The proliferation of surcharging

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Abstract

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The last couple of years have witnessed a rapid proliferation in 'surcharging', the practice of removing hidden costs and making them visible, or charging customers for new expenses associated with being in business. The growing popularity of surcharging suggests some companies may be obtaining a degree of pricing power they have been lacking in recent times. This paper examines the growing trend towards surcharging, where it is being practised, and evaluates some of the rationale, pros and cons of applying surcharges.

INTRODUCTION

The late Charles Kemmons Wilson, a father of five, disliked having to pay an extra $2 per child in the motels his family stayed in during a 1951 summer holiday. There would be no such additional charges in the Holiday Inns he went on to establish across America and in fifty other countries around the world (Anon., 2003b).

Although 'surcharging' has been around for a long time, the last couple of years has seen a rapid proliferation of the practice, in many products and services, across a wide range of industries. This paper examines the growing popularity of surcharging, and the forms or guises it is taking. In the process of examining the rationale, the pros and the cons of surcharging, numerous examples are presented, drawn predominantly from Australia and North America.

DEFINITION

Some surcharges are collected on behalf of other organisations, most commonly

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governments. In such cases, the role of the company may be likened to that of a tax collector. Such surcharges are not the focus of this paper. The surcharges that are examined herein are those that are collected by a company, for a company, and as such have a direct impact on an organisation's bottom line.

Surcharging can be defined as the process of charging customers for a product, a service or a component thereof, which was previously provided free of charge, in either an overt or a covert way. In the case of an existing (overt) component of a product or service being surcharged, the practice could also be viewed as unbundling a bundled product. Other components may previously have been covertly hidden, or sunk, into the cost of the product or service. In such cases, surcharging may be an attempt to establish the product in its own right, add value to it and differentiate the product from competitive offerings.

INNOVATION STAGNATION?

Why has surcharging suddenly become so popular? Wooldridge (2002), in an article titled 'Back to basics — and a bit of cheating', argues that many companies have reached the limits of growth: global markets have been penetrated, new product ideas close to exhausted and production processes totally re-engineered. Where will growth come from, he asks? Well according to Wooldridge, 2003 will be the year of 'sneak pricing': 'scrounging around for a few extra pennies here and there . . . [ie] . . . adding hidden charges'.

Neil Shoebridge, one of Australia's foremost marketing journalists, recently concurred with one of Wooldridge's comments when he wrote that 'The number of new products released each year has been steadily declining since the late 1990s' (2003b). Shoebridge told the author that his statement is based on anecdotal evidence, with which few marketers and retailers disagree (2003a). Nobody in Australia appears to track the number of new products released each year.

There certainly appears to be considerable evidence to support Wooldridge's hypothesis of a slowdown in product innovation. As one would expect, such evidence is more compelling for tangible goods than it is for intangible services.

Launching new products and services is a risky business, made even trickier in the current economic environment. For this reason, companies are understandably pursuing alternative, low- or reduced-risk strategies, namely product line extensions and product convergence.

Product line extensions have been most prolific in fast-moving consumer goods (FMCGs), where there are numerous examples, such as:

- Coca-Cola have recently launched lemon and vanilla flavoured Coke and Diet Coke.
- Pepsi have also launched a lemon-flavoured cola drink, as well as Pepsi Blue-Chilled Cola.
- There are now at least six versions of Nestlé's famous Kit Kat chocolate bar: the 'traditional' four-fingered bar; the two-finger snack-sized bar; the chunky Kit Kat and the caramel chunky Kit Kat. In white chocolate, there is a choice of the traditional (four-fingered) bar as well as the chunky Kit Kat.
- George Weston Foods has recently extended its Wagon Wheels product line, adding a strawberry variety.
- Proving that strawberry is the flavour of the month, an icon in Australian confectionary, the Cherry Ripe, has now been joined by the Strawberry Ripe.

