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WORKING PAPER

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ASSEMBLY — 37TH SESSION

ECONOMIC COMMISSION

Agenda Item 49: Liberalization of international air transport services

PRICE TRANSPARENCY AND SURCHARGES

(Presented by Brazil)

EXECUTIVE SUMMARY

This paper tackles the information asymmetry problem related to the charging of items besides the airfare, such as issuance and fuel surcharges. Theoretically, the airfare should contemplate all costs generated by the provision of the air transportation service. However, the charging of extra items from which the consumer cannot escape has become widespread in the industry. This may create distortions which hamper consumer welfare and economic efficiency. This paper exposes the problems and suggests alternatives to overcome them.

Action: The Assembly is invited to take note of the information presented in this paper and encourage Contracting States to adopt the Regulation suggested by Brazil.

Strategic Objectives:	This working paper relates to Strategic Objective D — Efficiency.
Financial implications:	Not applicable.
References:	

1. INTRODUCTION

1.1 In the past decade, air carriers have implemented a pricing mechanism with unwanted effects. Companies dilute their costs across different categories: airfare, surcharges and taxes. As a consequence, it is not clear for the consumer what is the final price of the air service, making price comparisons between different airlines difficult, especially considering the diffusion of air services search systems.

1.2 Economic regulation requires a market failure to justify its existence. In the case of the air transportation services, this failure comes in the shape of asymmetric information. Consumers do not easily access final prices of air services. They must find their way through a meandrous process to finally compare prices. This paper shows this benefits air carriers in detriment of consumers.

1.3 To tackle this problem, Brazil has enacted a regulation which obliges air carriers to include all indispensable air service items, such as fuel, in the airfare. This is valid for all stages of the buying process. Only those which are separable from the basic air service, such as buying assistance or refreshments, may be charged for separately. Taxes are used exclusively for items which will be passed onto other entities, such as airport operators and the government. Taxes here refer to those due by the passenger and passed onto other entities by the airline. Naturally, taxes applied to the same service do not vary between companies. This regulation enables the consumer to access information more easily, enhancing price comparison, competition and, consequently, consumer welfare and economic efficiency.

1.4 The analysis is made considering the air transportation of passengers. But it can be directly extended to cargo without impairing comprehension of the arguments.

2. HISTORICAL BACKGROUND

2.1 In the end of the 1990’s, air carriers under IATA argued oil prices were temporarily high due to conflicts in the Middle East which disturbed supply. Oil price volatility led to the creation of an extra charge known as the fuel surcharge. This would allow air carriers to swiftly adjust their final prices to consumers without having to constantly change their airfares recorded in the GDS (Global Distribution System). Additionally, there was the expectation that uncertainty would cease and the fuel surcharge would be scrapped altogether when oil prices returned to their historical levels.

3. THE TEMPORALITY ARGUMENT

3.1 The fuel surcharge was put into place to avoid constant changes of airfares registered in the GDS due to frequent and drastic oil price changes. Therefore, once oil prices stabilized, the surcharge should be revoked. However, the expectation that oil prices would retreat to historical levels did not materialize in the following years. In fact, oil prices spiked significantly from 2001 onwards. Although the 2008 financial crisis pressured oil prices downwards, they are still considerably higher than in 1997. It stands out that, retrospectively, prices before 1997 were stable. This raises doubts about the validity of the temporality argument supporting the practice of the fuel surcharge.

3.2 Nevertheless, it is worth pointing out a crucial aspect of the matter: fuel is only one of the numerous inputs of the industry. Hence, its costs should be covered and reflected by the airfare charged for the service provided, as well as all other costs of the industry. After all, this is standard practice in all sectors of the economy, even those heavily dependent on petroleum products. Furthermore, a supposedly temporary extra charge is still in place, more than ten years after it was implemented. At the time of its implementation, many countries exerted airfare controls. For this reason, there was a high regulatory cost to change airfares due to frequent input prices variation. Nowadays, the economic environment is less regulated and airlines are freer to determine and change their airfares, since those alteration and regulatory costs have become insignificant.

3.3 The discussion above intends to highlight the feebleness of the temporality argument. An input cannot be treated separately from others in the cost structure to stabilize the apparent price of a service, on a temporary or definite basis. Keeping airfares rigid when inherent operational costs creates an artificial stability which misleads consumers concerning the total cost of the airfare, as the next section discusses.

4. UNSUITABLE EXCLUSION OF COSTLY ITEMS

4.1 Economic rationality implies that firms transfer changeable input costs onto goods prices. This should also apply to air carriers. Specifically in this industry, fuel is one of the most significant costs. There is no plausible reason for it to be charged separately. Furthermore, there is no standard on fuel surcharge values. Consequently, there is great variability regarding how companies spread how much they charge for the airfare itself and fuel surcharges. This impairs consumers' ability to compare final air ticket prices, hampering the very existence of outright competition in the market.

4.2 In short, the cost of a service should be completely reflected in one single price. In this case, one cannot exclude the consumption of fuel from the service of flying. Thus, it is an inseparable cost, unlike others such as charging for in-flight refreshments or excess luggage. These are separable in the sense that passengers may choose not to consume them whilst flying. Hence, it is not inappropriate to charge for them separately.

