

Feeling the burn



A RECENT ACT LONDON REGIONAL GROUP MEETING DISCUSSED THE KEY ISSUES FOR TREASURERS IN FUEL COST HEDGING. JULIET TEWUNGWA LISTENED IN.

The volatility of oil prices between 2007 and 2012 has made it increasingly important to hedge fuel costs, particularly in the airline industry. The primary aim of hedging in this instance is to try to offset exposure to price fluctuations with the goal of minimising exposure to unwanted risk. In other words, the aim is to smooth price changes rather than make a profit.

On average a major airline uses up to 40 million barrels of oil a year, equivalent to about half a day's worth of the total global output of oil. Given that fuel represents around 20% of an airline's total costs, airlines cannot afford to purchase their annual fuel requirement in one go – it would be virtually impossible to store it all in any case – so having a hedging programme is not only logical, but helps combat volatility. Unlike the haulage business, however, the airline sector is not subject to duty or tax on the purchase of fuel (as a result of international agreements such as the Convention on International Civil Aviation), so there is no need to discount this when forecasting.

The discussion at the ACT regional meeting focused on the two main hedging structures a treasurer can opt for: a fixed contract or a swap with a counterparty, usually a bank.

FIXED-PRICE HEDGING With a fixed contract the organisation pays a fixed price irrespective of the oil price at any given time. This creates certainty. On the flip side, if the price of oil dips below what the organisation has agreed to pay, it will not enjoy any benefit from lower fuel prices.

HEDGING WITH SWAPS Under the swap method the organisation signs a contract to purchase a given volume of oil for a fixed price on a set date; effectively, it is swapping the variable market price for a fixed price. This gives the organisation the assurance of knowing exactly how much it will be paying for its fuel ahead of time.

For example, if you decide to fix the price at, say, \$100 a barrel in six months' time, in six months you will pay your counterparty \$100 per barrel of oil you have bought while the counterparty will pay you the market price for that oil on that date in return. There are three possible outcomes for the treasurer here:

- "draw" – the market price for oil in six months' time turns out to be \$100, so the payments required by the counterparty and the organisation cancel each out;

- "win" – the market price is greater than \$100, so the counterparty pays the organisation more than it receives from the organisation;

- "lose" – the market price is lower than \$100, so the organisation pays the counterparty more than it receives back.

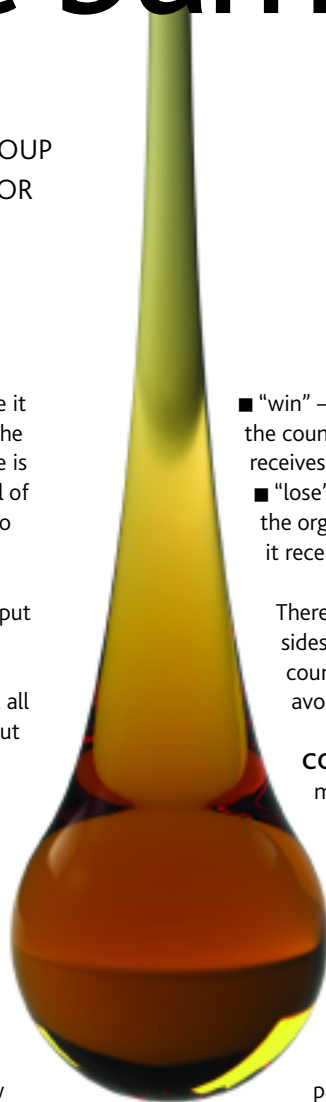
There is a possible fourth outcome too: both sides go bust, so all bets are off. Hopefully, your counterparty risk management process will avoid that outcome.

COLLARS There was some consensus at the meeting that the most desirable way to hedge fuel is to use collars – put and call options based on a set range of oil prices. In this case you put a "band" around what you are willing to pay (and what range of price is acceptable). If you fix the price at, say, \$60 a barrel, you would still pay that price even if the market price fell below that, although if it rises substantially you can pay more, up to an upper "stop loss" limit. However, the danger of doing nothing – i.e.

not hedging – is that you will pay whatever the oil price is at any given time and may be unable to recoup extra costs by passing them on in higher prices to customers.

