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FROM “SUPERCYCLE” TO “SUPERMAYHEM”: COMMODITIES TRADING IN A VOLATILE MARKET

With commodities markets currently experiencing extreme price fluctuations, commodities traders face difficult challenges, both in terms of ensuring that their contracts remain profitable and due to the increased risk of their counterparties being either unable or unwilling to perform their contractual obligations.

What is happening?

Global energy markets have been making the news recently because of high prices, particularly due to the ongoing European gas crisis. Other commodities markets are also volatile. Copper prices rose above US$10,000 per tonne during LME Week and the price of agri commodities such as coffee and wheat have also been rising sharply this year, whilst the prices of iron ore and palladium have fallen.

Given the uneven nature of the post-pandemic economic rebound, the impact of energy transition and continuing geopolitical tensions, it seems likely that commodities prices will continue to move unpredictably and significantly.

Where there is significant price movement between the date of contract and the date of delivery, there is a risk that a commodity contract becomes unprofitable for either a trader or their counterparty. This can expose traders to financial risk for their own business, or to the risk that their counterparty defaults, either because the contract has become commercially unappealing or because of insolvency. In the LNG market, for example, cargoes have seen a fourfold increase in prices in recent months. Even the most resilient buyers will struggle to absorb that level of rise.

How can traders protect themselves?

In the current extreme trading environment, not all of the usual "common sense" measures are capable of offering cast-iron protection. Hedging against price fluctuation is much more difficult in an unpredictable market. And whilst traders may opt to limit their exposure by increasing their activity on the spot market for new contracts, many are already locked into existing longer-term contracts. We identify below some of the steps available to traders, noting limitations where appropriate.

1. Credit checks

It is common for sophisticated commodities traders to carry out credit checks and other due diligence on their counterparties, particularly for longer term, higher value or higher risk trades. Such processes are even more important in the context of today’s market, in which circumstances can change rapidly and a previously reliable party's creditworthiness may be affected suddenly or unexpectedly.

2. Credit insurance

For similar reasons, credit insurance may be a prudent option for higher value or higher risk trades, even in the face of increased premiums.

3. Payment guarantees

Payment guarantees are simple in principle: if you are concerned about your buyer's creditworthiness, you can require that another party guarantees their payment obligations. However, this offers effective protection only if the guarantor (e.g., a parent company) is themselves good for the money and so carrying out credit checks on both is advisable. It will also depend upon the terms of the guarantee and careful drafting is therefore critical. The best protection is offered by a demand guarantee (such as a Standby Letter of Credit) which is a "primary" obligation, enforceable independently of the sale contract. A standard guarantee is less effective because it is a

"secondary" obligation, only enforceable if the beneficiary can demonstrate breach of the payment obligations under the sale contract – which can give rise to challenge, dispute and a delay in recovery.

4. A 'pre-mortem' on key clauses

A counterparty seeking to walk away from a contract made unprofitable by market movement is likely to look to particular clauses to offer an escape route. These include termination rights, description and quality clauses giving rise to a right to reject and force majeure provisions. For some trades, it will be appropriate to carry out a 'pre-mortem' on those clauses. This is undertaken before the contract commences to identify what could happen to put it at risk by a counterparty relying on one or more of those clauses. It is then possible to plan ahead to prevent or mitigate against those risks and increase the chances of the contract's success.

5. Ipso facto clauses

'Ipso facto' clauses are relatively common in commodity sale contracts and permit the termination of a contract due to a party's insolvency. However, the local laws in certain jurisdictions including the UK, Australia, Singapore, and the USA will affect the enforceability of such clauses. Traders should therefore seek advice as to whether an ipso facto clause will offer them the protection they expect in the event of counterparty insolvency.

6. Stress test your price review clause

Standard price review clauses may not be adequate to deal with the current volatility. Taking action to remedy this could avoid exposure. We have advised a number of parties to existing long term contracts seeking to renegotiate such clauses.

Conclusion

Taking early action can reduce the risks to a trader's business. We are actively advising clients on these issues. If you have any questions relating to any of the above, please do not hesitate to contact the authors of this briefing.

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