MAVERICK ENERGY CONSULTING:
NATURAL GAS, DIESEL, UNLEADED GASOLINE & ELECTRICITY

MAVERICK ENERGY

FIVE STRATEGIES FOR FORWARD PRICING

ENERGY COMMODITIES

BY JOHN RIGHEIMER, PRESIDENT OF MAVERICK ENERGY

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Once a customer determines their purchasing objective and establishes their risk tolerance parameters, it is time to consider how to execute the plan. Below is a brief description of five strategies for making your procurement plan a success.

LOCKING IN A FIXED BUY PRICE: NYMEX PLUS/MINUS BASIS

This traditional hedge offers a "locked-in" NYMEX or guaranteed price, plus or minus any variation in actual basis. Basis is the local cash market price, minus the futures price. Futures and cash prices differ due to the varying costs of delivering energy to different locations.

Advantages

- Guarantees an end delivery price for pricing stability (hedging perspective)
- Yields best price if market increases (speculating perspective)
- Can price as much as 36-60 months in advance, depending on the commodity.

Disadvantages

- Does not participate in falling market prices
- Attempts to capitalize on price decreases by liquidating your position results in re-exposure to market risk. To liquidate the hedge, you sell back the fixed price to your marketer.

ESTABLISHING A MAXIMUM BUY PRICE: BUYING CALL OPTIONS (PRICE CAPS)

Buying a call option gives the customer a maximum or price cap without limiting the opportunity of price decreases. The price cap that a call offers is the strike price of the option plus the premium cost for the right, but not the obligation to call on your price cap. If future prices decrease below the strike price by the time the call option expires, you receive the current cash price (i.e. index), plus the amount of the premium you paid for the call option. More expensive (lower strike) calls offer a lower cap price, but a higher net price if prices decrease. Less expensive (higher strike) calls offer a higher cap price, but more opportunity of gaining from market price decreases.

Advantages

- Maximum price, but no minimum
- Hedged price in a rising market, floating price in a falling market
- Many levels of price insurance (strike prices) from which to choose

Disadvantages

- Premium costs; purchasing a long time period of protection in a volatile market is expensive

COLLECTING OPTION PREMIUMS: SELLING PUT OPTIONS (PRICE FLOOR)

This strategy is not considered a standard price risk management strategy because it affords very little protection against increasing prices. It will enhance the price paid for energy, but only by the amount of the premium taken in. It will outperform other strategies during very stable markets. Selling a put, floors your price at the strike price sold, minus the premium taken in, plus or minus the basis. Selecting a lower strike gives more opportunity for a price decrease, but will yield less income from selling the put. Selecting a higher strike will yield more income, but give less opportunity if prices decrease.

Advantage

- Performs better than cash/index purchases alone in a steady or declining market

Disadvantages

- Places a floor on the commodity price
- Only protection against increasing prices is the amount of the premium received

ESTABLISHING A MAXIMUM BUY PRICE WITHOUT A PREMIUM COST: SELLING PUT & BUYING CALL OPTIONS (THE COSTLESS COLLAR)

This strategy is the combination of a call (cap) and a put (floor). The strategy gives all the upside price protection of an outright out-of-the-money call purchase, but has no cost because of premium taken in from selling the put.

The maximum buy price equals the strike price of the call. The minimum buy price equals the strike price of the put. There are no premiums involved because the premium for the call is off-set by the premium received from the put.

Advantage

- Price risk protection of call option at no cost outlay for premium cost

Disadvantage

- Limited opportunity for price decrease, because of the price floor

USING STOP ORDERS TO MANAGE YOUR PURCHASES

You can place several different kinds of orders through your marketer or broker. The four most common are presented below.

The Market Order - An order for the purchase of a fixed price to be filled as soon as possible at the best possible price

The Price Order (Limit Order) – When you place a price order, you are instructing your marketer or broker to fill the order at a certain price or better. The marketer or broker will wait until the futures price is at or below the certain price before executing the trade.

The Stop Order – In this case, you instruct your marketer or broker to place your order at a certain price level. A sell stop must be below the market; a buy stop must be above the market.

The objective with a sell stop order (liquidating your fixed price) is to be un-hedged when prices appear to be falling and hedged when they appear to be rising (maintaining your fixed price). The objective with the buy stop order (for entering the market with a fixed price) is to be un-hedged when prices appear to be falling and hedged when they appear to be rising.

Advantage

- Simulate the protection of caps and floors without the cost of option premiums

Disadvantage

- The possibility exists that the order will not be filled. Unlike options (calls & puts) the market may never penetrate the price you have specified, thereby exposing you to price risk.

CONCLUSION

Energy markets are more volatile than other traded commodities. Due to this volatility, it is prudent to consider the above pricing strategies, ranging from a simple fixed price to the use of calls and puts to manage your price risk. Remember, you must first determine your procurement objectives and tolerance for risk. Doing so will help you determine the types of strategies needed to bring solutions to your energy buying program.

John Righeimer is President of Maverick Energy, an energy consulting and training firm located in Aurora, IL. Prior to Maverick Energy John was Vice President of Sales & Trading for Peoples Energy Services Corporation in Chicago, IL. John has been in the energy industry since 1989.