FUTURES $ OPTIONS

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

There's no free lunch

Here we are, in the midst of another summer of oil price uncertainty. As I sit to write this article, in early June, prices have just made yet another new high. Since my crystal ball is as foggy as anyone else's, I don't know where prices will be by the time this article is published, but I feel fairly safe in predicting that the swings that we have been seeing in the markets—about a nickel per gallon on a daily basis—will still be around. Prices keep moving up and down in 20-cent clips for next winter, and people wonder why it's hard to get a handle on this market.

With all of this going on, many companies have been trying to "find the best way" to plan for next winter. It is clear that customers want stability. Also, perhaps for the first time in years, many loyal customers are starting to "shop around", as oil prices have gone into the stratosphere. In order to combat "shopping", many oil companies felt the need to come out with their "winter programs" earlier this year than in years past. The logic is quite sound: get the customer committed to a program early, and he or she will be less likely to shop and/or to complain later on. Companies who spent the time and effort in training their customer service reps (which, in many cases, as the switchboards lit up, included the owners, themselves) about the whats, whens and whys of oil prices also fared much better.

There is no doubt that from a C.S.R.'s perspective, everyone is complaining. If some of your customers call (whether the call is to ask why prices have jumped, or why their budget is 40% more than last year, or whether they are inquiring about your competitor's $1.89 cap—*for the summer, only!!!*), it still might be true that 95% of your customers are happy. However, from the C.S.R.'s vantage point, 100% of the customers are complaining! The fact that it is 100% of 5% can easily be lost, when it is the 13th call *that morning* with the exact same hostility.

The economics are pretty clear, and everyone—owner, manager, C.S.R., and customer—needs to understand that. Retail heating oil companies didn't *cause* prices to jump 60 cents per gallon since last June. Heating oil dealers are as much (frankly, more) a victim of price spikes, as anyone is. Everyone would love to return to the lower prices that we saw just a few years ago, and while that may happen, it is simply not today's reality.

Heating oil dealers are in business to provide good service (supply, maintenance, repairs, etc.), at a fair price. Without a doubt, the term "fair price" is subject to many interpretations, but in general it is enough money to keep the business profitable, and not so much so that customers will feel cheated. There is no perfect margin, and there is no perfect price. We all remember retail prices below $1.00/gallon, and on some level, we just cannot believe that they are where they are now. It is almost as if there is some sort of underlying guilt that many heating oil dealers have over the price of oil—as if it *is* their fault!! It's not!

Without a doubt, it is a noble endeavor to try to charge as low a price as you can to your customers—be it your street price, a fixed-price, or a capped-price. However, the question that needs to be asked is whether that price is going to meet your needs. Does it achieve the margin that you need? Is it being set because your competitor telemarketed 16 of your customers? Is it being set because you believe that prices will "have to" fall and you'll make up the margins later? Is it set at that level because, deep down, you don't want to lose any customer? Setting prices at a level in an attempt to lose zero customers will never work. Is your goal maximizing your profits (while not ripping off your customers), or maximizing your customer base (while dramatically cutting your profits)? Simple as this question is to answer, too many either choose the wrong answer, or don't even bother to ask the question. Unfortunately (or fortunately), proper price setting includes a willingness to lose some customers.

None of what is being written here is meant, in any way, to explain or to rationalize where oil prices are. They are illogically high, and all of us would be well served if prices dropped by 75 cents/gallon. Unfortunately, it seems that they are as likely (or more) to rise, as they are to fall. More to the point, for those offering capped-price programs, options premiums are borderline insane in their costs.

I feel like the guy in the retail store with the sign that says "I don't charge sales tax, I just collect it." Same thing here. We can only help our clients get their option protection. We don't create the markets. We shop for good prices, but with 20-cent swings the norm,

not the exception, premiums are very expensive. Even more to the point is the simple notion that as expansive as option premiums are, there are very few who are willing to sell these options, and to take on the risk. How many oil dealers would be willing to collect, say, 15 cents/gallon, and in return have unlimited risk if the market spiked? Suddenly 15 cents isn't really that much money.

Back to the title of the article. In an often misguided attempt to find ways to remain more competitive, and/or to increase profits, some oil companies have tried (and some "traders", "brokers", or "consultants" have recommended) to "play the market" to benefit from oil trading. As an example, some companies who might be looking at buying "call options" ("Calls" protect against a price increase, and return money to the owner of the option if prices exceed a certain level) might—understandably—be put off by the expense. After all, options that would have cost as little as 7 cents/gallon just a few years ago may be as much as 14 cents/gallon today. One strategy being touted by some is to buy that call option (for 14 cents), and to sell a higher-level (higher "strike price") call option, and to collect some money to offset the 14-cent cost of the original option. In essence, this strategy might collect 6 cents per gallon, bringing the "real cost" down to only 8 cents per gallon. Sounds logical, right? Why spend 14 cents, when you can spend 8 cents? As an aside, here, it should be noted that the strategy just mentioned, known as a "bull-call spread" can be a very sound speculative strategy, and can potentially be profitable. Actually, just about every strategy (from selling put options that have a lower "strike price" than puts already owned against wetbarrels, to selling two puts to finance purchasing one call, etc.) makes sense—in the right context! The concern is that, going back to our example, what happens when/if the market exceeds the higher strike price.

Here is an example: If you buy a $1.50/gallon call option for $0.14/gallon, and sell a $1.70/gallon call option for $0.06/ gallon, your "cost" would be $0.08/gallon (better than the $0.14/gallon that just buying the $1.50/gallon call would have cost). Now, let's assume, for the sake of discussion, that you have offered a cap to your customer—otherwise you wouldn't be crazy enough to play with options. Here's the issue: by selling the $1.70 call option, you are saying that IF the market moves to over $1.70/gallon, you are on your own. The most you can get back from this "spread" is $0.20/gallon (the difference between $1.50 and $1.70). Everything is fine and good, provided that prices remain below $1.70/gallon; but aren't you buying a cap because you are scared that prices might jump higher? Crazy as it sounds, we no longer worry about 20-cent moves. We're worried about the 40- and 60-cent moves. If prices do not go up, great; you saved 6 cents per gallon. But IF prices do spike (it's not as if it hasn't happened before), will that 6-cent savings have been worth it, if your margins are cut in half, or worse?

The same logic applies to those who own oil and have bought put options to protect against a decline in market price. This hedging approach, while it does allow for a certain amount of flexibility, also puts a dealer in a position where lowering retail prices can be very tough, until the put options' strike price is penetrated. As with everything, this strategy is sound, and should be a part of a hedging plan. Of course, put options (no different than call options) are quite expensive, and some try to sell lower strike-price puts as a way to offset some of the out of pocket costs for hedging. Is it a logical "trade"? It may well be—if you are looking to speculate. However, if you are buying put options as a method to make sure that your margins stay whole—even if prices collapse—being "short" a lower strike-price put can end up being very costly.

The message is fairly clear. Every benefit that the markets allow for has an offsetting set of risks. If you want unlimited risk, the up-front cost may be very little. If you want the best protection available, the cost may be quite steep. You need to assess, and to balance what you are after, what the risks are, and what the costs will be. A professional attempting to help you will address those items with you first, and foremost. Might some other strategies fit your needs? Possibly. But, you really need to start with a purist's view of hedging before delving into certain types of transactions that are not quite what they might seem to be. To end with a cliché, "if it looks too good……" you know the rest. ❑

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