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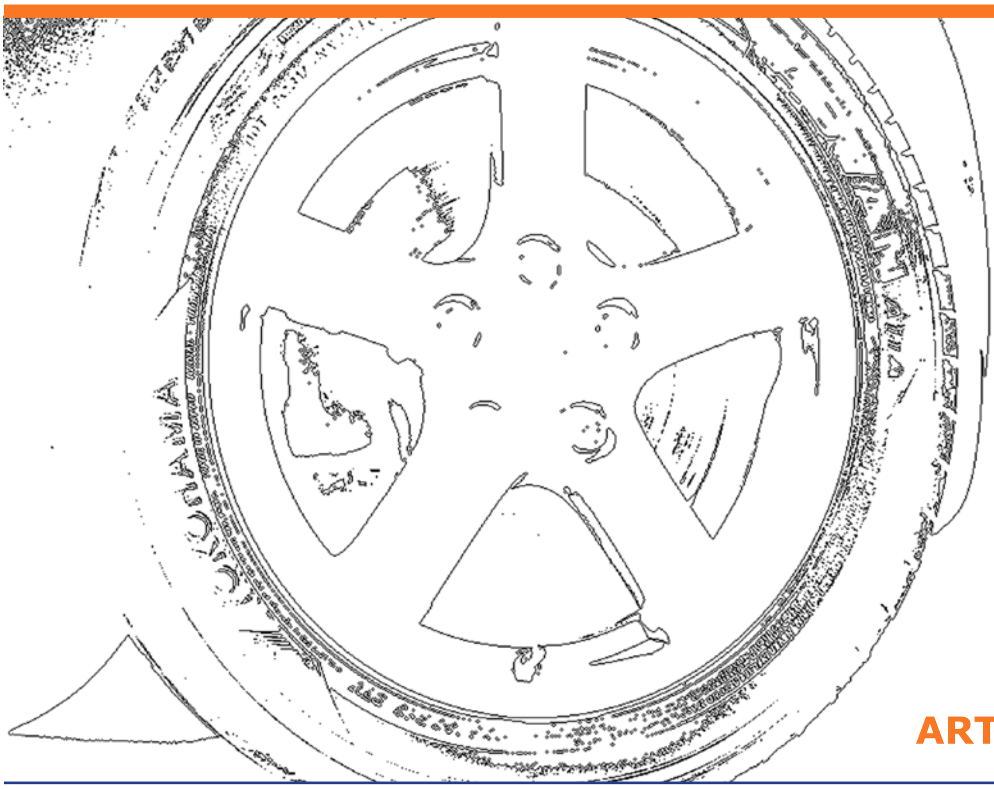

ARTICLE 7

The business car and contract hire

The business car and contract hire

Features

Contract hire is the leasing product that has enjoyed the most popularity with UK fleets over the years. More than a million cars are currently leased on contract hire, accounting for more than half company cars in the UK.

Contract hire is one of several different types of lease that we will mention here, so it's worthwhile pausing for a moment to ask the question: What is a lease?

Leasing is not defined in legislation. It is a contract for the hiring (or bailment) of goods or equipment.

Bailment is a long-established legal concept under which a person parts with possession of something under an agreement that says that he will recover it at a future date. There is a substantial body of law in this area, which the courts will apply in the event that the contract is silent on a particular issue.

Lessee

The lease agreement will refer to the Lessee, the Client or the Hirer. Some of the more progressive leasing companies are moving to 'plain English' contracts, in which the client is simply referred to as 'you'. Whatever wording is used, the lessee is the person who is granted the use of the vehicle for the period of the lease, subject to payment of rentals and meeting the other contractual obligations

Lessor

The lease agreement will refer to the Lessor, the Owner, the Company, us or we. This means the party granting the lease to another party, the lessee. The lessor may be a contract hire company, bank, finance company, leasing company or motor dealership that leases vehicles. In many cases the lessor may not be the owner of the vehicle. It may be an intermediary (a small contract hire company or broker) using a finance company's vehicles and acting as their undisclosed agent.

It is always worthwhile asking whether the lessor is the owner of the vehicle because if something goes wrong with the lessor's business you may find yourself dealing with an organisation that you have not heard of before.

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All of the leasing companies in the UK that carry out business with consumers have to be licensed under the Consumer Credit Act. They also need a data protection licence issued under the Data Protection Act if they wish to hold data about private individuals. The Financial Services Authority regulates those leasing companies that are owned by banks or that sell insurance products. Other than these, there are no special regulations to be followed or licences required to run a vehicle leasing business in the UK.

