Agenda

Advancing economics in business

Harmonising consumer protection in the EU: is it desirable?

In September 2013, the European Commission issued a proposal to promote a single digital market across Europe, including harmonising consumer protection. But is this desirable at the EU level, and is it suitable for all member states—and should the proposal be assessed at a national level? Given the increasing focus of policymakers and regulators on consumer welfare, the issues raised in this article are potentially also relevant to ongoing regulatory reform initiatives in the energy sector

The Commission's proposal aims to create a single market for electronic communications services (such as Internet access, and fixed and mobile telephony) in Europe. One of the key elements of this proposal is harmonising consumer protection in terms of transparency, quality of service and contractual conditions, as detailed in the following box. Similar market integration policies are actively being pursued by the Commission in sectors such as energy.[1]

The European Commission's main consumer protection proposals

Transparency: operators would be required to publish more detailed information on the terms and conditions under which services are provided, including prices and quality.

Contract termination: the conditions under which consumers can terminate contracts without having to pay penalties would be regulated (e.g. the minimum duration of the contract would not be allowed to extend beyond 24 months, and providers would not be allowed to automatically renew the contract when it reaches the minimum duration).

Expenditure control: operators would be required to provide ways for consumers to control their expenditure and avoid bill shocks.

Net neutrality: while operators would be allowed to provide 'enhanced quality' services over the Internet, they would not be allowed to impair the general quality of access to other Internet content when providing these services.

Switching: the proposal seeks to harmonise various elements of the switching process. This includes a requirement that the process is led by the receiving provider and that the timing allows for loss of service.

Source: Oxera, based on European Commission (2013), 'Proposal for a Regulation of the European Parliament and of the Council laying down measures concerning the European single market for electronic communications and to achieve a Connected Continent, and amending Directives 2002/20/EC, 2002/21/EC and 2002/22/EC and Regulations (EC) No 1211/2009 and (EU) No 531/2012', COM(2013) 627 final, 11 September.

The proposal follows from initiatives and interventions in the area of consumer protection by national regulatory authorities (NRAs) in the previous four years. As suggested by the strategic plans of various NRAs, the trend towards greater consumer protection is expected to continue in the near future. For example, the Annual Plan of Ofcom (the UK communications regulator) for 2014/15 includes promotion of consumer protection as one of its core strategies;[2] and BEREC (the Body of European Regulators for Electronic Communications) expects consumer protection to be one of the main drivers of regulation in Europe in the coming years.[3]

Two main factors underpin NRAs' growing interest in consumer protection.

Following the implementation of the core wholesale access remedies foreseen in the European electronic communications regulatory frameworks of 2002 and 2007,[4] regulators are now shifting their focus towards market outcomes (such as consumer response to increased choice).

A growing literature on behavioural economics is providing regulators with stronger theoretical grounds for intervention (for example, operators could use consumer biases such as inertia and myopia[5] to obtain higher profits).

Against this background, the Commission's package seeks to harmonise consumer protection initiatives across the EU. Specifically, it considers that the existence of a range of rules could be costly for consumers and operators engaging in cross-border activities and could therefore lead to a more fragmented market.[6] This view is not shared by operators and NRAs, however, which have criticised the proposal for being complex and prescriptive, leaving little room for regulators to apply more targeted interventions where necessary.[7]

In this article we explore how different proposed remedies may carry risks or have unintended consequences, and the extent to which these risks could be more problematic in particular member states based on their specific market conditions.

The costs and benefits of consumer protection

The behavioural economics literature provides a rationale for government intervention in the presence of consumer biases.[8] For example, consumers may procrastinate or find it difficult to compare complex price structures and products, and decide to stay with their current service provider even though switching would make them better off. Providers could exploit these consumers, by charging higher prices, for example, or providing consumers with lower-quality services. In such cases, regulators might consider intervening in the market to ensure that consumers are not harmed. The nature of this intervention could vary widely, from less stringent remedies such as mandating greater transparency, to more stringent ones such as imposing minimum quality standards or regulating contractual conditions (e.g. in relation to the duration of contracts).

