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Hedge your bets

As Michael Corley of Mercatus Energy Advisors explains, the collapse of OW Bunker taught the industry a hard lesson in the use of hedging strategies

'There are significant differences in the various hedging instruments available to hedge bunker fuel prices, differences that are often overlooked by many companies'

As bunker fuel prices have declined from approximately \$600 per metric tonne (mt) in mid-2014 to less than \$300/mt in recent weeks, and with the collapse of OW Bunker at least partially due to what has been called a \$150 million risk management loss, we must ask whether the bunker industry has changed, from a hedging and risk management perspective.

For starters, what has caused the significant decline in global crude oil and refined product prices? In short, the price decline is simply the result of supply and demand. More specifically, market participants have simply responded to an environment in which global supplies, thanks to strong production from both the Organization for the Petroleum Exporting countries (OPEC) and non-OPEC producers (particularly independent producers in the United States and Canada), are more than sufficient to meet a demand which is flat or worse.

While a significant change in prices, either up or down, should not, in or of itself, change the industry's price risk management perspective, such a significant change often creates emotional uncertainty leading many to question what have historically been considered sound business decisions. The price spike and subsequent collapse in 2008-2009, forced many in the industry to question their hedging practices and, in many cases, to update hedging policies, procedures and strategies to ensure that they were well positioned for another significant change in prices. Unfortunately, memories of such situations are often too

soon forgotten and, as a result, many companies are now experiencing the same uncertainty due to the recent price collapse.

Adding fuel to the fire is the collapse of the former industry darling, OW Bunker. While it appears that it will likely be many months or years before it is all sorted out, all indications are that OW Bunker's demise was the result of two risk management lapses. The first allegedly involved a 'risk management' position which, due to actually being more of a speculative trade than a risk management position, resulted in the afore-mentioned loss of \$150 million. In parallel, OW Bunker's Singapore subsidiary, Dynamic Oil Trading, is alleged to have experienced a loss of \$125 million due to fraudulent activity and/or lax enforcement of the company's credit risk management policies. While it is unfortunate that it has taken events of this scale to bring bunker credit risk management back to the forefront, our conversations with numerous market participants in recent months indicate that many are taking a much harder look at their credit risk management strategies, especially aggressive enforcement of credit limits.

As if the drastic decline in prices and the collapse of OW Bunker weren't enough, over the course of the past couple of years many market makers in bunker swaps and options, particularly large financial institutions, have scaled back or exited the market, creating lower liquidity in the financial products which are meant to provide the industry with the ability to hedge its exposure to volatile bunker prices.

In addition, much of the swaps and options trading has shifted from the bilateral market, in which market makers provide their counterparties with credit facilities which could be utilised for hedging, to cleared markets which require would-be hedgers to post cash collateral (margin) before they execute a trade. While the shift to cleared markets is certainly seen as a positive from a credit risk management perspective, for many cash strapped participants in the bunker market, it means having to allocate cash to hedging, a rude awakening for many.

So, how can industry participants adapt to the current environment as it relates to hedging? The key to developing, implementing and managing a successful bunker-hedging program is to utilise strategies which perform well in high, moderate and low-price environments, from both a price risk management and cash management perspective. This typically means making use of a combination of instruments, including swaps, call options and collars, among others.

In our firm's daily discussions with companies across the globe, there are several key aspects of bunker fuel hedging that we tend to emphasise because they are often overlooked or misunderstood by many in the industry.

First, the structure of a hedge is crucial. There are significant differences in the various hedging instruments available to hedge bunker fuel prices, differences that are often overlooked by many companies.

Second, exotic hedging structures, the industry term for complex hedging strategies, often involve the sale of options, either direct or indirect, which can lead to a disaster if the structures are not completely understood at inception as the positions evolve in an ever-changing market.

Third, companies involved in bunker hedging must 'stress test' their hedge portfolio on a regular basis to ensure that the performance of their individual hedge positions, as well as their entire hedge portfolio, are well understood in all potential price environments. These tests should not only address price (market) risk, but basis, credit and operational risk as well.

When a company makes the decision to develop a bunker fuel hedging program, one of the main challenges it faces is identifying the potential hedging strategies that will allow the company to meet its business objectives, regardless of the market environment. The first step in developing a sound bunker fuel hedging program should be to determine the company's risk tolerance as well as its hedging goals and objectives. More specifically, what is the company seeking to accomplish by implementing a hedging program? Is it to reduce cash flow volatility? To ensure that bunker fuel expenses do not exceed budget? To hedge inventory costs? Or to potentially obtain an advantage over competitors who do not hedge their exposure to bunker fuel prices? Only after answering these questions, as well as many others, should companies begin to discuss what hedging strategies might be appropriate to meet their needs and objectives.

In addition, there are a number of common hedging mistakes that companies should seek to avoid at all costs. First, it is crucial to remember that hedging should not be intended as a potential source of revenue. A well-designed hedging program should provide cash flow certainty, budget certainty, and the ability to lock in profit margins and/or protection against potentially rising bunker fuel prices. If a company

initiates a hedging program with the primary goal of generating revenue, it is no longer hedging or managing bunker fuel price risk, it is speculating on bunker fuel prices.

Furthermore, the vast majority of hedging mistakes are the result of a poor or non-existent bunker fuel hedging policy or of failing to stick to the policy. Most hedging mistakes can be avoided if the company takes the time and effort to create a proper hedging policy and to develop and implement strategies that will allow it to meet its hedging goals and objectives. Equally important is having the discipline to stick to the policy, despite changing market conditions. As we understand it, had OW Bunker operated according to its risk management policy, it would have not have incurred a large portion of the \$150 million risk management loss.

The maritime industry, especially its bunker sub-set, has always been quite volatile and subject to cyclical and structural changes, and the future is likely to present the industry with even more challenges. While many of these challenges are unknown at this time, we can be almost certain that bunker fuel prices will remain volatile for the foreseeable future.

In this light, market participants will be well served to develop and implement bunker fuel hedging programs, as well as accompanying policies, procedures and strategies which ensure that they not only mitigate their exposure to volatile bunker fuel prices but also the associated basis, credit and operational risks.

Clearly, the development, implementation and management of an effective bunker fuel hedging program requires a significant amount of time and expertise. Implementing a bunker fuel hedging strategy without the required expertise can quickly turn into a nightmare of epic proportions, as evidenced by the failed hedging initiatives of numerous companies over the years.

If your company does not have the in-house resources to properly carry out all required functions, it is highly recommended that you engage experts – either employees or consultants – who have the necessary expertise to assist you. Otherwise, you might very well likely find yourself in a situation similar to OW Bunker or its many creditors, counterparties and customers.

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