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# Success Criteria for Commodities Exchanges



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# What is a Commodities Exchange for?

- An organised and reliable marketplace to trade physical and derivative contracts?
- An intermediary of high credit standing to stand between buyers and sellers
- The creator of indicative prices that can be used by the economy more widely and improve physical commodity trading, warehousing, etc
- An opportunity for speculators and traders to profit from liquidity in trading commodities
- Around 100 Exchanges worldwide: coming decade important for trends.

## Now the reality

- Commodities form a minority of Exchange trading activity.
- Within commodities, softs/agriculturals form a small proportion themselves.
- Exchanges are neither cheap to launch nor to run
- Plenty of literature on what makes a commodity contract successful
- Multi-stakeholder organisations
- Major public sector concerns - too big to fail, at least in some cases
- No clarity on success criteria for Exchanges

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- Multi-stakeholder organisations
- Major public sector concerns - too big to fail, at least in some cases
- Criticism of Exchanges and private commodity price setting
- **No clarity on success criteria for Exchanges - what are stakeholders trying to achieve?**

# What Government wants

- Economic Growth and wider objectives e.g. development of warehouse receipt system
- Prestige from a well-run Exchange, including satisfy donors
- Price transmission and transparency through the market, up to a point
- All at minimal cost to Government
- Government lacks the expertise to determine if Exchanges are meeting their objectives

# What Shareholders Want

- Exchanges now largely demutualised
- Objective ought to be Total Shareholder Return (TSR) - capital value growth and dividends
- Only possible if Exchange is consistently profitable, and
- Investment projects exceed the weighted cost of capital (WACC) of the Exchange
- This information never provided to investors
- **Investors face a fog of uncertainty**

# What Management Wants

- Legacy institutions
- Empire-building - maintain and increase size of operation
- Empirical research shows focused on quantitative targets:
  - Number of traded contracts
  - Number of Exchange members
  - Open interest
  - New contracts
  - New members
- Management targets do not correlate strongly with either Government or Shareholder objectives

# A Way Forward

- Exchanges to recognise the constraints of their status as profit-making institutions
- Identification of profitable and unprofitable contracts in terms of TSR
- Development of clear cost structures for new contracts - marginal cost and return DCFs with risk analysis
- Shareholders to see new contract, marketing and other investment logics
- **Government provided with the information it needs to take the hard decisions as to which contracts it wants to support and how much it will need to subsidise an Exchange to make its wishes come true.**