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Actively managing commodity risk for competitive advantage

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Introduction

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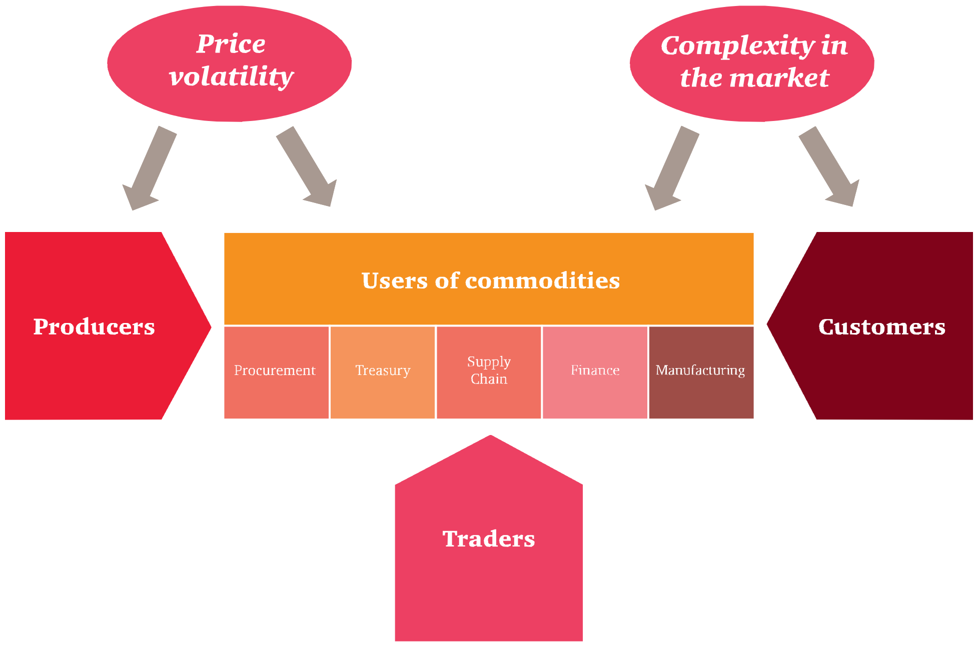
Users of commodities face being squeezed from multiple directions



- How should a user organisation respond?
- What is the right strategy?
- How is the strategy implemented?
- How do the various stakeholders collectively agree a way forward?

In setting up or re-reviewing CRM capabilities there are a number of considerations companies should be aware of to be successful

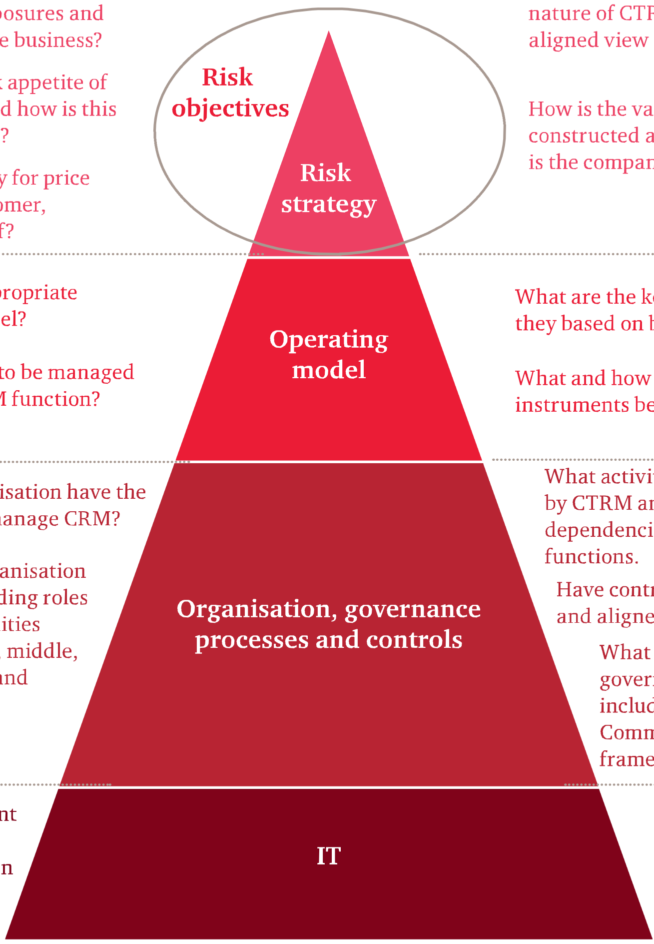
What is the underlying commodity exposures and the effect on the business?

