

**EXPLANATORY MEMORANDUM TO THE
SUPPLY OF EXTENDED WARRANTIES ON DOMESTIC ELECTRICAL
GOODS ORDER 2005**

2005 No. 37

1. This explanatory memorandum has been prepared by the Department of Trade and Industry and is laid before Parliament by Command of Her Majesty.

2. Description

The Order imposes an obligation on suppliers of domestic electrical goods, who also supply extended warranties for those goods, to provide certain information to consumers relating to the sale of extended warranties. It also provides consumers who purchase such extended warranties with certain cancellation and termination rights.

3. Matters of special interest to the Joint Committee on Statutory Instruments

None

4. Legislative background

4.1 In July 2002, the Director General of Fair Trading¹, pursuant to his powers under sections 47, 49 and 50 of the Fair Trading Act 1973, made a monopoly reference to the Competition Commission in relation to the market in the supply of extended warranties on domestic electrical goods in the United Kingdom.

4.2 The Competition Commission investigated that market and a report was laid before Parliament on 18 December 2003 (Cm. 6089). The Competition Commission found that a complex monopoly situation existed within the extended warranties market and identified practices which operate against the public interest. The Competition Commission recommended a number of measures designed to increase competition in this market.

4.3 The purpose of the Order is to remedy or to prevent the adverse effects specified in the Competition Commission's report and is made pursuant to the powers conferred on the Secretary of State under sections 56 and 90 of, and Schedule 8 to, the Fair Trading Act 1973. Although these provisions were repealed by the Enterprise Act 2002, they continue to apply in respect of monopoly references made before 20 June 2003².

5. Extent

This instrument applies to all of the United Kingdom.

¹ The functions of the Director General of Fair Trading have been transferred to the Office of Fair Trading pursuant to section 2 of the Enterprise Act 2002.

² See paragraphs 14 and 19 of Schedule 24 to the Enterprise Act 2002 and S.I. 2003/1397.

6. European Convention on Human Rights

Not applicable.

7. Policy background

7.1 The monopoly provisions of the Fair Trading Act 1973 enabled the Director General of Fair Trading or Ministers to refer a 'monopoly situation' to the Competition Commission for investigation. Where the Competition Commission concluded that there was a monopoly situation operating against the public interest, the Secretary of State was empowered to remedy the adverse public interest. These provisions have now been replaced by the market investigation provisions in Part 4 of the Enterprise Act 2002, but continue to apply in relation to monopoly references made before 20 June 2003.

7.2 In its 2003 report, the Competition Commission found that a complex monopoly situation existed in the market for extended warranties on domestic electrical goods sold at point of sale (that is, where the extended warranties and the domestic electrical goods to which they relate are sold at the same time). The Competition Commission identified certain practices as distorting or restricting competition and operating against the public interest.

7.3 The Competition Commission calculated that the cost of extended warranties appeared to be set by what retailers thought consumers would bear rather than in light of what competitors were charging. Over the 5 years analysed, the top 5 retailers collectively earned between £116m to £152 million more profit each year than they would have done if their returns on extended warranties equalled the cost of capital. Put another way, if the market were fully competitive, extended warranty prices could have been on average up to one third lower.

7.4 There has been substantial public interest in this Order. Consumer complaints about extended warranties first prompted an Office of Fair Trading investigation back in 1994. As a result of that, a voluntary code of practice was introduced in 1995. The Office of Fair Trading commissioned a review in 2001 and judged that the retailers' compliance with the code was poor. In light of this, they referred the market to the Competition Commission.

7.5 The Department has held two rounds of consultation, one lasting 12 weeks, the second lasting 30 days, on the remedies proposed. Policy changes were made following the consultation process. The Government's response to the consultations can be found on the Department's website at:
www.dti.gov.uk/ccp/topics2/pdf2/ewconresponse.pdf.