5. INFORMATION ASYMMETRY

5.1 Generally, the consumer uses the field "airfare" to compare prices, deeming the field "taxes" will not vary between companies. However, that is not the case. These extras are put under "taxes" and impede straightforward comparisons, confusing consumers. Besides, the lack of a standard for the entries also hampers consumers' ability to analyze prices between companies, since some may allocate a bigger share of costs under "extras" than others. Moreover, the uncertain price setting environment encourages companies to allocate a higher share of their costs as extra charges which are classified as "taxes". This is characterized as an adverse selection problem. Given the difficulty to compare final prices, airlines which exploit the information asymmetry benefit the most, as shown in table 1 and detailed in the next section.

6. THE LACK OF STANDARDS IN ACCOUNTING FOR FUEL SURCHARGE

6.1 There is no standard for the registering of surcharges in the most common airfare systems. Air carriers usually feed the ATPCO system, which registers surcharges under code Q. In this case, the surcharge will appear in the ticket under "fare" in the second screen.

6.2 The GDS, however, fed by the ATPCO and commonly used by travel agents, usually registers surcharges under codes YQ and YR. Now, the surcharges will appear in the ticket under "taxes", compromising consumer's access to information and ability to directly compare prices. Although the GDS can also register surcharges under the code Q, implying that surcharges will not appear as "taxes" in the ticket, the surcharge is only charged after some steps of the buying process. Again, it weakens price comparison, for the consumer will only realize the existence of the surcharge in the last step before buying the ticket. The example below illustrates how this practice hampers consumers.

Table 1 – Example of code use in the GDS system

<table>
<tr><th rowspan="2">GDS System</th><th colspan="6">Air carriers</th></tr>
<tr><th colspan="2">A</th><th colspan="2">B</th><th colspan="2">C</th></tr>
<tr><td>Code</td><td colspan="2">Q</td><td colspan="2">YQ/YR</td><td colspan="2">No surcharges</td></tr>
<tr><td>1st screen – Airfare presented</td><td colspan="2">$ 500,00</td><td colspan="2">$ 500,00</td><td colspan="2">$ 600,00</td></tr>
<tr><td rowspan="2">2nd screen – Ticket sale</td><td>Fare+surcharges</td><td>Taxes</td><td>Fare</td><td>Taxes+ surcharges</td><td>Fare</td><td>Taxes</td></tr>
<tr><td>$ 650,00</td><td>$ 50,00</td><td>$ 500,00</td><td>$ 200,00</td><td>$ 600,00</td><td>$ 50,00</td></tr>
<tr><td>Total ticket price</td><td colspan="2">$ 700,00</td><td colspan="2">$ 700,00</td><td colspan="2">$ 650,00</td></tr>
</table>

6.3 The first screen presents airfares of three air carriers. Only C transparently incorporates all costs in the airfare itself. In the first screen the airfares are presented, but the surcharges are not. As such, the consumer will dismiss C, as it has the highest airfare.

6.4 In the second screen, total ticket price is presented, including surcharges and governmental and airport taxes. As the table shows, the different values for each field may substantially confuse consumers. Besides the confusion, the consumer is misled by the initial information and, rationally, would not choose to buy from C, notwithstanding the fact it offered the cheapest ticket in the end.

7. ISSUANCE CHARGE

7.1 Commercialization expenses, as well as all other inseparable costs, should be included in the airfare. However, one aspect of issuance stands out. The sale of a ticket is not separable from the air service itself, but if the airline offers a channel in which costs are already included in the airfare, such as the internet, there is no reason why airlines should not charge for the use of less efficient channels, such as call centers and shops.

7.2 The issuance surcharge signals to consumers that some commercialization channels are more expensive than other. In this case, price differentiation between different commercialization means is desirable, for it gives consumers the incentive to choose the cheaper and more efficient channel. Nonetheless, airlines should clarify that the issuance charge represents an extra cost for an optional service, as long as they do not apply the surcharge on at least one channel, which is presumably the cheapest.

8. CONCLUSION AND REGULATORY IMPACT

8.1 The basic objective of introducing a regulation to address the problems explained in this paper, such as that enacted by Brazil, is to prohibit the detached charging of inseparable items in the provision of air transportation service. The regulation doing so must discipline the commercialization of airfares and airway bills. The rules should clearly state that all basic costs of the service must be accounted for in a single value under the fields "fare" or "weight charges". The regulation must disallow compulsory surcharges for items which are inseparable from the basic air transportation service. The aim is to ensure the airfare informed to the consumer precisely reflects the price of the service.

8.2 Companies should be free to charge as discretionally as they like to for optional items, as long as consumer awareness is not jeopardized. This creates a desirable product differentiation in the market. The field "taxes" may be used exclusively for resources which will be passed onto other organizations, such as the airport operator or the government. Evidently, this field should not vary between companies offering the same service. There should be no significant operational impact, as they would simply transfer the surcharges to the airfare. It should be noted that foreign companies have comfortably complied with the regulation in Brazil.

8.3 The regulation, if well enacted, should solve the adverse selection problem, create a clearer environment for the consumer to choose from and encourage product differentiation. The consumer should be the biggest beneficiary of greater competition and a wider array of services available.

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