Taming Commodity RISK

A two-tier hedging strategy

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Companies hedging commodity risk traditionally relied on procurement strategies such as fixed-price contracts, escalation clauses and inventory stockpiling to minimize the risk of price escalation. But with today's volatile commodity pricing, procurement measures alone often are not enough. Meanwhile, greater risk is forcing companies to step into the commodities markets for the first time, using derivatives instruments to further offset rising prices.

What is the solution for both types of firms? Companies with exposure to commodity price fluctuations can manage commodity risk with a two-tier hedging program. The first tier utilizes operational, or supply-side, hedging strategies. The second tier uses hedging strategies employing financial instruments such as derivatives to more fully cover risk exposure. Operational and financial hedging strategies can be used in tandem to mitigate financial reporting and secure investor confidence.

Pricing trends

Rising demand from countries in the Far East and elsewhere caused the price of steel to rise 96 percent in the first half of 2008, only to drop 72 percent four months later. Through September 2009, steel rose 51.5 percent off its low at the end of 2008. In a similar manner, oil reached a record high of $145 per barrel in July 2008, only to fall 77 percent five months later. Further, oil prices have climbed more than 118 percent off their lows.

But companies have been slow to embrace hedging strategies to manage commodity risk. Only 30 percent of companies in one 2006 survey said they actively managed commodity risk. Of those surveyed, 90 percent hedged foreign currencies and interest rates. Far fewer guarded against raw material price hikes. In a recent survey cited in Market Watch, 55 percent of CFOs said they have responsibility and policies to hedge commodity risk—up from 40 percent in 2007. Considering that so many hedge currency risk which is consistently less volatile than most commodities, it is surprising that financial managers don't focus more on these risks.

Before actively using derivatives, executive management should design a hedging policy to control derivatives usage.

