

BUYERS

**AN INTRODUCTION TO
MANAGING COMMERCIAL
RISK**

Nigel Draffin

BUNKERS

An Introduction to Managing Commercial Risk

PETROSPOT

Dedication

This book is dedicated to those risk management specialists of Shell International Marine and Shell International Trading who introduced me to the concepts and the methods discussed here when I was first asked to develop strategies for our bunkering activities – especially to J. D. Lynn of the Shell International Marine planning department who bravely shared the platform with me when we had to explain and defend what we were doing to senior management in the late 1980s.

Nigel Draffin



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An Introduction to Managing Commercial Risk

by

Nigel Draffin

M.I.Mar.E.S.T.

First Edition

Foreword by

Robin Meech

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Foreword

In these increasingly uncertain times we are all assessing risks and, when possible, devising a means to minimise them – consciously or otherwise. Increasing access to information should permit better risk management but without systems and an appreciation of the level of exposure or damage that can result from poor management, the process of trying to alleviate risk can have a negative impact. Risk management is not gambling but must be an integral part of a company's business processes.

This book is published at a very opportune time with the future seemingly less predictable now than at any time in the past decades. After many years of accepting that energy prices would continue to increase in real terms, they have faltered. At the time of writing, the majority of industry commentators are predicting that they will stay relatively low for some time but, with the rapid slowdown in capital exploration, they may shoot up again in the not too distant future. In the meantime, prices will be set by the market supply/demand balance rather than a cartel. Hence controlling exposure to price volatility has become even more complex and the approaches and concepts set out in this book provide both the seasoned trader and the newcomer with valuable insights.

The publication of this book coincides with one of the longest periods of poor freight income for the shipping industry, with perhaps the exception of tanker owners. This situation will lead to more shipowners becoming hostage to the banks, an amalgamation of the less fortunate owners and an acceleration of failures. The bunker suppliers, who globally are lending some \$6 billion to the shipping industry on an unsecured basis, have an even greater need to assess their credit risks and manage them. At the same time, bunker buyers are under even greater pressure to minimise costs which can result in purchases at the lowest price but not always at the lowest cost. Cheap fuel is often poor fuel which can expose vessels to the inherent risk of engine damage and in extreme cases, the loss of a vessel. Again, accessing and balancing the risks against achieving lower costs requires knowledge and experience as well as techniques.

We live in uncertain times with heightened political risk. Instability in the Middle East resulting from the failed Arab Spring and reduced incomes in the oil-producing states coupled with instability in South America, uncertain leadership in the United States and the resurgence of nationalism in Russia and China are affecting markets, resulting in increased uncertainty in the volatility of exchange and interest rates. These variables require oversight to add confidence to the future outcome of any business venture.

It goes without saying that the sudden demise of OW Bunker prompted nearly all participants in the bunker sector to re-assess their decision making. Evaluating

your counterparty risks intently and managing them is now becoming the norm. It has brought the issue of risk management onto the desks of all of us. This book authored by Nigel Draffin will be a welcome and timely aid to many who have thought they could leave risks to others. Knowing how to identify risks and minimise them at a reasonable cost is now an essential management skill.

Robin Meech

Chairman – International Bunker Industry Association

Managing Director – Marine and Energy Consulting Limited

June 2016

Preface

Each May, my publisher asks me what I would like to write about next, sometimes offering helpful suggestions. After discouraging my offer of a book on the history of fuel injection systems or a guide to medium-speed two-stroke ferries still in service, he asked if I would consider a book on risk management.

I know from the feedback from the students on the Oxford Bunker Course that this is a topic on which they are eager for more information, so I agreed, subject to the caveat that it should cover more than just bunker price risk management.

This book will not make the reader an expert. It is an exploration of the problems, available tools and the methodology intended to help the reader to make informed choices. It is not a substitute for expert advice. The dynamic nature of our business means that many of the variables will change from week to week, let alone year to year, so you will not be able to look up the price premium for an option at a particular strike price or determine the most sensible credit limit for an owner with a fleet of six ships. It should, however, give you the tools to understand the principles and guide you to ask the right questions when taking advice.

I have attempted to keep the subject matter relatively simple, even when that has meant restricting the degree of detail for the sake of clarity, but I hope that the references and links to other sources will permit the reader to explore further as required.

