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MARKETING COSTS FOR PERSONAL INJURY CLAIMS

Evidence of market failure

Report from Oxera Consulting Limited

EXECUTIVE SUMMARY

In December 2008, the Advisory Committee on Civil Costs (ACCC) proposed new Guideline Hourly Rates (GHRs) to aid judges in carrying out summary cost assessments (Nickell 2008). Noting that rates charged by personal injury (PI) claimants' solicitors were around the GHR, while those charged by PI defendants' solicitors were 20–35% lower, the proposed GHR rates broadly reflect the 2007 levels inflated by the ONS Average Earnings Index (around 8%).

One difference between the remuneration of defendants' and claimants' solicitors is that whilst defendants' solicitors recover their costs through fees charged to their clients, claimants rarely pay their solicitors' fees. Instead, under the standard 'no-win no-fee' arrangement for unsuccessful cases, the solicitor forgoes remuneration, and in successful cases, solicitors recover their costs from the defendant.¹

This research paper considers the impact of the current remuneration system on the incentives for claimants' solicitors to undertake marketing activities. Theoretically, the absence of any feedback from marketing costs incurred by the solicitor to the price paid by the claimant is likely to induce a higher level of marketing spend than would be observed in competitive markets where prices and costs are subject to a market constraint.

Whilst there are other constraints on claimants' solicitors' legal fees, including the GHRs, the analysis indicates that these have not been set to ensure that the level of marketing undertaken reflects the level that consumers are willing to pay for. Furthermore, the balance of power between intermediaries and solicitors in the market for PI claims suggests that any efficiencies achieved by the solicitor are likely to finance greater levels of marketing, as is evident in the general rise in referral fees over time. Industry experts have indicated that referral fees of approximately £400 were common in 2005, rising to £600 in 2007. Now fees in excess of £850–£1,000 would not be unusual.²

Indeed (as presented in section 4 of this paper), the level of marketing undertaken in the market for PI claimants' solicitor services relative to a broad range of competitive markets does appear high. Marketing spend within the PI market also appears high when benchmarked against the cost of Government campaigns to inform the public. For example, the expenditure by the Government on tobacco control in 2007–08 was less than half the total level of advertising in the PI market over the same period.³

In the letter from Nickell to the Master of the Rolls proposing the new GHRs, the ACCC explains that it feels 'unable to take the decision to move GHRs in the direction of defendants' solicitors rates when such a move could ultimately have serious

¹ Including a 'success fee' uplift to recover the costs of unsuccessful cases.

² Source: interviews conducted by Oxera.

³ Parliamentary publications and records.

implications for access to justice' (Nickell 2008, p. 4). A preliminary assessment of the potential impact of a downwards revision in GHRs is provided in section 5 of this paper. The results of the benchmarking exercise, combined with the functioning of the PI claimant market, indicate that it is likely that legal fees could be reduced without significantly reducing the number of PI claims. One reason for this is that the current level of referral fees appears significantly higher than the cost for making such a referral incurred by many intermediaries, who, as a consequence of their activity within other markets, already have access to potential PI claimants.

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1.0 INTRODUCTION

1.1 Objectives and remit

Oxera has been commissioned by the ABI to conduct research into the hourly rates used by claimants' solicitors for personal injury (PI) cases, and in particular to consider the level of marketing costs. The public letter sent by Stephen Nickell on behalf of the Advisory Committee on Civil Costs (ACCC) sets the immediate context of this report (Nickell 2008).

In this letter, the ACCC proposes new Guideline Hourly Rates (GHRs) to the Master of the Rolls, to apply from January 2009. While the ACCC makes some minor adjustments to the real 2007 GHRs, the proposed rates broadly reflect the 2007 levels inflated by the ONS Average Earnings Index (around 8%).

The ACCC notes that while rates charged by claimants' solicitors were around the GHR, those charged by defendants' solicitors were 20–35% lower.

The hourly rates of claimants' and defendants' solicitors would be expected to be similar since the level of skill required would be broadly comparable. The ACCC notes that it may be argued that 'claimants' solicitors incur additional costs arising both because claimant work does not appear at the door in a steady, uninterrupted flow and because they must pay "marketing" costs, such as referral fees' (these referral fees are paid by solicitor firms to intermediaries such as claims management companies (CMCs) that refer potential claimants to solicitors) (Nickell 2008). The ACCC intends to identify precisely how much of the gap between claimants' and defendants' solicitor rates can be accounted for by referral fees—the fact that defendants' solicitors also incur marketing and related costs would be taken into account in the analysis.

The importance of the proposed GHRs is heightened by the concurrent review of the PI claims process. The revised proposals, as set out within the Ministry of Justice's 'Response to Consultations', introduce a new system for road traffic accident (RTA) claims, with expected compensation of between £1,000 and £10,000 (Ministry of Justice 2008). The new system will remunerate successful claimant solicitors with fixed sums, at staged periods. It is expected that the GHRs will play a role in determining the appropriate level of these fixed recoverable fees.

This research paper is structured as follows. Section 2 assesses the functioning of the market for services to claimants. It considers the potential interaction between the level of referral fees and GHRs, and assesses whether there are adequate market mechanisms which could be expected to constrain these fees. Section 3 reports on the marketing costs incurred by PI solicitors. Such data is not publicly available, and must be estimated. It presents the results of both a direct and indirect approach. The direct approach is based upon the referral fee paid, and the indirect approach starts from the observed 20–35% fee discrepancy. These results for the marketing costs incurred by PI claimants' solicitors are then benchmarked against those incurred in a range of industries in section 4.

Section 5 summarises the main conclusions of the research and considers the possible impact on consumers of setting legal fees for claimant solicitors at a lower rate, potentially in line with the rates charged by defendant solicitors.

1.2 Methodology, data sources and terminology

Oxera has undertaken a market failure analysis. Consistent with this objective, the benchmarking exercise presented within section 4 compares the level of marketing costs within the PI claims market with a range of other markets. The report does not consider marketing costs at the individual firm level.⁴ However, for some of the benchmarked industries, the marketing costs of a sample of firms active within the industry are presented in order to overcome a lack of industry-wide data.

In general, the empirical analysis within this report relies on data sources covering the whole PI claims market that are available in the public domain. Where the available data was insufficient, data was obtained from a number of firms on an anonymous basis. In this paper the term 'marketing' is used to refer to a variety of forms of customer acquisition activities. In certain markets, such as consumer retail services (e.g. supermarkets), advertising is the dominant form of marketing. In others, such as energy supply, direct sales techniques are more prevalent. Within the benchmarking analysis, data may have been available only for the dominant form of marketing. Wherever this is the case, it has been noted.

⁴ Assessing the marketing costs of individual firms is not required for this analysis and poses a number of difficulties. Unlike overheads, for example, where an abnormally high level indicates a potential for improvement, high marketing costs for a given firm may indicate a wealth of attractive market development opportunities (a parallel can be drawn with R&D where a firm spending a higher proportion of its revenue on R&D than a rival would not be regarded as 'inefficient' but instead as having a more promising future). Furthermore, some firms may choose to spend more on marketing than competitors in order to build the value of their brand, an intangible asset, and hence the value of the firm (the strength of the brand being measured by the additional revenue generated from greater awareness of the firm and possibly greater reassurance of the quality of services offered).

2.0 ANALYSIS OF THE PERSONAL INJURY CLAIMANT MARKET

2.1 Personal injury market

In the 'Access to Justice Report', Lord Woolf recommends that all cases be allocated to one of three tracks to help control litigation costs (Woolf 1996). The current allocation of cases, described below, incorporates the proposals set out within the Ministry of Justice's Response to Consultation document (Ministry of Justice 2008).

- Small Claims Track—when the expected value of compensation for pain, suffering, and loss of amenity (PSLA) is less than £1,000, PI claims should be processed through the Small Claims Track.
- Fast Claims Track—when the expected value of compensation is between £1,000 and £15,000, PI claims should be processed through the Fast Claims Track.
- Multi-Track—when the expected value of compensation is above £15,000.

The purpose of the Small Claims Track is to provide an informal environment in which disputes can be resolved in a simple way. Only limited costs are recoverable; in particular, a successful claimant cannot recover costs for legal representation, other than a maximum sum of £260 for legal advice.

The large majority of PI claims are handled through the Fast Claims Track, where claimant solicitor remuneration depends on a number of other factors—the most important of which are:

- whether the claimant and claimant solicitor have entered into a Conditional Fee Arrangement (CFA);
- whether the claimant is successful;
- whether the claim falls within the scope of the Fixed Recoverable Costs Scheme (FRCS).

2.1.1 Influence of Guideline Hourly Rates

Where the claimant and claimant solicitor have entered into a CFA, the case is successful, and the case does not fall within the scope of either the FRCS or the Small Claims Track, the GHR can have a direct influence on the level of remuneration the claimant solicitor can recover. For successful cases, claimant solicitors recover 'base' costs, calculated according to their hourly rate multiplied by the number of hours worked, plus certain 'disbursements' including any 'after-the-event' (ATE) insurance premium. Base costs are then uplifted by a 'success' fee. The purpose of the success fee is to compensate the solicitor for the costs incurred in unsuccessful cases.

The ACCC 2007 survey (Nickell 2008) finds that the hourly rates charged by claimants' solicitors are typically close to the GHR. The influence of the GHR is strengthened further by the recommendation from the ACCC that judges use them as a starting point when undertaking summary assessments (Nickell 2008). As a result, changes in the GHR can

be expected to feed through directly into the amount earned by claimants' solicitors for handling these cases.

Since the 1999 Access to Justice Act, which permits a successful solicitor to recover fees from the losing party (rather than the claimant), and the removal of legal aid for PI, the prevalence of CFAs has increased substantially. These are now the dominant contract for employers' liability (EL) and public liability (PL) PI cases. However, since August 2003 (effective for claims made from October 2003), a large volume of PI claims have also been covered by the FRCS.

The FRCS was introduced after the legal costs of many PI cases had been successfully disputed by defendants. It covers all RTA claims where expected compensation is between £1,000 and £10,000, and Part 7 Proceedings (Court Proceedings) are not issued. Under the FRCS successful claimant solicitors can recover a fixed sum of £800, plus 20% of the damages agreed up to £5,000, or 15% of the damages agreed between £5,000 and £10,000.⁵ Therefore, the influence of the GHR in directly determining the level of claimant solicitor remuneration for such claims may be limited, but may influence the determination of both the fixed amount (£800) and the percentage of the agreed damages (20% or 15%).