However, regulatory experience in various sectors shows that these types of remedies are rarely costless; what may, in principle, seem like benign, consumer-friendly and procompetitive interventions can potentially have significant unintended consequences. Examples include:

- costs on other consumers—for example, a requirement to provide detailed advice to consumers before a product is purchased is likely to increase the overall cost of the product, and could therefore negatively affect consumers who do not value the detailed advice. This concern was considered by the UK Financial Services Authority when it decided to allow consumers to opt out of mortgage advice;[9]

- reduced choice and supply—this includes where products are withdrawn from the market as a result of minimum quality standards or product standardisation. For example, the proposal by the Belgium telecoms regulator (BIPT) to require broadband services to be delivered with minimum speeds may lead providers to withdraw offers that currently do not meet such quality standards (but which may still be attractive for some consumers);[10]

- moral hazard—this occurs where regulations may distort consumer behaviour to the detriment of the consumer/ overall service provision.[11] This was one of the concerns that led the UK Department for Business, Innovation & Skills to reconsider its proposal to increase (by a significant amount) minimum payment requirements on credit cards. In doing so, the Department envisaged that the proportion of consumers repaying their full outstanding balance would fall;[12]

- reduced competition—for example, by increasing price transparency, suppliers may find it easier to collude as prices would become observable. In the early 1990s, for example, the Danish Competition Authority began publishing pricing data for concrete to encourage consumer switching. Empirical analysis of the subsequent price increases indicated that the price transparency actually facilitated tacit collusion.[13]

Several of the above risks are highlighted by recent developments in the energy sector in Britain, where the sector regulator, Ofgem, has implemented a number of wide-ranging reforms, which, it has been argued, have had the effect of reducing competition.[14]

These potential costs need to be balanced against the expected benefits of the remedy considered (as illustrated in Figure 1).

Figure 1 A balancing act: assessing consumer protection remedies

Benefits

- avoiding harm to consumers via:
  - higher pricing
  - lower quality levels
  - bill shocks
- enabling consumers to make better decisions (i.e. optimise their consumption)

Costs

- regulatory costs incurred by government (e.g. monitoring)
- risks of (unintended consequences):
  - imposing costs on other consumers
  - reducing choice
  - distorting behaviour
  - lessening competition

Source: Oxera.

The Commission's proposed reforms are analysed below, exploring the balance between benefits and costs, as well as whether this balance depends on market conditions and the extent to which it may be unique to each national market. We focus on the specific reforms associated with increasing transparency, facilitating switching, and enabling consumers to avoid bill shocks.[15]

Bringing more transparency

The Commission's package outlines the minimum set of information in relation to prices, quality and terms and conditions that operators are obliged to make available to consumers (except when services are negotiated on an individual basis).[16] For example, for Internet services, operators are required to provide information on quality parameters such as data limitations and actual download/upload speeds, and the procedures that operators have put in place to manage and shape traffic. Consumers are allowed to decide whether to receive this information on an individual basis before the contract becomes binding.

Economic theory suggests that increased transparency can enhance competition, and incentivise firms to improve their products and services, as better-informed consumers are more capable of making purchases that suit them. In practice, however, more transparency can have unintended consequences. As mentioned above, disclosing information could enable firms to collude more easily by providing them with the means to identify deviations from the agreement. Also, consumers may focus unduly on the publicised information to the detriment of non-publicised information (e.g. prices against quality factors).[17]

Arguably, the incremental risk of these unintended consequences in the case of the Commission's reforms to transparency is likely to be low. First, providers already publish pricing and quality information regarding their services, and thus the risk of collusion should not significantly increase as a result of the proposed provisions. Second, the reforms seem to place equal weight on different product features (e.g. prices, Internet speeds, and contractual conditions), thus reducing any risk of consumers unduly focusing on only one of these when choosing their provider.

Furthermore, the proposed transparency obligations could arguably be implemented by operators at a low cost, as they require operators to make information available without having to provide detailed advice to consumers. These provisions may therefore generate more benefits than costs in all jurisdictions.

