

# A RAW SUGAR SWAP



A “swap” is a financial instrument between two counterparties which is traded “over the counter” (OTC) instead of via a financial exchange such as a stock exchange or a futures exchange.

Swaps can be purely financial in nature (e.g. interest rate swaps) but also can cover commodities, in which case they are referred to as Commodity Swaps.

A “Sugar Swap” is a Commodity Swap and is frequently used by Queensland milling companies as part of their forward season price hedging program, either for their own sugar risk management purposes or on behalf of cane growers looking to establish a sugar price for use in their cane price formula.

In the case of a Sugar Swap, the miller and a swap counterparty (usually a bank) will swap an uncertain and floating raw sugar price for a fixed raw sugar price to cover an agreed future time period.

Until a producer of raw sugar hedges their production they are regarded as having a floating sugar price risk. That is, until the miller fixes a sugar price they are exposed to a fluctuating sugar price. Normally, the miller would fix a raw sugar price by selling an Intercontinental Exchange No.11 (ICE#11) futures contract. However, although the ICE#11 contract is listed for up to three years forward, very few contracts tend to trade in the further-out contract positions, so futures market liquidity can be problematic. Furthermore, some producers might at times wish to hedge sugar prices four, or even five, years ahead, so hedging directly on the ICE#11 against the equivalent futures positions is simply not possible.

A raw sugar commodity swap between a bank (or other financial institution) and a miller provides a solution for millers wanting to fix far forward sugar prices.

## How does a raw sugar swap work?

Let’s assume Wilmar has an interest in fixing a sugar price for 1 lot of October 2018 futures (equivalent to 50.8024 tonnes of raw sugar). Today, a bank is offering to enter into a raw sugar swap with Wilmar at a price of A\$461.34 per tonne which Wilmar accepts.

The correct terminology for this swap agreement is that Wilmar has sold a swap to the bank (which the bank buys) at a fixed price of A\$461.34 per tonne against 1 lot of October 2018 futures.

At the maturity of the swap (usually 2 weeks prior to the ICE#11 October 2018 futures expiry) the bank will give Wilmar 1 sold lot of ICE#11 October 2018 futures and enter into a foreign exchange transaction with Wilmar, where Wilmar is selling the equivalent US Dollar amount and buying Australian Dollars.

If, on the swap expiry, the combination of the futures contract price and the rate of the foreign exchange transaction is below A\$461.34 per tonne, then the bank will pay a cash adjustment to Wilmar to restore the hedge to A\$461.34 per tonne. So regardless of what the October 2018 futures price and the A\$/US\$ exchange rate happens to be on maturity of the swap, the bank will guarantee to give 1 sold lot of futures to Wilmar at an equivalent value of A\$461.34 per tonne.

## Why would a bank be prepared to enter into this swap deal?

By buying a sugar swap, the bank opens up the potential to make a margin on the trade by either entering into an offsetting swap with another party (a bank or even a sugar refiner elsewhere in the world) or by hedging the risk of the market moving against them by selling a nearby futures position on the ICE#11 exchange and progressively “rolling” the position down the futures board to the October 2018 contract. In this example, “rolling” refers to the process of initially selling futures against a nearby ICE#11 futures contract where a high level of trading volume liquidity exists, and then progressively buying that position back and simultaneously selling forward into further forward futures contracts as traded volumes become more liquid. Though this does not provide the opportunity for a financial institution to exactly “back-to-back” the swap price provided to a producer, it mitigates the sugar price risk to which the institution has exposed itself by buying a sugar swap.

The important point to note in swap transactions is that by entering into a swap, the miller has transferred the fluctuating sugar price risk onto the swap provider. Swaps are one of the numerous instruments a sugar miller has at its disposal to manage price risk. In the case of growers supplying Wilmar with cane, swaps are generally used for the purposes of securing growers’ Price Requests under the Target and Call pricing mechanisms.

## CONTACTS

**Shirley Norris (Proserpine):** 0437 803 019

**Angus McKerrow (Plane Creek):** 0419 238 536

**Franco Zaini (Herbert):** 0419 476 770

**Yolanda Hansen (Burdekin):** 0439 002 240