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## Beat the Price at the Pump

Staff Writers

*Price hedging can help transit agencies reduce overall fuel costs, but it isn't without risk.*

Fuel prices — they've been a PF standard water-cooler talk for most of the past decade, right up there with the weather and the office coffee.

But as wild as they've swung and as high as they've gone, the average driver hasn't faced the same sort of budget shock that mass transit systems and other fleets have while fuel prices have done their best imitation of a roller coaster, heading up then down and repeating again and again.

To continue the roller coaster analogy, prices currently seem to have completed that thrilling drop from the top of the big hill, but chances are good there's another incline somewhere ahead of us.

In mid-March the retail price of a gallon of diesel fuel averaged about \$2.02 per gallon throughout the United States, down \$1.95 per gallon from the same time in 2008, according to the U.S.

Department of Energy's Energy Information Administration.

That is a microcosm of what can be learned from fuel prices in the past few years — prices are amazingly volatile and difficult to predict. That's why, at least anecdotally, more fleets, including those within mass transit organizations, are seeking to reduce both cost and price risk by hedging the future cost of fuel in different ways.

### **Risk and Reward**

In the current fuel climate, even the goals of reducing cost and price risk can be contradictory. Take the Greater Cleveland Regional Transportation Authority. The authority locked in diesel prices at \$3.17 for this year, a price significantly higher than the retail market price right now. But, the price seemed like a good idea when the Cleveland RTA locked it in last year. Plus, at that price, the system's fuel costs will come in at budget for sure, no matter how wildly prices swing in the remainder of the year, says Gale Fisk, executive director of the office of management and budget for the Cleveland RTA.

What looked like a good price at the time for Cleveland now looks like an outrageously high price, but it is still accomplishing what the transit authority set out to do. Such is the world of fuel price hedging. One can seek the greatest possible savings, the most stable price or to save a couple of cents per gallon over the average price, and there are a number of ways to accomplish those goals or a blend of those goals.

Figuring out what a mass transit organization wants its fuel plan to do is the first step in starting any plan, says Ryan Mossman, vice president and general manager of Houston-based FuelQuest's fuel services division.

FuelQuest provides industry expertise and software to help vehicle fleets manage fuel cost and use. Clients include UPS, Costco, Wal-Mart, Greyhound and dozens of other retail and delivery fleets, some using as many as 100 million gallons of fuel annually.

Many groups, both businesses and in the public sector, go about reducing fuel price and risk in a less than exacting manner, Mossman says. They may call a handful of local suppliers and pick the one with the lowest price on that day, even when seeking a long-term contract, he says.

Such an approach will only net a group the lowest price on a given day from a very limited area, instead of looking at fuel costs in a holistic manner.

After identifying a goal for a fuel program, a group needs to compare its fuel spending to an industry average, usually using one of the fuel price indexes, like Platts or Opus, Mossman says.

Only after figuring out goals and assessing where fuel buying stands, can a fleet make decisions on whether long-term, fixed-price contracts, index-based contracts, buying in the spot market or what combination of those methods will work, Mossman says.

In Austin, Texas, Capital Metro Transit started its first efforts to hedge fuel price at the beginning of 2009. The goal of the program is to “provide the best price at the least risk to make our budget expenditures more predictable,” says Randall Hume, executive vice president for finance and administration at Capital Metro.

Capital Metro has more than 500 fleet vehicles, including 402 buses for 60 routes. The organization served more than 35 million riders in its 2008 fiscal year.

And, despite a falling price market so far this year, that’s exactly what the program has done. Austin hedged at an average price of \$1.74 per gallon for some 126,000 gallons between January and September, Hume says.

Estimates are that the same fuel could have been purchased at \$1.55 per gallon in January and around \$1.41 in February and March. The difference between the market and the hedge has come to about \$100,000 in the three month span. But the long-term picture is what is far more important.

“Diesel savings compared to budget (are) \$2,075,000 and savings projected through the fiscal year ending (Sept. 30) is \$11.5 million,” Hume says.

That budget confidence is the absolute key to the Austin Capitol Metro program. Saving money is a distant second to being able to stay within budget on fuel.

“Our major funding source is a local sales tax, which is down about 9 percent from 2008,” Hume says. “Better management of diesel price volatility has allowed us to offset with some confidence a significant portion of that revenue loss without a major impact on service.”

Capital Metro has swap contracts only through December. The transit system anticipates more purchases in late spring or early summer, Hume says.

### **Risk Planning**

Creating a plan to reduce fuel price risk is a complex undertaking with multiple strategies available, all with strengths and weaknesses depending on an organization’s goals.

