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COMPETITIVE EDGE

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FOR THE FUTURE



INSIDE:

RISK MANAGEMENT

FUEL PROCUREMENT

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ECA COMPLIANCE

Compare and contrast

Continued low oil prices are taking a toll on many of those companies which hedged their bunker price risk at higher levels. Against this backdrop, Michael Corley of Mercatus Energy Advisors provides a clear and timely comparison of the main financial products for bunker fuel – OTC and exchange cleared contracts



In June 2014, Brent crude oil traded as high as \$115 per barrel, only to collapse and trade as low as \$45 a barrel in January this year. After rebounding in late winter and spring, Brent prices once again declined, this time to \$42 per a barrel in late August. Similarly, bunker fuel prices in many regions reached north of \$600 per metric tonne (p/mt) in June last year and have traded as low as \$200 p/mt in recent weeks.

Given the significant decline in prices, most in the bunker industry should be quite pleased that prices have declined as much as they have – correct? Unfortunately it's not that simple as many companies have hedged their bunker price risk at much higher levels and, as such, many are currently experiencing significant hedging losses.

While high fuel prices were a major factor that led to many companies' poor financial performance last year, low prices accompanied by hedging losses are creating similar problems for many companies this year. In what you might consider to be an odd case of irony, many of the companies currently experiencing fuel hedging losses are companies with strong balance sheets and credit ratings, factors which easily allow them to enter into large volume and/or long term hedging contracts. Make no mistake, many of these companies were well aware that they would experience hedging losses if oil prices were to decline significantly but concluded that *not* hedging was too much of a risk to take.

On the other hand, companies with weaker balance sheets and insufficient credit lines are often not easily able to hedge their fuel price exposure. As such, when bunker prices reached \$600 p/mt last year, the financial performance of most of these companies suffered as well. However, they have certainly benefitted from the subsequent lower prices as well. Both of these scenarios have also surfaced in other significant fuel consuming industries, such as commercial aviation and power generation.

While most in the industry are well aware of the basics of hedging, far fewer have a strong understanding of the cash management and credit risk aspects of bunker hedging. Given the significant volatility in crude oil and bunker fuel markets, the remainder of this article will explore various aspects of cash management and credit risk as it relates to bunker hedging.

In essence, there are two primary types of financial products for bunker fuel: bi-lateral

over-the-counter (OTC) and exchange cleared contracts. In the case of the former, a company wanting to engage in financial hedging generally needs to establish a credit line and execute an International Swaps & Derivatives Association (ISDA) contract, the industry standard contract for financial trading and hedging, with each and every counterparty with whom they want to be able to transact. Hedging with OTC products has long been, and remains, the default in the bunker industry, and for good reason – hedging with OTC products, via credit lines, requires significantly less cash than hedging with exchange cleared products.

That being said, hedging via exchange cleared contracts, rather than OTC contracts, is slowly beginning to increase due to new

collateral (known as margin), as well as standardised contracts (e.g. futures and options contracts) which are defined by the respective exchanges (i.e. ICE, CME Group, SGX, etc.).

To further compare the difference between the two types of products, consider the following example. Let's assume that you are a bunker trading company who, due to a commitment to a customer, needs to hedge 5,000 mt of Singapore 380 centiStoke (cSt) fuel oil for December at the current, forward market price of \$240 p/mt. If you were to execute a \$245 p/mt OTC swap with a counterparty with whom you have an adequate credit line (i.e. \$1,000,000), you would not need to post margin in order to execute the trade. Conversely, if you were to execute the exact same trade via an

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regulations (i.e. EMIR, Dodd Frank, etc.), which require many market participants (particularly banks and others deemed 'too large to fail') to trade via OTC cleared contracts, as well as an increasing desire by many companies to mitigate the credit risk associated with OTC contracts. As such, many counterparties are now requiring the companies with whom they engage in financial trading to do so via exchange cleared contracts.

