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An overview of hedging policy issues for fuel hedgers

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CTA Financial LLC is a registered Commodity Trading Advisor

Commodity trading contains risks, and you should fully understand those risks prior to trading. Please reference the www.ctafin.com website for the full disclaimer.

CTA Financial LLC profile

■ Chris Thorpe, CFA

- Education: MBA (INSEAD), BA (UBC)
- 2013-: Founder of CTA Financial LLC, a commodity trading advisor registered with the National Futures Association (regulated by CFTC)
- 2003-2012: Co-Founder of HCEnergy, LLC, a provider of exchange cleared energy derivative products. Sold to INTL FCStone (Nasdaq: INTL) in early 2011
- 2000-03: JPMorgan investment bank (New York) corporate finance including hedging products
- 1993-99: Methanex Corporation, the global leader in methanol production (various roles in Vancouver, Brussels, Dallas)

■ CTA Financial LLC

- Serving energy and fuels clients: Upstream, mid and downstream hedgers of oil, refined oil products, natural gas
- Member of National Futures Association, registered as Commodity Trading Advisor
- Advising on the use of futures, options and swaps in the regulated and non-regulated markets
- CME Clearport executing broker status
- No ties to single counterparty, dealer or bank for energy derivatives

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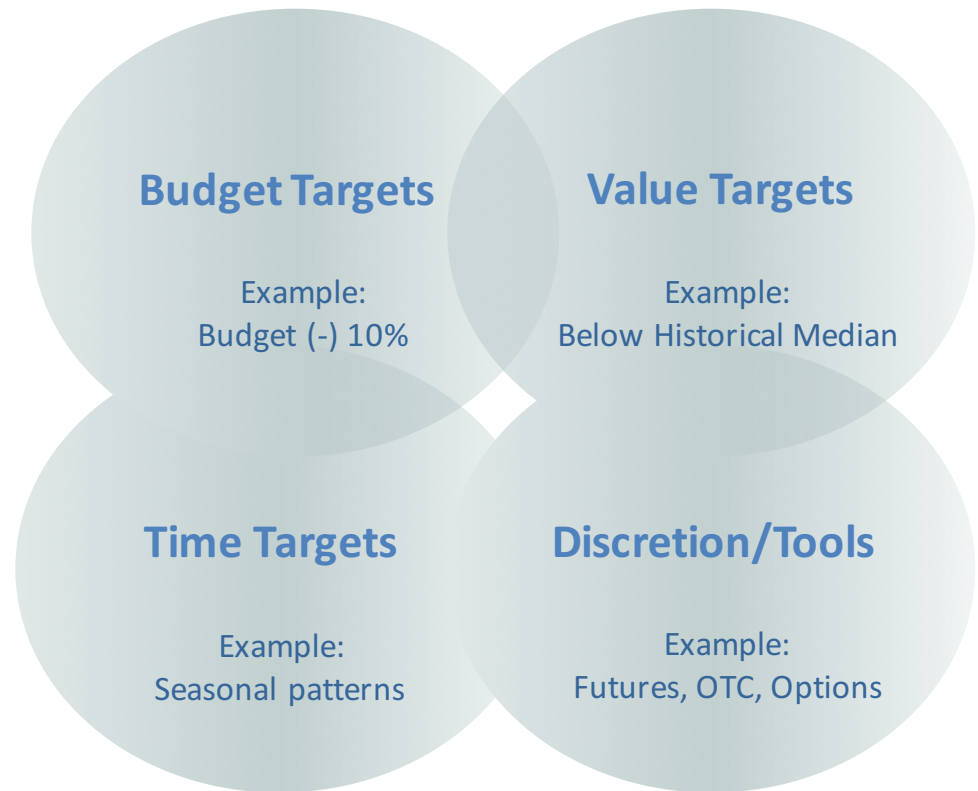
Hedge Strategy Development

A successful hedging program:

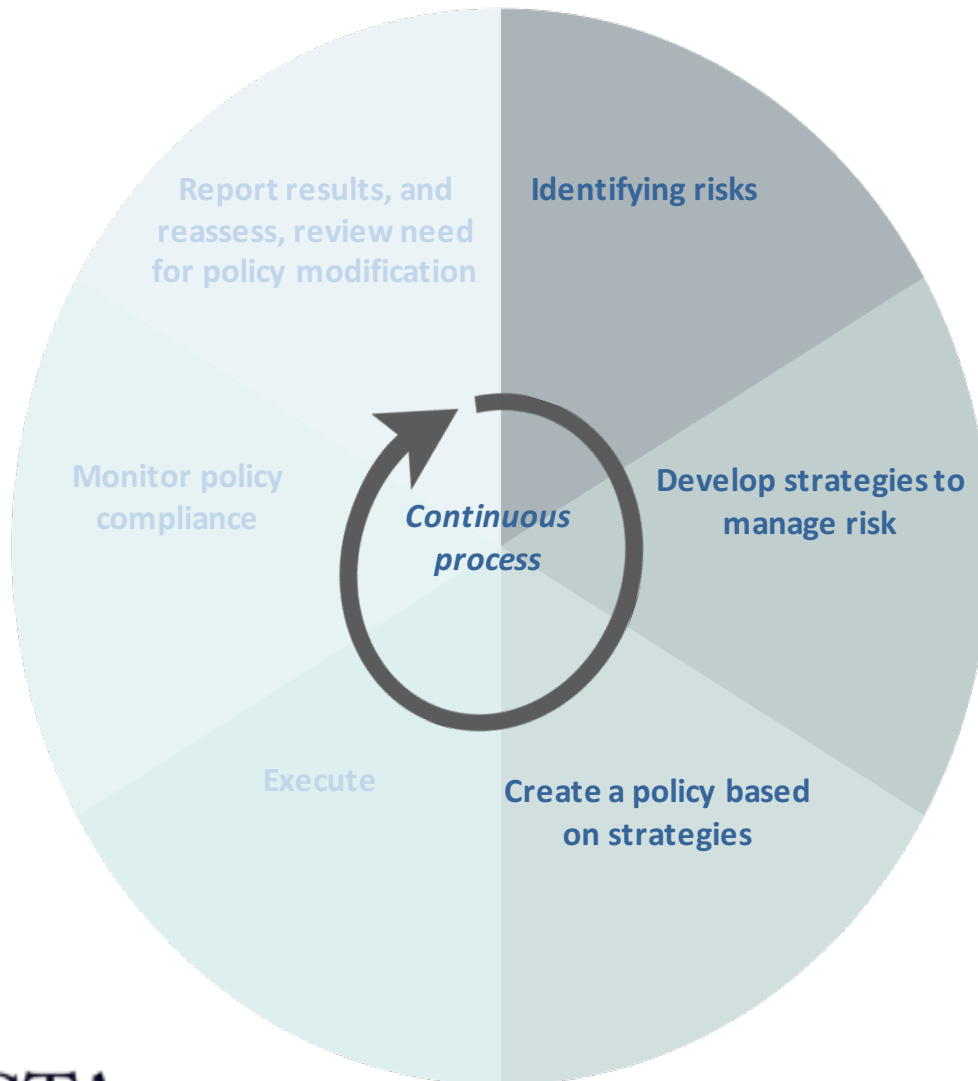
- Meets corporate procurement objectives
- Acknowledges quantified market risks and volatility
- Prepares for reporting impact on P/L and hedge accounting treatment changes
- Considers market opportunities beyond current planning cycle
- Contains objective execution parameters

HEDGE STRATEGY:

Designed to control price, not predict price.
May include a combination of...