Facilitating consumer switching

One of the core objectives of the Commission's proposal is to make it easier for consumers to switch providers. To achieve this, the Commission proposes to provide consumers with more flexibility to terminate contracts and to remove obstacles during the switching process.

The Commission's reforms to contract termination include:

- contract duration not exceeding 24 months;
- consumers being able to terminate (without having to pay a penalty) contracts that are tacitly or automatically renewed after reaching their minimum duration.[18] In practice, this provision implies that operators cannot offer these contracts.

The package also includes provisions to harmonise switching processes across the EU. Among these are:

- the switching process to be managed by the receiving provider, as opposed to the 'losing' provider;
- any loss of service during the porting process not exceeding one working day;
- the contract with the losing provider being terminated automatically after completion of the switch.

The Commission expects these provisions to allow consumers to switch providers more easily.[19] For example, shorter-term contracts would mean that consumers would not have to wait so long to switch providers without having to pay penalties. Similarly, consumers in contracts that can no longer be renewed automatically would be able to leave the contract at a lower cost after the initial term has been met. The greater flexibility of these conditions could therefore lead to a higher level of business 'stealing' and more intense competition between providers.

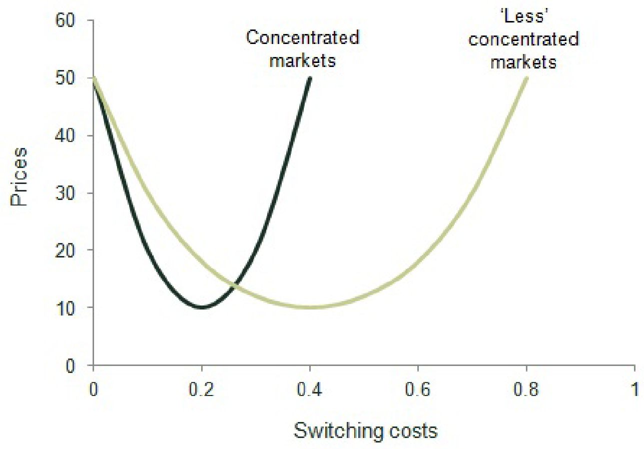
However, in some cases, higher switching costs may have procompetitive effects in that they may lengthen the expected customer lifetime (by lowering customer churn), thus making the acquisition of new customers more profitable for firms. This, in turn, could lead companies to invest and compete harder in attracting new customers.

These opposing effects on competition reflect two conflicting incentives that firms face: to increase prices and thereby 'extract' rents (i.e. generate profits) from existing customers, or to 'invest' by reducing prices and attracting new customers. The effect of switching costs on competition and prices (or other customer outcomes) will therefore depends on the relative strengths of these two effects.

A growing body of literature on this topic suggests that the balance between these two effects will depend on the characteristics of the market.[20] Studies have found that the relationship between switching costs and prices can be U-shaped, as illustrated in Figure 2. This means that when switching costs are sufficiently low, an increase in switching costs would lead to lower prices—i.e. the 'investment' effect dominates the 'extraction' effect. Conversely, at higher levels of switching costs, the extraction effect dominates and an increase in such costs would lead to higher prices.

Importantly, these studies find that the precise shape of the U depends on the market structure. In less concentrated markets, the U is broader (as shown in Figure 2)—i.e. the investment effect dominates for higher levels of switching costs, and is more likely to lead to lower prices than in more concentrated markets.

Figure 2 Stylised relationship between switching costs and prices



Source: Oxera.

