Project Brief

frontier economics

Hanging up the phone

PENALTIES FOR BREAKING PHONE CONTRACTS IN SPAIN

Last July a Spanish court quashed a fine of almost €26 million that the country's telecoms regulator had imposed on Telefónica. The watchdog had ruled that the terms of certain of Telefónica's fixed-term contracts for SME customers constituted a restraint on competition. In overturning the penalty, the court accepted Frontier's argument that the disputed contracts made sound economic sense and did not undermine competition.

A costly break

How much is an expert economic report worth? In this particular case, almost €26 million. That's the size of the fine that Spain's competition authority (the National Commission for Markets and Competition (CNMC) imposed on Telefónica Moviles España (TME) in October 2014, after ruling that the terms of a particular type of mobile phone contract sold to small and medium-sized businesses (SMEs) constituted an illegal constraint on competition. Frontier put together an economic case to support an appeal against the ruling. The National Court accepted the arguments and on 31 July 2017 quashed the fine.

These contracts offered SMEs a discount off their bills in return for a commitment to keep the service for a fixed length of time. Breaking the contract would incur a penalty which would increase as the end of the agreed term approached. The challenge from an economic point of view was that these penalties were at odds with standard practice in the industry. For instance, when an operator sells a subsidised smartphone, it requires the buyer to take out a fixed-term contract for, say, 12 months. If the customer decides to break the contract after 10 months, the penalty will be smaller than if she had done so after six months.

However, Telefónica's SME contracts, called "Premium PYME" in Spanish, did not include a handset subsidy. On top of that, they provided for cancellation penalties that increased over time, i.e., it was cheaper for the customer to break the contract early on than the day before it expired. Thus, the competition authority argued that these contracts (especially the penalty provisions) were designed to limit the ability of Telefónica's SME customers to switch suppliers and increased the cost for competitors of winning over their rival's clients.

We showed that there were good reasons why operators want to sell contracts with similar features to Telefónica's, which in fact are not as uncommon as the competition authority believed.

Three reasons why

1. Such clauses are common elsewhere, so there must be an economic rationale.

When the clauses were described to us, we rapidly realised that we had seen them before… in other industries. For instance, some gym clubs offer a discount upon joining if the member commits to stay for a minimum period of time (say 12 months); if the customer gives up after a few months, he may not get his money back. Similar provisions are to be found in insurance and IT support services, for instance. Perhaps a similar competitive rationale for such terms and conditions applies to the mobile phone business as well? If so, what was it?

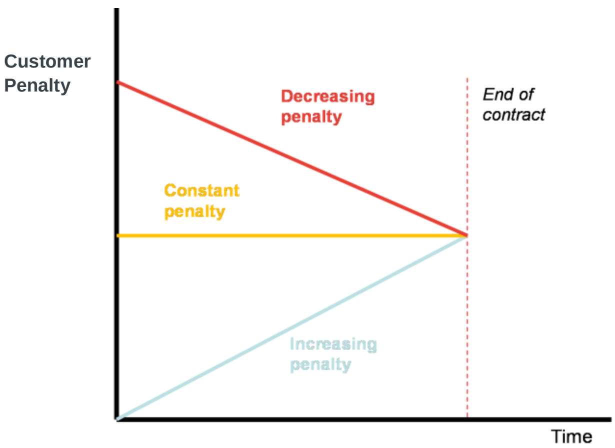
The answer is price discrimination. This sounds a terrible practice, but it allows companies to offer customers different prices according to their preferences. In this case, Telefónica provided two options. The first was the ability to switch to another supplier at any time but with no discount off the monthly bill. The second option did offer a discount in return for a commitment to a minimum subscription period (not much longer than a year).

What these contracts were doing, therefore, was screening the market and revealing the existence of customers with different preferences. They took into account the fact that consumers look at fixed-term offers in different ways. Some value highly being able to change operators at any time and are prepared to forego discounts; others prefer a cut-rate deal and are willing to take out a fixed-term contract in return. To meet the range of customer preferences, Telefónica introduced a "menu of contracts" with various options for discounts and fixed-term commitments.

2. A rising penalty scale is the most proportionate way of linking discounts to the terms agreed.

Penalty clauses are needed to guarantee the effectiveness of the pricing policy described above. In the absence of a penalty system, every customer would opt for a contract with a longer fixed term and correspondingly higher discounts because the benefits would effectively be cost-free (i.e., they would be able to change providers at any time and face no penalty). However, one of the aspects that worried the CNMC the most was that penalties for breach of contract increased over time.

Intuitively, it makes perfect sense that the penalty goes up over time: a consumer terminating their contract early must reimburse Telefónica for the cut-price deals they have enjoyed. What we showed is that applying rising penalties was the most proportionate way of ensuring consumer compliance with a fixed-term contract. This is because with the alternative – a system of constant or decreasing penalties – the initial penalty has to be high enough to ensure its effectiveness both at the start of the contract and just prior to expiry, where the incentives to switch provider will likely be higher. Under a schedule of increasing penalties, by contrast, anyone terminating their contract early need return only the discounts they have already pocketed.



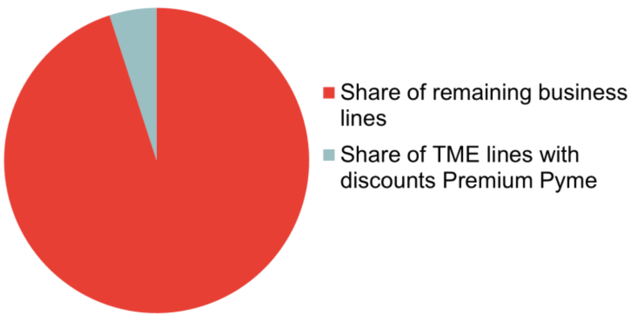
This is reflected in the chart: let's consider that 50 is the minimum effective penalty just before the expiry of the contract, i.e. if the penalty is lower, the customer will switch provider before expiring the contract. This implies that under a constant penalty system, the penalty must be 50 from the beginning to the end. A decreasing penalty system will require higher penalties for earlier periods converging to 50 just prior to expiry. Instead, if the penalties are increasing, they will be lower than under a constant and/or decreasing penalty system. This means that any other penalty system leaves the customer worse off.

3. The discounts cannot distort competition because they affect a small part of the market

In response to the CNMC's determination that the Premium SME contracts distorted competition, our report showed that:

- they affected a very small fraction of the market;
- they did not prevent a customer from transferring to another operator, judging from an analysis of switching rates and how many customers Telefónica lost compared to other operators;
- they did not affect the development of Mobile Virtual Network Operators in Spain, judging by a comparison with other countries and the business model they typically adopt.

The National Court accepted all the economic arguments presented by Frontier and **annulled the fine of €25.78 million imposed on Telefónica by the CNMC.**



Note: *these are only illustrative shares, as real shares cannot be disclosed for confidentiality reasons*

What we learned

Our main takeaway from this case is that commercial practices in different competitive sectors of the economy can be used to understand pricing policies in network industries. Even if they are uncommon, economics can cast light on their rationale and avoid that the "fear of unknown" prevents customers from getting deals best suited to their needs.

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