

Consumer contracts

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'Last year, as an April Fool's prank, video game retailer Gamestation put up spoof terms and conditions on its website which committed customers to selling their souls. 'Should we wish to exercise this option, you agree to surrender your immortal soul, and any claim you may have on it, within 5 (five) working days of receiving written notification from gamestation.co.uk or one of its duly authorised minions.' On that day 7,500 customers made a purchase from the site. Every single one ticked the box claiming they accepted the conditions, but no one noticed a thing'

Lucy Kellaway, Financial Times, 23 January 2011

'The requirement of good faith in this context is one of fair and open dealing. Openness requires that terms should be expressed fully, clearly and legibly, containing no concealed pitfalls or traps. Appropriate prominence should be given to terms which might operate disadvantageously to the customer. Fair dealing requires that a supplier should not, whether deliberately or unconsciously, take advantage of the consumer's necessity, indigence, lack of experience, unfamiliarity with the subject matter of the contract, weak bargaining position or any other factor listed'

Lord Bingham in *Director General of Fair Trading v First National Bank*
[2001] UKHL52 paragraph 17

EXECUTIVE SUMMARY

Entering into contracts for goods and services with firms is part of daily life. Most people do not read these contracts in detail before buying, or even click through to terms and conditions online, often because they assume that any standard contract is not negotiable, they rely on the reputation of the firm that they are doing business with, or they simply do not have enough time.

Where there are several aspects to a product or service being provided, competition can become focused on one particular aspect, most often the headline price. In these cases there is a risk that fierce competition on that single headline aspect pushes firms to recover costs, or restrict services, through less visible contract terms. For competition to work well for consumers, value on the headline aspects must not be undermined by unfavourable conditions in the small print.

If consumers are confident that the small print will be broadly consistent with their expectations, they can focus on shopping around for best value on the main elements of a deal. If, on the other hand, consumers fear that the small print contains nasty surprises, they will divert effort into scrutinising terms and conditions or be reluctant to buy at all. Transaction costs will be higher, and trust in markets will be undermined.

Giving consumers confidence in the small print empowers them to activate vigorous competition by traders on the main elements of the deal. There is, therefore, an important economic rationale for intervention to protect consumers, who take reasonable care themselves, from unfair contract terms.

'... the UCPD exists to protect from being misled consumers who take reasonable care of themselves, rather than the ignorant, the careless or the over-hasty'

Mr Justice Briggs in *Office of Fair Trading v Purely Creative Ltd and others* [2011] EWHC 106 (Ch) Paragraph 62

In our research, 20 per cent of people said they had experienced a problem with a consumer contract in the last year. Not all of these problems were serious, but some would have caused significant detriment

to consumers. The assessment framework developed as part of this study allows the OFT to focus its enforcement work on those cases that are likely to address real and significant consumer harm.

This study is not primarily about which terms contravene specific legislation, but rather about which terms harm consumers and how – an assessment that draws on a different and wider set of considerations than the law alone. Consumer law does not regulate contracts prescriptively. However, the OFT can use the *Unfair Terms in Consumer Contracts Regulations 1999* (UTCCRs) and the *Consumer Protection from Unfair Trading Regulations 2008* (CPRs) to tackle unfair contract terms.¹

This study sets out a systematic approach for assessing the overall effects of consumer contract terms and thus identifying those we think should be a priority for enforcement action. In setting out our approach we have drawn on our experience of enforcement work in consumer contracts to date and supplemented our knowledge with new research into consumers' understanding, expectations, and experience of consumer contracts.

Findings

Broadly speaking, our approach to identifying the potential for harm from a particular contract, before considering whether there is any breach of law, is to assess whether:

- a contract term changes the deal from what consumers understand it to be, or
- the way the contract is presented makes it difficult for consumers to understand and assess the implications of the deal properly, and
- learning effects are strong enough that the market is likely to deal with the problem.

¹ This study is not an interpretation of this legislation and should not be read as guidance. The OFT has published guidance on the UTCCRs and CPRs. See: www.oft.gov.uk/about-the-oft/legal-powers/legal/unfair-terms/guidance www.oft.gov.uk/business-advice/treating-customers-fairly/protection

If the deal is not what consumers understood it to be, and learning effects are weak, there is potential for significant harm to consumers.

One way in which a contract term can change the deal is where there are surprises buried in the small print. Our research found that for 80 per cent of those who had experienced a problem with a consumer contract, the problem came as a surprise.

Even where terms are not buried in small print, consumers can have trouble assessing them. For example consumers have trouble evaluating fees which are contingent in occurrence or amount, and sometimes those that are deferred, particularly when the decision is made under time pressure. They also place less weight on information if it is introduced late in the sales process. By exploiting such biases firms can, as it were, hide potentially unfair terms in plain view.

Assessing consumer harm arising from exploiting consumer biases is difficult. Marketing and sales, by their nature, depend to an extent on exploiting human biases, and for the most part consumers are broadly aware of and comfortable with this. There are instances, however, where such manipulation is harmful. For example, following a reference from the OFT, the Competition Commission (CC) found evidence that many consumers at the point of buying credit products were also sold poor value payment protection insurance (PPI) policies. Due to a lack of competition at the point of sale and the exploitative effect of selling a secondary product under time pressure, the CC banned sales of PPI at the credit point of sale.

In principle, where consumers make small, frequent purchases which they can evaluate easily, those encountering a problem can learn from the experience and avoid the problem next time. In a competitive market and where learning effects are powerful, contract terms which often create problems for consumers should not be commercially sustainable. We are therefore most concerned about the potential for harm when consumers make large, one-off or infrequent purchases, or where they purchase goods whose quality may be difficult to assess prior to purchase.

We do not, however, take learning effects for granted even in markets where learning should be possible. Research suggests that consumers may learn from mistakes, but that they do not necessarily learn fully and

correctly, and that knowledge decays over time. Consistent with this, we observe markets where contract problems persist, even where those markets are well established and many consumers are experienced purchasers.

Enforcement and next steps

When the approach set out in our framework finds significant harm, consumer law is likely to be infringed. The UTCCRs and CPRs both provide protections from harm associated with terms that take consumers by surprise or are difficult for consumers to assess in full, as well as other things such as aggressive practices. Either set of regulations may be breached when a firm does not explain or illustrate terms that are difficult for consumers to take on board, or when terms are presented so as to confuse or manipulate.

The OFT can also tackle contract problems using other tools, such as a market study or reference to the Competition Commission. Our assessment framework takes a broad view, identifying harm independently of the legislation that might tackle it.

Contract terms and associated practice which are likely to fail the tests of our framework and be of concern to the OFT include the following:

- **Unexpected restrictions to contract scope.** For example, restrictions of service or quality detailed only in small print or not clearly presented to consumers. The OFT has intervened against football season tickets not guaranteeing seats, and extended warranties offering limited cover.
- **Terms that impose unexpected risks on consumers.** For example, terms excluding a firm's liability for failure or external disruption, or imposing liabilities on consumers. The OFT intervened on Sale and Rentback deals in part on the basis that the tenancy offered was much less secure than many people realised.
- **Complex, deferred or contingent charges exceeding efficient costs.** Consumers expect firms to make money on the main elements of the deal and not to profit from small print charges. Recently, the

OFT brought a successful case against a letting agent over small print charges that did not correspond to any service provided.

- **Obstructions to consumer switching.** These include onerous cancellation requirements, excessive cancellation fees, and rollover terms that are unclear or difficult to opt out of. Recently, the OFT has intervened against cancellation terms used by gyms.

The assessment framework set out in this report is already now in regular use by OFT. Around seventy per cent of current cases in the Consumer Market Group relate to contract terms and include UTCCRs and/or CPRs issues. By making this framework public, it should also help those traders who are interested in assessing their own contracts for fairness, or in understanding the approach that the OFT takes in its enforcement work.

Thank you

During this study we have consulted industry, consumer groups and other regulators. We are grateful for their contributions and willingness to assist the OFT in its work.

1 INTRODUCTION

1.1 This study considers how contracts can make markets work well for consumers, or fail to do so. It identifies where consumer detriment is most likely to arise from consumer contracts and sets out how we will analyse contract problems. The study sets out an enforcement approach designed to increase the impact of the OFT's interventions.

1.2 The main outputs of the study are:

- new research on how consumers engage with contracts and how their behaviour determines whether they experience problems
- a systematic framework for assessing contracts and contract terms and identifying those that should be a priority for OFT enforcement action, and
- examples of types of contract term which are likely to be of concern to the OFT.

Motivation for the study

1.3 Well-functioning markets depend both on competition working well and on consumers making good choices. Vigorous competition spurs traders to deliver what consumers want as efficiently and innovatively as possible. Well-informed, confident, effective consumers play a key role in driving that competition. If consumers do not select the best goods and services on offer, traders are less motivated to deliver them.

Figure 1: Virtuous circle between consumers and competition



- 1.4 This report collates evidence of consumers' problems with a wide range of contracts and explores how problems arise.
- 1.5 We have developed and set out an 'effects-based' enforcement approach to consumer contract problems. Such an approach has long been used in competition cases but until recently consumer case law has developed with less reference to economic principles. The aim of an effects-based approach is to help regulators make good use of their limited resources by focusing on cases where detriment is highest. The enforcement approach is not a requirement of the legislation; it is rather a framework for assessing which terms are most likely to result in consumer detriment and is therefore for use in prioritisation decisions, alongside the OFT prioritisation principles.²
- 1.6 A simple, clear methodology for detecting and describing consumer harm from contracts should ensure our approach is clear and consistent, and increase predictability for traders.
- 1.7 This report sets out our current thinking on consumer contracts. It may be refined and updated in future. It is designed to be flexible and allows for a range of factors to be taken into consideration on a case-by-case basis.

² www.oft.gov.uk/shared_of/about_of/oft953.pdf

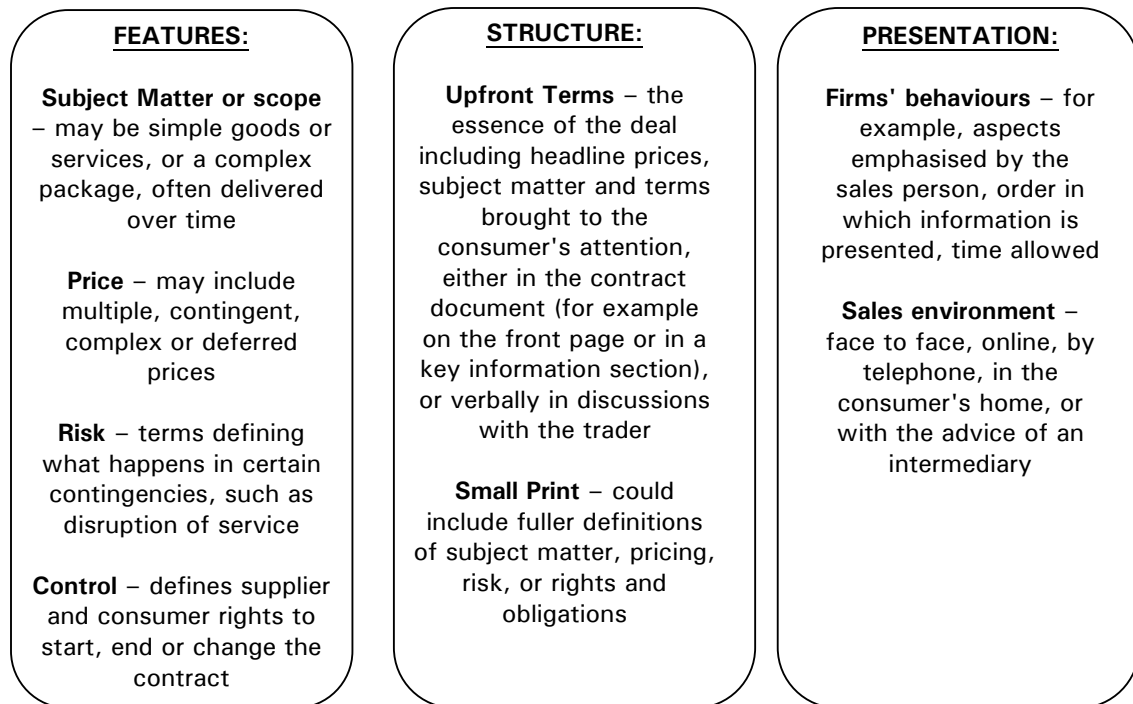
What is a contract?

- 1.8 Contracts are legally binding agreements that facilitate trade.³ They can be created by simple spoken promises in immediate transactions, like buying bread in a corner shop. They can be created even when consumers and suppliers are unaware of, and there is no explicit mention of, a contract. In more complex cases, contracting parties record the details of their agreement in writing. Over time, traders have developed the practice of selling many goods and services on the basis of standard-form written contracts that are not individually negotiated, thus saving time and effort in the contracting process.⁴
- 1.9 This study is about consumers' problems with complex oral contracts and standard-form written contracts. These can amount to a few short paragraphs or many pages. They may cover the provision of single or multiple goods or services, over short, long or indefinite time periods. Figure 2 summarises the various aspects of consumer contracts that this report covers.

³ For a discussion of the rationales for contracts and their enforcement, see Goetz and Scott (1980)

⁴ For a discussion of the economic efficiency of standard-form contracts see Katz(1998)

Figure 2: aspects of consumer contracts



Five types of consumer contracts

1.10 To help draw out common themes and problems we have defined five groups of products that have contract features in common. Our consumer research was structured around these five groups:

- **Subscriptions and memberships.** These are contracts for ongoing services, such as car or holiday clubs, season tickets or gyms. The **subject matter or scope** of these goods or services can be challenging, because it can be difficult for consumers to know before entering the contract what benefit they will get from it over time. For example, consumers may have less time to go to the gym than expected, or need use of a car club more often than expected. Problems to do with **consumer control** can also arise if it is difficult for consumers to change or end the contract.
- **Necessities.** This group brings together a set of everyday 'essential' services, on which a variety of consumers with different needs rely, but to which they perhaps give little

attention. These goods include TV, phone and broadband packages, gas, electricity and mobile phones. In this category, **prices** within and across contracts can be particularly difficult to evaluate. Furthermore, because contract periods can be lengthy, opportunities for **consumer control** (altering or switching contracts) are important.

- **Rentals and licences.** These are contracts where consumers enjoy limited use of goods without owning them, for example, rental of goods (hardware, DVDs), car or van hire, digital downloads and software licences. One issue with these contracts is the **risk** placed on the consumer in terms of their use of the product, such as acceptable use policies and charges that apply if certain outcomes come to pass.
- **Contracts for managing risks.** This is a group of contracts that consumers enter expressly to manage contingencies. The goods and services covered by these types of contracts include car warranties, car insurance, car breakdown cover, travel insurance, card protection or fraud assistance and home insurance. The **subject matter or scope** of these contracts is difficult since consumers find risks particularly challenging to evaluate.
- **Contracts for outcomes.** Here, consumers receive a package which may involve various goods or services, sometimes brought together over time. This includes disparate goods such as package holidays, home improvements and building works, and in-home services, like cleaning or electrical repairs. The **subject matter or scope** can be hard to evaluate, because consumers can find it hard to know their needs upfront, or evaluate how well the product will meet them. **Risk** is also important, as the subject matter can have many possible contingencies (influenced by the trader, consumer or external factors), in which case the attribution of liability strongly affects the outcome for the consumer.

Report Structure

1.11 This report is structured as follows:

- Chapter 2 considers the empirical evidence on people experiencing problems with contracts.
- Chapter 3 explores what economic theory, from the standard and behavioural economics literatures, predicts about how consumers behave and why they have problems with contracts.
- Chapter 4 looks in more detail at the extent to which learning effects can mitigate harm.
- Chapter 5 sets out the OFT's framework for assessing problematic contract terms and identifying consumer harm
- The assessment framework is an economic test, not an interpretation of the relevant law. Chapter 6 explains the consumer protection legislation relevant to consumer contracts and identifies how the legislation may address harms identified by the framework.
- Chapter 7 illustrates some common contract problems of greatest concern to the OFT and considers our previous enforcement actions and next steps.

2 EMPIRICAL EVIDENCE ON CONTRACT PROBLEMS

Introduction

2.1 Identifying the consumer detriment caused by specific contract terms is an empirical question, it depends on consumers' experiences and expectations of these terms. Whilst on individual cases we will often seek case-specific evidence, this chapter presents general empirical evidence on consumers' behaviour and experiences in using contracts. The content draws on previous studies by the OFT and others, alongside:

- a new survey of 4,000 consumers,⁵ focused on 32 products where consumer contracts (written or verbal) are commonly used (the 'YouGov Survey')
- Consumer Direct's database of consumer complaints, and a sample survey of 750 callers to the service who had experienced a problem with a contract (the 'Consumer Direct Survey')
- a laboratory experiment designed to investigate how accurately consumers can choose the best offer from a set of deals, and how their accuracy is affected by the introduction of fees that are percentages, probabilistic, or delayed and
- a series of case studies including in-depth interviews and focus groups that asked about consumers' experiences of five particular industries.

2.2 More detail on the new research is provided in the annexes.

⁵ Boosted by a screening survey of 75,000 people, that provided information on the relative sizes of the markets selected for the survey and problem incidences in each market. See Annexe D for a full report of the survey results

Key findings

- Twenty per cent of people had experienced a problem with at least one contract they had entered in the last year; people have multiple contracts, and five per cent of all contracts entered in the last year resulted in a problem.
- Younger people were more likely to experience contract problems.
- Problems were more common for telephone sales than for either face to face or internet channels.
- Problem incidence varied by industry: problems were reported with ten per cent of telecoms and internet packages, but only 1.5 per cent of family event packages such as weddings and parties.
- Many people do not read contracts in full, and instead focus on headline elements such as the price. Those that have a good read of contracts before buying experience slightly fewer problems than others.
- Consumers' ability to make sense of contracts is significantly affected by the way information is presented and the sales environment.
- Most consumers thought the most important information about the deal was clear to them but fewer than half agreed that contracts were clear about key risks involved, or what would happen if things went wrong.
- Consumers make other efforts, apart from reading the small print, to improve their understanding of contracts. Almost a third of people seek advice from other consumers, friends, family or intermediaries; over a third discussed their purchase with a sales person; and over half shopped around. However, none of these factors had a significant impact on the likelihood of encountering problems.

Contract problems

Incidence of problems

- 2.3 Many consumer purchases are problematic, whether or not written or complex oral terms and conditions are involved. A 2007 OFT survey⁶ found that around a third of UK consumers buying any good or service had experienced at least one problem purchase in the previous year. This suggests around 26.5 million problems in total, resulting in financial detriment estimated at £6.6 billion. Whilst most problems resulted in zero or low detriment, some consumers experienced high levels of detriment. While the median financial detriment was less than five pounds the average financial detriment was £250. This compares to the Consumer Direct survey, conducted as part of this study, which found a median detriment of £20 and an average of £407 specifically from consumer contract problems.
- 2.4 The YouGov and Consumer Direct surveys looked, more narrowly, at consumers' difficulties with purchases that involved an explicit contract which was written or verbal, as opposed to the implied contracts involved in very simple purchases. The YouGov survey looked at 32 common contracts (see Table 1) across a variety of product types. Within this set of contracts, 4.8 per cent of purchases in the last year had resulted in a problem or dissatisfaction,⁷ and, given that consumers generally enter into multiple contracts each year, on average one in five consumers had experienced a problem in a contract entered in the last 12 months.
- 2.5 The incidence of contract problems varies by type of consumer, perhaps driven by the products they buy, their shopping behaviour, and how they experience the sales process and contract.

