



INSIDE COVERAGE

Conover Transportation - What Fuels You Howard A. Morin, Senior Advisor, Conover Capital Management

Over the last few months we have seen the price of commodities creep up into historic levels. Now we drill into a topic that we deal with every day...fuel. The cost of gas and diesel always seems like it is going up and recently was close to an all-time high. Representing a major expense in your trucking business as significant as insurance, rent, vehicle payments, payroll, etc...it is an issue that owners cannot afford to ignore. Large fleet operators and small are questioning their ability to survive, especially staring into a time of economic uncertainty across the nation. This is an issue that requires some planning instead of scrambling for a solution when diesel tops \$5.00 a gallon.

So the question begs...what really is the problem? Why don't we just keep raising our prices or adding larger and larger fuel surcharges? The rising cost of fuel is probably not something that can infinitely be passed off to clients. When times are good, people are ok with increasing costs. These days it's hard to keep raising rates and surcharges, especially in an uncertain economy. Variable and flat-fee surcharges are not only showing up on regional and long-haul transportation services, but airline tickets, shipping, and short-haul deliveries as well. And unlike surcharges based on an index which go down when prices fall, flat fees tend to stay put. Some clients believe the link of these charges to actual fuel costs remains somewhat fuzzy and question them regularly. We have even seen smaller fleet operators lose out on new business because their fuel surcharge was higher than their larger competitor just to break even.

The implications of fuel management or the lack there of are huge. Many transportation business owners are asking themselves, what is the answer? Can I afford to sustain these rising costs? How do I stay competitive when bidding for new business? Some people are looking at Fleet Management Programs to leverage the economies of purchasing large quantities of fuel while others are looking at Fuel Cost Hedging.

For the purpose of this article we are going to look at the business of Fuel Cost Hedging. What is hedging you ask? The

term is derived from the phrase "hedging your bets" used in gambling games such as roulette. When you purchase insurance for your trucks and other vehicles, you are hedging. Doing so is one of the oldest means of hedging against risk, and insurance is purchased to protect against financial loss due to accidental property damage or loss, personal injury, or loss of life. Fuel Cost Hedging is the practice often employed by airline companies to protect against the shock of anticipated rises in price.

In the finance world, a hedge is an investment that is taken out specifically to reduce or cancel out the risk in another investment. By definition, hedging is a strategy designed to minimize exposure to an unwanted business risk such as the skyrocketing cost of diesel fuel while still allowing the business to potentially profit from an investment activity.

Some form of risk taking is inherent to any business activity. Some risks are considered to be "natural" to specific businesses. The risk of oil prices increasing or decreasing is natural to oil drilling and refining firms. Other forms of risk are not wanted, but cannot be avoided without hedging. Someone who has a transportation business for example, expects to face natural risks such as the risk of competition, poor service, and so on. The risk of the fleet being destroyed by fire or getting into accidents is unwanted and can be hedged via insurance policies.

Why do transportation firms hedge? Fuel costs have substantially risen over the past several years putting consistent pressure on these businesses (Airlines, Shipping Providers, and Ground Transportation Services) to maintain positive cash flows. The airlines have been hedging their fuel costs since the 80s. From day to day, we don't know if diesel is headed to \$5.00 per gallon in LA or down to \$2.00 per gallon in Spokane, but what are the implications of both? Major weather events like hurricanes and political instability in the Middle East could cause energy prices to rise dramatically

continued on page 2

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without much warning. How would this affect your business in the upcoming month, quarter, or year? In the words of an Ancient Chinese Proverb, "Predicting is very difficult, especially as it concerns the future."

What are the benefits of hedging? For starters, it allows businesses to generate more consistent and stable cash flows. Knowing when your trucks are busiest and how many containers your fleet can haul are easy and rather predictable. Guessing fuel prices and how they change is not. Fuel Hedging also allows an operator to take advantage of investment opportunities in times of high gasoline prices. It is more likely that businesses will go bankrupt when fuel and other costs are very high, and in such cases they are often forced to sell vehicles, equipment, and other assets at below-market prices.