The new system for RTA claims with expected compensation of between £1,000 and £10,000 is expected to cover the majority of straightforward claims where liability can be admitted within 15 days. This scheme will also remunerate claimant solicitors on the basis of fixed recoverable sums which are to be advised upon by the ACCC—the body that has proposed the new GHRs. It is expected that the fixed recoverable sums will be based on three dimensions:

- the solicitors' hourly charge-out rates;
- the grade of solicitors involved in each task;
- the amount of solicitor work required to settle a claim.

The GHR will have a key role in establishing solicitors' hourly charge-out rates.

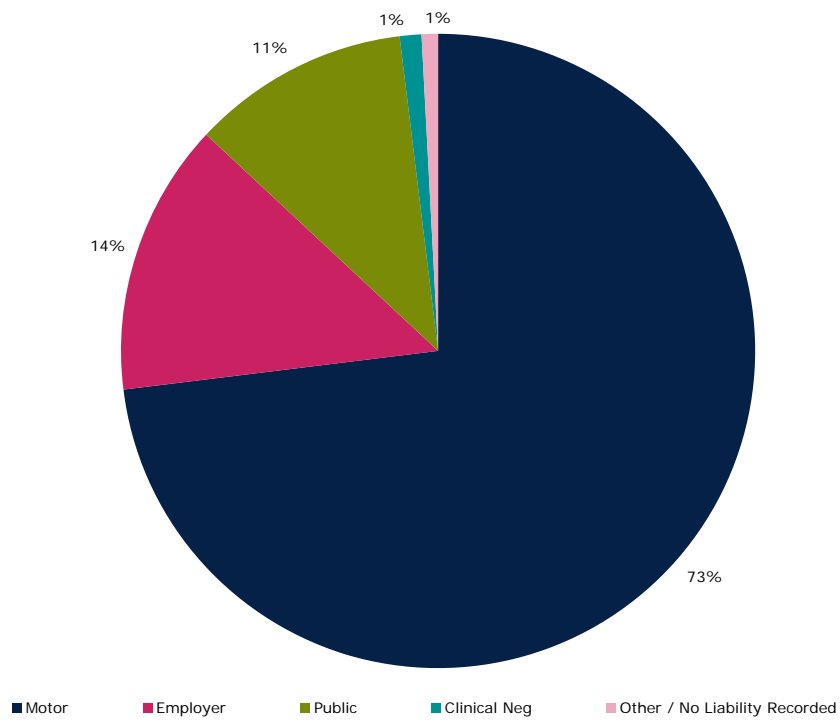
Where the claimant has not entered into a CFA, the solicitor is paid up front for any work undertaken. This may be covered by 'before-the-event' (BTE) insurance.

2.2 Personal injury claim market

PI claims cost around £7 billion per year—the majority of which result from RTAs (CMR 2007). In 2007 RTA claims accounted for around 73% of all PI claims, with EL and PL claims accounting for most of the remainder (CRU 2007).

⁵ These costs were based on a study of prevailing claimant solicitor costs (see Fenn and Rickman 2003).

Figure 1 Breakdown of PI claims by liability type



Source: Oxera analysis of CRU (2007).

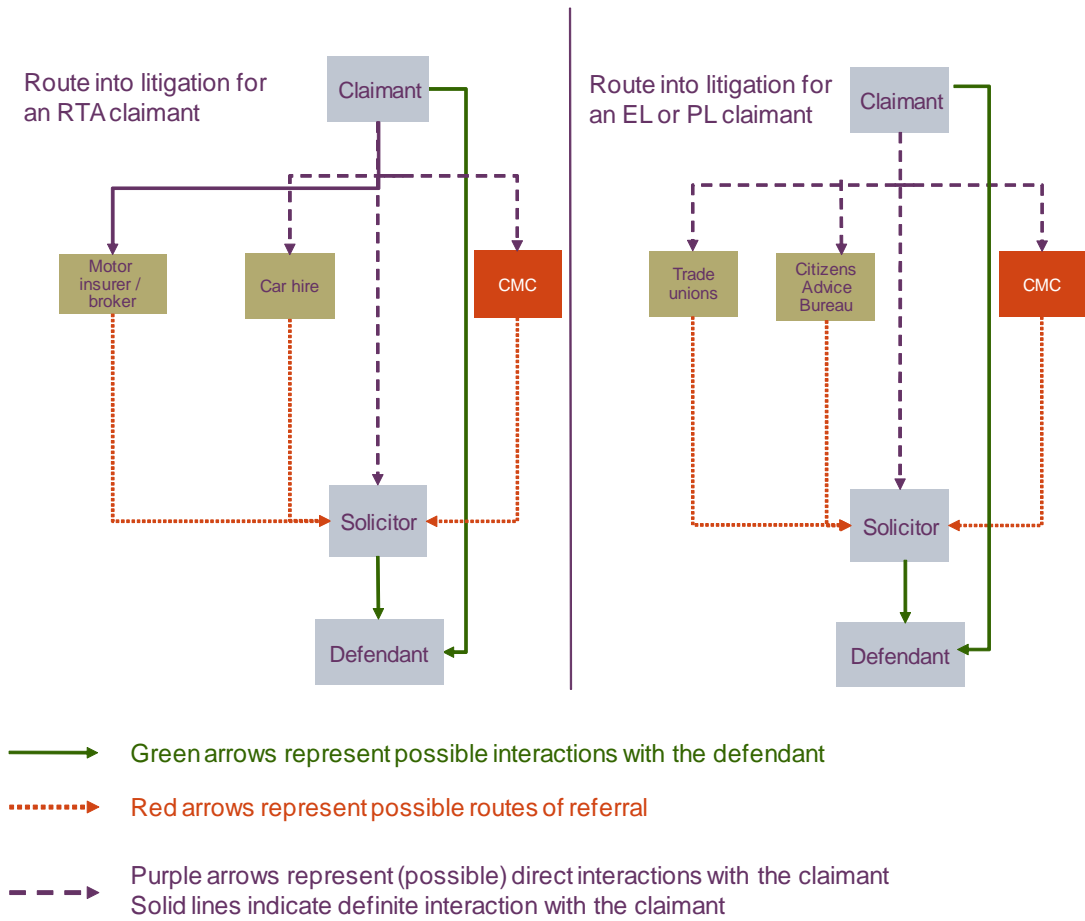
As explained above, the way each PI claim is pursued may vary. However, most claims are handled by a solicitor.⁶ Some solicitors attract this business through their own marketing, but the majority of cases are referred to solicitors by intermediaries. According to a survey of PI solicitors undertaken on behalf of the Law Society, the average number of PI cases conducted per annum for firms paying referral fees was 100 times that of those not paying.⁷

Figure 2 illustrates the possible routes into litigation for both RTA and non-RTA PI claimants: either through specialised CMCs or through intermediaries which, through the provision of their core products and services, may come into contact with potential claimants. For example, since RTA claimants may already be in contact with their own motor insurance company or broker, these firms are a source of information for the claimant to find out their rights regarding a potential PI claim.

⁶ For example, claims through the Small Claims Track are unlikely to involve a solicitor. Furthermore, if the liable insurer is aware, they may contact the claimant directly to offer compensation.

⁷ The sample size of PI claimant solicitors was 17, most of whom were reliant on paying referral fees (see Moulton Hall Ltd 2007).

Figure 2 Possible routes into litigation for different types of PI claimant



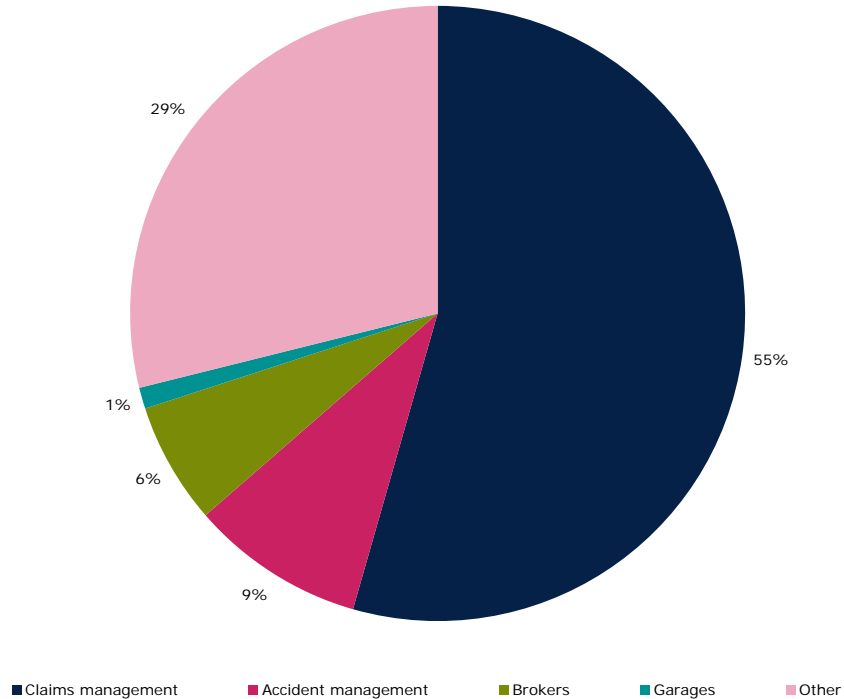
Source: Oxera.

Since the 2006 Compensation Act, most intermediaries receiving referral fees must be authorised by the Claims Management Regulator (CMR). The exceptions include those already regulated in respect of regulated claims management services—legal practitioners and insurers—and charities, not-for-profit agencies and independent trade unions.

Such registration has provided a valuable source of information into the activities and players within the PI referral market. As of February 2008, 1,385 firms had been authorised, and the breakdown by principal business activity of firms that applied for authorisation as of June 2007 is illustrated in Figure 3. Notably, only 55% of those applying for registration provided claims *management* services as their principal activity. The principal activity of the other firms applying for registration with the CMR cover a broad range, from accident management (e.g., the provision of credit hire and repairs) to insurance brokers.⁸

⁸ Realised referral market share may differ from the breakdown according to the application for authorisation for three main reasons. First, not all applications will be successful. Second, relative turnover may not accurately reflect the proportion of referrals handled. Finally, since insurance companies regulated by the Financial Services Authority are not required to register with the CMR, their role in referring claimants is likely to be underestimated. However, this analysis still provides insight into the referral market.

Figure 3 Companies applying for authorisation with the Ministry of Justice (June 2007) by turnover



Note: Accident management mainly covers the provision of credit hire, repairs, and legal expenses insurance. 'Other' includes a number of insurers.

Source: Oxera analysis of Ministry of Justice (2007b).

2.3 What determines the level of marketing costs within the PI claimant solicitor market?

2.3.1 What mechanisms constrain legal costs?

Marketing is a standard feature of any market. It can have an important role in reducing consumers' search costs, informing them about products and prices, and helping them to choose between brands.

