Customer Service, Information Asymmetry and Self-Regulation

The Australian Competition and Media Authority is conducting an inquiry called ***Reconnecting the Customer*** *"to examine customer service practices and complaints-handling practices within the telecommunications industry".*[1]

Divergent views have been provided to the inquiry of the role of competition in improving customer service. This paper identifies conditions under which customer service in a market will decline and potential remedies.

The Reconnecting the Customer Inquiry

In announcing the Australian Competition and Media Authority project *Reconnecting the Customer*, Authority Chair, Chris Chapman, said;

> *The broad objectives of the strategy are twofold. First, to implement specific measures to address current telecommunications consumer protection issues; and, secondly, to create a protection framework aligned to the needs and expectation of end users in the future service environment….*
>
> *To do this, the ACMA will be undertaking a formal inquiry into the industry's practices in dealing with the problems of its customers. The inquiry, which is consistent with the ACMA's evidence-informed approach, will also identify what should be the key elements of good customer relationship management and attempt to plot the pressure points in the interaction between customers and providers. In particular, I want the inquiry to shine a strong light on complaints handling and the unresponsiveness of the industry to its customers.*[2]

That specific inquiry into industry practices now shares the title of the overall project. The full terms of reference for the inquiry cover both customer service and complaint handling standards and practices. The overall objective is found in reference 9;

> *Identify the options for addressing any problems identified and their causes, including market-based, regulatory or institutional measures to facilitate best practice customer service and complaints-handling, having regard to the increasingly complex communications environment.*[3]

Following release of a discussion paper and receipt of submissions, the Authority has published a progress report.[4] In relation to strategies to improve customer-service the progress report noted;

> *Submitters have suggested a range of ways to improve customer service and complaints-handling. These range from market-driven solutions to more direct regulatory intervention.*
>
> *At one end of the spectrum, submitters contend that improvements will be brought about through competition. In an increasingly saturated market, service providers will need to differentiate themselves from their competitors in order to attract and retain existing customers. …*

At the other end of the spectrum, submitters told the ACMA that there were elements of the self- and co-regulatory framework that have contributed to the problems of customer service and complaints-handling and that more direct regulatory intervention is required. They highlighted the following elements, which are said to undermine the effectiveness of the industry code:

- *the lack of commitment to compliance with the TCP Code*
- *the lack of enforceability of the code provisions*
- *the failure of the TCP Code to deliver basic consumer safeguards or meaningful outcomes to consumers.*

Several submitters also noted that some problems might not be appropriate matters for co-regulation and for these problems, direct regulation is necessary. They tended to look at discrete issues, such as complaints-handling, as being matters that might not be appropriately addressed solely by the co-regulatory framework.

The ACMA in its progress report noted the discrepancy between the argument that competition would improve customer service and the evidence that customer service has declined despite competition. It is the contention of this paper that the core issue is an information asymmetry issue. This is discussed in the next section, as **The Market for Lemons**.

This framework of information asymmetry is then used to discuss the second assertions about the appropriateness or otherwise of self-regulatory or more direct regulatory mechanisms as **The Choice of Regulatory Tools**.

The Market for Lemons

The consequence of information asymmetry was captured by George Akerlof who delightfully described it as the market for "lemons", using the vernacular term for a poor quality car.[5]

Theory

In a simplified version let's assume a market for used cars in which cars are either good or bad. In this market there are two types of cars, good cars and bad cars, but only sellers can tell which is which (from experience).

If we assume a good car is worth $20,000 and a bad is worth only $10,000, and that we know from experience that only half the cars are good then a potential buyer using a rational approach will only be prepared to pay $15,000 for the car.

To all the potential sellers of bad cars this is a good deal, to the sellers of good cars it is not. As a consequence only the bad cars end up in the marketplace, and all that is for sale is lemons.

In the extreme case where there is a continuum of quality the market as a whole can disappear. The best example here is insurance markets where the insurer can only price premiums on averages. If the people seeking to be insured know their real risk, then those least in need of insurance take themselves out of the market, thus increasing the average risk and hence premium. The process continues until there are not enough customers left to insure.

Akerlof noted the similarity to "Gresham's Law" that 'bad money will drive out good'. In its specific form this relates to "debased" coins operating in a gold or silver standard; that is those that have had the amount of precious metal actually reduced.

