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Dear Andrea

Auto-Renewable Contracts: further comments on consultants' methodology

I am writing in response to your e-mail to Greg Mook of Friday 8th October, to which you attached a letter from Professor Crawford regarding our critique of his report.

We continue to have concerns with the Prof. Crawford's analysis. In particular, we believe that the key concern we have raised – namely, that the price coefficient is likely to be biased downwards and, hence, the effect of the auto renewable component is biased upwards – has not been fully addressed by Prof. Crawford's response.

Before commenting on the content of Prof. Crawford's letter, it is worth taking one step back and restating what the analysis is trying to achieve. This is to measure how the probability of switching away from BT *falls* due to the auto-renewable contract mechanism, *controlling for* a number of factors which are expected to play a role in a customer's decision to switch. One of the key factors that needs to be controlled for is the *price discount* offered to customers that sign up to ARCs (£2.99/month) – indeed, this is the main explicit benefit customers receive in exchange for signing up to the contract.[1]

In order to control for the impact of the price discount, ideally one would either (i) compare the same ARC contract over time and assess how the probability of switching increased if and when the discount was removed (or reduced); or (ii) compare ARC contracts with and without price discounts and see whether switching rates are materially different.

Unfortunately, neither of these measurements is possible with the available data – there is only one type of ARC contract and there have been no changes to the price discount associated with it. Therefore the analysis must rely on *proxies,* where the effect of price changes over time and/or price differences across plans are associated with changes or differences in the probability of switching away from BT.

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[1] For some customers there may also be additional benefits, such as the greater convenience and reduction in transaction costs of not having to re-contract with BT or make an active decision to select the same or a new plan. The analysis does not control for these benefits. Hence, to the extent that these exist, the ARC coefficient is picking up their effect on switching and is therefore likely to be biased upwards.

It is therefore crucial that the nature and context of these “proxies” can be directly read across to the context and nature of the price effect that is induced by the ARC price discount. Our main concern is that the “proxies” identified in the analysis are of limited relevance in assessing the impact of the ARC price discount.

Expected price increases

The most important limitation is, in our opinion, the fact that one of the key sources of price variation in the analysis relates to price increases happening at the end of promotional periods within fixed term contracts. Crucially, these price increases are advertised as a core component of the plan and are therefore *known in advance* by the customer that signs up to them. In our previous letter to Ofcom we argued that this necessarily means that we should expect these customers not to react to the price discount as much as they would if they had unexpectedly faced these price increases.

We do not think Prof. Crawford has been able to address this concern. He argues that the fact that a customer already knew about this price increase when signing up to the contract is irrelevant because *“even in a fully dynamic model, if prices rise a customer’s current utility will fall, no matter what he or she decided 6 or 9 months previously”*. In other words, he seems to suggest that because a particular type of economic model of customer behaviour says that when prices rise, utility falls, then our concern must be misplaced.

We strongly disagree with this view. Surely, we should be using facts and empirical evidence to test the robustness of a model, rather than the other way round? In this case we believe the economic model to which Prof. Crawford refers – and which seems to provide the theoretical underpinning of his empirical work – is lacking in one key respect: it does not take account of the ex ante expectations of customers taking up fixed-term contracts with promotional periods.
It is true that there may be some customers who may have *“intended to select a fixed-term contract, benefit from the discount and switch to another plan/product/provider at the end of the discount period”,* as Prof. Crawford states. However, by the same line of reasoning, there must equally be another group of customers who signed up to the contract with the intention of remaining with BT throughout the contract period *in the knowledge* that they would be facing higher prices at the end of the promotional period.

The key point we are making is that to the extent that there is a group of customers exhibiting the latter type of behaviour, then the estimated price effect will be diluted. Furthermore, the larger this group of customers is, the smaller the probability of switching away from BT at the end of the promotional period and therefore the smaller the measured size of price effect. We believe the group of customers who always intended staying with BT at the end of the promotional period will be much larger than the group Prof. Crawford identifies, because the amount of early termination charges payable if a customer left at the end of the promotional period would be higher than the discount received in the early months, and so such behaviour would not be rational.

In our view it cannot be disputed that the effect of the price discount on ARC customers’ behaviour has been significantly under-estimated by using this proxy. This is an empirical issue which we believe cannot be dismissed by reference to a theoretical model.

Additional points raised by Prof. Crawford’s response

Prof. Crawford also comments on our concerns regarding the treatment of “loss aversion” and “the size of price effects”.

In relation to loss aversion he states that *“it seems far more likely that customers on fixed-term contracts for whom the discount period has ended may themselves actually experience a loss that may induce them to switch”*. He then goes on to state that it is *“at least as likely that we’ve underestimated as overestimated ARC effects”*.

We continue to believe that ARC customers are currently enjoying a benefit which they would lose should they decide to switch, and this would therefore significantly reduce the probability of switching away from BT compared to customers that need to make an active decision to switch. We suggest that Prof. Crawford's comment that it is equally likely that ARC effects may have been underestimated as overestimated must shed considerable doubt on the reliability and robustness of the overall conclusion of the report. <u>We would caution Ofcom against using the results of the analysis as a basis for policy-making.</u>

Finally, Prof. Crawford dismisses our third concern with the analysis regarding the size of the price effects because it is predicated on the "loss aversion" arguments that he claims to have dismissed. We would point out, however, that this argument is predicated on both the "loss aversion" *and* the "expected price increase" arguments. To the extent that either of these arguments remains valid – and we have explained above why we still believe they both do – then our concern that the magnitude of price variations observed in the dataset are much smaller than the ARC discount continues to be relevant in assessing the robustness of the analysis.

<u>Wider picture</u>

As you know from our meeting and our previous letter, even if the above concerns about the consultants' analysis are set aside, we do not understand why Ofcom feels there is any need to take regulatory action when there is no evidence of any material effect on the competitiveness of the market overall, and BT's churn rate is [✂][2]. Whilst we appreciate your point that without ARCs, the market *might* be even more competitive, it is hard to see why Ofcom considers it is worth giving this issue priority over a number of other issues which you do not currently have the resource to deal with but which are currently having a much greater impact on competition.

Claudio mentioned that he doesn't understand why BT is keen to keep offering ARCs if we really believe they don't have a significant impact on churn. The problem is that we currently have [✂] customers on ARCs (mostly giving free evening & weekend calls - FEWE). Moving all these customers off FEWE and reverting them to standard pricing at the end of their minimum term would be a huge and costly communications exercise, and would be bound to result in high levels of customer complaints and dissatisfaction. These customers have opted in to what they know is a good deal, and they like the certainty of knowing they will remain on it unless they request otherwise.

ARCs are cost-efficient for us, because they remove the need to make a proactive marketing call at the end of a fixed term deal to sign customers onto another contract. If we could not use ARCs, increased costs would have to be passed on to customers as a whole, and customers out of contract could see significant price increases. Whilst Ofcom might argue that competition will always put downward pressure on prices, the short-term detrimental effect on consumers would seem to be disproportionate to the alleged (but unproven) detrimental effect of ARCs.

We plan to discuss this issue further at Gavin Patterson's meeting with Stuart McIntosh next week, but if you have any further comments in the meantime please let me know.

Yours sincerely,

DEE CHEEK
Manager Reglatory Strategy and Programmes

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[2] Redactions in this document are indicated by [✂].