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Dear Sirs

MTAA Application for Authorisation, 22 December 2006 (A91025)

Please find enclosed IAG's further submission in relation to the Motor Trades Association of Australia (MTAA) application for authorisation to develop and promote a 'real times guide' for use by smash repairers and insurers in Australia (**the MTAA application**).

We have already provided the Australian Competition and Consumer Commission (the Commission) with our views on the MTAA application (see our submission to the Commission of 27 February 2007). To summarise, IAG in principle supports the shift away from "Funny Time/Funny Money" (FT/FM) quoting to a system of "Real Time/Real Money" (RTRM) quoting. Moreover, while IAG is not prepared to support the MTAA's present application, it may be willing to support a future application that meets IAG's concerns (as presented in IAG's submission to the Commission).

The purpose of this letter is to address a number of important points raised by third parties, in particular, AAMI, regarding the manner in which "real money" should be addressed. This letter recommends that the Commission, in expressing a view on the application in front of it, refrain from accepting or rejecting the simplistic notion that market forces or individual repairers could, overnight, arrive at real money figures which would not negatively impact on average costs of repair. On the contrary, this letter seeks to provide compelling albeit brief reasons to support a view that the setting of maximum real money rates is likely to reduce the risk of costly and inefficient practices resulting in a move to real time real money.

If you have any further questions regarding this submission please contact Doukesa Georgas on (02) 9292 3321.

Yours faithfully

A handwritten signature in black ink, appearing to read "David Brown", is written over a light grey rectangular background.

David Brown

Head of Claims & Assessing

A Background

1. The insurance industry has expressed concern about the MTAA's present application, essentially asking that it be rejected.¹ This view, however, was not based on a rejection of RTRM quotes. Some insurers (including IAG) have expressed support for RTRM quoting;² AAMI considers RTRM as being unlikely to have direct impacts on its operations;³ and Allianz, while not directly opposing RTRM, feels it involves risks that the MTAA's application fails to address.⁴
2. Only the submissions of IAG and AAMI substantially addressed the real money aspect of RTRM quoting:
 - IAG expressed the view that development of real time estimates without addressing the question of real money quotes could anti-competitively raise prices, and, in any case, would be unlikely to allow effective and efficient RTRM quoting to emerge. Consequently, standardising real money quotes must be directly addressed in any application for authorisation.
 - AAMI concurred with IAG's first concern, that the MTAA application would allow "inappropriate discussions related to prices, rates and costs," (see the summary of their submission). However, AAMI also recommend that any application by the MTAA to develop a "real times guide must not include any dollar figure for hourly rates" and that there should be "no suggestion, promotion or discussion of average hourly rates" (see Section 6.2 of the AAMI submission).
3. As already noted, and in contrast to AAMI, IAG believes that appropriate discussion of rates is likely to be necessary if RTRM quoting is to promote economic efficiency in the industry. The purpose of this letter is to provide the Commission with good grounds for remaining neutral on whether future applications for authorisation from the MTAA should exclude consideration of "real money" quotes.
4. The remainder of this letter first demonstrates that the present and any proposed quotation system for car repairs must be viewed holistically (**Section B**). Isolated evaluation of the change of a single component in an integrated system will result in unexpected, and most likely adverse, consequences. As a result, a change in time estimates, which are a central element of any quotation system, requires consideration of the likely impacts on price. For example, without consideration of what prices might look like, it cannot be credibly claimed that repair costs will not increase under the new scheme. The letter goes on to show (**Section C**) that in practice developing and promoting substantive change of the time estimation process will necessarily require development of new pricing methodologies. Significantly, **Section D** then sets out some broader considerations that are relevant to any assessment of discussion of rates. Finally, **Section E** sets out a conclusion.

¹ Insurance Council of Australia, letter to the Commission dated 17 January 2007, and the insurance companies, cited in footnotes 2-4.

² See the first paragraph of Auto & General Insurance Company Limited's letter to the Commission dated 27 February 2007; Suncorp Metway Insurance Limited also seems to support RTRM quoting in principle, see paragraph 6 of their letter to the Commission dated 16 January 2007.

³ See the second paragraph of the summary of AAMI's submission to the Commission.

⁴ Allianz's submission to the Commission.

