

# Inflation-linked price rises: relevant behavioural economics concepts

## Overview

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- 1.1 Standard economic theory is built on a number of assumptions about how consumers make decisions under uncertainty. While these may provide a suitable model of rational behaviour, we know that the assumptions do not always hold.
- 1.2 Behavioural economics looks to overcome this issue by offering insights into how consumers make decisions in the real world. Ofcom has previously noted that consumers' preferences are not always fully formed and that they can be influenced by the decision-making environment, whilst Fletcher suggests that behavioural biases and heuristics can undermine effective consumer choice, which may justify policy intervention.<sup>1 2</sup>
- 1.3 This annex sets out various concepts from behavioural economics that we consider to be relevant to the assessment of inflation-linked price variation terms in telecoms markets. It is not exhaustive of all concepts but captures those we consider to be most relevant to inflation-linked price variation terms. We group them by different aspects of inflation-linked price variation terms within the consumer journey, covering how they are typically displayed; how they are typically encountered by consumers; how they are constructed; and finally how they are evaluated.

## How inflation-linked price variation terms are displayed

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- 1.4 Consumers tend to pay more attention to prominent information whilst overlooking information that lacks prominence. This is known as **saliency bias** and builds on the theory of selective attention, which describes how people suppress many sensory inputs whilst attending to a small number of sensory stimuli.<sup>3</sup>
- 1.5 Interventions to increase the saliency of information have been used to positively affect consumer behaviour in many contexts – for example, reducing calorie intake,<sup>4</sup> promoting environmentally-friendly behaviour<sup>5</sup>, and increasing awareness of surcharges.<sup>6</sup> By contrast, practices to reduce saliency of information can worsen consumer choices in other situations.
- 1.6 As shown in section 3, communication providers typically display their products online using one or two salient characteristics – typically the headline monthly price and a measure of quality (e.g. the speed of a fixed broadband service or a mobile data allowance) – whilst other information such as inflation-linked price variation terms are explained only later in the sales journey and/or in small print. This means that consumers may be more likely to

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<sup>1</sup> Ofcom, [Economics Discussion Paper 4: Behavioural insights for Online Safety](#), 2022.

<sup>2</sup> Fletcher, [The Role of Behavioural Economics in Competition Policy](#), 2023.

<sup>3</sup> McLeod, [Theories Of Selective Attention In Psychology](#), 2023.

<sup>4</sup> Bollinger et al., [Calorie Posting in Chain Restaurants](#), 2011.

<sup>5</sup> Tiefenbeck et al., [Overcoming Saliency Bias: How Real-Time Feedback Fosters Resource Conservation](#), 2018.

<sup>6</sup> Chetty et al., [Saliency and Taxation: Theory and Evidence](#), 2009.

place more emphasis on the salient element(s) rather than other elements. This could result in consumers failing to take sufficient account of inflation-linked price variation terms in their decision-making.

## How inflation-linked price variation terms are encountered

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- 1.7 When information is divided up and displayed sequentially, consumers can struggle to incorporate new information effectively. They may make decisions that they otherwise would not have if they had all the relevant information available to them at the same time.
- 1.8 Generally, **inertia** refers to the situation whereby consumers are reluctant to deviate from previous decisions they have made, even when faced with new information or changes to the environment.<sup>7</sup> Sunstein discussed the effects of inertia as a driving factor of defaults, and explains that unless the level of discomfort of sticking with the default, or selected choice, is high enough, consumers will tend to stick with the prevailing choice.<sup>8</sup>
- 1.9 There may be several explanations as to why inertia exists in decision making.
- 1.10 **Anchoring** occurs when consumers rely heavily on the first piece of information they are given and fail to adjust accordingly when presented with new information. Adjustments away from the initial anchor tend to be insufficient because they require cognitive effort, which consumers try to minimise.<sup>9 10</sup>
- 1.11 We also see that consumers' motivation increases as they approach the target, termed the **goal gradient effect**.<sup>11</sup> Increased motivation towards a goal (e.g. completion of the sign-up process) may outweigh any new information that could affect the decision-making process.
- 1.12 **Loss aversion** refers to the finding that consumers dislike losses far more than they enjoy corresponding gains. Therefore, if deviating from a prior choice is perceived as a loss, consumers may be less willing to change.<sup>12</sup>
- 1.13 Inflation-linked price variation terms are, currently, only explained in detail only towards the end of the customer journey – a journey which is complex and includes multiple decisions as found in our consumer research.<sup>13</sup> At this point, it may be too late to influence consumers' decision making because inertia may cause them to disregard or undervalue any new information regarding inflation-linked price variation terms. Inertia can therefore explain why consumers may continue to sign up to a telecoms service despite becoming aware of the price rises later on, rather than restarting the search process to find better deals.

