TORONTO

STAFF REPORT ACTION REQUIRED

The City's Statement Of Commodity Hedging Policies And Goals

Date:	May 19, 2009
To:	Executive Committee
From:	Deputy City Manager and Chief Financial Officer
Wards:	All
Reference Number:	P:\2009\Internal Services\Cf\Ec09016cf – et (AFS #9191)

SUMMARY

This report requests Council's approval of broad strategies to manage the variability in certain commodity prices through the creation of a new stabilization reserve and approval of a Statement of Commodity Hedging Policies and Goals to fulfill the requirement of Ontario Regulation 610/06 under the City of Toronto Act, 2006.

The intent of the proposed Policy is to govern all commodity price hedging agreements entered into by the City. The objective of the legislation and this Policy is to require in-depth analysis, disclosure and monitoring by Council and staff of commodity price hedge agreements.

RECOMMENDATION

The Deputy City Manager and Chief Financial Officer recommends that:

1. The City of Toronto's Statement of Commodity Hedging Policies and Goals, as contained in Appendix A, be approved.

2. The Deputy City Manager and Chief Financial Officer be delegated by Council with the authority to determine whether a particular commodity price hedging agreement is advantageous for the City while applying the policy contained in Appendix A to ensure that the financial position of the City will be enhanced by the use of such an agreement.

3. The Deputy City Manager and Chief Financial Officer be designated as the person responsible for administrative matters pertaining to commodity price hedging and

will delegate certain administrative duties and responsibilities to internal staff and external agents.

4. The Deputy City Manager or his/her designate(s), be authorized to:

   (a) enter into contracts for the purpose of securing a physical supply of commodities that are required by the City in its normal course of operation and in accordance with the policy in Appendix A, and
   (b) enter into Agency Agreements and/or other contracts and/or arrangements with Contract Agents (as defined in the Statement of Commodity Hedging Policies and Goals in Appendix A) for the purpose of purchasing, securing and/or delivery of commodities in accordance with the City's purchasing policies.

5. Council establish a reserve called the "Commodity Price Stabilization Reserve" as outlined in Appendix B to moderate the budgetary impact of commodities that are purchased in accordance with the City's Statement of Commodity Hedging Policies and Goals.

6. Municipal Code Chapter 227 (Reserves and Reserve Funds) be amended by adding the "Commodity Price Stabilization Reserve" to Schedule '3' – Stabilization Reserves.

7. The appropriate City Officials be authorized and directed to take the necessary action to give effect thereto.

FINANCIAL IMPACT

There are no financial impacts contained in this report. Management of commodity prices will be based on a thorough analysis of the potential financial risks to the City and a determination of an appropriate funding strategy. In some cases, that may involve the use of a stabilization reserve as recommended in this report, while in other cases it may involve the use of third part commodity hedging agreements. The policies recommended herein would govern such agreements.

DECISION HISTORY

Ontario Regulation 610/06 under the City of Toronto Act, 2006 requires Council to adopt and maintain a statement of commodity hedging policies with respect to the management of supply and price fluctuations before a financial agreement to hedge for the management of risk is entered into.

ISSUES BACKGROUND

In 2007, the Province approved Ontario Regulation 610/06 "Debt-Related Financial Instruments and Financial Agreements" under the City of Toronto Act, 2006. In addition to various financial tools, it authorizes the City to enter into commodity price hedging agreements. Since the Regulation does not provide a definition of a commodity, the Policy in Appendix A uses the following definition which includes commodities that may be used by the City to provide services to its residents but does not include financial instruments that could be hedged for speculative purposes, thus conforming to the Regulation:

> "whether in the original or processed state, an agricultural product, a forest product, a product of sea, a mineral, a metal, a hydro-carbon or bio-fuel or other physical goods but does not include chattel paper, a document of title, an instrument, money or securities"

O. Reg 610/06, as it pertains to Commodity Price Hedging Agreements, requires the City to adopt a statement of policies and goals relating to the use of financial agreements to address commodity pricing and costs before the municipality enters into commodity price hedging agreements.

