

## Outlook Continues Grim For Airlines As Oil Prices Remain Stubbornly High

Today, virtually any airline would jump at the chance to lock in a \$32 price tag, and \$40 and \$45 are looking attractive too.

Around 18 months ago, one airline industry executive was incredulous at the notion that carriers should consider hedging, given what he considered to be oppressively high prices at the time. “Why would anyone hedge at \$32?,” he asked at the time. “That’s crazy.”

Today, virtually any airline would jump at the chance to lock in a \$32 price tag, and \$40 and \$45 are looking attractive too. With crude oil stubbornly staying above the \$50 dollar a barrel mark for most of early 2005, airline executives are again left hoping for a significant

price reduction in the near-term future, while at the same time fully realizing that the global markets could also be just one major crisis away from \$60-plus a barrel pricing in the coming months.

Today’s high prices simply weren’t anticipated by most in the industry. Even as prices crept up in late 2003 and into 2004, there was a general feeling what went up would eventually come down and that prices would ease back into the \$30s. In early 2004, in fact, several carriers unwound their hedge positions to

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## Arizona Refinery Project Passes Major Hurdle By Gaining Air Quality Permit

A proposed new refinery in Arizona – which will be the first in the state and the first refinery in the United States in more than 30 years – passed a major hurdle last week with the **Environmental Protection Agency’s** approval of the state regulators’ draft air quality permit. At press time, the **Arizona Department of Environmental Quality (ADEQ)**, was in the process of issuing the permit.

“As we expected, EPA had no real issues with the permit we drafted,” ADEQ director **Steve Owens** said. “This is the toughest air quality permit ever proposed for a refinery.”

The permit was considered

one of the key steps to moving forward on the \$2.5 billion project. “It’s been a long time since a permit has been issued for a new refinery in the United States,” notes **Glenn McGinnis**, CEO, **Arizona Clean Fuels Yuma LLC (ACFY)**. “But there is still a lot to do,” he adds, explaining that an environmental impact statement from the **U.S. Bureau of Land Management** is needed for both the refinery and the pipeline. “That really is the next significant hurdle, to get that reviewed and issued.”

At the same time, the organization is focusing on

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**“When prices shot up so much last year, I think there was a general belief that it was a short term phenomenon. So people didn’t change their long-term decision making and tough action was delayed.”**

gain a short-term cash infusion in anticipation that crude oil prices would be significantly lower in the latter half of the year.

“Prices have been climbing for two years and there’s always been this expectation that prices are going to drop,” says **Ben Brockwell**, editor of **Oil Price Information Service**. “I think airlines and every other industry put off hedging or hedged only in small percentages, but now they’re facing the reality of ‘Listen I’ve got to do something to hedge some of my costs,’ and those who can are doing it even at these high prices.”

But Brockwell points out that no one, least of all the cash-strapped airlines, wants to be caught holding high-priced hedges. “It takes a lot of cash flow to hedge fuel prices and you don’t want the opposite thing to happen,” he says. “It’s one thing not to hedge going up but it’s another thing to hedge at the top of the market and pay a price when it drops. That’s a gamble that all industries have been taking so far and many are realizing it’s a gamble that many can no longer afford to take.”

**Agbeli Ameko**, partner with the Denver-based energy markets analyst firm **Enercast.com**, adds, “It makes sense to hedge at any level if you have upside exposure. If you’re not hedged now you’re paying a price, but you probably still want to do something to be hedged against a \$60 or \$62 oil price. Big industry users are certainly hedging even at these prices just in case a spike happens.”

Much of the current sentiment among analysts and industry observers is that oil prices could remain high for at least the remainder of the year.

**John Chapman**, principal, **Chapman Aviation Fuel Consulting**, says sustained crude oil pricing in the \$30s isn’t likely in the near-term future. “In the last several months we’ve seen many of the major investment houses upgrade their forecast for oil from the low \$30s to the low \$40s,” he says. “My personal opinion is that they are still behind the curve. It’s hard to say, but I think this year we’ll see crude oil average in the low \$50s and I think we’ll still see the very wide

differentials between light crude oil and the heavy crude oil. You’re really looking at a two tier market, between light sweet and heavy sour. Those refiners who have the capability to run heavy sour crude are making very nice margins.”