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<sup>7</sup> McGuire, [Cognitive consistency and attitude change](#), 1960.

<sup>8</sup> Sunstein, [Deciding by Default](#), 2013.

<sup>9</sup> Tversky & Kahneman, [Judgment under Uncertainty: Heuristics and Biases](#), 1974.

<sup>10</sup> Epley & Gilovich, [The Anchoring-and-Adjustment Heuristic: Why the Adjustments Are Insufficient](#), 2006.

<sup>11</sup> Liberman & Förster, [Expectancy, Value and Psychological Distance: A New Look at Goal Gradients](#), 2008.

<sup>12</sup> Kahneman & Tversky, [Prospect Theory: An Analysis of Decision under Risk](#), 1977.

<sup>13</sup> Ofcom, [Inflation-linked price rises: qualitative research report, 2023](#).

## How inflation-linked price variation terms are constructed

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- 1.14 Consumers tend to place more weight on immediate costs and benefits than future costs and benefits, which is known as **present bias**. Although discounting future benefits or costs is rational, consumers tend to *overweight* the present and *underweight* the future, which can lead to sub-optimal decisions in the long term.<sup>14</sup> Because of this, consumers are often described as myopic or short-sighted.
- 1.15 Present bias may apply to inflation-linked price variation terms. If consumers focus more on what they pay in the initial months than what they pay following the unpredictable annual price increase in future, they may underestimate the total price of the service over the contract period. This may be further exacerbated by providers who use salience bias to emphasise immediate costs over future price increases.
- 1.16 The impact of myopia may also be exacerbated by the uncertainty found within inflation-linked price variation terms as well as by longer contracts where two annual price rises will apply, with the second one applying to more distant future periods.

## How inflation-linked price variation terms are evaluated

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- 1.17 Consumers also display other cognitive limitations, which can be exacerbated by complex decisions. **Cognitive load theory** suggests that our working memory can only hold a limited amount of information at any one time and can therefore struggle when overloaded with complex information.<sup>15</sup> Combined with cognitive limitations such as low numeracy or literacy skills, it may be difficult for consumers to assess offers and make well-reasoned choices.
- 1.18 In the telecoms market, complexity of pricing information may make it hard for consumers, especially those with low numeracy skills, to compare and choose services effectively.
- a) In general, Ofcom's switching experience tracker research (2022) shows that 1 in 4 (25%) consumers do not feel confident that they can understand language and terminology used by providers, while around one in ten (11%) are not confident that they can compare costs in the market.<sup>16</sup>
  - b) Inflation-linked price variation terms are likely to increase the complexity of the decision significantly. As explained in section 3, they require consumers to understand a complex economic concept and do complex mathematical calculations to work out how much prices will increase by and what they will end up paying overall. They may also have to take account of compounding effects if their contract includes multiple price rises.
- 1.19 Research shows that many UK consumers have low numeracy skills. For example, research from the Government in 2011 found that approximately half of all working age adults have the numeracy level expected of a primary school child or lower.<sup>17</sup>

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<sup>14</sup> O'Donoghue & Rabin, [Present Bias: Lessons Learned and To Be Learned](#), 2015.

<sup>15</sup> Sweller, [Cognitive Load During Problem Solving: Effects on Learning](#), 1988.

<sup>16</sup> Ofcom, [Switching Experience Tracker](#), 2022.

<sup>17</sup> Department for Business Innovation & Skills, [The 2011 Skills for Life Survey: A Survey of Literacy, Numeracy and ICT Levels in England](#), 2012.