Hedging Without Futures

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Managing price risk with futures and options traded on the NYMEX carries overhead. It may include expenses such as a live futures-data charting service, salary for a risk manager or indirect costs such as tying up capital in a futures margin account.

A futures contract equals 1,000 bbl. or 42,000 gal. Marketers selling 5 million gal./mo., or more than 100 contracts, can generally justify setting up risk management capability within the firm. Companies selling more than 1 million gal./mo., may find a direct involvement worthwhile if an existing member of the firm has the time to invest. But for many marketers, a direct involvement with the futures exchange is not practical.

Are they out of luck? No. Many rack-suppliers provide price protection. Rack sellers take the responsibility of hedging upon themselves and pass along the hedge embedded in the physical product sold.

Basic services

The two basic services they provide are fixed price contracts and ceilings.

A fixed price contract sets a fixed purchase price over a given time frame. If you want to buy 100,000 gal./mo. for the next year, your supplier might quote you a price. If you deal with the supplier, then usually he or she will buy contracts on exchange for his or her own account to hedge the obligation to you. Thus, the interaction with the exchange is displaced to the supplier.

A ceiling or cap is like an insurance policy from your supplier that limits the maximum price you will pay over time. If you are concerned that the price of gasoline might rise to a level that will dampen sales, you might buy a ceiling to guarantee that prices will not go any higher than, for example, 60¢/gal.

You may choose to lower the cost of this insurance by agreeing to a minimum price regardless of how low the actual price may go (a "floor"). In a sense, the supplier is selling you a "call" option (the right to buy at an agreed price) and buying back a "put" option (the right to sell at an agreed price). The supplier usually then buys and sells options as a hedge. For example, buying call options ensures the supplier's ability to supply you at a price no higher than the ceiling.

Complex alternatives

In addition to these two standard price risk management services, some more complex alternatives are second-chance pricing; double-discount pricing; call and price; and average pricing.

In second-chance pricing, a buyer of fuel at a fixed price gets a "second chance" to price the fuel, based on a pre-agreed formula within a given period. For example, a buyer of gasoline at a rack in New Jersey may have purchased 100,000 gal./mo. for a year at 60¢. He or she may elect to change the price to the NYMEX gasoline price plus 10¢ at any point in the first two months of the contract. If the market price falls, he gets a second chance to price the gasoline; if price rises, he or she sticks with the original deal.

Another permutation of second chance pricing is with ceilings. Using the same conditions, a buyer obtaining a price ceiling of 60¢ has the choice of lowering the ceiling to the pre-agreed formula price for two months.

In "double-discount" pricing, you get the opportunity to buy fuel below market (for example, at 55¢/gal. instead of 57¢), but obligate yourself to purchase the same volume of gasoline at the same price the next month. You are selling the equivalent of a put option. Options have a market value, for which the supplier is crediting you. A possible drawback is that if prices fall substantially, or if gasoline for delivery the next month is trading at or below the agreed price, you can end up with higher than market-priced fuel the next month.

If you choose a "call and price" alternative, you agree with your supplier to a differential relative to a readily available index price such as the NYMEX futures price. For example, you may agree to buy fuel at a 10¢ premium to the NYMEX. Then, at any time, you can call and fix your price based on the pre-arranged formula.

Average pricing guarantees an average market price. If you buy a truckload of fuel every day, you already have a chance of buying fuel at no worse than an average market price. If you buy unevenly throughout the month, you can end up with fuel above the market average. This would happen in a falling market if you purchased heavily at the start of the month or in a rising market, at the end of the month.

Another advantage of supplier price protection is that quoted prices are based on the rack location at which you are purchasing and for volumes other than 1,000-bbl. increments. The disadvantages are that on a unit basis, direct hedging may be less costly for larger-volume marketers and that your ability to change your mind and lift or restructure hedges is more limited.

Independent counsel

With these alternatives, why aren't more gasoline marketers managing price risk? Deciding whether to hedge directly or through a supplier may seem overwhelming. It may be prudent to obtain the independent counsel of a registered commodity trading adviser specializing in energy price-risk management services to act on your behalf and look out for your interests on contractual matters, allowing you to begin to manage price risk from a more knowledgeable base.

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