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Fuel Oil Buying Clubs

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A Fuel Oil Buying Club Can Deliver Reduced Bills to Low-Income Consumers

As a commodity, fuel oil and propane are marked by their lack of differentiation between products sold by different suppliers. Unlike products that are differentiated by taste (e.g., Coke vs. Pepsi) or style (e.g., Honda vs. Ford), one gallon of fuel oil is pretty much the same as any other gallon of fuel oil. The significance of this is that competition for the fuel is thus based almost exclusively on price.

The importance of price in competition for home heating fuels is magnified because of the importance which home heating expenditures play in the consumer budget. Setting aside the nature of home heating as a necessity of modern life, the sheer magnitude of the expenditure on home heating is sufficiently large that consumers will pay it particular attention.

In light of this observation, Fisher Sheehan & Colton (FSC) recently found that a fuel oil buying club (such as the Boston-based Mass Energy Consumer Alliance) can deliver substantial benefits to consumers of fuel oil. In a feasibility study of a fuel oil buying club in New York, FSC reported that a buying club could generate hundreds of dollars of benefits per member while at the same time generating an organizational surplus that could be directed toward initiatives such as low-income fuel assistance and/or weatherization.

The discussion below presents some of the lessons learned through the FSC study.

The Role of Energy in a Consumer's Budget

Home energy bills are one of the highest annual expenditures in a consumer's budget. A typical consumer in the Northeast region of the country spent about $38,000 a year in the two-year period 1998 – 1999. Of those total expenditures, more than $13,200 was spent on shelter, including home utilities. Consumers spend roughly 20% of their total shelter costs on utility service (including water/sewer). In the Northeast, a consumer devotes about seven percent (7.0%) of all consumer expenditures (*not* of income) to home utilities.

Limited Periods of Competition

A consumer purchasing alliance seeks to reduce the dollars consumers spend on fuel oil through the aggregation of consumers. Using the market power achieved through aggregation, an alliance would seek to reduce total expenditures by negotiating for lower prices. To do so, however, the alliance must first convince customers to become members.

The heating season is most important to the feasibility of a group purchasing alliance competing for members. This season really demarcates the time during which a purchasing alliance can effectively compete.

Experience with other fuel oil group buying initiatives counsels that consumers are reticent to change oil vendors in the middle of the winter heating season. Once a satisfactory vendor is found, a consumer tends to effectively "lock in" their business to that vendor for the heating season. Consumers do not "experiment" or move to an unknown dealer (even a potentially less expensive unknown) during the cold weather months.

A review of heating degree-day data shows that the period of aggressive competition (and enrollment) would be through the month of October (and perhaps through November). While this is not to say that consumers will not enroll in a group purchasing alliance during the middle of the winter heating season, it *is* to say that the most aggressive solicitation, and most effective enrollment, will occur before cold weather sets in.

Moreover, clearly, the later a consumer enrolls in a group purchasing alliance, the lower the total dollar savings the consumer can expect to achieve through the heating season.

The Role of Services in Competition

Even while one gallon of oil is pretty much the same as any other gallon of oil, fuel oil vendors may be able to differentiate themselves by the service which they offer as well. Service can come in two forms. On the one hand, differentiation may come in quality of service. On the other hand, differentiation may come in the range of services offered.

To succeed, the group purchasing alliance must succeed in enlisting vendors that offer a full range of services. A survey of low-income households identified several factors that low-income customers considered to be equal in importance to price in deciding which fuel oil vendor to patronize.

Survey respondents indicated that price was important in "deciding who I buy my fuel oil from." Of the 79 persons completing these survey questions, 39 said that among the factors that were "most important" was the fact that "the price for fuel oil is the cheapest available."

Other factors commonly identified as being "most important," however, included that: (1) the fuel oil dealer be located close to me; (2) the fuel oil dealer will fill-up my tank at night or on weekends if I need it; (3) the fuel oil dealer will fill-up my tank only part-way if that is all I want; (4) the fuel oil dealer will offer a payment plan if I want it; and (5) I have used the fuel oil dealer before.

