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## **Let Competition and Choice Check Wireless ETFs**

by

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Early termination fees (ETF) in wireless device and service contracts are back in the news. Just last week, the Federal Communications Commission (FCC) sent a letter to Verizon Wireless seeking information concerning the wireless operator's policies and practices regarding ETFs.<sup>i</sup> Some of the questions relate to Verizon's ETF consumer disclosure practices and some relate to the cost and pricing of the wireless devices to which the ETFs apply. Moreover, a Senator recently sent a letter to Verizon Wireless' CEO to criticize its optional, prorated ETF in new contracts for one of the latest and more advanced smartphones. According to Sen. Amy Klobuchar, the ETF increase to \$350 for certain new smartphones is "anti-consumer and anti-competitive."<sup>iii</sup>

Now nobody likes to pay higher fees, even optional higher fees. But the apparent good intentions animating ETF-critics' call for regulation ignores the other side of the equation – the pro-consumer benefits of ETFs that reduce or eliminate the up-front cost of wireless devices and make the devices more economically feasible for consumers.

ETFs are a common term of use or feature in consumer contracts for a wide variety of products and services.<sup>iii</sup> In the context of wireless, ETFs allow carriers to make new cell phones and smartphones available to consumers on a more economical basis. For instance, AT&T subsidized the 3G iPhone to the tune of \$325 when it was first released.<sup>iv</sup> This allowed early adopters to obtain an 8-gigabyte 3G iPhone for \$199 or a 16-gig version for \$299.<sup>v</sup> For more basic cell phones, ETFs allow consumers to obtain new phones at zero down. (Even a non-economist can understand the cost to design,

manufacture, and make available the phone is greater than zero.) ETFs give carriers certainty that they will recapture their subsidy of wireless devices from consumers who enjoy the lower up-front cost.

Cell phone and smartphone contracts with ETFs are now almost universally optional for consumers. They can choose to pay the full cost retail cost of the wireless device or chose a subsidized device as part of a service contract with an ETF. In fact, at an FCC hearing last year,<sup>vi</sup> spokespersons for wireless, cable and DBS all testified that their industries give consumers a choice of whether to enter into service contracts with ETFs or not.<sup>vii</sup> As recent studies and analyses have pointed to the dynamic marketplace for wireless,<sup>viii</sup> consumers not only have the choice of whether to enter into a wireless service contract with an ETF, they also have choice among competing carriers offering optional ETFs.

What's more, wireless carriers prorate ETFs over the life of the service contract.<sup>ix</sup> Consumers that terminate service with their contracted wireless carrier further into the life of the contract are assessed a reduced fee. Despite this, some ETF-critics take issue with the amount of the fee and the pace of the prorating.<sup>x</sup> It is sometimes contended that the fee exceeds the amount of the carrier's subsidy or the value of the device and service. But whether the argument is that ETFs should be lower or that they should prorate more quickly during the life of the contract, one must ask who, rightfully, should be deciding what the value of wireless devices or services is or what price should be charged to consumers.

To the extent that an ETF might exceed the supposed value of the wireless device or service, at that point the ETF is simply a more expensive price option. ETFs are essentially a price component of cell phones and wireless services. (In 2005, CTIA submitted to the FCC a petition seeking a declaration that ETFs are "rates charged" under federal law and exempt from state regulation,<sup>xi</sup> but it withdrew the petition earlier this year.<sup>xii</sup>) Legislation or regulation that set ETF amounts or prorating schedules are therefore a type of price control. ETF critics apparently have strong disagreement with wireless carriers over the perceived value of wireless devices and services. Yet, as economist and Noble laureate Friedrich Hayek oft observed, there is no absolute or fixed value of a product or service since personal preferences of consumers all differ and market supply and demand is constantly adapting to changing circumstances.<sup>xiii</sup> When there is a disagreement over the value and price of products and services in a competitive marketplace, the market itself is the proper mechanism for ascertaining value and price.