Typically the consumer has three roles in a market: choosing the good/service (thus, the target of marketing); paying for the good/service; and enjoying the good/service. In competitive markets, where the consumer both chooses and pays for the good/service, marketing costs will be constrained by consumer behaviour. As a firm increases its marketing spend, everything else remaining the same (for example, no efficiencies are made elsewhere), its unit costs rise and, to remain in business, unit retail prices will also have to rise. All other things being equal, a firm with higher per-unit marketing costs must offer the consumer some advantage over cheaper rivals in order to remain in business, and this mechanism constrains these costs to those to which the consumer attaches some value. Although marketing costs may vary across firms, within a competitive market, marketing costs will therefore be kept within certain limits.

This feedback loop, where increasing marketing spend affects the price consumers pay, is typically absent in the PI claimant solicitor market. Almost all claims are either funded through CFA or by BTE insurance, both of which protect the claimant from the costs incurred by the claimant's own solicitor. As a result, there is no feedback loop between the marketing costs incurred by the claimant's solicitor and the price faced by that claimant for the services of that solicitor.

The question is whether there are any other mechanisms that impose constraints on fees charged by PI claimant solicitors (and their marketing costs). The following four potential mechanisms that may constrain costs for individual cases were identified—none, however, introduces any *market* mechanism whereby the *claimant* can constrain the costs of the provider of those services.

- **The FRCS introduced in October 2003**

- For claims that fall within the scope of the FRCS, the level of costs that claimant solicitors can recover is independent of the actual costs incurred. Whenever the level of recoverable fees exceeds the total cost incurred by the solicitor for pursuing the case, there is excess rent in the system. This rent is the maximum amount that the solicitor can pay for a referral (or spend on marketing activities) without incurring a loss on the case.
- Although this mechanism indirectly creates a cap on marketing costs, there is no evidence that the level of marketing costs incurred was considered when the fees were set. Furthermore, if solicitors reduce the internal costs of PI handling, for any given level of fixed fee, a higher level of marketing (and referral fee) is affordable. Thus, over time, fixed fees should be reviewed to ensure that they are still in line with efficient behaviour.

- **GHR**

- For CFA claims outside the scope of the FRCS, successful claimants' solicitors can recover variable costs from the defendant. Recoverable costs are calculated as base costs, plus disbursements, uplifted by a success fee. Since referral fees are not counted as disbursements, these payments (as with other marketing costs) are constrained by the level of base costs and success fee awarded.
- For most PI cases the success fee is set at 12.5%—chosen to enable solicitors to recover the costs of unsuccessful CFA cases. Base costs are calculated according to the solicitor's hourly rate and the number of hours worked. The reported number of hours worked may be negotiated downwards by the defendant. However, the institutionalisation of the GHR limits the scope for negotiation over this aspect of base costs since claimant solicitors generally charge around the GHR.
- By altering the level of the GHR (or success fee), the Ministry of Justice could in principle impose a constraint on the level of marketing spend by claimant solicitors. However, as with the FRCS, there is no evidence to suggest that the level of marketing has been considered in past determinations of GHR.

- Indeed, the observed discrepancy of 20–35% between defendant solicitors’ fees and the GHR suggests that the current GHRs allow claimant solicitors to spend a certain amount on marketing, over and above the level already incorporated into the defendant solicitors’ hourly rates.
- **Credit constraints**
 - The standard agreement between intermediaries and solicitors typically involves an up-front payment of the referral fee, or at least payment within a certain timeframe before the case has been settled. In contrast, under the prevailing legal arrangements, the solicitor will receive their remuneration only after the case has settled.⁹ Cases range widely in duration—many lasting approximately six months—however, higher-value cases can often take between two and five years to settle. This timing mismatch will impose additional costs on the solicitor—the significance of which will depend on the firm’s access to capital and the typical duration of the case.
 - Again, there is no reason to expect credit constraints to restrict marketing expenditure to the level claimants would be willing to pay for.
- **Part 36 offers**
 - If the claimant rejects a Part 36 offer, but the court does not improve upon this offer in the final amount awarded, the defendant is not liable for the claimant solicitor’s legal costs incurred after the Part 36 offer. This is another example of legal costs being constrained, but not necessarily at the level that could be observed in competitive markets.

2.3.2 The determination of referral fees

Few PI solicitors choose to advertise directly themselves, but instead use intermediaries. The solicitor can afford to pay a referral fee for a case up to the level of the legal costs they can recover, minus the other direct costs incurred. However, since neither of these is known with certainty prior to settlement of a case, the solicitor must take some risk when deciding to pay a referral fee and accept a case. In addition, negotiations over referral fees on a case-by-case basis are limited in practice, since almost all solicitors make written agreements that both standardise the referral fee across a number of cases and restrict the flexibility that the solicitor has to refuse individual cases (Moulton Hall Ltd 2007).

Claim management companies’ bargaining power

The exact level of a referral fee negotiated between solicitor and intermediary will depend on the relative bargaining power of each party.

⁹ The new fixed fee system proposes to introduce staged fixed fees, which may overcome this cash-flow problem.

The solicitor's bargaining power (at least in the short run) will be significantly affected by the costs of sourcing the same volumes of PI work through alternative means.¹⁰ In effect, they can choose between undertaking the marketing activities themselves or sourcing PI work through another referral company. In the long run, the *maximum* that solicitors will be prepared to pay as a referral fee, or to incur as in-house marketing costs, is the difference between the fees they can recover and the cost of actually executing the case once the potential claimant is engaged.¹¹ This is essentially a residual. A significant feature of this dynamic is that the 'price' (i.e., how much solicitors are prepared to pay) is determined by the *value* to the purchaser, not the *costs* to the provider. In contrast, in well-functioning markets competition usually drives prices down to the level of costs.

How credible is the threat of sourcing PI work through alternative options?

In many types of PI case there will be intermediaries that have a natural advantage in identifying potential claimants. This restricts the extent to which solicitors can source PI work as effectively, thereby reducing their bargaining power. Natural advantages arise when the intermediary has a captive market as a result of its activity within a secondary market. In some instances potential claimants may have already made contact with an intermediary as a result of the event that led to the potential claim—for example, motor insurance providers or brokers in the case of RTA claimants, and trade unions in the case of workplace injuries.

In addition, even if the intermediary has no intrinsic advantage in being able to identify potential claimants, the activities required to identify such claimants are not the same as those required to execute cases. Solicitors may have no advantage, and indeed may be at a disadvantage, in conducting customer acquisition activities, even when there is no natural advantage in terms of potential client identification. The cost effectiveness of marketing activities is likely to depend on a number of factors, such as economies of scale and scope and first-mover advantage.

Establishing a strong brand name through advertising generally requires substantial investment and a successful marketing strategy, but the investment required does not increase proportionally with the volume of work it (is expected to) attracts.¹² Therefore, the greater the output of the firm, the more scope for economies of scale, as the fixed expenditure on advertising can be recovered from a wider output base. If referral companies can handle a higher volume of PI cases than solicitors, there is greater scope for economies of scale in advertising. The top three advertisers within the UK PI claims market each spent in excess of £4.4m on advertising in 2007, significantly more than the next player's expenditure of £0.7m (Datamonitor 2008, Table 24). Whilst the top two are CMCs, the third is a solicitors firm, indicating that some solicitors have chosen to invest in their own brand name to attract claimants.

¹⁰ In the longer term, solicitors could exit the PI market and focus on other parts of the law.

¹¹ In practise PI solicitors may be willing to incur short-term losses, in order to be in a better position to attract future, profitable cases.

¹² An example of a strong brand which does not advertise is Google.

The importance of outsourcing marketing activities for small PI claimant solicitors is supported by the survey on PI claimant solicitors undertaken on behalf of the Law Society. This found that 'Most of the firms are reliant on paying referral fees to get PI cases, particularly the firms with less than 5 partners' (Moulton Hall Ltd 2007).

If the referral company is active across multiple markets, the potential for economies of scale is even broader. For example, an insurance broker is likely to offer a wide variety of products (including motor insurance, household insurance and personal insurance products such as travel insurance). If there is sufficient demand for each product, this product diversification will lower the advertising cost incurred per unit sold.

Companies that have already established a strong brand image within the PI market may benefit from a first-mover advantage for two reasons. First, maintaining a brand name will typically involve less advertising than establishing a new brand. Second, the advertising expenditure required to launch a brand name in a new market is likely to be lower than when other brands have already become established. This will reduce the extent to which some solicitors are as effective at marketing as established referral companies.

The emergence of solicitors offering claimants who make contact directly (thus bypassing the intermediary) a cash payment indicates that at least some solicitors feel that they cannot compete with referral companies by advertising alone. An example of this is Simpsons Millar, which is currently advertising a payment of £250 to claimants who sign a 'no-win no-fee' contract.¹³

These market features suggest that the referring companies have bargaining power over the solicitors. Solicitors bid for 'leads' from the referring companies—some referring companies have even instituted formal bidding processes to extract the highest willingness to pay from solicitors.

2.3.3 Who benefits from solicitor efficiency savings?

In the market for PI claimants' solicitors' services, the decision over which solicitor to use is made by the claimant—however, due to the prevalence of CFAs and BTE insurance, claimants rarely bear the cost. This reduces the incentive for solicitors to pass on any efficiency savings in the form of lower legal fees since, unlike in many other markets, lower prices are unlikely to attract a greater volume of work. Instead, if solicitors are in competition for claimants, such efficiency savings are likely to result in higher marketing spend—for example, higher referral fees to intermediaries. Thus the natural evolution of markets of this sort may be to reflect efficiency savings in case execution, not in lower prices but in higher costs (unless the administrative system that constrains cost recovery explicitly takes into account the reduction in case execution costs).

The following extract from the survey undertaken on behalf of the Law Society into PI claimant solicitors supports the finding that efficiency savings are passed on in terms of

¹³ <http://www.simpsonmillar.co.uk/offers/freeoffer.aspx>.

higher referral fees. Regarding the funding of referral fees, the survey found that 'firms either accept the additional cost or try and reduce other costs to the firm by changing the way they work through new technology and employing less qualified staff to increase the volumes of cases they can manage (Moulton Hall Ltd 2007).

