FALL 2003 VOL.45 NO.1

MITSloan
Management Review

Ian Ayres & Barry Nalebuff

In Praise of Honest Pricing

REPRINT NUMBER 4518

In Praise of Honest Pricing

Companies should spend less time trying to fool customers with hidden charges and devote more effort to competing on differences that really matter.

IAN AYRES AND BARRY NALEBUFF

Most video rental stores offer a midweek two-for-one special — an apparently good deal to entice people in on a slow day. The catch is that the offer does not extend to late fees: When customers are late in returning the videos, they have to pay a fee on each one. That second video isn't really free after all. And those late fees add up, constituting up to 20% of Blockbuster Inc.'s revenue, for example.

Similarly, cell-phone operators, rental car companies and many others announce one "low" price for their offerings while hiding various charges in the fine print. And in a way reminiscent of a price war, once some companies are pricing this way, others feel they have no choice but to follow suit.

The conventional wisdom is that such tactics are a good idea; after all, they allow companies to boost profits while seeming to price competitively. But hidden pricing can be harmful not only for consumers who can't figure out what something really costs but also for the businesses that engage in it. And as examples from the appliance industry and restaurant business demonstrate, companies that engage in honest pricing can enjoy important benefits — happier customers, clearer product differentiation and, consequently, higher profits. In short, telling people what things really cost can make more business sense than racing downward against competitors to an artificially low price.

Is Talk Cheap?

The cell phone business provides a striking example of hidden pricing. Consider a typical offer from Sprint PCS of 4,000 calling minutes for $39.99 per month. At first glance, the cost would seem to be a penny per minute. The rub is that only 350 of those minutes are "anytime"; the other 3,650 minutes are restricted to evening and weekend usage. If a subscriber goes over the allotted time on either segment, he is charged 35 cents per minute, and unused minutes from the month are forfeited. So what is the true cost per minute?

Since few people would use all the night and weekend minutes, let's say that off-peak usage is essentially free and that all the cost is based on calls made during peak times. For a subscriber who uses the 350 minutes exactly, the cost works out to a little more than 11 cents per minute. But assume that the subscriber uses 200 peak minutes in some months and 500 in others. In the low-usage months, the customer will be paying 20 cents per minute while forfeiting 150 minutes; in high-usage months, the real cost will be 18.5 cents per minute because of the 35-cent charges on the 150 minutes beyond what is allowed by the plan.

What starts off looking like a penny per minute turns into 11 cents, and then 20 cents, per minute because of the natural variability in usage. But the more important point is that no one knows what he or she is paying or which plan makes the most sense. Sprint knows, of course, but it isn't telling. In monthly statements, it *could* report to its customers the average price they have paid for each minute used. Instead, just like its competitors in the cell-phone business, it prefers to keep its customers guessing.

That might be understandable if it had clear advantages, but in fact such hidden pricing is harmful. Why? Because it induces massive churn, as customers change carriers as soon as a better deal comes along. And better deals come along frequently in the form of offers like this: "Sign up with Acme Phone, and we'll give you a new anti-gravity cell phone free!" As the novelty of the new phone wears off, however, and monthly bills are higher than expected, consumers start the cycle again. The churn rate in the industry has topped 40% per year, a figure that represents huge costs to the carriers. Rather than give away equipment on the front end, they would do better to lower their customer acquisition costs and focus on retaining customers with more honest pricing.

Fill 'er Up?

Car rental companies, in the way they handle gasoline charges, are also perpetrators of hidden pricing. Customers generally have three options, none of them good. Assuming they are returning the car to an airport rental location, they can risk missing their flights in order to find a gas station near the airport and put a couple of gallons in the car. As many people have discovered, this last-minute activity is a good way to end the family vacation on a low note.

Rental drivers who don't want this kind of tension in their lives can instead play a different game with the car companies. They can return a car with less than a full tank and pay the company $4 or even $5 per gallon for the missing gas. Or they can pay for a full tank at the outset at a small premium, say $2 per gallon, giving the company any gas that is left when the car is returned. Here, too, it is impossible to figure out the real price for the rental or which is the better deal. On average, how many gallons do people leave in the car when they pay upfront? And how much does the refueling surcharge add to the average bill? Companies know the answer to those questions, but consumers know only that they are being gamed.

The main point is that there is already a pump at the rental agency. That's where the car should be filled up. For efficiency's sake, the price of the rental should lead to that outcome.

There is one advantage to the status quo, however. The high refueling fees allow leisure travelers to rent cars for less than business customers. The idea is that the business person on an expense account doesn't personally pay for the refueling and thus doesn't care about the price. But the leisure traveler who would pay the fee ends up finding the nearby gas station and returns the car with a full tank. Profits from the business traveler end up subsidizing the leisure customer. Getting rid of hidden charges could lead to higher prices for leisure customers and lower prices for businesses. If that reduced overall demand, as one might expect, it could also lower industry profits.

