Options for fair early termination fees in consumer contracts

Consumer Affairs Victoria

Victoria The Place To Be

Department of Justice

Options for fair early termination fees in consumer contracts is a research paper, approved by the Director of Consumer Affairs Victoria, for an informed audience to prompt discussion on the calculation of early termination fees and Consumer Affairs Victoria's role in informing industry about the issue.

Disclaimer

Because this publication tries to avoid the use of legal language, information about the law may have been expressed in general statements. This paper should not be relied upon as a substitute for professional legal advice.

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1. Introduction

Since the introduction of Part 2B of the *Fair Trading Act 1999*, which voids unfair terms in consumer contracts, Consumer Affairs Victoria (CAV) has conducted reviews of the standard form contracts used in the domestic building, curtains and carpets, health and fitness, hire car, internet service provider, mobile phone, motor vehicle, pay TV and airline industries, among others.

One matter that arises frequently in what may be called 'ongoing' contracts – particularly those for the ongoing provision of services – is early termination fees (ETFs). Early termination is usually a breach of the contract but some contracts allow the consumer to terminate early and some provide for early termination on the occurrence of a stated event. In whatever way an early termination arises, the contract usually requires the consumer to pay an ETF which is, or is claimed to be, compensation for the loss the supplier will suffer because of the early termination.

In CAV's publication, *Preventing unfair terms in consumer contracts – Guidelines on unfair terms in consumer contracts* (2nd ed 2007) the material under 'penalty clauses' considers only a few circumstances in which ETFs would be considered unfair under the Fair Trading Act (see further below).

This research paper aims, firstly, to describe the economic benefits that consumer contracts with fair ETFs provide to the economy and, secondly, to go beyond the limited material in CAV's Guidelines and explore whether there could be a more prescriptive basis for generally determining how a fair ETF should be calculated.

Following work by the Commonwealth, states and territories, from 1 July 2010 unfair contract terms protections for consumer contracts will be available under the provisions of the Australian Consumer Law.

This paper is designed to provide a rigorous basis for discussion about how ETFs should be calculated so as not to be unfair. The views in this paper are those of CAV and do not represent Victorian Government policy.

2. Background

2.1 The general law

ETFs are a form of liquidated damages for breach of contract: in this case breach of the obligation not to terminate the contract before the expiry date. The general law on liquidated damages only regulates ETFs imposed where early termination is a *breach* of the contract, not where the early termination is allowed, upon payment of the fee[1].

To be valid, such an ETF must be a genuine pre-estimate of the loss that the supplier would suffer by the breach[2], which can be a genuine pre-estimate of the supplier's lost net profit (sometimes referred to as 'loss-of-bargain damages' or 'expectation loss') or of its wasted costs (sometimes referred to as 'reliance loss').

The issue under the general law is whether an ETF is a genuine *pre-estimate* of loss, so that the assessment is made prospectively, as at the date of the contract. The general law does not look, ex post facto, at the amount actually charged and compare it with the actual loss suffered, so it is irrelevant if the amount ultimately imposed under an ETF proves to be more (even a lot more) than the actual loss suffered.

The cases and materials on the general law issue indicate that *wasted costs* are composed of:

- the up-front costs incurred in the preparation for or the setting up of the contract (including the cost of inducements to enter into the contract[3]);
- **plus** the costs incurred in the course of the performance of the contract to the date of termination (excluding any components for fixed costs/overheads, which would have been incurred regardless of the early termination)
  - **less** the extent that those costs are recouped, for example by payments under the contract.

[1] Although there is some authority to the contrary (*International Leasing Corp (Vic) Ltd v Aiken* [1967] 2 NSWR 427 at 441-2).

[2] Otherwise, it is a 'penalty' or a 'fine' and unenforceable. The classic statement on the issue is from *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79 (per Lord Dunedin at 86-7): 'The essence of a penalty is a payment of money stipulated as in *terrorem* of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage … It will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach'. The High Court has amplified this by stating that 'the propounded penalty must be judged "extravagant and unconscionable in amount". It is not enough that it should be lacking in proportion. It must be "out of all proportion" ' (*Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] HCA 71 at [32]).

[3] Including the discount off the price payable under a more expensive contract or arrangement that the supplier would have entered into, had it known at the outset that the consumer would only proceed until the termination date. This is in the nature of recoupment of the opportunity cost of the early termination, not recoupment of lost profit. The alternative contract must be real, not a sham designed to support the charging of the alleged opportunity cost.

and that:

- *lost net profit* is composed of:
    - the unpaid amount of the contract price
    - **less** the costs that would have been incurred in performing the remainder of the contract
    - **less** the requisite discount for the value of the early receipt of the remainder of the contract price[4]
    - **less** the value of the supplier's obligation to take reasonable steps to mitigate its loss, for example, the net proceeds of any resale of goods recovered or the net value of any replacement contract that did eventuate or should have eventuated.

In both cases, the supplier would also be entitled to include provision for any special costs (not normally significant) caused by the early termination that would not otherwise have been incurred, for example time spent processing forms that would not have been spent at the normal expiry of the contract[5]. But if a wasted-costs ETF includes the opportunity cost referred to in footnote 3, these special costs may not be recoverable because they involve double-dipping in that they would not have been payable if the consumer had entered into the alternative contract.

Invariably, a wasted-costs ETF that is simply a flat or fixed amount, applying regardless of when the contract is terminated, cannot be a genuine pre-estimate because it does not attempt to take account of the extent to which those costs will be recouped or amortised, for example by the payments received under the contract (the amount of which will vary according to when the contract is terminated).

Similarly, an ETF that simply requires the paying out of the remainder of the contract price (sometimes called an 'accelerated payment' clause) cannot be a genuine pre-estimate of the supplier's lost *net* profit because it does not attempt to take account of the costs that would have been incurred in performing the remainder of the contract, the early-receipt discount or any offsetting factor.

[4] And less the value attributable to freeing up, for other uses, the resources dedicated to the contract, although query whether that is quantifiable.

[5] Note that an ETF is to be distinguished from other charges that may apply at the termination of a contract, for example interest charged on unpaid amounts.

2.2 Unfair contract terms under Part 2B of the Fair Trading Act

Part 2B was inserted into the Fair Trading Act in October 2003 following a recommendation of the Fair Trading Act Review Reference Panel in 2002[6]. It is based on the *Unfair Terms in Consumer Contracts Regulations 1999* (UK)[7].

Under Part 2B, unfair terms in consumer contracts are void. An unfair term is one that, in all the circumstances, causes a significant imbalance in the parties' rights and obligations arising under the contract to the detriment of the consumer (section 32W). There is a (non-exhaustive) list of matters that can be taken into account in assessing whether a term is unfair (section 32X).

