

Chicago Mercantile Exchange starts offering rainfall futures and options

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As the Chicago Mercantile Exchange starts offering rainfall futures, climate prediction is becoming big business.
Photograph: Anthony Devlin/PA Archive/Press Association Ima

Anybody reckon the heavens might open next year? Fancy taking a bet? You can do so in sophisticated fashion on the world's biggest derivatives market, the Chicago Mercantile Exchange, which has begun offering multimillion-pound futures and options on rainfall.

Famous for its colourful open outcry trading floor, the CME specialises in agricultural commodities, energy and interest rate swaps. But a hitherto unnoticed corner of the exchange is quietly growing in value by offering futures and options based on the weather. The newly minted rainfall contracts join existing products based on snowfall, hurricanes, frost and unusual lurches in temperature. They allow investors to go long on thunderstorms, short on drizzle or insure against a deluge.

Hedging on the weather is a young business – the first weather derivative was traded in 1997 by a US power company, Aquila Energy. But trading futures and options on climatic conditions has grown to be worth more than \$15bn annually according to the Weather Risk Management Association, which tracks activity. The CME says typical customers include utilities, concert promoters, sports impresarios, theme parks and any other businesses with profits highly vulnerable to the elements.

"These are for any businesses that have revenue or cost exposure that's a function of rainfall," says Tim Andriessen, the CME's head of alternative investment products. "You might have an outdoor event where attendance is important and rainfall will have a significant impact. Or an outdoor stadium for a sporting event, with the costs associated with that."

England's cricket authorities are all too aware of the problem; they once faced a storm of protest for refusing to refund Edgbaston ticket-holders for a day's play against Pakistan in which only two balls were bowled because of bad weather. And Walkers Crisps is facing a payout of more than £1m over an ongoing "rainy day" promotion fronted by Gary Lineker that has led to a deluge of winners correctly predicting rainfall in chosen locations on a map grid. Walkers' parent company, PepsiCo, has an insurance policy backed by Lloyd's of London to protect itself against an undue payout.

Last winter's heavy snowfall and prolonged icy freeze threw up another financial conundrum as local authorities ran out of grit, sending the price of salt rocketing. Britain's biggest private sector gritting company, Gritit, has waded in this year with a potential solution; it is selling weather derivatives that encourage towns and cities to take sophisticated positions hedging themselves against the financial fallout from undue frost.

Gritit has teamed up with a Swiss firm, CelsiusPro, to provide tailored "frost day certificates" that pay out after a certain number of freezing mornings.

"CelsiusPro has taken very clever software and simplified it so that even a greengrocer could buy an option for a few pounds," says Jason Petsch, commercial director of Gritit, which does extensive work for NHS hospital forecourts, construction sites and private roads. "Our interest is in using it to help our clients manage risk."

Petsch says government clients such as the NHS are under pressure to show "massive budgetary restraint" but that money flows out each time the weather closes in: "We're called in to do winter gritting outside hospitals every time the temperature drops to zero or below."

The weather is set to become an increasingly important financial variable as alternative sources of energy – such as wind and solar power – take root. Wind farms can only generate power when there's a prevailing gust and solar panels are useless in overcast conditions. Bill Windle, managing director of weather specialist RenRe Energy Advisors, says: "There's a proliferation of wind farms out there and they can only generate power when the wind is blowing. There's a potential need to manage that risk."

Futures and options offer more flexibility than straightforward insurance policies that pay out in the event of pre-agreed climatic conditions. They can build in sliding scales, and incorporate the precise impact on revenue of unexpected happenings. Windle, whose firm develops sophisticated weather contracts, uses long-term weather forecasts to help judge the pricing of exposure: "We do think there's value in long-term seasonal forecasts from a directional point of view. But if someone predicts that on 27 January the temperature at Heathrow will be 2C, I don't put a lot of stock in that."

On Chicago's trading floor, rainfall trading has got off to a slow start with just a handful of contracts changing hands each day. But the day could dawn when Wall Street finds itself gripped by an irrationally exuberant surge in investment in precipitation. To call it by a different name, a rain bubble.

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