

# Managing Foreign Exchange Risk Within Asset Procurement

Purchasing goods directly from overseas, or purchasing goods with a large imported content, adds an extra dimension to the basket of procurement risks an agency must consider – that of foreign exchange risk.



**Bruce Whyatt**  
Chief Foreign  
Exchange Advisor,  
Corporate Treasury  
Services

## About this article

It is becoming increasingly common for large and/or complex assets to be sourced, either partially or completely, from overseas, even though a supplier is based locally in Australia. Foreign exchange risk is the risk of losing money due to adverse movements in exchange rates.

Why does purchasing goods or services from overseas create foreign exchange risk? When a good is purchased from overseas, an agency is, in fact, purchasing two things – the good itself and the foreign currency necessary to pay for the good. Whilst the purchase of the good is visible, quite often the purchase of the foreign currency is not.

Take, for example, an agency that has contracted to buy machinery from Europe. Payment may be required in euro (EUR) in which case the Australian dollar (AUD) cost of the machinery will not be known until such time as the agency buys the EUR to pay the supplier.

An agency can stipulate that a contract to supply the machinery must be denominated in AUD. Whilst it may appear, on the surface, that the AUD price is known and fixed, this is often not the case. Contracts such as these often include a price variation clause which allows for the AUD price to change in line with a movement in exchange rates. Regardless of whether the foreign currency price is observable, when an agency is purchasing goods or services with an imported content, more often than not foreign exchange risk is present.

This article will address why foreign exchange risk matters, some of the methods available to agencies to address foreign exchange risk in procurement and some of the pitfalls to be aware of.

## Who is holding the Foreign Exchange Risk?

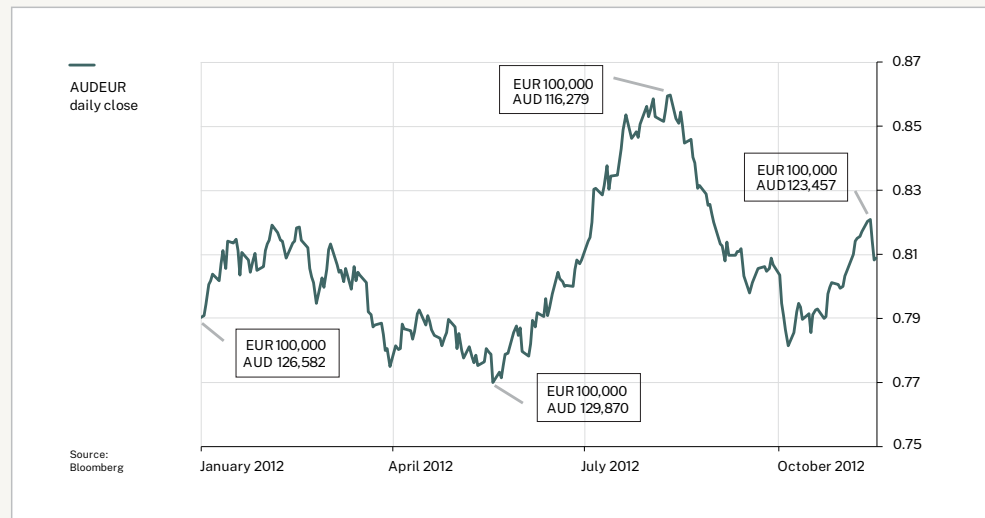
Foreign exchange rates move on a daily basis and, as we have seen over recent years, these movements can be significant<sup>1</sup>. Procurement can be a lengthy process, and when foreign exchange risk is involved the longer that process takes the greater the chance that movements in exchange rates will impact the cost of the asset. It is possible that such movements in price could put a procurement budget at risk. This is the case for whichever party holds the foreign exchange risk, be it the agency or the supplier.

A supplier based overseas will most likely prefer to receive payment in their local currency. If they are paid in a foreign currency, they will be exposed to exchange rate movements and cannot guarantee whether they will ultimately receive a fair price for their goods. This is no different for an agency. An agency may prefer to pay in AUD because they will know how much it is going to cost and don't have to be concerned with movements in exchange rates and risk exceeding their budget. When foreign exchange risk is involved, someone is going to have to hold and manage that risk. What is important is that the risk is transparent and the price paid to transfer that risk is fair. Further, if an agency is paying to transfer that risk to a supplier, they should be confident that the supplier is managing that risk appropriately.

