Commodity Hedge Collateral Drag

Scenario Type: Project Finance – Operating Phase
Asset Class: Resources / Energy Infrastructure (LNG, Mining, Midstream)
Situation Type: Operating assets with linear commodity hedges under cash-margined CSAs
Primary Issue: Liquidity erosion driven by hedge collateral mechanics, not asset stress

1. Decision Context

This scenario arises **after construction risk has cleared** and assets are operating as expected.

Cashflows are stable. Offtake agreements are in place. Debt service is being met. From a credit perspective, the project is healthy.

Yet liquidity tightens unexpectedly.

The IC question is **not** whether the hedge "works" economically. It is whether **liquidity behaviour under stress is compatible with the capital structure**.

2. What Changed

At close, commodity risk was addressed conventionally:

- Linear swaps
- Cash-margined CSAs
- Assumptions of revenue stability and DSCR protection

Collateral was acknowledged but **not stress-tested as a binding liquidity constraint**.

That assumption holds only in benign markets.

3. How the Risk Actually Manifests

The risk does not appear as a shock. It accumulates.

As prices move against the hedge:

- Margin calls become larger and more frequent
- Cash buffers are consumed mechanically
- Collateral posting becomes persistent

Critically:

- Margin responds only to mark-to-market

- Operating performance does not relieve liquidity pressure

A structure designed to stabilise cashflows begins to behave like leverage.

4. What Surfaces on Review

Consistent signals emerge:

- Collateral exposure materially underestimated
- CSA terms are asymmetrically punitive
- Hedge design reflects outdated volatility and correlation assumptions
- Governance strain appears as liquidity drains without economic explanation
- Decision options collapse under margin pressure

This was not the intended outcome at close.

5. Structural Assessment

This is **not** a hedge failure. It is **not** a market call problem. It is **a liquidity design failure embedded in hedge mechanics**.

Any response must simultaneously:

1. Preserve embedded hedge value
2. Stabilise liquidity behaviour
3. Maintain accounting and lender defensibility

Blunt unwind strategies typically violate all three.

6. Illustrative Structuring Logic

Objective: Prevent protective structures from behaving as uncontrolled liquidity levers.

Effective responses focus on:

- Separating economic protection from collateral intensity
- Aligning payoff profiles with liquidity capacity
- Redesigning CSA mechanics and settlement cadence
- Preserving embedded value while restoring control

Elegance is secondary. **Survivability under stress is the objective**.

7. Intended Outcomes

When addressed correctly:

- Collateral behaviour becomes measurable, bounded, and governable
- Liquidity leakage stops being episodic and unexplained
- Cashflows realign with operating performance
- Embedded hedge value is preserved, not sacrificed
- Management regains decision agency

Not perfection, control.

8. Applicability

Most relevant where:

- Long-dated linear commodity hedges are in place
- CSAs require frequent cash margining
- Commodity prices have moved materially
- Liquidity buffers are finite or covenant-sensitive

Less relevant where:

- Hedges are short-dated or lightly margined
- Physical settlement naturally offsets exposure
- Projects retain substantial unrestricted cash

9. IC Takeaway

This was not a failure of markets or commodities.

It was **capital drag created by collateral mechanics**, not asset stress.

Treating it as a pricing or hedging problem destroys value. Treating it as a **liquidity design problem restores control**.

10. Engagement Path

Primary Offer: Capital Efficiency Rebuild™– Commodity hedge re-engineering, collateral optimisation, CSA redesign

A full structural narrative is available for readers who wish to review the underlying mechanics, trade-offs, and remediation sequencing in greater detail.

Disclaimer

Illustrative scenario for discussion purposes only. Not a transaction summary or client-specific case study.