An Airline Shrugs at Oil Prices

Brian Harkin for The New York Times

A Southwest Airlines worker fueled a plane. Southwest's chief said the hedges against rising fuel costs "bought us time to retool our company."

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Southwest Airlines, in danger for much of this year of losing its quirky dominance in the domestic airline industry, could soon be standing, once again, head and shoulders above the competition.

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Graphic
Southwest's Profitable Bet

Better service? Happier and more productive workers?

Not this time. The reason for Southwest's rapidly increasing advantage over other big airlines is much simpler: it loaded up years ago on hedges against higher fuel prices. And with oil trading above $90 a barrel, most of the rest of the airline industry is facing a huge run-up in costs, and Southwest is not.

Southwest owns long-term contracts to buy most of its fuel through 2009 for what it would cost if oil were $51 a barrel. The value of those hedges soared as oil raced above $90 a barrel, and they are now worth more than $2 billion. Those gains will mostly be realized over the next two years.

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Other major airlines passed on buying all but the shortest-term insurance against high fuel prices, allowing Southwest executives a bit of schadenfreude.

"It's true," said Scott Topping, the treasurer of Southwest and the keeper of the hedges. "We're not sure what to root for," in terms of oil prices.

Southwest is also hurt by higher fuel prices, but far less than competitors, giving the carrier a distinct advantage in an industry where beating the other guy often seems more important than actually doing well. Some other airlines, meanwhile, could start reporting losses as early as the current quarter, unless they are able to rapidly raise fares, said Roger E. King, an analyst at CreditSights, an independent research company. "Airlines were not made for $90 oil," Mr. King said in a report last week.

Indeed, at American Airlines, annual fuel costs rise $80 million for every dollar increase in a barrel of oil, said Thomas W. Horton, the chief financial officer. The difference between January's low and today's price would translate into an increase of about $3 billion a year in fuel spending. So, this month, Jamie Baker, an analyst at JPMorgan, cut his estimate of 2008 results at AMR, American's parent, from a profit of roughly $500 million to a small loss and noted that American and others needed to raise fares.

It was just 10 months ago, in January, that other airlines were enjoying the prospect of Southwest's misery. As oil dipped down to about $52 a barrel that month — Southwest's hedges cap most of its fuel needs at about $51 a barrel, so they were of little use at that point — the carrier was looking like an airline with more than its share of problems.

Traditional hub-and-spoke carriers like Delta Air Lines and Northwest Airlines had deeply cut their costs by running through bankruptcy and could now profitably compete with Southwest's fares.

Moreover, because they could draw more business travelers with first- and business-class seating and other perks, hub-and-spoke carriers could bring in more revenue per seat than Southwest.

Southwest also has the highest labor rates in the industry because it was the only big airline that had not demanded deep wage concessions from workers.

Gary C. Kelly, chief executive of Southwest, was the architect of the fuel hedging program when he was chief financial officer. The big hedges were put on starting in 2000.

The hedges have helped keep Southwest profitable, producing gains on the hedging contracts of $455 million in 2004, $892 million in 2005 and $675 million in 2006, as well as $439 million for the first nine months of 2007, as oil prices have nearly doubled this year.

These gains mostly offset rising fuel prices while other airlines were largely unprotected against the increases.

Mr. Kelly does not play down the need for Southwest to change its business, including finding ways to charge more per ticket and to reduce operating costs.

The airline has already changed its boarding policy to favor business travelers and to end the practice of passengers lining up, as if for a cattle call, an hour or more before boarding. It is looking into arrangements for Southwest to be paid for funneling travelers to international airlines' overseas flights. And it is exploring selling tickets through channels other than its own reservation system and Web site, to better attract business travelers.

Of these and other changes intended to increase revenue at Southwest, Mr. Kelly said, "It's going to take us the entire decade." The hedges, he said, "bought us time to retool our company."