In a lease, the owner remains the owner and grants possession and use of the goods to the hirer or lessee, in exchange for a rental. Some of the language that we use in vehicle or equipment finance comes from the property world, where leasing is well established. Examples include 'term', 'rental' and 'peppercorn rental'. The closest we get to a definitive and authoritative document that describes leasing is *Statement of Standard Accounting Practice 21 Accounting for Leases and Hire Purchase Transactions* (SSAP21).

'Contract hire' is a British vehicle leasing industry expression. The equivalent product elsewhere in the English-speaking world would be called an operating lease or a closed-end lease.

Under contract hire, the supplier leases a vehicle to you for a fixed period and mileage, in return for a fixed rental. At the end of the lease, so long as the vehicle has not exceeded the agreed mileage and is in fair condition, you simply return it without further cost.

In calculating the rental the supplier will make an assumption as to the likely sale proceeds of the vehicle at the end of the lease (the 'residual value' or 'RV'). If the vehicle sells for more or less than this estimate, it will make a profit or loss respectively. Normally, you will have no financial interest in this profit or loss. Through this mechanism the supplier is said to take the 'residual value risk' in the vehicle.

As you don't pay the residual value, one way of viewing contract hire is to say that you are only paying for what you use – the diminution in the market value of the vehicle during the period when you are using it – rather than the whole price of the car. In other words, the depreciation.

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Contract hire is offered in two versions, 'maintenance-inclusive' or 'maintenance-exclusive'. If it includes maintenance, the supplier will normally pay for all standard servicing and maintenance work arising during the lease period.

The contract may limit the number of tyres the supplier will replace at its expense during the lease. It will invariably say that the supplier will pay for the vehicle excise duty (the 'tax disc') every year.

Practically all contract hire arrangements exclude motor insurance, although other insurances are often offered with contract hire, including credit payment insurance, payment accident protection, mechanical breakdown insurance, early termination protection and gap insurance.

The agreement will not cover work or expense that arises if the vehicle is damaged, neglected or wilfully mistreated. Examples include 'kerbed' tyres and wheels, engines being allowed to run dry, diesel fuel being pumped into petrol-engined cars, dented doors, broken mirrors and deep scratches. If the supplier chooses to pay for these items it will do so as a service to you and will recharge you the cost, although some suppliers will bear these costs, up to a limit set out in the contract.

Where maintenance is included in the contract, the rental will include an amount to cover the supplier's estimate of the cost of maintaining the vehicle. If the estimate is too low, the supplier will make a loss; if too high, it will make a profit. Through this mechanism it is said that the supplier takes the 'maintenance risk' in the vehicle.

It is important to realise that with contract hire you are buying more than just a financial product: you are getting a service and you will wish to satisfy yourself as to the ability of the supplier to deliver a good service to you.

Lease period

You can normally choose whatever lease period you require, though many contract hire companies will refuse to lease you a vehicle for less than twelve months or more than five years.

During the 1970s it was normal for companies to replace their vehicles after two years. In the 1980s and 1990s the average lease period increased and three years became the norm. The recession of the early 1990s prompted companies to look again at cost reduction and many extended their replacement cycle to four years. More than 50% of all fleet vehicles are now replaced every three years and more than 33% every four years, though it is likely that we will see longer lease terms because of the current recession – 2009.

Some companies feel that 80,000 miles is the ceiling for business car use, so they may choose a shorter lease period for high-mileage drivers.

Rentals

Almost all contract hire rentals are fixed, that is, they do not vary with changes in market interest rates. Hence you do not have any interest rate risk. This is one of the attractions of contract hire; it provides you with the certainty that your rentals will remain fixed for three or four years regardless of any movement in bank base rates.

Contract mileage

If you lease a vehicle on contract hire, the quotation and agreement (or the schedule to the agreement) will set out the maximum vehicle mileage allowed during the lease period.

The leasing company will have based their rental calculation on this mileage. Obviously, if the vehicle is only likely to cover a low mileage its true depreciation (the loss of market value) and maintenance costs will be lower than those of a similar vehicle covering higher mileage, so you will pay a lower rental.

If the agreed contract mileage is exceeded, you will have to pay an excess mileage charge. This allows the supplier to recover the additional depreciation and maintenance costs it will incur when excess miles are driven. The excess mileage charge will be an amount in pence per mile and will be set out on the contract or schedule.