The test of unfairness will apply whether an ETF is imposed because early termination is a breach of the contract, or as a consequence of the consumer exercising a right to terminate early, or as a consequence of the contract terminating early because of the occurrence of a stated event.

Part 2B also applies regardless of the form of the term under which an ETF is payable. An ETF that fails the general law test would be unfair but those that are structured to avoid the general law doctrine would not avoid scrutiny under Part 2B. This would also apply to ETFs in the guise of rights to forfeit pre-payments.

Further, the question under Part 2B is whether the term causes a *significant* imbalance. This means that unlike under the general law, judging the unfairness of an ETF under Part 2B would not appear to be restricted to whether the imbalance is 'extravagant and unconscionable'/'out of all proportion'.

Another issue is whether the unfairness of a term under Part 2B is assessed only at the time the contract was entered into[8] or whether it can also be assessed at the time the term is enforced. In the context of ETFs, the question is whether in its terms or in its application, an ETF can cause a significant imbalance to the detriment of the consumer.

Support for the broader interpretation could be found in the wording of section 32X, which refers to a list of exemplary terms that have the relevant 'object' (meaning at the time of entering into the contract) or 'effect' (meaning at the time the term is applied/enforced).

[6] In 2001, the then Minister for Consumer Affairs, Marsha Thomson MP, constituted a reference panel of consumer, industry, academic and legal representatives, chaired by Bob Stensholt MP, to formulate an issues paper for public consultation and to recommend amendments to the Act. The amendments to give effect to the panel's various recommendations, including the insertion of Part 2B, were included in the Fair Trading (Amendment) Act 2003.

[7] The 1999 Regulations replaced the Unfair Terms in Consumer Contracts Regulations 1994; both regulations implemented European Council Directive 93/13/EEC on unfair terms in consumer contracts.

[8] cf reg 6 of The Unfair Terms in Consumer Contracts Regulations 1999 (UK) which requires the assessment of unfairness to be made 'at the time of the conclusion of the contract'.

But in the Victorian Supreme Court case of *Jetstar Airways v Free* [2008] VSC 539, Cavanough J said, at [119]: 'In the UK, express provisions make it clear that the time of the contract is the only relevant time. No express equivalent exists in Victoria, but, in my view, the same is clearly implied'. (It must be noted that the comment was obiter dictum [non-binding opinion] and that the point was not the subject of argument or submission, including about the meaning of the words in section 32X.)

Further, if a term provides general benefits to the customers of a supplier but causes detriment to the complaining consumer, the question arises whether, 'in all the circumstances', the term causes a significant imbalance in the parties' rights and obligations under 'the contract' to the detriment of 'the consumer'[9].

In the English High Court case of *Office of Fair Trading v Abbey National Plc and others* [2008] EWHC 875 it was conceded by the banks that the charges they impose when customers exceed their credit limits without permission are not related to the costs of providing the services that triggered those charges but that they are designed to subsidise the provision of free banking for those who do not exceed their limit.

The banks argued that the charges and the free-banking pricing structure of which they form part 'are a proper basis for financing the provision of personal current account services generally'.

But Smith J said that the UK Regulations 'are concerned with the fairness of the individual contract between the seller or supplier and a particular consumer and are not directly concerned with whether seller or supplier treats fairly consumers as a whole'.

This approach treats 'the contract' and 'the consumer' (as those phrases appear in section 32W and in Reg 4 of the UK regulations) as referring to a particular or individual contract and to a particular or individual consumer respectively and not to the standard form contract in question and to any consumer who enters into that standard form contract.

But in an injunction application in relation to a term of a standard form contract (as was the case in *Office of Fair Trading v Abbey National Plc*) it is difficult to see why the issue should only be looked at in the more narrow way. On that basis, and given that section 32W looks to 'all the circumstances', a different conclusion might be drawn under Part 2B, so that in the context of ETFs, it might be permissible to have regard to any general benefits they provide to other customers of the supplier and the role that an ETF might play in supporting the supplier's business structure.

On the other hand, 'in all the circumstances' would not appear to justify having regard to circumstances outside the context of the relevant contract, including 'upstream' contractual issues[10] and broad economic or policy considerations.

[9] Section 32W asks whether 'a term in *a* consumer contract' causes a significant imbalance in the parties' rights and obligations under '*the* contract' to the detriment of '*the* consumer'. Similarly, reg 4 of the UK Regulations asks whether 'a contractual term' causes a significant imbalance in the parties' rights and obligations under '*the* contract' to the detriment of '*the* consumer'. However, s.32W requires that the assessment of unfairness be made taking into account 'all the circumstances', whereas reg 6 of the UK Regulations refers only to 'all the circumstances attending the conclusion of the contract'.

[10] In the Victorian Civil and Administrative Tribunal case of *Director of Consumer Affairs Victoria v AAPT Ltd* [2006] VCAT 1493, Morris J rejected as a justification for a term allowing AAPT to vary its consumer contracts unilaterally, that its 'upstream' contracts with Telstra, Optus and Vodafone (AAPT simply resold services supplied by these companies) allowed them to similarly change those contracts, and that there was therefore a commercial imperative to 'pass on' any such changes.

2.3 Unfair contract terms under the Australian Consumer Law

The creation of the Australian Consumer Law was engendered by the Productivity Commission's report into Australia's consumer policy framework titled *Review of Australia's Consumer Policy Framework*. In it, the Commission examined ways to improve the coordination of consumer policy development, the harmonisation of consumer laws and their administration across jurisdictions.

The ACL will constitute a single national consumer law which applies to the Commonwealth, states and territories. The Trade Practices Act 1974 will contain the ACL and make provision for its application, administration and amendment[11].

Like Part 2B, the ACL provisions will make unfair terms in consumer contracts void. But the ACL will have a different definition of 'unfair term'. Under the ACL, a term of a consumer contract will be unfair if:

(a) it would cause a significant imbalance in the parties' rights and obligations arising under the contract; and

(b) it is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term; and

(c) it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

Further, in determining whether a term is unfair, a court must take into account the contract as a whole and the extent to which the term is transparent and may take into account 'such matters as it thinks relevant'.

The explanatory memorandum to the ACL Bill draws the distinction between the position of an ETF under the general law and under the ACL. It states (chapter 2.60) that:

> **'to be valid [under the general law], a penalty imposed by a contract must be a genuine pre-estimate of the loss likely to be suffered by the party as a result of the breach or early termination, and should not be an arbitrary sum. However, under the unfair contract terms provisions the relevant consideration is whether the term is unfair, within the meaning given to that term by the provisions.'**

The 'meaning given to that term by the provisions' of the ACL would not appear to be materially different to that given by the provisions of Part 2B, including in relation to ETFs.

