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Business



Gideon Spanier

28.05.09

Hedging is a mug's game, the cynics say. Trying to hedge your bets on the direction of fuel prices, interest rates or currency movements can sometimes make the best brains look like fools. But if the volatility of the past two years has proven anything, it is that for most businesses prudent hedging is a lot smarter than doing nothing.

With so many companies loaded with debt, attention has focused on interest rates, which have caught out some firms spectacularly - pubs group Mitchells & Butlers lost £500 million when it hedged the wrong way as rates fell. M&B chief executive [Tim Clarke](#) paid the ultimate price by quitting last week.

But while interest rate hedging by corporates is commonplace - indeed a requirement when banks are lending large amounts of cash - currency hedging and, increasingly, energy hedging could be as important. Banks rarely make demands for firms to hedge such exposure despite being potentially a bigger liability than interest rates.

Experts such as risk management consultancy JC Rathbone warn some companies may have themselves dangerously exposed. The last two years when the oil price trebled to \$147, down 70%, and then jumped by half, have shown it is vital for firms to protect themselves against such gyrations.

The airline industry knows all about fuel, of course, as this has long been one of its biggest outgoings - well over 30% of expenditure in some years. [Howard Wheeldon](#), senior strategist at [BGC Partners](#), says energy hedging began in earnest 20 years ago around the time of the first Gulf War: "The rate at which it is now used, particularly by airlines that have shareholders, has grown out of all proportion in the last four years. Shareholders have wanted a reduction in risk and if an airline is properly hedged, they [shareholders] can see a better way forward for earnings. They tend to forget the implications for cashflow."

Typically, an airline might hedge or forward-buy 50%-70% of its jet-fuel kerosene needs. The impact on the balance sheet can be dramatic.

[British Airways'](#) results last week revealed a £988 million hit to its reserves on "marked-to-market movement on fuel and currency hedges" and changes in foreign debt.



Catching the vapours: kerosene jet-fuel prices gyrated wildly in last two years, causing a nightmare for airlines such as BA

BA's fuel bill shot up 44% to nearly £3 billion, as the airline swung to a £401 million loss in the year to March. The results suggest that, after declaring a £329 million profit from hedging against rising fuel costs between April and September 2008, it suffered as kerosene then fell by two-thirds from \$1400 per metric tonne in July. The fact that kerosene is traded in US dollars was another headache when sterling dived 30% after last summer.

Meanwhile, [Virgin Atlantic](#), which is privately held by [Sir Richard Branson](#) and Singapore Air indicated this week it kept its fuel bill to around £1 billion - saving as much as £400 million a year - with what it calls "prudent" hedging. Virgin posted a pre-tax profit of £68 million and credits its in-house fuel-buying team for buying as much as two years in advance from 200

Others, such as [Ryanair](#), have admitted they have suffered by not always buying ahead - or locking in prices at the wrong time, before they plunged. Luck plays a small part, of course experience and risk management are key.

Paul Newman, managing director of broker Icap Energy, says: "In any environment where the underlying commodity price or financial risk is high and volatile, and where operating margins are increasingly narrow, getting the hedging strategy right can be the difference between profit and loss."

In most cases companies are not looking to profit from hedging - witness the disastrous scenario when Mitchells & Butler tried that. Finance directors are just grateful if they minimise losses.

"It is about running your business on a managed basis, not a speculative basis," says Alastair Harris, director of energy at JC Rathbone.

Singapore Airlines illustrated the point this month with its quarterly results to 31 March, following the plunge in kerosene costs. "While lower fuel prices reduced expenditure on fuel by \$666 million, this was offset by losses in hedging of \$543 million," said the airline, which revealed \$112 million of losses came from "the early termination of several fuel hedging contracts".

[Barclays Capital](#), [Morgan Stanley](#) and [Goldman Sachs](#) are among the leading banks that deal in energy hedging. [Lehman](#) used to be another major player.

Any firm with large energy costs - not only those involved in transport but also manufacturing and production - has been actively managing its risk for years. What is changing is that more organisations recognise they must take action, particularly in the UK public sector, which is estimated to be an energy market worth £3.25 billion a year.

The Treasury is a big player through its buying arm, the Office of Government Commerce's Buying Solutions. Universities and colleges have also clubbed together under the banner of Energy Consortium, representing more than 200 educational establishments across the UK. Meanwhile, the Scottish Office has just put out to tender a deal to supply energy to a huge chunk of its public sector, encompassing health, the police and other services.

Group purchasing helps in the negotiation of prices. These deals tend to involve gas and electricity but, unlike oil, the market for hedging instruments such as futures, swaps and options is less liquid. Instead, as prices yo-yo sharply, many organisations have stopped buying on a traditional, annual fixed-price basis and switched to a system where they pay for a proportion advance and negotiate the rest later.

"When properly managed, it can save a huge amount of money," says Harris of JC Rathbone. "Some people have not necessarily instituted a risk policy and their costs have not been contained," adds Harris, who declines to name names.

Looking at the global energy market, experts note how prices are rising again as [China](#) emerges as a dominant new player. Britain is also now a net energy importer, which means we may face shortages unless we strengthen our nuclear capacity quickly.

The final point is that hedging cannot alter the fact that energy prices could move higher. Paul Newman of Icap Energy says, a hedging strategy is like a temporary rain coat — it can only provide some protection during the initial storm, as companies adjust their budgets. "It doesn't mean you can change the weather," says Newman. "In the end, even the best hedge will expire, and

then face the new conditions which everyone else is living with.”

It still makes good sense to carry that raincoat.

Robert Lea is away

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