

SAFE

HEDGING

By Dan Blunk

Using hedging techniques can protect margins, experts say

If you think using hedging techniques in fuel procurement is risky, you may want to take a closer look. Done correctly, not only is hedging not risky, but it actually reduces your exposure to risk. In fact, according to Jon Griswold, president of Griswold Energy Partners Inc., a Houston-based fuel procurement consulting firm, and Dominick Chirichella, a principal with Energy Management Institute, New York City, an education consulting and publishing company that focuses on the oil market, operators who aren't using these techniques could be at a disadvantage to competitors who do hedge their fuel buying.

Many marketers think that hedging is similar to gambling, a technique too risky to be worth exploring, says Griswold. This misconception may stem from the fact that some marketers have been burned in the futures market, a key part of hedging in



which people buy and sell contracts for commodities for future delivery.

However, Griswold says marketers who have lost money on the futures markets weren't actually hedging at all, but speculating, a form of futures trading that does carry significant risk. "Firms that have gotten into trouble using futures almost always make a report that they were hedging product and they lost money," Griswold says. "But when you look at it from an accounting standpoint, they were never hedging. They turned into speculators somewhere along the line."

Chirichella has had the same experience. "One of the biggest shortcomings I've seen in companies that approach hedging wrong is that they go over that line and become a specu-

lative operation," he says. "They wake up one day and they've lost a bunch of money and they say,

Hedge honcho: Jon Griswold, president of Griswold Energy Partners Inc., recommends marketers educate themselves about the advantages of hedging.

'Hedging doesn't work.' But they weren't hedging; they were speculating."

Futures playground

Griswold says marketers should think of hedging as a child's teeter-totter, with the physical, or "wet," barrels of gas on one end and the futures market on the other.

(See illustration on p. 144.) When a marketer buys physical product to put in his underground tank, that side of the teeter-totter goes down. At this point, the marketer is at risk because he is not protected should the price of gas go down. To minimize that risk, hedgers sell futures contracts for the same amount of fuel they already own, balancing the teeter-totter and reducing their exposure.

"Hedging always involves wet barrels vs. the futures, options or swap markets," says Griswold. "It's always that relationship that you're trying to lock in on." In this example, the marketer who bought wet barrels and did not sell counteracting futures has to hope the price of gasoline will rise so he can turn around and sell that fuel at a profit.

The key, Griswold says, is for marketers to only hedge an amount equal to the physical product they buy. This way, if the price of gas goes down, they lose some money on the physical product they've already purchased. But they

will make money on the futures side of the equation when they buy back the futures at a lower price than they sold them for. While this simple example

assumes a perfect relationship between the physical barrel and futures market, which isn't necessarily the case, it is much less volatile than the physical barrel prices alone.

With gas prices looking like they're moving up, selling gasoline futures to hedge physical barrels would be a bad idea, right? Wrong, says Griswold.

"Most c-store operators don't understand the relationship between the physicals and the futures market," he says. "They tend to not want to sell futures when the price is headed up, but they forget the other side, that their inventory goes up in value."

Griswold says marketers must accept that, to reap the benefits of hedging, they will lose at least a little money on one side of the equation. "When these marketers see all the money in their inventory (as prices rise), they get to thinking, 'Why do I need these futures?' So they keep buying that inventory and they quit hedging it and then the market turns south on them and bingo, they're losing money big-time."