What is the risk appetite of the business and how is this to be measured?

Who should pay for price changes – customer, producer or self?

Given cross functional nature of CTRM is there an aligned view on risk.

How is the value chain constructed and what risks is the company exposed to?



What is the appropriate Operating Model?

What risks are to be managed within the CRM function?

What are the key KPI's – are they based on budget rates?

What and how will financial instruments be used?

Does the organisation have the right skills to manage CRM?

What is the organisation structure including roles and responsibilities (includes front, middle, back, risk, IT) and location.

What activities will be owned by CTRM and are there dependencies on other functions.

Have controls been mapped and aligned to the system?

What is the ongoing governance process including Policy, CTRM Committee, reporting framework.

Given significant investment has IT resource been build into the project.

What are the business requirements for IT?

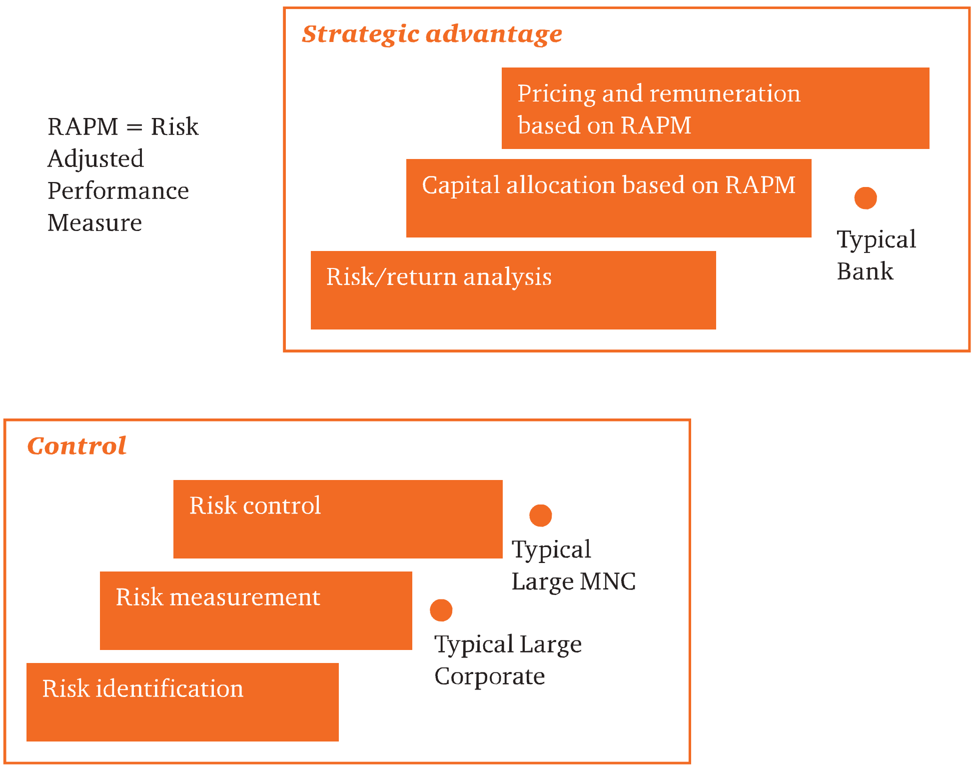
Is the system to be developed using existing ERP, bespoke, best of breed or in house?

Considerations for setting CRM objectives and strategy

2

Discussion: Should companies use a risk based approach to protect their operating margin or to actively enhance it?

RAPM = Risk Adjusted Performance Measure



Discussion: Should companies use a risk based approach to protect their operating margin or to actively enhance it?

