



## Should jet fuel surcharges be regulated, and if so, how?



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### ABSTRACT

By adding fuel surcharges to base fares, airlines pass on the impact of higher jet fuel prices to consumers. Given the wide range of design options for fuel surcharge schemes, the reduced price transparency and the question of fair cost recovery, fuel surcharges have become a consumer protection issue. The paper reviews the regulatory approach to fuel surcharges in Brazil, the European Union, Japan and the United States. Further, it addresses the complexity of attempts to construct fuel surcharge schemes that rely on estimates of per-passenger fuel costs. The paper concludes that regulatory activities should aim to include fuel surcharges in all initial fare quotes and advertising. Enforcing fuel surcharge schemes that ensure a fair cost recovery would result in high regulatory costs and would also be in conflict with deregulation policies of removing restrictions on airline pricing.

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### 1. Introduction

High and volatile fuel prices constitute fundamental challenges to air transportation. The airline industry has no control over the long-term trend towards higher oil prices and the short-term volatility in fuel prices. To mitigate jet fuel price risk, air carriers try to improve the fuel efficiency of their operations. Many of them also apply fuel hedging techniques to lock in fuel costs in advance reducing the potential impact of erratic oil prices (Morrell & Swan, 2006). Besides being costly itself, fuel hedging typically does not eliminate fuel price risk, but only a portion of it. Hedging oil prices aims to dampen the impact of price volatility while fuel surcharges (FSCs) compensate higher fuel costs (Air Transport Department, Cranfield University, 2009). In other words, hedging is an ex-ante fuel management strategy to offset the potential impact of high oil prices on future fuel costs and surcharges are an ex-post strategy to deal with an actual increase in fuel costs. In this sense, hedging and surcharges can be considered as two sides of one coin (Klophaus, 2012).

In the past decade, many airlines have implemented a pricing policy that splits airfares into base fares and add-ons for complementary à la carte items that are separable from basic air transport (e.g., checked baggage). FSCs but also government taxes and airport charges differ from such add-ons as they are not optional for passengers (Klophaus, 2013). FSCs are the result of airline pricing decisions to divide the total airfare into mandatory parts, a practice

that is referred to as partitioned pricing (Morwitz, Greenleaf, & Johnson, 1998). Today, FSCs are common among airlines. Furthermore, the share of FSCs in the total airfare has been growing during the last decade. Passenger airlines make it rather difficult to uncover how they calculate FSCs. Knorr (2012) argues that FSCs as applied today are skewed to favor airlines over consumers. FSCs have already triggered regulatory activities in many countries to put more methodology and transparency around their construction (ICAO, 2012).

This paper reviews the present regimes regulating FSCs in Brazil, the European Union (EU), Japan and the United States (US). Brazil bans FSCs based on the expressed view of the Brazilian civil aviation authority that there is no plausible reason for fuel costs to be charged separately. The European Commission as the executive body of the EU emphasizes the issue of consumer price transparency, i.e., the ability of air transport end users to compare airfares at any point of the booking process. Price transparency may also mean that consumers understand how prices are set. However, this is rather a price calculation issue than a price transparency issue. Public regulators in the US and Japan consider both, the transparency of the total ticket price to be paid by a consumer to a carrier (or agent) but also how FSCs are calculated. The US emphasizes their cost-relatedness while Japan regulates them in detail with a binding calculation scheme for all carriers. The paper discusses both regulatory issues, i.e., the calculation of cost-related FSCs and government-imposed price transparency.

The paper is outlined as follows. Section 2 reviews present regimes in Brazil, the EU, Japan and the US to regulate FSCs. Section 3 briefly discusses welfare implications of FSCs for consumers and

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airlines. Section 4 shows the multitude of factors that need to be considered and the resulting difficulties for public regulators trying to estimate the per-passenger fuel costs for different airline operations, while Section 5 looks at regulatory measures to improve price transparency if carriers are allowed to break down airfares into base fares and carrier-imposed fees such as FSCs. Conclusions are drawn in Section 6. The main conclusion is that current regulatory approaches in the US and Japan contribute to consumer protection but the resulting burden of rules and their enforcement might not be proportionate to the benefits. What is more, enforcing transparency about total ticket prices for passengers at all stages of the booking process might already be sufficient to avoid distorted consumer choices. However, if the partitioning of prices into a base price and a surcharge leads to biased choices of consumers with bounded rationality, a complete ban of FSCs as advocated by the Brazilian government might be the even more appropriate regulatory regime.