The above suggests that the balance between the costs and benefits of the proposed remedies may differ by country if market conditions vary across the EU. For example, while entrants in the broadband sector enjoy market shares above 70% in Bulgaria, Poland and Romania, they hold between 30% and 40% of the market in Luxembourg, Cyprus and Denmark.[21] The mobile telecoms market is even more heterogeneous, as the number of providers (including resellers and mobile virtual operators) ranges from three in Greece, Cyprus and Bulgaria to more than 30 in the Netherlands, France and UK.[22]

Avoiding bill shocks

To prevent consumers suffering bill shocks, the Commission's proposal requires operators to:[23]

allow consumers to set caps on their monthly expenditure. Furthermore, operators are required to notify consumers (free of charge) before the cap is reached and, if it is reached, could block services until agreed otherwise;

provide consumers, immediately prior to connecting a call, with access to information about the applicable tariffs on numbers subject to particular pricing conditions.

While these proposed remedies could help to reduce customer bills and the incidence of bill shocks, they could also result in higher costs being imposed on other consumers. For example, if the costs of running the free-of-charge mechanism were sufficiently high, consumers who can control their own expenditure could end up paying higher prices (than otherwise), as providers would have to recover the costs of the mechanism from all consumers.

Similar costs could arise with respect to the second remedy, as end-users who are well aware of the applicable tariffs may nonetheless have to go through the information disclosure process before their call is connected. That is, by protecting vulnerable consumers, more informed consumers could be made worse off. The benefits to the first set of consumers would therefore need to be balanced against the costs to the second set.

The risk of these unintended consequences is likely to depend on how consumers respond to the remedy, as well as on the size of the consumer group that the remedy is aiming to protect. For example, the benefits of operators disclosing tariff information prior to connecting a call could be outweighed by the costs where the proportion of vulnerable consumers is small.

Determining the size of the group of vulnerable consumers would therefore be crucial for balancing the benefits and costs of these remedies. Digital literacy rates could serve as an indication of the size of this group, as higher digital literacy rates indicate that consumers are better prepared for exploiting the advantages of communication technologies (such as the Internet) to gather and compare pricing information.

Data from the Commission shows that digital literacy rates vary considerably across the EU, from 6% of the population having no digital skills in Sweden, to almost 50% in Romania.[24] This evidence suggests that the size of the group of vulnerable consumers is likely to vary across the EU, and hence a closer look at the proposed remedies would be desirable.

Conclusions

The reforms proposed by the Commission range from less intrusive transparency obligations and the standardisation of switching processes to more intrusive regulation of contractual conditions. While some of these (such as transparency measures) are relatively uncontroversial, others are potentially riskier and may lead to additional costs that need to be assessed against the purported benefits.

Crucially, the cost–benefit assessment is likely to depend on specific market conditions, and a one-size-fits-all approach can therefore have significant unintended consequences. In such cases, the final decision could be left to NRAs—for instance, by allowing them to choose not to implement the remedies where this is justified by national circumstances.

[1] European Commission (2012), 'Making the internal energy market work', COM/2012/0663, November. The Commission's policies for the development of a single European energy market and associated consumer protection policies are summarised at: http://ec.europa.eu/energy/gas_electricity/consumer/consumer_en.htm.

[2] Ofcom (2014), 'Annual Plan 2014/15', 31 March.

[3] BEREC (2013), 'BEREC WP 2014', 17 October.

[4] European Commission (2002), 'Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services (Framework Directive)', 7 March; European Commission (2002), 'Directive 2002/19/EC of the European Parliament and of the Council of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities (Access Directive)', 7 March; European Commission (2007), 'Commission proposes a single European Telecoms Market for 500 million consumers', press release IP/07/1677, 13 November.

[5] Consumer inertia refers to instances where consumers tend to stick to their current choices even though switching provider would make them better off, while consumer myopia refers to instances where consumers fail to consider the long term when making their choices.

[6] European Commission (2013), 'Impact Assessment Accompanying the document Proposal for a Regulation of the European Parliament and of the Council laying down measures concerning the European single market for electronic communications and to achieve a Connected Continent, and amending Directives 2002/20/EC, 2002/21/EC and 2002/22/EC and Regulations (EC) No 1211/2009 and (EU) No 531/2012', COM(2013) 627 final, 11 September, p. 30.

