Wittingly or not, many companies encourage customers to make bad purchases – with the result that their profits depend on their most dissatisfied customers. Are you making the same mistake?

by Gail McGovern and Youngme Moon

COMPANIES AND THE CUSTOMERS WHO HATE THEM

ONE OF THE MOST INFLUENTIAL propositions in marketing is that customer satisfaction begets loyalty, and loyalty begets profits. Why, then, do so many companies infuriate their customers by binding them with contracts, bleeding them with fees, confounding them with fine print, and otherwise penalizing them for their business? Because, unfortunately, it pays. Companies have found that confused and ill-informed customers, who often end up making poor purchasing decisions, can be highly profitable indeed.

What follows is a cautionary tale. Some companies consciously and cynically exploit customers in this way. But in

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our conversations with dozens of executives in various industries, we found that the majority of firms that profit from their customers' confusion have unwittingly fallen into a trap. Without ever making a deliberate decision to do so, they have, over a period of years, taken greater advantage of their customers. In most cases, there's no defining moment when these companies crossed the line. Rather, they found themselves on a slippery slope that led to an increasingly antagonistic strategy.

Think of the cell phone service, banking, and credit card industries, each of which now demonstrably profits from customers who fail to understand or follow the rules about minute use, minimum balances, overdrafts, credit limits, or payment deadlines. Most of the companies in these industries started out with product and pricing strategies designed to provide value to a variety of customer segments, each with its own needs and price sensitivities.

Yet today, many companies in these industries and others find that their transparent, customer-centric strategies for delivering value have evolved into opaque, company-centric strategies for extracting it. Although this approach may work for a while – many notable practitioners are highly profitable – businesses that prey on customers are perpetually vulnerable to their pent-up hostility. At any time, customers may retaliate with vitriol, lawsuits, and defection.

Companies that extract value as a conscious strategy know who they are. But for those that do not realize where they're headed, this article can help them recognize and dismantle these risky value-extracting practices, reducing their vulnerability to customer retaliation and increasing their competitive advantage.

The Slippery Slope

Companies can profit from customers' confusion, ignorance, and poor decision making in two related ways. The first evolves out of the legitimate attempt to create value by giving customers a broad set of offerings. The second emerges from the equally legitimate decision to use fees and penalties to cover costs and discourage undesirable customer behavior.

In the first case, a company creates a diverse product and pricing portfolio to offer various value propositions to different customer segments. All else being equal, a hotel that has three types of rooms at three price points can serve a wider customer base than a hotel that has just one type of room at one price. However, customers benefit from such diversity only when they are guided toward the offering that best suits their needs. A company is less likely to help customers make good choices if it knows that it can generate more profits when they make poor ones.

Of course, only the most flagrant companies would explicitly seduce customers into making bad choices. Yet there are subtle ways in which even generally well-intentioned firms use complex portfolios to encourage suboptimal choices – tactics that hasten the descent down the slippery slope. Complicated offerings can confuse customers with a lack of transparency (hotels, for example, often don't reveal information about discounts and upgrades); they can make it hard for customers to distinguish among products, even when complete information is available (as is often the case with banking services); and they can take advantage of consumers' difficulty in predicting their needs (for instance, how many cell phone minutes they'll use each month).

Companies can also profit from customers' bad decisions by overrelying on penalties and fees. Such charges may have been conceived as a way to deter undesirable customer behavior and offset the costs that businesses incur as a result of that behavior. Penalties for bouncing a check, for example, were originally designed to discourage banking customers from spending more than they had and to recoup administrative costs. The practice was thus fair to company and customer alike. But many firms have discovered just how profitable penalties can be; as a result, they have an incentive to encourage their customers to incur them – or, at least, not to discourage them from doing so. Many credit card issuers, for example, choose not to deny a transaction that would put the cardholder over his or her credit limit; it's more profitable to let the customer overspend and then impose penalties.

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The Strategies at Work

These adversarial value-extracting strategies are common across industries, from banking and hotels to video stores, book-purchasing clubs, ticketing agencies, and car rentals. Here we'll look in detail at some examples of these strategies in the cell phone service, retail-banking, and health club industries.

Cell phone service industry. When they sign up for service plans, cell phone customers must generally choose a pricing "bucket." A typical carrier, for example, offers several dozen pricing options, ranging from low-priced plans that come with a limited number of minutes to high-priced plans that come with thousands. Each plan has its own restrictions and allowances.

