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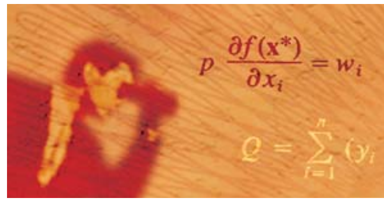

From the Editor

Early termination fees (ETFs) are frequently applied in contracts for services and products such as cellular telephone service, high-speed internet access, satellite TV programming, residential burglar alarm systems, and retail electricity. However, they have become the subject of both legal and regulatory controversy. For example, in the US, consumer groups have argued that ETFs limit the scope for consumers to switch between cellular service providers. Indeed, in some US states, the use of ETFs in the cellular telephone industry is now restricted or regulated. Similarly, in Australia, there is vigorous debate about the impact of ETFs on consumers in the emerging competitive retail electricity sector. These concerns also have led to regulatory review and intervention.

In this issue of *Antitrust Insights*, Greg Houston and Hayden Green in NERA's Sydney, Australia, office discuss the impact of ETFs on consumers and the implications of regulatory proposals to ban ETFs. They explain why firms offer fixed-term contracts that involve the imposition of ETFs and the reasons why ETFs can be an effective means by which service providers can manage the cost of customer switching and offer lower retail prices. ETFs also have the potential to raise the cost to customers of switching providers, but as Greg and Hayden point out, an assessment of the ultimate impact of a particular ETF arrangement on consumers requires more than an analysis of switching costs; it requires a careful analysis of the competitive dynamics in the market in question, including the nature of competition for long-term customer contracts in the first place.

Greg Houston is a Director with 20 years of experience in competition policy and regulatory litigation, as well as strategic and policy advice. He has appeared as an expert witness in competition and regulatory matters before the courts, in various arbitration processes, and in regulatory hearings in Australia, New Zealand, the Philippines, and the United Kingdom. Hayden Green is a Consultant, and he has advised clients on a range of competition and regulatory issues, including mergers, access to bottleneck facilities, predatory pricing, and price fixing.

I hope you enjoy this issue.

—Lawrence Wu, Editor

Assessing the Merits of Early Termination Fees

By Greg Houston and Hayden Green

In many markets, customers purchase services that are provided under fixed or long-term contracts that involve the imposition of early termination fees (ETFs). Such fees are sometimes charged if and when a customer wishes to break the term of his or her supply or service agreement. For example, a customer that enters a three-year cellular telephone plan may be subject to an ETF of, say, \$100 to \$200 if he or she terminates the contract prior to its end date. ETFs are common in many service industries, including financial services and subscription television.

Consumer groups have claimed that ETFs have an anticompetitive effect by limiting the ability of customers to switch suppliers, with the result being higher prices, lower quality service, and less competition among suppliers than would be the case if such fees were banned or restrained. In contrast, service providers respond that ETFs facilitate lower prices on the grounds that ETFs encourage them to invest in the front-loaded costs that are needed to attract and supply a new customer. Why do firms impose ETFs and what are the implications of proposals to ban or restrict ETFs?

Why Do Firms Impose ETFs?

A certain level of customer switching or "churn" is inevitable in retail markets where ongoing services are provided under some form of contract and customers migrate from one supplier to another. Consumers may place a high value on their ability to switch suppliers, but in many cases, customer switching will result in higher costs of supply and higher prices. For service providers, the increase in costs associated with customer transfers can take many forms. For instance, there are likely to be coordination and transfer costs that

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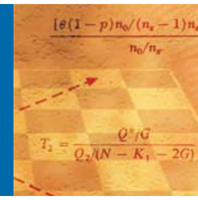
are incurred when customers switch from one provider to another. Firms also may face greater risk and the costs of uncertainty over the revenues and profits that they may earn from each customer sale. In such an environment, service providers may seek to improve the efficiency of their operations and/or reduce the volatility of their anticipated revenue stream. One additional solution is to supply their services under a long-term contract.

However, a supplier's desire to offer services under long-term contracts may be undermined if a customer, once signed, is able to terminate the contract or switch to another supplier at a very low or potentially zero cost. For example, if a contracted customer is able to cancel a contract at no additional charge, then the supplier would be deprived of the net revenue stream that it otherwise would have accrued over the course of the contract. In addition, the supplier may even be encumbered with unrecoverable costs. For this reason, service providers often impose ETFs on customers who terminate their contract prior to the end date of the contract. ETFs therefore represent liquidated damages associated with early contract termination by providing suppliers with a means to recover their capital expenditures and the remaining portion of any up-front or one-off costs of supply that they may have incurred. This is beneficial for customers because in a market characterized by a high degree of customer switching, a supplier that is unable to charge an ETF may not be willing to provide services of value to consumers for fear they will be left with unrecoverable costs.

