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Govt poised to hedge prices of 15-20pc imported POL products

ISLAMABAD: In a rare development, Pakistan for the first time in its history is all set to go for initiating the process to hedge the prices of 15-20 percent petroleum products of total annual imports of 68 million barrels oil either for up to two years get the benefit of the low prices of POL products in international market because of COVID-19 pandemic.

The government will use the financial instrument of call option for 15 million barrels of oil for one or two years divided in 12 equal monthly amounts for a strike price of $8-15 above current brent as long as fee is within acceptable range.

A call option provides the buyer of the option with a hedge against potentially rising prices and under the instrument a price cap is bought for a defined volume and a defined period of time. The call option has price which depends upon the length and level at which the call is set up.

Official documents and background discussions with top officials revealed that the government will initially hedge price of POL products up to 15 million barrels against its exposure of total oil imports that stand at 68 million barrels per annum to bring down the basket price of oil products. Because of the 15-20 percent hedging prices of POL of total imports, the basket price of petroleum products in the country would remain stable and cheaper as well.

The Finance Ministry and State Bank of Pakistan (SBP) have been working for last one month on the use of call option instrument for hedging the POL prices and to this effect, the government will start hedging the price of petroleum products that include crude oil, petrol, high-speed diesel and LNG with coverage 15-20 percent exposure to start with. And once this programme is operational, the government will consider increasing the coverage and making it an ongoing programme.

Since the Petroleum Division handles all POL products so it forwarded the summary to the ECC for approval and the decision has been taken in consultation with the Finance Ministry as the Petroleum Division has been working with the top mandarins of the Ministry of Finance for the last one month to evaluate the possibilities of hedging some portion of exposure to Pakistan for import of petroleum products that are directly and indirectly linked to crude price. This includes the crude oil, motor gasoline, high speed diesel as well as LNG. And more importantly, in this process, several discussions were held with Standard Charted Bank, Citibank and a consortium of Habib Bank with JPMorgan to understand the option available and the pricing mechanism.

In the next ECC meeting, summary of hedging prices of petroleum products being imported will be taken up. The copy of the summary is available with The News.

After brainstorming on the issue among the stakeholders, the government has decided to use the hedging instrument of call option for 15 million barrels of oil for 1-2 years divided in 12 equal monthly amounts for a strike price of $8-15 above current Brent as long as fee is within acceptable range.

The Pakistan State Oil (PSO) has been recommended in the summary to be approved as the counterparty and the Ministry of Finance will extend a guarantee of performance to PSO. The Petroleum Division has recommended to the ECC two scenarios for call options of hedging prices of 15 million barrels of oil either for one year or two.

Under the scenario one, there will be call option for 15 million barrels of oil for one year divided in 12 equal monthly amounts for a strike price of $8 above current Brent as long as fee is within acceptable range.

And under scenario two, there will be a call option for 15 million barrels of oil for two years, divided in equal 12 monthly amounts for strike price of $15 above current Brent as along as fee is within acceptable range.

The authorities concerned discussed two financial instruments that include straight swap and call option for hedging the prices, but the authorities of Finance Ministry and State Bank of Pakistan adopted the call option instrument for hedging oil prices.

The officials elaborated that if the call option is given by any bank or insurance company on behalf of Pakistan at $30 barrel per day, then in case the prices go up for instance to $50 barrel per day, the prices of 15-20 percent of total POL products for country would remain at $30 per barrel and the difference of $20 per barrel will be picked by the bank or insurance company that gave the call option. The price of 15-20 percent products would provide ease in overall basket price of POL products.

The Petroleum Division in the summary for ECC has also asked for notifying a committee led by secretary finance and comprising of secretary petroleum, secretary law and secretary planning plus managing director of PSO to finalise the call options with the selected banks. It also recommended the ECC t to give Ogra the government policy direction to include the monthly price of the option in the cost of LNG (or any other oil product chosen) in announcing the monthly prices.