<sup>1</sup> During the period July 2008 to October 2008 the AUD/USD exchange rate fell from 0.9849 to 0.6004 representing a decline of 39% over four months.

The following chart shows how the AUD cost of purchasing EUR100,000 has changed with exchange rate movements throughout 2012.

### Foreign Exchange Risk –changes in the AUD value of EUR 100,000 over the current calendar year.



### Risk has a price

The price of transferring risk may not always be obvious to an agency when a Request for Quote (RFQ) specifies pricing in Australian dollars. Quite often, suppliers will be asked to hold or fix a price for extended periods of time, whether during the procurement process or over a supply period. This increases the foreign exchange risk for whichever party holds that risk, be it the supplier or the agency.

There are many factors that an agency must consider when making a procurement decision, one of which is value for money. How does an agency know they are getting value for money when there is foreign exchange risk involved, particularly when there are multiple respondent bids with different underlying currency exposures and different payment structures? The answer is, by identifying what exposure exists and comparing all bids on an equivalent pricing basis. Value for money is not simply about the cheapest price. By identifying the risks and comparing bids on an equivalent basis, an agency can then make a decision based on what is best, overall, for their business – that the price paid to transfer risk is reasonable and that any risk to their budget is acceptable and manageable.

The more information an agency has to assess foreign exchange risk within respondent bids, the clearer the evaluation of that risk can be. Procurement templates require details of exchange rates used in a bid together with details of price variation clauses. However, procurement managers should be alert to suppliers providing AUD prices with foreign exchange risk embedded in “rise and fall” price variation clauses. A short clause along the lines of “...the price will be adjusted relative to the rate of exchange on date of invoice”, will transfer the foreign exchange risk back to the agency and will mean the price is not fixed in AUD. The agency is paying in Australian dollars, but the amount is unknown as it is to be determined by the exchange rate on a future date. Price variation clauses may also take effect on an annual basis.

The most appropriate approach for a procurement exercise will quite often depend on what is being purchased and the anticipated location of suppliers. If specialist equipment is being purchased for which the only suppliers are located in Europe, it may be appropriate to consider a tailored procurement approach. An agency may consider allowing suppliers to quote in AUD and their preferred currency (dual pricing). This can provide a clearer indication of the price a supplier is charging to take on the foreign currency risk and whether the risk would be better held and managed by the agency.

Introducing dual pricing into the procurement process is not always practical, and can create greater complexity during the financial evaluation stage. Evaluation of the respondent bids, where dual pricing has occurred, is more complex as the price of risk transfer needs to be identified and foreign currency pricing translated into Australian dollars for comparative purposes between respondent bids.

Western Australian Treasury Corporation (WATC) can assist agencies to determine the appropriate approach and can provide support in developing an RFQ suited to the individual procurement situation and the resultant financial evaluation process.



WATC assisted WA Police with the provision of foreign currency purchasing and hedging for key acquisitions to support frontline policing services in Western Australia.

## Conclusion

It is becoming increasingly common for government agencies to purchase large and complex assets that are manufactured overseas and imported into Australia. As these goods have an underlying cost base in a currency other than Australian dollars, it is important to consider how this may impact the procurement process and how risks will be managed.

Managing foreign exchange risk within the procurement process does not have to wait until the bids are received. With forethought and planning, an RFQ can be developed that will provide the information needed to make a fully informed decision on the materiality of any associated foreign exchange risk to the procurement budget.

## WATC Foreign Exchange Services

Treasurer's Instruction 826 requires "The Accountable Officer or Authority shall ensure that foreign exchange risk arising from financial activities...is identified, measured, considered and managed." The Instruction further requires that "...where a material foreign exchange exposure has been identified, the Accountable Officer or Authority shall seek and obtain advice from the Western Australian Treasury Corporation in the management of that exposure."

WATC assists clients to comply with TI826 by quantifying foreign exchange risk, designing currency management strategies and being a source of wholesale pricing. WATC has assisted many agencies at various stages of the procurement process, from developing RFQ documents through to analysing respondent bids and designing and transacting strategies to mitigate the foreign exchange risk. As a partner in satisfying Treasurer's Instruction 826, WATC provides advice that is tailored to a client's needs without prejudice or commercial interest and enables agencies to manage their foreign exchange exposures with confidence. If you would like to discuss your own agency's requirements in managing foreign exchange risk, please contact WATC.

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### Corporate Treasury Services

P: +61 8 9235 9122  
E: [csoperations@wadc.wa.gov.au](mailto:csoperations@wadc.wa.gov.au)