ACCC AD TECH INQUIRY SUBMISSION

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Background

- Dr. Nico Neumann is Fellow at the Centre for Business Analytics and Assistant Professor at Melbourne Business School
- Research and teaching areas: business analytics and marketing communications
- Industry commentator for advertising economics, transparency and measurement issues
- AdExchanger Awards judge

Advertising – Product Characteristics

The key challenge – advertising is a credence good

Assessing the value of advertising is very hard. The ultimate goal is often to change behaviour or drive sales (short and long term). However, the desired outcomes of ad campaigns depend typically on many factors (often external ones which are beyond someone's control). Understanding how individual ad elements (the creative idea, the creative product, the media placement, the execution etc.) contributed to a success or failure is even more challenging.

- *A credence good requires expert services, whereby the seller of the needed services does not only provide the services but also tends to act as the expert who determines how much treatment is necessary (Emons 1997)*
- *There is a big information asymmetry between buyers and sellers of credence goods, creating a strong incentive to cheat = moral hazard (Emons 1997)*

Advertising – Industry Characteristics

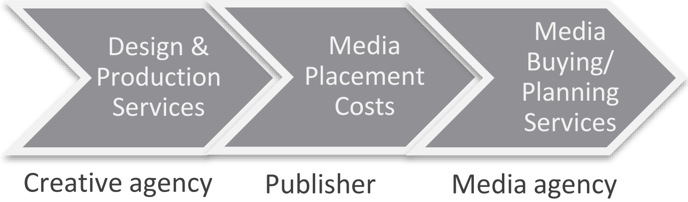
Lack of regulations and measurement standards

- No accepted single standard is used across media or companies, making direct comparisons of media placements and thus advertising efficacy challenging.
    - Example: TV advertising has different measurement units (e.g. audience rating points) than digital banner ads (e.g. clicks or impressions)
    - The industry has even argued about what constitutes a 'viewable impression' for digital banner ads (how long and how much does a creative need to be loaded on a screen)
- Almost no transparency in markets – there is very little (reliable) information available on size/ volume of media-placement markets and market prices. Media buys are usually negotiated individually for every client.
- The standard marketing-effectiveness practices in the industry are often not based on science and are generally very poor. The most widely used allocation procedure for media spend is based on various heuristics.

- ***Poor industry practices and a lack of standards have contributed to the information asymmetry between buyers and sellers of advertising, facilitating and worsening moral hazard.***

Advertising Services – until 1980s/ 1990s

The traditional, basic supply chain of advertising production:



Standard remuneration for ad agents *:

- ➢ **15% commission on media buys**
- ➢ **17.5% mark-up on production**

- ➢ **Result: Agencies had an incentive to sell more of every type of advertising (albeit media neutral).**
- ➢ **The big problem: "What is unusual in the case of ad agencies is that the commission is based not on the sales, if any, generated by the work of the advertising agency, but rather on the cost of the media purchased to help in the generation of those sales. Clearly, there is a serious moral hazard problem in this compensation method." (Zhao 2005, p. 269)**

*** Source:** **https://www.trinityp3.com/2016/07/changing-economics-advertising-agency-business/**

Advertising Services – Challenges Since 1980s/ 1990s

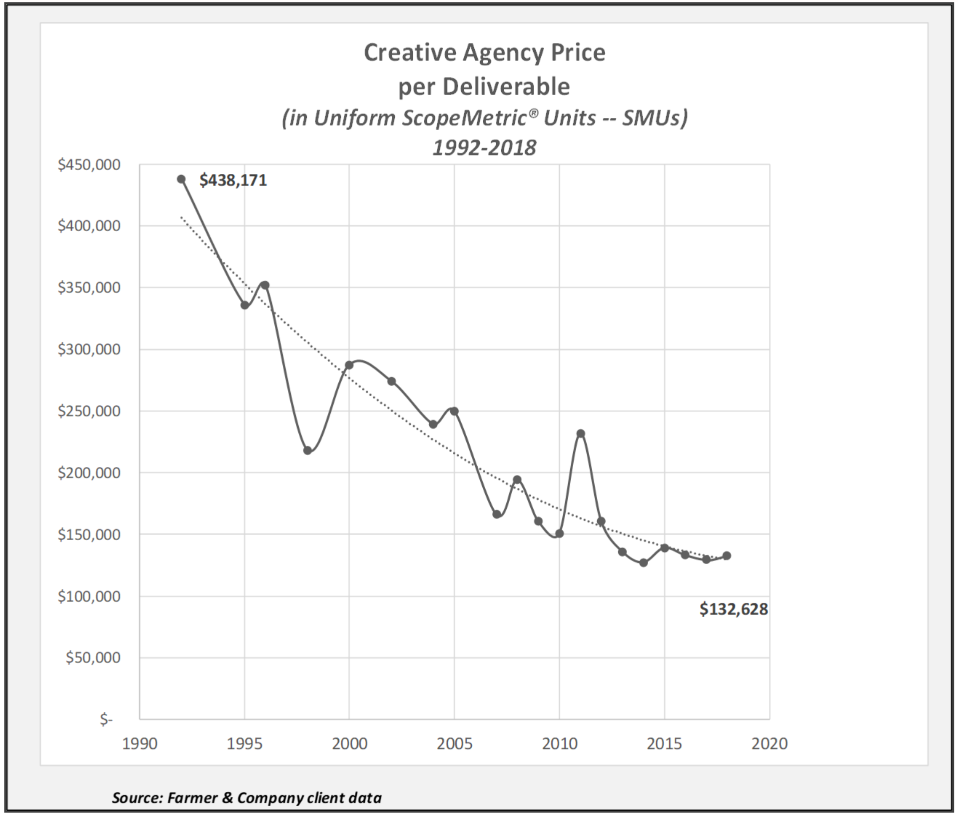
Increased pressure by clients to reduce media costs:

- **Commissions were continuously decreased over the years (Spake et al 1999, Farmer 2019). Today media-account commissions, if present, are often in the range of 5-10% only (Neumann et al. 2019).**
- **Change of business models: agencies introduced fee-based models. The most common type is a retainer, labour-based fee that is based on the number of full-time employees working on an account.**
- **Business models mix in the US in 2017 (according to Tom Finneran, executive VP of agency management services at the 4A's):***
  - 60% of agencies have a labour-based fee
  - 25 % fixed-fees
  - 15 % commissions-based remuneration/ hybrid models

In addition to cost cutting pressures by clients, ad agency services were under threat by the progress in automation and the emergence of the internet (in particular post 2000s). For a similar example, consider the travel industry: many people now book their holidays and trips online themselves instead of using travel agents. **

* Source: https://adage.com/article/agency-news/ideas-worth/311267
** Source: https://www.forbes.com/sites/johnnyjet/2017/11/06/do-people-still-use-a-travel-agency/#608aba3355e6

Evidence: The Decline in Agency Fees



Reproduced with permission. Source: Michael Farmer (2019), Madison Avenue Manslaughter, 3rd edition. LID Publishing.

SMU = ScopeMetric Unit, a proprietary uniform measure developed by Farmer & Company

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Advertising Agents – New Income Sources After Fees Have Declined

Cost-based fees can eliminate moral hazard (Zhao 2005) and also seemed to have reduced agencies' revenues, as shown by Farmer (2019).

Driven by the need to maintain or increase profits, agencies were seeking new income sources to make up for the decreasing client fees/ commissions associated with account management.

Three widely reported tactics to increase profits of agents are:

1. Retaining discounts and supplier rebates
2. Receiving kickbacks
3. Diversification: integration of new up- or downstream services by agency [groups]

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BRIEFING

Bombshell report claims US ad agencies unethically pad their profits with secret rebate schemes

LARA O'REILLY

JUN 7, 2016, 10:21 PM

FACEBOOK | TWITTER | REDDIT | LINKEDIN | EMAIL

US Air Force/Master Sgt. Lance Cheung

The report has huge implications for the US advertising agency sector.

- Association of National Advertisers report finds rebates and other non-transparent business practices are "pervasive" in the US media ad-buying ecosystem — despite agency groups persistently saying they don't take rebates in the US.
- The study found "evidence of fundamental disconnect in the advertising industry regarding the basic nature of the advertiser-agency relationship."
- The investigation found senior executive across the agency ecosystem "were aware of, and mandated," some non-transparent business practices.
- The study also found evidence of "potentially problematic agency conduct concealed by principal transactions; an agency (or its holding company or associated company) purchases media on its own behalf and later resells it to a client after a markup."

Source: https://www.businessinsider.com.au/ana-report-alleges-widespread-ad-agency-kickback-schemes-2016-6?

ad exchanger

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Agency Rebate Tensions Explode Into The Open, As Former Mediacom CEO Decries 'Kickbacks'

by Sarah Sluis // Friday, March 6th, 2015 – 4:00 pm

Share:

Jon Mandel

Agencies are not transparent about their actions. Agencies recommend media that is off-strategy when it works for their gain. Agencies accrue media earned by advertisers' spending and resell it to other advertisers. Agencies demand pay-for-play from vendors in order to be recommended, and cross the line in partnership relationships.