⁶ Office of Fair Trading (April 2008b)

⁷ Note that this is likely to underestimate total problem incidence since difficulties can develop after the first year of a contract

- 2.6 Young people were especially likely to have problems with their purchase (6.7 per cent of purchases by under 30s compared to four per cent of over 50s).⁸ This result held across 26 of the 32 contracts considered, indicating that experience rather than the types of products purchased is more important in determining the likelihood of experiencing problems. The role of experience was confirmed by consumers' stated views: older consumers highlighted prior experience and knowledge as a source of understanding whereas younger people blamed the lack of such experience when things went wrong.
- 2.7 Other demographic factors were only weakly associated with problems. Consumers on higher incomes, in higher social classes and those consumers who had reached a higher level of education reported more problems, although this may be partly due to the types of products purchased.
- 2.8 The channel of purchase is significant however. Whether a transaction is conducted face-to-face, over the phone, or via the internet can influence consumers' understanding of terms and conditions. This may be driven by the nature and degree of interaction with the sales person and sales materials, the accessibility and presentation of terms and conditions, the timing of when information is presented, and the time available to assess information and make a decision.
- 2.9 Problems were more common for telephone transactions (6.4 per cent) than for face-to-face or online (4.7 per cent and 4.6 per cent). These differences could be partly driven by selection effects, for example different products are more commonly purchased through different channels and different types of shoppers may use different channels. However, the findings broadly held across the surveyed products, with telephone

⁸ This contrasts slightly with past evidence which found that those aged 35 to 54 experienced the highest **number** of problems (Office of Fair Trading (2008b)). The difference could be partly explained by the differing product mix of the survey, and the possibility that this age group makes a higher number of purchases overall.

purchases being more problematic across 23 of the 32 goods and services in the survey.

- 2.10 There is some evidence to suggest that the lower incidence of problems online may be partly due to online shoppers being free from the time pressures and biased presentation of information that can be experienced over the phone or in a shop.⁹ For example, 72 per cent of telephone purchasers felt they had the opportunity to read the contract compared to 85 per cent for online and 77 per cent for face-to-face purchases. Similarly, almost 70 per cent of online purchasers felt it was easier to work out the best deal on the internet rather than by phone or face-to-face, compared to just five per cent who thought it more difficult.¹⁰
- 2.11 Furthermore, in the laboratory experiment conducted as part of this study, time pressure was found to have a significant negative effect on whether consumers chose the best option.

Problems by type

- 2.12 In the Consumer Direct survey¹¹ the most common problem was goods and services not meeting expectations. This is not always but sometimes could be a contract problem. Of more direct relevance to contracts, 78 per cent stated that terms were in dispute between the consumer and the trader, and in over half of these cases consumers felt the trader had interpreted terms to their own advantage. Other contract-specific problems included unexpected terms and conditions (34 per cent), problems

⁹ For discussion of the 'point of sale advantage' firms have when consumers are in their shop, see The Office of Fair Trading (2008a)

¹⁰ The lower incidence of problems among internet purchases is despite greater use of internet shopping by younger consumers, who are more likely, overall, to have experienced a problem.

¹¹ The survey only covered those consumers who self-reported that they had a contract for their purchase. Respondents could choose more than one category of problem.

cancelling (28 per cent) and unreasonable charges and penalties (27 per cent).

2.13 According to the YouGov survey, 80 per cent of problems came as a surprise. The main problems experienced by consumers included:

- unexpected issues and uncertainty about where the fault lies
- perceived unfair interpretation of terms and conditions
- cancellations, renewals and discount periods
- expecting features to be included in the scope of the contract that were not
- expecting a level of service or product that was not delivered
- unexpected charges
- access and availability of services and
- changing perceptions of benefits over time.

Problems by contract type

2.14 The YouGov survey looked more closely at 32 products organised into five broad contract types (see Table 1).

Table 1. Products and services by contract type

Contracts for outcomes	Contracts for risk	Rentals and licences	Subscriptions/ memberships	Necessities
Package holidays	Car warranties and insurance	Rental goods	Car clubs	Home entertainment packages
Family events	Car breakdown cover	Car or van hire	Holiday clubs	Telecoms and internet
Home improvements	Travel insurance	Digital downloads	Gyms	Gas, water and electricity
Travel (not package)	Travel assistance	Software purchases	Film/wine/book clubs	Mobile phones
Hotel (not package)	Insurance for goods purchased		Season tickets and pre-paid deals	Software subscriptions
In home services or repairs	Personal insurance		Loyalty schemes	
Goods delivered to your home	Card protection			
Other package events	Home insurance			
	Other warranties or guarantees			

Source: YouGov Survey

2.15 For each of the five broad categories, Table 2 shows the proportion of contracts entered in the last 12 months which resulted in a problem and the top three explanations given by consumers to explain the problems they encountered.¹²

Table 2. Common problems by contract type

Contract Type	Percentage of contracts (entered in last year) that resulted in a problem	Reason given for experiencing a problem	Percentage (of those who experienced a problem)
Necessities	7.5%	Poor customer service	44%
		Problems accessing the service or its availability	28%
		Lower quality of service than expected	20%
Risks	2.1%	Poor customer service	37%
		Firms interpret contract to their own advantage	28%
		Expected risks to be included when they were actually 'optional extras'	19%
Outcomes	6.2%	Service or product quality lower than expected	60%
		Final product or service very different from expected	41%
		Unexpected issues arose that were neither the fault of the consumer or firm	19%
Subscriptions	2.6%	Poor customer service	40%
		Service or product quality lower than expected	30%
		Problems accessing the service or its availability	30%
Rentals	3.3%	Firms interpret contract to their own advantage	19%
		Expected greater level of usage, more freedom/ownership of the product	16%
		Quality of the rental lower than expected	16%

Source: YouGov Survey

¹² Consumers could choose more than one category

- 2.16 Poor customer service was the top complaint for necessities. Other problems lower down the list were unexpected or disputed charges (19 per cent) and being charged when they exceeded the limits of the deal (15 per cent).
- 2.17 Other sources broadly corroborate these findings. For example, Otelo, ombudsman for telecommunications, reports that poor customer service (32 per cent), disputed charges (22 per cent) and service quality (20 per cent) comprise the main reasons for complaints.¹³ Similarly, the Financial Ombudsman Service (FOS) report that 60 per cent of complaints about banking and credit services relate to charges and 23 per cent relate to poor administration.¹⁴ The Energy Ombudsman Service reported billing issues (including disputed charges) as the main source of complaints (83 per cent) followed by attempts to transfer services (seven per cent).¹⁵
- 2.18 In rentals and licences contracts, a small minority expected to have greater freedom of use or ownership of the rental than they actually did. For software and digital downloads, this accords with survey evidence showing consumers are unclear about usage rights under copyright law.¹⁶ Elsewhere, a study of car rental found unexpected charges were the biggest single source of complaints.¹⁷

¹³ Otelo (2009), Pg. 22.

¹⁴ Financial Ombudsman Service (2010), Pg. 33.

¹⁵ Energy Ombudsmen Service (2010), Pg. 4

¹⁶ Consumer Focus (2010) - surveyed 2,026 British consumers aged 15+ .

¹⁷ www.which.co.uk/news/2010/09/top-ten-car-hire-tips-227822/

Problems by sector

2.19 Overall 4.8 per cent of purchases made in the last 12 months had resulted in a contract problem. However, this varied significantly across the 32 industries considered in the survey, ranging from 10.3 per cent for telecoms and internet packages to 1.5 per cent for family events, such as weddings and parties.¹⁸

Table 3. Problems by type of good or service (of contracts entered in the last 12 months)

Product or service	% of purchases resulting in a problem	Product or service	% of purchases resulting in a problem
Telecoms/ internet access	10.3%	Software purchases	3.2%
Home entertainment	9.1%	Rental goods	3.2%
Home deliveries	9.0%	Digital downloads	2.9%
Home improvement	8.5%	Card protection	2.7%
Travel (not package)	7.3%	Insurance for goods	2.5%
Mobile phones	6.9%	Other package events	2.4%
In home services or repair	6.3%	Car insurance	2.4%
Utilities	5.9%	Car clubs	2.2%
Package holidays	5.1%	Travel insurance	2.0%
Car or van hire	5.1%	Personal insurance	2.0%
Holiday clubs	4.9%	Travel assistance	2.0%
Hotels (not package)	4.2%	Loyalty schemes	2.0%
Software subscriptions	4.1%	Home insurance	1.8%
Gyms	3.7%	Season tickets	1.7%
Other warranties	3.6%	Car breakdown cover	1.6%
Film, wine, book clubs	3.5%	Family events	1.5%

Source: YouGov Survey

Information and behaviour as drivers of problems

2.20 To help understand how contract problems arise, our survey asked consumers about information collected before entering a contract, whether they understood the information they received and whether firms and their processes facilitated or hindered their access to and understanding of this information. Table 4 shows

¹⁸ This may partly reflect the more intensive use of telecoms throughout the year, as opposed to one-off experiences such as parties

analysis of how behaviours or experiences are associated with problems. For example, for those who had a good read of the contract, the probability of experiencing a problem was lower than for those who read less carefully or not at all.

Table 4 Consumer behaviour and the likelihood of problems

Factor	Significant impact on problem likelihood?	More or less likely to have a problem?
It was a standard written contract	Yes	Less
Had a good read of the contract	Yes	Less
Discussed purchase with a sales person	Weak	More
Did a lot or some shopping around	Weak	More
Sought word of mouth (feedback or recommendations)	No	--
Used an intermediary	No	--
Read sales and marketing materials	No	--

Source: YouGov

2.21 Looking in particular at the effect of reading the contract, having a good read reduces the probability of having a problem by around 1.2 to 1.4 percentage points¹⁹ (this compares with 4.8 per cent of purchases overall that were subject to a problem).

2.22 There is some weak evidence that shopping around and discussions with sales people actually increase the likelihood of having a problem. However, this may be partly due to the product characteristics that prompt shopping around and discussions with

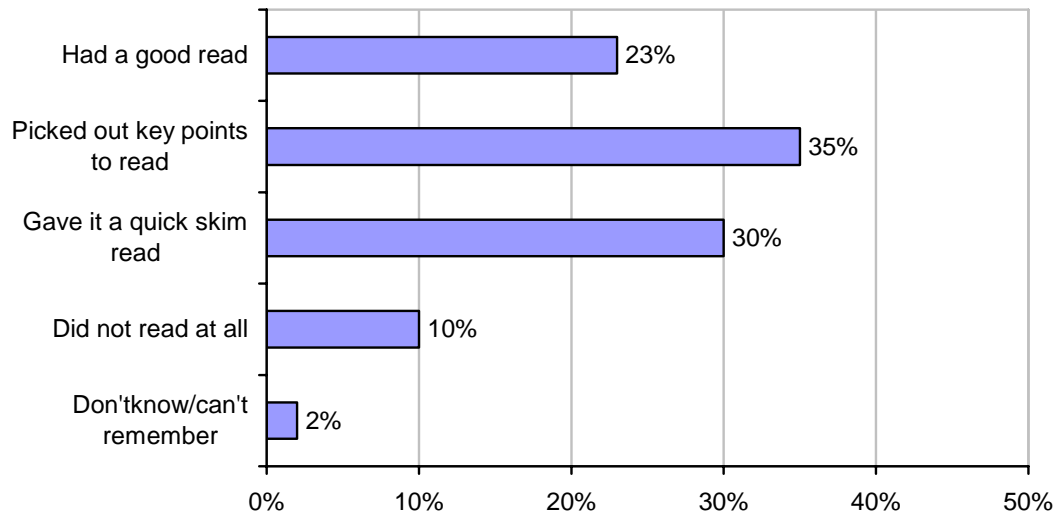
¹⁹ Depending on other factors – such as whether the contract is a standard one For a full analysis, see Annexe D

sales people rather than those activities themselves.²⁰ Overall, these factors explain only a small part of the variation in the data – in other words there are many other factors not accounted for here that may affect the likelihood of experiencing a contract problem.

Reading

2.23 Evidence from the YouGov survey suggests that most consumers do not read the contract thoroughly before purchase.

Figure 3. Behaviour of consumers before entering the contract



Source: YouGov

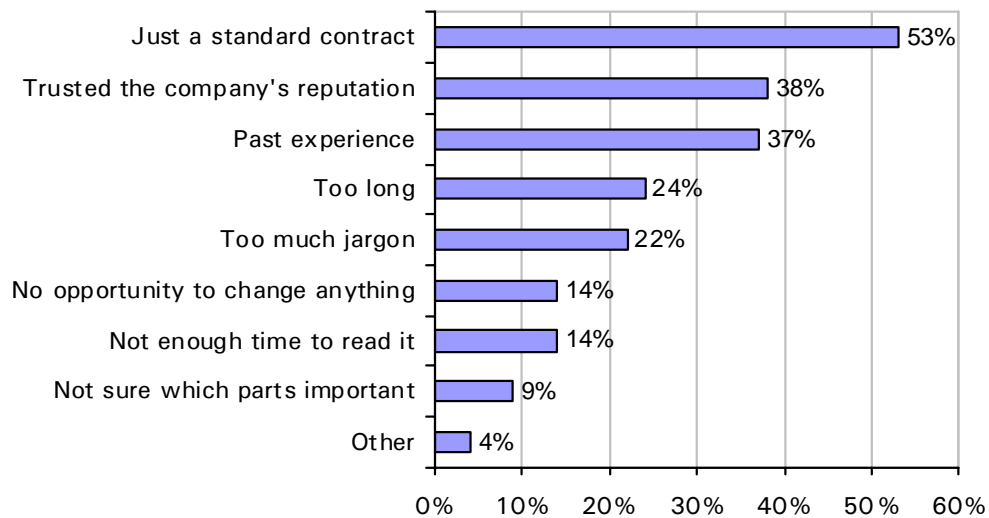
2.24 These findings broadly accord with other data: a 2010 study of 147 university students reported similar findings, and concluded that the low proportion of people reading contracts in full casts doubt on the theory that, provided a firm cannot price discriminate, it will be disciplined in its choice of terms and

²⁰ Statistically significant at the ten per cent level but not at the five per cent level. When controls are added for age and product type these factors are no longer statistically significant.

conditions by a minority group who pay close attention to contracts²¹ (the 'informed minority hypothesis'²²).

2.25 The tendency not to read contracts in full ('have a good read') arises despite the fact that 79 per cent of those consumers surveyed said that they were given enough time to read the contract. Respondents gave a wide range of (reported) reasons for not reading the contract. These are discussed further in Chapter 3.

Figure 4. Reasons for just giving the contract a skim read or not reading it at all (stated behaviour)



Source: YouGov Survey. Base: those receiving a written contract or terms and conditions and 'skim reading' or not at all reading at all (1,662)

2.26 The main reason given was that the contract terms and conditions were 'standard'. This may mean consumers think they are protected by the law, trust the company (specifically mentioned by 38 per cent), or think the contract is industry standard such

²¹ Becher and Unger-Aviram (2010). Found that at least one-third of consumers need to be 'informed'

²² Schwarz and Wilde (1979), Spence (1977), Salop and Stiglitz (1977)

that they cannot go elsewhere or do anything about the contract. Fourteen per cent of consumers in the YouGov Survey mentioned specifically that they had no opportunity to change anything.

- 2.27 Specific problems with the presentation of the contract, such as that it was too long or contained too much jargon, were also mentioned by a clear minority of consumers.
- 2.28 A large minority (37 per cent) stated that they did not read the contract because they had made similar purchases before, though it is not clear whether the implication was that these consumers did read the contract the first time they made a similar purchase or had simply not experienced any problems in the past and therefore did not consider it necessary to read the contract.
- 2.29 Consumers who had experienced a problem were more likely to say that they had not read the contract in detail because the contract was too long (40 per cent), contained too much jargon (30 per cent) or they did not have enough time to read it (26 per cent).²³
- 2.30 Notably, those on low incomes were significantly more likely to state that they had not read the contract in detail because they trusted the firm's reputation. Those with lower levels of education were significantly more likely to blame too much jargon for them not reading the contract.

Understanding

- 2.31 Whether consumers read contracts or not is immaterial if they are difficult to comprehend. In general, evidence on standards of numeracy and literacy among UK adults suggests that only a minority possess sufficient skills to deal with complex standard

²³ Consistent with this finding older consumers (over 51) were less likely to state these factors as reasons for not reading contracts

form contracts²⁴ and some contracts require abilities far above those of the average adult.²⁵

- 2.32 Consumer understanding can be impeded by the nature of the contract and shopping environment. We carried out an experiment to test how well consumers evaluate information under different circumstances and found that consumers made more mistakes when confronted with deferred or probabilistic fees, especially if their decision-making was also time-pressured.²⁶
- 2.33 The YouGov survey indicates how clear consumers felt about different aspects of the contract or deal once they had signed up. Overall, the majority of consumers thought 'the most important information' about the deal was clear to them (64-77 per cent)²⁷. Specifically relating to financial products, however, FSA evidence has shown that sometimes large gaps can exist between consumers' perceived and actual understanding of the products they buy.²⁸
- 2.34 Less clear were terms specifying what would happen in the event of things going wrong. Only around 45 per cent²⁹ agreed the

²⁴ The International Adult Literacy Survey (IALS) measures literacy in three domains – prose, document and quantitative literacy – and places individuals at one of five levels for each domain, with level five the highest. Sample data from the period 1994-1998 for the UK population aged 16-65 indicates that less than 20 per cent of the population reached level four or five standard on any of the three domains, this being the standard judged necessary to deal with 'standard consumer contracts, such as car rental agreements and insurance contracts'. See Table 2.2, pp 137-137, OECD and Statistics Canada (2000) Also: pp22-23, OECD (2010)

²⁵ Facebook's terms of use have a reading age of nearly 24 years old, compared to a UK average for adults of 12-13 (Plain Language Commission for BBC3 (2008)

²⁶ See Annexe F for details

²⁷ The clarity of 'the most important information' was asked for Outcomes, Subscriptions, Rentals and Necessities contracts.

²⁸ Financial Services Authority (2010)

²⁹ Forty-four per cent of those who were asked about 'outcomes' contracts, and 49 per cent of those who were asked about contracts dealing with risks

contract was clear about the key risks involved and a similar proportion agreed the contract was clear about what might happen if things went wrong. Similarly less than half agreed it was clear where responsibilities would lie (around 45 per cent)³⁰ and whether the consumer would have to pay (around 40 per cent),³¹ if things went wrong.

2.35 Despite mixed levels of clarity once consumers had signed up for the contract, a small majority stated they had adequate opportunity to ask questions about the contract (60 per cent) and felt confident enough to negotiate or discuss terms and conditions with the supplier (63 per cent). Unsurprisingly those who experienced a problem were less confident, with only 44 per cent agreeing they had an opportunity to ask questions about the contract and 54 per cent agreeing that they felt confident enough to negotiate.

