1
COMMODITY PRICE HEDGING POLICY

The Finance and Administration Committee recommends the adoption of the recommendations contained in the following report, September 12, 2007, from the Commissioner of Finance:

1. RECOMMENDATIONS

It is recommended that:

1. The Commodity Price Hedging Policy (the "Policy") shown as Attachment 1, be adopted for the purpose of all commodity price hedging activities.

2. The Commissioner of Finance and Treasurer, the Regional Clerk, and the Regional Chair be authorized to execute on behalf of the Region any documents necessary to implement the use of commodity price hedging financial agreements approved by Council, including any hedging agreements required for the AMO/LAS electricity procurement program approved by Council on May 24, 2007.

3. Staff be authorized to take all actions necessary to implement these recommendations.

2. PURPOSE

This report establishes a policy for the price hedging of commodity purchase agreements to which the Region has committed.

3. BACKGROUND

Ontario Regulation 653/05 of the *Municipal Act, 2001* requires that before the Region passes a by-law authorizing a commodity price hedging agreement, Council adopt a statement of policies and goals relating to the use of financial agreements to address commodity pricing and costs. The Commodity Price Hedging Policy discussed in this report satisfies the requirements of the regulation.

3.1 Price Volatility Represents a Financial Risk

The commodities to which this Policy relates are those typically purchased by the Region in the market place at the current price at time of purchase, also referred to as the spot market. Commodities purchased in the spot market are often subject to considerable price volatility—witness hydrocarbon fuels and electricity.

This volatility can represent a significant financial risk to the Region in that costs forecast in the Region's annual budget may prove to be substantially different from the costs actually incurred. An example of this is the effect of skyrocketing fuel costs had on our 2006 transit contact. A price hedging process seeks to fix at least a portion of the future commodity prices in order to reduce the impact on the Region from an adverse price increase.

3.2 The Price Hedging Mechanism

A hedge, for the purposes of this Policy, refers to the purchase of a commitment to acquire a specified quantity of a commodity, at a specific price, at some future point in time. A price hedge can be accomplished by purchasing a commodity or “futures” contract in the futures market or by entering into an agreement with an external party such as AMO/LAS as contemplated in the Electricity Procurement Strategy report.

In the first instance, the Region would acquire a contract for the delivery of the specific commodity, as stated above, at a specific price and point in time. Some contracts allow the purchaser to take delivery of the specified quantity of the commodity, although this is not contemplated by the Region, while other contracts provide for a cash settlement.

Assuming a cash settlement futures contract, at the maturity date, the Region would either pay or receive a settlement amount from the party that issued the futures contract. This “counterparty,” for the purposes of this Policy, would be a very credit worthy financial institution or other credit worthy entity. In the case where prices dropped from the contracted price the Region would have to pay a settlement cost which would be offset by purchasing the commodity at a lower price in the spot market. Conversely, if prices in the spot market are above the contracted price, the Region would receive a compensating payment from the counterpart.

3.3 The AMO/LAS Electricity Procurement Program

At its May 24, 2007 meeting, Council approved the report, “Electricity Procurement Strategy” (Report 5, Clause 9 of the Finance and Administration Committee), one of the recommendations of which was to authorize the Association of Municipalities of Ontario (AMO) and the Local Authority Services (LAS) of AMO to act as an agent to negotiate fixed price electricity contracts on behalf of the Region.

The AMO/LAS contract contemplates using, at least in part, price hedging options to fix the future price of electricity; in this case, the Region would initially pay the “spot market price” for electricity and the LAS would act as an agent to acquire hedging contracts; the Region would then pay or receive a payment from a third party, which may include the agent, to arrive at the negotiated contract price. Therefore, this agreement is considered a commodity price hedging agreement under provincial regulation and would be subject to this policy.

4. ANALYSIS AND OPTIONS

The commodity price hedging Policy is created to allow for the price hedging of the purchase commitment for a range of commodities, of which electricity is expected to receive the most immediate application. The Policy identifies an acceptable range of commodities and establishes objectives, standards of care, authorized price hedging instruments, reporting requirements, and responsibilities for the prudent use of hedging contracts.

The primary objective of a commodity price hedging agreement is to provide price stability by fixing future prices. Notwithstanding, there may also be times when it is beneficial to take advantage of short term price fluctuations to lock in favourable pricing for commodity purchase commitments.

The Policy applies strictly to situations where the Region has or will contract for the delivery of a specific commodity. The Policy does **not** allow speculative investment in derivative hedging instruments.

4.1 Key Provisions to Ensure Financial Flexibility and Reduce Financial Risk

1. The term or time-frame of the hedging contract will be chosen to balance price stability with the flexibility to adjust to changing market conditions and demand for the commodity within the Region. The Policy recommends that the Corporation enter into a financial agreement for a maximum term of five years.

2. While any proportion of the total or maximum Regional demand for a commodity can be hedged, financial flexibility is improved by selecting a proportion that is less than the forecast demand. The statutory limitations on the sale of financial agreements require that the Corporation must exercise caution in order to retain flexibility to respond to demand uncertainty. To that end, the hedging policy is that no more than 75% of the forecasted demand be hedged on an annual basis.

3. While the price hedging mechanism is a financial risk control measure, there are other financial risks associated with the market place in which hedging instruments are purchased. To mitigate these risks, the Policy recommends credit exposure limits, the use of standard agreements, and on-going monitoring of agreements to ensure that the objectives of the commodity price hedging process are met and that financial risk remains within acceptable levels.

4. The Policy recommends that partnership agreements be considered an option; for example, the AMO/LAS agreement referenced in the background section would be considered a partnership agreement.

5. All officers and employees responsible for commodity price hedging agreements will follow the standard of care identified in this policy. This will include, but not limit to, adhering to the Region's Code of Conduct and specific provisions outlined in the Policy, appropriate delegation of authority, and the competitive acquisition of hedging instruments.

6. For the purposes of this policy, commodities that may be hedged are as follows:
   - electricity;
   - hydrocarbon fuels such as gasoline, diesel fuel, and natural gas;
   - other commodities used by the Corporation, as determined by the CAO and the Commissioner of Finance.

7. The Policy sets out detailed reporting requirements for annual reporting to Council and at the time that the authorization of Council is sought in order to enter into a commodity price hedging agreement.

5. FINANCIAL IMPLICATIONS

There are no direct costs associated with this report. The Policy is expected to reduce financial risk by fixing the future cost of commodities purchased by the Region. In addition, the application of the Policy may on occasion improve the financial performance of the Region by allowing staff to fix the price of a commodity at an opportune time in the market.

6. LOCAL MUNICIPAL IMPACT

There are no local municipal impacts associated with this report. The Policy permits the Region to enter into partnership agreements that could include local municipalities although none are contemplated at this time.

7. CONCLUSION

The Commodity Price Hedging Policy is a mechanism to reduce financial risk by fixing the future price of commodities purchased by the Region. The Policy is to be applied only in relation to commitments to purchase a commodity or commodities and is not to be used for speculative investment purposes.

Price volatility increases financial risk by creating uncertainty with respect to future costs for budgeting and fiscal management. The use of price hedging reduces the financial risk by fixing future prices. Therefore, it is recommended that Council adopt the Policy shown in Attachment 1 to this report.

The Senior Management Group has reviewed this report.

(The attachment referred to in this clause is attached to this report.)