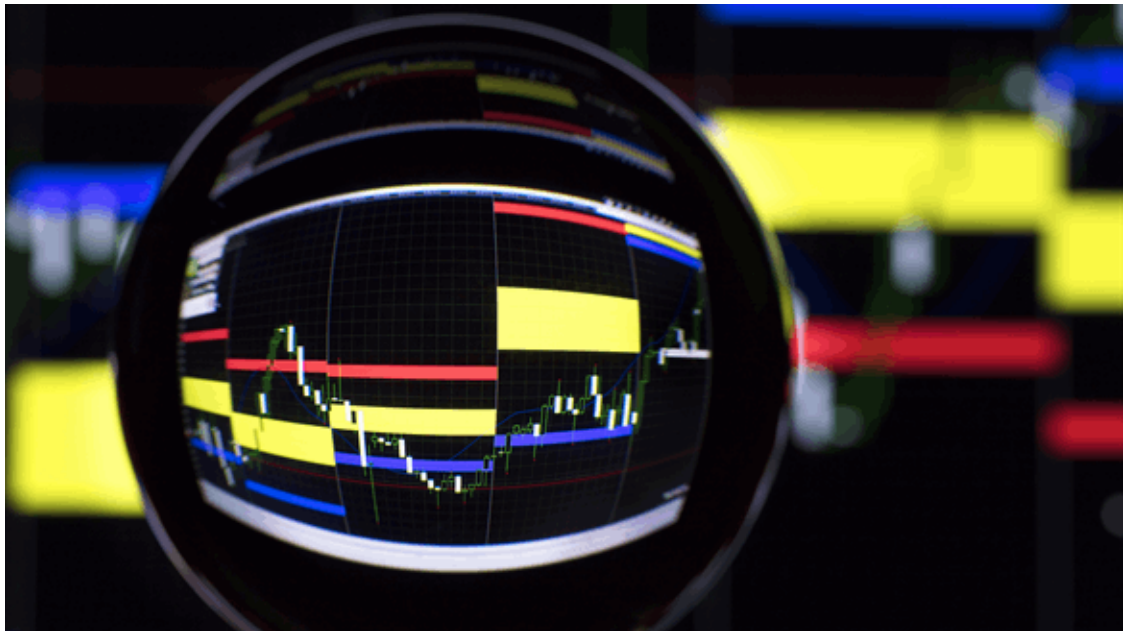


# RIGZONE

## ONLINE COVERAGE

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*Large fuel consumers and other crude and refined products market participants share a common recurring concern: market volatility.*

### Energy Market Volatility and Your Margins

by Richard Murphy

*This piece presents the opinions of the author. It does not necessarily reflect the views of Rigzone.*

Today, the refined fuels industry is becoming increasingly more volatile as the global energy market continues to undergo changes. Recently, top oil market-maker Geneva Energy Markets, LLC (GEM) responded to regulatory pressures by liquidating its trading book that previously held “millions of barrels of open interest across crude oil, refined products and natural gas,” according to managing partner Mark Vonderheide. Decreasing the number of large players in the market decreases liquidity, which will continue to exacerbate volatility concerns.

From balancing one’s supply and demand to responding to market fluctuations brought about by regulations, natural disasters, and geopolitical changes, there are many factors that can negatively impact a large fuel consumer’s margins – especially if those factors are not responded to correctly and in a timely manner. In order for industry participants to avoid margin decreases and stay competitive in today’s market, they must always evaluate risk and exposure while also looking for ways to drive efficiency in the supply chain.

## When Fuel Consumers are Their Own Worst Enemy

The refined fuels industry has experienced some extended periods of relative oil price stability, but then, intermittently, some periods of very high price volatility. Typically, the challenge lies in how fuel consumers naturally become complacent and accustomed to low volatility impact, which often sets those participants up for unfavorable earnings impact when volatility returns to the market.

Volatility creates both risk and opportunity for commercial fuel consumers, as well as other market participants. When viewing the risk portion of the equation, it is necessary to first define whether a consumer of refined fuels really has exposure to fuel price increases and how large the exposure is in financial terms. The airline industry, for instance, has seen jet-fuel prices surging over the past year by more than 50%. However, most carriers have been able to raise fares to cover some of the increase and still remain profitable, but not all of the costs have not been passed on. As a result, margins are being compressed and airlines like Delta Airlines have cut profit expectations, according to The Wall Street Journal.

Market volatility does present opportunities to hedge fuel purchases during the downturn and mitigate some of the impact of the increase. Those that are successful in doing so can then retain some of their price increases to boost margins or lower prices below their competitors to gain market share.

### Reducing Price Impacts

Hedging is the most useful tool to reduce the impact of price increases. However, it requires careful application and needs to be part of an overall strategy. It also requires a good sense of where prices are going. If not, one risks locking in very high fuel costs during a period of fuel price declines and losing market share to competitors able to take advantage of the lower fuel prices and lower their costs to end customers. This is precisely what has happened to some airlines during cycles where fuel prices were falling.

Some things to consider when determining a hedging strategy include:

- Do your competitors hedge their fuel costs?
- How do your competitors treat hedge gains and losses?
- Do your competitor's processes for hedging gains and losses affect the pricing behavior to their customer base?
- Do your competitors seem to use fuel cost advantage or hedging cost advantage to undercut your pricing and gain market share?

Whether a business has a degree of structural protection from the risk of market price volatility or must hedge against it, successful fuel management requires accurate, real-time information on fuel supply and demand, risk exposure profile, and the ability to quantify the existing profile of one's exposure to market price changes.

### Reducing Exposed Volumes

While reducing the physical volumes of fuel inventory reduces financial exposure, one must still keep operations supplied with enough fuel to support current market demands and future market expansion. Similarly, inventories must be maintained at a level that provides a reasonable cushion for inevitable supply and operations problems. Shutting down operations due to a lack of fuel is usually far costlier than the costs of extra inventory that prevents a shutdown.

Meeting the above needs while reducing inventory volumes requires active inventory management and supply chain efficiency. Supply chain efficiency starts with a clear strategy and a clear definition of success. That said, below are some strategic business questions a fuel consumer can ask in forming a business plan for supply chain efficiency and fuel management software requirements:



- How are supply inventories measured with demand to ensure there is not an undersupply or oversupply?
- What is the best way to ensure there is always just enough reserve supply to respond supply disruptions and natural disasters?
- What optionality exist to supply fuel to key operational location?
- In the event of a disruption, what is the optimal mix of moving existing inventories, purchasing new supplies, and taking on supply at other locations?
- How reliant can one afford to be on other's, possibly competitors, inventory volumes?

Answering these questions at both the strategic and operational levels requires a system that actively tracks inventory locations, products, levels, and logistical movements across a fuel consumer's entire business portfolio.

### **Margins Don't Have to Suffer**

All too often, legacy processes and outdated technologies leave fuel consumers flying blind on their real-time supply decisions, preventing them from capturing market opportunities. To effectively manage portfolio risk while also taking advantage of market opportunities, fuel consumers must have risk management software that provides them with full, real-time insight and analytics on their fuel purchases, consumption, movements, and inventories.

Many large fuel consumers are focusing on the transformation of their businesses to build new capabilities that optimize their value chain and reduce the costs of fuel purchases, fuel hedging, fuel supply, and fuel inventories; yielding significant enhancements in margins. As technology evolves and fuel consumers gain greater access to real-time data and competitor pricing, there is an increasing opportunity to improve margins through better business processes and the right commodity trading and risk management software.

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