The Role of Maintenance Services

The survey responses do not appear to support the conclusion that the delivery of maintenance services was particularly important to low-income consumers (although, it has been suggested, the importance of such service is greater for consumers with higher incomes). Instead, the services cited by survey respondents primarily involved payment and delivery options.

The Role of Payment Options

An undercurrent of ability-to-pay is evident in the low-income responses to requested service options. In addition to seeking the least expensive fuel oil available, 39 respondents indicated that the presence of a payment plan was important, while an additional 34 indicated that being allowed to obtain a partial fill-up when desired was important.

When asked to provide an unaided response to which factors were the most important in the selection of their fuel oil dealer, price was not a primary consideration. Of the 33 respondents answering the open-ended question, nine indicated that the most important factor was that the dealer offered credit arrangements or budget billing plans (three more indicated "flexibility," which could mean flexibility in fill-ups as well as flexibility in payment terms). Only three respondents identified "price" as one of the most important factors.

Service Differences Between Low-income and Non-low-income Consumers

A group purchasing alliance will need to marry the price-based concerns of lower income consumers with the service-based concerns of higher income consumers.

Experience counsels that higher income consumers will pay higher prices for increased service quality. This quality includes, for example, deliveries within 24 hours rather than 48 hours, as well as annual service contracts for heating equipment.

In contrast, lower income households are willing to sacrifice these service amenities for marginally less expensive fuel. To succeed in serving both markets (lower income and non-lower-income), the purchasing alliance will need to establish minimum service standards without pricing itself above the competition for low-income business.

The Risks of Consumers Not Shopping

One of the real risks to the viability of a group purchasing alliance involves the potential that consumers may not "shop" for retail fuel oil supplies.

Despite the theory that, due to the high portion of a consumer's budget devoted to home heating, consumers will seek to minimize those expenditures through shopping, one survey of low-income consumers found this often does not happen in reality. Of the 74 persons responding to this survey question, 60 indicated that they had purchased fuel oil from only one dealer. When asked how many dealers they call to check prices before asking someone to come fill their tank, 65 of the 74 respondents said they called only one dealer.

The lack of price checking by consumers occurs despite the presence of multiple fill-ups over the course of the heating season. Survey respondents typically reported from three to four fill-ups during the course of a heating season.

It is clear from the survey that the selection of a fuel oil dealer often does not turn on objective and measurable factors. In responses to the survey, 32 respondents indicated that they would choose a dealer because they have used the dealer before. In addition, the unaided responses included the fact that the dealer was "dependable." In the unaided responses, as many respondents said they chose their dealer because he or she was "friendly" as chose their dealer because he or she offered the lowest prices.

Whatever the theoretical responses to why consumers *might* choose a fuel oil dealer, the fact remains that 60 of 74 survey respondents (81%) indicated that they had purchased fuel oil from only one dealer in the 2000 – 2001 winter heating season, and 65 of 79 respondents said that they had contacted only one dealer to check on price before making their purchases.

These responses may indicate an informed dealer selection at the beginning of the heating season, which is simply not revisited during the heating season. If this is the case, the alliance must simply seek to time its outreach and member enrollment to compete for the *initial* decision on where to buy fuel oil.

In contrast, however, the responses may alternatively indicate a tight allegiance to fuel oil vendors irrespective of price, whether by choice or merely because of consumer inertia. If this is the case, the alliance may be facing a market that is hard to enter and in which it will be a struggle to acquire sufficient market penetration to achieve self-sufficiency.

Projected Bill Savings

The purpose of a group purchasing alliance is to arrange for fuel oil deliveries at prices that are less than "full retail" that would otherwise be charged. Group purchasing alliances functioning in states such as Massachusetts and Pennsylvania have negotiated prices that are a fixed margin over wholesale "rack" prices. One feasibility question presented to a potential buying club, therefore, is whether retail prices in the area to be served by the club are sufficiently high to support this type of negotiation process.

