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2009/2010 FUEL HEDGING PROGRAM

The Finance and Administration Committee recommends that Council adopt the recommendation contained in the following report dated December 9, 2008, from the Commissioner of Finance.

1. RECOMMENDATION

It is recommended that:

1. The Regional Treasurer be authorized to enter into hedging contracts with accredited financial institutions in accordance with the Region's Commodity Price Hedging Policy, in order to stabilize the cost of fuel for 2009 and 2010 and remain within the budget provisions for fuel.

2. PURPOSE

This report seeks authorization to enter into energy hedging contracts with credit worthy financial institutions to stabilize the cost of fuel during 2009 and 2010.

3. BACKGROUND

A Commodity Price Hedging Policy was adopted by Council in September 2007

At its meeting in September 2007, Council adopted a Commodity Price Hedging Policy that conformed with Ontario Regulation 653/05 of the *Municipal Act, 2001* which allows for the price hedging of commodities including electricity and fuel. The Policy includes the following key provisions:

- No speculative investing, selling or disposing of any part of the hedge interest;
- Hedging up to 75% of its estimated consumption of a commodity in any one year;
- Agreements will be with large well established financial institutions;
- Partnership agreements with other public sector partners including, local municipalities and education/hospital boards would be allowed where benefit can be shown to accrue to the Region;
- The programs to be a maximum of five years; and
- Annual reporting to Council

4. ANALYSIS AND OPTIONS

The Region Consumes Significant Amounts of Fuel

The Region consumes approximately 23 million litres of fuel each year. Table 1 which summarizes the estimated usage and average cost of fuel for the various service departments for the period September 30, 2007 to September 30, 2008 shows that the fuel cost for the period averaged $1.25 per litre.

Table 1
Estimated Fuel Purchases by Service Departments
September 30, 2007- September 30, 2008

Service Department	Annual Fuel Consumption- liters	Average Cost	Total $
EMS	600,000	1.24	744,000
Transit	16,785,000	1.26	21,120,000
Police	3,025,000	1.19	3,599,000
Other	2,298,000	1.23	2,837,000
Total	22,708,000	1.25	28,300,000

Currently, the Region is budgeting $1.00/litre for fuel in its 2009 budget. Every cent paid below this price will save the Region approximately $225,000. Given the volatility that has been experienced in fuel prices in the past several years, it would be prudent for the Region to examine the use of hedging contracts to ensure price stability going forward.

Hedging Contracts Mean the Region Pays a Negotiated Fixed Price for a Commodity

A hedging contract for commodities involves a consumer of a commodity, such as the Region, entering into a contract with a financial institution to hedge a fixed volume of the commodity for a stated period of time at a fixed price. In return, the financial institution agrees to pay to or receive from the Region a floating amount based on an agreed upon market index. The Region however, continues to buy its commodity from whichever supplier it chooses.

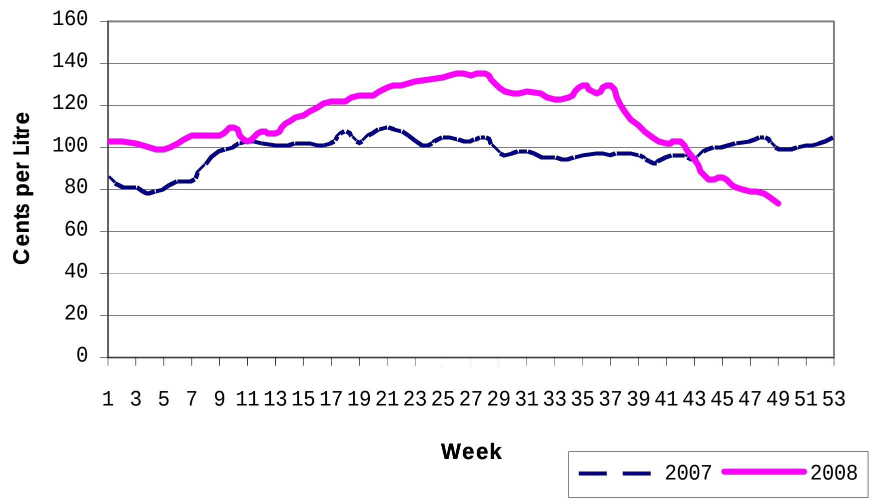
For example the Region could enter into a hedging contract for diesel fuel for a period of one year at a fixed rate of 80 cents /litre. In a particular period, if the futures exchange price is 85 cents a litre, the Region will benefit by 5 cents /litre and will be paid the difference by the financial institution. Alternately, if the futures exchange price during the period is 75 cents /litre, the Region will owe the financial institution 5 cents/litre. Settlement can take place at different intervals, usually quarterly or monthly.

