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Technology requirements in commodities

We are in the middle of a seismic shift in the commodity markets – a total restructuring of the industry and of the world economy that depends on it. How must suppliers of risk management technology respond?

A year ago, if you opened a newspaper at random, you might see multiple articles about the rise in the price of basic commodities – gold up threefold; copper booming; oil more expensive than ever. Today, a typical newspaper article will have moved onto the consequences – such as the surplus availability of investment, which has driven spectacular merger talks between some of the world's largest companies to produce truly global enterprises. And no doubt in a few years' time, commodity prices will have seen some more wild price swings due to imbalances in this rapidly changing industry. We may even see the failure of a high-cost producer that got caught out – so the column-inches will again focus on the need to insure against price volatility through options or hedging.

But the suppliers of risk management technology realise that their customers' requirements do not slavishly follow the latest headlines. We are not in the fashion business. Our purpose is to understand and anticipate our customers' technology requirements on the timescale of a typical technology investment, which is three to 10 years. So what are the main forces driving the technology requirements in the industry? I want to pick out two.

In the current climate, many producers feel sure that prices will remain comfortably above the cost of production for the foreseeable future. Because of this, several important producers now have an active policy of reducing their derivatives positions ('de-hedging'). Does this mean derivative risk management systems are no longer required?

As Woody Allen said, it is always dangerous to make predictions, especially about the future. However, looking on the timescale of a typical technology investment, I believe these conditions – with very large price imbalances between the market price and the cost of production – are unsustainable. It is at the basis of the capitalist system that the market will correct such large imbalances, one way or another. At the very least we must plan for much higher volatility going forward.

The second major requirement of technology in the commodity markets is particularly important for those directly involved in the supply chain, such as producers, smelters and fabricators. It may seem a trivial point, but these organisations need to gather information on which to base their financial planning. Following a number of mergers and acquisitions, a typical organisation will have multiple plants around the world. Even if the plants are individually controlled using the same general financial package, the packages are usually very heavily customised because the commodity supply chain is so specific. The result is that it is difficult to make these disparate systems talk to one another. This is not a trivial problem – the risk manager of a major producer described this situation some time ago in the following terms: "I know that I have $500 million worth of metal. It is somewhere round the world. I am just not sure where at the moment". Solving this sort of issue is a major – and unsung – success of the new wave of technology that has arisen with standard interfaces to bring the relevant information together in a unified way.

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The current period is one of extraordinary profits, especially for those most directly involved in the commodity supply chain. But this cannot last forever. It is almost a matter of detail whether the end is signalled by government action, windfall taxes, competition, or recession. When the easy profits finish, only the efficient will survive. The largest and most forward-thinking companies are now at the forefront of a new wave of investment in technology – technology that simply didn't exist five years ago – to make their global operations more efficient by tracking their material from multiple plants around the world and to allow them to take out appropriate hedging or insurance when it becomes necessary. This trend has already been recognised by the consulting companies who have set up specialist commodity operations to advise on this restructuring. It needs to permeate the entire industry.

Robert Brady, founder and chief technology officer of Brady