A comparison of retail fuel oil prices to wholesale fuel oil prices allows for conclusions to be drawn about the margin being received by fuel oil and propane dealers in the region to be served by a purchasing alliance. The New York State Energy Research and Development Authority (NYSERDA), under contract to the Energy Information Administration of the U.S. Department of Energy (EIA/DOE), tracks monthly and weekly retail prices by region in New York State.

To compare the prices at which a purchasing alliance would deliver fuel oil to full retail prices, a designated margin was added to rack prices posted at three terminals serving the area potentially to be served by the purchasing alliance. Weekly retail prices were obtained for each region from NYSERDA. Weekly rack prices were obtained for each terminal from the Oil Price Information Service (OPIS). A margin of $0.25 per gallon was added to rack prices to generate purchasing alliance prices.

Data from the U.S. Department of Energy showed that average annual fuel oil consumption for the area in question was roughly 830 gallons.

Assuming winter fuel oil purchases of a magnitude and timing calculated by FSC, a purchasing alliance would generate dramatic price and bill savings for its membership. The *lowest* calculated annual bill savings was $198 off a bill that would otherwise be $1,177 ($1,177 vs. $979).

These savings were obtained by comparing: (1) the average retail price, (2) average prices given a $0.25 over rack, (3) average savings per gallon, and (4) average annual bill savings generated by a margin over rack retail price. The average bill savings assumed an annual consumption of 800 gallons. Higher consumption would generate higher bill savings while lower consumption would generate lesser savings.

Dealer Participation

A fuel buying alliance should have contracts with multiple dealers to serve customers. The goal of the alliance should be to become a sufficiently large provider of customers to be "important," but to avoid becoming over-dependent on any particular dealer. An over-dependence can impede effective bargaining, since a decision to change dealers would hurt the alliance as much or more than it would hurt the dealer.

One alliance, for example, had an exclusive arrangement with one dealer. When the alliance switched vendors due to escalating prices, only 40% of the membership switched along with the alliance. An additional 40% stayed with the vendor and 20% of the membership went "somewhere else" (unknown, but lost to the alliance in any event).

FSC recommended that a fuel oil purchasing alliance should aim for an average member-to-dealer ratio of 500-to-1. Using this benchmark, a total membership of 5,000 customers would thus require 10 participating dealers to achieve the recommended ratio.

Organizational Staffing

A purchasing alliance should operate with staffpersons dedicated exclusively to the alliance, FSC said. An alliance should begin with two dedicated fulltime and one part-time staff. From its inception, an alliance would require a fulltime Fuel Oil Director and a fulltime Membership Director.

The Fuel Oil Director should focus on the operation of the alliance. He or she would work with vendors, track prices, enlist organizations to enroll low-income members, monitor income and expenses, and otherwise work to "create" the alliance organization and network.

The Membership Director should focus exclusively on enrollment and customer service. The Membership Director would recruit members, assign members to vendors, trouble-shoot customer service problems, and otherwise be the point of contact between the membership and the organization.

The need for a part-time support staff is anticipated, as well, to ensure that the Fuel Oil Director and Membership Director do not spend their time answering telephones and doing support work.

Beginning in the second or third year, an alliance should further expect to hire a fulltime field staffperson as well. This person would be a circuit rider within the alliance service territory to work with local organizations on everything from recruitment, to organizational training, to field-related customer service work. The field staff would be intended to ensure that the alliance has a regular, stable in-person presence in each of the counties within the service territory.

Given this staffing level, generating sufficient membership to meet organization expenses plus generating a surplus to provide services such as low-income crisis assistance and/or weatherization is entirely feasible.

For more information regarding the feasibility of forming a fuel oil purchasing alliance, contact:

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Fisher, Sheehan and Colton, Public Finance and General Economics (FSC) is a research and consulting firm with offices in Belmont (MA), Scappoose (OR), and Iowa City (IA).

FSC specializes in providing economic, financial and regulatory consulting. The areas in which *FSC* has worked include infrastructure financing, public enterprise planning and development, natural resource economics, community economic development, telecommunications, public sector labor economics, planning and zoning, regulatory economics, energy law and economics, fair housing, and public welfare policy.

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