



BDO VALUATION ADVISORS, LLC

# ENERGY DERIVATIVE VALUATIONS



## THE VOLATILITY SMILE: FACTORS IN ENERGY DERIVATIVE VALUATIONS THAT YOU CAN'T IGNORE.

### ► HOW IS THE VOLATILITY IN THE OIL MARKET IMPACTING ENERGY DERIVATIVE VALUATIONS?



Matthew Goldberg

We have seen large swings in the value of many energy derivatives this year, primarily due to the increase in implied volatility from Q2 to Q3. This increase was most prominent in short-term volatilities, which is significant because energy derivatives are typically susceptible to what's referred to as a volatility smile. This means that short-term and long-term rates are higher than mid-term rates. At the end of Q3 the smile was more like a smirk with short-term rates higher than long-term rates.

From an outside perspective this means there is still an expectation that volatility is abnormally high and will return to a more normalized level in the long-term. This also means that values are up now but may return to lower levels as volatilities shift in the future.

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## ▶ WHAT OUTSIDE FACTORS COULD HAVE THE GREATEST IMPACT ON ENERGY DERIVATIVE VALUATIONS IN 2012?



Jerry Cullins

In addition to volatility, major factors impacting energy derivative valuations include tensions in the Middle East and the European debt crisis – which is possibly burdening economies throughout Europe and the U.S. and stunting the growth of the Chinese economy – will most likely impact derivative valuations in 2012.

## ▶ WHY ARE COMPANIES USING ENERGY DERIVATIVE INSTRUMENTS? WHAT ARE THE OPPORTUNITIES AND CHALLENGES?



George Warton

Energy derivatives are most useful for hedging purposes. Companies are increasingly relying on derivatives to manage the risks associated with the fluctuation of energy prices. Energy derivatives are often used to lock-in prices, thereby minimizing the negative impact of price increases on future cash flows. Oftentimes, management will engage in speculative play in the commodity markets, with the hopes of generating positive investment returns. When these expectations do not transpire, it can lead to disastrous results. On the other hand, hedging against price changes takes away the opportunity to generate additional value for the company. Therefore, it's important for management to keep the objectives of the organization in mind while assessing the risk and return characteristics associated with engaging in energy derivative contracts.

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## WORLDWIDE INFLUENCERS ON 2012 ENERGY VALUATIONS

- While tensions in the Middle East have been around and are likely priced in current commodity values, any change in leadership among the oil-producing countries will affect the market.
- The European debt crisis is still evolving and could significantly impact the energy market in 2012. As Greece and Italy struggle under the burden of their debt and attempt to implement austerity measures, this may cause other countries to go into distress, possibly creating a general push away from the Euro as a single currency.
- China is growing into a more mature economy, and its expectation for growth should be expected to slow in 2012. China's population combined with both real and possible energy demands, has the ability to affect the market in the following year.

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