Ofcom: Automatic Compensation – call for inputs

Consultation response from the

Centre for Competition Policy

University of East Anglia, Norwich Research Park, Norwich NR4 7TJ

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Author:

- Prof Morten Hviid

This consultation response has been drafted by the named academic member of the Centre, who retains responsibility for its content.

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Consultation Response

The desire to offer customers compensation when they, through no fault of their own, have suffered a loss is understandable. This is especially the case where it appears that the firms could have taken steps to avoid the loss occurring in the first place.[1] Such compensation can also provide firms with incentives to do better, possibly even removing the need for regulatory interventions; hence, it is worthwhile considering where and when automatic compensation is an appropriate remedy. However, designing a workable scheme which does not lead to unintended consequences and which does not require costly monitoring, is challenging. Indeed it is not clear from the consultation document who will be charged with monitoring or auditing that the automatic compensation takes place and how much flexibility firms will have in how the schemes will be designed.

Specific comments on the document:

From the document it is difficult to assess which assumptions are being made about consumer behaviour and indeed the behaviour of smaller businesses. Are those who are concerned about many of the aspects of quality also sophisticated consumers? It may be reasonable to assume so.

Paragraph 2.2: "It is important that any compensation regime reflects what matters to consumers." While it is hard to disagree with this statement, it is less clear who should be tasked with discovering this, and by what methods. Some might argue that firms are in a better place to do so than a regulator, especially if the firms are sufficiently incentivised and are allowed to use the necessary instruments. One way for firms to discover what consumers really value is to offer them a number of choices which combine price with promised levels of compensation if various targets [to be specified in the contract] are not met.

Paragraph 2.4 "not receiving the service they expected". The wording is problematic since "expected" is vague. For this approach to make sense it must be feasible to write down clearly ex-ante in which situations compensation is triggered, and the appropriate level of compensation – an argument you seem to make in paragraph 2.8. If this is not possible, the two parties may disagree simply because they had different hopes about what might happen following a purchase. The merit of including residential consumers may depend on whether the quality element under scrutiny varies by household or by some well-defined group of consumers [presumably by area]. In the latter case, the choice of quality measures and the appropriate amount of compensation may vary across groups and the regulator would need to take a view as to whose preferences are reflected in the compensation scheme.

Paragraph 2.6 and elsewhere. Why should firms not be allowed to offer consumers and SMEs a menu of contracts with different prices and different compensations for different breaches, especially to deal with optimal risk allocation? We allow this in insurance where in some cases there is a default level of excess which in return for a change in the price of the insurance can be increased or reduced. For some customers, instant and effective number portability may be very important and they may be willing to pay a bit more to receive a significant compensation should problems actually emerge. Having default compensation which is relatively modest would enable the supplier to identify those customers for whom the harm from an error in number portability is particularly high and take necessary precautions to avoid paying the higher level of compensation.

Paragraph 2.10; Can this be dealt with within one set of rules? Imagine that the contract has a termination fee of £100. Then the remedy could simply be to offer a compensation of £100 so that the consumer could buy their way out of their current contract without being worse off.

[1] For example, for more than a decade we have seen a strong push for customers to have the right to seek compensation for losses arising from competition law infringements.

Paragraph 2.14: It may affect how they collect and store information. Do you foresee any dangers in this?

Paragraph 2.15: "technical or cost driven limitations in service monitoring." Who determines this and based on what evidence?

Paragraphs 3.4-3.7: Issues relating to the start of a contact. The issues identified appear to be a mixture of what might potentially be mis-selling and what may be poor implementation of a new contract or a switch. Some of these issues may be better dealt with directly by the regulator by issuing fines; in particular, regulator fines seem appropriate where one needs the weight of a lot of cases before there is good reason to be concerned. Some of the examples supplied in the consultation document appear to be cases where only the consumer is likely to be aware of the breach – in such cases, it is difficult to make the compensation truly automatic and it may end up looking more like an opt-in with consequently significantly lower expected take-up. In some of these cases it may also be difficult to demonstrate to a third party that a breach occurred, in which case the firm may simply refuse to pay the compensation. If so, what is the role of the regulator?

