SPECIAL FEATURE

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Marriage of inconvenience

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The drop in oil prices in a deteriorating financial environment is not necessarily a panacea for the transport industry's economic concerns. Barry Parker reports

The relationship between energy prices and the fortunes of transport companies has never been an easy one. On the one hand, the price of fuel, which is a significant cost for transport providers, is declining. Conversely, falling energy prices are predicated on a looming recession and perceptions of weakened demand.

For shipping companies, that translates into less cargo to be carried. For airlines, a lengthy and deep recession could lead to a dramatic slippage in passenger numbers, possibly nullifying the salutary impact of a reduction in expenses.

Reactions to the slumping shipping markets - in one high-profile case, an actual bankruptcy - have been varied. One well-resourced drybulk entity, Genco Shipping & Trading, took the pre-emptive step of cancelling orders for six vessels without forward charter commitments, priced at USD530 million in the aggregate.

Poor prospects

The anticipated demand outlook throughout the sector has turned to gloom as energy and steel-making raw material movements are projected to decline next year, and possibly further into the future as well.

With the cancellations, Genco forfeits deposits of USD53 million on the three capesize and three handysize vessel newbuilding contracts acquired in June at the height of the market, with deliveries slated for 2009.

The deposits - a customary 10 per cent of the total price - had been funded under Genco's USD1.4 billion 10-year credit facility led by DnB NOR and priced at Libor plus 85bp for the first five years.

Genco, mindful of the potential for opportunities to acquire vessels on the cheap in the current financial environment, has used operating cashflows to repay the USD53 million.

Loss of the deposit makes good business sense.

Decision time

One back-of-the-envelope calculation by analysts at New York-based investment bank Dahlman Rose puts the current value of the six ships at some USD300 million. Expressed another way, the forfeited amount is dwarfed by the USD230 million drop in the value of these six ships.

Analysts at investment bank Jefferies & Co note that the cancellation would reduce Genco's projected debt-to-capitalisation ratio from 61 per cent to 54 per cent in 2009. The Jefferies team estimates that USD477 million of liquidity will be freed up through reduced capital expenditures.

Depending on the result of discussions with lenders, including DnB NOR, Genco may be able to fund future acquisitions by drawing on an additional USD320 million, five-year facility that had been executed in September to partially fund the purchase of the six ships.

Pricing on that facility is Libor plus 120bp to 125bp, depending on the net debt-to-EBITDA (earnings before interest, taxes, depreciation and amortisation) ratio.

In a widely reported case, the market's downturn, compounded by the poor timing of risk-management decisions, has led to a bankruptcy filing for an owner heavily involved in the Baltic coal markets and in worldwide charter operations.

Britannia Bulk had caught a very fleeting initial public offering (IPO) window in May, raising USD125 million that went some way towards paying off USD185 million of 11 per cent senior secured debt that had been issued in November 2006.

However, barely six months after the IPO, Britannia Bulk found itself staring into the face of an acceleration notice from lenders.

At the time of its offering, Britannia Bulk entered into a five-year credit facility of up to USD170 million at Libor plus 175bp with Lloyds TSB and Nordea's Danish office, which then claimed that a material adverse change had occurred.

When sliding charter rates impinged on cashflows, and suddenly slumping vessel prices caused loan-to-value covenants to be pierced, the shipping company's credit rating was cut first to CC and then to D by Standard & Poor's (S&P) after the bankruptcy filing at the end of October.

Rating downgrade

In explaining the rating downgrade, S&P said: "Discussions with its lenders under its USD170 million term loan facility failed." The company had initially attempted to negotiate with bankers on a programme of vessel sales so that the USD158 million outstanding under the term facility could be repaid.

For many analysts, the slide in shipping rates and vessel prices for vessels, which caused Britannia Bulk to be caught out of the money, is a proxy for a sudden deflationary turn in the entire commodity spectrum, including energy prices.

One index, the Reuters/Jefferies-CRB Index, fell by 24 per cent during October: its largest monthly decline since compilation began 50 years ago. Widely followed marker prices of crude oil have plunged from

USD147 per barrel to levels around USD65 per barrel.

For transportation providers with exposure to fuel prices this has translated into prices of intermediate fuel oil - fuel for marine diesel engines, often referred to as bunker fuel - falling from prices above USD600 per tonne in June to about USD250 per tonne in early November.

Strategic position

Individual companies have been affected differently, depending on their exposure to energy prices and particular risk-management strategies.

Genco and peer companies pass on fuel charges under timecharters.

