BUDGETARY TARGETS VS. VOLATILE FUEL PRICES

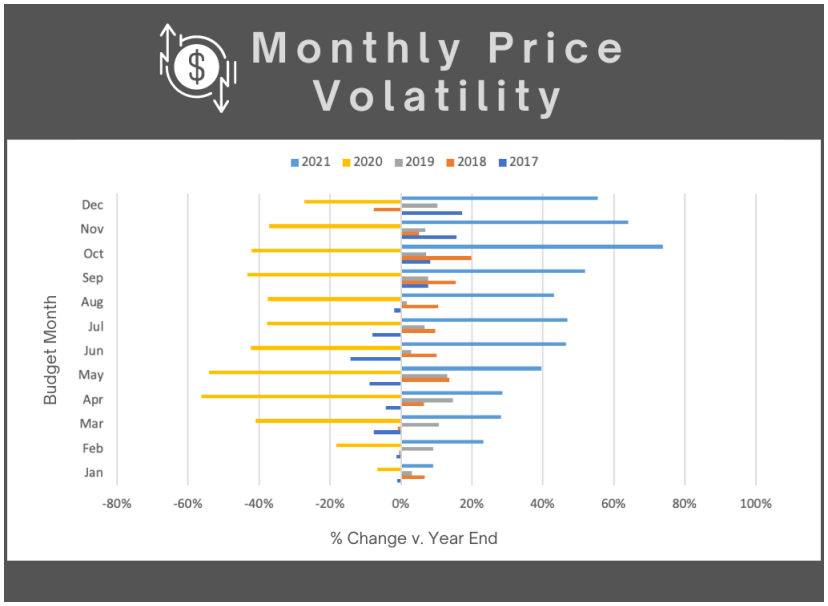
Client Category:
Municipal

Client Subcategory:
Transportation

Client Type/Industry:
Regional Transit Authority (train, bus)

BACKGROUND:

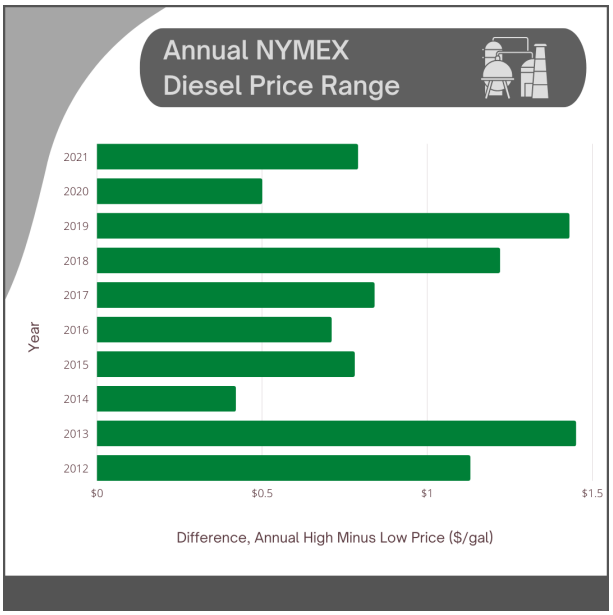
Our client is a major metropolitan transportation authority (the "Authority") that owns and operates a fleet of buses, subways, commuter rails and other forms of mass transit. The Authority consumes more than 1.6 million gallons of diesel fuel a month with total fuel expense comprising 20% of its budget for materials and supplies. Diesel was a mercurial commodity with annualized volatility ranging from 50-60%. Thus, the Authority was threatened by wild swings in fuel expense that could reach $25-30 million outside of its initial budget.

