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After the Super-spike

In March 2005, much was made—almost all of it in derogatory manner—over a proclamation from some in the Goldman Sachs Investment Research team that crude oil prices may see a "super-spike" to a level of $105 per barrel. At the time, crude oil (WTI futures) were at the high level of around $50 per barrel, and the analysts said that they were expanding the tip end of their super-spike range from the previously ridiculous (according to some) level of $80 per barrel all the way up to $105 per barrel. That statement set off fits of commentary over Wall Street's control of oil prices, and much about fear-mongering. No one ever really questioned the logic behind the opinion. Rather, they just assumed it was another kook, looking for his 15 minutes of fame.

On March 6, 2008, crude oil futures traded above $105 per barrel (and to $111 per barrel the next week). The super-spike had occurred. The only real issue was that it didn't seem like a spike, but more of a continuing illogical spiral that had no signs of stopping. Along with the move to yet another set of record highs, April heating oil futures contracts surpassed $3.10 per gallon, spot New York Harbor prices moved towards $3.20 per gallon and most Northeast racks exceeded $3.25 per gallon. Retail prices in some high-margin (gross margin, not net margin—as it is constantly pointed out to me!!) areas moved to the $4.00 per gallon level.

What happens now? A lot of finger-pointing. It's because of the "Enron Loophole." It's because the President hasn't mandated withdrawals from the SPR. It's because the Federal Reserve is so worried about recession that they don't care about the inflationary impacts of high energy prices. It's because of increased demand from China. It's about the pending military conflicts in Central America (Venezuela/Ecuador/Colombia) or the Middle-East (Israel/Gaza). It's because the "terror-threat" might be going up. It's because the weak equity markets are driving everybody into commodities as a hedge against the weak dollar. It's because "foreigners" can buy our stuff cheaply. It's because..... Are any of these true? Sure. Are all of them true? Probably, to a certain extent. It is simply bad that prices are where they are. There is no way around it.

Customers with fixed or capped prices for this winter should be thrilled. Many are paying over a dollar per gallon less than they would be forced to pay had they not been offered the programs by their oil dealer. Many of these customers are actually NOT conserving, due to high prices! Of course, as we live in the glass-half-empty world, all we can do now is say, "Sure, good deal for this year, but they are going to revolt when I come out with next years' prices..." Perhaps that is true, but at some point you just need to sit back and ask what your alternatives are.

Last year, those with fixed-price offerings saw prices plummet, and their customers (according to some customers, and—shockingly—according to some DEALERS) "got burned". What was the response? For many, they said that since prices fell LAST winter, they would certainly fall THIS winter. End result: too many customers are paying rack-plus for oil, when all they needed to do was to be on a pricing program. Perhaps a cap would have worked?!?

This year, according to a survey done by a large Northeast supplier, interest in pricing programs will be dramatically higher for next year (duh?), and no one thinks that the interest will be less. Will the offers be for fixed prices (at record levels), or will they be for caps? The tendency to try to outguess "next year's prices" is something that oil dealers have been doing since the early '90s. Unfortunately, it doesn't lead to all that much success—or restful nights. How many times do we need to hear about companies that "hedged some" or "sold without hedging" before we stop wondering why some companies are being forced to shut their doors, and hurt their customers.

Finger-pointing generally just makes "the pointer" look guilty. It's not your fault that prices are where they are. Think about it: you don't see supermarkets apologizing because the price of milk and meat (and most commodities) has increased. It simply gets passed through. Heating oil dealers are in a unique position that allows them to help their customers control their costs.

Paying the costs (premiums) for caps is not very easy. The costs are quite high, and there doesn't seem to be much out there indicating that those costs will soon be going down. However you set your program, you need to recoup the costs incurred—either by charging a fee for the program, or by including the fee in the margin that is charged for the oil (or a combination). More and more companies have started to charge a direct fee to participate in these cap programs—even if the fee doesn't cover all of the costs to hedge the price of oil. If you think about it, price caps for next winter (depending upon what prices do, and what location you are in) may likely be in the $4.00 per gallon range. If you look at the cost to hedge that oil of around $.20/gallon, you are, in essence, asking customers whether it is worth it to them to "pay" 5% of the anticipated cost of oil for next winter, for peace of mind in knowing that prices "can't get any worse."

The decision by "informed" customers should be based upon the likelihood that prices will move by more than 20 cents per gallon between now and next winter. For perspective, the annual range (low price to high price) in the early '90s was (only) around 20 cents per gallon. In 2000, that moved to around 45 cents per gallon. In 2004, that range exceeded 80 cents per gallon, and this year (so far), the range has been over $1.30 per gallon. Armed with these "facts," is it really so hard to rationalize a 20 cent premium for the customer to pay for the knowledge that prices will NOT exceed a certain level, buy MAY be significantly lower?

As further evidence that this peace-of-mind is a growing concern (that, and the fact that no one looks forward to the inevitable slew of phone calls as each year's price cap is set and conveyed to the customers), we have several clients who are starting to offer multi-year price caps. Who's to say that just because we are now at record-high retail prices, that we won't continue to see higher and higher prices in coming years?

So, we've seen the "super-spike," and the sun rose the very next morning. No one is in a position to say that prices will or won't spike even higher, but they are in a position to control the impact that any such spike will have on their customers, and on their business. They just need to accept that anything short of being hedged is a position of speculation. How sound a business plan is it to speculate with your future success?