Security of supply

- Improve supplier relationship and employ a more collaborative approach
- Flexibility of supply source (global options) to meet long term requirements
- Possibility of vertical integration

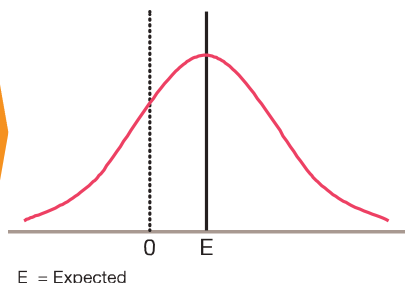
Sustainability of supply

- Regularise assessment of supply chain for business sustainability
- Explore alternative raw material/ specification to manage supply side risks
- Build flexibility and reliability into the supply chain to adjust with changing market

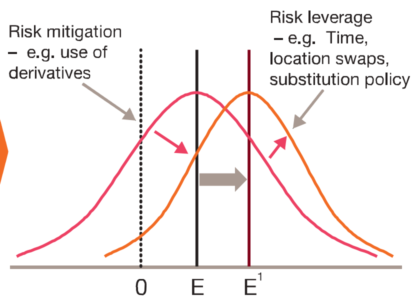
Use a risk based approach

- Better analytics, supply chain insights, improve demand forecast, contract terms
- Build long term strategy for transferring price risks – risk sharing with customers, suppliers
- Employ appropriate hedging strategies to reduce price uncertainties or use risk leverage

A: Profit distribution (applying a probability lens)



B: Impact of risk management on profit distribution (and hence on expected profits)



A key step for companies is to align any differing views on risk appetite across functions

Discussion: Should companies use a risk based approach to protect their operating margin or to actively enhance it?

What is the end state for users? – currently trend is from federated to enterprise….

Model

Federated risk management

- CRM responsibility embedded in local business operations
- Limited global view of commodity risks
- Focus on risk transfer and avoidance (e.g. fixed price supply contracts)

Enterprise risk management

- Leverage scale with aggregated view of risks across all businesses
- Risk appetite developed with focus on risk mitigation
- Use of financial instruments although limited. Hedge accounting likely to be key
- Centralized/ co-ordinated approach to risk management

Best margin risk management

- Risk based approach to achieve best procurement cost and best margin
- Real-time optimization of physical supplies, logistics and inventories.
- Use of sophisticated techniques including option strategies, substitution
- Use of appropriate quantitative anlaysis
- Sophisticated system capabilities aimed at providing market intelligence

Trading risk management

- Risk based approach to Supply, Trading and proprietary books with capital allocation
- Full front, middle and back office capabilities enhanced with commodity risk management systems (packages and bespoke)
- Sophisticated modelling and product control techniques to enhance market positions
- Strong compliance, tax and accounting capabilities to meet regulatory demands

Focus

Federated risk management	Enterprise risk management	Best margin risk management	Trading risk management
Traditional procurement role	*Employing risk mitigation within procurement*	*Improving margin through risk leverage*	*Trading becomes a source of profit in its own right*

Discussion: Should companies use a risk based approach to protect their operating margin or to actively enhance it?

Example of incorporating a risk based approach in the business planning process.

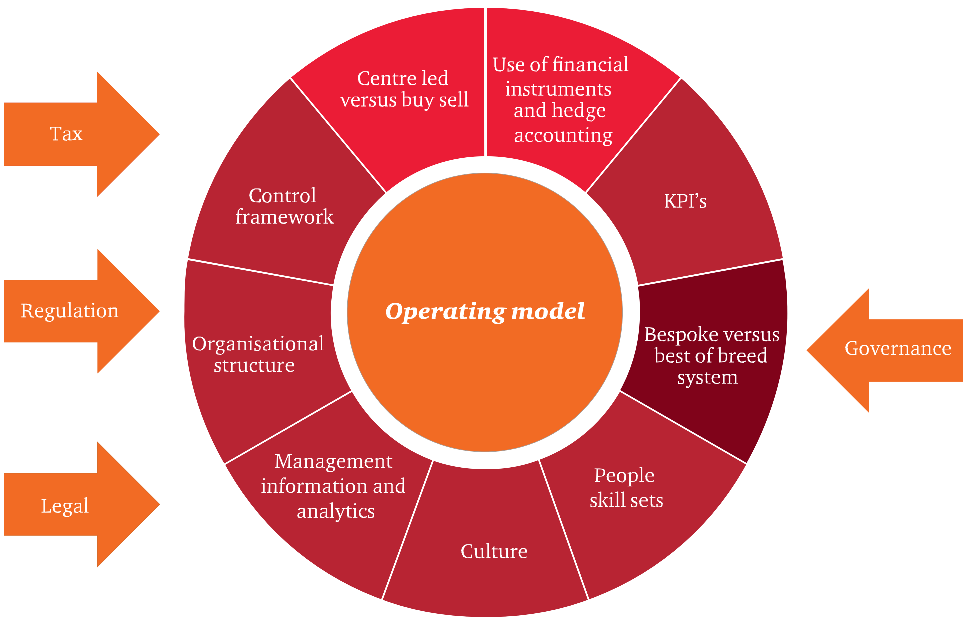
- **BOARD supported by EXEC considers the business environment (under scenarios), the current state of the business incl. its financial position and risk capacity. The BOARD then determines first cut (qualitative) risk tolerance and financial objectives for the new year.**
  e.g. T ll reasonable steps to maintain last year's profit of $90 M
  e.g. Grow last year's profit of $90 M but will accept some (quantified) downside risk
- **EXEC then develops related (more quantitative) first cut guiding risk appetite statements (RAS) related to the objectives.**
  e.g. Profit target is $ 90 M within a range of $85 and $95 M
  e.g. Profit target is $100 M within a range of $80 M and $110 M
- **BUSINESS then develops possible strategies to meet those risked objectives and considers a number of key business and risk factors.**
  e.g. The key drivers for profit and related interdependencies together with the available financial, procurement, processing & marketing profit management levers.
  e.g. The key related financial, business and operational risks that could impact on profit.
  e.g. The impact of commodity price volatility on profit, the extent of internal price risk diversification across the business and the extent to which price risks be shared with suppliers or customers
  e.g. The extent to which the commodity exposure profile can be modified using financial instruments within the stated risk tolerance and risk appetite statements or through risk leverage (e.g. trading around areas of competitive advantage)