If you are not familiar with exchange cleared contracts, the major differentiator between traditional, non-cleared OTC contracts and exchange cleared contracts is the facilitation of the credit and legal aspects of the products. As previously mentioned, traditional OTC products are facilitated via credit lines and ISDA agreements whereas exchange cleared products are facilitated via an account with a future commission merchant (FCM), which requires cash or 'cash like'

exchange cleared future, you would have to post and maintain margin with your FCM in the amount of approximately \$30,000 per lot or \$300,000 in total (1 lot = 1,000 MT).

Let's now examine how hedging with an OTC swap vs. exchange cleared future will impact your cash flow should the price change significantly between the day that you execute the trade and the final settlement on 31 December 2015. Let's assume that oil and fuel prices have declined significantly and on 31 October the current, forward market price for a December Singapore 380 swap is \$175 p/mt. As such, you have a current, mark-to-market (MtM) loss of \$70 p/mt or \$350,000. In the case of an OTC swap, you would still be well within your credit line of \$1,000,000 so you would not be required to post margin at this point in time. On the other hand, if you had executed this hedge via exchange cleared futures, based on the margin requirement

noted above of \$300,000, you would now have to post an additional \$350,000 to your FCM account in order to maintain the margin amount of \$300,000. In essence, the exchange and FCM are requiring you to demonstrate that you have the financial means to 'perform' should you be subject to the \$350,000 loss when the contract actually expires on 31 December or before if you were to liquidate the contract prior to expiration.

In a reverse situation, how would hedging your exposure via a traditional OTC swap vs. an exchange cleared future compare, if on 31 October, the then current, forward market price for a December Singapore 380 swap is \$300 p/mt? At \$300 p/mt you would have a current, MtM gain of \$55 p/mt or \$275,000.

In the case of the OTC swap, you would clearly be well within your credit line of \$1,000,000 and as such you would not be required to post margin. That being said, you now have a known credit exposure to your counterparty in the amount of \$275,000. As such, if your counterparty were to be declared insolvent, you would likely incur a loss of \$275,000 as you would still be required to supply your customer based on your initial hedge at \$245 p/mt. On the other hand, if you had executed this hedge via an exchange cleared future, based on the previously noted margin requirement of \$300,000, your FCM account would now contain \$275,000 of capital in excess of your margin requirement. As such, because your FCM, and in turn the respective exchange, is essentially your counterparty, you can be quite certain that your FCM will be able to provide you with your \$275,000 gain.

There are certainly exceptions to this argument (i.e. MF Global, formerly one of the largest FCMs in the world, declared bankruptcy in 2011) but due to space constraints, exploring this specific topic is beyond the scope of this article.

'While it appears that oil prices are rather stable at the moment, at some point in the not too distant future we are almost certain to experience significantly higher or lower oil prices. As such, all companies involved in bunker hedging should strongly consider the pros and cons of OTC vs. exchange cleared hedging'

Let's now consider the case of two companies which had entered into a December 2015 Singapore 380 swap when prices were trading in the \$600 p/mt range last June. Given the current market price of \$245 p/mt, the seller of the swap would have a MtM gain of \$355 p/mt, or \$1,775,000, while the buyer of the swap would have a MtM loss of \$355 p/mt, or \$1,775,000. While \$1,775,000 might not be a significant gain or loss to many companies, it could be large enough to sink a company without a strong balance sheet, a scenario which has certainly occurred many times in the oil markets. What if you had entered into a 5,000 mt swap at \$600 p/mt, which subsequently traded at \$245 p/mt, with Enron, Lehman Brothers or OW Bunker in the wake of their respective departures?

I think it's safe to say that you would have been quite concerned about collecting your \$1,775,000. On the other hand, had you entered into the exact same trade with one of said counterparties and subsequently submitted it to an exchange (i.e.

ICE, CME Group, SGX, etc.) for clearing, you could be quite confident that you would be able to collect your funds.

While it appears that oil prices are rather stable at the moment, at some point in the not too distant future we are almost certain to experience significantly higher or lower oil prices. As such, all companies involved in bunker hedging should strongly consider the pros and cons of OTC vs. exchange cleared hedging.

While there is certainly something to be said in favour of the cash management advantage of hedging via OTC contracts, there is equally something to be said regarding the credit risk management advantage of hedging via exchange cleared contracts as well.

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