

Agenda

Advancing economics in business

What's the price? Consumers and the art of hidden charging

Business models offering low up-front prices but stinging consumers with additional or 'hidden' charges are popular with firms, but they are a cause of complaint by consumers and of concern to regulators. What are hidden charges, and what harm might these cause to consumers? Why do 'fair-dealing' firms not always drive out the bad, and how should regulators respond? John Holmes, Principal Economist, *Which?* offers some thoughts on these issues, and asks whether it is now time for a change in the law¹

Arriving at the airport, eager to begin your holiday and tired of queuing, you face the car hire desk having pre-booked your car online, and paid by credit card, all you need now are the keys? No, you're asked about whether you want to pay extra for 'super collision damage waiver' or face the risk of £1,500 insurance excess. You also find a long list of exclusions for windscreen, tyres, roof and undercarriage. Finally, you are informed that you must return the car with a full tank of fuel. The queue at a foreign airport is no place to quibble, so duly paying the required amount, you leave with the keys—what other choice did you have?

These hidden charges, added to those of the flights (for payment method, baggage, shoe size or whatever other creative charges have been newly imposed), and surcharges for currency fluctuations since you booked your holiday can add up to a sizeable amount.² The sting of these charges may leave you wondering why they weren't clearly included in the up-front price—or whether you would have done something differently if they were—and an uncomfortable question of whether you were cheated?

Hidden charges are clearly a popular business model and appear successful or at least profitable. Firms often choose not to compete on the basis of clear and up-front fees and charges. A review of 530 UK-based online retailers revealed that 40% did not include compulsory additional charges when prices were first shown, only at checkout.³ The Cruickshank report noted that consumers are not adequately informed about their financial products, hindering comparison.⁴ The success of hidden charges as a business model is perhaps exemplified by statements from banks' internal documents:

these proposals [to increase insufficient funds charges] deliver substantial revenue growth by increasing the yield from existing overdraft customers' and 'increasing [insufficient funds] charges will have less impact on our marketing position [than] credit interest changes due to... lower visibility.'⁵

Consumers and regulators are much less satisfied with the prevalence of hidden charging, with legal challenges by consumer groups to airlines' charging policies and the Office of Fair Trading (OFT) undertaking a market study into price advertising.⁶ The recent bank overdraft charges case, which the Supreme Court ruled were not subject to unfair terms regulations, stemmed from long-running concerns as to whether these charges are sufficiently clear to consumers, form an obvious part of the bundle of services included in the product, and are levied at a fair price.⁷ The Financial Services Authority is investigating a number of firms for excessive mortgage arrears charges, which included costs unrelated to handling customers' arrears, and in one case has required up to £7.7m to be refunded to affected customers.⁸ So, how do we recognise hidden charges? Other than irritation or annoyance, what harm can such charging practices really have? Why don't fair-dealing firms drive out the bad, and what can or should consumers, firms and regulators do?

Defining hidden charges

For the purpose of this article, charges are hidden if unobserved and unavoidable by consumers.⁹ Simply put, a charge is likely to be hidden if:

- the final price the consumer pays differs from the ‘shop window’ price, or the existence or level of a charge was unanticipated; and
- these charges are practicably unavoidable; to avoid a charge the consumer must forgo purchasing the goods or service, or pay a penalty fee.

In practice, hidden charges may take many forms; presented as ‘cost recovery’ fees, such as surcharges for credit or debit card payments, or optional extras such as insurance liability waivers. *Which?* has regularly reported on cases where hidden charges arise, for example car hire, payment method surcharges among airlines or ticket agents, fees for financial services such as mortgage valuation fees, arrears fees, or charges for changing personal details.

The following examples illustrate some common characteristics or situations when hidden charges more frequently occur, and how they are applied to transactions:

- purchases are often ancillary or incidental to a more important goal but necessary to secure this more valued and significant purchase. For example, consumers *want* to buy holidays, cars and houses but *must* buy flights, car hire, insurance and mortgages to achieve their aim. The examples of hidden charging noted by *Which?* appear to be much less common among high-street retailers where the product itself is a direct fit to the consumers’ needs;
- purchases often involve multiple transactions (sometimes with multiple agents or firms), each incurring a small but cumulative cost;
- the transactions may be undertaken infrequently, months apart if not years; and
- the circumstances in which a contingent fee (those fees levied on consumers when certain conditions are met) may apply are unanticipated or unexpected, especially when considered at the point in time when initially committing to the purchase—for example, the charges levied for mortgage arrears are unlikely to be foremost in the customer’s mind when buying a home.