7.6 The policy intention behind the Order is to increase competition in the market for extended warranties by ensuring that consumers are provided with sufficient information on extended warranties so that they are able to 'shop around' for the best deal, and to provide adequate cancellation/termination rights and refund provisions

for consumers so that they are not locked into long-term contracts. The Order seeks to fulfil these policy objectives by ensuring that:

- the price and duration of extended warranties are located adjacent, or in close proximity, to the price of domestic electrical goods, both on displays in store, in catalogues, on websites and in press advertisements;
- consumers are provided with relevant information relating to the sale of extended warranties such as the fact that the law already provides them with certain rights in relation to the purchase of domestic electrical goods; that extended warranties can be purchased from other providers and that such warranties need not be purchased at the same time as the domestic electrical goods to which they relate;
- consumers of extended warranties that last for longer than a year are given adequate cancellation (45 days) and termination rights and the right to obtain full or pro rata refunds; and
- consumers can be given written quotations when seeking to purchase extended warranties in store, thus guaranteeing the price of the extended warranty quoted and any related offers, for at least 30 days.

7.7 Guidance has been prepared to help business. This can be found on the Department's website at: www.dti.gov.uk/ccp/topics2/pdf2/ewguidance.pdf.

8. Impact

A Regulatory Impact Assessment is attached.

There is no impact on the public sector.

9. Contact

Yuen Cheung at the Department of Trade and Industry (Tel: 020 7215 5417 or e-mail: yuenfan.cheung@dti.gsi.gov.uk) can answer any queries regarding the SI.

**THE SUPPLY OF EXTENDED WARRANTIES ON DOMESTIC
ELECTRICAL GOODS ORDER 2005**

REGULATORY IMPACT ASSESSMENT

**ORDER REMEDYING ADVERSE EFFECTS SPECIFIED IN COMPETITION
COMMISSION REPORT UNDER THE FAIR TRADING ACT 1973 ON THE
SUPPLY OF EXTENDED WARRANTIES ON DOMESTIC ELECTRICAL
GOODS**

ISSUE

1. The Competition Commission (CC) report on the supply of extended warranties (EW) on domestic electrical goods (DEG)³ was published on 18 December 2003 and concluded that competition in the market was not fully effective. It identified practices carried out by retailers who sell EWs at point-of-sale which restrict or distort competition and operate against the public interest.

OBJECTIVE

2. The CC recommended a series of remedies which they believe, in time, will open up the market for EWs for DEGs by introducing steps to encourage stronger competition. Consumers will be given more information about EWs and their statutory rights before purchasing so that they will be much better placed to make informed decisions on whether or not they need the EW and whether or not they are buying the EW which offers the best value for money. They will be allowed time to shop around even if they have already made an EW purchase; they will also get greater rights to cancel and receive a full refund, which should encourage switching of EW providers. This will also provide scope and encouragement for new entrants to the market to develop products specifically targeted to service this market which hitherto is heavily constrained by point-of-sale selling advantage.

3. It is envisaged that, taken together, the package of measures will reduce the point-of-sale advantage and expose providers to increased competition for customers; this will exert greater downward pressure on prices and consumers will be offered better terms and conditions. The Secretary of State for Trade and Industry accepted the CC's findings on publication of the report and agreed that it was necessary to take action to remedy those adverse effects. This Regulatory Impact Assessment covers the Statutory

³ Competition Commission Report: A report on the supply of extended warranties on domestic electrical goods, CM 6089

Instrument which has been made to remedy the adverse public interest identified by the CC.

RISK ASSESSMENT

4. The CC's adverse findings identified that the complex monopoly situation includes all retailers of DEGs who sell paid EWs at point-of-sale and that this situation acts against the public interest. EWs sold at point-of-sale are usually from the retailer selling the DEG. There is also a lack of information about alternative EWs. This means that consumers are not currently in a genuine position to weigh up the merits of competing products and may be pressured into purchasing EWs through "special offers" which are only available when the EW is purchased at the same time as the DEG. The CC found that prices of EWs tended to be determined by what the consumer would bear rather than by competition from alternative EWs. They also concluded that prices of EWs did not reflect variations in costs or risks and that retailers were charging more and making more profit than they would in a truly competitive environment.

