Ask the experts:

Understand the pricing pressures

How should treasurers be helping their organisations cope with fuel and commodity price volatility?

Andrew Koss,
Treasurer, Drax Group

The treasurer's remit has expanded in recent years to include areas such as pensions risk management as well as commodity and fuel price risk management. Although historically for companies commodity price exposures may have been relatively small compared with foreign exchange or interest rate exposures, the volatility of commodity prices can be breathtaking. Just looking at the commodities of relevance to Drax, the prices of oil, gas, electricity and coal has doubled over the past year.

So what can a treasurer do to manage such volatile exposures?

First, understand in as much detail as possible the exact nature of the exposure your company faces, as there is plenty of basis risk out there! For example, gas prices, highly linked to global oil prices, currently determine the price of electricity in the UK. However, due to current short-term supply constraints in the UK power markets, driven by outages at nuclear plants and other plants out of commission while they install equipment to meet new environmental legislation, the price of electricity is being squeezed by capacity issues as well. Buying gas contracts to hedge against power prices may not eliminate your exposures entirely. Another example is fuel price exposure: what type of fuel hedge (and there are many products out there) would best mitigate your company's risk?

Second, explore the correlations between commodity prices and other financial exposures. There has recently been a strong link between the price of oil and the dollar, with the former strengthening on the back of the latter's weakness and vice versa. Could it be that your company's concern at exposure to commodity price movements is more than offset elsewhere in the profit and loss or balance sheet? However, this does need to be reviewed on a regular basis as correlations can and do move over time.

Third, and more generally, help your company prepare for a world of higher commodity prices. Although shorter-term hedging may even out the peaks and troughs of volatile markets, the consensus seems to be moving to acceptance of a world in which commodity prices remain high. Global supply constraints, increasing demand for fossil fuels and metals in the developing economies, particularly in China and India, and the focus on climate change all appear to have signalled a shift in the market's view of longer-term commodity pricing. Oil price futures currently sit above $100 a barrel out to at least 2016, but this is equally applicable to other markets. Understanding these pricing pressures and ensuring your company is in a position to respond to them may ultimately be the best advice that you can give as a treasurer.

Rod Pirie,
Treasury Operations Manager, FirstGroup

First, by leading on policy formulation. A well-thought-out policy with full business and board support should set the context. A rigorous debate should be expected and encouraged because relatively small misjudgements here can lead to material costs post-implementation.

Ensure that the board (or other persons with delegated authority to act) is adequately equipped to make decisions for dealing with fuel price volatility. Involve respected external parties to provide market intelligence. Does the board understand the potential impact on the business (for example, that contracts could become loss-making) of rising fuel prices? Do board members understand the potential downsides of adopting a hedging programme? What is the potential impact of unhedged risk on shareholder value? What about foreign exchange risk presented by rising dollar costs? Why seek protection for one period instead of another?

In answering these, along with other questions, a policy that is both achievable and beneficial can be established.

Second, the treasurer can supervise policy compliance. This is particularly important in large organisations, where sometimes certain responsibilities (for example, on the execution of derivatives) will fall outside the remit of the treasurer's department. Here the treasurer occupies a unique position, being able to oversee all sides of the process. As such, treasurers can identify areas of weakness, and ask the necessary questions to have these corrected.

For example, physical contracts entered into by the procurement department may create different bases of pricing, leading to basis risk when swaps are entered into. Performance reporting will be key, and the treasurer can easily lead on that in its design and implementation.

Third, the treasurer can assist with – and, indeed, sometimes is responsible for – the effectiveness of hedge accounting under IAS 39. It is no small feat, even with relatively simple derivatives, to prove hedge effectiveness under IAS 39 for certain types of fuel price risks, and it is generally much more difficult when hedge accounting for interest rate and foreign exchange rate risks. Hedging different blends of diesel using combinations of crude, crack and differential derivatives against a background of different fuel markets with their own volatilities could, if not managed well, quickly conspire to turn a hedging strategy into income statement volatility.

A key role for the treasurer to play will be in identifying where this risk arises and how it can be dealt with. While treasurers cannot guarantee that the hedges will be effective, they can ensure that such ineffectiveness does not come as a surprise. Finance directors will always appreciate this, certainly if they are aware of the limitations of IAS 39!

In FirstGroup, we have an annual spend of more than $500m on diesel fuel. Fuel hedging is treated with the importance that it deserves, right up to plc board level. We have successfully managed the rise from $25 a barrel in 2002 to date. The Group Treasurer, Ian Weldon, and his team, have played a central role in this and the board views the treasury role as central to this key risk.

