



STAFF REPORT ACTION REQUIRED

Fuel Purchasing Program

Date:	September 26, 2011
To:	Government Management Committee
From:	Chief Corporate Officer
Wards:	All
Reference Number:	P:\2011\Internal Services\Fac\Gm11015Fac- (AFS 14595)

SUMMARY

Under existing Council authority the Deputy City Manager and Chief Financial Officer plans to enter into standard industry master agreements with financial counterparties governing the terms and conditions effecting fuel price hedges. The purpose of this report is to report back as requested by Council and to seek approval to enter into an agency agreement with each of the Toronto Transit Commission and other participating Agencies, Boards, Commissions and Divisions in order to implement fuel purchasing and price hedging arrangements on their behalf and to seek the necessary financial commitment authorities to administer the fuel purchasing and price hedging program. The intent of the fuel price hedging program is to reduce the price risks associated with purchasing fuel in the volatile oil market.

RECOMMENDATIONS

The Chief Corporate Officer recommends that:

1. City Council authorize the Deputy City Manager and Chief Financial Officer or his designate to execute agency agreements to allow the City to enter into price hedging transactions on behalf of the Toronto Transit Commission and the City's Agencies, Boards, Commissions and Divisions participating in the fuel price hedging program, and all such other agreements, certificates or assurances as may be required to administer the fuel price hedging program, on terms and conditions satisfactory to the Chief Corporate Officer and in a form satisfactory to the City Solicitor.

2. City Council authorize the Deputy City Manager and Chief Financial Officer or his designate to award fuel price hedging transaction contracts as described in this report in amounts representing financial commitments ranging up to \$40 million for forward terms not exceeding five years and for each year not exceeding the overall value of the annual fuel expenditures, from a roster of qualified counterparties.
3. City Council authorize the assessment of administrative costs, including any consulting costs, billing fees, and account management costs to all fuel end users participating in the program.

Financial Impact

Approving the recommendations would enhance staff's ability to better manage the City's and its Agencies, Boards and Commissions (ABCs) overall fuel costs, along with its exposure to market risks. Although there will be some administrative costs associated with the management of the fuel purchasing program, such as consulting costs, they are expected to be relatively small in comparison to the overall fuel cost.

The total 2011 annual fuel costs for the City and ABCs including Toronto Transit Commission (TTC), is estimated to be \$120 million (\$25 million for City and ABCs and \$95 million for TTC).

Funding for the cost of fuel (diesel and gasoline) will continue to be included in the annual operating budgets of City Divisions, Agencies, Boards, Commissions, and of the Toronto Transit Commission.

The Deputy City Manager and Chief Financial Officer has reviewed this report and agrees with the financial impact statement.

DECISION HISTORY

City Council at its meeting on August 5 and 6, 2009 approved a staff report titled "The City's Statement of Commodity Hedging Policies and Goals" (Report EX33.16). This report outlines the City's policies related to entering into commodity price hedging agreements for the City's fuel requirements.

<http://www.toronto.ca/legdocs/mmis/2009/ex/bgrd/backgroundfile-21508.pdf>

The approved report included the following recommendations:

- "(1) City Council approve The City of Toronto's Statement of Commodity Hedging Policies and Goals, as contained in Appendix A of the report (May 19, 2009) from the Deputy City Manager and Chief Financial Officer.

- (2) City Council delegate the Deputy City Manager and Chief Financial Officer 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 of the report to ensure that the financial position of the City will be enhanced by the use of such an agreement.
- (3) City Council designate the Deputy City Manager and Chief Financial Officer 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."

The approved report also requested staff from the City and TTC to investigate a joint purchasing program:

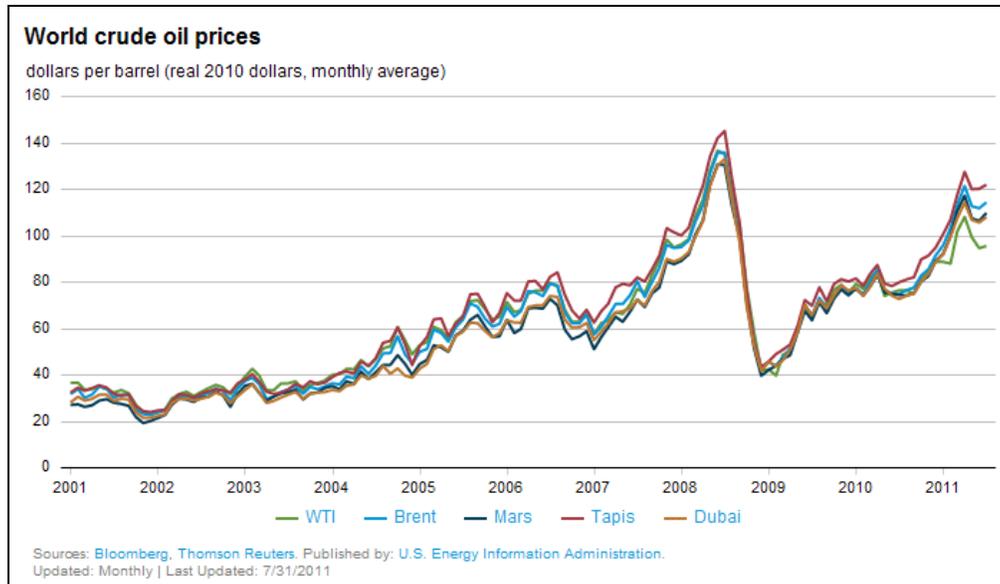
"TTC and City staffs have been discussing the prospects of combining their respective fuel purchasing programs and instituting a shared financial hedging program. If the attached policy is approved by Council, TTC and City staff will evaluate if combining programs would be beneficial to each party, and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