The final dynamic in the market is competition between solicitors for a relatively stable supply of PI work from referral companies. Referral fees have indeed increased over time. Evidence suggests that the payment of explicit referral fees began in 1999, at a level of approximately £50 per referral. For some BTE referral companies, this explicit referral fee was paid in addition to the solicitor accepting a number of unprofitable, non-injury, cases for every PI case referred. As the business model of such referral companies altered, and the non-injury cases were handled in-house, referral fees for the PI cases rose quickly to around £250. By 2006, fees of approximately £600 were considered typical and, more recently, fees of £850–£1,000 were considered not uncommon.¹⁴

Intermediaries with natural advantage

In the same way that intermediaries with natural advantages in identifying potential claimants have an advantage over solicitors, they also have an advantage over other intermediaries. Natural advantages arise when the intermediary has a captive market as a result of its activity within a secondary market. This advantage is therefore likely to be very specific. An RTA victim is likely to contact their own insurer (or insurance broker) with respect to that accident, but not multiple insurance companies or brokers. They may have an interaction with the garage that repairs the vehicle, but not multiple garages. Competition between intermediaries with natural advantages for the *same* potential claim is therefore likely to be absent or weak.

However, if the intermediary is also active in other markets, and the natural advantage is a general consequence of providing services in those other markets, the excess of any referral fee over the costs of the referral process may be competed away in this other market. For example, if the intermediary established the relationship with the potential PI claimant as a consequence of providing another service, any expected income from referral fees may be factored into the price of the original service, resulting in lower prices to consumers in that market.

Intermediaries without natural advantage

Where intermediaries do not have a natural advantage there will be more scope for competition between them. The main problem facing these firms is the location of potential claimants and (in the presence of a ban on cold-calling) persuading them to make initial contact. Their income is set by the referral fee and the number of cases they successfully refer. The referral fee is determined by the value to the solicitor, not their costs. The profit-maximising strategy for solicitor firms is to incur their own costs up to the point where marginal expenditure required to gain the next case is equal to the marginal value (i.e., the referral fee) that they can obtain. In this way solicitor firms

¹⁴ Source: various interviews conducted by Oxera.

maximise their total profits. However, if these firms are in competition for the *same* potential claimants, their actions in terms of additional expenditure may not only increase the number of potential claimants they acquire, but may also *decrease* the claimants acquired by their competitors. This interaction between firms will tend to stabilise at a level where, whatever the level of referral fees, CMCs compete away any excessive profit they might earn.¹⁵

Critically, with a market dynamic such as this, the apparent increase in potential claimants that an individual firm experiences as it increases its expenditure on inducing claimants to make contact is potentially very different from any increase in the *total* number of potential claimants who make contact with all CMCs. Similarly, the dynamic will work where CMCs *reduce* their expenditure on inducing potential claimants to make contact—the experience of the individual firm if it reduces expenditure on its own is different from that of the firms taken together if they all reduce expenditure. Even though marketing that expands market *share* rather than market *size* is a feature of competition in many markets, the level is generally constrained because higher marketing costs increase the price that consumers pay. However, a similar market constraint is absent in the market for PI claimants' solicitors services.

2.4 Conclusion

This section concludes that legal fees charged by claimants' solicitors are not subject to sufficient market constraints; therefore, the expenses incurred in marketing are not constrained by the claimant's willingness to pay. Within this structure, referral fees paid by solicitors (or the level of marketing costs they are willing to incur in-house) are likely to be the residual between the costs of actually executing the case and the costs that can be recovered via the administrative procedure from the defendants.

Both theory and practice indicate that, under the prevailing system, marketing costs will expand to take up the difference between the costs incurred by solicitors in actually executing the case and the costs they can recover. This is likely to induce a higher level of marketing spend than what would be observed in competitive markets where prices and costs are subject to a market constraint.

The analysis indicates that the referring companies have bargaining power over solicitor firms—some have instituted formal bidding processes to extract the highest willingness to pay from solicitors. This means that there is a tendency for referral fees to increase over time—any efficiency savings made by solicitors over time are likely to be passed on to the referring companies in the form of higher referring fees. This is confirmed by evidence on referral fees over time and the survey undertaken on behalf of the Law Society into PI claimant solicitors. In comparison, in more straightforward competitive markets, the level of marketing spend is determined by what the customers are willing to pay. This is

¹⁵ In comparison, intermediaries with captive secondary markets are unlikely to compete for the same potential claim, thus costs in attracting claims incurred by intermediaries with natural advantages are unlikely to be driven up in the same way.

considered in the following two sections: section 3 estimates the level of marketing spend in the PI sector, and section 4 compares this with the level of marketing costs in other markets, in order to provide some insight into the level of marketing for which PI customers may be willing to pay.

3.0 PI CLAIMANT SOLICITOR MARKETING COSTS

Under the current legal system, PI claimants do not (generally) pay their solicitors' fees. Instead, these are recovered from unsuccessful defendants, at a level determined either by the existing FRCS, or one that is deemed reasonable by the judge carrying out the cost assessment.

As explained in section 2, this lack of feedback of costs incurred by a solicitor on consumer prices indicates that marketing activities by claimants' solicitors are not constrained by the claimants' willingness to pay. If other constraints are ineffective, this may translate into an excessive level of marketing activity.

In preparation for the benchmarking analysis, this section reports on the level of investment in marketing by PI claimants' solicitors. In the absence of publicly available data on marketing spend by PI claimants' solicitors, this has been estimated. Two methods have been used. The first takes a top-down approach and is based on the 20–35% fee discrepancy between defendants' and claimants' solicitors reported by the ACCC. The second is a bottom-up approach and uses estimates of the referral fee as a starting point. The approach behind each estimate is explained in sections 3.1 and 3.2 respectively.

3.1 Estimation of marketing costs based on the 20–35% fee discrepancy reported by the ACCC

The ACCC notes that while rates charged by claimants' solicitors were around the GHRs, those charged by defendants' solicitors were 20–35% lower (Nickell 2008). The hourly rates of claimants' and defendants' solicitors would be expected to be similar since the level of skill required would be broadly comparable.

The ACCC notes that it may be argued that 'claimants' solicitors incur additional costs arising both because claimant work does not appear at the door in a steady, uninterrupted flow and because they must pay "marketing" costs, such as referral fees' (Nickell 2008).

Defendants' solicitors also incur marketing costs. The PWC 2008 law firms' survey reports that marketing and business development costs were between 2–3% of fees billed (PWC 2008). Since this does not consider the costs incurred by fee-earners undertaking business development activities, which are likely to be significant, or any forgone revenue from offering discounted rates, it may be considered a conservative estimate.

If, as suggested by the ACCC, the discrepancy between claimants' and defendants' solicitors fees accounted for additional marketing spend by claimant solicitors, and defendant solicitors also incur marketing spend of between 3–5% (still a conservative estimate), then the total amount that claimant solicitors' spend on marketing would be within 23–40% of their turnover for PI claims.

3.2 Estimation of marketing costs based on referral fee

The survey undertaken on behalf of the Law Society reports that PI claimant solicitors describe referral fees as 'acquisition costs treated no differently from advertising or marketing costs' (Moulton Hall Ltd 2007, p. 4). This suggests that referral fees are a suitable proxy for the marketing costs incurred by PI claimants' solicitors.

Some referral companies advertise additional services to customer acquisition at no extra cost to the referral fee—for example, claims management. In these circumstances, the referral fee may overstate the marketing costs incurred by solicitors. However, interviews with various firms and industry experts indicate that these additional activities are limited and that most firms focus only on customer acquisition. Furthermore, the Law Society report finds that, within the PI market, 'as a result of paying referrals the firms have an increased administrative burden' (Moulton Hall Ltd 2007, p. 4). This indicates that the referral fee may underestimate the full cost of outsourcing marketing to an intermediary. Thus, on balance, the referral fee seems a reasonable estimate of marketing costs incurred by PI claimants' solicitors.

Solicitors are not required to report on any payment of referral fees except at the claimant's request, and there is no (apparent) public record storing such information. Therefore, data on referral fees has been gathered from published sources and interviews. Table 1 summarises the referral fees cited within various public documents. However, information from interviews indicates that the current level of referral fees may be somewhat higher, at approximately £850–£1,000.

Table 1 Referral fees

Referral fees	Estimate	Source
Lower estimate	£250	Moulton Hall Ltd (2007)
Higher estimate	£900 ¹	ABI (2009)
Most common estimate	£600	Mean according to Moulton Hall Ltd (2007) and ABI (2009) reports Midpoint of range within Nickell (2008) Lower estimate reported within Ministry of Justice (2007a) Estimate of a typical fee in CMR (2007)

Note: ¹ Higher estimates in excess of £1,000 were cited during confidential interviews.

Source: Oxera calculations using data from ABI (2009); Ministry of Justice (2007a); CMR (2007); Nickell (2008); Moulton Hall Ltd (2007).

Using both benchmarks, Table 2 presents a range of estimates of marketing spend as a proportion of base legal costs: between 23% and 40%. Adopting the higher estimates for referral fees of £850–£1,000 (as cited during interviews), marketing spend as a proportion of legal costs would be higher, ranging between 38% and 44%.

Table 2 Marketing relative to PI claimant solicitors' base legal costs

Estimate	Expected value of compensation	Explanation
23%	All claimants	The lower bound of the 20–35% fee discrepancy between claimant and defendant solicitors This assumes that defendant solicitors incur 3% marketing costs and claimant marketing spend accounts for the full fee discrepancy
27%	£1,000–£25,000	£600 referral fee divided by £2,257 base legal costs Base legal costs were estimated using ABI data on the mean legal costs for PI motor claims with expected compensation of between £1,000 and £25,000
40%	£1,000–£25,000	£900 referral fee divided by £2,257 base legal costs Base legal costs were estimated using ABI data on the mean legal costs for PI motor claims with expected compensation of between £1,000 and £25,000
40%	All claimants	The upper bound of the 20–35% fee discrepancy between claimant and defendant solicitors, plus 5% for marketing spend by defendant solicitors This assumes claimant marketing spend accounts for the full fee discrepancy

Source: Oxera calculations using data from ABI (2009); Ministry of Justice (2007a); CMR (2007); Nickell (2008); Moulton Hall Ltd (2007).

4.0 BENCHMARKING PI CLAIMANT SOLICITOR MARKETING COSTS

4.1 Approach to benchmarking analysis

Marketing typically serves two purposes in a market: to *inform* consumers about the characteristics of different products, and to *persuade* consumers to buy a product. These roles tend to overlap because all marketing contains at least some information on product characteristics.

Whilst marketing is tailored to the firm's interests these roles can also be valuable to consumers. For example, where consumers' search costs are significant, marketing may be an effective way of *informing* them about products and prices, and helping them to make consumption decisions. Where this occurs marketing provides immediate benefits through increased consumer choice, but can also foster dynamic benefits by increasing the intensity of competition in a market.

