What role does Economics have to play in Contingent Charges Regulations?

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Overview

- Why have contingent charge regulations?
- What might economics say about designing policy for contingent charges?
- Are contingent charge regulations broken and if so, how do we fix them?

Why have contingent charge regulations?

What are contingent charges (CCs)?

- **Charges that are imposed only on the occurrence, or non-occurrence of a particular event.**
  - Unauthorised overdrafts fees.
  - Gym contract termination fees.
  - Letting Agency termination fees on sale of house.

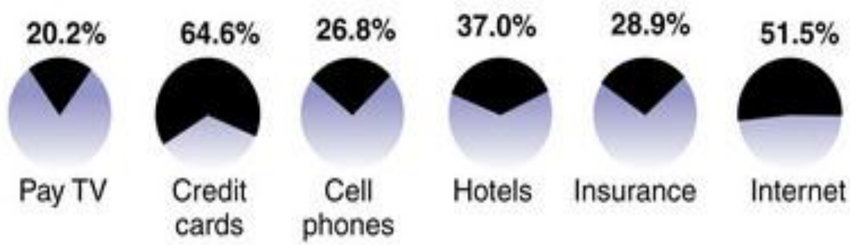
Hidden fees hit consumers

A recent national study found the average adult pays about $942 annually in hidden fees; some highlights:

Service	Fee	Fee cycle	Total
Groceries	$2.47	7.5 orders per month	$222.40
Cell phone	$9.70	Per month	$116.36
Cable/satellite TV	$9.52	Per month	$114.20
Air travel	$33.44	3.05 tickets per year	$102.01
Hotels, lodging	$24.82	3.83 stays per year	$95.08
Credit cards	$7.72	Per month	$92.64
Banks, ATM fees	$6.95	Per month	$83.46
Internet access	$3.71	Per month	$44.56
Insurance	$13.48	2.67 transactions per year	$36.00
Retirement services	$9.83	3.65 transactions per year	$35.87
NOTE: The annual fee estimates were rounded to the nearest cent total and may not add up correctly as presented		**Total**	**$942.58**

Fighting back

Percent of consumers who successfully resolved their complaints about fees:



Source: "Gotcha Capitalism," Ponemon Institute   Graphic: Lee Hulteng, Judy Treible   © 2008 MCT

Why may firms use CCs?

- **Firms may use contingent as an efficient way to recover unexpected costs of customer actions.**
  - Allocates the cost of those actions to those individual who incurred the costs.
  - May reduce the degree of cross subsidisation between customers.
  - May deter inefficient behaviour and solve adverse selection problems.

Concern that firms may exacerbate or exploit biases through use of CCs

Well informed, confident, and effective consumers can play a key role in activating vigorous competition between firms

Access

Make finding information hard: Hide in T&C

Use contingent triggers which are hard to assess

Assess

Obfuscate charge terms or conditions

Structure pricing with several contingent element (Drip pricing):

Act

Surprise charges in terms

Automatic Renewals

Contract exit charges

Vigorous competition should provide firms with incentives to deliver what consumers want as efficiently and innovatively as possible

