

Fueling Historical Losses - How Rising Fuel Costs Have Exposed Strategic Flaws in the Airline Industry

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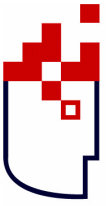
By focusing on controlling labor costs, the airlines have failed to address the most volatile cost driver, fuel costs, thus placing most industry members in substantial economic jeopardy.

The two largest cost drivers in the airline business are fuel and labor. Collective bargaining agreements fix the cost of labor in the short term and, due to the complex negotiating process, cannot be restructured quickly enough, if at all, to offset a rapid spike in other operating costs. The second largest cost driver, fuel, is also the most volatile. As crude oil maintains a price point approaching \$40 a barrel, driving costs and losses higher, some airlines are finding that their lack of strategic fuel management is accelerating their path to bankruptcy.

It has been estimated that fuel costs account for 15% of the total costs to run an airline. According to industry consultant AeroEcon, every \$1 increase in the cost of crude directly translates into an additional \$180 million worth of operating costs across the industry. Continental Airlines has forecast an additional \$700 million in fuel costs due to the sharp rise in fuel price. Normally, a transportation company in this environment would adjust its pricing to pass the additional cost on to the consumer, but earlier strategic errors have made this difficult in today's airline industry.

Southwest Airlines, famous for its low cost model, has made a key part its strategy to hedge fuel costs and lock in future fuel prices. Lehman Brothers estimates that Southwest has hedged 80% of its fuel needs for the remainder of the year by locking in a price of about \$25 a barrel. Already profitable, Southwest is now in a position to watch the competition suffer substantial operating losses while it captures value from increased traffic as consumers shun fare hikes by the competition and potentially provokes an industry-wide price increase. Southwest is not alone in this situation. Both JetBlue and Alaska Airlines have hedged more than 30% of their fuel costs throughout the year. While not as protected from fuel volatility as Southwest, these airlines will benefit from the decision to proactively control fuel costs.

If Southwest exemplifies the use of fuel contracts to gain a competitive advantage, then Delta, Northwest, and US Airways epitomize the failure to grasp the strategic advantage of fuel hedging. Unhedged, these airlines are in the unenviable position of trying to compensate for the highest fuel costs to occur in 13 years. Even should they now desire to hedge future costs, they are unable to do so: due to their poor current credit ratings, these unhedged airlines are incapable of financing hedging contracts and must bear the market price. Unable to control fuel costs and, competing against hedged companies, these airlines are finding it difficult to pass the additional costs on to passengers. Lacking revenue from price increases, Delta, North-



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west, and US Airways have called for labor concessions in order to avoid bankruptcy filings. Fully exposed to the high cost of fuel, these companies find themselves at the mercy of the labor unions.

Critics of hedging contracts are quick to point out the unrealized gains when spot prices drop below the hedged price. The risks and opportunities of hedging can be debated at length, but it is clear that fuel hedges can be a critical part of an airline's strategy. In sum, by locking in the most volatile operating cost, management can focus its attention on strategies that increase revenue and reduce less volatile costs.