## 2. Differing international regulatory regimes

### 2.1. Fuel surcharge regulation in Brazil

The Brazilian civil aviation authority ANAC (Agência Nacional de Aviação Civil) prohibits the detached charging of inseparable items in the provision of air transportation services by means of carrier-imposed fees and surcharges to facilitate final price comparisons by consumers. Fuel costs should be covered by the airfare like other operating costs. In accordance with this principle, no FSCs exist for flights originating in Brazil. In a presentation given at the assembly of the International Civil Aviation Organization (ICAO, 2010), Brazil encouraged other contracting states to adopt its ban of FSCs as additions to base fares in order to enhance price comparison, competition and, consequently, consumer welfare and economic efficiency.

The Brazilian regulatory approach is simple as it avoids any question with regard to the cost-relatedness of FSCs and contributes directly to more transparent airfares. It does not accept reasons for the ongoing practice of airlines to apply FSCs. The view of the Brazilian civil aviation authority is that there is no plausible reason for fuel costs to be charged separately (ICAO, 2010). This also dismisses any justification of FSCs by airline representatives that simply refers to the fact that fuel costs are more volatile and less controllable than other major cost items.

### 2.2. Fuel surcharge regulation within the European Union

European regulators are more concerned about the issue of price transparency than about how FSCs are calculated. According to Article 23 of Regulation 1008/2008 on common rules for the operation of air services each carrier operating from an airport located within the European Union (EU) should indicate the final ticket price from the beginning of the booking process. In addition to the indication of the total fare, at least the following has to be specified: taxes, airport charges, and other charges, surcharges or fees, such as those related to security or fuel when these items are added to the base fare.

### 2.3. US fuel surcharge regulation

In a notice, the US Department of Transportation (DOT, 2012) provided guidance on airfare advertising. The stated purpose is to bring about voluntary compliance by the airlines. Accordingly, any separate listing of taxes and/or fees.

“... must accurately distinguish between taxes and government fees on the one hand and carrier-imposed fees on the other. In

addition, with regard to information about carrier-imposed fees ... such disclosure must accurately represent the actual cost of the item for which the charge is assessed ...”

“When a cost component is described as a fuel surcharge, for example, that amount must actually reflect a reasonable estimate of the per-passenger fuel costs incurred by the air carrier above some baseline calculated based on such factors as the length of the trip, varying costs of fuel, and number of flight segments involved.”

The notice addresses both, how FSCs should be set and the transparency issue associated with FSCs. However, with regard to price transparency, the notice focuses on the correct information about the legal nature of FSCs as carrier-imposed fee. It does not mention the more important consumer protection problem of fare advertisements and initial price quotes that do not include price components such as FSCs and therefore may distort consumer choices. In theory, the stipulated cost-relatedness of FSCs may make sense. However, in practice it is just about impossible to set an FSC at ticketing date to reflect the per-passenger fuel costs for a flight scheduled to depart up to one year in the future.

### 2.4. Fuel surcharge regulation in Japan

FSCs in Japan are subject to approval from the Japanese Ministry of Land, Infrastructure, Transport and Tourism. Furthermore, there is a common scheme for all air carriers serving Japan on how to apply and change FSCs based on length of haul. They are limited to international passenger tickets and are not applicable for itineraries originating in Brazil for reasons discussed in Section 2.1. The applicable FSC is based on a review of the two-month average price of Singapore kerosene-type jet fuel and will be fixed for two months for tickets issued from one and a half months after the announcement of the revision (see Table 1).

Table 2 depicts how FSCs per person for flights from and to Japan vary depending on the previous review period's average fuel price per barrel (BBL). The source of the table is the website of Japanese carrier JAL and it refers to ticket sales other than in Japan and Europe where the values are denominated in US dollars (\$). JAL also shows similar tables for other sales origins with other currencies. Other carriers operating from and to Japan apply the same FSCs.

The surcharge for incoming long-haul flights to Japan is the same as for outgoing flights. All FSCs will be abolished if the average fuel price index value falls below a baseline price of \$60 per barrel. For every index value above the baseline, the smallest surcharge applies for travel to/from Korea, the highest for long-haul segments to/from North America, Europe, Middle East and Oceania. The surcharge for tickets issued until January 31, 2013 for travel between Japan and North America, Europe, Middle East or Oceania purchased outside Japan and Europe amounted to \$327 corresponding to an average fuel price of \$130 - \$140 per barrel. The surcharge amounts are the same for adults, children and infants occupying a seat.

**Table 1**

Period for application and revision of fuel surcharges for flights from/to Japan.

Ticketing date	Announcement	Review period	Applicable FSC
April–May	2nd half of February	December–January	see Table 2
June–July	2nd half of April	February–March	
August–September	2nd half of June	April–May	
October–November	2nd half of August	June–July	
December–January	2nd half of October	August–September	
February–March	2nd half of Dec.	October–November	

Source: <http://www.jal.co.jp/en/inter/fuel/kerosene.html>, visited January 31, 2013.

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