Automatically Renewable Contracts

Research into their effects and proposals for a General Condition

Redactions are indicated by [✂]

Consultation

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Section 1

Executive summary

1.1 Automatically Renewable Contracts (ARCs) , also known as ‘rollover contracts’ in communications markets are contracts that, at the end of a minimum contract period (MCP) – whether this is an initial or subsequent period – roll forward to a new MCP by default, unless customers proactively inform their Communications Provider (CP) that they do not wish this to happen. While under a MCP, a customer is usually subject to an Early Termination Charge (ETC) should they wish to end the contract and change supplier.

1.2 We are concerned that ARCs are damaging to consumers and competition in communications markets. We have identified two types of harm to consumers: a *direct effect* coming from the potential for ARCs to increase individual consumers' exposure to switching costs (in the form of an ETC) and an *indirect effect* coming from the potential for ARCs to lessen competition in the market, thereby reducing the pressure on firms to lower prices, and improve quality for all consumers.

1.3 Whilst we recognise that ARCs may also have beneficial effects for some consumers – e.g. those who expect to remain with their supplier and who value the convenience of not having to renew their contract proactively – we believe these benefits are relatively limited and are outweighed by the costs.

1.4 Since 2008, Ofcom has been monitoring ARCs in UK residential and business fixed voice markets, and we have carried out targeted research on the effects of ARCs. BT is the largest provider currently offering ARCs in these markets. They are also available from several smaller fixed voice providers such as Adept Telecom, Eze Talk, italk and Axis Telecom. We calculate that currently around 15% of UK residential fixed voice consumers are contracted to ARC packages. BT has also introduced ARCs into residential broadband propositions.

1.5 Our research, in particular the expert econometric analysis that we have commissioned, indicates a clear causal link between ARCs and reduced levels of consumer switching. Furthermore, it shows that the effect is separate from the impact on switching levels of other factors such as price discounts. We believe this effect stems from the opt-out nature of the process for contract renewal, rather than a lack of transparency surrounding ARC terms or the complexity of the process for opting out. Because it stems from such a core aspect of ARCs this indicates that any example of such a contract is likely to be harmful to consumers and to effective competition.

1.6 **We are therefore proposing an amendment to General Condition 9[1] (GC9) to prohibit "opt-out" processes for MCP renewal (processes where end users automatically enter a new MCP by default unless they proactively inform their CP that they do not wish this to happen) in any form in the fixed voice and broadband sectors**. We propose that this amendment will cover services to residential customers and business customers with no more than ten employees. The proposed amendment would be in addition to proposals for amendments to GC9 currently under consultation in our Changes to General Conditions and Universal

[1] A General Condition is a regulatory condition that has been set by Ofcom and applies to all communications providers who have been defined in that GC.

Service Conditions consultation[2] which contains Ofcom's proposals for amendments to GCs to implement the requirements of the new common framework for communications regulation in the European Union.[3]

1.7 In this consultation document, we:

- explain the development of ARCs in communications markets;
- explain the harm which we believe is caused to communications markets and consumers by ARCs;
- present the evidence we have gathered and explain its significance; and
- make proposals to amend General Condition 9 to prohibit ARCs.

1.8 In developing our proposals, we have conducted research in a number of relevant areas. As a major provider of ARCs, most of our evidence is based on information from BT, although we believe the identified harm would apply across the market. The following research reports are annexed to this document, namely:

- Annex 7: Empirical Analysis of BT's Automatically Renewable Contracts, August 2010 – an econometric study analysing the impact of BT's automatically renewing contract on its customers decisions to switch to another CP.
- Annex 8: Supplementary report to Empirical Analysis of BT's Automatically Renewable Contracts, February 2011 - clarification on certain aspects of the econometric analysis. This report is being prepared for publication and will be published shortly.
- Annex 11: Mystery shopping survey summary by E-Digital, September 2009 - to see whether BT promotes ARCs ahead of other options, and whether consumers are given all facts about ARCs in order to facilitate effective purchasing decisions.
- Annex 12: BT Renewable Contracts - a Report by Spring Research, August 2009 – to assess the knowledge and understanding of ARCs terms and conditions among BT customers.
- Annex 13: Analysis of Call Recordings by Mott MacDonald, October 2009 – to understand the accuracy of information that BT call centre advisors provide to consumers in relation to ARCs at point of sale, and whether advisors verify that customers understand the ARC prior to agreement.

1.9 In addition, we are publishing comments made by BT on the econometric study of BT's ARCs:

- Annex 9: BT's first response to empirical analysis, 1 October 2010 – an initial letter from BT to Ofcom in response to the econometric analysis
- Annex 10: BT's second response to empirical analysis, 21 October 2010 - a second letter from BT to Ofcom reinforcing its response to the econometric analysis

[2] http://stakeholders.ofcom.org.uk/consultations/gc-usc/
[3] http://ec.europa.eu/information_society/policy/ecomm/tomorrow/index_en.htm

1.10 We welcome the views of all interested parties on our proposals. Details on the consultation period and how to submit views are at Annex 1.

Section 2

Introduction

Background

2.1 Many Communications Providers (CPs) offer fixed term contracts that require customers to commit to paying for a service for a minimum contract period (MCP) in return for an incentive, such as an equipment subsidy – for example a mobile handset subsidy or a set-top box – or a price discount. In order to exit fixed term contracts before the end of a MCP, customers usually have to pay an early termination charge (ETC).

2.2 Automatically Renewable Contracts (ARCs) in communications markets are contracts where, at the end of a MCP (whether this is an initial or subsequent period), the contract rolls forward to a new MCP by default, unless customers proactively inform their Communications Provider (CP) that they do not wish this to happen. (In this consultation we sometimes refer to ARCs as "rollover contracts", and sometimes refer to a new MCP as a "new contract".)

2.3 Since early 2008, when ARCs first emerged in UK residential communications markets, Ofcom has been interested in understanding the effects they might have on consumers and competition. This reflected our wider concern with potential barriers to switching in the communications sector, and the current project has been conducted alongside our Strategic Review of Switching[4] and our Additional Charges enforcement programme under the Unfair Terms in Consumer Contract Regulations (UTCCR).[5]

2.4 ARCs continue to be a feature in residential fixed voice markets, and in business markets. Currently approximately 15% of UK residential fixed voice consumers are on ARCs. BT has also introduced ARCs in the residential broadband sector.[6]

2.5 ARCs are not currently a feature of the mobile market. However, we would have significant concerns if they were to emerge. This is because, whilst we recognise that the mobile sector exhibits a number of differences from the fixed voice and broadband sectors (for example innovations in handsets are important for driving the dynamics of the market), our research shows that the impact of ARCs stems from core aspects of consumer behaviour, and therefore there is a strong case that they would also have harmful effects in the mobile sector. However, we are not proposing to include explicit prohibition of ARCs in the mobile sector in our current proposals as we have targeted our proposals at the current harm we observe in fixed markets. However we would urgently revisit this issue if ARCs emerged in the mobile sector.

2.6 We do not propose to extend the proposed prohibition to services provided to businesses with more than 10 employees. Our evidence relates to residential consumers, and we believe that much of the behavioural research relates to residential consumers and small business users. Contractual barriers to switching (such as ARCs) are less likely to be a feature in services provided to larger businesses since contract due diligence is a normal part of the procurement process for them and in any event the likely effect would be significantly different.

[4] http://stakeholders.ofcom.org.uk/binaries/consultations/consumer-switching/summary/switching.pdf
[5] http://stakeholders.ofcom.org.uk/consultations/addcharges/
[6] We understand that BT has around [✂] broadband customers on ARC contracts.

2.7 This consultation presents the findings of our research concerning the effect of ARCs and sets out our proposals for addressing the harm we have identified. This section sets out the context to our research. Section 3 discusses the general concerns that motivated our research and underpins our analysis. Section 4 presents the research we have commissioned and discusses our interpretation of the results, drawing on our analysis in Section 3. In Section 5 we present our proposals for a GC on ARCs.

The emergence of ARCs

2.8 ARCs have been a well established feature of some calls packages available to businesses, but were not common in residential markets until they were introduced by BT into its domestic call packages in February 2008.

2.9 Under BT's original offer, residential customers could opt for a 12 month ARC featuring unlimited evening and weekend calls at a discounted monthly price of £11.54. This represented a discount of 21% on the standard monthly rate of £14.53.[7] Termination of the contract within the MCP (initial or subsequent) would result in the customer having to pay an early termination charge of £7.50 per month.[8] Contracts were automatically rolled forward to a new 12 month MCP unless customers informed BT that they did not want this to happen. Customers could provide notification of this at any time, and BT provided a reminder letter around one month before the expiry of each MCP.

2.10 BT subsequently broadened its ARCs to other residential call packages – Unlimited Weekend and Unlimited Anytime.

2.11 In June 2010, following discussions between Ofcom and a number of fixed-voice operators, BT announced significant reductions to its ETCs, and currently the ETCs which apply for each remaining month of any MCP when a customer terminates the contract early are: £2.50 for Unlimited Weekend, £3 for Unlimited Evening and Weekend, and £5.50 for Unlimited Anytime.[9] These reductions applied to all customers on existing contracts as well as new customers.

2.12 At present BT still offers ARCs, but with reduced marketing emphasis – for example, the packages advertised most prominently on its website do not feature ARCs, but variants of its Unlimited Anytime and Unlimited Evening and Weekend are available that do feature ARCs.

2.13 BT is the only large provider currently offering ARCs to residential fixed voice customers. However, several smaller providers also offer them. For example:

- Adept Telecom offers an 18 month renewable contract on its residential package providing free evening and weekend calls. Adept requires 30 days notice of contract termination prior to the ending of the contract term or the contract will roll forward to a new contract term. An ETC of £5 for every month remaining in the contract applies for customers wishing to cancel their contract within a MCT.[10]

[7] The same discount was also offered on a contract without an ARC term but with an 18 month MCP instead of 12 month one.
[8] Prior to April 2009 the ETC was equal to remaining monthly payments.
[9] See http://consumers.ofcom.org.uk/2010/06/cheaper-charges-for-uk-consumers-to-end-phone-contracts/
[10] http://www.adept-telecom.co.uk/wp-content/uploads/2009/03/adept-ts-cs-nov-10.pdf

- Eze Talk offers a residential contract which automatically renews to a new MCP unless customers give notice that they do not want to renew 28 days before the contract expiry date. ETCs are £8 per month for the remaining MCP for customers who wish to cancel their contract during a MCP.[11]

- italk offers a 24 months renewable contract which can be cancelled by the customer at least one month before the anniversary of the contract.[12] Cancellation by the customer during any MCP (initial or following automatic renewal) will incur an ETC based on the outstanding period of the MCP. Following recent engagement with Ofcom under its Additional Charges Enforcement programme, italk has reduced its ETCs for fixed voice significantly. Its new monthly ETC is now £3 and £5.50 respectively for its italk 2 and italk 3 packages. italk is currently in the process of updating its terms and conditions to reflect these changes.

- Axis Telecom offers a contract with an initial MCP of 18 months which continues from year to year unless cancelled by the customer with at least 1 month's notice before the end of the initial MCP or subsequent anniversaries. Cancellation by the customer at any other time results in an ETC of £150.00 if the cancelation takes place in the first month of a MCP. This figure is reduced by £6.50 for each successive month of the contract completed prior to cancellation.[13]

2.14 A number of CPs also provide ARC based offerings to small business users. For example:

- Talk Talk Business offers an initial 24 month MCP which automatically rolls forward to subsequent 12 month periods unless the customer contacts the provider at least 30 days before the end of the original MCP to inform them that they do not want the contract to be renewed. Termination by the customer at any other time within a MCP after the first year results in an ETC of £125.[14]

- Titan Telecom offers a one or three year initial term requiring the customer to give at least 3 months written notice if he/she does not want the contract to be rolled forward automatically. Termination by the customer at any other time within a MCP results in an ETC of £150.[15]

- Optimum Calls offers a 5 years initial term which automatically rolls forward to subsequent 5 year terms unless the customer gives notice by Royal Mail recorded delivery within 30 days of the ending of a MCP. Termination by the customer at any other time within a MCP results in an ETC of £395.[16]

2.15 BT currently has six different broadband ARC packages, which offer a discount of between £2 and £3 per month off the standard price in exchange for a 12 month ARC.

[11] http://www.eze-talk.com/info/terms-and-conditions.aspx#Ending the contract
[12] http://www.italktelecom.co.uk/faq.html
[13] http://www.axistelecom.co.uk/terms_res.htm
[14] http://www.talktalkbusiness.co.uk/legal/small-business-terms/
[15] http://www.titantelecom.uk.com/media/TitanTermsConditions.pdf
[16] http://www.optimumcalls.com/legals.php%2310

Ofcom's investigation

2.16 Since their introduction in the residential sector, Ofcom has had serious concerns about the potential harm that ARCs may cause, particularly if they become a widespread feature of this market.

2.17 Our analysis of their potential effects is explained in detail in Section 3. To summarize, we are concerned that ARCs increase the likelihood of MCP renewal, and increase switching costs in the market to the detriment of consumers and competition. We are also concerned that they induce customers looking to switch to systematically contact their existing provider thereby potentially introducing some elements of a Losing Provider Led (LPL) switching process into a Gaining Provider Led (GPL) switching processes, that is the potential for targeted save activity, such as 'bespoke' offers[17].

2.18 We initially looked at ARCs in the context of our Review of Additional Charges published in December 2008.[18] The Review set out our guidance on how we would enforce the Unfair Terms in Consumer Contracts Regulations (UTCCR) in the communications sector. Our current guidance states the conditions under which we believe ARC terms are more likely to be judged as 'fair' under the UTCCR.[19] This includes where the ARC term is transparent and a clear reminder is sent to the customer.

2.19 However, the test of fairness under the UTCCR is a legal test specific to those regulations and does not necessarily capture the full economic effects of a contract term. Consequently, our concerns about the effect of ARCs remained and we commissioned some market research to better understand their effects and determine whether some form of intervention is appropriate.

2.20 Our initial market research, conducted in 2009, focussed on transparency and customer awareness in relation to BT's ARCs propositions, and included a mystery shopping exercise, and a customer survey. This focus reflected the fact that, at the time, only a relatively small proportion of BT's ARC customers had rolled forward to a new contract (most contracts were sold in the second half of 2008) and the impact of ARCs was not yet clear.

2.21 Towards the end of 2009 we commissioned Gregory S Crawford, Professor of Economics at the University of Warwick, and ESMT Competition Analysis[20] to conduct an econometric analysis of BT customer data in order to identify whether BT's ARC term had an impact on customer switching. An econometric approach was necessary in order to isolate the impact of the ARC term itself, as separate from other factors such as the price discount associated with the offer, and changes in the competitive dynamics in the market. The approach also allows us to abstract away from specific features of BT's offer and customer base and enables us to extrapolate the findings with more confidence to other offers that could emerge in the future. This is discussed in Section 4.

[17] As we discuss in our Strategic Review of Consumer Switching, we do not believe such save activity is in the interests of consumers and competition. We have now received stakeholder responses on our consultation and we are currently considering them.

[18] http://stakeholders.ofcom.org.uk/binaries/consultations/addcharges/statement/addchargestatement.pdf

[19] See paragraph 97 onwards in our Guidance - http://stakeholders.ofcom.org.uk/binaries/consultations/addcharges/statement/Guidance.pdf

[20] ESMT Competition Analysis is a subsidiary consulting firm of the European School of Management and Technology.

2.22 Our research has focussed on BT's ARCs offerings. This is because BT is the largest provider of ARCs by a very significant margin – indeed it is the only large supplier of residential voice services which offers ARCs – and therefore also the most robust source of data for research. This does not mean that our concern about ARCs is restricted to BT's offerings. Indeed, we believe that our research confirms that ARCs have inherent characteristics which are likely to be harmful if provided by any CP. We have been careful in making generalizations from the BT data, and we discuss in detail in Section 4 why we believe our findings regarding BT's ARC terms can be extrapolated to any example of an ARC in the fixed voice or broadband sectors. That is why we propose to address this harm by amending General Condition 9. This is explained further in Section 5.

2.23 Our response to the emergence of ARCs has reflected a particular concern that they may spread rapidly throughout the communications sector and become an established feature. While BT remains the only large provider to offer ARCs, the retention benefits that ARCs provide mean they will remain attractive to suppliers, and are likely to become more so as the customer bases and market shares of CPs other than BT grow. And, as we discuss in Section 3, we do not think the widespread adoption of ARCs would be a slow process but might be a sudden shift. Our proposals in this consultation reflect this concern.

ARCs in other sectors

2.24 Whilst we are mindful that many of the effects discussed in this document are specific to ARCs in communications markets, we are aware that similar issues have been or are being addressed in other industry sectors.

2.25 In the energy sector, Ofgem initially considered the use of ARCs in non-residential supply and took action in 2009 to limit the length of MCPs after the initial period to 12 months.[21] In March 2010, Ofgem wrote an open letter to residential energy suppliers reminding those offering ARCs of their obligations under energy supply licences and the UTCCR.[22] In January 2011 Ofgem published a consultation, which expressed concerns over the transparency of ARC terms and conditions in the energy sector and presented proposals to modify the Standard Licence Conditions in the sector to address this.[23]

2.26 The Office of Fair Trading (OFT) has undertaken a comprehensive study into consumer contracts focussed on customer understanding of contract terms and on how firms approach contracts, including any practices which intentionally or unintentionally disadvantage customers.[24] We think the OFT's work is significant in understanding the effects of ARCs since the harm we have identified is partly a consequence of customers' understanding of the effects of ARCs as well as other behavioural factors (see Section 3).

2.27 We have not conducted an exhaustive survey of ARCs (and similar terms) in other sectors since experiences elsewhere, including the rationale for, and impact of

21 http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=99&refer=Markets/RetMkts/ensuppro

22 http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Documents1/Amendment%20to%20Energy%20Supply%20Probe%20proposals%20relating%20to%20automatic%20contract%20rollovers%20for%20micro%20business%20consumers.pdf

23 http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=Fixed%20Term%20Offers_Consultation%20Final.pdf&refer=Markets/RetMkts/Compet

24 http://www.oft.gov.uk/OFTwork/markets-work/current/consumer-contracts

ARCs, are likely to be shaped by the specific features of the markets concerned and may not generalise more widely. However, it appears that many examples of automatically renewing contracts do not subject a consumer to an ETC after the rollover and are primarily aimed at ensuring the continuation of a service that would otherwise stop.