These are among the claims made by Jon Mandel, former Mediacom CEO and chairman/CEO at the consultancy Dogsled Enterprises. Mandel addressed marketers Thursday at the ANA Media Leadership Summit, in a presentation that elicited a chorus of hushed whispers from those in attendance.

The news was controversial enough that the ANA prefaced it with antitrust warnings, worried that marketers might collectively (and illegally) rise together to combat the practice.

Source: https://www.adexchanger.com/agencies/agency-rebate-tensions-explode-into-the-open-as-former-mediacom-ceo-decries-kickbacks/

Discounts, Supplier Rebates and Kickbacks

Clauses to retain rebates etc. may be written in contracts and fine prints

*Example *: "The Agency reserves the right to retain any commissions, rebates, allowances, credits, discounts or any other benefits allowed to the Agency by any Media Vendor, or other third- party supplier, including any relating to prompt payment of media accounts or the Agency's volume with a particular Media Vendor."*

Hidden kickbacks can be enabled through reciprocal business deals among media companies

*Example **:" Some arrangements go like this: A large media shop, poised to spend $1 million with that ad-tech executive's firm to buy digital ads last year, asked for $200,000 to be routed back to the agency's corporate sibling in Europe. The $200,000 would pay for a presentation or presentations by the sibling's consultants. But these types of presentations aren't worth a fraction of the price tag, according to numerous executives dealing with the same issue, who spoke on condition of anonymity for fear of losing business."*

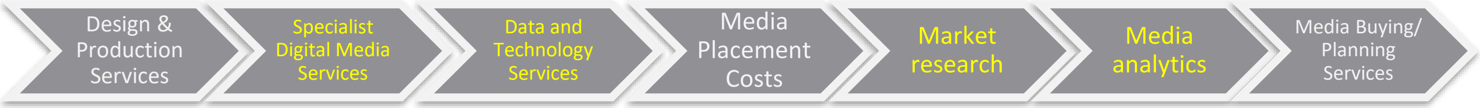
- **The problem: these practices can be unethical (if not disclosed openly to clients) and potentially illegal in some jurisdictions. Uncovering kickbacks disguised as another service or good is very challenging without auditing every reciprocal business deal among media companies.**

*** Source: http://www.adnews.com.au/opinion/how-to-spot-hidden-commissions-in-media-buying**

**** Source: https://adage.com/article/agency-news/media-agency-kickbacks-real/297707**

Integration of New Up- or Downstream Services by Agency [Groups]

The media supply chain has grown and become more complex over the years:



Diversification

Advertising agencies have increasingly invested in media owners/ publishers and or new services that emerged over time (see yellow-font elements in graph above). Agency networks have grown through vertical integration while also expanding internationally over recent decades.

- **Result: the diversification has created new conflicts of interest and just shifted the moral hazard problem. In particular the case of owning media analytics/ planning services and the product that is sold (advice or inventory) is of concern (see also Inderst and Ottaviani 2009): this combination can be seen as 'grading or auditing your own homework'. Hence, it is easy to steer media spend towards entities which the agency group has invested in to increase its overall revenues.**

Further Problems of Media Digitalisation and Ad Tech (Programmatic Advertising)

1. **Digitalisation** (in particular the emergence of the so-called programmatic ecosystem) has increased the complexity of the ad-buying process and thus **information asymmetry between buyers and sellers.**
2. The long ad-tech supply chain (with multiple intermediaries) and contractual requirements to source digital media inventory primarily or exclusively through agency network partners increases the **risks of double marginalisation.**
3. **Retaining rebates creates incentives among agents to shift money to more lucrative channels:** "Rebates are lowest for traditional media, such as television and radio, where they can total up to 5 percent of overall spend with a given TV or radio supplier. Even though this isn't large on a percentage basis, when advertisers invest a major portion of their budget in traditional media, rebates can amount to very large sums. Rebates for out-of-home advertising are typically larger, as much as 15 percent. **In digital media, rebates are the largest, estimated at 20 to 35 percent**, when both cash and noncash AVBs are included. " (Armstrong et al. 2018, p. 2)
4. **Common payment methods for digital media are highly problematic:**
   - ➢ Volume based metrics not linked to outcomes (e.g. CPMs/ markups) – this is the old non-sales-related commission moral hazard, which is now just pushed downstream in the new supply chain.
   - ➢ Performance-based metrics (payments per click, engagement or other action) – this often creates a double marginalization problem too (Dellarocas 2012).
   - ➢ Both the volume-related and most per-action payment methods (other than sales related) are easy to fake or to game and have contributed to the surge in **advertising fraud.**

Advertising Fraud

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REPORT: Ad fraud is 'second only to the drugs trade' as a source of income for organized crime

Ronan Shields, The Drum Jun 6, 2016, 11:01 PM

Click fraud will become so rampant that it will cost advertisers more than $50bn by 2025, according to The World Federation of Advertisers (WFA), with the trade body advising brands to apply caution to their digital investment until the ad tech sector more effectively deals with the problem.