While this may appear to be a customer-centric way of offering value, these service portfolios are in essence designed to take advantage of customers' difficulty in predicting their usage by penalizing them either for using too much time or for not using enough. The carrier benefits when consumers choose plans that don't reflect their actual consumption patterns, regardless of the direction of the error. In fact, as much as 50% of U.S. carriers' income comes from overage and underage fees – what the industry refers to as "breakage."

✕ Are your most profitable customers those who have the most reason to be dissatisfied with you?

✕ Do you have rules that you want customers to break because doing so generates profits?

✕ Do you make it difficult for customers to understand or abide by your rules, and do you actually help customers break them?

✕ Do you depend on contracts to prevent customers from defecting?

Tactics like these may be profitable, but they also fuel seething discontent. The U.S. Federal Communications Commission logs tens of thousands of consumer complaints against cell phone companies per year. The constant carping, which proliferates on blogs and company-specific hate sites (www.hateverizon.org is a typical example), generates untold amounts of bad publicity. Deep dissatisfaction is further manifest in relentless customer churn; it is not unusual, for example, for a major carrier to turn over a quarter of its customer base in a year – a strikingly high percentage, given that most users are shackled by contracts. This level of turnover requires companies to engage in endless, aggressive customer acquisition, including extravagant spending on advertising. In 2005, the U.S. cell phone service industry spent more than $6 billion on ads, with acquisition costs averaging $300 to $400 per customer.

Dissatisfaction and churn should be particularly worrisome to firms that see their customers defecting to a competitor that provides a transparent and friendly alternative. Consider what happened in the cell phone industry when Virgin Mobile USA arrived on the scene in 2002. The deck seemed to be stacked firmly against the company: The industry was already crowded, penetration was high, revenue growth was slowing, and Virgin enjoyed little U.S. brand recognition, aside from its reputation as a quirky airline.

What the company did have going for it was its simple offer: a pay-as-you-go pricing plan with no hidden fees, no time-of-day restrictions, no contracts, and straightforward, reasonable rates. With an annual advertising budget of only $50 million (less than one-tenth the budget of some incumbents), the company acquired 1 million subscribers in five quarters, matching the industry record for reaching that mark.

Today, Virgin Mobile USA has nearly 5 million subscribers and a churn rate well below the industry average for pay-as-you-go subscriptions, even though its customers are free to leave without penalty. In an industry notorious for low satisfaction rates, Virgin's customer satisfaction has been stellar, hovering in the 90th percentile since the service launched. What's more, existing customers have been acting as goodwill ambassadors: As of last year, more than two-thirds reported recommending the service to friends and family.

Virgin's competitive strategy was explicitly designed to take advantage of customers' unhappiness with the abusive practices of incumbents. As Dan Schulman, CEO of Virgin Mobile USA, told us, "Our target customers didn't trust the industry pricing plans. These are savvy consumers, and they hate feeling like they're being conned. We designed an offer to differentiate ourselves from the competition." Schulman's remarks echo comments we heard from executives in the banking, health club, and mutual fund industries, among others, who have designed transparent offers as a conscious strategy to attract their rivals' dissatisfied customers.

Retail-banking industry. When people sign up for checking accounts, they are usually asked to choose from more than a dozen offerings. Depending on the minimum balance they agree to keep in the account, the bank pays a particular interest rate and may waive or adjust certain fees.

But consider what happens if customers do not stay within their minimum balance buckets. If their balances fall below the minimum, they pay various penalties and service charges; if their balances climb well above the minimum, they are stuck with a lower interest rate than they would have earned had they chosen a different bucket. Here again, the firm wins and customers lose, regardless of the direction of the error. And here again, customers who make unwise product selections tend to be more profitable than those whose selections fit their needs.

As banks have discovered the profit potential of fees and penalties, they have gradually adjusted their tactics to take advantage of customers. When some banks tally up customers' accounts at the end of each day, for example, they debit checks in order of size – biggest check first – rather than chronologically. This increases the chance that the remaining checks will bounce, allowing the bank to charge the customer for multiple overdrafts. Similarly, many banks have phased in "courtesy" overdraft provisions that enhance the likelihood that customers will engage in consumption behaviors resulting in penalties. Customers using ATMs, for example, are increasingly allowed to overcharge their accounts without being informed that they are doing so; notification comes later, in the form of a hefty penalty.

According to one estimate, consumers paid $53 billion in overdraft fees in 2006, a 58% increase from five years earlier. These numbers are only rising: The average overdraft fee hit a record high in 2006. Overall fees levied on customer accounts have climbed steadily during the past decade; in 2005, increases in fee income at four of the ten largest banks were in the double digits.