Andy Gooch,
Managing Director,
Natixis Commodity Markets

Traditionally, commodity hedging instruments were used by commodity producers and intermediaries, while treasurers from many commodity-consuming companies were more adept at hedging their foreign exchange and interest rate risk. However, due to the increasing volatility in the cost of their raw materials, many consumers have begun to realise how effective commodity hedging instruments can be in preserving profitability.

The first obligation on treasurers seeking to help their organisations cope with commodity price volatility is to fully understand the identity of their business and their company's position in the value chain. With this platform the treasurer is in a position to recognise and analyse the precise nature of their company's risks.

To assess which risks to reduce or eliminate, treasurers then need to evaluate what their tolerance is to changes in the cost of raw materials and how this can affect the performance of the business. What is the percentage of current commodity consumption in the cost structure? How have current commodity prices impacted the last 36 months of cashflows? How successfully has the company been able to transfer surcharges to its customers? They will also need to recognise any mitigation effects from the correlation of commodity prices with other exposures, for example with the price of the dollar.

Given this assessment, it is the treasurer's responsibility to identify the most effective cost protection solutions and propose them to the board. The board is responsible for agreeing and approving the hedging policy, to be executed by the treasurer and the treasury team. There then needs to be independent monitoring of the execution of the policy reported on a regular basis to the board or risk committee.

There are a large number of both sophisticated and unsophisticated hedging tools available. Providers such as Natixis can work with treasurers to identify which tools are best suited to tackle their particular exposures, in line with the policy and constraints laid down by the board or before any policy has been ratified. The tools themselves do not bear the same level of risk so a thorough understanding of their mechanics is needed. To simplify, the linear products (forwards, futures and swaps) enable the consumer to lock in a price for a period of time, and the options products (which come at a premium) can both eliminate the risk of an increasing price and give downside participation should prices fall.

Many tools not only allow treasurers to take a short-term view for the sake of their annual budgeting but also a mid-term view, where markets are liquid for long-dated maturities, that satisfies a more strategic outlook.

Ian Peake,
Former Deputy Treasurer,
Hanson

There are two key areas in which the treasurer can add value: initially in the assessment of the risk, and then in the execution of the agreed policy.

Treasurers' background in risk uniquely positions them in the organisation to assist in assessing risk. Procurement functions in many traditional businesses may be focused on cost minimisation, with the risks of input cost variability being considered as a secondary issue. This may to lead procurement functions striving for minimal absolute costs rather than minimising risk.

An initial risk assessment may include analysis of the sensitivity of costs, margins or profitability to fluctuations in fuel price. Input cost volatility can easily be sourced from the financial and commodity markets, and should drive the focus towards the more risky products. For instance, typical interest rate volatilities are in the 2-5% range, and foreign exchange volatilities 5-20%, yet fuel volatilities can be 30-90% and more. Maybe we should refocus our traditional treasury activities accordingly!

In addition, when performing the risk analysis, consideration will need to be paid to the competitive environment of the business. Faced with rising input costs, is there scope to increase output prices or make surcharges? Better energy efficiency or utilisation of alternative cheaper fuels or materials may be possible. With a minimal additional capital expenditure, the flexibility to use different fuel types may be built into the production process. For example, asphalt plants can be fuelled by natural gas or fuel oil; and waste tyres or recycled oil can be burned in cement kilns. These areas are certainly not the sole domain of the treasurer, but the treasurer can definitely add value to the debate, to ensure that the appropriate risk parameters are clearly understood and agreed throughout the organisation, leading to the formulation of a policy for each fuel or commodity risk.

Execution of hedges under the policy could be in the form of physical delivery contacts negotiated with suppliers at pre-agreed fixed prices. The treasurer can assist in this process by monitoring the ongoing risk. However, suppliers may not be willing to take on the risk themselves. They may charge a premium for doing so; or supply may be fragmented, with too many individual suppliers to make separate supplier negotiation efficient. Derivatives are often the ideal alternative and the treasurer, being the derivatives expert in the organisation, is the ideal person to execute paper hedges. Once consumption data has been collated, and a relevant tradeable benchmark identified, it is important to test its effectiveness to identify weaknesses as early as possible. Time spent at this stage, refining the hedge relationship and removing basis risk, is certainly not time wasted. Treasury departments are usually already set up with the infrastructure – such as ISDA (International Swaps and Derivatives Association) agreements and treasury management systems – to trade, settle and account for these commodity derivatives as with any other derivatives, although extra development work may be required to upgrade systems to be IAS 39-compliant.

Over recent years Hanson has developed risk strategies for a range of fuel and commodities including natural gas, electricity, gasoil and diesel used in the production and supply of heavy building materials: aggregates, cement, ready-mixed concrete, asphalt, bricks and precast concrete pipe and products.