On the other hand, ETFs might result in higher switching costs. For example, a supplier might set an ETF that was in excess of the actual damage caused by the early termination or unrelated to the recovery of up-front sunk investments. Thus, the rationale for imposing ETFs and the consumer implications of a ban on ETFs will depend greatly on the characteristics of the market in question and the structure and amount of the ETF itself. Indeed, whether the increase in switching costs leads to higher prices can only be appraised with an in-depth competitive analysis of the market in question.

Our Practice

NERA economists employ economic theory and quantitative methods grounded in a thorough understanding of the market facts to provide a full range of theoretical and empirical economic analysis and testimony in matters involving mergers and acquisitions, antitrust litigation, and competition policy. We advise companies and their attorneys, as well as governments and regulators, throughout the world on investigations of alleged monopolization, abuse of dominant position, and market power. We analyze the entire range of economic issues that arise in antitrust cases, including market definition and market power, market structure and entry conditions, pricing, and other conduct affecting competition, profitability, and damages. NERA's expertise includes assessing and, when necessary, testifying to the economic merits of allegations of foreclosure and exclusionary conduct, tying and bundling, refusals to deal, vertical restraints, collusive behavior, essential facilities, and anticompetitive pricing behavior.



How do ETFs Affect the Competitive Process?

The inclusion of ETFs for services provided under fixed-term service contracts potentially enables retailers to *reduce* charges for those customers willing to make such a commitment. Lower prices are possible depending on the strength of the supplier's expectation that the initial and ongoing costs of serving a customer can be recouped from the monthly payments that are received throughout the contractual relationship and the imposition of an ETF should the customer terminate the contract before its end date. Long-term contracts incorporating ETFs can therefore be an effective means by which retailers can *manage the cost of customer churning* and potentially offer *lower retail prices* as compared with shorter term arrangements that do not involve a fixed-term commitment.

An ETF also may simply provide for an additional point in time at which competition takes place. While the imposition of an ETF may raise the cost to consumers who terminate service midway through the course of their contract, there may be greater competition at the point where suppliers compete for new customers or customers whose contract has just expired. This more intense rivalry for new customers is likely to take the form of up-front giveaways and discounts. For example, in Australia, cellular phone providers give away or sell cellular phone handsets at a high discount to obtain new customers. Thus, an analysis that focuses solely on the switching costs faced by consumers who are under contract may provide a misleading view insofar as it overlooks past and future rivalry.

Assessing the Effect of ETFs on Pricing and Costs

To assess the likely price effect of imposing an ETF, it is useful to consider how pricing may be different if firms were not allowed to assess ETFs. One important difference is that there is greater scope for customers to switch to alternative suppliers if ETFs were prohibited. As a result, the expected *net revenue* stream per customer will be lower if the supplier does not change its prices. However, if the service provider is to recover its upfront costs, prices are likely to rise. Because ETFs increase the *certainty* of a supplier's net revenue stream, they may allow it to *reduce* charges for those customers willing to make a minimum service commitment. As noted earlier, the existence of ETFs is likely to engender more intense up-front price competition for new customers.

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Increasing the intensity of up-front price competition is generally beneficial to consumers, although the effect will vary from one industry to another. For some products or services, an ETF may lead to lower prices because purchases of the primary product at issue may lead to future purchases of a follow-on product. This is possible in markets where customers are likely to migrate to higher quality, more profitable retail products over time. For example, a subscription television provider may benefit from offering a very low monthly price for a 12-month analog service contract if it expects that customers are likely to upgrade to digital television service.

In other markets, an ETF may encourage a provider to offer discounts to encourage sales of a complementary product or service. For example, a telephone company may find it profitable to reduce the price of a 12-month broadband contract if

gaining an additional broadband customer increases the probability that the same customer will also purchase additional phone services.

However, in industries characterized by limited prospects for profitable, related product sales and little potential for market growth, this revenue-based effect of ETFs may be less profound. Energy retail services appear to be one such example due to their status as an essential, homogeneous service where the scope for product development or related market sales is low.

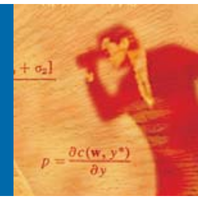
Another important difference is that the service provider's *costs* are likely to be higher in a world without ETFs because of the costs and potential inefficiencies associated with greater customer churn. These inefficiencies include not only the higher operating and capital costs directly associated with the provision of the service, but also the higher legal and other costs associated with enforcing a fixed-term service contract that a customer is unable to break, even for a fee.