[7] BEREC (2013), 'BEREC views on the proposal for a Regulation "laying down measures to complete the European single market for electronic communications and to achieve a Connected Continent"', BoR (13) 142; BEREC (2014), 'BEREC publishes its views on the European Parliament first reading legislative resolution on the European Commission's proposal for a Connected Continent Regulation', press release, 17 May.

[8] See, for example, Oxera (2010), 'Behavioural economics, competition and remedy design', Agenda, November; and Ciriolo, E. (2011), 'Behavioural economics in the European Commission: past, present and future', Agenda, January.

[9] Financial Services Authority (2003), 'Mortgages and Home Finance: Conduct of Business', 16 October.

[10] BIPT (2014), 'Proposition du Conseil de l'IBPT relative à la fixation du débit de l'accès functionnel a Internet et Avis du Conseil de l'IBPT du 13 Janvier 2014 relatif à la composante géographique du service universel', 25 April.

[11] In the context of telecoms, such unintended consequences may arise when the regulator imposes price caps on services to avoid potential bill shocks. By doing so, consumers may pay less attention to their consumption levels and end up spending more than they otherwise would.

[12] Department for Business, Innovation & Skills (2010), 'A Better Deal for Consumers: Review of the Regulation of Credit and Store Cards: Government Response to Consultation', March, pp. 14–5.

[13] In this case, the market did not experience an increase in input costs or demand. See Albaek, S., Mollgaard, P. and Overgaard, P.B. (1997), 'Government-assisted Oligopoly Coordination? A Concrete Case', Journal of Industrial Economics, 45:4, pp. 429–43.

[14] See Oxera (2012), 'Economic appraisal of Ofgem's domestic tariff proposals', March[https://www.ofgem.gov.uk/ofgem-publications/39560/scottish-power-oxera-report.pdf].

[15] Net neutrality provisions are not covered, as they require a more extensive assessment.

[16] European Commission (2013), 'Proposal for a Regulation of the European Parliament and of the Council laying down measures concerning the European single market for electronic communications and to achieve a Connected Continent, and amending Directives 2002/20/EC, 2002/21/EC and 2002/22/EC and Regulations (EC) No 1211/2009 and (EU) No 531/2012 C', COM(2013) 627 final, pp. 52–6.

[17] See, for example, Federal Trade Commission (2004), 'The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment', February.

[18] Known as automatically renewable contracts (ARCs).

[19] European Commission (2013), 'Proposal for a Regulation of the European Parliament and of the Council laying down measures concerning the European single market for electronic communications and to achieve a Connected Continent, and amending Directives 2002/20/EC, 2002/21/EC and 2002/22/EC and Regulations (EC) No 1211/2009 and (EU) No 531/2012 C', COM(2013) 627 final, p. 59.

[20] Dube, J.P., Hitsh, G.J. and Rossi, P.E. (2009), 'Do Switching Costs Make Markets Less Competitive?', Journal of Marketing Research, 46, pp. 435–45, August; Cabral, L. (2012), 'Switching Costs and Equilibrium Prices', NYU Working Paper No. 2451/31545, March; Arie, G. and Grieco, P.L.E. (2014), 'Who Pays for Switching Costs?', Simon School Working Paper No. FR 12-13, 27 March; Pearcy, J. (2014), 'Bargains Followed by Bargains: When Switching Costs Make Markets More Competitive', Working Paper, 8 May.

[21] European Commission (2014), 'Trends in European Broadband Markets 2014', Digital Agenda Scoreboard, p. 17.

[22] European Commission (2012), 'Indicators about mobile and fixed communications (voice and internet access) as well as on telecom revenues and investments', Excel spreadsheet, 18 June.

[23] European Commission (2013), 'Proposal for a Regulation of the European Parliament and of the Council laying down measures concerning the European single market for electronic communications and to achieve a Connected Continent, and amending Directives 2002/20/EC, 2002/21/EC and 2002/22/EC and Regulations (EC) No 1211/2009 and (EU) No 531/2012 C', COM(2013) 627 final, p. 56.

[24] European Commission (2014), 'Measuring Digital Skills across the EU: EU wide indicators of Digital competence', May, p. 14.