TIME TO REASSESS THE RISKS

BEN PRESTON OF MACQUARIE BANK EXPLAINS THAT, AS TREASURERS BECOME MORE AWARE OF THEIR EXPOSURE TO COMMODITY PRICE MOVEMENTS, THEY ARE TURNING TO THE COMMODITIES MARKETS TO LESSEN THEIR RISKS.

There is currently good reason to be particularly interested in commodity markets. The price of a barrel of oil is striding towards 20-year highs, and has fallen more than 30% since the war in Iraq began: aluminium prices have been poor because of anticipated expansion of Chinese production capacity and coffee and cocoa prices have made huge gains up from lifetime lows caused by global over-production. Alongside these supply-side factors, investors continue to be interested in commodities as an alternative to the traditional investor markets of equities and bonds, particularly with gold and oil returning to the headlines. This article analyses why treasurers are increasingly being made aware of their businesses' exposure to commodity price movements and why they are turning to the financial markets to mitigate these risks.

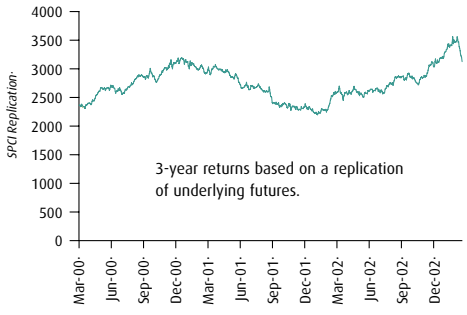
WHICH EXPOSURES SHOULD FIRMS BE FOCUSED ON? The Financial Services Authority (FSA) defines a commodity to include any physical product that can be traded on a secondary market and the positions with respect to these contracts, and which is not an equity, foreign exchange or interest rate position. This exclusionary definition (that is, defining commodities in terms of what they are not) implies a very broad range of products. Commodities can therefore include agricultural products, base metals and other minerals, and various precious metals other than gold. The definition also encompasses the energy spectrum, which includes oil and oil products, natural gas and power. There is a vast range of commodity products traded on exchanges globally which businesses can access for the purposes of commodity risk management.

So what commodity price exposure do treasurers face? Obviously, large oil companies, metals producers or refiners, grain houses and any commodity or trading company directly involved in these markets will have direct price risk exposure. For companies that use commodities to produce finished goods, commodity price exposure is more subtle. There may be reference commodities in service contracts leading to earnings that are strongly correlated to commodity prices, or there may just be credit risk exposure to suppliers which, in turn, have large commodity price exposure. It is important for companies to identify what commodity exposures they have, or have inherited, or have had passed on to them and then once identified, they can choose to mitigate or integrate these risks into their overall business objectives.

To take an example, on the one hand, it is clear that large aluminium producers are inherently involved in such direct exposures as participants in the commodity business and shareholders seek exposure to such businesses with the commodity risk intact, even if the short-term price volatilities are smoothed out in the derivatives markets. On the other hand, taking a downstream industry, the North American car industry produced 18 million cars last year, each fitted with a catalytic converter, which on average requires eight grams of platinum and four grams of palladium. The price of platinum group metals has been extremely volatile over the past three year, and car manufacturers have been forced to address this price risk. Through commodity risk management strategies such downstream industries have a menu of possibilities to eradicate or just alter their exposure. It is vital that all commodity exposures are identified – from a million barrels of crude oil right down to 1oz of palladium.

To facilitate the availability of effective risk management strategies, a huge amount of work has to be done to create industry standards and pricing benchmarks for both the established and emerging commodity markets. It is through confidence in pricing and delivery

FIGURE 1
THE STANDARD & POOR'S COMMODITY INDEX.



mechanisms for each commodity market that buyers and sellers are attracted to the futures and forwards markets, and that supply contracts can reference on the main, global price benchmarks.

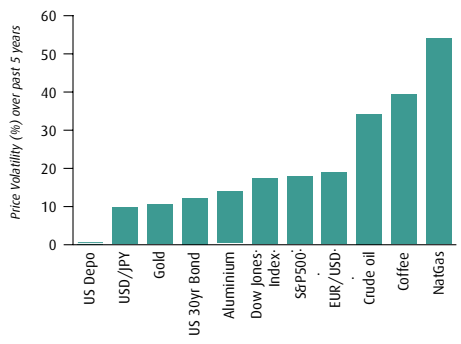
MARKET EVOLUTION. The regulated exchanges provide the market for the commodity futures and forward contracts. One such global market place is the London Metal Exchange (LME), which celebrated its 125th anniversary last year. The LME grew out of the need for metal in post-industrial revolutionary Britain. Importers were exposed to great risks as they awaited the safe voyage of their cargos and on arrival were subject to whatever price they could get at port. Out of this grew the need for a standard forward contract so that the merchants could sell forward. The LME standardised these contracts and trading times and, today, the contracts are used in all aspects of metal producing or consuming industries to mitigate industrial metal price risk. Today's standard LME benchmark, the three-month contract, is derived from the fact that, in the 19th century, copper took about three months to ship from the mines of Chile to the warehouses in Britain and it has been the Exchange's flagship contract for more than 100 years.

