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# Taking Control of Your Energy Costs

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Management Notebook

Can transit authorities "game" the energy markets? The short answer is "yes." A somewhat longer answer is that most of the time, the energy markets game most transit authorities. They just don't know it.

With energy prices fluctuating, sometimes wildly, and for the past year heading inexorably higher, it is nonetheless possible for transit operations to protect themselves from both the price volatility and ever-increasing costs hitting their budgets every quarter.

Obviously, the cost structure of just about any transit agency is influenced by the price of fuel—whether it is gasoline, fuel oil, or natural gas. For example, Metro Transit of Minneapolis/St. Paul, Minn., burns more than eight million gallons of diesel fuel a year. The Metropolitan Atlanta Rapid Transit Authority burns an estimated seven million gallons a year; Metro in St. Louis, six million, and so on.

Fortunately, the energy markets provide the tools to mitigate these costs, in the end offering a clear advantage in the form of better controlled and, often, lower costs.

Unlike financial markets, markets for physical commodities differ because they also take into account other factors such as the cost of storage, insurance, and risk of disruption of supply—the co-called "terrorism premium"—and other inputs that aren't factors in pricing a financial asset.

While the evening news headlines give us the daily fluctuations in prices, the energy markets offer a daily—indeed, minute-by-minute—snapshot of the collective expectations for energy prices, whether it's raw crude oil, heating oil, jet fuel, natural gas, or what-have-you.

Here's where things get interesting. Because of all the price inputs and market fundamentals unique to energy, most of the time, fuel in the future—in the form of futures contracts on these various energy commodities (especially petroleum products)—costs significantly less than you can buy it for today.

Look in the business section of most local dailies or *The Wall Street Journal* under Futures Prices. For example, a futures contract for West Texas Intermediate Crude, the benchmark oil futures contract in New York, 12 months from now is selling at $39.36 per barrel, but the "spot price," namely the price you would pay for that

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same barrel now, is $43.87. Translation: a company can lock in an equivalent amount of fuel, deliverable in the future, for $4.51 per barrel cheaper than they have to pay for it today.

The problem is two-fold. First, many transit administrators distrust the futures market, associating it with wild, so-called "naked" speculation, not to mention an additional cost of doing business. Fact is, a transit agency that will need to use the fuel anyway is not speculating. The agency is buying insurance in one market—in essence, it is literally buying time—to offset an expected expenditure elsewhere in its business. That's also the second thing companies don't like—insurance. Read: still another cost worth avoiding.

Most transit companies' strategy is to pay whatever the price is for energy today and hope for lower prices tomorrow—no strategy. To do without energy is not an option. But in a very real way, the decision not to hedge is the decision to speculate. In biting the bullet and paying higher prices today, they are paying a premium for immediate availability of fuel without controlling the variability of cost: Buy now; pay more now; and who knows what we'll pay tomorrow.

The bottom line is that this pricing dynamic offers an astute transit company the opportunity to hedge its fuel costs in a way that wrings out the volatility and often captures the price savings embodied in the futures price versus the spot price. For instance, Metro Transit in Minneapolis/St. Paul employs a program—one that in the past seven years has saved taxpayers a significant sum and also allowed Metro Transit to more accurately build its annual budget.

The secret, however, is in looking at market expectations and market history to make market decisions, something that not all hedging programs do.

Looking at market expectations shows us what the market thinks it is going to do. But looking at its history can often provide important clues of when the futures market is over-reacting to a situation, either on the upside or on the downside. As a result, in some situations the best course of action may be to do nothing, even though futures prices are lower than spot prices; in other instances, just the opposite may be true, with historical prices—combined with futures prices—dictating a much more aggressive buying program.

The beauty of all this is that the data is all there. And in return for a little planning—risk management—a public transit agency can enjoy stable and often lower energy costs and have a much higher degree of certainty of the impact of this critical cost on its budgets and finances.