Weather Futures Example

Customer A has a monthly energy bill of $500,000. Customer A is worried that the coming winter could be severe and that its energy bill might jump substantially. Customer A's research shows that a 1% increase in HDD results in a 2% increase in its energy bill.

Customer A could buy weather futures to mitigate this risk.

<u>Example</u>

Customer A buys Chicago HDD Index January 2000 valued at 1,250.

A 1% increase in HDD would be worth $1,250.

A 2% increase in the Customer A's energy bill would cost an additional $10,000
($500,000 x .02 = $10,000)

Thus, Customer A would need to buy 8 contracts
($10,000/$1,250) = 8

Say the winter is severe and the HDD contract settles at 1,500.
This would result in a profit of $25,000 per contract or a total profit of $200,000
(1,500 – 1,250) x $100 x 8 = $200,000

The 250 HDD increase represents an increase of 20% which, if Customer A's research is correct, would result in a 40% increase in Customer A's energy bill. This would be an increase in its energy bill of $200,000 ($500,000 x .40 = $200,000) that would be offset by its gains on the weather futures.