Airlines have been slow to respond, Chapman says. Despite the myriad cost-savings measures taken by virtually all global airlines, longer-term cost-savings measures – primarily in the form of new aircraft – will likely accelerate. “When prices shot up so much last year, I think there was a general belief that it was a short term phenomenon. So people didn’t change their long-term decision making and tough action was delayed.”

“But the way to deal with high prices usually requires investment,” Chapman continues. “When you have high prices you get some change in the demand function by behavior change. For example you spend more money on more efficient airplanes and I think the increase in orders and industry interest in the Boeing 7E7 Dreamliner is an indication of that.”

Not everybody, however, believes sustained high prices are a given. Brockwell, for one, feels that the market fundamentals may augment a shift downward in crude pricing. “You have to have a lot of guts to predict \$30 crude but I think the cycle could change and we could go back there,” he said. “I just don’t know the timing of that. It took the futures market a while to catch up with fundamentals because the fundamentals were tightening before the futures market began to heat up. But now the fundamentals are getting worse and the futures market will eventually catch up to the fact that inventory is building for gasoline and east coast storage is filled up.”

But the wild card in all this is demand, especially in China and the US. Ameko notes that in many ways oil producers are still playing catch up when it comes to demand, but that no one is quite sure just when the current high prices will begin to be felt by the global economy.

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© 2005 World Jet Fuel Report

Published biweekly by:  
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**“Prices will come down when we start seeing some broad-based demand destruction. It doesn’t necessarily have to be a recession, but there has to be some evidence of a reduction in consumption.”**

“We’re not seeing any signs of global economic slowdown, but is important to note that the inflationary effect that these high oil prices could trigger often take time to hit,” he says. “The forces of supply and demand should pull it back down to the mean which is what people call mean reversion. The reverted mean for crude is about \$38 but the question is, when will we hit that number, or is the demand too strong to allow for that mean reversion.”

**Jim Ritterbusch**, president of Galena, IL-based **Ritterbusch & Associates**, says the current market may be overemphasizing the uncertainly surrounding crude supplies and production capacity, while at the same time underestimating the fact that strong demand going forward is also not a certainty.

“Prices will come down when we start seeing some broad-based demand destruction,” he says. “It doesn’t necessarily have to be a recession, but there has to be some evidence of a reduction in consumption.”

Ritterbusch cited several other factors that could contribute to a reduction in crude pricing including a determination by OPEC to crank up production to capacity level so they can get ahead of the demand curve.

While it is difficult to gauge exactly the impact that hedge funds and speculators have played in driving up oil prices, Ritterbusch also adds, “You’ve got to remove some of the causes for this huge capital infusion in the oil market and one thing that could help is a stronger dollar.”

As to when all these factors will come into play to trigger a significant drop in crude prices is still up in the air, but at least some analysts suggest it could happen sooner rather than later.

“It is cyclical and I think the back of this market will be broken in early summer or late spring,” Brockwell says. “Inventories are plentiful, but the market is still operating on this notion that worldwide capacity only exceeds demand by a million barrels a day. And that extra capacity has been

sopped up by very strong Chinese demand.”

Brockwell continues, “But at some point Chinese demand is going to flatten out as well and there is going to be a growing supply and receding demand, because these prices will have an effect on demand. I’m surprised they haven’t already.”

**Sharing The Pain**

For the aviation industry in particular, demand for air travel hasn’t waned despite the skyrocketing costs of jet fuel that have prompted price increases and fuel surcharges among many global airlines. Airlines in Europe and Asia were generally successful in passing on at least some of their additional fuel costs to travelers last year, while US airlines were less successful until very recently. Yields have been hurt around the world however, with high fuel prices combining with low fares due to intense competition. With no guarantee that fuel prices will drop or even hold steady, the global airline industry could be in for another grim year.

**American Airlines**, for instance, says its costs for jet fuel could be up as much as \$1.4 billion in 2005 to more than \$5 billion. Parent company chief executive **Gerard Arpey** told a recent analyst conference those numbers were based on a average price of \$1.65 per gallon, adding American spent \$3.97 billion on fuel in 2004, up \$1.1 billion from 2003.

**Delta Air Lines** is also seeing fuel costs impacting what had been some very positive steps away from a potential bankruptcy. Analysts now estimate the carrier’s 2005 fuel costs will be up \$1 billion, nearly completely offsetting the \$1.1 billion in annual wage and benefit concessions the carrier extracted from both management and unionized employees.