Indeed, in recent years other carriers could identify investments they needed to make — redoing airplane interiors to compete against foreign airlines, upgrading computer systems to improve employee productivity and airline reliability — but they often lacked the money for the projects. All but American Airlines among the major hub-and-spoke carriers have spent time in bankruptcy, and American only narrowly avoided it.

Other airlines certainly could have hedged in the late 1990s when they were solidly profitable. But they were a little giddy over that decade's boom, entering into expensive labor agreements and, in some cases, buying new planes.

Since Sept. 11, 2001, some airlines have been too broke to hedge; many agreements between parties in the energy derivatives market require players either to have a strong credit rating or to post collateral. Also, some forms of hedging are expensive.

Southwest's hedges used during the first nine months of 2007, which included options that allowed — but did not require — it to buy energy products at certain prices, cost $42 million. A small sum in retrospect, but not so easily spent when higher oil prices were only a possibility.

Early this year, more airlines were in decent financial shape and, with oil at about $52 a barrel, it would have been a smart time to do some hedging. "Everyone was tired of having Southwest's advantage rubbed in their noses," said Frank Boroch, an analyst at Bear Stearns.

Still, airlines did very little. "Maybe they were distracted," Mr. Boroch said, noting that US Airways was trying to buy Delta during this period. "It's a copycat industry. If everybody is in the same boat, that's going to give you comfort, or an excuse."

At $52 a barrel, airline executives were thinking, "'Maybe this will continue,'" Mr. Boroch said. "'Why hedge at $52 when it might go to $40?'"

JetBlue Airways, which had kicked itself in early 2006 for not having hedged fuel costs, did not do much this year, either. "We all wish we were Southwest," said Tim Walker, a JetBlue officer who manages its fuel contracts. "Southwest was just gorgeous what they did years ago. They put their foot down."

Now, airlines unprotected from higher oil prices face some tough decisions, Mr. Boroch said. They can ground some gas-guzzling planes and hope that reduced capacity drives up fares and thus profits. They can merge with another airline to reduce costs, which is what a New York hedge fund is asking Delta and United Airlines to do. Or, as Mr. Boroch noted in a report this month, they can "maintain the status quo until Chapter 11 becomes inevitable again."

He has started charting how much cash individual airlines have and how many months it would last under various oil-price outlooks.

Higher fares would certainly help airlines, and the companies are trying. But raising listed fares and actually collecting significantly more money per ticket are two different things. When fares are raised, airlines can end up selling fewer of the higher-priced seats and more lower-priced seats, and reap little increase in the average seat price.

Mr. Boroch counted six industry fare increases in the third quarter, yet Southwest's average ticket price for that period, $105.37, was just 62 cents higher than a year earlier.

Through October, a survey by the Air Transport Association of seven big airlines, excluding Southwest, found domestic fares actually paid by passengers up just 0.3 percent. "The trend of higher revenues more than offsetting higher fuel prices is at risk of ending soon," Philip Baggaley, an analyst at Standard & Poor's, said in a report last week.

The question for Southwest is whether it can turn yet another huge temporary advantage into a long-term edge. Its revenue-raising ideas are relatively modest, initially seeking an additional $100 million in annual sales. And it faces labor negotiations with its main worker groups. None want to make concessions.

Southwest's best immediate bet may be that other airlines stumble again. Every jet grounded by a hub-and-spoke carrier is a growth opportunity for Southwest. And any merger of big airlines would probably eliminate flights in some markets, another opportunity.

It really comes back to taking advantage of the misfortune of others. In a memo to Southwest managers last May, Mr. Kelly, the chief executive, laid out the obstacles the company faces. But then he quickly noted, "this cycle could, and should, be another one of those times we can prevail."

Southwest generally expects high fuel prices to prevail and, if it sees what it thinks is a short-term decline in oil prices, the carrier would consider adding to its hedges for years beyond 2009. It was not just the other airlines that failed to hedge in January, with oil at about $52 a barrel. That was also an opportunity for Southwest, said the treasurer, Mr. Topping.

"In hindsight," he said, "we'd have picked more up."

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