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Airlines' dilemma in 2009 - fuel hedging and the law of physics

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Fuel hedging and the law of physics

What goes up, must come down. Or that is the theory, anyway. But in the case of fuel hedging contracts, it's mostly been up, up and up. The barrel-price yo-yo has slammed airlines on both sides of the hedging fence as we saw throughout 2008 and again in recent weeks, with many airlines announcing big losses due to their unfortunate bets last year. Though this is like a double-edged sword. While we're seeing the fuel-hedging players licking their wounds right now, those airlines that pre-purchased fuel contracts at late '07 or early '08 prices were crowned geniuses at that time. They had a good run. In fact, most fuel-hedgers have had a very good run for several years.

Of course, the reverse also proved true as those too late to the hedging party got locked into summer '08 rates, and watched their profits fly away as crude closed the year more than 50% off its peak. Even fuel hedging whizzes Southwest and Ryanair have attributed the bulk of their Q3 and Q4 losses to 'upside-down' hedging contracts. But when airlines that dedicate significant resources to playing the fuel markets can be burned by volatility in the oil market, what recourse do other airlines have? For airlines pursuing a less involved, more ad-hoc strategy toward hedging, we've seen that the sudden drop in prices has effectively limited their advantage in an environment of falling fixed costs. Now, more than ever, airlines need to shore up their hedging strategies with specifics in mind.

In 2009, we're going to see two distinct types of hedging-contract buyers. The strategic airline that managed to limit its exposure to hedged contracts in the middle of 2008, and is therefore in a position to capitalize on historically low fuel prices; and the tactical airline that is locking into hedging contracts now, exploiting the current commodity market bottom.

While the current fuel price levels do provide an attractive entry point for future hedging contacts - we are at a 5-year low, after all – I feel that some carriers, like LCCs and mid-sized airlines, would be better off pursuing permanent strategies centered on group purchasing (or other methods of minimizing fixed cost volatility), rather than ad-hoc hedging. That's where I would bet my money if were a low-cost carrier today.

Most contracts placed will be for shorter periods, as it's highly unlikely that carriers will take out forward contracts for longer periods anymore, as the cost of protecting this risk becomes very prohibitive. Because in the long run, fuel prices will rise again but on a scale and at a rate that hedging is ultimately ineffective at mitigating. In the short term, the volatility of crude oil just makes some types of fuel hedging a losing bet.

About Airsavings

Created in 2001 by airline industry professionals to serve the growing needs of mid-sized airlines in cost reduction and ancillary revenue generation, Airsavings is a group buying service focusing on fast growing airlines. By combining the purchasing volume of participating airlines, Airsavings was the first to apply to the airline industry a successful concept already in use in the auto, chemical and hospitality industries. Airsavings group buying expertise, combined with the knowledge of airline internet booking engines, has uniquely positioned Airsavings in the area of ancillary revenues - now a vital lifeline for airlines. Airsavings proprietary industry platform called AirlinePlus, enables carriers to deliver a multitude of ancillary services found most useful and with the greatest potential for mass adoption and profitability. For more information, please visit www.airsavings.net.