COMMENTS

As part of its approval of the City's Long Term Fiscal Plan in 2005, Council considered the issue of expenditure variability and determined that the preferred outcomes are that:

1. the City is adequately protected from financial risks associated with expenditure/revenue variability; and
2. financial plans are put in place to deal with budget variability.

One such risk is that related to the cost of commodities such as fuel which can fluctuate due to market and other forces. There are essentially three options in managing the financial impacts of commodity price fluctuations, each of which may be applied pursuant to this report:

1. enter into commodity price hedging agreements, which are intended to reduce the risk of adverse price movements in a commodity;
2. self fund the risk of a particular commodity through a stabilization reserve; or accommodate the risk within the overall City budget.

The Deputy City Manager and Chief Financial Officer will determine the best option to be used, based upon current and forecasted commodity and capital market conditions coupled with the outcome of the application of the analysis as specified in the Statement of Commodity Hedging Policies and Goals in Appendix A.

Although the City's wide range of programs and services included in its combined $11.9 Billion tax and rated supported 2009 capital and operating budgets provide a natural hedge by being able to offset price variations, it may be advantageous to actively hedge purchases where the potential financial impacts are sizable or when global commodity markets are especially volatile. This hedging can be done either through an internal stabilization reserve or through the purchase of financial instruments from a third party.

TTC and City Fuel Purchasing Practices

The TTC obtains its diesel fuel and gasoline by tender and engages in physical hedging whereby the lowest contracted prices are locked in for up to a year and the fuel is supplied to the TTC during the year at the contracted price.

TTC and City staffs have been discussing the prospects of combining their respective fuel purchasing programs and instituting a shared financial hedging program. If the attached policy is approved by Council, TTC and City staff will evaluate if combining programs would be beneficial to each party, and if appropriate, examine the logistics and request approval from Council and the Commission.

New Commodity Price Stabilization Reserve

This report recommends the creation of a new Commodity Price Stabilization Reserve within the Stabilization Reserves as outlined in Appendix B so that, in future, accounts can be created for specific commodities for which it makes financial sense to internally manage price variability. Funding for the reserve would be considered as part of the annual budget process and withdrawals made according to procedures that would be established for each respective commodity/account.

Recommended Hedging Policy

While Electricity and natural gas represent significant commodity costs for the City and are covered by a previously Council-approved policy, “City Electricity Purchase and Results for Expressions of Interest (REOI) 9119-06-7107”, Report # 5 of the Policy and Finance Committee Report as approved by Council on June 27th, 28th and 29th, 2006. However, there are other commodity purchases, such as diesel and bio-diesel fuel, unleaded gasoline, propane, engine oil and roadway salt for which the entering into commodity price hedging arrangements may be advantageous for the City.

The Regulation and the City’s proposed policy clearly states that the commodities that are being hedged must be required and used in the normal course of the City’s provision of services to its residents and does not include securities or financial instruments that are not directly related to the pricing of these required commodities. In other words, the City is not allowed to engage in hedging activities for the sole purpose of speculation.

Commodity hedging provides flexibility to potentially mitigate or manage potential price fluctuations. The suppliers, with whom the price hedge agreements are made, generally hold bid prices for a short period of time. As a result, in order to respond in a timely fashion when appropriate pricing is offered, authority must be delegated to the appropriate City staff as outlined in the Statement of Commodity Hedging Policies and Goals as found in Appendix A.

The delegation of authority is divided into two main sections. The Deputy City Manager or his/her designate(s), is authorized to i) enter into contracts for the purpose of securing a physical supply of commodities that are required by the City in its normal course of operation and ii) to engage a Contract Agent in accordance with the City's purchasing policies.

The Deputy City Manager and Chief Financial Officer is the designated person responsible for administrative matters pertaining to commodity price hedging and will delegate certain duties and responsibilities to internal staff and various financial institutions as required.

The Commodity Price Hedging Policy and provincial Regulation requires the Deputy City Manager and Chief Financial Officer to submit an annual report to Council providing all commodity price hedge agreements that are in place for the City.