To best approach price hedging, a fleet needs to understand a few major points. First, trying to pick a price or seek the lowest possible cost isn’t advisable in such a volatile market, says

Wayne Penello, president of Risked Revenue, which creates strategic energy hedge programs to help companies manage costs.

Next, one needs to understand the price potential of the fuel market. It's a market that has risen about 12 percent per year in recent decades, but individual years can see much wilder swings, either up or down, Penello says.

Lastly, a group needs to establish what its "can't live with it" price is. Once established, by looking at the market's potential for change in the short-term and combining that with what the cut-off price is, a fleet can decide what percentage of fuel needs to be hedged at what price, Penello says.

"Most municipalities are very clear about their objectives," he says. "They don't want to be guessing on price."

It might seem to be a tough market to hedge in by buying futures right now. Wholesale prices are around \$1.21 per gallon for April. For next year, the price is around \$1.62 per gallon. But, buying futures, selling them off at maturity and using that to offset the purchase price of off-the-rack or wholesale fuel, can create insurance and cap what someone pays if there is a price spike.

The question for mass transit systems, like any other fuel user, is "Is the fuel program worth the cost?"

Smaller fleets probably don't have someone with commodities market experience on hand and hiring someone or employing an outside consultant might create more costs than savings. But, for something as complex as investing in futures, instead of simply seeking a long-term fuel contract, the risks are high for people without significant financial market experience, Penello says.

### **Pricing for the Future**

The Greater Cleveland Regional Transportation Authority has turned to commodity buying to help hedge fuel prices. The transit authority locked into a fixed-price contract at \$3.17 per gallon for this year. At the time that seemed like a great price and, despite being significantly above the market now, will still allow the Cleveland RTA to meet budget on fuel prices, says Fisk, the executive director of the office of management and budget.

"At that time we felt really good about that price level," Fisk says.

The RTA pushed for a state law that would allow the mass transit organizations to buy fuel futures. Currently, the organization is buying futures at \$1.80 per gallon for 2010.

"When the futures mature we sell them and use the excess or the deficit as an offset to augment the actual market purchase price," Fisk says.

Fisk says investing in future commodities rather than locking into a single long-term contract makes a lot of sense. The contract represents a single decision point, a price at a specific moment of time. And that can turn out to be really right or, like the \$3.17 contract, really wrong in terms of where the market is heading, Fisk says. Buying futures lets the mass transit organization make a hundred different decisions over time, something that should lead to a better price.

The Greater Cleveland Regional Transportation Authority has a fleet of roughly 500 buses and served some 57.9 million passengers in 2008.

Like the other transit organizations, reducing cost fluctuations is the main goal.

“The first thing is managing risk and second is saving money,” Fisk says.

While managing risk is a sure thing with a well constructed program, saving money is more of a gamble since predicting the market perfectly is an impossibility.

With where the market is now, Cleveland anticipates reducing its fuel budget to around \$9.8 million in 2010, down from a recent peak of \$18.8 million. That \$9.8 million figure would be the lowest amount spent on fuel since 2004, Fisk says. To do that, Cleveland will have some 90 percent of its fuel for the upcoming year hedged with futures.

### **Long-Term Investment**

The Cleveland RTA was spurred to look at fuel cost containment after determining its prices had gone up 200 percent between 2004 and 2008 and another 60 percent in 2008.

Those wild fuel price fluctuations forced Cleveland and Austin to look at how they could control the risk associated with fuel price cost, but hedging prices to avoid spikes isn't a new invention.

Some fleets have been working on the issue for years.

The Metropolitan Atlanta Rapid Transit Authority has been working to reduce fuel price risk since the late 1980s, according to Richard Marsh, senior director of treasury and capital programs at the transit authority.

MARTA has used a stand-alone hedge structure, avoiding long-term fuel contracts. The efforts have created cost avoidance in excess of \$20 million, according to Marsh.

The hedge program covers roughly 80 percent of diesel fuel and compressed natural gas used by the transit authority and has been very successful in eliminating price risk for fuel. The system has been using the same price risk reduction tactics since its program began about two decades ago.

“The program removes uncertainty,” Marsh explains.

MARTA is the ninth largest mass transit system in North America serving 105 million passengers in its 2008 fiscal year. In addition to light rail lines, the system has more than 600 buses, most of which run on clean diesel or compressed natural gas.

“After salaries, energy is MARTA's largest expense and it is essential to remove the price volatility to properly plan,” Marsh says.