It has become fashionable to call excess mileage charges ‘penalties’ but this is an unfair expression. All that these charges should do is ensure that you pay for the mileage actually covered by the vehicle.

If you lease several vehicles from one supplier, pooled mileage will normally be included in the agreement. This allows any under-mileage driven by one car to be credited against over-mileage in another, thus reducing the net excess mileage charge.

Excluded cars – exotics

While several thousand makes and models of vehicle are available on contract hire, some contract hire companies will refuse to lease certain vehicles. These include ‘exotic vehicles’, that is, extremely expensive cars where it is difficult to set residual values and maintenance budgets and where there are relatively few examples on the road.

You will also find it difficult to obtain contract hire on unusual imported vehicles or grey imports and probably impossible for kit cars.

Contract hire quotes

The written quote from the contract hire company will typically show the rental split between finance and maintenance elements.

The rental reflects the supplier’s estimate of the depreciation of the vehicle (the cost less the residual value), vehicle excise duty, the likely cost of servicing and maintenance and (if you have requested this) an allowance for the cost of a replacement vehicle when the primary vehicle is off the road.

As the supplier is taking the residual value risk, you might expect it to charge a premium for doing so. In practice, however, few companies make these charges, as competitive pressure always means that rentals have to be as low as possible or you will take your business elsewhere. Similarly, it would be logical for the supplier to charge a premium for taking the maintenance risk but in practice this is seldom seen.

Quotes normally show the carbon dioxide output of the vehicle, so that your driver can calculate the amount of benefit-in-kind tax they will have to pay on their company car.

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Most contract hire quotes expire after thirty days. Normally the quote will include a clause allowing the supplier to recalculate the rental if the manufacturer's list price changes before you order the vehicle. It was once common for quotes to contain a similar protection against interest rate rises but this is less common nowadays.

If you receive a quote that is acceptable to you, it is probably a good idea to accept it promptly. Otherwise there is the danger that the manufacturer will increase the price and the rental will have to be increased. This can lead to disappointment if the driver then discovers that the revised rental exceeds his allowed limit.

Most suppliers now offer quotes online. Some ask you to register and give them some information about you so that they can decide the appropriate rental to charge; a lower rental if you have a large fleet and are creditworthy, a higher one if you have only a small business with a small fleet. There is nothing sinister in this; it's just normal commercial practice. There is more competition for bigger clients and this drives down prices, whereas smaller clients have to pay the 'rack rent', (to borrow another expression from the property rental market).

Some contract hire companies offer internet-based quotations without 'pre-qualifying' you, but generally speaking you will get a lower rental from a company that knows something about you.

If you have an established relationship with a contract hire company you may be offered the use of their web-based quoting system. Rather than phoning several times to ask for quotes as you refine your choice of vehicle, you just click away until you have chosen the vehicle and rental that suits you.

Early termination

You may decide to terminate a contract hire agreement before the contracted end-date; for example, if the vehicle has been written-off in an accident or stolen, or if the driver has left your employment.

All contract hire companies will allow you to terminate your lease early; indeed, where this arises because the vehicle has been lost or stolen, it

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is difficult to think of anything else that could be done.

The supplier entered into the lease expecting that you would keep the vehicle until the contractual end-date. They calculated their rentals and arranged their own funding on this basis. They also expected to get capital allowances for the full term of the lease.

On early termination they have to clear their books, recover any extra costs to be borne in keeping their own funding in place until the end of the lease, recover any adverse effects of disrupting their capital allowance flows and (perhaps) recover some element of the profit they had hoped to make had the contract run to maturity.

With all finance agreements, although you make equal monthly repayments the amount outstanding does not decline in equal monthly amounts. This is because finance agreements are annuities.

Many contract hire agreements are silent on what happens in the event of an early termination. This can lead to misunderstandings and disputes when early terminations occur, so it is far better to agree this in writing with the contract hire company up front.

There are several methods of calculating a contract hire early termination settlement figure. They include:

The percentage of future rentals method

This may be defined in a simple formula that says something like:

- If you terminate in the first 12 months we will charge you 60% of all future rentals.
- If you terminate in the second 12 months we will charge you 50% of all future rentals and
- If you terminate thereafter we will charge you 40% of all future rentals.

There is no consistent way of calculating this figure in the market, and individual suppliers will have their own way of calculating this charge.