Speculating vs. hedging

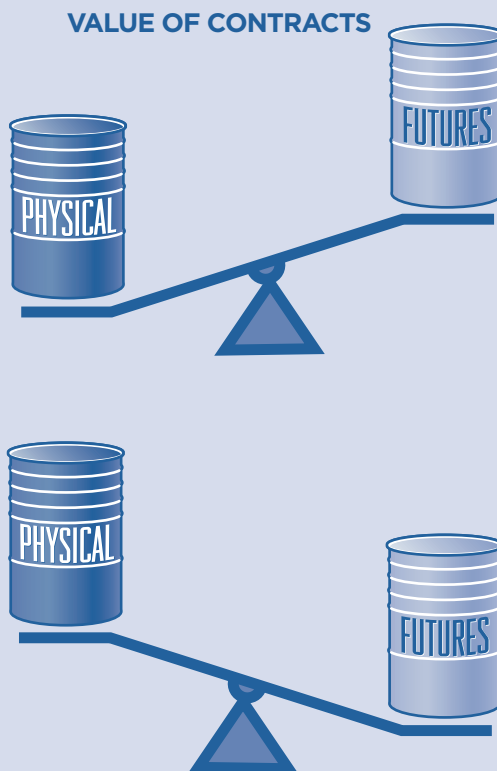
While hedging is a way of reducing the risk, speculating increases it. The key difference, Griswold says, is that hedgers only sell futures to offset the fuel they have already purchased. Speculators do not balance that equation.

Ironically, some marketers reading this article are actually speculating because they are buying only wet barrels and not hedging, says Griswold. "If anything, buying gasoline in the physicals market and



Ups and downs

Hedging is simply a way of reducing the risk on your fuel inventory, says Jon Griswold, president of Griswold Energy Partners Inc., Houston. By selling futures contracts equal to fuel already purchased, marketers can make money on those futures if the price of gasoline goes down. If the price of gasoline goes up, marketers make money on the physical inventory side of the teeter-totter.



hoping it goes up in price is pure speculation," he says.

The reason most marketers don't feel as though they are exposed is because they hold the fuel only for a few days before they sell it to consumers. The problems arise when marketers hold onto inventories for longer periods of time, during which the price can fluctuate. That is when hedging is a valuable tool, he says.

Chirichella says retailers must do their homework to use hedging techniques effectively and that hedging must be fully supported by upper management. However, he insists it is not a huge investment. "I don't

Hedge honcho 2:

Dominick Chirichella, principal with Energy Management Institute, says the full support of upper management is critical to successfully implementing hedging strategies.

want to give the impression that you have to hire a hotshot trader and work at this 24 hours a day," he says. "In most small and mid-sized chains, it's not even a full-time job for someone once you get established."

Keeping up with the big boys

Chirichella and Griswold agree that as big boxes and large grocery chains get more involved in fuel purchasing, hedging techniques will grow in importance. "Smaller guys should be doing this because their competitors are doing it and saving lots of pennies a gallon," Griswold says.

Take a big-box retailer that sells gasoline. In addition to hedging its inventory, it also will go a step further and buy fuel directly from pipelines when it's advantageous to do so.

One example Chirichella and Griswold describe: If a big-box retailer watching the New York Mercantile

Exchange (NYMEX), the key futures exchange, sees that gas is getting cheap down in the Gulf compared to the Midwest, its fuel team will buy fuel

directly from the pipeline, rather than pay the rack price, which is higher because of the cost to haul it from the pipeline to the rack. If the big box pays

5 cents less per gallon by cutting out the middle man, that gives it an advantage on the street price.

Chirichella says marketers don't have to have huge operations to use more advanced fuel-purchasing techniques. "You could do this if you have three stores," he says.

Getting educated

Hedging is not entirely without risk. The biggest risk marketers take when exploring hedging is getting caught out of position because of a lack of knowledge.

Griswold and Chirichella advise retailers to take courses on hedging and examine their businesses closely so they know what they can expect. But even experienced hedgers can occasionally lose. "The risk is that the relationship [between wet barrels and futures] changes," Griswold says, "but it's much, much, much lower risk to hedge than not to hedge."

Chirichella says, "There's no such thing as a perfect hedging technique that will protect your margin 100%." There are cases, for example, where a hedger will not be able to capture margin that non-hedgers gain due to fluctuations in the market.

However, he says, as oil markets get more volatile, hedging becomes more important. "I don't see how or why anybody would run a business that is actually exposed to the tremendous variation in margins due to ups and downs in the oil market and not do anything about it," he says.

The true risk is not to hedge, Griswold says. "I would not get involved with anyone who wants to tell me, 'The market's going higher, so buy it,'" he says. "In all likelihood, they don't carry the necessary expertise." ■