Manage Your Weather Risk By Buying It

(NAPSA)—While it may still be true that you cannot control Mother Nature, some are finding that the weather can be put to use as the basis for managing financial risk.

Experts estimate that nearly 20 percent of the U.S. economy—at least $1 trillion—could be described as weather sensitive.

This weather sensitivity can create a situation where the earnings of a business can be adversely affected by summers that are hotter than normal or winters that are much colder than anticipated (and vice versa).

Just as a cold snap before harvest can drive up the price of orange juice, a warmer than expected winter may mean less of a demand for heating fuel, which can translate to unused supplies of oil or natural gas. Beginning in the late 1990s, the concept of weather as a tradable commodity began to take shape.

This involved creating a portfolio or index of seasonal or monthly average temperatures based on 10-year historical data and assigning dollar values to those averages.

Investors could then use the derivative to protect against an unexpected spike or drop in those average temperatures.

For example, a company might use a weather derivative to protect against the effects a winter 5° F warmer than the historical average might have on its business. It would use the derivative in much the same way an international business might trade foreign currencies to protect the sale of products due to the market fluctuation in the value of exchange rates.

In 1999, the Chicago Mercantile Exchange (CME), the largest derivatives exchange in the world, created a market for a financial product that could be used by businesses to manage the risk created by even more extreme movements of temperature.

In the late 1990s, the idea of weather as a tradable commodity began to take shape. More than $18.5 billion in notional value of weather contracts have traded at CME since January 2004.

"Weather influences people," said Felix Carabello, associate director at CME for its Alternative Investment Products group. "Weather drives the economy because it drives consumers to purchase, or conversely not to purchase, items or services."

Carabello has seen increasing interest in weather derivatives from energy, utility, recreation, construction and retail businesses in order to manage their financial risk due to hotter or colder than average temperatures. CME Weather futures and options on futures are standardized contracts traded publicly on the open market.

The contracts are legally binding agreements made between two parties—buyers and sellers—and are settled in cash based on the final monthly or seasonal index value determined for each contract by Earth Satellite (EarthSat) Corporation.

To learn more, visit the CME Web site at www.cme.com/weather.