



FUTURES \$ OPTIONS



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Don't go about it backwards...

Regardless of whether retail prices are still hovering around \$3.40 per gallon, or if they have spiked towards \$4.00, or fallen below \$3.00, this winter is poised to (yet again) go down as the winter with the highest heating oil prices in history. The reasons for the high prices are plentiful, but the fundamental logic behind such high prices is very hard to find. None of this is new, as we have been seeing inexplicable moves in energy (and equities, and real estate, and currencies...) for the better part of this decade. What will Chinese demand do to oil prices? What about Iran's nuclear aspirations? How about the sub-price credit crisis? While all of these news-leaders are taking center court in the winter of '07-'08, there have been just as many reasons for the price swings over the past few years, and you can be certain that future years will have their own sets of market-moving stories.

At this point, most companies have made their decisions as to where they stand with regard to pricing programs—either offered to their customers, as most do, or for themselves as an internal hedge. There are strong feelings and arguments for and against pricing programs (the biggest “pro” being to try to keep your customers from shopping around for “greener grass”), as well as much discussion over the value of (expensive) cap offerings versus simply (wrong word to use, but you get the point) offering a fixed price. The more volatile the price, the more valuable the cap is—but also, the more expensive the cap is.

Regardless of which type of program you feel is the most appropriate for you to offer to your customers, the choices of HOW to protect (hedge) yourself is growing and growing. There are fixed wetbarrels, futures contracts, swaps, options, collars, option-spreads, *swaptions*, weather-contingent hedges, “look-backs,” “knock-outs” (I'm not making this up!), compound options, etc. The more sophisticated and customized the instrument, the more it needs to be researched. We have seen all of the above types of transactions, and have actually transacted each and every one, at some point in time. All have some value, but that value needs to be measured.

As an example, if you want to offer a price cap, typically you would buy a call option to protect you against prices going up. Call options (actually all options) have gotten quite expensive due to the rising prices and volatility, so some will (appropriately) look for other methods to cap their costs. Another way might be to fix costs via futures/swaps or supplier wetbarrels, and to buy put options to protect against a drop in value of those fixed price gallons. Both approaches are fairly straightforward, and (fairly) easy to understand. There is a deductible and there is a premium. The lower the deductible, the higher the premium, and viceversa.

Another, slightly more sophisticated (and financially—at least up front—more attractive) choice might be to buy the call option and to sell a put option to help finance the purchase of

the call option. The approach to “collaring” the market has a significant benefit—the out-of-pocket expense is far lower, due to the “collected” premium from the sale of the put option. The downside? If prices fall too far (yes, that happens too—remember last winter?) your cost of oil will NOT go down, as you have sold (also known as “written”) the put option, and you “lose” when prices fall below the put options strike price. If you are fairly certain that prices won't move that much, then this is a logical approach, but it does bear asking two pointed questions: 1) What crystal ball is telling you that prices won't move? and 2) If you don't think they are going to move, why bother buying the call option in the first place?

The previous paragraph is important to understand, because with every “exotic” offering, while there are most definitely some potential benefits (lower premiums, more “downside participation”, etc.), there are *always*—not *sometimes*, but *always*—offsetting risks/exposures. In your life, someone—maybe a parent, aunt or uncle, grandparent, or friend—told you that there is no free lunch. Well, they were right.

I like innovative hedging/trading strategies as much as the next guy—well, actually more than the next guy. However, you really need to define where the hedging ends and trading (and speculating) begins. Most of these strategies do have some tangible benefits if the market “goes in your favor”, but the real question when assessing a hedge approach is what happens when the market doesn't go in your favor. I have found that many of these approaches are best suited to end-users who are looking to save some money on the cost of their hedges—while making a CONSCIOUS decision that the “savings” might turn into additional costs. As an end-user, you have the power to make that decision, because the pricing impact falls at your doorstep. As a reseller (oil dealer), the possible savings needs to be considered against the possible additional costs, or lost revenues.

As the article is titled, you can't go at this backwards. Don't find a great “trading strategy,” and then model your customer offering in response to how you want to hedge. You need to figure out exactly what you want to offer to your customers—*there are those who can help you do this*—then assess the risks that you are willing to accept, and the risks that you need for others to take on (for a cost)—*there are those who can help you do this, as well*. Once you are comfortable with what you want to show your customers, and with what you are willing to risk to make that a reality, you can start to model your best hedging approach (yeah, yeah, there are those who can help...). One of the main goals in hedging/risk-management, in addition to transferring risk, is to make sure that you aren't caught by surprise if the oil prices or the weather behave erratically (or would that be “normally?”).

Set up your plan, execute your hedges, and remember: the offerings for '08-'09 are right around the corner (sorry!!).