When entering into the lease the supplier will have no idea when you may ask to early terminate the lease, or how much the vehicle will be worth (or how much the insurance settlement will be) at that time.

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Hence a 'percentage of outstanding rentals' settlement policy is risky for the supplier and can cause them to make a loss.

Nonetheless, many contract hire companies offer this arrangement as it gives you certainty and removes the need for discussion and debate, and possible disagreement, at a later date.

Sliding scale based on time of the early termination

This is a refinement of the percentage of outstanding rentals method. At the start of the agreement the supplier will provide you with a chart showing the amount that will be payable, month by month, in the event of early termination. An example is shown below.

This schedule assumes a £12,000 capital cost, a 3+33 rental profile on a thirty-six month lease and a £4,000 residual value. As this is a contract hire agreement the vehicle will be returned to the supplier on termination.

Termination during month number	Amount payable	Termination during month number	Amount payable
	£		£
1	4,900.69	19	1,782.07
2	4,752.19	20	1,663.27
3	4,603.68	21	1,544.46
4	4,455.17	22	1,425.66
5	4,306.67	23	1,306.85
6	4,158.16	24	1,188.05
7	4,009.66	25	801.93
8	3,861.15	26	712.83
9	3,712.65	27	623.72
10	3,564.14	28	534.62
11	3,415.63	29	445.52
12	3,267.13	30	356.41
13	2,494.90	31	267.31
14	2,376.09	32	178.21
15	2,257.29	33	89.10
16	2,138.48	34	Nil
17	2,019.68	35	Nil
18	1,900.87	36	Nil

Note that nothing needs to be paid if you terminate during months 34, 35 or 36, as no rentals are due in those months.

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Termination schedules such as this are less common in the vehicle leasing market but are often seen with other forms of equipment leasing, particularly 'big ticket' leases involving large amounts.

The sum of the digits method

This is also called the Rule of 78. It is often seen in full-pay-out contracts such as hire purchase and loans.

Actual cost method

Under this method, the lessor will take the balance outstanding in its books, including any arrears of rental, add any costs or fees it has paid to recover or sell the vehicle, deduct the sale proceeds of the vehicle and charge you the difference. Normally, for the sake of simplicity, capital allowance or other tax matters are ignored.

This is a particularly simple method of calculating an early termination settlement and can be a feature of 'open-book' contract hire arrangements.

The actuarial cost method is often the cheapest method of early termination available to you. For this reason it is usually only offered to large, creditworthy businesses with large fleets, where there is strong competitive pressure and the contract hire company is keen to preserve the relationship.

Other early termination issues

Whatever early termination method is used, the amount you are charged will include any arrears, interest on arrears, costs, fees or expenses that the supplier incurs in recovering and selling the vehicle.

If the agreement is regulated by the Consumer Credit Act, you have the right to hand it back after half the payments have been made.

Most contract hire companies will offer you a lease for any period you wish between 12 and 60 months. While it may be your policy to take all vehicles on lease for, say, three years, there may well be occasions when you know in advance that you are likely to need a particular

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vehicle for a shorter period of hire. For example, you may be providing it to an overseas visitor who is in the UK for a fixed period, or to someone who plans to retire in 18 months.

In these situations you will invariably save money if you enter into the lease for the shorter period at the outset. If you think it likely that you may later wish to extend the lease, speak to your leasing company before entering into the lease to discuss whether and on what terms they will be prepared to extend it. While the rentals that you pay will be more expensive initially, this arrangement will normally work out cheaper than entering into a three-year lease and early terminating after 18 months.

The message is simple: don't enter a lease knowing it is likely that you will have to break it early; enter into it for the period you expect to need the vehicle.

You may have to terminate a lease early because a driver has left your employment. So long as you have a use for the vehicle you will find that it is almost always cheaper for you to redeploy it within your business rather than hand it back and pay an early settlement charge.

If you expect to have a high incidence of early termination, perhaps because you are in an industry with high staff turnover, you should consider taking ex-lease or used cars for some staff to avoid early termination costs.

Depending on your fleet size, some manufacturers and contract hire companies may be able to provide you with long-term demonstration vehicles. While generally these are only provided to allow you to test the vehicle in real-life use, it is a fact that many companies use long-term demonstrators as a tool to reduce vehicle costs and create a more flexible fleet.

