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Discussion Paper

The Impact of Commodity Price Risk Management on the Profits of a Company

by

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Abstract

It is well recognized that for producing companies hedging the commodity price by using financial products like forwards or futures has become an important part of the company's production process. But apart from the direct impacts of hedging on the production and hedging costs the use of financial products affects the financing of the company: Hedging the volatile commodity prices leads to a reduction of the risk premium the company has to pay for its debt capital, since hedging contributes to more confidence of the investors in the redemption of the debt. In this paper we therefore analyze this dependency of hedging and financing and derive optimal hedging extents for companies in different market situations based on a long-term model. By hedging the commodity price, companies can realize a surplus in profits. Thereby, the optimal hedging extent for a monopolist is often up to 100%, whereas for companies in a polypolistic market the optimum is always less than 100%. These results are illustrated by examples for a producing company.

JEL-Classification

G32, Q31, Q56

Keywords

Commodity price risk management, Hedging, Resource management, Long-term corporate management, Risk Premium