

## Oil Prices Squeeze Airlines, But Southwest Can Gloat

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NEW YORK (Dow Jones)--As oil prices head toward \$40 a barrel Thursday, squeezing transportation company profits, one petroleum user is sitting pretty: Southwest Airlines Co. (LUV).

The Dallas airline has hedged more than 80% of its fuel needs for the next two years at a price of \$24 a barrel. And Southwest is the only U.S. carrier to have hedged most of its fuel.

How important are those fuel hedges for Southwest? "It's huge," said Chief Executive Jim Parker in an interview with Dow Jones Newswires earlier this week.

That foresight was the reason Southwest turned a profit in the first quarter, while other airlines bled due to high fuel costs and depressed air fares. Without the hedges, Southwest's profit of \$26 million would have been a loss of \$8 million.

And the hedges have allowed Southwest to keep its air fares low, thus putting the squeeze on competitors as they attempt to add fuel surcharges. Various airlines have made about a dozen attempts in the last few months to impose blanket fare increases, but stiff competition makes it difficult to pass fuel cost rises along to passengers.

So why aren't other airlines so well-hedged? The best-hedged have only locked in prices for around 30% of their fuel needs, while others waited so long that their hedged prices are nearly twice that of Southwest. Others have no hedges at all.

The problem is that buying hedges requires credit lines or cash, two things in short-supply for many airlines last year when Southwest was planning its fuel needs. Plus, the airline business has traditionally attracted executives who like to take risks, and are sometimes willing forego hedges in a bet that fuel prices will drop.

Hedging fuel prices involves buying futures contracts or other instruments to offset a possible rise in oil prices. Hedging can also be incorporated into an airline's fuel procurement program. Extensive hedging programs keep airlines' fuel costs stable and predictable, while small hedge programs at least insure that fuel prices won't cause an airline to go under.

Frank Shea, chief financial officer of World Fuel Services Corp. (INT), said airline executives are beginning to wise up about the importance of fuel hedges, but most are still exposed to a lot of risk.

"If you look at their financial statements it looks like the grin of an old-school hockey goalie - there are big black gaps in it," Shea said. "How many teeth got swallowed by hockey goalies before they started to wear a mask? What does it take to get people to protect themselves?"

AMR Corp.'s (AMR) American Airlines said in the past that every 1-cent increase in the price of a gallon of jet fuel translates into an additional \$33 million annual cost for AMR. Continental Airlines Inc. (CAL) has said every \$1 rise in the price of a barrel of oil boosts the airline's total fuel costs for the year by \$38 million.

Both turned a loss in the first quarter.

AMR, which was on the brink of bankruptcy last year, liquidated its fuel hedges because it needed cash. Since then, the airline has made progress cutting costs, narrowing losses and beefing up liquidity. The high oil prices are slowing that progress, Chief Executive Gerard Arpey said in an interview with Dow Jones Newswires on Monday.

"I do think I'm pleased with the progress we've made this year, and if not for fuel prices...you would see more momentum being built into our plan," he said.

American has now hedged 16% of its second-quarter fuel and 6% of its second-half fuel at \$32 a barrel and on Thursday announced a \$2 fare increase to make up for the rising cost of fuel.

Other airline executives say they are stuck in a quandary: to buy expensive hedges, or to hope that oil prices will fall?

"Like many of the others, we are just looking for that window of opportunity," said Frontier Airlines Inc. (FRNT) Chief Executive Jeff Potter in an interview with Dow Jones last month. Frontier has hedged 7% of its fuel needs for the year.

Continental Airlines Inc. (CAL) hadn't hedged fuel for this year because the airline expected prices to drop, and needed the money for other things. Now, Continental has capped its fuel price for the second quarter at \$40 a barrel on 80% of its fuel, and has hedged about half of its fuel for the second half at prices between \$32 and \$40.

Delta Air Lines Inc. (DAL) and US Airways Group Inc. (UAIR) liquidated some hedges in the first quarter for cash. It left Delta with no hedges for this year, and US Airways with no second-quarter hedges. US Airways has hedged 33% of its second-half jet fuel needs at a price of 83 cents a gallon.

World Fuel Services' Shea said he thinks there's another reason most airlines are poorly-hedged: the industry has traditionally attracted executives who like to take risks. Fuel-price insurance has never been part of the culture.

"Because this has been going on for so many decades, I kind of think it has become part of the industry. It's like wildcatters," Shea said. "It's a classic example of risk-prone entrepreneurs. They like risk, they seek risk."

The rise in oil prices caused airlines' shares to drop, with some of the least-hedged airlines taking the biggest hits. Delta shares were down 5.9% at \$5.76; AMR was down 5.6% at \$11.56; US Airways was down 10% at \$2.08. Southwest outperformed the industry, down 1.2% at \$14.27.