5
2010 ANNUAL REPORT: FUEL PRICE HEDGING PROGRAM

The Finance and Administration Committee recommends the adoption of the recommendation contained in the following report dated March 8, 2011, from the Commissioner of Finance.

1. RECOMMENDATION

It is recommended that this report be received for information.

2. PURPOSE

This report describes Fuel Price Hedging Program activities and outcomes during 2010.

3. BACKGROUND

At its meeting in September 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). The Regional Treasurer was authorized by Council in March 2010 to mitigate fuel price volatility to the end of 2012.

A hedging contract for a commodity involves a consumer of a commodity, such as the Region, entering into a contract with a financial institution to hedge a fixed volume of a commodity for a stated period of time at a fixed price. In return, the financial institution agrees to pay or receive from the Region a floating amount based on currency and commodity market outcomes. As fuel price hedging contracts are financial instruments, the Region is free to continue buying fuel from whichever suppliers it chooses.

Typically, hedges are rooted in the commodity index to be hedged. However, there is no direct commodity index for diesel fuel. While West Texas Intermediate (WTI) crude oil does serve as a strong proxy for *current* fuel prices, New York Mercantile Exchange No.2 Heating Oil (HO) futures contracts have a nearly perfect correlation over the past 15 years to the *future* price of high sulphur unbranded Toronto rack diesel fuel.

By initiating HO price hedges, the Region is able to improve cost stability and budget certainty for a portion of its fuel consumption. When pump prices rise, the Region may offset a portion of high pump prices through hedge gains. When pump prices fall, any hedge losses are offset by pump savings. The goal of a hedge is not to make money or generate savings, but rather to provide price stability for volatile and market-driven commodities such as fuel.

4. ANALYSIS AND OPTIONS

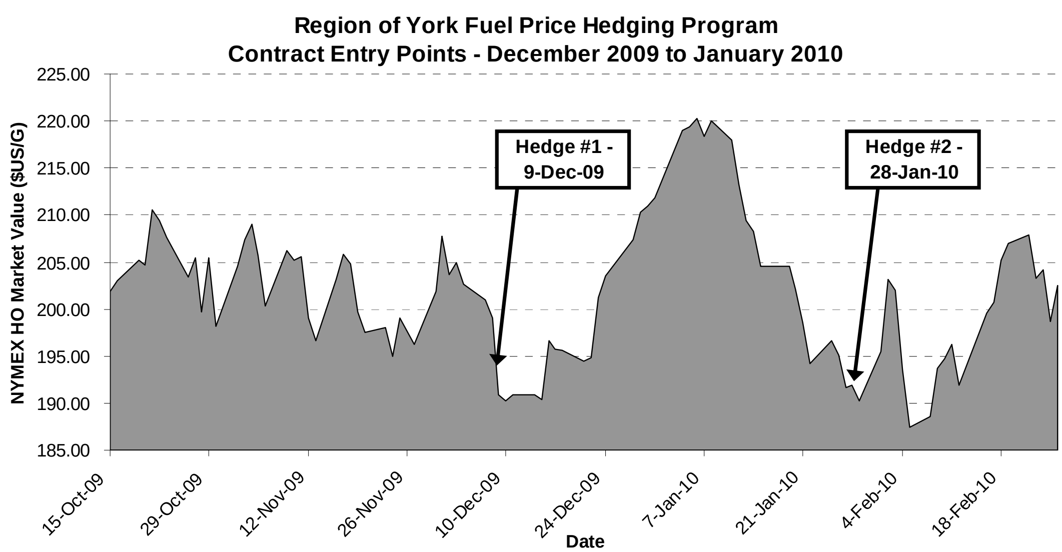
Agreements required to execute fuel price hedging contracts are now in place with four financial institutions

Following negotiations and legal reviews in Summer 2009 and Spring 2010, the Region has successfully amended joint International Swap Dealers Association (ISDA) Master Agreements with three of its financial partners and enacted foundational terms with a fourth partner. As a result, fuel price hedging contracts may now be executed with the Bank of Nova Scotia, Canadian International Bank of Commerce, Royal Bank of Canada, and/or the Toronto-Dominion Bank. The Region has successfully secured terms which promote consistent hedging terms with each of these institutions.

Favourable market conditions led to the Region's first hedging transactions for the 2010 calendar year

Based on market outlooks and reports that pointed to excess North American fuel distillate supply, staff executed two calendar 2010 fuel price hedges in December 2009 and January 2010 based on optimal entry points for a HO hedge. At both of these times, market conditions resulted in the value of crude oil and HO futures slipping by more than 10 per cent and below equivalent budget provisions for fuel. Combined with favourable exchange rate conditions, this resulted in optimal entry point conditions and budgetary cost certainty being achieved.

The table below demonstrates daily market settlements for HO between October 2009 and February 2010. Both hedging contract entry points are highlighted.

