www.bunkerspot.com Volume 17 Number 4 August/September 2020

BUNKERSPOT

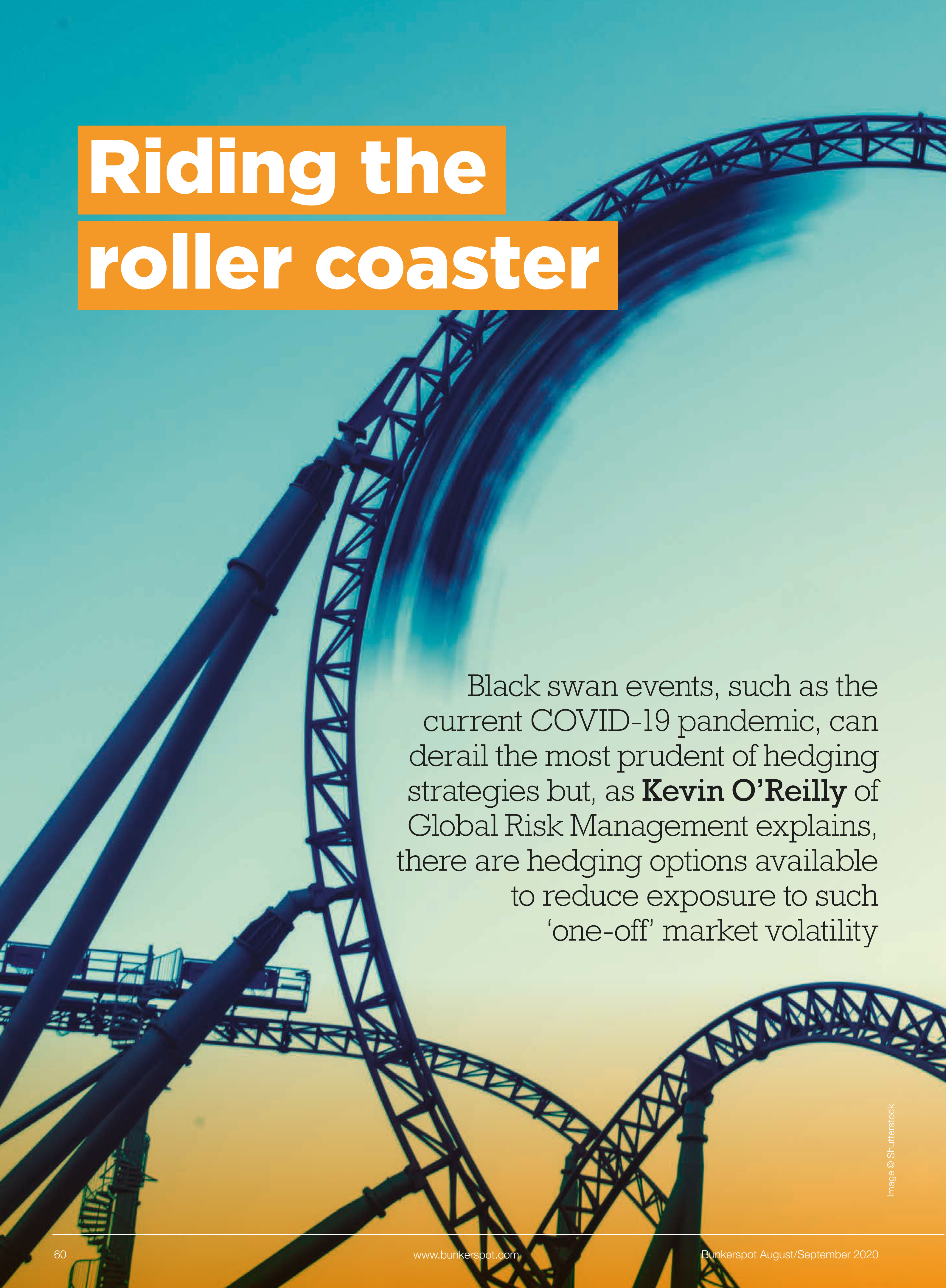
CLIMATE CHANGE

ADAPTING TO NEW INDUSTRY CHALLENGES

INSIDE:

