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Perspectives on Price Risk Management & Evolving Strategies

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As coffee prices have remained at levels below the cost of production for many producers and risk became a very real crisis, industry organizations are taking steps to broaden the tools available to mitigate risk along the supply chain.

By Rachel Northrop

Those in the coffee industry who buy and sell green coffee are constantly negotiating the price of coffee for each contract and shipment. Green coffee prices are subject to the risk that they will either rise or fall, and the coffee trade has many tools historically used to manage this risk. These tools have evolved over time, and managing risk today involves understanding how the tools are used and reported on.

The price of coffee, and the management of its risk, centres around the Arabica futures contract, Coffee "C," traded on the Intercontinental Exchange (ICE) in New York. David Farrell, ICE Futures US chief operating officer, presented at the Global Coffee Platform's recent webinar on ICE Coffee Markets, in which he identified the three main functions of the coffee futures exchange as "risk management to offset commercial risk, price discovery, and [as] a buyer and seller of last resort."

Commercial risk is offset through the trade of futures contracts, which are contracts to buy or to sell a specific quantity of goods at a specific price for a fixed point in the future. The Arabica coffee futures contract is for 37,500 pounds (lbs) of green coffee. While this potentially hedges a large amount of risk it also represents significant risk exposure and margin call requirements, which correspond to a percentage of the contract's total value. Managing risk usually includes options as part of a strategy, as they represent less risk exposure while still providing an avenue to protect against price drops or spikes.

"Futures markets are designed to bring together the different parts of the supply chain to transfer risk," explained Farrell. Physical stakeholders are not the only participants in the coffee futures exchange; speculators enter the market to provide the liquidity needed for the ecosystem to function. "Liquidity means something different to everyone," he noted. To the ICE, "a liquid market is about allowing participants to trade into or out of positions without price impact, or 'moving the market.'" In 2012, the elimination of the open outcry pit and move to fully electronic trading allowed for more players, notably hedge funds and high frequency traders, to participate more easily in the market.

Farrell calls the transitions to electronic platforms a "slow revolution in risk management practices in the agricultural markets." A further evolution of futures markets as a tool for managing price risk is the existence of Over-the-Counter (OTC) accounts for trading futures and options. For trades made through an OTC account, the counterparty is a single brokerage firm rather than regulated exchange participants.

Gerardo Patacconi, head of operations for the London-based International Coffee Organisation (ICO), in his presentation at the Ernesto Illy International Coffee Awards in New York in October, remarked, "Non-fundamental factors can also affect price levels. Speculation in coffee futures markets can intensify price movements." Understanding how these intensifications happens requires looking beyond the fundamentals to patterns in the data.

Reports and Data

The futures exchange is regulated by the United States' Federal government's Commodities and Futures Trading Commission, and as such is required to report open interest, the total number of open long and short positions, weekly in the public *Commitment of Traders* report, which groups positions by commercial and non-commercial traders. Commercial traders are those hedging physical coffee risk, while non-commercial traders participate for speculative reasons.

Carlos Mera, senior commodities analyst at Rabobank, explained that "an increase in open interest means there are larger positions from existing traders or new traders entering the market. As of mid-December, the open interest in futures and options was 16 percent higher YOY. The largest increase is seen in commercial players, as Brazilian farmers and exporters have been keen sellers in this rally."

Reports provide a snapshot of the market at a given moment, and, combined with the study of historic charts, can help aid in decision making when managing risk using futures and options. Data from market reports can be interpreted given what is happening on the fundamental side or given broader economic conditions that influence how speculators participate in different markets.

According to Mera, "Even though there has been a lot of speculation, non-commercial players have reduced their share in the total open interest, this is in part because as some funds were getting longer and longer, many other funds were cancelling their short positions."

With the "slow revolution" to electronic trading came the rise in high frequency trading by non-commercial participants. Because these high frequency trading tools approach the market from a mathematical perspective, reviewing technical data to make risk management decisions requires adopting statistical as well as fundamental perspectives. Comparing specific market conditions to historical averages allows participants to take advantage of all available technical data, particularly when trading options as part of a futures hedging strategy.

Broader Price Risk Context

"The most important currencies for coffee are the US dollar, the Brazilian real and, to a lesser extent, ▷


Image courtesy of Vanessa L Facenda

the Colombian peso," Mera told *Tea & Coffee Trade Journal*. "While the dollar does not change much, the Brazilian real has been very volatile in the last seven years. A weaker Brazilian real makes it more profitable for farmers to produce and sell coffee. The same holds for the Colombian peso, but to a lower extent."

Coffee trades on a US exchange but is grown and consumed in countries with currencies other than the US dollar. Considering exchange rates is another component to a risk management strategy. "With the increase in Arabica prices, many players reassessed their risk management approach," noted Mera. "This is particularly so in Brazil, where coffee prices have reached near record BRL-denominated prices. We have seen a lot of activity in the OTC market, as many farmers hedged a proportion of future crops."

For coffee growers, risk management starts with determining the kind of coffee they will produce. Specialty coffee is not necessarily priced using the same market-discovered benchmark as commercial coffee, but it requires many added costs, comes with other risks, and trades in smaller volumes. For farmers and cooperatives which do not have access to the financing to operate a risk management strategy using futures and options, they might look to produce something that cannot be commodified and use this niche-creation as their hedge.