5. Profits earned by retailers on EWs, are shown to be consistently and substantially above the cost of capital. This margin reflects the huge competitive advantage of selling EWs at point-of-sale; the EW can be sold as an immediate and relevant secondary purchase at a time convenient to the customer. The five major retailers (Dixons, Comet, Powerhouse, Littlewoods and Argos) have in total made profits in excess of the cost of capital in the range of £116 to £152 million per annum, over 5 years to 2002. If profits on EWs for these five retailers had been in line with the cost of capital, prices of EWs could have been on average up to a third lower.

6. The costs of the proposed remedies are considered modest in relation to the significant consumer detriment identified in the CC report. The main focus of the proposed package of remedies – supported by the majority of the CC – is designed to allow the market to continue to operate in its current fashion but to expose it to more direct and effective competition. This will secure better value for money for consumers opting to purchase EWs. There remains a risk that the proposed remedies will not go far enough to secure that outcome. This is reflected in a more challenging remedy package supported by a minority of CC members. Hence it is proposed that the Office of Fair Trading (OFT) will be specifically invited to monitor and review in two years time the effectiveness of the remedies in force and consider whether there is a case for further action.

7. The CC also considered other remedies⁴ but decided not to pursue them. These included:

- requiring retailers to display prices of manufacturers' EWs;
- tables of comparative information on EWs;
- publishing information on EW profitability;

⁴ Details of alternative remedies are set out in paragraphs 2.376 to 2.419 of the report

- a requirement to provide EWs on DEGs sold by other retailers;
- requiring annually renewable policies to be offered;
- requiring the unbundling of different elements of the EW;
- limits to sales incentives; and
- benchmark products.

OPTIONS

1. Do nothing.
2. Self regulation.
3. Ban on sale of EW giving cover for more than one year.
4. Securing undertakings from the parties.
5. Statutory Instrument.

Option 1: Do Nothing

8. About 18.5 million EWs were issued in the UK in 2001 with a total value of around £900m and an average warranty price of over £48. The top 5 EW retailers (who account for 80% of paid EW sales) have, over the five years analysed, collectively earned, on average between £116m and £152m more profit each year than they would have earned if their return equalled the cost of capital⁵. Put another way, **were this market fully competitive**, it is estimated that EW prices offered by the top five EW retailers could have been, on average, up to one-third lower (though it is not possible to extrapolate from these figures to the remaining 20 per cent of the market). The do nothing option would result in consumers continuing to pay this high price.

9. There is very little competition in the market for EWs at present, unlike the market in DEGs. We reason that making it easier for consumers to shop around, by providing consumers rights to cancel and switch providers, augmented by greater information about warranty costs and coverage, will encourage EW providers to compete for business and produce downward pressure on EW prices.

Option 2: Self-regulation.

10. Self-regulation has been tried and shown to be ineffective. The OFT investigated the selling of EWs in 1994. As a result of that investigation, a voluntary Code of Practice was introduced in 1995, sponsored by the British Retail Consortium. OFT investigated again in 2001 and found that compliance with the voluntary code was poor and self-regulation had not worked even though it had been in place for six years. Hence their referral of the market to the CC.

⁵ Cost of capital is an estimate of the price a company must pay to raise the capital it employs. It reflects the return required by investors to invest in the company's activities rather than elsewhere. For a more detailed explanation of the methodology see paragraphs 2.166 to 2.218 of the Commission's report

Option 3: Ban the sale of any EW at Point-of-Sale giving cover for more than one year.

11. One option suggested by a minority of the CC was that there should be a ban on the sale of EWs at point-of-sale which gave cover for more than one year. This ban would apply for 30 days from the day of purchase of the DEG and would require consumers to shop around, effectively making the purchase of longer EWs an entirely separate transaction. This would be in addition to the same information and cancellation requirements as we are proposing.

Option 4: Undertakings

12. The Fair Trading Act 1973 allows for two ways of introducing remedies: undertakings and orders. Undertakings can only be put in place with the agreement of the party or parties concerned. Once accepted, undertakings are legally binding. Given that there are hundreds of retailers offering EWs for DEGs in the UK, it is not practical to seek undertakings from them all.

