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### Gas-station owners try oil futures market

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By George Anders, The Wall Street Journal

AUBURN, Calif. -- As a boy in the 1950s, Walt Dwelle loved helping out at his family's gas station. When price wars arose, the Dwelles would grab a can of blue tempera paint, write "19.9c" on butcher paper, and then tape the new prices in front of the station. Customers streamed in and business thrived.

It isn't so easy any more. The gas-station business is in turmoil, largely because of wildly zigzagging energy prices. With oil prices once again hitting record highs, station owners are jockeying to see who can get fuel on tolerable terms. Profit margins have been squeezed for operators from mom-and-pop independents to the company-owned stations of Exxon Mobil Corp.

Now Mr. Dwelle and some other independent station owners are trying their luck in the sharp-elbowed world of commodities futures. They hope to find trading strategies that will stabilize costs and shore up profits. A misstep in this new world can be ruinous, but some of these nervous rookies are succeeding.

Last winter, Mr. Dwelle and his three brothers locked in bargain prices for 25 percent of their gasoline, a move that saved more than \$1 million. In March, they correctly bet that runaway oil prices were about to peak. Currently, they are hedged against a further price leap. Overall, futures trading has helped their bottom line in 10 of the past 13 months.

Tiptoeing into the commodities market "feels spooky at first," says Mr. Dwelle, 57 years old. Profit-and-loss swings can be huge and unexpected. That's especially jarring for managers who have spent years worrying about the small stuff, such as hiring cashiers or keeping snack shelves well stocked.

A growing number of gas-station owners are taking the plunge. According to industry consultants, about 20 percent of gas-station owners now use the futures markets, up from almost nothing two

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decades ago. That tally doesn't count giant integrated oil companies such as Chevron Corp. or Exxon Mobil, which have been active in the futures markets for decades.

Currently major oil companies own about 5 percent of the nation's 169,000 gas stations. About 60 percent of stations carry the big companies' signage but are operated by independent licensees. The rest are off-brand stations. The industry has been retrenching for years, in the face of tighter environmental rules, dwindling profits from service garages and the emergence of giant stations that can displace three or four smaller predecessors. All told, the U.S. station count has dropped 17 percent since 1994.

Station operators traditionally haven't agonized over what the next truck of fuel might cost. Refiners generally price their unbranded fuel about 2 percent or 3 percent below their house brands, which offer greater prestige and fancier additives. That gap lets independents position themselves as cheaper, no-frills alternatives.

Most of the time, wholesale prices adjusted uniformly when oil prices rose or fell. So station operators simply passed along costs to the public. Motorists might squawk, but even major swings in energy prices hardly altered the competitive balance among stations.

In the past 18 months, two things have changed. First, intense gyrations in world oil prices have station owners obsessing about timing fuel purchases to the hour, so they can buy more at the troughs and less at the peaks. This year has seen wholesale gasoline prices gyrate as much as 10 cents a gallon within a day. In such times, a station owner's most crucial decision may be whether to refuel tanks at Tuesday afternoon's prices or hold out for cheaper terms the next morning.

Second, unbranded gasoline isn't any longer the automatically cheaper alternative to branded products. Sometimes that's because refineries have rejiggered their price lists, helping house-brand stations get cheaper fuel. In other cases, refinery shortages or heavy betting by speculators are jacking up prices in the unbranded market, to a degree that no one expected.

For independent filling stations, which rely on cheaper unbranded fuel to be competitive, "these are tough times," says Mary Welge, an analyst at Oil Price Information Service of Wall, N.J. "They got used to one kind of market dynamics for generations. Now they're getting killed."

Tradition runs deep at the Dwelles' business, Nella Oil Co. The company name is an oblique tribute to the Dwelle brothers' grandfather, Walter Allen, who entered the gasoline business in 1931. (Nella is Allen spelled backward.) An ancient yellow and red pump, set to 17 1/4 cents a gallon, graces the lobby at Nella headquarters.

Family members say that closely held Nella has annual revenue of about \$700 million and net income of at least \$10 million in its good years.