Despite improved traffic and cost cutting, **Continental Airlines** also reported losses in 2004, most of

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**Among US budget carriers Southwest Airlines continues to be the best positioned against the current high oil prices.**

which could be tied to higher expenses. For the full year, the carrier reported a net loss of \$363 million on revenues of nearly \$10 billion. Continental said its fuel costs for the year rose by \$268 million or 20%, to \$1.587 billion, despite only a 4.1% rise in the number of gallons consumed.

For the full year 2004, UAL, parent company of **United Airlines**, reported a net loss of \$1.6 billion, or a loss per basic share of \$14.57, compared to a net loss of \$2.8 billion in 2003. Excluding special items, UAL reported a net loss of \$1.2 billion, despite a 9.8% rise in full year revenues to \$16.4 billion.

United noted fuel costs for the full year were up 42% to \$2.94 billion. For the fuel year, United paid an average of \$1.25 cents per gallon of jet fuel, up 33% over the 94.1 cents per gallon it paid in 2003. **Glenn Tilton**, UAL chairman, president and chief executive, said despite good progress with cost reductions with more planned going forward, "Record fuel prices and pressure on revenue led to unacceptable results."

**Northwest Airlines** recently announced it was boosting its annual cost-saving target from \$950 million to \$1.1 billion, amid criticisms from its unionized employees that they're being asked to bear the burden for the carrier's failure to implement an effective fuel hedging strategy. "NWA Flight Attendants are tired of paying for management's mistakes," **Karen Schultz**, PFAA's national contract coordinator, said this past week.

For the full 2004 year Northwest reported a loss of \$878 million despite an 11.9% revenue rise to \$11.28 billion. Northwest noted fuel costs for 2004 were up 41.8% to \$2.2 billion, and added it had about 25% of its first quarter 2005 fuel hedged, and is about 6% hedged for the remainder of 2005, Northwest was blunt in its assessment of the high oil pricing, noting each 1 cent rise in the cost of a gallon of jet fuel adds about \$1.6 million to its monthly expenses.

Among US budget carriers **Southwest Airlines** continues to be the best positioned against the current high oil prices. Southwest currently

has about 85% of its estimated fuel for 2005 hedged at a cap of \$26 dollars a barrel. But even with those hedges in play the Southwest still said it expects its Q1 fuel costs to run higher than the 89.1 cents per gallon it paid during the last three months of 2004. America West said it is about 45% hedged in 2005 and about 2% hedged for 2006, while JetBlue indicated it is about 22% hedged for the current year

Unlike in the US, where only recently have carriers been able to get fuel-related fare hikes to stick, European and Asian airlines have successfully been imposing and then raising fuel surcharges on tickets for well over a year, although most carriers in the region stress those fare boosts don't come close to covering their higher oil costs.

**British Airways** recently raised its surcharge on long-haul flights to \$30 each way and on short-haul flights to \$11.25, saying oil prices made the move "unavoidable". The carrier noted the fuel surcharge would bring in an additional \$300 million annually, but added that still only a fraction of the \$563 million to extra fuel related expenses it expects to incur this year.

While it won't report annual results for several months, **Air France KLM** noted its operating income was off dramatically in the quarter ending last December, despite a rise in traffic. Air France KLM said operating expenses during the quarter grew 8.6% to \$6.24 billion, due primarily to a 58% in its fuel costs to \$1 billion for the three months, despite some offsetting hedge-related savings.

Even **Lufthansa**, which had about 90% of its fuel needs hedged in 2004, saw fuel costs for the fiscal year's first nine months rise 30% to \$1.7 billion. But the German carrier has been able to not only boost fares by 3% but also triple its fuel surcharge over the past year, helping to boost Lufthansa's full year revenue projections by 6% to \$2.2 billion.

In Asia, major carriers generally performed well in 2004 due to a surge in passenger traffic and a

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**The general consensus both within the aviation industry and among analysts is that at least one – and possibly more – major US airline is facing extinction.**

better pricing environment. But low-cost carriers are gaining strength there as well and that, coupled with the high fuel costs, make for challenging times.

**Cathay Pacific**, for example, reported an earnings rise of 4.3% in the second half of 2004, but remained cautious about 2005, not least because of its weak hedge positions. The carrier hedged about 30% of its fuel costs last year, but has only 15% of its fuel needs hedged for the first half of 2005 and only 4% for the second half. Cathay spent HKD\$7.84 billion on fuel last year, against HKD\$5.24 billion in 2003.

