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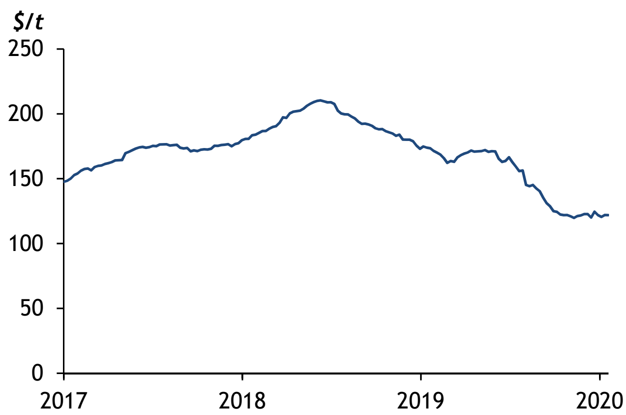
Wood Pellet Futures

What are wood pellet futures?

Wood pellet futures are cash settled, rather than physically delivered, instruments used by the market to manage price risk.

Everyone actively trading in the wood pellet market is becoming exposed to increasing price volatility as the market grows and develops, prompting counterparties to look at ways of managing this risk. One way, which is popular across all other major commodity markets such as coal, crude oil and natural gas, is to use futures contracts to lock in pricing — either as a buyer or a seller — around a physical, index-linked offtake agreement.

Wood pellets 90 day Index NWE cif



How do they work?

If a company is trying to hedge, it will essentially be trying to neutralise price risk around an index-linked physical position.

Using the example of a wood pellet buyer such as a power generating utility, the company will have short, medium and long-term offtakes linked to the *Argus* cif NWE wood pellet price. While this helps to mitigate certain performance and credit risks, the utility is then exposed to the price fluctuations in the market that are reflected in the index.

In order to manage this price risk, the utility will look to enter a futures contract whereby cash flow with another counterparty is “swapped” around the cif NWE index.

The utility will buy a futures contract at a given price, while on the other side of the trade another counterparty will sell at the same price — the fixed price leg. The buyer pays and the seller receives this fixed price. At the same time, the buyer and seller agree a reverse transaction under which the buyer receives and the seller pays a price that will be the average value of the *Argus* cif NWE wood pellet index for an agreed settlement period — the floating price leg.

By having the futures contract in place, the buyer ensures it will never pay more for its received physical volume than the price in the futures contract.

If the market rises during the period of delivery, the buyer will receive the difference between the fixed price leg and the index-linked volume, because of the floating price leg in the contract.

The index-linked price is the same as the price paid for the physical volume received under the separate offtake agreement. The buyer is hedged and has neutralised adverse price movements.

How does clearing work?

An additional step in the risk management process is clearing.

This is when an exchange or other central clearer becomes the central counterparty. In the example above, the utility trades with the seller directly, but this trade is then “given up” to the exchange and the exchange becomes the counterparty on the opposite end of the trade for both buyer and seller.

In this way, credit risk —the risk of a party to the trade defaulting and not performing — is pooled with the exchange as the central counterparty.

Furthermore, it enables companies to trade with other companies with which they do not have a direct link — an “ISDA” — so long as the other counterparty has a clearing account with the exchange. This broadens out the pool of participants that can trade directly.

How do I get set up?

For further information on the wood pellet derivatives market and Argus services in the biomass market more broadly, please contact Freddie Staermose (freddie.staermose@argusmedia.com).

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