Marketing may also facilitate the entry and expansion of new firms with further dynamic benefits from more intensive competition. For example, new firms may use marketing to expand their market share, exploiting economies of scale and capturing the demand of established firms (see Church and Ware 2000, p. 570).

Whilst marketing can provide value, it is not without cost. Since marketing is an additional activity for a firm to undertake; holding output constant and comparing with a situation where no marketing takes place, the cost of supply is higher in the presence of marketing. Thus, where marketing has a minimal effect in informing and/or persuading consumers, given the additional cost it introduces into the market, it may be considered (from the consumers' perspective) to be excessive. In particular, high expenditure on brand marketing can be a concern for efficiency. This is because, to the extent that brand marketing does not inform consumers about real differences between products, it may increase rather than reduce consumers' search costs by creating product differentiation that is perceived rather than real. This can reduce the intensity of effective competition, such that firms' efforts to improve their market shares are channelled into marketing expenditure (which may increase perceived product differentiation) rather than low prices.

It is not within the scope of this research paper to precisely identify the efficient level of marketing within the PI claimant market. Instead, the approach taken in this section is to compare the level of marketing with a range of markets, each of which shares some similarities with the PI claimant solicitor market, although importantly, unlike PI claimants, consumers face the cost of the product. The market for mobile telephony has also been considered. Here such a constraint was absent and the regulator intervened with the aim of limiting marketing and acquisition spending (Competition Commission

2003a).¹⁶ Therefore, this analysis can be used to assess whether the level of marketing currently undertaken in the PI market is comparable to the level that consumers pay for in other markets.

In addition, this section draws comparisons between the marketing spend by PI claimants' solicitors and the costs incurred by the Government during various public information campaigns to inform the public. If the key role of marketing within the PI claimants' solicitor market is to inform potential claimants of their rights to claim, this comparison can provide a useful benchmark to assess the current level of marketing cost in the PI sector.

The level of marketing undertaken by a firm will depend on a number of factors. Gupta and Lehmann (2001) argue that customers can be considered as important intangible assets of a firm; thus the level of marketing spend increases with the expected lifetime value of each customer. As either the value of the service/good increases or the number of purchases each customer is expected to make increases, for a given cost, a firm will invest a greater (absolute) amount in marketing, although in proportion to the total value of sales, marketing spend may decrease. Therefore, it is reasonable to expect a higher level of marketing in markets for higher-value consumer goods such as cars than for soft drinks, for example. On the other hand, for certain low-value products the expected number of purchases may be higher than for high-value products, thus mitigating this effect to a certain extent. Again, soft drinks are a suitable example.

Another determinant that affects the level of marketing spend will be the types of marketing that are both available to the firm and effective in increasing sales. For some markets, such as energy supply, specific customer acquisition activities may be required to effectively persuade consumers, whereas for other retail consumer goods a lower-cost method of marketing such as advertising might be as effective.

The development stage of the market is also likely to have a significant impact. When there is a large cohort of unaffiliated consumers—for example, during the early stages of a market—marketing levels may be relatively high. Marketing to attract unaffiliated consumers may be more cost-effective than when competing over existing market shares.

In certain markets, marketing can play an additional role in informing and persuading consumers. It may, for example, serve as an input that enables consumers to derive more social prestige when the advertised product is consumed. This complementary role for marketing was identified by Stigler and Becker (1977).¹⁷ In sum, the level of

¹⁶ In the case of mobile telephony, when a customer receives a call from another network, the terminating (receiving) network is paid a termination fee by the originating network for carrying the call. The terminating network then has an incentive to undertake marketing and other customer acquisition expenditure to increase its market share of customers and to receive an increase in its net termination revenue. The cost of such advertising can at least in part be recovered through the termination revenue received and, critically, this revenue is paid for by the originator of the call through their call charges, and not the customer that has been acquired by the terminating network. Since 1999, the regulator has intervened and capped termination rates, excluding the cost of marketing and customer acquisition costs when estimating the appropriate price caps for call termination.

¹⁷ The complementary nature of marketing is also discussed in Telser (1964).

marketing costs depends on a range of factors and is likely to vary by market and product. This section therefore considers a range of markets. In section 4.2 marketing undertaken within a range of consumer good markets is estimated by considering the marketing costs for a sample of manufacturers and retailers. This includes common consumer products such as energy and groceries, but also goods with higher value such as furniture and cars (to take into account any possible effects of economies of scale).

The service provided by solicitors in the PI sector is a professional service. Sections 4.3, 4.4 and 4.5 therefore consider marketing spend within markets for other professional services. Section 4.3 does this for services offered to businesses, and sections 4.4 and 4.5 for services offered to consumers.

Section 4.4 compares the marketing activity by PI claimants' solicitors with the level within markets for other claims services (offered to consumers), specifically in relation to mis-selling of financial services products, and section 4.5 draws comparisons with the level of marketing within other civil legal services (offered to consumers).

Section 4.6 compares the marketing spend within the PI claimants' solicitor market with the costs of Government campaigns.

4.2 Marketing costs for consumer products

Markets for a range of consumer products are included in this analysis, many of which are generally considered highly competitive. Firms operating within such markets typically have significant constraints on their marketing costs imposed by consumers; therefore, it would be expected that such marketing costs represent a level that consumers are willing to pay for.

To estimate the marketing costs within different consumer goods markets, Tables 3 and 4 present the marketing costs incurred by a sample of firms active within such markets. While marketing costs may vary between firms active within the same market—thus these figures are only approximations of the average level of marketing within a specific market—the variations observed do not appear large, especially when compared with the estimates of marketing spend within the PI claims market. For example, in the market for soft drinks, advertising/net sales for Coca-Cola are twice the level of that for Pepsi. However, at 10% this is still less than half the level within the PI claims market, estimated to be between 23% and 40%.

For many consumer goods, the manufacturer and retail distributor are different companies, both of which may undertake marketing activities. For example, marketing activities undertaken by both Tesco and Colgate may affect the sales of Colgate toothpaste. In cases like this, the level of marketing can be estimated by taking a weighted average of the marketing costs incurred throughout the value chain. For toothpaste, this will lie somewhere within the two estimates, 1% and 11%. By splitting the sample of firms into wholesalers, presented in Table 3, and retailers in Table 4, it is clear that similar levels of marketing activity are undertaken by firms active at both points of the value chain.

For wholesalers, marketing activity is considered by comparing advertising as a proportion of net sales or turnover—both of which represent the price of the end-product to the customer. Excluding mobile telephony (where the Competition Commission considered the level of marketing activity excessive—this is considered separately below), marketing activity ranges between 1% and 17%, and the mean is 9% (Competition Commission 2003a). For retail firms, Table 4 presents advertising expenditure as a proportion of an estimate of the value added by the retailer, gross profit. The estimates in Table 4 range between 1% and 12%, within the range for wholesalers, and the mean is 7%, similar to the mean of 8% for wholesalers. In addition to advertising expenditure, some firms may incur additional costs, such as loyalty card schemes and/or sponsorship. Although a loyalty card scheme could be considered a discount on prices, arguably it could also be considered an extension of marketing. Including the cost of Tesco's loyalty card scheme (in terms of vouchers given away) increases the estimate of its marketing activity to 12% of gross profit in 2007.¹⁸ This is more comparable to Morrisons advertising spend ratio, another supermarket retailer in the sample, but whose loyalty card scheme was limited to the sale of car fuel in 2007 (Morrisons 2008, p. 51).

Since PI claimants' solicitors provide the service of legal representation, the equivalent for the PI claims market is to consider marketing spend as a proportion of base legal costs. As presented in Table 2, this is estimated to range between 23% and 40%. This is above the range of figures reported for all retailers in Table 4 except energy suppliers, and for the majority of manufacturers reported in Table 3.

This higher level of marketing activity observed within energy supply markets compared with other consumer goods is explained in the 2003 Competition Commission merger investigation (Competition Commission 2003b). According to the Commission, 'changing energy supplier is a more complex decision for customers than, for example, changing a brand of household product at the supermarket.' Reasons given include: 'the time taken to learn about different suppliers prices, uncertainty about future prices, inertia, the hassle factor and fear of billing problems.' The Competition Commission considers that one consequence of this is that 'suppliers tend to incur high costs in attracting new customers, in particular through direct selling and advertising.'

To the extent that both CMCs and energy supply companies often interact directly on an individual level with potential customers, the nature of marketing activities may show some similarity, although differences still apply—for example, an energy supply company will typically be persuading a customer to *switch* suppliers, whilst a CMC will typically target a 'new' customer, unaffiliated with other firms. Furthermore, an energy supply company will be marketing on behalf of the generator, thus it may be appropriate to consider its marketing costs as a proportion of the total cost of the competitive parts of

¹⁸ Tesco has also been cited as limiting its marketing budget to 1% of gross sales. This is equivalent to around 12% of gross profit in 2007—comparable to the combined cost of advertising and club card vouchers. FusionBrand (2004).

energy supply (i.e., generation and retailing). This would reduce the measure of marketing activity substantially, to below 15%.¹⁹

However, even compared with the market for energy supply, estimates of the current level of marketing activity within the PI claims market appear high, ranging between 23% and 40%, compared with 25%.

It is also worth considering Ford in more detail, which compared with the rest of the sample manufactures significantly higher-value goods. Ford manufactures significantly higher-value goods than the rest of the sample. According to its 2007 annual report, total vehicle sales rose to 444,600, indicating an average sale value of about £20,000. Interestingly, marketing activity by Ford is also one of the lowest estimates in the sample, indicating that there may be economies of scale in advertising. The legal costs of PI claims are of higher value than many of the other products in the sample included in Table 3. Therefore, this indicates that should consumers face the cost of marketing for PI claims, the level of marketing undertaken may be constrained at the low end of the figures presented in Table 3.

On average, Ford spends approximately £128 on marketing per vehicle sold (Ford Motor Company Ltd 2007). This is still somewhat lower than the referral fees paid within the PI claims market.

4.2.1 Case study: mobile telephony

The marketing spend ratio observed within mobile telephony in 2001 is of particular interest. Prior to regulation, mobile call termination rates were set by the terminating network but paid for by the customer of the originating network. As a result, the prices charged by the terminating network were not constrained by their own customers' willingness to pay. In addition, the market dynamics were such that revenue earned from call terminations was likely to be used to acquire more customers (who would then receive more calls) and, as a result, the excess revenue was competed away.