Hidden charges may not only distort the decisions of consumers from a demand perspective, but can also weaken competition between firms on the supply side. In addition, good firms, which abstain from hidden charges, may not drive out the bad. It is worth exploring these two effects in more detail.

How do consumers respond?

In terms of the potential impacts on consumers, hidden charges can:

- result in direct financial loss—the charges do not reflect reasonable or efficiently incurred costs;
- weaken competitive rivalry or the effectiveness of competition—prices that are excluded from a headline price are ‘insulated’ from competition, potentially distorting the switching decisions of consumers, compared to the case where they anticipated the existence and level of the charge.¹⁰

At their simplest, hidden charges create or exacerbate information asymmetry between consumers and firms. Hidden charges increase the search costs for consumers to discover better price offers, costing time to diligently explore the market. If price offers are time-limited, for example tickets to see a popular band or seats on a flight, searching the market is an ever-moving feast—with a real risk of losing a current bargain while comparing other offers.

But shouldn’t consumers simply be more aware of the practice of hidden charges? And do they not simply learn over time? How ‘hidden’ are some of these charges to the consumer? After all, the menu of options offered by airlines, the costs of using a credit card abroad and bank charges have all been widely reported. Can we expect informed consumers to adapt to these charging practices, avoiding the pitfalls (by making the necessary mental calculations of ‘actual’ prices) or accepting hidden charges as necessary to secure the goods or services they want?

Whether or not consumers do actually suspect or anticipate hidden charges may, however, be irrelevant to them losing out. As outlined above, the characteristics of hidden charges or circumstances in which they are applied may exploit limitations to consumers’ ability to process and compare price offers, leading to (possibly systematic) mistakes. This limitation to consumer behaviour is often termed ‘bounded rationality’.¹¹ As a result, it may not just be myopic consumers who are harmed by hidden charges. For example, knowing that the ‘headline’ price is unlikely to be the final or ‘real’ price does not necessarily weaken the impact of ‘price anchoring’: the ‘low’ price has a suggestive effect on a consumer’s subsequent and relative price comparison between rival offers. This recognises that choices are ‘reference-dependent’.¹²

In addition, consumers may be prone to over-optimism. This may lead to an underestimation of the frequency with which consumers may be faced with contingent

fees, resulting in overconsumption. Conversely, consumers may overestimate the probability of an event occurring, for example the risk of a motoring accident while on holiday.¹³ Hidden charges are not, therefore, just a problem for poorly informed or inattentive consumers, which suggests that information remedies alone may not be effective.

Firms' response to hidden charging

As noted above, firms may have an incentive to employ hidden charges, which may earn more revenue than being 'fair'.¹⁴ However, if hidden charges prejudice consumers, once this practice is revealed, would consumers not simply switch to fair-dealing firms, with the 'good' driving out the 'bad'? Even if consumers are poorly placed to respond individually to hidden charges, surely it is in the interests of firms to highlight cases of hidden charges employed by rivals to attract disgruntled customers? This version of an 'unravelling principle' suggests that credible claims from firms that adopt a fair charging policy should be rewarded by customers switching from 'silent' (and therefore presumably unfair) rivals.¹⁵

However, it appears entirely feasible that individual firms do not gain any benefit from educating consumers about rivals' hidden charging. This can lead to a market where 'competition on the merits' is made up largely of ever greater efforts to employ hidden charging practices. Two cases are considered below where this may arise. First, price-shrouding suggests that rational consumers would exploit hidden charging at the expense of myopic consumers and fair-dealing firms. The second, more general case, considers the cost of asymmetric information: the strength of consumers' learned expectations that undermine any attempt by a fair-dealing firm to gain a competitive advantage over rivals that levy hidden charges.

The model of price-shrouding considered by Gabaix and Laibson is not directly relevant to hidden charges as defined in this article, in that the model deals with add-on charges for which¹⁶ there is a discrete demand and which are avoidable. However, it does offer an insight into why hidden charging may become entrenched in a market, even with some informed consumers and rivalry between firms. There may be a price to honesty, turning consumers into less profitable customers. Specifically, Gabaix and Laibson considered a model of price-shrouding, where firms charge for add-on services while offering an apparently low headline price. Both myopic and rational consumers use the product. Myopic consumers are unable to anticipate the existence of the add-on charges and cannot take steps to avoid the add-on costs. In contrast, rational consumers are able to

anticipate the add-ons and take steps to avoid the additional cost. Shrouding prices in this way leads to myopic consumers paying more for the product than rational consumers. A fair-dealing rival, which attempts to 'de-bias' myopic consumers, would not necessarily attract additional customers: informed rational consumers would stay with the add-on firms but enjoy the benefit of avoiding those charges. Informing consumers would result in lower revenues for 'add-on' firms but no additional custom for a fair rival.

