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Council Approved	Y
CAO Approved:	N/A

TITLE: Commodity Price Hedging	**Edocs No.: 1806705** **Original Approval Date: October 18, 2007** **Policy Last Updated: April 18, 2013**

POLICY STATEMENT:

A statement of policies and goals governing the use of commodity price hedging agreements.

APPLICATION:

All financial commitments for the purpose of fixing future prices through commodity price hedging, including related agreements that are entered into by the Region, its boards and subsidiaries, and those employees responsible for the control, management, or purchasing of hedging agreements.

PURPOSE:

This policy establishes objectives, standards of care, authorized price hedging instruments, reporting requirements, and responsibilities for the prudent use of hedging agreements.

DEFINITIONS:

Agent means an individual or organization acting on behalf of the Region to provide advice on price hedging strategy and/or to execute agreements and transaction.

AMO means the Association of Municipalities of Ontario.

Commodity means, whether in the original or processed state, an agricultural product, a forest product, a product of the sea, a mineral, a metal, a hydrocarbon fuel, electricity, a precious stone or other gem, and other physical goods but does not include chattel paper, a document of title, an instrument, money or securities.

Commodity Price Hedging Agreement or "hedging agreement" mean a financial instrument to fix the cost and/or manage the financial risk associated with the purchase of a commodity.

Counter party means a party to a hedging agreement which, for the purposes of this policy, is usually a financial institution or other entity that is offering the hedging agreement to the Region.

Financial Agreement means a commodity price hedging agreement.

Futures Market means an exchange where commodity price hedging agreements may be purchased or sold.

Hedge means, in the context of this policy, a financial commitment to acquire a specified quantity of a commodity, at a specific price, at some future point in time.

Region means the The Regional Municipality of York (York Region).

DESCRIPTION:

A) PREAMBLE

Price volatility on commodity products purchased by the Region presents both a budgeting challenge and a financial risk. While long-term, fixed price contracts can be tendered or negotiated for some products, other products are subject to market pricing at the time of the delivery of the product or the demand for the product is sufficiently uncertain that long-term commitments are not available or prudent.

The primary purpose of a commodity price hedging agreement is to provide price stability/cost certainty by fixing some portion of future commodity prices. A secondary purpose is to use hedging to lock in favorable pricing for commodity purchase commitments, when other means, such as long-term contracts, are not practicable.

B) PRIMARY OBJECTIVES OF THE COMMODITY PRICE HEDGING PROGRAM

The primary objectives for the Region's commodity price hedging program are as follows:

1. Adhere to statutory requirements
2. Promote financial flexibility
3. Limit financial risk exposure.

1) Adhere to Statutory Requirements

A commodity price hedging agreement may only be undertaken if the agreement is in compliance with the relevant sections of the *Municipal Act, 2001* and regulations thereunder. Requirements include but are not limited to the following:

a) The Region may enter into a financial agreement only for the future delivery of some or all of a commodity or the future cost of an equivalent quantity of a commodity. A financial agreement shall not be entered into for the purpose of speculative investing; and

b) The Region is prohibited from selling or disposing of the financial agreement or an interest in the agreement. An exception to this requirement exists if there is a sale or change of use of real property to which the agreement applies or the Region ceases an activity for which the commodity was being acquired.

2) Ensure Financial Flexibility

The commodity price hedging program will be managed in a manner consistent with other financial and management objectives. Approval by Council will be required prior to commencing a hedging program for each commodity. Follow-on approval may be sought if a proposed financial agreement is inconsistent with stated program goals but is deemed to be in the best interest of the Region. In this instance, the motivation to price hedge may be driven by price volatility or other external factors that would indicate the value of a financial agreement.

a) Term of Hedging Agreements

The term or time-frame of the hedging agreements will be chosen to balance price stability with the flexibility to adjust to changing market conditions and demand for the commodity within the Region. For example, a standard term for one form of electrical energy financial agreement is four years. Therefore, consideration will be given to demand cycles, price volatility, and comparable industry purchasing practices when establishing the term of a financial agreement.

Once Council has approved a specific commodity hedging program, a series of shorter term hedging agreements may be employed. However, the total length of time covered by any hedge will not exceed thirty (30) months beyond the execution date without further approval by Council. Each financial agreement within the approved time frame must be approved by the Commissioner of Finance & Regional Treasurer (or designate).

b) Proportion of Commodity to Be Hedged

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 measurement of forecasted demand will be specific to the context or project. The analysis prior to entering into a financial agreement should include a determination of historical annual demand where available and other factors that will affect forecast demand.

