FUTURES $ OPTIONS

What did I learn?

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There are many sayings and quotes that might be apropos for this time of year, as we look forward to the end of the hard winter season and start to plan for the next winter season. Some are as simple as: "Those who do not learn from history are doomed to repeat it." And "Insanity can be defined by doing the same thing as you did last year, but expecting a different result." This has been an extremely stressful year for many—primarily those who simply refused to believe that prices would do what they did. The weather seems to have become more unpredictable than ever, gyrating from two-week periods of unseasonable warmth to two-week periods of frigid temps. As of today, the notion of the worst "Perfect Storm"—high prices with warmer-than-normal weather—may indeed be the end-result of the winter of '05-'06.

It's the beginning of January 2006, and the offers for the '06-'07 winter season have already started (slowly) to leak out. Despite warnings of "Super Spikes" to $105 per barrel, and experts predicting $200 per barrel by 2010, as I sit to write this article, I am looking at an offer (from a company in New England) offering a very low fixed price for next winter. The reason that I am looking at it is that the price seems to be based upon a hope (a prayer) that prices will fall over the next few months. Otherwise, this company might join the growing list of oil companies who "speculated themselves" out of business.

What is more interesting than the low-ball offer that this company is making is what they are NOT saying. Since the offers that they put out last spring or summer turned out to be cheaper than customers would have paid otherwise, too many companies assume that their customers are very well aware of this "savings". As I read the offer for next season, I realized that what appeared to me as a very low price, might (rightly so) appear to the customer as a high price (certainly higher than for this winter). How can a low price appear to be high? Just by bad planning and worse communication.

As this season ebbs away, and planning is made for next, there are a few things that MUST BE considered.

1- Let your customers know that they saved money by being part of your program. Don't assume that, just because your capped (or fixed) price is 40 cents per gallon less than they would be paying otherwise, the customer is aware of this. From the customers' perspective, he/she is paying more than ever before. Why would they think that they are getting a good deal? Let them know what you have done for them. It will make it a lot easier for you (and them, and—most importantly—your staff) when you come out with the new (likely higher) offer for '06-'07.

2- Plan. One of the nicer four-letter words in the English language, but one that is not often enough implemented. In this environment, seat-of-the-pants hedging simply does not work. You cannot hedge when your gut tells you to. If you have a program that will be offered to your customers (or pros-

pects) starting on a certain date, you need to sit down and commit some time to planning out what you will need to make for a successful offering—are you buying wetbarrels contracts with put options? Are you placing oil into storage? Are you buying call options? Are you buying futures contracts? Have you factored in for the unpredictable weather? Competent assistance (here is where I am supposed to put in a big plug for Angus Energy, but I'm not going to!) is readily available. It doesn't have to be too confusing, but does have to be addressed.

3- Start early. Timing has become a bigger and bigger issue as price volatility has increased. No matter what anyone says, there are no specific days or months that work year in and year out. We have (and I am sure that you have) seen a lot of different, "well if you buy here....." approaches. Some work out okay, but the time that it doesn't can be quite expensive. Unless you believe that you can CONSISTENTLY out-guess the markets, it is hard to argue the logic of ratable buying/hedging. You won't end up with the lowest price, but (more importantly) you won't end up with the highest price. We have seen, time and time again, that when left to our own devices, we end up panic-buying when the market rallies, and waiting too long when the market falls. Starting early and keeping to a plan can (and should) save a lot of unnecessary stress. Slow and steady wins the race.

4- Although it may seem obvious—stick to the plan. Most companies don't even sit down to write out a plan. That is unfortunate. What is more unfortunate is when a company does commit their plan to writing, but then fails to execute the plan. If the plan made sense, it needs to be acted upon. If it didn't make sense, it needs to be re-written. It is harder to take a hands-off approach in the heat of the battle (or, for our case, a rallying or falling oil market). If you KNOW that the plan is correct for your company, allow someone to make sure that the plan is executed. We all want the best price for our clients/customers. However, that can lead to making irrational decisions that end up costing the customers more. If you truly believe that customers want a ceiling/cap on their costs, but also want to always "be in the game" if prices are below the cap, you need to set up your hedge to accomplish that. If your goal is to pay lip-service to that logic, but to still try to pick the bottoms, you are playing with financial fire.

5- The last item that we are finding under consideration by many dealers is extending their cap offerings (and hedges) to cover a 12-month period. One of the most common complaints seems to be that during the time period between the end of a cap offering period (say, April 30th), and the start of the next cap period (say, October 1st), deliveries that are made at higher levels than the prior years' cap level are very irritating to customers—and, much more importantly, encouraging "shopping". By extending the cap to 12-months, the company has the ability to keep prices in line all the way through the renewal of the next years' cap—so that the customer should never get a delivery at a "surprise price". Related to avoiding surprises, many companies who previously required written authorization to have customers on a cap, are switching to an "opt-out" program for their caps—premise being to "let sleeping dogs lie". You cannot do this (as easily) with fixed-price offers, but it seems to work quite well with cap programs.

Speaking of fixed-price offers, there are some very affordable hedge programs which address the main concern of all oil dealers—making sure that the gross profit margins are sufficient to cover all expenses and meet budgeted profits. Of the real concerns that fixed-offers (back by fixed priced oil) have—more specifically in today's high price environment—are (1) customers who simply leave if prices fall—despite contractual obligations and/or penalties. If you have a $200 penalty, and prices have fallen $.40/gallon, what would YOU do? The higher the fixed-price offer, the more sensitive (some) customers will be to falling prices. And, it's not only the lost margins, it is also the fact that you may end up with more gallons bought than sold, as customers leave. If prices have, indeed, fallen, those extra gallons will have to be moved through your system at a loss—or at an unduly burdensome price to your variable-priced customers. In addition, once that customer leaves—with you eating some losses, and not making the margins for that year—you are also minus one customer and the value that that customer brings to your business.

Another pitfall for fixed-price offers occurs when prices rally during a cold winter (remember what a cold winter is?). If you need to "go to the market" to buy extra gallons, those gallons—with the exception of the quickly-disappearing fixed-quantity fixed-price programs—may well end up costing you more than the sales price of those gallons (after factoring in the variable expenses to deliver the oil). It cannot be assumed that any additional gallons, due to cold weather, are just found profits. They might end up being found losses! Hedges exist to protect against these exposures, and it is worth your while to investigate if you still offer fixed-price programs.

One the bright side, those who planned and executed their hedge programs in the spring and summer of '05 are enjoying very successful seasons—even with the price and weather volatility. You have enough to worry about just dealing with the operational aspects of your business. Everything has to be done correctly, for the business to run smoothly. Shouldn't you deal with the pricing (hedging) element properly, as well?