT is looking at is the fee a leaseholder is required to pay to his freeholder when he sells or rents his leasehold property or disposes of it in some other way. Some businesses have said that the fee covers the expense they incur in carrying out the administration work involved in processing the assignment of the lease.

⁷ www.oft.gov.uk/news-and-updates/press/2010/19-10

⁸ www.oft.gov.uk/OFTwork/consumer-enforcement/consumer-enforcement-current/retirement-homes/previous-updates

Manchester United season tickets⁹

- 3.24 Following a complaint from the Manchester United Supporters Trust the OFT identified a number of potentially unfair terms with the club's season tickets. Season ticket holders had the right to seats at league games, but were required to pay for any home cup tie at which the club chose to offer them a seat, whether or not they could attend. At the same time, they had no right to seats at cup matches. So they could be required to pay for matches they did not want to attend, and kept away from ones they did want to go to. We challenged various terms as unfair, including these, notwithstanding the potential for arguing that they were 'core' terms within the scope of the Regulation 6 exemption. There was a significant element of lack of transparency unrelated to the plainness or otherwise of the language used in that what the consumer would end up paying was unclear. Also there was in our view fundamental contractual imbalance.
- 3.25 Manchester United did not accept that the terms were unfair, but responded positively and agreed to amend its terms to ensure that every season ticket holder was guaranteed a seat at every home league and cup game, and received clear information about when he or she was likely to be moved from their seat for a cup match. The club also agreed to provide clear and upfront information to supporters before selling them tickets, enabling them to calculate the maximum total cost for a holder over a season based on the club reaching the final stage in all competitions, as well as an indication of the number of home cup games in the previous campaign.

Q7. If so, do you think any of these charges are unfair and if so, why?

- 3.26 See our response to Question 6.

⁹ www.offt.gov.uk/news-and-updates/press/2009/43-09

Q8. What would be the impact on your sector or your business in terms of its pricing policy if the law was changed to allow the level of all contingent, ancillary or non-transparent charges to be assessed by the courts for fairness?

N/A.

Q9. Are there other potential consequences or wider impacts of allowing the assessment of contingent, ancillary or non-transparent charges for fairness?

3.27 The best protection for consumers is competition, wherever it can realistically be expected to take place. However, most standard form contract terms are not subject to effective competition and therefore need to be open to assessment for fairness. 'Headline' price terms that consumers see, understand, and compare, give rise to genuine competition and deserve to be exempt from assessment. The same cannot be said of terms imposing charges that are outside the ordinary consumer's practical contemplation. We see no reason to anticipate that subjecting such terms to assessment would have any wider effects beyond those which have arisen from application of the fairness test to standard form consumer contract terms generally. The overall effect is likely to be, as with other terms, to discourage businesses from using unexpected 'small print' provisions to strengthen their balance sheets, and conversely to encourage them to raise revenue competitively. This would be beneficial to the economy as a whole and to consumers individually.

3.28 Contingent, ancillary or non-transparent charges may not result in consumer harm in all circumstances. We consider the law needs to avoid prescriptiveness that would leave enforcers unable to assess the potential detrimental impact of such charges before deciding whether intervention is necessary. But as long as the effect of legislative change is only to clarify that the fairness test does apply to certain terms whose position in relation to it is unclear or otherwise unsatisfactory, this issue should not arise since UK enforcers are statutorily required to use their

regulatory discretion in a way that is transparent, accountable, consistent, proportionate and properly targeted at the most important cases.

4 ADDITIONAL INFORMATION

OFT Consumer Contracts Market Study

- 4.1 We are also currently considering issues relating to consumer contracts in our market study launched in February 2010.¹⁰ This is examining when, how and why contracts may cause difficulties for consumers. The study is considering how well consumers understand typical contracts and how this varies when contracts are, for example, presented online, over the phone or during a face-to-face sales pitch. We are also looking at how businesses approach consumer contracts, and any practices which deliberately or unintentionally disadvantage consumers, and whether any of the practices which appear to harm consumers in fact benefit them in other ways. The report is due to be published later in 2010.

¹⁰ www.offt.gov.uk/OFTwork/markets-work/current/consumer-contracts