The statutory limitations on the sale of financial agreements require that the Region must exercise caution in order to retain flexibility to respond to demand uncertainty. To that end, the hedging policy requires that no more than **80% of the forecasted demand** shall be hedged on an annual basis.

As indicated in Section F2, a thorough analysis of term and demand, the assumptions underlying the forecasts and the recommendation arising from this analysis must form part of the report to Council when seeking approval prior to commencing a hedging program for each commodity.

3) Limit Financial Risk Exposure

The commodity price hedging program is a mechanism for limiting financial risk by establishing a level of certainty for future prices.

a) Market/Demand Risks and Control Measures

There are risks associated with using market-based financial instruments:

i. **Market risk** in that there may be an opportunity cost if the price of the commodity falls below the purchase price in a hedging agreement. In other words, if the Region had not entered into a hedging agreement it would have benefited from the lower cost of the unhedged commodity.

While staff involved with the recommendation of a commodity price hedge will be expected to monitor and consider the general trend in the price of the commodity, the key benefit of the hedge is to ensure financial predictability where needed.

The financial loss on the hedge agreement from a price drop will be offset by purchasing the commodity via traditional means at the lower price, in essence fixing the cost of the commodity at the hedge price. Conversely, if the price of the commodity increases, the Region would realize a net gain on the hedge.

ii. **Demand risk** in that the Region may use less of the commodity than forecasted, leading to the possibility of excess hedging. This policy stipulates that a maximum of 80% of the forecast demand may be hedged; where the forecast demand has a high level of uncertainty, hedging a smaller proportion of the demand is appropriate.

b) Financial Risk Control Measures

Agreements are usually with counter parties such as large financial institutions but occasionally may be with another entity such as a large supplier.

i. **Credit risk or "counterparty risk"** exists in the event that the commodity price has risen and the counterparty cannot fulfill the terms of the agreement. Although default is considered a remote risk, risk control measures will be undertaken prior to entering into a financial agreement.

The following risk control measures are to be applied in a manner so as to limit financial risk exposure:

a) limiting the Region's exposure to a counterparty based on credit ratings and on the degree of regulatory oversight and regulatory capital;

b) the use of standardized agreements; and

c) ongoing monitoring with respect to the agreements.

ii. **Competitive price risk** that a competitive price hedge agreement may not be available in the market or available but only at an undesirable price. As part of its analysis, staff will monitor the market and will consider other options including the use of fixed price contracts and/or purchasing on the "spot market".

Risk may also be mitigated through participation in a third party pool such as an AMO-based program or by placing financial agreements with multiple counterparties.

C) PARTNERSHIP AGREEMENTS WITH OTHER PUBLIC SECTOR PARTNERS

Under some circumstances it may be beneficial for the Region to enter into partnership agreements where it is anticipated that a superior financial benefit can be achieved (e.g., higher quantity). Partners shall be within the public sector and may include municipalities, education and hospital boards, or buying groups organized by municipal organizations such as the Association of Municipalities of Ontario (AMO).

In the latter case, the "buying group" may act as an agent for the Region, including executing hedging transactions on behalf of the Region provided they follow the specific parameters set out by the Region. These parameters would include: the quantity to be hedged not exceeding the quantity assigned to the agent by the Region; the term of the hedging not to exceed the term of the agreement with the agent where the term of agreement with the agent is to be governed by this policy; and the assessment of the credit worthiness of the agent's counterparties to be consistent with the requirements of this policy.

In principle, a partnership or agency arrangement is an acceptable practice where the benefits can be clearly delineated. Partnership or agency agreements will be considered an option under the terms of this policy.

D) STANDARD OF CARE

All officers and employees responsible for commodity price hedging agreements will follow the standard of care identified in this policy.

1) Ethics and Conflicts of Interest

All officers and employees involved in the commodity price hedging process are expected to abide by the Region's Code of Conduct. In particular they shall:

a) Refrain from personal business activity that could conflict with the proper execution and management of the commodity price hedging program, or that could impair their ability to make impartial decisions;

b) Disclose any material interests in financial institutions with which they conduct business;

c) Disclose any personal financial/investment positions that could be related to the performance of their commodity price hedging duties; and

d) Not undertake personal financial transactions with the same individual with whom business is conducted on behalf of the Region.