Responses to the specific consultation questions

Question 1: What are your views on our initial thinking regarding the factors potentially relevant in determining:

(a) scope, including possible eligibility;

There are no a priory reasons to exclude consumers from automatic compensation. The challenge when it comes to scope is to define what constitute a breach of a promise by a supplier to a customer and to ensure that the breach cannot be triggered by actions taken by the customer [or for that matter a firm's supplier or a rival].

(b) form and process of compensation;

Ofcom needs to decide whether the compensation rule is a default rule which the two parties can agree to vary or if it is an immutable rule. The latter would require Ofcom to fully understand what it is that all customers want and, where there is variation in this, to carry out the trade-off of one set of customer desires against another set. There are some benefits from choosing the default carefully because it can allow those with a direct financial interest in the transaction scope to experiment and innovate.[2]

(c) level of and basis for compensation; and

What are the principles? See response to question 2 below.

(d) possible costs and risks of introducing automatic compensation?

Depending on the design of the compensation scheme, there may be a risk of under- or over-compensation and of distortions of the investment decisions of suppliers. I struggle to make sense of paragraph 2.20 about the possible risk to competition. Some of this may depend on whether the level and format of compensation is a default or an immutable rule. If one firm is better at ensuring consumers receive an appropriate service and hence faces a reduced risk of paying compensation, that the compensation scheme leads to the exit of one or more inferior rivals is a demonstration of effective competition and that the market has worked. That is surely what is desired.[3] If you are suggesting that it may be appropriate to protect firms who face such a significant risk of paying

[2] For a discussion of the importance of default rule, see Morten Hviid, 1996, Default Rules and Equilibrium Selection of Contract Terms, International Journal of Law and Economics 16, 233-245, and papers cited therein.

[3] At least if we are looking for a market based solution to a perceived lack of quality in the offerings of the suppliers.

compensation that it jeopardies their financial viability, then you should consider identifying which consumers should be saddled with the apparently low-quality providers [without full compensation], if for no other reason than to assess any distributional impact.

There is another possible interpretation of paragraph 2.20, that Ofcom wants to allow for different levels of quality co-existing in the market and that if we design automatic compensation inappropriately we may drive the "low [but adequate] quality - low cost" option out of the market. This can be avoided by careful design especially of what triggers the compensation. A system which mandates large automatic compensation if a firm does not match its own claim about its broadband speed should not be a problem; such a system would not force a low speed firm out of business [so long as there is a demand for a correctly identified lower speed product], but it would make it [too] costly for firms to make exaggerated claims about their speed and would enable firms to make credible statements and consumers to feel confident about claims.

Question 2: Are there any additional considerations?

There is a more general issue about the principles of automatic compensation. The key concerns with automatic compensation are:

1. The extent to which the firm can control its environment and, hence, whether errors occur for which compensation should be due.
2. The extent to which the error can be "manufactured" by the user, rival firms or other interested third parties.
3. The administrative cost of providing automatic compensation.
4. If we are concerned about potentially very large liabilities for particular firms, we might consider whether it is appropriate to use opt-in behavioural biases to curb the amount of compensation requested rather than reducing the size of the refund [if we think that the consumer should bear some of the risk, see next issue].[4]
5. Whether it leads to firms being overly cautious because the financial penalty for getting it wrong has increased significantly. This concern might apply more strongly in markets where there is a lot of innovation

Principles behind automatic compensation could be stated in terms of a series of questions which should be asked:

1. Who can affect the probability of a breach?
    a. Exogenous – then it is a matter of risk allocation. Who is best able to cope with the risk? It would not always be the firm since breaches may be correlated – i.e. everyone on the train is delayed by the same amount of time.
    b. Only the seller – depends on the cost of providing the seller with incentives to take optimal care
        i. Is optimal care the same as "no breach"? "no breach" may only be optimal if the cost of ensuring no breach is small or the consequence of a breach is severe. If so, then full and automatic compensation is appropriate.
    c. Both seller and buyer – case of double moral hazard as neither will take enough care unless appropriate incentives are provided. [point made in document, see paragraph 2.11]
2. Who has the necessary information to determine that a breach has occurred? [I interpret paragraph 2.15 to be about this.]
    a. If seller, then stronger case for automatic compensation
    b. If only buyer, then refund must be based on a request.