2.28 For example, ARCs are a common feature in the insurance industry but are deployed to ensure that there is no gap in critical cover where customers have not renewed. There is no penalty for cancelling cover in these circumstances. Therefore ARCs in the insurance industry are fundamentally different to those in the communications sector where ETCs are levied for cancellation before the end of a MCP. Similarly, the automatic renewal of annual subscriptions to newspapers and magazines does not typically subject the consumer to an ETC.

Treatment of ARCs in overseas communications markets

2.29 We are aware that other regulators and some international institutions are working on contract renewal arrangements and barriers to switching generally, and in some cases on ARCs specifically. Moreover, a number of EU countries have passed primary or secondary legislation that makes ARCs and even consecutive opt-in MCPs after the initial contract period unlawful. For example,

- In the Netherlands, under legislation enacted in 2009, Chapter 7 of the Telecommunications Act provides that contracts must move to a monthly basis after an initial MCP – effectively prohibiting ARCs.[25]

- In France, the “Chatel Law” contains a number of relevant provisions, including requirements that providers cannot impose contracts longer than 12 months unless the same offer is available for a period of less than 12 months, and that ETCs levied in any period after the initial 12 months of a contract cannot be greater than one quarter of the value of monthly subscriptions remaining under the contract term. The Chatel Law also prohibits any MCP greater than 24 months.[26]

- In Italy, the “Bersani Law” (2007) allows consumers in the communications industry to terminate contracts with 30 days’ notice while capping ETCs to the direct costs incurred by the operators when the service is terminated. In practice this has meant that operators have found it very difficult to justify ETCs after the initial minimum contract period when a subsidy which has been recovered through monthly charges ends. This effectively eliminates any commercial incentive to introduce the type of ARCs we are discussing in this consultation.

- In its recent paper on Broadband Bundling, the OECD comments specifically on ARCs. The OECD notes that ARCs can “severely hamper competitive choice” and recommends that, to assist switching, Governments should “prohibit any automatic initial contract renewals”.[27]

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[25] For an English synopsis see http://www.iclg.co.uk/index.php?area=4&country_results=1&kh_publications_id=157&chapters_id=3890

[26] For an English synopsis see http://www.twobirds.com/Finnish/News/Articles/Sivut/New-French-law-gives-consumers-greater-rights.aspx

[27] OECD (2011), “Broadband Bundling: Trends and Policy Implications”, *OECD Digital Economy Papers*, No. 175, OECD Publishing. doi: 10.1787/5kghtc8znnbx-en. http://www.oecd-

The revised European Common Regulatory Framework

2.30 In 2009, the European Parliament and Council of Ministers agreed a package of reforms to the common framework for communications regulation which applies across all EU Member States.[28] The new package is required to be transposed into the national laws and regulatory systems of Member States, including the UK, by May 2011.[29] As a result, Ofcom is currently consulting on proposed changes to GCs in our consultation entitled Changes to General Conditions and Universal Service Conditions[30].

2.31 The revised framework includes amendments to the “Universal Service Directive”.[31] These amendments include a new Article 30 which deals specifically with requirements for consumer switching, including a requirement that Member States ensure that “without prejudice to any minimum contractual period…conditions and procedures for contract termination do not act as a disincentive against changing service provider”.[32] In the recitals to the Directive, it is also clear that consumers should be able to change providers when it is in their interests to do so and without hindrance by (inter-alia) “legal obstacles”, including contractual conditions.[33]

2.32 We believe that these new requirements of the European framework are relevant to our work on ARCs. As well as clearly signalling the intent of the European Commission, the Parliament and Council of Ministers to ensure that Member States remove contractual barriers to switching, they also directly mandate Member States to ensure that arrangements at the end of contracts do no raise barriers to switching. We believe that automatic renewal mechanisms which require proactive opt-out by subscribers (as in ARCs) create ambiguity around the ending of contracts, and this raises barriers to switching for some subscribers. In Section 5 we explain in detail how the proposed amendment to General Condition 9 fits with the requirements of the amended Universal Service Directive.

Impact assessment

2.33 The analysis presented in this document represents an impact assessment, as defined in section 7 of the Communications Act 2003 (“the Act”). In Sections 3, 4 and 5 we discuss all of the relevant factors and options that we have considered, including their impact on stakeholders including both consumers and suppliers. It is for the reasons set out in those sections that Ofcom believes its proposals will support the competitive process, thereby furthering the interests of citizens and consumers in fixed line telephony and broadband markets.

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ilibrary.org/docserver/download/fulltext/5kghtc8znnbx.pdf?expires=1298641702&id=0000&accname=guest&checksum=94B5FD295899CE340952C954F7C5DE33. See page 37.

[28] http://ec.europa.eu/information_society/policy/ecomm/tomorrow/index_en.htm

[29] Transposition of the revised framework in the UK is being led by the Department for Business Innovation and Skills (BIS). BIS consulted on proposals for the transposition in September 2010. See http://www.bis.gov.uk/Consultations/revised-eu-electronic-communications-framework?cat=closedawaitingresponse

[30] http://stakeholders.ofcom.org.uk/consultations/gc-usc/

[31] Directive 2009/136/EC of the European Parliament and of the Council amending Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:337:0011:0036:EN:PDF

[32] See Article 30(6) of Directive 2009/136/E. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:337:0011:0036:EN:PDF

[33] See paragraph 47 of the recitals to of Directive 2009/136/E. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:337:0011:0036:EN:PDF

2.34 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This reflects section 7 of the Act, which requires Ofcom to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information about Ofcom's approach to impact assessments, see the guidelines, Better policy-making: Ofcom's approach to impact assessment, which are on Ofcom's website.[34]

2.35 Specifically, pursuant to section 7 of the Act, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the Act) is secured or furthered by or in relation to what we propose.

Equality Impact Assessment

2.36 Ofcom is separately required by statute[35] to assess the potential impact of all our functions, policies, projects and practices on the equality of individuals to whom those policies will apply. Equality impact assessments (EIAs) assist us in making sure that we are meeting our principal duty of furthering the interests of citizens and consumers regardless of their background or identity. We have given careful consideration to whether or not our proposal to amend General Condition 9 will have a particular impact on race, age, disability, gender[36], pregnancy and maternity, religion or sex equality[37]. We do not, however, envisage that the proposals contained in this consultation will have a detrimental impact on any particular group of people.

2.37 Nor do we envisage any need to carry out separate EIAs in relation to race or gender equality or equality schemes under the Northern Ireland and Disability Equality Schemes. This is because we anticipate that our regulatory intervention will affect all industry stakeholders equally and will not have a differential impact in relation to people of different gender or ethnicity, on consumers in Northern Ireland or on disabled consumers compared to consumers in general. Similarly, we do not envisage making a distinction between consumers in different parts of the UK or between consumers according to income. Again, we believe that our intervention will not have a particular effect on one group of consumers over another.

[34] http://stakeholders.intra.ofcom.local/binaries/consultations/better-policy-making/Better_Policy_Making.pdf
[35] The Equality Act 2010.
[36] Including gender reassignment
[37] Including sexual orientation.

Section 3

The potential harm from ARCs

Introduction

3.1 In this section we set out our thinking regarding the impact that ARCs may have on consumers and competition. We consider both the negative effects and the possible benefits for consumers. The analysis presented in this section lay behind our initial concerns following the introduction of BT's ARCs in February 2008 and prompted our subsequent research into their impact. We use this analysis to interpret the evidence that we discuss in the next sections of this consultation. In particular, we use the theory of harm developed in this section to assess whether the observed impact of BT's ARCs can be extrapolated to similar offerings that other CPs may introduce, and from fixed voice to broadband and mobile offerings.

3.2 We identify two types of negative effect on consumers: a *direct effect* coming from the potential for ARCs to increase individual consumers' exposure to switching costs (in the form of an Early Termination Charge (ETC)) and an *indirect effect* coming from the potential for ARCs to lessen competition in the market, thereby reducing the pressure on firms to lower prices and improve quality.

3.3 The section begins with a discussion of the potential benefits of ARCs, before considering the theoretical harm. We then weigh up the relative costs and benefits and set out why we consider there is a significant risk that the former outweighs the latter. We are interested in the general impact of ARC terms and, unless otherwise stated, our analysis abstracts from specific features of particular offers (such as the content or timing of reminder letters before the rollover date or the specific level of the ETC).

3.4 While we leave a discussion of the evidence to the next section of this consultation, we stress that our thinking presented in this section has evolved in the light of the evidence available.

The potential benefits of ARCs

3.5 Ofcom recognises that the introduction of new tariffs and contracts can provide significant benefits for consumers. Our general presumption is that in a competitive market with well-informed consumers and no barriers to competition, firms will be induced to offer new contracts that provide increased value to consumers. Where competition is effective it is for the market to decide whether a new type of contract succeeds.

3.6 Consequently, we believe it is appropriate to begin a discussion on the impact of ARCs with an assessment of their potential benefits for consumers. Any assessment of harm must be balanced against the benefits and it is therefore useful to set out clearly upfront the potential benefits of ARCs.

3.7 In considering the potential benefits it is important to remember that even if regulation prohibited ARCs a firm would still be able to offer contracts with Minimum Contract Periods (MCPs) including any price discount or other benefits tied to the MCP. The difference involves what happens at the end of each MCP if a consumer takes no action during that MCP.

3.8 We believe ARCs have the following potential benefits for consumers:

- Any price discount or other benefits (e.g. the provision of equipment such as handsets) that the firm is *only* able to offer because of the presence of the ARC term;

- The convenience of not having to renew a contract at the end of each MCP.

Price discounts (and other benefits)

3.9 It is common for CPs in the communications sector to offer price discounts or other benefits in return for a customer's commitment to a MCP. One reason is that the provision of a service in a number of cases involves an upfront cost to the supplier (such as connection costs or equipment provided to the customer). An MCP allows the supplier to incur this cost and recover it over time from the consumer's monthly charge without either demanding a lump-sum payment upfront or charging a higher monthly price to reflect the risk that the customer will leave before the costs are recovered. This is likely to be valued by some consumers.

3.10 The important question, however, is whether there are reasons why an ARC term enables a firm to offer additional benefits *beyond* those associated with the MCP itself. ARCs may in practice increase the likelihood of renewal (as discussed below) and therefore have similar features to a longer MCP (or simply increase the average length of tenure across all customers). However, any resulting benefits from the longer commitment on the part of the consumer, such as spreading upfront costs over a longer period, could be achieved simply by having a longer MCP in the first place, which would have the advantage of making the exact level of commitment clear to the consumer. As an ARC term would only be an indirect method of generating commitment it is unlikely to be the best method.

3.11 In cases where the ARC term does not affect the likelihood of renewal the benefits of ARCs are not immediately apparent since the term merely affects the nature of the MCP renewal process. During each MCP the contract is effectively identical to one without an ARC term and so should not generate obvious additional benefits. The most likely benefit is where processing an automatic renewal saves resources compared to a pro-active opt-in decision (e.g. less need for the involvement of customer services staff). These cost-savings can then be passed on to the consumer in the form of a price discount. The extent of these benefits will depend on the CP in question, though there is no reason to expect them to be a significant proportion of the total costs of supplying a service over the course of a MCP.

The benefits of convenience

3.12 ARCs may be valued by consumers who expect to remain with a supplier and wish to continue receiving any benefits associated with the MCP without having to pro-actively renew their contract when each MCP expires, but who also do not want to be tied into a much longer MCP.

3.13 These benefits depend on how bothersome an opt-in renewal process would be for the consumer in the absence of ARCs and how confident the consumer is of staying beyond an initial MCP. The more time and effort a consumer has to spend signing up for a new MCP the more beneficial an opt-out process might be for a consumer that expects to stay with their supplier beyond the initial MCP.

3.14 Nonetheless, there are reasons to think these benefits may be limited:

- In the absence of ARCs, CPs should have an incentive to make any opt-in renewal process as easy as possible;
- A consumer confident of staying with a given provider would be prepared to sign up for a longer MCP. If ARCs are preferred to this it means the consumer values the option to leave to at least some extent (and will therefore care about the ease of opting-out as well);
- The costs of forgetting to renew an MCP must be balanced with the risk of forgetting to opt-out of an ARC. Furthermore, the risks of failing to opt-in are not paramount since the expiry of an MCP in the communications sector typically means the contract reverts to a month-by-month relationship, and not the cessation of supply.

3.15 We also note that if ARCs are primarily about offering consumers convenience we would expect the automatic renewal feature to be optional at the point of sale – i.e. offered alongside an identical tariff with an equal length MCP but no automatic rollover term.[38] A consumer could then choose whether the ARC term was right for them.

3.16 Nevertheless, we recognise that ARC terms are likely to be valued by some consumers in the market and that this needs to be weighed against any potential harm. We discuss this further below.

Question 1: Do you agree with our assessment of the potential benefits of ARCs for consumers, including the source of the benefits and their magnitude? Please provide evidence to support your response.

The potential harm which results from ARCs

3.17 Since their introduction, we have been concerned that ARCs have the effect of reducing switching by locking consumers into long contract terms with financial penalties (ETCs) for exit. Whilst this may not be harmful for some individual consumers who would not switch even if these penalties did not exist, we think it is likely to be harmful for others who are discouraged from switching by the existence of ETCs. This means that the competitive process is harmed as, on average, switching barriers are raised and people switch less.

3.18 It might be argued that consumers would not select an ARC package if they wanted to retain the option of switching cost free, but a counter argument for this is to question why CPs would deploy ARCs if they are only attractive to customers who would not switch even without an ARC.

3.19 It might also be argued that customers on ARC packages are able to effectively trade off the price discount and the renewal (i.e. they choose to forego cost free switching in return for the discount). Whilst this may be true in some individual cases, the evidence shows that a significant proportion of customers are not fully aware of the renewal mechanism and so cannot have made such a finely balanced judgment.

3.20 Prima-facie it therefore seems likely that ARCs are a mechanism for deterring consumers who would otherwise switch from doing so, which reduces switching

[38] We note that on introduction BT offered its ARC contract alongside a non-renewing contract with an identical price discount but an 18 months MCP.

generally and so is harmful to competition. In the remainder of this section we explore these points in greater depth, and explain how we have developed a theory of harm in light of the evidence we have gathered (presented in Section 4).

3.21 Under an ARC the default outcome if the consumer takes no action is for an MCP to be renewed at the end of each contract period. This means the consumer continues to be subject to a switching cost in the form of an Early Termination Charge (ETC).

3.22 This creates two potential sources of harm. First, consumers may be subject to switching costs that they did not intend or expect, preventing them from switching supplier to take advantage of new offers in the market. Second, a greater proportion of consumers in the market will be subject to an ETC at any point in time, reducing the incentive for firms to compete for each others' customers. Importantly, while the first source of harm only affects the individual subject to the ARC term, the second would have indirect (or 'spillover') effects for the market as a whole.

3.23 A theory of potential harm needs to address three possible counter-arguments in the context of ARCs:

- Why would ARCs increase the likelihood of a consumer's MCP being renewed?
- What are the harmful effects of consumers continuing to be subject to MCPs beyond the initial contract period?
- If ARCs are harmful for consumers how could these contracts survive in a competitive market?

3.24 We now set out our thinking on each of these issues.

The influence of ARCs on consumers' renewal decisions

3.25 An ARC term simply changes an opt-in process for contract renewal into an opt-out one (and therefore changes the default outcome if the consumer takes no action). It involves no contractual commitment on the part of a consumer regarding the renewal of their MCP and simply affects the *process* by which this occurs. Since the options available to the consumer remain the same, any influence of ARCs must stem from the opt-out process itself. There are reasons to think this can have a significant impact on consumers' choices.

3.26 To begin with we note that, whereas a firm has an incentive to make an opt-in process as convenient as possible for the consumer, the same is not necessarily true for an opt-out process. For example, it is possible that fewer customer service resources will be devoted to the design and implementation of an opt-out process. There is a real possibility that the opt-out process will not be as customer-friendly as it should be. Nevertheless, our analysis does not rest on the assumption that the opt-out process is overly complicated or time consuming (and in fact the evidence discussed in Section 4 shows that from a process point of view, it is not particularly difficult for example to terminate a BT ARC).

Reduced flexibility over timing of contract renewal

3.27 Whatever the actual details, any opt-out process will invariably involve some time and effort on the part of the consumer. This effect is bolstered by the fact that in order to make an informed decision the consumer may need to devote time and effort to searching the offers available in the market to get a sense of the relative benefits of switching supplier.

3.28 The cost of effort need not be significant in order to influence whether or not the consumer rolls forward to a new contract. Unlike an opt-in process, where the consumer has no deadline for signing up to a new contract after the expiration of their MCP, a consumer under an ARC has to make a decision before the date of the rollover. The effort of opting-out therefore only needs to deter the consumer for a short period of time to have a lasting effect. The impact of failing to opt-in, on the other hand, is lower since the option to do so does not disappear.

3.29 Consumers will face many competing demands on their time and, with shifting pressures from work or their personal lives, they may not be in a position to allocate time to their opt-out decision before the date of the rollover. Whereas someone not on an ARC who is approaching the end of the MCP can delay the renewal decision until a more convenient date, a consumer on an ARC who decides not to act will find themselves subject to a new MCP and have to wait until the next rollover date (or pay an ETC to leave). Consequently, even a relatively sophisticated consumer who is fully aware of the ARC term may nevertheless be more likely to renew their contract simply because of the reduced flexibility in timing.

3.30 We note that some ARCs allow consumers to opt out of their next rollover at any time during their current MCP. BT's contract, for example, includes this option. Where this ability is made transparent, it provides a forward-looking customer with more flexibility and may help mitigate the impact of the rollover deadline discussed above.