2.36 In order to consider how consumers are affected by the wider sales process and how this may affect the incidence of contract problems we also considered the impact of:

- sales materials and sales people
- seeking consumer feedback and advice and
- shopping around

Sales materials and sales people

2.37 Sales materials, and talking to sales people, may in principle help or hinder consumer decision-making. On the one hand sales people and materials are a source of information about the product that

³⁰ Forty-five per cent of those who were asked about 'outcomes' contracts and 44 per cent of those asked about rentals

³¹ Forty-two per cent of those who were asked about 'outcomes' contracts and 41 per cent of those asked about rentals Clarity about terms specifying what would happen in the event of things going wrong were only asked of those purchasing Outcomes and Rentals contracts, with the exception of 'what might happen if things went wrong' which was also asked for Subscriptions contracts.

may be easier to comprehend than the contract itself, and sales people can answer consumer questions. On the other hand their motivation is towards concluding a sale, meaning information provision may be selective. Furthermore, when face to face with a salesperson, consumers may be subject to direct sales pressure or more subtle social pressures (e.g. from people queuing behind them) to purchase the good or service.

- 2.38 Consumers seemed to be relatively confident about the accuracy and usefulness of sales material. About two-thirds of consumers (67 per cent) felt materials were accurate, compared to only 13 per cent who thought they were inaccurate. 63 per cent thought sales materials were fair compared to only eight per cent considering material to be deceptive.
- 2.39 There was some (weak) evidence that discussions with sales people were associated with having more problems – but this appears to be driven by the types of purchases in which such discussions are more common. Other research indicates that salespeople can strongly influence consumer decisions, even if their incentives are made transparent. In the presence of skilled salespeople, disclosure of important information may do little to help consumers avoid problems.³²
- 2.40 Nonetheless consumer perceptions of sales people were generally positive. Seventy-five per cent felt that sales people gave good information to help them make a decision, compared to ten per cent who did not. Only 14 per cent felt that the sales people they had interacted with had pressurised them, as compared to 68 per cent who felt they had let them make up their own mind.

Consumer feedback, advice and intermediaries

- 2.41 Consumers can also seek information and advice from other consumers, family and friends and intermediaries such as brokers and price comparison sites.

³² De Meza, Irlenbusch, and Reyniers (2007)

- 2.42 Nearly a third of consumers (31 per cent) sought feedback from family and friends or other free sources, with younger and lower income consumers more likely to do so. Among those that sought feedback, about 78 per cent felt it improved their decision either to some or a great extent.
- 2.43 Use of intermediaries was limited to only about ten per cent of consumers overall,³³ though this was more common for those buying contracts to manage risks, where around 45 per cent used an advisor, broker or price comparison website. Motivations to use intermediaries were mainly to save money or time rather than compare terms and conditions.

Shopping around

- 2.44 Almost 55 per cent of survey respondents shopped around 'some' or 'a lot' when choosing their contract, but 22 per cent did no shopping around at all. Searching for the lowest price was the main reason for doing so (71 per cent) with 'finding the best match for requirements' second (60 per cent). Fewer consumers shopped around to compare terms and conditions (30 per cent). This is consistent with evidence that consumers focus on a limited number of variables to simplify their decisions.³⁴ This implies that shopping around may not result in better awareness of problem terms, if this is not the focus of consumer search.

Conclusion

- 2.45 Our main findings are summarised in the box at the beginning of this chapter. The next chapter goes on to discuss the economics of consumer contracts, including behavioural aspects that build on the findings of the research discussed here.

³³ Questions about intermediaries were asked of all consumers, except those purchasing subscriptions and memberships contracts.

³⁴ See Chapter 3

3 THE ECONOMICS AND PSYCHOLOGY OF CONSUMER CONTRACTS

- 3.1 For markets to work well for consumers they require on one side, vigorous competition, and on the other, confident consumers that properly access, assess, and act on information.³⁵ On both sides of the market, consumer contracts are important: contracts can influence and be influenced by competition; and contracts can help or harm consumers by affecting, or exploiting, how they collect, use and act on information.
- 3.2 This chapter is in three parts. The first discusses how contracts can affect the dynamics of competition in a market, and vice versa. The second part discusses the reasons why consumers typically do not read contracts in full. The third section discusses how consumers assess and act on the information they do register, and identifies some common behavioural biases that consumers display.
- 3.3 Some of the themes in this chapter will be explored in greater depth in a forthcoming OFT report: *Consumer Behavioural Biases in Competition*.³⁶

³⁵ Office of Fair Trading (2010c)

³⁶ Office of Fair Trading (2011 - forthcoming)

Key findings

- Standard form contracts can be good for competition by making shopping more simple and making it easier to shop around. But some contract terms can worsen competition by making it harder to compare offers, or switch supplier.
- Competition can improve contracts if traders can signal the quality of their contracts and benefit from a reputation for fair dealing.
- But consumers tend to focus on the headline price and a small number of contract features, so small print terms are subject to less competition. Traders can have an incentive to obscure features in the small print, and use them to earn excess profit.
- Profit from small print terms can be eroded by competition and lower prices up front, but this effect is likely to be partial, and low upfront prices can lure consumers into making inappropriate purchases of goods with poor small print terms.
- If charges for optional services are high, and only revealed in small print, then consumers might lose out by not being able to afford the optional service. Or it could be only vulnerable consumers are caught out by paying for the expensive small print service, and subsidise other consumers who benefit from low up front prices.
- In most cases, consumers do not read contracts, because they cannot challenge it, think the information is not useful or readable, are committed to the purchase, or feel social pressure not to read. This can be sensible and rational.
- Consumer errors, biases, and time pressure or stress can sometimes mean that even when consumers read or are given information about a contract, they do not properly assess it and shop around.

Competition and contracts

- 3.4 Some seemingly complex contract features can be an efficient part of a well-functioning competitive market. For example, contingent charges can be an efficient way to target cost-recovery, ensuring that only those consumers who give rise to additional costs have to pay charges related to them. For instance, if only those who make use of an optional service pay for that service. Such charges would not usually be a cause for OFT concern. Sometimes, however, contingent charges or other contract features can harm consumers. The following discussion explores when competition delivers an efficient outcome that is fair to consumers, and when it fails to do so.

The effects of contracts on competition

- 3.5 The main benefits of standard form contracts are that they save the expense of many individual negotiations, and reduce transaction costs by making shopping simpler.³⁷ This time saving should free consumers to put effort into comparing offers, thereby giving firms a stronger incentive to offer low prices and good quality and service.³⁸ However, particular contract features can also sometimes impede competition by introducing search and switching costs.
- 3.6 Search costs may arise from confusing contracts or pricing structures that make it difficult for consumers to compare firms' deals. This can weaken traders' incentives to offer the best possible terms³⁹ (since, for example, consumers cannot distinguish price reductions amid complexity).⁴⁰ As such, there can be an advantage from being the first trader the consumer

³⁷ Rakoff (1983)

³⁸ Katz (1998)

³⁹ And in the extreme they will charge monopoly prices, even where there are many firms (Diamond (1971)).

⁴⁰ Gilo and Porat (2006)

considers. In extremis, traders who deliberately mislead consumers can benefit at the expense of more honest competitors.⁴¹

- 3.7 Switching costs can arise, for example, from cancellation policies (such as fees or notice periods) that deter consumers from switching supplier. High switching costs can, in turn, dull the incentive for firms to compete for each others' customers as they are locked in to contracts. This can result in higher prices for everyone.⁴²

The influence of competition on contracts

- 3.8 Competition can drive improvements and sometimes choice in contract terms. If consumers care about a feature like a contingent charge, the firm should be able to attract consumers by offering a better deal or clearer choices.⁴³ Where we expect competition to work well in driving price, quality and choice in consumer contracts, we will be less inclined to intervene.
- 3.9 However, competition does not prevent or resolve all contract problems, for a number of reasons. First, consumers cannot always distinguish easily between those firms that offer deals with good terms, and those that have harmful terms. As a result the market does not reward firms that offer good terms. Any firm who wanted to offer better terms than its competitors (which were more expensive to deliver) would not have an incentive to do so, because consumers would be unwilling to pay more for higher quality terms which they do not see or properly assess.⁴⁴

⁴¹ Lal and Matutes (1994)

⁴² For a much more detailed discussion see OFT (2003)

⁴³ See OFT (2008a), also OFT (2009)

⁴⁴ Klein and Leffler (1981), Baird and Weisberg (1982). This is analogous to only poor quality cars ('lemons') being sold in the second hand car market (Akerlof (1970))

- 3.10 Second, where there are search costs, more competition – in the sense of more firms in the market – can sometimes make things worse: with more and more competitors, it becomes harder for consumers to distinguish good deals, and weakens the incentive for firms to offer them.⁴⁵
- 3.11 Third, consumers tend to focus on headline prices and do not compare other small print terms such as charges for ancillary or contingent services. Small print terms are therefore subject to less competitive pressure.⁴⁶ As a result, firms may deliberately obscure ancillary charges or other negative terms in order to profit from them.

Waterbed effects

- 3.12 Even where competition fails to improve terms and conditions, or even makes them worse, it can have offsetting benefits. Competition in the upfront price may, through a 'waterbed' effect,⁴⁷ erode profit made on small print terms, in effect handing it back to customers. This effect reduces the net harm to consumers, and may, in some circumstances, lessen the need for OFT intervention.
- 3.13 Concerns may remain, however. First, the waterbed effect may only be partial. If competition is not sufficiently intense, up-front competition will not erode all rents extracted through small print.
- 3.14 Second, a low upfront price may lure consumers to purchase a product which does not offer the best deal once the higher small print terms are taken into consideration. Had they known, they might have preferred to buy elsewhere or not at all.

⁴⁵ Stahl (1989)

⁴⁶ One study of software found that prices are sensitive to competitive conditions, but contract terms are not. Marrotta-Wurgler (2006)

⁴⁷ For detailed discussion see Annexe B and OFT (2011, forthcoming)

- 3.15 Third, if the small print term is revealed at a late stage it can result in under-consumption of associated services. For example, in a car hire contract if the details of an excess waiver are revealed late in the process, once the consumer has already decided to take up the main deal, the consumer may decide the waiver is too expensive and do without it. Consumers may be harmed if they end up making less use of the small print service than they would have done if the up-front price had been higher and the later optional charge been lower. In the car insurance example, the harm is from being underinsured.
- 3.16 Fourth, the small print charge may disproportionately hit vulnerable consumers. For example, in the case of unarranged overdraft fees, these small print charges allow firms to charge lower upfront prices to all consumers, but will only be incurred by a subset of consumers. As a result there is a degree of cross subsidy from those that incur the fee to those that do not. This redistribution may be undesirable, particularly if poorer consumers or other vulnerable groups are more heavily represented in the group that pays more. However, firms may not have an incentive to make the charges clearer, because providing consumers with this information could mean less profit from the small print fees, higher up-front fees, and a loss of custom from the consumer who had been benefiting from the cross-subsidy.⁴⁸
- 3.17 To sum up, competition can drive improvements in the terms and conditions of consumer contracts.⁴⁹ However, there are also circumstances in which competition either fails to drive improvement, or actually gives rise to contract problems, and therefore there may be a case for intervention.

⁴⁸ Gabaix and Laibson (2006)

⁴⁹ The detailed mechanisms involved might include consumer learning (covered in Chapter 4), self regulation (see OFT 2009a), or third party solutions such as price comparison or review websites (see OFT 2008a)

Consumers and contracts

- 3.18 Classical economic models of perfectly competitive markets rely on assumptions that consumers have perfect information and make optimising decisions about whether and what to buy. But of course real people behave differently to 'rational economic agents'. Extensive literatures in psychology and behavioural economics explore what these differences mean for models of economic decision-making. For example, people often have conflicting or non-economic objectives, or may be subject to systematic biases, short-cuts or errors, particularly when decisions are complex or made in circumstances that influence, distract or pressure.
- 3.19 Consumers make the best decision they can, based on the information and computational capacity they have available. But that might not be the same decision they would have made with perfect information and perfect rationality.⁵⁰ The following discussion describes how harm can result.

Accessing information – reading the contract

- 3.20 Contracts are often needed for complex transactions with many dimensions. Many products have features that are only observed after use ('experience' attributes such as the speed of a broadband service or quality of package holiday arrangements) or may even remain unknown after purchase ('credence' goods such as professional advice and technical repairs).⁵¹ The more elements of a contract that are unknown before purchase, the more likely consumers are to be harmed by a problem later, but firms can influence the extent to which consumers know what they are getting in to.

⁵⁰ Stigler (1961) , *The economics of information* , Journal of Political Economy, Vol. 69

⁵¹ Experience and credence attributes contrast with 'search' attributes, verified before purchase. See Nelson (1970) and Darby and Karni (1973). For a discussion of competition in markets with these attributes, see OFT (2011, forthcoming)

- 3.21 The contract document may contain important details about these elements. However, as our research confirmed, consumers rarely read entire contracts before purchase,⁵² even though thorough reading does seem to slightly reduce the likelihood of experiencing problems.
- 3.22 However, it is not clear that the benefits from reading contracts in full outweigh the costs, and it may be rational (in the classical economic sense) not to read the contract. In addition, a number of behavioural biases can also make consumers less likely to read all terms and conditions.

The benefits of reading contracts

- 3.23 The perceived benefits of reading a contract can be low if:
- consumers feel unable to do anything about unfavourable terms they discover, because they are unable to bargain,⁵³ they believe the contract is industry-standard, or feel they are unable to go elsewhere.⁵⁴ When asked why they did not read contracts, 53 per cent of survey respondents who did not read or only skim-read the contract said this was because it was 'just standard', while 14 per cent felt they had no opportunity to change anything.
 - consumers feel they are protected by the law or trust firms to be fair. Thirty-eight per cent of people in our survey who didn't read or only skimmed their contract said they trusted the firm. This is supported by EU survey evidence that 78

⁵² See Chapter 2 for this and other evidence

⁵³ Standard form contracts, offered on a take it or leave it basis, contrast with traditional contract analysis which assumes they are drafted or negotiated by both contracting parties. In fact, firms may use standard form contracts explicitly to signal non-negotiability Gilo and Porat (2006)

⁵⁴ Though it is usually argued that monopolists are better off limiting supply and raising prices than including onerous terms (and may well produce quality that is too high from the point of view of efficiency), unless the tastes of the marginal consumer are unrepresentative of others. Spence (1975), Comanor (1985), Craswell (1991)

per cent of UK consumers agree that traders respect consumer rights, and 70 per cent trust the authorities to protect consumer rights.⁵⁵

- consumers feel the contract contains no useful information, because the value of understanding what happens in any one contingency can be low. This may reflect consumers' tendency to simplify decision-making by ignoring certain pieces of information (as discussed below under 'assessing and acting on information').
- consumers look at relative rather than absolute search costs. They may compare the benefit of reading the contract with the cost of the product rather than the cost of reading. They may therefore put more effort into making a large proportionate saving on a low value item than to making the same absolute saving on a high value item.⁵⁶

The costs of reading contracts

- 3.24 Consumers' perceptions that there are only limited benefits from reading the contract are likely to weigh against quite high costs of doing so. Factors affecting the cost of reading contracts can be practical or psychological. The document itself can raise the costs of reading if it is long, in small print, uses complex language, has a poor structure, or is on low quality paper.⁵⁷ Twenty-four per cent of people in our research who did not read or skim read the contract said it was too long and 22 per cent

⁵⁵ European Commission (2010)

⁵⁶ A consumer may be willing to travel an hour for a half price offer on a £20 pen, but would not do so for £10 off £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.

⁵⁷ See Annexe D: research participants preferred headings, a well-laid-out structure, clear simple language, and highlighted key facts. They criticised small fonts and poor-quality carbon paper, and said long contracts made them suspicious of hidden terms, but also deterred reading.

blamed too much jargon. Other practical influences that can raise the cost of reading, or otherwise prevent people from knowing about elements in their contract, include internet purchases from small-screen devices that limit reading⁵⁸ and distractions such as noise.⁵⁹

3.25 In dealing with these difficulties, some consumers also lack the skills needed to assess contracts.⁶⁰ In numeracy this is particularly so for two growing consumer groups – the youngest and oldest age groups.⁶¹ In our research, consumers with lower levels of education were also more likely to blame too much jargon for them not reading the contract.

3.26 There can also be social pressure not to scrutinise contracts, for example because of others queuing. Shoppers may feel reading a contract will be seen as an expression of distrust, or as a failure to conform and cooperate, with physical proximity to the seller strengthening the effect.⁶² Furthermore, after negotiations with salespeople, consumers can feel obliged to co-operate and conclude the transaction. Meanwhile, sellers might discourage reading if they are impatient to close the deal. They may also be nervous of what consumers will discover, or of answering questions. They may be unwilling to confront their own lack of ability to alter contracts, or be concerned that contractual discussions will discourage other buyers.⁶³

⁵⁸ OECD (2010)

⁵⁹ For example, Fujikawa and Kobayashi (2010) ; Schwarz, Sanna, Skurnik and Yoon (2007),

⁶⁰ For example see FSA (2006)

⁶¹ Department for Education and Skills (2003); and *Labour Force Survey* (2008). Efforts to improve financial literacy, for example, have not always succeeded (de Meza, Irlenbusch, and Reyniers (2008))

⁶² OFT (2004), *Annexe F: Psychology of buying and selling in the home*

⁶³ Becher (2007)

- 3.27 Once consumers invest time and effort, or otherwise commit to the purchase, they may avoid information in the contract that could reduce their enjoyment of the purchase (perhaps driven by behavioural biases, discussed in more detail below). They may see little value in finding out more, particularly if the contract is seen late in the process, when they have little time to read the terms and conditions or feel like they already own the product.
- 3.28 An example of the importance of timing is shown in the case study research on mobile phone insurance (see Annexe C). Consumers reported feeling 'overloaded' with information, having already chosen a phone, accessories and tariff. More generally, in some markets, the contract is not received until after purchase, so pre-reading is entirely ruled out.⁶⁴

Consumers are unlikely to read contracts in detail

- 3.29 There can therefore be low benefits and high costs of reading contracts, and the empirical evidence shows that consumers do not generally read them in detail. Taking this into account, we will take as our starting point that in most circumstances consumers do not, and should not be expected to, read contracts in their entirety before signing. This is not to say that consumers bear no responsibility for understanding the products and services they buy – consumers must try to understand the main features. However the evidence suggests that, in most circumstances, consumers cannot be expected to scrutinise small print.
- 3.30 Equally, it is not to say that firms have no responsibility to make contracts a sensible length and draft them in plain, intelligible language. This is important for any consumers who do wish to read the contract before signing, as well as for any consumers who need to refer to the small print later on.

⁶⁴ For discussion, see Hillman (2002)

Assessing and acting on information⁶⁵

- 3.31 Even when consumers have read the contract or had terms brought to their notice they may still not correctly assess, and act on, that information. They may:
- not properly compare the contract with other offers and therefore not choose the best deal. This could be more likely if they receive information late, after they've committed to the purchase, or at an otherwise unhelpful time.
 - make errors in understanding the contract or its implication, or in the actions they take as a result. This could be caused by complexity (and cognitive limitations), by behavioural biases that affect decisions about time or uncertainty, or by stress and emotion. In turn, these biases and errors can be induced and exploited by the way information is presented or 'framed' by traders.
- 3.32 Consumers are subject to a wide range of influence and biases when assessing contracts, as identified in the literature on behavioural economics and echoed in our research findings. Below, we discuss each influence in turn: timing and commitment, complexity, time and uncertainty, and stress and emotion.

