

CASE STUDY

# Managing Exposure to Oil Price Volatility in Uruguay

## OVERVIEW

*Uruguay is a net importer of crude oil. A significant hike in oil prices could have a negative impact on the country's economic activity and public sector finances, putting pressure on the government to divert fiscal resources away from priority areas. An oil price hedging program implemented with the World Bank in 2016 will help Uruguay mitigate the impact of significant oil price increases on the fiscal budget and overall economy, as part of the government's comprehensive strategy to manage macroeconomic risks.*



## Background

Uruguay is paving the way with an ambitious renewable energy program, which provides close to 95% of its electricity needs from clean energy sources. While oil makes up a declining share of the energy mix, Uruguay still relies on oil imports to meet its total annual energy demand. In 2015, Uruguay imported 14 million barrels of oil.

An unexpected increase in oil prices could force the government to divert budgetary resources from priority areas. Adverse oil price shocks also negatively impact individual consumers and

increase production costs for businesses that rely on oil and its derivative products.

## Risk Management Objectives

Increasingly, countries like Uruguay are facing uncertainty from volatile global economic conditions and seeking support to reduce fiscal exposure to commodity price shocks. Uruguay's finance ministry wanted to insulate the budget from abrupt and significant increases in oil prices. It also wanted to continue to underpin macro-financial resiliency in line with the government's risk management strategy.

## IBRD Financial Solution

The World Bank Treasury and the Debt Management Office of the Ministry of Finance of Uruguay worked together to design an oil hedging program, as part of the government's comprehensive risk-management framework to protect the economy against global volatility.

In June 2016, the government gave the go-ahead to the World Bank to intermediate the execution of a series of derivative transactions with market counterparties.

This hedging program, which covers around half of Uruguay's total annual oil imports for 12 months, will help moderate the negative impact of significant oil price increases on Uruguay's fiscal budget and the overall economy.

With this transaction, Uruguay once again took up the helm of trailblazer among emerging market countries, becoming the first sovereign to execute a commodity hedge with the World Bank.

## Transaction Details

<b>Role of World Bank:</b>	Collaboration and technical assistance in the design of the hedging program and intermediation between the country and the market
<b>Financial instrument:</b>	IBRD commodity hedge (a call option which gives the buyer the right, but not the obligation, to purchase a set amount of barrels of oil at a pre-agreed price ("strike" price))
<b>Barrels of oil:</b>	6 million/ approximately half of Uruguay's annual oil imports
<b>Period:</b>	12 months
<b>Price/fees:</b>	Premium for the call option and IBRD hedging transaction fees

## Outcome

Working closely with the Uruguayan Debt Management Office, the Bank provided the expertise in derivative execution and the flexibility needed by the government to execute this transaction at competitive pricing, in a fast-changing environment. At the same time, preparation of the transaction in close collaboration with the Debt Office and market counterparties helped to build institutional capacity for future risk management transactions.

The oil hedging program is part of a broader engagement between Uruguay and the World Bank to manage fiscal risks, which includes the [innovative weather and oil derivative transaction](#) completed in 2013 to mitigate the negative impact of drought on the energy production and financials of the state hydro-power company.

The World Bank Treasury customizes financial solutions to meet clients' unique financing or risk management needs at the project or portfolio level. The Bank can execute derivatives and other capital markets transactions across sectors —e.g. energy, agriculture or disaster risk management— as an intermediary for sovereigns, sub-nationals or state-owned enterprises in both IBRD and IDA countries.

## Working with the World Bank

As a transaction intermediary, the World Bank leverages its triple-A credit rating to provide member countries with improved market access and financial terms, while helping to build capacity and strengthen confidence in the implementation of hedging programs.

Potential candidates for replication would include member countries whose economies are highly exposed (as an exporter/importer) to a specific commodity or groups of commodities, which make a country's fiscal position and economic activity vulnerable to international commodity price fluctuations.

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