Ferry Service Business Case White Paper

Ferry services and cruise lines consume vast quantities of fuel to run their vessels. It is typically among the top cost items in their budget and almost certainly the most unpredictable. Most operators struggle to manage fuel costs both at the procurement level and in terms of budget compliance. The volatile swings in price over the course of a year can have detrimental impacts to profits and give the folks in the finance department sleepless nights!

To make matters worse, the majority of seasonal operators have to set and publish ticket prices long before the first one is ever sold. Hence, any unplanned cost increases, especially for fuel, can be difficult if not impossible to recoup.

One New England ferry service decided to take control of fuel prices and embarked on a hedging program to provide budget certainty and preserve profits. They called Hedge Solutions for help.

Business Profile

The Client is the statutory regulatory body for all ferry operations to and from the islands from the Massachusetts mainland, as well as being an operator of ferry service from the mainland Cape Cod to the islands of Martha's Vineyard and Nantucket, and the only ferry operator to carry automobiles to the island. The Client also operates several freight vessels, thus serving as the main link for shipping any commercial goods to Martha's Vineyard and Nantucket that are not transported by air. The Client currently operates nine vessels. Four of these are auto/passenger ferries featuring roll-on/roll-off ramps for cars traveling to the islands, as well as climate-controlled seating and a bar and concession stand for passengers. The fifth vessel is a passenger-only catamaran operating fast ferry 35 knots (40 mph) one-hour service between Hyannis and Nantucket. Four of the other ferries are open-top roll-on/roll-off ferries, primarily for larger trucks and freight.

The annual fuel expense for the ships is $8-$9 Million and represents one of the largest expenses to budget. Each year the Client forecasts fuel prices in order to set their annual budget. If fuel prices go up significantly, it is extremely difficult, if not impossible, to raise ticket prices in order to meet their budget and performance targets. In 2008, fuel prices almost doubled in less than 6 months. Even more problematic was the timing – energy prices spiked during the peak travel season. The Client was forced to implement an emergency increase in fuel prices for their first time in history. They theorized that fixing prices was the only way to manage the risk.

However, after then witnessing prices collapse at a faster pace than they spiked, they were concerned about the liability of fixing the price outright. This strategy had been considered several times and was also proposed by the fuel provider.

Key Challenges

The Client set a primary goal to do a more effective job forecasting and budgeting for fuel prices to protect their bottom line but that came with several layers of difficulty. First and foremost, there is a steep learning curve and inherent difficulty understanding fuel hedging concepts. This includes the need to grasp energy market intelligence and the application of hedging tools such as swaps and options. On the procurement side, the Client had to gain knowledge of the best RFP process and specific supplier offers using indexes such as NYMEX, Platts, and OPIS. From there, a tight system of accounting, reporting, and monitoring had to be in place to track price hedging performance.

Most ferry operators, our Client included, are not equipped to manage such a complex process even though the outcomes can be financially beneficial. Knowing this instinctively, the Client interviewed several fuel consultants and settled on Hedge Solutions because of our ability to advise and educate simultaneously.

Services and Results

Hedge Solutions has been providing a customized menu of services to the Client for the past 18 months:

- Critical Path Delivery:
  - Generation, execution and management of risk management strategy
    - Long term risk management and fuel hedging plan
  - Fuel price forecasting
    - Provide forecast of energy markets for presentation to their board
  - Execution of fuel procurement and hedges (to include full oversight of RFP process)
    - Improved RFP, bidding process, enlarging the pool of potential suppliers
  - Education and advice on fuel markets
    - Annual energy markets and risk management presentation at their offices
    - Detailed overview of energy / fuel markets – past and future
    - Education on options hedging
  - Real time view of results, data management, financial reporting
    - Physical to paper accounting and reporting
    - Quarterly review of hedging strategy, results

The results for the Client have been impressive, both in empirical financial terms and in terms of their broader understanding of the fuel markets. The Client is now well versed in the fuel market, combining knowledge of how the physical market behaves in relation to the futures market and key hedging strategies. This business intelligence has flowed through the organization to the board level to ensure that all stakeholders have a practical experience with the new processes and outcomes.

Faced with various methods for buying and hedging that we proposed, the Client chose to “cap” their price using an options strategy. This allows them to budget for a price ceiling while maintaining the ability to participate if the market drops, something that cannot be done if the price is fixed. Hedge Solutions designed a new RFP process around a transparent price benchmark, managed the vendor selection, and executed the options trades.

The result has been an annual net savings of over $240K on the renegotiated vendor agreement and an additional $600K in payouts from the hedging activity; this yields a total savings of $840K or $.30 per gallon of fuel used! More importantly, the Client is no longer exposed to price spikes that could dilute profits.