



Client Alert

Proposed Derivatives Regulations May Adversely Impact an Already Turbulent Jet Fuel Hedging Market

As crude oil prices reached record highs this past summer,¹ jet fuel costs began to account for a greater percentage of airlines' operating costs.² In anticipation of oil prices soaring even further, airlines began hedging oil at prices that regrettably turned out to be much higher than actual prices. With oil's precipitous drop to below US\$40.00 a barrel, these hedging contracts have left global and domestic carriers with losses totaling in the billions.³ Even Southwest Airlines, long envied for its jet fuel hedging strategy, has felt the sting as it incurred US\$117 million in losses in the fourth quarter of 2008 relating to the falling value of its jet fuel-hedging positions.⁴

According to the International Air Transport Association, approximately half of all jet fuel used by the global airline industry was hedged in 2008.⁵ With airlines being hard hit by astronomical losses related to jet fuel hedging, many have called into question the utility of the practice. Considering that the price of jet fuel has gone from US\$2 a gallon in 2007 to US\$4 in July 2008,⁶ the prima facie appeal in jet fuel hedging is its potential to reduce the effects of energy price volatility; an expense to which airlines are particularly vulnerable, as jet fuel represents a significant component of their cost structure.

In order to cope with volatile price swings, airlines hedge jet fuel costs by locking in the cost of future jet fuel purchases. Hedging protects airlines from rising jet fuel costs and enables them to stabilize costs, cash flows and profits. Conversely, however, jet fuel hedges also reduce an airlines' ability to realize gains when jet fuel prices decline. However, unlike investors, who enter into derivatives to profit from oil price swings, airlines hedge to level price volatility so that going forward they can develop and deploy an appropriate business strategy.

Underlying any airline jet fuel hedging strategy is the notion that oil prices move in cycles instead of consistently in one direction. If properly understood, the use of a variety of derivatives over the oil price cycle can be the basis for an effective jet fuel hedging strategy; for example, receive-fixed swaps are used at cycle low points to lock in low prices whereas caps are used at cycle high points to guard against future increases in prices as well as to allow an airline to benefit from reductions in price. In the mid-range of the cycle, where cycle movement is more indeterminable, collars are used to lock in a known range of prices so that an airline will be protected against further price increases.

Despite the dearth of evidence linking the over-the-counter ("OTC") derivatives market with the financial crisis, the current economic turmoil has nevertheless prompted a push for closer scrutiny of these financial instruments. To this end, the Committee on Agriculture of the US House of Representatives (the "Committee") approved the "Derivatives Markets Transparency and Accountability Act of 2009" (the "bill") on February 12, 2009 which is intended to bring greater transparency and accountability to the commodities market.⁷

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The bill, which has been recommended by the Committee to be considered by the entire House of Representatives, in relevant part, calls for the US Commodity Futures Trading Commission (“CFTC”) to: (1) subject all OTC commodities transactions to reporting and recordkeeping requirements⁸ and (2) set position limits for: (a) all physically-deliverable commodities⁹ and (b) fungible OTC transactions that have the potential to disrupt market liquidity or otherwise affect price discovery in the market.¹⁰ Moreover, the bill also calls for prospective OTC transactions to be cleared through a CFTC-regulated entity.¹¹

In conjunction with Congress, the CFTC has also called for greater oversight over the OTC derivatives market and futures market, both of which have facilitated jet fuel hedging for airlines. Under the current regulatory regime, the CFTC: (1) grants bona fide hedge exemptions to swap dealers in the futures markets from speculative position limits so that they can better manage the risk that results from serving as a market maker to OTC clients and (2) classifies swap dealers’ trading activity as “commercial” in its Commitments of Traders report since swap dealers principally use the futures markets for the commercial purpose of hedging their price risk.¹²

In June of 2008, the CFTC undertook a survey of swap dealers and index traders to better understand the positions held by participants in the futures market. From the survey, it recommended, among other things, that: (1) swap dealers be removed from the “commercial category” and a new category be created for reporting purposes; (2) “long form” reporting be developed for large traders to better assess their trading activity and (3) staff undertake a review of whether to eliminate the *bona fide* hedge exemption for swap dealers and instead create new limited risk management exemptions.¹³

Airlines principally hedge jet fuel by entering into customized OTC contracts with swap dealers, who in turn hedge their own risk by entering into other swaps and futures contracts since customized OTC contracts offer low liquidity. Accordingly, many

market participants, from US swap dealers to global and domestic airlines, are asking themselves how these proposed regulatory initiatives, if implemented, will affect jet fuel hedging in the airline industry.

