



Commodity Price Rise Mitigation Strategies

Introduction

Price volatility in commodity markets is increasingly becoming a key challenge for companies in the chemicals, metals, manufacturing, aviation, and oil and gas sectors. In the past, companies have resorted to declaring force majeure during times of high volatility. It is important for firms to manage price fluctuations effectively because their earnings are linked very closely to market prices.

The rapid economic growth of the emerging Asian and Latin American markets and the influence of investor hedge funds and speculators have boosted commodity prices to new highs. These factors, combined with the global recession and the adverse credit environment, have driven prices down at an alarming speed. This price volatility not only threatens the survival of individual companies but also puts entire markets and industries at risk.

Steps for Commodity Price Risk Mitigation

A company can follow three steps to ensure that its commodity procurement efforts are properly managed in terms of risk, cost, and supply regardless of the current economic environment.

1. Profile commodity risks
2. Understand the market dynamics of commodities
3. Identify supply, price, and risk goals

The goal of a successful procurement strategy is to secure supply, mitigate risk, and minimize price volatility. Historically, proactive companies have relied on a range of commodity management options. The suitability of each approach differs by commodity and market.

The use of each approach depends on the company's time horizon. Some strategies are not expected to change the price that the company is currently paying and may even require investments in the near term. However, they could produce positive results in the long term.

Risk Management Options

| Option | Description | Characteristics |
|-------------------------|--|--|
| 1. Market-based Pricing | Let commodity pricing swing fully with the market through either a direct or indirect market index (e.g. no position). | <ul style="list-style-type: none"> • Low cost • Highest volatility • Risk borne by purchaser |
| 2. Collar Pricing | Let commodity pricing swing within agreed limits, as contracted directly with supplier(s). | <ul style="list-style-type: none"> • Low cost • Bound volatility • Element of risk shared between buyer and supplier |
| 3. Fixed Pricing | Fix commodity pricing directly with the supplier | <ul style="list-style-type: none"> • Low cost • No volatility (in the short term) • Risk borne by purchaser |
| 4. Financial Hedge | Arrange pricing directly with the supplier (1 or 2 above), then transact a financial hedge to lock in pricing. | <ul style="list-style-type: none"> • Some cost • Can eliminate volatility • Risk borne by purchaser |
| 5. Operational Hedge | In combination with 1, 2, or 4 above, purchase and inventory material in an attempt to buy low. | <ul style="list-style-type: none"> • Some cost • Managed volatility • Risk of betting against the market |
| 6. Backward Integration | Own/take a position in the direct producing assets of the commodity (e.g. buy the farm/manufacturing plant). | <ul style="list-style-type: none"> • High fixed costs • Low volatility (usually) • Can be very risky and requires an understanding of running the new business and an explicit strategic need |

Fixed pricing was a common strategy adopted, but it is not effective when commodity prices are extremely volatile or moving upward. A few suppliers are willing to lock in a long-term price, whether it be a firm-discounted price or the market price. A better strategy is market-based pricing, which typically relies on transparent and available barometers, such as market indices, to monitor and set prices.

Examples of Price Risk Mitigation Strategies

Case 1:

The General Motors Corporation has an agreement with its suppliers to adjust prices on a monthly basis for automobile parts made from aluminum based on the spot prices of the commodity trading in the New York Mercantile Exchange. This hybrid strategy (collar pricing), which incorporates market based and fixed pricing, lets the commodity price swing between the maximum and minimum limit. The supplier makes a profit if the cost of the commodity decreases because the buyer is bound to purchase it above the market price, and vice-versa.

