# What to Do If Hedging Hasn't Fixed Your Unpredictable P&L

"Isn't our hedging supposed to solve this?" Each month-end stressed-out accountants sweat to explain your company's volatile P/L and risk reconciliations that show that the hedge results are failing to offset company exposures. No one can blame the futures brokers either – hedge transactions have been reconciled and were executed as specified. The problem must be somewhere else – possibly buried in the hedge targets or potentially in the reporting? The immediate task is to identify the glitches before bad information leads to faulty decisions.

It is not uncommon for deep-rooted operational issues to throw off risk calculations and confuse price risk management reporting. Hedge targets (created through the calculation of risk exposures) and reporting both crystalize at the end of a cumulative event chain. But it's Murphy's Law that processes involving diverse activities present ample opportunity for subterranean troubles to percolate into the numbers describing them. At the tail end "smoking guns" are hard to spot but to an experienced eye there are often patterns in the symptoms they create. These offer clues as to the where's, the who's and the how's buried in a myriad of company functions – and a thorough investigation will often shed light on more than one. Let's consider a few locations worthy of some exploration:

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CRMA and CRCI provide customized services to address all issues associated with price risk management. Across commodities David Waite and Michael Lockwood deliver risk management oversight and co-ordination, and research services to our clients. Simple precisely executed concepts are the foundation for our work and the basis of our contribution to our client's success. We listen to clients. We commit the full spectrum of our firms' resources to build custom-made solutions that meet our client's specific needs.

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**Plant/Operations:** Most managers don't even think to suspect their industrious production people. Their remit seems so distant from pricing but the price risk impact of their activity can manifest itself in very real ways. One problem deeply buried here lies in the plant's material balance. The culprit is estimation, used extensively in some balances, especially when material at risk transmutes through different physical and chemical forms from solid to solution. Estimates can impact risk activities through calculated inventories used for reconciliations, disguised plant losses or even inaccurate plant efficiency calculations. These can lead to adjustments to bring hedges in line with calculated inventories that are themselves inaccurate. Such issues can also quietly drive buy or sell side bias into risk calculations sending hedges steadily farther away from true course.

**Logistics:** Also overlooked with regularity are the people that control much of the flow for materials at risk, raw through refined, bulk through packaged, receiving and shipping, features of every operation. They hold the key to volumes and timing triggers, both critical to the tracking of risk exposure. Lax practices here, such as untimely information sharing or sloppy record keeping can translate to a constant flow of offsides, large to small, via volume adjustments and urgent past due physical pricings. At the reporting end, many of the problems here will appear as annoying financial "noise" in the hedge reconciliation. ERP-risk systems, geared to monitor such slippage, often reveal a surprising level of volatility emanating from this department.

**Commercial:** Chief among the suspects is generally the commercial team, both procurement and sales. Uninformed creativity and compromise built into sales and purchase contract terms, reinforced by performance measures that do not consider risk, yield results that do not blend well with the fundamentals of price risk management. We've seen a host of novel problems generated here. Hedge reconciliations at the reporting end often point to the impact of optionality in commercial terms such as unknown quantities, unknown timings and agreed cancellation rights.

**Accounting:** They say "don't shoot the messenger" but could it be that this group plays an active role in the financial volatility confusion too? Standard accounting practice does not make their lot an easy one as it can itself cause "apparent" volatility. Hedge accounting is meant to resolve such issues but the proofs it requires can be terrifically burdensome. Hence, it is sidestepped by many and is unfamiliar to the majority of accountants in small to medium-size operations. A confused definition of price risk is a surprisingly common and simple sign of an existing problem here.

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**Line Management:** At the risk of undesirable career consequences this group cannot be overlooked. The structures and processes they define can contribute significantly to problems. Organic growth, lack of understanding and an underestimation of risk consequences are generally the root causes. Indications of management-based trouble include ill-formed hedge targets caused by poor information flow between departments with competing or unaligned objectives. Another sign are budget driven data integrity issues caused by a heavy reliance on spreadsheets that are managing material risk.

So who could it be, the plant supervisor with the flow sheet in the refinery, the operator with the forklift at the weigh scale or the salesman with the putter in the office? How might the hard-pressed manager with the scheduler in the airport factor in? It might be one, it might be more. To resolve the issues some fieldwork is needed and bringing some experienced eyes along could make a difference.

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