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FUEL HEDGING PROGRAM IN 2010

The Finance and Administration Committee recommends the adoption of the recommendation contained in the following report dated January 29, 2010, from the Commissioner of Finance.

1. RECOMMENDATION

It is recommended that:

1. The Regional Treasurer, or designate, be authorized to enter into fuel price hedging contracts in accordance with the approved *Commodity Price Hedging Policy* and where, in the opinion of the Regional Treasurer, a financial benefit may exist.

2. PURPOSE

In January 2009, Council authorized the Regional Treasurer to enter into fuel price hedging contracts in order to mitigate fuel price volatility to the end of the 2010 calendar year. Approval is now requested to enable the Regional Treasurer to initiate future hedging contracts to increase fuel price certainty and promote more accurate fuel budget forecasting. In accordance with the approved *Commodity Price Hedging Policy*, the current program may operate for a period of up to five years, until December 2014.

In accordance with Ontario Regulation 653/05 (as amended) of the *Municipal Act, 2001* this report also summarizes activities undertaken in 2009 as part of the Region's Fuel Hedging Program.

3. BACKGROUND

Effective fuel price hedging allows the Region to control and budget for fuel costs using more predictable future pricing. The purpose of a hedging contract is to provide price stability for volatile and market-driven commodities such as fuel.

In October 2007, Council adopted a *Commodity Price Hedging Policy* that conforms with Ontario Regulation 653/05 of the *Municipal Act, 2001* which allows for the price hedging of commodities (including fuel).

Typically, hedges are rooted in the commodity index to be hedged. However, there is no direct commodity index for gasoline or diesel fuel. Based on a nearly perfect (98%) correlation over the past 15 years to the future price of diesel fuel, heating oil futures contracts are used by most organizations to improve cost stability and budget certainty for future fuel costs. As futures contracts only hedge commodity prices, it is important to note that other factors such as profit margins and exchange rate conditions can also impact Regional fuel costs.

4. ANALYSIS AND OPTIONS

The Region has Agreements in Place with Three Financial Institutions to Allow for Potential Hedging Contracts

Following negotiations and legal review, the Region successfully amended joint agreements with three of its financial partners to meet hedging requirements. As a result, fuel price hedging contracts may now be initiated between the Region and the Bank of Nova Scotia, Royal Bank of Canada, and/or the Toronto-Dominion Bank. The Region continues to discuss opportunities for hedging partnerships with additional financial institutions.

Fuel Price Forecasts Point to Rising Demand and Rising Prices between now and 2011

Recent market conditions have proven to be volatile for fossil fuels. Crude oil prices rose from a low of $70.67 US/barrel in early December 2009 to more than $83 US/barrel in early January 2010, an increase of more than 20% in less than one month. This was followed by a drop to $75 US/barrel at the end of January.

The following table presents current outlooks for West Texas Intermediate (WTI) Crude Oil future pricing, with corresponding estimated diesel pump prices based on current exchange rate conditions and profit margins:

Table 1: Current WTI Crude Oil Outlooks, at January 29, 2010

	2010 Average		2011 Average	
Source	**Price Forecast ($USD/barrel)**	**Est. Local Diesel Pump Price (cents/L CDN)***	**Price Forecast ($USD/barrel)**	**Est. Local Diesel Pump Price (cents/L CDN)***
Department of Energy (EIA,US)	$75 - $82	97.3 – 106.4	+$82	+106.4
Royal Bank (CAN)	$80	103.8	$80 - $84	103.8 – 109.0
Toronto Dominion Bank (CAN)	$80	103.8	$84.50	109.7
Scotiabank (CAN)	$90	116.8	$92	119.4

As the Region's fuel budget is set at $1.00 per litre in 2010, and the average diesel pump price in Southern Ontario was 95.6 cents per litre as of January 25, 2010*, these commodity forecast increases reinforce the benefit of fixing a portion of the Region's future fuel costs. Hedging a portion of the Region's total expected consumption also positions the Region to more accurately forecast annual budgetary requirements for diesel and gasoline in the future.

** per data produced by MJ Ervin & Associates, for the Ontario Ministry of Energy & Infrastructure.*

Favourable Market Conditions led to the Region's First Hedging Transactions in 2009 and early 2010

In November 2009, Regional staff developed a recommended hedging threshold based on commodity outlooks and market reports. In early December 2009, market and currency conditions resulted in optimal entry point conditions being met.

On December 8, 2009 the Regional Treasurer approved York Region's first commodity price hedging transaction with the Toronto-Dominion Bank following a review of competitive price quotes. More than 4.5 millions litres of NYMEX No.2 heating oil were hedged at that time. Following a spike in commodity prices, market conditions eased in late January 2010 as a result of reduced heating oil demand and renewed strength for US currency. On January 27, 2010 the Regional Treasurer approved the execution of a hedging contract for an additional 4.2 million litres of NYMEX No.2 heating oil.

Together, these two hedges represent more than 42% of the Region's estimated total fuel consumption in 2010. Based on the 98% correlation between heating oil and diesel commodity prices, these two contracts translate to an estimated equivalent diesel pump price of between 91 and 96 cents per litre in 2010.

Cost Certainty and Future Hedging Benefits are the Focus in 2010

As current outlooks see fuel prices continuing to rise in the coming years, the Region will continue to monitor commodity market conditions closely in 2010 and seek opportunities to extend hedging benefits into 2011. Hedging contract horizons will not exceed 18 months beyond the effective date in order to mitigate the effects of long-term commodity price variability. In accordance with the Region's *Commodity Price Hedging Policy*, up to 75% of the expected fuel consumption in a given year may be hedged.

5. FINANCIAL IMPLICATIONS

If average diesel pump prices remain above 96 cents per litre in 2010, the Region expects to benefit from its contracted hedging volumes this year.

An average of three bank forecasts at the end of January 2010 estimated average oil prices in 2010 at $83 US/barrel, which translates to diesel pump prices of about 108.1 cents CAD/L. If prices move in line with these forecasts, the Region estimates that existing hedging contracts would generate about 7.1 cents per litre, or $618,000 in hedged diesel fuel price relief this year. When combined with other rebates and savings, the Region may be able to stay within net fuel budget limits in 2010 even when pump prices rise to 110.1 cents per litre.

While profit margins and currency conditions will cause monthly hedging relief to vary, it remains clear that expanding the Region's fuel hedging interests will work to reduce the effects of future price volatility beyond 2010.

6. LOCAL MUNICIPAL IMPACT

There are no impacts to local municipalities arising from the recommendations in this report.

7. CONCLUSION

Based on fuel price hedges executed to date, the Region has reduced the volatility of fuel costs to the end of 2010. In order to continue to benefit from cost certainty for future fuel needs, it is recommended that the Regional Treasurer, or designate, be authorized to enter into fuel price hedging contracts where a financial benefit may exist.

For more information on this report, please contact Mikael Gariepy, Fiscal Policy Analyst at Ext. 1667.

The Senior Management Group has reviewed this report.