Subsequent to the approved report, a consultant was hired to review the purchasing options for the City and TTC. It was recommended that the City together with the TTC purchase fuel on the spot market with a physical fuel supplier and implement a fuel hedging program with multiple counterparties to mitigate the price risk. Due to the credit rating requirements for a hedging program, which the TTC does not have, it was recommended that City and the TTC work out a joint fuel purchasing program. The TTC approved a report on March 1, 2011 to enter into an agency agreement with the City:

http://www3.ttc.ca/About_the_TTC/Commission_reports_and_information/Commission_meetings/2011/March_1_2011/Reports/Procurement_Authoriz1.pdf.

COMMENTS

Petroleum fuel (diesel and gasoline) prices fluctuate in tandem with the oil prices. As crude oil price rose quickly to historic records in 2008, diesel and gasoline prices also reached all time highs. The following chart shows the volatility of crude oil prices for the last few years as traded in the US major trading hub NYMEX. The price ranged from as low \$30 per barrel in 2002 to over \$140 per barrel in 2008.



Given the current market situation, price risk is forecasted to remain high due to uncertainty in the economic recovery, global supply and demand, and aging oil infrastructure.

Based on best practices in the industry, City staff looked into improved purchasing options for all its fuel needs. A consultant was hired and met with staff from City divisions and TTC to discuss and investigate an improved strategy to purchase fuel. The objective of the strategy was to minimize the City's risk related the fluctuating fuel market.

The City and TTC use approximately 114 million litres of diesel and gasoline annually with an estimated fuel cost of \$120 million for 2011. The City and TTC currently purchases its physical fuel from a single vendor/supplier based on weekly spot prices as recommended by the consultant. The weekly pricing would generally cost less over the traditional monthly pricing as the supplier does not have to put up a margin to carry the risk.

The consultant also recommended that a financial hedging option should be put in place to mitigate the price risk associated with the spot price for physical fuel purchases. The hedging arrangements would provide the City and TTC with a multiyear strategy to manage the fuel costs and allowing the City to obtain competitive price quotes from a roster of prequalified counterparties.

The following scenario illustrates a hedging contract or contract for difference (CFD). If the City budgeted \$1.30 per litre for its fuel purchases, it could create a price hedging agreement with a counterparty at a strike price of \$1.30, based on a known index. If the index price rises to \$1.50 per litre, the counterparty would pay the City \$0.20 cents per litre, offsetting the unexpected fuel price increase. If the index price falls to \$1.10 per litre, the City must pay \$0.20 cents per litre to the counterparty. That money would come

from the \$0.20 cents per litre the City or ABCs is saving on the physical fuel purchases. The net result is that the City and ABCs pay a fixed price of \$1.30 regardless if the market price is fluctuating up or down. This also provides the City and ABCs with a budget certainty over the long term.

Fuel Purchasing Strategy

The objective is to develop a multiyear fuel purchasing/hedging program that would provide the City & TTC with a strategy to mitigate price risks due to market exposure/volatility and to provide year over year price and budget certainty. The fuel purchase and price hedging program will allow for the efficient management of the City's fuel costs by enabling a diversification of terms (e.g. 1-5 years) of transactional price hedging contracts within the portfolio. The program will also enable the City to hedge its fuel from a roster of prequalified counterparties, thereby allowing City staff the ability to obtain competitive price hedge quotes on an ongoing basis.

Fuel Purchasing Team, Roles and Responsibilities

1. Create a Fuel Purchasing Team that includes representation from key Divisions and major fuel stakeholders; Facilities Management, Corporate Finance, Accounting Services, Fleet Services, Legal Services, Purchasing and Materials Management, Toronto Transit Commission and an external consultant as required. The Fuel Purchasing Team would oversee the fuel purchasing program and provide direction as required.