CONTANGO, COMPETITION AND COLLAPSE In futures or options trading, longer-term contracts carry a higher price than near-term contracts. The premium accorded to longer maturities is a normal condition of the market and reflects the cost of carrying the commodity for future delivery. Typically, the further in the future the maturity date lies, the higher the price of the contract. That relationship is described as contango. If the opposite is true, and the price of a longer-term contract is lower than the price of one with a closer expiration date, the relationship is described as backwardation.

Some of the main risks in hedging include contango, competitive positioning, natural offset to an economic collapse, technological breakthroughs, credit constraints, hedge accounting and systems.



THE MOST DESIRABLE WAY TO HEDGE FUEL IS TO USE COLLARS – PUT AND CALL OPTIONS BASED ON A SET RANGE OF OIL PRICES. THIS PUTS A “BAND” AROUND WHAT YOU ARE WILLING TO PAY (AND WHAT RANGE OF PRICE IS ACCEPTABLE).

Contango (where the price of a forward or futures contract is trading above the expected spot price at contract maturity) is inherent in hedging. However, front-end macro problems are more important than contango, which is not really happening at present. Volatility in the market is currently being generated by geopolitical issues such as possible conflict with Iran.

In terms of competitive positioning, airlines will often look at their competitors' hedging programmes and do something similar as no-one wants to be too far out from the others. Before the financial crisis UK airlines in general hedged about 60–65% of their fuel costs, while French airlines hedged about 80%. When the financial crisis struck, French hedge books suffered massive losses and were hit harder than their UK and German counterparts. Since the crisis, a more structured hedging methodology is being used to avoid such losses. The lesson is never to hedge 100% because of potential economic crises and other unpredictable factors such as natural disasters (such as the volcanic ash cloud from Iceland in 2010). Look at what your competition is doing and follow their lead, and never go in too hard, could be good advice.

Airlines have to be careful how they allocate credit as well, especially in case a bank goes bust. The trend at present is that more people seem to be moving from banks as the counterparty to large oil companies and trading houses. Looking at the credit ratings of counterparties is advisable, as is having a conservative credit policy, so that at the first sign of risk, credit can be switched off. Keeping an eye on your trade book, variance and risk is also advisable, as is managing currency risk closely.

THE FUTURE? In 2010, the EU looked at aviation carbon emissions and is looking to include aviation in the European Trading Scheme in 2012. The aviation industry does not look on the scheme very favourably as it will make life more difficult. Carbon trading has also proved hugely volatile. In the last six months it has fluctuated between €15 and €6 a tonne; for a country like Germany, which uses more oil and coal than many other European countries, this means buying more credits.

The US and the BRIC countries (the four big emerging economies of Brazil, Russia, India and China) are also against the scheme. While it looks set to become compulsory this year, there are doubts about whether it will be extended in 2013 and beyond.

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Less risk, more return

KERRIN ROSENBERG PUTS THE CASE FOR GREATER AGILITY AND A BROADER RETURN-SEEKING TOOLKIT.

Pension funds have run too much risk in two areas: equities and interest rate exposure caused by underhedged liabilities. But if they reduce these risks, how will schemes earn the returns they desperately need?

Struggling for a better answer, many funds have resigned themselves to sitting tight and hoping for an improvement in the funding level, after which they plan to derisk. If, by some miracle, we return to the investing conditions of the 1980s and 90s, these dynamic derisking plans will come to good use. But on the more plausible assumption that we face many more years of anaemic growth interspersed with bouts of financial panic, we suggest a different approach.

Pension funds need to become more agile.

If we acknowledge that current financial conditions may not be that conducive for taking risk, why not derisk temporarily, with the intention of rerisking in the future? Perhaps long-term investors should think of their journey as taking place on well-lit motorways (where it makes sense to speed up) but also on dim country paths (where it would be foolish not to slow down). No one travels at the same speed regardless of the terrain, and it is no more sensible to keep risk at a constant level regardless of the economic outlook.

A more dynamic approach can add real value, but it is unlikely to be enough. Pension funds also need to broaden their toolkit of return-seeking ideas. There are many ways to take risk and equity investment is only one of them. By broadening the toolkit, schemes should have access to a range of investments that are appropriate for different investment conditions. A well-diversified portfolio will contain many different risks, each small in size and ideally sensitive to different underlying drivers of return.

There is no doubt that if the next five years look anything like the recent past, it will be extremely difficult for pension funds to improve their solvency. Dynamic derisking plans are a perfectly sensible way of dealing with good fortune. However, it is, unfortunately, very likely they will not be triggered. Investing in a more agile and better-diversified approach is a credible Plan B.



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