[11] The initial tranche of the ACL, composed mainly of the unfair contract term provisions, will come into operation on 1 July 2010. The full ACL is intended to be implemented by the Commonwealth, state and territory governments by the end of 2010 for commencement on 1 January 2011. In the interim, pending the implementation of the full ACL in Victoria, Victoria will amend Part 2B as of 1 July 2010 to align its provisions with the ACL provisions, with the intention that Part 2B will be repealed when the full ACL is applied in Victoria.

In particular, taking into account 'the legitimate interests of the party who would be advantaged by the term' (the supplier), 'the contract as a whole' and 'relevant matters' under the ACL would appear to be analogous to taking into account 'all the circumstances' under Part 2B, although the legitimate interests of the supplier might include its 'upstream' contractual obligations, a matter that is not within 'all the circumstances' under Part 2B (see above).

But in the context of ETFs, however, the legitimate interests of the supplier and other relevant matters would include the role that an ETF might play in supporting a particular business structure of the supplier and any general benefits to the supplier's customers that are protected by the existence of an ETF in a contract, but perhaps would not include broad economic or policy considerations (see further below).

2.4 CAV's Guidelines on unfair contract terms

CAV's *Guidelines on unfair terms in consumer contracts* set out that the following contract terms would be regarded as unfair:

- a requirement to pay an amount higher than a genuine pre-estimate of the loss that a supplier expects to suffer from an early termination;
- a requirement to pay a cancellation fee unrelated to the reasonable costs reasonably incurred by the supplier from the early termination; and
- a requirement to pay all of the supplier's costs and expenses arising from an early termination, not just the net costs.

This would include an ETF that is simply a flat/fixed amount and an ETF that simply requires the paying out of the remainder of the contract price (see above).

As stated above, the purpose of this paper is to explore whether more prescriptive guidelines can be provided for the calculation of a fair ETF

2.5 Other legislation dealing with ETFs

This section examines several jurisdictions that have created regulations dealing with ETFs across different industries.

2.5.1 Consumer Credit Code

Under section 72(1) of the Uniform Consumer Credit Code (UCCC), a court may void or vary an ETF that is 'unconscionable'. Section 72(4) states that an ETF is unconscionable only 'if it exceeds a reasonable estimate of the credit provider's loss arising from the early termination, including the credit provider's average reasonable administrative costs in respect of such a termination'.

The usefulness of this formulation for this paper is that the 'reasonableness' criterion in s.72(4) is close to the concept of unfairness under Part 2B (and the Australian Consumer Law). Unfortunately, there have not been any cases under s.72(4).

One view of these provisions is that they must be read in the light of the general law. That view holds that 'the credit provider's average reasonable administrative costs in respect of the termination' means wasted costs, and that because s.72(4) says that 'loss' *includes* those costs, 'the implication is that loss extends to the gains that the credit provider would have made if the contract had run its course, that is loss of bargain (expectation) damages'[12].

[12] See Duggan & Lanyon *Consumer Credit Law* para 10.2.12. The lost net profit would be any difference between what the lender would have gained under the contract if it had gone the full term and what it gains from re-lending the money at any lower interest rate.

But under the general law, the word 'including' in s.72(4) must be read down, that is, it cannot mean that 'loss' is composed of lost net profit *and* wasted costs because that would be double recovery. It must mean that an ETF under the Credit Code can be composed of lost net profit *or* wasted costs.

Another view is that the provisions need *not* be read in the light of the general law and that, on its plain meaning, s.72(4) suggests that the ETF should be restricted to wasted costs, that is, 'loss' refers to the costs wasted in the preparation for or in the setting up of the contract or in the course of the performance of the contract to the date of termination[13]; and 'average reasonable administrative costs in respect of the termination' refers to the average *special costs* incurred in processing an early termination.

The approach of the Credit Code, in referring somewhat ambiguously to 'the credit provider's *loss* arising from the early termination' can be compared to the approach in the UK to early termination of credit contracts, which focuses clearly on the *costs* of early termination to the lender. The Financial Services Authority, which regulates home loans, states in its *Mortgages and Home Finance: Conduct of Business Sourcebook* that:

'early repayment charges' must be 'a reasonable pre-estimate of the costs as a result of the customer repaying the amount due under the regulated mortgage before the contract has terminated', and that the interest component cannot be calculated according to the Rule of 78 'because it effectively overstates the cost to the mortgage lender'.

The UK Consumer Credit (Early Settlement) Regulations 2004, which cover consumer credit contracts other than home loans, also prohibit the calculation of the interest component of 'early settlement figures' using the Rule of 78. The 2003 White Paper on consumer credit[14], on which the regulations were based, states that the then-existing regulations, 'including the calculation formula known as the Rule of 78, can result in substantial benefits to the lender, as the settlement fee is not necessarily in proportion with the actual "breakage" costs associated with repaying the loan early'.

[13] Possibly including the opportunity cost in relation to any 'honeymoon' interest rate given as an inducement to enter into the loan contract; but cf Beatty & Smith *Annotated Consumer Credit Code and Regulations* para 72.30 who posit three possible approaches to 'loss': actual loss of money, loss of expected profit, and 'honeymoon rate' opportunity cost.

[14] *Fair, Clear and Competitive: The Consumer Credit Market in the 21st century* (Cm 6040)

2.5.2 Energy Retail Code – Electricity Industry Act 2001 and Gas Industry Act 2001

Energy companies must comply with the *Energy Retail Code* to receive licences under the above Victorian legislation. The Essential Services Commission administers the Code. It looked at ETFs in retail energy contracts in 2006.

The ESC's assessment of the relevant principles is helpful although these contracts are somewhat different in that the consumer pays 'per use', meaning that the concept of lost net profit is somewhat speculative, whereas most services contracts entail a fixed or minimum amount, meaning that early termination results in an unpaid amount and that lost net profit can therefore be calculated.

Clause 32(b) of the *Energy Retail Code* requires that any agreed-damages term, which includes an ETF, must be 'a fair and reasonable pre-estimate of damage the retailer will incur if the customer breaches their energy contract, having regard to the related costs likely to be incurred by the retailer'.

In its Draft Decision (July 2006) the ESC determined that damages should be constituted by 'incremental administrative costs' plus 'foregone net margin' (lost net profit) with the total capped at 2% of the annual electricity bill or 2.5% of the annual gas bill for the remaining period of the contract.

But the reference in clause 32(b) to 'the related costs likely to be incurred by the retailer' suggests that an ETF should reflect wasted costs, not lost net profit and in its *Final Decision – Early Termination Fees – Compliance Review – December 2006*, the ESC determined that:

> **'[T]he most straightforward and unambiguous estimates of damages from early termination are those that result from the link between customer actions and the direct costs incurred by retailers. These costs include the costs of inducements or gifts that are provided to the customer when the contract is signed[15], the incremental administrative costs associated with early termination (such as final meter reads) as well as any hedge book imbalance cost[16] (noting that, like fixed term loans, the effect of early termination can also be a benefit). These costs[17] do not include foregone net margin[18] or other customer acquisition costs[19]'.**

[15] Excluding discounts off the regulated 'standing offer tariff', because 'it is not considered accurate to view them as a "cost" that the retailer has incurred to attract the customer. Any "losses" due to price discounting could only be analogous to out of pocket costs paid for inducements if retailers are somehow entitled to receive the standing offer tariff for retail service'. See also footnote 3.