Figure 1: Historic average percent change

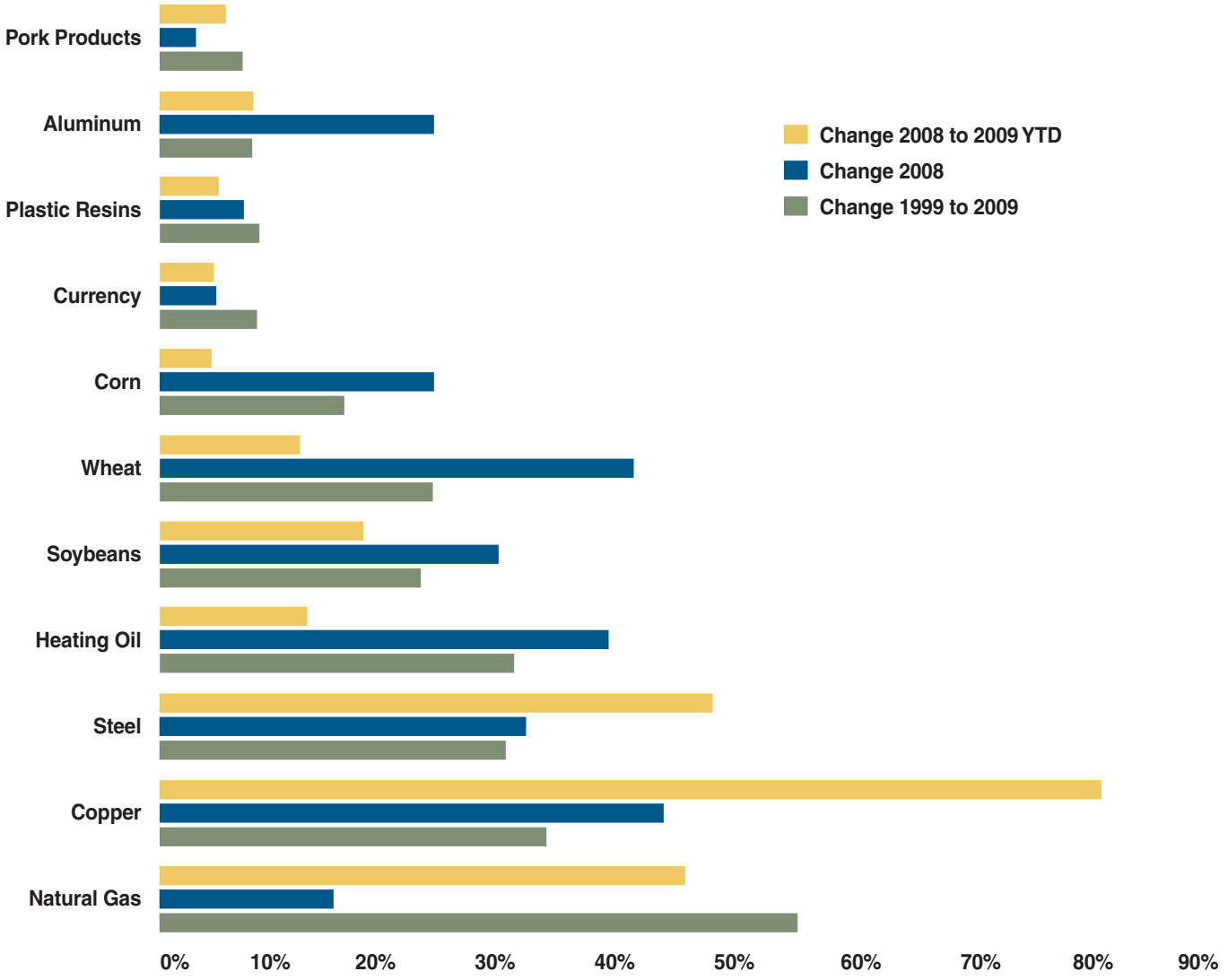

Figure 2: Comparative historic average percent change - ranking

Average Absolute Percent Change 1999 to 2009			Absolute Percent Change from December 2007 to December 2008			Absolute Percent Change from December 2008 to September 2009		
1	Natural Gas	54.9%	1	Copper	46.6%	1	Copper	82.7%
2	Copper	36.6%	2	Wheat	45.5%	2	Steel	51.5%
3	Steel	31.6%	3	Heating Oil	40.6%	3	Natural Gas	48.5%
4	Heating Oil	31.1%	4	Steel	34.6%	4	Soybeans	20.0%
5	Soybeans	26.4%	5	Soybeans	29.8%	5	Heating Oil	13.5%
6	Wheat	23.8%	6	Corn	24.0%	6	Wheat	11.9%
7	Corn	18.2%	7	Aluminum	23.6%	7	Aluminum	8.0%
8	**Currency**	**10.2%**	8	Natural Gas	17.2%	8	Pork Products	5.4%
9	Plastic Resins	9.8%	9	Plastic Resins	8.3%	**9**	**Currency**	**5.1%**
10	Aluminum	8.6%	**10**	**Currency**	**4.7%**	10	Plastic Resins	5.0%
11	Pork Products	6.5%	11	Pork Products	2.8%	11	Corn	3.6%

Commodity Data Source: U.S. Bureau of Labor Statistics www.bls.gov *Foreign Exchange Data Source (EUR/USD): U.S. Federal Reserve www.federalreserve.gov*

The policy should identify the person or persons responsible for managing the hedge program, particularly derivatives; define commodity risk tolerance levels that might trigger derivatives usage; and name acceptable financial tools and techniques. Policy guidelines should further direct derivatives managers to use simple instruments until the manager's skill level matches the complexity of the derivative.

Assign responsibility

First a company's top executives must assign to a hedging manager or managers clear responsibility for managing commodity risk and coordinating strategy across the company. Who plays this role differs among companies. Where responsibility should lie is a function of a number of factors specific to a company, including:

- Is the treasury group familiar with the use of derivatives for foreign currency and interest rates already? Can this knowledge be transferred to the purchase of food, metals and energy commodities?
- How substantial is the commodity risk to the gross margin of the division or the entire company?
- How widespread is the knowledge of derivatives at the company? What has been the historic experience of the company using these hedging instruments?

For most well-managed companies, a multidiscipline, coordinated risk management committee with oversight by senior management, strict policies, controls, frequent counterparty credit risk assessments and reporting usually leads to a successful hedging program.

The hedging manager must identify line items in the company's financial statements that could vary based on price fluctuations both with today's raw material supply order and with supply orders up to 18 months into the future.

That risk is then measured against budget. The hedging manager determines the notional value of risk by assuming the company would be able to buy a commodity, like corn, next year at today's prices. He or she compares that notional value to historical price volatility and forecasts to measure the size of risk. For example, if the price of natural gas moves 50 percent, 25 percent or just 5 percent in the next 12 to 18 months, hedging managers can determine how those price changes might affect financial statements.

Based on potential price movement, the hedging manager can then decide whether the company can tolerate that risk or if the company would be better off managing that risk. For example, the airline industry typically cannot tolerate big price surges in fuel because so much of their cost structure is tied up in fuel.

The hedging manager must select an appropriate, supply-side hedging technique to pursue, such as a fixed-rate contract with suppliers, a defined escalation clause or a risk sharing agreement, or inventory stockpiling to use or resell if prices escalate. If a company can negotiate a 12-month agreement to fix its costs or selling prices, or it can have a reasonable escalation clause that shares risk with its customer or supplier, using an operational approach might be easier to manage than hedging daily derivatives.

When supply-side hedging techniques do not sufficiently align commodity risk with corporate tolerance levels, financial hedging techniques must be selected. For a company that has significant energy risk where its supplier can provide fixed prices for only 30 days or will not provide fixed prices at all, the futures or forward market can provide a liquid hedge of this risk for a reasonable cost for up to 18 months.

As commodity derivatives go mainstream, regulators are paying close attention to the paper trails and audit controls required by FAS 133. To initially qualify for hedge accounting, companies must, in part, complete hedge assessments on purchase contracts, forecast probability of transactions and ensure that executed hedges fall within the company's risk tolerance parameters. Companies must also prepare detailed and contemporaneous documents as required by FAS 133.

Companies are required to update forecasts against the notional value of the underlying instrument and account for ineffective hedges. Most companies report mismatched hedges at least quarterly. For large companies, sophisticated modeling is used to support daily hedging activities and reporting. Modeling might be more onerous for middle-market and smaller companies, especially when derivatives hedging is undertaken only once a week or once a month.

Measure success

When it comes to managing commodity risk, the objective for any company should not be to make money. Rather, companies that pursue hedging strategies should be interested in limiting risk to acceptable levels and eliminating significant volatility in financial statements for a specific period of time. Developing or purchasing software that can measure exposures and highlight the techniques they employ to manage the risk is critical.

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