Volatile Philippine Energy Costs

Between exceptional GDP growth (7.8% for the first quarter of 2013, the highest in Asia) and an increasingly wealthy middle class, energy consumption in the Philippines is rapidly increasing. The growth is so fast that existing large power plants are unable to meet demand in the short term, and planned projects will not come online until 2015.

This trend is driving a surge in oil and coal imports, as the Philippines only produces 1/12 the oil it needs and 1/2 the coal it needs domestically. Data from the Philippine Dept of Energy shows oil import volume rose by 5.9% just last year. Unfortunately, the price of oil is especially volatile. Fig 1 shows WTI crude in USD over the last 2 years. Price swings of up to 15% over 4-6 months are not uncommon.

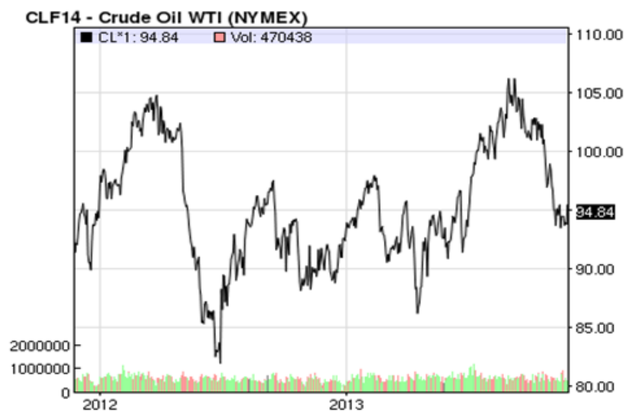

fig 1.

However, what really matters is oil priced in Peso, the operating currency of Philippine power companies. Fig 2 shows a simple average of Brent, West Texas Intermediate and Dubai Fateh, priced in PHP/barrel. Note the price swings are even greater when priced in Peso, up to 35% over a few months. Philippine power company revenues are in PHP, but must buy oil priced in USD. Because of this mismatch between expense currency and revenue currency, operating margin volatility can be extremely high. How can this volatility be reduced? Currency hedging can potentially reduce domestic oil price volatility by half, from about 30% down to about 15% (the volatility of oil priced in USD.)

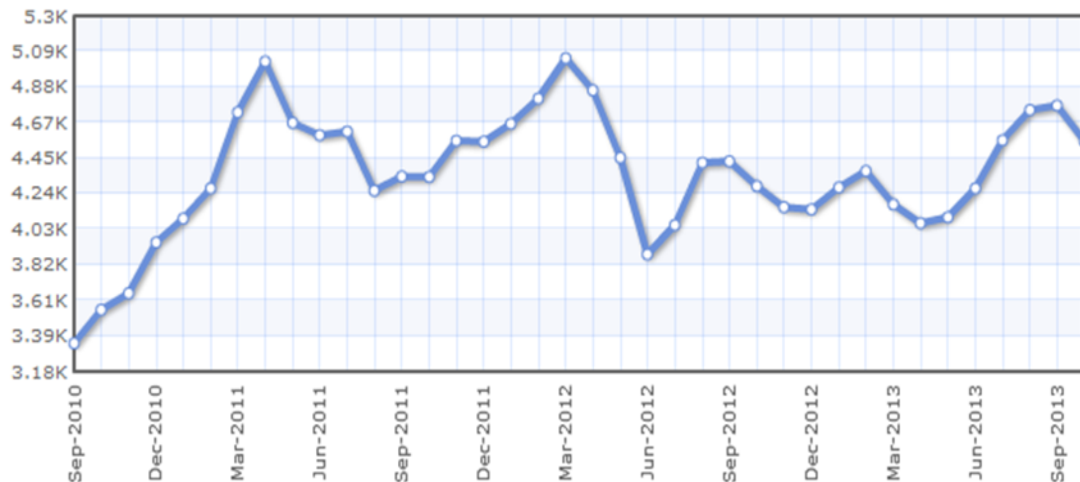

fig 2.

Philippine energy companies who elect to hedge currency risk will be able to offer more attractive rates than their competitors, and experience a more stable earnings flow. In addition, the CFO will never have to explain why earnings were impacted by FX on an earnings call!

Hedging FX risk offers deeper benefits for a company. In addition to eliminating balance sheet risk and reducing earnings volatility, it can improve company credit and valuation. It can enhance the ability to attract capital, because investors desire maximum Sharpe ratios (return-risk free rate)/(volatility of returns). Finally, it can improve team morale, as a year's hard work isn't at risk from some macro event half a world away impacting earnings.

A *properly-executed* currency hedging program will vastly reduce the effects of exchange-rate volatility on energy company net revenues. A well-designed hedging program exhibits several characteristics:

- Integrates both balance sheet and cash flow hedging strategies
- Uses an objective and well-defined process (no subjective market timing, or reliant on one individual)
- Trade execution doesn't create unnecessary FX gain/loss events on the balance sheet
- Minimizes derivative and other FX-related banking costs

Multi-billion dollar multinational companies *usually* have the expertise needed in their Treasury departments, but often, even large firms whose revenues are in the hundreds of millions do not have in-house derivatives and hedging expertise and need third party consultants. A CFO might be tempted to simply utilize their banking relationship manager for advice, but this is not advisable. While banks offer the FX products needed to implement a hedging program, banking personnel often do not have the Treasury experience necessary to design and implement an effective hedging *process*, and will often select inappropriate products. Additionally, they do not make the best fiduciaries, and the FX market is very opaque.

If you would like to learn more about how currency hedging can benefit your company, or desire assistance setting up a hedging program for your company, please visit our website at www.CurrencyRiskManagement.com, or contact us directly:

Paul Stafford,
Managing Director
01 (406) 546-8410
pstafford@currencyriskmanagement.com

Paul Stafford received the Bachelor of Science in engineering from UC Berkeley, and a Master's in engineering from Stanford University.

Stefan Whitwell,
Managing Director
01 (917) 214- 6833
swhitwell@currencyriskmanagement.com

Stefan graduated from the Wharton School of Business at the University of Pennsylvania and was subsequently awarded the Chartered Financial Analyst designation by the CFA Institute, and recently the Certificate in Investment Performance Measurement (CIPM) designation.