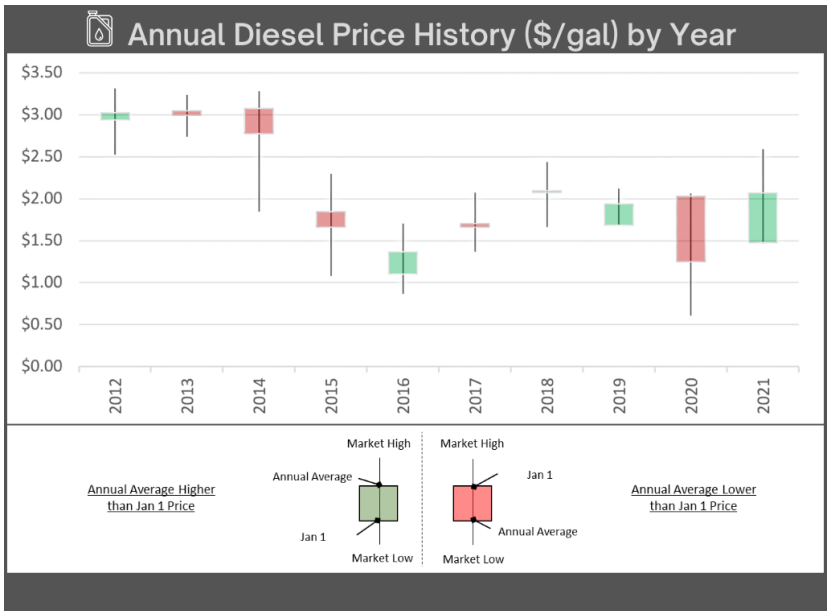


Not only was fuel volatility bad for budgets, but it was bad for reputation as well. The Authority's customers and local citizens had taken an interest in its decision making, increasingly related to the management of operating expenses. With the Authority in the spotlight, it needed a solution that was thoughtful and effective. The Authority needed a third party to achieve the goal, build credibility, and show critics it was a good steward for the public trust.

PROBLEM:

Volatile fuel prices threatened the transit authority's ability to meet budgetary targets every year. The price of diesel represented a substantial portion of the authority's operating budget and varied at a magnitude and pace that far exceeded the entity's ability to respond. They started each year at a disadvantage, with revenues from ticket sales covering less than half of their budget, resulting in thin margins and little room for uncertainty.





The Authority is also a governmental entity subject to accounting rules established by the Governmental Accounting Standards Board ("GASB"). More specifically, with over-the-counter hedging instruments, the Authority must show its compliance with GASB statement 72, **Fair Value Measurement**, and GASB statement 53, **Accounting and Financial Reporting for Derivative Instruments**.

50% **reduction of** variability in the **budget was the goal.**

PRIMARY OBJECTIVE:

Minimize the volatility of the fuel budget using standard financial tools.

SECONDARY OBJECTIVES:

Create an easily-understood process and plan for communicating progress to senior transit authority executives.

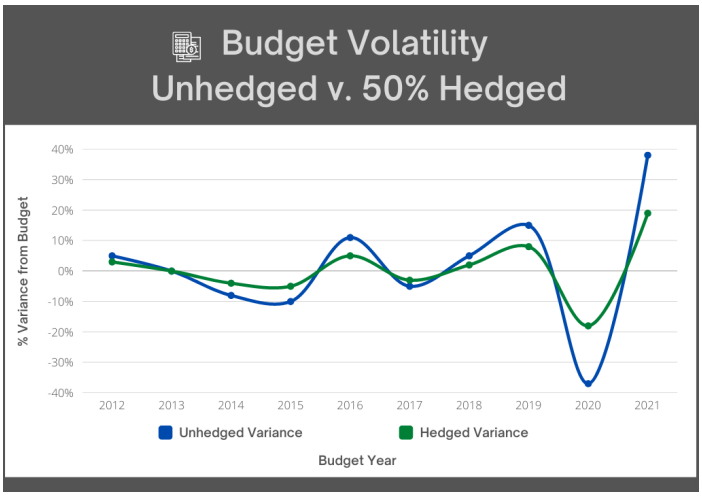
Manage the program in a manner that minimizes the risk/cost of scrutiny from third party observers.

SOLUTION:

HedgeStar and Blue Lacy worked directly with the client's treasury team to assess the prevailing market for diesel and volatility to quantify the goal of "reducing the impact of volatility" into a measurable target, for which success could be identified in objective terms. This included examining the potential exposure inherent to the client's operations such as the impact of volatility if they did nothing, assessing impact under various market scenarios, and applying various market-defined volatility regimes. From this collaborative analysis, we determined the target was to reduce this variability in the budget by 50% from the baseline scenario. We analyzed various hedging instruments (options, fixed-price instruments, and structured products) and combinations of those hedging instruments to create a menu of tools that would achieve the goal and presented the cost to execute each combination along with the tradeoffs of each proposed hedging path. Blue Lacy provided guidance for ranking preference of each and deeper insight into how the portfolio would require ongoing attention, investment, and resources once executed.

