Fuel hedging: From IAS 39 to IFRS 9

October 2016

Niall Naughton

Contents

01

Strategies for fuel hedging

	Futures/Forwards	Swap	Options
Advantages	✓ A standardised contract ✓ Specific quantity/quality of a commodity for a price agreed upon ✓ Delivery and payment occurring at a specified future date ✓ One cash flow	✓ Exchanges their exposure to a floating fuel price for a fixed fuel price over a specified period of time ✓ Several cash flows ✓ Swaps could be preferable to futures as they use the monthly average price rather than the price on a specific date	✓ The buyer of the contract has the right, but not the obligation, to purchase or sell a particular amount of a specific commodity on or before a specific date or period of time ✓ Limited loss / unlimited gain ✓ Gives consumers favourable prospects: a hedge when prices are higher, market prices when prices are lower
Disadvantages	× Like insurance, prices of hedges usually carry an upfront cost so even if markets remain neutral, companies can lose money × Futures/Forwards contracts expire on a specific day of the month and most businesses consume oil every day	× The airline is locking in their jet fuel cost (for long time) regardless of whether fuel prices increase or decrease so are subject to market volatility × Risky – one party wins & one loses	× Premium in cash is required upfront

Fuel hedging in practice

AER LINGUS & RYANAIR

They aimed to take advantage of the low oil prices in 2015 by locking in low fuel costs with futures contracts. However, they actually hedged their fuel costs above 2016 prices as prices continued to decrease. Ryanair at 165% above spot prices earlier in 2016, whereas Aer Lingus at only 38% above spot prices.

DELTA AIRLINES

They reportedly lost $450million in 2016 on fuel hedges in the form of futures. They anticipated a significant rebound which did not occur. This adds to the $712million lost in 2015. They have lost over $4billion on fuel hedging over the last 8 years.

THAI AIRWAYS

They have hedged 40% of their 2016 fuel needs with futures at a decent price and aim to raise its passenger load to more than 80%, boosting earnings. As fuel hedges wind down, they expect to benefit from low fuel prices.

SOUTHWEST

They made a 1.3 billion gain with futures in the 2000s, enabling them become one of the best-run airlines. However, they have more recently lost money on hedges. Their 2016 hedge lost them $1 billion as they paid 50 cents to 60 cents more per gallon for jet fuel than some rivals. However they still see a strong future in the benefits of hedging.

02

Implications of IAS 39 on fuel hedging (I)

Necessary requirements under IAS 39:

Formal documentation

The following must be documented at the **inception of the hedge**:

1. **RISK**
   Risk management objective & strategy for hedge
2. **NATURE**
   The nature of the risk being hedged
3. **HEDGED ITEM**
   Clear identification of the hedged item or transaction (risk components of non financial items)
4. **INSTRUMENT**
   Clear identification of the hedging instrument
5. **EFFECTIVENESS**
   How hedge effectiveness testing will be assessed in sufficient detail to establish a firm and consistent basis for all periods for that relationship.

Effectiveness testing

Prospective effectiveness test
(At inception and at each reporting date)

Is hedge expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to hedged risk during period for which hedge is designated?

Retrospective effectiveness
(At each reporting date)

Is actual effectiveness within range of 80% - 125%?