3.31 However, there are reasons to think the benefits of this are limited. The decision on whether to roll forward will be closely connected to an assessment of the value of switching supplier and this can only be conducted close to the date at which the switching will occur since the consumer will need up-to-date information on the offers available in the market. Communications markets are very dynamic and even a few months can see material changes. Consumers' individual needs in the sector may also change quite rapidly over time. We would expect that, in general, the vast majority of consumers who decide to opt-out would do so close to the rollover date (and the available evidence discussed in Section 4 supports this).

Consumer inertia – the 'default bias'

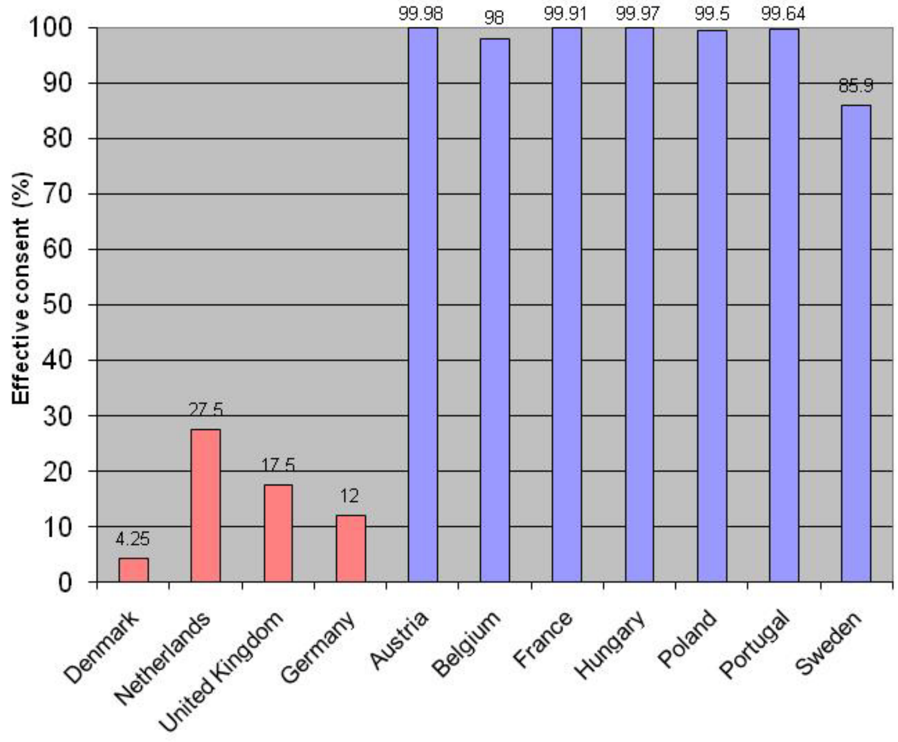
3.32 The above analysis suggests that even relatively sophisticated consumers, who make rational forward-looking decisions, may be affected by the existence of the ARC term. However, there is a growing recognition that consumer behaviour is influenced by psychological factors as well as careful cost-benefit calculations. The field of behavioural economics explores the ways in which individual decision making is influenced by factors such as emotions, habits and cognitive limitations.

3.33 Of particular relevance for ARCs is the general tendency of individuals to exhibit inertia in their decision making (this is sometime labelled the 'status quo bias'). A well known manifestation of this tendency is that default options can have a significant impact on choices even where the cost of making a decision is low. The so-called 'default bias' has been observed in a number of contexts:

- *Pension take-up*. Studies show that take-up of employer pension schemes is significantly higher when individuals are automatically opted-in.[39]

- *Organ donation*. Countries with an opt-out system for organ donation have significantly higher rates of (presumed) consent. This is illustrated dramatically in Figure 3.1 below (reproduced from Johnson and Goldstein (2003) [40]). It shows rates of (presumed) consent for organ donation across a range of countries. As can clearly be seen, consent rates are significantly lower in those countries with opt-in systems (Denmark, Netherlands, UK and Germany) compared to those with opt-out systems. There are of course numerous differences between organ donation decisions and contract renewal. Nevertheless, the chart shows the significant potential of default effects.

Figure 3.1: Organ donation consent rates in countries with opt-in vs. op-out



Source: Johnson, E. J., et al. (1993) "Framing, probability distortions and insurance decisions" *Journal of Risk and Uncertainty*

- *Insurance options*. The states of New Jersey and Pennsylvania both introduced an option of cheaper car insurance in the early 1990s that carried a restricted right to sue for personal injury. Each state chose a different default option when implementing the changes. In Pennsylvania, the default was to remain on full right-to-sue whereas in New Jersey consumers had to actively choose this option as otherwise they would get the cheaper option by default. Following the change 75% of Pennsylvanians retained the full right-to-sue whereas only 20% of New Jersey residents did the same. Although other differences between the two states

[39] For example, Madrian and Shea (2001) find that take up after one year increases from 49% to 86%. See Madrian, B. C. and D. F. Shea (2001) "The power of suggestion: inertia in 401(k) participation and savings behaviour", *Quarterly Journal of Economics, Vol. 116 (4), pp. 1149–1187.*

[40] See Johnson, E. J. and D. Goldstein (2003) "Do defaults save lives?", *Science*, Vol. 302, pp. 1338-1339.

could explain some of the effect, a good deal of the difference is likely to be the result of the different default options.[41]

3.34 The research finds that the ‘default bias’ occurs across many different contexts and can have very powerful effects. This suggests there is a real risk that many consumers will roll forward to new MCPs simply because of inertia, regardless of whether this is the best choice for them. The potential for inertia to influence decisions suggests that even ARCs with extremely simple opt-out procedures may still have an impact on contract renewals.

Targeted Save activity – introducing some elements of LPL processes into a GPL process

3.35 Fixed voice services provided via BT’s Openreach network currently operate a Gaining Provider Led (GPL) system for switching supplier.[42] Under this system the consumer only needs to contact their new supplier in order to switch. Losing suppliers are effectively not allowed to target retention offers on the consumer during the 10 day switchover period. This contrasts with a Losing Provider Led (LPL) system where the consumer must contact their existing supplier in order to initiate the switch and where the losing provider can systematically engage in save activity with every consumer who intends to switch.[43]

3.36 ARCs can enable a supplier in a GLP environment to engage in the type of targeted save activity usually associated with a LPL system. Under an ARC a consumer that intends to switch at a future date must contact their supplier in order to opt out of the rollover (or face paying an ETC). This provides prior warning to the supplier that the consumer intends to switch and creates an opportunity for targeted save activity.

3.37 Ofcom has recently explored the potential effects of targeted save activity in a LPL system in our Strategic Review of Consumer Switching consultation, published in September 2010. In the consultation, although we acknowledged that consumers who received retention offers may have a positive experience of them, we took the view that targeted save activity (in a LPL environment) is likely to weaken competition and reduce the benefits from competition to consumers overall.[44] We think this preliminary conclusion also applies to a significant extent to situations where ARC terms mean that some key features of a LPL process are introduced in a GPL process.

Question 2: Do you agree with our assessment that ARCs are likely to increase the probability of contract renewal (despite only altering the process for renewal)? Please explain your answer.

What are the harmful effects of switching costs?

3.38 The above analysis suggests ARCs increase the likelihood that a consumer will remain under an MCP with their existing supplier following the end of each contract

[41] See Johnson, E. J., et al. (1993) “Framing, probability distortions and insurance decisions” *Journal of Risk and Uncertainty, Vol. 7(1), pp. 35-51.*
[42] There is no coordinated process for switching to or from a cable network and it is up to the consumer to organize ending their service with the existing supplier and initiating it with the new one.
[43] Ofcom research has found that retention activity is more prevalent in LPL processes than GPL ones. See http://stakeholders.ofcom.org.uk/binaries/consultations/consumer-switching/summary/switching.pdf , specifically Figure 23 on page 46.
[44] See http://stakeholders.ofcom.org.uk/binaries/consultations/consumer-switching/summary/switching.pdf , particularly section 5.

period. This in turn suggests a greater proportion of the market will be subject to an MCP and therefore higher switching costs (in the form of ETCs) at any point in time. This is particularly true if ARCs become an established feature of the market, offered by many suppliers. The increased switching costs can harm both the individual consumers concerned and the wider competitive process.

3.39 A consumer subject to switching costs is less able to change providers as new offers become available in the market or as their personal circumstances and needs change. A consumer is also less able to switch in response to lower than expected quality of service or bad experiences with their existing provider, such as billing inaccuracies or service interruptions. Consequently, even if switching costs had no impact on the value of offers that firms make available in the market at any point in time (which in general is not the case[45]) they can still prevent locked-in consumers from taking advantage of them.

3.40 Switching costs can also harm competition, including the intensity of price competition and the incentive for new entry and innovation, and thereby worsen the outcomes for all consumers in the market. Our consultation for the Strategic Review of Consumer Switching contained a survey of the economic research relating to switching costs.[46] The theoretical research shows how switching costs can lead to distorted price structures, which may have positive or negative effects on prices overall (i.e. over a product's lifecycle) and on new entry in a market. On balance, however, it is considered that switching costs are more likely to lead to higher prices. This view takes especially into consideration the growing empirical literature which findings are consistent with the fact that lower switching costs increases competition and reduces prices.[47] The key force underlying the effect on prices is the incentive a firm has to raise prices to existing consumers who are to some degree locked-in by the presence of switching costs. We note that much of this analysis does not apply directly to *contractual* switching costs generated by MCPs since the monthly price agreed with the consumer remains fixed for the period in which the consumer is subject to the switching costs.[48]

3.41 Nevertheless, the switching costs caused by MCPs may still have harmful effects on competition in the market. In particular, higher switching costs in the market may reduce the incentive for firms to engage in any activity the profitability of which depends on the number of customers that can be gained (i.e. where there are economies of scale). This includes:

- Marketing campaigns;
- Entry by a new operator (where there are at least some fixed costs, as will be the case in the communications sector);
- Investment in innovation (such as product development or other forms of R&D).

3.42 Marketing campaigns may be important for driving price competition by making consumers more aware of the offers available in the market. The incentive to cut prices will be partly determined by the number of consumers whose attention can be drawn to the new offer and marketing expenditure may be an important element in

[45] Ibid.
[46] Ibid. See paragraphs 5.3 to5.32.
[47] Ibid, see especially paragraphs 5.29 and 5.51.
[48] The firm could, however, seek to increase profits by reducing the quality of service since this is not easily defined in the supply contract or monitored on an individual basis.

this. Where a significant proportion of consumers in a market are subject to a MCP a firm's (unit) customer acquisition costs will increase since a given marketing campaign will reach fewer 'free' customers. There is little a firm can do to reduce its marketing costs in response to an increase in the proportion of customers subject to a MCP by targeting marketing activity at those customers not subject to a MCP (other than its own customers). Consequently, we can expect marketing activity to fall with potential knock-on effects for the intensity of price competition.

3.43 Entry and innovation are two activities often associated with economies of scale. Entry often involves fixed costs, particularly in cases where this involves investment in a network but even entry at the retail level will require a minimum investment in, for example, branding. When these costs can be spread across a larger number of consumers the investment will be more profitable. Innovation is also often subject to similar economies of scale since the development costs associated with a new product or production process will not typically depend on the volume of customers subsequently supplied. Consequently, the more customers that can be served, the more profitable the investment will be.

3.44 A counter argument might be that the ability of all firms (including new entrants) to sell contracts that involve a longer term commitment by the consumer (whether they appreciate this or not) strengthens the incentive for entry and innovation since the consumers that are gained can be expected to remain for longer. In other words, the investing firm might be incentivized by its own ability to sell ARCs, even though their presence in the market increases switching costs and makes entry or expansion harder at first. This might be thought of as analogous to arguments in favour of extending the duration of intellectual property rights such as patents; although it creates obstacles to enter or expand in a market, entry and innovation are nonetheless encouraged since the resulting 'prize' is increased.

3.45 We do not think this argument is particularly convincing in the fixed voice and broadband markets. Successful innovators have many 'first mover' advantages and can expect to retain their customers without the need for contractual barriers to switching provided they meet their customers' expectations and do not lag behind competitors. In addition, the early stages of entry are often crucial for a firm particularly where there are financing constraints or where 'network effects' mean the value of the service increases with the size of the customer base.[49] In this context the ability to sell ARCs and retain consumers more easily in the future will likely provide only limited compensation.[50]

Question 3: Do you agree with our assessment that increased switching costs resulting from ARCs are likely to harm competition, in particular the incentives for new entry and innovation? Please explain your answer.

How could harmful contract terms survive in the market?

3.46 In general, competitive markets will deliver outcomes that maximise the benefits for consumers. Consequently, if ARC terms are harmful for consumers it might be

[49] Network effects are divided into *direct effects* where the service is inherently more useful with more subscribers (e.g. VOIP services such as Skype) and *indirect effects* where larger services attract more suppliers of complementary services (e.g. applications for smartphones). They are both a common feature of communications markets.

[50] Simple time discounting also means that earlier profits are more important. This can generate a so-called 'front loading effect' – see Segal and Whinston (2007) "Antitrust in innovative industries", *American Economic Review,* Vol. 97(5), pp. 1703-1730.

argued that competition in the market will ensure they do not survive. Firms that offer ARCs will see their market share fall as consumers select alternatives from competing suppliers and will be forced to withdraw the ARCs.

3.47 There are, however, a number of reasons why consumers may purchase ARCs even where they are harmful to the competitive process (and possibly to themselves):

- *Lack of transparency*. Consumers may be unaware of the ARC term at the point of sale. We discuss the evidence on this point in Section 4.

- *Myopia or over-optimism*. Consumers may focus on the immediate benefits of the contract and fail to consider the long-term implications and/or underestimate the effects of the ARC term.

- *Contractual externalities*. By affecting the competitive process, ARCs can impose costs on all consumers in the market regardless of whether they are subject to an ARC or not. An individual consumer considering an ARC will not take this wider impact into account. This is an 'externality' problem akin to carbon emissions or traffic congestion.

3.48 A lack of transparency is not necessarily an inherent problem of ARCs. However the effects may be greater for these contracts since the switching costs created by the ETC mean consumers are less able to reconsider their choice once they have become aware of the ARC term. Also, to the extent that ARCs are still unfamiliar to consumers in this sector, even prominent contract terms may be overlooked by at least some consumers.

3.49 Even where consumers are aware of the contract term they may not always accurately predict its effects on their behaviour or they may focus excessively on the short term benefits. Behavioural economics suggests individuals often have difficulties in making forward-looking decisions, particularly where they have to forecast their own needs and their own future behaviour. Weighing up the costs and benefits of an opt-out renewal process 12 months in advance of the renewal date is a very difficult decision for a consumer to make.

3.50 For example, individuals often exhibit an 'overconfidence bias' whereby they are excessively optimistic regarding their own abilities.[51] This can lead them to fail to predict their own future behaviour. In the case of ARCs, consumers may over-estimate their future will power and therefore underestimate their inertia at the rollover date. For example, studies show people signing on for gym membership frequently believe they will attend more than they actually do and make inappropriate contract choices as a result.[52]

3.51 There is also evidence that peoples' estimates of their future needs are anchored by their current needs and desires. In other words, people fail to allow for the fact that changing circumstances will change their needs. This is sometimes called a 'projection bias' – people predict future needs by projecting current needs forward. For example, studies have shown that people who purchase cold weather clothing on

[51] For example, one study found 80% of people rank themselves as being above average drivers – see Svenson (1981) "Are we all less risky and more skilful than our fellow drivers?" *Acta Psychologica*, 47, pp. 143-48.
[52] Della Vigna and Malmendier (2006) "Paying not to go to the gym", *American Economic Review*, Vol. 96(3), pp. 694-719.

cold days are more likely to return them.[53] In the case of ARCs, people who believe a BT contract is the most suitable today may not allow sufficiently for the fact that this may change.

3.52 Furthermore, the ETC means that consumers are less able to adjust their choices even if they do subsequently become aware that they misjudged the effect of the ARC, since they cannot change contract without paying a penalty. This means the ability of learning to mitigate the effects over time could be limited.

3.53 ARCs may also be privately beneficial for the consumer who agrees to them but nevertheless harmful for the market as a whole. A consumer will weigh up the private costs and benefits of the contract and will not take into account the wider impact of the switching costs on firms' incentives to compete, which will affect all consumers. By removing themselves from the pool of 'available' customers their decision can reduce competition, as argued above, but this effect will largely fall on other consumers and will not be factored into their choice. The effect from any one consumer agreeing to an ARC will be small, but when aggregated across all consumers who sign up to them the effect could be significant.[54]

3.54 As noted above, this 'externality' effect is analogous to the harm caused by carbon emissions or traffic congestion. For example, each additional driver who makes a journey on congested roads lengthens the average journey time for all other drivers and even though this effect is very small for any single driver, when it is aggregated across all vehicles on the road it can lead to significant delays. In the case of ARCs, we would similarly expect the reduction in competition from having any single consumer subject to an ARC to be very small but the effect may also be significant when aggregated across all who sign up for them.

3.55 These effects mean that ARCs could survive in a competitive market despite being harmful for consumers. The actual incentive for a firm to introduce them will vary depending on their individual circumstances. ARCs can reduce churn by increasing the proportion of a firm's customers subject to an ETC at any point in time and this may be profitable for a supplier, particularly one that has a large customer base that it is seeking to retain. On the other hand, we might expect reputational costs to the firm if consumers feel they have been 'cheated' by the contract term and there will be an additional cost to the firm associated with any additional price discount they would offer that is explicitly associated with the ARC term.

3.56 The likelihood of ARCs spreading in a market will therefore depend on how firms weigh up these costs and benefits. In our view ARCs are particularly likely to spread where market shares become relatively stable and most firms focus their business strategies on customer retention rather than acquisition. We can also expect a focus on contractual retention strategies where future developments in the switching process (e.g. from a LPL to GPL system) may limit the ability of firms to offer targeted retention offers. So far it appears that BT is the only large provider that has regarded ARCs as a profitable business strategy. However, once multiple firms have an incentive to adopt ARCs we can expect their introduction by suppliers to 'snowball' quite rapidly, since the reputational risks to any one firm will decrease as ARCs

[53] See Conlin, O'Donoghue and Vogelsang (2007) "Projection Bias in Catalogue Orders", *American Economic Review,* 97(4), pp.1217-1249.

