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1 October 2010

Dear Claudio

Auto-Renewable Contracts: BT's comments on consultants' report and on Ofcom's preliminary conclusions

Following our meeting last week, I am writing to confirm our concerns regarding the "Empirical analysis of BT's automatically renewable contracts" produced by Professor Crawford and ESMT Competition Analysis.

As we explained, we are concerned on two levels:

1. At a detailed level, we believe that there are some flaws in the methodology employed, which give rise to some misleading results
2. At a top level, even if these flaws are ignored and the results accepted at face value, we do not agree with the conclusions being drawn both by the consultants and by Ofcom regarding the likely impact of ARCs on competition in the market, and the consequent need for regulatory intervention.

1. Detailed comments on the report and its methodology

Professor Crawford and ESMT CA have clearly carried out a comprehensive analysis of the real-life data we have provided, and there is much to commend in their report, as they have taken care to try to control for the key factors which would have impacted on customers' switching behaviour, in addition to the ARC mechanism. These other factors rightly include the effects of tenure, take-up of other BT services, the size of ETCs, and the size of the price discount that customers receive in exchange for the extra commitment that a renewable contract entails.

Impact of price discount
However in relation to this last factor, we believe that the consultants have not got it right. There are important omissions in the measurement of the "price" coefficient which are likely to have biased the estimated effect of the price discount downwards, and hence to have led to an overestimation of the impact of the ARC mechanism itself on these customers' decision to stay with BT.

The price discount of £2.99 (effectively providing customers with "free" evening and weekend calls) is clearly the key reason why customers choose to sign up to the ARC and stay with BT after the initial MCP. To control for this, the consultants have looked at how other relative price changes in the dataset have affected customers' propensity to switch away from BT. The key price variations they have used to observe customers' behaviour in this respect are the price increases experienced by customers in fixed term contracts as they come off these plans – for example, customers of BW12 (an Unlimited Anytime Plan (UAP) 12 month contract) and Oval (an Unlimited Evening and Weekend Plan (UEWP) 18 month contract), who experience price increases at 3 months and 12 months into their contracts, respectively.

The difficulty with this approach is that customers signing up to these contracts knew in advance that these price increases would kick in, and therefore we would expect the price increases to have a negligible effect on those customers' decision to switch. These price increases are therefore *not* analogous, in terms of their impact, to the price increase (or loss of discount) that a customer would experience if they switched away from BT whilst on an ARC. Even if a BW12 or Oval customer had forgotten about the pre-notified price increase, and the increase triggered a decision to switch, they are likely to postpone this action until the end of their MCP in order to avoid ETCs. So the measured effect on the probability of switching induced by the price changes in the dataset is likely to be significantly smaller than the true effect that the ARC price discount is having on ARC customers' propensity to switch.

An additional source of price variation used by the consultants to measure price effects on switching is derived from changes over time in the price of competitors' plans and contracts. However these price variations (as shown in Figure 14 of the consultants' report) do not appear to be as large as the price discount enjoyed by ARC customers. Therefore the switching induced by these price increases is relatively small compared to the loyalty-enhancing effect of the ARC price discount. Again the result is that the effect of the discount is underestimated and the effect of the ARC mechanism is overestimated.

Finally in relation to the price discount, the consultants' analysis does not account for the impact of "loss aversion" or "risk aversion" effects. "Loss aversion" is a widely-recognised characteristic of consumer preferences and decision-making, whereby individuals strongly prefer avoiding losses to making gains, leading to "risk aversion" when evaluating potential gains. Customers on ARCs are likely to view the price discount they receive as an acquired benefit that they would lose should they decide to switch at the end of their MCP, and due to "loss aversion", this is likely to significantly increase the probability that they will stay. Similarly, to obtain the "gain" of a lower price offered by a competitor, customers have to take the proactive decision to switch; and they are less likely to do so due to "risk aversion". This asymmetry of effect between the discount offered by the ARC and the discount potentially available from another CP has not been controlled for in the analysis. Again the result is that the price effect is biased downwards compared to the true loyalty-enhancing effect of the ARC price discount, leading to the effect of the ARC mechanism itself on switching being overestimated.

The report's conclusions are highly reliant on an appropriate measurement of the price coefficient. For example, if the price coefficient were -0.02 (instead of -0.01 as reported in Table 2), the impact of the £2.99 discount would be to lower the probability of an ARC customer switching away from BT by 44% relative to a standard contract (instead of the 22% reported in Table 2). This effect would significantly dilute, and potentially wipe out, the impact of the ARC mechanism itself on switching rates (estimated at 18.8% with the new ETCs). **The inability to control properly for the effect of price on switching means that the report's conclusions are not at all robust.**

Impact of self-selection
As we discussed with the consultants in advance, self-selection is a real concern and we have been unable to control for it ourselves when attempting to analyse the impact of ARCs on switching. We do not believe the consultants have controlled for it adequately either.

Given that when ARCs were launched, much of BT's promotion was done through above-the-line advertising, it is very likely that many of those who proactively signed up were precisely those who have a lower propensity to switch away from BT in any case. This may be because they are long-standing loyal BT customers; and/or because they are quite happy with BT, particularly if they are paying less; and/or they value the lower price associated with ARCs and do not mind that this might increase their switching costs.

