



**SAMUELSON LAW, TECHNOLOGY & PUBLIC POLICY CLINIC
CENTER FOR CLINICAL EDUCATION**

ACTING CLINICAL PROFESSOR AND DIRECTOR
Deirdre Mulligan
(510) 642-0499
dmulligan@law.berkeley.edu

SCHOOL OF LAW (BOALT HALL)
BERKELEY, CALIFORNIA 94720-7200
TELEPHONE (510) 643-4800 §
FAX (510) 643-4625
<http://www.law.berkeley.edu/academics/samuelson/>

February 26, 2007

Federal Trade Commission/Office of the Secretary
Room H-135 (Annex E)
600 Pennsylvania Avenue, NW
Washington, DC 20580.

Re: Negative Option Workshop - Comment P064202

Dear Commissioners,

Thank you for giving us the opportunity to discuss our research at the January 25, 2007 workshop on negative options marketing. The Samuelson Law, Technology & Public Policy Clinic submits the following comments to supplement the presentations of Jens Grossklags and Nathan Good. These materials are relevant to several key issues in negative option marketing: consumers' reading behavior; installation behavior; presentation of price; intertemporal decision making; and transaction costs.

Reading Behavior

In a recent workshop paper, *Empirical studies on software notices to inform policy makers and usability designers*,¹ Jens Grossklags and Nathan Good perform a preliminary assessment of issues around presentation of notices. They report on average length, average readability and provide views on reading behavior during the experiment:

We have presented results on readability and presentation of EULAs from 50 popular free or free-to-try programs available for download on a distribution page. We suggest

¹ Available online at <http://usablesecurity.org/papers/grossklags.pdf>.

that the length and complexity of documents can significantly lower the notice and consent success rate achieved...

Without significant improvements to notice and consent procedures for consumer programs it is doubtful that most consumers genuinely assent to the use of their desktops for advertisements, the installation of software with behavior that falls within the broad definition of spyware, or limitation of usage rights. We do not expect that there exists a one-size-fits-all solution, in particular, given the increasing popularity of mobile and small-screen devices. Notice and consent involves many stakeholders. Companies are urged to improve their information dissemination practices and regulation may carefully adjust misaligned incentives in the market place. But improved notice procedure will likely result also in a more substantive obligation for users to read notices.

Also relevant to consumer reading behavior is an "experiment" performed by PC Pitstop. That organization hypothesized that hardly any consumer reads EULAs. To demonstrate this hypothesis, PC Pitstop offered to pay money to anyone who read the company's EULA and wrote to PC Pitstop:

...included a clause in one of its own EULAs that promised anyone who read it, a "consideration" including money if they sent a note to an email address listed in the EULA. After four months and more than 3,000 downloads, one person finally wrote in. That person, by the way, got a check for \$1,000 proving, at least for one person, that it really does pay to read EULAs.²

Installation Behavior

In *Noticing Notice: A Large-Scale Experiment on the Timing of Software License Agreements*,³ Nathaniel S. Good, Jens Grossklags, Deirdre K. Mulligan, and Joseph A. Konstan studied the problem of how individuals made decisions to install spyware. They found:

Our study of 222 users showed that providing a short summary notice, in addition to the End User License

² Larry Magid, *It Pays To Read License Agreements*, PC Pitstop (n.d.), available at <http://www.pcpitstop.com/spycheck/eula.asp>.

³ Available at http://www.ischool.berkeley.edu/~jensg/research/paper/Grossklags07-CHI-noticing_notice.pdf.

Agreement (EULA), before the installation reduced the number of software installations significantly. We also found that providing the short summary notice after installation led to a significant number of uninstalls. However, even with the short notices, many users installed the program and later expressed regret for doing so. These results, along with a detailed analysis of installation, regret, and survey data about user behaviors informs our recommendations to policymakers and designers for assessing the “adequacy” of consent in the context of software that exhibits behaviors associated with spyware.

Presentation of Price

In ...*Plus Shipping and Handling: Revenue (Non) Equivalence in Field Experiments on eBay*,⁴ Tanjim Hossain and John Morgan demonstrate that how price is presented can affect consumers' decision making. They argue that: "consumers pay attention to the list price while neglecting the 'add-on' price associated with shipping or with the gratuity. Therefore, they systematically underestimate the total out of pocket price paid for the items being purchased or consumed and hence the seller is able to sell more of a given item than had that firm simply listed a single total price." This work has direct relevance to how negative options can be marketed to mask fees and other charges to consumers. Hossain and Morgan found:

Many firms divide the price a consumer pays for a good into two pieces—the price for the item itself and the price for shipping and handling. With fully rational customers, the exact division between the two prices is irrelevant—only the total price matters. We test this hypothesis by selling matched pairs of CDs and Xbox games in a series of field experiments on eBay. In theory, the ending auction price should vary inversely with the shipping charge to leave the total price paid constant.

Contrary to the theory, we find that charging a high shipping cost and starting the auction at a low opening price leads to higher numbers of bidders and higher revenues when the shipping charge is not excessive.