My main message is that risk management is a core tool for all businesses and it is much wider than just price risk. The principles can be applied to many disciplines within our industry. It is quite acceptable to assess a risk and decide that no further action is needed at that time – it is folly not to assess the risk in the first place.

Nigel Draffin

June 2016

Acknowledgements

The author wishes to thank all those who have contributed help, comments, images and encouragement throughout the conception, gestation and production of this book.

Special thanks are due to Phil Owen who first tasked me with producing a risk management programme in 1987 and was my mentor throughout that process. Thanks are also due to Robin Meech, Chris Thorpe and Morten Grønbech Terp for their contribution to the ideas and guidance on the topics in this book.

I also thank the students on the *Oxford Bunker Course* and other training events for their questions, and their application to the subject matter during what is always one of the more challenging subjects of study.

I must also acknowledge the contribution made though general discussions and debate of papers on risk management at conferences from 1988 at *SIBCON* through to today. The first IBIA convention in 1993 featured two presentations on this issue, one from Phillippe Lautard of Elf (now TOTAL) and another from me, both of which produced a lot of discussion and encouraged the industry to look at this new tool as an important part of the business of bunkering.

The author also extends his thanks to Llewellyn Bankes-Hughes and his team at Petrosport for encouraging him into writing his eighth book on bunkering. Particular thanks are due to Lesley Bankes-Hughes and Cheryl Marshall for designing, producing and bringing the book to life.

Nigel Draffin

May 2016

About the author

Bunkers: An Introduction to Managing Commercial Risk is a clearly-written reference book that offers the reader far more than a simple explanation of price risk management and the hedging tools and methods available today. It also provides a wide-ranging examination of the many forms of commercial risk that affect bunker suppliers and traders, just as much as they affect ship operators and charterers, including credit, counterparty, political, currency, insurance and even business continuity risk.

Researched and written by Nigel Draffin, this highly-accessible book offers a useful checklist to those wishing to minimise commercial risk of any sort. In easy-to-follow terms, Nigel describes the workings of futures markets and the use of exchange-traded hedging tools, as well as over the counter swaps, options and other derivatives. He provides insight into some of the more complex risk management techniques and offers strategies to manage risk portfolios. The book also covers pricing, volatility and exposure, as well as tax rules, accounting and financial regulations.

This compact but highly practical book also provides a useful risk management glossary and comprehensive index, as well as a 'where to go for help' section designed to assist the reader.

Nigel has been involved in shipping for some 50 years and with the commercial bunker market for over 25 years. After joining Shell Tankers as an apprentice engineer in 1966, he rose through the ranks, serving on all classes of vessel, including VLCCs and LNG tankers. He came ashore in 1979 to join the newbuilding department of Shell International Marine. After two years of new construction in Ireland, South Korea and the Netherlands, he transferred to Shell's Research & Development unit, specialising in control systems, fuel combustion and safety systems.

In 1986, Nigel moved to the commercial department as a bunker buyer and economics analyst. In 1988, he was promoted to be Head of Operational Economics, responsible for all of the fuel purchased for the Shell fleet, the operation of the risk management policy and the speed/performance of the owned fleet. In March 1996, he joined the staff of E.A. Gibson Shipbrokers Ltd in the bunker department, and became the manager. In 2006, this department merged with US-based broking house LQM Petroleum Services, where Nigel was Senior Broker and Technical Manager until he became a full-time consultant, lecturer and author in 2015.

Nigel is a founder member of the International Bunker Industry Association (IBIA) and has served several times on its council of management and executive board. He has also served as the association's Chairman. He is the author of IBIA's

Basic Bunkering Course and Course Director of the Petrosport Academy which runs industry-recognised training events such as the *Oxford Bunker Course*.

Nigel is a member of the Institute of Marine Engineering, Science and Technology (IMarEST) and Past Master of the Worshipful Company of Fuellers.

Llewellyn Bankes-Hughes

Managing Director, Petrosport Limited

June 2016

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BUNKER BROKERS

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He is a well-respected trainer and lecturer and Course Director of the Petrosport Academy, which runs the *Oxford Bunker Course* and a range of other professional bunker and shipping courses worldwide.



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