

Case: Logistics Facility caps seasonal snow removal expense with a snowfall hedge

A 1.2 million square foot regional distribution center located in the snow belt supports over 200 retail outlets. The facility operates as a cost center and with over 50 acres of paved parking area incurs significant snow removal expense most years. The facility's general manager has a solid track record for continuously improving both its productivity and cost efficiency, which is recognized and appreciated by the company's executive team. However, snow removal expense overruns resulting from above average seasonal snowfall usually caused the distribution center to incur a deficit for that year. While the general manager and his superiors understood that there was little they could do to control the weather, they nevertheless lamented the unpredictability of the distribution center's performance against budget.

In his search for a solution to snow removal expense overruns the general manager experimented with a snow removal contractor willing to offer seasonal snow removal on a fixed price basis. The snow removal contractor used by the facility for the past 4 years provided great service, but was unwilling to accept a fixed price contract unless it included a significant premium over the average expense level. The general manager had to find another contractor willing to work on a fixed price basis, which proved challenging and ultimately disappointing. The new contractor not only failed to meet expected service levels from the outset, but service deteriorated further once the season's snowfall began to exceed average levels. Ultimately, the general manager was compelled to have his own maintenance staff put in overtime to perform some snow removal and deicing in order to ensure that safety standards were met. Complaints to the snow removal contractor were met with retorts about how much money was being lost on the contract and the possibility that they might be forced into bankruptcy.

The general manager ultimately found a viable to control snow removal expense with a snowfall hedge. The hedge allowed the facility to cap snow removal expenses in seasons with above average snowfall while retaining their preferred snow removal contractor on a pay per push basis. The distribution center experienced the benefit of the snowfall hedge during the 2010-11 season when total snowfall exceeded the average by almost 17". The hedge almost completely offset the above average snow removal expense, effectively capping the facility's seasonal snow removal expense.

Exhibit A: Snow Removal Figures for the 2010-11 Season

Snow removal expense in an average season	\$	370,876
Seasonal average snowfall		38"
Actual seasonal snowfall		54.9"
Seasonal snowfall in excess of average		16.9"
Actual seasonal snow removal expense	\$	485,750
Cost of snowfall hedge	\$	66,758
Snowfall hedge payout	\$	165,918
Seasonal snow removal cost after hedge payout	\$	386,590