The World Federation of Advertisers says ad fraud will cost advertisers $50 billion a year by 2025. Shutterstock/Anton-Burakov

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Brands Lose Up To An Estimated $50 Billion Annually From Ad Fraud

by **Laurie Sullivan** **@lauriesullivan**, March 5, 2019

About three-quarters of U.S. fraudulent advertising traffic is "sophisticated" invalid traffic, according to data released Tuesday.

Looking at IP and blacklists no longer works, said Guy Tytunovich, CHEQ founder-CEO, and a former Israeli military intelligence officer.

Tytunovich called ad fraud the second-largest organized-crime scheme globally, in terms of revenue generated, including narcotics.

"The industry needs to understand that for the last 10 years, vendors have been talking about different methods for detecting fraud through probabilistic and simplistic approaches," he said. "At the end of the day, which I learned working for the defense intelligence in Israel, it's a cat-and-mouse game. These methods no longer work."

CHEQ, whose scientists continue to build out a military-grade ad-verification service, analyzed 4.1 billion ad requests made in the United States across 1.2 million websites between October 2018 and February 2019 -- up about 20% from the prior year. About 18% of the online ad traffic was fraudulent.

Source: https://www.businessinsider.com/wfa-report-ad-fraud-will-cost-advertisers-50-billion-by-2025-2016-6?IR=T

Source: https://www.mediapost.com/publications/article/332752/brands-lose-up-to-an-estimated-50-billion-annuall.html

Why Has There Been Little To No Market Correction or Self Regulation?

The nature of the advertising product (credence good) and lack of industry standards is problematic:

- **The degrees of freedom in determining and reporting advertising-success metrics facilitates coalition between advertisers and their ad agency, whereby the latter can promise to make the client "look as good as possible" (basically selling 'confirmation bias') in exchange for business contracts.**
- **Even without possible collusion: objective assessment of advertising services is challenging for advertisers and their superiors (in particular for new complex digital and programmatic media).**

The nature of the agent-principal relationship combined with the problematic compensation structures lead to moral hazard in teams and possible collusion (Alchian and Demsetz 1975, Tirole 1986):

- **The advertiser acts as an advocate for the agent (they selected).**
- **The advertiser may exploit information asymmetry in their organisation and manipulate information provided to superiors in exchange for other benefits (side contracts in the form of hidden kickbacks from the agent to the advertiser, such as sport game invitations or regular dinners and events).**
- **The typical retainer relationships increase the risk of collusion: The likelihood of side contracts is more likely to form out of long-term relationships (Tirole 1986, Kofman and Lawarrée 1993).**

Example: Suspected Possible Collusion Between Marketers and Agents

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BUSINESS

Samsung Probed U.S. Marketing Operation Over Dealings With Business Partners

Company laid off number of staff amid broader realignment and executive turnover

By Alexandra Bruell and Suzanne Vranica

March 21, 2019 4:25 p.m. ET

Samsung Electronics Co. audited its U.S. marketing operation to investigate whether employees violated company policies in their dealings with business partners, resulting in layoffs of several staffers, according to people familiar with the situation.

Source: https://www.wsj.com/articles/samsung-probed-u-s-marketing-operation-over-dealings-with-business-partners-11553199923

Risks and Negative Consequences of Current Advertising Practices

- **The current advertising-service practices show many worrying characteristics and symptoms of an highly inefficient market that reduces overall consumer welfare largely through moral hazard:**
  - Potential mismatch of consumer information and product needs (Anand and Shachar 2011).
  - Inefficient advertising costs increase the prices of the advertised products.
- **The inefficient market mechanisms in combination with an increasing advertising spending in digital channels and overall have attracted many cyber criminals, as shown by high levels of ad fraud in the last decade.**
  - Money is assumed to be diverted from big companies to 'bad guys' (and may be used to subsidise or fund other illegal activities).
- **Money that used to fund journalism, content and news publishers is diverted to intermediaries/ advertising agents in many digital channels (e.g. see Neumann et al. 2019).**

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