FUEL MANAGEMENT
BUNKER CLAIMS
MARKET FOCUS: CANADA
ELECTROFUELS

Riding the roller coaster



Black swan events, such as the current COVID-19 pandemic, can derail the most prudent of hedging strategies but, as **Kevin O'Reilly** of Global Risk Management explains, there are hedging options available to reduce exposure to such 'one-off' market volatility

Image © Shutterstock

Modern commodity price hedging practices are largely acknowledged to have started in the mid-1800s with American farmers meeting at the newly formed Chicago Board of Trade, initially to deal in the cash markets for grains and then later agree with dealers and consumers to commit to buying fixed amounts of a specified grain at a specified price. These contracts became known as futures. Dealers or consumers thus knew what their grain costs would be, and farmers similarly could be assured of known future cashflows for a given crop. This certainty enabled all parties to better plan their economic decision making: consumers knowing their input costs for food products or feedlots and farmers making better planting decisions based on the costs of various crops.

In early 1981, the US government ceded control of the oil price to market participants, marking the beginning of the physical West Texas Intermediate (WTI) crude oil spot market. The ensuing volatility led to the creation of the WTI Futures market in 1983. This market became a key hedging product for oil producers, refiners and later the transportation sector. It also led to a slew of other listed futures (Brent, Gasoil, Heating Oil, Gasoline, etc.) and the eventual creation of the Over-the-Counter (OTC) commodity swaps and options markets. Furthermore, the OTC market led to a whole new industry in bespoke hedging solutions by banks and investment companies, like Global Risk Management, for any company that had fixed price exposures to commodity prices.

The cashflow certainty that commodity price risk hedging gives has led to the development and proliferation of whole commodity-based and dependent industries. The legendary oil and gas entrepreneur and former CEO of Chesapeake Energy, Aubrey McClendon, almost singlehandedly developed the US natural gas drilling business (and later shale gas production) by perennially hedging his natural gas production. By selling his company's future production into the contango curves that the natural gas futures market presented to all participants, he financed greater drilling programs and technological advancements that fed major parts of the American economy, helped create a cleaner environment from electricity generation and reversed America's dependence on LNG.

However, whilst hedging assures cashflows and helps fix commercial budgets through the array of commodity tools that companies like Global Risk Management offer clients, no one can fully hedge against truly exogenous shocks or so-called Black Swan events – events that cause huge and quick distortions in the production or consumption patterns of a particular commodity. Taken in this context a well-matched production or consumption profile can suddenly become unhedged and indeed a liability due to such an event and lead to financial distress, something that price hedging is supposed to guard against!

In the era of COVID-19, nearly all parts of the economy have been affected by the global approach countries have taken to fighting the pandemic: namely reducing all travel and telling citizens to only travel in emergencies. No industry has felt this more keenly than the global airlines industry and their fuel hedges that secured pricing for their anticipated consumption have suddenly become a huge financial burden – as the demand for physical fuels dropped sharply so did the prices for jet fuels. Their fixed price hedges no longer served the purposes they were designed for due to such an exogenous demand shock. Airlines further face a double whammy of a loss of operating income due to few flights and contracts that have locked them in to volumes and prices far greater than their actual needs.

Dennis Lysemose Andersen

'Deviations in physical consumption from planned financial hedging have always been a known potential challenge when consumers are employing risk management instruments, but no one had anticipated the sheer scale of the COVID-19 lockdown and its effect on airline travel. Financial contracts do allow for restructuring and offer some flexibility as new fuel consumption patterns surfaced,' says Dennis Lysemose Andersen, Head of Sales, Denmark, at Global Risk Management, reflecting on a challenging but ultimately rewarding start to the year.

Dennis and his team worked diligently with their clients as they restructured jet fuel hedges by rolling forward their obligations to when the jet fuel will be needed later on. Dennis goes on to say: 'These hedge amendments have helped reduce the short-term adverse effects for many clients. However, other companies have opted for compensation for hedge losses though government relief programmes.

'It is unclear to me at this time just how successful this approach will be. Being proactive and working with your hedge provider is the best way to work through these challenging times.'