Contingent charges may exacerbate inherent consumer biases

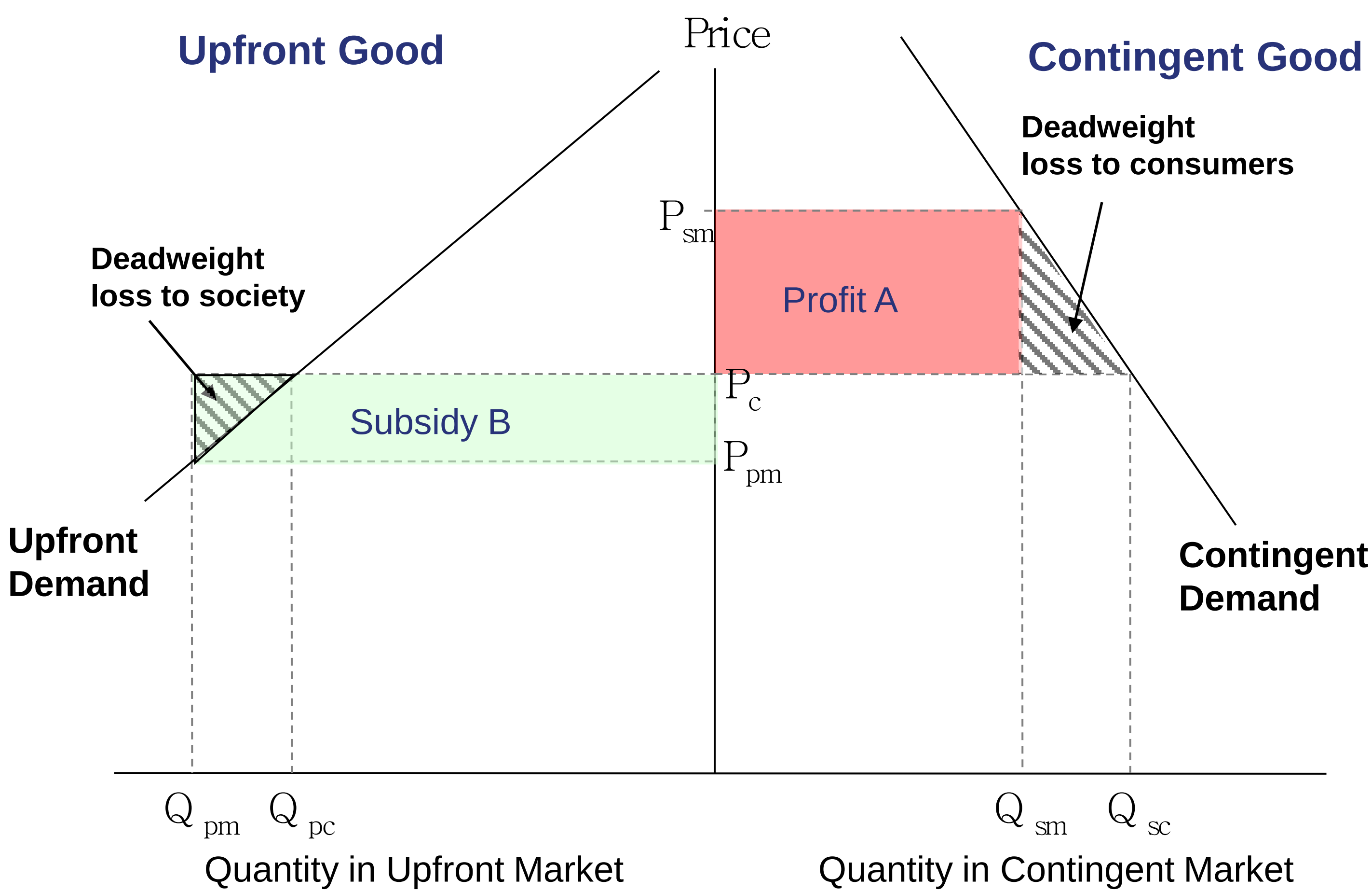
CCs to exploit consumers?

- **Possible outcome of contingent charges is to soften competition.**
  - Makes it harder to compare across products (relaxed degree of product substitution)
  - Raises switching costs (see Farrell and Klemperer).
- **Of course contingent charges may intensify competition for the upfront product.**
  - If each customer is profitable, firms may be willing to compete away these profits to obtain customer.

Competition to the rescue?

- **Even greater competition may not solve problems**
- **Degree of 'waterbed' depends on the degree of competition.**
  - All profits are only competed away when there is perfect competition in the primary market.
- **Consumers who benefit may not be the same as consumers who pay – fairness issues.**

Cross subsidisation through competition may not be efficient



When held up to the light, this full page newspaper ad reveals other airlines' hidden fees.

Nor may competition restore balance

Gabaix & Laibson (2006)

Model which results in inefficient equilibrium (naive do not correctly estimate and thus over pay for add-ons)

All firms exploit biases with none of them having incentive to correct

Spiegler (2006)

Competition leads only to more price obfuscation (naive make mistakes as they only sample market prices)

Competition could even make things worse

Markets might not self correct

Competition in markets doesn't always mitigate concerns

Does economics have a role in contingent charge regulations?

Standard economist problem:

- On one hand contingent charges have clear efficiency rationales.
- On other hand contingent charges can both exploit and exacerbate consumer biases, and may soften competition.
- How to design rules or screens to delineate between beneficial and harmful contingent charges?

Constraint through Upfront Market

- **Does consumer behavior in upfront market constrain firms' use of contingent charges?**
  - Can/Do consumers see both upfront price and any contingent charges before purchasing?
  - Can/Do consumers sensibly estimate the probability of triggering any contingent charges?
  - Do consumers have viable alternatives which they compare across when purchasing upfront product?
- **Can versus Do**
  - Difference between whether consumers 'can' do something or whether 'do' do something.
  - In reality, likely to be a spectrum, which is facilitated or exacerbated by different firm practices. Threshold question?