[54] This leads to a 'coordination failure' whereby consumers would be better off if they could collectively agree not to sign up for ARCs but are unable to do so owing to their fragmentation. See for example Rasmusen et al. (1991) "Naked Exclusion", *American Economic Review,* Vol. 81(5), pp. 1137-1145 and Segal and Whinston "Naked exclusion: comment", *American Economic Review,* 90(1), pp. 296-309.

become more widely established in the market. We therefore think that, given the general long run trends, the risk of widespread adoption of ARCs will increase over time in the fixed voice market and the broadband market.

Question 4: Do you agree with our analysis that ARCs could survive in a competitive market, despite causing harm to competition. Do you agree that there is a risk of ARCs spreading in the market and that this could be rapid? Please explain your answer.

Discussion of the costs and benefits of ARCs

3.57 In Section 4, we present and discuss the evidence we have gathered. We set out here the reasons why we believe there is, a priori, a significant risk that ARCs are harmful for consumers and competition. We think the risks are embedded in the core properties of ARCs rather than stemming from the particular manner in which they are implemented, and therefore are likely to apply to most if not all examples of them, regardless of the specific details.

3.58 As noted above the benefits of ARCs are unclear. Some consumers may value the convenience of not having to pro-actively renew their contract after each MCP, but this needs to be weighed against the added cost of opting out of a renewal. It is not clear that consumers purchasing ARCs would place significantly more weight on the first of these since a consumer who is confident of staying with their provider would be prepared to opt for a longer MCP anyway, instead of choosing an ARC. In communications markets, which are highly dynamic, the option to switch supplier has a significant value and the ease of opting out of an MCP renewal is an important concern.

3.59 It is also not clear that ARCs allow a firm to offer significantly greater benefits than a standalone MCP, since the level of commitment on the part of the consumer is the same in both cases. This suggests that even where we observe ARCs being offered with a discount attached, the ARC term itself is unlikely to be crucial for this.

3.60 At the same time ARCs carry a clear risk of increasing the prevalence of switching costs in the market to the detriment of consumers and competition. We identify a number of reasons why the ARC term may increase the likelihood of a consumer renewing their contract even though it only affects the process for making a choice not the options available. The reduced flexibility regarding the timing of the renewal decision is a core feature of an ARC contract and will exist no matter what the specific details of the contract are. So, for example, while factors such as the precise nature of the opt-out process or the existence of a reminder letter may mitigate the effects they cannot eliminate them completely.

3.61 Our current view is that an increased prevalence of switching costs is likely to be detrimental for competition in the market, potentially reducing the intensity of price competition, innovation and entry by new firms. These effects will likely harm all consumers in the market regardless of whether they are subject to an ARC themselves. The level of harm will depend on the level of switching costs (ETC) which will vary across different markets in the communications sector. However, as long as an ETC is present we can expect an effect.

3.62 The exact level of harm from ARCs is likely to vary according to the market in question, the detail of the specific offers and the proportion of end users on these contracts. However, for the reasons set out above we believe the risk of harm will exist for any example of an ARC. Furthermore, we believe the theoretical benefits are sufficiently low that in all cases there will be a significant risk that the costs of ARC contracts outweigh any benefits.

Summary of our concerns

3.63 To summarize, an analysis of the theoretical impact of ARC contracts reveals the following concerns:

- ARCs increase the likelihood that a consumer's contract will be renewed even though these terms do not affect the available options or the level of commitment on the part of the consumer (merely the *process* for making a choice).

- ARCs increase the (aggregate) level of the switching costs in the market, harming both the individual consumer and competition. This is a particular concern if ARCs become an established feature of the market, offered as standard by many firms.

- Despite the harm they cause, ARCs may nonetheless survive in a competitive market. There are reasons to think that they may become more widespread over time, as more firms turn to a customer retention rather than acquisition strategy.

- Relative to the risk of harm, it is not clear that ARCs offer significant benefits for consumers.

Section 4

Review of evidence

Introduction

4.1 In Section 3 we set out our concerns regarding the impact of ARCs on consumers and competition. We have reviewed a range of evidence from the market in order to assess whether our concerns about ARCs appear justified and therefore whether any intervention is appropriate.

4.2 In the course of our study, we took into account the following sources of evidence:

- **Econometric analysis of switching** – we commissioned Professor Crawford and ESMT to examine the effects of ARCs on switching activity using a large database of customer data from BT. This analysis attempted to control for a range of other factors which affected switching rates in order to isolate the impact of the ARC term (and of the level of early termination charges – (ETCs)).

- **Evidence on consumer awareness** – we commissioned three studies to determine whether BT's marketing activity was transparent and whether consumers properly understood the ARC term. The consumer research comprised telephone interviews and mystery shopping, and an analysis of call centre recordings.

4.3 Looking at the evidence in the round, and placing particular weight on the econometric analysis, we conclude that ARC terms are likely to have a material effect on switching activity in the market. The econometric analysis of BT's ARC offer suggests that the rollover term was responsible for a monthly switching rate among customers which was around 35 per cent lower after the initial MCP than for standard contracts.

4.4 While we cannot isolate with certainty the forces that lie beneath the effect, we think there is a strong likelihood that much of it stems from core aspects of consumer behaviour (in particularly the 'default bias'). We think the effect is therefore likely to be generated by any example of an ARC introduced in the sectors we are considering, regardless of the specific details.

Econometric analysis of switching

Introduction

4.5 The levels of switching we observe in the market will be affected by a number of factors including prices, the general state of the economy, customers' tenure with their existing supplier and so on. This complexity makes it very difficult to isolate the impact of the ARC terms through a casual examination of the raw data. In particular, a direct comparison of switching rates between customers on ARCs and those on other offers may fail to isolate the impact of the ARC term itself as distinct from other differences (e.g. customers on ARCs may be newer customers who have joined BT more recently).

4.6 To address these challenges, we commissioned Professor Gregory Crawford, of the University of Warwick, and ESMT Competition Analysis to analyse the effect of automatically renewable contracts on BT customers' switching behaviour.[55] Using customer data supplied by BT as well as price data from PurePricing and macroeconomic data from the Office of National Statistics, Prof Crawford employed well-established statistical techniques to explore patterns in the data and estimate the *causal* effect of the ARC term on household switching behaviour in the fixed voice telephony market. Prof Crawford's report is provided at Annex 7.

4.7 In particular, Prof Crawford's analysis sought to assess to what extent (if any) the introduction of a rollover clause (ARC) depresses customer switching (all else equal). As explained in Section 3 above, we would expect these contracts to depress churn as this is the main benefit for the provider to be assessed against the "cost" of offering discounts to customers. What is important here is the assessment of the "materiality" of the effect.

4.8 The application of any quantitative technique of this kind involves making certain assumptions, for example about how the various factors that influence switching behaviour interact and the nature of those factors we cannot observe directly. In fact, any attempt to make inferences from real-world data about the impact of different variables must make assumptions of this kind, whether explicitly or not. The strength of employing a rigorous econometric approach is that the assumptions are made explicit and can be subject to debate.

4.9 Many of the issues surrounding Prof Crawford's methodology are discussed in detail below. In concluding that the results of the analysis are robust, we have taken into account arguments put forward by BT and the expert advice of Prof Crawford.[56]

4.10 In the paragraphs below, we discuss:

- Prof Crawford's **econometric methodology**:
  - the data available to Prof Crawford for his analysis;
  - Prof Crawford's econometric model; and
- the **results** of Prof Crawford's analysis, including:
  - a discussion of the robustness of the results, including some concerns raised by BT about the analysis and Prof Crawford's rebuttal.
  - our interpretation of the results, in particular the underlying causes of the identified results and extrapolation to other scenarios.

Econometric methodology

Data obtained to conduct the analysis

4.11 To support Prof Crawford's analysis, Ofcom obtained from BT a large dataset of customer-level information. The data related to 180,000 customers, randomly drawn

[55] Prof Crawford was Chief Economist at the United States Federal Communications Commission between 2007 and 2008. During his academic career, Prof Crawford has focused on applied industrial organisation, with a sector focus on the communications industries. Prof Crawford was aided in his work by ESMT Competition Analysis, in particular Dr. Nicola Tosini.

[56] We shared Prof Crawford's report with BT on 3 September 2010. BT made a number of comments on 22 September 2010 on the approach followed by Prof Crawford, that we have taken into account in drafting this document.

from the population of individuals that were BT customers on 31 December 2008 and followed through time until 31 March 2010 or (if earlier) the time they left BT. As Prof Crawford explains (Annex 7 paragraph 2.1.1), we selected the sample size and sampling date to maximise the quality of the dataset and ensure that the econometric model could robustly estimate the effects of interest.

4.12 In relation to each of the (roughly) 180,000 customers, Ofcom obtained a range of data, including:

- **Plan information** – the history of the type of plan (e.g. unlimited anytime plan) and type and length of contract (e.g. standard, 12-month fixed-term, 12-month ARC), as well as the price paid by the customer and information regarding any early termination clause.

- **Date information** – the date on which each customer joined BT and, where relevant, the date on which the customer (subsequently) switched away from BT.

- **Other information** – whether the customer took other BT services at the sampling date, and the customer's postcode.

4.13 We also obtained from other sources the following data:

- **Competitors' retail prices** – we obtained time-series retail price data for the period covered in the analysis for the fixed-line voice services offered by BT's major competitors. Changes in rivals' retail prices were one of the variables for which Prof Crawford sought to control.

- **Macroeconomic variables** – aggregate and regional data for the UK economy were provided by the Office for National Statistics. The UK's macroeconomic environment was another variable for which Prof Crawford sought to control.

4.14 Several data-cleaning checks were carried out on the sample, resulting in data for a total of 144,849 customers being used in the analysis.[57]

Observations on the raw data

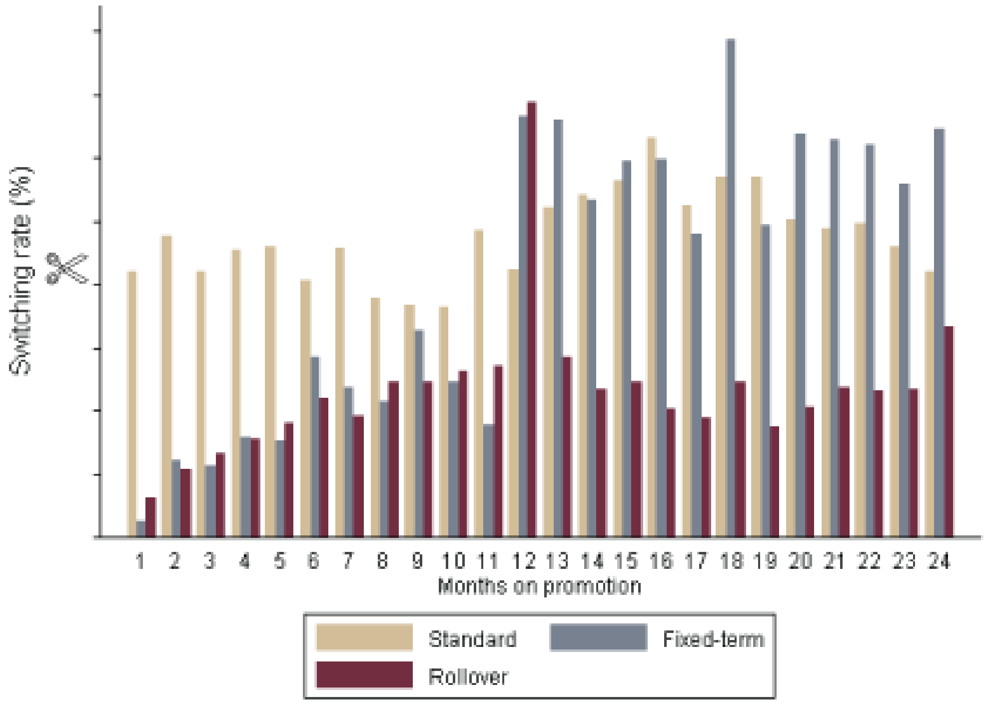
4.15 Before commencing his detailed econometric analysis, Prof Crawford examined switching patterns as revealed by the raw data (Annex 7, section 2.1.5).

4.16 Prof Crawford highlighted that, as we would expect, switching rates for customers in fixed-term and rollover contracts were, during the contract term, lower than for customers in standard contracts. In the 12^{th} month of the customer's tenure on their plan, there was a spike in switching among ARC customers (although, this spike is no higher than for those on fixed-term contracts), but this switching level fell back sharply in subsequent months. After the 12^{th} month, the level of switching among customers who had taken an ARC was lower than that among both standard customers and those who had taken a fixed-term contract that did not rollover. This intuitive result is illustrated in Figure 4.1 below (note, the scale on the y-axis has been redacted at BT's request).

[57] See Annex 7 at section 2.1.3 and Appendix 2 of the report for more detail on the data-cleaning process. In particular, from the original sample were discarded customers on "grandfathered products" like BT Together Local and BT Working Together.

4.17 Prof Crawford also highlighted that, while switching rates were much higher among new customers (who had fewer years' tenure with BT), the impact of ARCs was similar in that both short-tenure and long-tenure customers switched less when on ARCs.

Figure 4.1: Switching rates by contract type and tenure on promotion



Source: Empirical analysis of BT's Automatically Renewable Contracts, Professor Gregory Crawford and ESMT CA, August 2010

Econometric model

4.18 Prof Crawford's econometric model sought to explain the extent to which being on an ARC affects a customer's switching behaviour. That is: how often do households on ARCs switch after the expiry of their first minimum contract period relative to households on fixed-term and standard contracts?

4.19 Figure 4.1 shows that there is a clear relationship between ARCs and switching activity. However, there are numerous other possible factors associated with a customer's decision to switch, such as the length of time a customer has been with an operator and the price of rival offerings. It was important that Prof Crawford's model controlled for these other variables, filtering out their effects on consumers' switching decisions. Only having done so could sound conclusions be reached about the effects of the rollover characteristic alone on switching decisions.

4.20 The model therefore featured a number of variables for which Prof Crawford sought to control (see also Annex 7, section 4.1.1 for further explanation):

- **Macroeconomic environment** – switching might be affected by the wider economic climate, so the model controlled in particular for the unemployment rate (varying by region and by month).

- **Tenure** – switching is strongly negatively correlated with length of tenure with BT. The model therefore controlled for whether a household was a new customer, the time the household had been with BT and the time the household had taken its current package.

- **Service plan** – certain plans might differ in their attractiveness to customers (for example, the Anytime plan might induce more loyalty than the Evening and Weekend Plan). The model therefore controlled for the plan taken by each household.

- **Other products** – customers might be less likely to switch from a CP if they take multiple products such as broadband and pay TV, perhaps due to higher perceived switching costs. The model therefore controlled for whether customers took each extra product.

- **Month in minimum contract period**[58] – customers in fixed-term and ARCs are typically subject to an ETC, which reduces as the contract runs its course. As the penalty for switching reduces over time, the month of a customer's contract is likely to affect switching, so needed to be controlled for in the analysis. This variable applied to both fixed-term and rollover customers in the first 12 months.

- **Fixed-term contract customers (post-MCP)** – customers on fixed-term contracts might, even after the expiry of the contract period, have an altered likelihood of switching. The model therefore included a simple variable stating whether or not the customer had previously been on a fixed-term contract.

4.21 A rollover variable was applied to customers who had been on ARC contracts for longer than 13 months.[59] This is the key variable we are interested in and the estimated coefficient on this variable (i.e. the size of the effect) tells us the impact of rollovers on consumers' switching decisions, controlling for the factors listed above.

Price discounts within ARCs

4.22 An additional complication was that customers on ARCs receive price discounts. Failing to account for these price discounts could erroneously attribute low switching rates to the rollover characteristic of contracts rather than to the price discount. Prof Crawford accounted for this possibility using a variety of sources of price variation in the data, including the percentage difference between a customer's current plan and the lowest available from a competitor. In practice, the most important information for identifying the effect was differences in switching rates between customers on two types of rollover contract that differed only in the price discount.[60]Using this data the effect of price discounts could then be isolated and stripped out of the results. As we explain below, this price effect explained some of the reduced switching among households on ARCs, with the remainder due to the rollover characteristic itself.

[58] This is relevant because Prof Crawford's analysis sought to explain the effect of ARCs on switching behaviour after the initial 12-month period.
[59] More specifically, a 'dummy variable' was used – i.e. a variable that takes the value of either zero or one and which is used to capture the effects of 'step' changes as opposed to factors that can vary continuously.
[60] As discussed further below Prof Crawford's supplementary report on price variation shows that this is the most important source of price variation. See Annex 8.

Self-selection by customers taking ARCs

4.23 Prof Crawford also explicitly considered the possibility that inherently 'loyal' customers might self-select into ARCs. That is, it could be that those households who choose ARCs are inherently less likely than other households to switch away from BT. It could be that, regardless of whether these households take an ARC, they would be relatively unlikely to switch to a rival. It is further possible that this inherent characteristic is not picked up by any of the model's other variables such as the customer's service plan or the other products a customer takes. Without accounting for this possibility, it could be that the econometric model would not adequately address the *causal* relationship between ARCs and switching behaviour. This would result in an erroneous conclusion that ARCs reduce switching, when customers who were anyway unlikely to switch had simply self-selected into ARCs.

4.24 Issues of this type are common in econometric studies (and data analysis more generally), and reflect the fact that, unlike controlled experiments such as field studies or laboratory studies we cannot assign contracts to customers randomly, but instead it is customers themselves that choose one contract over another. It is one issue highlighted by BT when we shared our results with them. The advantage of a rigorous econometric approach is that it identifies clearly what the issues are and provides tools to address them.

4.25 To handle this problem, Prof Crawford created a further model specification which accommodated the possibility of self-selection. Prof Crawford's technique was to simultaneously estimate an equation for the selection of ARCs as well as switching. For this to work, the analysis needed to identify variables that affected ARC selection *but not* switching.[61] Prof Crawford exploited differences in the timing of switching and selection decisions and used lagged versions of the switching variables to achieve this. This isolated the causal effect of ARCs on switching behaviour from any tendency of ARCs to go hand-in-hand with inherent loyalty to BT. The technique is explained further at Annex 7, sections 3.2 and 4.1.3.

