Surcharging as a Facilitating Practice

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CCP Policy Briefing

BACKGROUND

- When firms interact repeatedly, they can form an understanding to dampen competition, which may enable them to maintain high prices and acquire larger profits. Firms can sustain high prices if each firm's short-term gain from breaking the understanding (by setting a low price) is outweighed by the long-term benefit from maintaining the high price. When firms find it difficult to reach an agreement they may adopt certain practices that potentially increase the likelihood of collusion being sustained. In general, these practices either help firms to reach an agreement or affect the incentives of maintaining the understanding, by decreasing the short-term gain of setting a low price or increasing the long-term benefit of maintaining the high price.
- Separately itemised surcharges have become a standard form of pricing for firms in industries that experience temporary cost shocks due to rises in the price of an essential input. In many cases firms preannounce the level of their surcharge during its implementation and give some indication of the length of its duration.
- This form of pricing is observed in the steel industry and many of the transport industries, especially in the airline industry since the unprecedented increases in oil prices. British Airways (BA) is currently being investigated by the Office of Fair Trading (OFT) for allegedly fixing the level of its long-haul fuel surcharge with its rivals.
- There have also been a few cases in recent years of cartels that have explicitly communicated the level of their surcharges to help fix prices when marginal costs have increased. This raises an interesting question: why would firms illegally fix price increases and then precariously highlight the act by separately itemising the increase as a surcharge, which could increase the risk of alerting a competition authority? The reason may be because the surcharge has a critical role to play in the process that enables the firms to set higher prices in the first place.

METHODOLOGY

- It is well known that firms' incentives to maintain or break collusive agreements are affected by fluctuations in market conditions. Consistent with previous empirical evidence, CCP has developed a collusive model with price matching punishments that suggests colluding firms may find it difficult to set higher supracompetitive prices during a temporary cost shock. However, in the same model, when firms implement surcharges and commit to when they will be removed they are able to set even higher supracompetitive prices during the cost shock.

KEY FINDINGS

- The model demonstrates that when an industry's marginal costs are temporarily high, firms face a problem created by the uncertain future expectation of costs decreasing. If firms expect costs and prices to fall in the future they have an incentive to lower their price earlier than expected to capture more of the market, because they will receive a short-term gain in profit with little or no long-term loss. As a result, to avoid triggering a price war firms may prefer to maintain rigid prices throughout the cost shock.
- However, surcharges can facilitate higher prices during the cost shock if firms credibly commit to when they will be removed in the future. This commitment effectively preannounces that price will fall by the level of the firm's surcharge when costs fall in the future. The long-term benefit of maintaining a high price during the cost shock

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becomes more attractive, because if a firm breaks the collusive agreement by lowering its base price, first, its rival will match the base price in the next period and, second, firms are still committed to reducing their surcharge when costs fall. This threat of a low price in the future means firms are less likely to reduce their price during the cost shock, so they can set higher prices.

POLICY ISSUES

- Past research suggests that consumers are more understanding of price increases when companies say they are as a consequence of matters beyond their control and consumers will often have this confirmed by news reports. They are also likely to take comfort if firms tell them how long the surcharge is likely to last, helping with financial planning for many consumers.
- However, there is evidence here that companies can collude and use the surcharges to stabilise the collusive activity and charge consumers higher supracompetitive prices. At a time of unstable energy prices for example it is important that competition authorities are all the more vigilant to abuses by firms that are seeking to exploit consumers.

THE CCP

The ESRC Centre for Competition Policy (CCP), at the University of East Anglia, undertakes competition policy research, incorporating economic, legal, management and political science perspectives, that has real-world policy relevance without compromising academic rigour.

FOR MORE INFORMATION

The full working paper will be published very soon. More information about CCP and its research is available from our website: www.ccp.uea.ac.uk

ABOUT THE AUTHOR

- Luke Garrod is part-time Research Associate for the CCP while he completes his PhD. Luke is interested in new behavioural industrial organisation and competition policy, and his research focuses on whether firms can exploit consumer behaviour that is commonly simplified by economic theory.