CTA FINANCIAL

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Weekly crude options now uniquely offered at CME Group.

Ask a mechanic if he can fix your car and he may respond by asking you what the make and model is to ensure he has the right tools for the job. Ask an oil supply and trading manager to recommend the best hedging tools and she likely would respond similarly with a resolute "it depends". Indeed, one size does not fit all in the world of risk management. At least for commercial oil hedgers, specific hedging challenges are best solved with specific tools. Fortunately CME Group offers a menu of futures and option choices that traders can pick according to value, expiry date, size and liquidity.

Among the most granular and specific tools are the weekly crude oil options offered uniquely by CME Group. Historically these kinds of options have been a popular choice among traders of agricultural products and financial indices due to the short term, event or headline news driven nature of their markets. For example, government statistics and weather can influence crop prices substantially in one week. Similarly, jobs data may influence broad stock markets from one day to the next. These event sensitive markets have gravitated toward the date specific weekly options as a common hedging and trading tool.

Although crude oil market players are regular users of futures, swaps and options, many commercial hedgers are still discovering the crude oil weekly options recently listed by CME Group. There is no doubt that the use of crude oil options has been popular among crude oil producers for years. This is partially driven by financing since lenders typically require that reserves be hedged (at least on the downside) to protect their loan value. Not surprisingly hedging for oil producers is often a mandatory condition prior to borrowing. In contrast downstream consumer hedgers and refiners often choose futures over options. This is particularly common when refiners capture the difference between refined products markets and crude oil inputs or "crack spreads" by selling refined product futures and buying crude oil futures as one trade. However, even spread strategies do not completely eliminate risk.

Buying options is often the lowest risk strategy and can be likened to buying insurance to create specific price floors or caps to limit risk. Alternatively, options can be used to minimize or eliminate collateral margin call risk associated with futures or swaps. Despite their benefits as hedging tool, options are often overlooked due to the perceived complexity or initial premium cost to the buyer. In addition, option strategies often need to be rebalanced or rolled to extend the life of a hedge or rebalance a position. With the addition of weekly options, oil hedgers now have even more reason to consider options to complement futures or swaps strategies.

The benefits of weekly options are quite simple: First, weekly options have the lowest premium cost compared to monthly options and second, weeklies provide additional date specific expiries. When faced with a hedge for days or a week, using a monthly option may not be the best fit or may require modifications to fit a given use or strategy. For hedgers or traders expecting risk until a certain day, economic event or business decision, weekly options (listed daily for the next 5 business days) may provide the best tool to manage risk. Given known economic events such as government data, statistics or reports, a trader can choose the weekly option with a more specific expiry day closer to a known upcoming event or release of data.

Weekly options may also be convenient to complement existing futures or monthly options positions. If a hedger typically uses futures to hedge, a weekly option may provide the solution to offset partial volume that does not fit a futures or monthly option strategy. For example many hedgers prefer futures since they provide a 1 for 1 volumetric hedge (or 100 delta). Futures are straightforward and easy to understand for management, investors and lenders. However, when volumes are uncertain, over or under hedging using futures can become a significant risk. In contrast, weekly options provide a more certain or specific hedge for a short time period. If not the time specificity, the lower cost may be the highest benefit since many avoid using options due to the premium itself.

Let's consider some applications of weekly options in the market. A crude oil producer has recently enjoyed high yields in his wells creating increased volume and leading to an underhedged position perhaps below the covenant requirements of his loan agreement. Management expects DOE data to be bullish in the coming week and the inventory could gain significant value. However, with macro conditions very uncertain and loan covenants potentially breached it would be too risky to leave the position underhedged. Given a bullish viewpoint, the producer can use a low cost weekly hedge to provide some price certainty while the CFO reviews the position with her bank. In this case, the cost of a weekly put option can be applied to the inventory holding cost. In the case of a rally, the producer can sell the inventory at a better level. If not sold, a better long term option can be placed or futures can be used to lock in inventory value gains. In the event of a market sell-off, the option will have intrinsic value that can be captured completely when sold or captured partially through using its credit against a new hedge.

Using a downstream example, let's consider a crude oil buyer. In this case, a refiner is has committed to buy 300,000 bbls of crude oil off the local pipeline in two weeks. The barrels will price the week of delivery and the trader has concerns that markets may rally ahead of the pricing week. Normally, the refinery management hedge with futures avoiding options due to the premium cost. Fortunately, a weekly call option is available for the exact week of the delivery at a cost well below the monthly Asian or American or European option. When the oil is priced each day of the delivery, the buyer can re-set the hedge by selling futures for exact volumes each day thereby matching the price of the current market. Meanwhile, the option will capture any increase in prices allowing the hedger to apply that credit to his crude oil costs.

Though options are often a better risk management tool than futures or swaps, the premium paid for the options creates a limit based on a hedgers budget. After all, a hedger must pay the premium up front and must be prepared to lose the entire premium in the event the option expires out of the money and worthless at expiry. Of course multiple options strategies exist to mitigate premium costs. Spreads, for example, can substantially cut down the cost of an option. Fortunately, weekly options are short tenor by design so the up-front premium is already substantially reduced. To put premium or relative cost of weekly option into context, the value of the weekly option purchased a week from expiry is comparable to a monthly option with one week to expiry.

Using weekly options strategies are an excellent fit for short term hedging or hedge balancing. Besides the low cost, the second clear advantage is being able to pick the best expiry date in order to hedge exact time exposure. Since crude oil prices are often priced on a daily basis, using a specific day or series of days is useful to fit a given pricing window for both buyers and sellers. Though expiry precision and low premium may be the most compelling reason to use weeklies, some view them simply as a complementary tool to balance existing futures and monthly options positions. As more traders discover weekly crude oil options offered by CME Group, they will undoubtedly be pleased with the flexibility and customization benefits.

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*About The Author: **Chris Thorpe** is a CFA charter holder with over 20 years' experience in commodities and finance. In 2003, Mr. Thorpe co- founded HCEnergy, LLC, a NYMEX-based provider of energy derivative products and hedging strategies. Following HCEnergy's sale to INTL FCStone in 2011, Mr. Thorpe founded CTA Financial LLC as an independent commodity advisor. Prior career experience includes corporate finance roles at JPMorgan and physical commodity trading with Methanex Corporation. He holds an MBA from INSEAD and a bachelor's degree from the University of British Columbia. Alongside CTA Financial, Mr. Thorpe co-founded Brick Investment Partners LLC, a private investment firm.*