The nature and extent of the applicable costs will vary greatly across industries. For some, such as cellular phone service or subscription television retailing, significant up-front inducements are typically provided to stimulate customer sales, thereby raising the cost of acquiring a new customer.

For consumers, higher costs can lead to higher prices. For example, cellular phone service providers often provide a handset at no explicit additional charge if the customer enters a long-term contract with an ETF. Similarly, subscription television retailers may provide and arrange for installation of a set-top unit with all programming packages. Absent ETFs, customers may have to pay an additional fee for a cellular phone handset or for the installation of a set-top unit.

In a world where ETFs are not allowed, firms also may face higher administrative costs. For instance, transferring customers who switch to a rival for service where uninterrupted provision is important—such as energy or cellular phones—may involve significant coordination and transfer costs. In these examples, the role of ETFs in ensuring cost recovery is particularly important because the cost of churning increases with the magnitude of any unavoidable initial or subsequent outlays. Were ETFs prohibited or limited in their application in this context, the consequence may be a material increase in retail prices. However, in industries where such outlays are less significant, this price effect may be minimal.

If service providers are precluded from recovering such one-off costs by imposing an ETF that effectively forces customers who terminate their contract early to pay for their share of the upfront or subsequent transfer costs, then the expected cost of customer churn must be borne by all customers, whether they are loyal or not. In order to set prices that recover their forward looking costs and to account for the diminished certainty in their revenue streams, service providers would need to incorporate



the expected cost of churning in the prices that they charge to all of their customers.[1] Consequently, the effect of an ETF may well be to *lower* retail prices relative to the prices that would be set in a world in which ETFs were banned.

The Broader Implications of ETFs for Consumers

Assessing the implications of ETFs on consumers requires an approach that is no different from any other fact-based inquiry into the dynamics of pricing and competition in the market in question. The challenge is to identify those circumstances where practices that are generally pro-competitive and therefore pro-consumer may artificially raise switching costs without any benefit to consumers. For example, does the ETF penalize consumers by imposing a charge that is not related to the recovery of up front sunk investments and at a level that reflects excessive liquidated damages from early termination? If so, then further inquiry is needed to determine whether the ETF has the effect of actually deterring consumer switching and causing customers to pay higher prices than they otherwise would have paid. On the other hand, do consumers value the upfront investments and services that would not be provided absent ETFs? If so, then ETFs may be nothing more than an important dimension of competition. As discussed below, these and other questions are often useful in assessing whether ETFs have the potential to lower prices, increase consumer choice, or facilitate consumer lock-in.

The Potential for ETFs to Lower Prices

In markets where ETFs are banned or restrained, *all* customers have to bear the costs of "early" contract terminations, whether the customer is switching suppliers or simply stopping service. The process of spreading the costs of customer churning (that previously would have been recovered from ETFs) across all retail customers is likely to have the following effects:

- Customers on fixed-term contracts would probably face *higher* prices overall because they will be required to contribute to the cost of early churning that they themselves would not otherwise have generated.
- Customers on contracts without a fixed term or an ETF may also face *higher* prices because the ability of the service provider to offer a price discount to customers in return for a fixed-term commitment will have been reduced.
- Switching costs would be lower because customers would no longer incur ETFs if they changed vendors.

To summarize, the "smearing" of costs caused by imposing limitations on the ability of firms to levy ETFs is likely to create both winners and losers in the

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short term and higher prices on average. As an example, the US Cellular Telecommunications and Internet Association recently characterized such cost smearing as harming the majority of customers who receive substantial benefits from purchasing service contracts with ETFs "in order to 'protect' a small percentage of subscribers who wish to terminate." [2]

The Potential for ETFs to Increase Consumer Choice

By allowing for ETFs, service providers may offer a greater variety of contractual options to long-term customers to take advantage of the larger, more certain revenue streams associated with serving these customers. Absent such fees, service

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providers may be reticent to offer long-term contracts involving discounted prices for fear of being saddled with unrecoverable costs associated with customers who terminate service early or switch to rival retailers before the end of their contract. Certainly, the extent and magnitude of any up-front inducements to new customers would diminish markedly if service providers were at a significant risk of not being able to recover such costs from customers over the period of the contract.

ETFs therefore potentially give customers greater choice. For example, ETFs may encourage suppliers to offer a wider variety of contract terms and payment options, which may allow customers to choose contracts that best suit their needs and ability to bear risk. Similarly, ETFs may provide retailers with a greater incentive to offer new and innovative products—particularly if the result is the ability to sell their services to new customers.

