Monitoring & Managing Commodity-Price Risk: The Panama Experience

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Agenda

1. Panama’s commodity exposure and risk
2. First steps towards executing hedging tactics
3. The development of a National Hydrocarbon Hedging Strategy
4. Future Prospects
5. Concluding Remarks
Panama’s commodity exposure and risk

The Republic of Panama is a net importer of oil and is vulnerable to sudden shocks in price.

- Approximately 46% of Panama’s electric energy depends on crude oil derivatives.
- Bunker “C” or Fuel-oil represents approximately 79% of the fuel consumed by Panama’s thermal power plants; the remaining plants use Light and Marine Diesel.
- On average, the demand for crude oil has grown 19% between 2005 and 2009.
- It is expected that transformative projects advanced by the Government such as the modernization of public transport and the development of new hydroelectric plants will lower the dependency of the Republic on fossil fuels.
Panama’s commodity exposure and risk

Central Government commodity-linked subsidies grew by 63.7% between 2007 and 2008.

- On average, electric energy subsidies have represented 23% of total fiscal incentives provided by the government.
- The spike of oil prices in 2008, evidenced the need of a concrete action plan to limit the increase in government transfers resulting from dramatic increases in the price of crude oil and its derivatives.
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First steps towards executing hedging tactics - 2009

To mitigate the risk of large swings in the price of Fuel-oil to the Republic, in December 2009, the Public Credit Directorate executed the first oil hedge in the history of the country.

- For eight of the twelve months of 2009, the call had a payout for the Republic. Net contributions to the Tariff Stabilization Fund were US$19.4 million after accounting from premium payments.
First steps towards executing hedging tactics

In 2009, Panamanians didn’t suffer an increase in their electric bill due to the implementation of the Hedge.

- The call was able to eliminate the fuel surcharge and stabilize the price of electricity for all citizens.
- This electricity price stability allowed for business to grow and prosper in the midst of a global financial crisis.

- Based on this experience, the Public Credit Directorate coordinated with other government agencies and presented to the Cabinet Council the country’s first National Strategy for Hedging Commodity Risk.
- This Strategy was assigned a budget for fiscal year 2010.
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The development of a National Hydrocarbon Hedging Strategy

The lessons learned during 2009 allowed for the strategy to be improved and adapted to the country’s needs.

- A rolling coverage strategy was implemented allowing for changes in the strike price and premiums payable resulting from drastic changes in the price of the underlying commodity.
- By selecting bimonthly settlement, Panama was able to reduce the premium slightly and increase or decrease the number of barrels covered per month.
A National Hydrocarbon Hedging Strategy - PROCESS

In addition to the Ministry of Economy and Finance (MEF), there was an active participation of other government agencies such as the regulator for electric services and the office of the Secretary of Energy which allowed for the alignment of the strategy’s objectives.

Legal
- Adapt the ISDA to the needs of the country
- Negotiate and sign the ISDA
- Design an RFP
- Select winning bidder
- Formalize through Cabinet Decree

Operative
- Design the Strategy
- Monitor the Market
- Execute the Strategy
- Barrels to cover – Regulator & Secretary of Energy
- Legal & Execution – MEF
- Selection of winning bidder – MEF
- Confirmation of bid and execution – All parties
A National Hydrocarbon Hedging Strategy - LEGAL

The Republic utilized a competitive process to negotiate a very beneficial ISDA for its strategy.

• **Unilateral Credit Support Annex (CSA)** – The Republic did not post guarantees. This is understandable given the nature of a call. However, the winning bank had to post guarantees prior to the call being effective virtually eliminating counterparty risk. This is not a market practice.

• All participants had virtually the same ISDA document, as the Republic worked along its legal counsels to harmonize them through a negotiation process. Those banks that were unwilling to comply were left out of the process.

• The documentation of the first transaction served as a basis for the documentation we would eventually use in our strategy.
A National Hydrocarbon Hedging Strategy – OPERATIVE ASPECTS

There are several execution risks associated with a hedging strategy.

• It is important to confirm prices prior to execution.

• In our second transaction, after proposals were presented and the evaluation process was completed, Investment Bank A was not able to maintain its price offered, which at the moment was the least expensive option for the Republic.

• This situation required the Republic to execute the transaction with the succeeding price offered, which was provided by JP Morgan Chase as firm offer at US$10.17 per barrel, including the cost for a performance bond as additional guarantee.

• Fuel-oil is not a liquid commodity. Using the wrong approach can cause the market to move against you.
A National Hydrocarbon Hedging Strategy - 2010

The rolling strategy is conducive to a more dynamic management of commodity risk including spreading out counterparty risk among different investment banks.

1st Phase Execution
Strike price: US$70/bbl
Premium: US$10.17/bbl
Counterparty: J.P. Morgan

2nd Phase Execution
Strike price: US$71/bbl
Premium: US$5.30/bbl
Counterparty: Barclay’s Capital
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Future Prospects and Expected Return to the Central Government

Given an average price for Fuel-oil of $80/bbl price the strategy is expected to produce savings in Central Government transfers of more than US$15 million.
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Concluding Remarks

The effectiveness of each hedging transaction must be measured against the stated objectives for which it was executed. From a Government’s perspective: A hedging strategy is meant to provide insurance not income.

• A hedging strategy must always have an objective in mind. In the case of Panama it was to eliminate the fuel surcharge on the electricity bill. This was accomplished by matching the strike price of the hedge with the price used by the regulator as a base for the price of electricity in any given semester.

• From the very beginning, Panama´s objective was centered on allowing the country’s businesses to remain competitive in the event of a rapid increase in the price of Fuel-oil used to produce 46% of the electricity in the country.

• The communication and synergies achieved between the Ministry of Economy and Finance, the National Authority for Public Services (regulating body), the office of the Secretary of Energy and the Office of the Comptroller General was a key element in the success of the program.

• The lessons learned from the first transaction executed for fiscal year 2009, allowed us to design a more flexible and adaptable strategy better suited to the needs of the country.
Concluding Remarks II

The effectiveness of each hedging transaction must be measured against the stated objectives for which it was executed. From a Government’s perspective: A hedging strategy is meant to provide insurance not income.

• The ability of the Central Government to better estimate the amount of subsidy transfers to the sector has allowed for a better planning of its resources under the General State Budget.

• There are several key factors that will determine the effectiveness of the strategy. These include:
  • Planing and designing a strategy based on the specific needs of your country. There is no one size fits all approach;
  • Prepare the appropriate documentation for the implementation of your strategy. This includes selecting and contracting a reliable and reputed legal advisor.
  • Monitoring and following-up on international market prices. This must be a daily exercise in the context of measuring the effectiveness of your strategy and assumptions;
  • Preparing for execution of a phase of the strategy will require constant market feedback from your counterparties. Maintain active dialogues with all your ISDA providers.
  • Identifying the right strategy means involving all relevant government agencies. Sometimes the right decision is to go unhedged or partially hedged. The local players know the market and they can provide invaluable feedback resulting in the assumption of calculated risks.
Thank You