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BUSINESS

‘Overhedging’ Oil Prices Lands Some Coronavirus-Battered Global Airlines in Further Trouble

The collapse in fuel prices disrupts company moves aimed at smoothing out turbulence in the energy markets

Singapore Airlines Ltd., suffered the first annual loss in its near-48-year history, in part because of charges on oil hedges.

PHOTO: EDGAR SU/REUTERS

By Chong Koh Ping
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As global airlines reel from the huge drop-off in business caused by the coronavirus, some face a second hit from this year’s historic plunge in oil prices.

Some international airlines use financial instruments known as hedges to lock in years of fuel costs, a method aimed at smoothing out turbulence in the energy markets and providing guidance on one of the industry’s biggest expenses.

However, the collapse in energy prices this year has left companies “over-hedged,” effectively meaning they have bought more insurance than they can now use. This is another trouble spot for airlines already slashing capacity to adjust to a new world of closed borders, empty planes and fearful travelers.

Earlier this month, British Airways' parent company, International Airlines Group, took a €1.325 billion charge on overhedging. Air France-KLM, one of its main European rivals, has recorded a similar hit totaling €455 million.

Losing Altitude

Singapore Airlines share price

Note: S$10=US$7.04.

Source: FactSet

And this week one of Asia's highest-profile flag carriers, Singapore Airlines Ltd. , suffered the first annual loss in its near-48-year history, prompted in part by the equivalent of $638 million in charges on oil hedges.

The hits included nearly $500 million in mark-to-market charges against what are now "surplus hedges" because it has slashed capacity for the financial year through March 2021. The rest stems from losses on hedge contracts that matured in the three months to end-March.

The irony is cheaper oil should, in theory, be good news for airlines and other big consumers of energy. Jet-fuel prices are linked to crude oil. But when the energy markets break sharply from their expected ranges, as has happened this year, it can disrupt preconceived hedges.

U.S. carriers have in general pulled back on their use of these financial instruments in recent years, after being wrong-footed by an earlier plunge in oil prices about five years ago. Hedging missteps cost Delta Air Lines Inc. $2.3 billion in 2015, and United Continental Holdings Inc. lost $960 million on its bets the same year.

For proponents, hedging can help airlines plan further ahead. "You can lock in one of the most variable costs in airline operation, and make longer-term budgets more reliable," said Michael Poulsen, a senior oil-risk manager at Global Risk Management, which helps companies develop hedging strategies.

But many airlines steer clear, instead using customer fuel surcharges as a way to adapt to changing energy prices, said Steve Sinos, vice president at Mercatus Energy Advisors, an energy advisory and research firm.

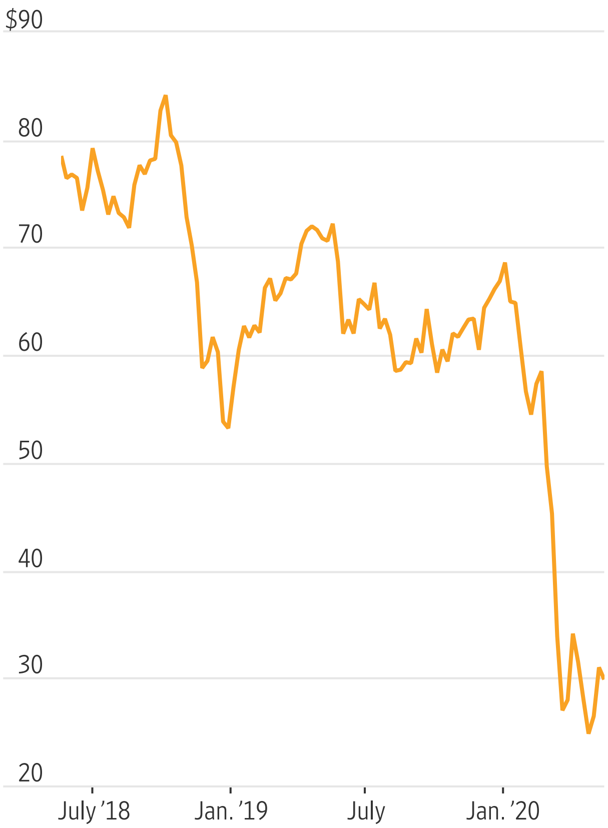
Singapore Airlines has had an unusually farsighted approach to its fuel bills. In recent years, the Southeast Asian company has hedged some fuel costs up to five years out, while the rest of the industry generally has a one- to two-year horizon. Of the 33 listed global airlines with fuel-hedging policies, Singapore Airlines' was by far the longest, Morgan Stanley research in July 2019 found.

In January, Singapore Airlines said it had hedged the bulk of its expected fuel costs out to March 2025. For the four years from April 2021, it had hedged more than half of its fuel needs based on Brent crude at $58 to $62 a barrel, plus some extra protection based on jet fuel.

Airlines sometimes buy longer-dated hedges based on Brent, the global oil benchmark, because this market is bigger and more liquid than jet fuel.

Low Energy

Brent crude oil futures, price a barrel



Source: FactSet

Singapore Airlines said it expected to see further hedging losses, and marked down the fair value of its other hedges by $1.47 billion. Its remaining hedges include some for the current financial year that are still deemed effective, a spokesperson said, and others for future years.

"We expect to maintain our fuel-hedging policy to mitigate the impact of volatility in fuel prices," the spokesperson said in an email. "However, given the uncertainty in the market, we have taken a pause in our current hedging strategy and plan to monitor developments closely before entering into any additional hedges."

In March, Singapore Airlines said it would raise the equivalent of $6.2 billion by selling shares and convertible bonds, and could raise a further $4.4 billion by issuing additional convertible bonds, to help tide it through the crisis brought on by the coronavirus. The company's largest shareholder, Singaporean state investment company Temasek Holdings, will underwrite the fundraising.

Carmen Lee, head of investment research at OCBC Bank, said Singapore Airlines' decisions made sense before the coronavirus emerged and oil prices crashed. "In the past, they had clarity on their passenger capacity. And they had to hedge in case oil prices go ridiculously high," she said.

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