OFFICE OF
REGULATION REVIEW

Regulation and the direct marketing industry

A submission to the Working Group on Direct Marketing

SUBMISSION

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The Office of Regulation Review

The Office of Regulation Review (ORR) — located within the Industry Commission (IC) — is responsible for advising on the Commonwealth Government's regulation review program. Amongst other functions, the ORR provides public advice on regulatory issues. In recent years the ORR has contributed to the policy formulation process on competition issues, has provided related advice to Industry Commission inquiries, and has published research papers on the issues. In this submission the ORR offers comments on some emerging issues relating to the direct marketing industry.

The direct marketing industry

Direct marketing is a growth sector of the retail market. The Australian Direct Marketing Association (ADMA) estimates that gross sales by direct marketing amounted to $4.3 billion in Australia in 1994, with annual growth currently exceeding 20 per cent. The size of this market, along with the large growth rate, indicates strong consumer acceptance of direct marketing.

The large growth rate of direct marketing is due to technological developments associated with database applications and to developments in the telecommunications sector.

Consumers are attracted to direct marketing for various reasons. Chief among these reasons are price considerations — lower prices always attract consumers. Direct marketing offers shoppers the convenience of being able to shop from home. Direct marketing expands the range of choice for shoppers, and provides more competition for traditional methods of product distribution.

In order to place the growth of direct marketing in context, it is necessary to reflect on the history of retail marketing. Retail marketing in Australia has a history of change. For example, the post-war period saw the rise of discount stores. The distribution of consumer goods moved away from service providing retailers towards chain and discount stores providing fewer services and less personal selling. Increased consumer mobility and the advent of television in the 1950s, which increased the cost-effectiveness of advertising, enabled these centralised stores, because of price and convenience advantages, to gain at the expense of specialist stores. This trend has continued with the modern move away from suburban/local shopping centres towards large shopping malls.

Like the advent of the shopping mall, the rise of direct marketing (made possible by technological developments, and made attractive by its convenience) can be viewed as just another step in the evolution of retail marketing. At this time, direct marketing complements as well as competes with other forms of marketing.

Market disciplines on poor performance

Direct marketing is an industry possessing several characteristics which pre-dispose both buyers and sellers to exercise particular caution when dealing with each other.

Direct marketing, as defined in the Discussion Paper, "encompasses all those marketing activities which promote the sale of products or services at places other than on registered retail premises". In contrast to traditional shopping, buying from direct marketers usually provides no opportunity for product inspection, there is little (if any) scope to compare prices and quality with competing items, and the return of goods is more difficult. These obvious features tend to make consumers more wary so that direct marketers must put a lot of effort into establishing and demonstrating their credibility.

Consumer wariness is reflected in the types of products sold via direct marketing. There is a minimum price below which direct marketing is largely ineffective, because the cost saving does not justify the additional waiting time associated with home delivery. Consumers risk disappointment with a trial purchase of a new product, or from a new supplier. It could be argued that, in making any trial purchase, consumers would place a high weight on the risk of disappointment, and buy only cheaper goods. There is therefore a maximum price above which the risk of disappointment outweighs any gains, in the form of a lower price and more convenience, to the consumer. Hence, many direct marketing campaigns feature relatively low priced consumer durables.

Direct marketing also tends to concentrate on compact products. Larger, bulkier products are more expensive and more difficult to home deliver. Naturally enough, higher home delivery costs reduce the cost effectiveness of direct marketing.

For firms to establish their credibility, and therefore to win over sceptical consumers, there are several actions that can be taken. Such firms need to demonstrate that they are not fly-by-night operators. For example, new suppliers will make a set of conspicuous investments to signal to consumers that they have a long term commitment to the market. Much of the early efforts of a business are to establish name recognition and goodwill. Firms will not engage in expensive, long term advertising campaigns, or provide a wide range of products, if they are short term operators. This is particularly true given that new businesses can take several years to break even.

Once any business has established a good reputation, a core of repeat purchasers becomes established and that helps ensure the long-term viability of the business. If a business develops a poor reputation, past consumers will not repeat purchase, and some potential new customers will take their business elsewhere —

ultimately such businesses fail. For direct marketing businesses, ADMA has indicated that more than two-thirds of customers make repeat purchases — this underlines the strong incentive for such businesses to build up and maintain a favourable reputation.

In the case of low priced goods for which repeat purchase is common, a company would be most unlikely to engage in misconduct because the repeat purchase aspect gives the consumer easy access to retribution, and provides the consumer with the experience by which to judge misconduct.

Potential impact of regulation

The size of the direct marketing industry, and its rapid growth in recent years, suggests that consumers are fairly happy with the performance of the industry. The Discussion Paper, however, has identified certain potential problem areas, including privacy and cooling-off periods. The potential impact of regulation in these areas is discussed below.

