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GLOBAL COMMODITIES FORUM 2013

Recommitting to commodity sector development
as an engine of economic growth and poverty reduction

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Beyond derivatives,
How to better manage risk exposures in commodity dependent countries?

By

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STRATEGIC RISK MANAGEMENT

Beyond derivatives,
How to better manage risk exposures in commodity dependent countries?

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Risk Management is a managerial matter, not a trading decision

- Major Private Commodity Companies are convinced that to maintain their leadership they will have to invest heavily in logistics infrastructures and industrial tools
- These investments will be supported by organic growth operations but also by acquisitions
- Their external growth seems to be the fastest and least risky vectors to optimize the risk-return associated with the capture of new markets (both upstream and downstream) and the reduction of uncertainty of "Greenfield" projects
- Commodity and energy market prices Volatility, Regulatory uncertainty and Credit risk concentrations appear as the three most significant risks of their business models
- These risks are perceived as all the more important that they weigh a great deal in the expected volatility of their results and hence, in the financial terms and covenants of the financing they need to get from their banks and markets to finance their development

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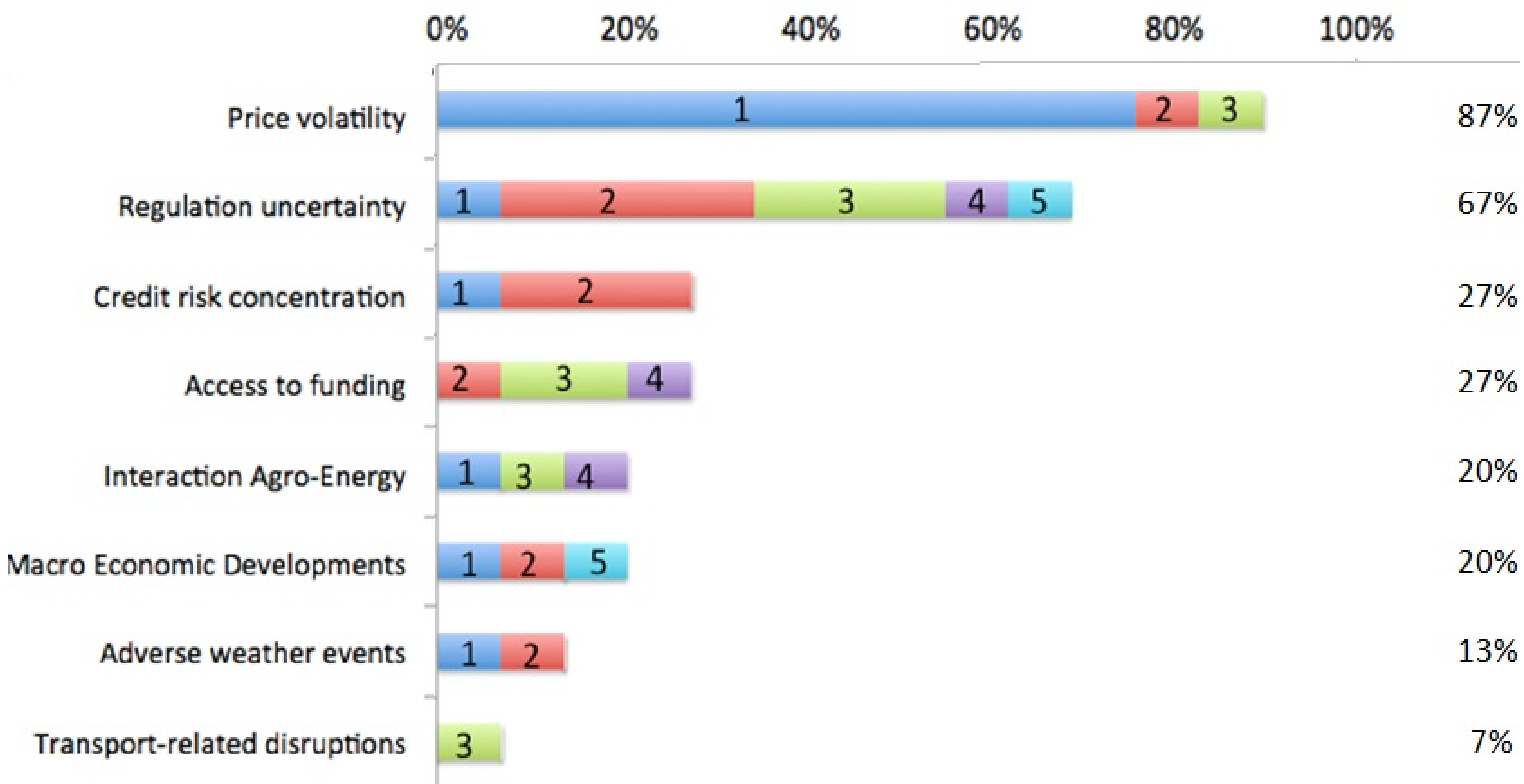
How leading commodity companies perceive and rank their risk exposures ?



