



The real cost of self-insurance

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When asked what I do for a living, various answers come to mind. “Energy risk management”, “oil trading”, “energy marketing consultant”, and “derivatives market-maker” are a few of the answers that I have used, depending upon the questioner. However, if the answer needs to be short, direct and simple, I will just say that I am in the insurance business, and that my clients are in the oil industry. Nice, simple and straight-forward.

The notion of insurance is the simple control or “management” of risk. A party looking to avoid the negative consequences of an event—fire, death, medical cost or injury—pays a premium to a “risk taker”—the insurance company. In return for the collection of that paid premium, the insurance company provides the (generally financial) peace of mind that if the “feared event” that the insured was hoping would NOT happen, does end up occurring, the insurance company will “pay out” to the insured. In looking at various types of insurance, there is always the need to strike a balance between cost and protection. More to the point, the simple notion that the higher the policy deductible, the lower the premium, requires its own sets of analysis.

All of this is true with hedging of oil prices. Heating oil companies who offer capped prices to their customers are generally looking to transfer price and volume risk to another party. In order to transfer that risk to someone who is willing to assume it, a premium is paid. Despite the fact that most of us have opinions—some well-founded, some not—about what each season will bring as far as price movements and HDDs, the vast majority of those who offer fixed or capped prices to customers do enter into some type of risk-management (hedge, insurance, etc.) plan to protect against “what can go wrong”.

In last month’s column, we discussed the travails of those with fixed-price offers. While it is true that most customers will comply with the terms of their contract, this past month and a half has been very trying for those with fixed-price contracts with their customers. We know all the logic, and much of it is sound, but the customers are complaining nevertheless. What I wanted to look into this month was the one sub-group of oil companies who are actually in a worse position than the fixed-offer companies.

That group is made up of companies that, for one reason or another, after making the sound decision to offer a capped price to their customers, followed that up by NOT capping their own costs. Typically speaking, it didn’t happen by design (and perhaps not having a plan was part of the problem), but rather by circumstance. In most cases, the dealers locked in the price of their supply, and then either “decided to wait” before buying the “downside protection” of a protective put option (an “insurance policy” that would pay out in the event that prices fell past a certain price), or—in a somewhat more calculated manner—made the decision that the high cost of the protection of the put option was “just too much” to spend.

The first group, the “I’ll wait” guys, simply falls into the category of de facto speculators. This category has existed since hedging began, and will be around long after we have all retired to Florida to play golf. Human nature is filled with second guessing, and often it is easier to do nothing than to actually make a decision. This group would be best served spending some time, BEFORE making an offer to their customers, setting up a hedging plan. If you think about it, the simple fact that wetbarrels were “locked in” with a supplier immediately took the oil company from passive-observer to speculator status. Not many oil dealers relish the thought of being a speculator, especially those who don’t even want to offer a program in the first place. Yet, there they are, owning wetbarrels at prices well above the current market, without any protection against a drop in price.

The second category, the “it’s too expensive” guys, are a little more blatant in their assumption of risk, a/k/a speculation. While it is hard to deny that option premiums were quite expensive this past summer (and remain so today), in an effort to save 10-, 15- or 20-cents per gallon (yes, a lot of money) some have seen the price of their wetbarrels lose an almost 60-cent per gallon worth of value.

Why is it a big deal to be in one of those groups? If not obvious, let’s look at the promise to the customer. A capped price offer assures customers that prices will never exceed a certain level, and strongly implies that should market prices fall, the price charged by the oil company will fall, as well. If hedged properly (via either put options backing up fixed-price wetbarrels, or call options), when prices fall is when there can be a win-win situation with customers. On one hand, the cost of oil to the customer will fall, and on the other hand the profit margin for the oil dealer should increase—there is no reason that ALL of the drop in price needs to be passed along to the customer. The oil dealer keeps his or her word to lower prices and at the same time pads the bottom line. This simple concept is the core belief that keeps us as strong supporters of capped-price offers, as opposed to fixed or variable ones, despite the high cost (options premiums) to participate.

This is the year that heating oil dealers who have been offering price caps to their customers, even though fixed-price offers have been lower, should be “reaping what they have sown”—and most are. Fixed-offer dealers, for the most part, are making their planned margins (without the opportunity to improve the margins, but without having them shrink—unless they are wilting under price-pressure from customers). The problem for the fixed-price companies is more of a credibility issue, as prices charged are most often well above those charged by capped or variable offers. Those who are offering variable (rack-plus) sales are, too, achieving good margins, while being priced competitively for the first time in a few years.

The only real sector of the industry that seems to be suffering financially is the capped-offer companies who are not properly hedged. They have the choice of either NOT lowering prices (and ticking off their customers), or lowering their prices, as they should (and ticking off their accountants). The reality is that those in this tenuous position offered the “Cadillac” (the cap), but bought the “Chevy” (the fix), because it was so much cheaper, while hoping that no one would notice.

Did they save 15-cents per gallon on those “unprotected gallons”? Perhaps, and that will offset some of the pain. However, this really needs to be a reminder to all of us that even IF troubles persist in the Middle East (as they are), and even if Venezuela continues to be run by an absolute maniac (which it is), and even if the North Koreans are bent on a game of nuclear “chicken” (fairly clear), and.... If you take all of those potentially bullish scenarios—as were portrayed during the summer—and you mix them in the “energy blender”, you still might come up with collapsing prices. Don’t like speculating? Transfer your risk.