Timing and consumer commitment

- 3.33 Firms can, to some extent, control the timing of when and how consumers receive information about products. For example they might wait to reveal negative information until late in the shopping process, when consumers are more likely to proceed to buy the product. Consumers are less likely to walk away at a later stage of the purchasing process because of:

⁶⁵ For discussion set in a competition, as opposed to consumer, context, see OFT (2010c)

- **search costs.** If firms reveal information late in the shopping process, it takes more time to collect information about more than one product, and consumers will be more likely to purchase from the first trader they visit.
- **sunk costs and confirmation bias.** Once consumers have invested time and effort, this engages a set of behavioural biases. Commitment to the product, and a desire to be consistent with previous behaviour, means that where consumers consider they have already invested time, effort or money – sunk costs⁶⁶ – they are less likely to walk away from the contract if unappealing terms are revealed late in the shopping process. Consumers also tend to ignore information that contradicts their existing views ('confirmation bias').⁶⁷ Sticking to a past course and ignoring contradictory information in the contract may help maintain self-esteem, and reflect a desire to be consistent.
- **loss aversion, reference points and endowment effects.**⁶⁸ Prospect theory explains that consumers are 'loss averse' and tend to feel pain from losses more than pleasure from equal magnitude gains,⁶⁹ which means they are willing to pay more to avoid a loss than they would pay for a similar gain.⁷⁰ Furthermore, people appear to measure losses or gains compared to a reference point – often their current position or endowment. These insights are important because they

⁶⁶Thaler (1980)

⁶⁷ See for example Nickerson (1998).

⁶⁸ For a full exposition see Kahneman and Tversky (1979) and for a discussion of the implications, see OFT (2011, forthcoming)

⁶⁹ This has been shown for price increases vs. reductions in markets from eggs to insurance Putler (1992); Dawes (2004)

⁷⁰ Participants in a classic experiment made different (hypothetical) policy decisions depending on whether statistics were expressed as lives lost or lives saved. (Tversky. and Kahneman (1981), For a discussion of loss aversion in a marketing context, see Kahneman and Novemsky (2005)

explain how consumers' decisions can be distorted. Before consumers have committed to buying a particular product, they have an internal valuation of the good – based on the pleasure of gaining ownership of it – and are theoretically willing to pay a price equal to that valuation. Once consumers have invested time and effort in the shopping process, they feel some ownership of the good, and their valuation changes. They are now willing to pay more for the good, because they are paying to avoid a painful loss, rather than paying for a gain. This is the endowment effect.

- 3.34 Together, these influences mean that if a consumer has made the decision to enter a contract, they may be less willing to walk away and compare other offers, even when poor terms or additional costs are revealed late in the shopping process.⁷¹
- 3.35 Loss aversion can also be exploited by firms more generally by making consumers feel they are avoiding a loss, rather than making a gain. For example, if an expensive feature is set as the default option, consumers will feel more pain by giving up the feature than they would have felt pleasure from gaining it – so they are willing to pay more than they would have if the decision had been framed differently.⁷²

Consumer errors in dealing with complexity

- 3.36 As well as making consumers feel frustrated or dissatisfied,⁷³ complex information can lead to poorer decisions, even if consumers are given full information about the contract in good time. Consumers have limited processing power, and the experiment commissioned as part of this study (see Annexe F) provides stylised results showing how complexity affects the

⁷¹ Consumers in a recent experiment tended not to give up perceived 'bargains' even when they turned out to be more expensive than expected Office of Fair Trading (2010a)

⁷² This is also known as a status quo effect. See: Levin, Schreiber, Lauriola and Gaeth (2002).

⁷³ Eisenberg (1986)

quality of their decisions. When asked to choose between two alternative deals with a combination of payoffs and fees, consumers were less likely to make the correct choice when the fees were probabilistic or delayed – particularly so if a time limit was imposed on their decision.

3.37 Traditional economic models assume that consumers rationally maximise utility, prefer certainty to uncertainty, and value outcomes absolutely, rather than relative to a reference point.⁷⁴ In reality, consumers use simplifying rules of thumb ('heuristics') to deal with situations where there is too much information to evaluate or choice overload. Consumers can suffer when contracts exploit the short cuts they take. For example:

- consumers may stick with a default option not only because of the endowment effect, but because doing so simplifies their decision making. Opt-out organ donation and automatic pension enrolment both exploit this effect for positive purposes, but in consumer contracts default options may be harmful if they are not clearly explained to the consumer and are not suitable for the consumer in question.
- when choosing from a list, consumers exhibit a compromise effect⁷⁵ or extremeness aversion⁷⁶ and tend to choose middle options. Firms can play on this by altering what lies in the middle. This is an example of a framing effect, where consumers make different decisions depending on how the information is presented.⁷⁷
- consumers often consider only a limited number of variables, such as the headline price, when comparing products. This

⁷⁴ Von Neumann and Morgenstern (1944)

⁷⁵ The probability of choosing an item can increase when it is middling in a choice set
Simonson (1989)

⁷⁶ For discussion, see Gourville and Soman (2007)

⁷⁷ Sometimes called 'choice architecture'. Thaler and Sunstein (2008)

can mean, for example, that they do not take full account of ancillary or contingent charges, and can end up purchasing a product that is more costly than they expected or could have purchased elsewhere. Even where consumers are made aware late in the shopping process of new information, they can sometimes 'anchor' to the original price and fail to fully adjust their assessment of offers or contracts as more information is revealed. These harmful effects can be exacerbated if contracts contain irrelevant or dense text that confuses consumers or hides that information which is most important to them.

- 3.38 With reference to this last point, most terms in standard form contracts are not likely to be attributes on which consumer's focus – one reason why consumers tend not to read them. Moreover firms can manipulate the situation by putting things in the small print that should be salient, along with things with things that are of less importance to the consumer.
- 3.39 Simplifying and standardising product information can make decision-making easier.⁷⁸ But, when considering the impact of intervention in consumer markets, it is important to understand that consumers' tendency to assess only a few key variables means that too much information may sometimes do more harm than good.⁷⁹

Decisions about time or probability

- 3.40 As well as the general effects of complexity, consumers can make particular errors when a contractual decision relates to things (such as charges or services) that take place over time, or in uncertain circumstances.

⁷⁸ European Commission (2010)

⁷⁹ National Consumer Council (2007) As well as leading to poorer decisions, complex information can make consumers feel frustrated or dissatisfied Eisenberg (1986). This issue is also considered in OFT (2010c) and OFT (2011, forthcoming)

- 3.41 Consumers' preferences change over time, and can be inconsistent. They can therefore be harmed if contracts that require them to estimate future usage – such as mobile phone contracts or gym memberships – have onerous commitments, such as tie-ins with long notice periods or high cancellation fees.
- 3.42 Furthermore, consumers typically overvalue the present relative to any future time.⁸⁰ This makes them less willing to spend time now in understanding how the contract deals with problems which may occur in the future. It also means that consumers tend to:
- ignore or undervalue future (and contingent) charges, so firms can make such charges higher than if consumers paid them full attention
 - procrastinate, and have imperfect self control, because they overvalue time and effort today relative to time and effort tomorrow, without anticipating that they will feel the same tomorrow. Expensive rollover terms, or low 'teaser rates' followed by high prices, can exploit consumers' tendency to put off tasks such as cancelling and switching.⁸¹
- 3.43 A related tendency is for consumers to be overoptimistic, even when aware of the facts.⁸² Overall, consumers tend to underestimate their usage of goods that bring pleasure now and pain later, such as contingent fees in credit cards,⁸³ or mobile phones calls, where significant numbers in our survey

⁸⁰ A standard economic assumption is consistent discounting between two points in time. In reality, hyperbolic discounting means consumers value money today more than tomorrow, but are more indifferent between money next year and a day later. (Laibson (1997))

⁸¹ O'Donoghue and Rabin (2001), Shui and Ausubel (2005). Default bias (a rule of thumb consumers use to help in complex decisions) is also relevant here.

⁸² For example overestimating their driving skills or intelligence - Kruger and Dunning, (1999)

⁸³ Bar Gill (2004)

underestimated their usage⁸⁴ Conversely, consumers tend to overestimate their usage of goods that bring pain now and pleasure later (in our survey, a fifth of respondents overestimated how often they would use their subscription – for example to a gym).⁸⁵

3.44 Firms will tend to design contracts that cater to consumers' misperceptions and self control problems. They have an incentive to exploit consumers' underestimation of demand for 'leisure' goods such as credit cards, through high marginal charges, and exploit the overestimation of demand for 'investment' goods such as gyms through high up-front fees⁸⁶

3.45 Consumers also make other errors in assessing probabilities. For example, they:

- often pay much more to go from very small risks to none at all, than for similar risk reductions that still leave some uncertainty.⁸⁷ They may therefore be susceptible to sales techniques that emphasise certainty – hence the OFT's past concerns about the emphasis put on 'peace of mind' by those selling extended warranties.⁸⁸
- tend to believe that events they can easily call to mind are more likely, so tend to focus on the dramatic or interesting contingencies⁸⁹ and ignore unfamiliar but possibly more likely events. This can mean that consumers are overly willing to pay

⁸⁴ See Annexe D. 14 per cent underestimated their usage and the remainder 'got it about right'

⁸⁵ (6 per cent underestimated usage, and the remainder 'got it about right'. Overestimation was also documented by DellaVigna and Malmendier (2004)

⁸⁶ Grubb (2009)

⁸⁷ This 'certainty effect' involves overvaluing certainty, Kahneman and Tversky (1979)

⁸⁸The Office of Fair Trading (July 2002)

⁸⁹ Tversky and Kahneman (1973)

for insurance that covers low probability but dramatic events like those covered by payment protection insurance.

- can sometimes ignore low probabilities. The flip-side of overpaying to avoid dramatic events is that people tend to ignore, and are too willing to accept, punitive terms attached to uninteresting and low probability events.⁹⁰ Those consumers with no experience of past contractual problems may have no 'available' events to make them alert.⁹¹

3.46 Because, for many reasons, consumers may be unaware of the risks associated with a product, firms can have incentives to provide higher risk but cheaper products. This creates a role for government to regulate quality, or impose on firms (rather than consumers) the liability for when things go wrong, so that they have the correct incentives to mitigate risks.⁹²

Stress, emotion, and decision making

3.47 In the context of reading contracts, we have already discussed the social pressure, from both the seller and other buyers, which consumers can face when purchasing in store. Concerns may also arise where:

- consumers face pressure selling. The emotions associated with buying at home can make them particularly susceptible⁹³

⁹⁰ For a discussion of the problems people have in evaluating low probabilities, and how their decisions can be reversed depending on how probability information is presented, see Kunreuther, Novemsky, and Kahneman (2001). The tendency to ignore low probabilities may follow from an inclination to eliminate uncertainties or to simplify decision-making

⁹¹ Or they may (mistakenly) not attribute problems to contract terms (Shmuel I. Becher (2007)

⁹² Spence (1977)

⁹³ Legislation is in place to protect consumers (The Cancellation of Contracts made in a Consumer's home or place of work etc Regulations (2008)). For discussion of the

- time pressures are involved, leading to impulsive decisions⁹⁴ and mistakes – in the experiment carried out as part of this study, a 20 second time limit made respondents 12 to 20 per cent less likely to choose the best option from a set of two deals.⁹⁵
- stress and emotions drive poor decisions.⁹⁶ This was a particular concern in the OFT's market study on sale and rent back⁹⁷

3.48 However, a moderate amount of stress can be constructive for efficient decision-making. Where people think a decision is not risky (for example because they are internet shopping in a relaxed home environment)⁹⁸ they are more passive and invest less effort in gathering information and reaching optimal decisions.⁹⁹

psychology of doorstep selling, see Office of Fair Trading (2004), especially *Annexe F: Psychology of buying and selling in the home*

⁹⁴ See discussion of time limited offers in OFT (2010a). For discussion in the context of a conflict model, see Janis and Mann (1977)

⁹⁵ See Annexe F

⁹⁶ See Janis and Mann (1977), Wright (1974), and Oatley and Johnson-Laird (1987)

⁹⁷ OFT (2008d). For another discussion of stress in the housing market, see Eskridge (1984)

⁹⁸ For example, Balloon (2001) discusses the effect of not signing a physical contract

⁹⁹ Becher (2007)

3.49 We will be more likely to intervene in cases where disadvantaged or vulnerable consumers are harmed.^{100 101} Vulnerability can be driven by characteristics of the consumer such as cognitive ability, and characteristics of the transaction such as high stress environments. We take both into account, and expect higher standards from firms that deal with vulnerable consumers or consumers in vulnerable situations.

Conclusion

3.50 Here we have presented evidence showing that there are often good reasons why consumers do not always read contracts in full. As a result onerous terms in the small print can take them by surprise. Furthermore, even where consumers are aware of contract terms, they can still be harmed if they fail to properly assess and act on the information. Whether consumers search effectively and drive competition can be strongly influenced by the nature of the terms, and the way they are presented and explained.

¹⁰⁰ For example, the Consumer Protection from Unfair Trading Regulations (2008) prohibit unfair trading practices that target vulnerable consumers by virtue of age, infirmity or credulity, while the OFT has a responsibility under the Equalities Act (2010) to consider how our work affects people according to age, ethnicity, gender and sexuality

¹⁰¹ See OFT Prioritisation Principles OFT (2008f)

4 LEARNING FROM EXPERIENCE OR ADVICE

- 4.1 In Chapter 3 we discussed how the behaviour of consumers and firms can exacerbate the risk of consumers experiencing contract problems. We would be particularly concerned if traders deliberately hide surprising terms in the small print or cynically exploit people's natural biases or limitations. On the other hand, harm may be limited where consumers can and do learn about contract problems and about patterns in their own behaviour.¹⁰²
- 4.2 If consumers learn and have a choice about whether and from whom to buy, firms should face competitive pressure to change, since those firms with reputations for fair dealing would tend to thrive, while firms with bad reputations should lose business. Learning is more likely in markets where consumers make frequent purchases or can benefit from the learning of others via word of mouth. However, when purchases are infrequent, or low-involvement,¹⁰³ learning may be limited. Furthermore, where mistakes lead to irrevocable and significant detriment, the fact that consumers are able to learn may not be sufficient to prevent serious harm (for example, buying the wrong pension).
- 4.3 For learning to limit the harm from consumer contracts, three steps are needed. First, consumers must recognise past problems or errors. Secondly, consumers must identify how they could improve in future. Finally, consumers must act on this knowledge, in a way that reduces the number of problems they encounter. This means actively using their experience to make better choices next time. Poor experiences do not always result in improved decisions in the future. In some cases, contract problems may discourage consumers from shopping around in the future as they perceive it to have little benefit or may lead them to choose 'safer' incumbents over new entrants who are perceived to be more risky. Learning therefore only has the potential to mitigate harm

¹⁰² For a wider discussion of remedies see Office of Fair Trading (2008a)

¹⁰³ Products or services where consumers are likely to have a low level of engagement in the purchase, such as utilities or cleaning products.

when it helps to empower consumers, rather than discourage them or make them overly risk averse.

Recognising an error

- 4.4 Consumers may realise they made a purchasing error if they experience a problem. However, in other circumstances, they may not experience a problem, or may not realise that it results from an error. For example, unless they need to make a claim, a consumer may be unaware that an insurance contract does not provide the cover they thought they had paid for. Learning is more likely for contracts where quality can be verified after purchase rather than those where verification is not possible ('credence goods').
- 4.5 In general consumers are more likely to recognise a mistake caused by a misperception or misjudgement of the offer than they are to recognise an error that resulted from a deviation from standard behaviour due to a behavioural bias, such as because they were subject to an anchoring effect or suffered from inertia.¹⁰⁴

Identifying improvements

Learning from others

- 4.6 People may learn from others or from experience.¹⁰⁵ Learning from other people is slower when products or services delivered under contract are not standardised,¹⁰⁶ or when consumers have different usage patterns. Word of mouth may also be limited for some contracts, for example people's reluctance to discuss their own financial situation may limit the extent to which consumers can learn from others about financial products.

¹⁰⁴ See Office of Fair Trading (2011)

¹⁰⁵ Intrapersonal or interpersonal learning – see Bar-Gill (2008)

¹⁰⁶ For standardised products 'social learning' can be stronger than the effects of advertising - Mobius, Niehaus, and Rosenblat (2005)

4.7 However in many markets word of mouth is commonplace - our survey found that nearly a third of consumers had sought third party feedback or recommendations. In markets where word of mouth feedback is accessible and reliable, there is scope for this form of learning to act as an important discipline on the quality of goods and services provided, potentially including the quality of terms and conditions. Our research indicated that conversations with sales people were not associated with fewer problems.

4.8 The wider literature also suggests that advice from a salesperson may not always be advantageous to consumers:

- advice may not be impartial, and salespeople and commissioned advisors can exert a strong influence on consumer decisions, even when their incentives are transparent.¹⁰⁷ Evidence from financial services shows that people with less education seem to place more trust in advisers, and, in general, consumers are often unaware of potential conflicts of interest – through their position of trust, advisers can exploit consumer biases.¹⁰⁸ Disclosure of advisers' incentives may not reduce this influence,¹⁰⁹ and may even make things worse by overloading consumers with information¹¹⁰
- even if advice is impartial, consumers may give it inappropriate weight, particularly if they have paid for it¹¹¹
- the limits in cognition, discussed in Chapter 3, also apply to interpreting advice, so complex advice may be of little use to consumers¹¹²

¹⁰⁷ Meza, De, Irlenbusch, and Reyniers (2007)

¹⁰⁸ European Commission (2010)

¹⁰⁹ Financial Services Authority (2008)

¹¹⁰ For example, Federal Trade Commission (2004) The effect is context dependent – see European Commission (2010)

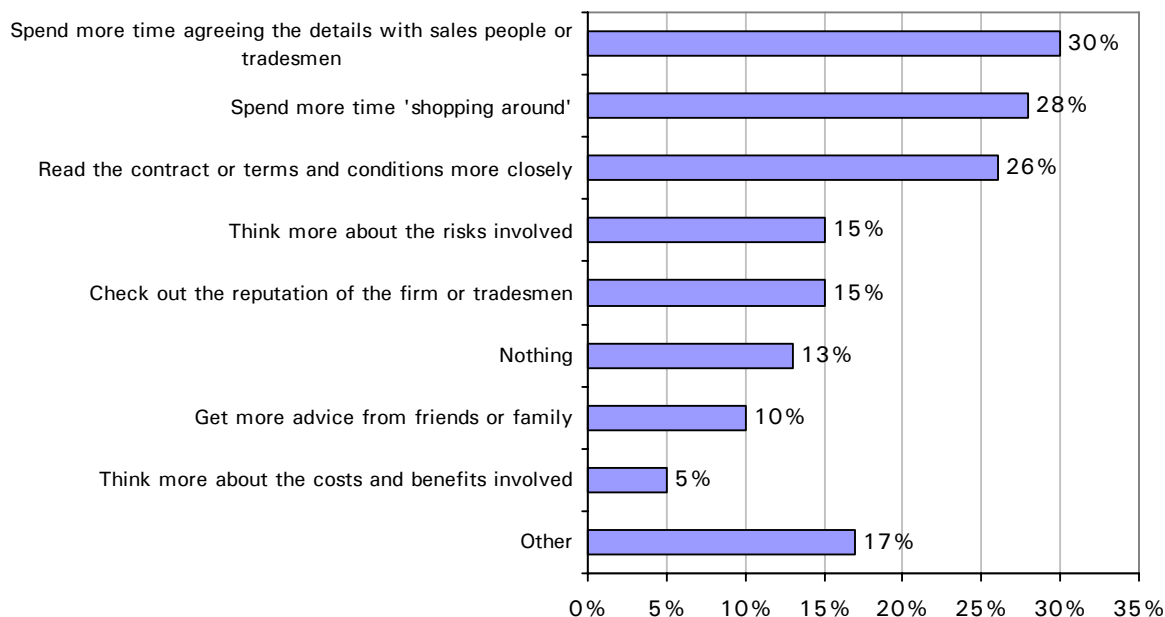
¹¹¹ F. Gino (2008).