Meanwhile, product convergence appears to be overtaking innovation in software and electronic goods, in the case of the latter becoming known as 'combination devices' or 'crossbred products'. Sony has recently admitted to pursuing such strategies because it 'does not expect its next breakthrough to come from a single new electronic device' (Anon., 2003a). Other examples include:

— South Korea's LG Electronics have recently converged the humble kitchen fridge with radio, television, video-messaging and, once hooked up to a broadband internet connection, the facility to replenish the contents of the refrigerator automatically. Washing machines, air conditioners and microwave ovens are reported to be the next 'smart appliances' (Bryan, 2003).
— Mobile phones are rapidly converging with products such as personal digital assistants (PDAs), digital cameras and digital music players.
— LG Electronics, Samsung and Orion are all producing combination DVD–VCR players.
— Meanwhile, Microsoft's Internet Explorer has not seen much innovation since Version 3, but it does feature better integration with other Microsoft products, such as Outlook, Windows Media Player and MSN Search (Wilstrom, 2003).

Despite the absence of new product innovations, companies are still seeking to grow their market share, revenue and shareholder value. For many companies, surcharging appears to be a ray of light in the quest for some elusive pricing power.

THE RATIONALE FOR SURCHARGING

The reasons for levying surcharges can be classified into five categories. First, surcharging can be used to modify customer behaviour in three ways (explained below). Secondly, changes to the legal and regulatory environment in which a company operates may facilitate the introduction of surcharges. Companies may levy surcharges to associate themselves with or disassociate themselves from additional costs of doing business, both actual and planned. They may be introduced as a short-term or temporary measure. Finally, surcharging may facilitate a means to an end, namely a change in a company's pricing methodology. Each of these categories is examined below.

Surcharging modifies customer behaviour

The practice of surcharging can modify customer behaviour in one of three ways. First, it can encourage customers to do certain things that will reduce a company's overheads. In the USA, companies such as Primus, MetroPCS, NetBank, Ameritrade and the USAA are all charging customers for printed and mailed invoices, but provide them free of charge online or by e-mail (Bayot, 2002b).

Secondly, surcharging can discourage certain types of behaviour, or even customers. Car rental companies will argue that their surcharges for drivers under the age of 25 reflect the higher risk of renting to such customers. It also discourages such drivers from renting. Many restaurants in Melbourne (Australia) are charging corkage to those patrons who bring their own liquor, but not those who purchase from the restaurant's bar (Port, 2003).

Thirdly, surcharging can be used as a means of outsourcing part of the search, selection or sales process to the customer. Like many low-cost airlines, Australia's Virgin Blue tries to outsource the booking of its flights to customers via its website by charging $A10 extra per flight for telephone bookings. It promotes this surcharge, however, as a discount for online bookings.

Legal and regulatory changes

A change in the legal or regulatory environment in which a company operates may provide it with an opportunity to levy a surcharge. From 1st January, 2003, the Reserve Bank of Australia (the Central Bank) has allowed companies to pass on credit card merchant fees to their customers. Such fees were, until the changes, covertly hidden within the cost of a product or service purchased on credit.

Qantas, who are highly dependent on credit cards as a form of payment, have publicly stated their intention to apply a 1 per cent levy to all credit card bookings (Hughes, 2003), and commenced doing some from 1st July, 2003

Association or disassociation

Surcharges are also a means for a company to disassociate itself with a surcharge, and attribute its imposition on third parties such as its suppliers. Once again, examples are plentiful in the aviation industry. Airlines flying to, from and within Australia are currently fighting the recently privatised Sydney Airport over the latter's plans to introduce a terrorism levy, via which it is seeking to recover the additional cost of terrorism insurance (Koutsoukis, 2003).

Surcharges can also be used for positive association. Some Broadway theatres are now charging patrons a 'restoration fee' (Bayot, 2002a), which says to their clientele 'we are improving things for you'.

A short-term tactic

Companies may opt for surcharging when they envisage the need for a surcharge will not be permanent. Air Canada recently increased its domestic fuel surcharge from \$C30 to \$C50 on routes of 300 miles or more, owing to soaring fuel costs (McArthur, 2003). A spokeswoman for the company said that the company 'still considers the fuel surcharge to be a temporary fee'.

Facilitating a change in pricing methodology

Finally, surcharging can be used as a means of facilitating the introduction of a new pricing methodology. As in many countries, banks in Australia used to make their money on the difference between borrowing and lending rates of interest. The industry is now moving to a 'user-pays' model, and surcharging is increasingly common.

THE PROS AND CONS OF SURCHARGING

The practice of surcharging may be giving some companies a degree of pricing power that has recently eluded them. It is not, however, an ideal practice for all companies. The implications of surcharging extend well beyond an organisation's pricing function, as the following pros and cons of surcharging illustrate.