Extensions

Normally, leasing companies will be happy to allow you to extend a lease at the end of the contract period. However, there will be some circumstances when they may not permit an extension. These are:

- If you are in default of your payment or other obligations. Here they may not feel inclined to do anything that will prolong their relationship with you.
- If the vehicle has already cost a lot to maintain and costs are likely to mount. The supplier will be concerned that the additional rentals you pay might be dwarfed by the extra running costs. Similarly, they may wish to end the lease if a major service on the vehicle will soon be due.

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- If the value of the vehicle in the used vehicle market has fallen sharply, the supplier may wish to dispose of it as quickly as possible to avoid any further loss.
- If you want to keep the vehicle until a month when the used vehicle market is traditionally sluggish – December, for example –the supplier will fear that they will make a loss if they allow this.

There are two methods of extending a contract – formal extension and informal extension.

Informal extension

Where you want to keep a vehicle for a short period, perhaps for up to three or four months, the supplier will normally allow you to do so.

With informal extension, the rental is normally kept at the same level and they don't ask you to sign a new contract.

However, if you simply keep hold of the vehicle against the supplier's wishes you may well find they increase the rental after the contracted end-date.

Formal extension

If you want to retain the vehicle for a longer period, the supplier may agree to grant a formal extension. An agreement will be drawn up, commencing on the end date of the original contract and showing a new end date.

In the past, formal extensions were arranged at reduced rentals, reflecting the fact that the monthly depreciation of a three-year old car is that much lower than its monthly depreciation in the first three years. However, the recent sharp decline in used vehicle values has left many contract hire companies nursing big losses on residuals. Some may only be willing to formally extend a lease if they can charge an increased rental.

There is a limit to how much of this a client will tolerate. After all, if the resultant rental is a lot higher than the old rental, you may prefer to enter into a new lease for a new vehicle, or to rent a car on daily hire.

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Accessories

The contract hire agreement will refer to accessories fitted to the vehicle after delivery. This clause may simply deny you the right to attach an accessory, or it may allow you to do so if the accessory is removed at your expense at the end of the lease without damaging the vehicle. Often the agreement will say that any accessories added to the vehicle become the supplier's property.

In practice, most contract hire companies are willing to allow accessories to be added post-delivery if they can be sure that these will not detract from the value of the vehicle, or affect its safety or efficiency.

The advice here is simple; if you wish to add an accessory after delivery, speak to the contract hire company first.

Collection and inspection

At the end of the lease period the contract hire company will contact you to arrange vehicle collection. Most will collect from any address to suit you, for example, from your fleet department, head office, a regional office or the driver's home.

When the vehicle is collected the collection agent will complete a report for both parties to sign, confirming that the vehicle has been handed over and whether there has been any damage to the vehicle.

It is in both parties' interests that this report should be as accurate as possible to avoid later disputes about the condition of the vehicle.

As part of offering a good customer service, many contract hire companies will deliver the driver's new vehicle and collect his ex-lease vehicle at the same time. This is 'key-for-key exchange' and it has obvious advantages for everyone. The disadvantage is that the driver, in their excitement over the arrival of their new vehicle, may sign a form that confirms that there is damage to the old vehicle without realising that he has done so. He may not even have noticed the physical damage to the old vehicle. Some days or weeks later you will receive a bill from the supplier for the damage and a dispute ensues.

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In many ways, the ideal approach to collection is for the fleet manager, or someone else in your company who is familiar with vehicles, to inspect all vehicles at the end of the lease and sign the collection report.

Bear in mind that if the car is dirty, the light is poor or the weather is bad it may be difficult for the condition of the vehicle to be assessed accurately.

Fair wear and tear

The contract hire agreement will say the supplier is responsible for the maintenance and repair of the vehicle, and the replacement of tyres, etc arising from normal use. It will also say that the vehicle has to be returned to the supplier at the end of the lease in good condition 'fair wear and tear for the age and mileage excepted'. Which leaves us with the question; what is the dividing line between fair wear and tear and unfair damage?

Fortunately, the BVRLA has produced a Fair Wear and Tear Guide for use by the industry and its clients.

In addition to this guide, the BVRLA has issued fair and tear guides covering light commercial vehicles and heavy goods vehicles. Copies are available from the **BVRLA.**

Insurance

All contract hire agreements require that you insure the vehicle comprehensively. The supplier will normally ask for proof that insurance is in place and that the renewal premiums have been paid.