4.9 In some circumstances taking professional, particularly independent advice, may mitigate risks to consumers.¹¹³ However, as our research suggests, advice does not necessarily mitigate the risk of experiencing a problem. In particular we do not believe that the fact of consumers receiving advice should lower the standard of clarity expected of consumer contracts.

Learning from experience

4.10 People often intend to learn from experience, particularly after they suffer an expensive problem. In the YouGov survey respondents who had experienced a consumer problem were asked what they would do differently in future. Figure 5 shows the responses they gave.¹¹⁴

Figure 5. Intention to Learn – 'If you bought something similar in the future, what if anything, would you do differently?'



Source: YouGov Survey, base: those that experienced a problem

¹¹² See OFT (2008a)

¹¹³ See OFT 311 www.offt.gov.uk/shared_offt/reports/unfair_contract_terms/oft311.pdf

¹¹⁴ Similar results were found in an earlier study - OFT (2008b) - where the intention to change behaviour was more likely the higher the detriment experienced.

- 4.11 However, consumers' learning intentions may not be ideally suited to avoiding future problems. The two most common intentions – to discuss more with sales people (30 per cent) and to shop around more (28 per cent) – were actually weakly associated with slightly more, not fewer, problems.¹¹⁵ Reading contracts more closely, however, which does seem to be associated with fewer problems, was mentioned by just over a quarter of respondents.
- 4.12 Thirteen per cent of those who experienced a problem felt there was nothing they could do differently or better next time, suggesting a minority experience a feeling of powerlessness in the face of standard, non-negotiable, contracts and business practices.

Acting to avoid problems

- 4.13 We have discussed consumers' intentions to learn, but this is not the same as actually modifying their behaviour to avoid similar problems in the future. Consumers' ability to act on learning can be limited by the choices available, and by their abilities. For example, some biases that lead to consumer mistakes are hardwired and some limits to computation are difficult to overcome. The evidence on actual learning is mixed.
- 4.14 The qualitative case studies conducted as part of this market study identified some market-specific examples of learning:¹¹⁶
- from experience, and publicity surrounding our case against Foxtons, some landlords entering contracts with letting agents had learnt that some agents use renewal fees (payable, typically for no extra work done by the agent, when a previously found tenant renews their tenancy). These landlords explicitly acted on this knowledge and took both up-front and

¹¹⁵ Note these results were statistically significant at the ten per cent level but not at the five per cent level within a regression analysis which included a range of variables. See Annexe D

¹¹⁶ See Annexes C and E

renewal fees into account when deciding which contract to enter

- gym-users who had experienced, or heard about, problems with cancellations in the past were more likely to read their contract when signing up
- very experienced car hire users took steps such as purchasing their own insurance before hiring, completing detailed vehicle checks, and using credit cards with low limits to limit what firms could take as pre-authorised charges. Those who had previously experienced problems were much more likely to scrutinise the contract, particularly terms relating to their previous problem

4.15 More generally, research shows that consumers do sometimes learn, but not fully, and that knowledge decays. In 2010, we commissioned an experiment testing subjects' repeated purchasing behaviour under different pricing conditions.¹¹⁷ It demonstrated that errors and consumer welfare losses generally declined as experience increased, but at a slowing rate, so that learning did not completely eradicate many problems. Evidence from elsewhere supports these findings:

- in the credit card market, making a late payment — and paying a fee — reduces the probability of a late payment in the subsequent month by 44 per cent. But there is a 'forgetting effect' so that a late payment charge from the previous month is more influential than an identical charge paid a year ago - the likelihood of incurring a fee increases as previous fee payments recede further into the past. Overall, learning is partially offset by knowledge depreciation, but its net effect is still positive¹¹⁸

¹¹⁷ The Office of Fair Trading (2010d)

¹¹⁸ Agarwal et al (2008)

- in the current account market, of those accounts paying an insufficient funds charge in 2006, more than 57 per cent also did so in 2005¹¹⁹

4.16 As well as learning about potential contract problems, consumers may also learn about themselves over time. For example, consumers can recognise their own weaknesses and use commitment mechanisms to help overcome their self control problems – for example by using illiquid assets to commit to long-term saving. However, the evidence is mixed on the extent to which consumers can learn to overcome behavioural biases. Furthermore, consumers may not experience a problem each time they make a biased decision and as such may not recognise they have made an error which they could learn from.¹²⁰

4.17 Consumers' awareness of their own behavioural biases is unlikely to eliminate consumer detriment. For example, confirmation bias (a tendency to place a lower weight on information not in support of a current viewpoint) can affect how well consumers use information, such that ambiguous information given to people differing in initial beliefs can move those beliefs further apart.¹²¹ This bias will continue to affect the consumers' interpretations, even when they are asked to deliberately seek contradictory information to overcome the bias.¹²² Similarly even when people understand their systematic overconfidence, they do not always apply this knowledge to improve their predictions.¹²³

4.18 To some extent, consumers may learn subconsciously. Consumers have been found to have poor conscious recall of product

¹¹⁹ Office of Fair Trading (2008c)

¹²⁰ See DellaVigna, (2009), Rabin (1996), also Einhorn and Hogarth (1978) for a discussion of why people fail to learn from feedback they get over time.

¹²¹ Lord, Ross and Lepper (1979)

¹²² Larrick (2004)

¹²³ Griffin and Tversky (1992)

pricing,¹²⁴ but can behave as if they remember prices, because they have subconsciously created internal valuations of products they see.¹²⁵ Frequent buyers are more sensitive to price rises and less influenced by contextual price information, even where they cannot recall past prices.¹²⁶ However, the OFT market study on Advertising of Prices, published in 2010, found that this associative learning is not powerful enough to fully overcome sensitivity to price framing effects.¹²⁷ Subconscious learning will also be less relevant for infrequently purchased products.

- 4.19 Consumer mistakes can create wider benefits from the learning they provide. Such experiences teach consumers market skills that are transferable across many day-to-day decisions, and can enhance their active involvement in markets. Experimental evidence confirms that consumers can transfer learning from one market 'game' to another, especially for closely related games.¹²⁸ More generally, the education literature has explored the differing roles of general and context-specific knowledge, and described specific requirements for the transfer of knowledge, such as close similarity of tasks, or individuals' deliberate 'abstraction' of principles so that they can applied elsewhere.¹²⁹
- 4.20 The YouGov Survey supports the idea that consumers learn from experience, within or across markets, and that this learning pays off to reduce problem incidence, but still does not eradicate consumer harm. Older people were less likely to experience problems across virtually all contract types – people over the age of 50 experienced problems with 3.6 per cent of contracts within

¹²⁴ Dickson and Sawyer (1990); Krishna Currim and Shoemaker (1991); Vanhuele and Dreze (2002)

¹²⁵ Briesch, krishnamurthi, Mazumdar and Raj (1997)

¹²⁶ Thomas and Menon (2005)

¹²⁷ Mountainview Learning for the Office of Fair Trading (2010)

¹²⁸ Huck, Jehiel and Rutter (2010)

¹²⁹ Perkins and Salomon (1989)

the first year of entering them, compared to 5.4 per cent for the under 30s. The role of experience was confirmed by consumers' stated views: older consumers highlighted prior experience and knowledge as a source of understanding, whereas younger people blamed the lack of such experience when things went wrong.

- 4.21 However, we found that both young and old people experienced problems across all sectors. In mature markets where the stock of informed consumers is likely to be stable, the best test of how well learning protects consumers overall might be simply to measure how many and how severely people are harmed. The insights presented in this chapter will help us assess whether learning mechanisms are likely to bring about a correction in the market, or whether contract problems are there to stay.

Conclusion

- 4.22 Overall we consider that learning is most likely to reduce the likelihood of experiencing a contract problem where products are purchased frequently and/or where consumers are able to easily verify quality. However, learning is often not complete and can decay over time. Importantly, for learning to be sufficient to mitigate consumer harm it needs to be more than simply recognising that a specific term has resulted in a problem, it needs to result in demonstrable changes in consumer behaviour. Consumers not only need to be able to learn which terms may be harmful, they must also be able to actively control whether they incur the term or be able to avoid it completely when choosing which contract to enter.

5 ASSESSING HARMS

Key findings

The assessment framework developed in this chapter sets out how we will assess the harm from consumer contract terms. This will feed into the OFT's prioritisation process and inform our decision about whether to take action in a particular case.

The main principles underlying this framework are:

- For competition to work well, consumers must understand the deals they are entering into, and value on the main element(s) of the deal must be backed by small print that corresponds to expectations.
- Therefore consumer contracts should be clear, the main features should be presented so that consumers properly assess them and act on the implications, and other terms and conditions should be in line with expectations.
- In a competitive market where consumers can learn from bad experiences, problematic contract terms should not be profitable in the long-run and intervention may be unnecessary. We are most likely to be concerned about harm in markets where consumers make large one-off or infrequent purchases, or they are unable to assess the quality of the goods they buy.
- Concerns may also arise where learning effects are weak for other reasons or where consumers have little control over whether or not contingent charges are incurred; or where consumers do not face better alternatives.

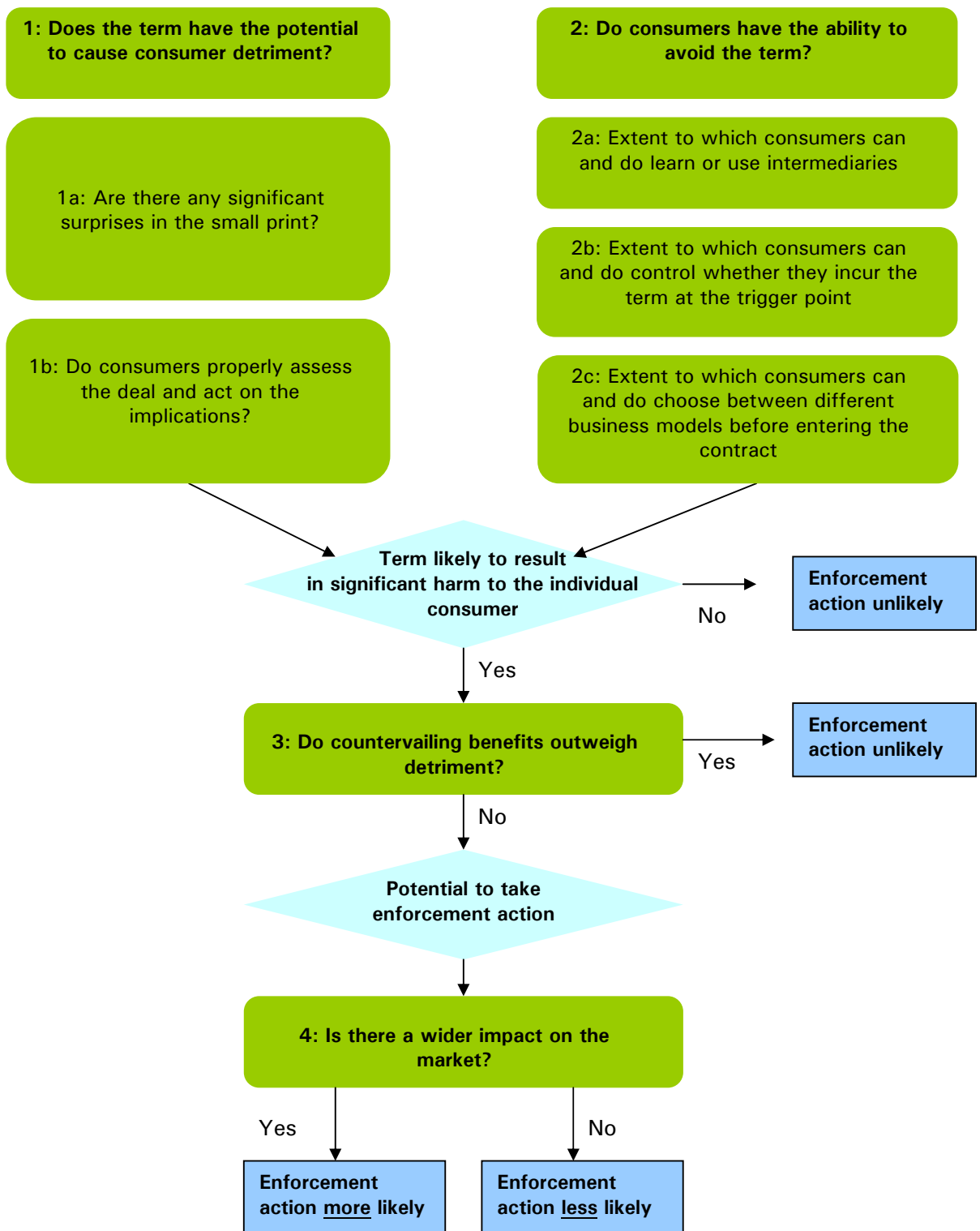
Where the framework identifies a term that is likely to give rise to large-scale, serious harm we are likely to take action – using any of our enforcement tools – to get that term clarified, amended or removed from the contract.

Introduction

- 5.1 This chapter describes the systematic framework we will use to test whether contracts and associated practices cause significant consumer harm and should therefore be a priority for enforcement action. The framework is not a description of the law (for a discussion of the law, see Chapter 6). It is a tool for making an economic assessment of whether and how contract terms harm consumers. This economic impact analysis feeds into our prioritisation process.¹³⁰
- 5.2 This is the first time we have set out an effects-based framework for assessing consumer harm. It is designed to be flexible, allowing wider issues to be considered on a case-by case basis. Nonetheless we may update it in future in the light of further experience and as the case law develops.
- 5.3 The framework consists of a series of questions we will consider when assessing contracts or contract terms. To answer these questions we will look for empirical evidence on consumer experiences, behaviours and expectations, of the kind presented in Chapter 2.
- 5.4 The assessment framework is summarised in Figure 6 below, and explained in more detail in the remainder of the chapter. In essence, it tests whether consumer contracts are **clear**, whether the main features are presented so that **consumers can properly assess them**, and whether the other terms and conditions are **in line with consumer expectations**. Where this is not the case, consumer contracts are potentially harmful. The framework also tests whether consumers can **learn about contract problems** and **avoid them**, such that harm is likely to be limited in practice.

¹³⁰ This framework should therefore be considered alongside the OFTs Prioritisation Principles: www.ofg.gov.uk/shared_ofg/about_ofg/ofg953.pdf

Figure 6: Assessment framework for prioritising enforcement action for consumer contracts



Screen 1: Is there potential harm?

- 5.5 Chapter 3 explained how well-functioning markets depend on consumers making informed choices between firms. There will be harm to consumers and markets if consumer purchases regularly turn out to be worse value than expected or different to what was understood.
- 5.6 For consumers to be able to assess a deal they must be aware of the key elements – the main proposition. Consumers will be aware of those aspects that are explicitly brought to their attention or sought out – we refer to these as 'upfront terms', and to the rest as 'small print'.
- 5.7 Consumers can be harmed by small print surprises or through errors in their assessment of up front terms.¹³¹ Small print terms are considered under Screen 1a, and upfront terms are considered under Screen 1b¹³².

1a. Are there any significant surprises in the small print?

- 5.8 As our research confirmed, most consumers do not read all terms and conditions in detail before purchase and, as discussed in Chapter 3, there can be good reasons for this. This is not to say that it is never necessary for consumers to read the small print, or that it is not important that the small print is in plain and intelligible language – consumers who do read the small print, before or after purchase, must be able to understand it. However it is important to recognise that there is potential for small print terms to come as a surprise to most consumers, even those who

¹³¹ This framework focuses on how a particular term can harm particular consumers or groups of consumers. Other discussions have focused on how to collect evidence on how many people are harmed or to quantify the financial or other detriment they experience. See, for example, OECD(2010), OFT(2008b) and OFT(2006c)

¹³² See Chapter 1 for definitions of 'small print' and 'upfront' terms. Please note these categories do not necessarily correspond to the legal analysis of terms covering 'core' and 'non-core' issues for the purposes of the UTCCRs.

are 'reasonably well-informed, reasonably observant and circumspect'.¹³³

Terms are out of line with expectations

- 5.9 Even without scrutinising the small print, most consumers will have an expectation of what it contains. For consumers to have correctly understood the deal there must be nothing in the small print which is significantly out of line with that expectation. Correspondingly (as discussed in Chapter 3) for competition to work well, value on the main proposition must not be undermined by small print that does not correspond to expectations.
- 5.10 There may be consumer harm if small print terms and conditions significantly worsen the deal, bringing it out of line with what consumers expect. For example surprising small print terms may include those which:
- give rise to higher than expected charges, for example if there are high unexpected charges for returning a hire car late
 - unexpectedly restrict the scope of the deal, for example significant exclusions in an insurance contract
 - unexpectedly change the balance of risks in the contract, for example by making it difficult for consumers to obtain redress following events which are outside their control
 - reduce the consumer's control or enhance the firm's control over the deal, for example by unexpectedly inhibiting cancellation or having an automatic rollover
- 5.11 We will aim to use empirical evidence to establish what consumers expect. Clearly it will vary from product to product, and potentially between different consumer groups. To assess whether the term has resulted in consumer harm, we will aim to collect empirical evidence on, for example, the number and types of problems encountered and the behaviour of the consumer and

¹³³ The Consumer Protection from Unfair Trading Regulations, 2008, 2(2)

trader before the contract is signed. Generic empirical evidence of this kind is considered in Chapter 2.

- 5.12 In considering empirical evidence of consumer expectations, we recognise that sectors can become known for small print problems. We would not regard evidence of general awareness or unease about small print risks in a sector as evidence that consumers are properly cognisant of specific terms and conditions. To be persuaded that a term was not a surprise, we would need to be convinced that consumers were fully aware of the specific term in question and consciously agreed to it.

How can traders avoid causing harm?

- 5.13 Where small print terms may worsen the deal compared to consumer expectations, traders could consider bringing these terms clearly to consumers' attention upfront. By making these terms genuinely transparent, such that consumers understand and assess them as part of the deal, the trader can ensure that the term does not come as a surprise.
- 5.14 However, if terms relating to particular elements of the deal properly belong in the small print, for example because they are unavoidably too numerous to explain clearly to consumers within a practical timeframe, traders should ensure the terms are broadly what consumers would expect to find in the small print.

