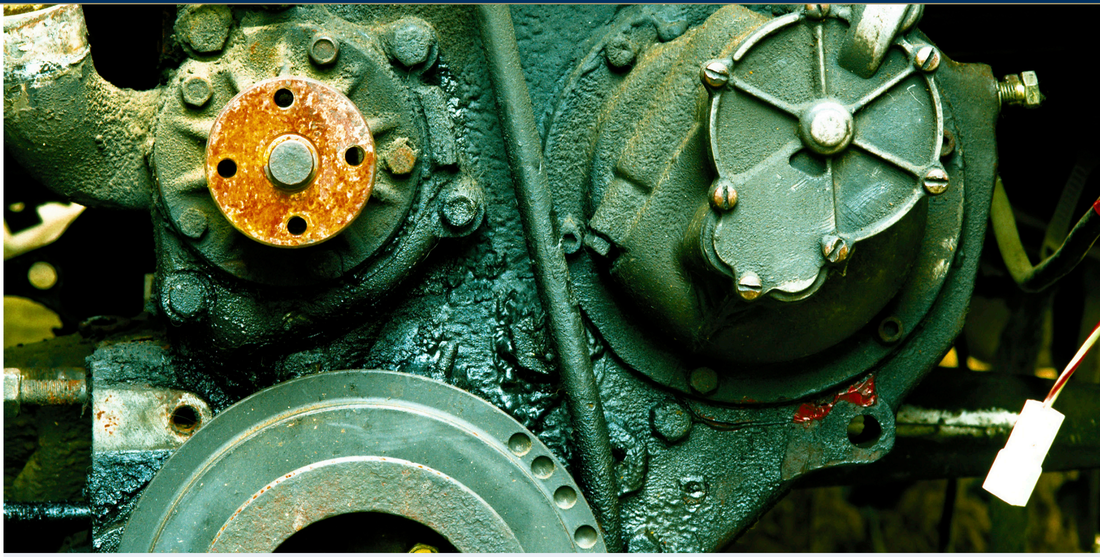
Hedging diesel



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One common method for hedging diesel is using the liquid No.2 Heating Oil futures contract traded on the CME Group Exchange (which will be replaced by a new "New York Harbor Ultra-Low Sulfur Diesel" contract beyond the August 2012 contract).

Heating oil futures is frequently used for the hedge because the two fuels are produced together and chemically similar; they both belong to the distillate fuel oil group, including jet fuel, kerosene, etc. Diesel fuel is often priced at a stable premium to that of heating oil. But it is important to note that while hedging diesel fuel through heating oil futures can be effective, the different quality specifications of the two products after all introduce an element of risk – basis risk.

EXAMPLE

In March, an independent trucking company which uses diesel fuel for its fleet, is looking to forward contract supplies for September, seeing that current prices appear to be at bargain levels. But because of the volatile fuel oil market of late, fuel oil distributors are reluctant to forward commit with a firm price more than 30 days in advance. And with private forecasts calling for tighter supplies, higher fuel oil prices by September 1, it decides to fix its fuel cost for the fall, to lock in profitable cost levels and better manages its cash flow. On March 15, the trucking company, calculating that it needs 126,000 gallons for the fall months, decides to buy three October Heating Oil futures at $2.9830/gallon. The size of one contract of heating oil futures is 42,000 gallons (one US gallon equals 3.785 litres).

	Cash Diesel	October Heating Oil futures
March 15	\$3.0310/gallon	\$2.9830/gallon

By September 1, distillate fuel prices have risen as anticipated, the trucking company decides to buy the diesel in the market and simultaneously sell the October Heating Oil futures to close out the hedge.

	Cash Diesel	October Heating Oil futures
Sept. 1	\$3.1330/gallon	\$3.0670/gallon

The gain in October Heating Oil futures:
(\$3.0670 - \$2.9830) x 126,000 = \$10,584

The higher cost for diesel:
(3.1330 – 3.0310) x 126,000 = \$12,852

Although the gain in heating oil futures is less than that in cash diesel, by hedging with heating oil futures, the trucking company is able to offset much of the higher diesel cost. On the other hand, if distillate fuel oil prices have fallen instead, and provided that the heating oil/diesel basis stays relatively stable, as seen in the example above, the loss in October Heating Oil futures would be offset by the lower cost in diesel, and again the trucking company would have locked in a diesel price at the March 15 price minus the cost of the hedge.

For more information about diesel hedging, or commodity/financial futures, please contact us.

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