Although Oftel began regulating termination rates in 1998, the 2002 Competition Commission investigation concluded that termination rates were too high. The Commission recommended that termination rates should be cost-reflective and, critically, it decided to exclude *any* customer acquisition costs from this calculation (Competition Commission 2003a). The costs of customer acquisition were to be recovered only from those charges faced by the network's own customers. These findings were reinforced in the 2009 Competition Commission investigation into these rates (Competition Commission 2009). The Commission was also mindful of a potential circularity whereby if it included customer acquisition costs within mobile termination rates this would simply

¹⁹ 15% is calculated on the basis that energy generation is 50% of total energy costs (Ofgem 2008), distribution is 20% (Ofgem 2009) and supply costs are the residual. On the basis that energy generation is 70% of total energy costs (the upper bound within Ofgem 2008), marketing costs as a proportion of supply and generation costs are estimated to be about 3%.

lead to an increase in expenditure without necessarily increasing the number of customers.

Table 3 presents the Competition Commission's findings regarding the average level of marketing activity by each of the four mobile operators in 2001. These were considered high and—in particular as regards handset subsidies—to be encouraging an inefficient level of 'switching' (when a consumer changes to an alternative mobile operator) and 'churning' (when a consumer remains with the same mobile operator, but changes handset). The Competition Commission estimates the average total customer acquisition and retention costs (including the cost of handset subsidies) across the four MNOs to be £682m in 2001/02, 23% of the average turnover

Table 3 Marketing expenditure for firms active within wholesale consumer products markets

Sector/firm	Measure of marketing expenditure in 2007 ¹	Description of the measure	Source
Mean excluding mobile telephony	8%	Marketing expenditure/net sales ²	Thomson Financial Datastream and annual report
Ford	1%	Advertising expenditure/net sales	Nielson Media Research and annual report
Hewlett Packard	1%	Marketing expenditure/net sales	Thomson Financial Datastream and annual report
PepsiCo, Inc	5%	Advertising expenditure/net sales	Thomson Financial Datastream and annual report
Cadbury	6%	Marketing and selling costs/net sales	Thomson Financial Datastream and annual report
Anheuser-Busch Companies	9%	Advertising and promotion expenditure/net sales	Annual report
Proctor & Gamble	10%	Advertising expenditure/net sales	Thomson Financial Datastream and annual report
Coca-Cola Company	10%	Advertising expenditure/net sales	Thomson Financial Datastream and annual report
Colgate-Palmolive	11%	Advertising expenditure/net sales	Thomson Financial Datastream and annual report
Unilever	13%	Advertising and Promotions/turnover	Thomson Financial Datastream and annual report
Diageo	15%	Advertising, marketing and promotion expenditure/net sales	Thomson Financial Datastream and annual report
Four major MNOs ¹	23%	Total acquisition costs/turnover	Tables 5.1 and 7.9 from Competition Commission (2003a)

Notes: ¹ The four major mobile network operators (MNOs) considered here are Vodafone, Orange, T-Mobile and O2. In this case, the figures estimate marketing expenditure in 2001/02, not 2007. ² Net sales are the total operating revenues earned by a firm when it sells its product (gross sales) minus sales returns (i.e., refunds), sales allowances (i.e., reductions in price of defective merchandise), and sales discounts.

Source: Except for the four MNOs and Ford, marketing spend is sourced from the respective company's 2007 annual report and net sales/turnover is sourced from Thomson Financial Datastream. Marketing spend for Ford is sourced from Nielson Media Research (2008) and net sales from the 2007 annual report.

Table 4 Marketing expenditure for firms within the retail sector

Name of retail outlet	Measure of marketing expenditure in 2007	Description of measure	Source
Mean	7%		
Currys Group Plc	1%	Advertising expenditure/sales ¹	Nielsen Media Research and annual reports
Tesco Plc	2%	Advertising expenditure/gross profit	Nielsen Media Research and annual reports
Asda Stores Ltd	2%	Advertising expenditure/gross profit ²	Nielsen Media Research and annual reports
PC World Computer Superstore	3%	Advertising expenditure/sales ³	Nielsen Media Research and annual reports
Marks & Spencer	4%	Marketing and related/gross profit ⁴	Annual reports
Argos Ltd	4%	Advertising expenditure/gross profit ⁵	Nielsen Media Research and annual reports
Homebase LTD	5%	Advertising expenditure/gross profit ⁶	Nielsen Media Research and annual reports
Sainsbury's Supermarkets Ltd	5%	Advertising expenditure/gross profit	Nielsen Media Research and annual reports
Debenhams Plc	7%	Advertising expenditure/gross profit	Nielsen Media Research and annual reports
Wm Morrison Supermarkets Plc	9%	Advertising expenditure/gross profit	Nielsen Media Research and annual reports
Tesco Plc	12%	Advertising expenditure plus club card vouchers given away/gross profit	Nielsen Media Research and annual reports
Energy supply ⁷	~25%	Acquisition costs/gross margin	Phoenix Natural Gas (2009)

Notes: ¹ Gross profit was not reported; Currys Group sales have been used instead. ² Gross profit was not reported directly and has been calculated as operating profit plus employment cost. ³ Gross profit was not available, instead PC World sales have been used. ⁴ Gross profit was not reported directly and has been calculated as operating profit plus operating expenses less retail occupancy. ⁵ Gross profit was not reported directly and has been calculated as revenue minus cost of sales before exceptional items. ⁶ Gross profit was not reported directly and has been calculated as revenue minus cost of sales before exceptional items. ⁷ In December 2001, Ofgem estimated that a new entrant's margin in the GB gas market would be around £40 per annum, comprising supplier's operating costs of £20 per annum, customer acquisition costs of £10 per annum (based on a cost of £50 per customer amortised over five years), and a profit margin of £10 per annum.

Source: For each company (excluding energy supply) advertising expenditure is sourced from Nielsen Media Research and gross profit from their annual reports. Ofgem's estimates for energy supply are as reported in Phoenix Natural Gas (2009).

4.3 Marketing for professional services (mainly offered to businesses)

PI solicitors provide a professional service to claimants. To the extent that this might drive higher marketing costs compared with consumer goods, it is appropriate to consider

marketing for other professional services. Such services include those provided by accountants, actuaries, architects, engineers and solicitors practising types of law other than PI. Data on many of these markets was not readily available.

Table 5 Marketing expenditure by law firms: % of total turnover

Professional service	Marketing expenditure as a percentage of turnover (excluding business development activities undertaken by fee earners)	Source
Law firms	2–5%	PWC (2008) and Stanley (2007)
Accountancy	3%	Interview with industry experts

Note: According to a survey conducted by *Legal Week*, the average annual advertising expenditure as a percentage of turnover was less than 5% for a majority of law firms (i.e., 90% of the respondents) (Stanley 2007). According to a survey undertaken by PWC, marketing was 2–3% of fees billed in 2008 (PWC 2008). The PWC survey defines marketing costs to 'include salaries, all practice development activities, corporate entertaining, market research, advertising, seminars, public relations, brochure costs and any costs in respect of outsourced marketing functions.'

These results indicate that for areas of law *other than* PI, and within accountancy, marketing costs are considerably lower than for PI services. An estimate of the cash equivalent of business development activities undertaken by fee earners in accountancy (such as developing client relationships) suggested that total marketing expenditure would still be below 15%.

4.4 Marketing costs for financial product compensation claim services

Consumers have the right to make a claim if a financial services product has been mis-sold or, under specific circumstances, if the price they have been charged is considered 'unfair'. For example, in recent years, compensations have been paid out in relation to the mis-selling of payment protection insurance (PPI) and unfair bank charges for unarranged overdrafts (OFT 2006).²⁰ In 2000, regulatory action by the Financial Services Authority (FSA) enabled endowment policy holders to make a claim if their policies were likely to yield less than they might have anticipated (FSA 2000).

For all these claims, the victim can claim for compensation directly; however, intermediaries such as CMCs and solicitors also offer to pursue the claim on behalf of the claimant.

There are strong similarities between the market for claims in the context of financial products and claims for PI compensation. First, the activities required to inform and effectively persuade a consumer to pursue compensation for a financial product are likely to be similar to those required in the context of PI compensation. Second, the level of compensation awarded for cases regarding financial products is similar to that in many PI cases. For example, the CMR estimates the total cost of a PPI policy of a five-year £5,000

²⁰ Currently all claims for unfair bank charges are on hold pending the outcome of the ongoing appeal of the 'test case' that was launched by the OFT on July 26th 2007 (OFT 2007). Whilst the Court of Appeal confirmed that the unarranged overdraft charging terms for personal current accounts can be assessed for fairness, the banks can still appeal directly to the House of Lords (OFT 2009).

consumer loan to be around £2,000, and for a £100,000 mortgage over ten years to be around £4,500 (CMR 2007). Third, remuneration is typically on a no-win no-fee basis.

The key difference is the absence or presence of a feedback loop of costs into consumer prices. Whilst in PI cases the solicitor recovers their costs from the unsuccessful defendant, in most claims for financial products, the intermediary must recover their costs from the claimant.²¹ Another difference is the type of services offered. Given the ability of an individual to directly pursue a claim, the majority of the costs incurred are more likely to result from administration and claims-handling and marketing, rather than the provision of legal advice.

When handling claims for financial products, the intermediary typically charges the claimant a fee in the form of a proportion of the compensation awarded to recover the costs it has incurred. Estimates of the prevailing market rates are summarised in Table 6 below. The principal costs incurred by intermediaries handling financial product claims include marketing used to attract new claims, and administrative costs arising from the handling of each claim. This means that marketing costs as a proportion of the value of the claim are lower than indicated by the fees in Table 6.

There is no information available in the public domain to allow a breakdown of the total costs into marketing and administration. If marketing costs were 30% of all costs incurred (which would be high), this would indicate that marketing expenditure as a proportion of compensation awarded for financial product claims ranges between 3% and 11%, with a mean of around 10%. In reality, marketing costs are unlikely to be as high as 30% given that this is likely to be a competitive market where prices are constrained by consumers. As reported in previous sections, the range of percentages of marketing costs is typically much lower than 30%. The approach of assuming that 30% of total costs relate to marketing is therefore conservative.

²¹ There is evidence that some firms are able to recover costs from the defendant—for example, the Financial Claims Service reports receiving a referral fee of £350 from solicitors who can recover this through their legal costs from the defendant. Source: www.financialclaimsservice.co.uk/nofees.html, as of March 6th 2009.

Table 6 Fees paid to intermediaries handling claims for financial product compensation

Type of claim	Fee as a proportion of compensation awarded	Marketing cost as a proportion of compensation awarded (estimate)
Mis-selling of PPI, unfair bank charges Mean	25%	8%
Mis-selling of PPI, unfair bank charges Upper estimate	29%	9%
Mis-selling of PPI, unfair bank charges Lower estimate	10%	3%
Endowment policy claims Mean	29–35%	9–11%
Endowment policy claims Upper estimate	35%	11%
Endowment policy claims Lower estimate	15%	5%

Source: Estimates of fees for claims regarding the mis-selling of PPI and unfair bank charges were collected from various websites. Estimates of fees for endowment policy claims are as reported in CMR (2007).

