University of East Anglia

CENTRE FOR COMPETITION POLICY

Applicability of the literature on price guarantees to the PAC and MAC processes

Morten Hviid

ESRC Centre for Competition Policy and UEA Law School

July 2010

In two areas covered by Ofcom, a consumer may have to contact its current provider in order to switch to a rival provider. The necessity to contact the current provider is shared with the seemingly unrelated marketing strategy of providing price guarantees. To request a match or a refund, a customer must talk to the provider it either would like to or have already purchased from. This raises the question of the extent to which specific procedures governing the switching process has similar effects to price guarantees. The literature on low price guarantees is reviewed in a separate document and will in the following be referred to as the LPG survey. The question we seek to address in this note is: what can we learn about the likely effects of the switching procedure on consumers?

The two areas are: Broadband, where consumers may have to request a MAC code from their current provider in order to switch, and Mobile phones, where consumers who want to port their numbers have to request a PAC code from their current provider in order to switch providers. The MAC process is not the only process for switching broadband services. Broadband consumers may also switch using a Notification of Transfer (NoT) process (this is essentially a gaining provider-led process i.e. the consumer needs only contact the new/gaining provider who takes care of transferring the service and not code or contact with the losing provider is required) or they can switch using a "Cease and Reprovide (C&R)" process (i.e. where consumers stop their existing service and contract a new service and have to coordinate the end of the existing service and the beginning of the new one themselves).[1] Importantly, whether a consumer goes through either of these processes is not their choice and depends on the underlying infrastructure used by their existing and new providers to supply their broadband services. Similarly, consumers switching their mobile telephony services without porting their number use a C&R process.[2] In this analysis

[1] In 2009, 16% of consumers who switched broadband services went through a MAC process, 50% went through an NoT process, and the remaining switchers went through a C&R process.

[2] In 2009, 62% of consumers who switched mobile telephony services went through a PAC process and 38% went through a C&R process.

however, we are only interested in the impact on competition of MAC and PAC. More details are provided below.

> The Migration Authorisation Code (MAC) process for switching broadband: In order to switch, the consumer necessarily needs to obtain a code (the MAC) from their old supplier, which they need to hand to the new supplier who then takes care of the arrangements to transfer the consumer's broadband service. Without that code, the consumer cannot switch to the new supplier.
>
> Porting Authorisation Code (PAC) process for switching mobile telephony: In order to switch, say from Orange to Vodafone while keeping their existing number, the consumer necessarily needs to obtain a code (the PAC) from Orange, which they need to hand to Vodafone for the telephone number to be transferred. Without that code, the consumer cannot switch to Vodafone while keeping her existing number.

MAC and PAC are referred to as "switching rules" in the following discussion.

The key feature for our purposes is that in both cases the consumer has to talk to the current provider before switching. Thus the current provider gets an opportunity to engage the consumer in a conversation. As part of this conversation it is evidently possible for the current provider to make a counter-offer to retain the consumer. It is worth noting the following two points:

- The consumer is under no obligation to reveal what offer has been made to them by the rival provider they are planning to switch to.
- The provider cannot refuse to supply the requested information about the code.

If consumers are insistent and refuse to engage in any conversation with the current supplier, the switch will happen and the only advantage the current supplier obtains from the switching rules is that that they can increase switching costs by getting a reputation for dragging their feet over handing over the code.[3] Such a reputation may harm them when they attempt to attract new customers. To assess the extend to which the following effects matter, it is be important to understand what determines the willingness of consumers to reveal information about their new offer and in particular what limits current rules and legislation puts on the extent of the pressure that can be exerted by the current provider on the consumer to divulge the information.

Unless otherwise specified, we will base the discussion that follows on two core assumptions:

- Consumers do inform the current provider about the new deal they wish to switch to.
- Consumers' switching decisions are based purely on a financial motive.

While the first assumption is essential to the discussion, the second is not, so long as the consumer is to some extent driven by the desire to save money or get a better deal.

[3] The effect of switching costs on switching behaviour is not the topic of this note.

From the outset we should be clear that the switching rules do not amount to a price guarantee in the classic sense because there is not promise by the current firm to match any new offer. It may act as if there was a price guarantee because the firm could chose to make such an offer at the point where the consumer has not yet completed the switch. Because we are in both cases considering a contract-based ongoing supply of a service, the closest form of guarantee which matches the effects of the switching rules is the meet-or-release clause discussed in Sections 2.8 and 4.1 of the LPG Survey.