Source: Study carried out by Strategic Risk management during January 2013

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How they deal with risk uncertainty to deliver reliability?

Commodity Producers

More exporter than traders

Blurred responsibilities

Few written procedures and systems

Traders have few incentive on global performance

Commodity Processor

Strategic Commodity purchasing procedures & Risk Management

Local operations

Regional trading centers

Large international network (local presence in more than 30 countries)

Strategic sourcing alliance

Delocalized Trading Companies (fully or partly owned)

Traders managed on performance versus budget

Risk management report to Top management

Commodity Traders

Centralized Strategic Trading & Risk Management

Regional trading centers

Large international network (local presence in more than 30 countries)

Strategic sourcing alliance

Often partly owned by producers and or processors

Traders managed on performance (rarely weighted by risk)

Risk management report to Top management

Global Trading Commodity Company

Matrix Organization

Global presence in more than 50 countries

Highly structured , clear written procedure and systems

Global Trading center by Region & by Product

Each trading desk is a profit center & acts with other desks as if they were external companies

Trader managed through remuneration plan indexed on performance and capital use

Risk management report to Top management

Company relative size by Sales and numbers of « traders »

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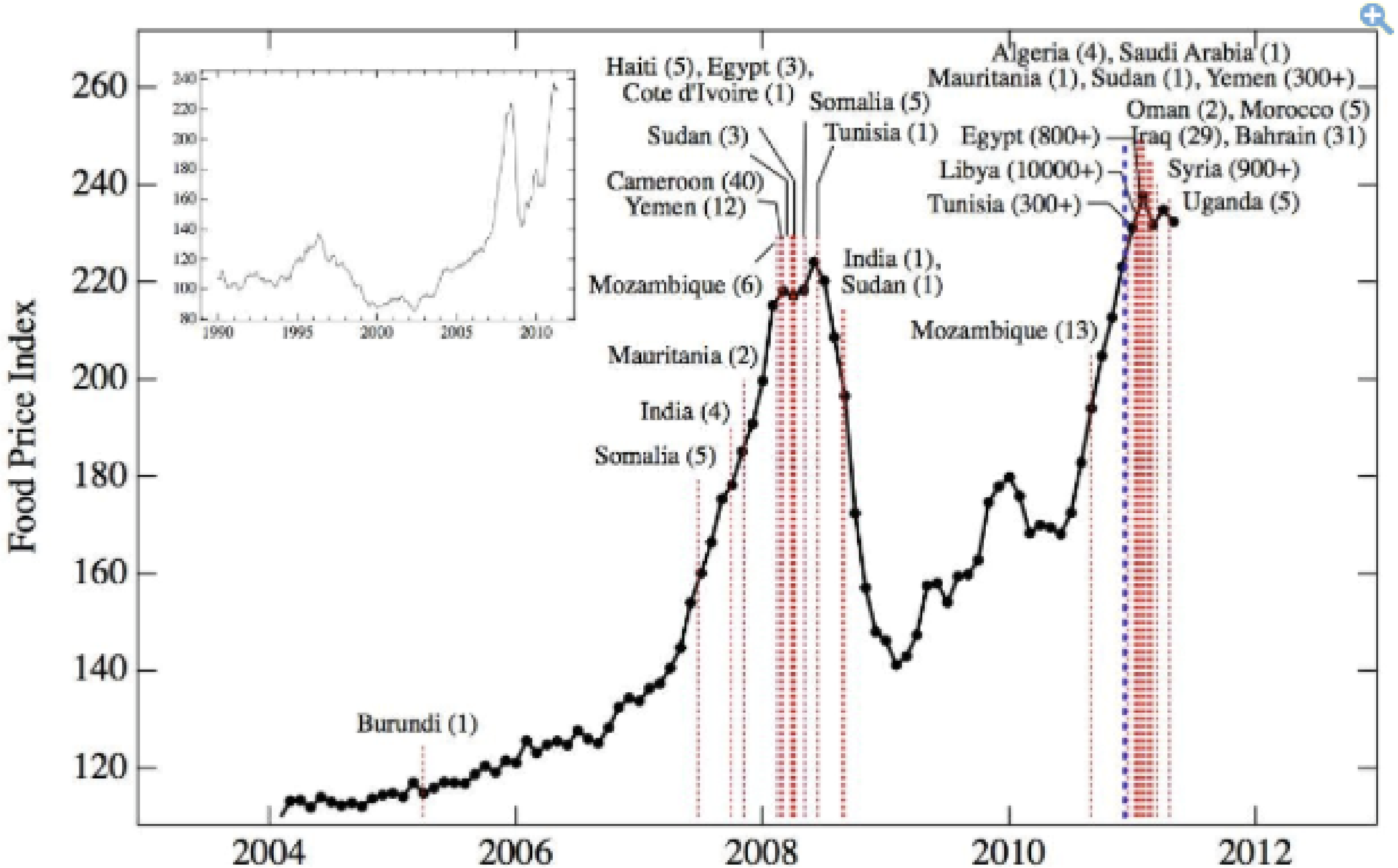
For Leading Commodity Companies, Food Unrests matter but are not a major issue concern



Lagi, Bertrand, Bar-Yam

For Commodity-Dependent Government or State owned Companies is different

- The Mission of Government and, by delegation, of Commodity Boards and/or State owned Companies is to improve, **years after years**, the revenues of domestic commodity producers/processors.
- Commodity dependent countries have specific characteristics such as:
  - They are naturally long of commodities on which they are **price takers** and not price maker
  - They are generally **not diversified** in their sources of revenues
  - They have very **poor infrastructures** (physical and financial)
  - They think locally and very rarely globally **while commodity market are global and interconnected**
  - They sell their products to Global traders, often with **a lot of imbedded options** in the contracts.
- Understanding and managing risks for the long term is a key issue for improving local commodity producers/processors revenues

