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Oil price volatility - risks and opportunities in 2015

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Update 2 - How has the drop in oil prices affected other commodities?

The effects of the dramatic drop in the price of both Ice March Brent, the international oil marker, and its US counterpart Nymex March West Texas Intermediate, have been widespread. This is impacting not only the oil services industry, where many firms have cut their capital budgets as well as jobs, but also a number of markets across the world. The commodities market, in particular, has been widely affected with the prices of metals such as copper, lead and nickel dropping, albeit not as dramatically as oil, and the price of gold increasing.

In passing, it is worth noting that the death of King Abdullah last week has prompted some investors to bet on a change in strategy as a result of the change in the leadership of Saudi Arabia, OPEC's largest producer and de facto leader, with Crown Prince Salman succeeding King Abdullah.

The sharp fall in oil prices amid deteriorating sentiment over the global economy has made investors weary of

However, many analysts expect King Salman and Ali al-Naimi, Saudi Arabia's oil minister, to stand by the existing Saudi oil policy, at least in the near term. That is, to allow market forces to determine the oil price and press ahead with unrestrained production of crude in order to eclipse more marginal producers and to not risk losing market share, despite the effects that this has had on the price of oil.

investing in other commodities

How has the drop in oil prices affected other commodities?

The sharp fall in oil prices amid deteriorating sentiment over the global economy has made investors weary of investing in other commodities.

Copper, in particular, has been hit very hard, slumping to its lowest price levels in nearly six years. This was triggered by aggressive selling by Chinese hedge funds earlier this month when the market was on the edge because of the collapse in the oil price and when physical demand in China was weak because of the approaching lunar New Year holiday. Other metals have also taken a hit, with nickel and lead experiencing recent sharp decreases.

As the price of oil has dropped, gold, on the other hand, has experienced its highest price level since August 2014 as many investors have sought to invest in the market to park their capital. With the Euro falling to an 11 year low as a result of a number of factors including the Swiss National Bank's decision to decouple from the Euro and the European Central Bank's quantitative easing measures, gold has risen very quickly.

On top of a growing trend for banks to dispose of their commodities businesses, there is a debate whether banks will continue to finance trading in commodities. Oil, at least in the near future, is likely to provide a low return with most commentators thinking that the price will not rise substantially for the foreseeable future, with some even going so as far as stating that the price will fall as low as USD20 per barrel. Therefore, the incentive for banks to finance this particular commodity would appear to have fallen away. This could see a space open for non-bank lenders to come into the market and play a much more active role in the financing of commodities. These entities are generally subject to less regulation and have access to a more diverse set of methods to inject capital into financings.

Impact on existing contracts

In the oil market, many, if not most participants will enter into hedging contracts against a price fluctuation. However, this is often a hedge against a rise in the oil price and some participants will, as a result of the current conditions, have found that they have been asked to make margin payments to hedge counterparties as they are 'out of the money' on the hedging contract.

Exit options?

Parties may find it difficult to remove themselves from their existing commodities contracts.

Force Majeure: A force majeure clause allows one party who has been subject to a pre-defined event to suspend performance under the contract, or , in a worst case scenario, allow one or both parties to terminate the contract. The key point to note is that performance by the affected party should be rendered impossible to perform (sometimes being severely hindered is also considered to constitute force majeure). Some parties may look to rely on this provision, however it is unlikely that the fall in oil prices will constitute a force majeure event under contracts.

Material Adverse Change clauses: There is a possibility that parties could look to material adverse change clauses in their agreements as a way of terminating their contracts. However, these clauses are usually drafted to concern the state of the individual contract participants (e.g. a party's credit rating) rather than market realities. These provisions are also notoriously difficult to rely on in the event of a termination. Of course, if a party's credit rating, for example, were to be affected because of the fall in oil prices, then this could provide an option for the other party to terminate under this type of provision.

What can parties do to counter the drop in oil prices?

It may be possible for parties to include, in future contracts, a clause which is effectively a 'hedge' to be triggered by a pre-determined event (for instance a defined rise or fall in the oil price, e.g. if oil drops below USDX per barrel). This could give parties the ability to re-price the contract in this event, to ensure the contract remains economically viable, or at least to be obliged to enter into good faith negotiations around re-pricing. Depending on the level of bargaining power between the parties, it may even be possible to incorporate such a fluctuation as a termination event.

Existing contracts could also be reviewed to see if there is the possibility of amending them to include such a clause, but re-negotiating an existing contract which does not have a contractual mechanism for this already built in would seem unlikely.

The full impact and the duration of the drop in oil prices remains to be seen; but what is certain is that this is a worrying time for the commodities market. Parties will have to consider the terms of their existing contracts as well as continuing to consider ways to mitigate risk when embarking on transactions in the future. This could include a renewed reliance upon derivatives as a way of protecting against price and foreign exchange risk.

This update is the second in our series on the impact of oil price volatility. To read the previous update please click here.

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