Financial Writing / Thought Leadership
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Managing commodity price risk

Stable pricing can make a world of difference

Commodities can be a significant driver of a company's revenues or costs. Yet, given their volatility, they also pose a substantial risk. Unexpected price swings can negatively impact both your budgets and bottom line. How can you minimize your risk exposure? If you own a business that buys or sells meaningful amounts of commodities, such as fuel, metals or agricultural products, you could benefit from a sound hedging strategy to stabilize your commodity prices.

Price stability

Hedging to protect your gross margins from wild or inconsistent price swings requires separating the physical commodity from the price risk. Your company will still purchase physical materials in the same manner; however, it will simply enter into a financial hedge alongside the physical purchases, or sales.

The hedge enables you to buy a commodity at a fixed (hedged) price over a designated time period. At the end of each month, based on where the commodity index settles, you will either receive or make a payment to settle at your hedged price. When the index increases beyond the set price, you will be paid the difference. When the index is less than the hedged price, you will pay the difference; yet you will realize a lower price in that period for your monthly physical purchase.

Some businesses – such as those with transportation costs – may find it more difficult to withstand price spikes in commodities that they can't easily pass along to customers. A company that burns through 100,000 gallons of diesel per month and can't risk a 50-cent price increase, for example, can hedge the diesel price to offset any price change on the diesel index for a chosen time period.

Understanding price risk

Defining the price risk your business can bear is critical to hedging effectively. Recall the last time a commodity's price increase affected your ability to pass along cost to customers. This will help you identify an effective pricing threshold at which you should hedge.

When determining whether to hedge, be honest about the maximum price increase your company can absorb. Specify exactly how much of the increase you can pass along to customers, and ensure you are hedging enough to protect your company's margins. Setting your price will help you consistently execute against your business strategy with a budget that reflects both the set commodity price and its duration.

Determining your strategy

A sound hedging strategy will typically extend 24 to 36 months. This "rolling hedge horizon," moving from one 24- or 36-month hedge to the next, allows companies to average out the dollar cost and mitigate volatility in commodity pricing. You may decide to hedge 75 percent of your commodities spend over the first six months of the year and taper down gradually. Over time, continue to add layers (percentage of spend hedged, duration, price thresholds, etc.) and execute your strategy with discipline. If you determine the price risk exposure is large enough to hedge, then be consistent with your hedging program. Do not stop and start a program or attempt to time the price movement.

Conduct an annual review, checking to ensure your exposure to pricing volatility has not changed based on your set price threshold. Verify that both your contracts for the buying and selling of commodities and your price risks are the same, and check to see whether budget line items have changed. Confirm that your strategy is in line with your risk exposure. Hedging is good insurance. It can help you become much more thoughtful and disciplined about your exposure to pricing volatility and develop a strategy to reduce that risk.