FUTURES $ OPTIONS

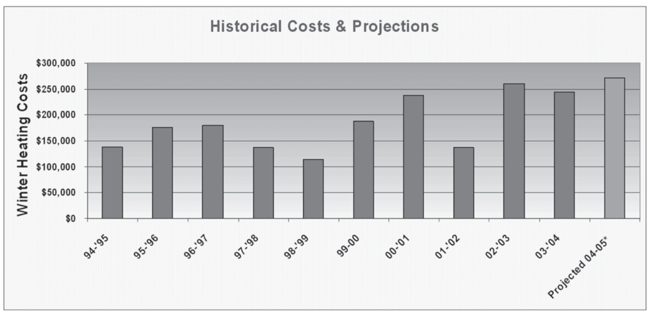
Commercial accounts

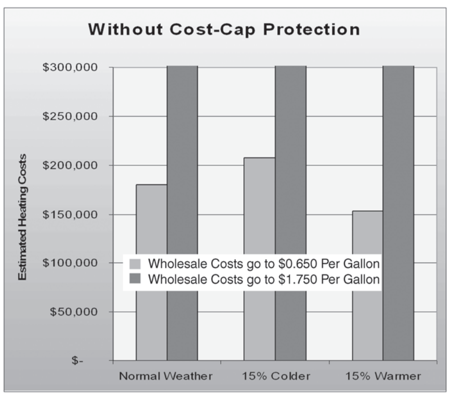
*by Philip J. Baratz, C.T.A.**

It is a great understatement to point out that the oil markets, over the past year and a half, have been the most volatile and unpredictable in history. Many things that we believed to be true, are starting to appear to be nothing more that urban legends, thanks to a series of facts in the World's "New Reality".

Some, but not all, of the facts are as follows: $40 per barrel crude oil is NOT reserved for wartime…. OPEC is great at paying lip-service, but really does not want oil down to $25 per barrel…. Refinery margins, usually very "elastic", have been very high for a few months, and have NOT attracted the usual strong imports of refined products….Chinese demand is well outstripping available supply and refining capacity…. 5- and 10-cent moves (both up and down) in product prices are no longer the rare occurrence that they once were…. the "impact" of Iraqi oil supplies, or lack thereof, is much greater than its volumes…. tax liens might put Russia's largest oil producer into bankruptcy…. and, yes, there are more.

Unpredictability has been playing havoc with oil dealers attempting to offer pricing programs (capped or fixed) to their customers, and irrational "waiting for prices to drop" decisions have left many in a position of either locking in smaller than desired margins, or offering higher than desired prices. As has been noted over and over, if consumers will have to pay over $2.00 for a gallon of gasoline, is it a far stretch to see heating oil prices at those levels—or higher? By now, most companies have bitten the bullet, and come out with their programs. The volume of "why are you doing this to me?" phone calls from customers is definitely higher than in most years, but good preparation—along with a willingness to lose some accounts—has most oil dealers in a position that should allow for full (or mostly full) margins.





So, the homeowner is taken care of. In most cases, he or she won't pay much more this coming winter that he or she is paying (per gallon) during this summer. This is thanks, primarily, to the fact that we are witnessing the highest summer prices that we have ever seen, and the fact that (anticipated) winter prices are not that much higher than current levels. So who is at risk, as far as heating oil costs?

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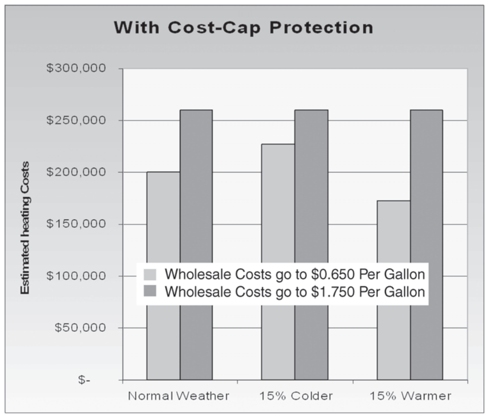

Taking the oil dealer out of the equation for the moment—we are assuming that PROPER risk-management tools (both price and volume) are in place—the sector with the biggest potential for cost (as opposed to simple price per gallon) swings is the small and medium sized commercial account. This type of account, oddly enough, has fewer risk-management options available to it. In actuality, the nature of the smaller margin (usually 15 to 25 cents per gallon) has precluded oil dealers from offering price caps to the commercial accounts. Also, the nature of the commercial account has worked against them.

These accounts will often have more than one supplier—obviating the viability of a capped price from ONE supplier. The second, more important factor is within the mindset of the commercial account itself. Often, the account is focused only on TODAY, and TODAY's price. For example, if rack prices are @$.80/gallon, the commercial account may pay $1.00/gallon, and have paid a good price (.20 over) THAT DAY. Then if prices fall to $.50/gallon, he may pay $.69 (only .19 over), and then if racks jump to $1.45/gallon, his cost might be at $1.68/gallon (.23 over).

In all cases, the price, relative to THAT DAY's costs, were good. What was not regarded was that while the supplier of the oil was making their "normal" margin (19 to 23 cents), the end-user's price had fluctuated by over 100! That, to me, is the essence of the problem that commercial accounts face: they do not have the opportunity to hedge their costs since (a) they may buy from multiple suppliers, (b) even if buying from one supplier, only, the supplier—thanks to high premiums and basis risk—will usually shy away from the high-cost realities of capping commercial accounts, and (c) the focus is too much on TODAY, and not enough on "the budget".

When you add in the fact that in the last five years, volumes (heating-demand based) have fluctuated by over 25% from one year to the next, the total costs (price times volume) have fluctuated by over 100%! That means that while homeowners burning 1,000 gallons per year have had their costs really under control, companies who own several apartment buildings, and who use (for example) 200,000 gallons per year, have had absolutely no control over their prices—except to know that they paid a good price—that day!

If you look at the attached charts, the first shows an example of a commercial accounts' total costs over the past decade, provided that they use (in a normal winter) 200,000 gallons, and that their costs were "Merc + 25". We used actual pricing, and actual demand on a heat-curve with actual HDD's per season. The second and third charts show the "what-if's" of capping the total cost of heating, in different scenarios.

The new product that we have been offering is a Total-Cost-Cap. Figuring out that their budget of total dollars was more important than the per-gallon number, per-gallon differential, or # of HDD's in a particular week, made this process much easier. We're just capping their TOTAL costs. It is something that can be marketed by heating oil dealers to commercial accounts, and can be offered with or without supply. However, logic would dictate that whoever offered the concept to the end-use customer would have the inside track on supplying that customer, as well. For more information, feel free to contact us—or to have your commercial account contact us.

Who knows where prices will be over the next winter? If you have protected yourselves to the point that you know what your margins with be (at least within a nickel a gallon), what do you think the value to the end-user will be to know that, AT WORST, he will pay "x" in total? It is a valuable tool, and a great door opener. ❑