

In the first of a series of articles profiling energy users and their risk management strategies, we take a look at Texas-based Southwest Airlines, one of the most active hedgers in the aviation industry. By *Joe Marsh*

Hedging on the fly

★ Texas-based Southwest Airlines' customers will pay up to \$4 more per round trip as of late May, despite the airline's high level of fuel price hedging. The move comes as Los Angeles jet fuel closed at \$1.39 a gallon on May 17, 40% higher than the price six months ago, when it was hovering around the \$1 mark (see figure). And it shows how vulnerable even a well-hedged airline is to the price of crude oil.

Jet fuel is the biggest cost for airlines after labour. Jet fuel and oil represented 15.2% (\$762 million) of the 2003 operating expenses of Southwest, a low-fare domestic carrier based in Dallas with operating revenues of \$5.9 billion last year.

Southwest is not alone in its fare increase – among others, UK flag carrier British Airways is imposing a £5 (\$8.80) charge on round-trip fares. And Houston-based Continental had planned to add up to \$40 to round-trip fares, although it backed off when other US carriers did not follow suit.

Results

However, the most active fuel hedgers do seem well placed to handle the present high-price, high-volatility scenario. Southwest has hedged around 80% of its expected fuel requirements for this year, with oil prices capped below \$24 a barrel (bbl); 80% of those for 2005, with prices capped at around \$25/bbl; and a portion of those for 2006 (see table, page 46). “The company's hedging programme resulted in the recognition of hedging gains of \$63 million in first-quarter 2004 fuel and oil expenses,” says Beth Harbin, spokeswoman for Southwest Airlines.

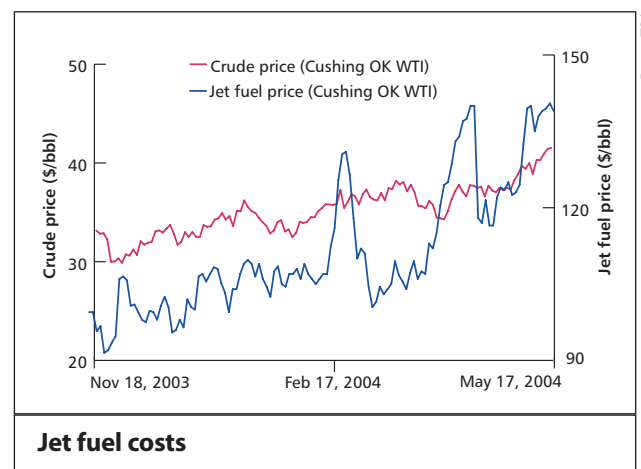
Southwest outdid many other carriers in the first quarter of this year with its net profits of \$26 million, although this figure is some way off its first-quarter 2003 profits of \$121 million. Other low-fare airlines also reported

small first-quarter net profits, including New York-based JetBlue (\$15.2 million) and Arizona-based America West (\$1.2 million), while some of the bigger, international carriers fared a lot worse. Delta and Continental, for example, posted net losses of \$383 million and \$124 million respectively for January to March 2004. Delta says it may even have to file for Chapter 11 bankruptcy if it cannot create a more competitive structure.

Hedging strategy

Southwest has been hedging for a long time, but stepped up its involvement around 1998 when prices were very low, says Harbin. “Before that, we had a limited programme that provided some catastrophic protection,” she says.

With regard to hedging strategy, the two-strong risk management team is fairly sophisticated in terms of the contracts it uses. Southwest does mainly over-the-counter trades, says Harbin, and primarily uses banks to do them. “As of December 31, 2003, the company had a mixture of purchased call options, collar structures and fixed-price swap agreements in place,” she says. As of the same



Airline	Q2	Q3	Q4
AirTran	25%	10%	10%
Alaska	40%	30%	31%
American	16%	6%	6%
America West	35%	20%	10%
Continental	80%	45%	45%
Delta	0%	0%	0%
JetBlue	44%	40%	40%
Northwest	0%	0%	0%
Southwest	80%	80%	80%

Percentage of fuel costs hedged for 2004

Source: Lehman Brothers

prices and continue to focus on managing our overall unit costs," she says.

Technology

To achieve its management goals, Southwest uses the RightAngle system from Oklahoma-based SolArc, a provider of supply and trade management software to global energy companies. Rob Myrben, vice-president of fuel management at Southwest, says: "SolArc's solution integrates the supply side of our business to the inventory management side, providing us with a complete view of our position at all times."

RightAngle allows Southwest to capture its fuel supply contracts and track both their movements and all related costs from purchase to consumption, says Myrben. "By providing a full view of our fuel position on a single platform, SolArc's solution should give us the ability to make better supply decisions."

The software replaced a combination of Excel spreadsheets, Access databases and a mainframe accounting system, adds Myrben. "RightAngle was originally designed to handle the needs of a fuel marketing-type company," he says. "Modifications have been made to accommodate our special needs." And it seems to have been a success: Southwest plans to implement the next release of the system in the third quarter of this year.

SolArc itself clearly sees its involvement in aviation fuel supply management as a beneficial one. In May, it formed an alliance with Varec, which provides fuel management and tank-gauging systems. The two companies plan to integrate their fuel management solutions to form a joint product for airlines, which will include price risk management and reporting. Varec says its FuelsManager suite of software products has long been a standard of major oil companies, as well as an emerging system of choice for the aviation industry.

Use of SolArc's software has certainly not done Southwest any harm. The airline has now been profitable for 52 consecutive quarters and claims to have the lowest operating cost structure in the US domestic airline industry. Its prudent approach to risk management suggests it can continue in this vein. "We look at fuel hedging like you would insurance for your home or car," says Southwest's Harbin. "There is a cost to pay, but you're happy to pay it in case something happens, like a sharp increase in the cost of fuel." **ER**

date, the majority of Southwest Airline's first-quarter 2004 hedges are effectively heating oil-based positions in the form of options contracts, she adds. Most of the rest are crude oil-based positions.

"Because jet fuel is not traded on an organised futures exchange, liquidity for hedging is limited," adds Harbin. "However, we have found that both crude oil and heating oil contracts are effective commodities for

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hedging jet fuel." Other carriers echo this view – German carrier Lufthansa, for one, does much of its hedging using crude oil contracts.

Diversification

Southwest's multi-faceted approach would seem to be a wise one. Francis Van der Velde, managing director of Brussels-based consultancy Fuel Purchasing and Consulting, says: "If you only use swaps, you can be caught out, as you're only covered in one direction. You would be well off in the current market, but if – and, hopefully, when – the oil market falls, you may lose out."

Yet Southwest has not changed its hedging approach significantly as a result of the high oil price, says Harbin. But what if the crude price continues to rise substantially? "We'll continue to monitor the fluctuation in fuel