The Economist

## Weather derivatives

# Come rain or shine

### The outlook for the business of hedging against the elements

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Perfect weather for wind-up merchants

WEARING lots of layers and a decent waterproof coat is one way to guard against changeable weather. Firms facing losses because of a big freeze or baking sun do not have that option. Insurance companies have long offered cover against flooding, hurricanes and other catastrophes. For less calamitous changes in the weather, derivatives are a better option.

This is still a "niche market", says Tim Andriesen of CME Group, the exchange where most weather contracts are traded. According to the Weather Risk Management Association, an industry body, the value of trades in the year to March 2011 totalled $11.8 billion, nearly 20% up on the previous year, though far below the peak reached before the financial crisis took the steam out of the business. In 2005-06 the value of contracts had hit $45 billion.

Weather derivatives had an inauspicious start: the first trade was done by Enron in 1997. The instruments were initially used by American energy companies to hedge against the effect that unseasonal temperatures could have on gas sales. But abundant shale gas in the United States has rendered hedges against mild weather less important.

Energy companies are still the biggest users of these trades and contracts based on temperatures continue to be the most popular form of weather derivative. But Europe is now the largest market, according to Jürg Trüb of Swiss Re, a reinsurer. And demand for sophisticated and flexible over-the-counter products, which involve other variables such as rainfall, snow and sunshine and are tailored to meet customers' specific needs, are growing far more quickly than standardised, exchange-traded contracts.

The weather-derivatives industry hopes that farmers will pile in to purchase hedges against sun and rain that can affect the size of their harvest. Subsidised government-insurance schemes offer them some reassurance already, but derivatives can fill gaps or boost coverage. Big construction companies, with tight deadlines and costly penalty clauses, are also turning to derivatives. So too are retailers and companies that run big outdoor events beholden to the weather. Online providers such as CelsiusPro and eWeatherRisk offer small businesses simple and relatively cheap weather-risk coverage.

But widening the industry's appeal further may be tricky. In many instances the direct correlation between weather and revenues is not obvious. And collecting current and historical

weather data to calculate risks is harder in Africa or India, both regarded as potentially big markets.

As they look to renewables, it may be that energy companies are the best bet for future growth as well as current revenues. There have been some big transactions with companies that generate hydropower, which requires consistent snow and rain. Products based on sunshine for the solar industry are now available. And some firms are offering contracts to limit the exposure of wind farms to either a lack of puff or gusts that are too strong for turbines. This is helping energy firms to raise cash to invest in pricey wind projects by guaranteeing long-term returns from unpredictable blasts of air. If so, an ill wind might now blow some good.

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