The Potential for ETFs to Facilitate Customer Lock-In

Notwithstanding the benefits described above, long-term contracts may raise switching costs. Indeed, some commentators have contended that ETFs may serve to *restrict* consumer choice. For example, a recent survey identified ETFs as among the top five factors that prevent customers from switching in various consumer markets in the UK.[3] A similar survey of US-based cellular telephone customers claimed that roughly half of consumers surveyed would consider switching companies if ETFs were eliminated.[4] But do switching costs imply that consumers are worse off?

Not necessarily. First, while much of the rhetoric surrounding customer lock-in focuses on the consumer, the risks of any long-term contractual arrangement are not asymmetric. Although it is true that a customer may enter a long-term contract and subsequently wish to switch, other factors suggest that the customer is enjoying a windfall benefit at the expense of the retailer. For example, an unusually hot summer might drive energy prices up, benefiting retail customers whose prices are set by a long-term contract. In these circumstances, the *service provider* may well prefer to re-contract with the customer at a higher rate, but is prevented from doing so. Thus, an important reason why a customer might enter a long-term contract is to protect against potential future price rises.

Second, those who contend that ETFs restrict consumer choice may well be focusing upon a very narrow point in time in the retailer-customer relationship. ETFs potentially provide

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NERA Economic Consulting is an international firm of economists who understand how markets work. Our 45 years of experience creating strategies, studies, reports, expert testimony, and policy recommendations reflects our specialization in industrial and financial economics. Our global team of more than 500 professionals operates in 21 offices across North and South America, Europe, Asia, and Australia.

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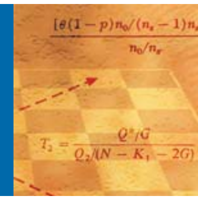

customers multiple options *at the time they select a service provider*. Thus, even if a customer with a long-term contract is not able to switch to a rival service provider for an extended period, there was nonetheless competition *for* that customer. In other words, even if ETFs raised switching costs for customers already under contract, they would tend to heighten competition *for* new customers.

Third, many customers are well informed when they enter into contracts with ETFs and are therefore not likely to be misled, as long as the service provider has properly disclosed the existence and terms of any ETF. Moreover, as noted above, the potential to levy an ETF is likely to give a consumer a greater variety of options and therefore a product that is more likely to meet the customer's needs.

The Implications of Proposals to Ban ETFs

The controversy over the potential for ETFs to raise switching costs and to facilitate customer lock-in has led to a variety of policy proposals, including an outright ban on ETFs. One basis for such a proposal is that simpler and more transparent pricing—even if the result is less consumer choice with respect to the products that are sold in the market—might be preferable from the consumer's perspective. In particular, the argument is that if ETFs were to be banned and the cost of churn spread across all customers over time, then the net prices of competing service providers may be more readily ascertainable and comparable. Put slightly differently, the argument is that *removing* an element of product differentiation may *enhance* competition by improving the transparency of the competitive process.

Advocates of proposals to ban ETFs also suggest that consumers may not be well informed. Indeed, notwithstanding the frequency with which consumers encounter ETFs in consumer markets, recent behavioral studies have suggested that when faced with a decision involving an upfront benefit and future avoidable cost, consumers tend to place too little weight on costs that may arise in the future. For instance, one economic commentator recently concluded that when comparing prices, consumers:[5]

- place too little weight on the importance of disconnection fees, such as ETFs;
- place too little weight on costs that may make it more costly to switch suppliers in the future; and
- do not invest enough time and effort to get the information they need to make informed choices.

On the other hand, there are several reasons to be skeptical of claims that a ban on ETFs would benefit

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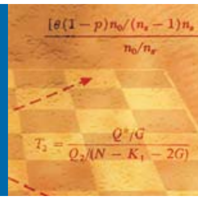
consumers. First, any regulatory intervention to constrain the range of price structures that can be offered by a service provider is unlikely to be in the interests of customers. This is particularly true for products or services with high initial and low ongoing costs, where the ability of the service provider to offer different prices to different consumers (e.g., through the use of ETFs) is desirable for full cost recovery. As noted earlier, ETFs are likely to lead to lower average prices.

Second, a decision to prohibit or constrain early termination payments would reduce the number of dimensions upon which retailers may compete, thereby increasing the potential for implicit price monitoring and coordination. This would be an undesirable outcome in many of the industries in which such fees are common, particularly if the market structure is relatively concentrated.



