Regulating Early Termination Fees: When “Pro-Consumer” Legislation Isn’t

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In the wake of the recent economic crises, legislators are understandably eager to protect consumers. Yet in the rush to do so legislation has now been introduced to “protect” mobile telephone consumers that is decidedly anti-consumer. The “Cell Phone Early Termination Fee, Transparency and Fairness Act” would require the Federal Communications Commission (FCC) to regulate the pricing of mobile telephone contracts by establishing anachronistic, cost-based regulation of the fees that mobile telephone service providers charge to consumers for terminating fixed-term contracts before their expiration. Advocates of the legislation argue that it is necessary to protect unsuspecting consumers from unfair and hidden early termination fees (ETFs) that lock consumers in if, for example, a consumer were to terminate a 24 month contract with a mobile telephone provider after only 16 months. A closer look at the economics of mobile telephony, however, reveals that consumers are being remarkably well-served in the provision of mobile telephony and the proposed “cure” is likely to be decidedly worse for consumers than the identified “ailment.” To understand this conclusion, I first briefly review the evolution of pricing in the mobile telephone industry and then examine the basic economic motivations for, and consequences of, ETFs in this industry.

The Evolution of Pricing in Mobile Telephony

In 1983, when the cell phone was introduced into commercial service, it weighed over four pounds, was colloquially referred to as the “brick phone” and usage cost approximately a dollar per minute for “air time.” With such pricing many anticipated that mobile telephony would evolve as a niche service consumed largely by the wealthy and those with specialized needs for mobile communications. Yet today wireless service is essentially ubiquitous, with over 265 million subscribers in the United States and some 4 billion worldwide. While the mass market adoption of mobile wireless services and devices has unquestionably been partially driven by technological advances, the pricing of wireless telephony too has evolved in a decidedly pro-consumer manner over time. Even a cursory look at the evolution of pricing in the industry provides considerable insight into its exploding consumer popularity. In the mid 1990s, a minute of airtime usage had a price of 55 cents. Today it is 5 cents per minute on average, and for consumers who subscribe under plans involving “buckets” of minutes the price of an infra-marginal minute is zero. And for handsets, the evolution of pricing has been

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equally dramatic. The original “brick-phone” marketed by Ameritech in 1983 sold for roughly $4000. Handsets have now evolved from voice-only mobile telephones to sophisticated mobile voice, data, video and internet access devices, and the price paid by consumers who agree to a fixed term contract is most typically well under $500.

Yet despite the beneficial evolution of pricing in the wireless telephony industry, the standard model of pricing in the industry has been criticized. This criticism has been most pointedly directed at the standard practice in the industry of offering consumers fixed-term contracts (typically either one or two years in duration) for airtime along with a handset at a deeply discounted price as one of several service plan options. As part of the term-contract, mobile telephone companies have required the payment of an ETF in the event that the consumer chooses to terminate his or her relationship with the provider prior to the expiration of the contract. Depending on when the contract is terminated and the amount of the handset discount provided to the consumer on the front end of the contract, these early termination fees can be significant. When faced with this ex post charge some consumers are unhappy, and many have vented in the form of consumer complaints to both the Federal Trade Commission and the FCC. Most recently, this consumer displeasure has manifested itself in proposed legislation to directly regulate ETFs. But before passing the proposed legislation, legislators should carefully ask several questions. (1) What is their economic rationale; that is why do we observe ETFs at all? (2) What problem or problems does this legislation propose to fix? And, (3) what are the costs of the “remedy?” In short, what are the economics of ETFs?

**The Economics of ETFs**

While ETFs are not ubiquitous, they are not unique to the mobile telephone industry. Indeed, such fees are common in contracts ranging from apartment leasing, to automobile leasing, to club memberships to the provision of information technology services. So why does this feature of contracts arise and what are its economic consequences? Four economic concepts are potentially informative with respect to the rise of ETFs in the case of mobile telephony services: (1) opportunism; (2) market power; (3) information asymmetries and (4) externalities.

