Will Rising Fuel Oil Prices Endanger the Profitability of Rental Housing?

Fuel prices are at six-year highs.

Fuel oil prices1 in 1996 are about $.10 higher per gallon than last year (see graph below), and represent the highest oil prices since the gulf war nearly six years ago. As the worst of this year's heating season approaches, property owners are understandably edgy.

Not only are fuel prices surging, price swings are more dramatic than in recent years, due in part to low oil stocks. Throughout much of 1996, refinners maintained lower reserves to cut inventory costs and to hedge against lower crude oil prices should Iraq resume oil production.

Such uncertain market conditions translated into a roller coaster ride for retail prices in 1996. Fuel vendors sharply increased their prices last spring and again in the fall as they faced a combination of higher demand for heating oil and lower than normal reserve levels.

Because of low fuel reserves, refinners shift production among different fuel types (i.e., heating oil, gasoline, diesel, etc.) as demand requires. Since late October, refinners have stepped up heating oil production to near record levels. Building owners, however, are still awaiting relief from bloated retail prices.

Fuel oil prices have risen slightly over the long term.

In the last ten years, nominal fuel prices have increased only slightly, while real (inflation-adjusted) prices have actually fallen until this year.

As the graph on the next page shows, nominal oil prices have risen moderately in the last decade except in 1990-91 and 1996. Following the 1990 Iraqi invasion of Kuwait, retail prices swelled as much as 50%, but the spike in fuel prices faded by the spring of 1991. Price increases since this time have been mild.

Real prices dropped roughly 9% from the end of the gulf war through last year. Fuel prices reverted to gulf war levels in early 1996, though, and remained unusually high throughout the year.

Property owners are spending less of their budgets on fuel.

Since prices of other goods have risen substantially more than fuel oil prices, fuel constitutes a declining portion of operating and maintenance costs (O&M) for New York City's multifamily properties. The relative weight of fuel has declined from about one-quarter of O&M expenses in the early 1980s to less than 10% currently. (See graph on the following page.)

Buildings also require less fuel oil as their owners install more efficient heating mechanisms which use number 2 fuel oil and implement further energy conservation techniques. Also, as additional suppliers offer number 2 heating fuel, vendors encounter greater competition to maintain their prices. Thus, changes in the fuel oil market may have less impact on owners' budgets in future years.

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1. Nominal prices do not account for inflation. 

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Retail Prices of Fuel Oil Are Substantially Higher than Last Year.

(Wighted Average for Numbers 2, 4 and 6 Fuel Oils)

A very large increase in fuel costs would cut profitability to 1992 levels.

The question on the minds of every real property owner is: Will increased fuel prices cut into profits?

According to Income and Expense Statements filed with the Department of Finance, owners’ average net operating incomes (NOI) were 39.3% in 1994, compared with 36.6% in 1992, the lowest point of the real estate recession. Holding income and all other expenses constant, fuel costs would have to increase nearly 50% to reduce NOI to 1992 levels.

Although 1996 fuel prices are considerably higher than last year, this price increase has likely reduced the NOI of an average property by less than 1%. Properties with marginal profitability have probably experienced larger declines in net income.

Sharp increases in fuel prices will likely abate.

Heating oil production is soaring as refiners increased output in the last two months. Further, Iraq has indicated its willingness to comply with the six-month limited oil sales agreement originally signed in May.

According to officials at the American Petroleum Institute, refiners are churning out higher than normal amounts of heating oil - 3.6 million barrels of oil per day, or 600,000 barrels more than normal during winter months. This output is sufficient to begin building oil stocks and to provide ample fuel oil during the severe winter months.\(^2\)

Iraq is also expected to add 500,000 barrels of crude oil per day to the worldwide supply as early as December or January. Given increased output of crude as well as heating oil, fuel oil prices should show signs of stabilizing this winter.

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Note: Fuel prices presented in this brief are derived from the Rent Guidelines Board monthly survey of fuel vendors who supply numbers 2, 4, and/or 6 fuel oil to multifamily buildings in New York City. Prices represent the weighted average of the three fuel grades unless otherwise noted.

1 Fuel prices represent how much a consumer pays per unit of fuel, typically measured in gallons. Fuel costs, on the other hand, reflect both the price per unit of fuel oil as well as the amount consumed.