Terms are out of line with efficiently incurred costs

- 5.15 In some cases consumers may not have specific expectations about particular terms, but may instead have an expectation or assumption about the basic commercial proposition or business model. With regards to small print charges in particular, our starting point is that consumers expect firms to make money on the main deal, rather than profit from small print terms. For example, our research with landlords showed that they did not

expect to be charged by their letting agent when no additional services were supplied.¹³⁴

- 5.16 We will assess small print charges, including ancillary or contingent charges, by comparing the level of charges with associated costs. Having charges at cost means firms are not tempted to deliberately hide the term from consumers because they expect to profit from it.
- 5.17 The specifics of any cost assessment will depend on the case in question but in principle we aim to assess costs by reference to efficiently minimised Long Run Average Incremental Costs (LRAIC).¹³⁵ This includes the direct costs of serving the consumer, and also indirect costs that relate to the triggering of the charge.¹³⁶ For example, if a consumer damages a hired product, the firm will not only have to incur the cost of repairing the product but will also be unable to hire the product to other consumers while it is repaired.
- 5.18 We also note that consumer harm may arise where consumers **have** formed expectations about the charge, but these expectations are below efficiently incurred costs. For example, if costs vary significantly between firms, charges might be cost reflective but still higher than consumers expect, so that consumers might not choose the deal that's best for them once all charges are taken into account. In these circumstances, transparency will be particularly important.

¹³⁴ See the focus group discussion on lettings agents fees, in Annexe C

¹³⁵ The LRAIC of increasing output beyond a benchmark level. This includes all product (or term) specific costs, whether fixed or variable. See: European Commission (2009).

¹³⁶ As with other elements of the framework this is not an interpretation of the consumer law. For example, when considering whether the law has been breached we will also take account, where relevant, of the legal jurisprudence on the appropriate recoverable measure of damages that would be allowed by a court.

How can traders avoid causing harm?

- 5.19 Again, one option is for firms to move these charges up front, such that consumers factor them as part of the deal, and they do not come as a surprise.
- 5.20 However, consumers may not necessarily be able to absorb this information up front, for example where there are an unavoidably large number of contingent charges, or where consumers are already facing a large amount of information in connection with other aspects of the deal. In these circumstances, traders should ensure that small print charges are broadly cost-reflective.

Example - cancellation terms

- 5.21 Cancellation terms are an important example of charges that can give rise to consumer harm. If cancellation charges are well understood as part of the main deal, they are unlikely to raise concerns.
- 5.22 However, cancellation charges and processes are often in the small print. Furthermore consumers often find it difficult to assess how likely they are to cancel a contract (particularly for products such as subscriptions and memberships where they cannot assess the value of the product in advance) and often do not seek these terms out before buying. As a result cancellation terms may be considered under Screen 1a.
- 5.23 Where cancellation charges are not part of the upfront deal, then, in line with general expectations that traders should not profit from small print terms, charges should not be set significantly above costs.
- 5.24 The specifics will vary case by case, for example depending on whether the trader has incurred large upfront costs to provide the contract or whether the trader is operating at capacity. In principle, however, we consider that it is reasonable for traders to recover the administration costs associated with cancellation, plus compensation for loss of bargain (taking into account the firm's legal duty to mitigate its loss). The starting point for this could be

the value of the remaining life of the contract, less the expected gain from reselling that capacity or from avoiding the costs of delivering the remainder of the contract¹³⁷ or it could be the discount the customer received for taking a fixed rather than a rolling contract.¹³⁸ In all cases the trader should not receive a windfall as a result of the consumer's breach of contract.

Summary of screen 1a

5.25 When assessing whether there are any significant surprises in the small print we will consider the following questions.

- i) Are there any non-price small print terms which *significantly* reduce the attractiveness of the purchase?**
- ii) Are there small print charges which *significantly* increase the cost of the deal?**
- iii) If so, are these in line with costs?**
- iv) Are these costs *significantly* higher than might be reasonably expected (including out of line with industry average)?**

5.26 Traders can avoid the harm from small print surprises by drawing terms to consumers' attention up front such that the consumer can factor them into the deal. However many terms properly belong in the small print. In these cases traders should seek to avoid these terms coming as a surprise to consumers by setting them in line with consumer expectations.

¹³⁷ For a description of this calculation for package holidays, see OFT(2004c) and for telecoms, Ofcom(2010b)

¹³⁸ Though in any calculation, firms should not be compensated twice for the same loss. See OFT (2008e) (Group 5)

5.27 Terms that are upfront may still cause consumer detriment, however, for example where they are unnecessarily complex or manipulative. These concerns are considered next.

1b. Do consumers properly assess the deal and act on its implications?

5.28 Even where terms are clearly brought to consumers' attention up front, there may still be harm if, as a result of the complexity of the term or behavioural biases, consumers cannot, or do not, accurately compute the implications of the deal or compare offers. As with screen 1a, our assessment under screen 1b will use both case-specific and general evidence of the kind described in Chapter 3 and Annexes E and F.

5.29 In some cases, consumers may simply find the language hard to understand. If the explanation of the term is not clear, consumers will not be able to assess the term. Therefore the first requirement is that all terms be written in plain and intelligible language.

5.30 However, even if the wording of the term is clear, consumers may still not fully assess its implications. For example, a consumer may easily understand the existence of a charge but may not be able to compute the implications of that charge for the overall cost of the deal. As discussed in Chapter 2 this is particularly likely if the term requires complex calculations or if the level of a charge is probabilistic or requires estimates of future usage. Time pressure also increases the likelihood of consumers making mistakes.¹³⁹

5.31 Terms which are brought to a consumer's attention late in the day are also less likely to be taken into account. This is partly because of 'confirmation bias' and 'endowment effects', which mean that consumers are psychologically committed to the deal before they have actually signed it (see Chapter 3), but also because consumers may, quite rationally, not want to invest time or money in searching again for a new deal at this late stage in the process.

¹³⁹ See Annexe F

- 5.32 In addition to confirmation bias and endowment effects, Chapter 3 covered a number of other common behavioural biases. We may be concerned about contract terms or associated practices which play on these biases to the detriment of consumers. For example, this could be where contracts attach expensive fees to contingencies for which consumers underestimate the probability of their occurrence, or discount heavily because they do not occur immediately.
- 5.33 In some situations, consumers may be able to assess the value of the deal to them initially, but their assessment of the value changes over time. For example, at the time of signing a gym contract, a consumer may plan to visit the gym regularly, but may turn out not to do so. We do **not** regard this as necessarily a problem in itself if, at the time of entering the deal, the consumer is fully aware of the implications. As noted above, however, selling contracts on the basis of optimism bias can significantly increase the harm from high cancellation fees and we regard business models that seek to profit from a combination of optimism bias and impeding cancellation as potentially harmful to consumers.
- 5.34 In general we are more likely to take enforcement action where traders actively exploit consumer biases than where the bias is simply brought to the transaction by the consumer. We are particularly concerned about misleading or high pressure sales, and about exploitation of vulnerable consumers, by which we mean those who, by their nature or their situation, have difficulty obtaining or assimilating information, or who may face serious harm from inappropriate purchases.
- 5.35 In some cases harm may be avoidable through improved transparency or helping consumers better understand the deal on offer. However, there may be cases in which, even when the deal is quite clearly presented, some consumers will fail to assess it properly. For example, our sale and rent back market study found examples of people so desperate to save their home that they would sign up to a deal despite deeply unfavourable terms such as heavy discounts on the purchase price and minimal security of

tenure. Some consumers were aware of these terms but discounted the associated risks because they were desperate to solve an immediate problem. In such cases there is clear potential for significant harm and intervention may be needed which goes beyond ensuring transparency.

- 5.36 Where consumers get professional advice in connection with their purchase, advisors may be able to explain some of the complicated language in the agreement. However they will not necessarily point out the implications of the terms or be able to assess all the implications on behalf of individual consumers, for example contingent charges which require estimating the probability of certain events. Our view is that the fact of consumers receiving advice in connection with certain transactions does not lower the standard of clarity expected of consumer contracts.

How can traders avoid causing harm?

- 5.37 In many cases, firms can help consumers to properly understand their offers, for example by providing illustrations of the implications, or by bringing terms to a consumer's attention at an appropriate time in the process. However, as discussed in Chapter 3, in some situations providing additional information can do more harm than good.¹⁴⁰ Where it is impossible to explain terms sufficiently that consumers can properly assess them and act on the implications, it may be necessary to alter or remove the term altogether.
- 5.38 Firms may want to recommend that consumers obtain professional advice. However clearly firms should not require consumers to seek advice where advice would not be needed if the information was clearly explained.

¹⁴⁰ National Consumer Council (2007)

Summary of Screen 1b

5.39 When assessing whether consumers can properly assess the deal and act on the implications we will consider the following questions.

- i) **Are the upfront terms clear**
- ii) **Can a consumer compute the implications of the terms without *significant* error?**
- iii) **Is the term brought to the consumer's attention in sufficient time to act?**

2: Can consumers avoid the term?

- 5.40 Alongside our assessment of whether the term is potentially harmful, we will also consider how likely it is that the term will cause significant harm in practice.
- 5.41 In principle, where consumers encountering a problem can learn from the experience **and** avoid such problems in the future, harm will be limited. In a competitive market where learning effects are powerful, problematic contract terms should not be commercially sustainable and there may be no case for intervention.
- 5.42 In making our assessment we will not only consider whether consumers are able to avoid potentially harmful terms in theory, but also whether there is evidence of consumers taking this action in practice. We will consider first whether consumers can and do learn about contract problems, and second whether they can and do avoid them, either by choosing a different contract, or by not triggering the problematic term.

Learning

- 5.43 As discussed in Chapter 4, consumers can learn about contract problems either through their own experience or vicariously, for example via word of mouth or customer feedback. Learning from

experience is possible where consumers make small, frequent purchases they can easily evaluate. Conversely, the most obvious risk of harm comes in markets where consumers make large one-off or infrequent purchases, or where they purchase goods whose quality they are unable to assess. For example, sale and rent back is an example of such market. It is also an example of a market where vicarious learning effects are particularly weak, as people are reluctant to discuss financial difficulties with others.

- 5.44 It is worth noting that experience does not always lead to better decisions in the future. Negative consumer experiences can make consumers less confident, less likely to shop around¹⁴¹ because they think it has little benefit, prefer incumbents who are perceived as less risky¹⁴² over new entrants or decide not to switch. For example, five per cent of vulnerable consumers in an Ofgem survey said they did not switch because they wouldn't trust another supplier.¹⁴³ In some circumstances, therefore, experience of contract problems can lead to **weaker** competition, further worsening the outcome for consumers.
- 5.45 In principle we might expect positive learning effects to be a more significant factor in new markets, where consumers learn about potential problems, then begin to avoid them, and firms react by improving their contracts to remove problematic terms. However, as discussed in Chapter 4, the research suggests that whilst consumers can and do learn, they rarely learn fully and that knowledge decays over time. This may explain why we observe relatively mature markets in which contract problems persist. Consistent with our approach to assessing the potential for harm, our assessment of the potential for learning effects will be, as far as possible, evidence-based.

¹⁴¹ OFT (2006c)

¹⁴² Tykocinski and Pittman (1998)

¹⁴³ Ofgem (2008)

Control

- 5.46 Where consumers can and do learn about potential problems, harm may be mitigated if consumers also have some control over whether or not to trigger a particular contract term. For example, someone hiring a car has control over whether they return it on time, but little control over whether they have a puncture. There is therefore likely to be more harm from unavoidable charges than from avoidable ones. Consumers who have past experience of an unfavourable term can in future avoid terms over which they have control.

Choice

- 5.47 Consumers who learn about contract problems may also arguably be able to avoid them by choosing a different contract to enter in the future. Where there is little or no choice, either between contract providers, or between contract terms on offer, the scope for harm is greater.

Summary of Screen 2

- 5.48 When assessing whether consumers avoid potentially harmful terms, we will consider the following questions.

i) To what extent can and do consumers learn, either from experience or others, or use intermediaries?

Given that consumers can and do learn:

ii) To what extent can and do consumers control whether they incur the term at the point at which the term is triggered?

iii) To what extent can and do consumers choose between different business models before entering the contract?

3. Are there sufficient off-setting benefits?

5.49 In certain circumstances, there may be reasons why terms of which the consumer is not aware or does not fully appreciate, do in fact benefit them. In such cases even though Screens 1 and 2 of the assessment framework might suggest concerns, we may conclude that harm from the term is limited, as the benefits to consumers outweigh the harm. In that case, we would be unlikely to take enforcement action.¹⁴⁴ It is possible that a range of terms may have benefits for consumers in certain circumstances and we will therefore consider possible benefits as part of our assessment of net harm. For example:

- terms restricting contract scope **may** benefit consumers if firms cannot provide valued services without excluding technical elements that are difficult for consumers to understand, or if more comprehensive explanations or disclosure would significantly increase costs or lengthen sales processes
- terms excluding liability for risks **may** benefit consumers, for example if an insurance contract could not reasonably be provided without excluding cover for particular eventualities, but the product still provides valuable benefits overall once the exclusion is taken into account
- terms restricting consumers' control over contracts – such as tie-ins and rollover provisions – **may** provide benefits, for example if consumers are protected from vital services lapsing, or if tie-ins or cancellation fees help firms stabilise their revenues and so obtain cheaper financing with the benefit passed on as lower contract prices

¹⁴⁴ This has a similar effect to Article 101(3) EU Competition Law, which exempts agreements where the pro-competitive benefits produced by an agreement outweigh the restrictive effects on competition

- harm arising from products such as warranties being sold together with another product at the point of sale of that product, may be offset by the convenience of the joint purchase¹⁴⁵

5.50 However, any potential benefits will need to be weighed against the potential consumer harm and we will in any case only take such benefits into account if they cannot be obtained in a less harmful way. For example, terms which defer payment could in principle benefit consumers by allowing them to stagger payments. However, rather than setting deferred charges, traders could offer a choice of upfront or deferred payment, being clear about the nature of any credit agreement on offer. This would remove the potential for harm because it requires consumers to focus on the matter, and make an active choice about what may be best for them.

5.51 Also, we may still consider a term harmful if it harms one group of consumers but benefits another, particularly if the harmed group is low income or vulnerable. The fact that the earnings from some fees may be redistributed to all customers through a waterbed effect may not remove the concern.

Summary of screen 3

5.52 When assessing whether countervailing benefits outweigh the detriment of a specific contract terms we will consider the following questions.

- i) Are there offsetting benefits which are sufficient to offset harm?**
- ii) Can these be attained in a less harmful way?**
- iii) Do the benefits flow to the same consumer group?**

¹⁴⁵ See the discussion of the loss of convenience from the point-of-sale prohibition for payment protection insurance, in Competition Commission (2010)

4: Are there any wider market implications to consider?

- 5.53 Screen 4 specifically looks at whether benefits flowing to other groups of consumers, whilst not preventing some consumers from suffering harm, may lower the priority we attach to a particular term. This will depend on the relative sizes of these consumer groups, the levels of benefit and detriment involved and whether the groups facing potential harm are particularly vulnerable.
- 5.54 In addition, Screen 4 considers the interaction between the term and competition in the market, as discussed in Chapter 3. We may prioritise action against harmful terms that damage competition in a market. For example, complex tariffs that make it difficult for consumers to compare deals on offer from different traders may mean firms do not have to compete as vigorously with each other.

Summary of Screen 4

- 5.55 When assessing whether there are any wider implication of the contract term, we will consider the following questions, as well as any sector-specific issues.

- i) Extent to which harm is offset by benefits to other groups of consumers?**
- ii) Extent to which competition may be expected to mitigate harm?**
- iii) Extent to which the term may be expected to be detrimental to competition in the wider market?**

Example

- 5.56 To illustrate how the screens work in practice, Box 1 briefly shows how the thinking applies to one of our recent cases.

Box 1. Example of Assessment Framework: Foxtons' sales commission terms in contracts with landlords

In July 2009, a High Court judgment ruled that a number of terms in Foxtons' contracts with landlords which related to renewal and sales commissions were unfair under the UTCCRs. This box uses the assessment framework to show how Foxtons' original terms caused consumer harm. Foxtons have subsequently made significant improvements to these terms (see Annex C for discussion).

Screen 1a – small print surprises: These terms were considered to be small print terms, because they were not explicitly sought out or brought to the consumer's attention. The terms were not in plain and intelligible language. The OFT argued that the terms were not part of the core bargain. In particular, the renewal commission was not mentioned in marketing materials or on the website. The fees were therefore a surprise to consumers. There was also uncertainty about when and how often the commission terms would be triggered.

Screen 1b – consumers failing to fully assess upfront deals: Even if consumers were to read the renewal and sales commission terms, they could still make mistakes in their assessment. The judge found that consumers would be unlikely to think the terms through, despite reading them. Evidence that consumers were sufficiently well informed would come from the fact that consumers had negotiated these terms, as well as clear disclosure if not active flagging.

Screens 2 – consumer learning and control: For consumer landlords, letting properties is not part of their business, and they have only limited opportunities to learn about renewal commissions over time. The sales commission in particular is very unlikely to be experienced more than once. Once in the contract there is no opportunity for landlords to control the fee. Meanwhile, renewal (and to some extent sales) commissions are widespread, and therefore landlords have limited opportunity to avoid the terms by switching traders.

Screen 3 – countervailing benefits: Foxtons argued that the contested fees enabled them to charge less elsewhere. If such benefits exist, the OFT believed they could be achieved less harmfully by making terms clearer and giving consumers a choice to pay a higher up front fee or a lower fee plus renewal commission.

OFT actions

5.57 The OFT has a set of general prioritisation principles which govern whether or not it decides to take action on a case.¹⁴⁶ These weigh up the impact of the action on consumers and the strategic significance of the case, against the resource required to take the case and the risk involved in it. The assessment framework described above is intended to feed into the prioritisation process for cases involving consumer contracts.

¹⁴⁶ Office of Fair Trading (2008f)

5.58 Where we consider that there is likely to be significant harm from a consumer contract, we will consider taking enforcement action. A precondition of such action will necessarily be developing an arguable legal case (see Chapter 6) and, if the case goes to court, persuading a judge that the law has been breached and that imposition of a sanction is appropriate. Depending on the nature of the problem, the outcome of such action may involve requiring the trader to:

- make the term clearer
- bring the term to consumers' attention and fully explain its implications. For example, not leaving discussion of key aspects of the contract until late in the sales process
- bring the term into line with consumers' expectations. For example by reducing the level of the term in line with cost, or
- stop using the term in its entirety.

5.59 This last remedy is likely to be sought only where there is no other way of dealing with the harm, or the potential harm is so severe that no other remedy is appropriate. For example, although consumers are free to enter into risky deals where they can be expected to adequately assess the risk, consumers are not good at processing the risk of low probability but highly detrimental outcomes. This is one reason why, for instance, it is illegal for shops to assign away their responsibilities for people who are injured in their premises.

5.60 Most of the discussion in this chapter relates to harm that we would expect to be able to address through the UTCCRs. However, as discussed in Chapter 6 the OFT has other tools at its disposal and may consider using any of them to address the harm it identifies. For example, when we found that consumers did not fully understand the risks involved in sale and rentback agreements, we recommended that the most expedient way of preventing detriment would be for the FSA to regulate these contracts.

Conclusions

- 5.61 Our main findings are summarised in the box at the beginning of this chapter. The next chapter goes on to discuss how we can use consumer law to address contract terms found to cause harm under the assessment framework.