B Smash repair quotations systems are highly integrated

5. Smash repair quotation systems are complex and highly integrated. Consequently, to evaluate the implications of a change of any element of the system requires considering how the system as a whole will respond. Two layers of complexity stand out. The lower, or “micro”, layer relates to the specifics of the quotation system, which often interact in complex ways. Key elements of this are:
 - how time spent by employees with different skill levels is measured, and whether these embody allowances for set up and clean up times;
 - how parts are priced, which may involve issues of procurement, and allowance for consumables; and
 - how overheads are recovered.
6. All of these elements interact. For example, under the present system, many of the costs of consumables are embedded in general labour rates, while a mark-up on parts allows for the recovery of some overheads. Thus a change in, for example, the way time is measured, can change how the costs of set up, clean up, consumables and even overheads are recovered.
7. The upper, more “macro”, layer concerns the interaction between insurance companies and smash repairers. Perhaps the most crucial part of this process is the training required for those making and reviewing quotes. For example, given the degree to which the elements of a quoting system interact, a move from funny to real time quotes would result in significant changes in how quotes would be formulated and assessed, which in turn would require substantial learning by the many hundred insurance assessors nationwide (IAG has 450 alone), and even larger numbers of repair shop employees who provide work estimates. Changes would also have to be made to quotation software packages, financial models and business plans (at least in larger shops), and even remuneration practices (since payments for work done may no longer match up with past payment mechanisms).
8. To see the complexity of these interactions, over both layers, consider the possible impacts of a change from funny to real time measurement:
 - All rates associated with times spent will need to be adjusted.
 - Any mark-ups in funny time measurements, for example, to recover job set up and clean up, will need to be adjusted or alternative means of recovery will need to be implemented. For example, IAG’s real time painting estimates provide, in contrast to funny time approaches, separate job set up and paint loading charges.
 - Recovery of labour costs across different skill levels may change, requiring changes in the relative prices of different types of labour.

- Any mark-ups in funny time measurements, for example, to recover consumables, would need to be recast, or an alternative means of recovery would need to be implemented. As an example, IAG is recommending a separate cost component for consumables under a real time estimation process, rather than the funny time process that involved a mark-up on general labour rates.
 - To the extent that overheads are recovered by means of mark-ups, adjustments will have to be made.
 - Estimators and assessors will have to learn the new rules, including new quirks, commonly made errors, opportunities for gaming, and mistakes likely to be generated due to old habits no longer appropriate under the new system.
 - Shop floor remuneration processes, including performance measures and payments, may require adjustment, and over a period of time those adjustments may feed back into real time prices.
9. The direct implication of these interactions is that only system-wide evaluation can hope to predict the consequence of any given change. For example, a change in time measurement alone provides no information about how repair costs are likely to change. To understand RTRM repair costs requires, at a minimum, knowledge of what the new time rates are, as well as how set up, clean up and consumables are recovered. Thus, for example, in the absence of information on real time rates, no valid claims as to whether the proposed system will raise or lower costs can be made.
10. It is also the case that complex systems like smash repair quoting have a life of their own which is difficult to predict in the abstract. Knowing the rules and prices of a quoting system is not enough to provide a good understanding of the likely outcomes it will generate. Instead, some experience of how the process works is also necessary.
11. In summary, an understanding of the whole of the new process, combined with practical experience, is required before even the most basic statements about the new system can credibly be made.

C Real time implementation *de facto* determines real money rates

12. The preceding section showed that to predict outcomes under a new quoting system required broad knowledge of the workings of that system. This section shows that for similar reasons, implementation of a single component of a new quoting system, for example, real time measurement, in essence, forces specification of the other components of the system.
13. Development and promulgation of a new time estimation process requires working closely with repair shops. This is necessary to both ensure time estimates are realistic, and to ultimately convince shops to adopt the process.

14. Beginning with development, it can be difficult to direct a process of measurement when it is not considered in context. Real time measures are intended to be an input to a process that provides for transparent and efficient cost-reflective quotes. Yet the previous section showed that the outcome of a quote system interactively depends on a broader range of matters than just time measurement, so to achieve the system's goals these matters must be known and considered.
15. Even more importantly, promulgation of new approaches like real time measures requires that shops accept the approach and take costly steps to change their processes. Indeed, in the absence of compensation, this would also apply to shop floor experiments for the purposes of developing real time measurement. As a result, repair shops are not going to accept a new measurement process without any idea of how it is going to affect their businesses. It is neither realistic nor even likely to be possible for a shop to make use of real time estimates without concurrent application of prices designed for those estimates. Consequently, any reform process will necessarily involve some implicit or explicit discussion of rates.
16. In short, developing real time measurement without implicit or explicit real money prices would be, at best, difficult, while promulgating a measurement standard without prices is perhaps impossible. Thus, any application for authorisation must deal with communications about prices, including what processes will be used to guarantee that the authorisation will generate beneficial outcomes.