[16] Because 'the cost to serve residential and small business customers typically includes an estimate of the cost of hedge mismatch risk'.

[17] Analogous to wasted costs.

[18] Analogous to lost net profit.

[19] Including fixed costs/common costs/overheads, such as the costs of marketing and setting up accounts, and related administrative costs.

There are several reasons why the ESC altered its position about foregone net margin/lost net profit, which are set out it in its *Revised Draft Decision* (October 2006):

1. there is no requirement for a consumer to take a minimum amount of energy under the contract, so, in fact, there may not *be* any foregone net margin
2. even on the basis that consumers would have used energy after the termination date, the remaining contract revenue is uncertain and varies from customer to customer and over time, making any calculation of foregone net margin administratively burdensome to suppliers, with the costs possibly exceeding the maximum allowable ETF
3. if an ETF allows a supplier to recover the profit expected from a consumer over the remainder of the contract, even though it does not provide a service in that time, the supplier has weaker incentives to comply with its obligations under the contract (because it is in a no-lose situation)
4. suppliers may have less incentive to engage in discounting if they know that it reduces the ETF they can charge. Any loss that would otherwise result from having above-market prices can be recovered from the ETF charged to consumers who transfer to lower cost suppliers. The ability to recover foregone net margin encourages suppliers to lock consumers into long term contracts[20].

The usefulness of the ESC's analysis for our purposes is reduced somewhat because part of its opposition to lost-net-profit ETFs is attributable to the fact that energy retail contracts are only 'pay per use'[21]. But it also gave another, more general objection to lost-net-profit ETFs:

> **It is also worth noting that if foregone net margin was part of the ETF, the period for which 'damages' are recovered would necessarily extend beyond the period for which energy retail services were provided. The Commission believes that this is generally not appropriate, and companies should not be compensated for services that were not carried out even if that service was envisioned at the outset of the customer relationship. The Commission believes that uncertainties in consumption are an inherent feature of competitive environments and should not be viewed as an element of the 'damages' that consumer decisions impose on firms.**

In other words, the ESC believes that suppliers should absorb any lost profit[22].

[20] Note that the last three reasons are policy considerations rather than matters that a court would take into account in determining whether an ETF is a genuine pre-estimate of loss.

[21] '[A]rguments that ETFs should include foregone net margin are essentially contentions that retailers should be compensated for expected consumption that did not materialise. The Commission believes that it is not appropriate to view an unexpected loss of consumption as necessarily "damage" because energy consumption at guaranteed, predetermined amounts was not specified as part of the contract.'

[22] The ESC's change of direction was supported by the Energy and Water Ombudsman Victoria and by the Consumer Action Law Centre.

In its place, the *Revised Draft Decision* adopted a wasted-costs approach and identified two relevant costs:

- common costs – those associated with acquiring and serving the supplier's entire customer base (including marketing costs and commissions paid to direct-selling staff)
- direct costs – those incurred directly and entirely because of transactions with the individual consumer, either in acquiring the individual consumer as a customer or in providing the service to the consumer.

The ESC concluded that no element of common costs should be included in an ETF and that the only direct costs that should be included are the merchandise/inducement costs incurred when the customer signs the contract and the costs that result directly from the early termination of the contract (for example, the final meter reading and the final bill)[23].

Finally, the ESC determined that the simplest way to calculate wasted costs in a fixed-term contract is to pro-rata the up-front inducements according to the time left on the contract[24] and add that amount to the special costs.

2.5.3 UK Unfair Terms in Consumer Contracts Regulations 1999

There is no UK case law on the Regulations as they pertain to ETFs and the only time that the UK Office of Fair Trading has looked in detail at ETFs is in its *Guidance on Unfair Terms in Package Holiday Contracts – March 2004*.

The *Guidance* notes that ETFs in holiday package contracts 'often set out a scale of cancellation charges that imposes a fee for cancellation that rises with the approach of the departure date', and adopts the general law position (genuine pre-estimate of loss) as the criterion for assessment of fairness, without any discussion on whether the tests might be different.

The *Guidance* states that while these sliding scales are acceptable, they must take account of the supplier's obligation to mitigate, for example by making reasonable attempts to resell the package or to withdraw from the relevant transport and accommodation obligations.

It then sets out that each item in the sliding scale must represent:

- revenue that would have been received
- **less** any costs saved by the cancellation (usually only variable costs, not fixed costs/overheads)
- **less** net revenue received on resale (that is, exclusive of costs of resale)
- **plus** special administration costs of processing the cancellation, that is over and above administration costs that would have been incurred if the contract had proceeded.

These sliding scales therefore represent lost net profit. Unfortunately, there is no discussion about whether lost net profit or wasted costs is the more appropriate measure of loss[25].

[23] The ESC did not identify any direct costs associated with provision of the service to the consumer.

[24] Presumably, if the ESC considered that there *were* direct costs associated with provision of the service to the consumer, they would also have been prorated.

[25] See section 4.1 regarding the special position of 'allocated asset/ contracts such as these.

3. The economics of long-term consumer contracts

This section surveys the literature on the economics of long-term consumer contracts in retail markets for the provision of goods/services. An assumption has been made that the long-term contracts considered in this section have an ETF attached that is not unfair.

3.1 Benefits of freedom of contract

The economic analysis of legal rules assumes that individuals are rational and aim to maximise their well-being by making the best agreement possible, subject to the constraints imposed by the law and the other party. This principle (freedom of contract) is one of the key principles that underlies contract law.

Freedom of contract is based on the assumption that all benefits and costs can be measured in dollar values, including 'non-economic' considerations. Individuals determine the dollar values to be placed on the benefits and costs of an agreement. Furthermore, individuals will maximise the difference between their benefits and their costs.

It follows that, left to themselves, parties on equal terms will reach the agreement following a period of bargaining that maximises the benefits to both sides. Such an outcome is desirable because it is efficient, that is, from a given pool of resources, the net benefit to the overall community is maximised (Ham 1989, p.650)[26].

Despite the importance of freedom of contract in today's markets, the implicit laissez-faire values of the theory do not perfectly map on to the contemporary environment of consumer contracts. The theory of freedom of contract traditionally applied to businesses.

Today, far more contracts are entered into by consumers with businesses than between businesses. Individual consumers often do not bargain and negotiate contract terms with large firms that maintain a degree of market share in a retail market. For example, consumers do not have the time or the need to bargain contract terms or they may not have the requisite knowledge[27].

