



GLOSSARY

Futures and Options Terminology

American Option	An option that may be exercised on any day ahead of expiry. These trade primarily on the futures exchanges.
Arbitrage	The simultaneous purchase and sale of an instrument in two separate markets, when the price is out of line.
Asian Option	An option that is exercised or settled against an average over a period.
At the money Option (ATM)	An option with an exercise price at the current market level of the underlying.
Basis	The gap between the active futures price and the implied forward price of the underlying commodity.
Basis Swap	Basis swaps are used to hedge exposure to basis risks, such as locational risk or time exposure risk. For example, a natural gas basis swap could be used to hedge a locational price risk: the seller receives from the buyer a Nymex settlement value (usually the average of the last three days closing prices) plus a negotiated fixed basis, and pays the buyer the published index value of gas sold at a specified location.
Black-Scholes	Options pricing theory derived by Fisher Black and Myron Scholes, based on the theory that price volatility is random around a given trend.
Call	The right, but not the obligation, to buy something, such as a future or swap contract, at a fixed price in the future.
Combination hedging	A risk management strategy that uses a combination of hedges using different derivative instruments to meet a specific need.
Contracts for Difference	This term is used as an alternative to the term swap. The term is often applied to hedging instruments used in the UK electricity market, and in the Brent “CFD” market.
Covered option	An option written against an underlying position
Curve-lock swap	Swap which “locks” the counterparty into an existing price relationship in the forward curve, with the aim of benefiting from any shifts in the forward curve e.g. between backwardation and contango.
Delta	The rate of change of the value of an option with respect to changes in the price of the underlying commodity



Diff Swaps	Contract to exchange the difference between 1) the differential between the price of two products (fixed), and 2) the actual differential over time (floating).
Double-up swap	This instrument grants the swap provider an option to double the swap volume before the pricing period starts; granting this option, swap users can achieve a swap price which is better than the actual market price. The mechanism by which this is achieved involves consumers (who are buying fixed) selling a put swaption, or producers (who are selling fixed) selling a call swaption; in either case, the premium earned from the sale is used to subsidize the swap price.
European Option	Option that can only be exercised on the date of expiry. These typically trade in the OTC markets and can be liquidated or offset prior to settlement.
Exchange-traded	Futures or options that are traded on an exchange such as NYMEX or IPE, with standard contracts and rules.
Exercise	The conversion of the option into the underlying commodity.
Extendable swap	The extendable swap is constructed on the same principle as the double-up swap, except that instead of doubling the swap, the provider has the right to extend the swap, at the end of the agreed period, for a further predetermined period.
Futures	A forward contract that trades on an organized exchange allowing traders to take position in the market at a future date
Gamma	The rate of change in delta per unit change in the underlying instrument
Historic volatility	The change in the absolute value of a commodity or instrument over a certain period, expressed as a percentage of the LOWEST price recorded in that period
Implied volatility	The volatility implied by a certain option price
In the money option (ITM)	An option with intrinsic value at the time of purchase.
Inter-month spread	Simultaneous purchase and sale of a future in two separate trading periods
Long position	A trader buys something, in the hopes that its value will go up
Long-liquidation	Selling of a long position



Margin swap	Refining margin swaps
Margins	A deposit paid on a futures transaction. Initial margin is paid, followed by top-ups as the position develops. Margins are paid to the exchange.
Naked option	A short option position in which the writer does not have the underlying commodity
Off-market swap	In this type of swap, a premium is built into the swap price to fund the purchase of options or to allow for the restructuring of a hedge portfolio. Off-market swaps are generally used to restructure or cancel old swap/hedge deals: essentially, they simulate a refinancing package.
Options	A system of trading under which the writer of the option gives someone the right but not the obligation to buy or sell an underlying commodity, for instance, a futures contract. Options can be over-the-counter or exchange-traded. Because the writer of the option faces more risk than the buyer, he charges a premium for his services.
Out of the money Option (OTM)	An option with an exercise price lower than the current market level of the underlying instrument. Such an option has no intrinsic value, but has got time value, as price changes in the underlying might bring it back into the money.
Over the counter (OTC)	Bilateral markets in which contracts for futures, options and swaps are written on a tailor-made basis.
Participation Swap	Similar to a regular swap in that the fixed price payer is fully protected when prices rise above the agreed (fixed) price, with the difference that the client “participates” in any price decrease. For example, a participation swap agreed at a level of \$80/mt for high sulfur fuel oil, with a 50% participation, would offer full protection against prices above \$80/mt. But the buyer would retain 50% of the savings generated when prices fell below \$80/mt.
Premium	The price of an option, as determined by an options pricing model.
Pre-paid swap	By means of a pre-paid swap, the fixed payments that form one side of the cash-flows generated by a standard swap, and which are normally paid over the life of the swap, are discounted back to their net present value and paid as an immediate cash sum to one of the swap counterparties. That counterparty will then make floating price payments over the life of the swap, just as in a standard swap. Pre-paid swaps are often used as a source of project finance or pre-export financing.



Profit-taking	Long liquidation or short-covering set off by the desire to realize the profits in a position.
Put	The right, but not the obligation, to sell something, for instance, a futures contract or swap, at a fixed price in the future.
Refining margin Swaps	Swaps that simultaneously hedge the price of the products (or output) of a refinery, and the price of the crude oil feedstock (or input). That is, the products are sold, and the crude is bought, for equivalent forward periods. Refinery margin swaps effectively “lock-in” the profitability of a refinery.
Rho	The rate of change of the value of an option with respect to the risk-free rate of interest.
Short Position	A trader sells something he doesn’t have, with a view to buying it cheaper at a later date.
Short-covering	Buying back of short sell positions.
Spread	The difference between two futures contract months (or contracts for different commodities).
Stop-loss orders	Buy or sell orders put in through a broker, which are automatically triggered if the price moves above or below a certain level.
Straddle (long)	Simultaneous purchase of a put and a call option with different maturities. This is a bet that volatility will increase; the rise in the value of one option will offset the nonproductive premium paid by the other option.
Straddle (short)	Simultaneous sale of a put and a call with different maturities, with a view that volatility will go down
Strangle	Buying a call and buying a put with the same maturity
Strike price	The price which the buyer of an option decides to lock in. For instance, at \$13.00 spot, WTI puts and calls can be written at strike prices at... \$14.00, \$13.50, \$13.00, \$12.50, \$12.00...
Swaption	Option to purchase (call swaption) or sell (put swaption) a swap at some future date.
Theta	The rate of change of the value of an option with respect to time.
Vega	The rate of change of the value of an option with respect to the volatility of the underlying instrument (also sometimes called kappa).