D Other general considerations

17. The considerations set out above highlight the importance of assessing the “real money” consequences of any move to “real time” as part of the general analysis of whether such a move would yield net benefits. However, this does not exhaust the factors relevant to the possible desirability of allowing an application that focuses on “real time” to also cover issues of “real money”.
18. More specifically, IAG stresses the need for the Commission's analysis to take account of the broader nature and economic characteristics of markets for smash repair services.
19. Motor vehicle insurers compete for business on the basis of both price, in terms of the insurance premia policyholders must pay, and “quality”, in terms of repair quality and speed with which repairs are undertaken, but also convenience to the policyholder in the event that they are involved in a smash. Competing on price forces insurers to manage the costs of claims, since these are the largest component of costs that insurers incur. For motor vehicle insurers, managing the size of repair bills is therefore an essential way of limiting rising insurance premia.
20. However, the smash repairer market is characterised by extensive “information asymmetries”. This simply refers to the fact that smash repairers are likely to have much more accurate information than the consumers who purchase their services (or the insurers that act on their behalf) about:
 - the extent of work required to repair a damaged vehicle to its previous state;
 - the quality of repair work undertaken by the smash repairer; and

- the true cost of the repairs that they undertake.
21. There is considerable scope for information asymmetry to lead to market failure in motor vehicle smash repair markets. This is particularly the case if an individual consumer is dealing with a smash repairer. Insurance companies can hire experts to try to overcome the problem. However, even in this case it is considered likely that repairers would still retain a substantial information advantage about the quality and true cost of their work, particularly given how difficult it is to estimate the time and materials for some repair work.
 22. Some smash repairers are able to exploit this information asymmetry by, for example:
 - recommending or prescribing additional work to a motor vehicle-owner which is really unnecessary (that is, ‘over-servicing’);
 - performing an incomplete or low quality repair job to ensure that the customer has to come back to have more repairs done later; and/or
 - charging the motor vehicle-owner a price that is not commensurate with the quality of the repairs.
 23. The problems associated with information asymmetry are compounded when (a) consumers play an important role in selecting a smash repairer and (b) as a result of insurance, consumers themselves do not bear the full cost of the choices they make. In those circumstances, consumers themselves may:
 - Have little incentive to monitor the costs associated with smash repairs; and
 - Allow their decision to be swayed by amenities that are largely extraneous to the quality and ultimate value of the repair job obtained.
 24. When these conditions are met, there is a significant risk of wasteful forms of competition emerging. More specifically, smash repairers may have incentives to provide amenities that influence consumer choice to levels of provision that exceed the efficient level (i.e. the level at which consumers would value those amenities, were they directly facing their cost).
 25. One way in which insurers can limit the extent of the resulting inefficiency is to specify maximum amounts that can be charged for particular tasks. Such maxima would not prevent competition from occurring, as insurers would continue to seek the best price for each repair. They would, however, signal to smash repairers who would otherwise engage excess costs that those costs cannot be recovered.
 26. An insurer such as IAG could impose such maxima unilaterally. However, there may well be gains, including in transparency and confidence in the process, were such maxima discussed with smash repairers. Discussions of this kind would seem especially important in the context of a wider shift in the charging basis, such as that involved in the move to RTRM.

E Conclusion

27. In this letter we have set out to show:

that the outcomes of an RTRM quoting process cannot be predicted without (1) substantive “paper” knowledge of the process, notably of time measurements and prices, and (2) substantive experience of how the system works in practice; and

that the development, and especially promulgation, of RTRM quoting is probably impossible without, among other things, at least implicit knowledge of the real money measures proposed.

28. Additionally, we have also set out wider considerations that highlight economic characteristics of smash repair markets, characteristics that make it important to control potential excess costs.

29. As a consequence, any application to authorise real time estimates by the MTAA must consider the whole RTRM process and the wider desirability of minimising the costs to consumers of obtaining smash repair services.

30. In this light, notwithstanding the comments from third parties, most notably AAMI, IAG urges the Commission, in commenting on the present submission by the MTAA, to maintain a neutral stance on whether future authorisations should include reference to prices.