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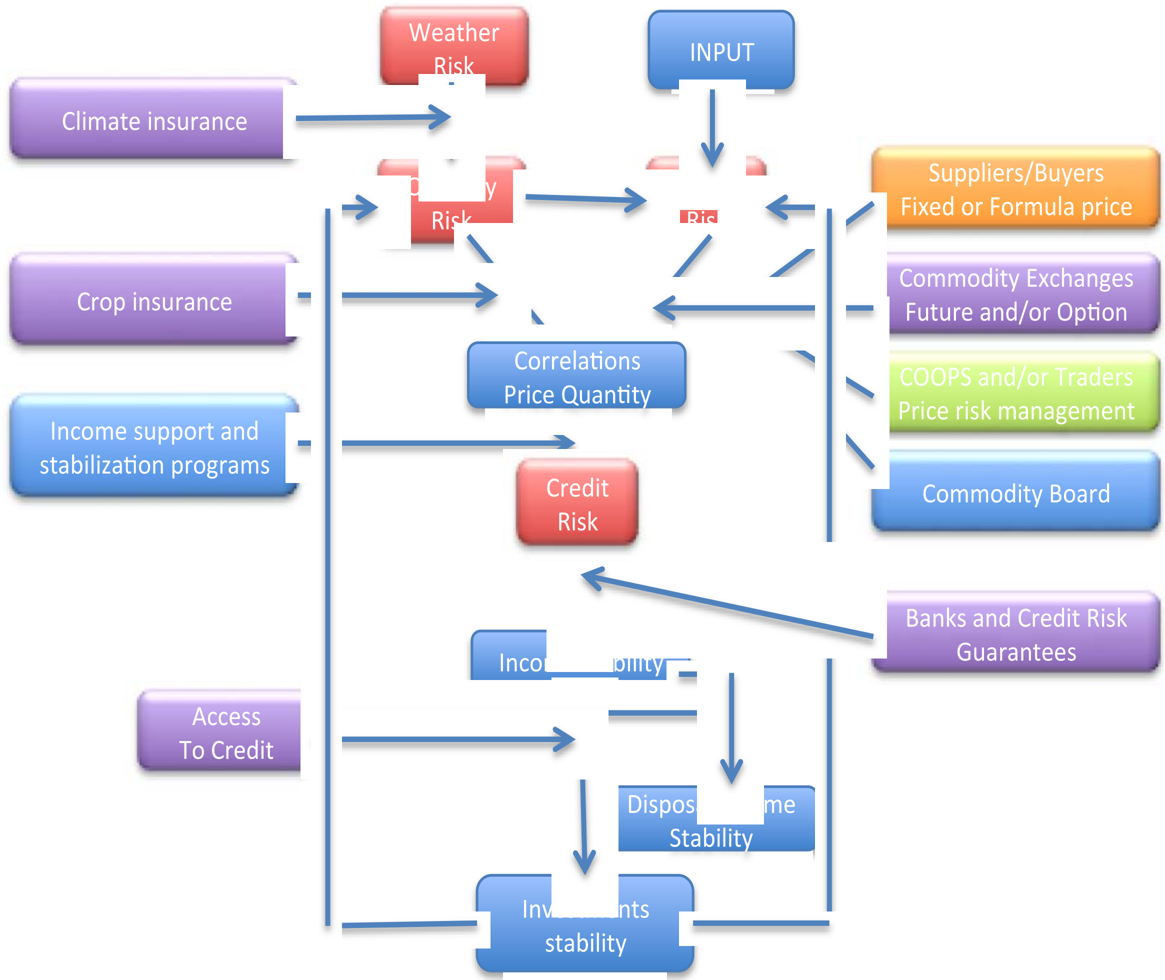
Stabilizing revenue is NOT ONLY getting a better price than the average annual market price

- **Clear view of your targets and of what it implies**
- **Access to funding** for physical infrastructures (road, storage capacity…)
- A good **understanding of commodities economics** and interactions with production input and other commodities
- Access to financial market for **educated traders** with capacity to trade volatility through physical/future « basis » trade, maturity, quality and geographical arbitrage
- **Strong risk management process and reporting**