**Virgin Blue Holdings Ltd.** said earlier this month that record jet fuel prices may wipe out two-thirds of its profit for the next fiscal year. The carrier predicted that a higher fuel bill will strip about \$70 million from after-tax earnings in the year starting April 1. Virgin Blue hasn't hedged fuel purchases for the year.

**Facilitating A Shakeout?**

Chapman suggests most carriers may be well positioned for when fuel prices do come down. "The airlines are estimated they could make a nice profit with crude oil in the mid-\$30s range, and they felt it would be necessary to have oil in the low \$40s to break even." Barring that scenario, however, a shakeout of airlines may be inevitable.

There is some argument though it tends to be in the minority, that high fuel prices may ultimately be good for the aviation industry, again especially in the US, in that it may finally force carriers to deal with the issue of overcapacity and its impact on fares. At a recent Goldman Sachs transportation conference in New York, **AirTran Airways** Chief Financial Officer **Stan Gadek** went as far as to say, "I love high fuel prices. Fuel is the going to be the single greatest catalyst in accelerating the restructuring of this industry. The only way to shed fuel cost is to shed capacity."

And the general consensus both within the aviation industry and among analysts is that at least one –

and possibly more – major US airline is facing extinction. The possibilities run the gamut, from bankrupt US Airways or United to one of those teetering on the brink, such as Delta. Smaller airlines are also increasingly vulnerable, with carriers like Independence Air facing severe distress.

"The competition is so severe among US airlines, that there could be the possible fallout of several players," Chapman says. More immediately, the industry is seeing a slow scaling back in demand for jet fuel due to cutbacks on routes and schedules. In the US in particular, several major carriers have scaled back their domestic service, instead concentrating on higher-yield international business. But overall, routes that can't produce a return in the high fuel price environment are more likely to be cut. "Slower demand growth (for fuel) should ease the supply-demand imbalance in 2005," notes Chapman. "Although jet fuel prices are likely to remain high in absolute terms and relative to crude oil, marketing margins may come under pressure."

One thing appears to be certain: the current fuel prices aren't sustainable in the US market unless capacity shrinks and consumers can be persuaded to pay more for travel. Until then, most carriers will continue to siphon money, cutbacks will become more severe and bankruptcies more commonplace, waiting for what many believe to be an inevitable shakeout. **JFR**

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**Arizona Refinery Project Overcomes Hurdle By Getting Air Quality Permit**  
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negotiations with Mexican officials that will allow for a pipeline to be built across Mexico to bring in crude oil. Specifically ACFY is negotiation with state oil monopoly **Pemex** to bring heavy sour crude oil up through Mexico and into Yuma on a pipeline owned and financed either by Pemex or **WesPac Pipelines**. A \$500 million pipeline and terminal investment will be required, McGinnis says.

“The negotiations and discussions have been ongoing for three years now, so its taken a long time,” says McGinnis. “There have been changes on the political side in Mexico, the way they look at a project like this, and there have been changes in the perception of the supply of crude oil. One of the concerns in Mexico is whether or not the country had the ability to commit to a long-term supply agreement with us that would provide for 140,000 barrels of crude oil for 20 years. Their reserves were in decline, frankly because of a lack of investment on their part in development of their resources. They seem to have turned that around with some policy changes....”

**Becoming A Reality**

With the EPA’s approval of an air permit for the proposed refinery, the project has begun to look like something that will eventually come to fruition. “This is by no means a done deal, but certainly it has passed a major hurdle,” says **John Chapman**, principal, **Chapman Aviation Fuels Consulting**.

That means a lot for a project that has been on the drawing board for well over a dozen years and has gone through myriad versions. The original plan included a refinery site near Phoenix but because of an expansion of a non-attainment zone in Miracopa County to include the proposed site, a new location was found in the desert near Yuma. The original air quality plan was submitted to ADEQ in 1999. “In their defense there was a change of location of the facility,” says McGinnis, who says the company decided to move the location because the non-attainment zone “would make

it somewhat difficult to make any modifications or changes. The actual draft permit was ready to be issued in the summer of 2003 and the company decided to move the location. That led to about a 12-month delay in the permit issue.”