The attached policy statement in Appendix A satisfies the requirements Regulation under the City of Toronto Act, 2006 that requires Council to adopt and maintain a policy addressing commodity hedging. Adherence to the policy will assist the City in achieving the lowest and least volatile commodity pricing, given physical and financial market conditions without risking the City's credit rating through prudent management of the associated risks.

Fleet Services, Purchasing and Materials Management, Facilities and Real Estate and City Legal have been consulted in the preparation of this report and the policy as contained in Appendix A.

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SIGNATURE

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Cam Weldon
Deputy City Manager and Chief Financial Officer

ATTACHMENT

Appendix A – City of Toronto Statement of Commodity Hedging Policies and Goals
Appendix B – Commodity Price Stabilization Reserve

Appendix A

City of Toronto Statement of Commodity Hedging Policies and Goals (Excluding Energy Commodities)

1. Policy Statement

It is recognized that the City of Toronto is a respected participant in global commodity and financial markets. Adherence to this Statement of Commodity Hedging Policies and Goals will enhance its reputation and ensure the City's continued efficient access to commodity and financial markets while managing the risk inherent in these volatile markets.

The City will consider commodity price hedging agreements as a means of fixing, directly or indirectly, or enabling the City to fix the price or range of prices to be paid for the future delivery of some or all of the commodity or the future cost of an equivalent quantity of the commodity, where it is advantageous for the City.

This policy excludes energy commodities such as electricity and natural gas which are covered under a separate policy.

This policy ensures that Council complies with the commodity hedging provisions contained in the City of Toronto Act, 2006 and Ontario Regulation 610/06 while providing Council with the flexibility to meet the City's commodity needs during its term-of-office.

The City seeks to maintain the highest possible credit rating. While the City recognizes that external economic, political, natural or other events may affect its credit rating, it is committed to ensuring that actions within its control are prudent and necessary as they relate to the procurement of commodities and the management of the associated risk.

Definition of a Commodity for purposes of this Policy:

> "whether in the original or processed state, an agricultural product, a forest product, a product of sea, a mineral, a metal, a hydro-carbon or bio-fuel or other physical goods but does not include chattel paper, a document of title, an instrument, money or securities"

The provincial Regulation and this policy clearly states that commodities that are being hedged must be required and used in the normal course of the City's provision of services to its residents and does not include securities or financial instruments that are not directly related to the pricing of these commodities.

To be clear, the City is not allowed to engage in hedging activities for the sole purpose of market speculation when the hedging is not related to the purchase of a commodity.

2. Authority and Accountability

Ontario Regulation 610/06 under the City of Toronto Act, 2006 requires Council to adopt and maintain a statement of commodity hedging policies and goals before the City can enter into a commodity hedging agreement.

The Deputy City Manager and Chief Financial Officer is the designated person responsible for administrative matters pertaining to commodity price hedging and will delegate certain administrative duties and responsibilities to internal staff and external agents.

The Deputy City Manager or his/her designate(s), is authorized to enter into contracts for the purpose of securing a physical supply of commodities that are required by the City in its normal course of operation and to engage a Contract Agent (as defined below) in accordance with the City's purchasing policies

3. Role and Responsibilities of the Deputy City Manager and Chief Financial Officer

Financial matters relating to commodity hedging

The Deputy City Manager and Chief Financial Officer or his/her designate(s) will determine whether a particular commodity price hedging agreement is advantageous for the City while applying the following criteria to ensure that the financial position of the City will be enhanced by virtue of the use of such an agreement:

a) that the all-inclusive contracted price and cost to the City of the commodity will be lower or more stable than it would be without the agreement;
b) provide a detailed estimate of the expected result of using such an agreement;
c) evaluate the financial and other risks to the City that would exist with the use of such an agreement and determine if such risk would be lower than the financial and other risks to the municipality that would exist without such an agreement;
d) using his/her best judgment and in his/her sole discretion, determine that the agreement contains adequate risk control measures; and
e) provide periodically, not less than annually, lists to Council of Commodity Hedging Agreements and such other information as may be required.