An interactive process with several cycles between Board, Exec and Business before statements, objectives and strategies are finalised.

Considerations for CRM operating model

3

Discussion: What are the key operational considerations in setting up commodity capabilities?



Companies need strong project governance to manage the many considerations when setting up capability

Closing messages

4

Given market dynamics there is a strong case for users of commodities to establish or enhance CRM capabilities

- *Commodity risk is emerging as a critical differentiator of business performance, driven by a number of key trends including commodity price volatility and an increase in the **complexity of commodity markets**.*
- *This price volatility and market complexity is the 'new normal' and has major implications for business performance.*
- *We see users of commodities especially within retail and consumer and industrial products being more active in their management of risk but note there is still a significant journey for most companies if they want to create capability which is able to add value to the business.*
- *As companies look to improve their CRM capability it is imperative to align all stakeholders across Finance, Treasury and Procurement given the potential divergence of objectives these functions will have.*

Your PwC contacts

Paul Ward

Partner
UK Commodity Lead
+44 (0) 7739 874690

Alpesh Shah

Director
Commodity Modelling
+44 (0) 7956 664804

Nick James

Director
Commodity Risk – Strategy Expert
+61 (0) 438 511 007

David Stebbings

Director
Commodity Risk – Operating Model Expert
+44 (0) 7801 180018

Robert Waddington

Senior Manager
Commodity Operating Model Expert
+44 (0) 7720 430125

Konstantin Suplatov

Director
Commodity Risk – Operating Model Expert
+44 (0) 20 7213 1804

We have a global network of over 200 CTRM specialists who can bring insights and good practices to your CTRM challenges

Strategy

Risk appetite, Capital/asset allocation, T , Supply chain optimisation, Product design, Contract structuring.

Risk management

Risk analysis and models, Policy, Reporting, Valuation methods, Risk metrics and limits.

Governance and control

Product control, Fraud risk, Accountability and decision frameworks, Governance frameworks.

Operating model

Roles and responsibilities across the business, Organisation (including back/f t office structures), Location analysis, Entity structures, Book structures, Talent, Performance management f

Strategy and risk management

Operating model, governance and control

Technology, data and process

Accounting, tax and regulatory compliance

Technology and data

Data and systems architecture, Data modelling, Systems strategy, Package selection, implementation and review, Programme and change management.

Process

End to end process design, Documentation, Training, Lean/continuous improvement, Standards and delivery models.

Accounting

Accounting standards, Financial reporting, Audit.

Tax

Planning, Compliance and reporting, Indirect and direct tax structures, Personal tax.

Regulation

Compliance with European, US/DFA and Asian legislation.

Our CTRM team are drawn from a wide ranging background and include specialists with the following skills: Trading strategy, T , Product control, Risk management, Regulation, Accounting, Treasury management, T , Governance, Data and Technology, Assurance and Control.

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