It would seem that an enterprising company could gain an advantage by trading off hidden gasoline fees for more satisfied customers. So what's preventing the Hertz Corp., for example, from doing so? The biggest obstacle is the difficulty of convincing consumers that simpler pricing actually benefits them. Assume that Hertz gave up hidden gasoline charges and increased the price of renting a car by $3 per day. Hertz would no longer appear first on Expedia and other reservation systems because it would seem to be undercut by all its competitors. Hertz could advertise: "Attention consumers, we really are the cheapest — everyone else has hidden costs!" But that requires consumers to trust Hertz and be more aware of such costs. Hertz would have to educate the market all by itself. Until it completed that education process, it would be at a disadvantage compared with all its rivals.

Many businesses get trapped into hidden-cost pricing. They don't make any more money because the competition for customers forces them to compete away these profits on the front end. Fortunately, there is a way out of this trap.

The Yellow-Sticker Solution

In 1992, the U.S. Environmental Protection Agency introduced the Energy Star program, a *voluntary* labeling program designed to help consumers understand the economic benefits of energy-efficient products. At first, the labeling was limited to computers and monitors, but by 1996 the Energy Star program had been extended to cover most home appliances. Today, everything from traffic lights to entire hotels and supermarkets fall under its rating system.

> Hertz could advertise: "Attention, we really are the cheapest — everyone else has hidden costs!" But that requires consumers to be more aware of such costs.

The stickers provide total-cost-of-ownership information. They allow consumers to add in the expected energy costs to the initial purchase price. Before the program began, consumers had no good way of figuring out whether a more energy-efficient machine was a good deal. Consequently, people had little motivation to pay premium prices for energy-efficient machines; instead, they mostly chose low-priced, energy-hog appliances. The result was bad for the environment and consumers, who missed opportunities to save money. Indeed, the program is said to save consumers $5 billion annually.

The program is also a boon for industry. Product differentiation is one of the basic ingredients of profits, and the Energy Star program makes differentiation possible. Without the stickers, air conditioners differ mainly in their BTU rating. With them, they differ in BTU rating and energy efficiency. Companies have an incentive to invest in creating more-efficient units because the benefits of those products can be quantified for consumers. A manufacturer whose air conditioners use $500 less in electricity costs can demonstrate this advantage to consumers and either raise its prices or gain market share.

Another form of transparency can be seen in unit pricing at supermarkets. Before unit pricing, consumers didn't really know how much they were paying for a product. A $1.79 box of chocolate chip cookies might contain 50 or 100 cookies, and most people didn't want to do the math to figure out the cost per ounce for every single product they were buying. To make their products seem to be of better value, manufacturers simply increased the size of the packaging. The end result was excess packaging, disappointed customers and a waste of valuable shelf space at the retailer.

Consumer advocates, working in conjunction with government and leading supermarket chains, got unit pricing under way circa 1970. Such pricing leads to lower costs. It also protects companies that play it straight from being dragged down by perceptions that the product category offers poor value — big packages with little in them.

Of course, unit pricing is silent on the question of quality — some chocolate chip cookies are better than others. Unit pricing isn't perfect, but it's a step in the right direction. And it wouldn't be hard to implement. For cell-phone services, Sprint and its competitors could tell subscribers both their per-minute cost and which plan would be best, given their likely or actual usage. If cell-phone ads compared the total user cost of one plan with another, pricing would become more straightforward. In particular, that overdraft fee of 35 cents per minute would likely disappear.

In Germany, the electric utilities actually compare plans for their customers. At the end of each year, customers are *retroactively* put in the plan that would have been the cheapest given their usage. And the system rewards customer loyalty, too, since people who switch providers in midyear lose the low-price benefit for the previous year.

That system clearly benefits consumers. Honest pricing can also raise industry profits, too. Imagine a hypothetical example involving cell-phone carriers. Assume that the lifetime value of an average customer falls from $450 to $400 because she is able to choose the optimal plan (which is less expensive than the confusing options she used to have). Recognizing that customers are worth less, providers scale back on handset subsidies, from $300 to $200. The value of a customer falls less than the upfront subsidies due to the system's increased efficiency, and the company ends up making $200 per customer rather than $150 with the status quo.

Unit pricing protects companies that play it straight from being dragged down by perceptions that their product category offers big packages with little in them.

There are many other businesses that could help themselves and their customers with more transparency. Credit card issuers could disclose to prospective customers the likelihood that they would ever pay late fees. Car dealers could tell people the odds that they would actually make a claim against an extended warranty. Gyms could tell their members how much they pay per visit on the basis of their annual membership fee and their actual usage. In each of those cases, the companies could tailor their offerings to suit their customers and decide to compete on differentiation rather than price.