For these reasons, the concept of freedom of contract when applied to consumer contracts should be viewed as the propensity for firms in particular industries to offer the greatest possible amount of contracts that business and consumers value.

[26] Ham, A., ' The Rule Against Penalties in Contract: An Economic Perspective', *Melbourne University Law Review*, Vol 17, 1989-90.

[27] In this context, the Australian Bureau of Statistics' *Adult Literacy and Life Skills Survey 2006* found that in relation to 'the minimum required for individuals to meet the complex demands of everyday life and work in the emerging knowledge-based economy':

- 46% of Australians (36% of people with qualifications/59% of those without; 64% Non-English Speaking/46%ESP) were below that level in relation to 'prose literacy' (defined as 'the ability to understand and use information from various kinds of narrative texts including texts from newspapers, magazines and brochures;
- 47% (36% of people with qualifications/59% of those without; 62% NESP/47% ESP) were below that minimum level in relation to 'document literacy' (defined as 'the knowledge and skills required to locate and use information contained in various formats including job applications, payroll forms, transportation schedules, maps, tables and charts');
- 57% (42% of people with qualifications/65% of those without) were below that level in relation to numeracy (defined as 'the knowledge and skills required to effectively manage and respond to the mathematical demands of diverse situations'); and
- 70% were below that level in relation to 'problem solving' (defined as 'goal-directed thinking and action in situations for which no routine solution is available').

Across industries, the ability of businesses to offer a menu of contracts is possible partly because government regulations do not limit the variety of contracts businesses can provide on the condition they are fair and valuable to consumers.

In this context, contract law regulations introduced in different jurisdictions that aim to minimise consumer detriment are positive developments (Allan & Hiscock 1992)[28]. This was the driving impetus for the introduction of the unfair contract terms in the Fair Trading Act and the Australian Consumer Law. Importantly, these regulations do not diminish the significance of freedom of contract but they do provide for sites of intervention when a consumer contract is deemed to cause an unfair level of consumer detriment.

3.2 Long-term contracts in retail markets

Given that the overwhelming majority of contracts are of benefit to consumers and businesses, particular retail markets have been dominated by long-term consumer contracts.

In retail markets where ongoing services are provided, it is inevitable that there will be a level of customer switching between suppliers. With customer switching, businesses face greater risk and uncertainty over their revenue and profit stream and increased costs (such as coordination and transfer costs) when customers migrate from one supplier to another (Houston & Green 2007)[29]. This results in higher costs to businesses, which are passed on to consumers as higher prices.

To avoid these costs, businesses may offer to supply their services under long-term contract. By contracting their services to customers, business and consumers both benefit. With increased certainty over future revenues and profits, businesses can provide services to all customers that they may otherwise not have been able to provide or can provide their services at a lower cost. For example, gym memberships give firms confidence to invest in facilities (which benefits all gym users) while consumers who take up a contract at the gym get lower per-use rates.

3.3 Early termination and the costs of switching suppliers

Early termination of a contract is usually a breach of the contract. But some contracts allow the consumer to terminate early and some contracts provide for early termination on the occurrence of a stated event. In whatever way an early termination arises, the contract usually requires the consumer to pay an ETF which is, or is claimed to be, compensation for the losses the supplier will suffer because of the early termination.

Switching costs are costs that consumers absorb in changing to a different supplier of a product or service, of which ETFs are just one element. Examples of switching costs include the time involved in learning about new equipment; transaction costs (doing ‘paperwork’); foregone incentives the incumbent may have created (for example loyalty programs, discount coupons); early termination fees; and perhaps some ‘emotional’ or psychological costs associated with brand loyalty (Klemperer 1995)[30].

[28] Allan, D. & Hiscock, M., *Law of Contract in Australia*, 1992, p 3-4.

[29] Houston, G. and H. Green (2007), ‘Assessing the Merits of Early Termination Fees’, *Economics of Antitrust: Complex Issues in a Dynamic Economy*

[30] Klemperer, P. (1995) ‘Competition when consumers have switching costs: an overview with applications to industrial organization, macroeconomics and international trade’, *Review of Economic Studies* 62, pp. 515-539.

Consumers will, as part of the decision to purchase, make rational decisions about how much to spend on 'search costs'. These include all research to compare alternatives, including researching switching costs (if any apply to the transaction in question).

Several authors who have investigated switching costs (for example Waterson 2003[31] Klemperer 1995) argue that their presence leads to sub-competitive outcomes and that the resulting welfare losses may be substantial. They claim that these practices may raise prices and create deadweight losses and may also discourage new entry, further reducing market competitiveness. They also reduce the product variety available to consumers in reducing firms' incentives to differentiate products in real (functional) ways. Finally, because they reduce competition, firms may dissipate more social surplus in costly activities to create them.

It seems that switching costs do cause sub-competitive outcomes and therefore pro-competitive policies aimed at reducing switching costs should be encouraged. But fair ETFs are only one part of switching costs and do relate to the value of the long-term contract itself. An inappropriate mechanism, with the aim of simply reducing the size of ETFs across all industries in the economy, could result in an increase in the contract price for some industries.

3.4 Economic benefits of ETFs

As discussed in 3.2, long-term contracts are offered so that businesses can avoid the greater risk and uncertainty over revenue and profit streams and increased costs (such as coordination and transfer costs) associated with customer switching.

But if a customer is able to terminate the contract or switch to another supplier at a very low (or potentially zero) cost, the benefits to the business (and all its customers) of offering to supply services under contract are undermined. The business would be deprived of the net revenue stream that it would have accrued under the contract and may even be encumbered with unrecoverable costs (Houston & Green 2007).

Consequently, businesses impose ETFs on customers who terminate contracts before the end date. Hence, the analysis of the benefits or costs of long-term contracts to consumers and businesses in the areas of price and competition are inextricably linked to the imposition of fair ETFs by firms.

As stated previously, the availability of long-term contracts with fair ETFs will lower the cost of providing services in the long term.

Evidently, ETFs create a cost at the point of switching. But they also create a complementary increase in competition at the point where suppliers compete for 'locking in' new customers. Providers in certain industries are willing to provide up-front investment in services and products.

For example, a mobile phone service provider often provides a handset at no explicit additional charge if the customer enters a long-term contract with an ETF. Similarly, pay television retailers may provide and arrange for installation of a set-top unit with all programming packages (Houston & Green 2007).

[31] Waterson, M. (2003) 'The role of consumers in competition and competition policy', *International Journal of Industrial Organisation* 21, pp. 129-150.

The availability of long-term consumer contracts with fair ETFs provides for a greater range of contracts offered to customers, enabling the provision of goods and/or services offered spread over the life of the contract with no up-front cost. This option to spread the cost of related product sales/services may be of great benefit to certain consumers and increases competition by virtue of the fact that a wider range of contracts are available (freedom of contract achieved).