4.26 By controlling for other explanatory variables and accounting for these additional complications, Prof Crawford was able to observe the extent to which switching behaviour after the initial 12-month contractual period could be explained by the rollover characteristic of contracts.

Factors not analysed

4.27 The rollover variable used to capture the effects of ARC contracts on switching does not distinguish between underlying causes. As we mentioned in Section 3, the 'opt-out' feature of ARCs provides BT with opportunities to make retention offers to those customers who call to opt out of renewal. The data available to Prof Crawford were inadequate to allow him to analyse the effects of this feature on switching activity. Similarly, Prof Crawford could not easily explore with the available data the 'behavioural' effects associated with ARCs, through which customers might rollover into further MCPs by default. This does not affect our ability to identify a causal effect from rollovers on switching but does mean the underlying causes have to be inferred. We consider the underlying causes below in paragraphs 4.57 to 4.61, drawing on our analysis in Section3.

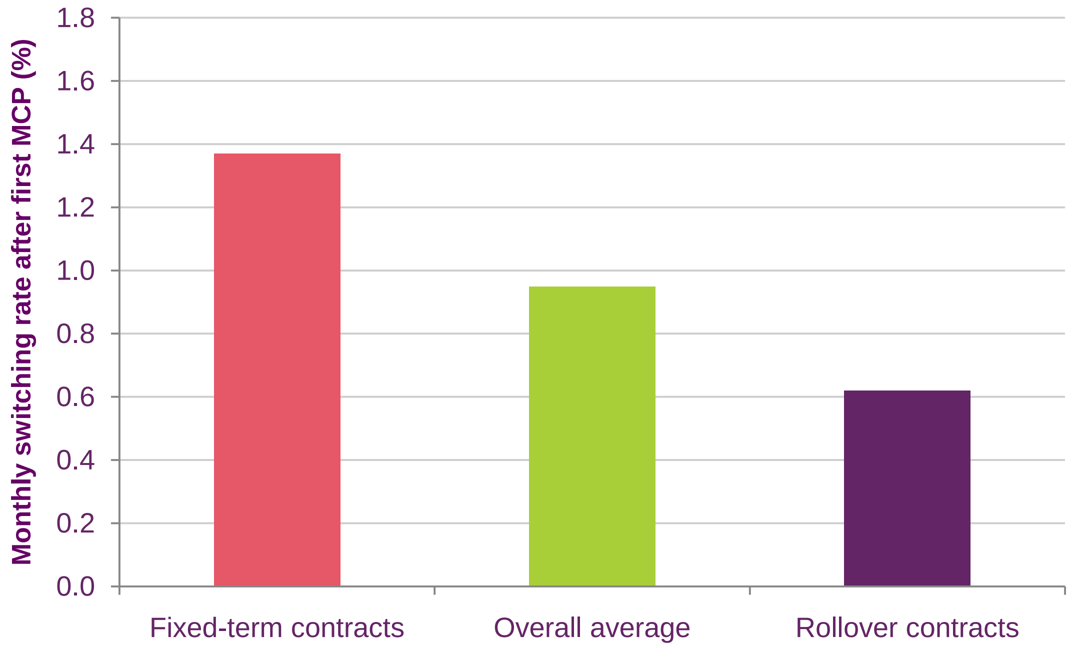
[61] See Annex 7 section 4.1.3 for an explanation of his technique

Results – significant effects on switching

Headline results

4.28 Prof Crawford's results show that ARCs have the effect of significantly reducing switching activity after the initial MCP. The baseline switching rate, calculated as the predicted switching rate of the average observation in the sample, was 0.95 per cent per month (which equates to an average annual switching rate of 10.8 per cent). The estimated effect of the ARC term was to reduce consumers switching after their first MCP to an estimated monthly rate of 0.62 per cent. This was estimated to be 0.33 percentage points lower than for comparable customers on standard contracts, and 0.75 percentage points lower than for comparable customers on fixed-term contracts.[62] This striking result is illustrated in Figure 4.2 below.

Figure 4.2: Estimated monthly switching rate after first MCP, by contract type, controlling for price discounts and self-selection



Source: Empirical analysis of BT's Automatically Renewable Contracts, Professor Gregory Crawford and ESMT CA, August 2010

4.29 This is an important result, suggesting that ARCs have a significant negative effect on switching activity (and therefore on the competitive process). These results are after having controlled for the price discount feature of ARCs and for self-selection. Prof Crawford estimated that self-selection accounted for a small (0.01 percentage point) further reduction in the monthly switching rate, and that price discounts accounted for a still further 0.15 percentage point reduction.

4.30 These results are also presented having controlled for the other variables set out at paragraph 4.20 above. Prof Crawford explains that some of these variables had very significant effects on switching (see Annex 7, section 4.2 and Table 2). In particular:

[62] These comparisons hold constant all other independent variables and hence show the effect of rollovers on the 'average' customer in the data.

- **Tenure at BT** – for example, a household with eight years' tenure at BT would be less than half as likely to switch as a household with only four years' tenure.

- **Broadband services** – customers who also take a broadband service would be around half as likely to switch as customers who do not.

- **Minimum contract period** – the effect of being in a MCP is very strong, and mirrors the effect in Figure 4.1: compared to customers who are not in a MCP, switching rates are significantly reduced during the MCP, but are significantly higher in the month that the MCP expires.

Significance of reductions in ETCs

4.31 In October 2010, BT reduced the ETCs associated with its fixed term voice contracts, including ARCs.[63] For the Evening and Weekend offer that is of most relevance for our empirical work, ETCs fell from £7.50 per remaining month to £2.50.

4.32 Since we only have customer data for the period up to 31 March 2010 all the findings reported above apply to the higher ETC levels. As the estimated effect of rollovers is likely in large part to be due to the continuation of switching costs in the form of ETCs this raises the question of whether the effects are likely to be significantly reduced at the new level of ETCs. We can be certain that the changes will reduce the effect of the rollover term to some degree, but it is an empirical question what effect remains with lower ETCs. For example, as Figure 4.1 shows above, we observe a large jump in switching rates between month 11 of an MCP and month 12, suggesting that even relatively low ETC payments nevertheless deter switching compared to an absence of ETCs.

4.33 The data we obtained is rich enough to allow us to estimate the impact that different ETC levels have on consumer switching and therefore predict the effect of the lower ETC rates that came into effect in October. The total ETC payment a consumer must make if they leave varies across the observations in the data according to: the month of the MCP the consumer is in, the specific plan they are on and whether the observation falls before April 2009, when BT's ETCs on fixed term contracts reduced slightly.[64] The data covers a wider range of ETC levels, from consumers who have just started a more expensive fixed contract (e.g. Unlimited Anytime) to those on more basic fixed packages who are in their 11th month.

4.34 Prof Crawford adopted a variety of modifications to the central model in order to assess the impact of ETC levels (see Appendix 2 of the report). In particular, the amount of ETC a consumer would pay if they switched in each month was explicitly included in the model (instead of just the month-in-MCP)[65]. The relationship between ETC level and switching rates was assumed to be linear (although with a discontinuous jump when the ETC reaches zero during the last month of the MCP) and the resulting slope of the relationship estimated.

4.35 Based on this analysis, we can predict the effect of lowering ETCs by the amount of the October reduction. The average ETC faced by a rollover customer in the sample

[63] See http://consumers.ofcom.org.uk/2010/06/cheaper-charges-for-uk-consumers-to-end-phone-contracts/
[64] In April 2009 BT's ETCs reduced from remaining monthly payments to £7.50 in the case of the Evening and Weekend offer and £8 in the case of Unlimited Anytime.
[65] Prof Crawford also separated the effects of ETCs in the first MCP from ETCs in the second, and allowed a common effect from being on a rollover contract that spans both MCPs.

during their second MCP was £54.8. At this ETC level the rollover term in the contract was predicted to reduce switching in the second MCP by 0.5 percentage points (from 1.92% per month to 1.42%). The estimated effect of reducing this to £19.2 was to increase switching rates for customers on ARCs to1.56% per month, decreasing the impact of ARC to 0.36 percentage points.

4.36 These estimates are only predicted effects as we do not have data for switching rates when ETCs per month are at the lower rate. Nevertheless, consumers in the data set are subject to a wide range of ETC levels and this allows us to get a good idea of how they respond to changes in the ETC level. The data suggests that the existence of ETCs creates a general reluctance to switch that is present even when ETCs are at relatively low levels. This is in line with our expectations given the dramatic spike in switching rates in the 12^{th} month of an MCP, as shown in Figure 4.1 above.

Interpreting the results

4.37 There are a number of issues relating to the findings that we now discuss:

- the magnitude of the estimated effects;
- the robustness of the estimates;
- the likely underlying causes of the results, and (related to this);
- whether the findings can be extrapolated to other situations.

4.38 In interpreting the magnitude of the estimated effect of rollovers it is worth remembering that in terms of the rights and obligations the consumer has, the ARC term in itself changes little. It simply alters the process for renewing the MCP, without in any way obliging the consumer to renew. Despite this, the study found that rollovers have a strong influence on switching rates, in broad terms comparable to other factors that we would expect to have a strong impact such as whether the consumer also takes broadband with BT.

4.39 Accounting for self-selection and price differences, the econometric work finds that the rollover term reduces switching rates after the initial 12 month MCP by 0.33 percentage points (relative to the average observation in the data), a reduction of 34.8%. When compared to customers on fixed term contracts whose initial MCP has ended the reduction in switching is 54.8%. This last comparison is particularly noteworthy since the natural alternative to an ARC is one that has the initial MCP but no automatic rollover.

4.40 In Section 3 we set out our concerns about the potential impact of ARCs on the competitive process. The magnitude of the effect estimated by Prof Crawford suggests these concerns are valid. In particular, we note the strong incremental impact of ARCs on new consumers (as opposed to those who have been with BT for significantly long periods of time)[66] since these consumers are likely to be an important driver of competition.

4.41 As Prof Crawford concludes:

[66] See Figures 15 and 16 of the econometric report which show survivor functions for new customers and those who have been with BT for longer than five years.

> *"The evidence is consistent with the view that BT's rollover contracts significantly increase switching costs in fixed voice telephony markets. The existing economic literature has raised concerns about the influence of switching costs on competition and welfare that suggests rollover contracts may therefore be cause for concern, particularly in light of BT's continuing (if diminished) role as the largest firm in the market."*[67]

Robustness

4.42 The robustness of the results depends on the quality of the data and the validity of the specific methodology used. The data Prof Crawford and ESMT have used is of very high quality, consisting of detailed observations for over 140,000 BT customers[68] and covering a period of 15 months. The methodology employed (specifically the use of a discrete-choice Probit model) is also standard for quantitative work of this type. As with any statistical model, certain assumptions are imposed in order to derive the results, and a judgement has to be made as to whether they are appropriate. In our view, none of the assumptions made in the analysis is unusual or counter-intuitive.

4.43 Nevertheless, as with any study of this kind, issues surrounding the robustness of the results remain. Indeed, one of the benefits of a rigorous quantitative approach is that potential concerns are brought to the fore and can be carefully examined. Prof Crawford and his colleagues discuss a number of issues in their report. We also shared the report with BT who provided us with a critique of the work. The two main issues raised by BT were:

- Has the work adequately accounted for selection bias?
- Has the impact of the price discount associated with the ARC been identified?

Selection bias

4.44 To recap, selection bias refers to the risk that those customers who choose ARCs may be different from those who do not in ways that: a) reduces their likelihood of switching and b) we cannot observe and therefore control for ('unobserved heterogeneity'). The influence of these unobserved factors may then be falsely attributed to the ARC term. BT highlighted this issue in its critique of our work. It is worth noting that our concerns are for those factors which we neither observe directly nor which will be picked up by the other variables we measure; as we note below the tenure variable is likely to act as a good proxy for much of the unobserved differences between customers.

4.45 Selection bias is a common problem in studies of this kind and Prof Crawford's report has a detailed discussion on the effects and the methods of accounting for it (see Section 3.2 and 4.2.3 of the report). Two important points are worth making here. First, the study tests alternative specifications for the rollover equation that is used to address the issue and concludes that the degree of self-selection is not being underestimated.[69] Second, and equally importantly, the influence of selection bias on the estimated effects of the rollover term is ambiguous. If the only effect of selection

[67] Annex 6, section 5.
[68] As discussed above, the original sample size comprised over 180,000 customers which was reduced to just over 140,000 once the data was cleaned.
[69] See section 4.2.3 of the report.

bias was on our estimate for the impact of rollovers we could predict the direction of the bias with some certainty. However, selection bias could simultaneously affect the estimates for the effects of a number of explanatory variables in our model, in particular tenure with BT. Given this, we cannot say that it would obviously bias the results for rollovers one way or another.

4.46 We would intuitively expect some degree of selection bias and Prof Crawford does find evidence of a small effect in the data. In our view, the fact that the magnitude is small is not necessarily surprising. The most likely source of selection bias is the presence of self-selection: consumers will aim to choose the contract that fits their circumstances best. The introduction of ARCs was backed up by a significant marketing campaign that emphasized the price discount first and foremost.[70] Given this and the fact that the ARC term was new in the context of fixed voice services there is a strong likelihood that the ARC element of the offer played little role in the choice of contract for the majority of consumers.

4.47 BT's critique of our work argued that we had failed to account for self-selection and that many customers on ARCs had a lower propensity to switch because they were long term loyal customers who value the price discount, not the rollover term. However, we note in response that tenure and the price discount are measured and controlled for in our analysis. BT disagreed that we had adequately measured the impact of the price discount; we discuss this issue next.

The effect of the price discount

4.48 The impact of the price discount is identified in the study in a variety of ways. In particular the econometrics can compare switching rates between customers who are identical in all respects, including the precise plan (e.g. Unlimited Anytime), except the contract type they chose (standard, fixed-term or ARC) and therefore the price they pay.[71] This provides a strong method for identifying how price affects consumers' willingness to switch.

4.49 In two letters sent to Ofcom in October 2010, (Annexes 9 and 10) BT argued that Prof Crawford has underestimated the impact of the price discount on the switching decisions of ARC customers. It noted that, since the prices paid by consumers on ARCs have not changed, we can only use proxies for the effect of the discount. BT argued that the proxies used are of limited relevance. In particular BT points to:

- a failure to account for expectations regarding price changes;
- a failure to account for 'loss_aversion', and;
- the small magnitude of changes in competitors' prices over time compared to the size of the ARC price discount.

4.50 One source of price variation used in the study is the change in monthly price within a contract as customers' MCPs expire (or temporary promotional periods end). BT argued that customers on standard fixed contracts knew when they signed up that the price discount would end when the MCP expires (or promotional period ends)

[70] For example, our mystery shopping exercise, set out below, showed that over half of BT advisers did not tell callers that the MCP would automatically renew at the end of the first MCP unless they opted out.

[71] This source of price variation was not highlighted in the original report. In subsequent correspondence and in his supplementary report, Prof Crawford has emphasized this price variation.

and that this does not therefore prompt switching. According to BT, the effect of this price increase is not analogous to the loss of an ARC price discount that a customer would suffer if they left BT.

4.51 BT further argued that we had failed to account for 'loss aversion', that is the tendency of individuals to avoid experiencing losses relative to seeking gains. The price discount that ARC customers benefit from is an established benefit that customers fear to lose. The prospective 'gains' from switching to another provider are given much less weight. This creates a loyalty effect from ARCs that our analysis does not account for. BT also noted that one source of price variation used in the report – changes in competitors' prices over time – involves small changes relative to the discount ARC customers receive.

4.52 We asked Prof Crawford to evaluate the points raised by BT. He took the view that BT's arguments are not persuasive. Regarding expectations, the likelihood of switching supplier today will depend on the savings that can be achieved and this is not affected by past expectations about the size of these savings. The fact that a price increase was expected does not reduce the benefits of switching supplier.[72]

4.53 We commissioned Prof Crawford to explore in more detail the various sources of price variation and their relative importance for the final results and this work is presented in the supplementary report in Annex 8 (which will be published as soon as possible after this consultation). The report shows that although BT was right to be concerned about the source of price variation associated with the loss of temporary promotional discounts (since this price variation does not appear to drive switching), this was not an important source of price variation for the results in the original study. The most important source of price variation is the difference in price discount associated with different special offers for otherwise identical rollover contracts. When this price variation alone is used we obtain results nearly identical to the original study (rollovers are found to reduce switching by 32.6% instead of 34.8%).

4.54 As noted above, BT makes reference to the phenomenon of 'loss aversion' and cites the pioneering work of Daniel Kahneman and Amos Tversky.[73] Loss aversion refers to the tendency of individuals to prioritise the avoidance of losses over the achievement of gains when making choices. However, even within the framework created by Kahneman and Tversky (and therefore assuming loss aversion is present) the impact of the effect on behaviour is hard to predict since one must identify a 'reference point' against which an individual assesses whether an outcome is a 'gain' or a 'loss'. BT implicitly assumes the existing price is the reference point for a consumer on an ARC. However, this is only one out on a number of possibilities including the average offer in the market, the best offer in the market or even the consumer's aspirations. The field of behavioural economics has not yet established a reliable framework for predicting how reference points are set.[74]

4.55 It is equally plausible, if not more likely, that consumers use the best offer available in the market as a reference point, particularly in a competitive market that features intense marketing activity. In this scenario, loss aversion would not create a general

[72] Prof Crawford further notes that even though customers facing a price increase in the middle of an MCP (from the expiry of a promotion) must pay an ETC, we control for ETCs in the model.
[73] Kahneman and Tversky (1979) "Prospect theory: an analysis of decision under risk", *Econometrica*, 47(2), pp.263-91.
[74] For a discussion on this issue see Koszegi and Rabin (2006) "A model of reference dependent preferences", *Quarterly Journal of Economics*, 121(4), pp. 1133-1165. These authors propose a model in which the reference point is the average outcome a consumer expects from engaging in the market.

reluctance to switch and instead could well prompt it. This would create a particularly strong motivation to switch for customers at the end of a standard fixed contract who *actually* experience a loss.

