

Master Your Margins With Timely Hedging

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EACH THANKSGIVING AS WE GATHER AROUND the dining room table, my mother-in-law insists that we offer up something we're thankful for. My husband and his brothers did this grudgingly as kids and still groan today as they're forced to express a real emotion in front of their loved ones.

Last month, as I pictured this scene being repeated across the country, it occurred to me that no one I know would be giving thanks for higher energy prices. Even worse, many consumers erroneously think that when heating oil prices are high, dealers are taking home a bigger margin. For most home heating oil retailers, that couldn't be further from the truth.

Much of the time we spend on risk management is focused on protecting fixed and capped price sale commitments, typically offered in the form of annual prebuy or cap "programs." But the topic of risk management extends beyond the world of programs, into the margins generated from oil you pick up at the rack and mark up to the customer. For many of you, the day-to-day, rack-to-retail margin is the lifeblood of the business. In this article, I'd like to give you food for thought on an out-of-the-box way to manage that margin.

Similar to the thought process behind covering a program, hedging rack-to-retail business is about protecting margin. For rack-to-retail oil, margins can be maintained as long as your retail price changes when the rack moves. If the rack drops a nickel, you lower your price a nickel. If the rack goes up a nickel, you go up a nickel. Moving your posted price with the market, penny for penny, is what keeps the margin constant.

Now, before you stop reading, let me be the first to say that we rarely see that happen

among oil dealers. More typically, we see them struggle to keep up with increases at the rack. And in falling markets, many jobbers are able to delay or forgo lowering their posted price in the short term, expanding their margins.

Taking Advantage of a Fall

Given this more realistic pricing environment, let's take a look at hedging rack-to-retail business. Knowing your target margin is essential. If you need to be 50 cents over the rack, consider opportunities to lock in margins of 50 cents or better. Let's look at an example in which the market has been strong and margins are only 48 cents a gallon. That day, the market takes an abrupt 7-cent dip, and you keep your price the same. Margins are now 55 cents a gallon. Consider the strategy of spending some of that margin increase on a call option.

A call option is a contract that pays a return if the market rallies. If the market falls, the return is zero. The premium, or cost, of a call option will depend upon time to expiration and market volatility. Premium has also increased as the NYMEX has rallied; calls cost more in a market trading in the \$2.50s than in a market trading at \$2.00.

For our example, let's use 5 cents per gallon for the price of a call option that will expire over the next two weeks. By spending 5 cents for the call, you've dropped the margin back to 50 cents off the bat, but locked 50 cents in as the minimum margin for the next two weeks. If the market rallies and you're unable to raise the posted price, you'll still net 50 cents as the call option pays off penny for penny with an increase in the NYMEX.

If the market falls instead, you'll maintain the 50-cent margin if you lower the price with

the market, or expand your margin beyond the 50 cents if you don't come down penny for penny. No matter which way the market moves, you make at least the 50 cents.

Sounds great, right? The challenge in hedging is to stay focused on the net return between what you make on picking up and delivering the oil, plus what you spent on hedging (call option premium) and any return you received. It's human nature to play Monday morning quarterback. If you bought the call option on that down day and the market went straight up for the next two weeks, you receive a big payoff on the call, and feel like a genius! But if the market dropped like a rock after you bought the call option, you get nothing in return. In that case, was it wrong to hedge?

Invest in a Sure Thing

The answer is "no" if your goal was to lock in the target of 50 cents; you've guaranteed that margin through hedging no matter which way the market moves. Keeping a daily record of the rack price, your posted price, and the resulting margin is a critical part of this process.

Knowing what you typically make at a given time will help you recognize opportunities when they occur. If margins expand way beyond normal, you'll have a reason to lock them in. And whether or not the call option pays off, you'll know you've ensured a better return for your company.

Monitoring the oil market and doing your best to keep up with higher costs at the rack is not going to go away. But as 2007 comes to a close, hopefully I've given you some food for thought on one way to capture better margins over the next year. ☐