



Futures and Flexibility

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I am preparing this article on the tenth floor of the Dynasty Hotel in the heart of Singapore's shopping district. Singapore is not only a major Asian financial and trading center, but also a major refining center with most of the major oil companies and trading houses supporting offices here. This city is a stop between Bahrain and Bangkok on a tour during which we are teaching low-risk trading and hedging techniques around the world.

I was reminded here of the lack of flexibility and lack of ability to protect profits that existed in the United States as recently as 10 years ago, and thought about how some of us take the advantages that the futures market has afforded us for granted.

In the June issue of *NPN*, we discussed the ability to buy or sell forward using futures to take advantage of rising and falling markets. So what are these additional advantages?

Win-lose to win-win

Even a market novice can tell you in a few words the key to success in any commodity market—*buy low; sell high*.

In a physical market, where there is no liquid futures market, this can be difficult. If you are a supplier such as a refiner or trader, you may wish to liquidate as much of your inventory as possible if you think prices are high or if they are falling. However, you may find many of your buyers reluctant to purchase from you at that time. Even if you are correct in your view of the market, you might not be able to take advantage of your perception because of the lack of liquidity in the physical market.

Conversely, if you are a buyer, and prices are low or are rising, suppliers may wish to hold inventory and refuse to sell any more than minimum contractual obligations as they wait for prices to rise to a level that they find to be satisfactory.

In much of the United States and Canada, where there is a good correlation between future prices and physical gasoline or diesel prices, this dilemma

can be solved by using the EFP, which stands for *Exchange For Physical*.

The EFP is a mechanism that disconnects the buyer's and seller's underlying price and simply sets price in terms of a differential (a premium or discount relative to the futures contract). The buyer pays the seller by transferring one futures contract to the seller for every 1,000 bbl. of gasoline or diesel

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fuel purchased, plus or minus the differential agreed. The seller can sell the futures contracts transferred by the buyer at any time prior to the expiration date of the futures contract.

Thus, in a liquid futures market such as the New York Mercantile Exchange, where tens of millions of gallons changes hands every day, a buyer and seller transacting a deal for a 5,000-bbl. barge of gasoline can both win.

Here is an example of this process:

Terminal operator A. Rack & Co. wishes to buy a 5,000-bbl. barge of gasoline from one of its regular suppliers, Indy Pendent Refining Corp. (IPR). It is late June, and the gasoline market has been in a slump following a strong spring season. There have been operational problems at two major refineries in the Gulf Coast and prices are starting to rise. The price of the August gasoline contract is 58¢/gal. at the time of A. Rack's requirement. At expiration, the contract is above 62¢.

As soon as A. Rack identifies the need to purchase gasoline, it buys five August gasoline contracts on the New York Mercantile Exchange at 58¢. It then makes inquiries among its major suppliers, and two days later, it finds that IPR has a barge that best fits its time requirements. IPR sells A. Rack the barge of gasoline at a 1¢ premium to the August gasoline contract.

Now the August gasoline contract is 59.5¢, which they agree on as an "underlying price." Each company calls its futures broker, reporting that A. Rack has sold IPR five futures contracts at 59.5¢. The brokers "announce" the transaction to the floor of the exchange.

Meanwhile, IPR still believes that the gasoline market will continue to rise. It holds its futures contracts through the month of June, into late July, selling them then for 63.5¢. Thus, A. Rack has purchased a barge of gasoline for an equivalent of 59¢/gal., and IPR has sold the same barge for an equivalent of 64.5¢/gal.

Mutual satisfaction

Here is how the transaction is accomplished:

A. Rack buys five futures contracts for 58¢ (on the exchange) and sells them at 59.5¢ (to IPR), for a net profit of 1.5¢/gal. It buys a 5,000-bbl. barge of gasoline at a price of 60.5¢ (59.5¢ plus 1¢ premium). The price of the gasoline (60.5¢) less the profit on the futures contracts (1.5¢) gives an equivalent purchase price of 59¢/gal.

IPR sells a 5,000-bbl. barge of gasoline to A. Rack for 60.5¢/gal., and at the same time, buys five futures contracts for 59.5¢. Later, IPR sells the futures contracts at 63.5¢, netting a profit of 4¢/gal. on the futures contracts. The price of the gasoline (60.5¢) plus the futures profit (4¢) is equivalent to the overall price of 64.5¢/gal. for the transaction.

Thus, both of the firms involved in the transaction are able to achieve a price with which they are satisfied.

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