Fuel Purchasing Plan

2. Estimate annual fuel requirements and secure fuel delivery to each location in order to maintain a continuous fuel supply for all operational needs.
3. Establish an annual fuel cost target that includes the necessary contingencies to ensure that fuel costs can be maintained within this target, with a desired risk tolerance and confidence level. Given the volatility of petroleum prices, a frequent review of the fuel portfolio of supply contracts will be required.
4. The fuel cost target includes the fuel commodity cost and the program costs such as administration, outside supportive consulting services, billing and account management costs. These costs are passed on to the fuel end user participants on a proportionate basis.
5. Where feasible, consider grouping the City's major fuel users and TTC into separate purchase contracts that would enable each buyer to have its own supply portfolio according to its own price risk tolerance. Separate purchase contracts would also avoid fuel cost cross-subsidization between buyers.

Fuel Hedging Implementation

6. Maintain a pool of three to five qualified counterparties, enabling the City and TTC to hedge from any of them based on price whenever new hedges are required. It will be necessary to complete a “Master Contract” with each counterparty. The current master contract for fuel hedging is the standard form of ISDA (International Swaps and Derivatives Association) agreement together with the associated Schedule and Credit Support Annex.
7. Structure a portfolio of fuel hedging contracts and targets to fix pricing for a percentage of fuel volume in a manner that allows for price minimization while enhancing price certainty, and permits an appropriate level of risk management:

- a. Based on the City’s and TTC’s risk profile, the City’s outside advisor has recommended the following portfolio to fix pricing given current market conditions:

Recommended Fuel Portfolio	
Term	Percentage of Volume at Fixed Price
Year 1	75-85%
Year 2	45-55%
Year 3	20-30%
Year 4	10-20%
Year 5	0-10%

- b. Market conditions are continually monitored by the Fuel Team (in conjunction with the City’s advisor), and percentage allocations are adjusted as appropriate.
 - c. Arrange an optimal mix of short and medium-term transactions to enable a diversification of purchases of up to five years on a rolling fixed price supply portfolio (eg. 1-5 years) in accordance with the Fuel Team ongoing recommendations.
8. Issue and accept request for quotations (RFQ):
 - a. Issue RFQ to prequalified suppliers/counterparties for a portion of fuel requirements according to the recommended portfolio.
 - b. Review bids and award contract if price is within the established target taking into account of overall risks and market conditions.
 9. Re-assess the petroleum fuel supply portfolio regularly, adjusting as required to maintain target pricing and to maintain an acceptable level of risk in compliance with the City's Statement of Commodity Hedging Policies and Goals.

Settlement and Reporting:

10. Create a corporate flow through account for processing fuel program costs including hedge settlement invoices and program costs such as administration, outside supportive consulting services, billing and account management costs.
11. Review and process hedge settlement or contract for difference (CFD) invoices submitted monthly by the suppliers, and allocate hedge settlement based on each participant's proportionate share of volume.
12. Track volume and costs reviewing them quarterly, at minimum, in order to match consumption with purchases, and provide regular analysis of the fuel purchasing program and adjust the strategy as necessary.

Roster of Counterparties

In accordance with the City's purchasing by-law and purchasing policies and procedures, a roster of qualified counterparties is being put in place. The counterparties were selected based on credit rating, performance capabilities, contract terms and conditions, experience and references. The City will enter into master agreements with the selected counterparties. Once the master agreements are in place, these firms will form the City's roster of fuel suppliers, which will be given the opportunity to provide fuel commodity hedge pricing quotations as required and requested by the City.

Transactions and Timing

The City will issue price quotation requests for a specific volume and term to the counterparties on the roster. The quotation requests will be issued by email and close on a specific date and time. Due to market volatility, the lowest bidder will be contacted by phone to confirm the quoted price. The successful bidder then issues a written confirmation to the City of the transaction.

It is critical to note that due to the volatility of the market, the industry practice is that price quotations are generally not held open for any length of time. Therefore, it is important to continue to have the flexibility to act in a timely manner. For this reason, this report recommends that the Deputy City Manager and Chief Financial Officer or his designate be authorized to issue quotation requests and award hedging transactions.

The annual fuel cost for the City and ABCs including TTC is approximately \$120 million and the recommended strategy is to hedge a portion of the required fuel in blocks. At current pricing and based on 20% volume and 5 year terms, it is possible that the value of future individual transactions may range anywhere up to \$40 million. This report therefore is recommending that the Deputy City Manager and Chief Financial Officer or his designate be authorized to issue fuel pricing quotation requests and award hedging transaction contracts as described in this report in amounts representing financial commitments ranging up to \$40 million. The upset limit is for forward terms not

exceeding five years and for each year not exceeding the overall value of the annual fuel expenditures. The recommendations would allow staff to lock-in prices over a longer contract term according to the purchasing strategy.

This report was prepared in consultation with City Legal, Financial Planning, Fleet Services, Purchasing and Material Management Division, and Toronto Transit Commission.

CONTACT

Jim Kamstra, Manager, Energy & Waste Management, Energy & Strategic Initiatives, Facilities Management Division, 392-8954, jkamstra@toronto.ca.

SIGNATURE

Bruce Bowes, P. Eng.
Chief Corporate Officer