If a wireless device and service contract accompanied by an ETF is popular with consumers (who readily choose the ETF contract over competitive options), legislative or regulatory interference—however well intended—is short-sighted paternalism. In a dynamic marketplace such as wireless, market mechanisms and not political mechanisms best allow prices to reflect changing supply and demand.

Perhaps the most heavy-handed position suggested against ETFs is an outright ban. At last year's FCC meeting, one state public utility commissioner insisted that the FCC

outlaw ETFs—in the name of protecting consumers.<sup>xiv</sup> As I listened to this state commissioner testify from the audience, I carried in my pocket a brand new cell phone obtained for free as part of a two-year wireless service contract with an ETF. The contract's price and terms were attractive enough to lure me away from a larger, competing carrier. Had the state commissioner's position been adopted, consumer choice would have been seriously reduced. And I would not have been enjoying the new phone or more attractive service.

An altogether separate matter that has emerged in a number of federal and state lawsuits involving wireless ETFs is the existence of fraud or unfair and deceptive trade practices.<sup>xv</sup> The results of such litigation, some of which has resulted in large class-action settlements, have primarily focused on informed consent of customers concerning ETFs or the prorating of fees in respective service contracts. None of the cases have found the ETFs themselves to be unfair or otherwise impermissible. Now, with the issuance of last week's letters of inquiry to Verizon, the FCC is seeking information concerning Verizon Wireless' consumer disclosure practices, as well information relating to the cost and pricing of the devices to which ETFs apply.

As with any other consumer product or service, wireless devices and service should be marketed and delivered in a way that provides consumers with adequate information to make an informed choice. It is not clear, however, whether such information disclosure practices ought properly to be within the domain of the FCC, as opposed to the Federal Trade Commission.

In any event, in the currently dynamic wireless marketplace, certainly with respect to the substance of the ETF terms, competition is the best check and balance on ETFs, giving consumers a greater number of affordable choices than they otherwise would have. Legislative or regulatory actions that, in effect, amount to price regulation in a market that earlier this year the FCC declared effectively competitive<sup>xvi</sup> would not only be paternalistic, but counterproductive and innovation-stifling overkill as well.

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<sup>i</sup> Letter from Ruth Milkman, Chief, Wireless Telecommunications Bureau, and Mark Stone, Acting Chief, Consumer and Governmental Affairs Bureau, to Steven Zipperstein, Vice-President – Legal and External Affairs, Verizon Wireless (December 4, 2009), available at: [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DA-09-2535A1.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DA-09-2535A1.pdf).

<sup>ii</sup> "News Release: Klobuchar: Wireless Carriers Early Termination Fees are Anti-Competitive and Anti-Consumer" (November 9, 2009) (including full text of Sen. Klobuchar's letters), available at: [http://klobuchar.senate.gov/newsreleases\\_detail.cfm?id=319787&](http://klobuchar.senate.gov/newsreleases_detail.cfm?id=319787&). Sen. Klobuchar previously introduced S. 2033: *Cell Phone Consumer Empowerment Act of 2007* (110<sup>th</sup> Congress, 2007-2008). For summary, full text and status, see <http://www.govtrack.us/congress/bill.xpd?bill=s110-2033>. For useful background information relating to Verizon's new ETF increase, see also Marguerite Reardon, "The 411 on early termination fees (FAQ)," *Signal Strength* (CNET blog) (November 20, 2009), available at: [http://news.cnet.com/8301-30686\\_3-10401929-266.html?tag=mncol;title](http://news.cnet.com/8301-30686_3-10401929-266.html?tag=mncol;title).

<sup>iii</sup> See Cecilia Kang, "Scrutiny of Phone Fees May Broaden to TV, Internet," *Washington Post* (May 31, 2008) (discussing ETFs in the context of cable, DSL Internet and paid TV services), available at: <http://www.washingtonpost.com/wp-dyn/content/story/2008/05/30/ST2008053002894.html>.

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<sup>iv</sup> Eric Savitz, "Apple: Oppenheimer Says AT&T iPhone Subsidy is \$325," *Tech Trader Daily* (June 19, 2008), available at: <http://blogs.barrons.com/techtraderdaily/2008/06/19/apple-oppenheimer-says-att-iphone-subsidy-is-325/>.