2) Delegation of Authority

The Commissioner of Finance and Regional Treasurer ("the Treasurer") will have the overall responsibility for the commodity price hedging program of the Region. However, the Director, Treasury Office, will have responsibility for directing/implementing the activities of the commodity price hedging program, as well as the establishment of procedures consistent with this Policy. Such procedures shall include explicit delegation of authority to persons responsible for commodity price hedging activities.

No person shall be permitted to engage in a commodity price hedging activity except as provided for under the terms of this policy. The Director, Treasury Office, will be responsible for all activities undertaken, and shall establish a system of controls to regulate the activities of staff.

Notwithstanding, the Region may delegate specific authority to an "agent" of the Region as contemplated under section C of this Policy. The authority delegated will be strictly governed by the terms of an agency contract that will be approved by Council.

3) Commodity Price Hedging Agreement Acquisition

Hedging agreements will be acquired on a competitive basis. Regional staff will use the futures market as the first option to acquire hedging agreements, or where the desired pricing is not available in an open market such as the futures market, solicit three or more bids, where available. The Region may enter into a financial agreement with one or more institutions where apportioning the total of the agreement is expected to confer a financial advantage.

4) Requirements for Outside Advice

Regional staff will be expected to have sufficient knowledge to prudently evaluate standard financial agreements or related contracts. However, should in their opinion the appropriate level of knowledge not exist, or as otherwise directed, outside financial and/or legal advice will be obtained.

5) Financial Payments

The nature of financial agreements requires that financial transactions, whether disbursements or receipts, will be made to or from financial institutions from time to time during the term of an agreement. Staff will apply the same level of diligence to these transactions as would be expected under the normal operating procedures of the Region. Further, these transactions will be fully disclosed in the annual reporting required under section F of this policy.

E) AUTHORIZED COMMODITIES FOR PRICE HEDGING PURPOSES

The definition of commodity provided in the Definitions section of this policy mirrors that of the applicable legislation. However, 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 Region, as determined by the CAO and the Commissioner of Finance.

F) REPORTING REQUIREMENTS

In addition to any information requested by Council or that the Commissioner of Finance and Treasurer considers appropriate, the following reports will be provided:

1. Annually, if the Region has any subsisting commodity price hedging agreements in a fiscal year, the Treasurer, together with the Commissioner(s) of the operating department(s) that initiated commodity purchase agreement(s) that form the basis for the financial agreement, shall submit to Council a detailed report on all subsisting financial agreements. The report will contain the following information and documents:

   a) A statement about the status of the agreements during the period of the report, including a detailed analysis of results stemming from any agreements;

   b) A statement indicating whether all of the agreements entered during the period of the report are consistent with the Region's statement of policies and goals relating to the use of financial agreements to address commodity pricing and costs; and

   c) A statement of transactions with financial institutions.

2. Before entering into a new commodity price hedging program, the Treasurer, together with the Commissioner of the operating department initiating the program, shall submit to Council a joint report with a recommendation assessing the costs and financial and other risks.

   The report shall include:

   - The fixed and estimated costs to the Region resulting from the use of the proposed commodity price hedge;

   - An analysis of the commodity demand over time including, where available, both historic and projected demand;

   - Whether the future price or cost to the Region of the applicable commodities would be lower or more stable than they would be without the agreements;

   - A summary of the assumptions used in the analysis of the preceding requirements; and

- A summary of other options available to the Region that might otherwise achieve the objectives of a commodity price hedging agreement.

G) RESPONSIBILITIES

Regional staff acting in compliance with this policy shall have the necessary authority to carry out the responsibilities identified within the policy.

In addition, the following specific responsibilities are identified:

1) The Commissioner of Finance and Treasurer and/or Director, Treasury Office, and/or Director, Supplies and Services, or designates:

   - Reviews and recommends to Council the financial and business aspects of any financial agreements;
   - May sign and execute documents on behalf of the Region and perform all other related acts with respect to financial agreements;
   - Ensures that all reporting requirements identified in this Policy are met.

2) Commissioner(s) of Operating Department(s)

The commissioner or designate prepares the analysis to support the reporting requirements in Section F of this Policy.

3) Chair of Council

The Regional Chair may execute and sign documents on behalf of the Region with respect to entering into a commodity price hedging agreement.

4) Regional Clerk

The Regional Clerk may certify and sign documents on behalf of the Region with respect to a commodity price hedging agreement.

REFERENCES

Municipal Act, 2001, S.O. 2001, c.25
Municipal Act, *2001*, Ontario Regulation 653/05 – Debt-Related Financial Instruments and Financial Agreements

CONTACT:

Director, Treasury Office, Finance Department

APPROVAL INFORMATION

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