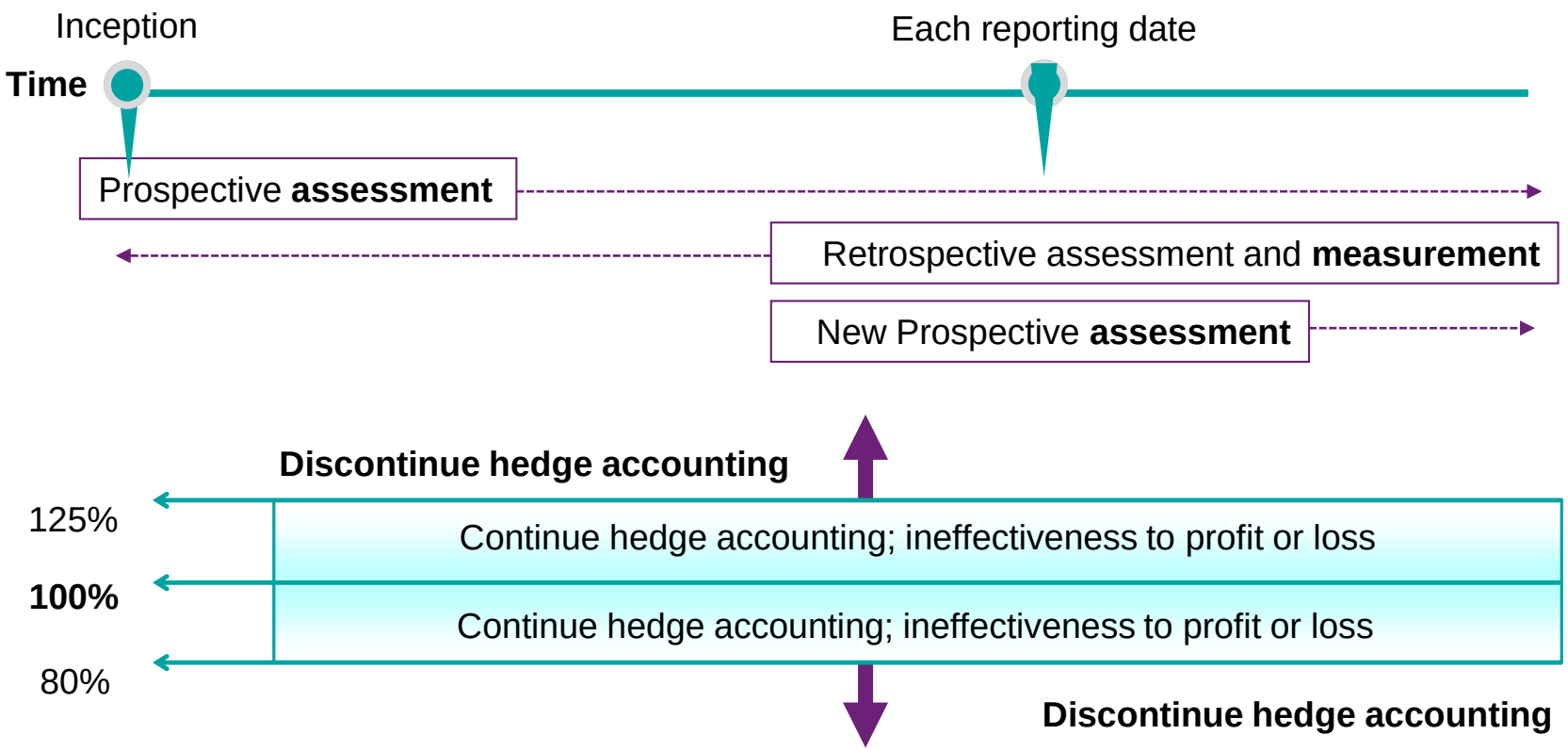
YES

YES

Hedge accounting is allowed
&
Ineffectiveness is recognised in profit or loss

Implications of IAS 39 on fuel hedging (II)

Assessment of hedge effectiveness & measurement of ineffectiveness:



The time value of the options is also considered through P/L.

03

Implications of IFRS 9 on fuel hedging

In November of 2013 the IASB published the definitive standards for hedge accounting. Companies have the option of early application of these standards.

The main objectives of the new regulations:

1. Align hedge accounting with risk management
2. Flexibility of standards in relation to efficiency

Such simplifications of the current requirements involve the obligation to present a greater quantity of information about the risk management in the company's policies.

The increase of information related to:

1. Risk management strategy of the company
2. How hedging could influence future cash flows
3. Impact hedging could have on financial statements

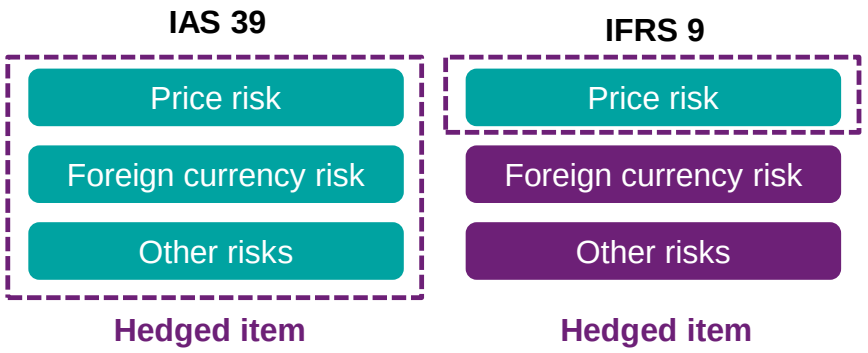
HEDGE EFFECTIVENESS TESTING	Economic relationship
RISK COMPONENT	Also for non-financial items
COSTS OF HEDGING	Time value of options, FWD element of a FWD contract and FX basis spread
GROUPS OF ITEMS	More designations of groups of items
DISCLOSURES	These are more extensive and more meaningful information and insights
DISCONTINUATION	Voluntary discontinuation of hedge accounting not allowed

IFRS 9: Risk components of non-financial items

An airline faces significant price risk with jet fuel for reasons like: rising inflation, changing crude oil price etc.

× Under **IAS 39** it was not permitted to hedge an individual risk component like crude oil.
✓ Under **IFRS 9** components like crude oil can be separated to a highly probable future purchase because:

- Crude oil is a separately identifiable component of the jet fuel price
- Changes in the fair value of the jet fuel price attributable to changes in the crude oil price are reliably measurable.



IFRS 9 *IN PRACTICE*

The Qantas Group uses options and swaps on jet kerosene, gasoil and crude oil to hedge their exposure to movements in the price of aviation fuel. The changes in aggregated exposure mean that Qantas can now hedge a combination of derivative and non-derivative exposures. This has allowed them designate economic hedging relationships as accounting hedges. This has reduced the mark-to-market movements of derivatives.

What are the following steps?

KPMG can help in the following areas:

Accounting, tax and reporting

- Help with a gap analysis
- Evaluate adoption alternatives
- Perform an impact and feasibility study
- Identify new accounting policies and modifications to documentation

Systems & Processes

- Identify gaps in information systems
- Help with policy, control and procedural changes
- Draft and review updated accounting policies
- Assess interaction with key IT initiatives
- Identify new key controls or reconciliations

Business

- Advise on impact of new model on key financial metrics
- Review of internal management information
- Review new or existing hedging strategies and the alignment of risk management in the business

People & Change

- Provide ongoing or one-off training sessions
- Provide staff to ease resource constraints
- Provide strong project management experience

The contacts at KPMG in connection with this report are:

Niall Naughton
Financial Services
Director, KPMG Ireland

Tel: + 353 (1) 410 1832
niall.naughton@kpmg.ie

kpmg.ie