Why Bother With Futures?

Cynthia Kase

We are now writing the final chapters of a century marked by change. Innovations considered radical when first introduced are now accepted without a second thought.

Without some of these innovations—the internal combustion engine, the assembly line and oil wells, for example—the gasoline marketing business would not exist.

As the world continues to change, so does the structure of the energy industry, and with it, motor fuels marketing. Innovations, such as the introduction of energy futures and their use in the daily operations of gasoline marketing firms, continue to change the way business is done.

A "future" is a contract to buy or sell a commodity in a future month. Gasoline futures have been traded since 1981 in this country on the New York Mercantile Exchange. Each contract is for 1,000 bbl. (42,000 gal.), and contracts are "listed" for delivery 18 months into the future. Futures can be used to increase operational flexibility, to manage business risk, as well as to compete for capital.

Years ago, interest in "markets" was left to the finance department and was focused on currency risk and interest rates; however, a barrel of oil or gallon of gasoline today is recognized as a financial asset, the fluctuations in price of which, just like an dollar or deutsch mark, can impact the bottom line.

Heretofore, only larger companies may have been able to afford the expertise necessary to properly utilize futures, but consolidation of smaller marketers into mid-sized firms and the growth of "managed futures"—accounts managed by outside professionals known as CTAs (commodity trading advisors)—have paved the way for the expansion of the benefits that futures can bring to mid-sized firms. The following examples illustrate this point.

An independent gasoline retailer is doing about 400,000 gal./week of business. The retailer owns his or her own transportation and buys at least half of the firm's requirements on a noncontract basis, shopping the rack for the lowest price every day. However, he or she neither owns storage, nor has storage readily available in the area.

Prices have been rising steadily due to refinery turnarounds and high shipping costs. The marketer would like a place to put some gasoline in order to stock up while prices are still reasonably low. He or she decides to lock in half of the firm's volume for the next two weeks by buying 10 gasoline contracts.

Each day, the independent retailer picks up gasoline as usual from the rack, and sells back one gasoline contract. For protection, the retailer has decided that if prices stop rising and then fall by a half cent, he or she will liquidate on any remaining contracts in his or her possession.

In this and the following examples, futures are shown to enhance the business position of the user. No strategy wins all the time; losses may occur when using futures. Under certain circumstances, they can be substantial. Also, a "stop" is highly recommended to manage risk, that is, to take profit or cut losses if the market turns in an adverse direction. Depending on factors such as liquidity and volatility, the price at which contracts are executed may be worse than the desired stop level.

Risk management

A large multibranded distributor owns a terminal and buys in barge lots from a major oil company. After receiving a barge delivery, the distributor is holding over 2 million gal. in inventory. In two days, the terminal will receive a 5,000 bbl. (2.1 million gal.) barge delivery. Wholesale prices that were rising throughout the summer have now started to decline as Labor Day approaches.

The terminal operator decides to sell five futures contracts to offset the risk of holding the gasoline in a falling market. Once the gasoline is delivered, the marketer buys back a futures contract for every 40,000-50,000 gal. cleared out of inventory. For protection against prices turning against the company, the marketer will start buying back any remaining contracts if prices rise by 80 points or more.

A gasoline retailer wishes to expand his or her successful fleet business. A large delivery service is willing to commit to a one-year contract of 80,000 gal./mo. provided that the retailer guarantees a price of no more than $1.24/gal. The retailer, whose overhead is about 55¢/gal., buys 24 futures contracts (two contracts/month for twelve months) at an average price of 59.5¢/gal., locking in a revenue over $100,000.

The retailer then approaches his or her local banker for a loan to install card-swipes and two more pumps at facility.

An admonition

In the same way that you do not have to go to medical school to visit a doctor, or become an architect to contract an addition to a home, you do not have to be a skilled futures trader to properly obtain professional services in the future area. However, proper use of futures requires education and experience. Trading and hedging with futures is a skill that takes time to learn properly.

Just as modern medicine has improved quality of life, futures can improve business. But, however marvelous triple bypass surgery may be when performed by a qualified surgeon, you would not ask your supply manager to operate after attending one AMA convention.

Be advised that trading futures without appropriate preparation and practice may result in a similar outcome as the surgery. Market analysis and the decision to use futures in business is a serious step. It is important that you use care in recognizing the risks involved and in obtaining the proper professional skills.

Cynthia Kase, a veteran energy trader and internationally recognized futures-market expert, is president of Kase and Co., a commodity trading advisor firm specializing in energy trade and hedging advisory services. Kase and Co. is at 34 Ellicott Pl., Staten Island, New York, NY 10301-2106. (718) 727-2214. Fax: (718) 727-2352.