The full version of Gresham's law actually includes a requirement that there is a rule of legal tender requiring both coins to be accepted. That is because both "buyer" and "seller" can identify good from bad. But if only the person offering the coin could tell (by prior testing) then only the bad coins would be offered but the receiver would not know.[6]

Akerlof identifies a number of remedies for the identified problem. The first is signalling by vendors about quality either by guarantees or by branding. Finally he identifies licencing practices as is used for the professions.

Information Asymmetry in Telecommunications Markets

The contention we wish to make is that in the market for telecommunications services the information asymmetry works the same way. Prior to making a purchase a consumer has no real idea of what the standard of customer service is from a particular provider. As a consequence they make their purchasing decision on the basis of an "average standard of customer service."

As a consequence a telco that is investing in better service doesn't improve market share, they either lose market share because the price to cover the higher cost of quality service or they retain share but at a lower margin. In the medium term they will simply let customer service decline.

In the reverse the firm with below average customer service retains market share and does so with better margins, and has no incentive to improve customer service.[7]

One might wonder why the consumer does not do more research about the quality of providers before purchase. There are a number of reasons. The first is the low expected return from the investment in search. Finding out about customer service would take a lot of time and it is not commensurate with a purchase the consumer values at its monthly rate rather than its lifetime value.[8]

The second is an incorrect reliance on regulation; the marketplace is well-regulated therefore no one can be bad therefore the difference between providers is small. That is regulation works as a kind of guarantee on the quality of all providers.

The third is a consequence of branding; the supplier has invested so much in their brand that the consumer believes they aren't going to risk brand damage and therefore their customer service will be good.

Responses to Asymmetric Information

The initial thought on how to respond to asymmetric information is to mandate greater information disclosure. This usually does not work. Firstly the disclosure itself doesn't really reduce the customer's search cost – being given a 40 page product disclosure statement in financial services requires me to read a whole lot of stuff that is irrelevant. Secondly the fact of disclosure can be interpreted by the consumer as a kind of "regulatory guarantee".

Greater regulatory enforcement including "naming and shaming" suffers from similar problems. If the regulator criticises a whole industry the consumer thinks there is even less return from search. If the regulator names and shames individuals the consumer mostly hears about the industry being bad and not individual firms. But more importantly it builds on the implied regulatory guarantee – this provider must be all right otherwise they wouldn't be able to sell.

The alternative for the regulator is to work with the natural tendency towards brand and signalling. Rather than naming and shaming they can analyse and praise. More generally this matches up with standard behavioural theory; catch the providers doing something right not something wrong.[9]

Part of the challenge is identifying the good behaviour. The ACMA has released in the progress report the outcomes of focus group research and notes, "the elements of good service identified in the focus groups are remarkably similar to those identified in the submissions made by consumers." This similarity should act as evidence that the submissions made by consumers accurately represent the attitudes of consumers.[10]

The Consumer Council of the Australian Communications Industry Forum undertook an exercise to identify the attributes of a quality service provider. Subsequent research has identified how this exercise could be refined to provide some meaningful tools for investigation.[11]

The complaint statistics from the TIO also provide some meaningful data. There are some important considerations in deciding how to use this data. The data needs to be referenced to the relative size and activity level of the provider. The statistical reliability of any measure also needs to be carefully measured, since a large number of service providers are relatively small and hence will be poorly represented in any sampling exercise.

These issues deserve active consideration in a separate discussion stream. Suffice to say here that it is possible to discern the attributes of quality of a service provider and to measure them.

The Choice of Regulatory Tools

A further dimension inherent in the progress report is the debate over whether the poor quality of customer service requires stronger direct intervention regulatory tools or not. This section makes the case for the greater use of genuine self-regulatory approaches.

The Purpose of Regulation

A full exposition on the purpose of regulation is beyond the scope of this paper. Suffice to say there are two dominant alternative views.

On one extreme any regulation is an intervention into the marketplace and substitutes centralised goals for those of the market. Under this interpretation all regulation is bad and results in loss of welfare (which happens to coincide with economic efficiency).

On the other extreme is the view that corporations acting in their own (profit-maximising) self-interest will always do the wrong thing by the customer unless adequately supervised.

Both views however tend to be paraded using the mask of standard economic theory and justify regulation only in response to "market failure". Where they disagree is on where markets fail or how extreme failures have to be before the cure of regulation is better than the disease.

An alternative construction is available if the economic analysis is sophisticated enough to incorporate the learning of institutional, evolutionary and behavioural economics. In this world view economic agents are not the perfect utility maximising agents of the standard theory, and markets are seen to be constructions of society not some theoretical clearing house.

