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## Disclosure Strategies for Hedging Programs

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Energy executives today are faced with an unprecedented combination of economic risks and uncertainty. Exposure to commodity price volatility adds another layer of risk to an already uncertain environment, and companies need to find ways to mitigate this risk. Hedging remains a tool companies can use to manage price risk, reduce budgetary uncertainty, and enhance working capital and liquidity management.

Although the reasons behind hedging are clear to the company, they are often less so to investors and stakeholders. Recent changes to accounting rules and investor communication are now addressing this need for increased transparency. For example, SFAS 161 now requires companies to disclose “how and why an entity uses derivative instruments.” Companies paying little attention to SFAS 161 would do well to study the negative effects of poor hedge program communication practiced by Asian airlines in 2008 and 2009. These companies provided minimal disclosures behind their derivative strategies and were therefore poorly rewarded when the hedges were offsetting fuel losses. When the market turned, investors discounted prior successes, focused very heavily on billion-dollar hedge losses, and heavily punished the airlines in the equity markets.

When designing disclosures to satisfy increasing calls for transparency, companies should bear three principles in mind:

1. Risk management cannot be successful without clearly-defined and understandable objectives;
2. Transparency in risk management practices will provide more value to a firm than applying best-in-class practices without purpose or understanding;
3. Effective financial statement disclosures should reflect a hedge program’s clearly-defined objectives (item 1) as well as management’s understanding of the hedge program’s value to investors (item 2).

### Applying Transparency to Hedging Approaches

An effective hedging program can help prevent significant losses, margin compression, and, ultimately, bankruptcy. However, it does not work without proper communication. In some cases, companies may not even consider implementing a hedging system for fear that communication gaps with management, board members, or investors could result in second-guessing. Companies have even hesitated to implement hedging programs because of concerns that investors may punish them if they depart from perceived industry norms.

Effective hedging programs are built on a strong understanding and communication of underlying risks, relevant hedging strategies, available tools, and associated valuation and reporting requirements. This includes investor communication, proper disclosure, and coordination between risk-management, procurement, sales, and operating groups. These items are often addressed in terms of hedging purpose, program risks, and corporate coordination.

**Hedging Purpose:** In the traditional discussion of risk, hedging was done for margin protection, volatility reduction, M&A or debt requirement, and to focus on the core business by eliminating non-core risks. Hedging was also done to provide strategic product pricing and service offerings. More transparent approaches clearly show hedging goals and strategies related to bankruptcy protection, protection of working capital, protection of liquidity, and managing a fluctuating dollar against import and offshoring strategies.

**Hedge Program Risks:** Traditional hedge program risks included the negative perception of trading and risk management, use of inappropriate or unapproved derivatives, poor execution, accounting issues, and timing of earnings. Additionally, intellectual property and skills availability occasionally hindered the development of hedge programs. More transparent approaches highlight risks related to significant risk of divergent practices within an industry, as companies approach the market in new manners and “standard practice” becomes harder to identify. There can also be additional risks associated with counterparty credit, margin and collateral increases, exposure to speculative interest, capital flight to offshore exchanges, GAAP to IFRS conversion issues, and insufficient monitoring in volatile markets. All of these risks will become more transparent to investors and stakeholders through SFAS 161’s enhanced disclosure requirements and supplemental material.

**Corporate Coordination:** The traditional discussion around corporate coordination for a hedging program focused on finance and treasury as well as accounting. Transparent hedge programs should now include discussion of transactions in purchasing, finance, and treasury; monitoring, which includes credit and accounting; managing, which includes planning and sales; and communication, which includes corporate social responsibility (CSR) reporting and executive level communications. SFAS 161 has placed an even higher premium on corporate coordination as financial statements must now disclose “how and why” a company is hedging, in addition to the hedge program’s financial results.

### **Elements of a Transparent Hedging Program**

The traditional elements of a hedging program were strategy and control. Companies were concerned with identifying and measuring commodity risks based on defined qualitative and quantitative metrics. Companies also sought to establish hedge strategies to treat critical risks in accordance with company tolerances and goals. They developed and implemented governance, risk reporting and continuous monitoring programs to oversee risk mitigation and optimization activities.

While all these elements remain important, communications have emerged as a key element in the success of a hedging program. It is no longer sufficient to have a program that works—companies need to explain why it works, what its goals are, and how it contributes to firm value over long periods. In addition to covering SFAS 161 requirements, external communications may help shape a company’s reputation as either a responsible fiduciary and community steward or as an undisciplined speculator. External communications should include investors and analysts, non-investor stakeholders, governments, and rating agencies.

- **Investors and Analysts:** Under SFAS 161, companies are now required to disclose how and why the company uses derivatives, including the objectives for using those instruments, context needed to understand those objectives, and strategies for achieving them. To be truly transparent, companies should also communicate what its hedging expectations are for both the long-term and the short-term, which hedging controls are in place, and what the company’s skill set is. Most importantly, the company should convey the long-term value of hedging as opposed to quarterly or even annual results that may place an undue focus on temporary market trends at the expense of multi-year risk management goals, metrics, and successes.
- **Non-investor stakeholders:** A company should include its hedging and commodity risk management program in its CSR reporting process. This reporting would include how much hedging takes place for reasons other than profitability, such as hedging against inflation for low-

- income food programs, maintaining reasonable consumer fares, and reducing downsizing and outsourcing.
- **Ratings Agencies:** Companies should know and communicate the interplay between debt covenants, credit thresholds, liquidity, and derivative positions. Companies should comply with rating agency expectations regarding risk management in order to avoid putting their credit rating at unnecessary risk.

## **Conclusion**

Faced with heightened volatility in both the commodity and credit markets, corporate stakeholders are paying greater scrutiny to decisions related to hedging. At the same time SFAS 161 is requiring greater hedge program transparency, energy and financial market regulators are increasing their oversight roles and plan to introduce additional regulatory reporting requirements. Add to this a reduction in access to capital, and hedging has become not only a more critical business need, but one that is more expensive. Poorly supported and communicated hedging decisions will now be more visible and their impact on a company more pronounced. Now is the time for management to ensure the performance of the hedge program is truly aligned with the strategy of the company and presents a compelling risk management story when disclosed in full detail.

### ***About Eco Risk Markets LLC***

*Eco+Risk is a private firm which specializes in helping companies manage their commodity fuels expenditures. They have worked with leading companies to establish a practical approach to managing the risks surrounding commodity price volatility through the execution of consistent, efficient and well-communicated hedge programs. They have also taken this approach to the next logical step and integrated overall energy price management with their client's renewable fuels and sustainability initiatives.*

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