On the face of it, milking consumers for fees would seem to be an effective business strategy. Profits for American banks have increased by close to 67% over the past ten years. Stock prices are up for the largest banks, and so are revenues. So why shouldn't banks rely on high fees? As in the case of the cell phone industry, customer frustration has become acute. According to a recent Consumer Federation of America survey, an overwhelming majority of people believe that permitting overdrafts without notice constitutes an unfair business practice. Consumer complaints have become so pervasive that in 2007, New York congresswoman Carolyn Maloney reintroduced the Consumer Overdraft Protection Fair Practices Act to prevent banks from charging overdraft protection fees unless customers explicitly opt in to the service.

These banking practices have a powerfully corrosive effect on customer satisfaction. Consumers haven't been shy about using the legal system to express their ire. Bank of America, for instance, is fighting a much-publicized class action lawsuit alleging that the bank improperly collected overdraft fees from direct deposit accounts configured to receive Social Security benefits.

It's no surprise that when a nice guy comes along, customers defect. Consider the online bank ING Direct: In the six years since its launch, ING Direct has taken a determinedly customer-friendly stance, offering products that are straightforward and easy to understand. From the start, the firm deliberately rejected banking orthodoxy by offering savings accounts with no fees, no tiered interest rates, and no minimums. Today, it offers equally simple checking accounts and gives customers surcharge-free access to a network of ATMs. Its Web site contains none of the cross-selling clutter that is characteristic of most banking sites, and its portfolio of offerings remains a paragon of product and pricing simplicity.

The approach has paid off. ING Direct is now the fourth-largest thrift bank in the United States, with total assets of more than $60 billion. In this highly competitive industry, ING Direct is adding 100,000 new customers a month, and its customer base is rapidly approaching 5 million.

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Health club industry. Health club companies have a long history of luring customers with attractive short-term offers, assaulting them with aggressive sales pitches, and then binding them with long-term contracts. That's because some of their most profitable customers on a cost-to-serve basis have been those who were enticed to sign up for a long-term membership but then rarely visited the club. Indeed, many companies, knowing that the typical health club customer will underuse the facility, intentionally sell many more memberships than they have the floor space to accommodate.

Moreover, many health clubs make it hard for customers to understand the terms of the contract and figure out the options for extricating themselves from the agreements. An investigation conducted by the New York City Council a few years ago, for example, concluded that 41% of clubs in the city didn't explain their fees in writing, 81% didn't give potential members a contract to read at home, and 96% didn't inform customers of all the ways they could legally cancel a contract.

Not surprisingly, many of these firms have faced the same customer wrath that has plagued the cell phone and banking industries. In New York State, hundreds of formal complaints led then attorney general Eliot Spitzer to launch an investigation in 2001 into the sales and marketing practices of Bally Total Fitness, the industry's largest player. The firm settled in 2004, agreeing to improve its cancellation policies, monitor compliance with them, and make restitution to customers. The state of New Jersey, also responding to hundreds of complaints, has brought litigation against almost two dozen health clubs that allegedly failed to notify customers of their rights or provided fraudulent contracts. The U.S. Better Business Bureau continues to receive thousands of complaints per year about health clubs, putting the industry in the top 1% for the volume of complaints received.

Customer churn at the major health clubs continues unabated, running as high as 40% annually despite the lock-in demanded by contracts. Endemic customer dissatisfaction has put health clubs on a customer-acquisition treadmill that requires them to spend ever more to attract new customers as their existing ones seek a way out.

The industry appears ripe for an existing player to break ranks or for a new one to challenge the industry's bad behavior. In fact, some clubs seem to be getting the idea. Life Time Fitness has become one of the largest fitness chains in the country by eschewing contracts altogether. Membership to Life Time Fitness comes with a 30-day money-back guarantee and can be canceled at any time with no penalty. The company's attrition rate is 10% below the industry average, even though its customers can easily leave. Meanwhile, other clubs – including Curves, 24 Hour Fitness, and a host of smaller companies – are now offering pay-as-you-go options and experimenting with less antagonistic, even encouraging, ways to retain customers, such as reward points for members who work out regularly. As Brad Fogel, chief marketing officer at 24 Hour Fitness, explains, "We've learned that by giving customers incentives to visit the club more frequently, they become more loyal and ultimately remain with us longer."

Although these clubs cater to different segments (Life Time Fitness, for example, attracts families looking for a lavish array of services, while Curves is known for its no-frills, bare-bones workout facilities), they share an explicit strategy of attracting customers disillusioned with the aggressive, acquisition-oriented approach for which the industry is known.