The critical relationship between contract design and opportunism was first pointed out by recent Nobel-laureate Oliver Williamson. In particular, he observed that in the event that parties to a contract engage in asset-specific investments as part of the contracting process, the potential arises for one of the parties to the contract to engage in ex post opportunistic behavior. In the case at hand, a consumer who receives a $600 handset for $200 as part of the provider’s incentive package to attract the customer, may, absent contractual safeguards, simply walk away with the handset. Faced with this prospect, providers would simply be unwilling to provide any asset (e.g., a handset) for less than immediate and full compensation at the initiation of the contract. This threat then gives rise to the natural tendency to incorporate duration safeguards into the contract. Thus, early termination fees can be seen as the logical market response to the potential for opportunistic behavior.
A second potential reason for the emergence of ETFs may spring from a mobile telephone provider’s existing market power or desire to enhance its market power. A combination of sufficiently long contracts and sufficiently high ETFs may “lock in” consumers to a given carrier with the consequence of creating market power over those customers. Aside from the theoretical potential, however, several realities of this market provide reasonable assurances that ETFs are not creating market-power-enhancing consumer lock-in. Most directly, the dynamics of competition in the mobile telephone industry undermine the practical ability of any mobile telephone service provider to gain control over price by enacting an ETF. Specifically, prior to signing a contract with a particular carrier, a consumer most typically will be able to choose from among four to eight mobile telephone service providers who are actively vying for her patronage. Any one company that seeks to lock in customers by unwarranted and unwanted ETFs runs the risk of not securing the customer in the first place. One must think no further than Southwest Airlines’ “Bags fly free” advertising campaign to be reminded that carriers that impose unwarranted contractual conditions run the risk that another carrier will choose to compete in that space by offering lower prices or more attractive contractual terms. Indeed, this appears to be what happened in late 2006 when Verizon first announced that it would begin prorating ETFs over the life of the contract. Other major carriers were forced by competitive pressures to follow. Thus, absent explicit (and illegal) collusion among the carriers, the competitive dynamics in the industry are likely to ensure that ETFs do not become an exploitative means of promoting of carriers’ market power.

Consumer lock-in effects of ETFs are also avoidable by consumers who typically are offered the option of purchasing handsets at the non-discounted retail price or by bringing a compatible handset to the carrier for service activation. With these options, consumers can operate on a month-to-month basis and are able to terminate their contracts without an ETF. Moreover, even when consumers do sign a fixed term contract, carriers typically prorate any ETF over the life of the contract, which has the effect of reducing the costs of switching for consumers. And for consumers that do seek to switch carriers early in the life of the contract (and would consequently face higher ETFs) an active secondary market has arisen that mitigates any “lock in” effects of ETFs. Commercial websites such as Cellswapper.com, TrademyCellular.com and CelltradeUSA.com act to link consumers that seek to switch out of a contract with those consumers who may be seeking to acquire a mobile handset and service. Finally, another fundamental reason mobile telephone contracts don’t create or exploit market power is that when customers sign the fixed-term contract, the service provider also is binding itself to a set price for the duration of the contract. Providers do not lock the customer in and then raise the price. They lock the customer in and then adhere to an agreed price for the duration of the contract, at which time the consumer can again shop around without penalty.

While these features of the market and the contracts themselves would seem to mitigate any market-power enhancing effects of consumer lock-in, the most compelling evidence that pernicious consumer lock-in is not pronounced stems from data on
consumer switching. In 2008, over 20 million subscribers in the United States voluntarily disconnected from their wireless service provider to switch to another carrier. Such a pronounced indication of consumers’ propensities and abilities to switch mobile service providers is an overwhelming indication that ETFs do not materially deter consumers from switching to the carrier of their choice.

A third potential relevant concept to the mobile phone pricing debate centers on the central economic concept of information asymmetries. It is, of course, well-known that the normally healthy process of competitive contract negotiation can break down in the event that one of the parties to the contract is asymmetrically under-informed regarding the terms of the contract. In the case of ETFs, if consumers are asked to sign a fixed tem contract but are not informed about the financial consequences of early termination of the contract, then genuine consumer harm can result. The practical question then arises regarding the affirmative obligations that mobile telephone providers have to ensure that consumers fully understand all relevant terms and conditions in mobile telephone service contracts.