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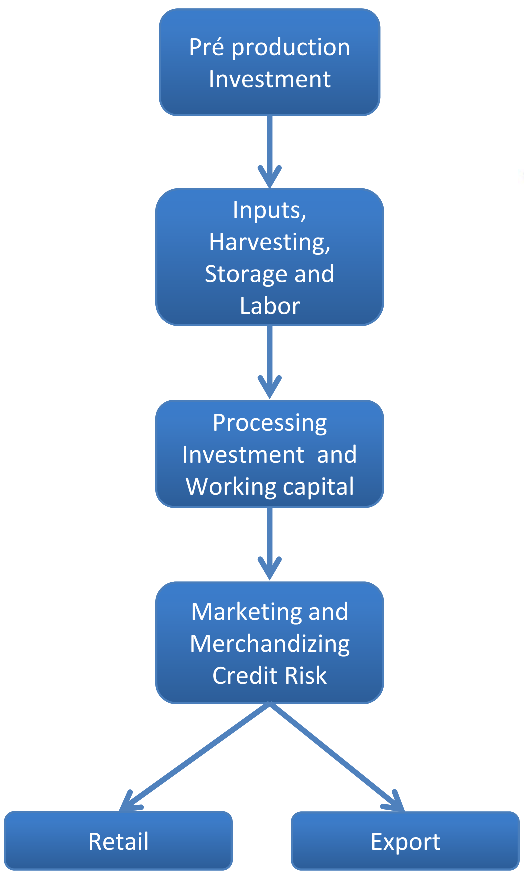
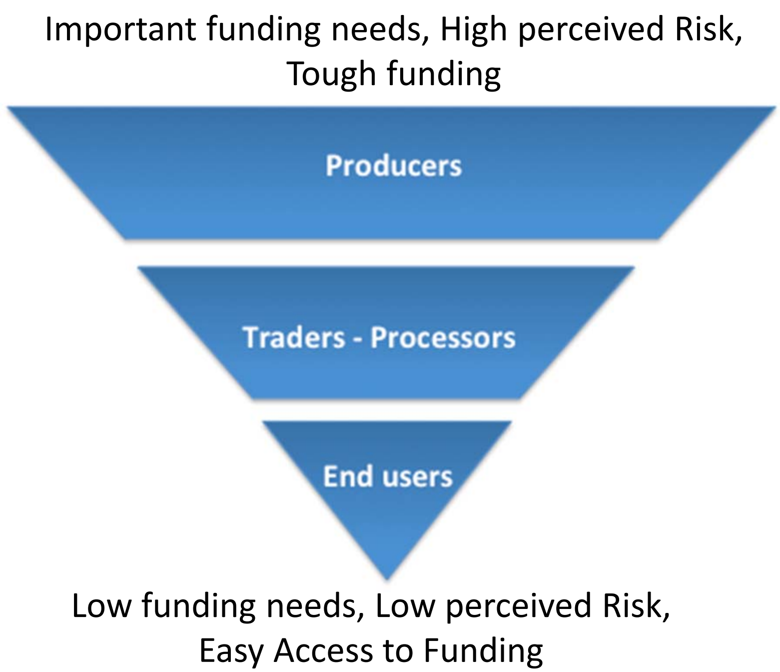
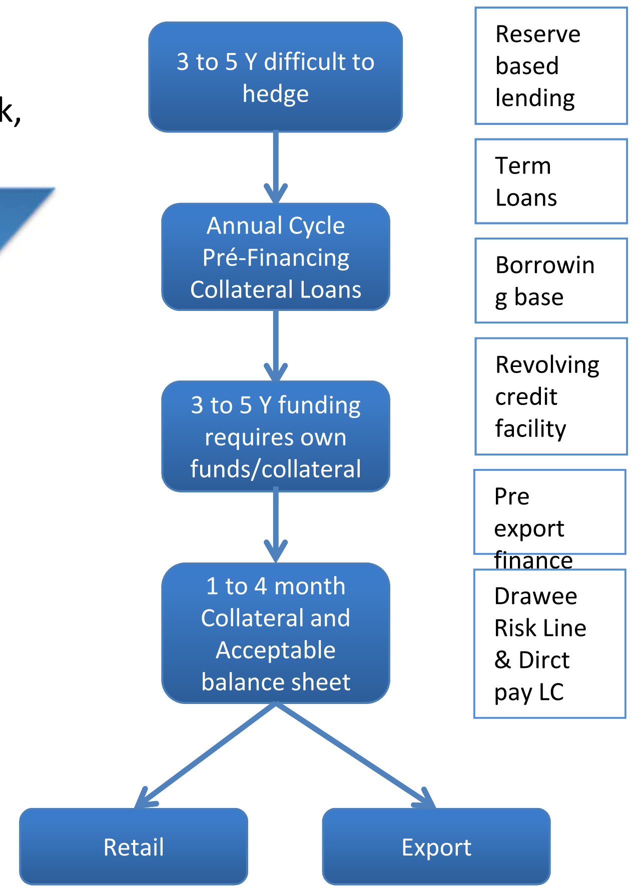
How to fund the transactional risks ?

