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Automatically renewable contracts hamper switching to competitors

On behalf of Ofcom, E.CA and Gregory Crawford empirically analysed the impact of BT's automatically renewable contracts on customer switching behaviour between telecom providers. Accounting for a variety of confounding factors, including tenure, bundling, price discounts and self-selection into contracts, it was found that households on automatically renewable contracts switch 35% less often than comparable households on standard contracts. In light of these findings Ofcom decided to prohibit these contracts in the fixed-line voice and broadband sectors for residential and small-business customers.

In early 2008, the UK's incumbent communications provider BT introduced automatically renewable contracts for residential customers of fixed-line voice services. Under such contracts, a minimum contract period – typically lasting 12 months – is renewed automatically and early termination charges apply if customers leave before the minimum period ends. In exchange for this diminished flexibility, customers receive a price discount.

As the number of customers on automatically renewable contracts grew, the UK's communications regulator Ofcom became concerned that these contracts could increase switching costs and thus harm customers directly. Furthermore, the increased switching costs could reduce the incentive of market entry and result in increased prices overall. In late 2009 Ofcom asked Professor Gregory S. Crawford of the University of Warwick and E.CA to empirically analyse the effect of automatically renewable contracts on BT's customers' likelihood to switch to competitors.[1]

Data

A random sample of 180,000 customers was drawn from the population of BT's customers. Data were collected on the individual histories of contract choices from the beginning of 2009 up to March 2010. In addition, information was gathered on each customer's account start and end date, her postcode as well as subscriptions to additional, non-voice services (broadband and TV). We augmented the resulting monthly panel dataset to include the prices of BT's main rivals (TalkTalk and Virgin)[2] and with local economic conditions measured by the unemployment rate.

Econometric analysis

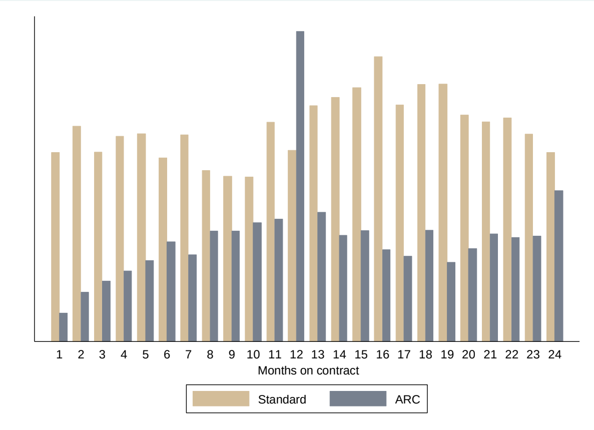
Plotting the rates of switching for customers on standard contracts versus customers on renewable contracts over time – as shown in the graph below – provides a first glimpse into the different switching patterns: within the minimum contract period switching rates for customers on renewable contracts are significantly lower than for customers on standard contracts and switching rates spike

[1] All consultation and statement documents, including the final report of E.CA in collaboration with Gregory S. Crawford, are available on Ofcom's website at http://stakeholders.ofcom.org.uk/consultations/arcs/.

[2] From the marketing research firm PurePricing.

when the minimum period ends and no early termination charges apply.

Switching rates over time for customers on standard and renewable contracts



Source: Own calculations based on data provided by BT.

Taking this graph as the point of departure, the econometric analysis attempts to control for several factors that may confound the relationship between switching and contract type, in particular:

- Customers on renewable contracts may have joined BT more recently. To the extent that an increased length of time with a provider reduces the likelihood of switching, ignoring tenure may understate the reduction in switching due to renewable contracts.
- Automatically renewable contracts typically offer price discounts. Not taking those into account may overstate the reduction in switching.
- Furthermore, customers who also subscribe to BT's other non-voice services may be less likely to switch. Ignoring bundling effects may therefore also bias the effect of renewable contracts on switching.

However, what is more challenging to control for is self-selection: customers who intend to remain with the provider for a longer time period may be more likely than other customers to choose automatically renewable contracts. In order to control for self-selection, the decision to switch provider is modelled conditional on the choice of contract.[3] The results show that automatically renewable contracts still significantly reduce switching: after the initial minimum contract period, customers on renewable contracts are about 35% less likely to switch than comparable customers on standard contracts.[4]

Regulatory consequences

Citing our report as the *"core piece of evidence"* on the likely negative impact that automatically renewable contracts have on consumers and competition, Ofcom launched a consultation in March 2011 proposing to prohibit automatically renewable contracts in the fixed-line voice and broadband sectors for residential and small-business customers and to require instead the explicit consent of customers for the renewal after an initial commitment period. A decision confirming this proposal was taken by Ofcom later that year.[5]

[3] For modelling purposes, a recursive bivariate probit model was specified. See Maddala, G. S., 1983. *Limited-dependent and qualitative variables in econometrics*, Cambridge, UK: Cambridge University Press.

[4] This significant reduction is due in part to the persistence of early termination charges beyond the initial minimum period and in part to the intrinsic "opt-out" nature of renewable contracts, the latter alone contributing to a 26% reduction.

[5] The prohibition took effect from the end of 2011 for new contracts and from the end of 2012 for existing contracts.