The second case recognises that, for consumers, determining which firms are fair-dealing or not has a cost.¹⁷ This information asymmetry may enable hidden charges to persist, in a scenario loosely analogous to a 'market for lemons' (where the uncertainty of identifying good and bad quality products undermines the gains from trade). Hidden charges are, by definition, difficult to uncover and, once experienced, may affect consumers' judgement about firms' truthfulness. If all consumers expect to be 'cheated' by firms, and face costs in uncovering hidden charges, they may be disincentivised or disinclined to sort the wheat from the chaff. This may especially be the case where the goods or services concerned are ancillary or incidental to the consumers' main purchase. These views may become entrenched over time; consider, for example, the expectations of consumers dealing with estate agents. Consumers do not seek out or reward fair-dealing firms with their custom, relying on their rule of thumb that all firms 'cheat'. These perceptions may be slow to change. In this environment, competition may be ineffective at driving firms to offer transparent, comparable and fair prices.

What outcomes do we want?

Comparing products supplied by rival firms is the driving force of competition and underlies *Which?*'s mission to enable informed choice. *Which?* considers, perhaps naively, that consumers should be able to choose goods and services based on price, quality, convenience or any other attributes that consumers value. Firms should strive to deliver goods and services that meet these needs. If a charge cannot practicably be avoided, it should be included in the up-front price offer that consumers depend upon to compare products. If firms put more effort into hiding charges than 'competing on the merits', consumers are poorly served: competition degenerates into an arms race of new and evolving hidden charges that replace those uncovered by astute consumers or banned by regulators. In such circumstances consumers caught out by hidden charges should expect full and prompt redress.

For most consumers, 'punishing' firms that use hidden charges is impractical—we just want to enjoy the goods

and service purchased, not make a statement of principle. Individually, consumers are poorly placed either to avoid or challenge hidden charges. Although we have seen a number of consumer protection measures introduced in recent years—for example the Consumer Protection from Unfair Trading Regulations (CPRs)—these have yet to make a significant impact on those firms using hidden charges. The CPRs do not offer redress and the recent ruling on bank charges by the Supreme Court may well limit the opportunities for individual consumers seeking redress in the future. In many circumstances, the only sanction appears to be in refusing to finalise a purchase once aware of hidden charges. This is not realistic or proportionate, especially if hidden charges are ancillary to a more significant or important purchase (such as a holiday or home).

Firms that wish to adopt a fair-dealing pricing policy should be welcomed. However, the commercial rationale to do so may be weak. As noted above, hidden charges are likely to be a valuable revenue earner, making customers more profitable to the firm with hidden charges than without. Abandoning hidden charges as a business model is likely only if firms are rewarded by greater customer numbers, or face a realistic prospect of meaningful enforcement and redress for customers affected.

If consumers or firms are unable (or disinclined) to address hidden charging then regulatory action may be the only remaining option. Regulators have been busy with issues of price transparency and fairness. For example, the airline industry has been subject to a number of initiatives to improve the transparency of its sales process and price advertising.¹⁸ Despite the intensity of effort by regulators, loopholes remain. The market study on price advertising is a welcome next step. This study must consider in more detail the circumstances where harm arises. Remedies should seek to align the interests of consumers and firms more closely, if at all possible. However, a realistic and wider deterrent may ultimately be necessary, with

enforcement action against industry-wide practices rather than limited to individual firms.

What next?

The efficacy of enforcement action has been questioned. The recent bank charges ruling in the Supreme Court resulted in some unfair criticism of the Office of Fair Trading. On reflection, it is not clearly a failing of the regulator but instead a failing of a law intended to protect consumers, which has been interpreted in a way that prevents assessment of whether firms are treating customers fairly. So, what can be done?

As a starting point, *Which?* is calling for the Financial Services Bill to amend the Unfair Terms in Consumer Contracts Regulations to enable consumers to challenge hidden charges in financial products. But we need to do more than this. Consumers, firms and regulators need legal clarity for all contracts and, where firms persist in practices that harm consumers, regulators and consumers must be given the tools to address the problem at hand. The process should be carefully considered, and we are mindful of avoiding unintended consequences.

