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**Fuel Hedging in the Airline Industry – The Case of Southwest Airlines**

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1. Introduction to Fuel Hedging

Fuel is one of the largest and most volatile costs for airlines. Deregulation in 1978 forced airlines like Southwest to manage fuel price volatility. Scott Topping of Southwest led efforts to hedge fuel costs for budget stability.

2. Overview of Southwest Airlines

Founded in 1971, Southwest started with simple principles of low fares and reliable service. Over the years, it became a major U.S. domestic airline and a pioneer in operational and financial innovation.

3. The Importance of Fuel Hedging

Due to volatile fuel prices, airlines can't always increase ticket prices. Hedging allows cost control, earnings forecasting, and protection from price spikes.

4. Fuel Hedging Strategies

Southwest used:

- Swaps: Fixed for floating rate
- Call Options: Right to buy at fixed price
- Collars: Price range lock-in
- Futures/Forwards: Price lock contracts

5. Basis Risk Management

Due to lack of jet fuel liquidity, related commodities like heating oil/crude are used. This leads to basis risks:

- Product Basis Risk

- Time Basis Risk

- Location Basis Risk

6. Regulatory Framework - SFAS 133

Under SFAS 133, derivatives must be reported at fair value. Hedges must pass effectiveness tests (80-125 rule or correlation) to qualify for hedge accounting.

7. Southwest's Hedging Record

Between 1995-2000, Southwest effectively reduced fuel costs through hedging. In 2000, its hedged cost was significantly below market average.

8. Competitive Landscape

With low pricing power in a competitive market, fuel cost control becomes a strategic necessity. Southwest stood out due to effective hedging.

9. Financial Performance

The thesis details consistent growth in revenue, ASM, and fleet from 1996 to 2000, highlighting strong profitability aided by hedging.

10. Evaluation of Hedging Alternatives

Scott Topping's choices:

1. Do nothing

2. Vanilla swaps

3. Options

4. Zero-cost collars

5. Futures contracts

Tested under two scenarios: price drop and price spike, each strategy performed differently.

11. Combining Strategies

Combining options, swaps, and collars can provide protection and cost balance. No one-size-fits-all exists.

12. Hedged vs. Unhedged

- Unhedged: Exposed to risk

- Hedged: Protected, but might miss benefits of falling pricesBalance is key.

13. Market Trends - Contango & Backwardation

Market structure affects strategy. In contango, futures > spot prices; in backwardation, the reverse. Strategic timing is essential.

14. Strategic Recommendation

Continue using a combination of tools. Monitor basis risk and SFAS 133 compliance. A dynamic approach based on fuel forecasts is advised.

15. Conclusion

Southwest's fuel hedging showcases smart risk management. Effective use of derivatives helped maintain competitiveness and profitability.

This case underlines the importance of strategic financial planning and hedging in the airline industry.