4. Role and Responsibilities of the Deputy City Managers (Richard Butts and Sue Corke)

Determining physical requirements and purchasing and securing the supply of a commodity

The Deputy City Managers or his/her designate(s) will be authorized to:

a) execute commodity procurement contracts and enter into transactions in accordance with the policy;
b) provide written reports to Council regarding the past performance of Commodity Hedging Agreements, future strategies and other issues as requested; and
c) enter into Agency Agreements and/or other contracts and/or arrangements with Contract Agents for the purpose of purchasing, securing and or delivery of commodities.

5. Role and Responsibilities of Council

If the City has any subsisting commodity price hedging agreements in a fiscal year, the Deputy City Manager and Chief Financial Officer shall prepare and present to Council a detailed report on all of those agreements.
The report must contain the following information and documents:

a) A statement about the status of the agreements during the period of the report, including a comparison of the expected and actual results of using the agreements.
b) A statement indicating whether, in the opinion of the DCM&CFO, all of the agreements entered during the period of the report are consistent with the City's statement of policies and goals relating to the use of financial agreements to address commodity pricing and costs.
c) Such other information as Council may require.
d) Such other information as the Deputy City Manager and Chief Financial Officer considers appropriate to include in the report

6. Contract Agent

"Contract Agent" means an external agent, contractor, consultant, or other representative retained by the City to assist with the procurement, sale, and/or delivery of commodities for the City in accordance with the City's Purchasing and Procurement Policies.

The Contract Agent will only be authorized to act within the scope of his/her specific authority under any executed contract/agreement with the City and shall, in accordance with such a contract/agreement, provide a variety of services to the City, as required.

7. The City and Counterparty Credit Ratings and Risk Parameters

Counterparty is a party to a contract which, for the purposes of this policy, is usually a financial institution or other entity that is offering the hedging/financial agreement to the City. If the counterparty's credit rating falls below BB (S&P); Baa2 (Moody's); and/or BB (low) (Dominion Bond Rating Service), the City may demand Adequate Assurance of Performance. "Adequate Assurance of Performance" shall mean sufficient security in the form, amount and for the term reasonably acceptable to the City, and/or, but not limited to being able to provide an unconditional irrevocable letter of credit or prepayment.

When a supplier has no credit rating, a guarantee from the Parent Corporation (assuming Parent Corporation meets credit rating requirements as stated in the first paragraph is acceptable.

The City seeks to maintain the highest possible credit rating that can be achieved without compromising the delivery of services and programs through prudent budgetary and debt management policies and procedures and will not jeopardize its credit rating through imprudent hedging of commodity prices.

8. Statutory Reporting and Disclosure Requirements

The Deputy City Manager and Chief Financial Officer shall report to Council at least once each fiscal year with respect to any and all commodity price hedging agreements in place.

The report shall contain, as a minimum, all requirements as set out in O. Reg. 610/06 and include:

- a statement summarizing any contingent payment obligations under the commodity price hedging agreement that, in the opinion of the Deputy City Manager and Chief Financial Officer, would result in a material impact for the City, including agreement termination provisions, equipment loss, equipment replacement options and guarantees and indemnities; and

- a summary of the assumptions applicable to any possible variations in the commodity price hedge agreement payment and contingent payment obligations

The report, if required, shall be presented to Council on an annual basis after the end of the City's fiscal year after the City's accounts are closed.

Appendix B

Commodity Price Stabilization Reserve

1. Location within the Consolidated Reserves/Reserve Funds Schedule

   Account within Schedule #3 – Stabilization Reserves

2. Statement of Purpose

   This account will be used to moderate the budgetary impact of commodities that are purchased in accordance with the City's Statement of Commodity Hedging Policies and Goals.

3. Service Area or Beneficiary Program

   The Deputy City Manager and Chief Financial Officer shall have primary responsibility for the account.

4. Initial Contribution:

   NA

5. Contribution Policy

   Funds will be provided as part of the Operating Budget.

6. Withdrawal Policy:

   Funds may be withdrawn as per the Operating Budget.

7. Review Cycle

   The use of the account will be reviewed in three years and a decision to continue or discontinue its use will be rendered at that time.