THE WALL STREET JOURNAL. ONLINE

May 28, 2008

BUSINESS

By GEORGE ANDERS

Why Rivals Don't Copy Southwest's Hedging

May 28, 2008; Page B2

With oil near $130 a barrel, why does **Southwest Airlines** stand alone in the airline industry in its aggressive use of hedging to keep fuel costs under control?

Southwest has locked in more than 70% of its jet-fuel requirements this year at a price equivalent to $51 a barrel for crude oil. By contrast, other big carriers have hedged 30% or less of their fuel needs this year. Those carriers generally expect to pay the equivalent of $85 to $100 per barrel of oil under their hedging programs.

FORUM

[1]

Fuel prices are up 90% in the past year, and carriers can't raise prices fast enough without alienating customers.

Discuss[2]

For Southwest, the payoff has been huge. Low-cost fuel has helped it stay profitable in the past year, even though its core airline business otherwise would have operated in the red in some recent quarters. Meanwhile, other airlines are posting losses, jacking up airfares and resorting to hefty baggage-check surcharges in an effort to cover escalating fuel costs.

Southwest's hedging amounts to "a very bold move," says Roger King, an airline analyst at CreditSights Inc. When he asks other big carriers why their hedging has been so limited, he hears from those that sought bankruptcy-court protection in the wake of the Sept. 11, 2001, terrorist attacks that their hands were tied by creditors.

That's a partial explanation. After all, cash was scarce for airlines in Chapter 11 bankruptcy proceedings. Creditors got nervous about the financial commitments involved in hedging. Even carriers that didn't file for Chapter 11 had bank covenants that may have limited their ability to hedge.

Yet Southwest's hedging advantage has widened in the past two years, when most other airlines had moved beyond their post-Sept. 11 travails.

David Carter, an associate professor of finance at Oklahoma State, has an interesting perspective on why rivals haven't caught up to Southwest. Prof. Carter helped write a 2004 case study on Southwest's hedging that is taught in business schools. Although the study details how Southwest uses home-heating-oil futures and other instruments to make its hedges work, Prof. Carter says he has heard from only one other airline that seemed interested in putting that knowledge to work:

the German carrier Lufthansa.

Other carriers may have opted for caution because it is psychologically hard to switch strategies when prices are moving against you, Prof. Carter says. Airlines that didn't hedge much when oil was at $25 or $40 a barrel might have felt uncomfortable launching a big hedging program when oil got above $60.

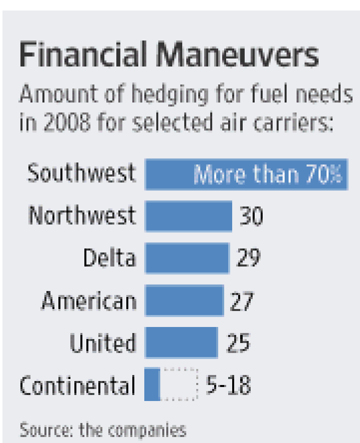
Frequent management shuffles at many airlines also might have made it harder for carriers other than Southwest to jump into hedging in a big way, Prof. Carter adds. A hedging blunder early in a CEO's tenure might overshadow whatever else that boss might be accomplishing.

Southwest's treasurer, Scott Topping, offers another possible explanation of why his airline has stayed ahead of the pack so long: Since the late 1990s, Southwest's hedging strategy has been set by two or three people, rather than by committee, making it easier to act decisively.

Some people worry that any company trading actively in futures or options is engaged in risky speculation. But Mr. Topping argues that for airlines, the real risk lies in not hedging their fuel purchases. Airlines need to buy jet fuel constantly, he notes. In today's volatile energy markets, they cannot plan future costs with any reliability if they always are at the mercy of the spot market.

Hedging lets carriers get a better handle on fuel costs, he says. If oil prices plummet, airlines that are less heavily hedged might have a slight advantage. But many hedges are set up to provide both protection against soaring prices and some benefit from falling prices.

Southwest values its current portfolio of hedges at $2.8 billion. That is such a hefty amount that on last month's conference call with analysts, Southwest's chief executive officer, Gary Kelly, was asked whether the airline should just sell its hedges, distribute the money to shareholders and then raise fares to deal with higher fuel costs.



Fuel is pumped into a **Southwest Airlines** plane at Los Angeles International Airport. ▶

"Only if we want to go bankrupt," the CEO retorted.

In the current market, Mr. Topping says, it may be hard for any airline to line up additional hedges on appealing terms. Southwest's longest-dated hedge, covering more than 15% of its fuel needs in 2012 at about $63 a barrel, was lined up about a year ago.

These days, futures prices for crude oil are at around $130 a barrel, even for delivery years from now. Bargains are not any better in contracts for home-heating oil, which more closely parallels jet-fuel trends. Long-term contracts aren't discounted the way they were a year or two ago.

"We can't become addicted to this cost advantage that we've built up," Mr. Topping says. "We need to continue to manage other costs the way we always have."

But even if Southwest's hedging wizardry is nearing an end, it has been a big enough boon that other airlines should ask why they missed out.

Write to George Anders at george.anders@wsj.com[3]

URL for this article:
http://online.wsj.com/article/SB121192242646723961.html

Hyperlinks in this Article:
(1) http://forums.wsj.com/viewtopic.php? t=2696
(2) http://forums.wsj.com/viewtopic.php? t=2696
(3) mailto:george.anders@wsj.com

RELATED ARTICLES FROM ACROSS THE WEB

Related Articles from WSJ.com
- Airline Oil Lobbying Alarms Financial Firms Jul. 12, 2008
- China Airlines Foresees Quarterly Loss Jul. 11, 2008
- June Is Cruel to Big Names As Prentice, Tosca Get Hit Jul. 11, 2008
- Cathay Sticks to Expansion Plans Jul. 11, 2008

Related Web News
- Credit Suisse downgrades, higher oil prices pressure shares Jul. 14, 2008 marketwatch.com
- Credit Suisse downgrades, higher oil prices pressure shares Jul. 14, 2008 marketwatch.com
- High Oil Prices Hit India's Airlines Jul. 07, 2008 businessweek.com

More related content *Powered by Sphere*