From this perspective comes the view that markets don't in fact work without regulation. As a simple example for markets to work you do need things like property rights, enforceable contracts and usually agreed money. These are all aspects of regulation usually taken for granted but they are regulation none the less.

The Source of Regulation

The core regulatory elements in the example all evolved through the process of exchange. They did not exist before exchange, and they were not imposed by theory. They evolved because they worked.

The best example of the evolutionary approach is the theoretical work of Axelrod of the evolution of co-operation in a simple Prisoners' Dilemma game.[12] The evolved rules are then imposed on the markets by the participants themselves. The best example is how stock exchanges developed as co-operatives of stock brokers.

In technical terms a well-formed theory of the economy needs to not only include regulation as an influence on the market, but it also needs to incorporate a theory of how the institutions of the market (in the broad sense of the word) came to be. In more geekish speak – regulation is endogenous to markets, not exogenous.

Regulation and Behaviour

The challenge in understanding regulation is that it is often viewed as a legal activity rather than a social activity; that social activity is the subject matter of economic science. The legal approach draws one to understand regulation as writing rules and enforcing them.

The social construction of regulation understands it more as being about the behaviours induced in market participants rather than the rules by which they are instructed to behave.

While the legal view will conflate self- and co-regulation and regard them as slightly different variants of the same "light touch" approach, the social view understands self-regulation to be much more.

The analogy is to individual behaviour. We all encourage self-discipline, especially in the young. In fact society as a whole practices self-discipline most of the time. Most of us don't break laws (or commit sins) because the action

that would break the law is not "the right thing to do" rather than because of potential legal (or even after-life) consequences.

That is what self-regulation is about; it is also mostly what firms do.

The major exception is industries with a great deal of instability. If that instability in part comes from a great deal of entry and exit or new products and services the self-regulatory behaviour can break down due to a lack of understanding of consequences rather than a lack of will.

Many commentators will dismiss discussion of the behaviour of firms within a framework of firms having a choice on how they behave because of a dominant theory of the firm that firms must and do only act to create (maximum) shareholder value.

This view is erroneous as an empirical observation, as an economic consequence of profit maximising behaviour, as a historical description of firms and as a legal obligation. However, for the purpose of this discussion it needs only to be shown as being wrong on its presumption that firms have limited choice in how to behave (i.e. shareholder maximising).

Chief executives and other senior executives are paid very high salaries. They are paid these salaries because they daily make decisions about the firm. They do not simply feed numbers into a calculator and get a decision on how to behave.

Understanding Self-Regulation

The fact that self-regulation might be the desired outcome does not mean that there is no role for regulators. Indeed the invocation of self-regulation in the Australian telecommunications legislation is an invocation to regulators, not to industry.[13]

Using the analogy of personal behaviour, we don't expect children just to develop self-discipline on their own. They might well do so if we truly left them alone. But we decide to use the benefits of our experience in teaching them self-discipline.

A most common feature in the modern classroom is the idea of a behaviour compact between the students and the teacher that sets out the rules of behaviour.

It is no contradiction to say it is the role of the regulator to guide or nudge the industry towards self-regulation.

At the same time it is wrong to think that the regulator's role here is to offer a choice between self-regulation and direct regulation. The choice needs to be between effective self-regulation and significant negative consequences.

As a simple example, in the consideration of Mobile Premium Services over the last five years or more there has been reluctance on the part of the mobile operators to take responsibility for the service. The choice the industry should have been offered was not "fix this or we will regulate it for you", it should have been "fix this or we will prohibit you from charging for these services on phone bills."[14]

Conclusions

The ACMA in progressing the *Reconnecting the Customer* inquiry needs to extend its thinking beyond simplistic descriptions of markets and consequences of competition to understand the full dynamics of markets.

The nature of the information asymmetry about customer service is unlikely to mean that competition will improve the outcome. The regulator can play a role in changing the outcome by changing the information, in particular by improving the payout for the provider of good customer service.

Understanding real firms and real markets also results in a better understanding of the distinction between self-regulation and direct regulation or co-regulation. In the long term only self-regulation is consistent with effectively functioning markets.

The ACMA needs to play a more active role in facilitating the understanding of all participants in how real markets work and therefore what the appropriate and effective interventions will be to improve outcomes for consumers.