Containership owners - including Danaos, Global Ship Lease and Seaspan - are similar to aircraft lessors.

As financial owners, they pass on fuel risk to charterers; usually under lengthy timecharters, but sometimes under bareboat charters. These box carriers, in turn, have followed a strategy of passing on fuel price increases to their customers through bunker adjustment factors (BAFs). (See sidebar on page 9.)

Liner carriers combine vessel in-charters with actual shipowning. The large liner carriers have now taken the draconian step of putting their owned vessels into lay-up: a cost-saving gambit not seen on a large scale since the 1980s.

The impact of actions by carriers - such as Neptune Orient Lines (NOL) and Yang Ming Marine Transport - are not much different from the airline fleets parked in the desert, with nearly all variable costs suspended.

Lay-ups represent a follow-on from the intermediate practice of slow steaming, which has been prevalent over the past year. Reduced speed lowers the consumption of fuel, which is a significant variable cost component (despite the portion recouped through BAFs). At a macro level, slower speeds soak up extra teu capacity since more vessels - each with less yearly deliverability - are required to move a set amount of cargo.

Thus a 'string' or 'loop' (a port rotation in a particular service) that previously required seven vessels to provide weekly service could now require eight ships.

Many listed drybulk companies restrict leasing activities to timecharters where fuel prices are the responsibility of customers.

Close study of Britannia Bulk announcements reveals that a portion of its out-charters, on 'voyage' terms, required the company to absorb fuel price risk.

In strong freight markets, negotiated bilateral rates agreed between owners and charterers will respond to movements in fuel prices; the shipowner can increase a charter rate to compensate for increased fuel prices.

The real risk for such companies comes under contracts of affreightment, where a fixed price is agreed on multiple liftings going forward in time - without provisions for fuel price escalation.

Management actions at Britannia Bulk during the third quarter of 2008 (3Q08), which are now being closely scrutinised by the company's board of directors, included a "fuel hedge which is currently uncompetitive because it is hedged to prices that are significantly above the current market price of bunker fuel".

Price risk

In the tanker shipping sector, the least battered in shipping space, fuel price exposure may be retained if the owners are chartering out in the volatile spot market, also under voyage terms.

Well-known players such as Overseas Shipholding Group (OSG) and General Maritime Corporation are indeed exposed to fuel price risk, with the greatest dangers being fixed-price contracts - US dollar per tonne contracts - including those tied to 'worldscale' rates denominated in US dollars.

Throughout 2008, the tanker trades have seen rates well above historical averages, providing a form of operating leverage that partially compensated owners for increases in bunker fuel prices.

The USD4.5 million increase in the voyage expense item in General Maritime's 2Q08 income statement to USD11.7 million - compared to the period a year earlier - is tied mainly to increases in fuel prices, with these expenses actually declining relative to the USD12.6 million logged in 1Q08.

Hedged in

Revealing the operating leverage in action, 2Q year-on-year revenues rose by USD18.2 million over the comparable 2007 period. Unlike Britannia Bulk, which put on a large fuel hedge as energy prices reached their zenith, General Maritime entered into a pair of spread trades in the fuel markets that were designed to take advantage of shifts in price differentials rather than absolute levels.

One such trade, entered into in January, saw a gain of USD155,000 as the result of a narrowed spread between Gulf Coast fuel oil and bunker fuel in Houston, where General Maritime vessels regularly call with inbound crude oil cargo.

OSG described its 3Q08 as "the best Q3 in company history". The company also benefited from operating leverage when its voyage charter revenues rose by USD33.7 million, versus the previous year's 3Q, at a time when its voyage expenses category rose by USD14.8 million.

OSG said this rise was "principally due to higher fuel expenses". OSG has created synthetic timecharters for very large crude carriers (VLCCs) trading

in pool arrangements and therefore subject to earnings volatility.

OSG's treasury department has used tanker freight swaps complemented by bunker fuel swap contracts to simulate out-charters of its vessels that are exposed to extreme volatility in their primary trades.

OSG's hedging proceeds are off-set against the freight revenue or fuel cost accounts - if they are highly correlated.

In 3Q, OSG's hedging activities actually gained USD8.6 million, even after netting out 'mark to market' losses. OSG's gains are real; actual results were better than predicted by a correlation analysis between the hedge and actual historical data.

K-Sea Transportation Partners had a different wrinkle on the market. The New York Stock Exchange-listed owner of United States flag barges in the transport trades, with an S&P rating of BB-, requested that the rating agency withdraw the rating, citing the perilous state of the debt markets.

