US banks take on weather risk

US investment banks are moving to become weather derivatives market-makers that will add much needed liquidity to the fledgling market. Merrill Lynch in July became the first US investment bank to execute an over-the-counter weather derivative trade as a market-maker, and Salomon Smith Barney is exploring whether to enter the market as a risk taker later this year.

Like other investment banks, Salomon is already brokering structured weather transactions. Louis Dreyfus Risk Management, Hess Energy Trading Company and Chubb Financial Solutions are also gearing up to take on net risk positions this autumn.

The new firms planning to warehouse weather risk join Koch Industries, Enron, Swiss Re New Markets, Aquila Energy, Societe Generale, Southern Company Energy Marketing, El Paso Energy and Reliant Energy as market-makers in this sector.

"Weather hedging can reduce volatility in earnings," noted David Maccarrone, Vice-President for natural gas company equity research at Goldman Sachs in New York. "Investors crave predictability and growth," he added. The US Commerce Department recently estimated that one ninth of the US gross domestic product is affected by weather.

Price discovery in the OTC temperature market remains difficult. But Enron Online's e-trading platform for OTC derivatives is helping the weather derivatives market grow as it is drawing in new end users, say market participants. It is also offering pricing spreads that are five to 10 degree-days wide, they note. "It's indicative of where the OTC market should trade," said one official, noting that the tight bid-offers are useful references.

> The US Commerce Department recently estimated that one ninth of the US gross domestic product is affected by weather

A degree-day is a measure of the variation of one day's temperature against a standard reference temperature, typically 65 degrees Fahrenheit (18 degrees Centigrade). Both cooling degree-days (CDDs) and heating degree-days (HDDs) exist. Customers on EnronOnline's site can only order about 10 $100 city temperature contracts at a certain price at a specific time, the official noted.

More than 10 contracts can be purchased through the platform but at a weighted-average price. In the OTC market the average price per HDD is $5,000–$10,000. Degree-day spreads in the OTC market occasionally start as wide as 100 days and are then whittled down during a trade's construction. IFR

Swiss Re to roll out on-line sales

Swiss Re plans to make its on-line weather derivative products available to UK clients. Even though the site was launched on 26 May, legal and regulatory obstacles had to be resolved before the web-based service could become accessible for end-users in the UK.

To date, UK users have been able visit the site but were denied trading access to buy any of the products. The final go-ahead is expected soon. When the site was launched, it was immediately rolled out to US, Canadian, Swiss and other European markets.

Norway and Finland followed soon thereafter. Swiss Re is following in the footsteps of other weather derivatives market players, like I-WeX.com, tradeweather.com and EnronOnline, which tried to take their products on-line (*see IFR 1317, 1345*).

In its end of May launch, Swiss Re introduced the sale of weather derivatives via its ELRiX platform. The products are primarily heating degree day and cooling degree day put or call options targeting utilities, gas distribution companies, heating-oil distributors and other temperature-sensitive businesses. IFR

On-line OTC commodity exchange forms alliance

The Intercontinental Exchange (ICE) – the US electronic over-the-counter commodity exchange – has formed an alliance with the six natural gas and energy suppliers that make up the Energy Trading Platform Holding Co (ETP). ICE plans to launch a London operation and is also preparing its debut in Singapore.

Under the arrangement, the ETP members that banded together earlier this year to form their own on-line energy trading forum join ICE founding firms Morgan Stanley Dean Witter, Goldman Sachs, Deutsche Bank, Societe Generale, BP, Royal Dutch/Shell Group and TotalFina Elf Group as liquidity providers for the exchange.

ETP member companies American Electric Power, Aquila Energy, Duke Energy, El Paso Energy, Reliant Energy and Southern Company Energy Marketing have also enlisted as ICE partners.

The deal makes sense on several levels. For the ETP companies it cuts their lead time into the energy OTC e-trading market and reduces transaction costs as the ICE will charge its liquidity providers the same commission on every trade. According to a recent estimate by the Gartner Group, on-line trading saves roughly 15% per transaction. From a cost saving perspective, ICE should also pan out well for the OTC dealer players.

Trading in financial and physical OTC contracts on precious metals, crude oil, natural gas and electricity will be possible through the platform. The exchange's debut trade was scheduled to be a precious metal transaction. IFR

ISDA explores master agreement

The International Swaps and Derivatives Association (ISDA) is considering developing a single master agreement that would act as one documentation platform for the full range of derivatives transactions.

