

## **Hedging Future Commodity Price Risk Can Damage Your Company's Liquidity**

Ron Wells warns that hedging future commodity price risk is something to consider, only if you guard against the chance that the outcome could damage your company's liquidity and/or its competitive position.

Whether you are a producer of an energy commodity or a consumer of wholesale quantities of natural gas, electricity, coal, aviation fuel, or diesel (for example) the prospect of fixing the future price at which you will be able to sell or source such commodity is very attractive. This is especially the case for your Financial Accountant, who is keen to produce a neat and tidy three year budget. However dangers lurk, not only should you consider counterparty future failure risk (failure to perform contract obligations and/or failure to pay) you must consider your competitors. If you hedge and your competitor does not, you will either win or lose; that is, if market prices move against you, your competitor will take advantage and you will stand to lose market share and profit. On the other hand, if prices move in your favour (that is to say your hedge protects you from an adverse price movement) you will be able to trump your competitor, at least in the short term.

The win or lose 'gamble' involved is the reason many businesses either decline to hedge (decline to agree fixed price future delivery or supply contracts, or derivatives that achieve the same end) or hedge only a proportion of requirements.

Once a decision is made to hedge, a business selling a product faces counterparty risk in two respects; namely, performance risk and payment risk. If a buyer, the hedging business incurs counterparty performance risk exposure.

Performance risk can be quantified daily, by reference to market prices, in order to deduce the difference between the fixed price contract (hedge) and the market value of the underlying commodity to be delivered or purchased in the future. This is the marked-to-market (m2m) value of the contract each day and the actual amount that would be lost (or gained) if the contract was not honoured and the delivery had to be replaced by purchase or sale in the market on that day. Hence the m2m value is the quantum of exposure that one party to a hedge has to the other, its counterparty. This approach assumes the existence of a liquid market in the commodity and at the place of delivery in question.

If you have a margining agreement with your counterparty, and your position on any day is 'out of the money' (you would owe your counterparty money if the deal were terminated immediately) and the amount you would owe exceeds the

agreed threshold (effectively a credit limit) you will have to post margin. That is you will have to pay cash or provide a Standby LC (if allowed in your agreement) to your counterparty, equal to the difference between the amount you would owe and the threshold.

The point is that you cannot predict how prices may move – that is the reason a margin agreement is put in place, it provides mutual protection since it is usually a two-way agreement. However this means that you also cannot predict how much cash or committed LC facility you may have to use from day to day, in order to cover provision of margin. To make matters worse, often margin agreement thresholds are tied to credit ratings or covenants, so if your credit standing deteriorates the amount of margin you have to post can increase rapidly, an eventuality that is unpredictable. Mathematical models can provide some ‘worst case’ future scenarios based on which you can estimate your potential liquidity requirements. However the models available assume that the future will resemble the past. Unfortunately negative ‘Black Swan’ events<sup>1</sup> – the very events that cause massive price volatilities and could seriously damage your liquidity - cannot be predicted by mathematical means.

Thus Lehman Brothers failed due to a lack of access to liquid funds; it could not pay its margin calls due to lack of immediately available cash. Do not let the same happen to your company. Understand and monitor daily the possible negative implications of any margin agreements that exist, and actively negotiate such agreements to maximise contracted thresholds and minimise the possible escalation of ‘calls’ if negative events occur. Furthermore negotiate ‘committed’ (they are never truly committed) credit lines with your house banks, to cover short-term needs that may arise.

Lastly exercise tight control over any derivatives portfolio to ensure that hedges closely relate to physical transactions, and that the reference prices used in determining settlement amounts correlate closely to the price movements that relate to the physical transactions covered. In other words, seek to avoid speculative ‘open’ (un-hedged) derivative positions arising. In this way, at least, you can ensure that hedged positions will be self-liquidating when they mature. You will nevertheless have to manage the day to day liquidity implications in the interim periods.

Hedging is a complicated business so please note that this article barely scratches the surface of the subject. Nevertheless I hope that it will give you a sufficient basis upon which to consider the implications that it could have for your business.

Ron Wells

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<sup>1</sup> See article in CCR Magazine, issue August 2009, regarding Black Swan Events. See a copy at: <http://www.barrettwells.co.uk/blackswan.html>

**Ron Wells** is the author of *Global Credit Management - an Executive Summary*, published by John Wiley & Sons Limited. This is a concise but authoritative work that exposes the power of credit, see [www.barrettwells.com/gcm.html](http://www.barrettwells.com/gcm.html) for details. The **Chinese** version of this book has been published, it is an ideal gift for Chinese business executives of all types; Chief Executives (CEOs), Chief Financial Officers (CFOs), Treasurers, Credit Managers, Entrepreneurs starting or running their own businesses, and students of business practice preparing to face the tough challenges of business management, see [www.t3plimited.com](http://www.t3plimited.com) (English) or [www.t3plimited.net](http://www.t3plimited.net) (Chinese) for details. **Ron** is an active member of the International Energy Credit Association (IECA) and the Association for executives working in Finance, Credit and International Business (FCIB). His free access international credit management web site [www.barrettwells.co.uk](http://www.barrettwells.co.uk) is highly regarded as a valuable resource for those interested in trade finance and business-to-business credit management. **Ron's** email address is: [ron.wells@barrettwells.com](mailto:ron.wells@barrettwells.com).



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