BACK TO RESULTS

NEW SEARCH

A Survey of Corporate Risk Management: Too hot to handle? - Virtually riskless (part 5 of 9)

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MATTHEW BISHOP DERIVATIVES may have far more to offer than merely a means of hedging the risk of existing business activities or speculating on financial markets. Consider Enron, which since the late 1980s has grown into one of America's largest gas merchants, thanks to a new range of products known as Enfolio Gas Resource Agreements. These products depend crucially on the sophisticated use of derivatives.

Prompted by both suppliers' and consumers' dissatisfaction with the volatility of gas prices set in the spot market, Enron started to sell long-term contracts guaranteeing a pre-agreed price for its gas. The 'Enfolio Gas Bank' guarantees a fixed volume at a fixed price; the 'Enfolio Index' offers a fixed volume at a price linked to a natural gas index; and the 'Enfolio GasCap' sets a pre-agreed maximum price. These products have proved hugely popular. To provide them without potentially bankrupting itself, Enron uses a variety of derivatives contracts to hedge the risks involved. Its reward is a juicy cut as the middleman.

Enron's experience shows how derivatives can transform the nature of a business - in this case, by allowing the development of branded products in what had been a commodity business. But derivatives can have other business uses too. For example, the Tennessee Valley Authority, a utility, in 1994 devised a way of meeting higher-than-expected demand without building new generating plant. Instead, it used options giving it the right, but not the obligation, to buy in electricity from outside. In effect, it created a virtual power plant that could be 'switched on' should the need arise, at a much lower cost than a real one.

Peter Tufano, an economist at Harvard Business School, reckons that financial engineering may become as crucial to the long-term success of some firms as mechanical engineering used to be. But in a recent article* he argues that these opportunities are likely to be exploited only when general managers and financial engineers work together on solving problems. Moreover, it is striking that where derivatives have been successfully deployed to achieve strategic goals, the financial techniques used have been extremely simple.

* 'Financial Engineering and Corporate Strategy'. By Peter Tufano. Harvard Business Review; January 1996