Hedge Policy life cycle: Identification and planning



Once risks are identified

- Develop strategies for short term, long term or individual deal risk or specific volumes or customers
- Review whether the strategies will help the company reach its objectives
- Create a policy based on the strategy including what instruments can be used, who has authority, how are duties shared, and how will the policy be managed and controlled and reported

Execution, monitoring and reporting



Once strategy and policy is in place

- Execution includes day to day operation
- Execution may include the decision of what counterparties, brokers or trading platforms are used
- Once hedges are in place they must be monitored for policy compliance
- Reports of how the hedge performed must be created and reviewed to see if policy modifications are needed

Ask yourself the following questions

1. Are the assumptions of why the hedge strategy is needed clear and defined?
2. In assessing the hedge strategy is it clear as to the trade off between the risks and benefits?
3. Has the board been given the forecast hedge results under different scenarios and is the board comfortable with these results?
4. Have the hedge results been considered in the context of the liquidity, funding and capital required
5. Are there appropriate controls in place to manage the risks of using hedge tools?
6. Has the strategy been back tested for extreme scenarios (worst case?)
7. Has a specialist reviewed the policy to ensure appropriate controls are actually in place?

Dynamic versus static hedging

<u>Dynamic</u>	<u>Static</u>
Policy and limits set by board/Ownership	Policy and limits set by board/Ownership
Tactical plan sets boundaries to execution	Hedge strategy strictly defined including timing
Market + business factors allow for rebalancing contain boundaries + management approval	Hedge set and cannot be modified without Board approval

Considerations

- Allow some flexibility to management to adapt
 - Rebalancing does not mean “unhedged”
- May keep management “in check” when control issues exist
 - Board approval often slow +unable to quickly change director

Execution must fit policy

Relationship

- Physical supplier with fixed price forward or combination
- Financial hedge products
 - Bank or bi-lateral OTC
 - Exchange cleared futures, options, swaps through clearing broker
- Execution (phone) brokers, consultants and advisors

Execution task

- Internal responsibility
 - Chain of command and backups
- OTC
 - Direct with supplier
 - Broker assisted
- Exchange cleared
 - Electronic platform
 - Phone broker
 - Direct order entry

Position management

- Trade confirmation
 - Instantaneous
 - Dailies
 - Inventory and cash flow
- Reporting
- Error handling

1) strategic hedging review and execution plan

Service	Key questions	Main concerns
Strategic review	What is the hedge policy? Does it have the flexibility to be effective?	All constraints
	Price targets (swaps now ideal, but...)	Credit, collateral margin, option premium
	What derivative products may provide best solution?	Review alternatives and combinations
Execution plan	What is our hedge execution (“trading”) strategy?	Liquidity environment, timing, premium, bullet, stack or strip issues. Spreads and allocation flexibility.
	Should we use of OTC counterparty versus exchange traded market or both? If both, what allocation?	Access to all available tools and platforms and SEFs for current execution and rebalancing. Today’s best OTC solution may not be in 1,2-5+ years
	What is the trade capture platform? Are there mark to market issues, reporting, accounting?	Will existing platform and in-house tools be adequate?

2) tactical implementation and rebalancing

Service	Key questions	Main concerns
Implementation	What is trade item priority?	Front or back months, minimum delta cover
	What market orders will be used?	Limit orders, MIT, GTC, partials, swaps laid-up with options, etc.
	What time period can be used to layer in the hedge(s)?	Programmatic or discretionary?
Rebalancing	When should rebalancing take place?	Programmatic or discretionary? Delta targets?
	Should options be rolled into swaps if targets hit?	What level triggers spread or sale of option and initiation of swap, what are trade consequences (cash, collateral, tax)
	Should options be rolled up or down if market has material change?	Capital exposure may be captured or lost

Controlling price risk

- Can I hedge effectively in the marine fuel markets?
 - Yes, but....
 - A plan and strategy is essential
 - Policy needs attention
 - Access the entire tool box available
 - Be ready for change and adapt