FUTURES $ OPTIONS

"Remember how profits are calculated"

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

It's a beautiful summer day. The sun is shining, the beach is full, and the waves are fairly calm. Golf courses are busy, but not too crowded, as oil dealers use this time of year to take some mid-week days off, and hit the links. Back in the office the phones are quiet, and the first wave of budget payments are coming in. —Summer 1995

It's a sweltering summer day. The sun is beating down on those lucky enough to get out to the beach for a little bit. Golf clubs are still under cobwebs, as oil dealers—despite the best made plans—are still trying to figure out what to do for next winter. In the office, the phones are busy, and the budgets payments have, begrudgingly, started to come in.—Summer 2005

So much of our industry has changed in the past decade. Whether it is the growth, and then the struggles of the industry "super-companies", or the extreme volatility in prices, managing a retail business today takes skills and disciplines that were not required 10 or 20 years ago. As several of our clients have pointed out, "this is not my father's oil company." Like it, or not, failure to change with the times will end up leaving you in a tough position.

What used to be seen as price ranges to cover a month, seem to occur on an almost daily basis. It has become (almost) normal to see crude oil prices range $1 - $2/bbl., and heating oil prices to range 4-6 cents/gallon—all in a single day. There has been a tremendous amount of time, effort, and pain expended in trying to figure out how to best manage price risk. Can you really have a cap that is that high? Can you really expect customers to cover all the hedging costs? Can customers really afford budget payments that are 75% higher than last year? How does that *^&*#@ competitor offer such a low price—is he crazy? Etc., etc. As if speculating on prices weren't bad enough, too many are now speculating on the future of their businesses.

If you don't offer a program, customers are going to leave. If you offer a program, and don't hedge (properly), you might not make any money. If you offer a program, and hedge, you might bite into your margins. If you offer a program, and charge enough to cover your hedging costs, you should make your full desired margins. Which way should you go? Personally, I vote for #4. Most people vote for number #4, yet all too many have problems acting on what they inherently know is the most logical approach. Instead, they point fingers at everyone else, without looking into the mirror. We all try to rationalize what happened when things go bad, but too often, we are doomed to repeat the same mistakes. After last summer's ('04) price spikes, thousands of oil dealers throughout the Northeast vowed to not allow the same thing to happen to them. By fast-forwarding 12 months, way too many of them are in the same boat as last year—with many of those "boats" taking on water, fast.

A lot of the above falls under the "beating a dead horse" category. Prices are going to move—up or down—whether we like it or not. The oil market's moves are so unpredictable that it is often an exercise in futility to even try to predict. The basic premise is that if prices rise, it's bad for consumers and oil dealers. If prices fall, consumers pay less, and dealers should be able to increase their margins. There. The secret is out. But prices are only one part of the "profitability formula".

Although price volatility has pushed other things onto the back-burner over the past two years, the demand side of the equation (especially in times that are anticipating conservation—a/k/a lower consumption) cannot be forgotten. If the best scenario for oil dealers is a season with low prices and high HDD's, then the worst scenario is one with high prices and low HDD's. With overhead (receivables financing, product acquisition and financing, insurance, etc.) at record levels, each gallon not sold, takes on greater significance. Much as you cannot convince your customers to raise their thermostats, and keep their houses warmer, you cannot do anything about Mother Nature deciding that after a few normal winters, it might be time for a warm one.

The weather, in which "normal" is anything but, continues to show a long-term (30 year) warming trend, and a shorter-term (10 year) tendency to be either much warmer, or much colder. Cold weather would be welcomed (in most cases—especially, if you are properly hedged), as it provides the opportunity for additional, unplanned, profit margins. On the other hand, the warm weather can wreak havoc with profitability. Even if your margins are good and stable, margins are calculated on a per-unit (per-gallon) basis. If you aren't selling the units, it's hard to make the money. That is where the weather protection kicks in.

Much has been discussed with regards to weather hedging over the past five years. We have had a year that (in most locations) was 15% warmer than "normal", and a year that was equally colder than "normal". We have also had years that really turned out to be "normal". What will the winter of '05-'06 bring? If you think predicting oil prices is tough, try to predict the weather—and I am saying this as a Florida resident preparing for the third hurricane of the summer, a full two months before hurricanes are "supposed to" start to form.

Hedging against warm weather does depend upon many factors. An assessment has to be made of gallons sold per HDD, how/whether the local weather stations' tracking of HDD's matches up with your actual sales, and of course, the cost to hedge. The basic premise of hedging against warm weather is that it serves as a "surrogate

customer". In other words, if the weather is so warm that the demand by your customers for heating oil is less than you need it to be, the weather hedge kicks in to "pay back" part, or all, of the lost profits on those gallons.

In years past, the cost of weather hedges was one of the many considerations in the decision making process—and rightfully so. Before spending a penny or two per gallon to protect profits, you do need to assess whether it makes sense, and whether it is affordable. Much of last summer was spent hoping and praying that oil prices would go down (not that different than this summer), and many oil dealers couldn't take their focus away from prices long enough to consider whether the weather hedge was appropriate for them. This year, it seems that for many of our clients, and many oil dealers in general, two things have changed: The first is that, on a percentage basis, many more dealers have accepted that price moves are totally out of control, and have bitten the bullet, and established and executed a hedging plan. This has allowed the dealers to focus on the non-oil price related issues, such as volumetric (weather) risk. This "luxury" didn't really present itself last summer. The second, which is really a double-edged sword, is that the penny or two of costs just doesn't seem to be as daunting any more. The mere fact that option premiums which a few years ago cost only about 6 cents per gallon are now, regularly, 13 to 17 cents per gallon, has taken some of the sting (we can probably call it "numbness") out of spending some money on weather hedges. The costs of ALL hedging need to be passed along to the customers, but we are, unfortunately, no longer in an environment when the matter of a few cents per gallon is the "make it or break it" decision maker for clients. That, too, is both a good thing and a bad thing, but a simply reality nonetheless.

How will things in the industry look a year from now? It's a very good question. The answer is that no one knows. If things continue on their current pace, there is a good chance that some of your competitors may not be around. It seems that you need to remain profitable to stay in business for the long haul. Is weather hedging the magic pill to fix all of the ails? Likely not, but it is one of the factors that a well-rounded hedging plan should consider.

As always, speak with someone that you are comfortable with. Take the time to review the numbers, and to see where you are, and where you need to be. If you want a second opinion, call us. But make the call. The markets, quite obviously, won't wait for you. ❑