Finally, externalities become relevant in this debate as the nation has declared a commitment to extend broadband service beyond market levels to achieve “universal” broadband service. In practical terms, the relevant question then is whether the pricing model adopted by various mobile service providers accelerates or slows the deployment of broadband service to the populace. Here the role of ETFs is almost certainly positive. Specifically, in the absence of ETFs, handset prices faced by consumers are substantially increased. This increased up-front charge is likely to deter the acquisition of modern smartphones that offer mobile broadband access to consumers. Indeed, carriers’ profits turn on the value created by, and, thereby, usage of mobile services. In this regard, broadband deployment provides a significant value to both consumers and producers. (Broadband−enabled handsets are used significantly more intensely than non-broadband-enabled telephones.) A logical path, then, for producers to achieve significant penetration of broadband service through mobile telephony (which requires higher-cost and better data service) is by ensuring that there is a large population who own high-end broadband-capable mobile phones (e.g., the Blackberry, iPhone, or Droid) Thus, while carriers do not provide contracts with deeply discounted handsets and ETFs in order to help achieve the country’s universal broadband service goals, their pricing policies are certainly congruent with those goals.

The “problems” of ETFs

Faced with a large potential market, competition among the nation’s mobile service providers to secure new and retain existing customers has been intense. The result has been the emergence of deeply discounted handset prices as a competitive attempt to attract customers. When viewed through an economic lens, ETFs are seen to have arisen as a by-product of this intense competition and the potential that this discounting creates for ex post contract opportunism. With this understanding in hand, the relevant focus then logically turns to the issue of what problems are created by mobile service
contracts that contain ETFs. As we have seen, with tens of millions of mobile telephone consumers changing providers annually, ETFs do not appear to created market-power enhancing lock-in. And the presence of deep discounts has acted to accelerate the deployment of mobile broadband consistent with national universal service policy efforts. This leaves as the sole remaining potential problem the possibility that consumers have been uniformed or misinformed regarding the terms and conditions of their mobile service contracts, including the provisions surrounding an ETFs that may accrue in the event of early termination of the contract. While reasonable debates can surely occur regarding the extent to which carriers have an affirmative obligation to notify consumers of terms and conditions, any conceivable solution to this concern is most directly addressed by “notification requirements” rules rather than cost-of service regulation. Unfortunately, the proposed legislation markedly deviates from this path.

The Costs of the “Solution”

The proposed legislation would directly regulate ETFs by specifying a link between the price paid by the consumer for a handset and the “cost” to the mobile telephone provider associated with acquiring the handset. In particular, the proposed legislation would limit an ETF to a level no greater than the “cost to the provider of the handset provided to the subscriber, reduced by the price paid by the subscriber at the start of the subscriber’s contract.” Moreover, the legislation would not only cost-base regulate ETFs, but it would require additional regulation to establish “ratable reductions” of ETFs over the term of the contract. Students of the economics of regulation will readily recognize the inherent pitfalls of such cost-based regulation. Several particularly harmful effects are likely to result. First, any binding limits on ETFs that result from the legislation are almost certainly to be met with increases in the upfront prices paid by consumers for handsets. This will have the effect of harming price sensitive consumers and will perversely slow the achievement of the nation’s broadband universal service goals. Second, the regulations raise a raft of questions regarding the level of “the cost to the provider of the handset device.” Hearings to determine the appropriate cost standard (e.g., marginal, average, average incremental) are likely to give rise to significant and unnecessary regulatory costs that in the end harm consumers. Third, and most obvious, with hundreds of handsets and literally millions of contracts in play, the regulatory costs of enforcing the legislation are likely to be very high, if not prohibitive, in both a direct and opportunity cost sense.

Conclusion

Consumers who seek to change mobile telephone contracts (either to a new phone with the same provider or with a new provider) are often unhappy about the requirement that such a change will involve the payment of an ETF. But the solution to this happiness is not through the proposed legislation. Policymakers can and should ensure that carriers accurately and fully specify the terms of contracts so that consumers do not
suffer from information asymmetries. Similarly, antitrust authorities can and should vigilantly monitor this and other industries to ensure the presence of vigorous competition among industry participants. Policy measures designed to promote these ends are, however, already in place. Thus, while the proposed legislation may be nominally appealing, directly regulating ETFs is ultimately a measure that is likely to offer more costs than benefits to consumers.