Some owners think they are too small or a hedging strategy will not reap any reward or have impact. One of the most frequent questions I get is "What are the risks of not hedging?" By not hedging, transportation companies are taking on the increased risk of rising fuel prices into their business model. That may be fine if there are large cash reserves. Most operators are not in this position with the rising cost of insurance, regulation, and other everyday operating expenses. When fuel prices rise dramatically it is hard to pass all of the cost on to customers. At some point raising prices, let's say greater than 10%, will cause a 10% reduction in revenue. There is a magic number in there that says at some point raising prices will cause a significant drop in revenue. The success of such efforts over time is very unpredictable. Are your clients willing to sustain yo-yo pricing from month to month or year to year based on changing costs? More and more, we are seeing trucking and other transportation providers, especially with large diesel-guzzling fleets that want to manage risk, prevent huge swings in operating expenses and bottom line profitability choose to insure themselves adequately and hedge fuel prices.

There are many more available fuel hedging strategies than we have room in this article to describe. There are a variety of hedging strategies available to luxury transportation companies, ranging from simple to sophisticated. These include:

- **Common Stock** - The common stock of global oil companies are traded on major exchanges and can be bought and sold. This represents an equity ownership stake in the leading providers of oil and gas.

- **Exchange-Traded Funds (ETFs)** - A representative basket of securities that trade like common stock. An index representing fuel prices or the cost of a barrel of oil can be bought or sold as easily as common stock.
- **Equity and Index Options** - A call option is the right to buy a particular asset at a predetermined fixed price (the strike) at a time up until the maturity date. These contracts in certain combinations can be used to protect or leverage virtually any outcome. There are options available on a multitude of underlying instruments such as gas company common stock, fuel and gas indexes, and ETFs.
- **Futures Contracts** - A futures contract is an agreement to buy or sell a specified quantity and quality of a commodity, such as gas or oil for a certain price at a designated time in the future. The buyer has a long position, which means he/she agrees to make delivery of the commodity (i.e., purchase the commodity). The seller has a short position, which means he/she agrees to make delivery of the commodity (i.e., sell the commodity). Futures contracts are traded on an exchange, which specifies standard terms for the contracts (e.g., quantity, quality, delivery, etc.) and guarantees their performance (removing counterparty risk).

Financial instruments such as stocks, options, and futures involve significant risks. You can find additional information on the investment vehicles described in this article by visiting the following websites:

- New York Stock Exchange www.nyse.com
- Chicago Board Options Exchange www.cboe.com
- NASDAQ Stock Market www.nasdaq.com
- The New York Mercantile Exchange www.nymex.com

For more information about whether any of the strategies described in this article may be an appropriate solution for your business, contact your Conover Insurance Representative or the team at Conover Capital Management.

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Meet Your Transportation Insurance Team



Randy LaRiviere - Vice President

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Randy LaRiviere joined the commercial insurance sales team of Conover in 1991 and is a 20 year veteran of the insurance industry. Randy started working with transportation risks in 2004. About 35% of his clients are transportation-related accounts. Randy is based out of Yakima, WA.



Andy Emerick, CIC - Vice President

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Andy Emerick joined the commercial insurance sales team of Conover in 2002 and has been in the insurance industry for 11 years. Andy specializes in large property and transportation risks and has a diverse client base ranging from agriculture and distributing to manufacturing and real estate. Andy is a member of the Conover Corporate Executive Team and is based out of Kirkland, WA.



Kyle Mahuika - Account Executive

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Kyle Mahuika joined the commercial insurance sales team of Conover in 2009. Kyle worked at Washington's second largest petroleum distributor for two years and has owned his own business. He understands the intricacies of how companies and businesses work. Kyle specializes in transportation and agriculture related risks. He is based out of Pasco, WA.



Leslie Dawson - Account Manager

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Leslie Dawson joined the commercial insurance service team in 2000 and has 11 years of insurance industry experience. Leslie specializes in and manages a large book of our transportation business. She is counted on daily for her management expertise in all of our transportation customer's needs.

Team Depth & Perpetuation

Our Sales Team is backed by experienced teams of account managers, administrators and claims managers. Each executive is assigned an account manager that helps service their clients. The Sales Team also has access to a pool of administrators to help process certificates, endorsements and other items as necessary.



Natali RoQue - Account Manager

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Natali RoQue joined the transportation service team in January 2010. Natali has six years of insurance industry experience and is key member of the transportation team. Natali is involved in the frequent day-to-day needs and changes of our transportation clients, safety seminars and driver training programs.

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