Because fuel costs are often one of the largest line items in a budget, fleets and mass transit organizations need to think about more than simply fuel price when they come up with a strategy.

“You need to look at the entire breadth of what the fuel plan is,” says Mossman, the vice president at Houston-based FuelQuest. “Sometimes there's all this focus on fuel price that people forget other things.”

Mossman urges organizations to study how much fuel they have on hand to make sure reserves aren't too high. Many organizations have far more fuel than needed on hand, creating, in effect, resources that are sitting around waiting to be used.

Having too much fuel on hand isn't the only way an organization that hadn't taken a comprehensive look at its fuel system could be spending more than it has to. Given the up and down nature of fuel prices, errors can easily creep in to fuel invoices.

Lastly, too many organizations take the freight of the fuel for granted. Money can often be saved on the freight charge by shopping around instead of using the company supplying the fuel as the default freight company, Mossman says.

"It's a game of cents, but when you add it all up it can add up to a lot of money on the bottom line," Mossman says.

### **Off the Rack Fuel**

Even with a contract or hedge system in place, the small percentage of fuel that is bought "off the rack" can still make up a significant cost. Those prices can jump nearly 15 cents per gallon in less than 24 hours depending on what's going on on the major indexes like Platts or Opus. Fleet managers and fuel purchasers should at least keep an eye on those prices since they take around a day to trickle down to local suppliers. Knowing when to buy or not buy on the spot market can also save some money, although it isn't a sure thing for reducing price risk, Mossman says.

Mossman also suggests index-based long-term contracts. For organizations that consume large quantities of fuel, it is possible to enter into a contract where the price paid for fuel is tied to the market price but set at a few cents per gallon below that market price. Those contracts are attractive to competitive businesses because they allow for fuel costs to come in a few cents per gallon below what competitors are paying.

Of course, the amount of fuel contracted for will determine how far under market price the contract will be. The more fuel purchased, the more likely a contract will be further below the market index it is tied to.

The good thing about these strategies is that they tend to work whether the fuel price market is rising or falling. In fact, Mossman doesn't recommend overhauling a price volatility reduction strategy based on how the market acts over a short period of time, preferring to re-examine a strategy instead when an organization's overall fuel goals change.

### **Staying Consistent**

Being able to stay consistent with strategy is probably a good thing given current market conditions. Price spikes in early 2008 gave way to tumbling prices later that year and into this year. But, no one should take low prices now as an indication that they'll stay that way for the long run.

"The companies that really get it understand that volatility is here to stay," Mossman says.

Austin's Capitol Metro has purchased swap contracts through December during its first efforts with fuel price hedging. The program hedges prices on about 50 percent of the diesel fuel used from October through December. Only about 30 percent is hedged from now until October, according to Hume.

"We have held off on doing additional hedges until we start seeing some consistent rise or pattern in fuel prices," he says. "Since prices have been very low, we are trying to take advantage of that as long as we can."

Realistically, Hume knows the hedge program is likely to grow once prices start back up, a seeming inevitability once worldwide demand picks up again as supply isn't likely to increase.

"[The program] will probably grow once fuel pricing becomes more stable," Hume says. "I doubt if we ever hedge more than 60 percent to 70 percent."

It's almost a foregone conclusion that prices will eventually head up again. Mossman points out that demand has dropped because of the slowing world economy. Once that picks up again the inherent supply issues that pushed prices so high last year will likely return.

The Metropolitan Transit Authority of Harris County, Houston already has its full fuel supply under price control measures.

"We include all Metro-operated and contract-operated revenue vehicles using diesel fuel," according to Raequel Roberts, associate vice president of marketing, media and corporate communications for Metro.

The Houston program began in 2005 with a goal to minimize the volatility in the fuel budget variance, Roberts says.

"To date, Metro has seen a net savings when compared to the market," she says. "The primary advantage is budget certainty for diesel fuel."

Even with the price drops in recent months, organizations that still haven't tried to find ways to minimize price risk are starting to look into what they can do.

"The run up in prices last year has definitely forced everyone to consider ways to manage the risk in prices as it concerns their fuel," Penello says.

The bottom line, according to experts, is that price volatility for diesel fuel is a fact of life for the long run. Current low prices don't reflect what will happen when worldwide demand picks up again.

Even fixing things not directly related to fuel price, like cost of delivery, inventories on hand and billing errors, can save pennies per gallon, which add up when one is measuring fuel use in the hundreds of thousands or millions of gallons per year. Finally, examining what you are paying for fuel and creating a plan to reduce price risk can be very successful in reducing budgeting concerns, even in times of price uncertainty.

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