<sup>v</sup> *Id.*

<sup>vi</sup> "Public Hearing on Early Termination Fees (ETF): Federal Communications Commission – June 12, 2008," available at: <http://www.fcc.gov/realaudio/presentations/2008/061208/>.

<sup>vii</sup> See "Statement of Daniel Brenner, Sr. Vice President, Law & Regulatory Policy, National Cable & Telecommunications Association: FCC Early Termination Fee (ETF) Hearing in Wireless Docket 05-194, June 12, 2008", available at: <http://www.fcc.gov/realaudio/presentations/2008/061208/brenner.pdf>; "Testimony: John F. Murphy, Senior Vice President, Controller & Chief Accounting Officer, DIRECTV" (June 12, 2008), available at: <http://www.fcc.gov/realaudio/presentations/2008/061208/murphy.pdf>; and "Written Testimony of Verizon EVP Thomas J. Tauke, Federal Communications Commission ETF Hearing, Thursday, June 12, 2008," available at: <http://www.fcc.gov/realaudio/presentations/2008/061208/tauke.pdf>.

<sup>viii</sup> See, e.g., Federal Communications Commission, *Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services (CRMS Thirteenth Report)*, WT Docket No. 08-27, at 5 (January 16, 2009) (finding that "U.S. consumers continue to reap significant benefits – including low prices, new technologies, improved service quality, and choice among providers – from competition in the CMRS marketplace, both terrestrial and satellite," and that "there is effective competition in the CMRS market"), available at: [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DA-09-54A1.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DA-09-54A1.pdf); see also, e.g., Robert W. Hahn and Hal J. Singer, "Why the iPhone Won't Last Forever and What the Government Should Do to Promote its Successor," at 10-16 (September 1, 2009) (discussing market dynamics and market share among handset device makers), available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1477042](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1477042); Everett Ehrlich, Jeffrey Eisenach, and Wayne A. Leighton, "The Impact of Regulation on Innovation and Choice in Wireless Communications," at 6-20 (September, 2009) (discussing the state of competition in carriage and upstream markets, and concluding that market performance indicates relevant markets are competitive), available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1478528](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1478528); and Gerald R. Faulhaber and David J. Farber, "Innovation in the Wireless Ecosystem: A Customer-Centric Framework," The Heartland Institute, (November 20, 2009), available at: [http://www.heartland.org/article/26390/Innovation\\_in\\_the\\_Wireless\\_Ecosystem\\_A\\_CustomerCentric\\_Framework.html](http://www.heartland.org/article/26390/Innovation_in_the_Wireless_Ecosystem_A_CustomerCentric_Framework.html).

<sup>ix</sup> Kent German, "Sprint to start prorating early termination fees," *Crave: the Gadget Blog From CNET* (October 23, 2008) (discussing Sprint's prorating of ETFs and observing that "T-Mobile started prorating fees in June [2008] following the lead of Verizon Wireless and AT&T"), available at: [http://news.cnet.com/8301-17938\\_105-10074400-1.html?tag=mncol:title](http://news.cnet.com/8301-17938_105-10074400-1.html?tag=mncol:title).

<sup>x</sup> See note 1, *infra*.

<sup>xi</sup> "CTIA Petition for Expedited Declaratory Ruling on Early Termination Fees" (March 15, 2005), available at: [http://files.ctia.org/pdf/filings/050314\\_CTIA ETF Petition.pdf](http://files.ctia.org/pdf/filings/050314_CTIA ETF Petition.pdf).

<sup>xii</sup> Christopher Guttman-McCabe, [Withdrawal filing,] "CTIA Petition for Expedited Declaratory Ruling on Early Termination Fees," WT Docket No. 05-194 (June 12, 2009), available at: <http://files.ctia.org/pdf/filings/090612 ETF Withdrawal Filing.pdf>.

