Copper: managing price risk

Perspectives *is an occasional section to present notable information about companies that may be directly or indirectly related to the wire and cable industry. If your company has information that it believes should be included, send an e-mail explaining why to editorial@wirenet.org.*

Commodities have gone through unprecedented price volatility in recent years, and one product that has been subject to especially violent swings is copper, a staple of the wire and cable industry. In just the past nine months, copper has soared to record highs only to plummet to multi-year lows. That yo-yoing effect has put more than one company out of business and has figuratively changed the definition of inventory from "stock on hand" to "potential nightmare."

John E. Gross

Why the sudden reversals? There is more than one factor, from fundamental considerations and changes in foreign exchange rates to speculative influences as well as our overall perception of future economic conditions. Thus, it comes as no surprise that many organizations feel that they are at the mercy of the markets, with little or no control over metal prices or the damaging impact upon their business. That may be true in that no one person or company can control the price of copper, but there are tools available that can help you manage price risk and prevent your business from becoming another statistic of turbulent times.

The first step is to clearly define the risk your company faces. Is it the difference between the price you pay for metal and your selling price, or do you make the sale first and then buy the metal necessary to fill the order? Do you have to quote on a long-term project with firm metal prices and wait some period of time before learning that you were awarded the business? Or, is it the valuation of inventories that poses the risk? Each of these scenarios raises a different element of risk, but each one also has a solution to managing and controlling that risk.

In the world of commodities, there are two terms of paramount importance that are all too often either confused, or misunderstood: hedging and speculating. The dictionary defines hedging as "protecting oneself from losses in market fluctuations with a counterbalancing transaction." Speculating, on the other hand, is defined as "buying or selling in the expectation of profiting from market fluctuations." Clearly, these are two very different approaches to the market, and should be treated as such. For our purposes here, the focus is on hedging and how it can work for you.

The most basic form of hedging is to buy and sell a physical commodity like copper on a "back to back" basis. For example, a wire and cable manufacturer may agree with a customer that the base price of copper contained in a product will be the market price on a specific day. Correspondingly, the manufacturer will buy copper from their supplier on that same basis. Thus, there is neither a gain nor loss on the price of copper, and the margin that is built into the selling price is protected. In the normal course of business though, there are many other variables that may prevent such a transaction from occurring, thereby necessitating a different approach.

Within North America, the vast majority of copper related transactions are based upon trading on the New York Commodity Exchange (Comex) with the official daily closing, or settlement price recognized as a benchmark for the industry. Futures markets such as Comex serve many purposes. First and foremost, it is the arena of price discovery, as buyers and sellers transact their business, with the resulting prices communicated to the market at large. The futures market is also the vehicle that enables one to offset, or hedge price risk exposure.

For example, assume that a manufacturing company had the opportunity today to sell its product at a firm price, with delivery six months into the future, but had not yet purchased the copper to make the product. To avoid the risk of paying a potentially higher price when they purchase the physical copper, they could instead place an order to buy copper in the futures market as an offset to the sale. When the time comes to buy the physical metal, they would correspondingly sell the futures position. Thus, regardless of whether prices rose or fell, the profit on their product was protected. There is a cost for buying the futures, of course, but it is minimal, likely less than 1-2 percent of the total copper cost, and a company many find that it is well worth the elimination of the potential risk if prices spike.

From another point of view, let's take a look at a utility that is doing its planning and budgeting for the upcoming year. For planning purposes, the utility can look at prices for 2010 today, and see that for the full year, the average price of copper is about $1.75 per pound. The utility has a good estimate of its wire and cable requirements for 2010, as well as transformer and hardware needs. What it doesn't know, however, is who it will be buying from, or precisely when it will be taking delivery. The one thing it does know is that it wants to stay within budget, and therefore must control future costs.

To achieve this objective, the utility can buy, or lock in

Wild changes in copper prices in 2008 made for the best and worst of times for some wire and cable producers.

copper prices on the futures market today for 2010, and be assured that its budget requirements will be met. When the time comes to place the orders for delivery and to agree with its suppliers on metal pricing, the futures market position will be sold at the then-current market price. Thus, the combination of the futures transaction, coupled with the physical purchase price, will comprise the total cost of copper, in line with expectations, regardless of where the price is in 2010.

There are other scenarios where hedging can help. Companies typically must maintain some level of inventory to support their business. During the first half of 2008, copper averaged $3.67 on Comex. Thus, many companies were holding inventories with historically high valuations. If management was concerned about a decline in prices, they had the opportunity to sell copper in the futures market, and thereby offset, or negate the potential of losses from falling prices.

So, the reality is that while any company that buys copper can—and likely will—face risks from price swings, there are just as many solutions and tools available to mitigate the exposure. Doing nothing and hoping the market will work in your favor is not part of a prudent business plan. A cable manufacturer should focus on its business, not worrying about the copper market, which is why a well-planned hedging program is a valuable tool.

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Editor's note: John E. Gross will be a panelist on a one-hour WAI webinar on June 3 that will focus on the risks of volatile copper prices and how companies can avoid them. *See p. 30 for more details.*