Downwards exposure

The downswing in energy prices came to bite K-Sea in an unusual way. The company's version of fuel hedging - holding substantial stocks of fuel inventory - backfired.

The company explains: "The sharp decline in the price of oil in September resulted in our recording a loss on the carrying value of the diesel fuel used to power our tugboats."

Airline operating risk also includes fuel exposure. The case of US low-cost carrier Southwest Airlines illustrates the challenges facing airlines as energy prices have reversed course.

At Southwest, fuel cost represented 35.7 per cent of operating expenses in 3Q08, versus 28.2 per cent for the same period a year earlier. However, fuel prices are dropping rapidly.

Considering that the IATA's worldwide jet fuel price index, which is heavily weighted towards Europe and North America, has recorded precipitous drops, down to USD2.02 per gallon (USD673 per tonne) - less than half the levels recorded at the market's zenith in late June.

This figure is well below Southwest's average fuel price of USD3.61 per gallon for 3Q. For airlines that entered into various fuel hedging agreements when jet fuel prices were above current levels, falling prices for kerosene have led to 'paper' losses, mainly from marking outstanding positions to the now drastically lowered market prices.

Southwest, the darling of investors due to its nearly two-decade run of profits, showed an overall loss of USD120 million in 3Q, even though its operations were profitable.

At Southwest, the only investment-grade credit among US carriers, price risk management, a mainstay of the airline's low-cost strategy, worked well as fuel prices were rising. Southwest has earned a corporate rating of BBB+ (stable) from S&P, after a downgrade from the A- designation earlier in the year.

According to Southwest, the carrier's 3Q loss was "attributable to adjustments related to a decline in market value of the derivative contracts the company utilises in attempting to hedge against jet fuel price increases". In other words, the paper loss dragged down the overall accounting result.

Fuel expenses

The US majors were also snagged in a similar trap, with Delta Air Lines, Northwest Airlines and United Airlines all showing accounting losses after marking down high-priced hedges put on at prices above those of Southwest.

For Southwest, the hedges worked both operationally and financially at high fuel prices, and provided a competitive advantage enabling the airline's low-cost fare structure to remain intact. In the previous quarter, 2Q08, earnings included USD361 million of non-cash gains.

However, with the oil price downturn, the outstanding hedge positions have become an albatross. If they were closed out at the end of 3Q, when oil prices approached a nadir near USD60 per barrel, they would yield large losses.

The recent loss must be put into perspective. During the first nine months of 2008, gains on Southwest's hedges off-set more than USD1.15 billion in rising fuel expenses, including USD387 million in 3Q, when prices peaked and turned downwards.

Earlier this year, with oil's climb up towards USD147 per barrel still out in front, S&P commented in a review of larger US airline credits that most of the carriers (except Alaska Air and Southwest) "have a relatively low proportion of their 2008 fuel needs hedged, because hedging high and volatile fuel prices is expensive and may require posting cash collateral".

Southwest says its hedge instruments consist of a mix of "purchased call options, collar structures and fixed price swap agreements", in addition to investment in futures contracts.

Managed portfolio

The airline estimated in a regulatory filing that 75 per cent of anticipated jet fuel needs for 2009 are covered, at prices equivalent to a crude oil price of USD73 per barrel. For 2010, roughly 50 per cent is covered, at prices equating to USD90 per barrel.

For 2011 and beyond, the percentages dwindle, with prices ranging from USD90 per barrel to USD93 per barrel equivalents. At the end of September, the hedge portfolio extended out to 2013.

What has been different this time for Southwest and its peer airlines is the impact of mark to market accounting - the impact of hedging contracts (at the prices of USD73 per barrel through USD93 per barrel) that will settle in the future.

While vastly oversimplifying the highly complicated area of hedge and fair value accounting, hedges at these prices will show paper losses if the spot oil price, used to 'mark' positions to the market, is at about USD65 per barrel. There lies the paradox of falling energy prices.

A further wrinkle of hedging is the imprecise correlations between the hedging instrument and actual fuel purchase prices.

For transport companies, the hedge always involves some sort of proxy: neither bunker fuel nor jet fuel are traded on futures exchanges.

In 3Q08, when prices peaked, there was a mark to market loss of USD202 million and losses from hedge 'ineffectiveness' of USD36 million, where predicted correlations yielded results that were overstated compared to actuals; the opposite of the OSG experience, where the shipowner actually gained due to results that were better than predictions based on correlations.