ETFs also enable providers to offer discounts to encourage sales of a complementary product or service. For example, a telephone company may find it profitable to reduce the price of a 12 month broadband contract if gaining an additional broadband customer increases the probability that the same customer will also purchase additional phone services (Houston & Green 2007).

These up-front investments in services and bundling of packages provides for fierce competition for customers at the point of supply, which benefit consumers. This does not occur in industries characterised by limited prospects for profitable, related product sales and little potential for market growth, such as energy retail services.

Despite this, long-term consumer contracts with fair ETFs provide for lower prices in the long-term across *all* industries. Across *some* industries, long-term contracts with fair ETFs provide for increased competition at the point of signing-up new customers while also enabling a wide menu of contracts for consumers.

In summary, enabling firms to offer long-term contracts in retail markets with a fair ETF attached provides benefits to all customers of that business by upholding the value of its contracts.

Firstly, the greater certainty over revenue and profit streams remains. As discussed above, businesses can provide services to all customers that they may otherwise not have been willing to provide or can provide their services at a lower cost.

Secondly, charging an ETF allows businesses to recover the additional costs incurred from a customer terminating early from the customer directly rather than spreading those costs across its customer base. Thus, customers seeing out the term of their contract are not 'penalised' by higher prices for those customers that decide to terminate the contract early.

Thirdly, the inextricable link between ETFs and long-term contracts enables firms in some industries to offer a large menu of contracts as well as providing for fierce competition for new customers using various strategies benefiting consumers.

Evidently, pro-competitive practices that bring down switching costs would be of benefit to consumers. But the costs that consumers incur from ETFs (one element of switching costs) need to be understood in the broader context of the benefits that long-term contracts provide to consumers in retail markets.

On balance, long-term contracts with ETFs provide benefits to consumers in the area of lower product prices, fierce competition at the point of competing for new customers and a wide variety of contracts that go towards the goal of freedom of contract.

4. Options for setting the boundaries of fair ETFs

In the following section, three distinct options for the determination of the fair calculation of ETFs for consumer contract are outlined for discussion.

4.1 Option 1: Wasted costs ETFs across all industries except for 'allocated asset' contracts

This option, involving a wasted costs ETF approach across all industries except for 'allocated asset' contracts (see further below), acknowledges that ETFs would likely be lowest under this formulation and aims to encourage more switching by consumers in retail markets. It also acknowledges the importance of upholding the principle of recovering profits for 'allocated asset' contracts that are terminated early.

A wasted costs ETF should generally favour consumers unless the supplier incurs very high set-up costs or would suffer a net loss if the contract ran its term.

For instance, a contract involving minimal set-up costs that is terminated close to the start of the contract would involve minimal wasted costs, whereas the lost net profit could be a substantial amount. If there were substantial set-up costs, a termination close to the start of the contract would involve substantial wasted costs but it would usually be less than the lost net profit.

If a contract involving substantial set up and/or running costs was terminated towards the end of the contract, the lost net profit would be insubstantial but the (substantial) wasted costs would more than be offset by the income received under the contract.

The following examples illustrate the position for the termination of a 12-month services contract at one, 6 and 11 months:

Example 1: (low set-up costs + high ongoing costs) $10 set-up costs, $8.50pm ongoing costs and $15pm revenue.	
1 month	
Wasted costs: $18.50 – $15 =	$3.50
Lost net profit: $165 – ($93.50 + $7.56[32]) =	$63.94
6 months	
Wasted costs: $61 – $90 =	no wasted costs
Lost net profit: $90 – ($51 + $2.25) =	$36.75
11 months	
Wasted costs: $103.50 – $165 =	no wasted costs
Lost net profit: $15 – ($8.50 + $0.06) =	$6.44

[32] Discount for the value of the early receipt of the remainder of the contract price calculated at 5%pa, $165 x 5% x 11/12 = $7.56. No provision is made for the net value of any replacement contract that did eventuate or should have eventuated, so the amounts for lost net profit are overstated to that extent.

Example 2: (high set-up costs + low ongoing costs) $50 set-up costs; $1pm on-going costs; $15pm revenue	
1 month	
Wasted costs: $51 – $15 =	$36
Lost net profit: $165 – ($11 + $7.56) =	$146.44
6 months	
Wasted costs: $56 – $90 =	no wasted costs
Lost net profit: $90 – ($6 + $2.25) =	$81.75
11 months	
Wasted costs: $61 – $165 =	no wasted costs
Lost net profit: $15 – ($1 + $0.06) =	$13.94

Example 3: (high set-up costs + high ongoing costs) $50 set-up costs; $8.50pm on-going costs; $15pm revenue	
1 month	
Wasted costs: $58.50 – $15 =	$43.50
Lost net profit: $165 – ($93.50 + $7.56) =	$63.94
6 months	
Wasted costs: $101 – $90 =	$11
Lost net profit: $90 – ($51 + $2.25) =	$36.75
11 months	
Wasted costs: $143.50 – $165 =	no wasted costs
Lost net profit: 15 – ($8.50 + $0.06) =	$6.44

Example 4: (low set-up costs + low ongoing costs) $10 set-up costs; $1pm on-going costs; $15pm revenue

1 month	
Wasted costs: $11 – $15 =	no wasted costs
Lost net profit: $165 – ($11 + $7.56) =	$146.44
6 months	
Wasted costs: Wasted costs: $16 – $90 =	no wasted costs
Lost net profit: $90 – ($6 + $2.25) =	$81.75
11 months	
Wasted costs: $143.50 – $165 =	no wasted costs
Lost net profit: $15 – ($1 + $0.06) =	$13.94

On policy grounds, a wasted-costs approach might be preferable not simply because it means that consumers generally pay less than under a lost-net-profit approach but because lower ETFs encourage more switching between suppliers and thus stimulate competition[33]. While this point was not made expressly by the Essential Services Commission in relation to energy retail contracts, it is implicit in its general policy grounds for excluding lost net profit ETFs (see above).

But the point was made expressly in the Regulatory Impact Assessment for the UK Consumer Credit (Early Settlement) Regulations 2004 (see above). The RIA justified the change from a statutory formula (Rule of 78) that produced a high ETF to one that produced a lower ETF on the basis that:

> **'the current rules stifle competition by increasing switching costs that tie consumers to their existing suppliers. A report by Egg Plc estimates that 65% of borrowers would reconsider moving their debt, or paying it off early, if they knew that a penalty fee would be levied. This inhibits both new entrants and existing lenders from gaining market share through more competitive loans.'**

Of course, this policy justification for low ETFs is not necessarily relevant to the question whether a wasted costs ETF is the only fair ETF under the *legislative* criteria, which appear to require attendance only to issues relating to the contract in question, not broad policy issues (see sections 2.2 and 2.3). Similarly in relation to the ESC's argument that profit-based ETFs provide suppliers with less incentive to engage in discounting.

