Transports And Diesel Fuel Hedging

The Greek cynic Diogenes was said to have wandered the streets with a lantern and when queried thereon would respond, “I am just looking for an honest man.” I once averred you could do the same thing at [fill in the blank of your favorite exchange] and say you were just looking for a True Hedger.

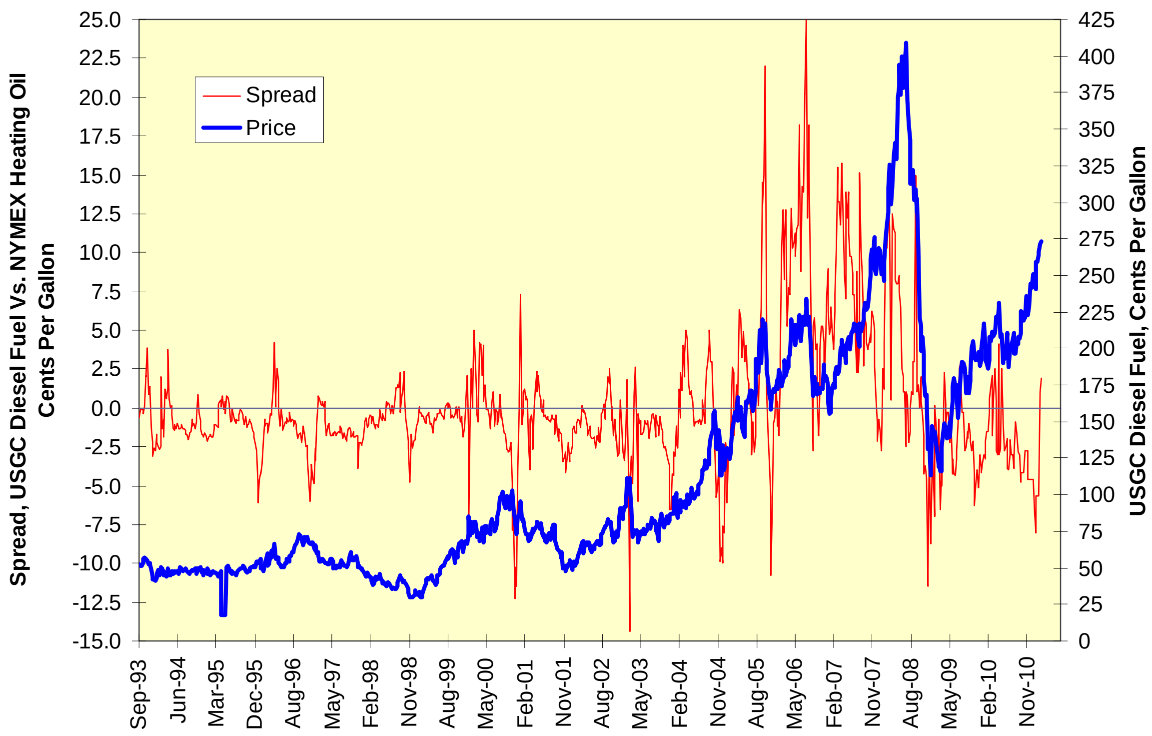
While you might think the Holy Grail was sitting under your nose in comparison, there are industries that actually do hedge and do it very adroitly (“Adroit” is not just a city in Michigan). Airlines, railroads, trucking firms and other transportation firms, airlines especially, have learned the hard way not hedging is a good way to go bankrupt or at least get a good beating when fuel prices rise. Southwest Airlines has been one of the better airlines in this regard.

Back To The Futures

Diesel fuel and jet kerosene both come from the same cut of the barrel as heating oil. All of the local basis swaps now used by fuel buyers and marketers thus have a tendency to trace back in one form or another to heating oil futures on the NYMEX. The futures allow you to catch the big up-and-down moves, but it is the local basis fluctuations that really drive hedge efficiency. When they start to go haywire, a technical term, the cost of doing business rises for everyone involved.

