

## FOR IMMEDIATE RELEASE

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### Research Opinion

#### Will Airlines Reduce Fuel Surcharges?

TORONTO (AirTrav Wire - 20 Sep 2011) – In response to questions from travel media asking about the possibility that airlines may reduce fuel surcharges in light of recent declines in energy prices, AirTrav Inc. has provided this Research Opinion.

#### **Continued price volatility**

Generally speaking jet fuel prices track crude oil prices. The crude price benchmark mostly used by North American air carriers is West Texas Intermediate (WTI) Sweet Light Crude. The WTI spot price is assessed at Cushing, Oklahoma.

Airlines typically need to understand trends and also the “forward curve” of oil that prices outwards multiple months and years. One of the challenges in energy pricing the past few years has been day to day trading price volatility. While the general WTI spot price trend has indeed been downwards since the peak this year in April, volatilities remain problematic and that may delay a decision by airlines such as Air Canada to reduce or eliminate select fuel surcharges.

More problematic for airlines has been a widening of the so-called *crack spread*, which is the refinery margin between crude oil and jet fuel output. Crack spreads have also been subject to frequent volatility. As a result, airlines are looking more closely into if and how they “hedge the crack spread” to preserve positive results in their fuel hedging programs. Fuel hedging helps airlines to reduce their exposure to price direction that can negatively impact cash flows, budgeting accuracy and earnings.

Another problem in the area of fuel hedging has been with the oil benchmark used to underpin many airline jet fuel hedging programs. For airlines that hedge their jet fuel price exposure who have used WTI as a proxy instrument, another challenge this year is that WTI and jet fuel prices have become less correlated than their historic tracking, leaving the relationship between the European Brent crude benchmark as a more reliable directional track for jet fuel prices. Many North American carriers that use WTI hedging instruments have not converted contracts to Brent based instruments either because of the high cost, or because they prefer a wait and see approach.

#### **Commercial mechanisms to offset high fuel prices**

Airlines also recover fuel cost from a combination of base airfares (i.e. price the market where it can to absorb as much fuel cost as possible) and fuel surcharges. So a fuel surcharge can go on or come off, but relative changes in the portion of base airfares attributable to fuel costs can be difficult to assess.

Moreover, in some markets an airline’s fuel surcharge decisions are almost completely driven by competitor moves. A good example of this is the trans-Atlantic market to/from Canada. Even

before Air Canada re-introduced a transborder fuel surcharge this past May – so for a time when there was no domestic or transborder surcharge – the airline maintained a fuel surcharge on routes to Europe. Air Canada’s response was that it had to maintain price positioning in a competitive market (i.e. other carriers were still imposing a surcharge).

**Timing of fuel surcharge decisions – data driven predictor?**

Past timing of surcharge decisions can also be difficult to use as predictors of future actions. Case in point is a set of data AirTrav Inc. pulled from Air Canada fuel surcharge actions the past three years. AirTrav also the number of days at which WTI spot prices trades at specific dollar levels.

Number of days with WTI spot oil prices below certain levels		Below \$90/bbl	Below \$80/bbl	At or below \$85/bbl
Sep-2011 month to date		15	1	4
% of trading days		94%	6%	25%
Aug-2011		20	1	12
% of trading days		87%	4%	52%

Date	Market	AIR CANADA - FUEL SURCHARGE		WTI Oil/Barrel & Price Metric		
		Action	One-way amount	Date Announced	3-MMA	MTD
23-Sep-11	Study reference price			\$79.58	\$91	\$87
4-Mar-11	USA	Re-introduce	\$10-Y / \$15-J	\$104.34	\$89	N/A
18-Sep-08	USA	Eliminate & roll into base fare	\$40	\$97.50	\$124	N/A
" " "	Canada	Eliminate & roll into base fare	See Domestic grid below	\$97.50	\$124	N/A
9-May-08	Canada & USA	New	\$20<480 km	\$125.94	\$109	N/A
" " "	" " "	" "	\$40<1,600 km>480 km	\$125.94	\$109	N/A
" " "	" " "	" "	\$60>1,600 km	\$125.94	\$109	N/A
N/A	International	Set per competition				

**LEGEND:**

WTI West Texas Intermediate (light sweet crude oil, spot price at the Cushing, OK benchmark hub)  
 3-MMA Three month moving average  
 MTD Month-to-date

- On 04 Mar 2011 Air Canada re-introduced a transborder fuel surcharge.
  - On the date of announcement, spot WTI was US \$104.34/barrel and the 3-month moving average (3-MMA) was \$89/barrel.
- On 18 Sep 2008 Air Canada rescinded its domestic and transborder fuel surcharges by announced it was rolling any required surcharges into base airfares.
  - On the date of announcement, spot WTI was US \$97.50/barrel and the 3-month moving average was \$124/barrel.
- On 09 May 2008 Air Canada announced new domestic and transborder fuel surcharges.
  - On the date of announcement, spot WTI was US \$125.94/barrel and the 3-month moving average was \$109/barrel.

As one example then from the above numbers, Air Canada's transborder fuel surcharge re-introduction in March 2011 occurred at a time when the WTI spot price was over \$21/barrel less and the 3-MMA was \$20/barrel less than at the prior re-introduction date in May 2008.

### **Conclusion**

We realize that a WTI oil price below \$80/barrel is symbolic, and the close today (Friday 23 Sep 2011) was indeed \$79.58. However, also note that in the month of August 2011 there was also a spot price close below \$80/barrel, which was \$79.32 on August 9. Perhaps more importantly, last month in August, WTI spot prices closed at the \$85/barrel range or lower on 52% of the 23 trading days. For the month-to-date 23 Sep, WTI spot prices have closed at the \$85/barrel range or lower on only 25% of the 16 trading days.

To make a long story short, AirTrav believes it will take another four weeks of sustained WTI crude oil prices at or below the \$80/barrel level before airlines such as Air Canada take a decision to rescind – in whole or in part – fuel surcharges in specific markets.

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