Also relevant to consumers' perception of product cost is Oren Bar-Gill's *Bundling and Consumer Misperception*.⁵ Bar-Gill argues: "Consumer misperception of the costs and benefits associated with a product or service is prevalent. It can be the product of

⁴ 6 *Advances in Economic Analysis & Policy* 3 (2006), available at <http://faculty.haas.berkeley.edu/rjmorgan/eBay.pdf>.

⁵ Published in American Law & Economics Association Annual Meetings (2006).

imperfect information or imperfect rationality (or both). It can be independent of any action taken by sellers. It can be instigated by sellers. And it can be mitigated by sellers." Bar-Gill's paper offers policymakers a framework for evaluating whether bundling of products affects consumers' understanding of costs.

Intertemporal Decision Making

Bar-Gill's paper also discusses how the presentation of costs over time can affect the consumers' perception of price.⁶ His discussion is directly relevant to the marketing of negative options, which present price information over time in such a way that may contribute to consumer misperception:

One special type of bundling that directly responds to consumer misperception is the intertemporal bundling achieved through multi-period subscriptions. In intertemporal bundling the only difference between the bundled components is the timing. For example, a year-long subscription—to a magazine, a wireless or landline phone service, an ISP, or a health club—provides the same service every month throughout the year. Why are multi-period subscriptions so common? Why not sell only single-period products or services? Consumer misperception provides an answer...

Many subscription services charge a one-time subscription fee as described in the preceding health club example. Other subscription services charge a per-period fee, but follow a fee schedule very different from per-period marginal cost pricing. In particular, many subscription services charge different per-period prices for different periods within a multiperiod subscription. Particularly common is the practice of offering a low price, or even a zero price, for an introductory period. One explanation for this practice is that sellers are exploiting consumer misperception—this time, consumer underestimation of future use. When signing on to a yearlong subscription service with a “two-month free” introductory offer, some consumers think that they will end the subscription after the first two months. Not all of these consumers actually end their subscription after two months. Put differently, sellers may be responding to consumers' underestimation of the length of the period during which they would need or want a subscription with the specific seller. If consumers

⁶ See also Stefano DellaVigna and Ulrike Malmendier, *Paying Not to Go to the Gym* (Apr. 15, 2005).

underestimate the effective subscription period, then sellers in a competitive market will backload their price as much as possible.

This too is an example of intertemporal bundling. The cement holding the bundle together is the cost of switching from one seller to another or simply the cost of terminating the subscription. It is consumers' underestimation of these switching costs that explain the viability of a below marginal cost introductory fee. Since switching costs keep the bundle together, it is not surprising that sellers do not make a special effort to reduce these costs. Perhaps the notorious ten minute "please hold for the next available representative" wait that must be endured to cancel a subscription is not merely the result of a seller's attempt to economize on the size of its customer service department. More direct measures designed to increase switching costs are lock-in clauses and termination fees. If consumers underestimate the cost of switching or, equivalently, underestimate the likely length of their subscription, sellers who fail to take advantage of switching cost-induced bundling and offer only per-period marginal cost pricing will not survive in a competitive market.

Transaction Costs

The Internet is a sophisticated communications medium that radically reduces transaction costs between individual nodes (like the telephone did over hundred years ago). Transaction costs play less of a role and make the scenario that Professor Katz described somewhat artificial and maybe not at the heart of the issue. In 1987, Malone et al. explained three different effects of information technology on the exchange process.⁷ These three effects suggest that Katz's focus on transaction costs is more suitable for offline transactions rather than the different situation online.

In *Technological Advances, Consumer Transaction Costs, and Consumer Welfare*, Rajeev K. Tyagi explains, that lowering transaction costs may even cause detriment to the consumer:

⁷ First, the communication effect: increase information flux per unit of time; second, the electronic integration effect: easier linkage between buyer and seller; and third, the electronic brokerage effect: the contracting process between seller and buyer becomes more efficient and effective. Thomas W. Malone, Joanne Yeates, and Robert I Benjamin, *Electronic Markets and Electronic Hierarchies*, 30 *Communications of the ACM* 484 (1987).

...Using a model in which consumers are simultaneously heterogenous in their transaction costs and in their marginal valuation of product quality, we highlight two mechanisms that can cause such reductions in consumer transaction costs to lower consumer surplus and reduce consumer share of the total social surplus. We also show that when a seller can invest to reduce consumer transaction costs, consumers may be better off with higher transaction costs. Finally, the paper shows how such reductions in consumer transaction costs can either lower or raise consumer prices.

Conclusion

Again, we appreciate the Commission's efforts in addressing challenges in the negative option marketing landscape. We hope these materials are helpful in supplementing the record.

Respectfully submitted,

/s

Chris Hoofnagle
Senior Staff Attorney
Samuelson Law, Technology & Public Policy Clinic

/s

Jens Grossklags
Ph.D. Candidate
School of Information