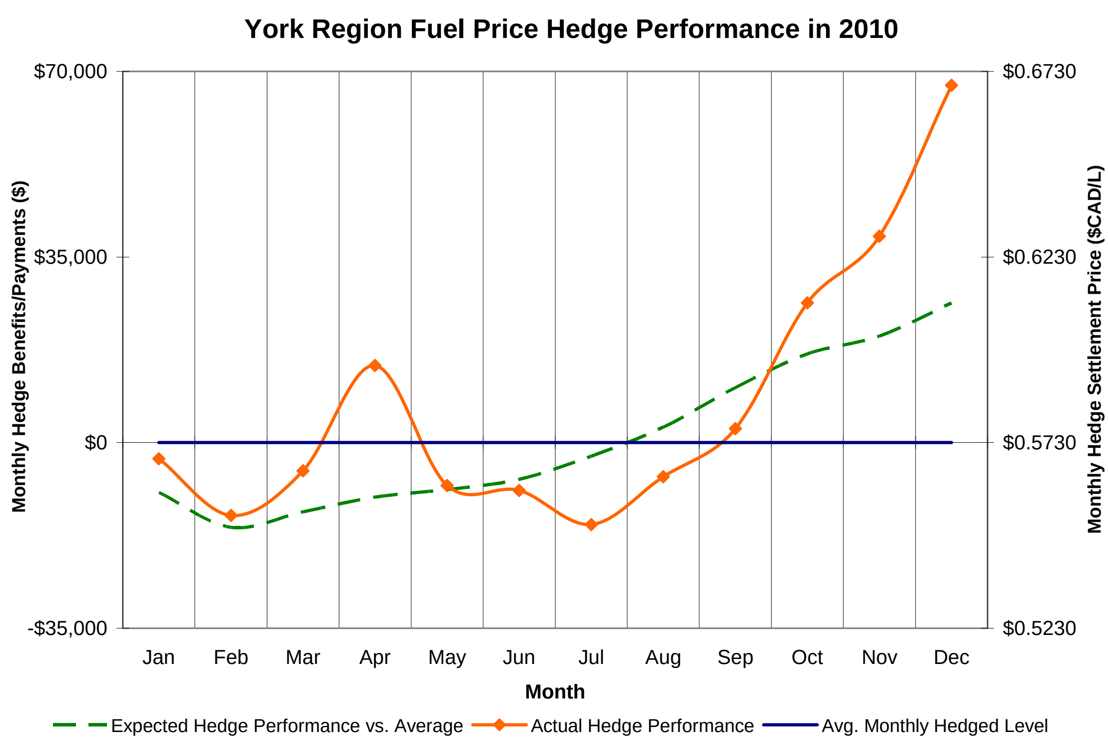


Together, these two contracts resulted in approximately 8.7 million litres of HO being hedged at an average HO price of $0.573 CAD/L in 2010. This equates to a Southern Ontario equivalent diesel fuel pump price of $0.977 CAD/L, and about 42% of the total volume of diesel and gas that the Region expected to consume last year.

It is important to note that these hedge entry points were selected and executed based on HO market conditions which kept the equivalent diesel fuel pump price within the provisions budgeted for diesel and gasoline. Both hedging contracts were executed in accordance with the statement of policies and goals described in the Region's *Commodity Price Hedging Policy*.

Higher fuel prices at the end of 2010 were partially offset by hedge revenues

The graph below demonstrates actual monthly HO (the proxy used for diesel fuel) hedge settlement amounts vis-à-vis expected monthly hedge performance. Note that hedging contract volumes were equally distributed across the 12 calendar months. While the hedges did not generate substantial revenues until commodity prices spiked at the end of 2010, they outperformed expectations in eight months of the calendar year.



In total, the Region made $60,950 in hedge payments and received $149,820 in hedge credits. As the average monthly settlement price for HO in 2010 equated to $0.583 CAD/L, this resulted in net hedge benefits totalling $88,870 or about one cent per litre of HO. While this revenue might otherwise signal a successful first year for the Fuel Price Hedging Program, it is the cost certainty that comes with a hedged position that is deemed to be the primary program goal and benefit.

Hedge contract revenues from 2010 were moved into the Fuel Cost Stabilization Reserve Fund in early 2011. These funds will be available to offset future budget impacts in the event that fuel prices place pressure on budgeted fuel volumes.

Market Conditions in late 2010 and early 2011 have prevented the Region from executing a hedge contract valued at or below the equivalent price budgeted for fuel in the 2011 budget

Fuel prices are reactive to supply and demand pressures, global weather trends and geopolitical instability in oil producing nations. If the Region were to execute a hedging contract based on inflated pricing observed in late 2010 and early 2011, it could generate a significantly unfavourable variance compared to the equivalent budget provisions for fuel. Staff continue to monitor market conditions in the interest of securing favourable hedging terms which will provide increased budget certainty.

5. FINANCIAL IMPLICATIONS

The Region received a net fuel price hedging benefit of $88,870 from hedge contract settlements in 2010. The financial implications of entering 2011 without a hedged position are not known at this time and are dependent on commodity market outcomes and currency conditions.

6. LOCAL MUNICIPAL IMPACT

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

7. CONCLUSION

The Fuel Price Hedging Program afforded cost certainty for more than 40% of total estimated fuel consumption in 2010, and generated a small hedging benefit. High commodity prices in late 2010 and recent global events have contributed to the Region being unable to secure a hedged position within equivalent budget provisions for 2011.

For more information on this report, please contact Brian Parrott, Manager of Fiscal Policy at Ext. 1667.

The Senior Management Group has reviewed this report.