The pros

Perhaps the biggest argument for surcharging is that it can generate additional revenue for a company, reduce its costs, or in some cases, both. The aforementioned companies that are now charging for printed and mailed invoices, not only save on the costs of printing invoices and sealing envelopes, they also gain revenue from those customers who continue to receive their bills in such a way.

The recent decision by Dell to remove 3.5 inch floppy disk drives as a standard feature of its Dimension range of desktop PCs is another example (Rojas, 2003). It costs Dell approximately \$US8 (\$A13) to fit the drive which will now become an optional extra. Assuming Dell holds the pricing on its PCs, it saves on costs, and gains revenue from the sale of optional extras.

Surcharging can also be used to avoid an across-the-board price rise. This is a big plus for a company operating in a low-inflation environment, with no pricing power. Furthermore, when companies dis-associate themselves from the surcharge, a certain degree of customer goodwill may be generated. Customers may perceive that the company is holding its prices, while being forced to pass on an extra cost associated with doing business that is beyond its control.

Surcharging may also give companies a better or an alternative measure of the elasticity of their customers. In an increasingly competitive business environment, companies need to have a greater understanding of how responsive customers are to a change in price, particularly during a price war. Customers who chose not to pay a surcharge for, say, an itemised telephone bill are likely to be more price inelastic than those that chose to do so.

The cons

The practice of surcharging is not without its dangers, however. It will only be effective where it is known, or can be proven, that a customer uses the product or service being surcharged. For many years, hotels have surcharged for the contents of a room's mini-bar. These days, nothing is sacred (Sharkey, 2002), and additional charges apply for such things as the use of a safe and the provision of telephone, fax and internet facilities (in the form of a 'connectivity charge'). Customers must use such features, and be known to have done so, for surcharging to be successful.

The benefits of surcharging may be outweighed by associated costs if the practice is not implemented with service-level improvements. Across-the-board surcharging without knowledge or proof of customers' using the surcharged product will undoubtedly lead to an increase in the number of customer complaints.

Surcharging companies should also have clear and concise terms and conditions associated with the application of such charges. The refund, exchange, alteration or cancellation of a product or service may provide a basis for a change in the level of the surcharge, possibly even its non-application. Surcharging companies need to be prepared for such eventualities, the absence of which may also be detrimental to customer service levels.

Likewise, surcharging must be, or must be perceived to be, applied equitably. Companies can be accused of levying discriminatory surcharges on non-internet-savvy customers, many of whom are just not online or still hold security concerns about the internet.

Surcharging may also adversely affect a customer's reference price, as well as their perception of the company. Given the recent proliferation of surcharging, it is not surprising that regulators are increasingly insisting that companies advertise tax and surcharge inclusive, not exclusive, prices. The Canadian Government recently flagged its intention to force airlines to advertise all-inclusive airfares (Brethour, 2003), in the face of growing customer complaints that passengers were being forced to pay airfares twice the advertised priced, once taxes and surcharges were added. Such price differentials may have a dramatic impact on both the customers reference price, as well as the price/quality perception of the company, particularly for companies pursuing a low-cost leadership strategy.

Surcharging also has the potential to cause sales channel conflicts. Consider for example, a company with its own online sales channel which is commission free, and a third-party sales channel which is commission paid. Surcharging the former, and not the latter, will push customers to the third-party sales channel, driving up the cost of that channel (in commissions paid) at the expense of more cost-effective channels.

CONCLUSION

Is surcharging re-asserting itself as a permanent feature of the pricing landscape, or is it a fad that will slowly disappear? Is surcharging positively correlated with a slowdown in product innovation? Or is it the post-September 11 pricing paradigm for the 21st century?

These questions are difficult, if not impossible, to answer at the moment. There are examples of surcharges not working and being withdrawn. SprintPCS removed a $3 charge for customers to talk to its call centre staff, because its customers did not like the charge (Bayot, 2002).

In contrast, some surcharges are getting more sophisticated. While Air Canada's domestic fuel surcharge is a fixed amount, one of its competitors varies its surcharges according to the distance flown (McArthur, 2003).

These examples may in fact provide an insight into how surcharging could evolve: along the same path that pricing itself has travelled, namely from fixed surcharges, to surcharges that vary by market segment, ultimately to dynamic surcharges for a segment of one.

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