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Solution: Hedging Advisory Services

ABC Oil Company

SUCCESS STORY: CAPPED PROGRAM FOR DIFFERENTIATION

ABC Oil Company is a 2nd generation retail home heating oil business in anytown, New England. They offer equipment installation and service, retail heating oil sold with budget plans, and are considering diversifying into HVAC servicing. ABC has always shared good relationships with their two main suppliers, and believes in a strict adherence to setting and achieving budgeted profits.

THE CHALLENGE

Aggressive competitors have taken away many of ABC's customers by offering one-year fixed and capped prices to homeowners, something that ABC is not familiar with. As ABC's CEO, Mr. DEF said, "my father told me that playing in the markets was risky, and that I should just service my customers. It worked for a while, but I can't afford to see my customer base dwindle so I need to offer something new".

THE OPPORTUNITY

After an assessment of what it would take to plan, implement and manage an offering to include fixed and capped price offerings, ABC decided to start small and to partner with Angus Energy to help put the pieces in place.

ABC wanted to focus on the capped price offering, so they could promise their customers protection against increasing prices while allowing for the benefit of paying less in the event that prices fell.

Angus Energy helps businesses, like ABC Oil, run their businesses more effectively, more efficiently and more profitability via our suite of solutions.

SOLUTIONS

As ABC had a very strong relationship with its suppliers, they felt most comfortable fixing their future supply price on the majority (70%) of their planned pricing program purchases. In order to offer the cap promised to their customers, they purchased downside protection "put options" on the same 70% of purchases to hedge the risk of falling prices. For the other 30% of their budgeted gallons, ABC purchased "call options" that place a ceiling on the cost of products and did not need to purchase corresponding fixed priced contracts.

As referenced above, the puts and calls reflect financial settlements against the price of heating oil on the NYMEX exchange. However, in order to address the "basis", the purchase of the 70% of the their volume at a fixed-price from their supplier locked in the basis and protected against a movement in the basis, or worse a "basis blowout". It should be noted that although basis blowouts are not common, they do need to be factored into the planning, and in this case, ABC understood that basis risk on the remaining 30% of their volume that was not fixed via wet barrel purchases, and would be purchased at the rack at the then current price.

Lastly, to protect against the negative impact of a

There are three main risks when trying to tie a price offering with a desire to hit budgeted profits:

1. **The movement of the price of oil as traded on the exchange (or a localized Index)**
2. **The change in the "basis" – the spread between the exchange or index and the local rack costs**
3. **Mother Nature – if there are more HDD's or fewer HDD's than planned, the impact on the sales volume can affect profitability.**

warm winter – not to the customers, but to ABC's sales volume and bottom line – ABC purchased HDD put options that reimburse ABC in the event that the seasonal HDD's were lower than a predetermined number. All of these actions and hedges required time, planning and costs. Factoring in all of the hedge costs into the ultimate price cap offering was a challenge, but ABC worked through it, charged cap customers (as is common in their area) a participation fee, and set the cap level accordingly to better protect a full margin.

RESULTS

As can been seen in **Figure 1**, prices were around $1.90 per gallon (NYMEX) during the spring of 2010. Assuming a 9-cent per gallon basis differential, a 20-cent per gallon option premium (covered by the customer's $199 "cap fee", and a desired $.90 per gallon profit margin, ABC would have offered a cap at $2.89 for the following winter ('10-'11).

When prices on the NYMEX rose to about $2.50 per gallon, ABC's customers would have paid the capped price of $2.89 per gallon, but ABC would have achieved full margin due to the combination of the pre-purchased wetbarrels (70%) and the trade settlement on the call options (30%), which would have offset the higher rack cost for those gallons.

As ABC's success in keeping both their margins and their customers increased, the cap a few years later would have had contrasting, but equally effective implications. Note that in **Figure 2** that during the Spring of 2014, prices were around $2,90 per gallon. Using the same economics as above, ABC's customers would have signed up for a capped price of $3.89 per gallon for the winter of "14-'15.

When prices fell through the fall and winter, and declined to the $1.70 per gallon range, ABC had to lower their delivered prices and their customers received deliveries of about $2.69 per gallon – a full $1.20 per gallon lower that what they would have paid had prices increased.

FIGURE 1

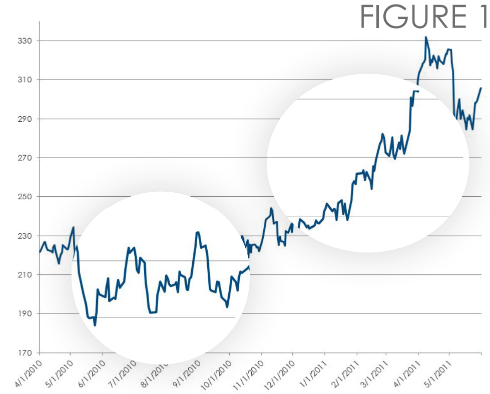
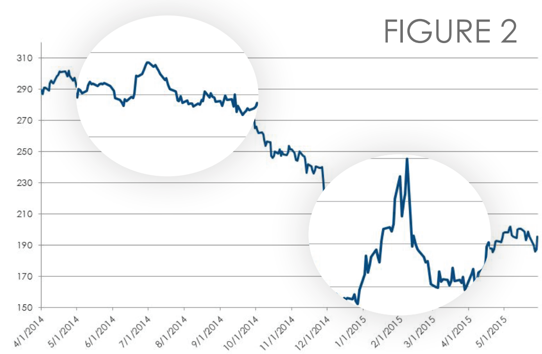


FIGURE 2



CONCLUSION

So, how did ABC do? The wetbarrels that they purchased were well "underwater" and cost ABC more than the "market price" during the winter. However, the "put options" that were purchased protected those gallons against the drop by reimbursing ABC for the market movement. In addition, the rack purchased gallons (30%) were all at the lower rack price, allowing for the full margins. The call options purchased (and paid for via the Cap Fee) just expired worthless, and had no impact on margins.

Note that, similar to the prior example, if the weather was warm, ABC would have been reimbursed at some level for the lost sales, and had it been colder, ABC would have reaped the benefits of additional sales, however, in this case, at full per gallon margins.

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