By contrast, 3Q07 results - coming at a time when oil prices were rising - showed gains of USD44 million (on mark to market) and USD11 million respectively, on effectiveness tied to correlations.

Hedging brings about real cash effects as positions are settled and also has implications for the balance sheet. Importantly, at a time when its cash position was deteriorating in 3Q, Southwest noted that its hedging portfolio included "significant futures positions" in heating oil contracts on the NYMEX as a proxy for jet fuel.

On balance

Analysts and rating agencies, as they examine airline balance sheets and carry out cashflow projections, are very aware that futures positions slipping in value may be accompanied by margin calls. Additionally, depending on the counterparty, swap agreements may also require a balance to be maintained, through either actual cash collateral or sometimes by posting letters of credit.

In an investor call discussing the recently ended 3Q, Southwest announced that it would tap USD400 million on a previously undrawn USD600 million revolving line of credit with a group of banks that includes Barclays, Citi, JPMorgan Chase, Suntrust and UBS.

Its purpose is described as a bridge until 2009, when future financings will be put in place. With the BBB+ credit rating, Southwest can borrow at a margin of 50bp, versus a 40bp spread that would have been applicable at Southwest's old A rating.

Gary Kelly, chief executive officer of Southwest, explains the decision to draw-down on the facility: "You get cash when you can, not when you have to have it."

The subject of analysts' call questions was very telling. Laura Wright, chief financial officer of Southwest, fielding analysts' questions about collateral requirements under fuel hedges with various 'what if' oil price scenarios, indicated: "At a USD60 per barrel rate ... we would feel pretty comfortable that anything we would have to do is manageable with the cash that we have today and what we are doing in the market."

On the previous day, NYMEX crude was priced at USD74.50 per barrel.

On that day, Wright said: "When we look really where we might have to put up a meaningful amount of cash, we have probably got a good USD20 off from yesterday's closing price."

In a follow-up question, she was asked for a definition of "meaningful".

For Southwest, Wright explained this would mean "a few hundred million dollars".

Carriers rethink fuel surcharges

Fuel prices play an important role in the containerised liner trades. Regulatory shifts, market forces and price transparency have caused changes in the way carriers treat fuel surcharges. Liner conferences are heading towards extinction: a trend hastened in mid-October with the complete abolition of trades serving the EU.

Under EU competition rules, individual companies may implement bunker adjustment factors (BAFs), but cannot co-operate as was possible prior to the abolition of the conferences.

A new group of consultants has emerged out of the ashes of the old conference secretariats, which have been re-invented as 'discussion groups' - entities permitted under the new rules.

One such organisation, the Transpacific Stabilisation Agreement (TSA), is a research and discussion group that guides carriers on Asia/United States trade lanes, but does not set rates. The increasing availability of fuel price data for bunkers in major ports has enabled carriers to utilise templated calculations, fed by well-established fuel pricing benchmarks.

The new style of BAFs is in marked contrast to the conferences' arcane and complex methods of handling bunker surcharges.

A common complaint had been the tendency of the surcharges to quickly ratchet upwards and linger, even after fuel prices had turned down. Since obfuscation ruled the day, cargo interests enjoyed little success challenging the old surcharges, which were initiated in 1990 at the time of the oil price shocks preceding the first Gulf War. The TSA voluntary fuel guidance to carriers, which is readily available for all to see on the group's website, provides price guidance based on a 'look-back' at bunker prices two months prior in relevant Asian and US ports. Thus BAFs effective in December will reflect prices from October.

One large line that was always outside the old conference system is following a similar approach, albeit unilaterally. Maersk Line, a behemoth in the container trades, has introduced a floating BAF tied to individual base rates for certain trade lanes, with a fuel adjustment tacked on. Designed to maintain a revenue neutral base rate, the overall rate (base rate plus fuel) rises as marker fuel prices move upwards. Conversely, the overall rate will be lowered as barometer fuel prices turn downwards and Maersk's fuel bill is lowered.

In theory, a large cargo shipper, such as a 'big box' retailer in the US, could implement a hedging programme to manage movements in the BAFs. The TSA's source for prices is Platts, a reputable service whose prices are routinely used for valuing and settling a host of energy-related derivative transactions. Yet, as the airline experience shows, adroit hedging involves market-timing decisions and large costs if chief financial officers get it wrong in highly volatile markets.

Ironically, big cargo movers benefit from a form of reverse operating leverage: while sales are down due to slumping consumption patterns, so are energy costs.