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Measuring Margins: Avoiding Complacency When the Market is Stable

by Jesse Lamb, Director, Solution Consulting for Allegro Development Corp.

When top oil-market maker Geneva Energy Markets, LLC (GEM) liquidated its trading book holding “millions of barrels of open interest across crude oil, refined products and natural gas,” managing partner Mark Vonderheide emphasized the pressures and potential damage of new market regulations. New regulation is “seriously damaging the liquidity in the energy market,” Vonderheide explained. With fewer large players in the market, liquidity also decreases, bringing volatility concerns to a head for the entire market, regardless of size.

From responding to regulatory changes and political uncertainty to balancing supply and demand and being prepared for disasters, market participants experience many factors that can negatively affect margins. These factors become even larger threats if they are not recognized and responded to correctly and in a timely manner. However, it is possible for a company to navigate the market, avoid margin decreases, and remain competitive at the same time. To do so, they must maintain constant vigilance in evaluating risks and opportunities while also striving for new ways to drive efficiency along the supply chain.

Understanding Risks and Opportunities

While the refined fuels market has experienced long periods of relative price stability, there have also been periods of high volatility. That said, fuel consumers often naturally become complacent in between periods of volatility, which can position them for unfavorable outcomes if they aren't prepared for a market shift. However, not all change is bad. Volatility, when it occurs, can create opportunity for commercial fuel consumers and other market players. The players who come out on top at the end are those who can distinguish the risks from the opportunities and navigate their choices wisely.

Volatility in the market can present opportunities to take advantage of downturns to hedge fuel purchases and mitigate the impact of an increase. If a large fuel consumer has limited or no ability to pass price increases to customers, the company has price exposure. In this case, to reduce exposure, the company may need to either reduce the impact of price increases or reduce the volume of fuel exposed. Successful players can maintain their price increases to boost their margins or choose to lower prices against competitors' to gain a higher share in the marketplace.

When it comes to the risk portion of the equation, however, fuel consumers must first define whether their end customer has exposure to fuel price increases and the financial terms of that exposure. If fuel price escalators are built into the contracts or any increases in fuel prices are easily passed on to end customers through fuel surcharges or cost of services, there is a degree of structural protection from the risk of market price volatility. Yet even if this is the case, fuel price increases are likely to affect transportation costs.

Taking Cues from the Market

During market price increases, successful players understand when and how to take advantage of hedging, but doing so

requires careful application and strong market predictions. Without proper hedging techniques, an organization may risk committing to high fuel costs during a time of price declines – thus losing market share to competitors who can offer lower costs to customers.

This is precisely what has happened to some airlines during cycles when fuel prices have risen. Just this year, the airline industry has seen jet fuel prices surge by more than 50 percent. While most carriers have been able to raise fares to cover some of the increase and still remain profitable, not all of the costs have not been passed on. As a result, margins are being compressed and airlines such as Delta have cut profit expectations, according to The Wall Street Journal.

This is where hedging comes into play; and no, it isn't just for fuel producers. Large fuel buyers and consumers have found that hedging of products is essential for the businesses in order to retain stability and predictability to a large cost item during volatile fuel-price swings.

When determining a hedging strategy, a company must consider:

- Competitors' hedging strategy
- How competitors treat hedge gains and losses
- How gains and losses affect the price a competitor offers to customers
- Whether competitors leverage fuel or hedging cost advantages to undercut other companies

Successful fuel portfolio hedging requires accurate, real-time information on fuel supply and demand, risk exposure profiles, and the ability to quantify the existing profile of one's exposure to market price changes. If a large fuel consumer is in the middle of a period of increasing prices and hasn't made the decision to hedge, they must watch the market volatility closely, develop a plan and act swiftly in order to not only protect them from rising prices, but also take advantage of any market downturns.

Reducing Inventory to Reduce Risk

No matter the market's state, proper inventory level management is a natural hedge to market volatility. It is crucial to keep all business operations supplied with an optimal amount of fuel to support both current and future market demands. At the same time, shutting down operations due to a lack of fuel is usually far costlier than the cost of extra inventory. In order to strike this delicate balance, companies must have real-time consistent availability of inventory data, access to a system that supports visibility of the entire distribution network, accurate inventory forecasting, and easy-to-use self-service analytical tools to ensure they have proper inventory levels that can better prepare them for inevitable market shifts.

Furthermore, to meet these needs while also maintaining optimized inventory volumes, a company must have a clear strategy and definition of success that will set the foundation for proactive supply chain management.

Answering the following questions at both the strategic and operational levels requires actively tracking inventory locations, products, levels and logistical movements across a fuel consumer's entire business portfolio:

- 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 enough reserve supply to respond supply disruptions and natural disasters?
- What optionality exists to supply fuel to key operational locations?
- 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 inventory volumes, including those of competitors?

Taking Advantage of Technology

With the digital era has come a surge in data and interconnectivity, which means businesses need innovative commodity management solutions that can provide them with enhanced position and risk management capabilities, regulatory compliance, and analytics. To reduce uncertainty and exposure in an often volatile environment, fuel companies must employ an integrated fuel management solution that can capture, measure and report on positions in real-time across complex portfolios.

The good news is that recent technology advances can make risk management processes and analyses much easier than ever before, according to 2018 Oil & Gas Outlook by Deloitte. That said, effective risk management, regardless of market stability, requires investment in flexible and extensible fuel management software, such as Allegro Horizon, that delivers instantaneous transparency into portfolios from front to back offices and has the ability to respond to today's market needs while changing and adapting for future growth opportunities.

About the Author

Jesse Lamb is the Director of Solution Consulting at Dallas-based Allegro Development Corp., the world leader in commodity management solutions. In this position, Jesse oversees a team responsible for demonstrating the broad capabilities of Allegro's commodity trading and risk management software. As part of Allegro since 1999, he has worked with users of the platform across the commodity spectrum, including customers in crude oil and natural gas production, logistics and refined fuels distribution. He holds a degree in accounting from Southern University and Agricultural & Mechanical College in Baton Rouge, La.