

Derivatives – The Next Big Thing for B2B?

Several vertical B2B exchanges have announced initiatives to offer non-financial derivative products to their customers. This article argues that verticals are natural partners for existing derivative exchanges, and that they are helping to create a demand for hedging instruments in sectors that do not currently have derivatives.

What is Going On?

Initiatives announced to date cover industry sectors that do and do not already have derivatives traded, and also cover both exchange traded and OTC derivative contracts.

Derivative Initiatives Announced by B2B Exchanges

Sector	B2B Exchange	Initiative	State of Offering
Energy	EEX	Electricity derivatives, using Eurex platform	Already trading
Chemicals	ChemConnect	Partnership with Chicago Mercantile exchange to develop bulk chemical derivative	In development
Metals	E-Metra	Partnership with Eurex to develop rival exchange to LME	To be launched Q1 2001
Weather	I-wex	Runs marketplace for OTC weather derivative contracts Developing exchange traded derivatives with LIFFE	OTC marketplace trading, Exchange traded derivatives to be launched in 2001
Shipping	Virtual Baltic	Planning to offer market place for OTC forward freight contracts	Press release

Why are B2B Exchanges Becoming Involved in Derivatives?

Derivatives represent a “value added service” that can be intermediated by a B2B exchange. Furthermore verticals and conventional derivative exchanges have complementary skill sets with respect to running a set of exchange traded derivative products.

In contrast, there are fewer reasons for an OTC market-maker like Enron to partner with a B2B exchange. Instead we are seeing in weather and shipping attempts to create a neutral marketplace for multiple OTC market-makers.

Derivative Capabilities of the Different Players

Type of player	Industry Expertise	Derivative Expertise	Trading Technology	Existing Customer Relationships
Derivative Exchange	Weak	Strong	Strong	Relationships with speculators and not users
B2B Exchange	Strong	Weak	No derivative exchange platform	Customers of B2B Exchange represent potential hedgers
OTC Market Maker	Strong	Strong	Variable	Set of relationships with industry hedgers

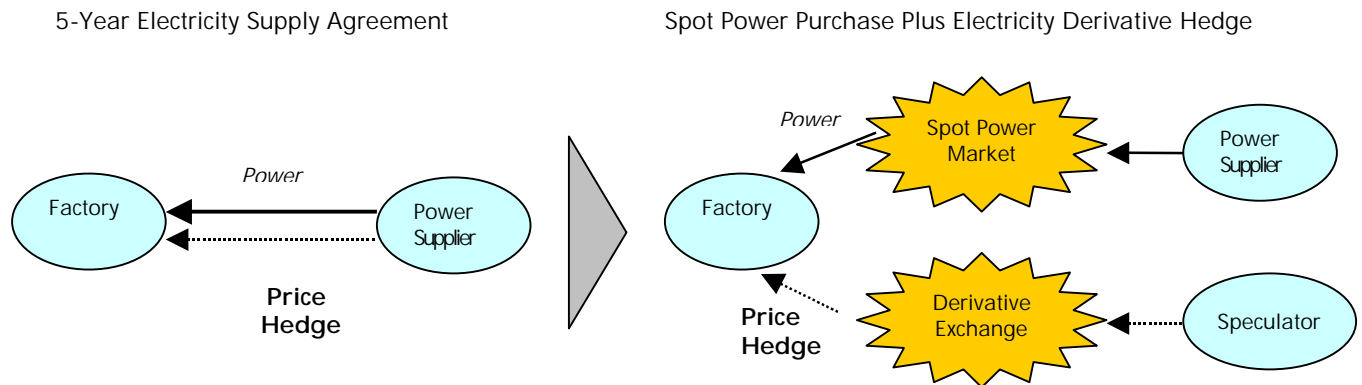
What is Driving the Creation of New Derivative Contracts?

Some of the initiatives announced above involve the creation of derivatives in completely new sectors. The key factors are increasing commoditisation and better data.

Growing Commoditisation

Greater competition (often caused by deregulation) has driven further product standardisation and price transparency. Given the choice, purchasers are less willing to enter into long term contracts if it results in less competitive pressure on prices. Consequently there is a desire to separate out provision from price risk management.

Separation of Physical Provision from Risk Management



Provision of Robust Data Another Driver

A second critical factor underlying the development of new non-financial products is the provision of appropriate data. The development of robust price indices allows the formation of a cash settled derivative where a physically settled contract would be unfeasible. Examples include the prices of particular shipping routes and bulk chemicals. B2B exchanges are having an increasingly important role in the provision of these price indices.

Likely Developments

B2B exchanges aim to create liquid physical marketplaces, and encourage contract standardisation wherever possible. This involves creating their own price indices, providing independent grading and inspection of settled products.

As has been seen in the energy markets, product standardisation is usually accompanied by greater competition, and a demand for a separation of provision and price hedging. So the long-term effects of vertical exchanges may result in even more new non-financial derivatives.

Endnote - Derivatives Demystified

Companies use derivatives either to hedge price risk or speculate. Hedging behaviour can be simplified into two scenarios:

- Supplier hedging: Costs are incurred at start of production process, sales made at the end. Suppliers want to hedge the risk that the product's price drops over this period
- Purchasers hedging: If a producer anticipates demand for commodity 3 months from now, it may want to hedge the risk that the price rises dramatically in the mean time.

Derivatives are not the only way to hedge these types of risk. Long-term contracts can be used to lock in price and terms to both supplier and purchaser (e.g., steel)

Three preconditions have to exist for a new derivative product to take off:

- Sufficient commoditisation: Product standardisation allows derivative contract terms to be specified, and is usually associated with many buyers and many sellers in the marketplace
- Sufficient price volatility: If the price doesn't fluctuate, it doesn't present a risk that needs to be managed.
- Sufficient market size: Industry hedgers have to be sufficiently exposed to the cost of the product to warrant hedging its associated price risk

Derivatives can either be bilateral agreements between two parties ("Over The Counter" contracts) or exchange-traded contracts. An example of an OTC contract would be Enron agreeing with an oil tanker operator to take on the risk that price of shipping oil across the North Sea drops in the next 6 months.

An example of an exchange traded contract is the LIFFE Robusta coffee contract: manufacturers and producers trade the right to buy/sell a standard lot of Robusta coffee for delivery at any one of 12 warehouses worldwide at a particular date.

Finally, derivatives can be split into physically settled and cash settled products. Physically settled contracts allow for the physical delivery of the underlying commodity to the counterparty: cash settled contracts are based on the movements of a representative price index (e.g. the Baltic Exchange shipping indices).

Shoomon Perry, March 2001