Privacy

The Working Group has concerns about privacy issues in relation to the development and use of mailing lists, and in relation to 'cold' and 'warm' phone calls ('cold' calling is where a consumer is approached for the first time; 'warm' calling is where the consumer is a previous customer). As noted by the Working Group, 'cold' and 'warm' telemarketing calls have the greatest capacity to unduly intrude into consumers' privacy because they are mostly carried out at the consumers' residence and out of normal business hours.

In discussing mailing lists, there are two possible regulatory approaches, opt-in and opt-out. Opt-in requires that traders obtain consumers' consent before placing their name on a mailing list. Opt-out allows direct marketers to send material to consumers, but gives consumers the option to choose not to receive any further information from that marketer.

The ORR favours the opt-out approach. Opt-in would unduly curtail the effectiveness of direct marketing because lists would be much smaller, and market growth would be harder to achieve. With regard to the opt-out approach, there is a strong incentive for firms to remove names from lists because a list that is ineffective increases the cost of business, and has a reduced resale value. In considering these issues, it is important to recall that many people benefit from the existence of mailing lists (as shown by the size of the industry), and that this must be balanced against the privacy concerns motivating those in favour of the opt-in approach.

With regard to 'cold calls', there is an incentive for business not to make invasive calls which antagonise potential customers. Such calls run the risk of eroding the goodwill of the company. 'Cold calls' tend to be used mainly by charities which perceive relatively low risk to their reputation by an unsuccessful call.

There is a similar incentive for business not to abuse 'warm calls'. While 'warm' calls are more likely to be successful than 'cold' calls because they target customers who have already expressed an interest in the product being sold, antagonising calls will only serve to reduce goodwill and to diminish the possibility of repeat purchases. Unsuccessful calls only cost money. When telemarketers narrow the market, they reduce operating costs, raise the percentage of sales, and can then make a higher profit. There is an additional potential safeguard for concerned consumers — being more selective in passing on their phone number and personal information will reduce the effectiveness of these lists.

Cooling-off periods

The mandatory inclusion of a cooling-off period would place direct marketing at a competitive disadvantage relative to other forms of retailing. Delivery of low cost items would be too slow for direct marketing to be an attractive alternative. Over-the-counter retailing is not required to offer cooling-off periods or unconditional money-back guarantees, so nor should direct marketing, unless a very strong supporting case can be demonstrated. At the least, a waiver option should be given so that repeat purchasers will not be unduly disadvantaged.

The case for a cooling-off period is strongest when the product is infrequently purchased, or when the goods purchased are of high value. This is where sellers have the most to gain from high pressure sales tactics. Consumers risk more disappointment with these sort of purchases, and gain little benefit from hindsight. Yet even in such cases, regulation may be unnecessary. Competitive pressures may cause sellers to offer money-back guarantees, or to require payment only after delivery is accepted. Such offers have been evident in Australia. Failure to adhere to such an offer would cause a loss of goodwill, and provide cause for action under the *Trade Practices Act*.

If a regulatory approach is adopted, then only those aspects of direct marketing that are conducive to high pressure sales tactics (eg door to door trading, not television advertising) should be regulated. The proposed solution should be sure to target the perceived problem.

A balanced approach

Regulating direct marketing per se would affect the manner in which business operates. In many cases, regulations would mean that a business would be

unable to pursue its first choice method of selling, and would be forced to pursue an alternative, possibly more costly, method. This would serve to increase business costs, which would place such a business at a competitive disadvantage. For example, without the use of marketing lists, businesses would be reduced to sending out catalogues more randomly or not at all. Any such regulations would provide protection to established selling methods from direct marketing.

These potential costs need to be balanced against potential benefits when assessing the case for regulation of direct marketing.

Direct marketing is not unregulated

There are various business laws affecting direct marketing, as well as all other competing forms of retailing, which offer consumer protection. The most notable examples are the *Trade Practices Act* and the various *Fair Trading Acts* in each State. The consumer protection provisions in these Acts are extensive, and provide protection from various forms of unscrupulous business conduct. Given that these laws are standard across all forms of retailing, there would have to be a strong case presented as to why direct marketing should be subject to specific additional regulation.

There are also market based means of protection available to consumers. Apart from the market disciplines on producer behaviour, and various safeguards available to consumers (such as the opt-out option), the use of credit cards provides protection from failure to deliver after payment. This is because credit card providers guarantee delivery.

Is consumer redress a problem?

Consumer redress, particularly in the context of information, payment and delivery, was regarded as a major problem in the Discussion Paper. The Working Group is therefore contemplating some industry-specific regulation. The above comments, however, indicate that consumers already have avenues of redress via existing laws and existing market mechanisms.

Government policy on regulation

The preceding sections have discussed some of the issues relating to the direct marketing industry. In contemplating regulation, however, there are further issues which the Working Group should consider.

