FUTURES $ OPTIONS

"What to do...."

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

About two weeks ago, I found myself in a place that was entirely unfamiliar to me—at a parent-teacher conference with my son's high school teachers. As my wife and I were sitting in one of the scheduled 10-minute meetings—this one with my son's very affable English teacher, Mrs. Greer—the discussion came around to writing and teaching. Mrs. Greer, whose essay expectations include use of words such as "juxtapose" and "conundrum" (of course, in proper context), commented that when it came to teaching proper essay writing, "it was about the process, not about the story". In other words, an essay could be written about many different topics, but should still have similar structures, nuances, and protocols. The conversation got me thinking about our industry (apparently I have the same 10-minute maximum attention span that I had when I attended high school) and about the process heating oil dealers incorporate with regards to offerings to their customers.

This summer was an incredibly stressful one for the many oil dealers who offered programs to their customers, only to wait, and wait, and wait…until they either panicked and bought, or decided to just "ride it out" this winter. Then, the fall arrived, and made the summer seem relaxing, by comparison. We have seen bankruptcy warnings from the largest residential heating oil company in the country, filings for bankruptcy protection from several family-owned heating oil businesses, and many cases of companies (and some co-ops) ignoring their obligations, and just raising prices above those that were promised to their customers—in each case, there were references to "being unhedged"—partially or fully. We have a number of clients who are always harping on the fact that oil dealers just give things away—service contracts, price caps, etc.—without either charging the appropriate price, or obligating the customers to remain.

Yes, customers are very happy to pay $1.75 per gallon to their oil company when retail prices are north of $2.00 per gallon. But some of those same customers run for the hills when their retailer is $1.69, and someone else is offering a $1.59 loss-leader price. Oil dealers seem to do this to themselves, and the customers take advantage of the inconsistent approach to customer retention. But I digress…. As mentioned, we all yearn for customer loyalty, but get a black eye as an industry when we (the collective "we") don't stand behind our offerings and promises. The past six months have been an expensive lesson to many oil dealers who made offers to customers, but didn't bother to protect themselves. Most, but not all, will make it through this winter, and I wanted to review some of the basics of hedging—specifically for a price cap, but the rules can apply to fixed-price offerings, as well—as a planning tool for next winter.

I know, I know—let's get through this winter first. That, my friends, is part of the problem. Once the winter ends—March, April, May—dealers seem to focus on getting their cap offerings out to customers, but not on getting the price protection in place to back up those offerings. As far as a cap program is concerned, the five most important months of the year are NOT November through March, but are the spring and summer months as the program is planned and executed. As many properly hedged oil dealers can attest to, once the plan is in place—even in this crazy market—you can focus your attention on delivering oil and serving your customer's needs instead of worrying about prices and weather. There is enough stress out there to deal with on a daily basis, without worrying about oil prices and "which gallons will be delivered when". If there is a way to avoid the worry, why not take advantage of it?

The topic of this article is "What to do", not "why to do it". The why—"why should I offer a program?"—is easy. In the past seven years we have seen prices average about $.40/gallon for an entire winter, and have also seen rack prices approach $2.00/gallon. We have seen a winter that was almost 18% warmer than normal, followed by a winter 16% colder than normal. The "why" is easy—it gets you customers, and helps you keep them. Homeowners do understand that oil prices are volatile—they do fill up their cars with gas—but they do not want to pay prices that are so much higher than their neighbors are paying.

So, what do you do? There has always been a great deal of hesitation in getting involved in hedging, most of it related to uncertainty. The uncertainly has not been associated with uncertainty over where prices will go—we all know that one. The uncertainty has been over understanding how to approach the process. Who needs for things to be more complicated? Everyone wishes to protect themselves, and their margins—and wants to have it done in a non-complex manner. We believe that this is quite achievable, as long as some rules are followed.

As obvious as this will seem, it does bear stating: start with a plan. The plan should be one that will work whether prices rise or whether they fall. There are not that many possible ways to hedge—manage risk—and, surprisingly, none of them are that difficult to understand. What happens when you make an offer? You either have bought something, or you haven't. If you haven't bought anything, then you are hoping (perhaps praying) that prices don't spike up, putting you in a position that several bankruptcy filers found themselves in this year. If you do buy, there are a few ways to approach this—fixing wetbarrels, fixing wetbarrels with protection against a drop in prices, and buying an option that gives you money back if prices go higher—to offset additional supply costs once winter arrives. If you KNEW, for a fact, where prices were headed, the choice would be easy. But, as mentioned, prices can be (and often are) all over the map. You need a plan that "keeps you in the game" at all times—high prices and low prices, cold weather and warm weather. As part of "the plan" we strongly suggest a mix of products (wetbarrels, options, etc.), and we can show you that no matter where prices go, you will always be in the game.

There are certainly oil dealers who bought oil in the summer, and are benefiting by the movement higher. What would have happened if prices collapsed in September instead of rallying? A few years ago, when prices drifted lower throughout the winter, there were dealers who patted themselves on the back, because they offered a cap and didn't buy anything! As a good friend of mine often says, "even a blind squirrel finds a nut once in a while." Guessing, even with good intuition, can work one year, maybe even two or three in a row, but premising the long-term profitability of your business on "gut feelings" can lead to a lot of Pepto Bismol® consumption. The "mixture approach" does not attempt to predict what prices will do—and how profits will be impacted. It does, however, target acceptable, predictable margins, and helps with a road map to get there.

There is a lot of detail that is necessary before setting up the right program for your company. It is not nearly as daunting a task as you might believe. If you are willing to commit just two hours, you should be able to get a very good handle on how it works. You may ask "how can I afford the time"? I ask "how can you not"? Imagine a two hour "investment" that may result in a clearer understanding of how this works, and a way to take dozens of hours of worry off your plate! □

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