

## NOTICE

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**Hedge Accounting: Benchmark crude oil contracts used in jet fuel hedges**

**Background:**

Airlines commonly use crude oil contracts to hedge their future jet fuel purchases as the market for these contracts is more cost effective than jet fuel contracts where supply is far more limited. Crude oil contracts are traded for a number of benchmarks, most notably Brent, West Texas Intermediate (WTI) and Dubai. The benchmarks trade at different prices with a premium paid for lighter crude oil as it is more easily refined into products including jet fuel.

Unlike IAS 39, IFRS 9 allows an airline at the time of hedge designation to choose whether to separate and designate only a particular risk component of a non-financial hedged item.

Jet fuel can be produced from different types of crude oil and therefore the relevant crude oil risk component is generally based on the physical crude oil actually used in the hedged item to avoid ineffectiveness. However in certain circumstances, the contractual price of jet fuel is based on a specific crude oil benchmark regardless of the physical crude oil input.

**Issue:**

This paper addresses whether a hedge using a single crude oil benchmark contract as the hedging instrument have no ineffectiveness if designated against the purchase of jet fuel when some of the jet fuel designated as the hedged item is not refined from that benchmark crude oil.

**Analysis of Issues**

IFRS 9 will allow for components of non-financial items to be hedged if the component is separately identifiable and reliably measurable. IAS 39 prohibited a components approach for non-financial items. As a result, if a crude oil contract was used to hedge jet fuel purchases, the hedge needed to be designated as a hedge of jet fuel and any ineffectiveness taken to income. Under IFRS 9, the hedge may be designated against the crude oil component resulting in the underlying hedged item and the hedging instrument both being crude oil.

The question then becomes whether this would result in no ineffectiveness in the hedge.

IFRS 9 application guidance indicates that different crude oil benchmarks (for example, Brent and West Texas Intermediate (WTI) crude oil) may be relevant for different geographical areas, and if an entity uses derivatives based on a benchmark that is not the relevant benchmark for hedging its risk then ineffectiveness may arise.

The IASB addressed this issue in IFRS 9, BC6.188. The IASB noted that the hedge accounting requirements would apply to the risk component in the same way as they apply to other hedged items that are not risk components. Consequently, even when a risk component was designated as the hedged item, hedge ineffectiveness could still arise and would have to be measured and recognised.

A relevant example was provided in IFRS 9, BC6.188(d).

An entity is exposed to price risk from forecast purchases of jet fuel. The entity's jet fuel purchases are in North America and Europe. The entity determines that the relevant crude

oil benchmark for jet fuel purchases at its North American locations is West Texas Intermediate (WTI) whereas it is Brent for jet fuel purchases at its European locations. Hence, the entity designates as the hedged item a WTI crude oil component for its jet fuel purchases in North America and a Brent crude oil component for its jet fuel purchases in Europe. Historically, WTI and Brent have been closely correlated and the entity's purchase volume in North America significantly exceeds its European purchase volume. Hence, the entity uses one type of hedge contract—indexed to WTI—for all its crude oil components. Changes in the price differential between WTI and Brent cause hedge ineffectiveness related to the forecast purchases of jet fuel in Europe. There is no market structure that would support identifying WTI as a component of Brent. In particular, the terms and conditions of the WTI futures cannot simply be imputed by projecting terms and conditions of those derivatives onto the forecast jet fuel purchases in Europe.

In IFRS 9, BC6.189, the IASB concluded that the designation of a risk component as a hedged item did not mean that no hedge ineffectiveness arises or that it would not be recognised.

The considerations for determining the appropriate crude oil benchmark in a geographical location as provided for in the IATA Airline Disclosure Guide - Hedge Accounting under IFRS 9, are set out below. Typically steps 1 and 2 are not conclusive and therefore step 3 may be conclusive:

1. If available, use the crude oil benchmark explicit in the jet fuel purchase contract.
2. If the purchase contract is not explicit, but the jet fuel in a given geography is produced exclusively from one crude oil product, then use this as the crude oil benchmark.
3. If steps 1 and 2 are not conclusive, then perform an economic analysis to determine the crude oil benchmark that most directly affects the price of jet fuel products purchased in each representative geography.

It has been observed that crude oil is exported around the world and even jet fuel itself is exported, making it sometimes difficult to establish the actual benchmark crude that was refined into the jet fuel purchased. Therefore determining the relevant benchmark crude oil may be challenging.

It should also be noted that if an airline hedges a percentage of their jet fuel purchases equal to or less than the amount refined from a benchmark crude oil they would be able to designate those hedges against the relevant benchmark to avoid hedge ineffectiveness.

If an airline uses a single benchmark crude oil contract, but identifies multiple benchmark crude oils as relevant for the jet fuel they purchase, the hedge would be effective, but not perfect. An airline would then need to measure the hedge ineffectiveness. For example, if Brent contracts were used to cash flow hedge purchases of jet fuel refined in various locations from Brent, WTI and Dubai crude oil, the hypothetical perfect derivative used to measure hedge effectiveness would be the relevant benchmark contract against the Brent contract used with the variance taken to income as hedge ineffectiveness. As result, the Brent contract would be a perfect hedge, but the jet fuel purchases where WTI and Dubai are the relevant crude oil, there would be ineffectiveness.

### **IAWG View**

**A hedge using a single crude oil benchmark contract as the hedging instrument may have ineffectiveness in relation to the purchases of jet fuel designated as the hedged item in the hedge that is identified as not being priced based on the benchmark crude oil of the contract.**