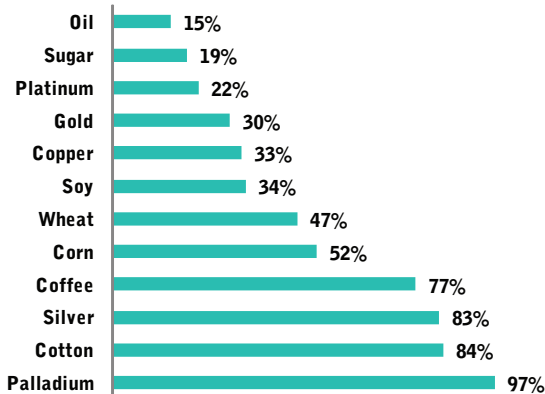
Case 2:

When commodity prices are uncertain, companies use futures or options contracts to minimize price swings prior to an anticipated sale or purchase of a commodity. More than 15 years ago, the Southwest Airlines Company locked in an aggressive hedging strategy that allowed it to buy oil at \$32 a barrel for 65% of its fuel consumption in 2006, \$31 a barrel for 45% of its needs in 2007, \$33 a barrel for 30% of its needs in 2008, and \$35 a barrel for one-fourth of its needs in 2009. Given current prices of over \$100 a barrel, the airline's seemingly uncanny strategy has given it a significant advantage over its competitors, few of which matched the accuracy of Southwest's long-term reading of the oil market.

Managing Commodity Price Risk

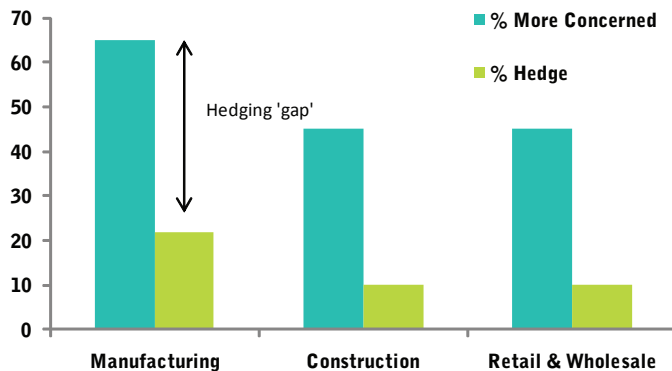
Leading companies generally analyze pricing dynamics, supply-demand dynamics, and the drivers of high spend materials to control commodity price volatility. The commodity fingerprint approach has been used by companies before. The commodity fingerprint framework evaluates the supply market for both purchased commodity material and all raw materials based on current conditions and the short- and long-term outlook.

Commodity Price Rise (2010)



Source: Oliver Wyman

Hedging 'gaps' by Sectors



Source: Iloydsbankcorporatemarkets

The manufacturing sector was the most concerned about commodity price risks. Although the sector had the highest hedging ratio of about 22%, the hedging gap was significant.

Many companies handle commodity price risk through their purchasing departments.

Exposure to Price Volatility and Supplier Risks by Industry

| | | | | |
|--|--------|--|---|---|
| Perceived Exposure to Price Fluctuations | High | Chemicals Food Mining and Metals | Construction | Transportation Oil, Gas, and Other Natural Resources |
| | Medium | Manufacturing | Industrial Equipment Consumer Goods Retail | Automotive Utilities (distribution of electricity, gas, water) |
| | Low | Pharmaceutical and Medical Products | Media and Entertainment Communication | Aerospace and Defense Electronics and High Tech |
| | | Low | Medium | High |
| | | Perceived exposure to supplier risks | | |

Mining companies manage the risk of commodity price fluctuations by maintaining a diversified portfolio of commodities. In addition, they typically do not implement a large-scale hedging strategy or price management initiatives. Instead, they aim to reduce costs on a continuous basis and maintain low-cost, efficient operations, which helps them optimize their portfolio and returns throughout the commodity price cycle.

Companies that successfully leverage their insight on commodity markets can improve their approach in managing commodities and gain a competitive advantage. A commodity price risk mitigation strategy can help companies reduce procurement spending and increase shareholder value compared to a sit and wait/do nothing approach.

Sources: Booz, ICIS, Accenture, SBB, Xstrata

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