But added value and differentiated products are not enough to protect against price drops that reach crisis levels for farmers. The September 2019 London Declaration, coming out of the CEO & Leaders Forum, held as a Special Session of the Private Sector Consultative Board established under the 2007 International Coffee Agreement, expresses deep concern for "the current coffee price crisis, including price fluctuations and the recurring nature of price shocks and impact on the economic viability of coffee growers."

Given the combination of sustained market levels below costs of production during 2018 and 2019 and changing climate patterns at origin, the risk for producers is not just one of loss but of losses great enough to ultimately lead to divestment from coffee production altogether.

New Approaches to Managing Risk

While one of the ICE's stated functions is to discover price as the "primary pricing market for [a] standard specification product" and provide a "benchmark for physical transactions," the London-based International Coffee Council's (ICC) Resolution number 465 from 20 September 2018, considers as its second point that "current prices do not reflect the market fundamentals." The resolution also considers that "current market price levels do not allow coffee growers in most producing countries to cover their production costs, compromising their economic sustainability."

A year after the ICC released the resolution, 23 industry and supporting organizations signed the Forum's London Declaration, which registered further concern for "the social and environmental sustainability of the value chain in most producing countries and the sector's ability to secure and maintain diversity of origins." The dialogue called for in the Resolution led to the Declaration, which in turn committed its signatories to timely shared and individual actions aligned with several focus areas, including "increasing resilience of farmers against shocks, improving access to finance, and preventing deforestation and forest degradation in the supply chain" to promote competitive and sustainable production and increased market transparency to foster responsible and equitable growth.

The Declaration's signatories also committed to immediate action on resource allocation "towards exploring the set-up of a global multi-stakeholder funding mechanism with the goals of leveraging investment in the coffee sector through the blending of private and public sector funding [and] supporting transparency efforts and policy reform," among others.

These actions culminated in the 2 December 2019 establishment of the Coffee Public-Private Task Force spearheaded by the ICO to "develop a roadmap to put into practice the commitments made by the signatories of the London Declaration," as stated in the Task Force's establishing document. "The ICO is coordinating a sector-wide dialogue on [price risk management] and other pressing questions that threaten the sustainability of the world coffee sector. This initiative is still in its initial stages," shared Jose Sette, executive director of the ICO.

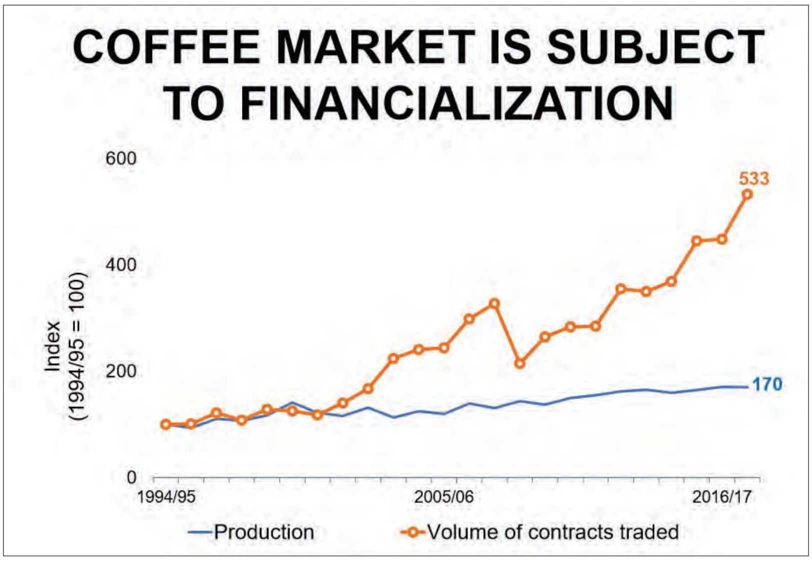
The task force agenda takes the five thematic areas of the Declaration and converts them to working groups dedicated to specific outcomes, from a feasibility study for a global stabilization fund to strengthening the "effective functioning of market institutions."

Patacconi addressed ways in which market institutions might be faltering, comparing the difference between the rate of increase in coffee production and the much higher rate of increase in volume of futures contracts traded, juxtaposing fundamental and market behaviours.

Farrell also addressed similar trends in behaviours within the market alone, noting that the numbers of commercial and non-commercial participants "are growing at a similar rate. In our view it's a symbiotic relationship. The more participants who are there to hedge, the more commercials are going to turn up to provide liquidity and vice versa." While the percentage of total positions from commercial traders has remained relatively stable between 40 and 70 percent since data collection began in 1986, the percentage of non-commercial positions increased from 10 percent to 50 percent, with the number of positions by non-reportable, smaller traders greatly decreasing over the same period.

It remains to be seen how and if the ICO's task force will intervene in the function of traditional hedging tools, or if perhaps fundamental factors will prompt the market to correct its low levels from the past two years. Patacconi offered several conclusions that are worth considering for those who actively manage price risk. "The cyclical nature of the market is a challenge for farmers and producing countries" and "current low coffee price levels are mainly the result of over production."

Taken together, the industry can reflect that both markets and production levels move in cycles, with correlating feedback cues between the two. Price risk management exists somewhere between emotion and calculation, and the more tools the coffee industry has at their disposal, the more all parties can develop suitable strategies for their inherent risks.



Source for both graphs: International Coffee Organisation

Image courtesy of Rachel Northrop

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