4.56 Regarding BT's point that price variation in competitors' offers was low, this is only an issue if we accept BT's argument that the other sources of price variation are not relevant. We do not accept this and note that other sources of price variation used are as large as the ARC discount customers receive.

Question 5: Do you agree with our analysis regarding the robustness of the econometric results? In particular, do you agree we have adequately accounted for the effect of the price discount and selection-bias? Please explain your answer.

Underlying causes

4.57 The data does not allow us to establish the underlying causes of the effect of rollover terms, merely that rollovers do have an effect. An assessment of the likely causes is important in assessing whether the effect we observe for BT's offer can be extrapolated to other scenarios and, in the event that we conclude ARCs are a problem, what the most appropriate response is.

4.58 As we set out in Section 3 there are a number of possible ways in which rollovers could affect contract renewal and switching, including increased complexity or lack of transparency of the opt-out process, reduced flexibility in the timing of the decision and the presence of consumer inertia. We also noted that rollovers allowed a retention opportunity in the form of 'bespoke' offers.

4.59 We have no evidence that the opt-out process suffered from low levels of transparency or was burdensome for consumers. Indeed we note that BT sends a reminder letter to consumers before the date of the contract renewal. Therefore our view is that the effects we observe are not a result of the specific way in which BT's contracts were marketed or implemented but are a general effect of ARCs.

4.60 We also have no evidence on whether retention deals are a significant cause of the reduced switching we observe. It remains a possibility that these were offered in sufficient numbers to explain at least a proportion of the effect we measure.

4.61 However, we think any effect from retention deals would be in addition to the increased likelihood of MCP renewal stemming from the opt-out nature of the renewal decision (and therefore the continuing presence of ETCs). As we set out in Section 3, the reduced flexibility in the timing of the renewal decision combined with likely consumer 'inertia' mean that rollovers may significantly increase the likelihood of renewal. In particular, research suggests the so-called 'default bias' is a widespread characteristic of human decision making. We think this is likely to explain a good proportion of the effects we observe, and may well account for the majority.

Question 6: Do you agree that we have correctly identified the underlying causes of the results of the econometrics? Please explain your answer.

Extrapolation to other scenarios

4.62 The data we have only relates to BT's contracts for fixed voice services. This is because, so far, this is the only significant example of an ARC being offered to a large number of customers in a communications market. However, the concerns we set out in Section 3 stem from the core characteristics of ARCs and apply across a wide range of situations. In this section we discuss whether the findings of our econometrics can be extrapolated to other situations and therefore whether ARCs are a concern in general rather than depending on the specific circumstances.

4.63 We consider the following extrapolations:

- to the long-run (i.e. whether any problems will cure themselves);
- to other providers of fixed voice services;
- to other communications markets;
- to small businesses.

4.64 It may be the case that the effects we observe are largely because ARCs are unfamiliar to consumers and that in the long run they will learn about the effects and adapt their behaviour accordingly, for example, by ensuring they plan ahead of the rollover date. However, as consumers only face one rollover every 12 months (or in some cases a longer period), they are provided with relatively few experiences from which to draw lessons and improve their decision making. Further, we believe that there is a good chance that the effects are underpinned by psychological factors that persist over time (the ‘default bias’). In any case, the fact that consumers may eventually adapt to ARCs does not mean they cannot cause significant harm in the meantime.

4.65 As we only have data for BTs we need to ask whether, on average, BT’s customers are different in some way compared to those of other fixed voice providers, or whether the effect we have measured is generated by some specific aspect of the way BT has implemented its offer, and which other providers would not adopt. Regarding BT’s customers it is possible that they are, on average, less active in the market and less experienced in switching. Potentially, the customers of other fixed voice providers might be more alert to contract terms such as ARCs and would be less affected by them. However, the econometrics measures and controls for tenure with BT and this is likely to capture most of the “difference” in BT’s customer base. Once tenure is controlled for, we do not think BT’s customers are likely to be significantly different from those of other providers.

4.66 Other providers might introduce ARCs with slightly different characteristics, for example a different opt-out process or a different method for reminding consumers of the rollover dates. However, other operators would face the same set of challenges as BT when designing their offers and would be likely to adopt similar solution. Indeed, BT’s offer could well form a benchmark that is imitated in full. Certainly, an operator would have little incentive to make changes that dilute the retention effect we have identified. Even were the offers to differ significantly, we note again that in our view the effect of ARCs stems from aspects of consumer behaviour that apply across a wide range of circumstances. We would expect a material effect for any realistic example of an ARC.[75]

4.67 Regarding other sectors, we take the view that there are enough similarities between the fixed voice and broadband markets that ARCs would be likely to have a similar effect in the latter. Fixed voice and broadband are technologically linked services and we can expect purchasing decisions will be made by the same consumer in many

[75] In particular, based on the econometric results, we think ARCs will have a material effect even when ETCs are relatively low.

cases. As the two services are jointly purchased by many consumers, we believe there is a need to ensure that any remedy for harm resulting from ARCs should cover both services to prevent application of ARCs to broadband services by CPs as a mechanism to circumvent the remedy for voice services.

4.68 We note that ARCs are not currently a feature of the mobile market. However, we would have significant concerns if they were to emerge. This is because, whilst we recognise that the mobile sector exhibits a number of differences from the fixed voice and broadband sectors (for example innovations in handsets are important for driving the dynamics of the market), our research shows that the impact of ARCs stems from core aspects of consumer behaviour, and therefore there is a strong case that they would also have harmful effects in the mobile sector. As explained in Section 5, we are not proposing to include explicit prohibition of ARCs in the mobile sector in our current proposals as we have targeted them at the current harm we observe in fixed markets. However we would urgently revisit this issue if ARCs emerged in the mobile sector.

4.69 Finally, in our view, small businesses (ten employees or less) will in general behave in a similar way to residential customers. Unless the business is such that fixed voice services are a significant proportion of costs, switching behaviour is likely to have more similarities with residential consumers than medium and large businesses. We do not think that the conclusions we have drawn from the econometrics can be extrapolated to medium and large businesses, which will have very different systems in place for procurement.

Question 7: Do you agree with our assessment that the results of the econometrics can be extrapolated to: a) all providers of fixed voice services to residential consumers and small business users (with ten employees or less); b) the broadband sector? Do you agree that it is inappropriate to extrapolate the results to medium and large businesses? Please explain your answer.

Other evidence – market research on consumer awareness

4.70 During our initial investigation and prior to commissioning the econometric study we obtained a variety of evidence to understand whether customers who had signed up to ARCs were aware of the contract term. At the time, an insufficient number of customers had reached their rollover date for us to obtain firm evidence on the impact of the contract term on renewal. However, given that ARCs were a new addition to the market we wanted to find out whether consumers on these contracts were aware of and understood them.

4.71 Issues surrounding the transparency of terms and conditions are not a central part of the concerns we set out in Section 3, since any shortcomings in this area do not represent an inherent problem of ARC contracts. However, the research does allow us to interpret the results of the econometrics by helping up assess whether our findings are generated by transparency problems specific to BT’s offer or behavioural effects that are likely to be common across all instances of an ARC.

4.72 We commissioned three pieces of research during 2009 regarding transparency and consumer awareness:

- Quantitative telephone interviews with 600 customers on ARCs;[76]
- A mystery shopping exercise;[77]
- An analysis of call recordings taken from two BT call centres.[78]

4.73 The telephone interviews found consumers had a good general knowledge of the calling plan they were on plan and expressed high levels of overall satisfaction. 79% of consumers in their first MCP and 69% of consumers in their second MCP were very satisfied with their plan. The details of the plan, including the level of the ETC and the presence of the MCP were less well understood but consumers did not express lower levels of satisfactions *after* they were informed of their terms and conditions. However, the rollover decision appeared to be passive rather than active and 59% of consumers in their second MCP did not realise they had been rolled forward.

4.74 The mystery shopping exercise involved 210 existing fixed voice customers (half existing BT customers, half customers of other providers). These customers were asked to contact BT by phone, make enquiries about the offers available and record whether they were provided information unprompted, only after prompting or not at all. The study found that BT was very proactive in marketing ARCs with over three quarters being told about the Unlimited Evening and Weekend offer. However, between 54% and 57% were not told during the call that the ARC contract automatically renewed at the end of each contract period.

4.75 Regarding the call recording analysis, we found indications that the sample of call recordings we were provided with was not random and consequently we do not rely on this study in our conclusions in Section 5 below.[79]

Assessment of the evidence on transparency

4.76 The results were somewhat mixed but, overall, we found no clear evidence that BT's marketing practices reduced the clarity of terms and conditions or that critical information was not made available, particularly in the run up to the date of the rollover, which is most relevant for the effects we have observed. In general, customers had a reasonable awareness of term and conditions. Where awareness was lacking it is not clear that this was because BT had failed to provide the information, rather than that consumers had not absorbed the information that was given. In particular, we note that 59% of consumers in the second year of their MCP were not aware they were on an ARC and therefore had rolled forward, despite the fact they would have received a reminder letter.

4.77 From this we draw the conclusion that a lack of transparency of terms and conditions is not the prime driver of the results we have identified in our econometric analysis. This focuses our attention on behavioural factors, as discussed above.

Question 8: Do you agree that the transparency of terms and conditions in BT's ARC contract is not likely to be the prime driver of the results identified in the econometric research?

[76] Conducted by Spring Research in August 2009.
[77] Conducted by eDigital Research in July and August 2009.
[78] Conducted by Mott MacDonald. The call recordings covered a period between April and July 2009.
[79] Specifically, the call recordings all related to successfully converted sales, which is very unlikely in a random sample.

Summary and conclusion

4.78 In the course of our research we have reviewed a number of sources of evidence into the impact of ARCs on consumer switching. Our core piece of evidence is the detailed statistical analysis of the switching patterns of BT's customers that we commissioned from Professor Crawford and ESMT. The work shows that, even after allowing for the price discount offered with the ARC and the possibility of self-selection by BT's customers, ARCs are associated with a significantly lower level of switching after the initial MCP. We also find evidence that switching is deterred even at relatively low levels of ETCs.

4.79 Since we have no clear evidence that BT's contracts suffered from a lack of transparency, we conclude that the effect we observe stems from the opt-out nature of the MCP renewal decision, which reduces consumers' flexibility at the rollover date and may exploit consumer inertia. Because of this, we conclude that the results can be extrapolated quite widely and are likely to be exhibited to a large extent by any version of an ARC that may emerge in the fixed-voice and broadband sector.

Section 5

Ofcom's proposal for addressing the potential harm from ARCs

Introduction

5.1 In Section 3 and 4 we considered the evidence we have collected and, in the light of our theoretical concerns, assessed carefully the harm that ARCs cause to consumers and competition. Our analysis led to the following conclusions:

- ARC terms reduce the ability to switch, with potential harm to consumers and competition.
- This effect is likely to stem from an increased probability of contract renewal (and therefore the continuing presence of switching costs) caused by the opt-out nature of the decision. Any version of an ARC is likely to have an appreciable effect, regardless of the specific details.
- Over time we do not believe that ARC terms offer significant benefits for consumers relative to the harm they cause.
- As some communications markets mature and firms focus their attention more on customer retention than acquisition, there is a significant risk that ARCs will spread in the communications sector. Widespread adoption in a market could be very sudden if the major providers decided to introduce and support them.
- ARCs are likely to have similar effects in both the fixed voice and broadband markets. We have not collected the evidence that would allow us to reach a firm view as to their possible effects in the mobile sector.

5.2 Our assessment of the most appropriate policy response is based on these conclusions. Although we have identified clear risks from ARCs and have taken the view that the benefits for consumers are unclear, we adopt a cautious approach in weighing up the need for intervention, in line with Ofcom's general preference against intervention. Any intervention carries a risk of regulatory failure that must be given appropriate weight.

5.3 We welcome views from stakeholders on our analysis and the initial conclusions we have reached.

Options for addressing harm

5.4 We believe there are four potential approaches that Ofcom could adopt in response to the harm we have identified:

- Option 1: do nothing;
- Option 2: introduce a GC aimed at improving consumer information;
- Option 3: introduce a GC preventing subsequent MCPs, once the initial one has ended;

- Option 4: introduce a GC requiring MCP renewal to be an opt-in process.

5.5 In this section we set out the merits of each approach and put forward the case for our favoured position, which is Option 4.

Option 1 – Do nothing

5.6 We could take the view that, notwithstanding the harm that has been identified, it is not appropriate to intervene at this stage. We might, for instance, take the view that the harm is not sufficiently serious to warrant intervention, or that there are already sufficient remedies in place to address the harm caused by these contracts, such as the Unfair Terms in Consumer Contracts Regulations 1999 ("the UTCCR"). We might also anticipate than any current harm is a short run phenomenon that will lessen as consumers become more familiar with ARCs.

5.7 However, based on the analysis presented in Sections 3 and 4 we think that it would not be sufficient to simply monitor developments and react accordingly at a future date. It would fail to address the current harm caused by ARCs that exist in the market and, if ARCs do spread throughout the sector, would mean a regulatory response would lag significantly behind events. This course of action would only be worth pursuing if there remained significant ambiguity in the evidence and analysis. Our current view is that this is not the case.

5.8 Further, while the UTCCR may be helpful in tackling certain aspects of consumer harm, particularly in relation to the overall fairness and transparency of contractual terms used in ARCs, they are unlikely to target our core concern, which is the adverse affect on consumers resulting from higher switching costs and reduced competition.

5.9 It is for these reasons that (notwithstanding any action that might potentially be taken under the UTCCR), we believe it is not a viable option for Ofcom to do nothing with respect to ARCs. We now discuss possible forms of intervention.

Intervention generally – Options 2-4

5.10 Our objective in widening intervention is to remove any existing or future harm to consumers caused by ARCs, whether direct (i.e. harm to consumers on ARCs) or indirect (i.e. harm to the broader competitive process). We do not (and do not need to) take a view on either the relative benefits to consumers from MCPs per se or on what level of switching in a market is 'sufficient' for competition to work effectively. What matters for competition is that consumers have the *ability* to switch and that this is not unduly restricted without the consumer having made an active commitment in the form of an MCP.

5.11 A central consideration underlies our thinking on an appropriate remedy: any intervention must reflect our concern that the harmful impact of ARCs stems from their central property – namely the opt-out nature of the renewal decision – not the specific manner in which they are implemented. The analysis of the evidence that led to this conclusion was set out in Section 4 (see paragraphs 4.57 to 4.61), which in turn built on our concerns set out in Section 3 (see paragraphs 3.2 to 3.31).

5.12 A response also needs to address our belief that the risk of harm is not confined to those contracts offered by a particular operator or to a particular type of service. As we discussed in Section 4 (specifically paragraphs 4.62 to 4.69), we think the effects we have identified with respect to BT's ARC is not a result of factors specific to BT customers or the fixed-voice market, or the manner in which BT marketed and implemented their contracts. Furthermore, we set out in Section 3 our concerns that ARCs could spread across the industry as markets develop, and our view that this need not be a slow process but might be a sudden shift (see paragraph 3.54). A proposed intervention needs to be broad enough to address these issues.

5.13 Ofcom's provisional view, subject to the outcome of this consultation, is that any intervention should be in the form of a GG, made in accordance with sections 45-47 and 51 of the Communications Act 2003 ("the CA"). In order to create a GC, Ofcom must be satisfied that such a condition is:

- objectively justified,
- not unduly discriminatory,
- proportionate, and
- transparent in relation to what it is intended to achieve.[80]

5.14 Options 2 -4 set out the form that such a GC might take. Of these, it is our provisional view that Option 4 will best satisfy these conditions, for the reasons set out further below.

Option 2 – GC aimed at improving consumer information

5.15 A light-touch intervention would be to introduce a GC that aimed at providing consumers with more information at the initial point of sale and at the date of renewal. For example, we could require consumers to be advised in clear, standard terms what the rollover term involves at the initial point of sale. We could also mandate the precise wording of a reminder letter and the timeframe for it to be sent ahead of the renewal date. We might also require multiple reminders, perhaps in a variety of formats (e.g. an email or a phone call).

5.16 This would have the advantage of keeping ARCs available for those consumers who value them while reducing the potential for harm. Also, as long as the requirements incorporated into the GC were not overly burdensome, the implementation costs for firms would not be significant.

5.17 However, our analysis of the evidence leads us to believe it is not sufficient to look for interventions that merely provide consumers with more information regarding the ARC term, whether at the point of sale or in a reminder letter sent before the rollover date. As we discussed in paragraphs 4.70 to 4.77, we have no clear evidence that the ARCs we analysed (BT's) suffered from particularly low levels of transparency (or from a complicated opt-out process) and consequently we concluded that the effects we identified were caused by the opt-out nature of the decision. It is not clear whether providing consumers with greater quantities of information, beyond that offered by BT in its ARCs, would have any significant effect. This could even, potentially, distract and annoy consumers.

5.18 We welcome views from stakeholders on whether an intervention based on providing more information to consumers would be sufficient to mitigate the harm from ARCs that we have identified in this consultation.

[80] Section 47 of the Communications Act 2003.

Option 3 – a GC to prohibit subsequent MCPs

5.19 A more interventionist approach would be to introduce a GC to prohibit a firm from offering MCPs to a customer once their initial MCP had expired. This would prevent consumers from being subject to ETCs beyond the initial MCP and eliminate the potential harmful influence of the design of a renewal process. This intervention would also reflect the fact that the clearest economic function of a MCP is to cover the upfront costs of initiating supply, which do not reoccur over time and therefore do not require the need for further MCPs. This is the economic rationale behind the legislative interventions in other EU countries (discussed in Section 2 above) that effectively eliminate any commercial incentives to offer MCPs once the initial MCP has expired.

5.20 However, we accept that operators are prepared to offer discounts and other benefits in return for a commitment from the consumer, and that many consumers will value this. While it is not possible to say what offers would be available in the absence of MCPs, and therefore how significant the benefits of subsequent MCPs are, we take the view that it would be disproportionate based on the analysis of the evidence gathered as part of this review to prohibit a firm from offering MCPs once the initial MCP has expired. In our view it should be possible to identify processes for contract renewal that preserve choice for consumers while limiting the harm caused by ARCs.