Option 5: Statutory Instrument

13. An Order under the Fair Trading Act 1973 can be imposed on parties and therefore does not pose the same difficulties as using undertakings. We believe that implementing these remedies by way of an Order is the sensible way forward given the large numbers of retailers involved.

14. This will require retailers who sell EWs to:

- show the price of the EW alongside or in close proximity to the DEG, in-store, in catalogues, on websites and in press adverts;
- give consumers information about statutory rights, cancellation rights, details of the warranty;
- give consumers 45 days to cancel their EW and receive a full refund, including a written reminder of this right at a later stage, and the right to terminate subsequently and receive a pro-rata refund;
- offer in-store customers a quotation preserving their right to purchase the EW on the same terms for 30 days if the consumer chooses not to buy it there and then and ensuring that any discounts tied to the purchase of the EW also remain available on the same terms for 30 days; and
- inform customers about whether or not their warranty provides financial protection in the event of the warranty provider going out of business.

ISSUES OF EQUITY AND FAIRNESS

15. The CC's recommendations are aimed at addressing the complex monopoly situation identified in their report and the resulting detriment to consumers. The recommendations affect many elements of the industry including those involved in the retail, fulfilment, insurance, underwriting or provision of EWs.

16. The OFT will monitor and review in two years time the effectiveness of the remedies and consider whether there is a case for further action.

17. The Order exempts small retailers who sell less than £10,000 worth of EWs in a year from the requirement to include an applicable EW price in any newspaper advertisements which contain prices of DEGs. The CC considered that placing this requirement on smaller retailers could be particularly onerous. It is therefore envisaged that the proposed exemption will avoid imposing an inequitable impact on those small retailers who sell low volumes of warranties (the CC report notes that four out of five of the 375 small retailers who provided detailed data to the inquiry, reported annual EW sales below £10,000⁶).

18. The CC also accepted representations that the requirements on advertising should not apply to radio or TV advertisements as the requirements could interfere with the effectiveness of those advertisements. A number of responses to the DTI consultation from the newspaper sector argued that this could provide an unfair advantage to broadcast media. However it is clear that this was an integral component of the remedies proposed by the CC, who noted that it is very unlikely that effective competition in the supply of EWs will develop if consumers do not know the price of the EW at the time they are deciding on the DEG which, at point-of-sale, could determine the EW they buy. The Secretary of State accepted this reasoning in 2003 and the Government still believe it carries weight. Newspaper advertising is a particularly effective advertising medium for DEGs, and in response to the industry concerns the Department has made a number of changes to this requirement by:

1. removing the requirement to give the price of the EW similar prominence to the price of the DEG;
2. removing the requirement to describe the EW as “optional”; and
3. removing the requirement to expressly include in the advertisement a statement that further relevant information relating to the purchase of EWs offered by the supplier is available upon request by a consumer.

19. The Order does not apply to suppliers who give free EWs or sell stand alone EWs, as the adverse public interest finding by the CC concerned retailers who sold EWs with DEGs at point-of-sale, not those who gave away EWs for free or who sold stand alone EWs.

BENEFITS

20. The main beneficiaries of competition in the market will be consumers. If consumers become as discerning in buying EWs as they are in, say, buying mobile phone airtime contracts, this will encourage competition from providers and force down prices. Businesses offering the best value for money EW packages may stand to grow their business as a result of these market opening measures.

⁶ Paragraph 2.439 of the report

COSTS

Environmental costs & benefits

21. We do not envisage any environmental benefits or costs.

Social benefits and costs

22. Consumers will benefit if they are more aware of their existing rights. For example, consumers can already get free EWs if they buy DEGs from certain department stores. Some credit cards offer free EWs if a consumer uses it to purchase a DEG. For example, Barclays told the CC that it has 10.4 million accounts⁷ who are eligible for free EWs.