The theoretically possible effects of the clause were discussed in Section 2 of the LPG Survey. Below we consider each of the effects of the switching rules in turn:

Effects on the incentives to compete:

> The switching rules do reduce the incentive of rivals to offer better deals. This is caused not only by the ability of the current supplier to match each offer - that on its own should be enough if the motive to switch is purely financial since at the point of the matching offer, there are still future switching costs which need to be incurred - but also by the possibility of a selective response. The current supplier will have access to the full usage history of the consumer and hence is able to assess the benefits of offering to match rather than simply to release. The implication of this, as noted in Section 2.8 of the LPG Survey, is that the firm offering the new deal gets an adverse selection of the consumers. This assumes that all firms assess consumers in much the same way, which appears a reasonable assumption. The effect is akin to the winner’s curse in a common value auction.
>
> Note also that if consumers are rational and know their value to the current provider, those of higher value also know that their switching costs will be higher because the current provider will fight to keep them. It may then be that the extra time spent on the phone may deter such consumers from even trying to switch, in which case the pool of people willing to switch will suffer even more from adverse selection, consisting mainly on consumers less valuable to a firm.

Effects on the ability to collude:

> The switching rule would also support any agreement not to compete, tacit or otherwise as descried in Section 2.2 of the LPG Survey. Having consumers informing it about the offers being made by rivals is a very handy way for firms in a sector with relatively few suppliers to keep an eye on what the rivals are doing.

Effects on entry decisions:

> Entry deterrence could be a serious issue in particularly due to the adverse selection effect identified above. While an existing supplier might be able to cope with new consumers being relatively more costly to supply through using their current consumers to cross subsidise new consumers, an entrant clearly could not.

Effects on the ability to price-discriminate:

> Price discrimination is clearly a possibility. Note that the usual way to undermine the price discrimination story in section 2.4 of the LPG Survey is

to show that not enough people use the price guarantee for the story to be credible. This does not work here. The consumer cannot switch without activating the matching offer. With that information the current supplier is able to decide how much it has to do to retain the consumer and that will likely imply different prices to different consumers.

There is little doubt that the switching rule would lead to price discrimination. The issue is more whether this is welfare enhancing or decreasing. Price discrimination can expand *total* welfare if it expands sales or if it result in increased sales for a more efficient firm. To expand *consumer* welfare it would have to do much more than that. A more precise assessment would involve separately estimating the elasticity of consumers who never switch supplier and those who do.

Effects on the ability to signal low prices:

Signalling is not an issue here. It can be assumed that current providers do not advertise the fact that they will use their final chance at keeping customers before releasing a MAC/PAC code to match a lower price. If the firms wanted to do this, they could simply offer their consumers a meet-or-release type guarantee.[4]

Effects on consumer search behaviour:

Incentives to search might be affected by the knowledge that (i) a way to get a better deal is to ask for the code, and (ii) the knowledge of a valuable consumer that as a result of the desire to retain them, their switching costs would be higher. The net effect is hard to assess.

Assessment

The literature on price guarantees can help us gain an insight into the likely effects on consumers from the PAC and MAC switching rules. This literature provides little to no support for the switching procedure for Broadband and Mobile phones.

The LPG Survey found that the most likely positive effect on consumers from price guarantees arise from their potential for providing a credible signal of low prices, thereby helping consumers make better choices. This effect is not relevant for the switching rules. The second avenue for a positive effect arises from the potential for price guarantees to enable price discrimination. The switching rules certainly have the same potential but Ofcom would then be left having to assess the effect of price discrimination on consumers and possibly on different consumer groups.

While the positive effects on consumers from the switching rules appear speculative and hard to measure, the negative effects are much more obvious. Of these, the biggest concern would relate to the intensity of competition. One would expect existing rivals and potential entrants to be concerned about the number and characteristics of the switchers which could be attracted solely through lower prices.

[4] Although a dominant firm might be concerned that such a guarantee would be incompatible with Article 102 TFEU or similar UK provision.

Caveats

For the effects to be significant, it must be the case that consumers do reveal the nature of their new offer and that they are willing to listen to counter offers. If, for example, most people switch because they are concerned about the quality of their current provider, the adverse impacts identified above are likely to be small.

The assessment of what we can learn from the literature covered in the LPG Survey does not take into consideration any efficiency effects that may arise from MAC/PAC and which would be lost if the system was to change. A final assessment depends on any efficiency effects from the current switching procedure over alternatives, that is, what the counterfactual is.