United, Delta Profit at Risk From `Silent Killer' in Fuel Hedges

By Mary Jane Credeur, Mary Schlangenstein and Paul Burkhardt - Jan 31, 2011

U.S. airlines including United Continental Holdings Inc. and Delta Air Lines Inc. may see 2011 profits eroded as an indicator of jet-fuel costs surges to a two-year high.

Most carriers try to smooth fuel-price swings with advance purchase contracts linked to the cost of crude or heating oil, a proxy for jet fuel. Those with hedges tied to crude futures have been less protected against rising costs, with the difference versus heating oil jumping more than 50 percent this month.

"This is out of control," said David Cush, chief executive officer of Virgin America Inc., the low-fare carrier partly owned by U.K. billionaire Richard Branson. "This is a kind of silent killer. It has a huge impact on airlines."

The crack spread, or price difference between crude and heating oil, widened to $25.87 on Jan. 27, the most since January 2009. Heating oil jumped 5.7 percent this month, while crude fell 2.2 percent.

Driving the divergence is a drop in the amount of crude processed by refiners and a growing supply of West Texas Intermediate, the U.S. benchmark crude, in Cushing, Oklahoma, where the WTI futures contract is settled, said Sander Cohan, an analyst with Energy Security Analysis Inc.

WTI stockpiles rose 2.3 percent to 37.7 million barrels in the week ended Jan. 21, the highest since August, according to the Energy Department. At the same time, heating oil futures have climbed because of cold weather, domestic consumption and the expectation of export demand to Europe, said Cohan, who is based in Wakefield, Massachusetts.

'Through the Roof'

"The absurdity is the crude market is falling and jet fuel is going through the roof," Cush said. He said Burlingame, California-based Virgin America has hedged about 80 percent of this quarter's fuel use, all on crude at an average of $82 a barrel.

Jet fuel for immediate delivery in New York Harbor rose 7.8 percent this year through Jan. 28, to $2.77 a gallon, and 41 percent in the past 12 months, underscoring the importance of airlines' hedges.

The largest carriers have raised ticket prices three times this month, and JetBlue Airways Corp. added a fuel surcharge of as much as $45 each way on Caribbean flights. Fuel and labor are carriers' biggest expenses.

"Longer term, we must, like any other energy-intensive industry such as oil companies, utilities and railroads, pass on these higher fuel costs to our customers," Delta CEO Richard Anderson said on a Jan. 18 conference call.

Flying Cut?

United may need to trim flying this year if fuel stays at current prices, CEO Jeff Smisek told investors on Jan. 26. Chicago-based United and Delta, the world's two largest airlines, used 7.9 billion gallons of fuel in 2010 at a cost of $17.2 billion.

The Bloomberg U.S. Airlines Index of 12 carriers slid 2.9 percent in January before today. A monthly decline would be the third in a row, the longest such streak since June 2008.

Because there is no futures market for jet fuel, airlines traditionally hedged most of their costs with contracts tied to the price of crude oil.

"They have to pick an instrument where you can hedge," said Andy Lipow, president of Lipow Oil Associates LLC in Houston. WTI is "the one that gives you the most liquidity over the longest period of time."

Contract Shift

Many carriers began shifting to contracts based on heating oil starting in 2008, when the spread between the two widened to a record $36. Monthly heating oil contracts are available to January 2013, while crude futures traded on the New York Mercantile Exchange are offered through December 2019.

Southwest Airlines Co., the largest low-fare carrier, has hedged at least 45 percent of its fuel needs each year through 2014, using a combination of crude, heating oil and unleaded gasoline.

Getting the right mix has "always been hard," Treasurer Scott Topping said in an interview. "It's always seemed to me that it's been feast or famine with the crack spreads."

Passenger airlines should adopt the practice of freight carriers United Parcel Service Inc. and FedEx Corp. and abandon hedging, said Hunter Keay, a Stifel Nicolaus & Co. analyst in Baltimore. UPS and FedEx offset price swings with fuel surcharges, which airlines have been more reluctant to use.

"If this industry all stopped hedging, there would be a much more rational pricing environment," Keay said in an interview. "It would be a landscape that would be far more conducive to fuel surcharges and would save airlines hundreds of millions of dollars in expense."

United, American

United has 63 percent of its fuel needs hedged for this quarter, split roughly evenly between crude and heating oil, according to a Jan. 26 regulatory filing. AMR Corp.'s American Airlines has hedged half its fuel needs this quarter and 36 percent for the full year.

Delta has 49 percent of its fuel needs hedged in the first quarter and is 36 percent hedged for 2011, with a combination of crude, heating oil and jet-fuel contracts, according to the Atlanta-based airline's latest annual report. New York-based JetBlue's hedges are based on a mix of crude, heating oil and jet-fuel swaps.

US Airways Group Inc., the fifth-largest U.S. carrier, stopped hedging in 2008's third quarter and its last contracts expired a year later.

"Fuel hedging remains exorbitantly expensive," US Airways President Scott Kirby said on a Jan. 26 conference call. Locking in a year's worth of fuel use would cost Tempe, Arizona-based US Airways about $335 million for the hedging contracts, he said.

JetBlue CEO Dave Barger said more passengers will eventually feel the fuel squeeze.

"The cost of energy is making it more expensive to fly a customer from A to B," he said in an interview. "We believe the industry needs to pass some of the burden of high fuel prices to the customer."

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