[33] The anti-competitive nature of ETFs in the US cell phone industry was criticised in a U.S. Public Interest Research Group Education Fund Report (*Locked in a Cell: How Cell Phone Early Termination Fees Hurt Consumers* by E Mierzwinski, K Smith and D Cummings, Washington DC, August 2005). The report was based on a poll of 1000 cell phone households, 36% of which said that ETFs of US$150-240 had prevented them from switching companies and 47% of which said they would switch 'as soon as possible' or 'consider switching' if ETFs were eliminated. The report estimated that 'by combining the actual costs incurred by the 10% of consumers who switched in the past three years ($2.5 billion) with the benefits lost by consumers who couldn't afford to switch ($1.2 billion) and benefits lost by consumers who felt the benefits were not enough to offset the fees ($929 million), cell phone early termination fees cost consumers more than $4.6 billion from 2002 to 2004' (executive summary).

It might be different in relation to the ESC's argument that if an ETF allows a supplier to recover the expected profit, even though it does not provide a service for the remainder of the contract, it has weaker incentives to comply with its obligations under the contract when it subsists (because it is in a no-lose situation). This might be regarded as something within the context of the relevant contract and not as an extraneous matter.

Similarly with the ESC's arguments that suppliers should not be compensated, through profit-recovery ETFs, for services they do not provide; and that uncertainties in consumption are an inherent feature of competitive environments, not to be hedged against through profit-recovery ETFs.

Another factor in favour of wasted costs is that its calculation is more transparent than that of lost net profit. The problems with lost net profit are: quantifying the costs that would have been incurred in performing the remainder of the contract; identifying the requisite discount for the value of the early receipt of the remainder of the contract price; and ascertaining whether the supplier has taken reasonable steps to mitigate its loss[34].

Finally, insistence on a wasted costs approach generally to contractual fees and charges might encourage traders to regard them simply as ways to deter consumers from undesirable practices and as offsets for the administrative costs such practices cause and discourage traders from regarding ETFs as 'profit centres', with the consequent incentive to allow, or even encourage such allegedly undesirable practices. But ETFs are less likely to fall into this category than other fees, for example dishonour fees or over-the-limit fees, as ETFs signal the end of the commercial relationship, which, presumably, is not something desired by the trader.

4.1.1 Method of calculating a wasted costs ETF

If the appropriate basis for calculating an ETF is considered to be wasted costs, the other issue would be to determine whether it is fairer that the ETF should be calculated at the time the contract is terminated or that it should be quantified at the outset. This is on the basis that Part 2B (and the Australian Consumer Law) allows for the issue to be determined on a basis other than the general law test of a genuine pre-estimate of loss.

Under the first option, the contract would stipulate that the consumer need only pay whatever wasted costs are incurred by an early termination and that those costs, including the offsetting effect of revenue received, are to be calculated at the date of termination, with a requirement that the supplier provide an itemised amount to the consumer. Where contract-specific costs cannot be ascertained, the use of average costs could be permitted, as there would not appear to be anything unfair about using average costs as the estimate of the wasted costs likely to be incurred over the term of an individual contract.

Under the second option, the contract would stipulate a fixed amount (based on estimated average costs over the term of the contract) and reduced pro rata according to the time left on the contract, which takes account of the offsetting effect of revenue received. This method produces a higher ETF at the beginning, and a lower one at the end of the contract.

[34] But it is not clear whether these technical problems in calculating lost net profit are matters that go to unfairness, although in high-churn industries, the assumption that the loss of one customer is quickly made up tends to make illusory the notion that the supplier actually loses profit from 'defecting' consumers.

Where there are insubstantial set-up costs but substantial ongoing costs, the averaging formula of the second option will *overestimate* the ETF for a termination close to the start of the contract. On the other hand, where there are substantial set-up costs but insubstantial ongoing costs, it will *underestimate* the ETF for a termination close to the start of the contract. Where there are substantial set-up and ongoing costs, or insubstantial set-up and ongoing costs, it is likely to produce a fairly accurate ETF.

It may be impractical to insist on the first option, even if it is likely to produce a more exact ETF, because of the extra costs involved in the individual calculations. A preset, prorated ETF has some problems but is likely to produce a fair amount. It also enables the consumer to see up-front what the cost of early termination will be, and, on balance, appears to be the fairer alternative.

4.1.2 'Allocated asset' contracts

Under these contracts, specific assets have been allocated to the contract that cannot, or cannot easily be reallocated elsewhere if the contract is terminated early: for example, a seat on an aeroplane may not be able to be resold after a certain time; a place at a private school vacated by a student may not be re-sellable until the end of the term (or until the end of the semester, or even until the end of the year); and it takes time to re-let a rental property.

In these cases, the respective contract typically allows the airline to refuse to refund the ticket price; the school to require payment of fees until the end of the term/semester/year; or the property owner to require payment of the rent until the property has been re-let[35].

The amounts payable in these cases are conceptually similar to ETFs and are probably characterised as lost profits, although they could possibly be characterised as wasted costs inasmuch as they constitute compensation for the opportunity cost incurred in committing the relevant asset(s) to the contract. But the amounts involved could not be reached if calculated according to the wasted costs approach. Therefore, even if a wasted costs approach was generally to be favoured for the calculation of ETFs, the calculation of ETFs for these 'allocated asset' contracts should continue to be permitted to be calculated according to the lost-net-profit formula.

The approach of the UK Office of Fair Trading to ETFs in package-holiday contracts, which was to sanction a profit-recovery approach (see above) could be analysed on this basis.

4.2 Option 2: Case-by-case analysis

A case-by-case option for the fair determination of ETFs would acknowledge the diversity of cost-recovery across industries, and across firms within industries. The case-by-case option would not require an economy or industry-wide decision about what is a fair approach to calculating ETFs. But the ability to invalidate unfair ETFs in particular contracts would still be available. The case-by-case option is very much a 'business-as-usual' option.

Retail markets for ongoing services vary significantly. For example, the retail energy services market offers a homogeneous service where there is little scope for businesses to differentiate their products and limited related market sales. On the other hand, in the mobile phone services market there is significant scope for service providers to differentiate their product and make related market sales (for example, mobile phones are included in the contract price).

[35] The general law requires that suppliers in these situations to take reasonable steps to mitigate their losses; for instance, property owners must use reasonable endeavours to re-let the property as soon as possible.

Consequently, the variation of contract types and how firms recover the costs of attracting new customers over the duration of the contract would be significant across industries.

Similarly with firms within industries differentiating their services and related market sales, that is, the structure of contracts, and firms' cost recovery within industries, will vary significantly.