The current proposed location is near Tacna, Arizona, about 40 miles east of Yuma. The plan is to build a state-of-the-art refinery on a 3,000 acre site, with capacity to produce about 150,000 barrels per day of motor fuels, including approximately 85,000 barrels per day of motor gasoline, 35,000 barrels per day of diesel fuel and 30,000 barrels per day of jet fuel. Assuming the necessary permits and approvals are gained, ACFY plans to break ground in late 2006 and be completed at the end of 2009, with operations starting in late 2009 or early 2010.

**Financing Needs**

Along with the additional permits, ACFY will have to line up financing to take the plan from paper to the ground. “It’s a group of private individuals that have developed the project to date,” says McGinnis. “Once we have our air permit and a letter of intent on the pipeline access, then we will be looking for equity investors from either the refining marketing business in the US or investment funds. The ultimate cost of the facility is about \$2.5 billion so we’re looking for significant equity partners who own and operate refining and oil facilities.”

**Platts Oilgram News** quoted McGinnis as saying the plan would require about \$70 million in new equity funding this year and another \$2.6 billion by late 2006. But the payback could be significant, he added, according to Platts, predicting cash earnings of almost \$400 million a year.

ACFY is billing the proposed refinery as the most technologically advanced in the history of the United States. When completed, the refinery will produce the cleanest burning

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**“Once we have our air permit and a letter of intent on the pipeline access, then we will be looking for equity investors from either the refining marketing business in the US or investment funds.”**





# World Jet Fuel Prices

## Spot Cargoes

**Trend** 

Rotterdam			Mediterranean			Middle East			New York			US Gulf Coast		
4/1	3/25	3/18	4/1	3/25	3/18	4/1	3/25	3/18	4/1	3/25	3/18	4/1	3/25	3/18
558.2	558.2	545.0	549.1	548.7	538.6	67.03	67.11	64.56	161.9	162.3	159.6	156.9	160.4	157.4
Chicago			Los Angeles			Pacific NW			CIF Japan			Singapore		
4/1	3/25	3/18	4/1	3/25	3/18	4/1	3/25	3/18	4/1	3/25	3/18	4/1	3/25	3/18
159.3	159.0	156.8	177.5	174.7	171.1	178.0	175.2	171.9	69.77	70.02	68.41	67.91	68.88	66.27

## Futures/Differentials

**Trend** 

IPE Gasoil*			NY Heating Oil			WTI Crude			Brent Crude			Rott Jet/IPE Gasoil		
4/1	3/25	3/18	4/1	3/25	3/18	4/1	3/25	3/18	4/1	3/25	3/18	4/1	3/25	3/18
514.5	522.1	491.2	166.5	155.2	162.1	55.40	53.81	56.40	54.29	52.17	51.85	43.70	36.10	20.50
NY Jet/Heating Oil			Gulf Jet/NY 2 Oil			Gulf/Los Angeles Jet								
4/1	3/25	3/18	4/1	3/25	3/18	4/1	3/25	3/18						
6.00	7.50	5.30	4.31	5.44	2.85	-20.60	-14.00	-13.68						

Key: U.S. weekly averages cents per gallon, WTI Crude, Asian jet in \$/barrel, Europe, Medd \$/Ton

Sources: Opus Jetfax, JFR

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Swissport also is entering the Italian passenger handling business. The new operations in Rome and Milan are scheduled to begin May 1. Swissport already conducts cargo handling operations in Florence, **Milan-Malpensa** and in **Milan-Segrate**. The new **Swissport Italy** subsidiary will be adding passengers handling to its Italian services portfolio. Under current plans, the new activities will initially extend to station management, supervision and

airport ticketing services (ATO) at **Rome's Fiumicino** and Milan's Malpensa airports.

### Servisair/GlobeGround Wins Amsterdam Contracts

**Amsterdam...** Servisair/GlobeGround has won contracts with three new customers for ground handling services at Amsterdam Airport Schiphol. **Phuket Air** will operate two flights a week between Bangkok and Amsterdam, expanding to three a week at the end of April. A new Turkish low-

cost carrier, **Corendon Airlines**, will operate four weekly flights between Istanbul and Amsterdam beginning in April, and another route is planned for the carrier between Antalya and Amsterdam. Finally, Air Berlin awarded Servisair/GlobeGround Amsterdam with a handling contract for their flights between Berlin and Amsterdam. Initially, Air Berlin will start with six flights per week, with expansion planned to include a second daily flight. **JFR**