This recent experience for most transport companies, coupled with uncertainty about their future operation and a potential second wave of COVID-19, has kept some companies hesitant to lock in a substantial amount of their revised predicted fuel consumption, even if the lower prices today are attractive and suitable to their budgets.

Many of our fuel consuming clients realise that they must protect their businesses from adverse fuel price fluctuations, so as supplements to traditional swap instruments, decision makers are increasingly exploring possibilities like call options, which grant the right but not the obligation to purchase fuel at a set price in the future. This form of hedging,

'Many of our fuel consuming clients realise that they must protect their businesses from adverse fuel price fluctuations, so as supplements to traditional swap instruments, decision makers are increasingly exploring possibilities like call options, which grant the right but not the obligation to purchase fuel at a set price in the future' along with other structures, will allow them to participate in lower prices should prices drop and not purchase at all if their demand is no longer there, thus reducing the financial accounting burden that a hedge program can sometimes create in such extreme times.

As we dig deeper into the different transport segments, we have seen that some commercial shipping segments, such as tankers and bulk carriers, are less affected by the economic impact of COVID-19 than the 'people-carriers' and as such lower oil prices have led commercial shipping to continue to use hedging for procurement (short term hedging of 1-2 stems which cannot be bought at fixed prices in the physical market). There is also a growing interest in longer-term contracts for freight and particularly waterborne trade that must continue but are largely free of human-to-human interactions.

'With the recent markets in turmoil we have also seen a growth in interest in fixed forward prices (FFPs). Bunker purchasers are buying more forward purchases in all tenors,' says Amy Barty, MD of Global Risk Management, Singapore.

Ferry lines are also gearing up for a rebound in demand, and thus consumption, now that countries are opening up and are starting to put hedges in place for 2021 and beyond. Cruise lines are still, of course, heavily affected by COVID-19 and Global Risk Management does not foresee material hedging programs to commence until later this year, and maybe not until into next year right before the 2021 summer season.


Amy Barty

Fuel hedging for inland consumption is continuing unaffected for agricultural companies who were very active at the market drop a few months ago. Moreover, many construction companies have remained active hedgers as they start infrastructure projects, often government initiated as stimulus. General power, oil and gas hedging for manufacturers and producers is also picking up: a welcome sign of economic activity returning.

Others in the energy business, such as fuel suppliers, inventory holders, cargo traders et al., have seen hedging opportunities that are more favourable still. Suppliers of major transport oil products benefit from the oil price contango which enables them to protect their inventory value by selling futures contracts higher than cash prices, and even locking in profitability as storage plus funding costs are less than the futures prices imply. So, whilst the physical flows can be subdued, hedging interest remains; despite this enormous disruption to the global economy and the ensuing demand shocks, hedgers of all stripes remain largely faithful to the principles first developed by those 19th century farmers in the American Midwest.

And the last word on risk management and how Global Risk Management is evolving to help more clients: 'Global Risk Management has over 15 years' experience in developing bespoke hedging solutions for our clients and many major participants in the global energy markets,' says Peder D. Moller, Managing Director and Chief Executive Officer of Global Risk Management.

'We have seen that commercial shipping such as tankers and bulk carriers are less affected by COVID-19 than the "people-carriers" and as such lower oil prices have led commercial shipping to continue to use hedging for procurement (short term hedging of 1-2 stems which cannot be bought at fixed prices in the physical market)'


Peder D. Moller

'Cruise lines are still, of course, heavily affected by Covid-19 and Global Risk Management does not foresee material hedging programs to commence until later this year, and maybe not until into next year right before the 2021 summer season'

'With a strong parent company (United Shipping & Trading Company A/S and Bunker Holding A/S) engaged in shipping, transport, bunkering and fuels delivery, Global Risk Management is uniquely placed to work closely with physical consumers to lock in prices and create effective hedging programs.

'As we expand our product suites to include power, natural gas, emissions certificates and renewable commodities, we look forward to broadening the scope of clients we hope to serve through our innovative combinations of deep markets knowledge and derivatives.'

Kevin O'Reilly,
CCO,
Global Risk Management

Web:
www.global-riskmanagement.com