Marketing spend by PI claimant solicitors has thus far been considered as a proportion of base legal costs. However, to draw comparisons with intermediaries that handle claims for financial product compensation, it is appropriate to consider marketing spend as a proportion of PI compensation awarded. This can be estimated by calculating a compensation-to-legal-cost ratio, as reported in Table 7.

Table 7 Legal costs and compensation awarded for personal injury claims

Type of claim	Fee as a proportion of compensation	Marketing cost as a proportion of compensation awarded (estimate)
PI compensation between £1,00–£25,000 Mean	167–191%	12–24%

Source: Oxera calculations using data from ABI (2009). The data presents the mean base legal costs paid and total compensation awarded for all PI claims between March 2005 and April 2007 with a compensation value of between £1,000 and £25,000 (a total of over 15,000 claims).

Using such ratios, the estimate of claimant solicitors' spend on marketing as a proportion of average compensation awarded is approximately 12–24%. This appears high compared with the estimate of marketing spend for claims relating to financial products, which, assuming that 30% of costs relate to marketing activities, is estimated to be 3–11%. As explained above, in reality, the marketing costs for financial product compensation claim services are likely to be even lower than the range of 3–11%.

4.5 Marketing costs for other civil legal services

Solicitors provide legal services for a multitude of reasons to both individual consumers and professional businesses. When such services are provided to individuals, many solicitors appear to acquire business in a similar way as within the PI claims sector—through referrals from intermediaries. This may reflect the fact that, similar to the PI claims market, individual consumers in these markets typically make a limited number of purchases (often only one), thus marketing activity in the main focuses on attracting new customers rather than maintaining a relationship with existing customers.

Table 8 summarises a range of (rough) estimates for referral fees paid by solicitors for divorce law, drawing up wills, employment law and conveyance services. Unlike in PI cases, referral fees for divorce cases are often negotiated on a case-by-case basis, in part because the value of a divorce case to a solicitor can vary substantially. Therefore, these figures should be considered as indicative of typical referral fees paid, rather than the average market rate. Figure 4 illustrates these referral fees as a proportion of legal costs per case that are typically incurred.

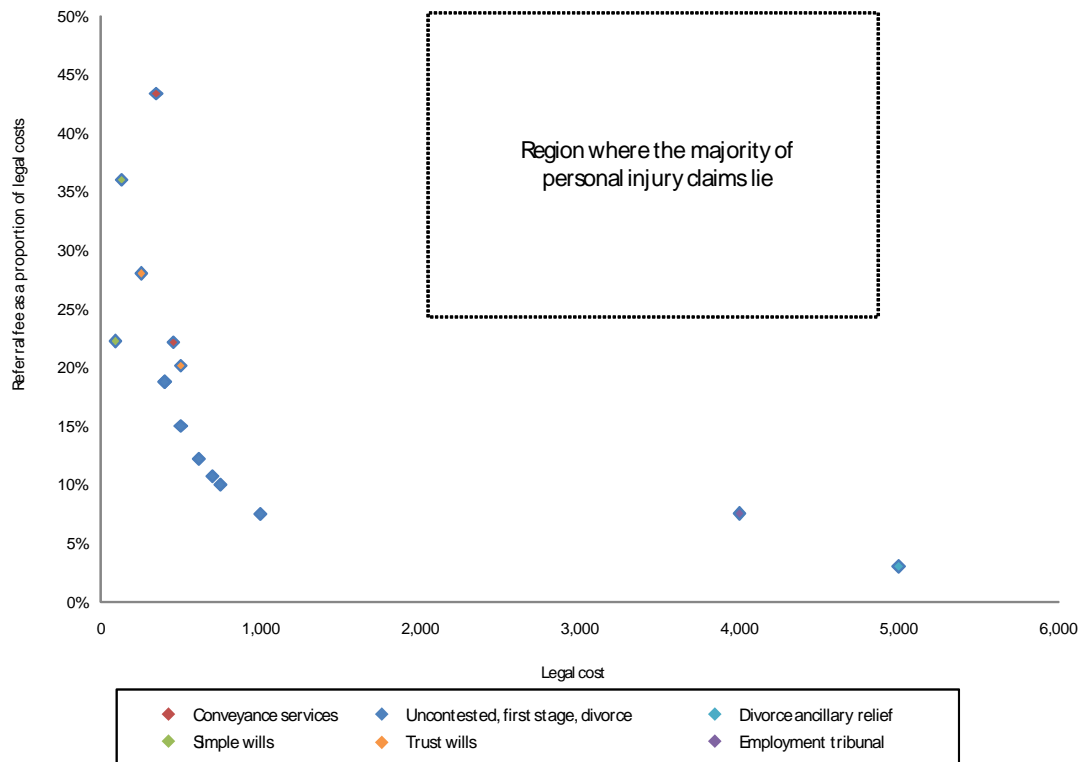
To the extent that there are a number of firms competing to provide these legal services, and consumers always pay for such services (unlike in PI cases), marketing activities are constrained to the level at which consumers are willing to pay.

Table 8 Absolute referral fees paid in other areas of law

Type of law	Referral fee	Source
Basic single wills	£20	The Loughborough Wills Service
Property trust wills	£70	The Loughborough Wills Service
Uncontested divorce (first stage only)	£75	Law Answers
Conveyance services	£75–£125; median £100	Moulton Hall Ltd (2007)
Discretionary trust wills	£100	The Loughborough Wills Service
Divorce ancillary relief	£150	Law Answers
Conveyance services	£150	Law Answers
Employment law	£300	Law Answers
PI cases	£600–900	Moulton Hall Ltd (2007), ABI (2009), Nickell (2008), CMR (2007) Ministry of Justice (2007a)

Source: The Loughborough Wills Service: www.fbwillsdirect.com/theloughborough/types_of_wills, Law answers: Lawanswers.co.uk.

Figure 4 Typical referral fees as a proportion of typical legal costs



Note: Data on referral fees is not readily available in the public domain. The estimates in this figure are considered typical but do not necessarily represent the whole market.

Source: Estimates of referral fees are as reported in Table 8. Typical legal costs were estimated from price quotes from various solicitors advertising their services online.

In absolute terms, referral fees paid by PI claimant solicitor firms are much higher than estimates available for other areas of legal work. For example, the referral fee for consultancy law, where the use of intermediaries is also common practice, is typically one-sixth or less than that paid by PI claimant solicitor firms (Moulton Hall Ltd 2007).

Compared with typical legal costs, referral fees paid by PI claimant solicitor firms can be quite similar to the levels observed for other types of law. For example, some referral fees for wills and conveyance services were also found to be between 20–45% of legal costs. However, due to the fixed-cost nature of marketing, marketing as a proportion of costs is expected to be higher for legal services of lower value.

Figure 4 illustrates referral fees as a proportion of typical legal costs, relative to the value of service provided. This illustrates that, whilst PI claimant solicitors still spend a high proportion of legal costs on marketing, solicitors providing services of similar value spend considerably less.

Thus, both in absolute terms, and adjusting for the value of the service provided by the solicitor, referral fees paid by PI claimant solicitor firms appear high relative to those paid in other areas of legal work.

This is the case even for wills which many consumers may undervalue. To overcome inertia and motivate the purchase of wills, it would be reasonable to expect a higher level of marketing than in other markets.

Marketing as a proportion of turnover is equivalent to marketing as a proportion of legal costs. Therefore, this indicates that for areas of law *other than* PI, marketing costs are much lower (as a proportion of total costs).

4.6 Marketing costs for Government campaigns

CMCs arguably fulfil an important social function in informing potential claimants about their rights in respect of any damages they might have incurred.

This means that it would be useful to benchmark the marketing costs incurred by claimants' solicitors against the costs of public sector campaigns.

Table 9 shows the marketing spend for a series of Government campaigns in aggregate terms, per capita and per target audience. This is compared with the total level of advertising in the PI claims market in 2006, and a rough estimate of the total value of the claims management industry in the form of the total amount of referral fees paid by solicitor firms.

In terms of a publicity campaigns, the amount spent on advertising in the PI market is considerably higher than what the Government would spend to target the general population in order to get over a message that the consumer possibly does not wish to hear. The Government campaigns are likely to be more limited in scope than the activities of CMCs, but the CMCs' message for the potential claimant may be more 'agreeable', since it is about obtaining compensation.

This comparison does not take account of any differences in the effectiveness of campaigns in terms of educating their target audience. Conducting such an assessment is far from straightforward and is beyond the scope of this study. Nevertheless, the table provides an indication of what is considered a socially acceptable level of costs for campaigns—the contrast with marketing spending in relation to PI claims is significant.

Table 9 Expenditure on public sector advertising campaigns and within the PI claims market

Type of government campaign	Aggregate expenditure , 2007–08 (£m)	Expenditure per capita, 2007–08 (£)	Expenditure per target audience 2007–08 (£)	Description of target audience
Tobacco control	19.0	0.31	0.45	The number of smokers aged 16 and over
Tobacco legislation	8.7	0.14	0.20	The number of smokers aged 16 and over
Sexual health ¹	6.9	0.11	0.44	Those aged 15 to 34 years who are most vulnerable to sexual diseases
Drugs prevention ²	2.0	0.03	0.13	Those aged 15 to 24 years who are most vulnerable to drug abuse
Alcohol	1.3	0.02	0.08	Those aged 15 to 24 years who are most vulnerable to alcohol abuse
Flu immunisation	1.4	0.02	0.15	As per the national policy of the Department of Health, the target group for the flu vaccine is individuals aged 65 years and over
5-A-Day	1.3	0.02	0.02	Includes all age groups
Total advertising spend in the PI market ³	41.0	0.67	1.31	All UK households
Estimated total value of the claims management market ⁴	240.0	3.95	7.72	All UK households

Notes: ¹ Including the Department of Health's contribution to the joint campaign with the Department for Children, Schools and Families. ² Department of Health's contribution to joint campaign with the Home Office.

Source: Parliamentary publications and records. ³ Advertising spend for PI services is based on Table 23 from Datamonitor (2008).⁴ Total value of the claims management market is estimated in 'very round terms' in CMR (2007), p. 7.

4.7 Summary results

For clarity, Tables 10, 11 and 12 summarise the benchmarking results presented within this section. Table 10 illustrates that, compared with most consumer product markets, marketing spend within the market for PI claims is high, including mobile telephony, a market that has been subject to regulatory intervention.

