

# The surcharges super-complaint

## An economic perspective

by *Stefano Ficco and Saattvic\**

On 30 March, the consumer association Which? submitted a super-complaint to the OFT regarding allegedly excessive surcharges on online debit and credit card transactions. (A super-complaint may be made by a designated consumer body when it feels that a feature or set of features in a market works towards significant consumer detriment.) It is alleged that players from several industries – including retailers, local authorities, estate agents and cinemas – indulge in this practice. The worst offenders, however, are said to be low-cost airlines. Which? estimates that the cost of processing a debit card payment is no more than 16p, while for a credit card payment, it is at most 1.8% of the transaction value. Most low-cost airlines, however, charge customers several pounds when they make such transactions, with some even charging per person per flight, even though there is only one transaction to process. Which? also launched an online campaign to gather support for its super-complaint.

The super-complaint suggests two broad measures: (1) the cost to the customer should be the same as the cost to the retailer; (2) retailers should be made to declare online payment processing charges upfront.

The OFT must publish a response within 90 days of the submission of the super-complaint detailing its planned course of action on the matter. The OFT may, among other actions consistent with consumer or competition law, disregard the complaint in its entirety, propose remedies within the 90-day period, commit to further investigation by itself or refer the case to the Competition Commission.

To simplify exposition, we will refer throughout to the airline industry. However, the conceptual analysis is valid for any industry. From an economic viewpoint, we shall consider the measures suggested by Which? in light of the following issues: (1) What is the product under question? (2) To what extent should airlines be allowed to pass transactions charges on to consumers? Should these be equal to the cost borne by the airlines? (3) What is the likely consequence of declaring (possibly high) transaction charges only towards the end of an online booking process? We address these questions in turn.

### What is the product under question?

A key insight that affects any analysis of online booking systems is that the “product” under question is not just the online booking system, but the entire package of the ticket plus all other ancillary services, including the service of being able to book online. We may think of it in the following terms:

Package price = Advertised ticket price + online booking fee + prices of other ancillary services (eg baggage fees).

The consumer cares about the total amount he or she needs to pay in order to reach their destination – the break-up of that amount is immaterial. For example, say a consumer faced a choice between buying a £1,000 ticket with no booking fee or a £100 ticket with a £10 booking fee. Even though the

booking fee is higher in the second instance, the total cost is also lower, and (other things being equal) a rational consumer should choose the second option.

### Passing transaction charges on to consumers

To what extent should airlines be allowed to pass transactions charges on to consumers? Should these be equal to the cost borne by the airlines?

We consider here only online ticket purchases. The relevant markets are: (1) the upstream market for the provision of online payment methods (ie the market of online payment services offered to airlines); and (2) the downstream market for online airlines tickets (ie the market where airlines compete for online consumers).

The price charged in the upstream market becomes a cost for the downstream firm. Passing upstream costs (eg the cost to airlines for providing an online payment service) on to final consumers is a natural feature of most markets. Put simply, when it costs you a lot to produce something, it is natural for you to charge a high selling price.

The extent to which such an increase in cost will result in an increase in price charged to end consumers (what is called the “pass-on rate”) depends mainly on three variables: the degree of competition in the downstream market (ie the online ticket market), the elasticity of demand (ie consumers’ sensitivity to changes in price), and the elasticity of supply (ie the sensitivity of the output supplied to changes in costs). Except in very extreme situations, the pass-on rate is always positive. (Extreme circumstances would be when demand is perfectly elastic – a situation where even a slight increase in price will result in all consumers not wanting to buy even a single unit. Here, there would be a zero pass-on rate.) Therefore, the fact that airlines charge for the provision of certain payment services should be regarded as a consequence of natural market mechanisms rather than a symptom of inefficiency per se.

A situation where transaction charges fully reflect the cost borne by airlines (as suggested by Which?) corresponds to a situation where the pass-on rate is complete (or equal to one). However, it is not uncommon for well-functioning markets to have incomplete pass-on rates (ie transaction charges would be less than the costs) or even more than complete (ie charges would be higher than the costs). Unless a full market analysis is conducted, however, it is impossible to establish what the natural pass-one rate should be.