6 CONSUMER CONTRACTS AND THE LAW

Introduction

- 6.1 This chapter considers how the OFT can use consumer law to address contract terms found to cause harm under the assessment framework described in Chapter 5 of this report. It describes some of the key legislation we enforce, and explores how far it covers harmful terms.¹⁴⁷
- 6.2 The purpose of the assessment framework is to assess consumer detriment arising from contract terms in a particular case, to inform our decision as to whether to take enforcement action. The framework will help us work efficiently and, by being made public, will increase transparency about how we approach our consumer contracts work.
- 6.3 We have designed the framework in the light of economic principles and evidence of how contract terms can harm consumers in practice. As such, the framework is not an interpretation of any individual piece of consumer protection law. We will apply the framework to help us decide whether action is called for, before deciding which of our powers it is most appropriate to use.
- 6.4 The framework does not replace the OFT's general prioritisation principles and should be read in conjunction with them. As part of our usual prioritisation process we may have a duty to consider complaints under particular legislation.
- 6.5 This chapter discusses whether and to what extent the existing consumer legislation addresses terms that the framework may identify as harmful – that is, how the law maps to the assessment Screens.

¹⁴⁷ This chapter is not exhaustive: see www.offt.gov.uk/OFTwork/consumer-enforcement/ for more information on the legislation and common law that we enforce.

6.6 Freedom of contract is important in British contract law. In consumer contracts, traders have broad discretion to design and make offers to consumers who are then free to choose whether to accept or reject the offer. Traders or consumers can bring actions in the courts when contract terms are breached. However, freedom to reject contractual offers and the ability to sue on breach do not guarantee that contracts will work well for consumers. Often consumers are in a weaker position than traders on two counts, firstly, because it is often difficult or impossible for them to bargain or assess the full implications of deals offered, and, secondly, because seeking redress at court can be time-consuming and costly.

6.7 Recognising both the value of freedom of contract and the need to protect consumers in some circumstances, consumer law does not regulate contracts prescriptively. Instead, the OFT and other enforcers, via consultation or the courts, can require traders to amend or remove terms or change practices that do not comply with the following:

- The *Unfair Terms in Consumer Contracts Regulations 1999*¹⁴⁸ (UTCCRs) which protect consumers from unfair standard terms – terms which were not negotiated with consumers and which have the potential to harm them. The UTCCRs recognise consumers' difficulties with contracts that contain unpleasant surprises (for example, when deals are difficult to assess or understand in detail) or that are openly one-sided (for example, when traders offer non-negotiable unfavourable terms which consumers may accept for want of better alternatives). In such instances it appears that freedom of contract offers little or no protection.

¹⁴⁸ The Unfair Terms in Consumer Contracts Regulations SI 1999/2083, implementing the European Directive 93/13/EEC. The OFT publishes guidance on the UTCCRs and their application to specific industries. See OFT311 and other documents, at: www.of.gov.uk/about-the-oft/legal-powers/legal/unfair-terms/guidance

- The *Consumer Protection from Unfair Trading Regulations 2008*¹⁴⁹ (CPRs) which protect consumers from unfair commercial practices in general, including the misleading use of unfavourable contract terms. The CPRs are intended to provide broad-based protection for consumers and so partly address in a general way some of the specific sources of detriment addressed by the UTCCRs. Because they cover dealings with the consumer before and (in the case of debt-collection for instance) after a contract is formed, the CPRs catch some detriment that is bound to escape the UTCCRs. There are also other laws specific to certain markets and commercial practices that provide further protections, such as regulations on sales away from business premises or on the consumer's doorstep, and the array of consumer credit legislation.

Protections from unfair terms: the UTCCRs

6.8 The UTCCRs apply a test of fairness to standard (not individually negotiated) terms in consumer contracts. They also apply a transparency test, which focuses on clarity of language more broadly. Certain terms may not be fully assessed for fairness, as explained below. If the OFT considers a standard term to have failed either test we can attempt to secure undertakings from the relevant firm to amend or stop using the term. Ultimately we can take court action to achieve the same end.

Test for transparency

6.9 The transparency test applies to all written standard terms in consumer contracts. The UTCCRs require terms to be expressed in 'plain and intelligible language'.¹⁵⁰ The Directive also explains that consumers 'should actually be given an opportunity to examine all

¹⁴⁹ Consumer Protection from Unfair Trading Regulations (2008), implementing the Unfair Commercial Practices Directive 2005/29/EC. The OFT publishes guidance on the CPRs. See: www.offt.gov.uk/business-advice/treating-customers-fairly/protection

¹⁵⁰ Regulation 7 of the UTCCRs. The OFT's main guidance document on unfair terms, OFT311, contains a section on how this is to be interpreted, with examples.

the terms'.¹⁵¹ The purpose of the legislation is clearly that the typical consumer should be able to evaluate a term before becoming legally bound by it, which requires that it must not only be in plain English (avoiding legal jargon) but also avoid vague wording, excessive length, unexplained calculations and difficult formats like tiny fonts or time-limited environments.

Test for fairness – which terms can be assessed?

6.10 The test of fairness does not apply in the same way to all standard terms in consumer contracts:

- any term that is not transparent may also be assessed for fairness – the rationale being that if a term is unclear consumers may not willingly have accepted it. This means we can seek not only that unclear terms be made clear, but also that unclear terms be amended or removed altogether on grounds of unfairness.
- as regards terms which **are** transparent, some important terms may be assessed for fairness in a limited way.

6.11 In more detail, the test of fairness can be applied as follows:

- any standard term in a consumer contract can be assessed for fairness except to the extent that the assessment relates to 'the definition of the main subject matter' of the contract or relates to the 'adequacy of the price or remuneration, as against the goods or services supplied in exchange' (this is sometimes called the 'core' terms assessment).
- all terms, including 'core' terms, must be plain and intelligible language and are fully assessable for fairness if they are not in plain and intelligible language.^{152 153}

¹⁵¹ Recital 19 of the Directive.

¹⁵² This exclusion from assessment for fairness is set out at Regulation 6(2) of the UTCCRs.

- where a term is 'core' **and** in plain and intelligible language, it may still be assessed on grounds other than the definition of the main subject matter, or the adequacy of the price. This could for example include the extent to which the term is flagged up to the consumer. Further, where a term is not directly the price, but merely has an impact on the price, or the definition of the main subject matter, it will still be fully assessable for fairness –for example price escalation clauses or other terms that have the potential for unfairly worsening the consumer's position on core issues compared to what he or she would reasonably have expected.

6.12 Assessable terms therefore include terms on 'core' issues that are not in plain and intelligible language, or are unfair for reasons other than a mere assessment of adequacy or description, and all other terms, whether in plain language or not.

6.13 Ultimately it is for the courts to decide whether a term is assessable for fairness, but the OFT believes the exclusion from assessment needs to be as narrow as is compatible with the requirements of the underlying Directive – and in our view, it should only apply to terms concerning the main value-for-money proposition as it is in fact understood by both parties including the consumer. Consequently, we believe that many terms imposing charges should be assessable, including any such charges shown to be outside of ordinary consumers' consideration whether because they are payable on a remote contingency or for other reasons.

Test for fairness – how is fairness assessed?

6.14 An assessable standard term is unfair¹⁵⁴ if 'contrary to the requirement of good faith, it causes a significant imbalance in the

¹⁵³ As discussed in Chapter 1 the definitions of 'core' and 'small print' under the UTCCRs do not necessarily translate to the definitions of 'upfront' and 'small print' in the assessment framework

¹⁵⁴ The general test of fairness is set out at Regulation 5(1) of the UTCCRs.

parties' rights and obligations arising under the contract, to the detriment of the consumer.'

- 6.15 The requirement of good faith is not explicitly defined in the Regulations or in the underlying Directive, but has been taken to embody a general 'principle of fair and open dealing'.¹⁵⁵ Traders should set out to make terms transparent. Terms which might disadvantage the consumer should be given appropriate prominence. Good faith is, however, about more than transparency – it also covers the substance and use of terms. A trader should not take advantage of a consumer's weaker bargaining position or lack of experience as to rights and obligations in a contract. Contracts should respect consumers' legitimate interests.
- 6.16 There is also no definition in the Regulations or Directive of 'significant imbalance' in rights and obligations. Thus interpretation, and how to apply the test of fairness as a whole in practice, is left for the OFT and other enforcers, informed by the decisions of the courts.¹⁵⁶ The UTCCRs do, however, contain a non-exhaustive list of potentially unfair terms (a 'grey list').¹⁵⁷ The OFT has published guidance, with examples of terms it has considered fair and unfair, drawing on its own extensive experience of enforcing the Regulations.¹⁵⁸

¹⁵⁵ Per Lord Bingham of Cornhill in *Director General of Fair Trading v. First National Bank plc*.

¹⁵⁶ The reference to 'rights and obligations' does not limit the scope of the Regulations. Any feature of a contract can be described as a right or obligation, including the subject matter and any price (by inclusion in a contract, obligations on a trader to deliver and a consumer to pay, respectively).

¹⁵⁷ Schedule 2, described in the test of fairness at Regulation 5 as an 'indicative and non-exhaustive list' of terms that may be considered unfair.

¹⁵⁸ See OFT311: www.offt.gov.uk/shared_offt/reports/unfair_contract_terms/oft311.pdf and also separate guidance notes on the application of the Regulations to specific industries.

6.17 Broadly speaking the UTCCRs offer good protection from unclear contract terms and from nasty surprises in small print (Screen 1a of the assessment framework). It is less clear how far the UTCCRs cover unfair terms hidden, as it were, in plain view or concerns we might have about exploitation of vulnerable consumers (Screen 1b) – other law, discussed below, is likely to be relevant here.

6.18 Table 5 below examines in more detail how the UTCCRs correspond to the effects-based approach embodied in the assessment framework.

Table 5: Economic and legal approaches (UTCCRs) to assessing consumer harm

Contribution to harm according to OFT's economic approach	UTCCRs provision
<p>Screen 1a 'Are there any significant surprises in the small print?'</p> <p>Prima-facie harm when a consumer cannot assess an unfavourable term not drawn to his/her attention.</p>	<p>A term is liable to fail the test of fairness if it creates a significant and unexpected imbalance to the detriment of the consumer, particularly because of the risk of the term's use being considered contrary to the requirements of good faith.</p> <p>However, the term may not be assessable for fairness to the extent that it deals with 'core' issues and is in plain and intelligible language.</p> <p>It is possible for our economic approach to find harm and consider a term surprising, but for a court to disagree on either point, for example because the concept of a hypothetical 'reasonable' person may not be identical to the actual consumers we consider to be involved in the case.</p>
<p>Examples of unfavourable surprises in small print:</p>	<p>Many terms capable of being considered harmful under our economic approach appear on the 'grey list' of terms likely to fail the test of fairness (Schedule 2 of the UTCCRs) or are in the OFT guidance on how the test of fairness applies beyond the non-exhaustive illustrations in the grey list, for example:</p>

	<ul style="list-style-type: none"> • terms that seek to: <ul style="list-style-type: none"> ○ allow a trader to vary what is supplied or vary terms generally.¹⁵⁹ • terms that seek to: <ul style="list-style-type: none"> ○ set charges for breach of contract or any other compensation to a trader above a reasonable pre-estimate of losses the consumer causes the trader¹⁶⁰ ○ allow the trader to impose any unexpected financial burdens (irrespective of traders' costs).¹⁶¹ • terms that seek to: <ul style="list-style-type: none"> ○ put the consumer at unexpected risk¹⁶² ○ deny the consumer redress for the trader not delivering on the contract or restrict the consumer's statutory rights¹⁶³ ○ allow a trader to escape its duty to perform its legal obligations¹⁶⁴ or limit liability for physically harming or killing the consumer.¹⁶⁵ • terms that seek to: <ul style="list-style-type: none"> ○ tie the consumer into the contract with weak or no cancellation rights, including excessive notice periods¹⁶⁶ ○ impose onerous ancillary obligations.¹⁶⁷
Screen 1b 'Do consumers properly assess the deal	There is no equivalent transparency test expressly set out in the UTCCRs. However the OFT considers

¹⁵⁹ UTCCRs: Schedule 2, paragraph 1(j). OFT guidance: Group 10.

¹⁶⁰ UTCCRs: Schedule 2, paragraph 1(e). OFT guidance: Group 5.

¹⁶¹ OFT guidance: Group 18(a).

¹⁶² OFT guidance: Group 18(b).

¹⁶³ UTCCRs: Schedule 2, particularly paragraph 1(b). OFT guidance: Group 2.

¹⁶⁴ UTCCRs: Schedule 2, particularly paragraphs 1(b) (c), and 1(o). OFT guidance: Groups 2, 3 and 15

¹⁶⁵ UTCCRs: Schedule 2, paragraph 1(a). OFT Guidance: Group 1.

¹⁶⁶ UTCCRs: Schedule 2, paragraphs 1(f) and (h). OFT guidance: Groups 6(a) and 8.

¹⁶⁷ OFT guidance: Groups 18 (g) and (h).

<p>and act on the implications?'</p> <p>Prima-facie harm when a consumer does not, with good reason, fully assess an unfavourable term drawn to her attention.</p>	<p>that this test is to some extent encompassed in the requirements of plainness, intelligibility and good faith, including openness and fair dealing. The UTCCRs ask whether:</p> <ul style="list-style-type: none"> • a term is in plain and intelligible language, which includes whether the consumer can understand not just the words but their effect, and • its use is consistent with the requirement of good faith, which is broadly about openness and fair dealing in general, and so can cover transparency issues. <p>The underlying Directive specifically indicates that consideration must be given to whether the consumer actually has an opportunity to read all the terms.</p> <p>We believe that a term may not be in plain and intelligible language if it has objectively difficult implications that are not fully explained by the trader: even if consumers are notified of it, it may remain hidden in plain view. It may also be unfair for the same reasons.</p> <p>Different courts in different contexts will reach different views on how far a business needs to go to explain matters to consumers.</p> <p>In some cases, though, sector-specific regulations may mandate explanations or illustrations, such as the Consumer Credit Act and FSA Regulations and Rules on contracts for financial products.</p>
<p>Screen 2: 'Can consumers avoid the term?'</p>	<p>The UTCCRs set out how contract terms may be unfair. Control is not specifically addressed, but if consumers are not able to avoid the term, this may be relevant to the assessment of good faith.</p>
<p>Screen 3: 'Is there a countervailing benefit?'</p> <p>Benefits to the same consumer from the same term that causes prima-facie harm.</p>	<p>When applying the fairness test one has to look at the significant imbalance in parties' rights and obligations arising under the contract. This necessarily involves considering any benefits the consumer received under the contract. However, a term in itself can have the potential for unfairness, even if there are other terms in the contract which benefit the consumer, or indeed the consumer received a good deal overall.</p>

Protections from misleading behaviour and undue pressure: the CPRs

6.19 The CPRs protect consumers from unfair commercial practices rather than unfair contract terms per se, though the use of particular terms can be a commercial practice for the purposes of the CPRs. Furthermore the CPRs offer some protection in respect of how contracts are sold.

6.20 The CPRs require traders to treat consumers fairly in a general sense before, during and after contracts are formed – so that consumers' transactional decisions (including decisions whether to contract with a business) are not distorted and so consumers get the goods or services they expect.¹⁶⁸ The CPRs have several key provisions:

- traders are prohibited from making misleading actions or omissions that cause the average consumer to make a transactional decision s/he would not have otherwise taken. Thus traders are prohibited from misrepresenting the terms of a contract or any relevant law such as statutory cancellation rights.¹⁶⁹
- traders are prohibited from engaging in aggressive commercial practices, for example to compel consumers to sign contracts.¹⁷⁰
- traders are prohibited from engaging in various specific banned practices.¹⁷¹

¹⁶⁸ The CPRs rationalise and replace a range of former legislation on trade descriptions, misleading advertising and other unfair practices such as pressure sales.

¹⁶⁹ Regulations 5 and 6 of the CPRs.

¹⁷⁰ Regulation 7.

¹⁷¹ Schedule 1 to the CPRs.

- there is a general prohibition on any conduct that is not 'professionally diligent' and that may materially distort the economic behaviour of the average consumer.¹⁷² This is a catch-all for unfair commercial practices that may not fall under the specific prohibitions. The professional diligence required of traders is defined broadly to include honest practice and good faith.¹⁷³

6.21 In determining whether a trader has breached the prohibitions (with the exception of the banned practices), we and other enforcers are required to assess whether decisions of the average consumer are distorted as a result of a trader's practice. This may be the average consumer targeted by the practice or the average vulnerable consumer rather than the average consumer.

6.22 Traders breaching the prohibitions can face civil or criminal enforcement by the OFT and other enforcers.

6.23 Table 6 below illustrates how the CPRs may apply to harms identified by the OFT's economic approach.

Table 6: Economic and legal approaches (CPRs) to assessing consumer harm

Contribution to harm according to OFT's economic approach	CPRs provision
Screen 1a 'Are there any significant surprises in the small print?'	Omitting to mention material information the consumer needs is prohibited as a misleading omission. A business can breach this prohibition by hiding the information in small print, without flagging it up, or by providing the information too late or in an unclear way. Regular use of surprisingly harmful standard terms may be prohibited as a misleading act and also a breach of the general prohibition against failing in professional diligence
Screen 1b 'Do consumers properly assess the deal and act on the implications?'	The CPRs may prohibit a trader from using a term assessed as harmful at this screen since using it may breach the general prohibition of

¹⁷² Regulation 3.

¹⁷³ Regulation 2.

	<p>failing in professional diligence or amount to a misleading action or omission.</p> <p>A trader may fail in professional diligence if it does not take steps to help consumers understand terms which are difficult for the average consumer to understand or take on board.</p> <p>It may amount to a misleading action/omission or a failure of professional diligence if a trader presents any terms so as to confuse or manipulate consumers.</p> <p>The CPRs explicitly prohibit pressure sales and other tactics that force consumers to overlook or misunderstand terms.</p> <p>The CPRs provide a route for the OFT to address harms which may escape the UTCCRs – such as core price terms that are in plain language but that nonetheless may be presented so as to manipulate psychologically. The OFT's study of the Advertising of Prices explores how traders affect consumers' decisions to buy goods or enter contracts by using descriptive tactics. That study explores in detail the applicability of the CPRs to price descriptions.¹⁷⁴</p>
<p>Screen 2: 'Can consumers avoid the term?'</p>	<p>The CPRs are breached when consumers' transactional decisions are distorted. Even when consumers can control unfavourable terms at the trigger point, or learn to avoid them, transactional decisions may still be distorted and so the regulations breached.</p>
<p>Screen 3: 'Is there a countervailing benefit?'</p>	<p>The CPRs do not address the question of whether unfavourable contract terms have beneficial aspects. The Regulations focus on unfair commercial practices, including omitting to mention or explain unfavourable terms, rather than the details of terms themselves. However the question of countervailing benefit may be relevant in assessing whether the information is material, and whether its omission, for example, has an impact on the consumer's transactional decision making.</p>

¹⁷⁴ See OFT (2010a)

Regulations for specific markets and commercial practices

6.24 A range of legislation regulates specific markets and commercial practices where sharp practices by some traders have led to legal requirements to disclose key information and to give consumers extra legal rights such as cancellation periods beyond statutory minimums. The OFT has powers to intervene via consultation or court action to challenge contract terms or commercial practices that may breach regulations. Examples of acts and regulations used by the OFT are:

- The Distance Selling Regulations (DSRs).¹⁷⁵ The DSRs give consumers extended rights of cooling-off, cancellation and reimbursement (beyond normal statutory rights) in any contract entered at a distance (such as online or by home shopping) to compensate for the greater difficulty in assessing goods and services compared to in store. They also require certain key information to be provided to consumers.
- The Doorstep Selling Regulations¹⁷⁶, which give consumers extended rights of cooling-off, cancellation and reimbursement when they contract with a trader away from that trader's own business premises. These regulations help prevent contracts being signed in haste or under pressure, especially where consumers may not be able or prepared for negotiations.
- The Consumer Credit Act 1974 (CCA). The CCA lays down detailed rules about how agreements for consumer credit and hire purchase must be documented and explained, as well as on practices including early settlement by consumers and repossession by traders. The CCA provides a general cancellation right, and allows consumers to challenge credit agreements because of an "unfair relationship" between them and the creditor. Under the CCA the OFT also licences and

¹⁷⁵ The Consumer Protection (Distance Selling) Regulations 2000.