Energy supply, a market where direct sales tactics were considered appropriate by the Competition Commission, has higher marketing costs than other consumer goods markets.²² However, even these are still lower than most estimates of marketing spend within the market for PI claims. Moreover, since an energy supply company will be marketing on behalf of the generator, it may be appropriate to consider marketing costs incurred by the energy supplier as a proportion of the total cost of the competitive part of energy supply (generation and retailing). This would reduce the measure of marketing activity substantially, to below 15%.

Marketing spend within other professional service markets (accountancy and commercial law firms) and for other civil legal services (divorces, wills and employment tribunals), whilst higher than within typical consumer goods markets, is still lower than observed within the market for PI claims.

Table 10 Summary I: marketing spend as a proportion of total costs/price of the product/service

	Estimate of marketing activity	Description of measure
PI claims	23-40%	Marketing costs as a proportion of base legal costs
Consumer products (wholesalers)	8%	Marketing costs as a proportion of turnover or net sales
Consumer product (retailers)	7%	Marketing costs as a proportion of gross profit
Mobile telephony	23%	Total customer acquisition costs as a proportion of turnover
Energy	25%	Marketing costs as a proportion of gross margin
Professional services	15%	Marketing and business development costs as a proportion of turnover (including 10% estimate for activities undertaken by fee earners)
Other legal services	18%	Marketing costs as a proportion of base legal costs

Note: The estimates in this table summarise the averages presented previously in this paper. For detailed sources see the references to the following tables: PI claims, Table 3; consumer products, mobile telephony and energy, Tables 4 and 5; professional services, Table 5; other legal services, Table 6.

Table 11 indicates that marketing activity within the PI claims market is high compared with markets for other types of claims. In this instance, to draw a like-for-like comparison, it is appropriate to compare marketing costs as a proportion of compensation awarded. On this basis, PI claimant solicitors are estimated to spend approximately 12–24% on marketing. In comparison, the full range for intermediaries handling other types of claims (such as compensation for mis-sold PPI or endowment policies) is estimated to

²² The Competition Commission considers that a number of factors, including 'uncertainty about future prices, inertia, the hassle factor and fear of billing problems', make customers reluctant to switch energy supplier. Thus as a consequence, the Commission considers that 'suppliers tend to incur high costs in attracting new customers, in particular through direct selling and advertising.' Since PI claims are one-off-purchases, problems relating to switching inertia will not apply to PI claimant solicitors, thus a lower level of marketing spend may be required. Competition Commission (2003b).

be lower, between 3–11%. In reality, the marketing costs for financial product compensation claim services may be even lower than the range of 3–11%, for the reasons explained in section 4.4.

Table 11 Summary II: marketing spend as a proportion of compensation

	Estimate of marketing activity	Description of measure
PI claims	12–24%	Marketing costs as a proportion of compensation awarded
Financial product compensation claims	3–11%	Half the total fee received, as a proportion of compensation awarded

Note: The estimates in this table summarise the means presented previously in this paper. For detailed sources see the references to the following tables: PI claims, Table 7; financial product compensation claims, Table 6.

Table 12 considers marketing spend per consumer. There is more than one measure available for PI claims, of which three are presented in Table 12. All measures of marketing spend per consumer within the PI claims market exceed the level spent within Government campaigns. Furthermore, when comparing referral fees paid in other legal markets, or the average marketing spend per vehicle sold, the level within the PI claims market appears high.

Table 12 Summary III: marketing spend per consumer

	Estimate of marketing activity	Description of measure
PI claims	£600	Typical referral fee
	£1–£2	Total advertising spend in the PI market per UK household
	£7–£8	Total value of the PI referral market per UK household
Ford	£130	Average marketing spend per vehicle sold
Other legal services	£20–£300	Typical referral fee
Government campaigns	Less than £0.50	Average marketing spend per target audience

Note: The estimates in this table summarise the means presented earlier in the report. For detailed sources see the references to the following tables: PI claims, Tables 3 and 9; Ford, Tables 3 and 4; other legal services, Table 8 and Figure 4; and Government campaigns, Table 9.

5.0 IMPACT OF REDUCING LEGAL FEES ON CONSUMERS

The ACCC has indicated that it 'feels unable to take a decision to move GHRs in the direction of defendants' solicitors' rates when it could ultimately have serious implications for access to justice.' (Nickell 2008)

It has been argued that marketing activities undertaken by CMCs and solicitors fulfil the function of informing consumers about their rights to claim compensation.

If this were the case, any additional money spent on marketing could result in more consumers being aware of their rights to claim compensation and more consumers exercising these rights. However, any marginal increase in the current number of claims is likely to involve considerable additional costs. Therefore, the question is whether the current level of spending on marketing activities is appropriate compared with relevant benchmarks.

In theory, any reduction in legal fees (which may result in lower referral fees) could reduce the number of claims, as if marketing activities were reduced, some people may fail to decide to make a claim—as a result of inertia, for example. However, the question is whether in practice marketing spend affects consumers' access to justice and their awareness of their rights to claim compensation to a significant extent. These questions are discussed in the following sections.

5.1 The level of spending on marketing activities

As explained in section 1, the survey undertaken by the ACCC indicates that the fees charged by defendants' solicitors are 20–35% lower than those charged by claimants' solicitors. The ACCC has noted that it may be argued that 'claimants' solicitors incur additional costs arising both because claimant work does not appear at the door in a steady, uninterrupted flow and because they must pay "marketing" costs, such as referral fees' (Nickell 2008).

The analysis in section 2 indicates that legal fees charged by claimants' solicitors are not subject to sufficient market constraints and may therefore be too high. Under the prevailing system, marketing costs will expand to make up the difference between the costs incurred by solicitors in executing the case and the costs they can recover. This also means that any efficiencies gained by solicitors are likely to be passed on to intermediaries in the form of higher referral fees, which may explain the increase in referral fees observed in recent years (typically around £400 in 2005, to £600 in 2007, and now potentially in excess of £800).²³

Some solicitors now offer direct cash payments to claimants who sidestep the use of an intermediary. For example, Simpsons Millar is currently advertising a payment of £250 to

²³ Source: interviews with PI claims market experts conducted by Oxera.

claimants who sign a 'no-win no-fee' contract.²⁴ This is further evidence that, for at least some parts of the market, recoverable legal costs are significantly above the level of costs incurred.

The evidence presented in sections 3 and 4 suggests that marketing costs in the PI market are high compared with markets where such costs are constrained by competition. In the analysis, the marketing costs were proxied by both the level of referral fees and the difference between the rates charged by defendants' and claimants' solicitors. This suggests that the current level of spending on marketing activities is high from a competitive market point of view.

Section 4 also shows that marketing costs are high compared with the costs of public sector campaigns aimed at informing certain target audiences. This is another indication that the current level of spending may be excessive, even from a social point of view.

5.2 The impact of lower legal fees on consumers

A reduction in GHRs could in theory have an impact on consumers through the following mechanisms:

- lower GHRs could reduce the funds available for marketing activities (such as the payment of referral fees) by claimant solicitors;
- as a result of the reduction in marketing, fewer people may become aware of their rights to claim compensation;
- a reduced number of PI claimants initiate a claim, either because they are not aware of their rights, or because of other factors such as inertia (in spite of the fact that they are aware of their rights).

The first mechanism is likely to hold: lowering GHRs will squeeze the residual between actual direct costs incurred in executing a PI case and the level of recoverable legal costs. Thus unless the reduction in GHRs drives additional efficiency savings, thereby lowering the direct costs incurred, the reduction in recoverable legal costs will reduce the amount that would otherwise be available for direct customer acquisition, and/or payment of referral fees.

The strength of the second and third mechanisms is weak. In fact, it is likely that marketing spend in the PI market could fall without significantly reducing the number of claimants:

- First, provided that the fee for making a referral exceeds the marginal cost involved, it is profitable for intermediaries to make such a referral. Evidence suggests that the prevailing market referral fee could be substantially higher than the marginal cost of referral for many intermediaries—in particular, all those intermediaries that have a natural advantage in already having access to potential

²⁴ <http://www.simpsonmillar.co.uk/offers/freeoffer.aspx>.

claimants. For such intermediaries a much lower referral fee would be sufficient for making such a referral profitable.

- Second, the market dynamics within the PI claimant market indicate that referral fees are set close to the maximum level that claimant solicitors are willing to pay—the full residual between recoverable legal costs and direct costs incurred, rather than the costs of referral. Even if marginal costs are equal to marginal revenues, there is likely to be a significant number of potential claimants where the costs of attracting them (and hence getting them in the system) are below the current level of referral fees. Thus many CMCs will still find this activity profitable even if the referral fee were reduced.
- Third, some intermediaries that do advertise to attract potential PI claimants appear to be competing for the same claimants rather than attracting more consumers to the market. To the extent that reducing the costs incurred by CMCs reduces the duplication of costs associated with the same potential claimant, the claimant will still enter the system while, in total, CMCs are still economic. This indicates that there is scope for a reduction in the level of PI advertising without reducing the proportion of the population informed about PI rights.

A reduction in referral fees may force intermediaries without a natural advantage to scale down their activities. The exact impact of this is difficult to determine. However, the following observations can be made.

- If intermediaries that do not have a natural advantage were to scale down their activities, it is likely that some of the consumers who they could have referred would now be referred by intermediaries that do. For example, some claimants currently referred by intermediaries that undertake explicit PI marketing activities may have already been in contact with another referral company.
- As shown in section 4, the current level of marketing is relatively high (even compared with the costs of Government campaigns). To the extent that the PI claims market is close to saturation point, cutting down on these marketing activities may not have a significant impact on consumers' awareness of their right to claim compensation.
- There is evidence that for certain consumers (in particular those over 55 and of social grades A and B), some forms of PI advertising actually result in a barrier to claiming. In one survey, 27% of respondents indicated that compensation claims advertising for personal injuries actually dissuades them from making a legitimate claim (Millward Brown 2006).

5.3 Concluding remarks

Section 4 shows that the current level of marketing costs in the PI sector is high compared with many other markets. This suggests that if solicitors' fees were subject to competitive forces, they (and therefore referral fees) would be lower.

If a non-competitive level of marketing costs in the PI market is considered necessary because of its impact on potential claimants, there is a second question to consider—is the prevailing system of ensuring the current level of 'access to justice' cost-effective?

Even if consumers are willing to fund this level of access to justice, another system might achieve the same level (PI claimant rate) but at a lower cost. Section 4 shows that the costs of Government campaigns are significantly lower than those of marketing activities in the PI sector. It may therefore be more cost-effective to centralise, at industry or Government level, activities aimed at informing claimants about their potential rights.

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