

Finance and Hedging in the Commercial Airline Industry

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By

Tony Webber

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PREFACE

During my time as the Chief Economist of the Qantas Group I reported to two of the best Chief Financial Officers (CFOs) in the business - Peter Gregg and Colin Storrie. Two things that these gentlemen have in common, amongst many (including their love of the water), is that they are both economists by trade, as I am. I often wondered why two economists would make the best CFOs and the answer was simple. These two men could understand the interrelated nature of economic and financial risk within the airline business. I'm not sure if accountants or finance experts have the same risk vision. For example, these men knew that when the oil price goes up, which adds to airline costs, this usually results in a stronger exchange rate, which reduces airline costs. They knew that the airline could handle higher oil prices caused by a stronger global economy placing upward pressure on energy demand, because they knew the stronger economic growth would position the airline in a favourable revenue environment. They also knew that higher interest rates, which places upward pressure on the airline's finance or capital costs, also resulted in a stronger currency, which placed downward pressure on a range of airline costs. By understanding these linkages, the two CFOs could better prepare the business for the economic and financial risks that the airline faced.

When I first started at the Qantas Group as the general manager of microeconomics, later to become the Chief Economist, I soon realised that I had to improve my understanding of airline finance. I started by first understanding airline financial statements, which I knew a bit about because I studied financial accounting in my first and second years at university in Newcastle, Australia. This wouldn't prepare me, however, for the complexity of airline financial statements. Airline financial statements are unlike financial statements of companies operating in other industries because the airline profit and loss statement is heavily influenced by movements in a single commodity price, namely jet fuel prices, and an asset price, namely the exchange rate. The balance sheet is deeply affected by the written down value of a single asset class, that being the aircraft equipment that the airline has purchased or has the right to use, while the cash flow statement is influenced by volatile revenue and cost streams as well as aircraft financing activities. In response to this complexity, airlines must use complex measures to describe the cost of the capital that is used to invest in