Nella owns 23 discount gas stations, operated under its Flyers and Olympian brands. It also manages 27 stations for Exxon Mobil and other majors. And it does some fuel wholesaling and truck refueling, all in central and Northern California.

"People say we're defined by a mixture of Depression-era thriftiness and military discipline," says Walt Dwelle, Nella's managing general partner. He spent five years as a Navy flight officer, peering at Soviet military installations in Egypt, before entering the family business in 1971. His two older brothers, 67-year-old Tom and 64-year-old Steve, are former Air Force pilots who flew combat missions in Vietnam. The youngest brother, David, 56, is the only nonmilitary man; he has become an expert in solar energy. All four brothers are Nella directors, along with the company's general manager, Rick Teske.

For decades, Nella didn't focus much on its fuel-buying habits. Executives poured attention into other areas, such as station signs, cleanliness and availability of on-site snacks. The Dwelles bought gasoline almost daily at whatever terms the market set, deferring to suppliers who didn't want to be locked into guaranteed prices months in advance.

At Nella board meetings over the past few years, this passive approach came under fire. "We realized we did well when fuel prices were falling," Steve Dwelle recalls. Cost savings could be passed along slowly to the public, allowing profit margins to fatten. But when refinery prices soared, pump prices couldn't keep pace and Nella's margins were squeezed.

As Steve Dwelle recently explained, "We wanted a defense mechanism to guard against the market's razor scratches."

The Dwelles hired a fuel trader from outside, but abandoned that idea in 2002 because his trading was too rapid-fire and unprofitable for their tastes. The brothers regrouped and decided to rely instead on someone who knew their way of doing things. They turned to Dolores Santos, a former filling-station cashier who had risen to become Nella's manager of supply and distribution.

Starting in the spring of 2004, Ms. Santos began buying gasoline futures on the New York Mercantile Exchange, in batches of 30 contracts a month. Each futures contract, an agreement to buy a certain amount at a given price by a given time, covered 42,000 gallons of 87-octane unleaded fuel, about one-quarter the amount that Nella's outlets typically sold in a day. Nella in effect was locking in future gasoline purchases at preset prices, hoping that these would prove to be bargains.

The Nymex trades as much as 100,000 gasoline contracts a day, chiefly on behalf of big oil companies and Wall Street trading desks. So global markets hardly felt a ripple from Nella's activity.

Ms. Santos also negotiated some complex "swaps" with energy traders

that amounted to bets on the future price of California's unique blend of low-emissions gasoline. If gasoline prices rose, the futures and swaps would become more valuable. If gasoline prices fell, the contracts would be loss-makers, but they would be offset by strong profits from Nella's regular operations.

At first, everything went right. Nella's early futures contracts locked in wholesale prices of about \$1.30 a gallon. (Those contracts don't include as much as 50 cents a gallon of at-the-pump taxes.) As energy prices rose in mid-2004, it became clear that Nella's contracts were at deliciously below-market rates. Rather than hold those contracts until their expiration date -- and take delivery of fuel through Nymex -- Nella cashed out a week or two early at a profit and used the winnings to help pay for gasoline from its regular suppliers. The Dwelles and Ms. Santos were delighted.

Later in 2004, oil prices slumped, crushing Nella's futures positions. Ms. Santos was devastated. She recalls waking up at 2 a.m., unable to sleep, and watching MSNBC news bulletins in the dark. "There's a war in Iraq, and I have to worry about how it's going to affect diesel prices in Fresno," she recalls telling colleagues. In the office, she sometimes grabbed little stuffed-animal tigers that perched atop her computer terminal and hurled them at colleagues to release tension.

For reassurance, Ms. Santos talked every few hours with Chris Mennis, a commodities broker who is a 25-year veteran of the energy markets. He moved to the central California coastal town of Aptos a few years ago so he could enjoy surfing on slow afternoons. His firm, New Wave Energy, became Nella's broker on all futures trades.

"Chris is my priest, my mom and my counselor," Ms. Santos says. "He yells at me when I'm about to do something stupid."