Option 4: - GC to prohibit opt-out processes for MCP renewal

5.21 The fourth option is for Ofcom to create a GC that requires MCP renewal on the basis of an “opt-in” (rather than “opt-out”) process. As stated above, it is our view that this approach would best target the specific harm caused by ARCs, and would also satisfy the statutory criteria for making a GC (set out in paragraph 5.13 above).

5.22 As set out in sections 3 and 4, ARCs have the effect of increasing switching costs. This means that consumers are less able to change providers, for example if they are unhappy with the quality of service they receive, or if they wish to take advantage of new offers that are available in the market. Higher switching costs can have the knock-on effect that providers have reduced incentives to price their services competitively or to continue improving the quality of those services.

5.23 At the same time, we take the view that the benefit to consumers from ARCs is unclear. While consumers may value the convenience of not having to pro-actively renew their contract, there is no reason to believe that an opt-in renewal process would be particularly burdensome (especially as a firm has an incentive to make it as convenient as possible). Some consumers may find that they often forget to renew their MCP under an opt-in system, however this suggests an equal risk of forgetting to opt-out from a renewal under an ARC. Additionally, whereas a consumer who fails to opt in can do so as soon as they remember, a consumer who forgets to opt out has to wait until the end of their next MCP or pay an ETC.

5.24 We also note that the marketing of those ARCs that have emerged to date has not promoted them on the basis of the added convenience, as we might expect if the term was mainly aimed at providing convenience for the consumer.[81]

[81] For example, our mystery shopping exercise showed that between 54% and 57% of callers to BT’s call centres were not told that the MCP would renew under an ARC.

5.25 Nevertheless, we recognize that any intervention carries a risk of regulatory failure and we welcome views from stakeholders on whether we have underestimated the benefits for consumers that are (and can only be) generated by ARC terms.

5.26 As set out in our analysis in section 4, in our view the core characteristics of ARCs mean that the consequent harm to consumers is likely to be the same in a range of circumstances, regardless of which communications provider is offering them or the details of how they are implemented. It is on this basis that we believe the introduction of a GC is, in principle, objectively justified.

5.27 Ofcom has given careful consideration to its policy for addressing ARCs, having regard to proportionality and the need to best target the harm that has been identified. We have considered in Option 3 above whether the GC should effectively ban all forms of "renewable" contract being offered to consumers in the telecommunications market, whether these operate on the basis of either an "opt-out" or "opt-in" mechanism. In our view, however, this approach would be disproportionate to the harm identified and would not achieve the correct balance between, on the one hand, consumer protection through effective competition and, on the other, commercial imperatives and encouraging industry innovation.

5.28 On that basis we are proposing to introduce a requirement that, where communications providers supply fixed-line telecommunications services[82] and/or broadband services[83] to consumers[84] and small business customers[85], they may only renew those end-users' contracts after the initial MCP if those end-users have expressly opted-*in* to a contract for a further MCP. This means that, moving forwards, customers will have to make a conscious choice to remain with the same provider on the same contractual terms before a communications provider can "roll them forward" into a further MCP. If the customer does not make this choice for any reason – for example, consumer inertia – the default position is that the customer will remain with the same provider, but on a standard term contract that may be terminated at any time without payment of an ETC.[86]

5.29 Ofcom's proposed approach marks a clear departure from the way in which ARCs currently operate, where a customer is automatically rolled forward into a further MCP unless they expressly opt-*out*. This requires the customer to be pro-active in taking steps to prevent themselves being placed on a further contract term. In practice, a number of factors are likely to impact on a consumer's capacity to do this optimally, such that the "opt out" mechanism effectively becomes weighted in favour of the communications provider. These factors have been set out in detail in section 3 and include (amongst other things) the "default bias", which refers to the prevalent tendency amongst individuals towards a passive selection of default options.

5.30 Ofcom's view, at least at this stage, is that the GC should only apply to contracts for fixed-line telecommunications services[87] and broadband services[88]. This means that

[82] Defined as narrowband call and/or line rental services.
[83] Defined as services that allow for the transfer of high volumes of data at high speeds.
[84] By "consumer" we will be relying on the definition already included in GC 9, namely "any natural person who uses or requests a Public Electronic Communications Service for the purposes which are outside his or her trade, business or profession".
[85] This means undertakings which employ no more than ten people.
[86] The contract may feature a disconnection fee that is not linked to the MCP. We would expect this term to adhere to the Unfair Terms on Consumer Contract regulations. See paragraph 119 onwards in our Guidance - http://stakeholders.ofcom.org.uk/binaries/consultations/addcharges/statement/Guidance.pdf
[87] See footnote 3 above.

the GC will not apply to contract arrangements for mobile telecommunications services. We have limited the scope of the GC because there does not appear to be a demonstrable need for such a condition in the mobile sector, given that ARCs are not currently being offered to consumers in this market. Ofcom has a duty to target regulation where it is needed and until ARCs emerge in the mobile sector we do not think it is appropriate to intervene. We would of course, reconsider this issue if ARCs emerged in the mobile sector.

5.31 In our view a GC which seeks to implement option 4 would be a proportionate means of removing the harm we have identified. It can target the root cause of the issue (i.e. the opt-out nature of the decision) and also applies broadly enough to deal with our concern that any version of an ARC that may emerge will have harmful effects. Given our analysis in Sections 3 and 4 we cannot be confident that any changes only to the mechanics of ARCs, such as the reminder process, will be sufficient. We therefore think that only the removal of opt-out systems of contract renewal can guarantee the removal of the harm we identified, and a GC is the only method by which this can be achieved. We also believe that a GC is appropriate since is broad enough to address the potential harm across the relevant markets.

5.32 We think there is a significant risk that ARCs will spread, with an increasing number of operators offering them across a variety of products. The retention effects of ARCs that we identified in Section 4 will make them an attractive proposition for operators, particularly as communications markets mature and more firms begin to switch their focus to customer retention. We also highlighted in our discussion that widespread adoption could be a sudden rather than slow process (paragraph 3.56). This also provides a reason for using a GC to address the potential harm, rather than attempting to deal with any issues retrospectively.

5.33 At the same time a GC restricting opt-out renewal processes places few limitations on the available outcomes for consumers. A consumer that wants to continually renew their MCP remains free to do so and a consumer that is confident of remaining with a supplier and willing to make a much longer commitment can sign up for an MCP longer than the standard 12 months. At the same time firms are free to make the opt-in process as convenient as possible, potentially including a reminder process similar to the one BT has adopted for its ARCs. Our proposed GC only changes the process for making a renewal decision not the options available.

Question 9: Do you agree that intervention regarding ARCs is warranted? Do you agree that a General Condition restricting opt-out renewal processes (ie option 4) is the most appropriate form of intervention? Do you agree that a GC should cover both residential and small business customers, but not medium or large businesses? Do you agree that mobile communications should be out of scope at this stage? Please explain your answer, and provide details of any alternative intervention you think more appropriate.

Timeframe for compliance

5.34 Our For those CPs that do not currently have any customers subject to ARC terms we think it is fair to require that compliance is immediate from the point when the GC comes into force since this does not require any positive actions that would impose costs. CPs would need to halt any existing plans to introduce ARCs, remove from sale any ARCs which they currently offer, and possibly replace these with alternative

[88] See footnote 4 above.

plans. We would expect this to be straightforward given that CPs would simply need to create new plans with opt-in rather than opt-out renewal mechanisms.

5.35 Our proposed intervention will impose some compliance costs on CPs who currently have customers on ARC contracts, since these customers will need to be informed of the changes and the CP will need to make the necessary changes to customer records. Given the extent of the potential harm we have identified we do not think the compliance costs undermine the case presented above for intervention. However, it does affect the appropriate time frame within which we require CPs to come into compliance.

5.36 In our view, compliance for an operator with customers currently on ARCs should involve costs that the CP will be accustomed to incurring in the course of its business and will be well able to manage. Compliance will require a CP to write to consumers informing them of the change, to adjust customer records so that the default is now non-renewal of the MCP and to inform customer service staff of the changes. Where a firm is actively marketing ARCs it will also need to make the necessary changes to marketing material. None of these costs will be unfamiliar to a CP and many will be incurred anyway, regardless of the change.

5.37 CPs will often write to their customers, for example to send bills and (where one is sent) rollover reminder letters, and consequently it should not be a significant burden to inform customers of the changes in their contract. The standard reminder letter will need redrafting, however there is no reason to expect this to be a costly task, especially as CPs are likely to review their letter on a regular basis in any case. Regarding customer records, any CP that offers ARCs must have existing systems in place to deal with the non-renewal of MCPs since customers retain this option under their contract. The CP simply needs to log the non-renewal onto their systems without waiting for the customer to contact them first. Updating customer service staff of the changes ought to be straightforward since a CP will make frequent adjustments to its contracts and tariffs and should have mechanisms in place for ensuring staff are aware of changes. We invite the views of stakeholders on the size of these compliance costs, in particular whether there are significant costs we have overlooked.

5.38 Even though we do not expect compliance costs to be significant, they will be affected by the timeframe for compliance. The longer the timeframe we allow for compliance the lower the cost to the CP is likely to be. However, a longer timeframe for transition would also extend the duration of the harm we have identified and would put CPs who have not introduced ARCs at a disadvantage in the market. On the other hand, requiring immediate changes may be disproportionate if it imposes much larger costs and only speeds up the removal of ARCs by a few months.

5.39 The overwhelming majority of customers currently on ARCs are subject to a 12 month MCP. This therefore provides a natural timeframe for implementation since we would be requiring that the change is made for each consumer before their next MCP renewal. All that is needed is that each existing customer is marked for non-renewal of the MCP on the CP's systems and the reminder letter sets out the changes to the customer's contract and informs them of the need to opt in to a further MCP.

5.40 Some CPs have ARCs with MCPs that are longer than 12 months and also do not send a reminder letter prior to the rollover date. Compliance within 12 months may therefore impose a larger incremental cost for these CPs. However, the risk of harm to consumers from these ARCs is also correspondingly higher. Therefore, we do not think it is proportionate to extend the proposed 12 months transitional period for

ARCs that are longer than 12 months, and would expect CPs with ARCs of greater duration to make arrangements to comply with the GC requirement within 12 months of it taking effect.

Question 10: Do you agree that we should require compliance with the proposed GC amendment immediately it comes into effect? Do you agree that a period of 12 months for compliance with our proposed GC for CPs with existing customer subject to ARC terms is sufficient to remove the harm associated with ARCs without imposing disproportionate costs on CPs? If you disagree, please provide evidence to support your view and suggestions for a more appropriate time frame.

The form of the General Condition

5.41 If Ofcom was to make a GC (for example, in accordance with option 4), our preference would be to amend GC 9, rather than to create a new stand-alone condition. This is primarily on the basis of efficiency, where GC 9 could accommodate our proposed amendment in a way that would complement and enhance the existing protection offered to consumers in relation to MCPs. In order to properly explain this proposal it is necessary to set out the recent developments that have occurred at a European level, and the consultations that are currently taking place.

5.42 In November 2009 reforms were made to the relevant EU Directives that govern communications matters across Europe. In particular, the Universal Service Directive[89] (from which many of Ofcom's powers to make consumer protection-related GCs arise) was amended so that Article 30 of that Directive now includes the following additional paragraphs:

> *"5. Member States shall ensure that contracts concluded between consumers and undertakings providing electronic communications services do not mandate an initial commitment period that exceeds 24 months. Member States shall also ensure that undertakings offer users the possibility to subscribe to a contract with a maximum duration of 12 months"*
>
> *"6. Without prejudice to any minimum contractual period, Member States shall ensure that conditions and procedures for contract termination do not act as a disincentive against changing service provider".*

5.43 The UK Government must ensure that these amendments are implemented into UK law by 25 May 2011. Accordingly, both the Department for Business, Innovation and Skills and Ofcom have been consulting on how best to achieve this.[90] The current proposal, as set out by Ofcom at Annex 7 of our Changes to General Conditions and Universal Service Conditions consultation[91] is that the current version of GC 9 be amended to incorporate the new provisions set out above[92]. Of these, the most

[89] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2002L0022:20091219:EN:PDF
[89] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2002L0022:20091219:EN:PDF
[90] See http://stakeholders.ofcom.org.uk/consultations/gc-usc/ and http://www.bis.gov.uk/Consultations/revised-eu-electronic-communications-framework.
[91] http://stakeholders.ofcom.org.uk/binaries/consultations/gc-usc/annexes/Annex_7_GC_USC.pdf
[92] The full text of GC 9, including those amendments, is set out in Annex 5 of this consultation.

relevant for our purposes is Article 30(6), which we are proposing to transpose into the current version of GC 9 as follows:

> *"9.3 Without prejudice to any minimum contractual period, Communications Providers shall ensure that conditions or procedures for contract termination do not act as disincentives for End-Users against changing their Communications Provider".*

5.44 The Changes to General Conditions and Universal Service Conditions consultation is due to end on 7 April 2011. If, having considered the responses from stakeholders, Ofcom decides to proceed with its proposals to amend GC 9 as set out above, we would propose inserting a further amendment to clarify the scope of the new GC 9.3. The new condition would then read as follows (additional wording in italics):

9.3 Without prejudice to any minimum contractual period, Communications Providers shall ensure that conditions or procedures for contract termination do not act as disincentives for End-Users against changing their Communications Provider. *In particular, but without limiting the extent of this paragraph:*

(a) Communications Providers who are providing Fixed-Line Telecommunications Services and Broadband Services to End Users must not, at the end of those End Users' initial or subsequent minimum contract period, renew those End-Users' contracts for a further minimum contract period unless that Communications Provider has first obtained those End Users' Express Consent; where

(i) "Fixed-Line Telecommunications Services" means Narrowband call and/or line rental services;

(ii) "Narrowband" means services provided over a Public Telephone Network.

(iii) "Broadband Services" means services that allow for the transfer of high volumes of data at high speeds";

(iv) "End-User" means Consumers (as defined for the purposes of this Condition) and small businesses that have no more than ten employees; and

(vi) "Express Consent" means the express agreement of the End User to contract with the Communications Provider in relation to each minimum contract period, the Communications Provider to obtain such consent no earlier than half way through the existing minimum contract period, and no later than two weeks prior to the expiry of that period.

5.45 We have set out at paragraphs 5.34 – 5.39 our provisional views as to the transitional period that CPs will need in order to implement the new GC. In light of that analysis we propose including a footnote to the GC which will clarify when it is to come into force. For those End Users who have not entered into an ARC with a CP as at that date of our final statement on Automatically Renewable Contracts (the final statement), the new GC will come into force immediately. Where, however, an End User is still on an ARC as at the date of the final statement, the GC will come into force twelve months after the date of the final statement.

5.46 Alternatively, if having considered the responses from stakeholders, Ofcom decides that GC 9 should not be amended to include a new GC 9.3 as proposed in our Changes to General Conditions and Universal Service Conditions consultation Ofcom's second preference would be to insert into GC9 the same wording as set out above, starting from paragraphs 9.3(a) onwards. This would form a new paragraph 9.4 and the remaining provisions would be renumbered accordingly. The transitional arrangements proposed in paragraph 5.45 above would also apply.

5.47 Because Ofcom is still awaiting the outcome of the Changes to General Conditions and Universal Service Conditions consultation, the Notification of a modification under section 48 of the Communications Act 2003 contained in Annex 5 of this document contains both variations of our proposed amendment to GC 9. If one of the outcomes of our Changes to General Conditions and Universal Service Conditions consultation is to amend GC 9 as proposed in that document, then Ofcom's first preference is to further amend GC 9 in the way set out in paragraph 5.44 above and in the "First Modification" set out in Annex 5. If, however, Ofcom decides not to amend GC 9 in the way proposed in the General Conditions and Universal Service Conditions consultation, then our second preference is set out in paragraph 5.46 above and in the "Second Modification" set out in Annex 5.

5.48 In paragraph 5.13, we outlined the tests contained within section 47(2) of the Act which modifications to conditions must comply. We consider that our proposal to amend GC 9, either in the form of the "First Modification" or the "Second Modification" set out in Annex 5, meets the criteria set out in section 47(2) of the Act. These are:

• objectively justifiable, on the basis of the harm Ofcom has identified in section 3 of this consultation;

• not unduly discriminatory, as the revised requirement will apply to all CPs to the extent that they offer, or intend to offer, ARCs and GC9 is therefore relevant to them;

• proportionate, as the change is the minimum necessary to address the harm that Ofcom has identified, while also preserving consumer choice and the ability of Communications Providers to develop competitive offerings; and

• transparent, as the both the purpose and requirements of the proposed GC are clear, and the GC itself will be readily accessible on Ofcom's website.

Annex 5 contains the formal notification of our proposal to amend GC9.

Question 11: Do you agree with the General Condition we propose? If not, what alternative form of GC do you consider more appropriate? Please explain your answer.

Annex 1

Responding to this consultation

How to respond

A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 12 May 2011**.

A1.2 Ofcom strongly prefers to receive responses using the online web form at http://stakeholders.ofcom.org.uk/consultations/arcs/howtorespond/form, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.

A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email arcs@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.

A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.

Jasminder Oberoi
2nd Floor - Consumer Group
Consumer Affairs
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Fax: 020 7981 3061

A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.

A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Jasminder Oberoi.

Confidentiality

A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.

A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at http://www.ofcom.org.uk/about/accoun/disclaimer/

Next steps

A1.11 Following the end of the consultation period, Ofcom intends to publish a statement during Summer 2011.

A1.12 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm

Ofcom's consultation processes

A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.

A1.14 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk . We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.

A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Vicki Nash, Director Scotland, who is Ofcom's consultation champion:

Vicki Nash
Ofcom
Sutherland House
149 St. Vincent Street
Glasgow G2 5NW

Tel: 0141 229 7401
Fax: 0141 229 7433

Email vicki.nash@ofcom.org.uk

Annex 2

Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.

A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.