With this variation, the approach taken by firms to determine their ETFs will also vary.

The risk in making an economy or industry-wide decision about what is an unfair approach to calculating an ETF is that by limiting the way firms can recover their costs of early termination, firms may limit the type of contracts they offer to consumers to reflect what costs they can recover in the case of early termination and this may limit the competition for customers at the point of competing for new customers. The critical risk of restricting freedom of contract is that contract terms that are efficient and mutually beneficial for some parties are ruled out.

Surveys have shown that a large proportion of consumers in particular retail market would switch service providers more readily if ETFs were lowered[36]. This may cause a concurrent increase in competition. The implication here is that the reduction in the size of ETFs for all industries will not require the firm to recoup these costs in other areas (for example, an increase in contract price).

Some analysts have gone even further to suggest that if ETFs were lowered through regulation, over the long-run, the market dynamic will shift to increase entry costs for suppliers, leading to a reduction in the number of competitors and an increase prices[37].

Evidently, some suppliers have charged ETFs over and above a genuine pre-estimate of loss that the supplier would suffer for early termination of a contract. But any assumption that ETFs are merely a 'profit-centre' for all firms across all industries would ignore the benefits that long-term contracts with ETFs provide to consumers (see section 3).

For businesses that base investment decisions on the increased certainty over future revenue streams through supplying services under contract, a wasted-costs ETF may undermine the contract's value. Consequently, the lower switching costs may be at the expense of limiting the contract types offered by firms to consumers or they may raise the prices to consumers who value the otherwise lower prices.

Considering the cases analysed in section 2.5, the Essential Services Commission found that ETFs should be calculated using the wasted costs methodology and not lost net profit. The energy market is a very specific market (similar good and no product differentiation) and as a result contracts offered do not vary widely. Also, the fact that consumers are charged on a per use basis could mean that the lost net profit methodology of calculating ETFs is difficult and costly.

[36] *Locked in a Cell: How Cell Phone Early Termination Fees Hurt Consumers* by E Mierzwinski, K Smith and D Cummings, Washington DC, August 2005 – see above.

[37] This position was put forward by Chris Field (member Economic Regulation Authority of Western Australia and professor of consumer law at La Trobe University) in his submission to the Productivity Commission's *Inquiry into Australia's Consumer Policy Framework* (Perth public hearing 23 March 2007) where he said that 'the pricing offered to consumers to enter into [telecommunications] contracts is premised on the fact that consumers will stay in that contract for a period of time', and that if ETFs were removed, consumers would switch to ever cheaper contracts, which 'ultimately over a period of time…will shift the market dynamic' by increasing the entry costs for suppliers, thus reducing the number of competitors and eventually increasing prices (p.173-4 transcript of proceedings).

But these characteristics of the energy market are not shared by industries such as the consumer credit and package-holiday markets. For instance, the sliding scales used to calculate ETFs in package-holiday contracts in the UK represent lost net profit.

In relation to credit contracts, it is worth noting that even within the same industry, different regulators across different jurisdictions have formulated different guidelines for determining ETFs. The Uniform Consumer Credit Code within Australia ambiguously allows for ETFs to be composed of lost net profit or wasted costs. But the UK Consumer Credit (Early Settlement) Regulations 2004 appeared to have deemed that lost net profit is not an appropriate way to calculate ETFs for firms within the credit industry.

These differences in calculating ETFs as determined by the relevant regulations could be said to reflect the diversity of firms' operating costs across different industries. Because of these differences, legislation mandating either wasted costs or net lost profit for the calculation of ETFs across all industries and firms might result in some markets not operating efficiently for consumers. The potential forfeit of freedom of contract in particular retail markets might be too great a risk and a substantial loss of welfare to consumers and businesses.

Whether an ETF is unfair or not might be said to depend on the characteristics of the market and the structure of the contract and the ETF itself. Consequently, a case-by-case analysis of individual firms' ETFs might need to be undertaken to determine if the ETF in question was unfair.

As part of the assessment, consideration would always have to be given to the competitiveness of the market in question. There are justifiable concerns that firms may use ETFs primarily for the purpose of constraining customer switching and/or as a 'profit centre', especially if the targeted audience is in any way vulnerable to persuasion or other sales tactics.

For those firms that are using ETFs as a 'profit centre', Sir John Vickers, the former head of the UK Office of Fair Trading, regards the unfair contract terms provisions in the UK as providing an opportunity to invalidate unfairly high ETFs on a case by case basis (Vickers 2003, p. 16)[38]. He regards these provisions as a practical and efficient tool which, importantly, does not impinge on freedom of contract.

A risk of restricting freedom of contract is that terms that are efficient and mutually beneficial for some parties might be ruled out. But the regulations on unfair terms in contracts impinge only on contract terms where there is an imbalance against the consumer.

The challenge with assessing ETFs is to identify those circumstances where practices that are generally pro-competitive and therefore pro-consumer and, on the other hand, those that may artificially raise switching costs without any benefit to consumers (Houston & Green 2007, p. 65).

For those firms that are using ETFs as a 'profit centre', the unfair contract terms provisions in both the Fair Trading Act and Australian Consumer Law could provide an efficient tool to invalidate unfairly high ETFs. Importantly, these provisions do not affect freedom of contract and only impact on contract terms where there is an imbalance against the consumer.

[38] *Economics for consumer policy:* the Keynes lecture, British Academy, 29 October 2003.

4.2.1 Suggested steps going forward for CAV in a case-by-case option

An implicit assumption of the case-by-case option is that all consumers are able to calculate the trade-off between the price offered at the beginning of the contract and the ETF levied in the event that they break the contract.

In order to calculate this trade-off, consumers need clear and available information regarding the size of the ETFs that would apply at any stage that the consumer wished to end the contract. There may be a role for the regulator to inform consumers on the value of calculating the trade-off between the price offered for a good or service and the ETFs levied.

Another avenue that the regulator could explore is to advocate for ETFs to be more prominent in advertising and marketing material or other materials used to sign up new customers. In order to determine the value of this proposal, empirical research needs to indicate that a substantial number of consumers neglect to obtain information regarding ETFs upfront or that a substantial number of consumers who attempt to obtain such information found firms to be evasive in complying.

4.3 Option 3: Presumption in favour of wasted costs

Short of mandating wasted costs as the basis for fair ETFs, it might be reasonable for there to be at least a presumption that this is the fair basis for their calculation (apart from ‘allocated asset’ contracts) unless the relevant firm can make a stronger case for lost net profit.

This option acknowledges the diversity of cost-recovery methods that firms use across different industries and within them. It also creates a disincentive to use ETFs as a ‘profit centre’, as firms will have to use resources to justify profit-recovery ETFs. On the other hand, provided that those costs are not substantial, the threat that this option would lead to the loss of mutually beneficial contracts would be minimised.

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