



# FUTURES \$ OPTIONS



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

## “I know what you did last summer....”

I just returned from a trip to New England, and had the opportunity to visit with a dozen heating oil companies over a three-day period. Accompanied by our very capable New England sales rep, we “hit the road” to find and confirm our assumptions about this heating season, and the causes for stress that seemed to be everywhere in New England this past summer, despite the Red Sox run to the Championship. Although prices this winter are higher than ever in history, there seemed to be an almost-accepting attitude that prices “are what they are”, and that there was not much that could be done about that. I applaud the oil dealers who understand that (notwithstanding conspiracy theories about people controlling and manipulating prices) dealing with the reality of prices should take precedence over trying to figure out WHY prices are where they are.

The frustration that was expressed had very little to do with current prices. Even though my few days in the Boston and Providence area were days with temperatures in the high-50s, the forecast was for a cold front to approach, and the feeling was that demand would arrive before the warm weather got too far out of hand. About that, only time will tell. The frustration that I heard was all based upon last spring and summer (and into the fall). Each time that prices moved higher, from April through August, there was a sense of disbelief, and a feeling that if ignored long enough, the high prices would just go away. Many companies came out with their pricing programs with plans to cover “when prices came back to where they *should be*”, and many others delayed their offerings (whether fixed, capped, pre-buy, etc.).

Both approaches caused trouble and sleepless nights. For those who offered pricing programs early on, their customers got a fair offer (although it might have seemed a bit high at the time), that turned into a great offer. Great for the customer, that is. In all too many cases, the oil companies spent most of the summer trying to figure out where prices would go, instead of just biting the bullet and backing

up their promises to their customers. Most in this category did end up biting the bullet (figuratively, hopefully) at some point, but their margins were such that making it through the winter was not nearly as assured as it should have been.

The companies who delayed did luck out, on one hand—they didn’t have to back up any promises that would squeeze their profits terribly. But the delays also created an unwanted ripple effect on their customers. All of a sudden, customers who had become accustomed to having their pricing programs set in June or July were calling their oil companies, and being told “the program will be out soon. We’ll get back to you.” Hearing that once, then twice, then three times, did not do much for customers’ comfort, and invariably led to (some) customers deciding to shop around. By trying to give the best deal to the customers (which, unfortunately, turned the oil companies into price speculators), many companies turned long-time loyal customers into shoppers. After all, if the company isn’t perceived to be loyal to the customer, why should the customer be loyal to the company?

In both cases—the unprotected, and the delayed offerings—losses (of profits and of customers) could have been easily avoided. If you start with the premise that customers are yours until you “blow it”, and not that you have to fight for their business every year, you can see what customers really want. They want a company that will keep them warm, that will respond to their service needs, and that will be priced competitively. Nowhere during our conversations with our clients did we find that oil dealers feel the need to have the lowest price. Unfortunately, sometimes that is forgotten, and buying when prices are at their lows is all that is sought. We prefer to try to help companies make sure that they don’t buy at the highs!

When you think back on your “controllable losses”, how many did you lose because you came out with a program (re-

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ardless of price and terms) at the same time that you make your offer every year? How many customers do you really lose ONLY because your cap is a nickel higher than your competitor’s cap? How much did “waiting and wondering when to buy” help you buy at lower prices than you actually ended up paying? If your answers were “very few”, “very few”, and “not much”, I commend your honesty. The simple reality is that in most cases, waiting for the “right time” is simply an exercise in futility. Do you want to buy (and sell) competitively, or do you want to buy at the absolute lows? If the latter, what are your chances of success?

As we have spoken about before, and you have certainly heard from others, steady, planned buying allows you to remain in the game. Bottom-picking, while it might work sometimes, can also leave you with that queasy “Summer of ’04” feeling.

A popular question from our clients has been what our feelings are with regards to locking in wetbarrel contract with suppliers. From a supply and basis perspective, we fully support the purchases—again, as long as the purchase is planned (not knee-jerk) and is part of a comprehensive hedging program. If you offer a cap, and you lock in wetbarrels, buy puts. If you offer a fixed price, and you buy wetbarrels, you don’t really need the puts (“downside protection”).

Timing of the wetbarrels purchases has also caused a lot of frustration. Most dealers don’t need exact 42,000 gallon increments for each month, but standard contract sizes usually require purchases in those quantities. More importantly, picking when you actually lock in the price of the wetbarrels can be an exercise in frustration for both you and your suppliers. The suppliers will quote you a “diff” to the NYMEX, a delivery time window, and set their own credit requirements—no different than you would if making a promise to someone for delivery at a later date. However, the suppliers (correctly so) are in no better a position to predict where prices will go than you (or I). Inevitably, some oil dealers will look for the supplier rep to make the decision, or at least guide the decision. It’s pretty much a no-win situation for the supplier. If they recommend correctly, the oil dealer might take credit for his own “gut feeling”. If prices fall, the oil dealer can always fault the supplier. Neither situation needs to happen. If, indeed, you understand the value of ratable (averaged) buying, then you need to seek out a way to buy your wetbarrels, accordingly.

One of the companies that we met with during the trip bemoaned the fact that the “big guys” can buy a few contracts every week, to make sure that their cost averaging works out. But, in his case, he had to pull the trigger all at once (this client only needed one wetbarrel contract to be fixed for a month during the fall). He told us how he wished he didn’t

have to pick the exact day, and time, to lock in his contract. If only he could buy “on average” like (his perception of) the “big boys”. As we spoke with more and more companies, we found that many shared this same concern: how can I take advantage of the supplier offerings without getting stuck with rolling the dice and trying to pick the right day?

There is an answer, and it’s based upon the same approach that we use with many of our clients who offer price-cap programs.

We can help set you up with a simple, easy to manage program that will allow you to ALWAYS avoid the lows, and to always buy your wetbarrels ratably. All of this without dozens of phone calls to your supplier, which no doubt, stresses both you, and the supplier. Imagine: one call, once a month, which would put you in the “I bought ratably” position you wish to be in.

Whether you offer only a cap, a cap and a fixed, or just a fixed price, you should have some wetbarrels fixed. Owning wetbarrels with put options still gives you a price cap, and can be very valuable when mixed in with “call” options as part of a hedging program. Wet product eliminates most basis risk (although history has shown that most basis blowout fears are just that—*blown out* of proportion). Having a plan in place for your hedging, which includes properly planned “paper hedges”, and properly planned and executed product purchases, is a winner every time. Working with your suppliers to have them do what they do best (provide product to you), and working with your customers to provide them with the comfort and flexibility that they want, will enable you to have what you want and deserve: satisfied customers who don’t shop around, and enough time during the summer to pursue those hobbies (travel, golf, etc.—remember all those things that you were going to do “someday”?) that you should be looking forward to all winter.

If you’ve heard it once, you’ve heard it a hundred times: People don’t plan to fail; they just fail to plan. It’s February, and although you are busy, NOW is the time to get your planning done. Talk to someone who understands what your needs are, and to someone who understands the ways to meet those needs.

