Price Risk Service

CRMA - CRCI

CRMA and CRCI provide customized services to address all issues associated with price risk management. Across commodities David Waite and Michael Lockwood deliver risk management oversight and co-ordination, and research services to our clients. Simple precisely executed concepts are the foundation for our work and the basis of our contribution to our client's success. We listen to clients. We commit the full spectrum of our firms' resources to build custom-made solutions that meet our client's specific needs.

# Seven Deadly Assumptions about Commodity Price Risk

For producing, processing and trading firms in the commodity industry, price risk can be like a predator looking to exploit weakness. There is nothing it likes better than corner-cutting assumptions, made by over-worked management, that inadvertently turn the businesses into quarry. Over the years and across the continents, CRMA and CRCI have run into a wide assortment of such specimens and in some surprising places. Here, we've listed some of the most common ones we see. Some are pure lethargy and in the right circumstances some are lethal. Have a look-through and see if you recognize any of these animals living close to home.

1. **"The trend is with us so why worry about risk?":** This troubled concept can appear to pay dividends for a long time, but it's speculation. Sadly businesses get built on this assumption and its inherent bias infiltrates purchasing, processing, selling and management practices. And then the trend changes – something violent and difficult to foresee, when history stops repeating itself – the rocks are just ahead and the tanker can't be turned around. Sound reporting, commercial terms, controls, limits and systems take time to develop. It makes sense to build

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your business with sound practices from the start so your real profits are assured. Like players in a game of Russian roulette, commodity processor profitability can only last so long when it's based on a gamble.

2. **"It will all even out in the long run":** Roughly translated "doing nothing is better than doing something". Maybe, in more traditional times this was not far wrong. However, with new cost curve changing technologies in a world of altering global supply and demand patterns and algorithmically driven trading taking prices to higher highs and lower lows we know it is no longer the case. While this is most commonly held by producers, how many processing businesses can survive a 30-40% raw material value write down in one quarter? For them the fallacy for this argument is that while there may be many ups to balance the downs over a period of years, it takes only one big loss to interrupt it for good.


3. **"I don't have risk because my supplier fixes my prices for me":** Getting a fixed price from your supplier is a good form of price risk management, especially for smaller companies that find it difficult to open and manage a broker account. The unseen trap however is that under the right circumstances it may not actually offset your price risk but instead intensify it. If business slows, September's fixed price may translate to a big loss on inventory come next spring. Similarly, if improvements cut production cycle times, an uptick in prices could end up cutting margins earned on sales. Volatile commodity prices require processors model their financial exposures both inbound and out. How fixed prices are being achieved is potentially irrelevant.

4. **"We have no risk as we are "naturally" hedged":** We've seen this one in some surprising places. Corollaries like "our scale makes us immune" and "we have the lowest production costs" often accompany this assumption too. For those unfamiliar with a natural hedge, it is the nirvana of the risk world and exists when pricing for buying and selling of equal volumes are synchronous. For virtually every sophisticated commodity processor however, natural hedges are fantasy. The banal realities of shipping delays, production losses, variable grades and sales cancellations go "wham" and send any pretense of purchase sales balance up in smoke. The protection of large scale and low production costs mean simply that managers have chosen to bury volatility in a corner and let the impact flow directly into unsuspecting shareholder pockets.

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5. **“Hedging will neutralize our exposures”:** This can indeed be true, but only based on the proviso that it has a solid foundation to work from. Hedging cannot adequately cover exposures from pricings with ill-defined volumes and unknown time frames. Aggressive commercial practices, poor production efficiency assumptions and sloppy record keeping risk turning a hedge position into a speculative one. Proper price risk management practice requires discipline be imposed throughout the system *before a hedge transaction is taken* to make this assumption a reality.

6. **“Administering price risk with spreadsheets will save money”:** Price risk systems are often an afterthought when competing with budgets for production, ERP and accounting systems. All too often, the risk function must choke on the IT cutbacks and is left thereafter to painstakingly assemble manual spreadsheets fed with reams of untimely data collected from disparate systems. This pretense of cost savings consequently directs the business into a minefield and sooner or later the company will take casualties. It assures that little things like as an extra digit, a miswritten formula buried deep or links broken by a server upgrade can suddenly become major hedge mistake, wrecking careers, terrifying staff involved and draining the company’s pockets. We’ve seen more than a few eye-watering offsides (Murphy’s Law almost always has it that they are losses) that could easily have paid for a proper system in the first place.

Price Risk Management is a discipline but it’s not Molecular Physics and experienced resources are available to you and your people

7. **“Managing price risk - It's too complicated”:** Oh.....really? It’s always surprising when we hear this from managers who oversee thousands of tons of metal purchases and sales connected to highly technical production processes requiring multi-million dollar equipment and high precision logistics. When you put colossal effort into making and moving quality product, why let under-developed office practices throw hard-earned production results out of the window? “Price Risk Management” is a discipline but it's not Molecular Physics and experienced resources are available to you and your people. A dose of outside expertise will result in lower volatility, greater flexibility for you and your clients and longer run profitability.


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