The problem of establishing a “normal” charge level is further complicated by the need to adopt an appropriate definition of cost. Over the years, antitrust authorities have been called on to determine the cost of providing goods or services in predatory pricing investigations. Among the measures used are:

- Marginal cost (MC): This is the increase in total cost due to the provision of one extra unit of the product.

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- Average variable cost (AVC): This is the total variable costs divided by the number of units. It is different from the MC if the MC changes with the number of units of the product.
- Average avoidable cost (AAC): This is the total cost that can be avoided if a certain number of units are not produced, divided by the number of units. This is larger than the AVC when certain cost elements are “quasi-fixed” – ie fixed when viewed from the perspective of one unit, but variable when viewed from the perspective of many units.
- Average total cost (ATC): This is the total cost divided by the number of units produced. It is larger than both the AVC and the AAC as it includes fixed or sunk costs.

Product characteristics help to determine the choice of cost concept to be used in each instance. For example, when analysing a business with significant fixed costs, the ATC seems a more appropriate measure. When a product is characterised by high but falling MC levels for the initial few units, and low but stable or increasing MC levels for subsequent units, then pricing at a low MC level would imply negative profits, and the business would make little economic sense. For this example, the AVC would be the more appropriate measure.

The claims by Which? imply a cost to an airline to be the MC of processing a booking transaction. However, an online booking system is characterised by other costs as well. As Stephen McNamara of Ryanair told the BBC: “The charge is to cover the entire system – the building of the website, the booking engine, the security of the website at the very end”. Given the nature of costs involved in running an online booking service, the MC is not the only relevant cost to be considered. Some account should be taken of other costs, and this would most probably result in figures higher than Which?’s estimates.

We also note that because the package product is characterised by some degree of product differentiation, all players enjoy some degree of market power. As such, some degree of pricing above costs is a natural feature. Antitrust authorities do not frown upon above-cost pricing so long as effective competition ensures that there are relatively close substitutes available, which act as competitive constraints on the market power conferred to players by product differentiation.

Finally, the package nature of the product also renders any charge requirement for debit cards (as suggested by Which?) ineffective as it can be easily bypassed by re-engineering price offers. Airlines could simply increase other end-charges (eg luggage fees) or even the ticket price to arrive at their desired package price.

### Timing of costs information

What is the likely consequence of declaring (possibly high) transaction charges only towards the end of the online transaction process?

The timing of information provision regarding different price components can have serious consequences for market outcomes. To see this, assume that consumers first see only the advertised ticket prices, but need to go through the entire time-consuming online purchasing process to see booking fees (and other ancillary charges). Thus, learning the total package price entails a cost (the opportunity cost of the time and effort invested) – these are what economists refer to as “search costs”. This example illustrates that, by declaring online payment

processing charges only at the end, airlines can artificially increase consumers’ search costs. Since comparison websites would typically report only advertised prices, consumers are required to enter individual airlines’ transaction pages in order to make effective and meaningful price comparisons.

In economics, search costs are known to detract from competitive forces – effective competition relies on consumers being able to compare all package prices, but with costs involved in learning package prices, consumers are less likely to want to search for information on all package prices from all airlines, hindering their ability to compare. This gives airlines market power as it allows them to charge more than they would be able to in the presence of effective competition. Naturally, the higher the search costs, the lower the willingness of consumers to carry out an additional search, and the higher the market power enjoyed by airlines.

Furthermore, since search costs make consumers less likely to acquire information on all possible price quotations, the airline that gets searched first has an inherent advantage in retaining the consumer. This creates an incentive (detrimental for consumers but beneficial to airlines) for airlines to reduce the advertised ticket price as much as possible in order to attract consumers, and then to compensate for this by charging high booking fees at the end. This insight provides a possible rationale for the observed practice of charging high booking fees and declaring them only towards the end of the online purchase process.

### Conclusion

While economic justifications for abolishing or capping online transaction fees seem rather weak, the practice of revealing payment charges (which often constitute a material portion of the overall price) only towards the end of the transaction process could be used as a device to increase consumers’ search costs, and thus firms’ market power. To the extent that this is the case, there might be a rationale for requiring airlines to reveal transaction charges upfront. The resultant reduction in search costs would reduce market power, and push the package price down.

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