Notes

[1] The details of the inquiry can be found at http://www.acma.gov.au/WEB/STANDARD/pc=PC_312222

[2] Chris Chapman "Telco Regulation 2.0 – Reconnecting the Customer" Speech to the CommsDay Summit, Sydney, 20 April 2010. Available at website above.

[3] Australian Communications and Media Authority *Reconnecting the Customer public inquiry; Terms of Reference.* December 2010. Available at website above.

[4] Australian Communications and Media Authority *Reconnecting the Customer: ACMA public inquiry; Progress report.* December 2010. Available at website above.

[5] George Akerlof 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism.' *Quarterly Journal of Economics* Vol 84 No 3 (Aug 1970) pp 488-500.

[6] Gresham's Law is very specific and does not run to all forms of currency and all markets. For example in international trade good money (US dollars) drives out bad. For this to occur there has to be choice between currencies and the ability of both parties to assess the quality. See Arthur Rolnick and Warren Weber ' Gresham's Law or Gresham's Fallacy?' *The Journal of Political Economy* Vol 94 No 1 (Feb 1986) pp 185-199.

[7] This issue was presented in a Game Theory way as an example of the Prisoner's Dilemma in David Havyatt 'Self-regulation in telecommunications didn't fail – it was never really tried.' Working Paper May 2010 available at http://www.havyatt.com.au/docs/wps/Self_Regulation.pdf.

[8] In addition the behavioural economics effect of immediacy comes into play. Consumers really make impulse decisions in stores or while on websites, not reasoned researched decisions.

[9] In standard behavioural theory if you punish the wrong behaviour you have no guarantee of what alternative behaviour will occur apart from avoidance, but if you reward good behaviour you know it will be repeated.

[10] ACMA progress report pp 15-17.

[11] The ACIF study and the research are in David Havyatt 'Service Provider Quality: the need for research' *Telecommunications Journal of Australia* 2010 but available at http://www.networkinsight.org/verve/_resources/CPRF_2009_papers.pdf#page=343

[12] See Robert Axelrod *The Evolution of Co-operation* and *The Complexity of Co-operation: Agent Based Models of Competition and Collaboration.*

[13] A summary of the legislative structure together with an impassioned plea for greater use of self-regulation can be found in David Havyatt's 'Self-regulation in telecommunications didn't fail'. *Op. cit.*

[14] The author will note that this advice was offered to the Secretary of the Department of Broadband, Communications and the Digital Economy in 2008 when consulted on how to get the industry to respond. In that advice the case of Senator Ian Campbell, the mobile operators and the formation of the Mobile Carriers Forum was outlined as the perfect case study.

About DigEcon Research

Purpose

DigEcon Research is a stand alone research body. Ultimately, its pursuit is policy research, the focus of which is the meaning and significance of the Digital Economy. This policy research encompasses both economic and social research.

Researching the significance of the Digital Economy

The concept generally referred to as the Digital Economy is frequently discussed but there is little shared meaning in the term. A key definitional issue is whether the Digital Economy is something yet to happen or in which we are now embedded.

DigEcon Research focuses on the analysis of social and economic change rather than an analysis of a notionally static "Digital Economy". Analysis of the change as it occurs should highlight those areas where there is genuine policy choice rather than merely a need to adapt policy to changes that have already occurred.

Before Thomas Kuhn popularised the idea of "paradigms" J.K.Galbraith railed against the "conventional wisdom". There is no denying that what Kuhn called "normal science" or the repeated application of existing theory to new problems results in most practical developments. It is equally true that the application of existing theory to problems they were not designed for results in, at best, vacuous solutions and, at worst, wildly dangerous outcomes.

The Digital Economy challenges the fundamental concepts of neo-classical economics. It also challenges most of the precepts of how societies are organised. In this context policy research needs to focus on what is different, not on what is the same. The Digital Economy is not just a matter of means of production but about the fundamental structures of social organisation.

Work program

This research is designed both to inform policy makers and to assist those who would seek to influence policy makers or to make business decisions. DigEcon Research however does not provide strategy recommendations nor undertake policy advocacy on behalf of any party.

A key element of the research will relate to the direct regulation of the converging industries of telecommunications, media, consumer electronics and information technology. However, the agenda encompasses the wider economic and social policy issues.

The scope of the research agenda will ultimately depend upon the researchers who wish to participate in what is more an idea than an entity.

In the crowded Australian research field there are a number of "bodies" that share some of the objectives of DigEcon Research. DigEcon Research aspires to contribute to the work of these and any other researchers in the field.