A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.

A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at www.ofcom.org.uk/consult/.

A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing	☐	Name/contact details/job title	☐
Whole response	☐	Organisation	☐
Part of the response	☐	If there is no separate annex, which parts?	

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here. ☐

Name

Signed (if hard copy)

Annex 4

Consultation questions

A4.1 We have asked the questions set out below in this consultation.

Section 3

Question 1: Do you agree with our assessment of the potential benefits of ARCs for consumers, including the source of the benefits and their magnitude? Please provide evidence to support your response.

Question 2: Do you agree with our assessment that ARCs are likely to increase the probability of contract renewal (despite only altering the process for renewal)? Please explain your answer.

Question 3: Do you agree with our assessment that increased switching costs resulting from ARCs are likely to harm competition, in particular the incentives for new entry and innovation? Please explain your answer.

Question 4: Do you agree with our analysis that ARCs could survive in a competitive market, despite causing harm to competition. Do you agree that there is a risk of ARCs spreading in the market and that this could be rapid? Please explain your answer.

Section 4

Question 5: Do you agree with our analysis regarding the robustness of the econometric results? In particular, do you agree we have adequately accounted for the effect of the price discount and selection-bias? Please explain your answer.

Question 6: Do you agree that we have correctly identified the underlying causes of the results of the econometrics? Please explain your answer.

Question 7: Do you agree with our assessment that the results of the econometrics can be extrapolated to: a) all providers of fixed voice services to residential consumers and small business users (with ten employees or less); b) the broadband sector? Do you agree that it is inappropriate to extrapolate the results to medium and large businesses? Please explain your answer.

Question 8: Do you agree that the transparency of terms and conditions in BT's ARC contract is not likely to be the prime driver of the results identified in the econometric research?

Section 5

Question 9: Do you agree that intervention regarding ARCs is warranted? Do you agree that a General Condition restricting opt-out renewal processes (ie option 4) is the most appropriate form of intervention? Do you agree that a GC should cover both *residential and small business customers, but not medium or large businesses? Do you agree that mobile communications should be out of scope at this stage? Please explain your answer, and provide details of any alternative intervention you think more appropriate.*

Question 10: Do you agree that we should require compliance with the proposed GC amendment immediately it comes into effect? Do you agree that a period of 12 months for compliance with our proposed GC for CPs with existing customer subject to ARC terms is sufficient to remove the harm associated with ARCs without imposing disproportionate costs on CPs? If you disagree, please provide evidence to support your view and suggestions for a more appropriate time frame.

Question 11: Do you agree with the General Condition we propose? If not, what alternative form of GC do you consider more appropriate? Please explain your answer.

Annex 5

Notification proposing to modify General Condition 9

Notification of proposed modifications under section 48(2) of the Communications Act 2003

Proposal for modification of General Condition 9 regarding the Requirement to Offer Contracts with Minimum Terms

1. Ofcom in accordance with section 48(2) of the Act hereby makes the following proposals for a modification of General Condition 9 of the General Condition Notification regarding Requirements to Offer Contracts with Minimum Terms.

2. The draft modifications are set out in the Schedule to this Notification. Two forms of the modification have been proposed in the alternative: if the proposals contained in Ofcom's consultation "*Changes to General Conditions and Universal Service Conditions*" are implemented, then the First Modification will apply; if the changes in Ofcom's consultation "*Changes to General Conditions and Universal Service Conditions*" are not implemented, then the Second Modification will apply. For the avoidance of doubt, only one form of the modification will be implemented.

3. The effect of, and Ofcom's reasons for making, the proposals referred to in paragraph 1 above is set out in the accompanying explanatory statement.

4. Ofcom considers that the modification referred to in paragraph 1 above complies with the requirements of sections 45 to 50 of the Act, as appropriate and relevant to their proposal.

5. In making the proposals set out in the Notification, Ofcom has considered and acted in accordance with their general duties in section 3 and of the Act and the six Community requirements in section 4 of the Act.

6. Representations may be made to Ofcom about the proposal set out in this Notification by 5pm on 12 May 2011.

7. If implemented, the modification shall enter into force on the date of Ofcom's final Statement on Automatically Renewable Contracts in relation to End Users who have not, as at that date, entered into a contract with a Communications Provider, where that contract automatically renews for a further minimum contract period (either at the end of an initial minimum contract period or at the end of a subsequent minimum contract period) without that End User's Express Consent. In relation to all End Users who are in a contract with a Communications Provider as at the date of Ofcom's final Statement on Automatically Renewable Contracts, where that contract automatically renews for a further minimum contract period (either at the end of an initial minimum contract period or at the end of a subsequent minimum contract period) without that End User's Express Consent, GC 9.3(a) comes into force 12 months from the date of Ofcom's final Statement on Automatically Renewable Contracts.

8. Copies of this Notification and the accompanying statement have been sent to the Secretary of State in accordance with section 50(1)(a) of the Act.

9. In this Notification:

   (a) "the Act" means the Communications Act 2003;

   (b) "General Conditions" means the general conditions set by the General Conditions Notification as amended;

   (c) "General Condition Notification" means the notification setting General Conditions under section 45 of the Act, issued by the Director General of Telecommunications on 22 July 2003, as subsequently amended;

   (d) "Ofcom" means the Office of Communications;

   (e) End User" means Consumers (as defined for the purposes of General Condition 9) and small businesses that have no more than ten employees;

   (f) "Express consent" means the express agreement of the End User to contract with the Communications Provider in relation to each minimum contract period, the Communications Provider to obtain such consent no earlier than half way through the existing minimum contract period, and no later than two weeks prior to the expiry of that period.

10. Except insofar as the context otherwise requires, words or expressions shall have the meaning assigned to them in this Notification and otherwise any word or expressions shall have the same meaning as it has in the General Condition Notification and otherwise any word or expression shall have the same meaning as it has in the Act.

11. For the purpose of interpreting this Notification:

    (a) headings and titles shall be disregarded; and

    (b) the Interpretation Act 1978 shall apply as if this Act were an Act of Parliament.

12. The Schedule to this Notification shall form part of this Notification.

Claudio Pollack

Head of Consumer Group

3 March 2011

A person authorised by Ofcom under paragraph 18 of the Schedule to the Office of Communications Act 2002.

SCHEDULE
MODIFICATION TO GENERAL CONDITION 9:
REQUIREMENT TO OFFER CONTRACTS WITH MINIMUM TERMS

The proposed additions are underlined in each form of the proposed modification.

FIRST MODIFICATION – WORDING TO BE USED IF THE PROPOSALS IN "CHANGES TO GENERAL CONDITIONS AND UNIVERSAL SERVICE CONDITIONS" ARE IMPLEMENTED

9.1 Communications Providers shall, in offering to provide, or providing, connection to a Public Electronic Communications Network and/or Public Electronic Communications Services to a Consumer, and other End-Users on request, offer to enter into a contract or vary an existing contract with that Consumer, or other End-User, which complies with the following paragraphs.

9.2 Any contract between the Communications Provider and a Consumer, and other End-Users on request, shall specify at least the following minimum requirements in a clear, comprehensive and easily accessible form:

(a) the identity and address of the Communications Provider;

(b) the services provided, including in particular whether or not access to Emergency Services and Caller Location Information is being provided, and any limitations on the provision of Emergency Services:

(c) information on any other conditions limiting access to and/or use of services and applications (where such conditions are permitted under national law);

(d) details of the minimum service quality levels offered, namely the time for initial connection and any other quality of service parameters as directed by OFCOM;

(e) information on any procedures put in place by the undertaking to measure and shape traffic so as to avoid filling or overfilling a network link, and information on how those procedures could impact on service quality;

(f) the types of maintenance services and customer support services offered, as well as the means of contacting these services;

(g) any restrictions imposed by the provider on the use of terminal equipment supplied;

(h) the Subscribers options as to whether or not to include his or her personal data in a directory, and the data concerned;

(i) details of prices and tariffs, the means by which up-to-date information on all applicable tariffs and maintenance charges may be obtained, payment methods offered and any difference in costs due to payment method;

(j) the duration of the contract, and the conditions for renewal and termination of services and of the contract, including:

(i) any minimum usage or duration required to benefit from promotional terms,
(ii) any charges related to portability of numbers and other identifiers, and

(iii) any charges due on termination of the contract, including any cost recovery with respect to terminal equipment;

(k) any applicable compensation and/or refund arrangements which will apply if contracted quality service levels are not met;

(l) the means of initiating procedures for the settlement of disputes in respect of the contract; and,

(m) the type of action that might be taken by the Communications Provider in reaction to security or integrity incidents or threats and vulnerabilities.

9.3 Without prejudice to any minimum contractual period, Communications Providers shall ensure that conditions or procedures for contract termination do not act as disincentives for End-Users against changing their Communications Provider. <u>In particular, but without limiting the extent of this paragraph:</u>

<u>(a) Communications Providers who are providing Fixed-Line Telecommunications Services and Broadband Services to End Users must not, at the end of those End Users' initial or subsequent minimum contract period, renew those End-Users' contracts for a further minimum contract period unless that Communications Provider has first obtained those End Users' Express Consent[93]; where</u>

<u>(i) "Fixed-Line Telecommunications Services" means Narrowband call and/or line rental services;</u>

<u>(ii) "Narrowband" means services provided over a Public Telephone Network.</u>

<u>(iii) "Broadband Services" means services that allow for the transfer of high volumes of data at high speeds";</u>

<u>(iv) "End-User" means Consumers (as defined for the purposes of this Condition) and small businesses that have no more than ten employees; and</u>

<u>(vi) "Express Consent" means the express agreement of the End User to contract with the Communications Provider in relation to each minimum contract period, the Communications Provider to obtain such consent no earlier than half way through the existing minimum contract period, and no later than two weeks prior to the expiry of that period.</u>

[93] GC 9.3(a) comes into force on [DATE OF FINAL STATEMENT ON AUTOMATICALLY RENEWABLE CONTRACTS] in relation to End Users who have not, as at that date, entered into a contract with a Communications Provider, where that contract automatically renews for a further minimum contract period (either at the end of an initial minimum contract period or at the end of a subsequent minimum contract period) without that End User's Express Consent. In relation to all End Users who are in a contract with a Communications Provider as at [DATE OF FINAL STATEMENT ON AUTOMATICALLY RENEWABLE CONTRACTS], where that contract automatically renews for a further minimum contract period (either at the end of an initial minimum contract period or at the end of a subsequent minimum contract period) without that End User's Express Consent, GC 9.3(a) comes into force on [DATE 12 MONTHS AFTER FINAL STATEMENT ON AUTOMATICALLY RENEWABLE CONTRACTS].

9.4 Communications Providers when providing Electronic Communications Services shall ensure that its initial contract concluded with Consumers shall not be for a duration of more than 24 months.

9.5 Communications Providers shall ensure that Users are able to subscribe to a contract with a maximum duration of 12 months.

9.6 Communications Providers shall:

(a) give its Subscribers adequate notice not shorter than one month of any modifications likely to be of material detriment to that Subscriber;

(b) allow its Subscribers to withdraw from their contract without penalty upon such notice; and shall,

(c) at the same time as giving the notice in condition 9.6 (a) above, inform the Subscriber of their ability to terminate the contract without penalty if the proposed modification is not acceptable to the Subscriber.

9.7 For the purposes of this Condition,

(a) "Communications Provider" means a person who provides Public Electronic Communications Networks and/or Services;

(b) "Consumer" means any natural person who uses or requests a Public Electronic Communications Service for purposes which are outside his or her trade, business or profession; and

(c) "User" means a legal entity or natural person using or requesting a Public Electronic Communications Service.

SECOND MODIFICATION – WORDING TO BE USED IF THE PROPOSALS IN "CHANGES TO GENERAL CONDITIONS AND UNIVERSAL SERVICE CONDITIONS" ARE NOT IMPLEMENTED

9.1 The Communications Provider shall, in offering to provide, or providing, Public Electronic Communications Services to a Consumer, and on the request of that Consumer, offer to enter into a contract or vary an existing contract with that Consumer which complies with paragraph 9.2.

9.2 Any contract between the Communications Provider and a Consumer shall specify the following minimum requirements:

(a) the identity and address of the Communications Provider;

(b) the services provided, details of the service quality levels offered and the time for initial connection;

(c) details of maintenance services offered;

(d) particulars of prices and tariffs, and the means by which up-to-date information on all applicable tariffs and maintenance charges may be obtained;

(e) the duration of the contract, the conditions for renewal and termination of services and of the contract;

(f) any applicable compensation and/or refund arrangements which will apply if contracted quality service levels are not met; and

(g) the method of initiating procedures for settlement of disputes in respect of the contract.

9.3 Where the Communications Provider intends to modify a condition in a contract with a Consumer which is likely to be of material detriment to the Consumer, the Communications Provider shall:

(a) provide the Consumer with at least one month's notice of its intention detailing the proposed modification; and

(b) inform the Consumer of the ability to terminate the contract without penalty if the proposed modification is not acceptable to the Consumer.

9.4 <u>Communications Providers who are providing Fixed-Line Telecommunications Services and Broadband Services to End Users must not, at the end of those End Users' initial or subsequent minimum contract period, renew those End-Users' contracts for a further minimum contract period unless that Communications Provider has first obtained those End Users' express consent where[94];</u>

<u>(a) "Fixed-Line Telecommunications Services" means Narrowband call and/or line rental services;</u>

<u>(b) "Narrowband" means services provided over a Public Telephone Network;</u>

<u>(c) "Broadband Services" means services that allow for the transfer of high volumes of data at high speeds";</u>

<u>(d) "End-User" means Consumers (as defined for the purposes of this Condition) and small businesses that have no more than ten employees; and</u>

<u>(e) "Express consent" means the express agreement of the End User to contract with the Communications Provider in relation to each minimum</u>

[94] GC 9.4 comes into force on [DATE OF FINAL STATEMENT ON AUTOMATICALLY RENEWABLE CONTRACTS] in relation to End Users who have not, as at that date, entered into a contract with a Communications Provider, where that contract automatically renews for a further minimum contract period (either at the end of an initial minimum contract period or at the end of a subsequent minimum contract period) without that End User's Express Consent. In relation to all End Users who are in a contract with a Communications Provider as at [DATE OF FINAL STATEMENT ON AUTOMATICALLY RENEWABLE CONTRACTS], where that contract automatically renews for a further minimum contract period (either at the end of an initial minimum contract period or at the end of a subsequent minimum contract period) without that End User's Express Consent, GC 9.4 comes into force on [DATE 12 MONTHS AFTER FINAL STATEMENT ON AUTOMATICALLY RENEWABLE CONTRACTS].

<u>contract period, the Communications Provider to obtain such consent no earlier than half way through the existing minimum contract period, and no later than two weeks prior to the expiry of that period.</u>

9.5 For the purposes of this Condition,

(a) “Communications Provider” means a person who provides Public Electronic Communications Services, excluding any service which is a broadcast of television programmes for general reception in, or in any area in, the United Kingdom, where every member of the intended audience of such a service is able to receive that service in an intelligible form and free of charge;

(b) “Consumer” means any natural person who uses or requests a Public Electronic Communications Service for purposes which are outside his or her trade, business or profession.

Annex 6

Glossary

Act: means the Communications Act 2003

Automatically renewable contracts (ARCs): contracts where consumers receive a benefit (e.g. a discount or additional call features) in exchange for signing up to a minimum contract period (usually of 12 months) that is automatically renewed unless the consumer contacts their provider to inform them of their intention to switch to a different plan (or to a different provider) once their existing minimum contract term expires.

Behavioural Economics: a field of economics which explores the ways in which individual decision-making is influenced by factors such as emotions, habits and cognitive limitations.

BT: British Telecommunications plc.

Bundle: Where a consumer purchases two or more services from the same provider and receives only one bill from the provider. The consumer may or may not receive a discount.

Communications Provider (CP): a person who provides an Electronic Communications Network (ECN) or provides an Electronic Communications Service (ECS) (the definition provided by the EU Framework Directive and Ofcom's relevant consultation).

Consumer: any natural person who uses or requests a publicly available electronic communications service for purposes which are outside his or her trade, business or profession (the definition provided by the EU Framework Directive and Ofcom's relevant consultation).

Customer churn: also known as customer attrition or customer turnover, the rate at which a business loses its customers.

Default Bias: derived from research into behavioural economics, the default bias is a type of behaviour based on the common observation that regardless the information available or the ease of making a choice, individuals are significantly influenced by default options (and furthermore that they are unlikely to anticipate these effects in advance).

Early Termination Charge (ETC): a charge levied on consumers who terminate their contract before the end of any Minimum Contract Period (or Subsequent Minimum Contract Period).

Fixed-line: means Narrowband call and/or line rental services provided to consumers and small business consumers.

Gaining Provider: The provider to whom the customer is transferring.

Gaining Provider Led (GPL) process: Switching process where the consumer only needs to contact the provider they are transferring to in order to switch.

General Conditions (GCs): a set of regulations that apply to anyone who provides an Electronic Communication Service or an Electronic Communications Network as defined in the Act. .

Losing Provider: The provider from whom the customer is transferring.

Losing Provider Led (LPL) process: Switching process where the consumer needs to contact the provider they are transferring away from as well as the provider they are transferring to in order to switch.

Minimum Contract Period (MCP): a minimum (fixed-term) contractual period set at the start of a contract (often for 12 to 24 months).

Narrowband (as defined in General Condition 24.19): services provided over a traditional Public Telephone Network, excluding services provided over a Cable Network.

Ofcom: Office of Communications. The regulator for the communications industries, created by the Office of Communications Act 2002.

Rollover date: the date on which an ARC will automatically renew into a new, subsequent MCP, unless the consumer contacts the CP to prevent this from happening.

Small businesses: businesses with up to ten employees.

Subsequent Minimum Contract Period: a consecutive MCP, starting at the conclusion of the initial MCP.

Switching costs: Costs incurred by changing supplier that are not incurred by remaining with the current provider. There are several types of switching costs including transaction costs, compatibility costs, learning costs, contractual costs, equipment costs, uncertainty costs, psychological costs, shopping costs and search costs.

List of Additional Annexes