- **Commodity Value Chain to Finance**
- **Commodity Finance & Risk Management**





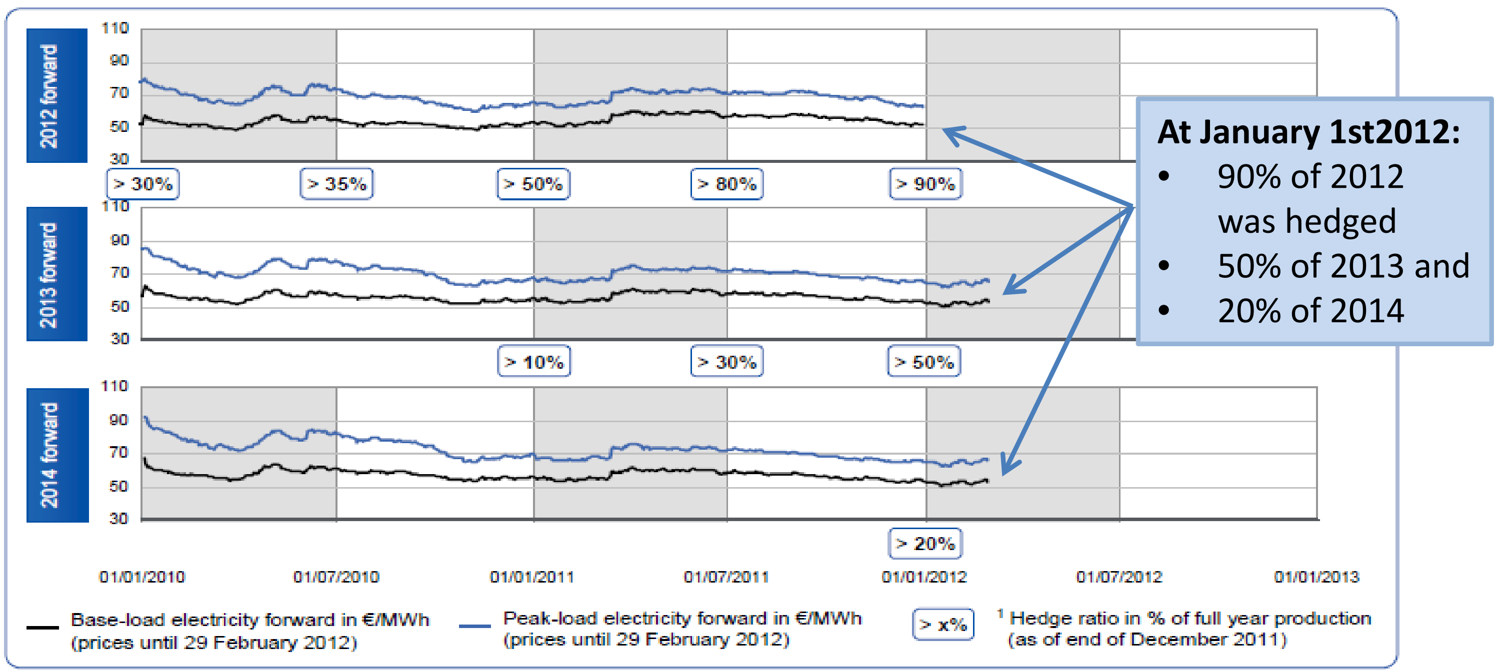


How to smooth Long term revenues?