[4] The current policy of refunding half the value of a return ticket if a train is delayed by more than a certain number of hours may be seen as excessive if automatically claimed by all the passengers on a busy commuter train, but appropriate when only a certain proportion of consumers claim. If one moved to automatic compensation, it maybe appropriate to reduce the level of compensation.

3. Could the seller ensure that it has the appropriate information?
    a. At what cost
    b. With what potential associated privacy issues?

Note that there is a strong analogy between the opt-in – opt-out debate in compensation, see the private enforcement debate in the UK and the EU.[5] Basically automatic compensation is akin to an opt-out [it gives rise to far greater compensation paid] because the wronged party does not have to do anything. This is particularly the case where the stated compensation is a default rule which the parties can contract around. Note that it is important that the firm cannot undermine the default by simply refusing to supply unless the consumer accepts something worse. Thus the offer with the default level of potential compensation must be genuine. Compensation which the consumer has to request corresponds to an opt-in because the wronged party has to take an action. Extensive experimental research on the choice between these two formats indicate that the number of claims arising from opt-out is far greater than opt-in, possibly by an order of magnitude. In effect you need to provide the default rules but not get in the way of parties contracting around this default. Note that as consumers are not naturally inclined to opt-out, the pressure is very much on the firm to offer a good deal to those it would like to opt out.

Question 3: Do you agree with our initial views on the service quality issues that could matter most to consumers?

There may be a difference between what consumers say they care about, what they complain about and what they actually care enough about to influence their choice of provider. What methods is Ofcom planning to use to elicit information about that and in particular the appropriate level of (default) compensation? Are you sure that consumers actually want compensation rather than some form of naming and shaming or acknowledgement of "guilt"?

One might argue that if consumers were really concerned about delay in implementing a contract or other easily measured quality levels, competition among providers might drive firms to offer credible assurances of high quality in the form of compensation should the supplier fall short of these standards. In other words, what methods do the suppliers currently use to make their promise of high quality credible? Are there other means, e.g. loss of reputation due to consumers using social media to name and shame, to ensure that firms keep their promises? Is competition in a particular sector likely to be too weak to discipline firms who are not delivering?

Question 4: Do you agree that some of the above issues may be more suitable for automatic compensation than others?

In general, see answer to question 2 above.

One key concern is that the event which triggers compensation has to be verifiable to a third party, for example Ofcom, to enable an audit to establish that compensation is actually being paid.

Another is that the chosen scheme may inadvertently become a minimum quality requirement at a level which may not be overall desirable.

Question 5: Do you agree that we should consider the need for exceptions and dispute resolution?

You should obviously consider the need for exceptions in the design.

The role for ADR in what is supposed to be a hassle free [for the customer] process giving them automatic compensation is difficult to identify. Indeed combining automatic compensation with ADR seems illogical.

[5] e.g. blog post by Sebastian Peyer: https://competitionpolicy.wordpress.com/2015/05/05/collective-actions-after-the-consumer-rights-act-2015/

Question 6: Do you think Ofcom should consider the relationship between retailers and suppliers and if so, how?

Yes, for a number of reasons: Disagreements between these two vertical levels may offer a space for ADR. More importantly automatic compensation schemes may enable an upstream wholesaler[6] to hold-up a downstream retailer. Where the upstream firms are also a retailer, it may distort the downstream competition or threaten to do so.

Also, it is important to recognise that introducing an automatic compensation regime will have implications for current vertical contracts between retailers and suppliers, and that they may enable hold-up once the retailer is facing a significant penalty for non-delivery. It may be necessary to design some sort of transition phase.

[6] Or indeed any supplier or labour union.