

“Fixed or stuck”

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



As many of you who have been readers of this column over the years are aware, given the choice between offering homeowners a “Capped” price or a “Fixed” price, I definitely prefer the former. My preference has nothing to do with an opinion of price direction. My opinion is also still firm, in light of option premiums (the true cost to offer a true cap) that have gone from about a nickel per gallon to the mid-teens per gallon in the past three years. I have heard all of the arguments back and forth over which is the better program, which is easier to sell, which has the best chances of customer retention, which has the best impact on the bottom line, etc.

While I am still unmoved—actually, given the market’s volatility, and the chance that a 75 cent *decline* in prices might happen as easily as a 75 cent *increase*, I am more convinced than ever that caps are better—a number of our clients and readers do offer fixed price programs, and their needs (and potential risks) deserve their turn in the spotlight.

We are in the midst of a number of “unprecedented” events in our oil world. Crude oil prices have moved through the 30s, 40s, 50s, and 60s over the past year and a half, and remain near record levels, despite apparent chinks in the economic armor, as \$3.00+/gallon gasoline and heating oil, along with record-prices for natural gas have started to erode some demand from the market. In our post-hurricane(s) environment, the balance between lost refining capacity—as of mid-October, more than 25% of our refining capacity was not being utilized—and the “conservation” will be a battle that will take weeks and months to fight. The only clear reality is that all we know about price movements and direction, and all that we have learned, seems to be out the window. A day that *doesn’t* see heating oil prices that move by more than a nickel is an absolute yawner, and a week that doesn’t see a 15-cent range is just about unheard of.

The volatility is quite stressful. Buying and selling decisions get tougher. Conversations with customers get tougher. Credit lines—both from banks and suppliers—are harder to manage. While predictability is all that we want, our markets are giving us no sure bets. Heating oil prices have moved up by about a dollar per gallon over the past year, and for all we know, they might drop back lower by that amount over the next year. Even the weather, year to year, has become that much more unpredictable. We hear about global warming, but we also have seen in the past five years record swings in cumulative HDD’s. Freezing Januaries have been followed by tropical Marches. Many locations have seen their 30-year highs AND lows all within the past five years. The “normal” swing (from the average) is over 10%, with 15% not being out of question (but perhaps 20% being the extreme).

When you offer a fixed price to a customer, there is a two-way commitment, but one that is more pressing on the oil company than on the homeowner. The promise from the company is that during the time period (full year, or “season”), the company will charge a fixed-price (for the sake of discussion, we will assume that the fixed selling price is \$2.25 per gallon, and that the oil company was able to secure fixed supply for \$1.70 per gallon, in an attempt to achieve a \$.55 per gallon margin) for ALL gallons delivered during that time period. If an oil company did a little math, and then calculated that average usage was, say, 1,000 gallons per customer, all the company would have to do would be to

go out and buy 1,000 gallons to be covered—and to make the \$550 per customer profit (before operating expenses). Right? Not so fast.

With extreme volatility can come questions about customer loyalty. If a customer committed to \$2.25 per gallon, and prices went to \$2.50, they would still buy. If prices went to \$3.25 per gallon, they would still buy, as well. Why not, if their “fixed price” is so good? How about if prices fell to \$2.00—would they stay? Probably, at least most. How many would leave (leaving can be simply quitting, or it can be quietly taking a small C.O.D. delivery a few days ahead of the planned—\$2.25 per gallon—delivery) at \$1.75? How many more at \$1.50? What happens is that when prices increase, there is an *obligation* to deliver at that price. However, as prices decline, there is a tendency to rationalize shopping. (“That *&@ oil company practically *forced* me to lock in my oil at those high prices!!”) Customer loyalty can, and will, be tested—especially in areas that promote a “my fixed-price is lower than his, so buy from us” mentality. Often these areas work on smaller margins, making them more susceptible to the pains of “missed margins”, and more at risk for liquidity.

Weather volatility can also impact greatly upon fixed price programs. If the weather turns colder than normal, the customer expects to pay the same fixed-price (it should be noted that life would be a lot easier if *with* the fixed price offer came a limit to the number of gallons that the offer covered), but you, the supplier, will now have to go to the market to buy new gallons to meet that delivery. If prices were to be significantly higher than where you fixed your cost on the original (1,000) gallons—an easy scenario to envision, you may be working twice as hard, and losing money to boot. Taking the opposite side of the spectrum, a warm weather scenario, also leads to some concerns. If it is warm outside, most customers will likely take all of their oil (say, 850 gallons), but what if prices fall, as well? Talk about getting kicked when you are down. On one hand, customers may quit due to the availability of cheaper oil, AND you will be sitting on more gallons that you need—that will now have to be sold, most likely at a substantial loss.

As many possible scenarios as there are, they can really be condensed down to four major “quadrants” of possibilities: Cold weather with high prices; cold weather with low prices, warm weather with high prices, and warm weather with low prices. Considering that the two (logically speaking) that are the most likely—cold weather with high prices and warm weather with low prices—both can have detrimental impacts upon your bottom line—it does pay to give some consideration to hedging against these negative impacts. Which is worse? It is really hard to tell, but the more extreme a move is—be it in price OR in HDD’s—the more of an impact it *will* have on a company’s profitability.

So, great, now we have something new to worry about!! While that is true, and is something that is not new, and always should have been worried about, the reason that it is now front and center has to do with the extreme levels of prices, and the extreme movement of those prices. Many companies have looked at these exposures, and tried to determine how to stay true to the fixed-price scenario without spending 15 or 20 cents per gallon to protect their margins. There are a number of answers and methods to deal with price and weather swings, but from where we sit, you shouldn’t look at available products, and try to get them to fit the perceived problem. You should clarify, and quantify the problem. Then, the solution should be set to address the specific risks, *not* to speculate on price direction. As small difference as it sounds like, customizing this type of protection costs less, and will help to achieve your goals—provided that the goals are predictable profits—not speculating that nothing will go wrong.

I was going to put a number of graphs and charts into this article, but the more I reviewed the data that we are using with our clients, the more I saw that the explanation would be longer than the article itself. If you would like a closer look at how to handle your fixed-price (and assumed volumes) program, contact us.

Hoping for a profitable winter for all!!