Economic benefits & compliance costs for business

23. Manufacturers/retailers and other EW suppliers/insurers will in future have to provide customers with enhanced information and rights to cancel/terminate EW contracts/receive refunds. The main costs we envisage are:

Implementation costs

i) Displaying EW prices alongside DEGs in stores or in advertising literature/catalogues. This will require staff time and labelling. Businesses already print catalogues and promotional fliers in the normal course of business. We do not envisage that businesses will have to print new, additional material but simply alter existing material. Costs should be minimal for those businesses which already meet or exceed the stipulated arrangements to supply such rights/information. For those businesses that do not, costs will be higher, but the cost of changing displays to ensure EW prices are shown in-store should not be more than £150,000 for even the largest companies. For smaller firms the costs will be significantly lower, with one middle-ranking player indicating that additional costs would not be more than £15,000. Overall, it is unlikely that these costs will total much more than £1.5 million for the whole EW sector.

ii) Providing a written notice reminding customers of their right to cancel the EW prior to the expiry of the 45-day period when a full refund is available (provided no claim has been made). Businesses typically either write to customers shortly after purchasing an EW to supply documentation etc. or provide written information in some other way. Subject to businesses taking steps to ensure consumers receive the notice in good time to be able to exercise their rights, and businesses ensure reasonable prominence is given to the additional statutory information, we see no reason why businesses should not include this notice within their normal method incurring minimal additional compliance cost.

iii) The cost of printing notice letters, quotations and in-store information leaflets. Retailers already print information leaflets about the EWs they supply. The existing leaflets will have to be modified but with suitable

⁷ 8.4 million Barclaycard customers and 2 million current account customers. More details about free EWs can be found in paragraphs 11.99 to 11.107 in Volume 2 of the Competition Commission report on extended warranties (CM6089-II)

prominence and a competitive product they may be also prove a useful means of attracting additional EW sales covering DEGs offered by other vendors.

Policy cost

iv) The cost of refunding consumers who choose to cancel their EWs and who will be entitled to either a full refund on cancellation (within the minimum time which is at least 45 days) or pro-rata refund on termination. This will effectively be an administrative charge which cannot be passed onto the consumer. Those businesses that already offer similar or better cancellation rights to consumers will incur minimal costs. Additionally, we have received representations that businesses will lose money where a claim is made on a policy before a refund (either full or pro-rata), and these costs may be passed onto consumers. The CC explicitly mentioned this in their report⁸ where they noted the increase in competitive pricing should minimise this.

v) The cost of displaying the price of an EW next to the price of the DEG in newspaper advertisements. There are likely to be some implementation costs covering the modification of advert format to implement the Order. Additionally, some newspaper organisations have indicated that this requirement might result in a switch from print-based advertising to other media where the requirement does not apply, although this would not represent a net cost of the requirement, but a transfer from one advertising medium to another. It is difficult to quantify the amount of DEG advertising that may shift; however, the Newspaper Publishers Association estimated in its response to the first consultation “that each percentage point shift in DEG advertising from newspapers and magazines to broadcast represents £1.013 million in lost revenue” (based on information from Nielsen Media Research). Additionally, we have since received figures that show the effect on the entire market could approximately double this impact in a situation where the share of DEG advertising in print is already dropping.

Other Costs

vi) One response to the consultation has indicated that there are likely to be £300,000 a year in administrative costs. The nature of these is unclear, but is likely to be shared between the policy cost (iv, above) and the costs of providing written reminders (ii, above).

vii) It is expected that the majority of retailers will implement the package of measures contained in the Order. It is likely that in the event of failure to comply or other dispute, most complaints will be made either to Trading Standards officers or local Citizens’ Advice Bureaux. Although these organisations are not empowered to enforce the Order, they may face increased costs if there is a significant increase in complaints following its implementation which they have to signpost to the OFT.