Third, even if consumers do not spend much time and effort when shopping for a service, they are not necessarily ill-informed or worse off. The amount of time and effort that individual consumers put into evaluating both upfront and potential termination or switching costs, and the extent of any investment made by them in investigating choices generally, is itself the outcome of an optimizing process. It follows that it cannot be said that the amount of time any individual consumer decides to commit to such evaluations is insufficient *per se*. Individuals may simply have better things to do with their time. Indeed, the UK National Consumer Council recently concluded that: "The majority of consumers believe that life is too short to worry about saving a few pounds here and there, while virtually all are keen to avoid unnecessary inconvenience."[6]

Fourth, a ban on ETFs would remove a type of contract from the marketplace, while allowing ETFs would only expand the choices that are available. For example, ETFs give customers an opportunity to cancel an otherwise unbreakable fixed-term contract. Further, allowing ETFs does not prevent service providers from offering more transparent and simpler pricing contracts. In contrast, a ban on ETFs may prevent customers from finding and purchasing the service and price that suits their needs the best.

In assessing whether the imposition of a particular ETF is likely to benefit consumers, it is reasonable to ask the following questions. First, if consumers were free to choose their contract, wouldn't they select an arrangement that best serves their economic interests? Second, do ETFs play a positive role in augmenting a service provider's willingness to improve its quality of service and to offer new and innovative products?

To summarize, banning ETFs would remove one or more dimensions of product differentiation between service providers, thereby limiting consumers' choices and their ability to manage their personal risk profiles. However, even if consumers are neither informed nor capable of effectively undertaking this risk management exercise, allowing ETFs need not be detrimental either to consumers or to competition.

Conclusion

The imposition of ETF clauses in long-term contracts is, in most cases, one element of a normal competitive process. Service providers commonly choose to offer lower prices for such contracts to reflect the associated cost efficiencies and the benefits of a more certain revenue stream. A ban or limitation on offers such as "sign up for a twelve-month plan and receive free installation and a lower monthly fee" that incorporate an ETF will, in most cases, only harm consumers.

This is not to say that ETFs always lead to lower prices. An ETF could raise switching costs in a way that leads to

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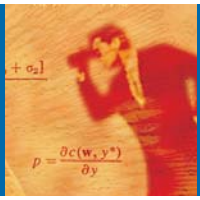

An economic analysis that focuses solely on the diminished ability of consumers to switch to a service provider's rival and break a fixed-term contract may overlook the extent to which there was rivalry for long-term customers in the first place and the degree of potential future competition when the fixed-term contract expires.

higher prices. If so, consumers would be harmed. However, determining the circumstances in which this is a likely outcome requires a careful study of the market in question. One consideration is the amount of the ETF itself and whether it gives the service provider excessive liquidated damages resulting from early termination. The competitive dynamics in the industry comprise a second category of considerations. An economic analysis that focuses solely on the diminished ability of consumers to switch to a service provider's rival and break a fixed-term contract may overlook the extent to which there was rivalry for long-term customers in the first place and the degree of potential future competition when the fixed-term contract expires. For this reason, surveys that indicate that a large proportion of customers would switch if given the option are of little probative value.

These considerations are central to any economic assessment of proposals to ban or restrict ETFs. Indeed, even if an ETF leads to higher switching costs, a ban or prohibition on the use of ETFs would not benefit consumers if the result is higher consumer prices or a reduction in the availability of product options and services. Thus, an economic analysis of a proposal to ban or restrict ETFs must go beyond an assessment of switching costs to include an assessment of the competitive dynamics that determine the ultimate impact of the policy on price and product availability.

NOTES

1 This is similar to a "public" service that is funded through general taxation rather than a user-specific tax.

2 *Reply Comments of the Cellular Telecommunications and Internet Association*, before the Federal Communications Commission, 25 August 2005, WT Docket No. 05-194, p. iv.

3 UK National Consumer Council, *Switched on to switching: a survey of consumer behaviour and attitudes, 2000-2005*, p. 2.

4 The result is based on a survey commissioned by the US Public Interest Research Group (US PIRG). The survey sample only included people who had a fixed-term contract with an ETF provision, and the survey did not examine whether consumers preferred contracts without ETF provisions over contracts with ETF provisions. See US PIRG (2005), *Locked in a Cell: How Cell Phone Early Termination Fees Hurt Consumers*, p. 2.

5 See "The Road to Confusopoly," a presentation by Professor Joshua Gans, Melbourne Business School, to the Australian Competition and Consumer Commission Regulatory Conference, July 2005.

6 UK National Consumer Council, *Switched on to switching: a survey of consumer behaviour and attitudes, 2000-2005*, p. 8.

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