Subsequently, other important global commodity exchanges arose including the New York Mercantile Exchange (NYMEX) and its COMEX division, the International Petroleum Exchange, and the Chicago Board of Trade, each of which are today key exchanges for price discovery over the spectrum of commodities. These futures markets have all been instrumental in overseeing transparent, industry accepted pricing. Today, not only do we have contracts built around these exchange referenced benchmarks, but in the recent climate of geo-political tensions and high profile credit events in the energy market, we have seen increasing numbers of credit-aware participants returning to the fully-collateralised security of regulated exchanges.

Commodity markets have been characterised by the rapid development of the over-the-counter (OTC) market. These OTC contracts, developed by institutional market participants, can be based around an exchange traded contract but are tailored to meet the circumstances of a company's exact exposure. Commodity risk is highly specific and is often written into pricing agreements and contracts that do not complement the suite of commodity futures products available on the exchanges. These price agreements and contracts will have an accentuated basis risk because of the inherent price volatility of commodities and the vagaries of pricing each specification. Tailored OTC derivative products are favoured by most companies wishing to mitigate particular commodity price risk.

While similar to currency and interest rate markets, there are several marked differences in commodity markets. Peculiar to commodity transactions there is, in many instances, the potential for physical delivery, and forward prices are therefore ultimately determined by underlying demand and supply for a commodity at that time, rather than interest rate differentials. Added to this, commodity exposures are often 'blended' into other financial products which adds a further degree of complexity. Forwards and options may, for example, be denominated in local currencies. Finally, pricing is often particularly sensitive to lags and nominated pricing periods, with the majority of contracts pricing against average periods, as opposed to single value dates. These considerations mean that a highly specialised commodity derivative market has evolved.

FIGURE 2
AVERAGE 20-DAY PRICE VOLATILITY OF ASSET CLASSES.



RISK INITIATIVES. Certain large-scale credit events in the past 24 months have highlighted the credit intensive nature of commodity trading, and participants have either reverted to regulated exchanges or have sought to mitigate counterparty risk associated with OTC contracts. Transaction netting, cross-product margining, collateral arrangements and credit intermediation are all products that are employed to mitigate counterparty risk. Focusing on settlement terms for physical transactions, so that they more typically become contracts for difference, mitigates the larger value-before-value exposures previously faced. In response to a general tightening of credit globally, many of the exchanges have embarked upon initiatives to extend their clearing services to the more popular OTC products.

Commodity derivatives have not escaped the new guidelines for derivatives accounting – for North Americans, FAS 133/8 and for Europeans, IAS 39/32. Treasurers already disclosing derivative exposure for non-commodity price risk can be assured that the same principles extend to the commodity world. Identification of commodity price risk assumed and appropriateness of hedging policy are essential in determining how commodity derivative exposures will be disclosed for income and balance sheet purposes.

So why should a treasurer use commodity derivatives? In many cases, firms reserve a significant amount of working capital for any potential cost surges that are correlated to commodity prices. Commodity derivatives can be used to modify the price risk exposure or merely to lock-in prices to ensure that budgeted costings are met and that working capital can be re-routed to more effective ends. Hedging can be used to reduce the working capital required to cover the volatile, but potentially low returning near-term commodity price risk, and allow it to be re-used for the proprietary, higher-returning business opportunities.

Additionally, when bidding for contracts and pricing their output, treasurers can offset any price risks implicit in fixed price contracts containing commodity price exposures. This can render more certain the projected cashflows from the contract and allow for more competitive valuation, removing the uncertain, or even undesirable, commodity price element from its budget. Similarly, when bidding for a contract that was previously fixed, the bidder can pass through the commodity price risk by reference to a commodity price index and, in some cases, optionality implicit in the contract can be monetised up front. In both these cases, any unwanted or excessive commodity price risks implicit in supply or purchase contracts can be mitigated through the futures or OTC derivatives markets, and potential gains can be locked in.

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