BENEFIT & RESULT:

The authority ultimately selected a portfolio of hedges that would concentrate volatility reduction in forward months with the greatest price risk exposure, using a portfolio that required the lowest upfront cash commitment, but one that also required ongoing resources to monitor. With strong market relationships, Blue Lacy was able to optimize portfolio execution, leveraging various credit support facilities from the authority's existing banking relationships, which resulted in zero cash due at execution.



We also designed metrics for which the transit authority would judge the success of the initial hedge decision, guided changes as necessary, and provided communication of the progress throughout the budget year. This included weekly reviews of progress relative to budget, ongoing advice on portfolio optimization, support for the upcoming fiscal year budgeting, educational support for the authority's employees, and market intelligence relevant to the transit authority's diesel consumption.

Additionally, to assist the Authority with GASB 72 and GASB 53 requirements, HedgeStar provided monthly fair values on the hedging instruments and effectiveness testing necessary to qualify the hedging instruments for hedge accounting. This preferential accounting and financial reporting treatment allowed the Authority to defer hedging gains/losses in the Deferred Inflows/Outflows account in lieu of recording those hedging gains/losses immediately as part of investment revenue in the statement of activities. The client successfully reduced its exposure by 50% and created a plan for the ongoing management of diesel volatility. Ongoing communication has allowed the treasury team to report on progress and frame the message in a manner that the executive team can easily digest and disseminate to all stakeholders. The portfolio is being tracked into the current budget year and we are preparing for the next budget year with intent to extend the portfolio to provide certainty for the budget and planning, further reducing volatility for upcoming years from the initial 50%. Now the Authority can take credit for its price risk management activities through reduced earnings volatility and greater budget certainty for its constituents.




ABOUT BLUE LACY ADVISORS, LLC

Blue Lacy Advisors is a thoughtful, creative consulting service with a core focus on protecting strategy. Our process is designed around well-defined goals, bringing together our knowledge and skills to create multi-tiered, credible risk management strategies that are sustainable in the long term. By equipping decision-makers with easily digestible, thoroughly investigated intelligence, we help you solve complex problems, seize opportunities, and reach your goals unapologetically.

One major characteristic which sets Blue Lacy apart from other advisors is our unique perspective on the concepts of strategy and risk. Unlike other companies, we zoom out to examine all possible components of your goals. We then organize them to find effective patterns that will optimize your ongoing performance, because risk and strategy don't stop at execution.

We take pride in making strategic planning accessible, adaptable, and easy to understand, while also improving the process and probability of success each outcome. In doing so, we aim to provide our clients with a clear and tangible broad view of each plan of action, giving you confidence and tools that are essential to successfully accomplishing your goals.

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Steve has filled various commercial roles in his nearly 20 years in energy markets. Before launching Blue Lacy, he spent time at a top 25 commercial bank, a bulge-bracket investment bank, a global consulting company, and a private equity fund. He uses this broad perspective to analyze market trends and look beyond the fundamental snapshots analysts commonly depend on to form opinions. As a result, clients rely on Blue Lacy to create defensible risk management strategies that support their core objectives and improve the probability of achieving their goals.

FULL SERVICE HEDGE

- Hedge Accounting Set-Up
- Hedge Accounting Close
- Auditor Interface
- Audit Committee, Board, Analyst Presentations
- Hedge Accounting Preview
- Pre-Post Hedge Accounting

ABOUT HEDGESTAR

Founded in 2004, HedgeStar delivers risk management consulting, derivative valuation and hedge accounting services, with a focus on providing transparency for financial reporting and hedge performance optimization software. We are experts in FASB, GASB and IFRS standards related to accounting for derivatives and fair value measurements. Our global clients include public and private corporations, real estate trusts, accounting firms, law firms, healthcare organizations, educational institutions, and governmental entities.

The HedgeStar team is comprised of valuation experts, Certified Public Accountants (CPAs), and hedging program professionals. We deliver our services with a personal touch. We understand our clients and their portfolios and are an extension of their risk, finance and accounting departments. We strive to live by our core values everyday. For more information visit www.hedgestar.com

Learn how HedgeStar's solution can help you manage your financial risk. Schedule a free, 30-minute assessment with a hedge accounting expert today: 952-942-6094

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