If it ain't broken, don't fix it...

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

It's the middle of August in one of the hottest summers in recent history. Temperatures in South Florida are regularly in the low-90s, and it is actually cooler there than in much of the Northeast. Natural gas prices, a major component for electricity generation for airconditioning, are at record levels, and heating oil prices at the rack are terrifyingly close to $2.00 per gallon. Supplier contracts for winter delivery are approaching $2.10 per gallon, and who knows where prices will be in a few months from now, when the winter is upon us?

Since the start of this decade, heating oil prices have averaged an annual move of over 70 cents per gallon, contrasted with moves barely one-third of that magnitude during the prior decade. Not that it takes a rocket scientist to make this claim, but in the next few months one of three things will happen: Prices will remain close to where they are right now; prices will be sharply higher than where they are right now; or prices will be sharply lower than where they are right now. I'd like to focus this article on how hard it is to predict which of the three will occur. For those of you who believe (and there are MANY of you out there) that you know what prices will do over the winter, you can stop reading right now. I'm sure there are some fascinating ads for heating equipment for you to read before you put down the magazine, and I am sure that there is a seat with your name on it waiting for you at the Mohegan Sun Casino.

Consumer tension has just begun in this (yet, again) new era of record-high prices. For most homeowners, the only way that they know that heating oil has jumped in price for the winter is thanks to correspondence by their oil dealer. As heating oil consumption has not started yet, the anticipated panic is yet to begin. Many oil companies have set out to proactively address these new, higher prices, in several different fashions. Some have gotten the message out to customers that prices are crazy and unpredictable, but cooler heads will prevail. The underlying message here is (mostly) to stay the course, and bear with the high prices for now—because prices can't stay this high, and are preparing to come down to "more realistic levels". A second group of dealers has gotten out the message that the "New World Order" is here, and regardless of the impact on the economy, high prices are here to stay, and will most likely get higher. Both groups tend to have some underlying conspiracy theories about "why" prices are doing what they are doing, but they do—at the very least—inform their customers of their opinions on where oil prices will be going.

Which approach will be the correct one? It would seem to me that it is impossible for both groups to be correct—prices can't fall, and yet rally sharply at the same time! One of the two messages will, most likely, turn out to be very wrong. In today's volatile price environment, one of these two groups might end up with customers paying 50, 60, or 70 cents per gallon more that their neighbors (if not more).

The alternative, as you are all aware is offering a capped price. The cap assures customers that prices won't exceed a certain level (similar in thinking to the concerns of those who anticipate that prices will only go higher, and therefore, promote fixed prices), but also the promise that if prices should fall (as is the prognostication of the "prices are too high, and have to fall" camp), that the oil dealer will lower the delivery price of the oil, along with the drop. Easy, right? No, not really. Thanks to the exaggerated swings in the markets, and the high price of the winter barrels, offering a price cap has become a very costly endeavor. It is not uncommon to see oil companies shelling out 10 or even 15 cents per gallon in order to procure the ability to offer a capped price to their customers. That additional cost is a hard cost, and needs to be recouped—added on to the "normal" margin via a "fee" or a higher margin (or a combination of the two).

It is easier to offer a fixed price of (say) $2.299 per gallon than it is to offer a cap of $2.449 per gallon (plus a $75 enrollment fee). It is even easier to tell customers not to worry about it, since prices are going to fall!! The issue is that dealers, all too often, seem to be making decisions on behalf of their customers because those decisions are EASIER to make. Why defend $2.449/gallon, when $2.299/gallon will work just as well? The reason is that IF (yes, the big "if") retail prices fall to $1.50 per gallon, your customers will be paying a heck of a lot more than the $75 that you would have had to charge them to be on your "cap program". A move in the opposite direction (higher) has more dire results when comparing the capped offering to the company suggesting to just "ride out the storm"—and that doesn't even take into consideration the credit and collections issues that may crop up this coming season—if not yet, already.

If a customer knows that prices might go up, down, or remain unchanged, and then makes a decision to do nothing, or to fix his cost, rather than to pay a "fee" (and perhaps a higher margin) to be on a cap program, then the customer has "made his bed", and will have to sleep in it. Thanks to the tremendous amount of loyalty that (full service, primarily) customers have to their oil dealers, they look to you for your "sage" advice. Incorrectly, they believe that you have the inside scoop on what the future holds for oil prices, and that you will always do the right thing for them. While the latter is more certainly true, the former (your crystal ball) is most certainly not true—otherwise you would be on your way to the Mohegan Sun right now!

The best and brightest minds in energy trading cannot find an explanation for what has happened over the past year. Are there reasons for each 20-cent movement? Sure. However, the reasons for each 20-cent rally still seem to be there, when prices "correct" 15-cents lower. There is a saying, "Hope for one thing, but prepare for the other". It was probably first stated by someone selling some sort of insurance policy, but it is perfectly apropos for what we are seeing in our markets. It is increasingly difficult to concoct a scenario with oil prices that can't happen. You know the five reasons that rack prices will break above $3.00 per gallon this winter, but you also know the five reasons why they will fall back to $1.00 per gallon. If you don't know them, call us—we hear both arguments all day long.

Neither you, nor I, are in business to speculate on either the price of oil, or on our customers' loyalty. I see less and less value in heating oil dealers being the low-cost leaders, and more and more value in pricing "in the game" and keeping the oil flowing.

In about six months from now, the whole "hedging process" will begin again—this time for the '06-'07 heating season. How many years in a row will you guess correctly about market direction? How many years in a row will your customers stay with you if you are wrong? ❑

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