- One way is to use derivatives to hedge, over a three years hedging program, the INPUT and the OUTPUT. Utilities in Europe are frequently using this type of technics for managing their margin (CSS)

Forward selling[1] by RWE Power in the German market

(Base-load & peak-load forwards in €/MWh)



(Average realised price for 2011: €63/MWh (2010: €67/MWh)).

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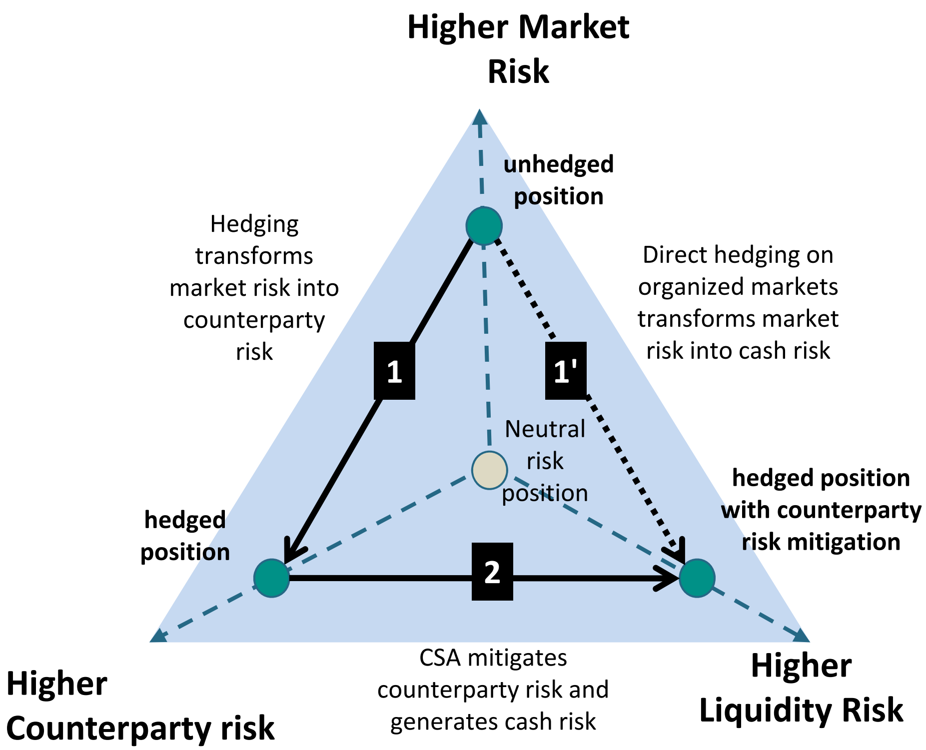
Provided you have the infrastructures and the people you can hedge but some constraints remain

Hedging constraints



Market risk vs counterparty risk vs liquidity risk

- **Market risk hedging policies should not be subject to any trade off with counterparty risk (as long as hedging is viable[1])**
- **Unless liquidity becomes an issue, counterparty risk should be mitigated**, with Margining Agreements (CSA) if necessary or deals on organized markets
- Other counterparty risk mitigation tools should always be considered, in particular: selecting highly rated counterparties, ensuring diversification…
- **Liquidity vs. counterparty risk trade off should be regularly assessed and consolidated through an iterative process :**

a. Assess needs for additional desired collateralization applying an adequate stress scenario

b. All liquidity needs have to be consolidated

c. If the impact is acceptable, an ad hoc Risk Committee authorizes the implementation of the desired collateralization
If not, the ad hoc Risk Committee has to make an arbitrage

