› Copper—Managing Price Risk Protects Profitability

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As you know only too well, the past several years have seen unprecedented price volatility for all commodities, with copper in particular subject to violent swings.

Many factors contribute to these sudden reversals, including fundamental considerations, changes in foreign exchange rates, speculative influences, and the overall perception of future economic conditions. It comes as no surprise that many organizations feel they are at the mercy of the markets, with little or no control over metal prices, or the damaging impact upon their business.

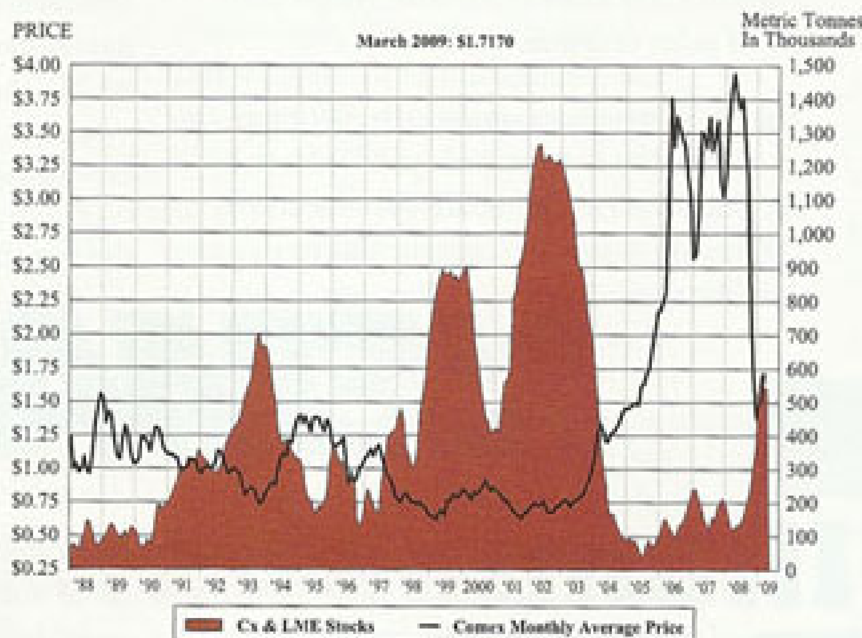
While it is true that no one can control the price of copper, there are nevertheless many tools available that can help you manage price risk, and enable your organization to prosper during turbulent times.

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 words of paramount importance that all too often are 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 manufacturing company may agree with their customers 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 its 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 a back to back transaction from occurring, thereby necessitating a different approach.

Within North America, the vast majority of copper-related transactions are based on the New York Commodity Exchange, or Comex, with the official daily closing, or settlement price, recognized as a benchmark for the industry. Futures markets such as Comex serve many purposes. Primarily, however, it is the arena of price discovery. The futures market is also the vehicle that enables one to offset, or hedge, price-risk exposure.



Copper Price & Inventory Comparison
January 1988 - March 2009
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For example, assume that a manufacturing company had the opportunity today to sell its product at a firm price, with delivery six months in the future, but had not yet purchased the copper necessary to make the product. To avoid the risk of paying a potentially higher price when it purchases the physical copper, the company 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, it would correspondingly sell the futures position. Thus, regardless of whether prices rose or fell, the profit on the product would be protected.

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 does have 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 the utility does know, however, 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, 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 orders for delivery and agree with its suppliers on metal pricing, the futures market position will be sold at the then-current market price. Hence, 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.

Companies typically must maintain some level of inventory to support their businesses. During the first half of 2008, copper averaged $3.67 on Comex. Consequently, many companies were holding inventories with historically high valuations. This brings us to yet another example. If management had been concerned about a decline in prices, it would have had the opportunity to sell copper in the futures market, and thereby offset, or negate, the potential of losses from falling prices.

Although there are any number of situations that can expose a company to price risk, there are just as many solutions and tools available to mitigate the exposure. When properly employed, hedging can protect your profitability, and enable you to focus more time on running the business, and less time worrying about the market.