Mr. Mennis says he urged Ms. Santos not to make reckless trades when energy prices weren't going her way. Keep whittling down futures positions gradually, day by day, he advised. Don't dump Nella's entire holdings in a single spasm.

"Are you trading to reduce your risks, or are you doing this to speculate?" Mr. Mennis repeatedly asked. Only speculators would dream of scoring big by outwitting the market's day-to-day meanderings, he explained. A gradual approach might not catch every last cent of possible profit. But it would guard against playing costly, mistaken hunches.

At Nella headquarters, Walt Dwelle grew mesmerized by oil-news bulletins and price updates on his computer terminal. "It was like a videogame," he says. "Once you started looking at the screen, you couldn't stop." In October 2004, a barrel of crude cost \$55. Two months later, it sunk to \$41, on the belief that a mild U.S. winter would reduce heating-oil demand. Then it surged to \$48 in January and \$58 in early April, propelled by strong demand from China and Wall Street

predictions of even-higher prices.

The price moves took a toll. As gasoline prices shot past \$2 a gallon, customers at Nella's stations largely stopped buying 91-octane premium fuel. Even BMWs and Corvettes made do with cheaper 87-octane gasoline. That switch cost Nella some of its highest-margin pump traffic.

Meanwhile, refinery outages in California caused the price of unbranded gasoline to soar. With more customers than they could satisfy, refineries offered their best deals to stations selling their own brands and jacked up wholesale prices for everyone else. That put Nella's Flyers and Olympian stations at a severe disadvantage. Because they were paying more for fuel, they either had to pass along the costs to customers -- and lose much of their traffic -- or stay cheap at the pump and watch their profit margins vanish.

In early 2005, some other off-brand stations in California closed their pumps for several weeks. Thick yellow tape blocked motorists' entry into once-busy refueling lanes. Only the snack shops stayed open, hawking coffee, donuts and beer. With wholesale unbranded gasoline costing as much as 15 cents a gallon more than branded, these stations didn't see any way to attract pump customers without selling at ruinous losses.

Nella wanted to hang on. Over dinner in San Francisco, Walt Dwelle asked a top refinery executive in March if he could temporarily give Nella a price break on unbranded gasoline. In return, he offered the official higher prices later, when they would be easier for Nella to stomach. The request was futile. "He was perfectly cordial," Mr. Dwelle recalled. "But his bottom line was: 'That's the way that markets work. And we respect the market.'"

Fortunately for Nella, Ms. Santos was on a roll. In the first quarter of 2005, her trading operations brought \$1.5 million of gains. It wasn't enough to offset Nella's losses at the pump. But it made the quarter far more tolerable.

In mid-March 2005, Nella executives and advisers huddled to talk about whether oil prices could possibly keep climbing much beyond \$50 a barrel. Several people said yes. But Walt Dwelle argued that a price bubble was about to pop. He decided that Nella should sell all its futures contracts right away -- months ahead of schedule -- on the belief that the company could lock in extra profits that way.

Walt Dwelle's move paid off in the short-term, as crude-oil prices in April slipped below \$50. But Mr. Mennis, the broker, worried that without hedging in place, Nella could be vulnerable to another jump in energy prices. He quickly persuaded the Dwelle brothers to embark on a different trading strategy. That approach involved purchasing options, which grant the right but not the obligation to purchase something at a set price on a future date -- in this case vast amounts of gasoline over the summer at \$1.95 a gallon. If prices stayed below that level, the options

would expire worthless. But if gasoline prices soared, the options would let Nella get supplies at below-market prices.

So far, Nella hasn't cashed out its options, because wholesale gasoline prices remain below the \$1.95 threshold level. But with crude-oil prices recently climbing above \$59 a barrel, wholesale gasoline prices are nearing levels at which Nella's options would make a difference.

Meanwhile, two fourth-generation members of the Dwelle family are getting started at Nella. They are cycling through a classic management training program, learning how to run individual gas stations. But one of the newcomers, Ken Dwelle, son of Tom Dwelle, is spending several months as an apprentice to Ms. Santos, learning the futures-trading business.

"I jumped at the opportunity to do this," Ken Dwelle recently said. "I can't think of anything more important to our future."

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