The Purpose of Hedging is to Provide Price Stability

The above example shows an important aspect of hedging. While hedges bring price stability, they also could potentially result in an opportunity cost. The Region might be able to purchase its fuel at a lower price during the period, but the price could also be higher. The concept of a hedge is not to make money, but to provide price stability during a time of price volatility. This allows the Region to control and budget for costs on a more stable base for its transit and other fleet operations.

As shown in Figures 1, fuel prices have been particularly volatile in the past several years. In particular, fuel prices in 2008 in the first three quarters are substantially higher than those in the previous year.

Chart 1
Average Retail Prices for Gasoline in TORONTO
2007 and 2008



This volatility would indicate a need to have price stability allowing for more predictable budgeting, cash flow management, and fiscal planning.

It is Important when Hedging to Ensure the Underlying Index is Representative of the Actual Price being Paid

Another important aspect of hedging as described above involves the use of a futures exchange that accurately represents the actual price being paid by the Region. Typically, the index chosen represents the actual commodity being used. There is no underlying index for diesel fuel; however, the underlying futures market which is widely used is related to heating oil. Heating oil represents a very deep market that tends to be stable over time, is liquid, and is highly correlated to the price of diesel fuel. For example, the NYMEX (New York Mercantile Exchange) No. 2 Heating Oil futures contract has a nearly perfect correlation over the past 15 years to the price of high sulphur unbranded Toronto rack diesel fuel. This means that paying a floating price to the financial institution based on the NYMEX Heating Oil Market should strongly reflect actual prices being paid by the Region for fuel from its suppliers.

Amount and Term of Hedging Contracts Should be Established in Compliance with the Region's Policy

The Region's hedging policy sets limits on the term and maximum size of contracts relative to the use of the underlying commodity. In compliance with the intent of the policy it is recommended that any hedging contracts undertaken in 2009 be limited to not more that 75% of estimated consumption for the years 2009 and 2010. These hedges may be undertaken by executing one or more transactions with one or more accredited financial institutions. All transactions will be reported to Council by means of an Annual Hedging Report.

5. FINANCIAL IMPLICATIONS

Hedging provides the Region the ability to stabilize its future costs for fuel. This would enable the Region to predict its expenditures in this area, allowing for easier budgeting, more predictable cashflow management and greater ease in determining future tax levy requirements.

Based on current hedging quotations for the period from January to December 2009, it is estimated that the hedge rate would be approximately five cents a litre above current pump prices.

6. LOCAL MUNICIPAL IMPACT

There are no impacts to local municipalities arising from the recommendations in this report. However the Region's Commodity Hedging Policy does allow for partnership agreements between the Region and Local Municipalities to jointly hedge commodities.

7. CONCLUSION

Commodity markets, particularly those for fuel have been very volatile in the past several years. Hedging provides the Region an opportunity to stabilize these costs allowing for easier budgeting, more predictable cashflow management and greater ease in determining future tax levy requirements.

For more information on this report, please contact David Williams, Manager, Treasury and Reserves at Ext. 1620.

The Senior Management Group has reviewed this report.