Roadside assistance

If you have selected a maintenance-inclusive arrangement this will normally include membership of a roadside assistance service. This may be just a basic service that attempts to repair the vehicle at the roadside and tows it to a garage of a roadside repair cannot be effected. Alternatively it may be a more comprehensive package including get-you-home and at-home cover. Some of the better packages include European Travel assistance too.

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Replacement vehicle

Contract hire agreements can provide you with a replacement vehicle (sometimes called a 'relief vehicle') if your vehicle is off the road.

The agreement will specify:

- The circumstances in which the replacement will be provided (if the main vehicle is off the road after an accident, or servicing or both)
- The delay before it will be provided (12, 24, 36, 48 hours)
- The period for which it can be used (7, 14, 28 days etc)
- The maximum number of days during the term of the lease for which replacement vehicles will be supplied.

Tyres

If you enter into a maintenance-inclusive contract hire agreement, the leasing company will pay for the replacement of worn tyres during the term of the agreement. It is likely that the contract will limit the number of tyres replaced and will not include tyres damaged by bad driving.

Generally speaking the number of tyres provided should cover normal driving over the lease period and mileage. You may wish to enquire into the driving habits of any driver who requires more than this number of tyres during the term of an agreement.

If you need an unlimited number of tyres, some contract hire companies will include this in the contract for a slightly higher rental.

Client default

The contract hire agreement assumes that the supplier will allow you to enjoy quiet possession of the vehicle. Your obligation is to pay your rentals when due and to meet the other obligations shown in the lease. If you fail to comply with any of these obligations, you will be in default of the terms of the agreement.

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VAT disallowance 50% of rental if any private use

As with all types of lease, if you wish to use the vehicle for private use, 50% of the lease rental will be disallowed as input tax for VAT purposes. This only applies to the finance element of the rental, not any maintenance element.

The contract hire quote will show the net cost to you after this disallowance.

Corporation tax deductibility of contract hire rentals

If you lease a vehicle on contract hire you can offset the whole or a part of the rental against your corporation tax (or income tax) liability.

Used vehicle contract hire

While the majority of the vehicles on contract hire in the UK are supplied when new, a small number of companies offer used vehicles on contract hire.
There are advantages to both parties.

You get a vehicle at a lower rental than you would pay for the equivalent new vehicle.

The lessor has a lower risk in the vehicle, which will not suffer the huge depreciation that normally happens when a new vehicle is driven out of the showroom door. So the gap between its value and the amount outstanding in the lessor's books from time to time will be closer should you stop paying and they have to repossess it.

However, practical issues have hampered the development of the used vehicle contract hire market. If a dealer has a used vehicle on his forecourt, you see it, like it, and decide to take it on contract hire from the dealer's contract hire company, things are very straightforward. He gives you a quote based on his knowledge of the vehicle, you sign the contract and he hands over the keys.

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If you decide you want to lease a used vehicle from a leasing company that is not part of a dealership, things get a bit more difficult.

- You phone them for a quote.
- They probably have to go and find a suitable vehicle, unless they happen to have an ex-lease vehicle available that meets your needs.
- You will want to inspect it to see if it is of satisfactory condition
- Then they will want to inspect it to establish a maintenance budget and a residual value.

There is a lot of expense for the supplier here (sourcing, transportation, inspection) even before you have seen the vehicle and if you then reject it they have no way to recover this cost.

For these practical reasons relatively few used vehicles are leased on contract hire. Nonetheless, a few companies specialise in it. They have cracked the supply problem, usually by forging relationships with used vehicle vendors, many of whom sell ex-rental or manufacturer demonstration vehicles.

One final point needs to be borne in mind. Most employees prefer not to be given a second-hand car as their company car.

Contract hire benefits

Contract hire offers you:
- The supply of a vehicle (no need for you to go out and find it).
- Low interest rates built into the rental (often lower than you would get if you searched the market for credit).
- The benefit of big fleet purchasing power.
- Payment of all routine maintenance and servicing bills (no need to scrutinise maintenance bills or negotiate with garages).
- Automatic annual vehicle excise duty renewal (no need to go to the Post Office to renew).
- An off-balance sheet finance product.
- No residual value risk.
- No maintenance cost risk.

The success of the product has been its simplicity. You get a vehicle for an agreed term and mileage and just hand it back at the end of the lease. So long as the agreed mileage has not been exceeded and the vehicle is undamaged, that’s all that needs to happen.