This is not happening yet despite all of the excitement in the petroleum world at the moment. If we map the spread between diesel fuel at the U.S. Gulf Coast and the NYMEX against the ordinal price at the Gulf Coast, we see basis volatility has yet to rise. Of course, if oil production remains threatened by political unrest, only a fool would bet basis volatility would remain low.

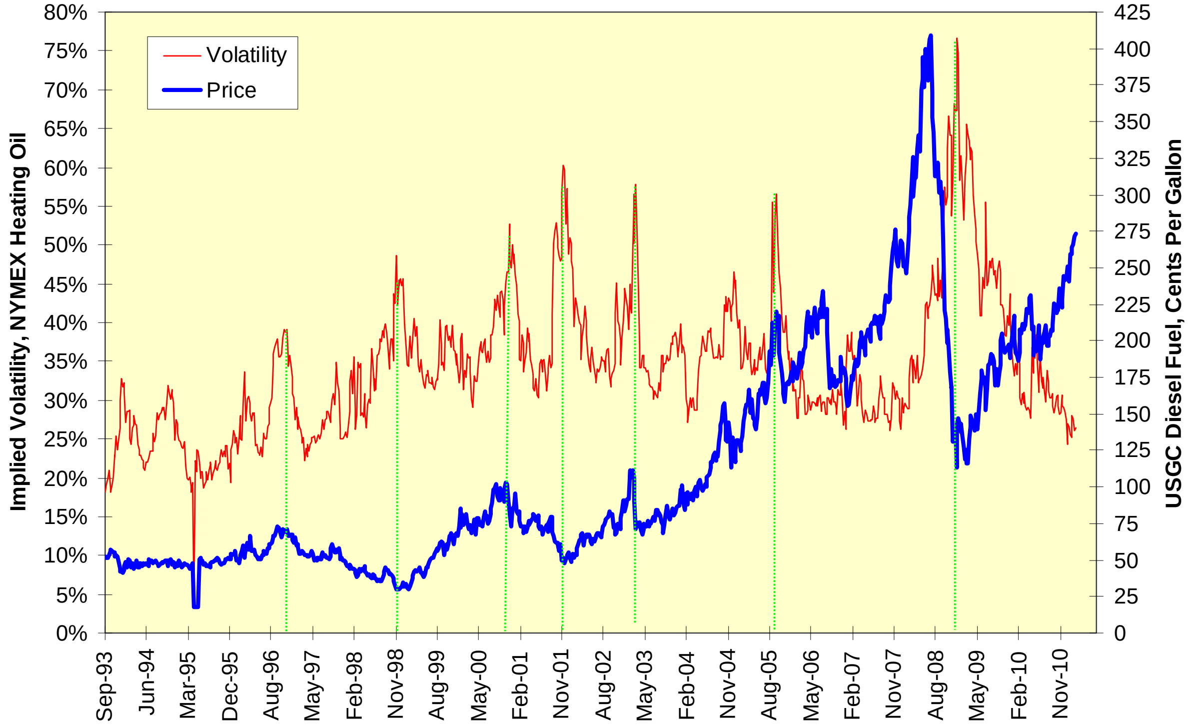
Basis Volatility Yet To Rise



Rather Be Lucky

Heating oil futures generally have had a demand skew in their volatility structure; as buyers are the more anxious party, volatility tends to rise along with price. It also is seasonal in nature, with volatility rising in the early winter months for obvious reasons. However, this volatility is near its lowest levels since the early 1990s even though prices have been rising. Buyers have been in no rush to cap rising prices.

Heating Oil Volatility Highly Seasonal



This low level of implied volatility is unlikely to persist in the face of another, 2008-style, price jump or in the face of continued unrest in oil-producing regions. Regardless of the outcome, it would be imprudent for fuel buyers to make that bet. If volatility rises, the cost of capping swaps and other price-protection arrangements for transportation firms will rise. It cannot be otherwise.

Here is the bargain: The transportation firms have to hedge, but you do not have to finance this for them as an investor, only as a customer. An underweighted position is indicated.