<sup>xiii</sup> See, e.g., F.A. Hayek, *The Road to Serfdom* (50<sup>th</sup> Anniv. Ed., 1994) at 55-56:

...because all the details of the changes constantly affecting the conditions of demand and supply of the different commodities can never be fully known, or quickly enough to be collected and disseminated, by any one center, what is required is some apparatus of registration which automatically records all the relevant effects of individual actions and whose indications are at the same time the result of, and guide for, all the individual decisions.

This is precisely what the price system does under competition, and what no other system even promises to accomplish. It enables entrepreneurs, by watching the movement of comparatively few prices, as an engineer watches the hands of a few dials, to adjust their activities to those of their fellows. The important point here is that the price system will fulfill this function only if competition prevails, that is, if the individual producer has to adapt himself to price changes and cannot control them. The more complicated the whole, the more dependent we become on that division of knowledge between individuals whose separate efforts are co-ordinated by the impersonal mechanism for transmitting the relevant information known by us as the price system.

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*Id.*, at 103:

In a competitive society the prices we have to pay for a thing, the rate at which we get one thing for another, depend on the quantities of other things of which by taking one, we deprive the other members of society. Price is not determined by the conscious will of anybody. And if one way of achieving our ends proves too expensive for us, we are free to try other ways. ... In a directed economy, where the authority watches over the ends pursued, it is certain that it would use its powers to assist some ends and to prevent the realization of others. Not our own view, but somebody else's, of what we ought to like or dislike would determine what we should get.

F. A. Hayek, *The Constitution of Liberty* (1960), at 227-228:

There are several reasons why all direct control of prices by government is irreconcilable with a functioning free system, whether the government actually fixes the prices or merely lays down rules by which the permissible prices are to be determined. In the first place, it is impossible to fix prices according to long-term rules which will effectively guide production. Appropriate prices depend on circumstances which are always changing and must be continually adjusted to them. On the other hand, prices which are not fixed outright but determined by some rule (such as that they must be in a certain relation to cost) will not be the same for all sellers and, for this reason, will prevent the market from functioning.

F.A. Hayek, *The Fatal Conceit* (W.W. Bartley III, editor, 1991), at 95:

... Value indicates the potential capacities of an object or action to satisfy human needs, and can be ascertained only by the natural adjustment through exchange of the respective (marginal) raters of substitution (or equivalence) which different goods or services have for various individuals... Each person has his own peculiar order for ranking the ends that he pursues... ...Since most material means can be used for many different ends of varying importance, and diverse means can often be substituted for one another, the ultimate value of the ends comes to be reflected in a single scale of values of means – i.e., prices – that depends on their relative scarcity and the possibility of exchange among their owners. Since changing factual circumstances require constant adaptations of particular ends to whose service particular kinds of means must be assigned, the two sets of scales of values are bound to change in different manners, and at different rates...

<sup>xiv</sup> See Anne C. Boyle, "FCC Comments: En banc ETF hearing" (June 12, 2008) ("I believe the wireless industry and its 260 million customers in our country today would be better off if early termination fee contracts were abolished"), available at: <http://www.fcc.gov/realaudio/presentations/2008/061208/boyle.pdf>.

<sup>xv</sup> See, e.g., Martiga Lohn, "Sprint Nextel Settles Minn. Lawsuit Over Contracts," *abcNEWS.go.com* (via Associated Press) (November 16, 2009), available at: <http://abcnews.go.com/Business/wireStory?id=9096412>; Kent German, "T-Mobile proposes settlement for early termination fees," *Crave: the Gadget Blog from CNET* (May 14, 2009), available at: [http://news.cnet.com/8301-17938\\_105-10241101-1.html?tag=mncol:title](http://news.cnet.com/8301-17938_105-10241101-1.html?tag=mncol:title); Chloe Albanesius, "Verizon Settles Early Termination Fee Lawsuit," *PCMag.com* (July 10, 2008), available at: <http://www.pcmag.com/article2/0,2817,2325287,00.asp>.

<sup>xvi</sup> See note 8 *supra*.