It seems that subjecting US swap dealers to position limits and eliminating their bona fide hedge exemption, which in turn subjects them to the futures markets’ position limits, will inhibit their ability to trade to better mitigate the risk associated with customized OTC contracts and increase liquidity. Given these trading constraints, US swap dealers will likely: (1) pass costs associated with this increased risk exposure to their OTC clients, which include global and domestic airlines and (2) be less inclined to tailor OTC contracts to meet an airline’s specific needs unless a substantial premium is paid. Moreover, reporting, recordkeeping and clearing requirements will generally increase transaction costs for all hedging parties.

Although airlines have recently incurred significant losses relating to their jet fuel hedging strategies, the necessity for jet fuel hedging as protection against volatile energy prices is clear as every extra penny paid for a gallon of jet fuel costs the industry nearly US\$200 million annually.¹⁴ Moreover, sophisticated jet fuel hedging strategies, which can be used successfully by airlines as both a sword and shield, have proven fruitful for those airlines who have implemented them with prudence and patience.

Nonetheless, even successful jet fuel hedging strategies raise serious risk management issues for airlines such as what percent of its projected jet fuel usage should the airline hedge and what degree of basis risk can the airline tolerate, given that oil futures only correlate with, but are not identical to, jet fuel costs. The proposed regulatory initiatives, if implemented, ultimately threaten to compound the complications already present in developing and deploying jet fuel hedging strategies as jet fuel hedging could become more burdensome, costly and difficult for airlines to obtain.

- 1 Margot Habiby, *Bloomberg.com*, "Oil Gains on Report That U.S. Economy Shrank Less Than Forecast," <http://www.bloomberg.com/apps/news?pid=20601082&sid=aw7ILCelroFw&refer=canada> (last visited Feb. 20, 2009) (stating that "Oil is down 72 percent from a July 11 record of \$147.27 a barrel . . .").
- 2 *Knowledge.Wharton.UPenn.edu*, "For Airlines and Others, Even the Best Fuel-price Bets Can Lead to Turbulence," <http://knowledge.wharton.upenn.edu/articlepdf/2087.pdf?CFID=1457242&CFTOKEN=71856907&jsessionid=a8306514224abfa0168b706c52292bb4383c> (last visited Feb. 20, 2009) (stating that "For years, fuel represented 10% to 15% of most airlines' operating costs, but this summer, as crude prices soared, its cost-share shot up to between 35% and 50% . . .").
- 3 Ulf Laessing and Daliah Merzaban, *Reuters.com*, "Kuwait Carrier Eyes Fuel Hedging for '09 Launch," <http://www.reuters.com/article/MiddleEastInvestment08/idUSTRE4A21XP20081103> (last visited Feb. 20, 2009) (stating that ". . . but only after top global carriers wrote down about \$2 billion in the third quarter in losses related to hedging).
- 4 *Southwest.com*, "Southwest Airlines Reports 36th Consecutive Year of Profitability and Fourth Quarter Results," http://www.southwest.com/investor_relations/fs_quarterly_earnings.html (last visited Feb. 20, 2009) (stating that "Including special charges totaling \$117 million (net), relating to noncash, mark-to-market and other items association with a portion of the Company's future fuel hedge portfolio . . . fourth quarter 2008 net loss was \$56 million.").
- 5 Jeremiah Marquez, *Forbes.com*, "Cathay Shares Fall Sharply on Fuel Hedging Loss," <http://www.forbes.com/feeds/ap/2009/01/08/ap5894796.html> (last visited Feb. 20, 2009).
- 6 *Id.* at 2.
- 7 *GovTrack.us*, "H.R. 977: Derivatives Markets Transparency and Accountability Act of 2009," <http://www.govtrack.us/congress/bills/977/bills/111/h111-977> (last visited Feb. 20, 2009).
- 8 Derivatives Markets Transparency and Accountability Act of 2009, H.R. 977, 111th Cong. § 5 (2009).
- 9 H.R. 977 § 6.
- 10 H.R. 977 § 11.
- 11 H.R. 977 § 13.
- 12 U.S. Commodity Futures Trading Commission, "Staff Report on Commodity Swap Dealers & Index Traders Commission Recommendations 1 (2008)," available at <http://www.cftc.gov/stellent/groups/public/@newsroom/documents/filecftcstaffreportonswapdealers09.pdf> (reporting the results of the special call survey of swap dealers and index traders, with several preliminary recommendations).
- 13 *Id.* at 12.
- 14 Ron Schelling, "Jet Fuel—To Hedge or Not to Hedge?," *The Trader's Journal*, Feb. 2008, at 12, available at <http://mediaserver.fxstreet.com/Reports/f235046f-21e4-46ee-a9df-4f3e89c81ef3/c174bcb4-8884-4dba-99ed-6a2375e6571c.pdf> (arguing that "Airline people . . . are becoming almost big (oil) hedgers in order to save on the biggest part of the cost of flying. It is only then that an airline can be able to make a profit.").

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