

FUTURES \$ OPTIONS

"The Twilight Zone"

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



This month has witnessed some of the wildest non-war or weather related moves that we have ever seen. Since the beginning of March, we have been on a wild roller-coaster ride that has elicited (and helped cause) predictions of crude oil exceeding (in what has been dubbed a "super spike") \$100 per barrel, and other claims that the high price of oil would cause such damage to the economy that prices would fall to below \$30 per barrel. Interestingly, both of these predictions, with myriad of others, started to hit the markets as the winter ground to a halt in late March, and traders were left seeking the next market-moving news.

At the tail-end of a very cold March, heating oil prices kept moving higher, before (temporarily?) peaking at levels above \$1.70 per gallon. The pain, felt by many dealers, was the last "kick in the stomach" in what was a very tough winter. Volumes were good, but very inconsistent, and prices moved 10 to 20 cents per week on a regular basis. For perspective, the average move in price for heating oil, during most of the 90's, was 20 cents—for an entire year. As prices moved higher, the pundits would ask the standard questions: How can the economy survive? How much of the rally in oil prices was caused by the weak U.S. Dollar? How can I charge more than \$2.00 per gallon? How can I charge more than \$2.25 per gallon? How can I charge more than...? We are leaving (and by the time this is read, have left) the season with more uncertainty than ever before.

Interestingly, this spring, despite (or because of) the insanity of prices, has brought to the forefront an extreme focus on pricing programs, both fixed and capped. History has taught us, time and time again, that **oil prices will infrequently do what is logical, and even more rarely what we hope they will do.** Many dealers have either recognized that there is no "right time" to hedge, or have been driven to this realization by absolute fear. In any event, risk-management (hedging) for next winter has started, and despite the extremely high costs to hedge, more dealers than ever are charting a course, and following the plan.

Since early in the spring, many companies have been following a ratable purchasing plan—sticking to the plan in spite of prices that moved up by 30+ cents per gallon during March, and unmoved by the 20-cent per gallon drop that followed the expiration of the April futures contract. Sure, we've seen some straying off the path. We have a client who, although he owned 20% of next winter's oil at a level that was 15 cents lower than the current market, was POSITIVE that his local competitor loaded up on oil at the lows in the early part of the winter. In addition, there were several clients who after panicking about the simple idea that they would have to charge more than \$2.00 per gallon to their non-capped cus-

tomers, are now comfortable that next winter's caps will have to be well above that level. If there is one uniform understanding (by those willing to get away from speculating) is that there is absolutely no way to predict where prices will be next winter—but that doesn't mean that customers cannot be protected against spikes, and it doesn't mean that companies cannot make their desired margins.

The key, in almost all cases, is communication. If the customer does not know that you are charging him/her \$.75 less than the non-capped customers are paying, why would you expect to avoid sticker shock when next winter's price is significantly higher than this year's? The customer is paying \$2.50 for a gallon of gasoline, his neighbor is paying \$2.25 for a gallon of heating oil, his hotel stays have energy surcharges, et cetera.

Collectively, we seem to think that the economics from one oil company to the next are dramatically different. Not so. If there were a concern, it might be over the ability of the customer to keep current with their budget payments. Or, it might be over the fact that unless prices do drop before next winter, we might see consumption drop, simply on the basis of conservation. However, way too much time is spent worrying about "the other guy" undercutting prices and stealing customers. How many companies weren't "into their banks" this winter? How many were sitting on positive cash balances? How many companies are thinking about aggressively adding new customers—arguably adding the more price-sensitive, or those without the greatest payment histories? Should there be concerns? Yes. But those concerns should focus on providing the best service, at competitive prices to YOUR customers, not in setting up programs to protect against the "other guy" who is targeting your customers—he probably isn't.

Many heating oil companies, small and large, are rethinking their strategies for this coming winter. Ratable buying seems to be a must. It's not so easy to do on your own, but there are those (we like to think that we were amongst the innovators in this) who will help you not only plan, but execute your plan.

Perhaps the biggest casualty this winter has been the number of companies, and the volume in gallons of those, who are offering fixed-price programs. From legislation in states such as Connecticut, to the simple realization that if prices do fall, there will be a lot of explanations (and quite possibly complaints and lost customers) to make to justify why their customers are paying \$.75 per gallon more than the other companies in town. Truth be told, offering a fixed-price is better than offering nothing at all. However, price caps, as expensive and over-priced as they seem (and may, indeed, be), still allow customer and companies to know what the maximum cost will be, but also allow (hopefully) for prices to fall. If you and your customers both have financial peace of mind, then you just have to concentrate on the important operational parts of your business.

If you have any questions about a price cap offering, be it the mechanics, the hedging, the reporting or the accounting, please feel free to give us a call. The cost to talk to us is nothing. The value may be priceless.

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