# Setting Up a Commodity Risk Management Program

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## I. Introduction

For companies where raw materials are a significant portion of their cost structure, the volatile nature of commodity prices can present challenges to running the business and meeting financial targets. A successful commodity risk management program helps a company manage their margins and reduces the impact from commodity price volatility. Key steps in the commodity risk management process include:

- Determining your business needs
- Identifying and quantifying your risk from commodity prices
- Developing a structured process for establishing and executing hedging strategies
- Focusing on margin management
- Ensuring policies and procedures are robust

In basic terms, commodity risk management means managing your margins. This is for both sellers (e.g. farmers) and buyers (e.g. food companies). You project or budget what your costs will be along with your revenue. Hopefully, that results in a positive margin. You then use hedging tools to lock-in that margin or manage it to remain profitable. Risk management is not speculating and should not be considered a profit center. In fact, not using risk management is speculative.

| Establish a Process Framework | Define Commodity Risk Profile | Develop Hedging Strategies | Review and Refine Strategies |
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| • Objectives<br>• Policy<br>• Standard operating procedures<br>• Roles and responsibilities | • Exposure and risk tolerance<br>• Commodity price pass-through<br>• Business impacts | • Market outlook<br>• Scenarios and strategy<br>• Tool selection<br>• Choose a strategy that is consistent with program objectives | • Key Performance Indicators<br>• Tracking reports<br>• Refine over time |

## II. Process Framework

A structured process is used to establish and implement a commodity risk management program. First, develop a process framework and define your commodity risk profile. A best practice is to establish a risk management philosophy and guiding principles that will help you in your decision making.

Given the large amount of financial risk exposure from commodities, hedging activity needs to be governed by robust policies and procedures. A commodity hedging policy can serve as the framework for the definition, measurement, and reporting of price-risks related to commodity hedging activity. Additionally, standard operating procedures are developed for each process step. The commodity hedging policy should contain the following:

- Define the scope of the hedging program
- Provide management oversight
- Establish approved strategies and tools
- Ensure proper controls and accounting
- Track, report, and measure hedging strategies and outcomes

### Risk Profile

Some companies have adequate financial resources to withstand negative impacts from commodity cost movements. Those companies may choose not to hedge their costs and speculate on the eventual outcome. However, publicly traded companies, companies with more leverage, or ones with strict financial targets often opt to utilize a variety of risk management strategies to manage their margins. Margin risk depends on the ability to pass through commodity cost changes to customers. More coverage should be taken on inputs that cannot pass on cost changes and less coverage should be taken for inputs that can pass on cost changes.

### Developing Hedging Strategies

Once the risk profile is defined, risk management strategies should be tailored to fit your risk profile. The market outlook will help determine how aggressive your strategy should be as they can vary when markets are moving up or down. There are a variety of tools to choose from to execute your strategy – futures, options, forward contracts, swaps, inventory, etc. Each tool has pro’s and con’s, so it is important to fully understand how each tool is used and what the expected outcomes are under different market outcomes.

### Review and Refine Strategies

On an on-going basis, hedging strategies are developed and executed with periodic review and refinement. One common failing of companies is to go back and measure how successful the hedge was. A best practice is to develop Key Performance Indicators (KPI’s) to determine what “good” looks like for commodity risk management. In addition, business needs and market conditions change over time, so the overall strategy and hedging philosophy should be reviewed on a regular basis to ensure it is meeting the objectives.

## III. Summary

For agricultural commodities, and dairy commodities specifically, the raw materials can represent a large portion of the cost of goods. Therefore, it is important to have a strategy for how to manage the price/cost volatility to protect your margins. A best practice is to establish a risk management philosophy and guiding principles that will help you in your decision making. The objectives of risk management need to be aligned with company goals and senior management should agree to the objectives of the risk management program. Given the large amount of money in play, policies, controls, and standard operating procedures should be developed as part of a structured process. It is also important to maintain discipline in executing risk management strategies. When needed, you should work with experienced professionals. Finally, risk management is not speculating and should not be considered a profit center. In fact, not using risk management is speculative.

## IV. References and Additional Information

For more information, contact:
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Other resources:

CME Group Dairy Homepage
http://www.cmegroup.com/trading/agricultural/#dairy

CME Group – Introduction to Dairy Futures and Options
http://www.cmegroup.com/trading/agricultural/dairy-futures-and-options-brochure.html