The Commonwealth Government's policy is to encourage 'minimum effective regulation'. Under the policy, a particular regulation will be supported only where a well defined social or economic problem exists, where other means of

solution such as market mechanisms or self-regulation are inappropriate, and where expected benefits exceed costs. The policy does not prescribe exactly what type of regulation should be used in a particular circumstance. Rather, it sets out principles and analytical requirements to be followed in the development of regulation. In considering regulation, relevant issues include:

- is the objective of the regulation clear?
- how do alternative mechanisms for achieving the objective compare?
- do the benefits of the regulation exceed its costs?

Alternatives to regulation

Two of the alternatives to government regulation are self-regulation and 'enforced' self-regulation. The terms of reference for the Working Group specify that consideration be given to options such as self-regulation. 'Enforced' self-regulation involves the innovative use of regulation — examples at the Commonwealth level include the television code and the banking code of practice. The pros and cons of these alternatives have previously been discussed in *Recent developments in regulation and its review* (ORR 1993). The following discussion draws from that work.

Key questions are when should government regulate directly, when should it defer to industry to implement its own codes, and when should it enforce self-regulation.

The market problems which best suit self-regulation relate to inadequate information. Information may be inadequate where it is misleading, where consumers are unable to evaluate it, where the cost of misinformation is high, or where providing it is very costly for firms. To overcome these problems, firms may co-operate by, for example, agreeing to information disclosure standards, or offering low-cost arbitration of disputes.

However, self-regulatory codes will generally not be appropriate where:

- enforcement mechanisms are inadequate. Self-regulation is difficult to enforce because it lacks the backing of legislation. For this reason, self-regulation is most effective in mature, concentrated markets or in markets where consumers make mainly repeat purchases. In a concentrated industry, it is easier for community interest groups and other firms to highlight breaches of the industry code. In addition, if the market consists mainly of repeat purchasers, customers can penalise firms for any divergences from the code by taking their custom elsewhere; and
- they have the potential to be used as an anti-competitive tool. This anti-competitive effect may be evident in a number of ways: entry restrictions,

restricted supply, restricted range of products, increased prices, and promotion of the cartelisation of the industry.

While direct regulation by government will generally be preferable to self-regulation by industry in such circumstances, enforced self-regulation may be a reasonable middle ground. Enforced self-regulation allows the industry itself to retain the power to revise and modify its code in response to changing community and consumer preferences, but also offers a mechanism for ensuring greater compliance with a code of practice.

Weighing up the benefits and costs involved in these processes, and determining on whom (industry or consumers) they would fall in the first instance, requires case-by-case analysis. In some cases, however, enforced self-regulation will provide a reasonable trade-off between the costs of direct regulation and the compliance problems associated with some self-regulatory schemes.

Regulatory impact assessment

Under the Mutual Recognition Agreement, Ministerial Councils can be called upon to make nationally applicable standards on any product in the marketplace. Given this mechanism, the Council of Australian Governments has developed and endorsed *Principles and Guidelines for National Standard Setting and Regulatory Action by Ministerial Councils and Standards Setting Bodies*. These have been developed to ensure that where new standards are considered, they are subject to sufficient scrutiny to guard against the imposition of unnecessary regulation.

Where a Ministerial Council or standard-setting body proposes to agree to regulatory action or to adopt a standard, it must first certify that the regulatory impact assessment process has been adequately completed. Adequate completion involves the preparation of a regulation impact statement which must include:

- a statement of the objectives of the regulation(s);

- identification and consideration of the alternative measures; and

- a broad indication of the relative costs and benefits.

The Working Group should bear in mind these requirements when it considers the need for, and nature of, any regulation of the direct marketing industry.

Concluding comments

Direct marketing is a relatively new form of retailing in Australia, but one which is growing rapidly. Correctly, the Working Group is examining this industry to identify potential consumer protection and other issues which may justify

government intervention. The ORR points out that, in accordance with government policy, government intervention will only be justified where a well defined social or economic problem exists. Accordingly, it is quite appropriate for the Working Group to focus on concerns such as privacy issues, problems of consumer redress and the need for cooling-off periods.

The identification of problems does not, however, always provide adequate justification for regulation. Further steps must be taken. First, are there other potential solutions? The problem may already be addressed by the *Trade Practices Act*, or the market may operate so as to limit the risks for consumers. A key consideration is that businesses aim to be profitable, and there is growing recognition that that requires good customer relations. Second, what are the costs of a regulatory solution? While a particular regulation may solve a problem, it will be costly to develop and enforce, and will often increase business costs. Increased business costs are invariably passed on to consumers in the form of higher prices and/or reduced choices. If that were to happen as a result of increased regulation of the direct marketing industry, many thousands of satisfied direct marketing customers would be the losers.