⁸ Paragraph 2.391, Page 98

SMALL BUSINESS IMPACT TEST

24. Over 80 per cent of the EW market for DEGs is met by just 5 large retailers. The proposed requirements will also impact on small businesses offering EWs, although the cost should be modest as in many cases it is likely that much of the compliance actions will be undertaken by the insurance business underwriting their EW offer. Again we believe this will primarily involve the staff time to produce and display the additional EW prices alongside the DEG price. In the main smaller retailers do not operate their own service backed warranty scheme but will offer EWs on behalf of insurance companies. The additional mailing/postage costs to advise customers of their cancellation/pro-rata refund rights and maintenance of records is likely to fall to the insurance firm providing the underlying EW rather than the small retail outlet.

25. Businesses who sell under £10,000 worth of EWs in one financial year will be exempted from the provisions to include EW prices in their advertising materials, although any EW sales in respect of DEGs will still be subject to the cancellation and termination rights.

CONSULTATION AND IMPLEMENTATION

26. During its investigation, the CC consulted widely and took into account evidence and views from manufacturers, retailers, insurers, associations, mobile phone sellers, computer sellers, other sellers of EWs and interested organisations. The CC also held individual hearings with a number of organisations and a public hearing in London in 2003.

27. On 28 February 2003 the CC published and sent an Issues Statement⁹ to retailers, manufacturers and insurers. On 20 May 2003 the CC published a Remedies Statement¹⁰ as it wished to consult parties on possible remedies. A revised version of the Remedies Statement was published on 23 July 2003¹¹.

28. The DTI also held meetings with interested parties at their request as well as holding two periods of public consultation.

29. On 28 July 2004, the DTI issued a draft Order for public consultation which ran for 12 weeks. In light of the responses received, the DTI revised the Order. The main changes were:

- Change in proposed implementation date

⁹ Appendix 2.1, Vol 3, Competition Commission report on supply of extended warranties on domestic electrical goods, CM 6089 III

¹⁰ Appendix 2.2, Vol 3, Competition Commission report on supply of extended warranties on domestic electrical goods, CM 6089 III

¹¹ Appendix 2.3, Vol 3, Competition Commission report on supply of extended warranties on domestic electrical goods, CM 6089 III

- Removal of the requirement for the price of an EW to be given “similar prominence” to the price of a DEG. This was changed so that the price of an EW had to be “clear and legible”.
- Removal of the requirement for the word “optional” to be displayed next to EW prices on websites, in catalogues and in print advertisements.
- Providing a carve out in relation to the cancellation and termination rights specified in the Order, for distance sold, insurance EWs which fall to the EU’s Distance Marketing of Consumer Financial Services Directive.

30. The revised Order was issued for a second period of public consultation on 18 November 2004. This ran for 30 days.

31. A detailed review of the responses to the consultation can be found at www.dti.gov.uk/topics2/pdf2/ewconresponse.pdf

COMPETITION

32. The aim of the remedies is to encourage stronger competition in the market for EWs. The remedies should ensure greater opportunities for consumers to shop around and secure better value for money and produce downward pressure on prices as providers compete for customers.

DEVOLUTION

33. Competition is not a devolved matter and responsibility rests with the Government of the United Kingdom. This order will apply to England, Scotland, Northern Ireland and Wales.

ENFORCEMENT AND SANCTIONS

34. Civil proceedings for an injunction or any other appropriate relief may be brought in respect of a failure to comply with the terms of the Order. The breach of any injunction or other order of the Court obtained as a result of such proceedings would constitute a contempt of court. Further, anyone harmed by a breach of the Order may be able to bring civil proceedings against the person responsible.

MONITORING AND REVIEW

35. The OFT will monitor compliance with the Order and review the effectiveness and benefits of the Order in two years time to see whether it needs to be varied, or revoked. The Secretary of State may then take further action as is appropriate. However, , it is envisaged that, in due course, responsibility for enforcing the Order, and the power to vary or revoke the Order, will be transferred from the Secretary of State to the CC, who would then be responsible for the Order.

MINISTERIAL APPROVAL

36. I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister

Gerry Sutcliffe

Gerry Sutcliffe, Parliamentary Under-Secretary of State for Employment Relations, Competition and Consumer Affairs

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