The analysis claims to have controlled for self-selection and concludes that "the effects of self-selection are both economically and statistically modest". This is demonstrated by showing that, if anything, switching rates for customers on ARCs relative to standard contracts are *more* different for old customers than for new ones. However this only challenges the assertion that the longer the tenure, the more likely a customer is to stay with BT. There is no allowance for the other reasons behind self-selection – in particular, the value of the lower price to customers.

Our strong belief is that, despite the thoroughness of the consultants' work, Ofcom cannot rely on its conclusions to provide the justification needed for regulatory action, given its inability to control for the key reason that customers choose to sign up for, and remain on, ARCs – i.e. the price discount.

2. More general concerns

General levels of switching

If we ignore the above comments for a moment and take at face value the conclusion that ARCs themselves provide a significant deterrent to switching compared to standard fixed term contracts, it is still hard to see why Ofcom is concerned, given that switching rates for BT customers are still very high (and have remained steady since ARCs were launched). BT's average annual churn for fixed voice consumers is at around [✂][1] the market average (which was around 8% in 2009 according to Ofcom's latest Consumer Experience Report).

It is interesting to note (again from the Consumer Experience Report, p111) that average switching levels in the Electricity and Gas markets are significantly higher than in communications markets; and yet ARCs are highly prevalent in those energy markets.

In any case, it is not necessarily true to say that a higher switching rate is directly correlated with a more competitive market, or that it will lead to consumers getting a better deal. For example, a lower switching rate could be the outcome of a mature market which has seen lots of entry in recent years and which has reached a steady state where the majority of consumers are satisfied with their current offers. Conversely a market with a higher switching rate could indicate that consumers feel they are not getting a good deal and want to shop around.

Economic theory

As acknowledged in the report, the economic literature on the effect of fixed term contracts and switching costs on competition and prices is ambiguous. That effect depends on a number of market-specific factors which have not been fully analysed by the consultants, and hence we feel that their strong conclusion (which Ofcom seems to share) that ARCs are "a clear cause for concern" is unconvincing and misleading.

Firms have two opposing incentives: either raise prices to "harvest" existing customers, or "invest" in acquiring new customers that will remain with the firm for a number of years. For sufficiently low switching costs, the "investment effect" dominates the "harvesting effect" and increases in switching costs lead to lower prices. For example, a study quoted in the report (Dube, et al, 2009)[2] provides theoretical and empirical evidence that switching costs of between 15 and 60% of the contracted price may actually increase competitive intensity in a market by increasing the incentives of firms to invest in acquiring new customers through low prices and promotional offers. Other theoretical papers based on an earlier version of Dube et al's results suggest that this is quite a general and plausible effect in many markets (Cabral 2008; Arie and Greco 2010)[3].

The UK retail fixed voice market is extremely competitive (as indicated through the removal of SMP), there has been plenty of market entry (facilitated in part by regulation of wholesale inputs), and prices are low compared to those in other countries. Therefore, we feel that the argument in the report (p.42) that fixed term contracts and ARCs are affecting incentives for market entry are completely unfounded.

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[1] Redactions in this document are indicated by [✂]

[2] Dube, Hitsch and Rossi (2009), "Do Switching costs make markets less competitive?" – Journal of Marketing Research, Vol 46, Issue 4, pages 435-445

[3] Luis Cabral (2008), "Small switching costs lead to lower prices"; Guy Arie and Paul Greco (2010), "Who pays for switching costs?"

Consumer experience
We are take great care to ensure that customers understand fully the terms to which they are signing up. We have taken great care to ensure that our letters (both at sign-up and reminder letters at renewal time) are as clear as possible (we shared these with Ofcom last year). Since then, we have made improvements to the letter process, and are continuing to do so. Recently, we have introduced a line on the bill, in the product description, reminding customers that they are on a renewing contract. As explained at our meeting, we monitor our advisors to check that they comply with the requirement to explain all the details to customers properly, and we consistently achieve compliance levels of 96%+, on the 5000 calls per month that we monitor.

We were therefore surprised and concerned by the results of Ofcom's mystery shopping and telephone interviews. As discussed last year, we believe that the mystery shopping results can be explained by the fact that the mystery shoppers were only making enquiries and they did not get to the stage of placing an order. Our advisers are trained to give full (scripted) details of the contractual arrangements only if an order is about to be placed (they then give a recap to ensure that the customer has understood and agrees the terms, before the order is finally placed). As for the telephone interviews, we do as much as we can to ensure customer awareness and understanding; but our experience suggests that it is unusual for consumers to have spontaneous recall of the full details of any type of contract they are in (without checking), for any type of service (energy, car insurance, other forms of insurance, mortgage, pay TV, etc).

Conclusions and next steps

In summary we do not feel that Ofcom has either the evidence or the justification for taking regulatory action against our ARCs.

We are having discussions with senior managers in our commercial team to understand their future plans and explore whether there is any flexibility. We understand that you wish to announce the results of your investigation. However, we feel it would be inappropriate to publish the consultants' report itself, given the significant flaws we have identified which cast much doubt on its conclusions. Should you feel differently, would you please let me know?

We will be in touch again once we have discussed further within BT, but in the meantime we would be very pleased to have Andrea's comments on our critique of the report (we have forwarded an electronic version of our slides as requested).

Yours sincerely,

Greg Mook
Director of Regulatory Affairs
BT Retail