ISDA's single agreement would pull together all existing ISDA agreements and encompass netting provisions for all derivatives – swaps, options, foreign exchange, repo and securities lending arrangements. The move, if taken, would be another approach to reaching the goal achieved by the cross product netting agreement that was published by the Bond Market Association (BMA) earlier this year. The BMA's agreement overlays the four most widely used master agreements for derivatives dealing with a new umbrella "master-master" agreement.

The BMA's Master Repurchasing Agreement, the Foreign Exchange Master Agreement, the International Swaps and Derivatives Association's Master Agreement and the Emerging Market Traders Association's Master Agreement for Options on Emerging Market Instruments are tied together through the BMA's agreement. Nine industry trade groups worked together to form the umbrella agreement.

While some industry officials believe that modernising the agreement and creating a single document would help allay fears of systematic risk and simplify unwinding of positions, others in the industry are not sold on the concept of an "all-singing, all-dancing" agreement. They say that ISDA should explore creating a bridging document that builds on all of its individual agreements.

Many firms, particularly in the US, already use bridging documents in-house, but having a standardised form would make it easier for users to negotiate with customers, say those in favour of the prospect of a move to a single agreement. IFR

Abbey National innovates loan hedge

Abbey National Treasury Services used an innovative derivatives structure in its recent £255m term loan for University College London Hospitals NHS Trust and Health Management. The swap structure offered it protection against a low-inflation environment – a rare feature in the context of a private finance transaction.

The loan involves a 40-year project vehicle, with a concession under the UK government's private finance initiative, whose income stream is fully inflation-linked.

To hedge against low inflation, a 35-year retail price index swap was entered with Abbey National Financial Products. The project vehicle is fully risk-covered, and the swap was entered in a notional amount that would provide for sufficient cover in a low-inflation scenario. IFR

BT reduces the strain

British Telecom is renewing the £16bn 364-day seven-bank club loan that it self-arranged in May for a further year and increasing it to £18bn. Although the UK telecoms giant is allowing the seven banks to reduce their hefty commitments a little by bringing a further five banks into the deal, it has sought and achieved more aggressive pricing with this renewal.

The original seven banks were Barclays, Bank of Tokyo-Mitsubishi, Citibank/SSSB, Deutsche Bank, HSBC, Lloyds Bank and Royal Bank of Scotland. The new banks are ABN AMRO Bank, Bank of America, Bayerische Landesbank, IBJ and SG. Citibank/SSSB is co-ordinating the deal and it is unlikely that further syndication will be conducted.

In a departure from previous jumbo loan etiquette, earlier this year both British Telecom and Vodafone AirTouch took the self-arranging route, with BT getting these seven banks to stump up £2.29bn commitments apiece for a paltry 2.5bp underwriting fee. Vodafone completed a more modest $5bn deal with a 15-strong club of banks.

The financing was priced even more aggressively than the original £16bn club. It is split into a £12bn 364-day revolving credit with a 12-month term out option, which will be used as a CP backstop, and a £6bn 364-day revolver also with a 12-month term out option which can be used by BT and its affiliates – with the implication that it will be drawn. IFR

Unilever taps the markets

Unilever – the multinational foods and household products group that is acquiring Bestfoods of the US – tapped the US dollar and euro corporate bond sectors with large size. The company was initially expected to raise $22bn in the syndicated loan market – an amount which fell to $15bn with the bond issues. The company is likely to raise just €5bn in the loan market and the remaining $9.5bn through public and private placements in the bond market.

The overall financing features nine banks, including the lead managers of the bonds issues: ABN AMRO, Deutsche Bank, Goldman Sachs and UBS Warburg. All four were, like their peer group, very keen to position themselves for the mass of private funding that Unilever has left to do in the bond sector.

The bond issue was initially expected to comprise $5bn and €2bn of bonds. The issue showed more clearly than ever how large a disparity there is between Europe and the US. Europe was enormously price-sensitive. The deal was oversubscribed at Libor plus 10bp – the eventual reoffer level – and undersubscribed at plus 9bp. IFR

These extracts are from IFR (International Financing Review). For further details, please contact Philippa Young on 020 7369 7521 (tel) or 020 7369 7397 (fax).
Email: philippa.young@tfeurope.com