A Bigger Profit Pie

Honest pricing should lead to happier customers and clearer product differentiation. Companies should also be able to make more money as the total cost structure of their industry improves. Some empirical evidence shows how that can happen.

A recent study reveals a case in which providing more information has improved profits: health scorecards for restaurants. In Los Angeles County, the Department of Public Health Services grades all restaurants on an A, B, C and D scorecard. For years, the grades were ignored. Restaurants were free to put their score in the window, but few of them did. Even restaurants that got an A avoided posting the grade. Perhaps they did not want to call attention to the general problem of sanitation; they might also have been worried (with good reason) about what would happen if a future inspection led to a B grade.

Following a CBS News exposé that provided an all-too-vivid look at the unsanitary conditions of local restaurants, the Los Angeles County Board of Supervisors voted to require that the inspection reports be publicly displayed. There were two immediate impacts. The majority of the poorly performing restaurants quickly improved their sanitation conditions (or they closed), and the average scores went up. Customers gained confidence in the quality of all restaurants and ate out more. The researchers, Ginger Jin and Phillip Leslie of UCLA, were able to measure the impact using local tax data. They found that A-grade restaurants saw total revenue go up by 14%, or $15,000 per restaurant, on average.

Hostess has to reveal the amount of fat in a Twinkie. So why shouldn't sellers be required to disclose how much customers really pay for their products?

Despite that outcome, many companies would have a knee-jerk opposition to the government's action in Los Angeles, seeing it as yet another regulation (indeed, the restaurant associations did oppose the requirement). But the issue isn't regulation so much as information — the information needed for a level playing field but not always provided by the market. And although companies collectively might like to make such information available, they do not individually have the same incentive to change the environment on their own. There may even be a first-mover disadvantage — the car rental company that unilaterally gets rid of its back-end gas charges and builds those fees into its advertised price, for example, will look more expensive than its rivals.

Some individual companies are willing to lead on this issue — Southwest Airlines Co. and JetBlue Airways use transparent pricing in their industry. The rest may want to consider the long tradition of requiring sellers to disclose what they know about themselves and their products. Hostess has to reveal the amount of fat in a Twinkie. Mortgage lenders have to include annual percentage rate (APR) numbers in their ads. Why shouldn't sellers be required to disclose what they know about how much customers really pay for their products?

Would banks, for example, make more money if home borrowers couldn't figure out what they were paying? More likely, they would spend more on mortgage brokers, advertising, bad debt and lawsuits as competition for confused customers ate away any excess returns. The larger lesson is that it isn't enough to fool customers. Companies also have to fool their competitors with pricing games, and that is much harder to do. Rivals are equally good at fooling customers and will spend heavily to attract them. If competition forces a business to spend an extra $1 today in order to attract a customer worth an extra $1 tomorrow, neither the business nor the customer ends up any better off.

Honest pricing, on the other hand, would force companies to compete on more important dimensions. Some forms of competition reduce the size of the profit pie — think teaser rates on credit cards or free cell-phone giveaways — since they reduce customer loyalty and increase churn. Others expand the size of the pie — think energy-efficient appliances — by improving product quality or fostering innovation. Imaginative managers may want to consider how a move toward honest pricing in their industry could help sell more and better products to a loyal customer base.

***Ian Ayres** is the William K. Townsend Professor of Law at Yale Law School in New Haven, Connecticut, and **Barry Nalebuff** is the Milton Steinbach Professor of Economics at the Yale School of Management. They are the authors of "Why Not? How To Use Everyday Ingenuity To Solve Problems Big and Small" (Boston: Harvard Business School Press, 2003) and can be reached at ian.ayres@yale.edu and barry.nalebuff@yale.edu.*

Reprint 4518. *For ordering information, see page 1.*

MITSloan
Management Review

PDFs ■ Reprints ■ Permission to Copy ■ Back Issues

Electronic copies of MIT Sloan Management Review articles as well as traditional reprints can be purchased on our web site: *www.mit-smr.com* or you may order through our Business Service Center (9 a.m.-5 p.m. ET) at the phone numbers listed below.

To reproduce or transmit one or more MIT Sloan Management Review articles by electronic or mechanical means (including photocopying or archiving in any information storage or retrieval system) **requires written permission.** To request permission, use our web site (*www.mit-smr.com*), call or e-mail:

Toll-free in U.S. and Canada: 877-727-7170
International: 617-253-7170
e-mail:smrpermissions@mit.edu

To request a free copy of our reprint catalog or order a back issue of MIT Sloan Management Review, please contact:

MIT Sloan Management Review
77 Massachusetts Ave, E60-100
Cambridge, MA 02139-4307

Toll-free in U.S. and Canada: 877-727-7170
International: 617-253-7170
Fax: 617-258-9739
e-mail:smr@mit.edu