Armed with the right tools, greater resource should be focused on frontline enforcement agencies, notably the Trading Standards Service. Finally, simple and more effective redress is necessary. Consumers in some markets, for example energy or estate agency, benefit from an ombudsman service, an alternative to court action when resolving disputes. A general consumer ombudsman, for those sectors without specialised representation, would enable all consumers faced with hidden charges (or misleading, onerous and unfair contract terms among others) to redress the balance between individuals and firms. Changing the rules of the game may be the only practicable steps to allow fair-dealing firms to drive out the bad.

John Holmes

¹ The Consumers' Association, which trades as *Which?*, is an independent organisation registered in England and Wales. By reviewing products and providing independent advice, *Which?* focuses on ensuring that consumers have the information to make the right choices. The views expressed in this article are those of the author, which may differ from those of *Which?*. The author gratefully acknowledges the assistance of Chris Warner, Pula Houghton, Clare Corbett and Dominic Lindley in reviewing the draft; the author must reluctantly accept liability for errors and omissions.

² *Which?* (2009), 'Surcharge Sting Hits Holiday Prices', June; 'The Hidden Costs of Cheap Air Fares', September; 'Steer Carefully', forthcoming.

³ Office of Fair Trading (2008), 'OFT Publishes Web Sweep Results for UK Top Online Retailers', March 7th, press release.

⁴ HM Treasury (2000), 'The Cruickshank Report: A Report to the Chancellor of the Exchequer', March, para 4.67.

⁵ Office of Fair Trading (2008), 'Personal Current Accounts in the UK', July, para 3.74.

⁶ Verbraucherzentrale Bundesverband (VZBV, the Federation of German Consumer Organisations) has taken action against Ryanair and Air Berlin for surcharges levied on credit and debit card holders. The *Local* (2009), 'Consumer Group Slams Air Berlin for Add-on Fees', July 15th. The OFT recently announced a market study into advertising of prices, which will consider a wide range of pricing practices such as 'bait' pricing and 'drip' pricing. Office of Fair Trading (2009), 'OFT launches market studies into advertising and pricing practices', press release, October 15th.

⁷ The Supreme Court recently ruled on whether bank charges for unauthorised overdraft fees are subject to tests of fairness under the Unfair Terms of Consumer Contracts Regulations (1999); see Supreme Court (2009), 'Office of Fair Trading (Respondents) v Abbey National plc & others (Appellants) [2009]', UKSC 6, press summary of November 25th.

⁸ See Financial Services Authority (2009) 'Mortgage Market Review', October, and 'Final Notice: GMAC-RFC Ltd', October 28th.

⁹ This definition excludes other detrimental pricing practices, such as complex or obscured price structures that make price comparison or calculation of the final bill difficult. It also excludes misleading price promotions, for example strategic sale offers that reference a previously 'high' (but in fact short-lived) price offer giving the appearance of a bargain; see, for example, *Which?* (2008), 'Supermarket Special Offers Exposed', December.

¹⁰ This also implies that consumers act on this information—ie, that consumers are rational, aware of their preferences, fully informed about product characteristics and prices, and able to rank different product offerings.

¹¹ See, for example, Kahneman, D. (2002), 'Maps of Bounded Rationality: A Perspective on Intuitive Judgment and Choice', December 8th.

¹² *Ibid.*

¹³ The New Economics Foundation (2005), 'Behavioural Economics: Seven Principles for Policy Makers', July, p. 10.

¹⁴ This has been empirically tested with Internet auctions and is suggested by the internal documents of banks quoted above. See Brown, J., Hossain, T. and Morgan, J. (2007), 'Shrouded Attributes and Information Suppression: Evidence from the Field', University of California at Berkeley, November.

¹⁵ Office of Fair Trading (2008), 'Assessing the Effectiveness of Potential Remedies in Consumer Markets', April, paras 4.9–4.13.

¹⁶ Gabaix, X. and Laibson, D. (2006), 'Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets', *The Quarterly Journal of Economics*, May.

¹⁷ The cost includes time and effort spent searching for details of charging terms and conditions. Also, for fast-moving products there is a risk of losing any initial price offer or the convenience of a particular deal (eg, concert tickets or seats on a plane).

¹⁸ Both the OFT and European Commission have taken individual and coordinated actions to improve the transparency and charging practices of airlines. See Office of Fair Trading (2009), 'Airline Improves Website Pricing Transparency', press release, August 14th; European Commission (2008), 'Airline Sweep Investigation – Background Information', press release, December 2nd.

**If you have any questions regarding the issues raised in this article, please contact the editor,
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