1) e.g.: for countries with illiquid markets and a little number of low creditworthiness counterparties, hedging is not viable

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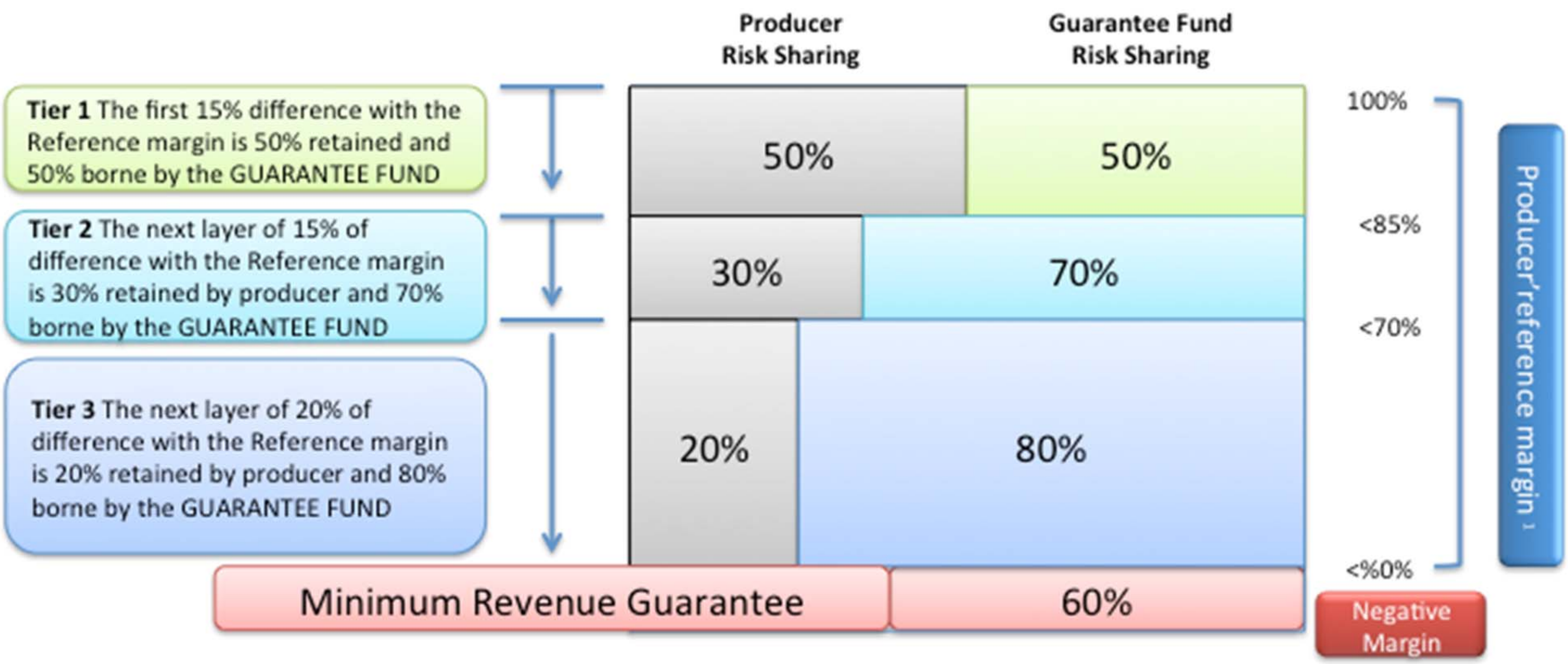
Now let's have a dream to protect producers revenue and make the environment safer and more reliable ?



- The programme largely inspired by Canadian programme could probably be funded X% by the International community (including NGO), Y% by Governments and Z% by Producers themselves
- It obviously implies Governance, accountability, accounting and infrastructures

1 three-year, moving-average net income taken out of the last 5years with the top and bottom years discarded

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