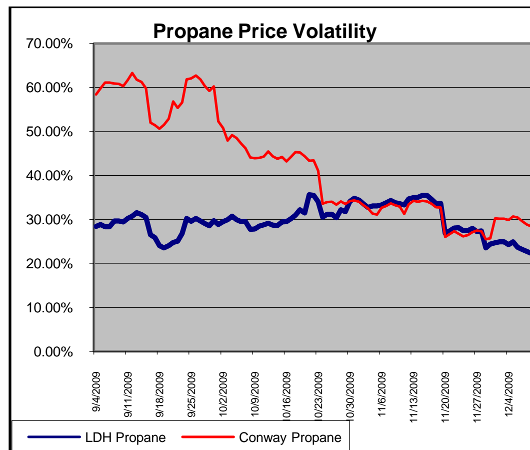
# Financial Hedging Strategies: *Using Propane Options*

## *The Problem*

Today's volatile propane market presents new challenges to retail businesses.

Rapid price movements of greater than 50 cents per gallon – once unheard of – are now becoming part of the seasonal landscape in propane wholesale markets.

As a result, retail propane marketers are now exposed to more risk to their bottom line margins than ever before.




## *The Solution*

Alliance Energy Services is a wholesale seller of financial options on propane, a hedging tool that works much like an insurance policy against rapidly rising or falling propane prices.

The use of propane options can help a propane retailer to lock in profitable margins in advance of the heating season – and to avoid seeing a year's worth of hard work go down the drain due to unpredictable market price movements.

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## *What is a Call Option?*

A Call option is used to hedge a company's risk to *rising* prices. It can best be explained by comparison to an automobile insurance policy:

*You pay a premium to secure coverage for your car. In return, the insurance company will pay you a settlement if certain events come to pass – for example if your car is wrecked or stolen.*

In much the same way, you pay a premium for a Call option. In return, the option seller pays you a settlement if prices settle above a certain number – that number is called the option "strike price". The strike price can be any price you choose, keeping in mind that the lower the strike price, the higher the premium.

Call options allow the option buyer to collect money in a rising market, without suffering losses in a falling market, making them a natural fit to hedge retail "price cap" programs.

Example:
On October 10th, ABC Propane Co. buys a 90 cent/gal (strike) call option for December propane. ABC pays a premium of 6 cents per gallon to Alliance for the option.

*At December 31st (option expiration), one of two things will happen, either:*

a) The propane price for December (month average) will be greater than 90. In this case, Alliance will make a payment to ABC equal to the December price minus the strike price. If the December price is 110, the payment would be 20 cents per gallon. OR
b) The propane price for December will be less than 90. In this case, the option expires and no settlement is paid.

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## *What is a Put Option?*

A Put option is just like a Call option, only a Put option will pay the option buyer when prices fall *below* the option strike price.

## *Benefits of Using Options*

A crucial argument for using options is that the maximum cost of the hedge is known up front (the option premium). Compare this to hedging with a physical pre-buy or a swap contract, where losses on the hedge can grow to surprisingly large amounts in a short time, and therefore must be monitored carefully.

Buying an option is a way to simplify the task of managing risk for a known and upfront fee, freeing up time and resources to devote to your core business.

## *Alliance Energy: Risk Management Services*

Alliance Energy Services can use its market access, economies of scale, and experience to hedge risk in today's volatile marketplace. With access to both physical propane and financial options markets, Alliance is able to efficiently manage risk for companies that don't have a dedicated risk management team in-house.

For many companies, outsourcing risk management needs with Alliance makes a lot of sense – providing access to strategies previously only available to the largest companies employing full time staff.

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