The Warning Signs

In our research, we've talked with executives from industries that, to a greater or lesser degree, profit from confused or ill-informed customers who make poor purchasing decisions. We've also identified a number of industries in which firms are just starting down the slippery slope as they discover the short-term profit potential of hidden fees, mysterious surcharges, confusing service options, and tricky fine print. This trend is apparent in the rental car industry, for example, as well as in the entertainment ticketing industry, where service, convenience, order processing, restoration, and other fees can add 10% to the base price of a ticket.

In almost every case, the executives we've spoken to have expressed discomfort with the practices, acknowledging them but arguing that they don't represent an intentional strategy. Almost uniformly, they describe a largely unconscious process of uncoordinated implementation. The punitive fees and restrictive contracts evolved gradually, with each value-extracting addition only slightly more company centric than the one that preceded it. As a result, these executives now find themselves conducting business in ways that they know make them vulnerable and create opportunities for competitors. But having slid this far down the slope, they find it hard to get a purchase on the way back up.

Companies should be on the lookout for signs of these harmful practices. As a start, executives should ask themselves the following four questions:

✖ **Are our most profitable customers those who have the most reason to be dissatisfied with us?** If the answer is yes, the company is extracting value from customers who do not feel they're getting a fair return and, in the process, exposing itself to a range of risks. A yes answer doesn't mean that customers are up in arms – yet. Rather, it means that they're not receiving the value they're paying for. It's only a matter of time before they look for ways to retaliate: at best, by spreading bad word of mouth – at worst, by suing and defecting.

✖ **Do we have rules we want customers to break because doing so generates profits?** There are certainly situations in which it is reasonable for a firm to penalize a customer – for instance, if a hotel guest destroys property. The penalty exists to recover costs, protect value for other customers, and, one hopes, act as a deterrent. However, when a company institutes a rule that, if violated, destroys value neither for the firm nor for its other customers, that rule will in time be recognized for what it is: a mechanism allowing the firm to extract additional value from customers. Such is the case when a bank charges a customer for conducting more than an allotted number of ATM transactions.

✖ **Do we make it difficult for customers to understand or abide by our rules, and do we actually help customers break them?** Companies should examine whether they actively facilitate profitable "bad" customer behaviors – things like bouncing checks, returning videos late, and exceeding credit card and cell-phone-minute limits. (Certain carriers, for example, make it cumbersome for customers to monitor their minute use.) Companies should also examine their product portfolios to determine whether their diverse offerings are designed to provide value or to take advantage of customers' ignorance or difficulty in choosing options that are in their best interest.

✖ **Do we depend on contracts to prevent customers from defecting?** Some situations clearly call for contracts just as some call for penalties. A manufacturer should not sell a $5 million mainframe computer on a handshake, for example. However, when contracts are used merely to prevent poorly served but profitable customers from defecting, they can harm both customer and provider.

Companies that rely on service contracts should ask whether these are functioning as the opposite of service guarantees. A service guarantee tells customers that the company is so confident in the quality of its value proposition that it will compensate customers who are not satisfied. In contrast, a long-term contract indicates that the company lacks confidence in its value proposition and needs to lock customers in so that it can keep their money even if they become dissatisfied. When such contracts are considered to be critical to a company's profitability or financial viability, it's a sign that the firm may be extracting value at the expense of customer satisfaction.

Climbing Back into Favor

Great CEOs recognize and seize opportunities; they also identify and eliminate vulnerabilities. The company-centric strategies described here represent a vulnerability – and any CEO focused on long-term sustainability would be wise to identify these strategies in the firm and begin dismantling them. Clearly, such practices can work in the short term, as the profits of certain practitioners attest. But as competitors emerge to exploit consumers' pent-up hostility, companies that bleed their customers in the ways described here should expect a punishing response, sooner or later.

As we've seen, sometimes all it takes to drive a mass defection is the appearance of a customer-friendly competitor: a firm that puts customer satisfaction and transparency first. The video rental industry learned the lesson the hard way when its customers, infuriated by late fees, flocked to service-oriented, fee-free Netflix when it launched in 1997. Netflix, it should be noted, had early success with its customer-friendly strategy but then landed on the slippery slope itself; a recent class action lawsuit against the company alleged that it intentionally delayed disc delivery to its heaviest users, thereby penalizing its best customers. The company has since taken steps to ensure that its method of prioritizing customer demand – based on what it considers a "fairness algorithm" – is more transparent.

Risk reduction is a good reason to purge antagonistic value-extracting practices. But doing so also presents companies with an opportunity for competitive differentiation. In industries where squeezing value from customers is commonplace, a transparent, value-creating offer can exploit customers' dissatisfaction with incumbents and drive rapid growth.

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