Mitigating fuel price risk

Well designed and executed fuel hedging programs mitigate airline fuel price risk, says Mike Corley, Mercatus Energy Advisors

It was only last January that Brent crude oil traded as low as $26/BBL. As this article is being written, the same barrel of oil has more than doubled in price, currently trading at $55.87/BBL. Similarly, US Gulf Coast jet fuel traded as low as $0.8755/gallon ($36.77/BBL) last January and is currently trading at $1.4939/gallon ($62.74/BBL). Yet, many airlines claim to be quite content with "lower" oil prices, a claim which is troubling to say the least when considered from a shareholder's perspective.

While fuel hedging has become a routine business practice for many airlines, and is the only proper way, beyond a robust and dynamic fuel surcharge policy, an airline can easily mitigate its exposure to volatile jet fuel prices, far too many airlines still choose to ignore their fuel price risk. Why is this the case?

Many airlines claim not to hedge their fuel price risk because they worry that should fuel prices decline significantly that they will miss the opportunity to benefit from lower prices. At the same time, some airlines argue that they have ceased all fuel hedging activities due to previous hedging losses. Yet others argue that their company isn't "sophisticated enough" to justify hedging their fuel price risk. While there is some logic in these views, they all ignore the fact the vast majority of airlines which do not engage in fuel hedging are airlines which have failed to properly recognize the significance of their fuel price risk and the impact said risk can and does have on their profit margins.

The past few years have shown that there are several lessons to be learned regarding fuel hedging in the airline industry. The extent to which airlines, as well as their shareholders and in some countries, financial regulators, learn from these lessons and act accordingly will only be told in time. While it is certainly true that the current, "lower" oil environment is much more beneficial than a "higher" oil price environment, the industry's memory of higher oil price environments is far too short. In early 2016, a significant number of airlines curtailed or eliminated their fuel hedging programs, because, as many of the relevant executives said at the time, "Oil prices are declining and are likely to remain low for the foreseeable future". Yet here we are in January of 2017 and oil prices have more than doubled from the lows of last January.

Make no mistake, such poor oil price forecasts, and the results generated by such forecasts, are not limited to airlines or other large fuel consuming companies. There are dozens of cases of organizations across the globe – privately held, publicly traded and state owned - which have experienced disastrous results, if not pushed to the brink of bankruptcy or have even gone bust, because they failed to properly manage their commodity price risk or engaged in highly speculative commodity trading, usually masked as "hedging". Far too often said cases were due to the organization's management and directors not fully understanding or appreciating their commodity price risk or their ability to properly manage the risk.

So, with the arrival of the new year, what is the state of the jet fuel and crude oil markets as it relates to hedging for both airlines? The following figures show the forward price curves for Brent and WTI crude oil as well as Singapore, US Gulf Coast and NW Europe jet fuel. While none of the forward curves are as attractive, at least in the eyes of a large fuel consuming organization, as they were one year ago, recall that it was not long ago when both commodities traded well above $100/BBL.

Where will forward prices go from here? Frankly, most airline management teams and boards of directors could produce a jet fuel market forecast which will be as accurate as most market "experts" as forecasting forward commodity prices requires one to not only fully understand the fundamentals of said commodity but also the fundamentals of complimentary and supplementary commodities, global and regional economic trends, foreign exchange rates, shipping rates, etc. That being said, the vast majority of airlines who have successful, sustainable fuel price risk management programs are well aware that their cash flow, risk mitigation, profit margin and competitive positioning needs are the most important aspects of their fuel price risk management programs, not their favorite analyst's commodity price forecast. In addition, it's important to note that even the best commodity market analysts produce inaccurate forecasts more often than not.

Now that we have established that it's nearly impossible to accurately forecast forward crude oil and jet fuel prices over any meaningful period of time, let's examine the key factors that airlines must always keep in mind with respect to fuel price risk management.

OIL FORWARD CURVE PRICE

Month	Brent Crude Oil	WTI Crude Oil	US Gulf Coast Jet	Singapore Jet	NW Europe Jet
Jan-17	$55.50	$52.67	$64.33	$65.97	$66.82
Feb-17	$56.17	$53.51	$65.35	$66.60	$67.38
Mar-17	$56.73	$54.36	$65.91	$67.04	$68.03
Apr-17	$57.17	$54.97	$66.23	$67.35	$68.72
May-17	$57.45	$55.41	$66.53	$67.65	$68.97
Jun-17	$57.60	$55.72	$66.94	$67.98	$69.26
Jul-17	$57.66	$55.88	$67.56	$68.33	$69.71
Aug-17	$57.66	$55.97	$67.97	$68.64	$70.00
Sep-17	$57.64	$56.02	$68.33	$68.94	$70.28
Oct-17	$57.60	$56.05	$68.01	$69.26	$70.51
Nov-17	$57.56	$56.04	$67.74	$69.28	$70.52
Dec-17	$57.52	$55.98	$67.74	$69.43	$70.66

- The vast majority of undesirable airline fuel hedging results are due to an improper, incomplete or nonexistent fuel price risk management policy. Airlines can avoid the vast majority of undesirable fuel hedging results by taking the time and effort to create a proper risk management policy based on sound analysis and well defined goals, objectives and strategies.
- Commodity hedging is a risk management activity and should not be considered a potential source of income. A well-designed and executed airline fuel hedging program should provide insurance against the potential negative impacts of volatile fuel prices in the form of cash flow, profit margin and competitive positioning stability. If an airline's fuel price risk management program initiates any commodity market transactions based on the company's view on forward crude oil or jet fuel prices, it is no longer hedging, it has entered the casino and is no longer engaged in commodity price risk management.
- Attempting to execute hedge transactions only when "good opportunities" are present or only when the company of one of its executives has a "strong feeling" about forward commodity prices highly likely to produce less desirable results than not engaging in any fuel price risk management activities.
- "All or nothing" fuel price risk management, whereby an airline hedges the vast majority of its anticipated fuel burn over a specified period or time, or none at all, utilizing a single strategy, based on its view of whether forward jet fuel prices will increase or decrease over said period of time, more often than not results in a cash flow and profit margin disaster.
- Relying on trading counterparts, who generally have little interest in an airline's actual jet fuel price risk management needs, to generate hedging ideas and strategies will, more often than not, result in undesirable hedging results. At the end of the day, the companies who provide hedging products to airlines are in the business of generating profits at the expense of their airline customers, a situation which can clearly create a significant conflict of interest.

The commercial airline industry, as well as commodity prices, has long been and will likely continue to be both a cyclical and volatile industry. Likewise, cyclical and volatile crude oil and jet fuel prices are going to continue to present many challenges to the industry. As such, the vast majority of airlines around the world will be well served to employ a proper fuel price risk management program which will produce predictable and desirable results in low, moderate and high crude oil and jet fuel price environments.

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