

FUTURES \$ OPTIONS

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Slow and steady wins the race

SPEED
LIMIT
SLOW &
STEADY



Lee Reitz

As a constant refrain from this column, I must point out that the time span in between the writing of the article and the reading of the article makes it practically impossible to be current with regards to oil prices. The swings that we have seen over the past few years, and continue to see, make seeing heating oil prices (today at \$1.70 per gallon) as likely to be at \$2.20 per gallon as they are to be at \$1.20 per gallon by the time this column is read. Therefore, it is a fair assumption that the volatility in prices that has caused crude oil to be as low as the mid-\$50s per barrel and as high as almost \$80 per barrel in the past year, gasoline ranging from the \$1.30s to the \$2.30s, and heating oil to see a \$.70 per gallon range, will not be going away any time soon.

Trying to deal with something that is as unpredictable as a teen-aged child (I now have two, with two more on the ho-

rizon) can make anyone lose their hair (take a GOOD look at my picture). Prices gyrate, sometimes with reason, sometimes without, but hardly ever in a predictable or patterned way. The billions of dollars that were supposedly made by speculators predicting \$100/barrel crude oil prices were (also supposedly) all wiped away in a quick 6-week period of time in the late summer. Those who kept trying to pick the tops of the markets were—eventually—right (even a broken clock is right twice a day), but when push came to shove, the “inevitable” drop to \$40/bbl. stalled, and prices (as of today’s writing) have moved up towards \$62/bbl. Once again, successful prognostication is a fleeting ability.

GIAGC

All this leads us to the topic of this month’s article: the slow and steady approach to hedging. Despite the hours upon hours of time that are spent by hundreds, if not thousands of heating oil distributors in trying to “figure out” not only what prices will do, but when, there is equal consternation in some corners by what we refer to as the “grass is always greener crowd” (we’ll refer to them as the “GIAGC”). This crowd, unfortunately for them, always seems to feel that they just missed out on the “right play” for this year. Over the past few years—up until this one—we saw steadily increasing prices from the end of one winter until the start of the next winter. Considering that there are really only (yes, it is that simple) three ways to sell residential heating oil: variable (rack \pm), fixed, and capped, looking in the rear-view mirror as to what the best program to HAVE offered is not all that hard.

As big supporters of the logic and ease

(if not always the cost) of offering a capped price, we have had—over the past few years—members of the GIAGC point out to us that they “should have” offered a fixed-price instead of a capped price. After all, if prices do go up, why spend the money on an options premium? All it does is make the sale to the customer higher, and force the oil dealer to charge a higher price

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Slow and steady wins the race *begins on p. 49*

for the oil. If prices are going to rise (and you would get no argument from me), the proper approach would be to buy fixed and to sell fixed. Interestingly, during those few years, there was very little talk of those who did not offer any program at all. Participation in “programs”, whether fixed or capped, continued to grow, and the main issues faced were when to hedge, when to offer, etc. The simple act of ignoring those who were selling on a variable basis was not because “they didn’t matter”, but because, with a capped (or fixed) price in place, the variable sellers (unless they were discounters—subject of an entirely different conversation) were simply more expensive.

So, although we “pushed” some to offer a cap, and they were not necessarily thrilled that their capped price (and in actuality, their delivered price) was 5, 10 or 15 cents higher than the fixed-price offers, they were quite pleased that their customers were paying less than the “average street price” and that the cap was actually controlling their costs and the costs to their customers. Most, if not all, stayed with the cap programs, but some in the GIAGC still thought that maybe, just maybe, the way to go would be the offering of a fixed price.

Then, this spring, summer and fall happened upon us. Prices did their steady winter-into-summer climb, as fears of problems in Israel, Lebanon, Iraq and Nigeria dominated the headlines. Not to be outdone, the Iranians continued on their merry (unobstructed) way towards uranium enrichment, and the North Koreans decided that detonating a “test” nuclear device or two would endear them to the rest of the world. Heating oil prices rose about 50 cents per gallon from mid-February till early August. Once again the rumblings from the GIAGC were centered around the fact that it wasn’t fair that they had to spend 15 cents per gallon out of their pockets, just so they could offer a price cap of (for example) \$2.999/gallon, while

their local competitors were taking away hundreds (okay, dozens...okay, tens...okay, four!) customers with a fixed-price offer of \$2.849/gallon. Again the variable guys were not even a blip on the radar, as prices were “certainly” destined to hit \$3.50 or even \$4.00 per gallon by the time the winter started.

So, as of mid-summer, and in most cases after “programs” were out to customers, the fixed-price offers seemed to be the way to go—assuming, of course that prices wouldn’t fall... During the second week of August, after winter heating oil prices (February NYMEX contract) hit highs of \$2.35/gallon, prices stopped moving higher, and suddenly all of the “news” was looked at in a bearish light, instead of a bullish light, for the first time in a long while. By the end of August, prices had traded as low as \$2.12 per gallon, and by the end of September, we saw trades as low as \$1.82 per gallon.

All of this was great news for those who offered the capped price. After all, the notion of a capped price was that IF prices rose, there would be a ceiling on how high they would get, but IF prices fell, then prices to the customers on the cap programs would fall as well. As prices did fall, cap-offering companies—depending upon exactly HOW they managed their own hedge programs (fixed with puts, calls, combination, etc.)—started to lower prices for the capped customers. The assumption was that each company that offered a cap was in a position to lower prices to their customers as (if) the markets fell, and that the company, in turn, would be in a position to maintain, and even increase their profit margins as prices fell.

So, smiles all around, right? Well...not so fast for the GIAGC. Suddenly, the fixed-price offering companies—formerly the bane of their existence—didn’t matter anymore. The simple fact that the fixed-price companies (using the example above) were still selling at a price of \$2.849/gallon, while the cap-offering

companies were selling at 20, 30 or 40 cents cheaper—and increasing their per gallon margins—suddenly fell on deaf ears for the GIAGC. Now, almost magically, this group wanted to know why they weren’t smart enough to offer only variably priced sales (as if that is what their customers would have wanted!).

Given an environment that sees prices move sharply higher, the fixed-offer will definitely beat out the capped offer, while the capped offer will blow away the variable offer (reminds me of rock, paper and scissors). However, if prices fall sharply, the variable offer will beat out the capped offer, while the capped offer will blow away the fixed-price offer. In other words, as long as prices remain volatile, and continue to move sharply, the capped offer will never be the cheapest to the customer. but, and this is the most important part, a CAP SHOULD NEVER BE BLOWN AWAY BY EITHER A FIXED-PRICE OR A VARIABLY PRICED SALE.

It is easy to be a part of the GIAGC, but if you always want to be in the game, and never want to give your customer a chance to leave you because it would save the customer 30, 40 or 50 cents per gallon, caps still seem to work best. At some point, if someone can save 50 cents per gallon, and get the same service that they are accustomed to, it is hard to talk them out of leaving. This should never happen with an offer of a price cap.

Back to the top. Regardless of timing, or cost, or “missed speculative opportunities”, the biggest hindrance to the successful and consistent offering of a capped program that will keep most (but not all) customers happy each year is in allowing yourself to fall into the GIAGC. Once you can accept that you cannot predict what will happen, it makes life easier for you, and (perhaps more importantly) for your staff. However, even though you can’t predict, you most certainly can protect. The choice is yours. □