¹⁷⁶ The Cancellation of Contracts made in a Consumer's Home or Place of Work etc Regulations 2008.

monitors businesses involved in activities related to credit, including traders that lend money directly and those selling goods and services on credit.

- The Package Travel Regulations (PTRs).¹⁷⁷ The PTRs regulate the sale and performance of package travel contracts sold in the UK, in particular placing requirements on the information given to consumers before contracts are signed.
- The Timeshare, Holiday Products, Resale and Exchange Contracts Regulations 2010, which provides cooling-off rights for consumers and information requirements for traders involved in sale and resale of timeshares and holiday clubs.¹⁷⁸
- The Supply of Goods (Implied Terms) Act 1973, The Sale of Goods Act 1979 and The Supply of Goods and Services Act 1982 which amongst other things specify terms that should be implied for the benefit of consumers in hire-purchase agreements, contracts for the sale of goods and contracts for the sale of services, respectively, as well as setting out the remedies available to consumers if the terms are breached.
- The Unfair Contract Terms Act 1977 which regulates the use of terms which seek to restrict or exclude a trader's liability in various areas (for example liability for death, personal injury or breach of the Sale of Goods Act).

6.25 Table 7 below illustrates how these regulations may apply to harms identified by the OFT's economic approach.

¹⁷⁷ The Package Travel, Package Holiday and Package Tour Regulations 1992.

Table 7: Economic and legal approaches to assessing consumer harm

Contribution to harm according to OFT's economic approach	Provisions
Screen 1a 'Are there any significant surprises in the small print?'	In each case, regulations may be breached if specific types of information are not disclosed at the correct time.
Screen 1b ' Do consumers properly assess the deal and act on the implications?'	Most of the regulations compensate for consumers' difficulties by mandating information requirements, cooling-off periods and cancellation rights. Regulations are breached if these are not provided.
Screen 2: 'Can consumers avoid the term?'	The law recognises that in the case of standard terms consumers may not be able to avoid terms or mitigate any negative effects by way of negotiation. Again, to some extent regulations compensate for this by mandating Information requirements, cooling-off periods and cancellation rights.
Screen 3: 'Is there a countervailing benefit?'	The various regulations tend to be silent on this question as they were designed to address specific terms and practices shown to cause net harm.

Conclusion

- 6.26 In general, consumer law addresses well the various harms suffered by consumers due to unfavourable contract terms. Existing laws are likely to allow the OFT to prevent terms being used when they are considered harmful under the assessment framework, and in some cases we may have more than one legal tool to address the harm identified.
- 6.27 There are some areas of uncertainty, for example around the exclusion from assessment for fairness under the UTCCRs. Our past experience suggests that, for the UTCCRs to achieve their purpose, the exclusion from assessment for fairness should be narrow, because consumers clearly and consciously agree relatively few terms relating to price.
- 6.28 On balance, however, the law provides considerable protection to consumers in relation to contracts and provides a suite of tools which we can use to tackle those consumer contract terms which we identify as likely to give rise to consumer detriment.

7 PROBLEMATIC TERMS AND PRACTICES

7.1 The previous chapters of this report set out the OFT's thinking about potentially harmful terms in consumer contracts. This chapter considers a number of common types of contract term, illustrating how they can cause detriment in practice:

- **terms setting the scope** of contract subject matter, for example details of what is to be delivered
- **terms covering risks** to contract delivery, such as traders' liabilities for failure or external disruption
- **remote charges:** any contract prices that consumers may not expect or take on board, such as any in small print or, if upfront, that are contingent, deferred or complex, and
- **terms covering cancellation and switching** (key aspects of consumer control), such as notice periods, cancellation fees and rollover terms

7.2 These types cover many terms found in practice. Together, they also cover a very high proportion of the contract problems that the OFT and other authorities have dealt with in the past, and continue to deal with.¹⁷⁹

Contract scope

7.3 Consumers can be disadvantaged when the contract delivers less than the consumer expected, for example through restrictions of service or quality which are not clearly explained. Difficulties can arise for example where:

- consumers find it hard to judge in advance the value of memberships and subscriptions

¹⁷⁹ We give examples where details of our cases can be made public. This is not possible for some current and planned enforcement action.

- contracts are inherently complex, and cover many contingencies that may not be salient when consumers first enter the contract but which later become important or
- contracts for outcomes contain technical or professional elements that consumers must take on trust. For example, in home repairs consumers must, to some extent, trust the trader about both what work is needed and its quality when complete.

Problems encountered

7.4 The OFT and other organisations have previously identified a number of scope problems that have arisen in practice including:

- Which? found examples of clauses in car hire contracts which stated that if customers could not produce the keys in the event of the car being stolen, they could be liable for the full value of the vehicle.¹⁸⁰
- The Financial Ombudsman Service (FOS), which settles disputes between consumers and financial services providers, has found examples of traders leaving important exclusions in the small print. However, FOS dismisses complaints when consumers ignore exclusions displayed prominently in Keyfacts sheets or fail to apply common sense.¹⁸¹
- Timeshares and other holiday clubs are especially hard for consumers to evaluate before sign-up. A common complaint is that there is a discrepancy between the deal implied by sales people, and the reality of, for example, the way the property is managed and maintained. The OFT has taken frequent action

¹⁸⁰ See Which? (2010).

¹⁸¹ See the FOS *Ombudsman News* series, available at: www.financial-ombudsman.org.uk/publications/ombudsman.htm

to improve the transparency of contracts and the behaviour of marketers.¹⁸²

- The OFT has acted against football season tickets that appear to offer but do not secure a seat at all home games.¹⁸³
- Package holidays come with associated consumer protections (specific cancellation rights and guarantees).¹⁸⁴ Sometimes, when travel agents, websites or other intermediaries construct consumers' holidays from individual components (travel, hotels, activities) the intermediary may imply or the consumer infer that there is a package when there is not. The problem is common enough that the European Commission is reviewing package travel legislation.¹⁸⁵
- The OFT, FSA and Competition Commission jointly intervened in relation to extended warranties and payment protection insurance (PPI). Both products tended to be offered simultaneously with associated goods or services, and were widely mis-sold by misleading descriptions and sales pressure. The effect on consumers and the relevant market was exacerbated by lack of competition at the sales point.
 - In the case of extended warranties, consumers bought poor-value protection (for example covering little more than a product's standard guarantee) when salespeople

¹⁸²Office of Fair Trading (2003b); and Office of Fair Trading (2006a)

¹⁸³ See for example: www.of.gov.uk/news-and-updates/press/2009/43-09

¹⁸⁴ Under the Package Travel, Package Holidays and Package Tours Regulations 1992, which implemented the Council Directive of 13 June 1990 on package travel, package holidays and package tours (90/314/EEC) also known as the European Package Travel Directive, which is currently under review.

¹⁸⁵ The Commission is considering modifying the European Package Travel Directive to protect consumers buying separate holiday arrangements interpretable as packages (sometimes known as 'dynamic packaging'). Some of the work done by the Commission to date on the Directive can be found on website of the European Union: see http://ec.europa.eu/consumers/cons_int/safe_shop/pack_trav/index_en.htm).

exaggerated costs of independent repairs, playing on consumers' desires to protect new purchases when there was little published information on their reliability.

- PPI protects consumers' payments under credit agreements, often in case of ill health or unemployment.¹⁸⁶ The contracts can be very complex. Consumers often could not determine whether payouts would exceed premiums paid. Furthermore salespeople had sometimes distorted consumers' decisions by implying that taking out PPI would help applications for credit.

Relevant provisions in the law

7.5 Certain problems with scope are specifically addressed under the UTCCRs.¹⁸⁷ Terms may be unenforceable and therefore subject to legal challenge if they seek to:

- exclude or restrict liability for failure to perform contractual obligations¹⁸⁸
- give the trader too wide a discretion in relation to the contract¹⁸⁹
- allow the trader to vary what is supplied or vary terms generally¹⁹⁰

¹⁸⁶ On PPI see: www.ofc.gov.uk/OFTwork/markets-work/completed/payment and websites of the FSA and Competition Commission. On extended warranties, see other sites and: www.ofc.gov.uk/OFTwork/markets-work/completed/warranties

¹⁸⁷ More general legal protections under the UTCCRs, CPRs, and other regulations are described in Chapter 6

¹⁸⁸ UTCCRs: Schedule 2, paragraph 1(b).

¹⁸⁹ UTCCRs Schedule 2, paragraph 1(i) and 1(m).

¹⁹⁰ UTCCRs : Schedule 2, paragraph 1(j) and (k).

- bind consumers while allowing the trader to provide no service¹⁹¹ or
- bind the consumer where the trader defaults.¹⁹²

Provisions for risks

- 7.6 This section covers risks to the delivery of contractual services, including external disruption or traders' failures to handle contingencies (for example to secure necessary inputs or manage overbooking). Risks to delivery are particularly common in contracts for outcomes.
- 7.7 From an economic efficiency perspective, the costs associated with a risk should fall more heavily on the party who can influence the probability of the risk occurring,¹⁹³ or can most cheaply insure against it¹⁹⁴ – in most cases this will be the trader.

Problems encountered

- 7.8 Small print terms sometimes expose consumers to significant unexpected risks, or to unexpected costs of known risks. For example:
- OFT took action against a ferry company whose terms and conditions disclaimed liability for early departures, delays, diversions or cancellations¹⁹⁵

¹⁹¹ UTCCRs: Schedule 2, paragraph 1(c) and (i).

¹⁹² UTCCRs: Schedule 2, paragraph 1(i) and (o).

¹⁹³ For discussion of how producer liability can correct the incentives to provide cheaper, higher-risk products that result from consumers mis-perceiving risk see Spence (1977).

¹⁹⁴ See OFT guidance OFT311: Analysis of other terms considered potentially unfair, Group 18(b). The guidance can be found on the OFT website at: www.of.gov.uk/shared_of/reports/unfair_contract_terms/oft311.pdf

¹⁹⁵ See www.of.gov.uk/OFTwork/consumer-enforcement/traders/2539/1/

- OFT has acted against traders attempting to restrict consumers' legal remedies, for example a landlord whose contracts included a term providing for the tenant to forfeit their lease without making it clear that the landlord would need a court order to evict.¹⁹⁶
- To deal with the unexpected risks that can affect air travel, the EU introduced specific regulation that dictates how airlines deal with delays, cancellations, and other contingencies, depending on whether they are caused by the airline or external factors.¹⁹⁷
- The OFT intervened on sale and rent back deals. Among other problems, some consumers did not take on board that, having sold their property to a landlord, their subsequent tenancy was not secure. Some consumers had been made aware of the short-term nature of the tenancy but understood it to be just a formality. Other consumers were more clearly aware of the risks but felt compelled to accept due to financial desperation and impressions that the market offered no better deals.¹⁹⁸

Remote charges

7.9 A 'remote' charge is any element of price that consumers either do not expect or do not fully take into consideration when deciding to purchase.

7.10 Charges that are delayed, contingent or complex, can be particularly challenging for consumers to correctly assess. Experimental evidence (see Annexe F) confirms that consumers are more prone to make errors when charges are deferred or

¹⁹⁶ For an example of the OFT acting against the use of the latter such term, see www.offt.gov.uk/OFTwork/consumer-enforcement/traders/3197/1/

¹⁹⁷ The Civil Aviation (Denied Boarding, Compensation and Assistance) Regulations 2005

¹⁹⁸ The problems was sometimes that relevant contract terms were in small print (which would fail Screen 1a) and sometimes that consumers seeing terms did not take them on board. See: www.offt.gov.uk/OFTwork/markets-work/completed/saleandrent

contingent, and that these errors are more significant when decisions are made under time pressure.

7.11 The OFT's Advertising of Prices market study¹⁹⁹ published evidence on how methods for presenting prices can alter consumers' subjective impressions of a deal, inducing them to make purchases they later regret. The methods include drip pricing, whereby a total price is revealed gradually – say by sequential web pages. In some ways this mirrors typical contract sales processes, where some small print terms may only become apparent to consumers later in the process or in some cases only after they have entered the contract. The research confirmed that gradual revelation of prices can make consumers underestimate total costs.

7.12 As explained in Chapter 5, our position on remote charges is that:

- if the charge is genuinely transparent and understood by the consumer, then we would not consider there to be grounds to intervene
- if however consumers do not fully take this charge into account when entering into the contract – either because the charge is in the small print, or because consumers are unable to assess it properly for any other reason – the charge should be set at cost

Problems encountered

7.13 Examples where consumers may have been unpleasantly surprised or otherwise disadvantaged by remote charges include:

¹⁹⁹ Office of Fair Trading (2010a)

- Car hire contracts - past studies²⁰⁰ have found that compensation charges for loss or damage are rarely summarised or illustrated on websites or by salespeople, leaving them as small print. Though this may not be harmful in itself, consumers regularly complain about charges felt to be excessive (such as traders seeking to replace merely chipped windscreens) or that cannot be disputed (such as when consumers' credit cards are pre-authorised but consumers do not know that charges can be levied without notice or appeal). This report includes a case study on car hire charges (see Annexe C).
- Personal Current Accounts (PCAs) - the OFT market study²⁰¹ found that over a fifth of consumers were unaware of insufficient funds (unauthorised overdraft) charges until incurred. Of those consumers incurring insufficient funds charges, the average incurred was £205. Following the publication of the market study, the OFT has worked with the industry to increase transparency of charges and take steps to give consumers greater control over these charges.²⁰²
- Utilities contracts:
 - Ofgem's last Energy Supply Probe²⁰³ found various energy deals with non-transparent contingent charges, such as tariff escalations depending on multiple factors

²⁰⁰ For example, complaints to Consumer Direct: 159 in Sept/Oct 2009: added charges (18% of complaints); disputed damage (17%); overcharged (6%); deposit not returned (6%); unexpected credit card deduction (8%); refund issues (10%). Also: European Consumer Centres Network, see: http://ec.europa.eu/consumers/redress/ecc_network/car_rental_report2005.pdf Which?, see: www.which.co.uk/news/2010/09/top-ten-car-hire-tips-227822/ AA Eurotest, see: www.theaa.com/public_affairs/news/aa-eurotest-car-hire-survey-2009-564656.html

²⁰¹ July 2008, see: www.offt.gov.uk/OFTwork/markets-work/completed/personal/

²⁰² See: www.offt.gov.uk/news-and-updates/press/2010/26-10

²⁰³ See: www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Pages/Energysupplyprobe.aspx

- In 2008, Ofcom reviewed contingent charges in telecoms contracts,²⁰⁴ finding some that were poorly advertised or high when encountered, including fees for ancillary services (to itemise bills or process payments), late or missed payments, and contract termination. Difficulty assessing complex prices may explain the recent finding by Which? that 10 million consumers may be on the wrong mobile phone tariff.²⁰⁵
- Residential contracts. The OFT has acted against excessive or arbitrary charges in tenancy agreements²⁰⁶ and against hidden renewal fees in letting agency contracts. The latter are sometimes charged to landlords when an existing tenant stays on in a property after an initial tenancy, even where the agent is no longer actively involved.²⁰⁷ This report includes a case study on letting agents' fees (see Annexe C). The OFT is also currently investigating whether transfer fees in retirement homes are unfair.

Cost calculation

7.14 In assessing whether charges are 'at cost', we will consider available evidence on a case-by-case basis but in principle will aim to benchmark against Long-Run Average Incremental Costs (as explained in Chapter 5).

²⁰⁴ See: <http://stakeholders.ofcom.org.uk/consultations/addcharges/>

²⁰⁵ <http://conversation.which.co.uk/mobile/mobile-phone-tariffs/millions-of-mobile-users-overpay-on-their-monthly-contracts/>

²⁰⁶ See www.ofg.gov.uk/shared_ofg/reports/unfair_contract_terms/oft356.pdf

²⁰⁷ See: www.ofg.gov.uk/OFTwork/consumer-enforcement/consumer-enforcement-completed/foxtons/

7.15 An example of such a cost calculation is the one the OFT set out in respect of default charges in credit card contracts,²⁰⁸ specifically that such charges should:

- reflect a reasonable pre-estimate of the net²⁰⁹ limited additional administrative costs which occur as a result of the specific breaches of contract and which can be identified with reasonable precision
- reflect a fair attribution of those costs between defaulting consumers
- be based on a genuine estimate of the total numbers of expected instances of default in the relevant period, and
- treat costs other than those net limited additional administrative costs as a general overhead of the credit card business which is disregarded in the calculation of a default fee

7.16 Similarly, Ofcom has set out that charges (or foregone discounts) levied on consumers that pay by methods other than direct debit, should only recover costs that are directly and causally attributable to the method of payment used. This excludes costs that may be associated, but not caused, by the payment method, such as general 'bad debt' costs associated with the provision of credit.²¹⁰

Measures to prevent detriment

7.17 In some cases, even prices set at cost can be surprisingly high and harm consumers, who might not have entered the contract

²⁰⁸ These principles are explained more fully in Office of Fair Trading (2006b). Ofcom (2010b) applies similar principles to communications contracts.

²⁰⁹ This denotes that a default charge should take into account a credit card issuer's expected ability to mitigate the loss it suffers as a result of default

²¹⁰ Ofcom (2010b)

had they been aware of the fee. In that case, the only way to avoid consumers being unpleasantly surprised by the term would be to bring it to their attention in good time.

- 7.18 In some sectors, an appropriate protection may be to give the consumer rights to challenge the fee on grounds of reasonableness. For example, leaseholders have the right to challenge service charges to freehold landlords.²¹¹
- 7.19 Elsewhere, consumers may benefit from being warned that they are in danger of incurring a charge, and having the opportunity to avoid it. For example, a survey carried out for the Personal Current Accounts market study found that 60 per cent would rather have a payment refused than enter into an unarranged overdraft.²¹²

Relevant provisions in the law

- 7.20 Certain problems with remote charges are specifically addressed under the UTCCRs,²¹³ for example terms that create unexpected price variation,²¹⁴ unfair penalties²¹⁵ or unfair financial burdens.²¹⁶
- 7.21 We have also published guidance on how the UTCCRs apply to default charges in credit card contracts.²¹⁷

²¹¹ www.direct.gov.uk/en/HomeAndCommunity/BuyingAndSellingYourHome/Leaseholdproperties/index.htm

²¹² The OFT's views on consumer control in unarranged overdraft fees are described in Office of Fair Trading (2009) *Personal current accounts – unarranged overdraft fees, decision on an investigation under the UTCCRs and next steps*

²¹³ More general legal protections under the UTCCRs, CPRs, and other regulations are described in Chapter 6

²¹⁴ UTCCRs: Schedule 2, paragraph 1(l).

²¹⁵ UTCCRs Schedule 2 paragraph 1(e)

²¹⁶ OFT guidance, OFT311: Analysis of other terms considered potentially unfair, Group 18(a).