Constraint on contingent charge use

- **Do consumers constrain contingent charges through their choice in use of them?**
  - Do consumers see the contingent charge and the value of triggering the incurrence of it before it is triggered?
  - Do consumers make conscious choices regarding triggering terms/conditions (i.e. can consumers choose not to triggering term with minimal effort or additional cost)?
  - Do consumers have reasonable alternatives to triggering terms/conditions, which they can choose (for example leave contract)?
- **NB: ‘can’ versus ‘do’ point previously also applies here.**

Consumer Detriment

- **If consumers cannot constrain firms, they may be exploited.**
  - But not all firms exploit consumers through secondary market practices, thus question of whether there is consumer detriment for at least some consumers?
- **Is price of contingent charge in line with cost of provision?**
  - Cost measured as the efficiently incurred, long run incremental cost (LRIC) to the firm of providing the product/service?
  - Could also be described as the cost the firm avoids in not providing the add-on product/service (AAC)?
- **Price equal to cost not necessarily a ‘safe harbour’.**
  - There may be some special cases where the terms and conditions are so obviously detrimental to consumers that we will be concerned regardless of the level of price (for example terms resulting in ‘gold plating’ or frivolous costs).

Efficiency Rationale

- **Even if there is harm, there may be efficiency rationales that outweigh the harm.**
  - Does the benefit outweigh the harm to the consumer?
  - Is the harm indispensible to the benefit realised?
- **Important consideration is difference between individual consumer and all consumers buying the upfront product.**
  - Is fairness assessed on an individual basis? Or across all customers?
  - Is cross subsidy across consumers a sufficient efficiency rationale if some lose and some gain?

Summary of principles

1. Is there a potential to protect oneself from exploitation through choice of a product without a contingent charge?
2. Is there a realistic potential to protect oneself through exploitation choice of triggering the contingent charge?
3. Is the contingent charge is detrimental?
4. Do not intervene if there is an efficiency rationale/benefit resulting from the practices that cannot be replicated and is passed back to consumers.

Does the economics fit with the law?

Do the law and economics link?

- **Legal test for UTTCR:**

  5(1) A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.

  6(2) In so far as it is in plain intelligible language, the assessment of fairness of a term shall not relate:

  (a) to the definition of the main subject matter of the contract

  (b) To the adequacy of the price or remuneration, as against the goods or services supplied in exchange

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Do the law and economics link?

Do consumers constrain through upfront purchases?

Are there efficiency rationale?

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Do consumers constrain through choice of triggering charge?

Is there consumer detriment?

Potentially – but it all depends on the legal interpretation

Banks case background

- **Background:**
  - Just under 1/3 of bank current account revenues are made on unauthorised overdraft charges (UOCs).
  - Unclear as to when account goes into overdraft (banks themselves could not tell the OFT cost of scenarios).
  - Correlation between incurrence and low income/savings.
- **Can they be assessed for fairness, and are UOCs fair?**
- **Unanimous ruling in UK High Court for OFT.**
- **Unanimous Court of Appeals: UOCs not core terms:**
  - were not part of the customers decision process when customers chose their bank.
  - were triggered only in exceptional cases.

UK Supreme Court Banks case

- **Case centred on assessibility for fairness under 6(2)(b):**

  6(2) In so far as it is in plain intelligible language, the assessment of fairness of a term shall not relate:

  (a) to the definition of the main subject matter of the contract

  (b) To the adequacy of the price or remuneration, as against the goods or services supplied in exchange.

- **Should (b) be read in context with (a), or as a standalone element?**
- **If standalone, then the price of a contingent charge is can not be assessed if it is in plain intelligible language.**

UK Supreme Court finding

- **Supreme Court found could not be assessed:**
  - 12 Million people have had the charge, and therefore can't be exceptional cases.
  - Allowed the banks to cross subsidise the free-if-in-credit model of the UK banks.
- **Somewhat confusing judgement:**
  - Hale - problem was not one of informed choice but lack of alternative choices, this is not a consumer problem.
  - Mance – Bank account is a 'package of facilities' for which some elements may have a charge. If can't challenge overall package, then can't challenge individual elements of that package.
- **Also declared finding was 'acte clair' and therefore not appealable to EU General Court.**

Are the UTTCRs broken?

- **Contingent charge regulations have moved back to a 'freedom of contract' stance:**
  - As long as it is written in plain and intelligible language, the charge of a contingent outcome is not a basis for an assessment of fairness.
  - Firmly places obligation on consumers to read all clauses within contracts in order to identify harmful contingencies.
- **Is this an efficient outcome for society? Should people be obliged to read every contract they sign?**

Conclusions

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- **Law and economics are close together – depending upon interpretation of regulations.**
- **Economics should have a key role to play in contingent charge investigations.**
- **If contingent charge fees are not assessable for fairness via the level of fees, this effectively asserts a 'freedom of contract' doctrine.**
  - Result is that contingent charge regulations become a blunt instrument for consumers.
  - Potential that the UK Banks case has dulled the UTCCR instrument to point of useless?